PART F

MISCELLANEOUS PAPERS

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PART F

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CONTINUED ON:-
PART G

18/3070

FROM: DAVID PERETZ
30 March 1987

CHANCELLOR

cc Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Sedgwick
Mr Odling Smee
Mr Culpin
Mr Kelly

TCSC APPEARANCE: STATEMENTS ON THE EXHANGE RATE

STATEMENTS ON EXCHANGE RATE

As requested I attach a list of your main recent statements on the exchange rate.

2. Also attached is the text of your reply to Mr Watts at the TCSC on 20 November. ~~(I am sorry that this is the corrected transcript rather than the final printed version, which is not immediately to hand.)~~

3. As far I know Mr Watts was wrong to suggest you said anything in your oral (Autumn) statement - or the ensuing questioning - about the exchange rate. He was probably referring to your remark on television on 9 November (when the exchange rate was indeed around 69½).

DLCP

D L C PERETZ

17/3070

Chancellor's Recent Statements on Exchange Rate

Statement	ERI	£/$	£/DM
A. Mansion House Speech - Paris Agreement			
17 October 1986 Mansion House Speech			
After oil price collapse, rate had fallen "but there are clearly limits to the necessary and desirable extent of that fall"	67.3	1.43	2.83
9 November 1986 This Week/Next week			
"I don't wish it to go [down] any further"	69.4	1.43	2.95*
19 November 1986 Debate on the Address			
"The necessary fall ... has now gone far enough"	68.0	1.42	2.85
20 November 1986 TCSC appearance			
See attached page.	67.6	1.41	2.83
5 January FT interview			
"I do not want it to fall any further"	68.8	1.47	2.84
B. Paris meeting - Budget			
22 February ITN interview in Paris			
"I've said for some time that I have...no wish to see the £ fall any further, by the same token I have no wish to see a substantial increase in the value of the £."	69.1	1.53	2.79**
C. Post Budget			
18 March Post Budget on the record briefing			
"like to see sterling roundabout where it is now". "to the extent that the exchange rate has risen since Paris my remarks now would be less lopsided".	72.6	1.61	2.95

* rates for close, Friday 7 Nov.
** rates for close, Friday 20 Feb

	ERI	£/$	£/DM
"I am perfectly content with the present level..."			
19 March This Week			
"I think it is round about right"			
"a period of exchange rate stability...is in the interests of British industry".	72.3	1.60	2.94

[Mr Watts *Contd*]

151. In view of that, and the emphasis you were giving to the importance of the exchange rate as one of the indicators of monetary conditions, have you given consideration to setting the exchange rate target range in the same way we had a target range for £M3, both to give an indication of where you intend that exchange rate discipline to be exercised and to remove uncertainty?

(Mr Lawson) The reality of foreign exchange markets, and this does not apply to monetary targets, would make that in my opinion an unwise course of action. I think there is clearly a case for being part of an explicit regional fixed exchange rate system. Alternatively, you can have the sort of policy which we have at the present time. I do not actually think there is a viable halfway house.

152. You reasserted earlier in your oral statement you did not wish to see sterling fall further.

(Mr Lawson) That is right.

153. I believe when you made the statement the basket was 69½ and I believe it is 67½. I understand that when you say "not fall any further", you do not want to stay exactly on that spot for the whole of the year. When there is such a variation over a relatively short period of time, I think that adds to uncertainty as to precisely what is intended in the period.

(Mr Lawson) The question of uncertainty is a very difficult one. I can quite understand that good people with all the best motives would like greater certainty as to at what point one would act in order to affect the exchange rate. On the other hand, that degree of certainty would also be playing into the hands of the short-term operators. In practical market management, I do not think it is sensible to be any more explicit than I have been.

Mr Watts: Thank you.

Chairman

154. Thank you very much Chancellor, I wonder if I might take up one or two of the points which have been raised already? I think you are aware there are some colleagues who have to be elsewhere in the House which is why we are slightly like an Agatha Christie thriller where the characters keep disappearing. This is in so sense my colleagues being discourteous to you. Could I ask you a couple of points which came up in the earlier discussion. In Paragraph 61 of the Autumn Statement it says: "for the past six years, high rates of growth of broad money . . . have been consistent with appropriately tight monetary conditions and thus a substantial fall in inflation."

(Mr Lawson) Yes.

155. Are you now saying that regardless of what is happening to M3 that might be consistent with low inflation or continuing to battle against inflation?

(Mr Lawson) Yes, that is what is implied here, certainly. I do not have the figures in my head but the change in the velocity of £M3 as between, say, the 1970s and 1980s is quite remarkable. I quoted the figures for, one five year period and another five year period in my Lombard Speech, showing that the ratio between the growth of money GDP and the growth of £M3 in one period and the ratio in another was quite different. This overrunning of the £M3 targets has been pretty well a feature of the period we have been in office, except for a short period when it was kept down by very heavy over-funding. I think this Committee was among those who queried whether that was achieving anything and I think it was partly this Committee's views on that which led us to abandon overfunding as a way of life. There has been this general tendency for broad money to grow very rapidly and yet, and this is the important thing, inflation has come down and come down very markedly and that is the proof of the pudding.

(Sir Peter Middleton) It is also true of Europe as a whole, or OECD as a whole.

156. You began by speaking of continuity of policy. The views you express now are radically different to those expressed at the beginning of the Government's period of office.

(Mr Lawson) I think that it is perfectly true to say that right at the beginning we did not expect to see such a sharp change in the velocity of £M3, but it actually happened very early on and we very quickly realised that things were changing. Indeed, in my Zurich speech to which Mr Budgen referred I alluded there to the fact that £M3 was giving a false reading. Although it is perfectly true we did not expect to see this sharp change when we first took office in 1979 it is something that became apparent very quickly thereafter: you will remember the abolition of the corset and the growth which continued in £M3 after it. This is not in any sense a new development, although it has become more pronounced so far as broad money generally is concerned as financial liberalisation and financial innovation have developed much further.

(Sir Peter Middleton) One might say that inflation has come down.

Chairman: Yes, we understand that. Chancellor, we have, as you have noticed, gone back quite a bit to the situation in the earlier years of the present Government because it seemed to us perhaps there could be some lessons to be learnt as I think you indicated perhaps some of them have been learnt. Obviously we will need to consider very carefully the various points you have made before producing our report for the House. We would appreciate the couple of notes we mentioned earlier on in order to help us in reaching our conclusions. Having said that, can I express my thanks to you and your colleagues for coming this afternoon. Thank you.

RS Alex

FROM: N M DAWSON
DATE: 30 March 1987

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MR S SHERBOURNE	10 DOWNING STREET
MR J R CALDER	I/R SOMERSET HOUSE
MR D H ROBINSON	DEPT OF FINANCE AND PERSONNEL ECONOMICS DIVISION RM249A STORMONT BELFAST 3S15
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RELEASE DATES FOR ECONOMIC STATISTICS IN APRIL

I attach the release dates for economic statistics in April.

2 Any enquiries please contact me on 5212, 99/2 HM Treasury.

Nigel Dawson

N M DAWSON

22/5

RELEASE DATES FOR ECONOMIC STATISTICS IN APRIL 1987

WEEK 1

Thurs	2	11.30	UK official reserves (Mar)
Fri	3	11.30	Housing starts and completions (Feb)

WEEK 2

Mon	6	11.30	Credit business (Feb)
"		"	Retail sales (Feb-final)
Thurs	9	21.00	Employment Gazette
Fri	10	11.30	Tax and price index (Mar)
"		"	Retail prices index (Mar)

WEEK 3

Mon	13	11.30	Producer price index numbers (Mar-prov)
Tues	14	11.30	Index of output of the production industries (Feb)
Wed	15	11.30	Cyclical indicators for the UK economy (Mar)
"		"	Labour market statistics: unemployment and unfilled vacancies (Mar-prov): average earnings indicies (Feb-prov), employment, hours, productivity and unit wage costs; industrial disputes.
Thurs	16	00.30	CBI/FT survey of distributive trades (end-Mar)
"		11.30	Public sector borrowing requirement (Mar)

WEEKS 4&5

Wed	22	11.30	Provisional estimates of monetary aggregates (Mar)
Tues	28	11.30	Balance of payments current account and overseas trade figures (Mar)
"		"	CBI Industrial Trends Survey (2nd-qtr)
Wed	29	11.30	Retail sales (Mar-prov)
Thurs	30	11.30	Preliminary estimate of consumers' expenditure (1st qtr-prov)

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TRANSCRIPT: For instructions on its use, see below. Ev 3

Chancellor's copy

HOUSE OF COMMONS

MINUTES OF EVIDENCE

TAKEN BEFORE

THE TREASURY AND CIVIL SERVICE COMMITTEE

MONDAY 30th MARCH 1987

THE RT HON NIGEL LAWSON, MP,

SIR PETER MIDDLETON, KCB and SIR TERENCE BURNS

Evidence heard in Public Questions 172 - 260

USE OF THE TRANSCRIPT

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4. This is an uncorrected and unpublished transcript of evidence taken in public and reported to the House.

5. No public use should be made of the text.

MONDAY 30th MARCH 1987

Members present:

Mr T.L. Higgins, in the Chair
Mr Tony Banks
Mr Anthony Beaumont-Dark
Mr John Browne
Mr Nicholas Budgen
Mr Ralph Howell
Mr Austin Mitchell
Mr Brian Sedgemore
Mr Richard Wainwright
Mr John Watts

- - - - -

THE RT HON NIGEL LAWSON, a Member of the House, Chancellor of the Exchequer, examined.

SIR PETER MIDDLETON, KCB, Permanent Secretary and SIR TERENCE BURNS, Chief Economic Adviser, HM Treasury, called in and examined.

Chairman

172. Mr Chancellor of the Exchequer, the Committee has seen as one of its functions in monitoring the work of the Treasury the improvement in actual documentation of our economic affairs. I believe we have over the years made some improvement in this by way of a team effort between the Treasury and this Committee, and we are particularly glad to place on record the fact that three of our recommendations last year - namely, that the list of press statements on the Budget Day (which is now a major feature of the documentation) should have an index provided; secondly, that the Budget Supplement to the Economic Progress Reprot should deal more adequately with the Budget; thirdly, that the Red Book itself should be more enthusiastically promoted - have all been accepted by the Government. We are very glad that that is so and would like to express our appreciation to the officials for the improvements which have been made. We are very glad indeed that you are able to be with us this afternoon. As you know, the timing of the

parliamentary recess has put us under very considerable pressure of time because normally we have a little while between the Budget and taking evidence on it and preparing our report before the recess. The way it has worked out this year we have to do so ahead of the recess, which is earlier, and still get a report out in time for the Second Reading of the Finance Bill. We certainly hope to do that. It has, as I said, meant the time available is rather shorter than otherwise would be the case which is one of the reasons why we are meeting earlier than usual this afternoon. Nonetheless, we are very grateful to you for coming and look forward to the answers to our questions. You are indeed welcome, as indeed are Sir Peter Middleton and Sir Terence Burns, who have been helpful to the Committee on many previous occasions. Do you have any initial statement which you would care to make? Then we can proceed straight away to questions.

(Mr Lawson) Thank you very much, Mr Chairman. Let me make a statement by way of introduction which I hope will be helpful to the Committee. Before I do so, let me thank you for your kind remarks about the improvements in the documentation. It is no coincidence that ~~there is this~~ we have made these improvements. We have consciously sought to follow in the ways you outlined the recommendations which ~~this~~ ~~your~~ Committee has made.

The Committee is always particularly interested in what it sees as new stages in the evolution of the Medium Term Financial strategy, so it might be helpful if I focus my opening remarks on that.

First the fiscal component: as the Committee will have observed, in place of the declining path for the PSBR as a percentage of GDP, which has been the pattern in all previous versions of the MTFS from its inception in 1980, we now have a constant 1 percent.

There is, I submit, nothing remarkable

about that except that we have achieved it so soon!. Clearly, the declining path cannot go on indefinitely; it has to level out at some point. It has been clear to me throughout my time as Chancellor that 1 percent of GDP would be an appropriate destination. This was implicit, for example, in the Green Paper "The Next Ten Years: Public Expenditure and Taxation into the 1990s", which I published simultaneously with my first Budget in 1984. If you turn to paragraph 55 of that Green Paper, you will see it stated that, "In the period to 1988-89, the PSBR is assumed to follow the illustrative path set out in the MFTS. Thereafter it is assumed to fall further as a share of GDP from 1 3/4 percent on 1988-89 to 1 percent in 1993-94."

The reasoning behind the 1 percent equilibrium level implicit in the Green Paper was made rather mroe explicit in my Lombard Association speech last April; ~~and~~ let me quote from that: "There is, of course, no scientific formula for determining the 'right' size of the PSBR ... But ... over the medium and longer term, it is clearly important that the amount of public debt, and the burden this imposes, should not rise as a proportion of GDP".

Indent quote

Over the medium and longer term the Government's objective is zero inflation. It follows that money GDP will by then grow at the real rate of growth of the economy, perhaps an underlying 2½ percent a year, to be on the safe side. Against that background a 1 percent PSBR will ensure that public debt does not rise as a share of GDP. This is the modern equivalent of the balanced budget doctrine. By contrast, to allow the debt/GDP ratio to remain constant on anything other than a zero inflation basis is simply a recipe for accelerating inflation.

It will be said, quite correctly, that we have been able to reach the 1 percent of GDP destination ahead of time only by virtue of privatisation proceeds of a little over 1 percent of GDP. But that is as it should be. And over the long term privatisation proceeds will be a gradually declining share of GDP until eventually they approach zero. The aim willbe to keep the PSBR at 1 percent of GDP throughout the process. Second, the monetary aspect: here the main evolution has been the agreement reached in Paris last month to seek a period of exchange rate stability. This is, I believe, as much in the interests of the UK - given the present constellation of exchange rates which the earlier Plaza agreement was designed to achieve - as it is in the interests of the wider international community. When I appeared before this Committee last autumn I explained that there had been a necessary exchange rate adjustment in the face of the sharp collapse of the oil price. I also explained that the necessary adjustment was complete and that I did not wish to see the exchange rate fall any furhter. I stressed that I continued to wish to see an exchange rate which exercised a financial discipline and was essentially non-accommodating in the face of inflationary pressures. Also implicit in my remarks was the view that I did not wish to see a substantial rise of the exchange rate from that level as it would clearly not make sense to reverse the exchange rate fall that had been the proper response to lower oil prices. Since then we have had the Paris Accord. All of us who were present agreed a period of exchange rate stability was both practicable and desirable. Following the original Plaza Agreement there had been a very large fall in the dollar; the yen and deutschmark are both up by about 60 percent against the dollar. That adjustment had been necessary to correct the earlier dollar overshoot and to create circumstances that would lead to a correction of the growing current account imbalances. It was always recognised that it would take time - the so-called J-curve -before this correction came through, but that is no reason for seeking an overshoot in the opposite direction.

It is clear that both Germany and Japan are having difficulty in adjusting rapidly to their very large exchange rate appreciations and making their economies more domestically orientated, just as it is taking time for the United States to make its own economy more export orientated.

So far as the United Kingdom is concerned, a period of exchange rate stability around the parities then prevailing had - and continues to have - obvious attractions. In the wake of the Paris Accord I therefore made explicit the view that had been implict in my pre-Paris remarks. Policy has accordingly been conducted in this light. As I have made clear on a number of occasions however - and not least to this Committee when I last appeared before it - in practical market management terms it is not sensible to be more precise than this or to reveal any operational details. No doubt some light will be shed by the passage of time but for the presentthat is all I wish to say on this aspect - except perhaps to emphasise two fairly obvious points. First, right from the start the exchange rate has played a key role in the conduct of monetary policy. Second, the objective of monetary policy remains, as it always has done, the battle against inflation. The present stance of policy is fully consistent with this.

Lastly, Mr Chairman, let me say this: what I have been describing so far are the latest stages in a consistent policy that has been pursued ever since we first took office in 1979. The real change is the change that occurred in the real economy as a result of the implementation of that consistent policy. To take just two examples, both of which I mentioned in the Budget Speech, but which bear repeating. In the 1960s and again in the 1970s Britain's rate of economic growth was the lowest of all the major European countries. In the 1980s our rate of growth has been the highest of all the major European countries. Again, both in the 1960s and the 1970s, growth of output per head in manufacturing in the United Kingdom was the lowest of all the seven major industrialised countries in the world. During the 1980s, it has been the highest in the so-called G7. In both cases we have gone from laggard to leader - not so much a change as a transformation.

In case there is any doubt about when the 1980s started, as every schoolboy knows the 1980s started in 1980 just as the 1970s started in 1970 and the 1960s started in 1960.

The plain fact is that British industry is in better shape than it has been at any time since the War. This came out very clearly as it happens from a very thorough five-page survey published in yesterday's Sunday Times. But perhaps more important still is that the clear message from the CBI's latest industrial trends survey, published last week. I pay tribute to industry for what it has achieved: the Government's job has simply been to create the right environment, which this month's Budget will reinforce.

Chairman: Chancellor, some of the points you make there do of course in effect answer questions which we asked officials and the Governor earlier and we will obviously need to consider those points very carefully. I think now we should move on to the questions we have for you.

Mr Watts

173. Chancellor, you have been justifiably pleased with the economy's growth performance in the '80s and indeed you have just made reference to that in your opening remarks. If I can cast myself in the role of Oliver Twist, do you regard a range of 2½-3% real growth per annum as the maximum which the United Kingdom economy can sustain?

(Mr Lawson) I do not know; we shall have to see. But the fact of the matter is it has been the fastest rate of growth of all the major countries of the European Community. It is a rate of growth which we have never sustained for a prolonged period in the past. If you look back you will see no period of six successive years in which we have ever, since the War, had growth of 2½% or more. Assuming that we do get 2½% or more in 1987 (and we are forecasting 3%) then we will for the first time since the War have had six successive years of 2½% or more growth each year. And so, while I do not rule out the possibility of the ~~economic performance and~~ supply side of the economy becoming more effective so that a higher rate of growth is possible, I reckon that we should not act Oliver Twist on this occasion.

174. Are there any further structural changes in the economy which you think would improve the growth potential further?

(Mr Lawson) ~~The policies which~~ We are pursuing are a whole battery of policies ranging from trade union law reform to competition policy to the privatisation programme, and ~~a whole lot of~~ many others. ~~continuing with them, and of course~~ I do not believe we have yet seen (because of ~~tremendous~~ time lags ~~and~~ the economy takes a long time ~~and people within the economy take a long time also~~ to adjust) the full response to the ~~supply side~~ changes ~~that~~ we have already ~~been~~ introduced.

175. You have mentioned the tax changes - I think particularly the Corporate Tax changes which appear to have helped to release some of the growth potential of the economy.

(Mr Lawson) I did not, but I should have done!

176. Well, I think you were implying it. What other factors do you think there are in the economy today which inhibit growth, and, as somebody who knows Slough quite well, to what extent would you think that school shortages are now an inhibiting factor?

(Mr Lawson) I certainly would not wish to blame Slough. But I do not think there is a particular problem ~~- at least I would not put it in the form of a problem~~ - with ~~school~~ skill shortages at the present time. I think, however, that most of our supply side problems ~~at the present time~~ are to be found in the ~~area of the~~ labour market. ~~generally.~~ In a number of ways, the labour market does not operate nearly as well as it should do. ~~and this is I think following on from~~ The Government has taken some major initiatives, with the trade union law reforms which we have introduced ~~and~~ the changes in economic policy that we have introduced, and the ~~absence~~ dropping of ~~all~~ the "beer and sandwiches in Number Ten" approach. ~~and that sort of thing.~~ It is now primarily up to management to ensure that the labour market works better. Within that ~~also~~ context I would like to see British industry invest more in ~~trading~~ training than it does at the present time.

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177. Finally, it does seem that unemployment problems are concentrated particularly amongst the unskilled. You have just mentioned the importance of training but do you think that, with the economy growing at around 3%, it will generate jobs to pick up this army of unskilled unemployed, or must we look to training measures to do that?

(Mr Lawson) I think training measures are important, ~~as I say,~~ and I would like to see industry doing more in this field than it does at the present time. There have been various studies done, particularly one I recall under the auspices of NEDO, which showed that whereas the British Government devoted ~~the same, roughly,~~ proportionately roughly the same resources to training as other comparable governments ~~did~~, the private sector of British industry did not invest as much in training as the private sector in most of our major competitor countries. ~~and~~ That I think is something which is a weakness in the British economy. But of course the proof of the pudding is in the eating and I am glad to say unemployment is coming down and has been for the past 7 months. ~~and~~ Although we do not make any forecasts, we suggest ~~here~~ in the FSBR that we expect it to continue coming down for the remainder of this year.

Mr Sedgemore

178. Chancellor, in table 3.7 headed "Real Output" you have got GDP projected to grow by 3% in 1987 and 2½% in 1988, and in table 3.1 output per head of the employed labour force fourth quarter of 1985 to fourth quarter of 1986 you have got growing in the manufacturing industry at 4¾ and in the non North Sea economy at 2¾. Do these figures, in line with other indicators, not suggest that unemployment is likely to stay around 3 million for the next 2 years? First of all, do you agree with that, and secondly, do you consider that to be an indicator of success?

230/4.

(Mr Lawson) No, I do not agree with it. ~~I think the best thing is~~ I will ask Sir Terence Burns to explain the reconciliation of these various different tables.

(Sir Terence Burns) You are comparing here non North Sea productivity with total GDP in the other table. If you were to take non North Sea GDP of course you would have to add something like ½% to those figures.

179. And in terms of unemployment what difference does that make?

(Sir Terence Burns) Against a background of this kind of growth of non North Sea productivity there is plenty of scope there for employment to rise.

Mr Howell

180. Chancellor, I am sure you are well aware that many employers are having difficulty in recruiting labour and unfilled vacancies continue to rise. I wonder to what extent you think that is a limiting factor on greater growth?

(Mr Lawson) ~~I think~~ If you look at the CBI surveys, one of the questions which firms ~~they~~ are asked ~~if I can recall it, and I have not got a copy here,~~ is what factors are likely to limit~~ing~~ their output. Only a very small proportion ~~- and somebody may have the latest figures - is~~ cite a shortage of skilled ~~manpower and shortage of~~ labour. So that although skill shortages are ~~that is~~ undoubtedly a constraint ~~the case~~ in individual instances, they ~~it~~ do~~es~~ not appear to be a ~~the~~ major factor for ~~of~~ the economy as a whole. It is certainly true, however, that one does come across - ~~and~~ I do in my constituency and you obviously do as well - cases all the time where despite the fact that the unemployment register shows a large number of people registered as looking for work, when advertisements go in the papers to fill a particular vacancy, very often people do not turn up; or, if they do turn up, they do not actually turn up

~~[figure latest survey is 9%]~~

23916

for the job when it is given them. But I think the various programmes which have been introduced under the aegis of the Secretary of State for Employment, particularly the Restart programme, may be helping in that direction.

181. Our Member competitors who do not have nearly as generous social security payments as we do are concentrating on a workfare system in order to encourage people back to work, yet our opponents are insisting that we should give people the right to remain unemployed.

Could you say a word or two about that argument, because it is becoming very topical?

(Mr Lawson) Let me say, first of all, I am well aware of the way ~~in which~~ you have been drawing attention to this very important field for many years ~~and years and years~~, long before most other people were aware of the nature of the problem. It is clearly the case that there is a relationship between the level of social security benefits and the level of unemployment. On the other hand, one has also to judge what level of benefit is appropriate in a civilised society. So a balance has to be struck ~~there~~. As for the question of whether ~~there should be~~ full benefits should continue to be available when there is clearly a job there for the individual which he chooses not to take, or a training place ~~there~~ which he chooses not to take, I think that is something we will have to look at.

182. Following on from that, although I agree with you and everybody who has called this a prudent Budget, do you not agree there is something rather imprudent in spending money on creating YTS places, then allowing those people for whom they are provided to turn them down and carry on drawing benefit?

(Mr Lawson) I do not think ~~it~~ that is anything to do with prudence, but the last part of your question raises ~~the~~ an interesting ~~question~~ point. I do believe that in a free society people should be able to turn down an offer which is made to them by the State of a training place ~~or whatever~~, and that there should not be direction of labour or anything like that. ~~I do not want to see that, but~~ The interesting question is, what then, ~~if they do~~ turn it down, is the obligation on the State to pay them ~~by way of~~ benefit if they have exercised their freedom ~~to turn~~ ~~it~~ down? That is a difficult question and it is one which becomes a live issue only when we reach the point when we really can guarantee to everybody that there is a training place for them.

Chairman

183. I think we would like now to turn to monetary policy. In the course of doing so may I ask one initial question? Clearly control of money supply is very important. Could you analyse for us the various components of monetary growth and the weapons which you have available for controlling them?

(<u>Mr Lawson</u>) I am not quite sure what you mean by the "components of monetary growth". We look at both narrow money and broad money. Narrow money is normally found more useful. That is growing pretty well at the centre of its target range.

184. Perhaps I might make my question a little clearer. For example, one might find the money supply grows because of last year's PSBR which was not refunded. On the other hand, there may be expansion of bank lending for other reasons. So that there are various ways in which the money supply may grow. What I am saying is would you care to distinguish between them and tell us what means you have available of controlling money supply?

(<u>Mr Lawson</u>) I do not think it is very necessary to distinguish between them, since what matters is ~~the~~ overall monetary growth ~~and since there is not really the fact that there are~~ we do not have separate instruments for separate ~~forms~~ cause(s) of monetary growth. Whatever the cause of ~~excessive monetary growth or~~ monetary growth which one might consider to be excessive, the only real instrument one has to deal with it is the level of interest rates, particularly short term interest rates.

185. Presumably it is somewhat different if one has a high PSBR which is not being funded as against a situation where, for example, there is great growth in consumer credit for one reason

or other. They are not the same, are they?

(Mr Lawson) The economy can evolve in various different ways. One might have a view as to the relative shares taht could be taken by the private sector or public sector. But Whatever view one takes ~~-I am not trying to be evasive -~~ On that the question ~~is,~~ remains, is the level of monetary growth acceptable or not? If it is unacceptable, if you think it is too high in terms of your anti-inflationary objectives, then your remedy is to put up interest rates.

186. So are you saying the only means you have of controlling it is the level of short term interest rates?

(Mr Lawson) I suppose that you could, of course, deliberately set out to plunge the economy into sharp recession and that would ~~certainly~~ probably have an effect on monetary growth. But that would be rather like burning the house down in order to get roast pork. Therefore, in practical terms the only way in which you control monetary growth is through the level of short term interest rates.

187. Our problem there was, we had some difficulty when we discussed the matter with officials in seeing whether they had any idea of the relationship between the rate of monetary growth and the effect of the given quantity of change in short term interest rates.

(Mr Lawson) There is clearly a relationship. I think what you may be concerned about here is the rate at which private sector borrowing has been growing. If you look at the figures, - there is a sort of myth it is all plastic, but it is not all plastic - ~~if you look at the growth of private borrowing, it~~ the growth as a share of GDP is entirely attributable ~~- entirely - as a share of GDP -~~ to the ~~great~~ growth of mortgage borrowing ~~s primarily,~~ Although there is no doubt some equity withdrawal, this borrowing is primarily for the purpose of house-purchase and house improvement.

~~Of course,~~ It is part of the Government's policy to encourage home ownership, including the purchase by council tenants of the homes in which they live. therefore, That leads to more mortgages being taken out ~~granted~~.

~~Therefore,~~ Provided that we can contain the monetary consequences of that - which we are doing, and have done - then I do not regard that as a matter of concern. ~~The raising of interest rates, if you wish to change it all, will bring it down if it goes too high.~~

If we were concerned about the monetary consequences, the appropriate action would be to raise interest rates.

That has both a direct~~ly~~ and an indirect~~ly an~~ effect. Experience shows when the mortgage rate goes up the desire to acquire mortgages goes down; that ~~There~~ is a direct relationship. But also, of course, a rise in ~~the~~ interest rate affects the rest of the economy. So ~~what one is trying to do is mainly to affect~~ our objectives for the overall rate of monetary growth can be ~~that is~~ achieved.

(Sir Peter Middleton) If you are talking about money which if M3 is bank deposits or if M0 is the monetary base, notes and coins and bankers' balances, given the fiscal policy since we abolished exchange controls and the corset came to an end, the only instrument is interest rates; there is not another one.

188. Again the overhanging glacier of no liquidity, which the Governor of the Bank of England has referred to, and expansion in consumer credit which we have already commented on.

(Mr Lawson) Which? Mortgages?

189. Amongst other things.

(Mr Lawson) Overwhelmingly. I think it is important that people grasp this. Balances on Credit card use has ~~s have~~ been growing quite rapidly. But Not only are credit card balances ~~they~~ a small proportion of the total amount of consumer credit, most are not credit anyway. People use credit cards rather like a charge card; in other words, they use them to buy ~~the~~ goods because that ~~it~~ is ~~a~~ convenient ~~way of buying the goods~~ but they repay the money before they get into the credit period. Is that not what Mr Banks does?

Mr Banks

190. I do not, no.

(Mr Lawson) Mr Banks does not. In many ways, Mr Banks is different from the average United Kingdom citizen, and that is yet another. If you look at figures, you will see that of the total amount of ~~consumer~~ personal sector credit outstanding, credit cards and charge cards account for under 5 percent. And, if you look at the growth of private borrowing as a proportion of GDP, ~~it has grown~~ (there is a chart ~~I~~ had put in the FSBR specially so that this Committee could see what has been happening, — the "frog" chart) ~~and~~ that growth is entirely attributable to the growth of mortgages.

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Chairman: For one moment I thought this mysterious relationship between the rate of interest and the growth of money supply might be solved by our taking a quick sample from Mr Banks, but apparently that is not so!

Mr Wainwright

191. Chancellor, in your Budget Red Book this year you begun the chapter on the MTFS by saying - not by any means for the first time - that the MTFS is intended to bring inflation down further over a period of years. In the same chapter, table 2.3, you set out as usual your output and inflation assumptions and in that table the assumption of the annual rate of increase of inflation rises above 3% per annum during each of the next 3 years, and comes back to a 3% per annum for 1990-91, which is exactly the same figure as the one you have assumed for the year which is now ending. When do you guess it may be practicable to assume a declining rate of inflation?

(Mr Lawson) The underlying trend is declining. You would not expect it, would you, to come down in a straight line, Mr Wainwright? There are bound to be fluctuations. I think if you compare what has happened in the 1980s with what happened in previous decades, particularly the '60s and the '70s, the difference is this: that although there are fluctuations, over the earlier period each peak was higher than the previous peak; each trough was higher than the previous trough. You have now seen a period in which, although again there have been ~~has~~ fluctuations, each peak tends to be lower than the previous peak; each trough ~~(I would hope)~~ is seen to be lower than the previous trough. ~~This incidentally~~ The slight bl ~~d~~ip upwards from 1986-87 ~~- I mean "blip" upwards, - the last two letters were correct! -~~ ~~from 1986-87-88~~ is occurring not only in the UK but in a number of other countries, for obvious reasons.

Ch
Do you want this {} left in as a joke?

I don't think so!
AA

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~~F83~~

192. Yes. It was not as you may have noticed so much the "blip upwards" that I was asking about: it was the fact that even when we get to some sort of assumed trough in 1990-91, the annual rate of inflation is still rising by a 3% rate, as you assume it is today.

(Mr Lawson) Th~~e~~ose are not forecasts anyway. We will have to see.

193. No - I would describe them as assumptions.

(Mr Lawson) That is right. We will have to see how we do. ~~and~~ That is not meant to be a trough in 1990-91 - ~~it~~ the projections just ends there. I would hope ~~it~~ the trend will go down further.

(Sir Terence Burns) The 1986-87 figure of course is unusually low because of the influence of the oil price reduction. If you were to look at the years that precede that you can see that is rather exceptional.

194. But nevertheless, are these figures not really an acknowledgement - and a just and proper acknowledgement - that far and away the greatest determining factor of the UK rate of inflation is the world rate of inflation?

(Mr Lawson) No, I would not say that. You can clearly have low inflation in a high inflation world. The Swiss have demonstrated that over many years. But it is equally clearly easier to get inflation down when ~~the whole~~ of the world ~~is~~ are pursuing anti-inflationary policies ~~or~~ all the major countries ~~of the world~~. That is one of the reasons why I welcomed the ~~con sensus - the~~ international consensus ~~, that is to say -~~ on economic policy which there is at ~~the~~ present ~~time~~.

195. But in contradistinction to world trends of inflation, could it be that the intractability of the annual rate which you still leave at 3% in 1981 is partly due to governments' fiscal policies? For instance, how far is the very rapid inflation in house prices way, way above 3% (most people think it is still in double digits)

20/196

due to official policies on mortgage relief, tax relief for mortgage interest, and the possibility of removing domestic rates and so on?

(Mr Lawson) I have no idea what the particular causes are of the rise in house prices. But ~~of course~~, in any economy, you will never get everything going up at the same rate. You will always have changes in relative prices: some things going up faster than others. I suspect, although I do not know, that you would find that house prices rise faster than the general rate of inflation in many other countries. What we tend to see anyway over a long period in this counry is a relationship between ~~the~~ house prices and the ~~level of~~ rate of growth of earnings, rather than the rate of growth of RPI.

Chairman

196. It is Mark Twain's remark, is it not, "By land they are not making it any more"?

(Mr Lawson) That is quite right.

Mr Wainwright

197. Turning to weapons for dealing with all this, does it not sometimes concern you that interest rates are now going to bear an enormous weight of policy - for instance, industry? Especially new companies and small companies that have not been able to build up a cash mountain are very disturbed at the current high rates of interest from the point of view of improving their investment which seems to have been very low this present year, and are urging sharp drops in interest rates. On the other hand, you have just indicated that you rely on interest rates now as virtually your sole weapon so far as prices are concerned, and bank lending for private purposes. Then again, there is also the sterling factor, where interest rates are believed to be potent. Do you not find sometimes you are faced with intractable contradictions?

21

(Mr Lawson) No, there is no intractable contradiction. There is no contradiction at all. ~~and~~ Indeed the way we run monetary policy in this country is much the same as it is in other major countries - particularly the US and Germany ~~- and~~ I would ~~advise you, or~~ commend to you ~~(I would not presume to advise you) to read~~ Mr Volcker's testimony to the Senate Banking Committee ~~I think it was~~ last month, on how American monetary policy is run. You will find it is very ~~very~~ similar.

Another joke, but perhaps leave this one out? NBW.

As for interest rates and investment, investment has been going ahead well. There was a bit of a dip in 1986. In many ways I think it is surprising how slight it was. You will recall that when I introduced the Corporation Tax reforms in 1984, a great deal of investment was brought forward from 1985 to 1984 and from 1986 to 1985, ~~and so~~ Investment went up very sharply, and everybody predicted then that there would therefore be a dip in 1986 because of the investment being brought forward. ~~Then~~ When you have superimposed on that the sharp pause ~~there was~~ in world economic activity following the oil price collapse ~~which also came~~ in the early months of 1986, ~~as I say,~~ it is really quite remarkable, ~~I think,~~ that ~~the~~ investment held up as well as it did. Now, of course, the forecast is for quite a smartish rate of growth this year ~~- 1987~~. As for interest rates, I think it is important not to exaggerate the position. It is very difficult to say what ~~the~~ real interest rates are. But if you take, ~~as it were,~~ three-month~~ly~~ money market rates adjusted for the current rate of inflation, you will find that among, ~~say,~~ the G5 countries, our real interest rate is only very very slightly above the ~~odds~~ others. Our real interest rate comes out at 5¾ ~~%~~ per cent - the same as Japan ~~at 5¾%~~. ~~You have~~ France and the United States ~~coming in~~ at 5 per cent and Germany the lowest at 4½ per cent ~~real~~. So that our real interest rates are ~~what~~, at most, ¾ ~~%~~ per cent above the average for the G5. Now that is above, I grant you, but I think the difference is frequently grossly exaggerated.

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198. _A propos_ the United States, it is really not part of the scope of our report to investigate alleged similarities between the economic policies of the United States and this country.

(_Mr Lawson_) No, but there is one point, Mr Wainwright, and I think it is this: I think comparative studies in this and, indeed, most other fields are illuminating not simply because you are trying to study what is happening in those countries but because you are trying to see whether there is anything peculiar about the policy we pursued in this country or the developments in this country. That is why I think it is illuminating.

199. One final question: when you were eventually deciding on the fairly substantial reduction of the PSBR for the coming year, were you anxious, amongst other things, to accommodate the fairly rapid rise in private sector borrowing, not to allow public sector borrowing to get in its way?

(_Mr Lawson_) No, I do not think that was the primary reason. As I say, you can always counter whatever may be the adverse monetary effects of excessive private sector credit by the appropriate level of interest rates, or the mix between interest rates and the exchange rate. It was more that, all things considered, the economy was going very well and I felt that a prudent Budget of this kind, in which the amount by which I reduced the PSBR as compared with the MTFS yardstick was greater than the amount by which I reduced taxation, was the correct judgment in those circumstances, taking everything into account.

(_Sir Peter Middleton_) Could I add a little point? I think there is still a bit of confusion here. The object is not to control bank lending. The bank lending has been growing more rapidly than the growth of GDP for at least the last ten years. The object is to use interest rates to bring about the monetary

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conditions consistent with the MTFS, growth of money GDP in bringing inflation down.

Mr Beaumont-Dark

200. If it does not sound too much like Harold Wilson, I think it is one of the best Budgets we have had since 1979 and I did think that.

(Mr Lawson) Thank you.

201. One of the reasons why I thought it was an excellent Budget was because you resisted the terrible temptation of all politicians to spend other people's money, particularly if it was there. I thought the reason you did that was so that interest rates (I am one of those who you might say exaggerate the importance of this; perhaps that is because I come from industry) could then come down more than this half a point, with this miserly Bank of England attitude at this time. Was that your idea - so that interest rates could come down?

(Mr Lawson) Mr Beaumont-Dark, first of all thank you very much for your kind remark about the Budget, which I greatly appreciate. Secondly, you say you come from industry; I always thought you were a stockbroker. ~~I do not want to pursue that any further.~~ As for ~~the~~ interest rates, interest rates have come down 1 percent, ~~partly -~~ half of it ~~-~~ in anticipation of the Budget, the other half following the Budget. ~~and~~ Certainly I felt it very desirable ~~necessary~~ to reinforce ~~- and it was building up before the Budget, I think -~~ ~~a~~ the climate of confidence in the way in which the Government was managing the public finances and managing the economy generally. That climate of international confidence will obviously be beneficial to industry in this country, ~~I think,~~ and I welcome the fact that industry itself in the shape of the CBI approved of the Budget.

202. It is kind of you to take an interest in my career, but I am a director of three industrial ocmpanies that employ 27,000 people. Two of them are very big, they can raise money on the stock market - which, as you say, is my other hat - and one can do that very easily. But you do neatly bring me to a point which the Bank of England made when I asked them a similar question to that which I have asked you: they gave the Marie Antoinette answer, "Let them eat cake". Companies can now raise money on the market - the big ones can. The two big companies I am a director of can raise it easily, but the small companies, which really are the seed corn of growth, have to borrow theirs upon the money market and from banks, and when you say that our interest rates are not really so high, only three-quarters of a percent higher than Germany, if you take the three to five year market and the ten year market - and our interest rates are very considerably higher than our competitors - do you not think that is so? I thought the Budget was to help the long term rates come down.

(Mr Lawson) In so far as there is a relationship between the PSBR and interest rates - and the PSBR is only one of many factors that influence interest rates - clearly a lower PSBR is helpful rather than the reverse. So I certainly agree with you on that. As for five and ten year money, on the whole ~~I think it is right to say~~ very few small businesses finance themselves that way and, of course, ~~one of the things we have seen anyhow is that~~ long rates have come down ~~quite a bit~~ in this country over the past few weeks and months. That is something I greatly welcome.

203. Long term interest rates are still about three times the rate of inflation.

(Mr Lawson) I think it is the difference rather than the multiple which is important [~~in a sense~~]. You want to look at what is the real rate. In fact, the yield [~~cover~~] curve now goes down at the long end; long rates are lower - slightly lower - than short rates now; so [~~that~~] companies can finance themselves long, if they are able to do so, more cheaply. But I do [~~one hundred percent share~~] entirely agree with the importance you attach to the small businesses; and I am well aware that many of the options that are open to bigger businesses are not open to small businesses. That is why there were a large number of measures in the Budget deliberately designed to [~~try and~~] help the small business sector. Of [~~which~~] these I think the most important is the move to cash accounting for VAT; but there were a number of other measures including, of course, the reduction in small companies' corporation tax rate from 29 percent to 27 percent.

204. You say that industry is in a better state now than at any time since the war. Its recovery rate may be better than at any time since the war, but many industrial companies that we depend upon to export are recovering from the pound going up to the 2.20 to 2.40, because in my era(many of us said so at the time) when the pound went over 2 and soared up, it cut a tremendous swathe through the manufacturing industry. There may be longterm good in it but there was a lot of short term pain. Would you agree it would be very damaging if the pound were allowed to march on again so that interest rates had to be used to curb the pound from going so high that once again industrial companies bore the heat of the day?

(Mr Lawson) I do not believe that we will see, left to its own devices, a repetition of the petro-powered pound of 1980. But in any event I have made it absolutely clear that I believe that sterling is around the right level now. I think this is a helpful constellation of parities for industry. ~~and~~ It is, therefore, an objective of policy ~~within the overall framework of policy~~ to try and keep it at around that level. We are assisted in that by the fact that there was ~~this~~ the international agreement to which I alluded in my opening remarks.

Mr Sedgemore

205. Chancellor, the Barclaycard spokesman says you are wrong. Over the weekend he said on average people actually borrow for four months. My question is this ---

(Mr Lawson) No, that is not ---

206. That is what he says.

(Mr Lawson) The statement I made is correct. It is something I have looked into very carefully.

207. Maybe he does not know his own business.

(<u>Mr Lawson</u>) If the Committee wishes a short note on credit cards ~~this, a short one,~~ we can let you have one. ~~it on credit cards~~.

208. Thank you. Perhaps we can continue on credit cards, then: in the last two years, the base rates have fallen from 40% to 10% - that is a drop of 30%. Access and Barclaycard have, throughout that period, continued to charge 26.8%. Marks and Spencers, who will not have Access and Barclaycard, charge 29.8% and Burtons charge 34.5%. Is it not time that (a) the Access cartel of Nat West, Lloyds, Midlands and the Royal Bank of Scotland was broken up, and (b) that these firms behave more responsibly and follow your lead in bringing interest rates down?

(<u>Mr Lawson</u>) As I say, the contribution of credit cards to the totality of private sector borrowing is very small. The way most people respond to these high rates of interest is by making sure they pay the bills before they get into the credit period. There are a number of people who do not do that; ~~and~~ those people ~~who do not~~, it would appear, behave in a way which is not terribly interest rate sensitive, and that may be a source of profits to the credit card companies. But of course nobody forces people to finance their purchases that way. ~~and~~ Bulk the vast bulk of private sector borrowing — and ~~consumer credit in~~ the entire reason ~~cause~~ for the increase in private sector borrowing ~~consumer credit~~ as a proportion of GDP, is, as I mentioned earlier, mortgages. ~~and so far as they are concerned,~~ And on mortgages, the building societies ~~of course~~ do not charge rates anything remotely approaching the rates you quoted. Nor the banks.

209. Barclaycard actually say that people borrow for four months and they are paying therefore an average APR of 19% - that is what they said this weekend. You did not actually answer the question. In supporting the usurers against the customers, are you mindful of

the fact that in Dante's Inferno the usurers were taken into Circle 7 and made to stand on hot sands beneath burning rains alongside the Sodomites?

(Mr Lawson) Well, I think that is a matter which, as Dante suggested, is best left to spiritual authority rather than to the Government of the day!

Chairman

210. It sounds inflammatory rather than inflationary! Mr Chancellor, we had a variety of questions about the PSBR and fiscal policies, some of which have actually been answered in your earlier statement, but I wonder if I might pursue just two of them. The first is this: you were saying that there had not been a change in policy as far as the objective of the PSBR is concerned, though those who thought the previous policy was to have it steadily declining and now find it is to be maintained at a constant level might feel that was a change but at all events we are clear what the situation is. Similarly I think there has been a dispute over a long time between yourself and this Committee with regard to how one should treat asset sales and we have consistently taken the view that one should treat that as a means of financing the PSBR rather than as negative public expenditure. I think the time has probably come for a truce as far as that is concerned. If that is so, may I nonetheless ask you whether you think your 1% target for PSBR is really the appropriate one, because if one were indeed to treat the proceeds of the asset sales as a means of financing the PSBR, that figure would still be at something approaching 2% - not precisely of course because the exact monetary impact is not the same in the case of asset sales as against issuing gilt-edged stock, but nonetheless it would seem, if that is so, you still have scope for going down from the 1% to a lower figure for the reasons I have just mentioned.

(Mr Lawson) ~~Well,~~ As was implicit in my opening remarks, using the yardstick of chart 2.5, if you look at the froth on the bottle of Guinness, if I may put it that way, rather than just the stout itself ----

211. Well, there is as much froth as there is actual Guinness - rather more!

(Mr Lawson) Yes, it is altogether an interesting chart. It clearly follows that ~~as~~ the amount of froth will diminish~~es~~, ~~because~~ privatisation proceeds are ~~is~~ now at a flat £5 billion a year, which will be ~~is obviously~~ a steadily declining proportion of GDP; ~~in itself a flat figure,~~ and eventually ~~some way out, it~~ proceeds will be less than £5 billion because we will gradually complete our privatisation programme~~s~~. There is a long way to go, but we will gradually complete it. So we will ~~actually~~ be coming down eventually ~~at the end of the day (where ever that is)~~ to a PSBR 1% of GDP shown by the black stout with no froth on top of it at all, and then we shall have met - you and I.

212. Yes, but the froth at the moment is going up rather than coming down.

(Mr Lawson) No. It is at its peak level. ~~and~~ It will be falling very slightly as a percentage of GDP ~~very very slightly going down~~, because the Public Expenditure White Paper and the Autumn Statement before it showed a steady £5 billion, and I do not wish to depart from that.

213. The only other point I think we would like to pursue is your statement in your opening remarks that the objective is to keep Government debt constant in real terms. That of course is only one side of the balance sheet. If one takes both sides of either the Government or the national balance sheet, is it your feeling that the net worth of the Government sector should remain the same over time?

(Mr Lawson) I do not think it is possible in practical terms to know what the net worth of the public sector is, whereas you do know what public sector debt is. ~~and~~ What I suggested and what was implicit in the Green Paper in 1984 which I made more ~~implicit~~ explicit ~~and~~ in my Lombard speech last year, was that ~~in~~ on a zero inflation ~~terms~~ basis, one wants to get to a ~~situation~~ position where public debt as a proportion of GDP is not rising. ~~because~~ You are likely to ~~do~~ get into all sorts of difficulties ~~, or are likely to,~~ if public sector debt is ~~steadily~~ rising as a proportion of GDP ~~and~~ it puts a burden on future generations, which I do not think one should put.

214. No, but it is very strange to look at only one side of the balance sheet, and there are improved figures which you have been creating recently which would help on the other side. Is not your objective to reduce the overall size of the public sector?

(Mr Lawson) Yes, indeed, and that is what the privatisation programme has been doing.

215. So why do you want the balance sheet to remain constant?

(Mr Lawson) No, it is not a question of the balance sheet remaining constant. ~~because you would be accused of double counting, if you counted both these things.~~ The fact that there ~~is this~~ are these privatisation proceeds is reducing the Government's need to borrow in the way you presented it. So I think it is a sensible long term objective to ~~ensure that sensible fiscal component of the overall financial discipline, to ensure that there is not a balanced budget (and~~ aim for a PSBR of 1 per cent of GDP. Although ~~I think~~ that the doctrine of the balanced budget did far more good than harm during the period of its operation, nevertheless I think a more appropriate formulation now is to ensure that public debt does not rise as a proportion of GDP on a zero inflation basis.

Chairman: I think we would now like to turn to some of the international aspects of the Budget.

Mr Browne

216. Could I ask a supplementary on that? Chancellor, do you not find it surprising, and obviously our oil revenues vary as to the price of oil, that considering the relatively small proportion of our revenues that come from oil and gas our currency is reviewed so much in the international markets as a petrocurrency?

(Mr Lawson) Yes. I think it used to be very surprising, that sterling was viewed in that light but ~~I think it is now less so~~ that is less true now. ~~Having been~~ We were able to weather, in a way that very few major oil producers were able to, the ~~sharp collapse -~~ dramatic collapse ~~- of~~ in the oil price with so little damage to the public finances or to the economy, and that ~~I think~~ has led to a reassessment worldwide of the strength of the British economy and of the relative importance of oil within ~~that~~ our economy.

217. With this reassessment and the fact that our Public Sector Borrowing Requirement, I think, is at very prudent levels and therefore one could argue it is reflected in the strength of sterling, what other things are preventing interest rates from cominng down? This is slightly repetitive but I would like to get more focus on what is preventing a further fall in interest rates at the short term end of the market.

(Mr Lawson) As I have said ~~first~~, if you look at our real interest rates, in so far as one can ~~despite the rather conventional way of measuring interest rates~~ measure them, they are not ~~so~~ far out of line with other countries. They are higher than the other G5 countries by a very small amount and probably about average for Europe, ~~I would have thought, round about average~~. There are a number of countries that have real interest rates higher than ours - the Netherlands does, Italy does, and a number of others. ~~I think~~ We are roughly in the middle ~~there~~. We have to have the level of interest rates which, ~~as I say,~~ is necessary to keep monetary conditions ~~right, to keep monetary policy~~ on track, and that is affected by a number of different factors. I think one of the factors - I do not pretend it is the only one - that would make a difference is that after the general election we will ~~be able to~~ see ~~a better constellation of factors affecting the interest rate internationally~~ greater overseas confidence because ~~I think~~ there is obviously residual nagging fear among people worldwide that there might just be a change of government, ~~in~~ which ~~case it~~ would be disastrous for the British economy. So that is bound to be a factor, there is no point in trying to deny it.

218. The other thing was on exchange rates. After the Accord, which I think all members of the Committee would agree was a desirable

conclusion, really the other agreement is the European Monetary System but in this area the exchange rates are broadly published, there is a band. Why do you still feel it is so undesirable to have a broad band published of exchange target rates for sterling?

(Mr Lawson) I think it is a matter of either being in the Exchange Rate Mechanism of the EMS or not. If you are in, then the whole thing is extremely formalised and it is all published. If you are not, then it does not make practical sense to publish the "bands" within which you are operating. It would just help those who are seeking to make money at the expense of the policy ~~and~~ It is for precisely the same reason that the other countries who are party to what I call Plaza II, the agreement in Paris last month, do not publish ~~the~~ bands either. In fact, we all agreed it was much more sensible not to.

Ch
It would be nice to pledge this, but I fear it was picked up as a quote by too many hacks AA

219. In Plaza II what happens if a given exchange rate starts to diverge from the stability region? Is it then up to the sovereign divergent country to take corrective domestic policy action or will all members of the Accord take concerted action?

(Mr Lawson) If domestic action is needed, then there is the presumption that that would be taken by the country that needs to take the action. If, however, it does not appear that that is the case and, therefore, that intervention would be appropriate in the currency markets, that intervention would be concerted.

Mr Budgen

220. Chancellor, it seems to me, as I listen to a good deal of what you say and what has been printed by the Treasury, that you are remarkably quiet and almost lacking in your usual vigour and self-confidence when you talk about your triumph over corporation tax. I recollect that in the days when you were a humble backbencher

and a silent whip you were very eloquent in private about the advantages of fiscal neutrality. Then along came your much-heralded elevation and you introduced important changes in corporation tax. I recollect there was much abuse directed towards you from great vested interests and the stockbrokers who speak on behalf of the industry said this would decimate manufacturing industry, and our many friends in the banking industry said that the reduction in their profits from leasing would lead to a scandalous attack upon their balance sheets. Now on this issue it seems you were entirely right and they were mostly wrong. Is there a general principle that you would now once again be able to underline for the Committee?

(Mr Lawson) First of all, Mr Budgen, may I thank you very much indeed for that tribute. I am naturally quiet - the word you used I think - so it is particularly gratifying to hear the case put so eloquently by you. It is certainly interesting that the United States, when they came to do their corporate tax reform so far as the corporate part of it was concerned not only followed what we had done but, as they will admit if you talk to them, consciously ~~followed what we had done~~ did so because they felt it was right. ~~and~~ I believe it has proved so in our case. What I think follows is that ~~there is - and I think this is what you are getting at - and~~ there must be a presumption in favour of fiscal neutrality and that you need a very good reason to depart from it in particular instances. But there well may be good reasons for departing from it either on a temporary or on a permanent basis in particular instances. ~~The presumption must be in favour of fiscal neutrality.~~ But I think it is quite wrong to see the corporation tax reforms simply in terms of a move to fiscal neutrality. There was a far more precise analysis which led to that conclusion~~, that is to say,~~ that what was wrong in this country so far as industrial investment was concerned was not that the totality of ~~industrial~~ investment was necessarily inadequate but that the quality was poor, the return on investment was poor, because very often the investment decisions were being taken for the wrong reasons.

221 Chancellor, all you are saying is part of the support for the general arguments for fiscal neutrality. You are explaining now to the Committee that there are two main consequences of a fiscal inequality. The first is that the general level of taxation is higher than it would otherwise be; the second that investment is inevitably distorted by taxation towards those areas which are tax breaks. There is nothing that you can describe as being completely limited to the corporation tax sector in your arguments, is there?

(Mr Lawson) I think that you do have to do two things when you are considering a possible tax reform. You have first of all ~~(and I think it is right to start with this general presumption in favour of fiscal neutrality but this goes beyond that)~~ to analyse the particular economic consequences of the existing lack of neutrality – the tax breaks or whatever you like to call them, ~~and~~ And you have then to consider what would be the consequences in that particular case of removing them. ~~and~~ That will vary inevitably from case to case.

222. In this particular instance, contrary to what the banks and manufacturing industry say, the advantages have been very substantial, have they not?

(Mr Lawson) I believe they have been, yes.

223. They have, first of all, stopped the tax incentive to use, at the margin, more machines and less men, and secondly a lower level of general taxation has been a factor in increasing the overall amount of tax-take that you have got from Corporation Tax?

(Mr Lawson) Yes. It has been a combination of the greatly increased profitability of industry, which I welcome, and of the change in the tax system. I think that the greatly increased profitability of industry is the greater factor, but nevertheless it is the interaction of the two which has produced the particular result. Incidentally, ~~while we are on this track, I think one has to be realistic or rather accurate:~~ I would not disguise the fact that there have been particular sectors of the economy that have been hit and have suffered as a result of this change. That is inevitable in any tax reform. But I have no doubt whatever that the economy as a whole ~~in~~ and the national interest ~~has~~ have been greatly advanced by this change.

224. For instance, would not your modesty allow you to present figures showing what the consequences for personal taxation of a policy of fiscal neutrality might be? It would be purely educational, would

it not? It would allow the nation to understand the advantages and disadvantages both of the relatively higher taxation which they have to grin and bear, and also the advantages and disadvantages of the tax breaks which ever citizen at present enjoys in just the same way as manufacturing industry and the banks much enjoyed investment allowances in the past.

(Mr Lawson) I do not see my primary role as that of an educator. I leave that to others.

Mr Beaumont-Dark

225. May I ask two things? Thinking of taxation and some of the changes you make, there are one or two people who have made comments about them so I wonder whether you could comment too. As you are aware, joint stock banks are heavily involved in overseas lending and they are being asked by Mr Baker and others to roll forward that lending so their overseas debt situation, which this Committee is working on at this very moment, means they are very heavily committed. But according to the Revenue they take a rather odd view that the tax relief was merely a subsidy to bank lending paid by the taxpayer. The banks say (I think with some justification) that this proposal to abolish tax on overseas earnings could make it much more difficult for them in recycling the debt that is so essential, frankly, to the financial stability of the rest of the world. Has the Revenue thought of that, or does it just not like losing tax that it thinks is its due, even though everyone else could lose a lot more?

(Mr Lawson) Whether the Revenue has thought of that or not, I can assure you Treasury Ministers have; ~~and~~ the decision to ~~have~~ include this particular provision ~~in~~ was a decision which was taken by me and my ministerial colleagues. The existing system ~~did~~ gave the banks an unwarranted subsidy in my opinion; ~~and~~ I think it is right that there should be a change (which ~~I think~~ they can well afford to bear. ~~but~~ It is right~~, I think,~~ on merit otherwise it would not have been included ~~there~~. But It is a complicated issue which no doubt we shall discuss very fully when we get to Committee stage ~~upstairs - or I assume it will be upstairs for~~ on this clause. As for the question of the banks and their foreign lending generally, I want to make it absolutely clear that I have not at any time interfered; I have not at any time urged the commercial banks to lend to particular Latin American countries or to re-schedule debts in a particular way. I have always made it absolutely clear that that is a decision which they must take on commercial grounds, and they fully accept that.

226. Chancellor, I accept that point and what you say - that you have not urged it - but surely you would agree, would you not, that bearing in mind the talks you have been involved in all over the world, including Japan and America, you are aware that British banks are heavily committed to this, and if they do now withdraw, of course they could afford to write it off but if their proper tax concession is now withdrawn and they decide not to re-cycle some of that debt, do you not think we would not be playing our part in trying to save some of the Third World countries going bust and up the wall?

(Mr Lawson) I think ~~provisionally~~ this years Finance Bill will have only a minor impact, if any, on their decisions in this area.

Mr Wainwright

227. I have two questions relating to the Inland Revenue: first of all, Corporation Tax yield, at any rate as estimated up to Budget Day, was some 15% higher than you had allowed for in your 1986 Budget. How far do you think that overshoot - and I suppose it might have almost equally turned out to be an undershoot - was due to the fact

that there is a huge overhang variously estimated in your Department of between 25 and 30 billion Corporation Tax losses which were fully agreed before you changed the law, and which are available entirely to wipe out liabilities? Now the Inland Revenue (so the Treasury assures me) does not collect and aggregate these agreed losses, although they are all on the files of the tax districts, so that there is no precise knowledge of the full extent of them - nor is there any knowledge of how much is being used up year by year, how much the glacier is being melted away year by year. Does not this not put the estimates for Corporation Tax yield into an impossible position?

(Mr Lawson) Let me respond to that in three ways. First of all, in forecasting tax revenues, I always believe in adopting a cautious approach. Secondly, this is a particularly complex and difficult field because ~~of course the tax losses,~~ the accumulated tax losses~~,~~ are distributed unevenly. The growth in company profits is also uneven, and therefore the way in which the two ~~things~~ mesh together and lead to a particular yield of Corporation Tax depends on the relationship between the pattern of improved profitability on the one hand and the pattern of accumulated losses on the other. The third answer I would give is this: ~~this was a question which you very properly put, or~~ a question very much on these lines ~~this territory~~ was one which you very properly put~~,~~ at the hearing with Treasury officials; ~~and~~ we undertook to let you have a note from the Inland Revenue on this, and that we shall do.

228. On an entirely different tax question of the proposed change you made in the Budget on the rate of Capital Gains Tax and insurance industry, the impression is, rightly or wrongly, that you have not yet said very much in explanation - let alone in defence - of this change which as you know has caused certain cries of pain from some quarters.

(Mr Lawson) I suppose you could call it, borrowing a phrase from Mr Budgen, fiscal neutrality. I think that it ~~would be~~ is reasonable that all companies' capital gains should be taxed in the same way, and I believe that ~~so far as~~ the change in the rate ~~goes it~~ is sensible. After all it is not capital gains tax for the most part which ~~they~~ companies are liable to, it is corporation tax~~, but~~ adjusted by a factor to make it ~~not corporation tax~~ apply at a different rate. ~~But~~ That was felt to be necessary at a time when the corporation tax rate was 52 percent. But Once the corporation tax rate ~~comes~~ came down to 35 percent it seem~~s~~ed to me no longer to make any sense at all to have a distinction between the corporation tax rate and the rate on other income flowing into the company. ~~and, of course,~~ For small companies again this is a change; ~~because it~~ the small companies' rate of corporation tax was 42 ~~odd~~ per cent when we came to office and ~~now~~ with that now down to 27 percent they would ~~actually be~~ have been charged more on their income from gains than ~~they were~~ on their income from other activities. ~~and then~~ Of course there is still the difference that there is indexation on gains. ~~But~~ There was also a longstanding complaint ~~of~~ about the effective double taxation of companies' gains ~~through the non-offsetability for~~ because gains could not be offset against ACT ~~purposes and,~~ Although that could have been put right without th~~is~~e change to the rates, it was very much easier to put it right by ~~bringing everything on to the straightforward corporation tax basis - everything~~ charging all gains at corporation tax rates and allowing them to be offsetable ~~for~~ against ACT. So I believe this is a better system and one, as I say, closer to fiscal neutrality than the earlier one.

Chairman

229. Roughly what do we think the additional revenue will be?

(Mr Lawson) It is in the Red Book. Let me refresh my memory ~~rather than rely on it~~. You mean from the insurance companies or in total?

230. Insurance companies.

(Mr Lawson) I think , speaking from memory, that the actual yield from gains on policy holders' funds,which is where I think the dispute arises rather than on shareholders' funds, is £20 million, which is a tiny fraction of the total amount of tax they pay.

231. Will it have a retrospective effect on existing policy holders?

(Mr Lawson) No, not what I would understand as retrospective.

Mr Mitchell

232. Chancellor, why do all the figures you have given us on things like investment and growth and job creation proving how successful the Government has been - with the greatest Chancellor since Sir Geoffrey Howe - miss out the years 1979-81?

(Mr Lawson) They do not fully do that. But I just felt that there ~~are~~ were so many different starting dates you can have...

233. What would the growth rate be?

(Mr Lawson) There ~~are~~ were so many different starting dates you can have; ~~you cannot even take when you are doing~~ for international comparisons - which is what I was doing - you cannot even do the measurement from cyclical peak to cyclical peak, because the cyclical peak is in different years ~~for~~ in different countries. ~~so~~ It seemed to me the simple commonsense solution was to take the decades. So I took the decades, the 1960s, the 1970s and the 1980s. ~~and~~ The difference is so striking, I think, that nobody can really cavil at it.

234. What would the economic growth rate be if you averaged out from 1979 per annum?

(Mr Lawson) The United Kingdom growth rate ~~if you took~~ from 1979 to 1986 would be ~~a~~ lower ~~rate~~ than it would be from 1980, obviously.

235. Say 1.4 percent?

(Mr Lawson) Something of that order.

236. Very low?

(Mr Lawson) Going up every year, because each year that goes on with a higher growth rate brings up the average.

237. I uncharitably wondered if it was not because so much damage was inflicted on British industry, a 28 percent loss of manufacturing capacity and 1.8 million loss of manufacturing jobs, in those years.

(Mr Lawson) No.

238. To really have any respectable performance at all you need to get growth now well above the half-cock rate of growth you had got, to repair the damage and bring down unemployment.

(Mr Lawson) It is not a half-cock rate of growth. What is forecast ~~at the present time~~ is 3 percent for this year. I recall an extremely well argued article you recently wrote, Mr Mitchell, in the Guardian saying that it was very stupid of the Labour Party to be crying "stinking fish" about the economy because it was totally implausible, because everybody knew the economy was doing very well. I think the line you took in the article in the Guardian was really one that did you more credit than the line you are taking for purposes which I cannot imagine this afternoon.

239. I am glad to know you are getting better informed, but the point is, Chancellor, you have recorded this high level of unemployment with the need to repair that damage and we do need a substantial and rapid rate of growth. There is an article by William Keegan in this Sunday's Observer ---

(Mr Lawson) I would not bother to ~~put~~ read that!

240. It is a very interesting and important article. "To return to anything like a civilised and just rate of unemployment an economy

needs several years of above average growth." Supposing you had returned to the rate you previously considered inadequate, it is not enough: that is correct, is it not?

(Mr Lawson) What is correct is that unemployment is coming down at the rate of something like 20,000 a month, which I would hope you would welcome, Mr Mitchell.

241. Is this niggardly rate of growth, by the standards achieved in the past by West Germany and Japan and which we have the potential of going over given unused resources and the fact that we have oil, the best the British economy can do or the best it can manage with your economic policies?

(Mr Lawson) There is no point in going on about the niggardly rate of growth. You know as well as I do that the rate of growth is historically high for this country; we are growing steadily at 2½ to 3 percent. This is not just a recovery from a recession - that period ended long since. ~~It has now~~ Output exceeded the 1979 ~~figure~~ level during the course of 1983 and since then it has been going on steadily up and up and up. Of course, we did have to clear up the mess that we inherited in 1979 and that took a little bit of time; ~~and that~~ it was a painful process and was not assisted by the fact that we then had the second oil shock, ~~at the time~~ with the world tipping into recession. But that is all past. ~~That is all past and~~ I do not think any purpose is served by harking back to the events of 1979-80. I am happy to discuss them, but I do not think it leads to any policy prescriptions for today.

242. Chancellor, it dodges the question rather thananswering it. Is this the best rate of growth the economy can manage or is it the best it can manage under your policies?

(Mr Lawson) ~~I think~~ The steady rate of growth of 2½ to 3 percent which we have been having has been in fact closer to 3 than 2½ oercent. Indeed, as Sir Terence Burns reminded Mr Sedgemore earlier on this afternoon, what we are forecasting within the 3 percent growth of the economy as a whole is something like 3½ percent for the non-oil economy, which is where the vast bulk of the jobs are. That, I think, is a satisfactory rate of growth. If we can on a sustained basis do better by improving the supply side of the eocnomy, which is what our policies are designed to achieve, then well and good.

243. So there is no hope of bringing unemployment down substantially, given the fact that in the last great time of inflation in the 1930s the rate of growth was 4 percent for a sustained period to bring unemployment down, which it did in the 1930s. With this rate of growth there is no chance of bringing unemployment down?

(Mr Lawson) But unemployment is coming down.

244. Substantially?

(Mr Lawson) Over the past 7 months at a rate of a little over 20,000 a month. That is not bad~~, not bad~~. It is still too high, I grant you, but it is coming down.

245. One of the arguments I put in that article in The Guardian which I am glad you have read was that a substantial proportion, say, of the growth of the profits, of the improvement in exports that has taken place is due to improved competitiveness. Now, it was wise of you therefore, taking over as Chancellor, to adopt Labour's policy of 1983 which was a 30% devaluation which you have given us, but since being responsible for so much of the improvements that have taken place, can I ask why you resisted it for so long? Why, each time the pound came down, you put up interest rates, and why you are still resisting it coming down to its natural level by high interest rates?

(Mr Lawson) I tell you why we have resisted it for so long - because it was plumb wrong. ~~and~~ That is why we have continued to ~~do so.~~ resist that prescription. Peter Shore I think it was, maybe under your tutelage, in 1982 called for two things: a 30% devaluation ----

246. Which we now have.

(Mr Lawson) ---- of the pound, and a substantial increase in ~~the~~ public borrowing - in other words, a fiscal boost. What we have had is a 20% devaluation of the pound of which over half was associated with the oil price collapse. He knew nothing about that coming any more than I did, and if he had done that 30% when he said he wanted to, then he would have undoubtedly felt he had to do ~~then~~ still more~~,~~ following the oil price collapse in 1986. So he would have been talking about something like a 40% at least devaluation, whereas what we have had is 20%. And so far~~,~~ from the public borrowing increasing as a share of GDP in the way he wanted it to, we have reduced public borrowing. ~~and~~ It would have been disastrous had we followed his prescription in either respect. That is why we have not done so.

247. The fact is the pound has come down; there are substantial benefits flowing from the new competitiveness, and you resisted it all the way down and you still are. Are we going to get investment? You forecast in the last Red Book that investment will go up by 5% growth. That has not occurred. Are we going to get the growth in investment? Are we going to get the economy growing more substantially than it is, unless you get interest rates down and the pound down still further?

(Mr Lawson) We have very good forecasters in the Treasury. They are certainly fallible, but they are better than any outside forecasters, and that is why The Guardian has just given them the "Golden Guru" award! ~~But~~ 1986 was a peculiarly difficult year to forecast because of the dislocating effect on the world economy of the collapse in the oil price. But there is no reason whatever to believe that the Treasury's excellent track record in forecasting ~~does~~ will not apply to our forecasts for 1987. Time, however, will tell. We will have this meeting, no doubt, in a year's time and Mr Mitchell will be able to go over this again!

248. How much of the failure to get that investment increase was in manufacturing?

(Mr Lawson) You mean how much of the forecasting error was in manufacturing?

249. Yes.

(Mr Lawson) I do not know.

(Sir Terence Burns) It just had its share the same as the other private sector components.

250. One final question on forecasting, since you raise the effectiveness of the forecasters: you said in the Financial Times that the Treasury forecast for the Public Sector Borrowing Requirement for

1986-87 was "up the pole". Could I ask Sir Terence Burns whether you were right in saying that, and if you were right in saying that, have you had to change any of their forecasts this year to improve them in the same way - kind of "fiddling while Terry Burns" - or are any of the forecasts this year "up the pole"?

(Mr Lawson) You are referring to my comment on the internal October forecast~~, I think,~~ of the PSBR? I think the question is directed at you, Sir Terence ~~Terry~~, but you do not have to answer it if you do not want to. I am the person on the stand!

(Sir Terence Burns) I do not think if one looks back at some of the forecasts we made last year the errors are any greater than we have made on some previous occasions. As we know, as the year went on, new information emerged and indeed the outturn of the PSBR was (and we think it is going to be for 1986-87) a good deal less than we thought last September/October.

(Mr Lawson) There is a seasonal pattern.

251. Is it possible that any of this year's forecasts are "up the pole" in the same way?

(Mr Lawson) I do have a certain advantage. I have been a Treasury Minister for over 6 years, and I have detected a seasonal pattern in the forecasters' forecasts; so I am able to aim off ~~(although they are meant to be seasonally adjusted they are not) at this seasonal pattern.~~

(Sir Peter Middleton) He aims off for us, and we for him. And ~~but~~ together we get a very good forecast!

Mr Banks

252. Chancellor, firstly let me say how grateful I am to you for your advice to me on how best to use my credit cards! Secondly, could I ask for some more advice on the question of balance of payments

in respect of invisible earnings, because I am a little bit confused in this area? During 1986 there was a revision upwards in the monthly calculated invisible earnings and then when the final outturn figure for 1986 was given it showed a revision downwards by 1.5 billion, I believe. Are you satisfied with the ways in which invisible earnings are calculated, and to what extent do you feel in the documents before us that one can rely on Treasury estimates for 1987?

(Mr Lawson) These figures for the invisible earnings and indeed the revisions do not emanate from the Treasury at all. We are merely consumers of these figures. The figures are produced by the Central Statistical Office. It is of course one of the areas that ~~I think~~ is intrinsically difficult to get right, and it is not surprising that there tend to be adjustments after the event for some time. Having said that, I think that what happened this year was unfortunate and I would hope that the Central Statistical Office can avoid it ~~that sort of thing~~ in the future. As for our overall position as a nation, ~~I think that~~ even making full allowance for the uncertainties there are in the figures of invisibles, we now have overtaken the United States and we now have the biggest invisible surplus of any country in the world; and that is something that is set to ~~will~~ continue ~~to be the case~~. / trs

253. In 1979, one of the first things that your Government did of course was to abolish exchange controls, and I suppose stemming from that one can claim that a great deal of earnings have been achieved in terms of money that has gone abroad and been invested. Do you have any way of estimating the impact on domestic investment of the outflow of capital from this country at all, and if so, are you able to say what differences that might have made on economic growth?

(Mr Lawson) I cannot give you a figure, but insofar as there has been an impact on domestic investment, I would expect it to be favourable. I am talking here about ~~This operates through~~ direct ~~British~~ investment overseas, not portfolio investment which I would say is neutral as regards investment in this country. Where there is direct British investment overseas, ~~I think~~ British companies overseas are more likely to purchase their requirements from Britain at the margin~~: they are more likely to purchase their requirements from Britain~~ than are, say, German owned companies or Japanese owned companies, and to the extent that that happens then obviously it has a favourable impact on investment in this country. There have been some studies done on this which I think lead to this conclusion.

254. Well, taking that point, it is also true that I think in 1983 we had the first balance of payments deficit on manufactured goods, and that deficit has increased alarmingly, so I believe some commentators have said, since 1983. First of all, in various statements I have heard you make, you do not seem particularly concerned. You do not think there is any long term damage likely to the economy because of this substantial and growing balance of payments deficit on manufactured goods?

Secondly, do you see that ever being turned round and round again or in what period of time do you see us perhaps moving back into surplus, because one was always brought up to believe that as a manufacturing nation on what we produce in terms of manufactured goods depends our worth.

(Mr Lawson) The economy has developed considerably. What I would certainly expect to see over a sustained period is that the current account as a whole would be in balance. That does not mean to say one particular component has to be in balance. I have already pointed to our invisible surplus which would suggest that you would expect visibles to be in deficit if the overall current account is in balance. One of the reasons also why I am not as concerned as you appear to be is because what I look to is the performance of British industry and in particular manufacturing industry in export markets; and our manufacturing exports are doing extremely well. British industry is doing very well in world markets. That is a real test of how competitive and effective we are. You can see this if you look at the proportion of our manufacturing output which we export. When we first took office we exported something like a quarter of our manufactured output; we now export getting on for a third. if you look at the latest trade figures - I do not want to place too much importance on one month's figures - they continue a pattern we have seen for some time [~~(it is not just one offbeat month, they continue a pattern)~~] in which Britain's exports have been rising faster than the exports of pretty well all our major competitors.

255. You said, Chancellor, that we were exporting a quarter of our manufacturing output and it is now a third. Could that be, of course, because our manufacturing output is that much smaller than it was in 1979 so that again is not a great success story?

What I find difficult to udnerstand is why it is that we have this capacity to suck in imports of manufactured goods in the very areas where you would have thought the British economy was able to provide those goods themselves - motor vehicles, for example, electrical goods. There is not a declining world market for these, there is an increasing world market. We do not seem able to produce the goods people in this country want to buy.

(Mr Lawson) Well, we do. What you are talking about are, relatively speaking, marginal differences; but I would not say they are totally without significance. On ~~the~~ your first point, on the statistically ~~point~~, the change in the ratio which I mentioned is overwhelmingly due to the increase in manufacturing exports. There has been a very, very small decline in the total manufacturing output, but it is overwhelmingly the big increase in manufacturing exports which accounts for ~~that~~ the change in the ratio. As for why we appear to have to import manufactured goods from overseas, I suppose that this is partly because we have a particularly efficient retailing sector in this country which does scour the world to provide the British customer with the best value for money, the latest fashions, whatever it happens to be. In some other countries their retail sector is not as highly developed. But I believe British industry is capable of rising to the challenge and that is again one of the reasons why I was so encouraged to see the very bullish survey of trends in manufacturing industry ~~- not for the whole of industry, for manufacturing industry -~~ which the CBI put out last Tuesday.

Chairman

256. Chancellor, obviously we wish to study carefully the various answers you have given to us. Could I just pick up one point you made on the currency bands in relation to the various international monetary agreements. I think you said the other countries

did not publish the bands. Our impression was previously that, although the Japanese had claimed there were such bands, the other countries had not actually admitted they existed?

(Mr Lawson) I am not saying whether they exist or not. What I am saying is, we do not publish the nuts and bolts of the Paris Accord. That is slightly different.

257. Well, I understand it is slightly different, but are you saying no such bands exist or not?

(Mr Lawson) I am saying that we did go into the question of currency fluctuations very thoroughly. We did go into the nuts and bolts, but we also agreed we woudl not reveal those to the market and I think that was sensible, and I am sure you will understand why.

258. I may not have made my question very clear. I understand you do not propose to reveal the limits within which the band may exist. What I was not quite clear from your answer was whether such bands exist eventhough the limits are not announced.

(Mr Lawson) I think it did follow from my answer that I did not wish to reveal the precise nature of the agreement.

259. What is the advantage of that?

(Mr Lawson) The advantage of that is so as not to make it easy for the operators on the foreign exchange market to speculate or deal successfully against the policy of the countries represented at the Louvre .

260. How would the existence of bands enable them to do that if they did not know the figures?

(Mr Lawson) It is the first step towards finding out the figures, is it not?

Chairman: We shall wait and see whether that is so. Mr Chancellor, thank you very much indeed, and you, Sir Terence and Sir Peter, for coming alogn this afternoon. As I say, we hope to have produced our report in time for the Second Reading of the Finance Bill, and we are most grateful to you for your evidence.

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From: SIR PETER MIDDLETON
Date: 30 March 1987

CHANCELLOR

FUNDING WORDS

You could either:

(a) simply quote the words from the BEQB in paragraph 2 of Peretz; or

(b) slightly amplify your 1983 and 1985 MHS statement as follows:

> "I have said consistently since 1983 that the aim of funding policy is to fund the PSBR by raising finance outside the banking system from the UK private sector, and from external flows. External flows include both the purchase of government stocks by the overseas sector and changes in the reserves - as is made clear in the monthly press notices on the money and banking figures".

2. Note that in 1983 you said "... and from external flows, to which too little attention is often paid".

PEM

P E MIDDLETON

15/3070

FROM: DAVID PERETZ
30 March 1987

SIR PETER MIDDLETON

cc Sir T Burns

FUNDING AND INTERVENTION

I said I would send you the various references. I am not sure I can do much better than attach the note I circulated on 17 March. I also attach the relevant extracts from:-

(i) 1983 Mansion House Speech

(ii) the 1985 Mansion House Speech

(iii) the December 1984 BEQB Bulletin article

(iv) a paragraph in the most recent BEQB about the objectives of funding policy.

(v) The paragraph from the full money figures press release (which came out at 11.30am this morning) showing the funding arithmetic for February.

2. The full statement of funding policy appears in each issue of the BEQB in the following terms:-

> "The objective of the authorities during the period under review remained that of fully funding the PSBR over the financial year as a whole through debt sales to the non-bank private sector and external and foreign currency finance of the public sector."

Intervention - or more accurately the underlying movements in the foreign exchange reserves - is one of the elements of external and foreign currency finance of the public sector. If the reserves increase then that is a negative contribution to funding: perhaps you could say it is rather like repaying sterling debt; or that we have to borrow more sterling to pay for the acquisition of dollars. If there is an underlying fall in the reserves then that helps to fund the PSBR.

DLCP

D L C PERETZ

7/3070G

WHAT DOES FUNDING THE PSBR MEAN?

1. Funding policy continues to be to fund the PSBR fully, and no more, over each financial year. For this purpose "funding" is as defined in:-

(i) The Chancellor's 1983 Mansion House Speech, where the Chancellor said that the broad aim of funding policy would continue to be "to fund the PSBR, by raising finance outside the banking system from the UK private sector, and from external flows". These words were referred to in the 1985 Mansion House Speech, in which the Chancellor defined the present policy.

go to 4 or to press notice para 8.

(ii) The regular Bank of England Quarterly Bulletin articles about the operation of monetary policy, which include a statement that the objective of funding policy is to fund the PSBR through debt sales to the non-bank private sector and external and foreign currency finance of the public sector.

(iii) The Bank of England's regular money supply press notices, which give a figure for the "public sector contribution to the growth in £M3" defined as the PSBR less debt sales to the non-bank private sector and external flows to the public sector, during the month. (When the move to calendar month reporting was made last autumn, the "counterparts" in the Bank's press notice were adapted so that the first two lines of the table show the PSBR and "funding".)

2. The main reference work is an article in the December 1984 Bank of England Quarterly Bulletin, which discusses funding the PSBR in more detail. The definition we use is the one referred to in that article as the "wider definition". That article explains the ways in which external and foreign currency transactions restrain the growth of liquidity, in the same way

as public sector debt sales to the non-bank private sector. The aim of the policy is to neutralise the effect of public sector transactions on liquidity.

3. **The treatment of intervention** is not always understood. Following the convention used by the CSO in the National Accounts it is treated as financing or negative financing (depending on the direction of change) of the PSBR rather than as something that serves to increase or reduce the PSBR itself. This is because intervention simply alters the mix of the government's financial assets and liabilities, and has no direct implications for government expenditure. Funding policy ensures that over the financial year as a whole the effect of intervention on domestic liquidity is sterilised.

4. The complete list of transactions that fund the PSBR is as follows:

- Purchases of public sector debt by UK nbps

    Other Public Sector debt (LA and PC debt)
    Central Government debt

        British Government stock
        Other (eg National Savings, CTDs, Treasury Bills).

- External and foreign currency finance of public sector

    Purchase of British Government stocks by overseas sector.

    Other (eg intervention/underlying change in reserves (increase +), overseas holdings of notes and coins (increase -)).

Monthly and quarterly figures are given in BEQB Table 11.3 and Financial Statistics Table 11.5.

Funding outturn 1985-86, and in 1986-87 to date

5. The February 1987 editions of the BEQB and Financial Statistics show an underfund in 1985-86 of £425 million and £420 million respectively (the figure for 1985-86 is still subject to small revisions). The money supply press notice for January 1986 showed a net overfund of about £3.7 billion in the first 10 months 1986-87 (figures for February will be published on 19 March).

Extract from Mansion House Speech, Thursday 20 October 1983

(a)

1983 Mansion House

24. The broad aim of funding policy will continue to be to fund the PSBR, by raising finance outside the banking system from the UK private sector, and from external flows, to which too little attention is often paid. By thus limiting the public sector's contribution to monetary growth, this will provide a basic control of the growth of liquidity, however measured. As in the past there may be occasions when funding ought to be either higher or lower than the PSBR, in order to take account of the private sector's demand for credit, and to provide a measure of control if the wider aggregates are growing excessively rapidly. But over the medium term there should be no systematic tendency either to overfund or to underfund the borrowing requirement.

Extract from Mansion House Speech, 17 October 1985

Funding

1985 Mansion House

The approach I have just outlined to the assessment of monetary conditions also has implications for the conduct of funding policy.

The purpose of funding is, quite simply, to ensure that the Budget deficit is financed in a non-inflationary way.

As I said on this very occasion, two years ago:

> "The broad aim of funding policy will continue to be to fund the PSBR, by raising finance outside the banking system, from the UK private sector and from external flows ... Over the medium term there should be no systematic tendency either to overfund, or to underfund, the borrowing requirement."

That was the intention.

But in practice, short-term considerations came to make overfunding almost a way of life. And that cannot make sense. It introduces distortions into the financial markets - not least a rapidly growing bill mountain - which are undesirable in themselves and can make policy harder to operate.

Accordingly, we are no longer seeking to control the recorded growth of £M3 by systematic overfunding. As I have said, we do not believe the recent behaviour of £M3 gives cause for alarm. But should it at any time become desirable to tighten monetary conditions, that would be achieved - and let there be no doubt about this - by bringing about a rise in short-term interest rates. The objective of funding policy is to fund the PSBR over the year as a whole: no more, no less. And that we are doing.

(C)

Funding the public sector borrowing requirement: 1952–83

This article[1] reviews the way in which the public sector borrowing requirement (PSBR) has been financed over most of the post-war period, concentrating on the implications of that financing for the banking system and monetary developments more widely. Since the adoption of targets for broad money in 1976, funding policy has assumed particular importance. Associated with this, certain developments, notably the occurrence in some periods of sales of debt to the non-bank private sector in excess of the PSBR, ie 'overfunding', and the potential implications of this for the liquidity of the banking system, have attracted much attention. This article seeks to set these developments in a longer historical context.

The various transactions by which the PSBR may be financed are described, together with the evolution of the pattern of financing, and the implications of funding for the monetary aggregates are examined. Overfunding is not a new phenomenon, although the influences which have given rise to it have changed over time. A number of factors have recently contributed to pressures on the liquidity of the banking system, so that overfunding has not been the sole, or even the dominant, influence underlying the accumulation of commercial bills by the Issue Department of the Bank.

How the PSBR is financed

In every year since 1952 bar one (1969), current and capital expenditure by the public sector has exceeded revenue and this deficit has had to be met by borrowing. The public sector can borrow from any of three sectors: the non-bank private sector, the overseas sector, and the monetary sector.[2] The division of financing among these three main categories is shown in Table 1.[3] Financing flows include changes in certain financial assets held by the public sector as well as all changes in public sector liabilities, both interest and non-interest bearing.[4] The way in which the PSBR is financed has important monetary implications. Some of the liabilities issued directly by government are money (notes and coin). In addition, interest-bearing government debt may be purchased by financial institutions which themselves issue monetary liabilities. The division of public sector finance between different sectors is therefore of special interest.

The non-bank private sector—consisting principally of households, financial institutions other than banks and companies—contributes to the financing of the PSBR through the purchase of both marketable and non-marketable debt. Marketable debt consists predominantly of government securities and Treasury bills. Non-marketable public sector debt consists mainly of the range of national savings instruments and certificates of tax deposit.[5] Increases in the non-bank private sector's holdings of notes and coin (shown separately in Table 1) also contribute to the financing of the public sector. They will give rise to a number of change to the balance sheets of the commercial banks and the Banking Department.[6] But ultimately (other things being equal) they will result in the Issue Department's liabilities increasing (as the note issue rises), together with its holdings of government securities, so reducing the amount of public sector debt which needs to be sold elsewhere to finance a given PSBR.

Dec84 BEQB

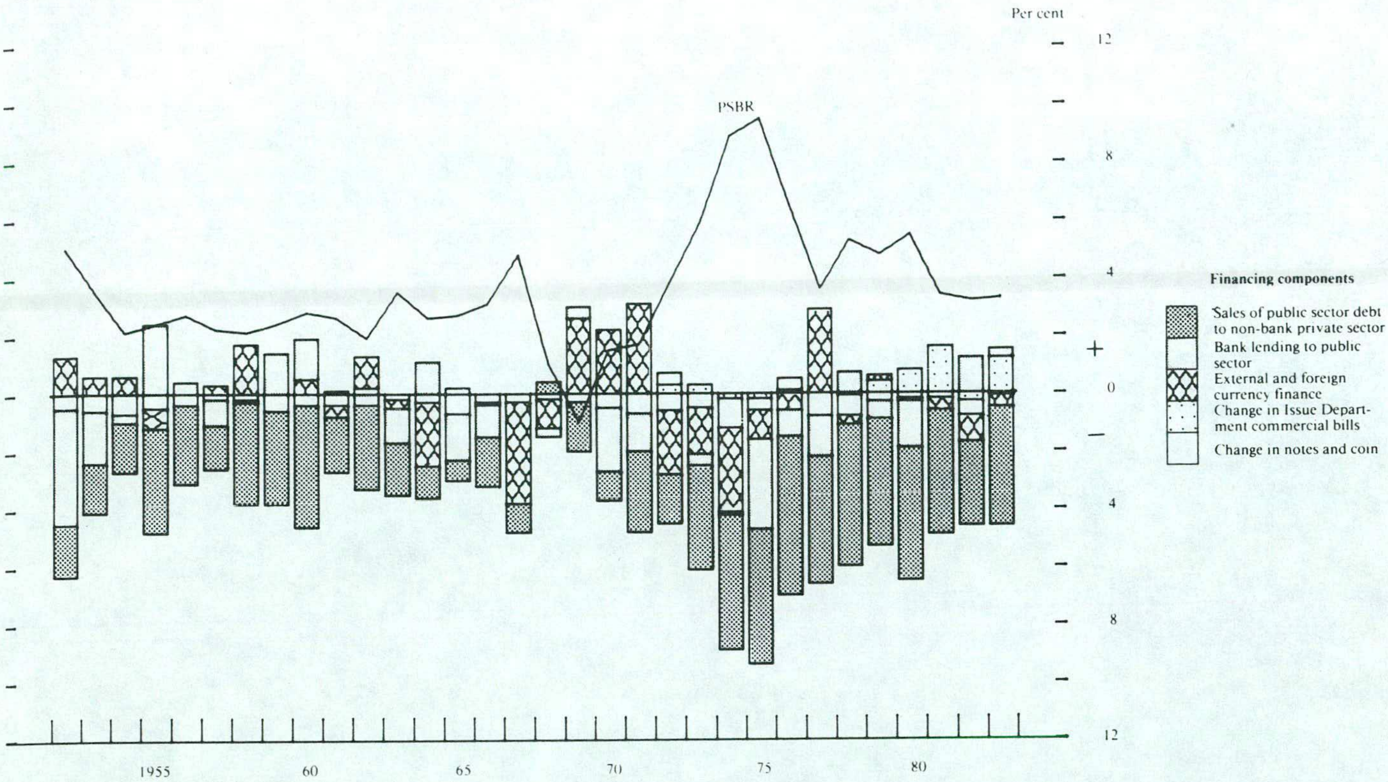
The overseas sector contributes to the financing of the public sector in part through non-resident purchases of public sector debt. These overwhelmingly take the form of purchases of government securities and Treasury bills by both official and private holders. The second element in external and foreign currency finance is foreign currency borrowing by the UK public sector from UK and overseas banks: this assumed particular importance in the mid-1970s when a considerable amount of foreign currency borrowing was undertaken at a time of external weakness. The proceeds of foreign currency borrowing may help directly to finance the public sector if used to purchase goods and services in foreign currency or in sterling (after conversion on the foreign exchange market).

Changes in the official reserves, arising from transactions in gold and foreign exchange, also contribute: the sterling proceeds of official sales of foreign exchange are used by the Exchange Equalisation Account (EEA) to repay

(1) Primarily the work of P A D Wright of the Bank's Economics Division.
(2) The monetary sector has only existed for statistical purposes since November 1981: prior to that, it is identified with the banking sector (from 1963) and before that with the London clearing banks.
(3) Recent figures are published in *Financial Statistics*, Table 2.6.
(4) The correspondence between the financing of the PSBR and changes in the national debt, as defined in the article on page 493, is not very close. The national debt consists of certain liabilities of central government (and, in the article on page 493, stocks issued by nationalised industries and guaranteed by the government). A reconciliation between the CGBR (which is of course only part of the PSBR) and changes in the national debt is given on page 496.
(5) And (prior to 1975) tax reserve certificates.
(6) The Banking Department of the Bank of England is part of the monetary sector along with the commercial banks.

Chart 1
PSBR and its financing as percentage of GDP[a]

Net borrowing +; net financing −



(a) Expenditure measure at market prices. For clarity and consistency with the tables, total borrowing has the opposite sign to the individual sources of finance.

outstanding government debt. Thus, in effect, they reduce the amount of government debt sales needed to finance a given PSBR. (It follows that there is no net effect on government financing where the proceeds of foreign currency borrowing are added to the reserves.)

The importance of this form of financing will obviously depend on the extent of official intervention in the foreign exchange markets. Until 1972 the authorities had an obligation to maintain the international value of sterling within a narrow margin either side of a fixed parity. The intervention required in this connection implied a direct link between external pressure on sterling and the contribution of the EEA to financing. Since then, no official peg for the exchange rate has existed and the authorities have exercised discretion in deciding whether, and by how much, to intervene to moderate changes in the exchange rate. There were several occasions in the mid and late 1970s when intervention was very heavy, notably in 1977. Since 1979, however, intervention has taken place on a much smaller scale.

The monetary sector also helps to finance the public sector through its holdings of cash and marketable and non-marketable debt (the latter being mainly certificates of tax deposit). In fact, historically, the monetary sector has been the residual source of finance for the public sector: this used to be secured through members of the discount market agreeing to underwrite the weekly Treasury bill tender. More recently, the public sector has changed from debtor to the monetary sector to short-term creditor. The amount of outstanding Treasury bills has been run down to a minimum level consistent with maintaining a Treasury bill market in existence, and the Issue Department of the Bank (which is included in the public sector rather than the monetary sector) has built up a portfolio of commercial bills. This development, which is explained later, has taken place against a need to provide assistance on a considerable scale to offset cash shortages in the money markets arising in part from central government debt sales in excess of the shortfall in other Exchequer transactions.

Scaling by prices and output[1]

The data shown in Table 1 are in nominal terms, ie at the prices prevailing in each of the years under consideration. Since the price level increased approximately nine-fold over the period and real output has more than doubled, it is difficult to discern real trends in the composition of financing from these data.

The PSBR and the main financing flows have therefore been recalculated as a percentage of nominal GDP for each year (Chart 1).[2] After a period of considerable stability

(1) Adjusted using the GDP deflator derived from national income statistics. The adjustment to constant prices throughout this article should not be confused with the concept of 'inflation adjustment' which has been used elsewhere, as in 'Real national saving and its sectoral composition' by C T Taylor and A R Threadgold, *Bank of England Discussion Paper No 6*, October 1979.

(2) All data, in both charts and tables, are for calendar years up to and including 1962 and financial years thereafter. References to years in the text should be interpreted accordingly.

Table 1
Financing the PSBR

£ millions, current prices
Borrowing and Issue Department purchases+/financing flows–

	PSBR(a)	Purchases of public sector debt by the non-bank private sector: Central government debt: Non-marketable(b)	Stocks	Treasury bills	Total	Other public sector debt	Total	Bank lending in sterling to the public sector: Central government debt: Stocks	Treasury bills	Other(c)	Total	Other public sector	Total	External and foreign currency finance of the public sector: Stocks and Treasury bills	Change in the reserves (d)	Other central government transactions(e)	Other public sector debt	Total	Change in notes and coin held by the public	Change in Issue Department holdings: Commercial bills	Export and shipbuilding credit
	1						2						3					4	5	6	7
Calendar years																					
1952	+ 794	+ 155	–353		– 198	– 94	– 292	– 220	– 512	+ 109	– 623	– 19	– 642	+ 398		–186	—	+ 212	– 72	—	
1953	+ 593	+ 45	–232		– 187	– 100	– 287	– 260	– 75	+ 13	– 322	+ 23	– 299	– 241		+344	—	+ 103	– 110	—	
1954	+ 371	– 147	+ 21		– 126	– 171	– 297	– 109	+ 111	+ 15	+ 17	– 75	– 58	– 147		+262	– 3	+ 112	– 128	—	
1955	+ 470	+ 79	–645		– 566	– 134	– 700	+ 403	– 99	+ 20	+ 324	+ 132	+ 456	+ 50		–182	+ 2	– 130	– 96	—	
1956	+ 573	– 11	–166		– 177	– 394	– 571	+ 59	+ 138	– 45	+ 152	– 76	+ 76	+ 103		– 93	– 13	– 3	– 75	—	
1957	+ 487	– 42	+ 85		+ 43	– 364	– 321	+ 32	– 217	– 45	– 230	+ 42	– 188	+ 112		– 37	+ 1	+ 76	– 54	—	
1958	+ 491	– 201	–266		– 467	– 340	– 807	– 144	+ 190	+ 10	+ 56	– 70	– 14	+ 41		+341	– 1	+ 381	– 51	—	
1959	+ 573	– 332	– 86		– 418	– 352	– 770	+ 418	– 31	– 14	+ 373	– 40	+ 333	– 91		+114	– 25	– 2	– 134	—	
1960	+ 710	– 320	–475		– 795	– 287	– 1,082	+ 365	+ 253	– 186	+ 432	– 78	+ 354	– 245		+404	– 40	+ 119	– 101	—	
1961	+ 704	– 164	+ 86		– 78	– 432	– 510	+ 162	– 43	– 91	+ 28	– 8	+ 20	+ 213		–277	– 53	– 117	– 97	—	
1962	+ 546	– 91	–258		– 349	– 482	– 831	– 328	+ 110	+ 177	– 41	– 74	– 115	+ 142		+239	– 51	+ 330	+ 70	—	
Financial years																					
1963/64	+ 1,083	– 99	+ 24	+ 89	+ 14	– 563	– 549	– 16	– 89	– 150	– 255	– 120	– 375	– 141	– 55	+ 130	– 23	– 89	– 70	—	
1964/65	+ 880	– 154	– 13	+126	– 41	– 359	– 400	+ 141	+ 418	– 19	+ 540	– 175	+ 365	+ 127	– 118	– 729	– 23	743	– 102	—	
1965/66	+ 995	+ 165	+ 29	+ 19	+ 211	– 464	– 253	+ 36	– 415	– 155	– 534	– 45	– 579	+ 141	+ 128	– 221	+ 30	+ 78	– 241	—	
1966/67	+ 1,217	+ 145	– 556	+ 38	– 372	– 281	– 653	– 562	+ 450	– 88	– 200	– 210	– 410	+ 55	– 112	+ 11	+ 17	– 29	– 125	—	
1967/68	+ 1,982	– 27	– 17	+ 1	– 44	– 383	– 427	+ 110	+ 41	+ 119	+ 270	– 271	– 1	+ 49	365	–1,151	+ 19	–1,448	– 106	—	
1968/69	+ 466	+ 60	+ 422	+ 42	+ 525	– 355	+ 170	+ 551	+ 34	– 312	+ 273	– 393	– 120	+ 112	– 105	– 473	+ 19	– 447	– 69	—	
1969/70	– 511	+ 254	– 899	+ 7	– 639	– 162	– 801	+ 93	+ 317	+ 122	+ 532	– 324	+ 208	– 42	– 71	+1,461	– 115	+1,233	– 129	—	
1970/71	+ 804	– 112	– 477	+ 5	– 584	+ 44	– 540	– 61	– 124	– 290	– 475	– 690	–1,165	– 186	+ 128	+1,311	– 70	+1,183	– 288	+ 6	
1971/72	+ 1,005	– 485	–1,235	+ 4	– 1,716	+ 21	– 1,695	– 819	– 125	+ 550	– 394	– 351	– 745	– 401	+1,399	+1,047	– 172	+1,873	– 433	– 5	
1972/73	+ 2,532	– 267	– 516	+ 5	– 778	– 337	– 1,115	+ 976	– 1	– 654	+ 321	– 41	+ 280	148	811	– 277	– 266	–1,502	– 421	+ 226	
1973/74	+ 4,450	+ 116	–1,499	+ 6	– 1,377	–1,334	– 2,711	– 11	+ 158	– 730	– 583	+ 282	– 301	+ 17	+ 123	+ 74	–1,434	–1,220	– 411	+ 193	
1974/75	+ 7,950	– 69	–2,290	– 49	– 2,408	–1,768	– 4,176	+ 52	– 437	+ 459	+ 74	– 201	– 127	1,073	+ 280	– 999	– 832	–2,624	– 874	– 149	
1975/76	+10,604	– 478	–3,859	–807	– 5,144	– 144	– 5,288	– 357	–1,875	– 436	–2,668	– 756	–3,424	+ 575	619	– 523	– 602	–1,169	– 460	– 263	
1976/77	+ 8,514	– 972	–5,797	+349	– 6,420	– 755	– 7,175	– 161	+ 518	+ 281	+ 638	– 55	+ 583	+ 69	+2,166	–1,685	–1,711	–1,161	850	+ 89	
1977/78	+ 5,520	–1,488	–4,914	–330	– 6,732	+ 82	– 6,650	– 967	+ 512	– 957	–1,412	– 685	–2,097	413	+6,345	–1,058	– 525	+4,349	–1,152	+ 30	
1978/79	+ 9,212	–2,688	–6,179	+676	– 8,191	– 326	– 8,517	+ 24	+ 200	+1,624	+1,848	– 719	+1,129	– 80	–1,523	+ 828	+ 193	– 582	–1,141	– 101	
1979/80	+ 9,932	+ 127	–8,328	– 7	– 8,208	– 952	– 9,160	+ 357	+ 263	– 398	+ 222	–1,554	–1,332	–1,390	+ 381	+ 763	+ 595	+ 349	– 554	+ 765	
1980/81	+13,173	–2,508	–8,871	– 74	–11,453	+ 638	–10,815	–2,684	+ 694	– 226	–2,216	–1,503	–3,719	–1,181	– 5	+ 837	+ 132	– 217	– 437	+2,015	
1981/82	+ 8,794	–4,473	–7,146	–102	–11,721	+ 392	–11,329	+1,392	+ 87	+ 309	+1,788	–1,902	– 114	– 110	–2,749	+1,445	+ 315	–1,099	– 492	+4,240	
1982/83	+ 9,161	–3,907	–4,609	–192	– 8,708	+ 270	– 8,438	+ 136	+ 142	+ 507	+ 785	+2,546	+3,331	– 802	–2,062	+ 346	+ 226	–2,292	–1,415	– 787	+ 440
1983/84	+10,043	–3,067	–9,763	+ 11	–12,819	+ 332	–12,487	– 708	– 19	+ 144	– 583	+1,504	+ 921	–1,230	– 28	+ 71	– 216	–1,404	– 219	+3,586	– 440

(a) The PSBR definition used here is that which applied before the 1984 Budget and thus includes changes in public sector bank deposits. Net borrowing is recorded as a plus in this column while financing items in the rest of the table are recorded with the opposite sign. Thus column 1 *equals* the sum of columns 2–7, but with opposite signs.

(b) Includes national savings, certificates of tax deposit, and Northern Ireland debt.

(c) Banking sector purchases of other central government debt consists mainly of certificates of tax deposit and (prior to 1975) tax reserve certificates, changes in holdings of notes and coin, Northern Ireland debt and changes in government indebtedness to the Banking Department. The trustee savings banks' claim on the Fund for banks for savings is included from 1982/83.

(d) Changes in reserves exclude changes resulting from allocations of special drawing rights.

(e) Other central government transactions consist of foreign currency borrowing and net transactions with overseas monetary authorities (foreign currency borrowing by local authorities and public corporations under the exchange cover scheme are not included). Changes in overseas holdings of notes and coin are also included.

Borrowing from the monetary sector has also changed in importance over the period (bottom panel of Chart 2). Until the late 1950s, there were net repayments of government debt held by the banks. This was part of the protracted process of adjustment by the banking system from its wartime role which had been essentially one of intermediary between the private sector and government and which had left it with very large holdings of (mostly short-term) government debt. From the mid-1960s, however, the public sector overall became a more consistent and heavier borrower from the banks, although net repayments of central government debt continued on balance to the end of the decade, offset to some extent by bank lending to the rest of the public sector. The early 1970s saw several episodes of heavy borrowing by central government. In 1971, the London clearing banks agreed to subscribe for £750 million of government stock in order to reduce their liquid asset holdings as part of the transitional arrangements for the introduction of *Competition and credit control* (although holdings fell back sharply the following year). In 1974 and 1975, the monetary sector's holdings of Treasury bills rose sharply in the face of a rapidly growing PSBR and relatively slack loan demand from the private sector. In certain years, notably 1972 and 1973, calls for special deposits contributed to financing the PSBR since the proceeds were lent by the Banking Department to central government.

Perhaps the most striking feature of recent changes in the monetary sector's holdings of public sector assets has been the fall in holdings of Treasury bills since 1976. This reflects the persistent pressure which has been placed on the monetary sector's liquidity in recent years, partly as a result of the heavy sales of public sector debt other than Treasury bills. Such pressures were traditionally relieved by the Bank purchasing Treasury bills from the banking system. The persistent shortages of liquidity, however, inevitably led to a depletion of the stock of these bills in the hands of the monetary sector. The Bank has more recently relieved such pressures by purchasing commercial bills from the banking system, a development facilitated by the measures announced in 1981 to broaden the list of (eligible) banks whose bills the Bank is prepared to buy.[1]

It is possible to analyse changes in the banks' asset holdings corresponding to these developments (Chart 4). Changes in definitions and coverage prevent a totally consistent balance sheet being constructed for the monetary sector over the period as a whole. Nevertheless, the chart illustrates how lending to the public sector has declined in importance in the banks' total business. The scale of adjustment required from the banks' wartime role can be gauged from the fact that in 1952 government stock and Treasury bills together were equivalent to no less than 50% of total sterling deposits of the London clearing banks. Apart from a temporary reversal in 1975–77, banks' sterling lending to the public sector, and in particular to central government, has declined in importance continuously, so that by 1982 only 18% of the monetary sector's total sterling balance sheet comprised lending to the public sector. At the same time bank lending to the private sector has increased rapidly.

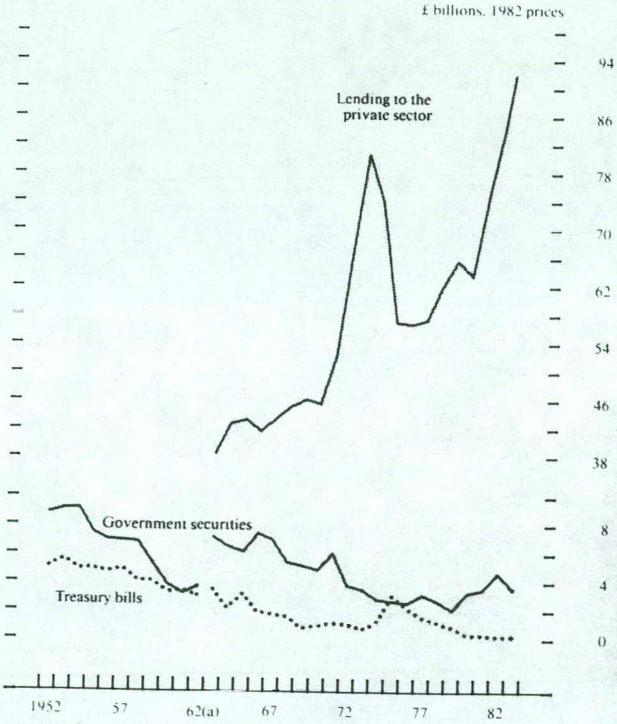
The monetary implications of alternative forms of finance

The government's deficit is always financed by one means or another so that the sum of the PSBR and the financing components in Table 1 necessarily is zero. The way in which financing is spread among the various sectors, however, has important consequences for the growth of the monetary aggregates. An important distinction is between borrowing from the non-bank private sector or the overseas sector on the one hand, and borrowing from the monetary sector on the other. For a given PSBR, an increase in sales of public sector debt to the non-bank private or overseas sectors will tend to reduce the growth of broad money, whereas borrowing from the monetary sector will not.

Funding and £M3

This can be shown in terms of the asset 'counterparts' to changes in £M3. These comprise changes in bank lending to the public, private and overseas sectors. Since banks form the residual source of finance to the public sector, it is usually helpful to consider bank lending to the public sector in terms of the total PSBR less that part financed

Chart 4
Sterling bank lending 1952–83



(a) Before 1962 figures relate to the London clearing banks; after 1962 to the banking sector.

(1) Recent changes in the Bank's operating techniques in the money market and the decline in the role of Treasury bills in favour of commercial bills are discussed in detail in the article, 'The role of the Bank of England in the money market', in the March 1982 *Bulletin*, pages 86–94.

less	other net sterling and foreign currency borrowing by central government (including changes in the reserves arising from transactions in gold and foreign exchange)
plus	all forms of money-market assistance by the Bank.

An increase in the public's holdings of cash will be reflected in reductions either in the banks' till money or, if banks need to acquire new notes from the Bank, in bankers' balances as these notes are paid for. As bankers' balances are replenished by the Bank's money-market operations, the last term in this identity will rise.

This identity for changes in M0, like that for £M3, has to be interpreted with care: it implies nothing about behaviour or the relationship between individual components. In addition, it should not be inferred that funding could be used as a means of exerting close short-term control over M0, because that would entail the Bank declining to buy bills in sufficient amounts to replenish bankers' balances when these were depleted by central government transactions. This, in turn, could leave the banks unable to meet their liabilities. Over a longer period, of course, it would be possible for the authorities, by underproviding money-market assistance, to put steady upward pressure on interest rates, which through its effect on the economy could reduce the demand for M0. The authorities' present methods of money-market intervention allow them to influence short-term interest rates but in a different fashion.

To keep the discussion manageable, the analysis in the remaining sections is in terms of definitions of funding particularly relevant to £M3.

External transactions and a wider definition of funding

So far, the discussion of funding has related the PSBR to domestic sales of public sector debt instruments. An alternative wider definition of over and underfunding takes account additionally of external and foreign currency finance of the public sector. Just as sales of public sector debt to the non-bank private sector help to restrain the growth in £M3, so do some of the external transactions by which the PSBR may be financed. For example, if overseas residents purchase British government securities and acquire the sterling to do so from the UK non-bank private sector, then UK residents' sterling deposits and hence £M3 will be reduced, in the same way as if these securities had been bought by the non-bank private sector itself. The extent to which the PSBR is over or underfunded on this wider basis, therefore, may help to provide a more complete picture of the effect of public sector finance on monetary growth: this picture may be particularly useful in periods when external finance of the PSBR is substantial.

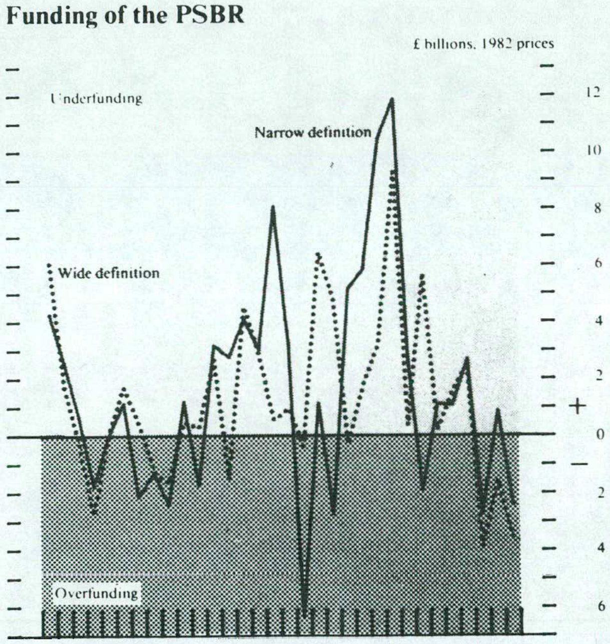
As with sales to UK residents, it does not automatically follow that sales of public sector debt to non-residents will depress domestic monetary growth by an equivalent amount. This will depend on non-residents' purchases being financed by bidding-away UK residents' sterling deposits. If, alternatively, the sterling required is provided by official intervention in the foreign exchange market, or if non-residents finance their purchases by running down their existing sterling deposits, there will be little or no effect on £M3.[1] Under normal circumstances, when the exchange rate is floating it is likely that such sales will have some restraining effect on the growth of £M3, though sales to domestic residents are likely to be more powerful.

Funding in an historical perspective

Chart 5 shows under or overfunding since 1952 on both narrow and wide definitions. Only rarely, if ever, has the PSBR been exactly fully funded. On the narrow measure, overfunding occurred in the late 1950s, again in the late 1960s, in 1977 and in two years since 1980, with periods of large-scale underfunding in between. In constant prices, the scale of overfunding in these latest episodes has been about the same as during the late 1950s, but rather less than in 1969 (when the PSBR was in surplus).

On the wide definition, although overfunding has been larger and more continuous since 1980, before then it was less common. This is because, particularly during the fixed exchange rate period, the conditions giving rise to strong domestic financial markets, substantial debt sales and (narrow) overfunding, would also normally be associated with external strength (and would imply rising reserves and positive external and foreign currency finance of the PSBR). The strong inverse relationship

Chart 5
Funding of the PSBR



(1) This is because non-resident holdings of sterling are excluded from all definitions of the UK money supply. These issues are more fully considered in the article 'External flows and broad money' in the December *Bulletin*, pages 525–9.

from non-bank sources. In this way, the following relationship can be shown to hold:

Change in £M3 *equals*		the PSBR
	less	net purchases of public sector debt by the non-bank private sector
	plus	the change in bank lending in sterling to the private sector (including Issue Department purchases of commercial bills)
	less	any increase in external and foreign currency finance
	less	increases in banks' net non-deposit liabilities.

It is important to remember that this is an accounting identity whose components are not independent of one another. The relation between the change in any one item and the growth in £M3 will not, therefore, generally be one for one. It is nevertheless true that the method by which the PSBR is financed is likely to have implications for the growth in £M3. At the simplest level, if sales of public sector debt to the non-bank private sector in a given period are exactly equal to the PSBR (ie the PSBR is 'fully funded' on the most familiar definition), then the government's domestic borrowing need have no statistical effect on the growth of £M3.

If, on the other hand, the PSBR is 'underfunded' on this basis (ie sales of public sector debt to the non-bank private sector are smaller than the PSBR), then domestic finance of the PSBR may contribute to the growth in £M3 if the government is forced to borrow from the banking system. Such borrowing has no direct effect on bank deposits but these will tend to rise as a result of the government spending which it finances. The net result is therefore to raise £M3, *ceteris paribus*. In contrast, when the PSBR is 'overfunded' (sales of public sector debt to the non-bank private sector exceed the PSBR), the growth of deposits and hence £M3 will tend to be reduced (since not all of the reduction due to the purchase of public sector debt by the non-bank private sector is replenished by government spending).

The counterparts to £M3 are, however, unlikely to be independent of one another, so in practice the relation between changes in funding and £M3 growth will not be one for one. If, to take an extreme example, the non-bank private sector financed new purchases of public sector debt entirely by increasing its borrowing from the banking system then £M3 would not be reduced. Nevertheless, for a given PSBR, the level of funding from the non-bank private sector is generally an important determinant of £M3 growth.

Funding and PSL2

Asset counterparts for other monetary aggregates may also be derived. For example, PSL2 includes the liabilities of a wider range of institutions than does £M3 (most notably building societies) and also includes holdings of certain short-term public sector debt instruments by the private sector (other than by banks and building societies).(1) Its counterparts will include lending by this broader group of institutions; and sales of a narrower range of debt instruments to a smaller residual private sector will act to reduce such lending. Thus, debt sales to the non-bank private sector are likely to have a proportionately smaller contractionary effect on PSL2 than on £M3. If such sales took the form of assets included in PSL2, they would, other things being equal, have no effect on that aggregate, while £M3 would tend to be reduced.

Funding and M0

M0, the measure of narrow money currently targeted, consists of notes and coin in circulation with the public, banks' till money and operational bankers' balances with the Bank of England.(2) Virtually all central government transactions with the private sector affect the last of these. The purchase of any central government debt instrument by the non-bank private sector or the banking system itself will, in the first instance, reduce bankers' balances and hence, other things equal, M0; any domestic central government expenditure will tend to increase them. Bankers' operational balances are very small however, relative to cash flows in the economy on any day, so the assumption that other things are equal is primarily an expositional device.

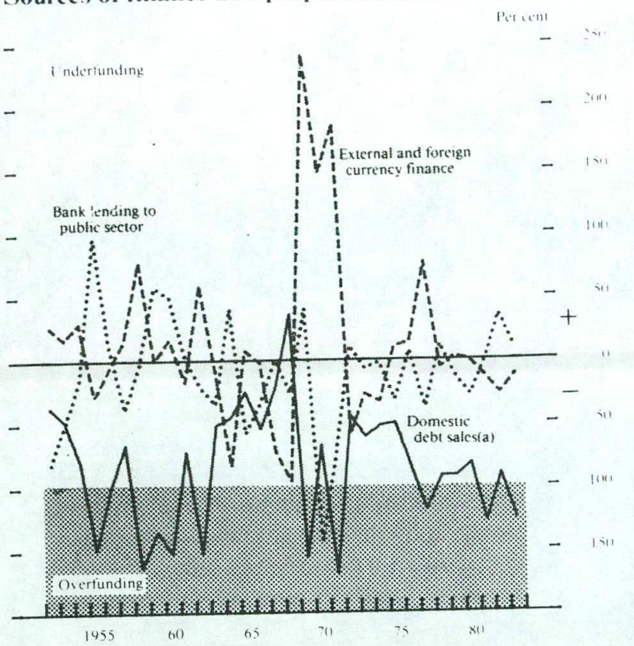
The remainder of the public sector (local authorities and public corporations) conducts its banking business with the commercial banking system so that flows between it and the private sector do not normally affect bankers' balances or M0.(3) An exception is where such transactions are financed by borrowing from the central government. In this case the CGBR is increased and there is a flow of cash from the central government to the monetary sector which affects bankers' balances and M0. Bankers' balances, however, represent a very small proportion of the total stock of M0 (about 1% in August 1984), and, because they are non-interest-bearing, are held at low levels by the clearing banks. Other things being equal, therefore, particularly heavy sales of central government debt in relation to the CGBR will necessitate action on the part of the Bank to relieve the strain on the banking system's liquidity before the change is large enough to have much impact on M0.

In accounting terms, changes in M0 can be related to the CGBR and its financing in the following way:

Change in M0 *equals*		the CGBR
	less	net sales of central government debt to all sectors

(1) Treasury bills, local authority deposits, certificates of tax deposit, and some national savings instruments.
(2) Non-operational deposits, which recognised banks and licenced deposit-takers are required to maintain at the Bank, are not included.
(3) Where local authorities or public corporations maintain accounts with the Bank, and also for the small number of private customers, their transactions will normally result in changes in bankers' balances. But such transactions tend to be small in relation to transactions on central government accounts and are ignored here.

Chart 6
Sources of finance as a proportion of the PSBR



(a) Net purchases of public sector debt by the non-bank private sector

between public sector debt sales to the non-bank private sector and external and foreign currency finance is shown in Chart 6.

The circumstances giving rise to overfunding have changed over time. Historically, the desire to maximise sales of government debt over the long run gave rise to a policy of 'leaning into the wind' in the gilt-edged market in order to maintain orderly market conditions and reduce the public sector's dependence on the monetary sector. At times when market sentiment was strong, this policy contributed to overfunding without this being necessarily an objective of policy *per se*. In the late 1950s, overfunding also arose because, as the banks ran down their holdings of government securities, these were effectively taken up by the non-bank private sector. Funding policy has assumed greater importance as a means of influencing the rate of broad money growth since the adoption of monetary targets in 1976. In 1977 the need to neutralise the monetary effects of substantial intervention in the foreign exchange market led to large issues of public sector debt and overfunding (narrowly defined). And overfunding has again been necessary at times in the last few years in order to offset the monetary effects of a rapid expansion in bank lending in sterling to the private sector.

Public sector finance and the liquidity of the banking system

Besides its monetary implications, the scale of funding also has potentially important implications for the banking system's liquidity. Many of the transactions involved have a direct impact on the banks' balances with the Bank of England, which form a crucial part of the banking system's liquidity—but this link is far from precise.

Thus, while overfunding is defined as the PSBR less debt sales by the public sector as a whole, it is the CGBR less central government debt sales which affect money-market liquidity. The reason is straightforward. The difference between the PSBR and the CGBR represents that part of the borrowing requirements of local authorities and public corporations which is not met by borrowing from central government. Because these bodies bank mainly with the commercial banking system, any borrowing they undertake from banks or through sales of debt to the

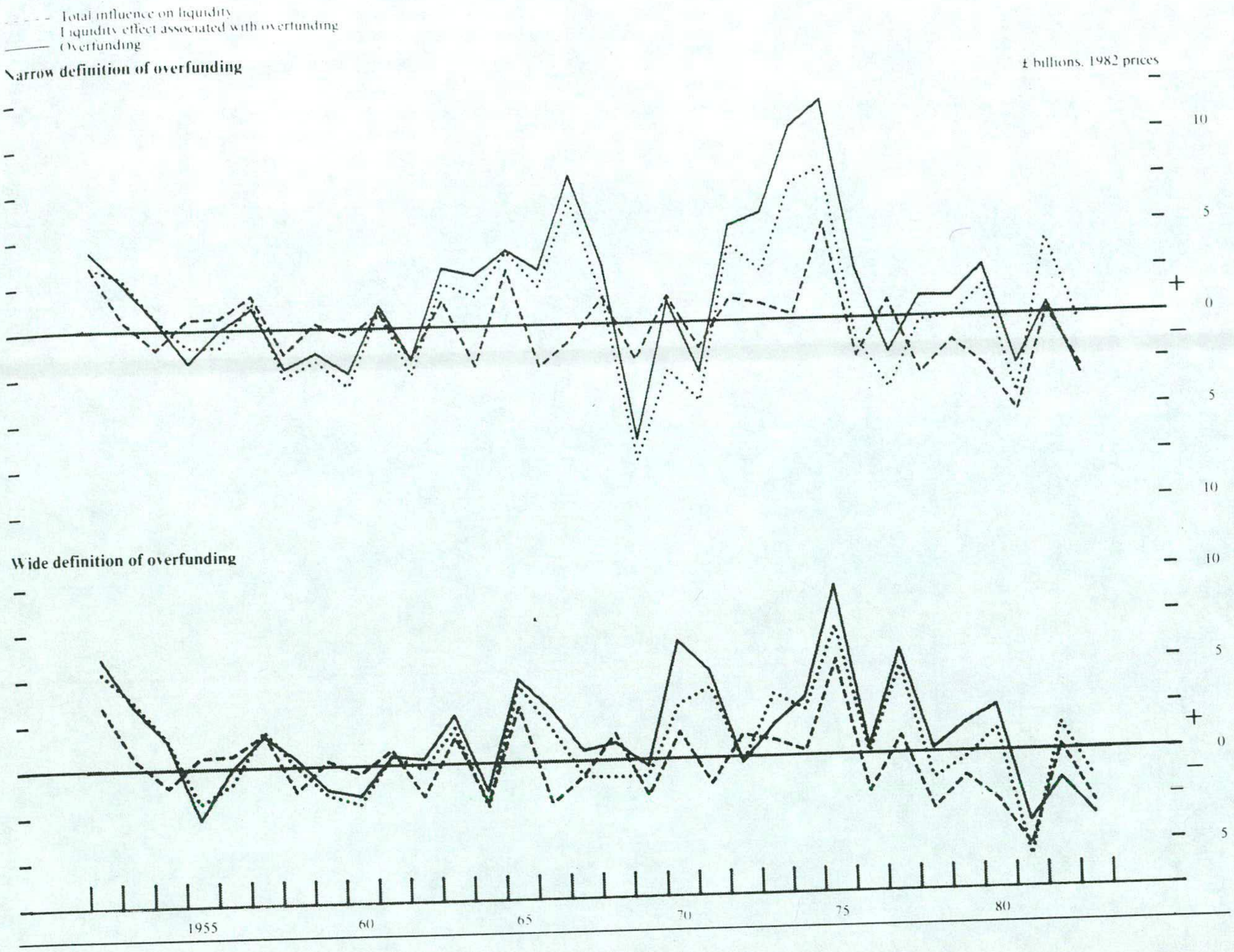
Table 2
Influences on monetary sector liquidity

£ billions, 1982 prices: annual averages

	Public sector borrowing requirement		Sales(−) of public sector debt to the non-bank private sector		Over-funding(−) narrow definition (columns 1+3)	Impact on liquidity (columns 2+4)	External and foreign currency finance		Over-funding(−) wide definition (columns 5+7)	Impact on liquidity (columns 6+8)	Sales of central government debt to monetary sector(a)	Notes and coin in circulation with the public	Other influences on liquidity (b)	**Total influences on liquidity (columns 10+11+12+13)**
	Total	*of which, CGBR*	Total	*of which, central government*			Total public sector	*of which, central government*						
	1	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*	*11*	*12*	*13*	*14*
Years(c)														
1952–54	+ 4.9	+ 3.7	− 2.4	− 1.4	+2.5	+2.3	+1.2	+1.2	+3.7	+3.5	−1.6	−0.9	—	**+1.0**
1955–59	+ 3.7	+ 1.3	− 4.5	− 2.3	−0.8	−0.9	+0.4	+0.5	−0.4	−0.5	+1.1	−0.6	—	**—**
1960–1964/65	+ 4.8	+ 1.4	− 4.2	− 1.6	+0.6	−0.2	−0.6	−0.3	—	−0.5	+0.4	−0.4	—	**−0.4**
1965/66–1969/70	+ 4.4	+ 1.6	− 2.0	− 0.3	+2.4	+1.3	−0.7	−0.7	−1.7	+0.7	+0.1	−0.7	−0.2	**−0.1**
1970/71–1974/75	+10.8	+ 6.2	− 6.8	− 4.7	+4.0	+1.5	−0.8	+1.0	+3.2	+2.5	+0.1	−1.7	−0.4	**+0.5**
1975/76–1979/80	+15.7	+12.7	−12.8	−12.1	+2.9	+0.6	+0.5	+1.4	+3.4	+2.0	−0.5	−1.5	−0.2	**−0.1**
1980/81–1983/84	+10.9	+11.9	−11.2	−11.7	−0.4	+0.2	−1.3	−1.4	−1.7	−1.2	−0.5	−0.7	−0.2	**−2.6**
1980/81	+15.3	+14.9	−12.6	−13.3	+2.7	+1.6	−0.2	−0.4	+2.5	+1.2	−3.1	−0.5	−0.1	**−2.5**
1981/82	+ 9.5	+ 8.3	−12.2	−12.6	−2.7	−4.3	−1.2	−1.5	−3.9	−5.8	+1.5	−0.5	−0.4	**−5.2**
1982/83	+ 9.2	+12.7	− 8.4	− 8.7	+0.8	+4.0	−2.3	−2.5	−1.5	+1.5	+0.2	−1.4	—	**+0.3**
1983/84	+ 9.6	+11.7	−11.9	−12.2	−2.3	−0.5	−1.3	−1.1	−3.6	−1.6	−0.7	−0.2	−0.3	**−2.8**

(a) Excluding Treasury bills and government indebtedness to the Banking Department.
(b) Central government borrowing from the 'other public sector' and other Exchequer transactions.
(c) Prior to 1963 calendar years are used: from 1963/64 they are financial years.

Chart 7
Overfunding and influences on the liquidity of the banking system



private sector will not involve a flow to or from the Exchequer, and bankers' balances will not be affected.

Table 2 (columns 1–6) shows first the relationship between overfunding on its narrow measure and the impact of the associated central government transactions on the banking system's liquidity. Over much of the period, the banking system's liquidity has taken the form of bankers' balances plus banks' till money and holdings of Treasury bills. With the depletion of the stock of outstanding Treasury bills, commercial bills have become an important component of the banking system's liquidity but these are excluded from the measure of liquidity used here, which is designed to reflect the impact of public sector transactions alone.

Through much of the period, the PSBR exceeded public sector debt sales to the non-bank private sector by a greater margin than the CGBR exceeded central government debt sales to the non-bank private sector; the scale of underfunding was therefore greater than the associated increase in money-market liquidity resulting from these transactions. This was particularly true on average during the 1970s (top panel of Chart 7) when the PSBR was much larger than the CGBR and the relationship between underfunding and its impact on liquidity loosened. More recently, however, as public corporations and local authorities have borrowed more from central government and less from the non-bank private sector, increasing the CGBR relative to the PSBR, the relationship has reversed.[1]

Thus, in 1982/83, there was modest underfunding but the CGBR greatly exceeded central government debt sales, implying a significant expansion in money-market liquidity, while in 1983/84 overfunding of £2.4 billion was associated with a much smaller contraction in liquidity. Broadening the concepts to include external and foreign currency finance (bottom panel of Chart 7 and columns 7–10 of Table 2) shows a rather different picture, especially during the 1970s. The relationship then between underfunding on this wide measure and the implied effect on the banking system's liquidity was much closer than on the narrow definition. During the 1980s overfunding has been much greater on average on this wide definition and has had a substantial contractionary effect on liquidity.

(1) The measures introduced in 1982 to encourage public corporations and local authorities to borrow from central government (through the National Loans Fund and the Public Works Loan Board) are described in the September 1982 *Bulletin*, page 353.

Besides the central government transactions identified so far, there are other financial flows which have a bearing on banks' liquidity in total (Table 2, columns 11–14). First, purchases by banks of central government debt will contract liquidity but will, *ceteris paribus*, not affect overfunding (which is only concerned with debt sales to non-banks). Second, increases in notes and coin in circulation will have a contractionary impact on the banking system's overall liquidity but again will leave over or underfunding unaffected. In combination, these transactions (together with other, residual, flows) have, until recently, tended to offset the impact on liquidity of (wide) underfunding, so that movements in overall money-market liquidity have been less expansionary than would be implied alone by those transactions affecting funding (bottom panel of Chart 7). This offset was particularly marked during the 1970s, when strong growth in the note issue on average counteracted the implied expansionary effects of underfunding on money-market liquidity. Since 1979, however, even though increases in the note issue have generally been smaller, the combined effect of transactions other than those contributing to overfunding has been on average greater, in contracting money-market liquidity, than those connected with (wide) overfunding. The difference over this most recent period between movements in overall money-market liquidity and the narrow measure of overfunding has been particularly marked.

6

(d)

Table M
Issues of gilt-edged stock

Stock	Amount issued (£ millions)	Date announced	Method of issue	Date issued	Price per £100 stock (£)	Payable per £100 stock: Initial payment(a) (£)	Payable per £100 stock: Further instalments (£)	Redemption yield (per cent)	Date exhausted
$2\frac{1}{2}$% Index-Linked Treasury 2001	50	18/11	Direct to Bank	18/11	$99\frac{1}{8}$			4.22(b)	27/11
$2\frac{1}{2}$% Index-Linked Treasury 2020	50	18/11	Direct to Bank	18/11	$90\frac{15}{16}$			3.59(b)	27/11
$10\frac{1}{2}$% Treasury Convertible 1992	200	28/11	Direct to Bank	28/11	$97\frac{3}{16}$			11.20	11/12
$9\frac{3}{4}$% Exchequer 1998	100	28/11	To National Debt Commissioners	28/11	91			11.17	—
9% Conversion 2000	100	28/11	Direct to Bank	28/11	87			10.87	5/12
$9\frac{3}{4}$% Treasury 2002	100	28/11	To National Debt Commissioners	28/11	$91\frac{13}{16}$			10.83	—
$8\frac{1}{2}$% Treasury 2007	100	28/11	Direct to Bank	28/11	$82\frac{7}{8}$			10.55	10/12
$10\frac{1}{4}$% Exchequer Convertible 1989(c)	100	22/12	Direct to Bank	22/12	$100\frac{3}{4}$			9.92	
$2\frac{1}{2}$% Index-Linked Treasury 2024(d)	600	19/12	Tender, no minimum price	30/12	78(e)	30.00	48.00 (10/2)	3.54(b)	19/1
10% Treasury 1994(f)	1250(g)	2/1	Minimum price tender	7/1	98	40.00	58.00 (24/2)	10.40	22/1

(a) If not fully paid at time of issue.
(b) Real yield, calculated on the basis of 5% annual rate of increase in the retail price index.
(c) Issued to assist market liquidity in this stock.
(d) The prospectus includes provision for exemption from UK taxation in favour of non-resident holders.
(e) Price at which the stock was allotted at the tender.
(f) The prospectus includes provision for exemption from UK taxation in favour of non-resident holders and for the loan to be available in bearer form.
(g) Of which £250 million was reserved for the National Debt Commissioners.

FEB 87 BEQB

dollar by $4\frac{3}{4}$% to $1.4837 and falling against the deutschemark by $2\frac{7}{8}$% to DM 2.8524. Interbank rates rose by $\frac{9}{32}$% to $11\frac{3}{16}$% at the one-month maturity, by $\frac{3}{16}$% to $11\frac{3}{16}$% at three months, and by $\frac{3}{16}$% to $11\frac{1}{8}$% at twelve months. Banks' base rates and building society rates were unchanged.

The gilt-edged market

The market began the period, which immediately followed Big Bang, with a confident undertone, but was set back early on by concerns about fiscal and monetary policy. Another, partly related, factor was the weakness of the exchange rate. By the end of November, therefore, yields had reached levels similar to those at the end of September. A more optimistic tone became apparent through December, largely in response to hopes surrounding the OPEC conference and the expected consequences for the exchange rate. By the end of the period, yields had fallen back by about $\frac{5}{16}$% throughout the yield curve from their levels at the beginning of November.

The objective of the authorities during the period under review remained that of fully funding the PSBR over the financial year as a whole through debt sales to the non-bank private sector and external and foreign currency finance of the public sector.

The authorities began the period having secured £0.6 billion through earlier sales of 10% Treasury Convertible 1991, which had been issued on 29 October. One stock was due to mature during the period—$2\frac{1}{2}$% Exchequer 1986, of which £0.6 billion was in market hands at the start of the period. In addition, $13\frac{1}{4}$% Exchequer 1987, of which £1.1 billion was in market hands, was due to be redeemed three weeks after the end of the period under review. Within the Bank's portfolio, there were still supplies of 3% Treasury 1991 available for sale.

The period opened with the market in good heart following the cut in the Japanese discount rate announced on 31 October and the call by the new Saudi Arabian Oil Minister for an OPEC conference. The authorities had taken the opportunity on the

(2)

MONEY AND BANKING FIGURES: CALENDAR FEBRUARY 1987

1 In the 12 months to February 1987, before seasonal adjustment, M0 rose by 4.1% and £M3 rose by 18.9%.

2 In February, before seasonal adjustment, M0 fell by 1.5% and £M3 rose by 1.9%. After seasonal adjustment, M0 fell by 0.8% and £M3 rose by 2.2%.

3 Within £M3 there was a rise in February of £50 million in notes and coin, a rise of £460 million in non-interest-bearing sight deposits and a fall of £200 million in interest-bearing sight deposits. Before seasonal adjustment M1 rose by £300 million (+0.4%) (Table C); after seasonal adjustment, M1 rose by 0.6%. Time deposits (including sterling certificates of deposit) of the UK private sector rose by £2,570 million.

4 The sterling value of private sector foreign currency deposits fell by £130 million, comprising a rise of £320 million reflecting transactions and a fall of £450 million reflecting the estimated change in the sterling value of the existing stock. Thus, before seasonal adjustment total M3 rose by £2,740 million (+1.5%) (Table C); after seasonal adjustment, total M3 rose by 1.8%.

5 Before seasonal adjustment PSL2 rose by £2,360 million (+0.9%) (Table E); after seasonal adjustment, PSL2 rose by 1.2%. Data for M2 in February are not yet available. In January, before seasonal adjustment M2 fell by £1,480 million (-0.9%) (Table D); after seasonal adjustment, M2 rose by 0.2%.

6 Rates of growth of monetary and liquidity aggregates over the last twelve months, before seasonal adjustment, are summarised in the table below:

M0 (weekly averaged)	+ 4.1%
M1	+21.0%
of which, non-interest-bearing M1	+10.4%
£M3	+18.9%
PSL1	+17.7%
PSL2	+13.1%

In the twelve months to end-January 1987, M2 rose by 12.9%.

7 It is not possible to calculate the growth of total M3 over the last twelve months, because there is insufficient information to calculate its level at end-February 1986.

8 Amongst the counterparts to the change in £M3, the net effect of public sector transactions (the PSBR less debt sales to the non-bank private sector and external flows to the public sector) was contractionary by £40 million (see

MONEY NUMBERS PRESS NOTICE

columns 1-7 of Table A). The central government borrowing requirement was £200 million and the direct contribution of local authorities and public corporations to the public sector borrowing requirement was contractionary by £580 million, resulting in a PSBR of -£380 million (ie a net repayment). There were net sales of central government debt by the non-bank private sector of £260 million, an expansionary influence; within this there were net sales of gilt-edged stock by the non-bank private sector of £470 million and net surrenders of CTD's of £180 million, partly offset by net purchases of National Savings of £350 million and Treasury bills of £60 million. There were net sales of local authorities' and public corporations' debt by the non-bank private sector of £180 million, an expansionary influence. External and foreign currency finance of the public sector was contractionary by £90 million.

9 Before seasonal adjustment, sterling lending to the private sector rose by £2,640 million; after seasonal adjustment, it rose by £2,910 million. Foreign currency lending to the private sector rose by £2,400 million in transactions terms.

10 The external and foreign currency transactions of UK banks were expansionary by £150 million (see columns 9-12 of Table A). Net non-deposit sterling liabilities fell by £120 million, an expansionary influence.

11 Tables I, J, K and L show the details of the banks' and discount market's balance sheets. Transactions of the UK monetary sector during the month, excluding inter-bank items and valuation changes on foreign currency items, are given in Table F.

Estimated seasonal movements in March 1987

12 The provisional seasonal movements for March 1987 are shown below. Bearing in mind the difficulties referred to in the December 1986 Bulletin note "Banking and Monetary Statistics: a change in reporting dates" (page 519), the figures should be regarded as more uncertain and more subject to revision than were the figures formerly given for banking months.

M0 (average series)	+ 50
£M3	+ 1,650
Bank lending in sterling to the private sector	+ 1,290

The seasonally-adjusted changes are obtained by subtracting (with due regard to sign) the seasonal movement from the unadjusted changes.

BANK OF ENGLAND
30 March 1987

CONFIDENTIAL

1 Alex
2 PWP

MONTHLY NOTE ON THE BALANCE OF PAYMENTS - MARCH 1987

* In January the visible trade deficit fell to £0.5 billion compared with £0.9 billion in December and the current balance showed a small surplus of £73 million. In 1986 the current account is now estimated to have been in deficit by £1.1 billion, following downward revisions to the surplus on invisibles.

* In the year to the fourth quarter of 1986 UK competitiveness, as measured by relative unit labour costs, appears to have improved by around 17 per cent. This reflects sterling's depreciation along with a rapid slowdown in the growth of UK unit labour costs relative to those of other countries. However, the rise of around 3½ per cent in the sterling index since the 'Louvre' agreement has reversed some of the earlier competitiveness gains.

* Export volumes (excluding oil and erratics) in the UK fell by 6½ per cent in January compared with December, partly reflecting the effects of bad weather, but rose by 4 per cent in the three months to January compared with the previous three months, continuing the upward trend evident since the spring.

* Import volumes (excluding oil and erratics) in the UK fell by 9½ per cent in January compared with December, partly reflecting the effects of bad weather, although in the three months to January they were 3 per cent above the level of the previous three months.

* The terms of trade, which worsened in the Autumn have firmed a little in December and January reflecting to some extent the steadier exchange rate and higher oil prices.

* Independent forecasts for the current account have improved on average to give a deficit of £2.7 billion in 1987. Most independent forecasters, however, have not yet taken account of the upward revision to the 1986 current account deficit published on 5 March.

S KING
EA2 Division

MONTHLY NOTE ON THE BALANCE OF PAYMENTS - MARCH 1987

Current Account

1. The January trade figures, published on 27 February, showed a deficit on non-oil trade of £0.9 billion, partially offset by a surplus on oil trade of £0.4 billion. The improvement on the non-oil trade deficit probably reflected the effects of January's bad weather. Import data cover the entire calendar month whereas export data cover the first two weeks of the calendar month together with the last two weeks of the preceding month. Thus, import data may have been affected more than export data by the bad weather. Overall, the visibles balance showed a deficit of £0.5 billion in January and, combined with a new projection from the CSO on invisibles for 1987Q1 of £600 million a month, it gave a current account surplus of £73 million. The current account for 1986 as a whole is now estimated to have been in deficit by £1.1 billion, following downward revisions to the surplus on invisibles.

TABLE 1: CURRENT ACCOUNT

£ billion

	Current Balance	Visible Total	of which: Oil	Manufactures	Other goods	Invisible Balance
1982	3.9	2.3	4.6	2.4	-4.7	1.6
1983	3.1	-0.8	7.0	-2.3	-5.5	4.0
1984	1.3	-4.4	6.9	-3.9	-7.4	5.7
1985	2.9	-2.2	8.1	-3.0	-7.3	5.1
1986	-1.1	-8.3	4.2	-5.4	-7.0	7.2
1986 Q1	0.7	-1.2	1.9	-1.3	-1.9	1.9
Q2	-0.1	-1.6	0.8	-0.6	-1.7	1.5
Q3	-0.9	-2.9	0.6	-1.7	-1.8	1.9
Q4	-0.8	-2.6	0.8	-1.8	-1.7	1.8
November	-0.4	-1.0	0.4	-0.8	-0.5	0.6
December	-0.3	-0.9	0.3	-0.5	-0.6	0.6
January 87	0.1	-0.5	0.4	-0.4	-0.5	0.6*

* CSO projection

CHART 1: CURRENT ACCOUNT

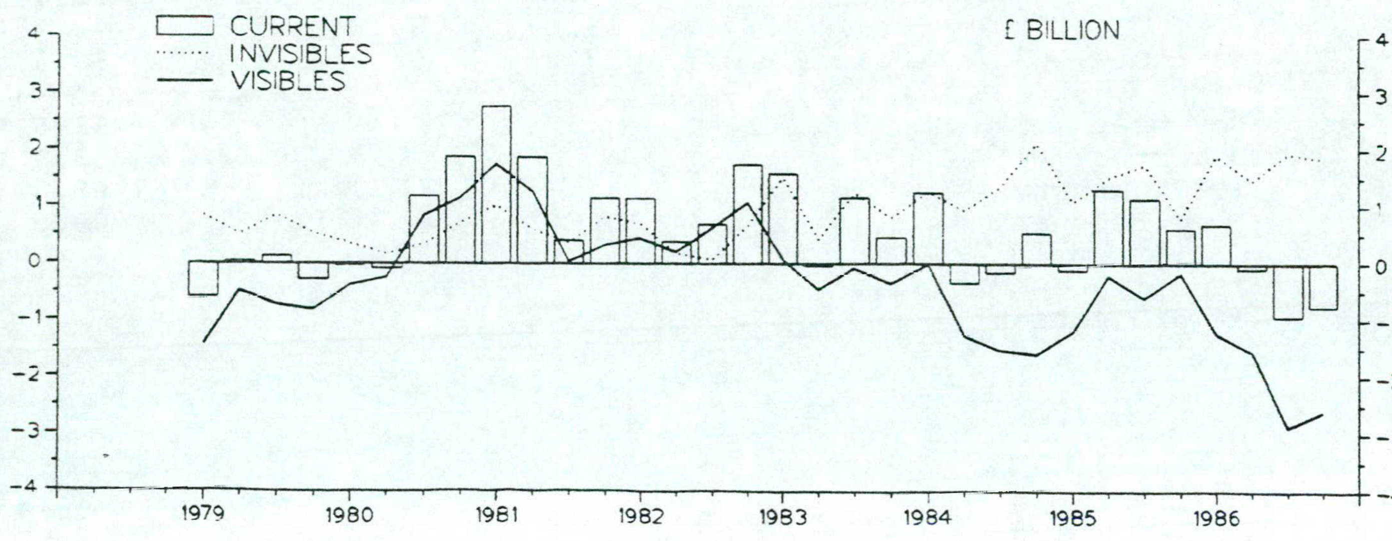


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CHART 1A: VISIBLE BALANCE

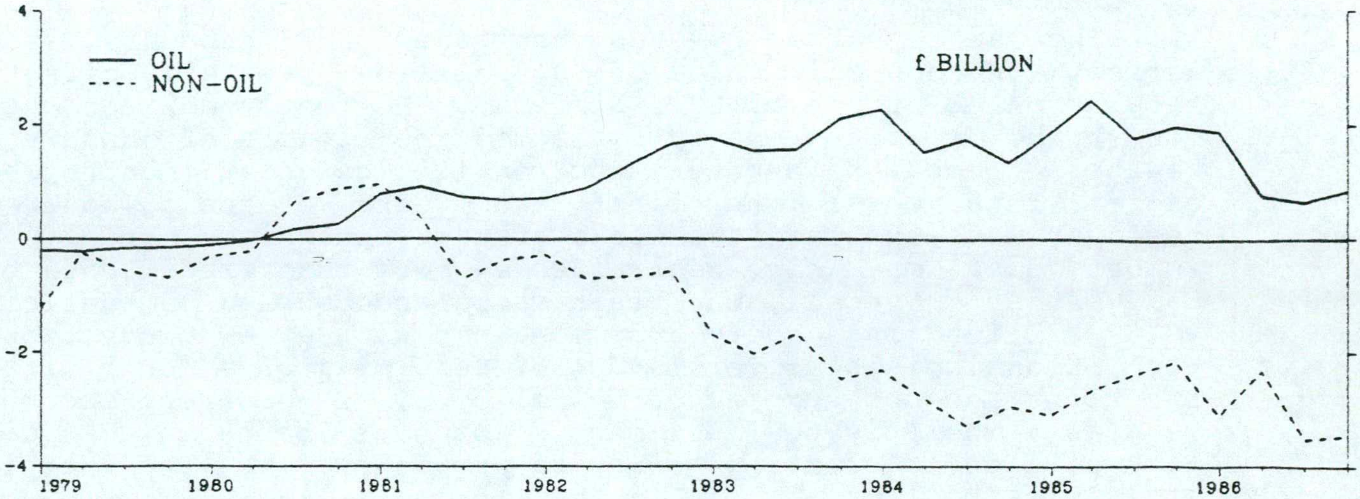


TABLE 2: RELATIVE UNIT LABOUR COSTS IN MANUFACTURING

Indices

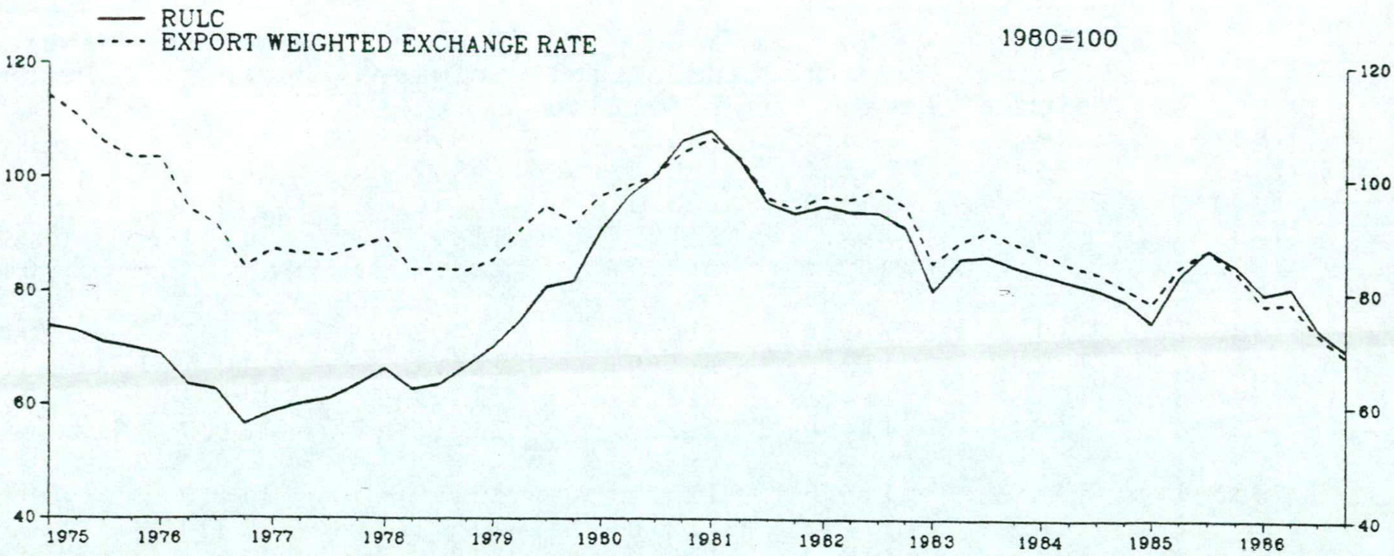
(% changes on a year earlier in brackets)

	Relative Unit Labour Costs in domestic currencies 1980=100	Export weighted Exchange Rate Index 1975=100	Relative Unit Labour Costs in common currencies 1980=100	Sterling Exchange Rate Index 1975=100
1982	98.3 (-2.9)	89.0 (-3.8)	95.0 (-5.6)	90.7 (-4.5
1983	96.8 (-1.7)	81.4 (-8.5)	85.5 (-10.0)	83.4 (-8.1
1984	97.9 (1.1)	77.5 (-4.8)	82.3 (-3.7)	78.7 (-5.5
1985	100.4 (2.6)	77.0 (-0.6)	83.8 (1.8)	78.2 (-0.6
1986	103.8**(3.4)	68.8 (-10.6)	77.4** (-7.6)	72.8 (-7.0
1986 Q1	104.1 (7.2)	71.9 (-0.3)	81.2 (7.0)	75.1 (4.2
Q2	105.0 (5.5)	72.3 (-8.4)	82.3 (-2.4)	76.0 (-3.7
Q3	102.7* (1.0)	67.3 (-16.6)	75.0* (-15.7)	71.9 (-12.4
Q4	103.2**(0.5)	63.5 (-17.6)	71.1**(-17.5)	68.3 (-14.5
November				68.5 (-14.4
December				68.4 (-13.5
1987 January				68.8 (-10.2
February				69.0 (-7.0

* estimate
** projection

CHART 2: UNIT LABOUR COSTS IN MANUFACTURING

1980=100



DETERMINANTS OF UK TRADE

Competitiveness

2. UK competitiveness (as measured by relative actual unit labour costs in manufacturing) improved by an estimated 17½ per cent in the year to 1986Q4. Following the sharp deterioration in competitiveness during 1985, the UK's competitive position by end 1986 had returned roughly to what it was at the end of 1984. The fall in the exchange rate during 1986 was almost entirely reflected in improved competitiveness because UK unit labour costs grew at around the same rate as those elsewhere - a marked improvement on previous trends but in part a reflection of divergent cyclical movements in manufacturing productivity in the UK and other G5 countries. Since the 'Louvre' agreement, sterling has appreciated by around 3½ per cent, reversing some of the earlier competitiveness gains.

World Trade and Domestic Demand

3. G5 countries' domestic demand on average showed further growth in the third quarter of 1986 following a sharp rise in the second quarter, although latest information suggests that the recovery in export volume growth was relatively modest (possibly reflecting a combination of the sluggish performance of exports from Japan and Germany, whose currencies have appreciated particularly strongly, and continued weak demand from oil exporting countries). Industrial output in the G5 countries other than the UK fell back on average in the fourth quarter, having risen slightly in the third quarter. Both UK domestic demand and production rose strongly in the third quarter; retail sales and manufacturing output continued to increase in the fourth quarter as a whole although both fell back in January as a result of the bad weather. Retail sales recovered in February.

TABLE 3: INDICATORS OF DEMAND

Indices 1980=100

	World			UK		
	G5 Export Volumes*	G5 Domestic Demand	G5 Industrial Production	Export Volumes**	Domestic Demand	Manufacturing Production
1982	99	100.9	96.7	99.3	100.4	94.2
1983	99	104.4	100.4	98.2	105.1	96.9
1984	107	109.9	108.5	107.6	108.0	100.7
1985	110	113.2	111.9	114.9	111.1	103.8
1986			113.0	117.7		104.1
1985 1	110	111.4	110.7	114.8	111.1	103.3
2	112	112.5	111.9	115.1	110.1	104.5
3	106	114.1	112.4	115.2	111.3	103.7
4	114	114.9	112.7	114.6	111.7	103.5
1986 1	107	115.5	112.7	111.9	114.0	102.5
2	112	117.3	112.8	115.1	113.4	103.5
3	107	118.3	113.4	118.5	115.4	104.6
4			113.3	125.3		106.0
November			113.3	127.3		106.1
December			113.4	126.5		106.3
January 87				118.5		103.9

VISIBLE TRADE

<u>Summary</u>

TABLE 4: VISIBLE TRADE VALUES

£ billion

	Total			Excluding oil and erratics		
	Exports	Imports	Balance	Exports	Imports	Balance
1982	55.6	53.2	2.3	41.4	44.7	-3.3
1983	60.8	61.6	-0.8	43.8	52.7	-8.9
1984	70.4	74.8	-4.4	50.9	63.3	-12.4
1985	78.1	80.3	-2.2	57.7	68.7	-11.0
1986	72.8	81.1	-8.3	59.2	73.5	-14.2
1986 1	18.2	19.4	-1.2	14.0	17.4	-3.3
2	17.8	19.3	-1.6	14.5	17.4	-3.0
3	17.6	20.4	-2.9	14.8	18.7	-3.8
4	19.3	21.9	-2.6	15.9	20.0	-4.1
November	6.6	7.6	-1.0	5.4	7.0	-1.6
December	6.5	7.4	-0.9	5.3	6.7	-1.4
January 1987	6.2	6.7	-0.5	5.0	6.1	-1.1
% change						
3 mths to Jan on same period year earlier	1½	13½		11	18	
3 months to Jan on previous 3 mths	7½	4		4½	5	
January on December	-4	-8½		-5	-9	

4. Tables 4, 5 and 6 show movements in trade values, volumes and prices. In January the visible trade deficit fell to £0.5 billion compared with £0.9 billion in December, although to some extent this was due to the distorting influence of January's bad weather. The terms of trade firmed a little in December and January, reflecting in part the steadier exchange rate and higher oil prices, together with a fall in commodity prices in SDR terms.

TABLE 5: VISIBLE TRADE PRICES

Average Value Indices 1980=100

	Total			Excluding oil and erratics		
	Exports	Imports	Terms of trade	Exports	Imports	Terms of Trade
1982	115.0	113.9	101.0	111.5	110.6	100.9
1983	123.5	121.9	101.3	119.2	118.9	100.2
1984	131.9	133.2	99.0	126.4	128.7	98.3
1985	138.8	138.3	100.4	134.2	134.1	100.1
1986	124.8	131.5	94.9	134.5	135.5	99.3
1986 1	130.4	134.8	96.7	134.4	134.9	99.6
2	123.1	130.4	94.4	134.3	133.8	100.4
3	120.8	128.1	94.2	133.9	134.8	99.3
4	125.0	132.9	94.1	135.4	137.9	98.2
November	125.2	134.4	93.2	135.2	138.2	97.8
December	124.5	133.3	93.4	134.7	137.9	97.7
January 1987	125.6	133.7	93.9	136.3	138.2	98.6
% change						
3 mths to Jan on same period year earlier	-7	2	-9	1½	6½	-4½
3 mths to Jan on previous 3 mths	2	3½	-1½	½	1½	-1½

CHART 3: TERMS OF TRADE

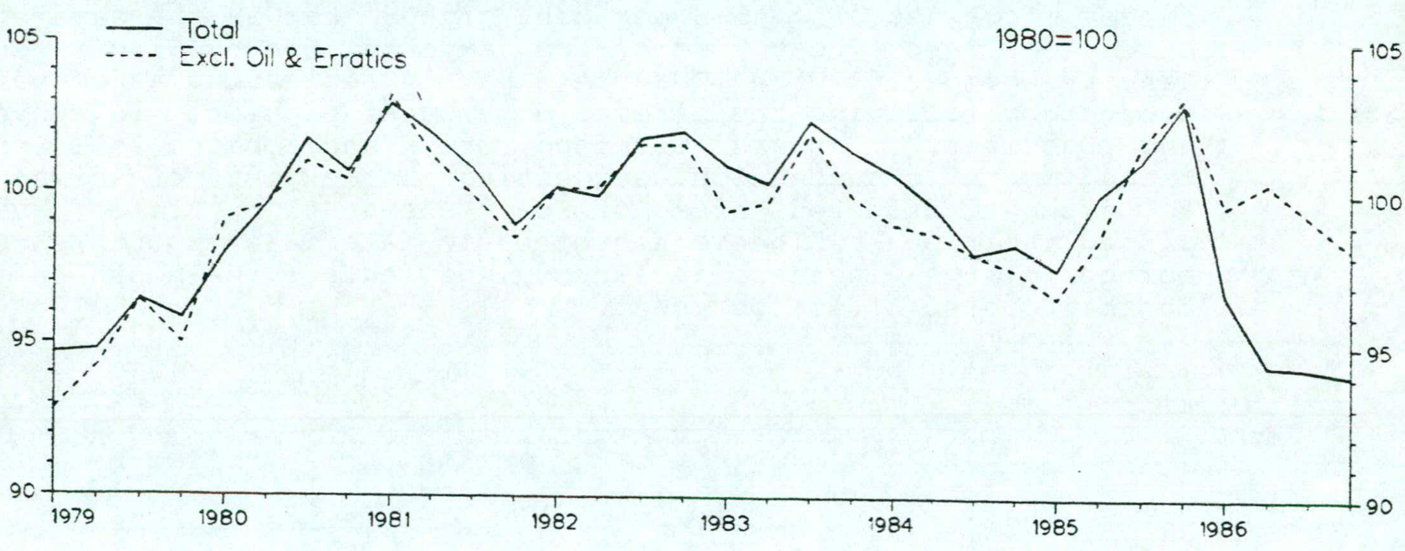


TABLE 6: VISIBLE TRADE VOLUMES

1980=100

	Total			Excluding oil and erratics		
	Exports	Imports	Ratio: Exports: Imports	Exports	Imports	Ratio: Exports: Imports
1982	101.9	101.5	100.4	99.3	112.7	88.1
1983	103.8	109.7	94.6	98.2	123.4	79.6
1984	112.5	121.8	92.4	107.6	137.0	78.5
1985	118.7	126.0	94.2	114.9	142.8	80.6
1986	123.1	133.9	91.9	117.7	151.1	77.6
1986 1	117.5	124.9	94.1	111.9	143.3	77.3
2	121.9	128.8	94.6	115.1	145.2	79.5
3	122.6	138.5	88.5	118.5	154.3	76.1
4	130.5	143.4	91.0	125.3	161.7	77.8
November	132.8	146.7	90.5	127.3	168.7	75.6
December	131.6	143.9	91.5	126.5	163.4	79.1
January 87	125.0	131.2	95.3	118.5	148.0	80.1
% change						
3 mths to Jan on same period year earlier	9	11½	-2	9	10½	0
3 mths to Jan on previous 3 mths	5½	½	4½	4	3	2
January on December	-5	-8	4	-6½	-9½	4½

Exports

5. The upward trend in exports, which appears to have begun in March 1986 (see Chart 4), has continued, with the volume of non-oil exports (excluding erratics) 6 per cent higher in the three months to January compared with the previous three months. Within the total, manufactures (excluding oil and erratics) rose by 2½ per cent in the three months to January on the previous three months to a level 6 per cent higher than in the same period a year earlier. The volume of fuel exports rose by 5½ per cent in January compared with December partly reflecting a recovery in production following the effects of a burst pipeline in November and December. Exports of food, drink and tobacco fell for the second month in succession, suggesting that exports of animal feed to drought affected areas of Spain and southern France have now passed their peak. The volume of basic materials exports showed a further large increase in January, giving a three month on three month increase of 15½ per cent.

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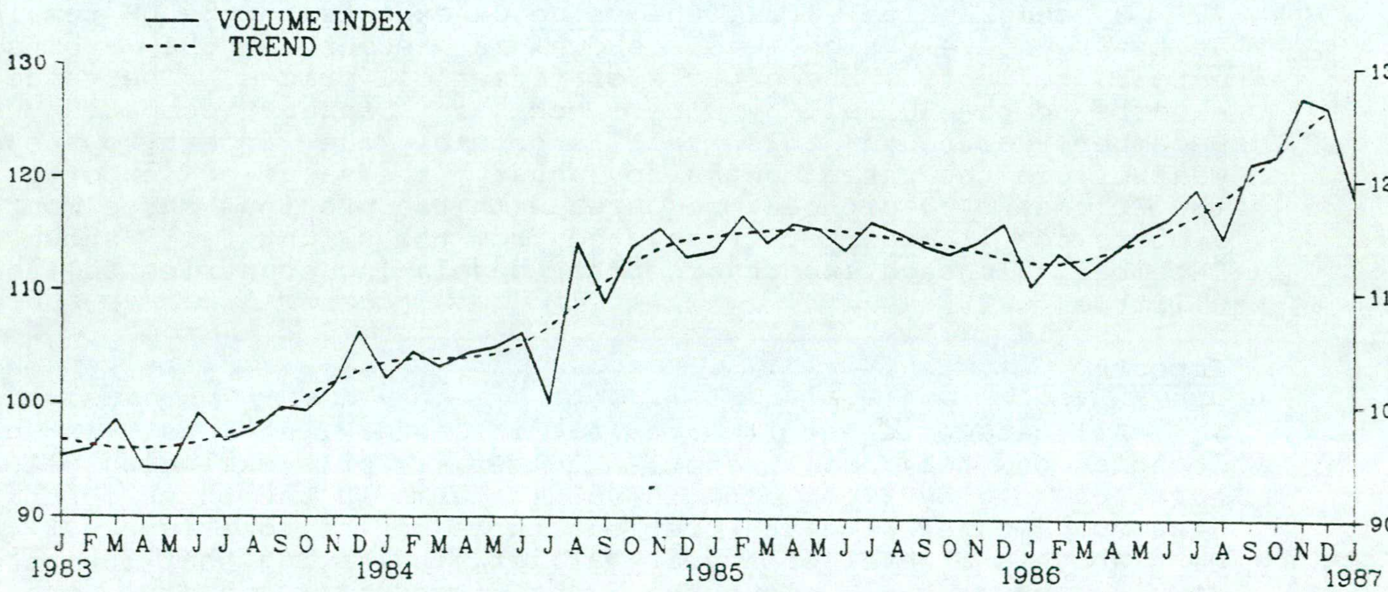
TABLE 7: EXPORT VOLUMES 1980=100

	Manufactures (excl. erratics)	Food, drink and tobacco	Basic materials	Fuel
1982	97.8	106.8	93.6	133.2
1983	96.2	110.2	101.0	147.7
1984	107.0	117.2	106.3	160.2
1985	115.7	119.2	106.1	171.7
1986	116.9	129.6	117.1	175.5
1986 1	111.7	118.7	110.7	178.3
2	115.8	119.8	102.3	170.4
3	117.6	133.5	126.3	174.3
4	122.6	146.2	128.9	178.9
November	123.4	149.1	128.2	180.5
December	123.7	140.4	142.1	177.5
January 1987	115.6	128.1	161.2	187.2
% change 3 mths to Jan on same period year earlier	6	24½	31	3
3 mths to Jan on previous 3 mths	2½	-2	15½	5½
Jan on Dec	-6½	-9	13½	5½

CHART 4: NON OIL EXPORT VOLUMES EXCLUDING ERRATICS



6. Manufacturers' export prices rose slightly in the three months to January although the magnitude of recent increases suggests that exporters have not yet taken full advantage of the lower exchange rate to raise profit margins. Instead, export prices in foreign currency terms appear to have fallen relative to those of competitors. Fuel export prices rose in January, reflecting the firming of oil prices. The underlying fall in basic materials prices continued in January.

TABLE 9: EXPORT PRICES*

1980=100

	Manufactures (excl. erratics)	Food, Drink and Tobacco	Basic Materials	Fuel
1982	111.7	113.9	98.8	131.2
1983	119.3	118.2	108.3	138.0
1984	126.4	122.9	129.2	148.6
1985	134.4	128.1	138.5	152.1
1986	136.3	129.8	120.6	77.0
1986 1	136.0	127.0	124.7	110.9
2	135.3	131.7	119.4	70.2
3	136.4	128.2	118.3	57.6
4	137.5	132.0	120.1	68.5
November	136.9	134.6	121.3	68.3
December	137.3	128.1	114.5	68.7
January 1987	139.6	130.7	110.8	75.8
% change				
3 mths to Jan on same period year earlier	3	2	-10	-47½
3 mths to Jan on prev 3 mths	½	2½	-5	16½

* average value indices

Exports by geographical destination

7. By geographical area, the value of exports to the US remained at the relatively high levels shown in recent months, to some extent reflecting the effects of firmer oil prices. The value of exports to the EC fell by 8 per cent in January compared with December, although this fall is probably due in part to the bad weather; in the three months to January, the value of exports to the EC rose by 5 per cent compared with the previous three months. Exports to oil exporters recovered from the slight fall shown in December, although exports to other developing countries fell back a little.

Imports

8. All categories of imports fell in January, at least in part because of the bad weather. However, imports excluding oil and erratics rose by 3 per cent in volume terms in the three months to January compared with the previous three months to a level 10½ per cent above the level of a year earlier, indicating that the trend remains upwards - although, even discounting January's weather distorted figures, the rate of increase appears to have slowed a little compared to mid 1986. The increases in imports of basic materials and of intermediate goods in recent months are consistent with rising domestic manufacturing output and, whilst imports of semi-manufactures have been unchanged in recent months, they remain at a high level. The rate of increase in consumer goods has slowed considerably in the last few months, but imports of capital goods remain buoyant.

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TABLE 11a: IMPORT VOLUMES 1980=100

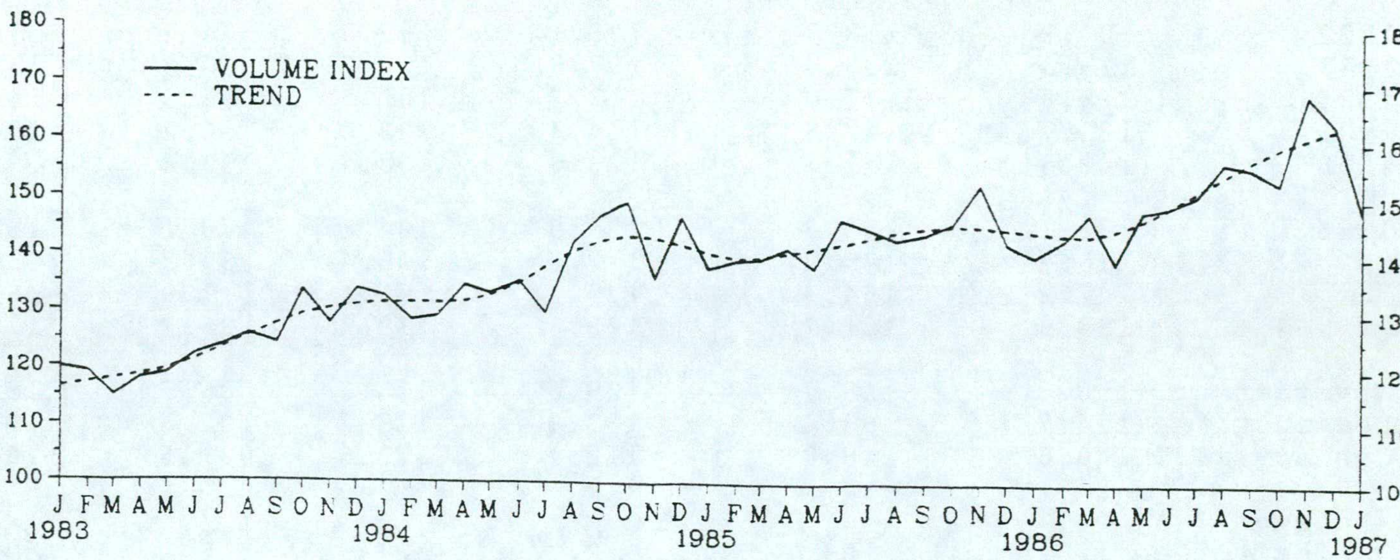
	Goods less erratics*	Goods less oil and erratics*	Food Drink and Tobacco	Basic materials	Fuels†	Manufactures less erratics
1982	107.1	112.7	108.1	93.0	74.5	116.5
1983	115.0	123.4	107.8	104.6	66.8	131.1
1984	128.8	137.0	112.3	101.7	86.5	146.7
1985	133.7	142.8	114.4	102.2	86.2	154.4
1986	142.4	151.1	123.5	108.7	93.4	163.0
1986 1	132.1	143.3	123.5	104.1	70.1	153.3
2	136.8	145.2	119.7	105.4	85.3	156.9
3	147.2	154.3	125.5	106.1	111.9	167.6
4	153.3	161.7	125.3	119.4	106.2	174.4
November	156.6	168.7	129.6	126.0	86.5	182.1
December	154.7	163.4	132.9	123.8	102.6	174.0
January 1987	140.6	148.0	116.1	123.6	91.5	160.2
% change 3 mths to Jan on same period year earlier	12	10½	10	21½	15	9½
3 mths to Jan on prev 3 mths	3½	3	3	14½	-18	2
Jan on Dec	-2½	-9½	-12½	0	-11	-8

† Figures affected by coal strike
* Balance of payments basis

TABLE 11b IMPORT VOLUMES OF MANUFACTURES

	Semi manufactures	Finished manufactures	of which: Passenger motor cars	Other consumer goods	Intermediate goods	Capital goods
1982	111.3	119.9	110.1	113.3	122.8	128.2
1983	123.3	136.4	125.5	124.9	136.2	153.1
1984	137.2	153.0	119.9	139.6	161.4	172.9
1985	143.9	161.4	127.9	139.5	172.8	187.1
1986	152.0	170.4	131.6	158.3	187.0	183.1
1986 1	147.3	157.2	126.2	144.5	169.9	172.4
2	149.2	162.1	125.0	154.2	180.8	169.5
3	154.8	176.0	142.2	164.6	192.6	185.2
4	156.6	186.4	133.0	170.1	204.9	205.4
November	159.3	197.1	136.4	181.0	222.6	211.5
December	155.9	186.4	122.4	175.9	201.3	208.9
January 1987	145.1	169.7	109.9	144.1	186.9	204.8
% change 3 mths to Jan on same period year earlier	6	11½	-3½	13½	15	11½
3 mths to Jan on prev 3 mths	-1½	4	-13½	3½	5½	9
Jan on Dec	-7	-9	-10	-18	-7	-2

CHART 6: NON OIL IMPORT VOLUMES EXCLUDING ERRATICS



9. Import prices in the three months to January on average rose compared with the previous three months. Within the total, manufactures rose by 2½ per cent, and food, drink and tobacco prices by 1½ per cent. Fuel prices continued to recover from the low levels shown in 1986Q3 - January fuel prices appear to reflect in part the sharp rise in oil prices during December, the full effect of which should be seen in February's figures.

TABLE 13: IMPORT PRICES*

1980=100

	Manufactures (excl. erratics)	Food Drink and Tobacco	Basic Materials	Fuel
1982	110.6	109.0	104.4	144.7
1983	117.5	118.6	112.8	154.1
1984	125.4	129.3	131.6	173.8
1985	131.7	132.6	130.2	180.0
1986	135.1	132.5	113.3	98.0
1986 1	134.1	129.1	114.9	143.5
2	132.9	131.4	113.5	103.8
3	134.3	132.8	110.8	78.1
4	138.4	136.6	113.8	84.4
November	138.7	136.7	116.0	85.5
December	139.1	135.8	112.9	86.9
January 1987	139.5	133.3	109.6	89.5
% change				
3 mths to Jan on same period year earlier	8	5½	-1	-44
3 mths to Jan on prev 3 mths	2½	½	1½	10

* average value indices

INVISIBLES

10. The CSO's balance of payments press notice, published on 5 March, contained a first estimate for the 1986Q4 invisibles balance, together with revised estimates for quarterly balances going back to 1984. The invisibles balance for 1986Q4 is provisionally estimated to have been in surplus by £1.8 billion. For the year as a whole, the invisibles balance is estimated to have been in surplus by £7.2 billion compared with a revised surplus of £5.1 billion in 1985

TABLE 14: INVISIBLES BALANCE

£ billion

	Services	IPD	Transfers	Total
1982	2.6	1.0	-2.0	1.6
1983	3.7	2.4	-2.1	4.0
1984	3.8	4.1	-2.3	5.7
1985	5.7	2.9	-3.5	5.1
1986	5.3	4.3	-2.4	7.2
1986 1	1.2	0.8	-0.1	1.9
2	1.2	0.9	-0.6	1.5
3	1.4	1.3	-0.8	1.9
4	1.5	1.2	-0.9	1.8
1987 1	-	-	-	1.8*

* projection

Services

11. The surplus on services in 1986Q4, at £1.5 billion, was broadly unchanged from that recorded in 1986Q3. For 1986 as a whole, the surplus fell by just under £0.4 billion compared with 1985, reflecting increased debits on civil aviation and travel, as more UK residents went abroad and increased use was made of foreign airlines, and rather restrained growth in travel credits, due to the effects on American tourists of the fall in the dollar and fears about terrorism. These effects were partially offset by increased credits on financial and other services.

Interest, profits and dividends (IPD)

12. The surplus on IPD fell by £88 million between 1986Q3 and 1986Q4 although, for 1986 as a whole, it improved by £1.3 billion compared to 1985. The fall between the third and fourth quarters of 1986 mainly reflected the effects on net earnings from direct investment of the recovery in the oil price during the summer - which increased North Sea oil debits more than credits. The increase in IPD between 1985 and 1986 was due to three main factors.

(i) The buoyancy of overseas securities markets, boosting net earnings on UK overseas investment.

(ii) The increased sterling value of earnings on overseas assets, due to the fall in sterling.

(iii) An improvement in the balance on oil IPD, reflecting a fall in oil IPD debits - greater than the fall in credits - as a result of the lower oil price.

Transfers

13. The deficit on transfers rose by £56 million between 1986Q3 and 1986Q4. The main reason for the deterioration was a lower level of general government receipts from EC institutions, due to a shortage of EC funds. The missing receipts should appear in the 1987Q1 figures. For 1986 as a whole, the balance on transfers improved by £1.2 billion, although this was largely the result of the effect of the late arrival of an EC VAT abatement, which had originally been destined for receipt in 1985Q4, but which ended up in 1986Q1.

CAPITAL FLOWS AND NET OVERSEAS ASSETS

14. Despite the current account deficit in 1986Q4, net capital outflows of £3.2 billion were recorded compared with a net inflow of £1.0 billion in 1986Q3. For 1986 as a whole, there was a net recorded outflow of £5.8 billion compared with a net outflow of £7.3 billion in 1985, giving a positive balancing item of £6.9 billion - £2.5 billion higher than in 1985. This balancing item, reflecting errors and omission in the balance of payments accounts, implied that there were unrecorded net credits on the current account and/or unrecorded net capital inflows.

TABLE 17: NET TRANSACTIONS ON CAPITAL ACCOUNT

£ billion

	1985	1986	Q1	Q2	Q3	Q4
Direct investment	-3.6	-3.9	+1.3	-0.1	-1.5	-3.6
Portfolio investment	-11.2	-11.5	-3.7	-4.8	-2.5	-0.4
Net foreign currency lending abroad	+4.9	+10.5	+0.8	+2.9	+6.0	+0.8
Net sterling lending abroad	+2.5	-0.5	+1.8	-1.4	-0.7	-0.2
Other	+1.8	+2.5	-0.8	+1.3	+2.0	-0.1
Official reserves	-1.8	-2.9	-0.6	-0.3	-2.3	+0.3
Total	-7.3	-5.8	-1.2	-2.4	+1.0	-3.2

- = net outflow, + = net inflow.

15. Within the capital account, outward direct investment rose by £1.1 billion in 1986Q4 following a rise of £2.0 billion in 1986Q3. These increases reflected greater merger and takeover activity in the US. Outward portfolio investment fell back in 1986Q4 compared with the previous quarter, although the relatively high levels recorded in the first three quarters of 1986 seem to be due to some extent to the effects of portfolio decisions by institutions preparing for 'Big Bang'. Net overseas borrowing by UK banks fell by £4.6 billion in 1986Q4, mainly reflecting the effect of distortion on the third quarter's figure.

Net overseas assets

16. Net overseas assets may have increased to around £110 billion at end 1986 (28 per cent of GDP), compared with a figure of around £80 billion at end 1985, despite a recorded current deficit. The estimated increase reflects the strength of world stock markets and the effects of sterling's depreciation, although it must be emphasised that the figure for end 1986 is very provisional, and may be subject to substantial revision as more information becomes available.

PROSPECTS

17. Independent forecasters are on average expecting a current deficit of £2.7 billion in 1987 compared to the Industry Act forecast's £1½ billion deficit but there are wide differences of view. The London Business School's February forecast shows a deficit of £2.3 billion for 1987, turning round to a surplus of £0.9 billion by 1990, as the beneficial effects of improved competitiveness come through. The National Institute, which has revised its forecast for 1987 down from a deficit of £5.6 billion to a deficit of £2.6 billion, expects a deterioration in the current account in 1988 - they are less optimistic than the LBS on the outlook for UK unit labour costs. No major independent forecasts have yet taken account of the revisions to the 1986 current account figures published on 5 March. It is therefore possible that over the next few months forecasters will raise their projections of the 1987 deficit.

TABLE 15: CURRENT ACCOUNT (£ billion)

	1987	1988	1989	1990
OECD (Dec)	-3.4	-6.0*	-	-
National Institute (Feb)	-2.6	-4.0	-	-
LBS (Feb)	-2.4	-1.0	-0.9	0.9
Phillips & Drew (Mar)	-2.3	-2.8	-2.4	-1.7
Goldman Sachs (Mar)	-2.0	-3.1	-1.9	-2.9
Henley (Feb)	-2.2	-2.6	-2.4	-3.3
Oxford (Jan)	-1.9	-1.1	-1.8	-2.6
Liverpool (Mar)	-1.7	-0.2	-0.8	-0.3
Outside Average (11 forecasts)	-2.7	-2.7	-	-

* 1988H1, annualised

INTERNATIONAL COMPARISONS

18. The US current deficit levelled off in the first three quarters of 1986, and latest information suggests that the rate of increase in the trade deficit may be slowing somewhat. The German and Japanese surpluses have shown no sign of falling from the very high levels reached at the beginning of 1986.

TABLE 16 COMPARISON OF CURRENT ACCOUNTS AS % OF NOMINAL GDP/GNP FOR THE G5

		US	Japan	Germany	France	UK	Total
1982		-0.3	0.6	0.6	-2.2	1.4	0.1
1983		-1.4	1.8	0.6	-1.0	1.0	-0.3
1984		-2.8	2.8	1.1	-0.1	0.4	-0.6
1985		-2.9	3.7	2.1	0.0	0.8	-0.7
1986		N/A	N/A	4.0	N/A	-0.3	N/A
1986	1	-3.2	3.6	3.9	0.6	0.7	-0.1
	2	-3.3	4.9	3.7	0.6	-0.1	-0.0
	3	-3.4	4.4	4.7	N/A	-1.0	N/A
	4	N/A	N/A	3.8	N/A	-0.8	N/A

FROM: A C S ALLAN
DATE: 30 March 1987

MR PERETZ

cc PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mrs Lomax
Mr Odling-Smee
Mr Grice
Mr Riley Miss C Evans
Mr M Brown
Mr Willmott - C&E

TCSC: PRIVATE BORROWING

The Chancellor made several points about private borrowing at the TCSC today:

(i) all of the growth in private sector borrowing as a percentage of GDP was accounted for by the growth in mortgage borrowing as a percentage of GDP;

(ii) less than 5 per cent of personal sector debt was accounted for by credit card debt;

(iii) most people use credit cards as transaction cards, and pay off the balance before any interest charges are incurred.

You will be able to check the exact references against the transcript.

2. The Chancellor promised a note on all this, and I should be grateful if you could co-ordinate this, in consultation with FIM and MP.

3. The source for (i) were figures Mr Riley had given me updating those in his minute of 23 March. The source for (ii) was the attached table provided for me by Mr Brown (the figure for bank credit cards in 1985 is in fact only 2 per cent, and although information about store cards is scanty, the number of these is very much smaller). The source for (iii) was the general

information provided by Customs last Autumn (I discover, for example, that the paper attached to Mr Knox's note of 15 December said that "Bank of England figures suggest that 90 per cent of additions to credit card balances are repaid within the interest-free period, whilst DTI advise that at any one time as many as 40-45 per cent of credit cards are being used in effect as charge cards".

ACSA

A C S ALLAN

TABLE 1: LENDING FOR HOUS...

Net Mortgage Advances
(£ million)

	Banks	Building Societies	Others	Total
1983	3560	10928	81	14569
1984	2043	14572	357	16972
1985	4092	14321	4	18417
1986 H1	1824	8856	93	10773

TABLE 2: GROWTH OF PERSONAL SECTOR DEBT

Annual % Change

	Mortgages	Consumer Credit	Other Borrowing
1982	16.6	19.6	27.5
1983	19.1	18.1	18.4
1984	18.7	16.4	11.4
1985	17.1	17.8	22.3

Table 3: The Composition of Personal Sector Debt in 1985

	£ billion	Share of total (%)
Total Stock	172.8	100
of which		
1. Mortgages	126.7	73
2. Consumer Credit	16.4	10
- overdrafts and personal bank loans	4.0	2
- monetary sector credit cards	2.8	2
- consumer credit companies	2.7	2
- other*		
3. Other borrowing	20.2	12

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TREASURY AND CIVIL SERVICE COMMITTEE

31 March 1987

Dear Carys

Mr Higgins will be writing to the Chancellor to thank him and the two senior officials who accompanied him for giving evidence yesterday.

A One supplementary paper was offered, on the topic of use of credit cards and the extent to which indebtedness of this character was cleared off quickly (and therefore was of less significance in aggregate measurements of consumer credit) or persisted, and had to be considered in a different light.

B I was also asked if the Treasury would indicate in quantitative terms the fiscal effect of the proposals affecting Lloyd's Reinsurance to Close.

I would be grateful if, as before, these papers could be available by noon on Friday. The text of the transcript will be sent to you later today.

Yours sincerely

Bill.

W R MCKAY
Clerk to the Committee

cc Mr Allan
Sir P Middleton
Sir Terence Burns
Mr Peretz
Mr Scholar
Mr Odling-Smee
Mr Sedgwick
Mr McManus IR - by fa

Carys Evans
HM Treasury
Parliament Street
SW1P 3AG

Mr Peretz - A
Mr Spence - B (IR - FAX)

I should be grateful if you could ensure that draft replies on both points are submitted to the Chancellor in time to be sent to the Committee on Friday morning please

CE
31/3

CE11

FROM: MISS C EVANS
DATE: 31 MARCH 1987

SIR PETER MIDDLETON
SIR TERENCE BURNS

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir Geoffrey Littler
Mr Cassell
Mr Odling-Smee
Mr Peretz
Mr Scholar
Mr Culpin
Miss O'Mara
Mr Allan

TCSC: CHANCELLOR'S EVIDENCE 30 MARCH

... I attach a copy of the transcript of yesterday's hearing. I should be grateful if you could return to me with your suggested corrections by 2pm tomorrow so that I can prepare a consolidated version to show to the Chancellor before sending to the Committee. I should be grateful also to receive any suggested corrections from copy recipients within the same timescale.

Carys Evans

MISS C EVANS

Ch

I agreed with Carys that it was more sensible to show you this tonight with my suggested amendments. She can then look also at officials' comments & come back to us if there are any conflicting suggestions.

AA

Many thanks. I accept all your (v. helpful) amendments — save one or two, — ~~[illegible]~~ — & have added a few of my own.

N

2823/2

SECRET

FROM: M L Williams

DATE: 31 March 1987

CHANCELLOR

cc Financial Secretary
Sir P Middleton
Mr Monck
Mr D Moore

ELECTRICITY PRIVATISATION

Before our meeting on 2 April, you might like to know how the work is developing in Mr Walker's group. No meeting is scheduled until 27 April, but DEn will be working up a paper before then setting out a possible route. A meeting has been arranged with the PM for 28 April.

The Treasury's Model

2. I have discussed with DEn officials the scope for breaking up the CEGB, which you have long identified as the best means of securing the benefits of competition. My note at Annex A was the basis of these discussions. You may not want to read the note in full, but in brief it:

1) Outlines a development of the model that we discussed at the meeting in your room before Christmas. It is similar to the model in Cooper and Lybrand's 1983 report (which we have not formally seen) and that in Alex Henney's recent CPS pamphlet;

2) describes how the model might work in practice. There is an extensive literature on the ways in which a system that secures full separation between generating and transmission might work. Unfortunately there is no clear cut example overseas (most US power pools include a dominating generator who absorbs the short term fluctuations). Any model has to show how demand and supply can be balanced in both the short term (by spot pricing etc) and in the medium

WILLIAMS → CH/EX 3/3

term (by generating the right signals for future capacity). My outline suggests a possible way forward, but it is not fully specified. There are also practical difficulties to be grappled with; in particular the transmission company would have to ensure system balance, ie stations have to be run out of merit order to make sure that the transmission network can cope with the actual inter-regional flows, and adequate reactive capacity; and also agree a schedule of outages;

3) sets out the possible objections to this model, with a view to identifying whether any are overriding.

Objectives

3. I have already noted that Mr Walker is not attracted to the Treasury's approach. His officials accept that many of the potential obstacles could be overcome, with will, energy and enthusiasm. However, they regard the following points as overriding:

1) the CEGB management would not accept the model's practicality. This goes deeper than Marshall (who would probably resign); we would be faced with serious management opposition;

2) union objections, already strong, would be inflamed to the point where strikes were likely (because they would realise that the only scope for generators to compete with existing capacity would be by manpower cuts);

3) the legislative complications are already acute. To these would be added the problems of having

to introduce new top management into each group, which would then have to establish a track record (individual power stations are operated as autonomous units, but their objectives are subordinated to those of the CEGB as a whole, and they rely heavily on the CEGB for planning and financial functions). Potential investors would also want to form a judgement about the regulatory regime, which at the time would be coping with the transition. All these factors make a successful privatisation within one Parliament impossible. (It would still be possible over two Parliaments; I know that John Wybrew's personal view is that the Government should consider this, if that is needed to get the right solution);

Not impossible: [illegible]

4) it would be impossible to break another coal strike, at least in the way it was done in 1984-85. This is more than a matter of coal stocks; it requires running stations in proportion to their actual and prospective coal stocks, ie completely overriding the normal economic signals;

5) the nuclear difficulties become insurmountable; either the stations would be distributed between the generating groups (which is considered implausible on grounds of public concern and management opposition, even if safety regulations and support arrangements could be put in place), or we would be left with the impossible task of administering the terms of competition between baseload nuclear stations and other non-nuclear stations. This latter point was noted by Max Wilkinson in the FT on 30 March; he seems to have been well briefed by the CEGB.

DEn MODEL

4. The option emerging within DEn (and the ESI) has the following key features:

1) the Area Boards would be amalgamated as one distribution company (DC);

2) the DC would have the right to build its own plant, or purchase directly from other suppliers, including from France. The avoidable cost criterion of the Energy Act would be widened to open up the scope for long term contracts. Other generators would have the right to use the grid, selling direct to final users. In such ways some competitive pressure would be put on the CEGB;

3) the CEGB would have an obligation to supply bulk electricity, but would not have the right to sell direct to consumers (thereby preventing the CEGB from squeezing out new entrants and the DC);

4) the obligation to supply the user would fall on the DC (how this obligation would be specified would essentially be a political decision, although competition with gas is relevant);

5) the DC would be controlled on an (RPI-X) basis, where X may need to incorporate a variety of exogenous factors. The focus of regulation on the CEGB would be in terms of the structure and level of the bulk supply tariff; structure is important if we are to avoid the CEGB undercutting competitors at the margin.

5. The model, which is currently being considered by Mr Walker, is seen as having the following main advantages:

1) we could push ahead straight away. A short bill to brigade the Area Boards could even be ready for the 1987-88 session (which has some advantages were the water legislation to slip). There is then scope for establishing a track record before sale (on the basis of further legislation) in the same Parliament;

2) we would be negotiating with two, rather than, 13, chief executives (ie 1 each for the DC and CEGB). There are also efficiency benefits from amalgamating the DCs (mainly at the managerial, rather than operational, level and by reducing premises);

3) there would be no need to devise and run-in a new arrangement for the grid. Associated costs of the Treasury model (eg supplying tariff-quality meters to all the stations, new computer hardware for the grid, loss of scale economies in stores handling) would be avoided;

4) the CEGB is likely to be more saleable than separate generating companies. Wider share ownership objectives would be
in the Treasury model
complicated by offering a number of apparently similar companies, at the same time trying to ensure their independence of each other (alternatively, corporate purchasers would be wary of the powers of the regulator and of the transmission company). Break-up would also risk breaking the momentum of the legislation, while the sale waited for the new management to establish itself. There would be implications for the timing of receipts (which Mr Moore is covering in a separate note);

5) the industry structure would still put some competiti~~on~~ve pressure on the CEGB. The regulator could also have powers, eg to disallow cost

overruns in tariffs. There would be room to encourage new, smaller and more flexible sources of electricity.

Assessment

6. There is no doubt that DEn's option would be more manageable than the Treasury's. I have yet to be thoroughly convinced that a route involving break-up of the CEGB would be impossible in one Parliament, but it would obviously be extremely difficult and require a substantial team in DEn. Certainly, real little work could be done until there was a CEGB management in place that accepted the game plan. Moreover, the objections in para 3 above are important, and the Prime Minister may attach a high weight to some of these.

7. One of the problems is the absence of any countervailing source of advice. CEGB are likely to assert that the Treasury model would not work. But CEGB co-operation would be needed to specify how a system that separated transmission from generation could be made to work; Coopers and Lybrand noted their own lack of information in their 1983 study. I therefore see the main questions for your meeting as:

1) Do we continue to push a model that involves break-up of the CEGB? Does this in practice mean taking Mr Walker head-on in the No 10 meeting? Certainly an early decision is required if we are to go down this route;

2) are we prepared to accept DEn's emerging model as a second best? My initial view is that it could be built on both to provide a practical route to privatisation and greater scope for competition in the industry. It could cope with amendment (eg to allow for more than one distribution company) without losing these advantages.

M L WILLIAMS

SECRET

ELECTRICITY PRIVATISATION: THE SCOPE FOR COMPETITION IN GENERATION

DEn papers have noted some of the difficulties with any options that involve breaking up the CEGB. This note addresses these with a view to exploring whether they could be acceptably overcome.

Objectives

2. The main objectives of break-up would be to improve the scope for competition, with benefit to the consumer through lower prices, consequent upon efficiency gains in operating and construction costs. "Operating" savings may arise from better management of existing stations. But overseas experience suggests that greater scope may flow from a wider range of power sources, including smaller units, many with higher thermal efficiency and lower capital costs per MW, than the CEGB is currently envisaging. Likely associated benefits include:

i) an end to cross subsidisation between different fuels (with implications for BCC);

ii) greater flexibility of electricity supply in the event of unanticipated demand movements in the medium term.

The Model

3. The model does not have to be specified in detail to illustrate the issues arising. But, in broad terms, it might comprise:

1) the CEGB's stations split into about 6 groups, each group having a mix of stations in terms of geographical spread, merit order and fuel; they would form the new generating companies (GCs) and be sold separately;

2) the CEGB's nuclear stations could be distributed among the GCs, but probably on the basis that the CEGB's nuclear support capability (at Barnwood) would not be split, but contract its services out to separate GCs. Alternatively all the CEGB's nuclear assets could be retained in a single company and either sold or retained in the public sector:

3) a separate transmission company (TC) established, based on CEGB's transmission assets, plus the pumped storage stations and the EdF link. The TC would be highly regulated and could be in either the public or private sector;

4) the Area Boards reorganised into one or more distribution companies (DC), and sold;

5) a regulatory authority (RA).

How it might work

4. There are a number of possible variants, and the details would need to be specified. But the market for gas in the UK provides a possible analogy, as do some of the proposals for the way in which the US power pools might develop (ie under a somewhat less harsh regulatory regime). Any system needs to be capable of matching the supply and demand both of capacity in the medium term and of power in the very short term on the grid.

5. The TC would play the key "central dispatch" role. It would work in a similar manner to the grid now, and be charged to dispatch stations in merit order on the basis of posted prices from them, but also to carry responsibility for scheduling maintenance, maintaining spinning capacity, ensuring stability, etc.

6. The DCs could contract to power (ie capacity) from the

GCs or rely on spot purchase from the TC. These constraints would essentially comprise a fixed capacity charge with a variable element based on marginal costs (and perhaps indexed to fuel etc prices). But the TC would in practice ignore the price terms of the specific DC/GC contracts, seeking only to optimise the cost effectiveness of the whole. Whether a particular GC or station was required (and thus its revenue) would depend on its standing in the merit order at the time. Details of all the contracts would be held by the TC who would charge or reimburse the parties accordingly. If in practice a DC as a result was supplied electricity below the price at which it contracted, the savings would be shared between it and the TC. The original contractor will have covered its fixed costs, but another GC, able to quote a lower marginal cost at the time, will have benefitted at its expense.

7. The DC/GC contract nevertheless offers gains to both parties: it provides the DC with an assurance of supply at a maxmimum cost (on which it can base its own tariffs) and gives the GC an assurance that its fixed costs will be covered, at least to the extent that it has secured forward contracts, and there is a prospect of profitable operation if it can keep its costs down. This will be an important consideration when new capacity is contemplated. In principle contracts could be of any duration, and take a variety of forms.

8. Most electricity users (ie tariff customers) would buy from the DC. But it would be open to larger customers to contract directly with the DC, or with a GC on a par with the DC using the TC as a common carrier (again on the analogy with the gas market). Under this system, the obligation to supply tariff customers would lie with the DC.

9. The DCs would be regulated on an RPI-X basis. The RA would arbitrate the terms of trade between the DCs and other parties (including independent generators and other customers who want to use the distribution network on a common carrier basis). The RA would also ensure that the TC fulfilled its duties, including ensuring that it did not discriminate between

generators. It would have limited responsibilities towards GCs other than promoting competition.

Potential Problems

(i) Nuclear Supply

10. There may be advantages (technical, managerial and financial) in organising the CEGB's nuclear assets in a single company, rather than distributing stations to the GCs. This company would include Barnwood (which would not be split up under any option), and other existing support. It would quote supply costs to the TC as would other companies, although its terms would be subject to scrutiny by the RA (whether the company was in the public or private sectors). The likelihood that the company was used for baseload would add to the competitive pressures on, and thus the attractiveness of, the GCs, but not otherwise affect the operation of the system. Baseload also comprises non-nuclear stations.

11. In practice there may be little advantage in selling the nuclear company, even if public safety concerns could be met. Receipts would probably be small unless the Government was willing to retain decommissioning obligations or guarantees. But it would (theoretically) still be open to the private sector to build new nuclear stations, eg contracting out support to Barnwood.

(ii) Management and Union Objections

12. The restructuring of the CEGB would have major implications for senior management, but less so for those below that level. The key groups, eg those supporting nuclear stations, running the grid, and operating individual stations, would be largely unaffected. Most individuals would have the prospects of enhanced earning power to the extent their company out-performed others. The opposition of the union leadership may be more vocal, but is unlikely to be more of a problem, under this scenario. The implications for top management would clearly need to be addressed soon.

(iii) Track-Record

13. The CEGB's internal accounting system is (should be) sufficiently sophisticated to create a run of financial accounts for the new GCs and TC. The need to establish a financial track record, as such, would therefore be less crucial than the difficulties of privatising companies with a relatively unknown and untried top management. But the potential earning power of existing assets would be well understood, and the new top management may be able to present 2 years results, leaving open the prospect of a successful sale. A further possibility would be transitional contracts with the DC based on existing supply patterns.

(iv) The Timetable

14. On the basis of a 1987 election, the planning deadline for privatisation in the next Parliament should be Spring 1991. If a decision on the broad option were made in late 1987, legislation would be necessary for the 1988-89 session, with the new companies operating from 1989-90.

(v) New capacity

15. The model relies on the price mechanism to generate new capacity; capacity shortages will push up the spot price signalling the scope for economic investment in new stations. The possible need for new capacity would be signalled some time before there was any physical need for capacity, since the higher price would reflect a movement down the merit order. The trend of the marginal price would also be clear, and the price to customers would not need to rise unduly before new capacity was available. There would however be a greater incentive for investment in smaller generating units (including CHP schemes etc) because they can be brought on scheme more quickly and are less risky in the event of unanticipated demand charges. The scale economies of large units are probably not sufficiently great to imply large efficiency losses.

16. More difficult is an inadequate (ie economically irrational) response by the potential new investors. But the RA would be

charged to remove possible market barriers.

(vi) Price Variation between regions

17. Under the model outlined, generation costs throughout the UK are equalised through the operation of the TC. The average costs to a DC wil depend on its portfolio of contracts, but there would, so long as the transmission system broadly matched the import/export balance, be little regional variation in marginal costs. In principle, a DC could charge tariff customers according to the added distribution costs that they impose. Were there to be different DCs, they might follow different practices in this respect. In principle it would be open to the Government (at some cost to receipts) to impose a public interest obligation on the degree of variation. But is has not done so for previous privatisations.

18. There may be substantial variations between non-tariff customers, but this will reflect their negotiating success as well as regional variation.

(vii) Endurance

19. The cost for Government of imposing an obligation on the GCs to carry non-economic excess coal stocks would be negligible. The obligation placed on the TC to meet the DC's contracts with GCs for supply, coupled with the TC's powers to discharge this responsibility in the most effective way, would allow it to act in a way not dissimilar to the CEGB during the 1984 strike. Endurance considerations are another reason for reviewing the options for coal privatisation in parallel.

(viii) Impact on BCC

20. Implicit in competition between GCs is a freedom to seek fuel from the cheapest sources. The implications for BCC, and a possible strategy for its privatisation, should therefore be considered in parallel. The short term impact could however be mitigated by a series of transitional contracts (not dissimilar to the existing deal, which allows for a declining first tranche

over time, but there would have to be provision for more non-BCC purchases). Falling coal prices in the medium term would help offset price rises, at least to some customers, that may be implied by a move to more commercial electricity pricing.

(xi) Liquidation

21. In the event of a GC going into liquidation, the liquidators would have an obligation to continue to supply to the extent required by the TC (and at the cost, ultimately, to consumers). In due course the liquidated assets would be purchased or new supply developed.

Conclusions

22. From this brief summary, the following main questions emerge:

i) Would the model outlined, or something like it, work in practice?

ii) Is the timetable feasible?

iii) Although there are a number of other potential problems, is it accepted that none is necessarily overriding?

iv) What are the key issues in judging the balance of costs and benefits?

M L WILLIAMS
18 MARCH 1987

td6

WORLD ECONOMIC DEVELOPMENTS

Summary

1. Nominal GNP in the G5 countries grew by an estimated 4½ per cent in the year to 1986 Q4, with real GNP and the GNP deflator both increasing by 2¼ per cent.

2. Latest figures show that industrial production is still weak in the G5 countries.

	Real GNP (85Q4-86Q4)	Industrial Production (Jan 86 - Jan 87)
US	2	0.6
Japan	2	0.2
Germany	2½	-1.6
France	na	0.0
UK	2½	1.8 (Dec)
G5	2¼	0.2

3. G5 consumer price inflation was just under 1 per cent in January, but will pick up to about 1½ per cent in February.

4. The trade imbalances of the US, Japan and Germany may have stopped expanding, but there is no sign yet of any reductions.

5. The Bank of Japan cut its discount rate from 3 per cent to 2½ per cent on 23 February. In the US the Federal Reserve has suspended M1 as a target monetary aggregate, but will continue to target M2 and M3.

6. Finance Ministers of six of the Group-of-seven countries met in Paris on 22 February. They agreed to co-operate to maintain exchange rates around current levels.

JOHN COLENUTT TONY DOLPHIN

1 APRIL 1987

SECTION A: NOMINAL AND REAL GNP

1. The annual growth rate of nominal GNP in the G5 countries slowed to 4½ per cent in the year to the fourth quarter of 1986. Inflation, as measured by the GNP deflator, fell to 2¼ per cent. As France has not yet released GNP estimates for the third and fourth quarters (because of a rebasing exercise) these, and other GNP figures for the G5, are part-estimates.

Table 1: Nominal GNP growth in the G5 countries*

	Nominal GNP	Real GNP	GNP Deflator
Annual percentage change			
1980	9.6	0.8	8.8
1981	9.7	1.5	8.1
1982	5.6	-0.5	6.1
1983	7.1	3.0	4.0
1984	8.5	4.7	3.6
1985	6.5	3.0	3.4
1986	5.5	2.5	2.9
Change from four quarters earlier (per cent)			
1985 Q1	6.1	2.7	3.3
Q2	6.6	3.1	3.4
Q3	6.7	3.3	3.3
Q4	6.7	3.0	3.6
1986 Q1	6.2	2.7	3.3
Q2	5.9	2.6	3.2
Q3	5.4	2.3	3.0
Q4	4.5	2.2	2.2

* G5 weighted averages are calculated using GNP in 1980 prices converted to a common currency using average 1980 exchange rates.

CHART 1: G5 REAL AND NOMINAL GNP

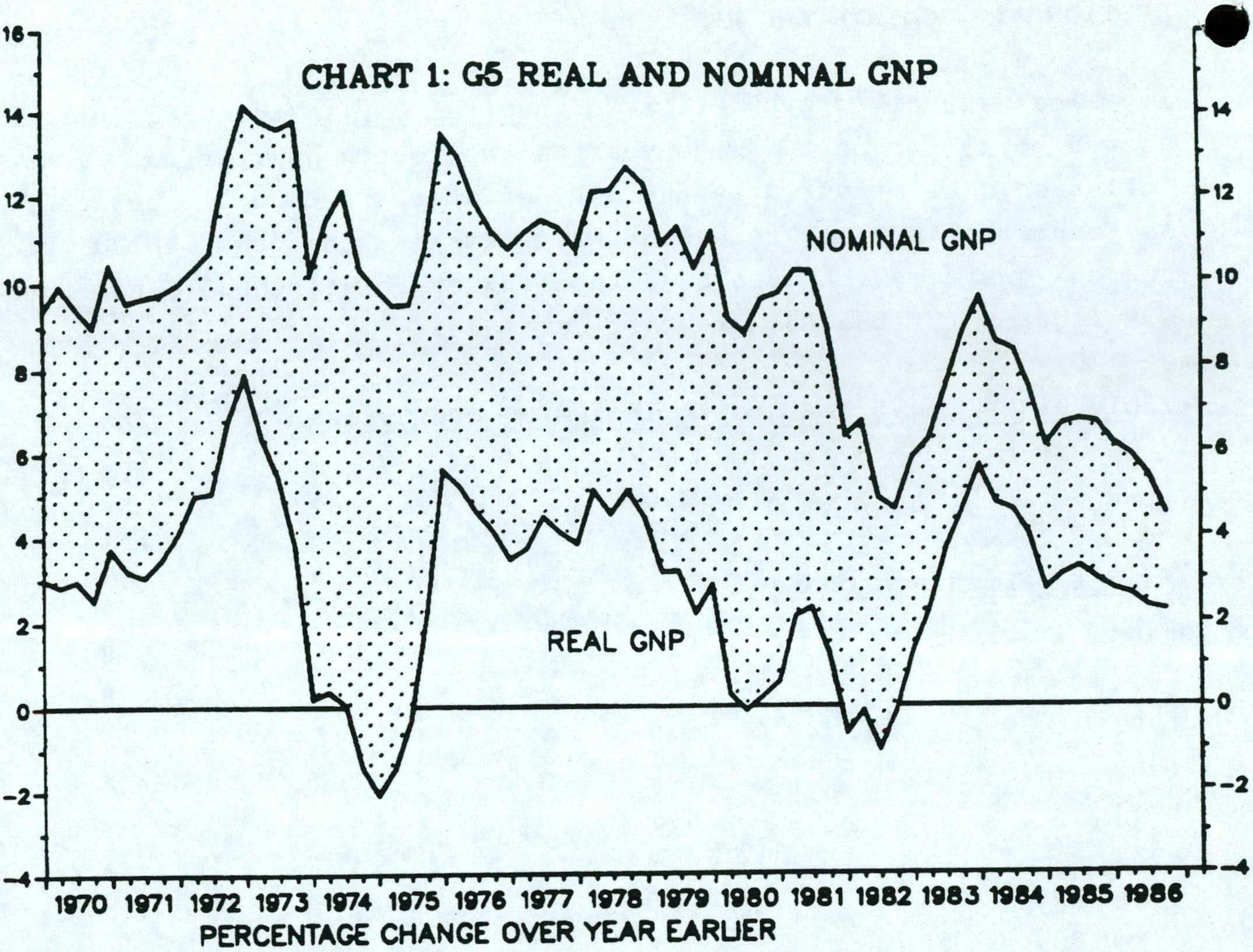
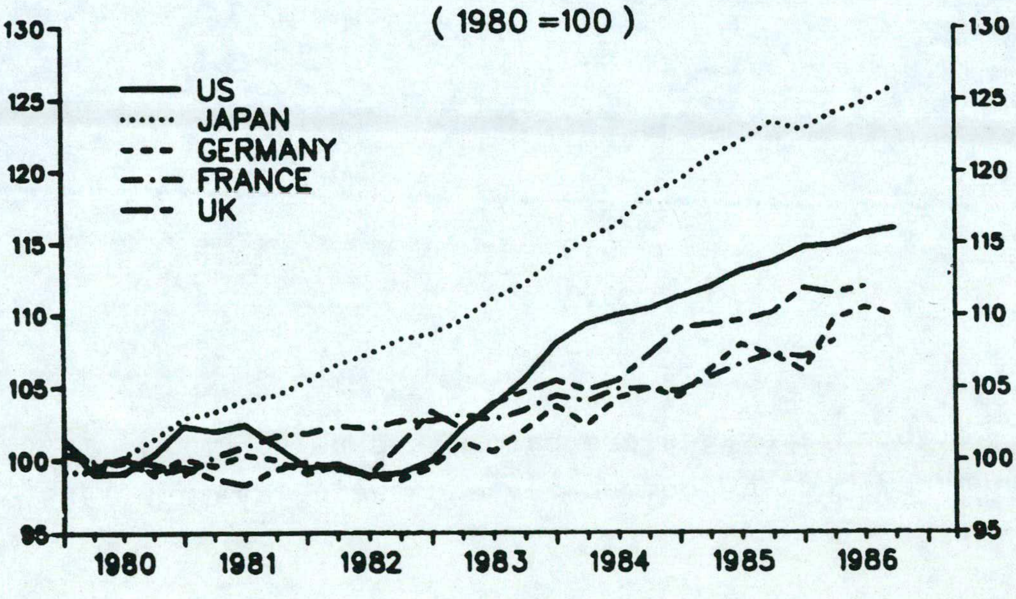


CHART 2: GNP IN THE G5 COUNTRIES

(1980 =100)



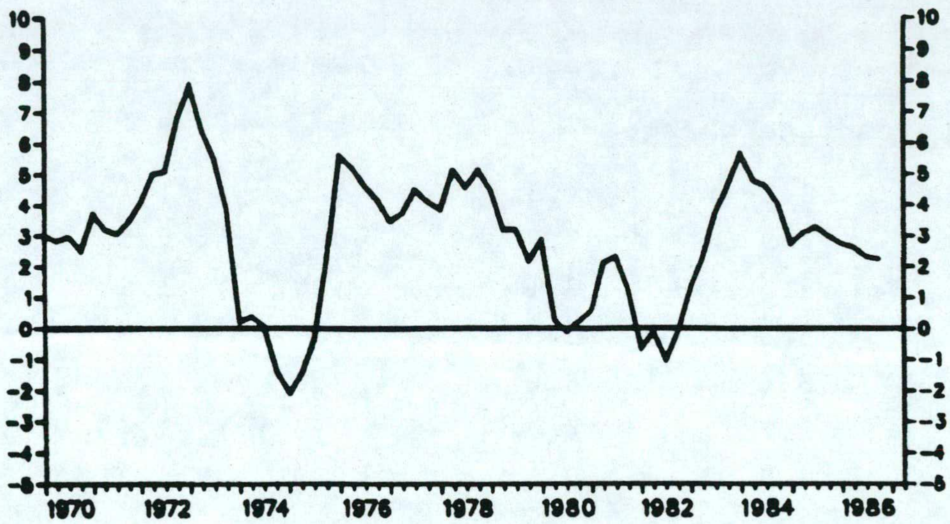
2. Figures for the fourth quarter of 1986 show that real GNP growth for the year to Q4 slowed in the US and Japan. Japanese growth in the year to Q4 was at its lowest for over twelve years.

Table 2: GNP growth in individual countries

		US	Japan	Germany	France	UK	G5
Annual percentage changes							
1980		-0.2	4.3	1.5	1.1	-2.2	0.8
1981		1.9	3.7	0.1	0.5	-1.0	1.5
1982		-2.5	3.1	-1.0	1.8	0.9	-0.5
1983		3.6	3.3	1.8	0.7	3.7	3.0
1984		6.4	5.0	3.0	1.5	2.1	4.7
1985		2.7	4.7	2.5	1.4	3.6	3.0
1986		2.5	2.5	2.5	2.3	2.4	2.5
Change from four quarters earlier (per cent)							
1985	Q1	3.0	4.7	0.6	0.3	3.4	2.7
	Q2	2.3	4.8	3.7	1.5	4.3	3.1
	Q3	2.7	4.9	3.5	1.6	4.0	3.3
	Q4	2.9	4.2	2.2	2.3	2.7	3.0
1986	Q1	3.1	3.0	1.7	2.2	2.5	2.7
	Q2	2.6	2.5	3.3	2.4	2.0	2.6
	Q3	2.3	2.3	2.3		2.1	2.3
	Q4	2.1	2.0	2.6		3.0	2.2

Note: Expenditure measure of GNP/GDP at market prices

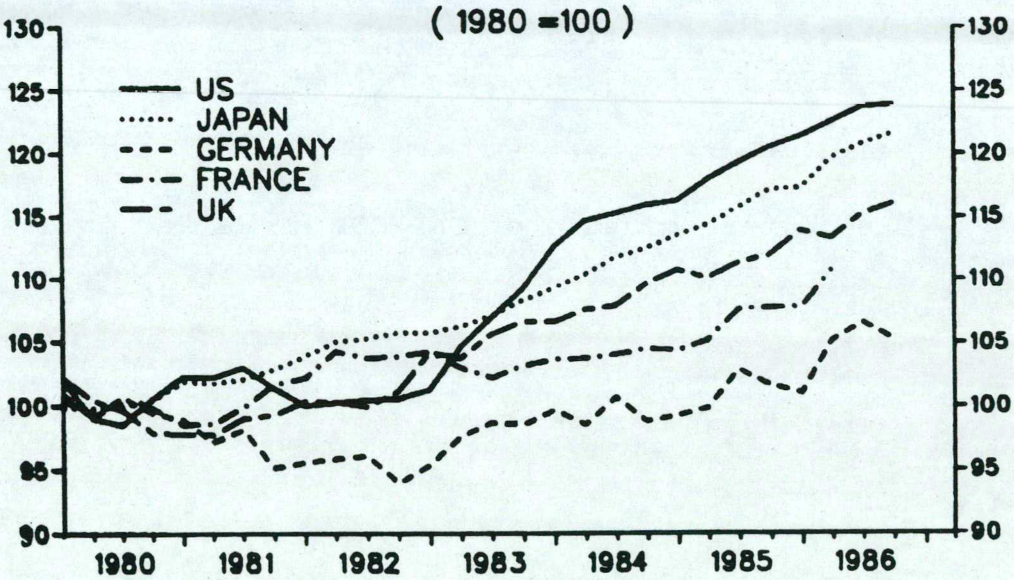
CHART 3: G5 GNP GROWTH



PERCENTAGE CHANGE OVER YEAR EARLIER

CHART 4: DOMESTIC DEMAND IN THE G5 COUNTRIES

(1980 =100)



3. Domestic demand growth in the G5 has exceeded GNP growth since the third quarter of 1985. In the fourth quarter of 1986 domestic demand in the US slowed sharply, bringing down total G5 domestic demand growth.

Table 3: Domestic demand growth in individual countries

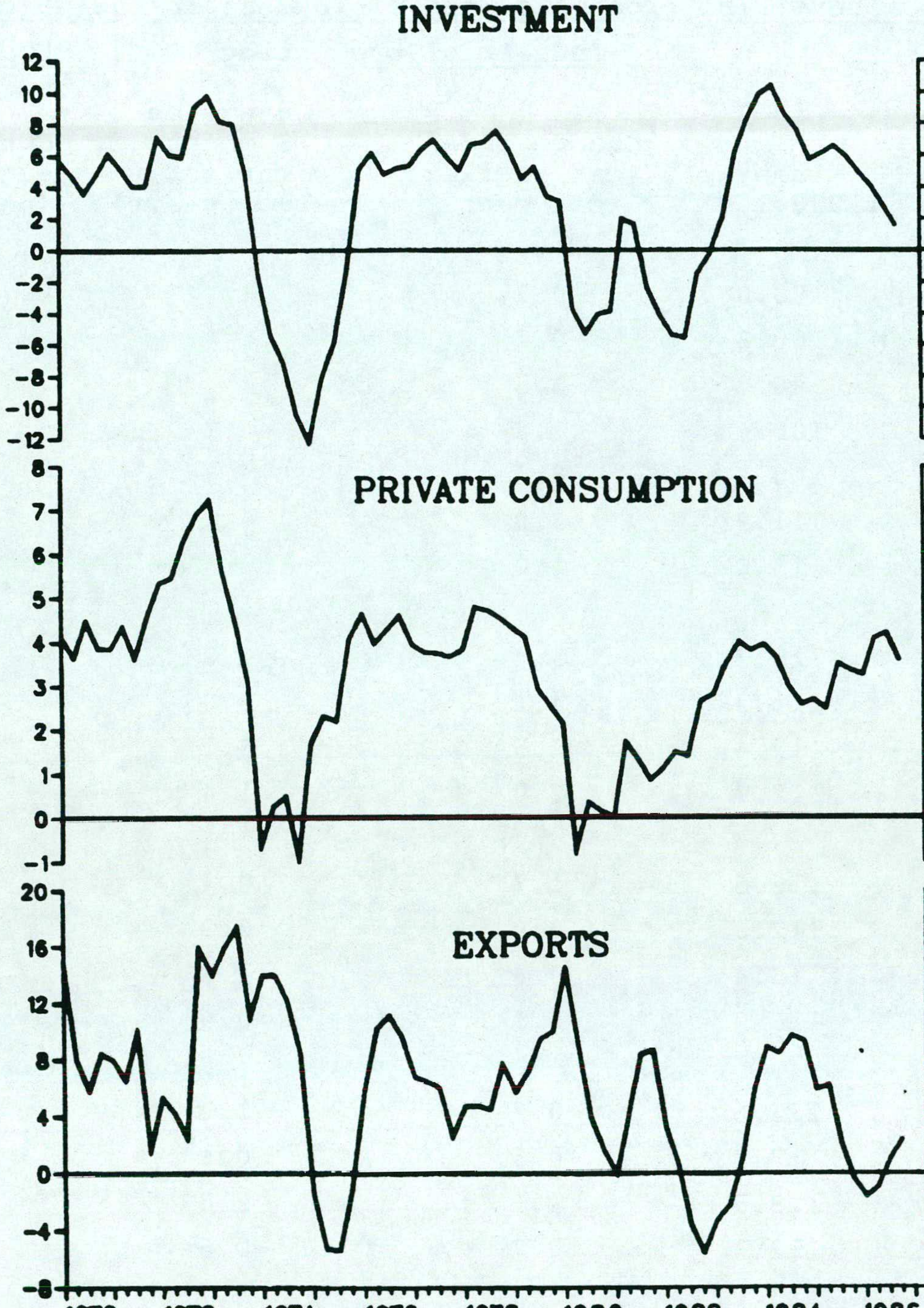
	US	Japan	Germany	France	UK	G5
Annual percentage changes						
1980	-2.0	0.8	1.1	2.1	-3.1	-0.7
1981	2.2	2.2	-2.7	-0.3	-1.5	0.9
1982	-1.8	2.8	-2.0	3.9	2.0	0.0
1983	5.2	1.8	2.3	-0.3	4.6	3.4
1984	8.5	3.8	1.9	0.8	2.7	5.3
1985	3.4	3.8	1.5	2.1	2.8	3.0
1986	3.7	4.0	3.6		3.2	3.7
Change from four quarters earlier (per cent)						
1985 Q1	3.2	3.8	-0.4	0.7	3.8	2.6
Q2	2.9	3.6	1.3	1.3	2.3	2.6
Q3	3.5	3.5	2.2	3.4	3.2	3.3
Q4	4.0	4.2	2.9	3.1	2.1	3.6
1986 Q1	4.4	3.3	1.8	3.2	2.8	3.6
Q2	3.9	4.6	5.3	5.2	2.9	4.3
Q3	3.7	4.4	3.6		3.5	3.7
Q4	2.8	3.8	3.6		3.7	3.1

4. The slowdown in growth in the G5 countries in the fourth quarter is attributable, in part, to slower growth in real consumers' expenditure with particular weakness in the United States and Japan. Investment continues to slow down, reflecting the maturity of the business cycle in the US and adverse effects in Japan and Germany from the appreciation of the yen and the deutschemark. Exports picked up modestly in the third and fourth quarters, and imports fell back, but the gap between the growth of export and import volumes remains wide.

Table 4: Growth of real expenditure in the G5 countries

	Real GNP	Private Consumption	Investment	Government Expenditure	Exports	Imports
			Annual percentage change			
1980	0.8	0.5	-2.5	1.2	7.1	-1.7
1981	1.5	1.0	-0.7	2.0	5.2	1.5
1982	-0.5	1.7	-4.2	1.2	-1.4	1.3
1983	3.0	3.5	4.0	1.1	0.3	2.9
1984	4.7	3.3	9.1	2.7	9.1	12.5
1985	3.0	3.0	6.1	3.4	3.4	3.5
1986	2.5	3.8	3.3	4.0	0.2	6.8
			Change from four quarters earlier (per cent)			
1985 Q1	2.7	2.7	5.7	3.6	5.9	5.2
Q2	3.1	2.5	6.1	1.7	6.2	3.4
Q3	3.3	3.5	6.6	3.5	2.1	2.3
Q4	3.0	3.4	5.9	4.7	-0.4	3.0
1986 Q1	2.7	3.2	4.9	2.6	-1.6	3.1
Q2	2.6	4.1	4.1	4.9	-1.0	7.7
Q3	2.3	4.2	2.9	3.5	1.0	8.8
Q4	2.2	3.6	1.6	4.9	2.4	7.6
			Indices (1980=100)			
1985 Q1	110.8	111.6	110.7	108.5	117.2	120.8
Q2	111.8	112.4	113.7	109.2	118.4	122.4
Q3	112.9	113.8	116.0	111.7	116.7	124.1
Q4	113.5	114.4	118.0	113.6	116.9	125.3
1986 Q1	113.9	115.2	116.2	111.3	115.3	124.6
Q2	114.8	117.0	118.4	114.6	117.2	131.9
Q3	115.5	118.6	119.3	115.6	117.9	135.0
Q4	116.0	118.4	119.9	119.2	119.6	134.8

CHART 5: G5 EXPENDITURE GROWTH



PERCENTAGE CHANGE OVER YEAR EARLIER

5. As Table 5 and Chart 6 show, <u>industrial production</u> in the G5 countries as a whole grew only very little throughout 1986. There is no indication of a pick up in recent months.

Table 5: Industrial production and employment in the G5 countries

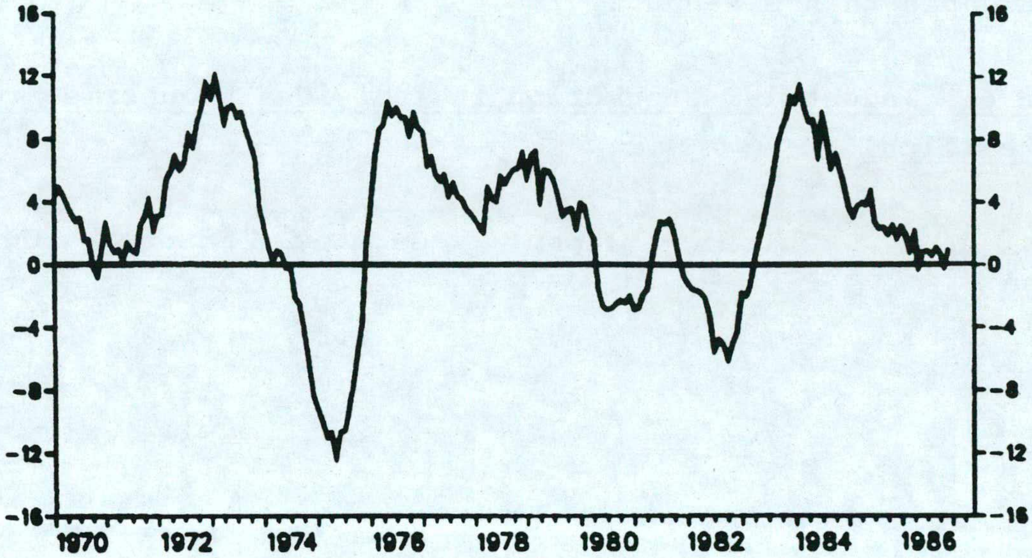
	Industrial production			Employment
	Index (1980=100)	Change on a year earlier (per cent)	Change on 6 months earlier, (per cent a.r)	Change on a year earlier (per cent)
1980	100.0	-0.7		0.5
1981	100.3	0.2		0.2
1982	96.7	-3.5		-0.6
1983	100.4	3.8		0.6
1984	108.7	8.2		2.1
1985	111.9	3.0		1.3
1986	113.0	1.0		
1985 Q1	110.7	3.4	2.2	1.8
Q2	111.9	4.1	3.0	1.1
Q3	112.4	2.5	3.1	1.2
Q4	112.7	2.0	1.4	1.2
1986 Q1	112.6	1.7	0.4	1.3
Q2	112.8	0.9	0.3	1.4
Q3	113.4	0.8	1.2	1.3
Q4	113.2	0.5	0.9	
1986 July	113.6	0.9	1.2	
Aug	113.0	0.5	0.1	
Sep	113.5	1.1	2.8	
Oct	113.3	0.7	-0.6	
Nov	113.0	-0.2	1.7	
Dec	113.3	1.0	0.8	
1987 Jan	113.1	0.2	-0.8	

6. Recent industrial production figures in individual countries have been erratic making it difficult to discern trends. In each of the G5 countries production was weak throughout 1986, but more so in Japan than elsewhere.

Table 6: Industrial production in individual countries (change on year earlier)

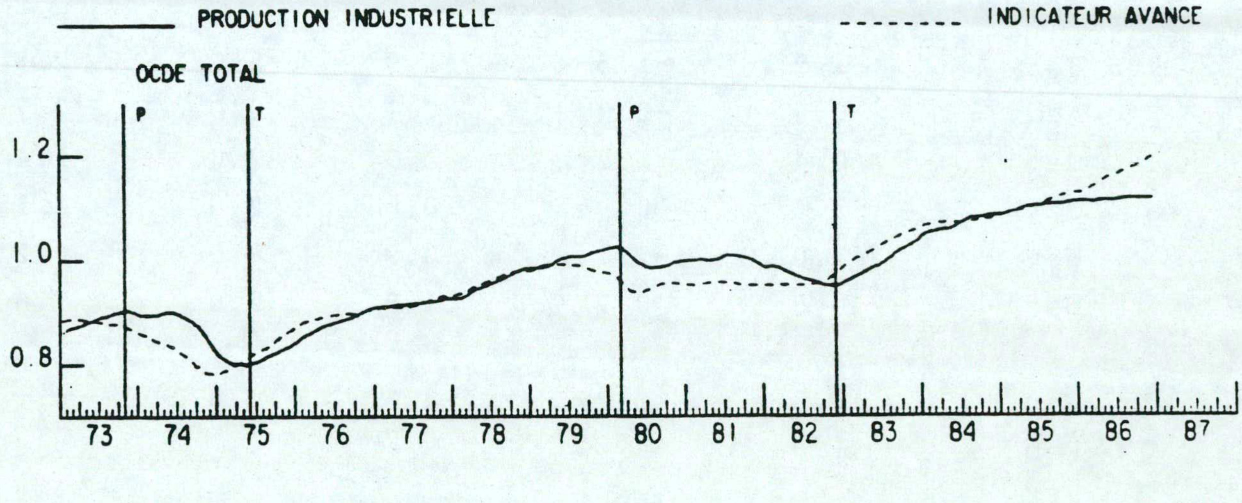
	United States	Japan	Germany	France	United Kingdom
1980	-1.9	4.6	0.3	-1.0	-6.7
1981	2.2	1.1	-1.8	-2.7	-3.4
1982	-7.2	0.4	-2.9	-1.4	1.8
1983	5.9	3.5	0.8	1.1	3.6
1984	11.5	10.9	3.4	2.9	1.2
1985	1.7	4.5	5.4	0.3	4.8
1986	1.0	-0.3	2.1	1.3	1.4
1985 Q1	3.2	6.6	3.7	-1.3	2.3
Q2	1.7	6.2	9.1	0.7	6.6
Q3	0.6	4.4	4.6	0.3	5.8
Q4	1.3	1.0	4.2	1.7	4.5
1986 Q1	1.6	1.4	2.9	0.3	2.5
Q2	0.7	-0.5	3.2	1.7	-0.3
Q3	0.8	-1.1	2.2	2.0	2.1
Q4	1.0	-1.0	0.3	1.3	1.0
1986 July	1.2	-1.5	1.9	2.0	2.3
Aug	0.6	-2.9	2.9	2.0	2.7
Sep	0.4	1.2	1.9	2.0	1.4
Oct	1.4	-0.9	0.0	2.0	1.1
Nov	1.0	-2.1	-0.9	0.0	0.2
Dec	0.6	0.2	1.9	2.0	1.8
1987 Jan	0.5	0.2	-1.5	0.0	
Feb	1.6				

CHART 6: G5 INDUSTRIAL PRODUCTION



PERCENTAGE CHANGE OVER YEAR EARLIER

CHART 7: OECD LEADING INDICATORS



7. The OECD's leading indicators, which are shown in chart 7, still point to a recovery of industrial production in 1987.

8. Unemployment has fallen in Germany, the UK and especially the United States since 1984, but in France the trend remains upwards.

Table 7: OECD Standardized Unemployment rates (per cent of labour force)

	US	Japan	Germany	France	UK	G5
1980	7.0	2.0	3.0	6.3	6.4	5.4
1981	7.5	2.2	4.4	8.1	9.8	6.4
1982	9.5	2.4	6.1	8.3	11.3	7.7
1983	9.5	2.6	8.0	8.3	12.5	8.0
1984	7.4	2.7	8.5	9.7	11.7	7.4
1985	7.1	2.6	8.6	10.1	11.3	7.2
1986	6.9	2.8		10.3	11.5	
1986 Q1	7.0	2.6	8.4	10.0	11.5	7.2
Q2	7.1	2.7	8.4	10.3	11.7	7.3
Q3	6.8	2.9	8.2	10.4	11.6	7.1
Oct	6.8	2.8	8.0	10.6	11.4	7.1
Nov	6.8	2.8		10.7	11.4	
Dec	6.6	2.9		10.8	11.2	
1987 Jan	6.6			10.9	11.2	

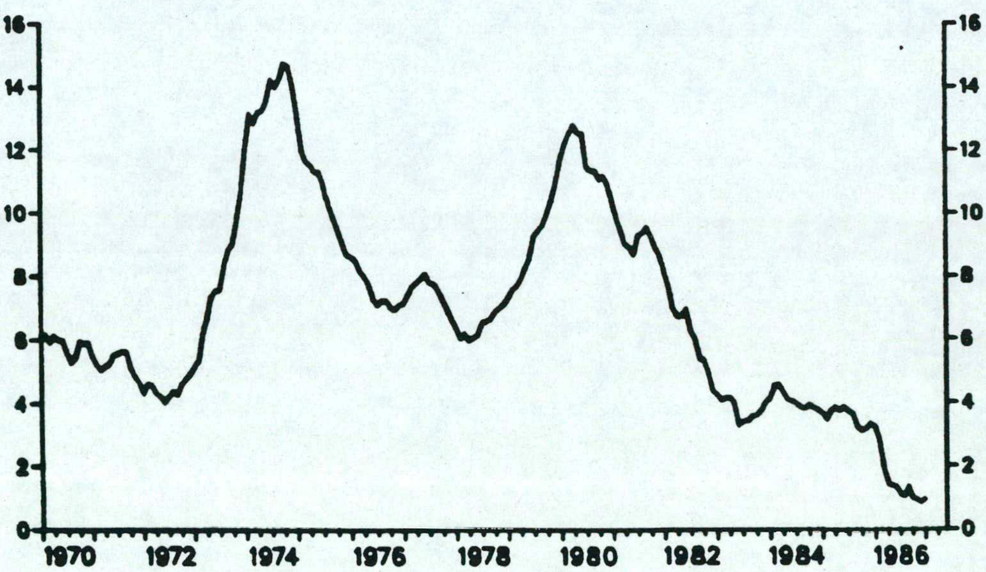
SECTION B: PRICES AND WAGES

9. G5 consumer price inflation remained at its lowest level for over 20 years in January. In both Germany and Japan prices are still lower than a year earlier. There are, however, signs in each country, except Japan, that inflation is picking up again as the effects of the fall in oil prices drops out of the twelve month comparison.

Table 8: Consumer prices (percentage change on a year earlier)

		US	Japan	Germany	France	UK	G5
1980		13.5	8.0	5.6	13.5	18.0	11.7
1981		10.3	4.9	6.3	13.3	11.9	9.2
1982		6.2	2.6	5.3	12.0	8.6	6.2
1983		3.2	1.8	3.3	9.5	4.6	3.8
1984		4.3	2.3	2.4	7.7	5.0	4.1
1985		3.6	2.0	2.2	5.8	6.1	3.5
1986		1.9	0.5	-0.2	2.5	3.4	1.5
1986	Sept	1.7	0.3	-0.4	2.3	3.0	1.3
	Oct	1.5	-0.6	-0.9	2.2	3.0	1.0
	Nov	1.3	-0.2	-1.2	2.1	3.4	0.9
	Dec	1.1	-0.4	-1.1	2.1	3.7	0.8
1987	Jan	1.4	-1.5	-0.8	3.0	3.9	0.9
	Feb	2.1		-0.5	3.4	3.9	

CHART 8: G5 CONSUMER PRICE INFLATION



PERCENTAGE CHANGE OVER YEAR EARLIER

10. Table 9 shows that the growth rate of unit labour costs (not cyclically adjusted) has risen in Japan and Germany reflecting weak output growth.

Table 9: Unit labour costs (manufacturing, percentage change on year earlier)

	US	Japan	Germany	France	UK	G5
1980	11.2	-0.5	7.9	12.4	22.1	9.7
1981	7.3	3.7	4.8	11.7	8.6	6.9
1982	6.2	-0.8	3.2	11.1	4.6	4.9
1983	-2.5	-2.2	-0.5	7.6	0.0	-0.8
1984	-0.6	-3.9	1.0	4.7	2.6	-0.1
1985	0.6	0.9	0.8	2.0	5.8	1.3
1985 Q1	1.1	-0.3	0.1	5.1	4.5	1.5
Q2	0.0	-0.2	0.1	1.4	5.4	0.6
Q3	0.8	1.1	1.6	1.7	7.1	1.7
Q4	0.5	3.3	1.3	-0.1	6.3	1.6
1986 Q1	0.0	3.0	2.8	-0.4	8.1	1.7
Q2	0.9	3.9	3.0	-0.1	7.2	2.2
Q3	-0.5	3.9	4.7	0.6	4.3	1.6

Source: IMF

11. Oil prices have remained close to, but generally lower than, OPEC's reference price of $18. OPEC's current production is thought to be significantly below quota.

12. UN commodity price figures are shown in Table 10 and 11. These are unit value indices, and are based on spot and producer prices. They are, therefore, more representative of long-term contracts and less volatile than the Economist commodity price index. They show that real commodity prices are now at very low levels historically.

Table 10: Commodity Prices (In nominal SDRs, (1980 = 100)

	Food	Agricultural Non-Food	Non-Ferrous Metals	Metal Ores	Oil
1980	100.0	100.0	100.0	100.0	100.0
1981	97.8	102.3	97.4	99.1	123.6
1982	91.3	96.3	91.3	101.1	126.7
1983	94.1	104.5	95.3	103.3	116.2
1984	93.2	115.5	96.8	102.8	117.5
1985	85.5	99.9	91.1	101.0	113.5
1986	83.2	82.7	77.3	84.1	52.8
1985 Q1	87.5	107.7	95.6	105.9	121.1
Q2	85.3	104.9	94.4	106.0	116.7
Q3	83.6	96.3	90.0	98.2	109.4
Q4	85.7	90.5	84.5	93.8	107.0
1986 Q1	90.3	87.9	82.2	90.8	80.5
Q2	86.3	84.1	78.5	85.5	46.0
Q3 est*	79.0	77.9	74.7	80.0	38.5
Q4 est*	77.3	81.1	73.8	79.9	46.2

Source: United Nations
* By Bank of England

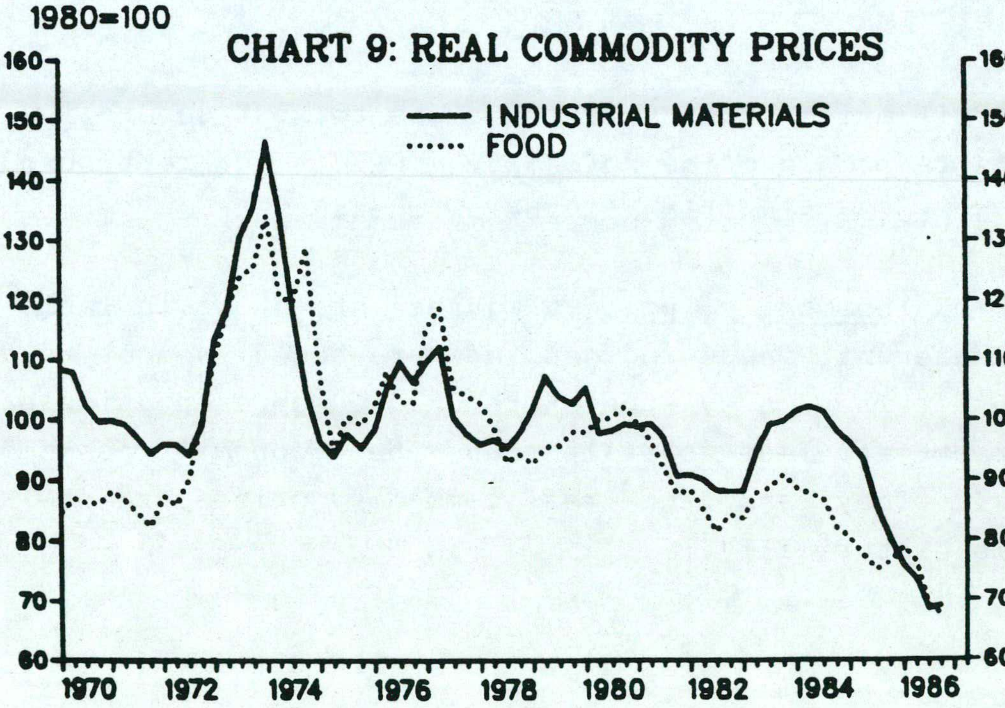


Table 11: Commodity Prices (1980 = 100)

	Real prices* Food	Industrial materials**	Oil	Nominal oil price $ per barrel***
1980	100.0	100.0	100.0	30.3
1981	93.7	96.4	118.4	34.0
1982	84.7	89.2	117.5	32.6
1983	87.6	95.2	108.2	29.0
1984	86.2	100.7	108.6	28.1
1985	77.2	88.7	102.6	26.9
1986	73.1	71.9	46.3	14.6
1985 Q1	80.2	96.1	111.1	27.3
Q2	77.4	93.4	105.9	27.0
Q3	75.0	85.5	98.1	26.2
Q4	76.3	80.1	95.3	26.9
1986 Q1	78.8	76.2	70.2	21.1
Q2	76.2	73.4	40.6	12.4
Q3 est	69.7	68.4	34.0	10.8
Q4 est	67.6	69.4	40.5	13.0

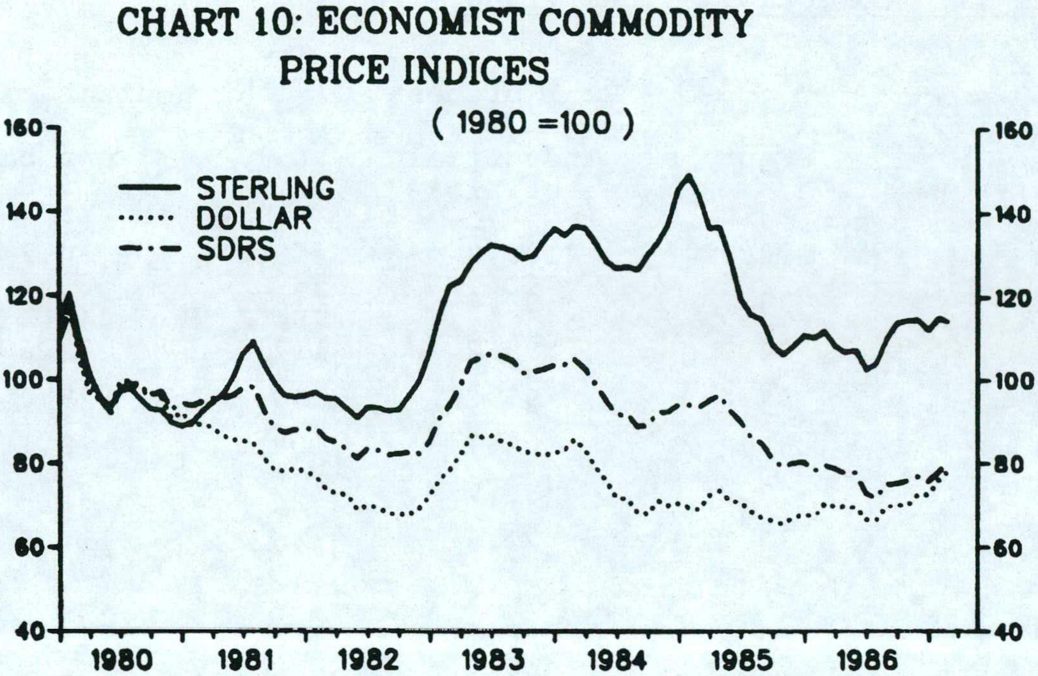
* deflated by the manufactures' unit value index.

** comprises agricultural non-food, non-ferrous metals and metal ores as shown in Table 8.

*** average OECD import price measured fob.

Source: United Nations

13. The Economist non-oil commodity price index provides an indication of more recent commodity price movements. Chart 10 shows that prices have recovered slightly from the very low levels reached in August last year. On 24 March the SDR all-items index was slightly higher than a month earlier, but 12½ per cent down on a year ago. In the past month food prices have been little changed, but industrial materials prices have risen slightly.



SECTION C: TRADE AND CURRENT BALANCES

14. G5 export volumes to various trade blocs are shown in Table 12. These figures are derived from the data for exports at current prices using total export unit value indices, because export UVIs are not available for separate trade blocs. The figures for total exports and exports to OECD include intra-G5 trade. The G5 export volumes index is a weighted average of the five individual countries exports.

15. Allowing for seasonal variations exports to OECD countries appear to have picked up slightly since the middle of 1986. Between the first eleven months of 1985 and the first eleven months of 1986 exports to OPEC countries fell by 19 per cent and exports to other non-OECD countries fell by 5 per cent.

Table 12: G5 Export Volumes (1980 = 100, not seasonally adjusted)

	Total	to OECD	to non-OECD	of which: OPEC	non-OPEC
1980	100	100	100	100	100
1981	102	101	106	119	102
1982	99	99	100	122	94
1983	99	102	93	100	91
1984	107	113	95	85	98
1985	110	119	93	75	98
1985 Q1	110	118	94	78	98
Q2	112	120	94	75	99
Q3	106	114	89	72	94
Q4	114	124	94	73	101
1986 Q1	107	118	84	67	89
Q2	112	124	86	64	93
Q3	106	118	84	55	92
1985 Nov	110	121	90	67	96
Dec	113	119	101	82	107
1986 Jan	102	113	80	63	86
Feb	106	119	81	60	88
Mar	112	123	89	69	95
Apr	117	130	91	74	96
May	106	117	84	60	92
Jun	112	126	84	58	92
Jul	113	125	89	62	97
Aug	96	103	82	53	90
Sep	110	125	81	50	90
Oct	120	135	89	57	99
Nov	109	122	83	56	91

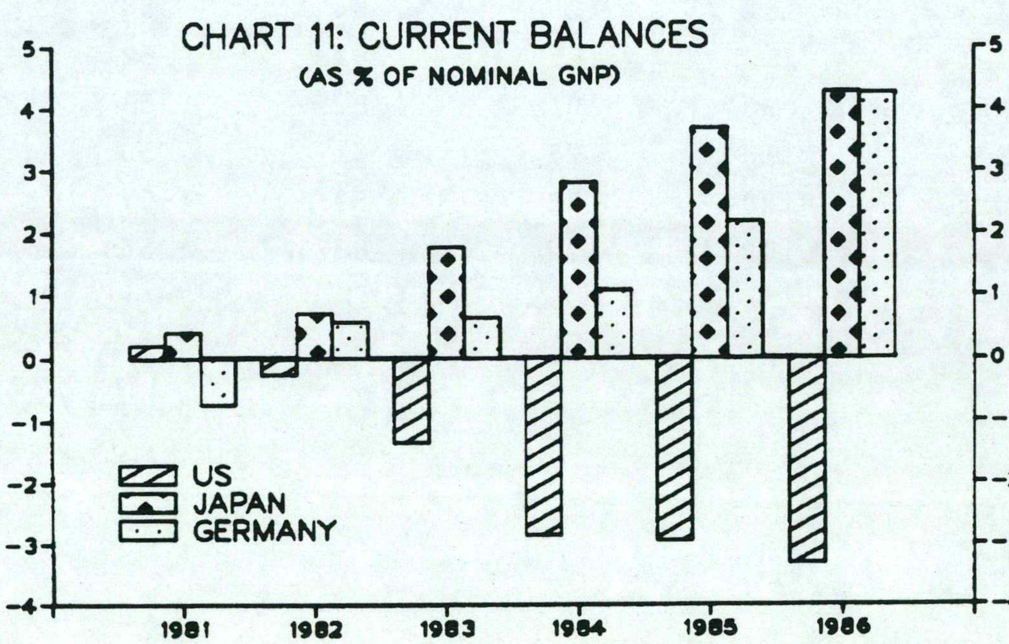
16. The US trade deficit in January was $15 billion, up from a revised estimate of $11 billion in December. Japanese and German trade surpluses in January, confirmed recent signs of a levelling-off, but gave no indication that their surpluses were beginning to decline.

Table 13: Current balance ($bn)

	US	Japan	Germany	France	UK	G5
1982	-11	8	3	-12	7	-6
1983	-42	21	9	-4	5	-16
1984	-107	35	6	0	2	-64
1985	-118	49	14	0	5	-50
1986	-141	86	36	4	-1	-16
latest 12 months	-141 (Dec)	89 (Jan)	37 (Jan)	4 (Dec)	-2 (Jan)	-13

Visible Trade balance

	US	Japan	Germany	France	UK	G5
1982	-36	8	21	-20	-3	-30
1983	-61	20	16	-9	-8	-42
1984	-114	34	19	-3	-11	-73
1985	-124	47	26	-3	-8	-63
1986	-170	93	52	-0	-13	-38
latest 12 months	-170 (Jan)	95 (Jan)	54 (Jan)	-1 (Feb)	-13 (Jan)	-35



SECTION D: INTEREST RATES, MONEY SUPPLY AND EXCHANGE RATES

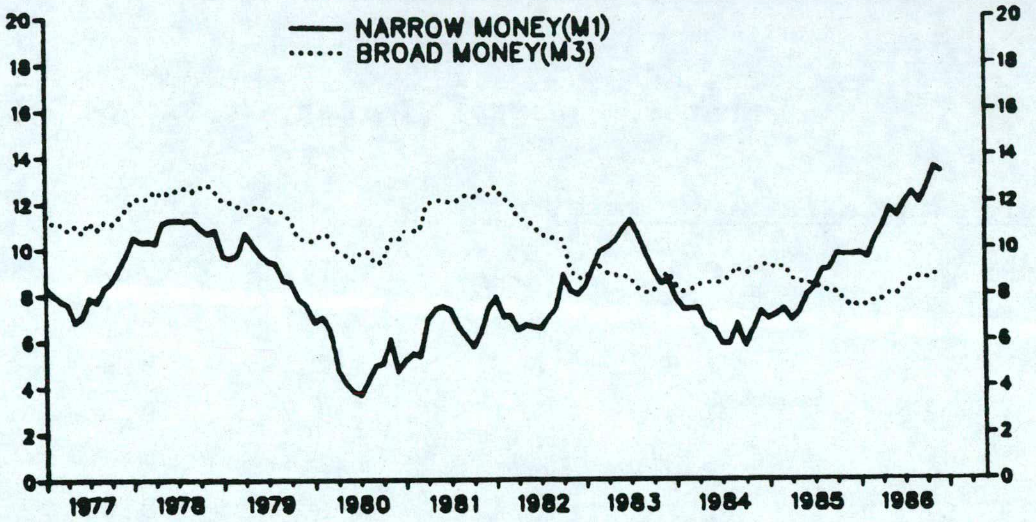
17. On 23 February the Bank of Japan cut its discount rate by ½ percentage point to 2½ per cent. On 9 March the Banque de France lowered its money market interest rates by ¼ per cent.

Table 14: Interest rates in the G5 countries

	United States	Japan	Germany	France	UK	G5 weighted average
Three-month interest rates						
1985 Q1	8.7	6.3	6.2	10.6	13.1	8.5
Q2	8.0	6.3	5.9	10.4	12.7	8.1
Q3	7.8	6.3	5.0	9.9	11.7	7.7
Q4	7.9	7.1	4.9	9.1	11.6	7.8
1986 Q1	7.7	6.1	4.6	8.8	12.4	7.5
Q2	6.7	4.7	4.6	7.5	10.3	6.5
Q3	6.1	4.7	4.6	7.2	9.9	6.1
Q4	5.8	4.5	4.7	7.6	11.2	6.1
1987 Q1	6.0	4.1	4.2	8.3	10.6	6.1
30 Mar	6.3	4.0	4.0	7.9	9.9	6.1
Long-term government bond yields						
1985 Q1	11.6	6.8	7.5	11.2	11.7	10.0
Q2	10.9	6.7	7.2	10.9	11.2	9.6
Q3	10.3	6.3	6.7	10.8	10.7	9.1
Q4	9.8	6.1	6.7	10.6	10.7	8.8
1986 Q1	8.6	5.5	6.5	9.6	10.7	8.0
Q2	7.6	4.8	6.1	7.9	8.9	7.0
Q3	7.3	4.8	6.1	7.7	9.7	6.9
Q4	7.2	5.1	6.4	8.4	11.1	7.2
1987 Q1	7.2	4.8	6.3	8.7	9.8	7.0
30 Mar	7.5	4.2	6.1	8.6	9.3	7.0

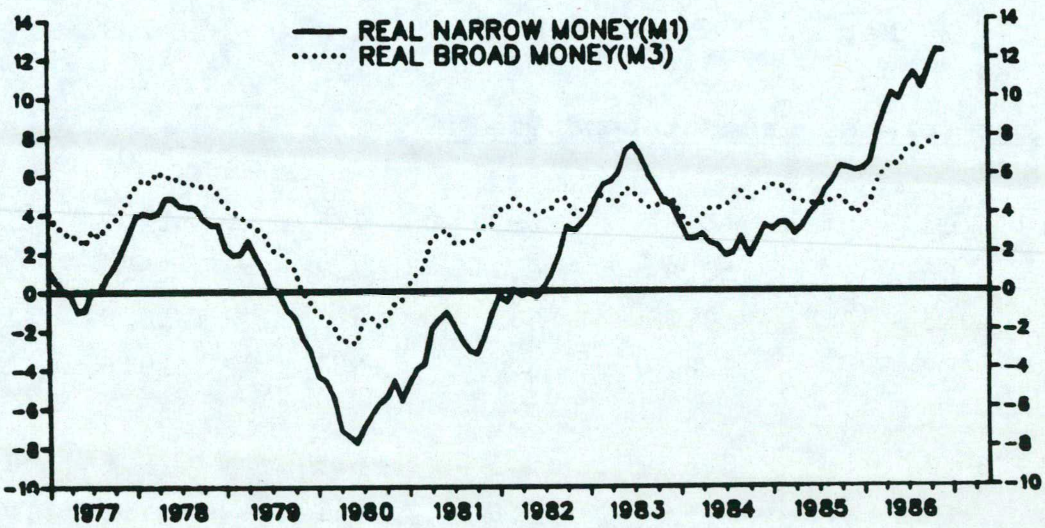
18. Monetary growth in the G5 countries accelerated during 1986. In the US M1 growth was well above the target range for 1986, though M2 and M3 grew just inside the top of their target ranges. In Germany CBM grew by 7.8 per cent between 1985Q4 and 1986Q4, compared with a target of $3\frac{1}{2}$ - $5\frac{1}{2}$ per cent.

CHART 12: G5 MONEY SUPPLY



PERCENTAGE CHANGE OVER YEAR EARLIER

CHART 13: G5 REAL MONEY SUPPLY



PERCENTAGE CHANGE OVER YEAR EARLIER

Table 15: Narrow money growth (Ml, percentage change on a year earlier)

		US	Japan	Germany	France	UK	G5*	Germany CBM**	UK MO
1980		6.2	2.6	2.4	8.8	4.1	5.1	4.8	8.5
1981		7.1	3.3	1.1	11.6	11.7	6.4	4.4	4.6
1982		6.6	5.8	3.6	11.9	14.6	7.3	4.9	0.9
1983		11.2	3.7	10.2	9.8	13.0	9.6	7.3	5.7
1984		7.0	2.8	3.3	10.5	14.5	6.7	4.8	5.6
1985		9.1	5.1	4.3	8.8	16.7	8.2	4.6	4.6
1986		13.2	7.0	8.9	8.3	22.1	11.6	6.4	4.0
1986	Jan	11.4	4.1	5.7	9.7	19.6	9.7	5.1	3.9
	Feb	10.8	4.2	6.7	9.0	20.2	9.6	5.3	3.8
	Mar	11.6	4.0	9.1	9.5	20.9	10.3	5.1	3.6
	Apr	12.2	6.3	9.7	7.7	20.1	10.9	6.0	2.8
	May	13.1	6.8	9.2	9.5	21.0	11.7	5.7	3.5
	Jun	12.8	7.3	10.4	7.5	21.7	11.4	6.0	3.2
	Jul	13.4	6.9	10.1	8.5	23.5	11.9	6.5	3.2
	Aug	13.7	8.4	10.5	9.5	20.9	12.4	6.7	4.1
	Sep	13.4	8.0	9.0	8.2	24.7	12.0	7.0	4.8
	Oct	14.2	8.3	8.7	7.0	23.7	12.5	7.2	4.9
	Nov	15.1	9.7	10.4	7.0	23.3	13.4	7.7	5.3
	Dec	16.6	9.7	7.6	7.0	20.8	13.3	8.3	5.4
1987	Jan	17.3	9.6	9.1		23.2			5.1
	Feb	16.5		9.3					4.1
1986	target	3-8						3½-5½	2-6
	outturn	15.7						7.8	4.1¢

* weighted average of five M1 series shown using 1980 GNP weights

** CBM is a constructed monetary aggregate not a true measure of narrow money. It comprises 100 per cent of currency in circulation plus 16.6 per cent of sight deposits plus 12.4 per cent of time deposits plus 8.1 per cent of savings deposits.

¢ percentage change on year earlier.

Table 16: Broad money growth (percentage change on a year earlier)

	US M3	Japan M2+CDs	Germany M2	France M3	UK £M3	G5*
1980	9.3	9.2	9.4	11.2	15.0	10.0
1981	11.9	8.9	10.4	12.1	19.8	11.8
1982	10.9	9.2	6.8	11.5	19.2	10.8
1983	10.0	7.4	2.9	10.0	11.6	8.6
1984	10.0	7.8	3.4	9.9	9.3	8.6
1985	9.0	8.4	4.3	8.2	12.2	8.4
1986	8.1	8.7	4.3	5.5	18.1	8.2
1986 Jan	7.0	9.0	4.3	6.5	13.9	7.5
Feb	6.8	9.0	3.7	6.3	15.6	7.5
Mar	7.1	8.9	4.0	6.2	16.7	7.7
Apr	7.9	8.4	3.0	5.0	17.5	7.7
May	8.0	8.4	2.5	5.9	19.1	8.0
Jun	7.8	8.6	3.0	5.5	18.6	7.9
Jul	8.4	8.7	3.6	5.8	18.2	8.4
Aug	8.6	8.9	4.6	6.4	16.4	8.6
Sep	8.7	8.9	5.1	5.1	18.9	8.7
Oct	8.8	8.6	5.5	4.6	18.6	8.6
Nov	8.8	8.3	6.7	4.8	18.6	8.8
Dec	9.0	8.2	6.0	4.4	18.0	8.7
1987 Jan	8.8	8.6	7.4		17.6	
Feb	8.4		7.5		18.9	
1986 target	6-9	8**		3-5	11-15	
outturn	8.8	8.6¢		4.6	18.9¢	

* weighted average of the series shown using 1980 GNP weights.

** projection.

¢ percentage change on year earlier.

19. On 22 February Finance Ministers and Central Bank Governors of six of the Group-of-seven met in Paris. They agreed "to co-operate closely to foster stability of exchange rates around current levels". In the four weeks following the meeting the dollar, yen and Deutschemark traded against each other in narrow ranges, but subsequently the yen appreciated against the dollar reaching a new high of Y144.7 = $1 on 30 March.

20. Table 17 shows movements in effective exchange rates during the 1980s and on key dates since the dollar peaked in February 1985. September 1985 and February 1987 are the dates of the Plaza Agreement and the Louvre Agreement respectively. The dollar is now 36 per cent below its peak value.

Table 17: Effective exchange rate movements (1975 = 100)

	United States	Japan	Germany	France	United Kingdom
1980	93.7	126.4	128.8	94.4	96.0
1981	105.6	142.9	119.2	84.3	94.8
1982	118.0	134.6	124.4	76.6	90.4
1983	124.8	148.4	127.1	70.0	83.2
1984	134.6	156.7	123.8	65.7	78.6
1985	140.7	160.5	123.6	66.3	78.2
1986	114.8	203.1	137.3	70.1	72.8
27 February 1985	157.2	157.1	117.2	62.0	70.2
20 September 1985	139.6	156.6	125.5	67.2	82.0
20 February 1987	104.0	209.1	148.3	72.2	69.1
31 March 1987	101.4	217.7	147.4	71.9	71.4

CHART 14: REAL AND NOMINAL EFFECTIVE EXCHANGE RATES

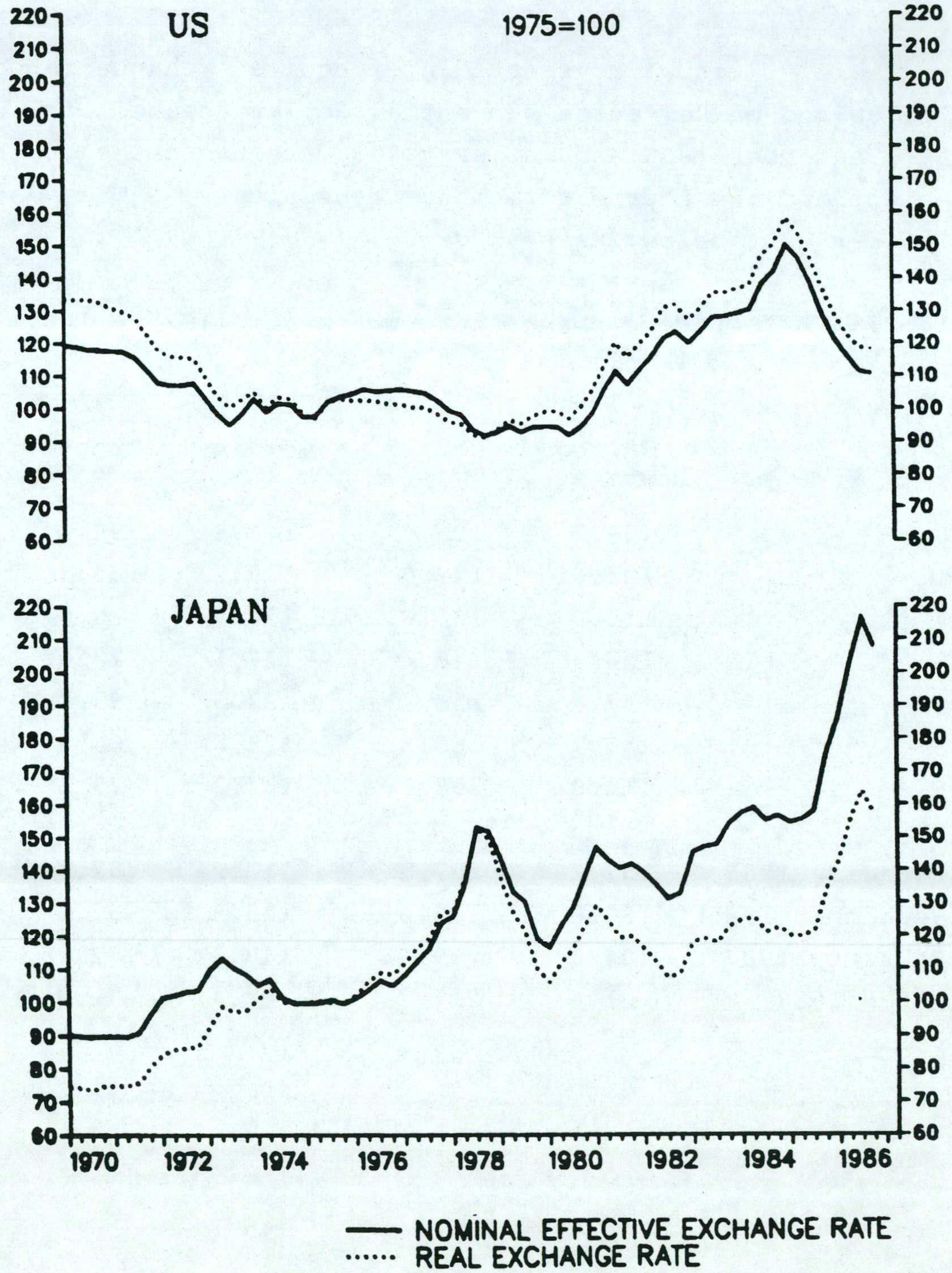
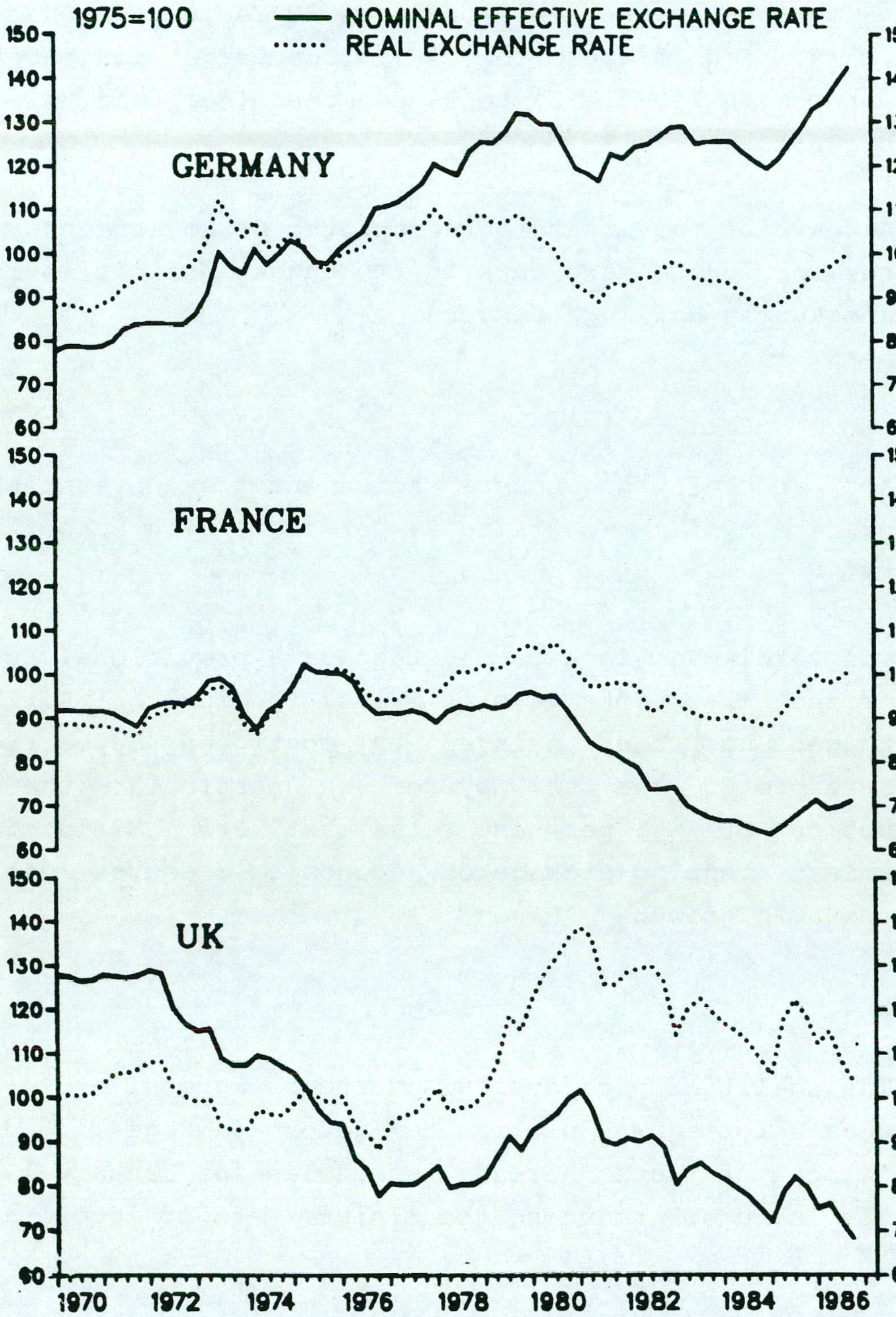


CHART 15:REAL AND NOMINAL EFFECTIVE EXCHANGE RATES



SECTION E: POLICY ANNOUNCEMENTS

US

21. Mr Volcker, Chairman of the Federal Reserve Board, announced in his Humphrey-Hawkins Testimonial on 19 February, that the M1 target has been dropped for 1987. The target range for both M2 and M3 growth in 1987 is 5½ to 8½ per cent (compared to 6 to 9 per cent in 1986).

22. As part of the Louvre Agreement the US Government reaffirmed its determination to make cuts in its budget deficit in line with the Gramm-Rudman-Hollings targets.

Japan

23. As part of the Louvre Agreement the Government cut its discount rate by ½ per cent (to 2½ per cent) with effect from 23 February.

24. The Parliament is expected to pass a provisional budget soon to cover the first fifty days of FY1987 (beginning 1 April). The full budget has been delayed by continued opposition to the planned reform of the tax system in particular the proposed introduction of a 5 per cent sales tax. Prime Minister Nakasone has promised a spring package of economic measures designed to boost economic growth.

Germany

25. The coalition partners in Government agreed, on 24 February, on proposals for a DM44 billion tax reform package (in addition to DM9 billion of cuts already scheduled for January 1988). The proposals include: reducing the minimum rate of income tax from

21 to 19 per cent and lowering the top rate by 3 per cent (to 53 per cent); raising personal allowances and reducing corporation tax from 56 to 50 per cent. DM19 billion would be recouped by subsidy cuts and consumer tax increases. DM5 billion of cuts will be implemented in January 1988. The remainder will come in 1990. The plans are now before Parliament.

Canada

26. The budget for FY1987 (beginning 1 April), announced on 18 February, raised indirect taxes on fuel and tobacco and slowed the growth of defence and aid expenditure. The federal government budget deficit is forecast to be 5½ per cent of GDP in FY1987 (from an estimated 6¼ per cent in FY1986).

ps7/19L

UNCLASSIFIED

FROM: N G FRAY
DATE: 1 April 1987

MR C J RILEY

TCSC: CURRENT POLICY AND MR SHORE

The Chancellor has seen and was grateful for your minute of 30 March.

Nigel Fray

N G FRAY

pmp

FROM: C J RILEY
DATE: 30 MARCH 1987

MR ALLAN

cc Sir P Middleton
Sir T Burns
Mr Odling-Smee
Mr Culpin

TCSC: CURRENT POLICY AND MR SHORE

Some briefing is attached on the assertions about the PSFD made by Charles Leadbeater in Friday's FT (article attached, with relevant passages highlighted). The article argued that policies in 1986-87 "broadly mirror the proposals outlined in 1982 by Mr Peter Shore".

2. On the other two aspects of policy mentioned in the offending paragraph - the exchange rate and monetary targets - it can be noted that:

- of the 20% fall in **the exchange rate** since 1982, 10% or more - "over half" - is due to the fall in oil prices since then

- the fact that there is no formal target for £M3 in 1987-88 does not mean that **monetary targets** have been abolished!

CJR

C J RILEY

please minute thanks

THE PSFD AND MR SHORE

1. Relevant figures for the PSFD, consistent with the FSBR, are as follows:

	1982-83	**1986-87**	**1987-88**
£ billion	8.4	11.0	9.4
% of GDP	3.0	2.9	2.3

2. Adding £5 billion to the PSFD in 1982-83, as was advocated by Mr Shore, would have raised it to £13.4 billion, equivalent to 4.7% of GDP. Uprating the Shore figures to take account of the increase in money GDP since 1982-83 yields the following:

	1982-83	**1986-87**	**1987-88**
£ billion	13.4	18.0	19.3
% of GDP	4.7	4.7	4.7

3. The Shore proposal thus implies a PSFD which is **more than double the figure proposed by the Government for 1987-88**, after allowance is made for the growth in money GDP.

Charles Leadbeater examines the policy errors which have led to persistent mass unemployment in the UK

Outside, with no way in

12

Charles Leadbeater

FINANCIAL TIMES

IN THE early 1980s this country went to war to defeat inflation, for the benefit of all. But now the survivors seem to have forgotten the dead and wounded."

That is how one monetarist-inclined, former senior Treasury official describes the history of unemployment under the Thatcher Government.

As he suggests, the record falls into two phases, raising two questions: first, what responsibility does the Government bear for the rise in unemployment in the early years of its administration? Second, could it have prevented the United Kingdom from becoming a country with persistently high unemployment?

While Mrs Thatcher came to power with policies very different from those of other post-war governments, her administration's approach to the problem of unemployment was shaped by the experience of the 1970s.

For most economists, a key lesson of that decade was that Government attempts to maintain employment above a certain level—described as the "natural rate"—would lead to permanently accelerating inflation. However, they were convinced that unemployment above the natural rate would be self-correcting because it would lead to lower wage pressure, decelerating inflation and higher real growth.

This philosophy underlies the Government's approach in the last eight years, but since the 1980-81 recession, the theory has simply not worked out. Despite unemployment of more than 3m, real earnings have risen at a faster rate than in the late 1970s when unemployment was at 1m. Inflation, meanwhile, is stable rather than declining. The Government, it seems, has seriously misread the labour market mechanisms linking unemployment, pay and inflation.

Three serious misjudgments can be detected in the crucial 1979-82 period, when unemployment rose from 1.15m to nearly 3m.

- In the first place, the Government did not realise how tight its monetary policy was, and so failed to anticipate the exchange rate overshoot, which had disastrous consequences for the tradable goods sector of the economy.
- At the same time, cost pressures were stoked when the Government sent the wrong signals to wage bargainers Rigorous monetary policy was intended to signal the need for pay restraint, but VAT increases in the 1980 budget intensified demand. Between 1979 and the end of 1980, wage costs per unit of manufacturing output rose by 36.6 per cent.
- Underlying both these things was an over-optimistic view of the flexibility of the labour market. "Ministers were being advised that wage bargaining would quite quickly and fully adjust to the Government's commitment to defeat inflation. They believed most of the adjustment would come in wages and prices rather than employment and output, so unemployment would self-correct," says Professor Alan Budd, of the London Business School, a former Treasury adviser.

Set against these criticisms are mitigating factors. The oil price rise was inescapable; and the nine Clegg Commission public sector pay awards were inherited from Labour's "winter of discontent."

Above all, the Government believed that to establish its counter-inflation credibility it had to stick to its policy despite the costs. It argued that wage bargainers would only learn from painful experience that it was within their power to maintain employment through wage restraint, rather than relying on the Government to pump up demand.

Mr Jon Shields, a former Treasury official and now director of the Keynesian-inclined Employment Institute, says of the early policy: "The Conservatives came to power at a difficult time. Manufacturing was overmanned, the oil shock, the world slowdown and wage demands were inescapable. But policy tended to exaggerate these factors rather than mitigate them."

None of this, however, explains why the rise in unemployment has been so sustained.

Keynesian critics of the Government argue that there is a continuing deficiency of demand. But while the Government's policies are hardly Keynesian, they have loosened considerably in the last few years, apparently in recognition of the need for a modified approach.

In the 1986-87 financial year, the public sector financial deficit has been increased to about £12bn; the last Autumn Statement announced a £4½bn increase in public spending; sterling's value has fallen by 26 per cent since late 1982; and last week's Budget sounded the death knell for sterling M3, so long the centrepiece of Government strategy.

These changes ironically, broadly mirror the proposals outlined in 1982 by Mr Peter Shore, then Labour's shadow Chancellor, which were widely ridiculed at the time. Mr Shore argued for: a £5bn increase in the public sector financial deficit then running at £7bn to £8bn; concentration of this fiscal boost on public spending; a drop of 30 per cent in the effective exchange rate; and abolition of domestic monetary targets.

If the explanation of persistent unemployment does not lie primarily in the area of demand, the inescapable conclusion is that the temporary shocks of the 1980s have created structural changes in the labour market, which in turn have left unemployment stuck at a high level.

The most obvious problem is long-term unemployment, which has risen steeply. Because of inadequate training, lack of recent work experience and demotivation, those involved are severely disadvantaged in competing for jobs. They exert little competitive pressure on wages: their lack of up-to-date skills makes them unattractive to employers, and their demoralisation curtails their search for jobs.

But even if they were in a position to compete, these people might have little impact on wage bargaining. "Employed workers—the 'insiders'—are setting wages to maintain their own employment, rather than price the unemployed 'outsiders' back into work," says American economists Olivier Blanchard and Lawrence Summers in a recent paper on UK unemployment. The employed have taken the Government's message to heart: they are pricing themselves into keeping their jobs on the best possible terms.

The lesson Blanchard and Summers draw from the UK's experience is that wage bargainers respond to unemployment only when they are threatened by it rising. So between 1980 and 1982 real earnings went up by only 1 per cent a year. But since then, with stable unemployment — and a lifting of the threat — real earnings have grown by about 3 per cent annually.

Although subcontracting has increased significantly in the past few years, few companies want to incur the considerable costs of redundancy, training and staff turnover by replacing existing workers with lower-paid ones from the dole queue.

As the threat of redundancy has receded, life has returned to normal for most people. The rise in overtime, skill shortages, profitability and house prices has sanctioned a resumption of "normal" pre-1979 pay bargaining.

Indeed the indications are that many companies are choosing to pay their employees well to motivate better performance, as the Confederation of British Industry makes clear in its recent submission to the National Economic Development Council: "Firms have to balance the higher costs of a pay settlement against the enhanced performance it could secure. It is impossible to obtain the best performance from employees through detailed work rules, constant supervision and threat. The only way this can be achieved is by establishing a skilled, motivated workforce."

Some of the effects of this pay and performance spiral can be seen in higher productivity growth, which some companies argue is maintaining low unit costs.

These developments have combined to undermine the logic of the 1970s view of the world. Pay and inflation are not responding to excess supply in the labour market to bring down unemployment.

But there is a more fundamental question: is a government, whose view of the world was shaped by the 1970s, capable of addressing the unemployment problem of the late 1980s?

There has been a battery of measures which attempt to reintegrate the long-term unemployed into the labour market, and to prevent others falling into the trap. The 255,000-place Community Programme offers work experience; the new Job Training Scheme will provide skills tuition and the 110,000 place Enterprise Allowance

CONT...

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CONFIDENTIAL

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MONTHLY NOTE ON THE BALANCE OF PAYMENTS - APRIL 1987

* In February the visible trade deficit fell to £0.2 billion compared with £0.5 billion in January and an average visible deficit of £0.9 billion a month in the second half of 1986. Combined with an unchanged invisibles projection of £0.6 billion, the current account showed a surplus of £0.4 billion in February.

* UK competitiveness, which improved by around 17 per cent in the year to the fourth quarter of 1986, has deteriorated in the first quarter of 1987 as a result of the firming of the exchange rate: by the end of March the exchange rate was over 5 per cent higher than in October.

* G5 domestic demand levelled out in the fourth quarter of 1986 following strong growth in the second and third quarters. UK domestic demand continued to rise in the fourth quarter but at a slower rate than earlier in the year.

* Export volumes (excluding oil and erratics) in the three months to February were 2 per cent higher than in the previous three months and 11 per cent higher than a year earlier. The underlying upward trend in the volume of manufacturing exports may have slowed recently.

* Import volumes (excluding oil and erratics) in the three months to February were 2½ per cent lower than in the previous three months. Assuming most of the effect of bad weather was unwound in February, it appears that the underlying level of import volumes has levelled out in recent months.

* The terms of trade has firmed a little since December reflecting the steadier exchange rate and higher oil prices.

* The Industry Act forecast in the FSBR projected a current account deficit of £2½ billion in 1987 compared with independent forecasts which still on average point to a deficit of around £2¾ billion.

D W OWEN
EA2 DIVISION

fst

MONTHLY NOTE ON THE BALANCE OF PAYMENTS - APRIL 1987

Current Account

1. The February trade figures, published on 26 March, showed a deficit on non-oil trade of £0.5 billion partially offset by a surplus on oil trade of £0.3 billion. The value of non-oil exports and imports both rose sharply from the low, weather affected, January levels, but the recovery in exports was much larger than that of imports, leading to a reduction of £0.3 billion in the non-oil visible deficit compared with January. It had been thought that imports were more affected than exports by the bad weather in January, but this now looks less likely although it is possible that there is still some recovery in imports to come from the effects of continued bad weather in Europe in February.

TABLE 1: CURRENT ACCOUNT

£ billion

	Current Balance	Visible Total	of which: Oil	Manufactures	Other goods	Invisibles Balance
1982	3.9	2.3	4.6	2.4	-4.7	1.6
1983	3.1	-0.8	7.0	-2.3	-5.5	4.0
1984	1.3	-4.4	6.9	-3.9	-7.4	5.7
1985	2.9	-2.2	8.1	-3.0	-7.3	5.1
1986	-1.1	-8.3	4.2	-5.4	-7.0	7.2
1986 Q1	0.7	-1.2	1.9	-1.3	-1.9	1.9
Q2	-0.1	-1.6	0.8	-0.6	-1.7	1.5
Q3	-0.9	-2.9	0.6	-1.7	-1.8	1.9
Q4	-0.8	-2.6	0.8	-1.8	-1.7	1.8
December	-0.3	-0.9	0.3	-0.5	-0.6	0.6
January 87	0.1	-0.5	0.4	-0.4	-0.5	0.6*
February	0.4	-0.2	0.3	0.0	-0.5	0.6*

* CSO projection

CHART 1: CURRENT ACCOUNT

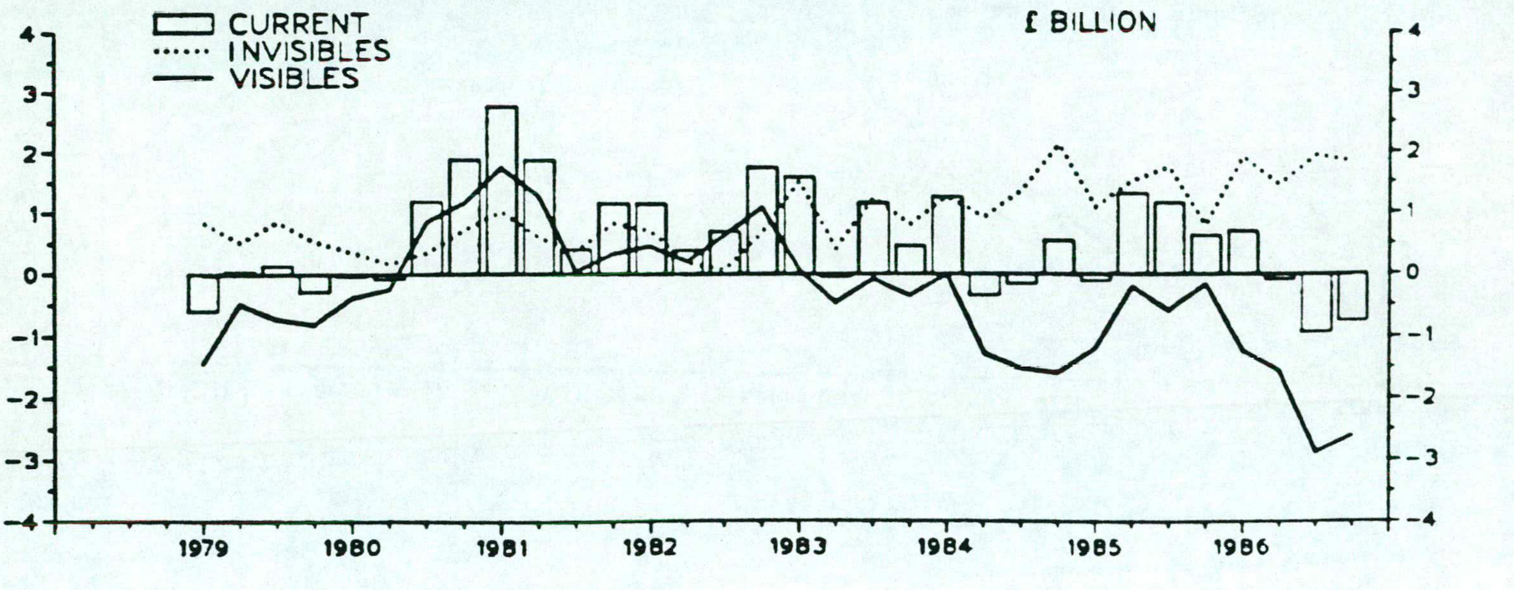

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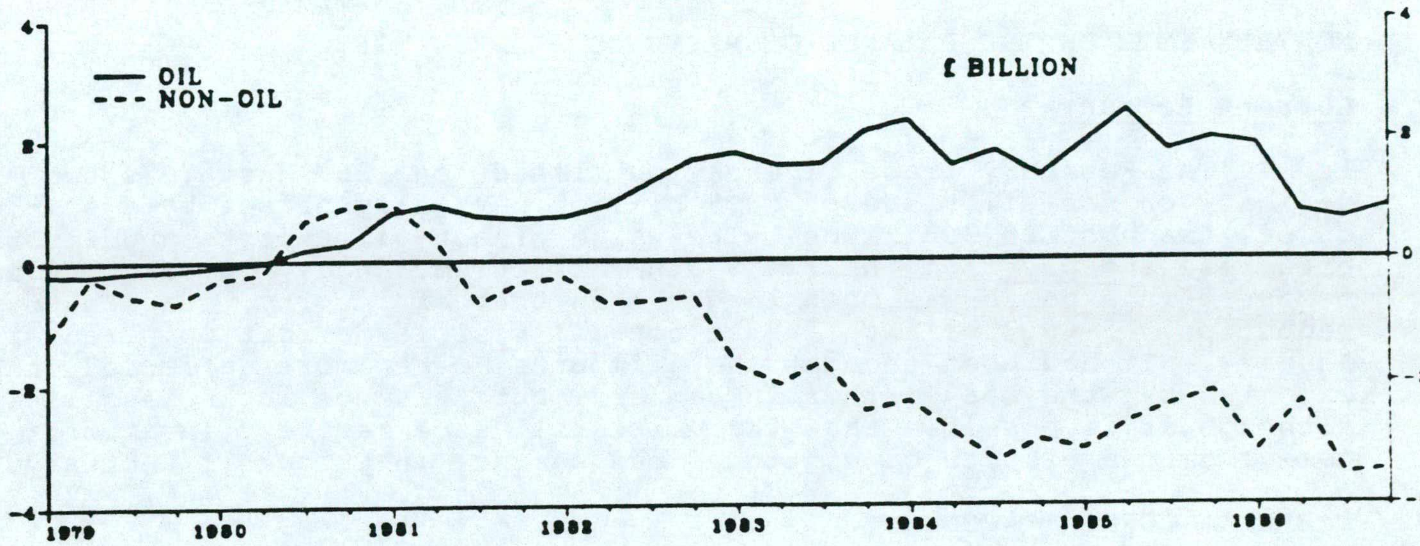
CHART 1A: VISIBLE BALANCE



DETERMINANTS OF UK TRADE

__Competitiveness__

2. UK competitiveness (as measured by relative actual unit labour costs in manufacturing) improved by around 17 per cent in the year to the fourth quarter of 1986 but has deteriorated since the autumn as the exchange rate has strengthened. By the end of March the exchange rate was over 5 per cent higher than in October while UK unit labour costs have probably been growing at a similar rate to those elsewhere.

CHART 2: UNIT LABOUR COSTS IN MANUFACTURING
1980=100

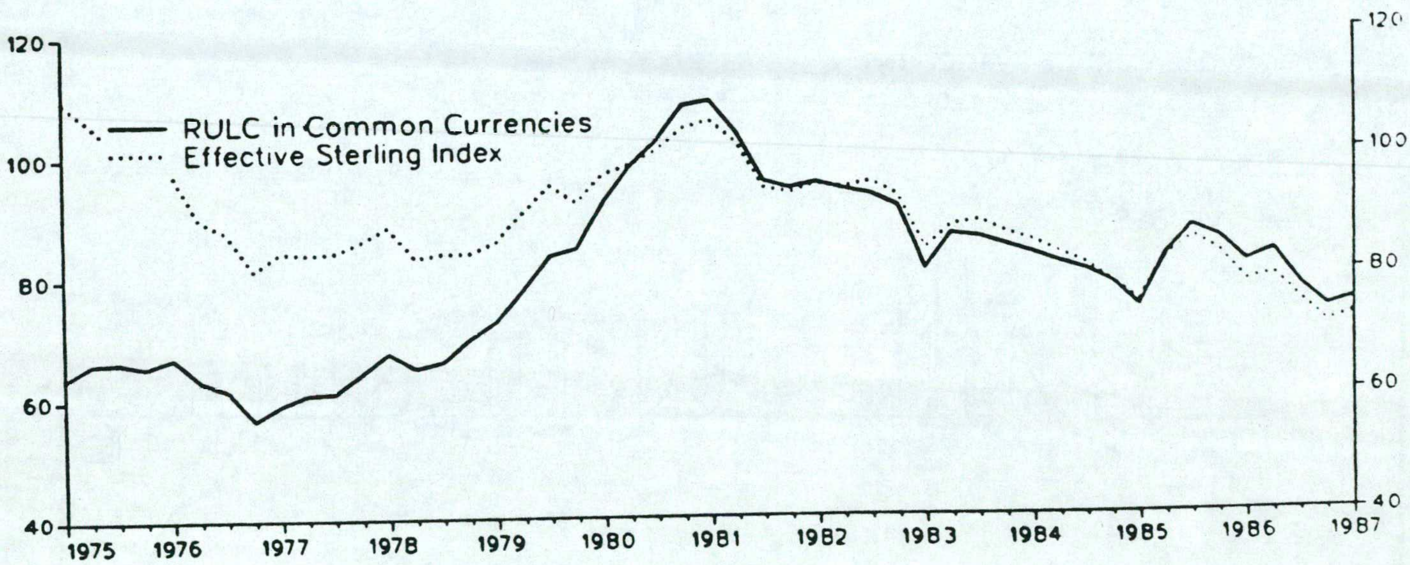


TABLE 2: RELATIVE UNIT LABOUR COSTS IN MANUFACTURING

Indices
(% changes on a year earlier in brackets)

	Relative Unit Labour Costs in domestic currencies 1980=100	Export weighted Exchange Rate Index 1975=100	Relative Unit Labour Costs in common currencies 1980=100	Sterling Exchange Rate Index 1975=100
1982	98.4 (-2.9)	89.0 (-3.8)	95.0 (-5.6)	90.6 (-4.5)
1983	96.7 (-1.7)	81.4 (-8.5)	85.4 (-10.1)	83.3 (-8.1)
1984	97.9 (1.1)	77.5 (-4.8)	82.3 (-3.7)	78.7 (-5.5)
1985	100.4 (2.6)	77.0 (-0.6)	83.9 (1.9)	78.2 (-0.6)
1986	104.0**(3.6)	68.8 (-10.6)	77.6** (-7.5)	72.8 (-7.0)
1986 Q1	104.1 (7.2)	71.9 (-0.3)	81.2 (7.0)	75.1 (4.2)
Q2	104.8 (5.2)	72.3 (-8.4)	82.2 (-2.6)	76.1 (-3.5)
Q3	103.0* (1.4)	67.3 (-16.6)	75.2* (-15.5)	71.9 (-12.4)
Q4	103.9**(1.1)	63.5 (-17.6)	71.6**(-16.9)	68.2 (-14.6)
1987 Q1	103.6**(-0.5)	64.5 (-10.3)	72.5 (-10.7)	69.7 (- 7.2)
1987 January				68.9 (-10.1)
February				69.0 (-7.0)
March				71.3 (- 4.4)

* estimate
** projection

<u>World Trade and Domestic Demand</u>

3. G5 countries' <u>domestic demand,</u> which grew strongly in the second and third quarters of 1986, levelled out in the fourth quarter reflecting in particular weakness in the US and Japan. G5 industrial production has also been flat in recent months and there remains no clear sign of a strong recovery in G5 <u>export volume growth.</u> <u>UK domestic demand</u> continued to rise in the fourth quarter but at a slower rate than earlier in the year. Retail sales in January and February were on average no higher than in the fourth quarter although recent figures have been distorted by bad weather.

TABLE 3: INDICATORS OF DEMAND

Indices 1980=100

	World			UK		
	G5 Export Volumes*	G5 Domestic Demand	G5 Industrial Production	Export Volumes**	Domestic Demand	Manufacturing Production
1982	99	100.9	96.7	99.3	100.4	94.2
1983	99	104.4	100.4	98.2	105.1	96.9
1984	107	109.9	108.5	107.6	109.9	100.7
1985	110	113.2	111.9	114.9	111.0	103.8
1986			113.0	117.7	114.6	104.1
1985 1	110	111.4	110.7	114.8	110.7	103.3
2	112	112.5	111.9	115.1	110.1	104.5
3	106	114.1	112.4	115.2	111.3	103.7
4	114	114.9	112.7	114.6	111.9	103.5
1986 1	107	115.5	112.7	111.9	113.8	102.5
2	112	117.3	112.8	115.1	113.3	103.5
3	106	118.3	113.4	118.5	115.4	104.6
4		118.2	113.2	125.3	115.8	106.0
December			113.3	126.5		106.3
January 87			113.1	118.5		103.9
February				134.0		

* Not seasonally adjusted.
** Excluding oil and erratics.

VISIBLE TRADE

Summary

4. Tables 4, 5 and 6 show movements in trade values, volumes and prices. The non-oil visible balance improved by £0.7 billion in the three months to February compared to the previous three months, almost entirely reflecting strong growth in exports volumes relative to import volumes. Over the same period the oil balance improved by £0.1 billion. The terms of trade has firmed a little since December reflecting the steadier exchange rate and higher oil prices.

TABLE 4: VISIBLE TRADE VALUES

£ billion

	Total			Excluding oil and erratics		
	Exports	Imports	Balance	Exports	Imports	Balance
1982	55.6	53.2	2.3	41.4	44.7	-3.3
1983	60.8	61.6	-0.8	43.8	52.7	-8.9
1984	70.4	74.8	-4.4	50.9	63.3	-12.4
1985	78.1	80.3	-2.2	57.7	68.7	-11.0
1986	72.8	81.1	-8.3	59.2	73.5	-14.2
1986 1	18.2	19.4	-1.2	14.0	17.4	-3.3
2	17.8	19.3	-1.6	14.5	17.4	-3.0
3	17.6	20.4	-2.9	14.8	18.7	-3.8
4	19.3	21.9	-2.6	15.9	20.0	-4.1
December	6.5	7.4	-0.9	5.3	6.7	-1.4
January 1987	6.2	6.7	-0.5	5.0	6.1	-1.1
February	6.9	7.2	-0.2	5.7	6.4	-0.8
% change						
3 mths to Feb on same period year earlier	4½	12		13	15	
3 months to Feb on previous 3 mths	3½	-1		2½	-1	
February on January	12	6½		13	5½	

TABLE 5: VISIBLE TRADE PRICES

Average Value Indices 1980=100

	Total			Excluding oil and erratics		
	Exports	Imports	Terms of trade	Exports	Imports	Terms of Trade
1982	115.0	113.9	101.0	111.5	110.6	100.9
1983	123.5	121.9	101.3	119.2	118.9	100.2
1984	131.9	133.2	99.0	126.4	128.7	98.3
1985	138.8	138.3	100.4	134.2	134.1	100.1
1986	124.8	131.5	94.9	134.5	135.5	99.3
1986 1	130.4	134.8	96.7	134.4	134.9	99.6
2	123.1	130.4	94.4	134.3	133.8	100.4
3	120.8	128.1	94.2	133.9	134.8	99.3
4	125.0	132.9	94.1	135.4	137.9	98.2
December	124.5	133.3	93.4	134.7	137.9	97.7
January 1987	125.6	134.0	93.7	136.3	138.2	98.6
February	127.2	135.6	93.8	136.2	140.0	97.3
% change						
3 mths to Feb on same period year earlier	-5½	1	-6½	1½	5	-3
3 mths to Feb on previous 3 mths	1	2	-1	½	1½	-1

CHART 3: TERMS OF TRADE

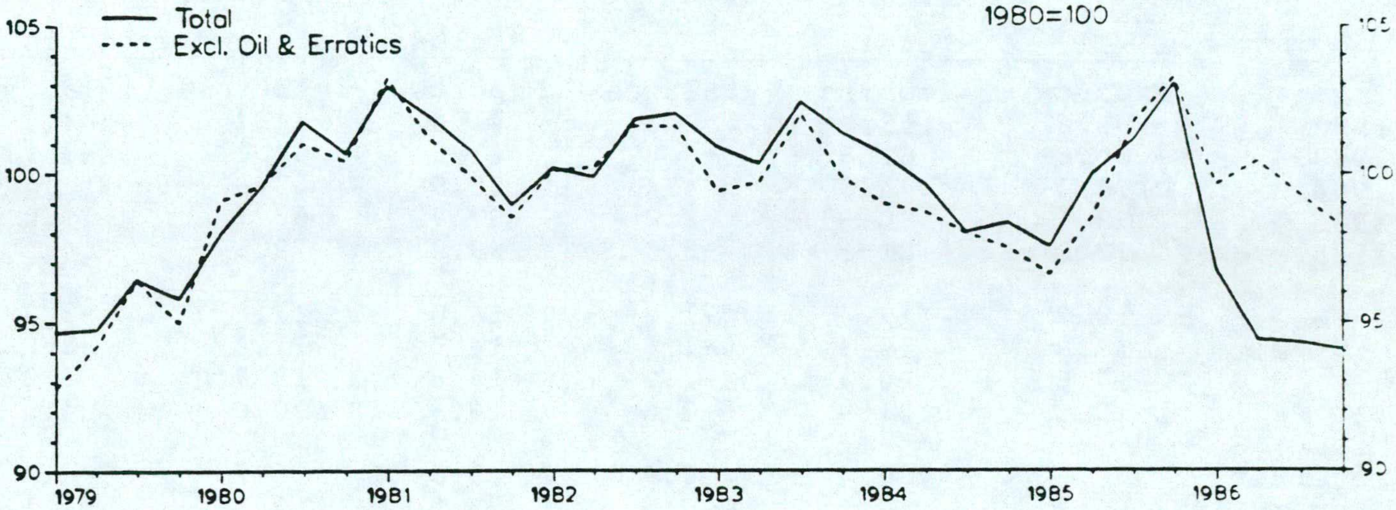


TABLE 6: VISIBLE TRADE VOLUMES

1980=100

	Total			Excluding oil and erratics		
	Exports	Imports	Ratio: Exports: Imports	Exports	Imports	Ratio: Exports: Imports
1982	101.9	101.5	100.4	99.3	112.7	88.1
1983	103.8	109.7	94.6	98.2	123.4	79.6
1984	112.5	121.8	92.4	107.6	137.0	78.5
1985	118.7	126.0	94.2	114.9	142.8	80.6
1986	123.1	133.9	91.9	117.7	151.1	77.6
1986 1	117.5	124.9	94.1	111.9	143.3	77.3
2	121.9	128.8	94.6	115.1	145.2	79.5
3	122.6	138.5	88.5	118.5	154.3	76.1
4	130.5	143.4	91.0	125.3	161.7	77.8
December	131.6	143.9	91.5	126.5	163.4	79.1
January 87	125.0	130.9	95.5	118.5	148.0	80.1
February	137.8	137.5	100.2	134.0	153.8	87.1
% change						
3 mths to Feb on same period year earlier	10	11	-1	11	9½	1½
3 mths to Feb on previous 3 mths	2	-3	5½	2	-2½	5
February on January	10	5	5	13	4	9

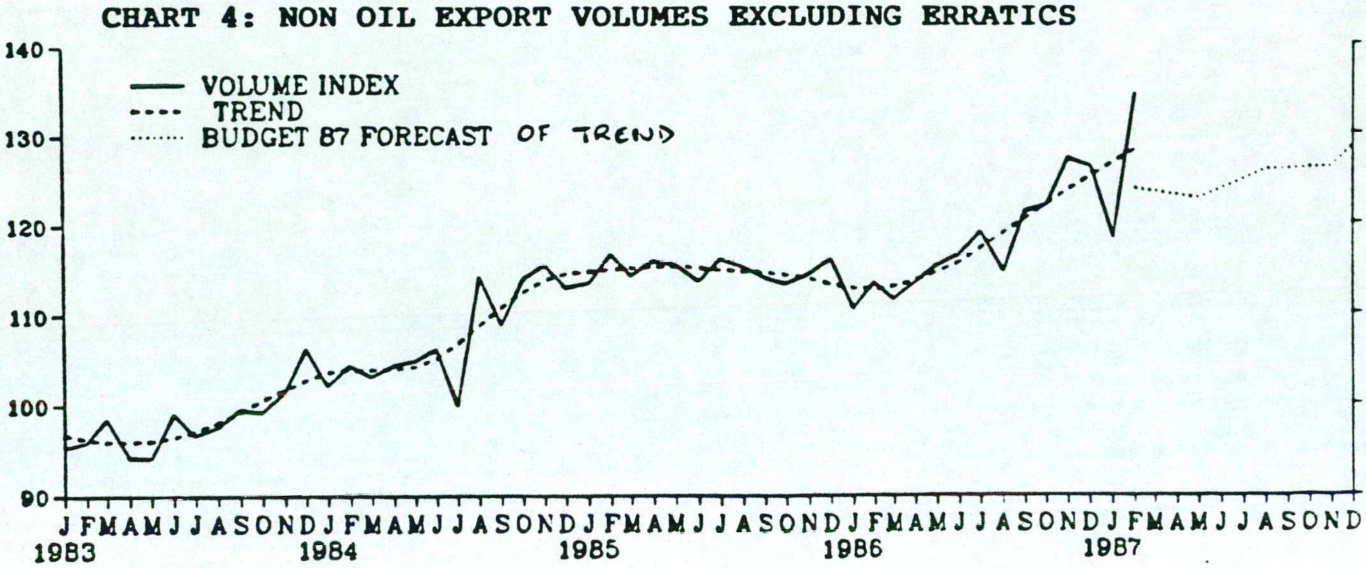
Exports

5. Exports recovered strongly in February, with the volume of non-oil exports (excluding erratics) in the three months to February 2 per cent higher than in the previous three months and 11 per cent higher than a year earlier. Within the total the upward trend in the volume of exports of manufactures (excluding erratics) may have slowed in recent months, and food, drink, and tobacco exports have fallen. The strong upward trend in total export volumes has been sustained by large increases in the exports of basic materials (mainly vegetable oil) and of gold, both of which may prove temporary. The FSBR forecast is consistent with some short-term fall in export volumes from the high level of the past few months before growth is resumed later in the year.

TABLE 7: EXPORT VOLUMES 1980=100

	Manufactures (excl. erratics)	Food, drink and tobacco	Basic materials	Fuel
1982	97.8	106.8	93.6	133.2
1983	96.2	110.2	101.0	147.7
1984	107.0	117.2	106.3	160.2
1985	115.7	119.2	106.1	171.7
1986	116.9	129.6	117.1	175.5
1986 1	111.7	118.7	110.7	178.3
2	115.8	119.8	102.3	170.4
3	117.6	133.5	126.3	174.3
4	122.6	146.2	128.9	178.9
December	123.7	140.4	142.1	177.5
January 1987	116.0	128.1	158.7	187.2
February	129.0	138.9	148.6	182.2
% change				
3 mths to Feb on same period year earlier	8	15	34	-½
3 mths to Feb on previous 3 mths	1½	-8½	20	2½
Feb on Jan	11	8½	-6½	-2½

CHART 4: NON OIL EXPORT VOLUMES EXCLUDING ERRATICS



6. On the basis of available information to the fourth quarter of 1986 it appears that UK manufacturing export volume growth has been considerably faster than growth of other developed countries' exports during 1986. This maintains the underlying improvement in UK relative performance, which has been evident since 1982 and is projected in the Industry Act forecast to continue in 1987. It is likely however, that the UK's share of world trade, in common with the other major industrialised countries, has declined as the newly industrialised countries (eg Korea, Taiwan) have experienced exceptionally rapid export growth.

Table 8: UK Share of Developed Countries' Exports of Manufactures (weighted by UK markets)

		Per cent
	Volume	**Value**
1980	9.7	9.7
1981	8.8	8.6
1982	8.8	8.5
1983	9.1	8.1
1984	9.2	8.0
1985	9.4	8.2
1986	9.5	8.0
1985 1	9.4	7.7
2	9.6	8.5
3	9.3	8.4
4	9.5	8.4
1986 1	9.2	7.8
2	9.5	8.3
3	9.4	7.8
4	9.8	7.9

7. Manufacturing <u>export prices</u> rose by 1 per cent in the three months to February compared to the previous three months, to a level 3 per cent higher than a year earlier. The rate of increase over the past year has been similiar to that of the producer output price index, suggesting that exporters have not taken full advantage of the lower exchange rate to raise profit margins but, instead, have reduced their foreign currency prices relative to competitors. Fuel prices rose again in February reflecting the lagged effect of the oil price rise during December. Basic materials prices rose sharply in February but the trend over the past few months has been downwards.

TABLE 9: EXPORT PRICES*

1980=100

	Manufactures (excl. erratics)	Food, Drink and Tobacco	Basic Materials	Fuel
1982	111.7	113.9	98.8	131.2
1983	119.3	118.2	108.3	138.0
1984	126.4	122.9	129.2	148.6
1985	134.4	128.1	138.5	152.1
1986	136.3	129.8	120.6	77.0
1986 1	136.0	127.0	124.7	110.9
2	135.3	131.7	119.4	70.2
3	136.4	128.2	118.3	57.6
4	137.5	132.0	120.1	68.5
December	137.3	128.1	114.5	68.7
January 1987	139.6	130.7	110.8	75.8
February	139.5	128.9	125.4	80.0
% change				
3 mths to Feb on same period year earlier	3	2	- 8	- 36
3 mths to Feb on prev 3 mths	1	-1½	-4	21½

* average value indices

Exports by geographical destination

8. The value of exports to the US and the EC rose sharply in February - growth in exports to these markets has accounted for most of the recovery in the value of exports since mid 1986. Exports to oil exporters have stabilised in recent months, having fallen sharply in the second half of 1986.

Imports

9. The volume of non-oil imports (excluding erratics), which fell by 9½ per cent in January because of bad weather recovered by only 4 per cent in February, leaving the level in the three months to February 2½ per cent lower than in the previous three months. Assuming most of the effect of bad weather was unwound during February, it appears that the underlying level of import volumes has levelled out in recent months. Within the total, imports of food, drink and tobacco and basic materials have continued to rise while the falls have been concentrated in manufacturing: imports of semis, intermediate goods and consumer goods have all fallen back. The falls in imports of passenger motor cars - down 20 per cent in the latest three months on the previous three months - and other consumer goods - down 3 per cent over the same period - are hard to reconcile with evidence of buoyant car registrations and continued growth in consumer demand. The Industry Act Forecast projected a continued upward trend in manufacturing and non-oil import volumes during 1987, though at a slower rate than during 1986.

TABLE 11a: IMPORT VOLUMES 1980=100

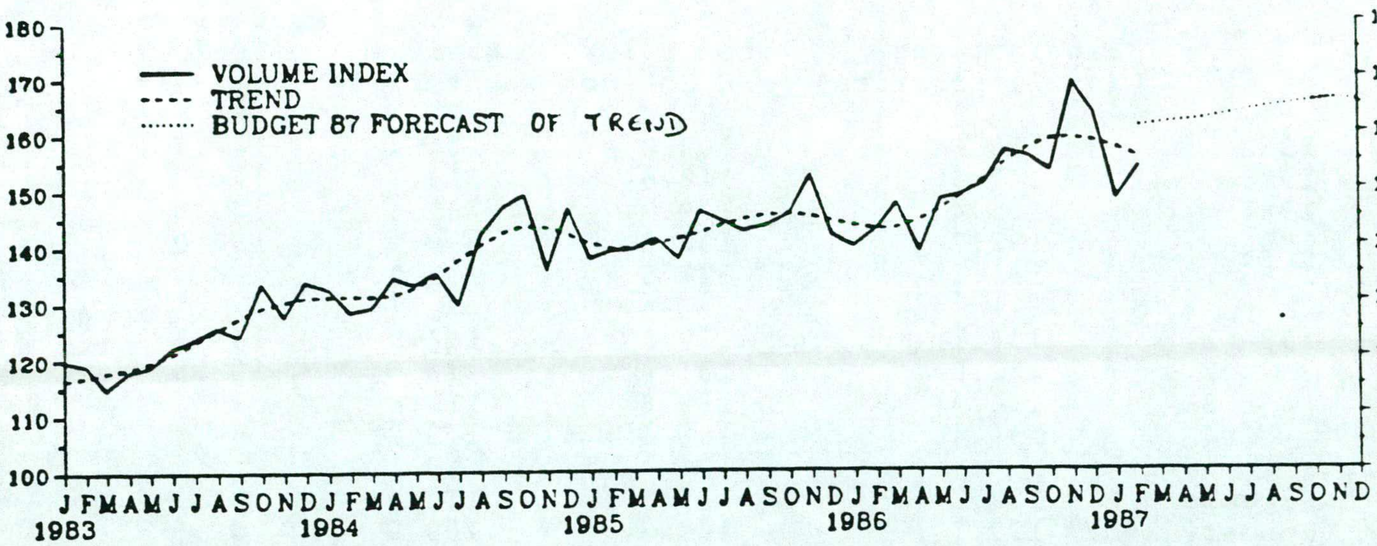
	Goods less erratics*	Goods less oil and erratics*	Food Drink and Tobacco	Basic materials	Fuels†	Manufactures less erratics
1982	107.1	112.7	108.1	93.0	74.5	116.5
1983	115.0	123.4	107.8	104.6	66.8	131.1
1984	128.8	137.0	112.3	101.7	86.5	146.7
1985	133.7	142.8	114.4	102.2	86.2	154.4
1986	142.4	151.1	123.5	108.7	93.4	163.0
1986 1	132.1	143.3	123.5	104.1	70.1	153.3
2	136.8	145.2	119.7	105.4	85.3	156.9
3	147.2	154.3	125.5	106.1	111.9	167.6
4	153.3	161.7	125.3	119.4	106.2	174.4
December	154.7	163.4	132.9	123.8	102.6	174.0
January 1987	140.2	148.0	116.1	123.6	91.5	160.2
February	147.0	153.8	130.4	124.3	103.6	160.1
% change						
3 mths to Feb on same period year earlier	12	9½	9	19	26	8
3 mths to Feb on prev 3 mths	-2	-2½	3	6½	-6½	-4½
Feb on Jan	5	4	12½	½	13	0

† Figures affected by coal strike
* Balance of payments basis

TABLE 11b IMPORT VOLUMES OF MANUFACTURES

	Semi manufactures	Finished manufactures	of which: Passenger motor cars	Other consumer goods	Intermediate goods	Capital goods
1982	111.3	119.9	110.1	113.3	122.8	128.2
1983	123.3	136.4	125.5	124.9	136.2	153.1
1984	137.2	153.0	119.9	139.6	161.4	172.9
1985	143.9	161.4	127.9	139.5	172.8	187.1
1986	152.0	170.4	131.6	158.3	187.0	183.1
1986 1	147.3	157.2	126.2	144.5	169.9	172.4
2	149.2	162.1	125.0	154.2	180.8	169.5
3	154.8	176.0	142.2	164.6	192.6	185.2
4	156.6	186.4	133.0	170.1	204.9	205.4
December	155.9	186.4	122.4	175.9	201.3	208.9
January 1987	145.2	169.6	109.9	143.9	187.5	204.5
February	155.7	163.0	91.4	161.8	178.9	183.1
% change						
3 mths to Feb on same period year earlier	5½	9½	-8½	11	11	12
3 mths to Feb on prev 3 mths	-3	-5	-20	-3	-5½	0
Feb on Jan	7	-4	-17	12½	-4½	-10½

CHART 6: NON OIL IMPORT VOLUMES EXCLUDING ERRATICS



10. In the fourth quarter of 1986 imports grew faster than total final expenditure implying some further rise in import volume penetration. However, present evidence suggests this trend may have halted in the first quarter of 1987.

Table 12: Import Penetration*

		Per cent
	Volume	**Value**
1980	13.9	14.0
1981	13.9	13.2
1982	14.6	13.7
1983	15.5	14.8
1984	16.5	16.2
1985	16.5	16.1
1986	16.9	16.2
1985 1	16.3	16.6
2	16.6	16.5
3	16.5	15.9
4	16.7	15.3
1986 1	16.3	15.7
2	16.4	15.7
3	17.2	16.5
4	17.6	17.0

* Imports (excluding oil) as a percentage of total final expenditure.

Import Prices

11. In the three months to February import prices were around 2 per cent higher than in the previous three months reflecting a 2½ per cent rise in manufactures, and a 9 per cent rise in fuel import prices as the effect of the oil price rise in December worked through. Food, drink, and tobacco and basic materials prices have been trending down recently, although the latter rose sharply in February in line with a rise in commodity prices in SDR terms.

TABLE 13: IMPORT PRICES*

1980=100

	Manufactures (excl. erratics)	Food Drink and Tobacco	Basic Materials	Fuel
1982	110.6	109.0	104.4	144.7
1983	117.5	118.6	112.8	154.1
1984	125.4	129.3	131.6	173.8
1985	131.7	132.6	130.2	180.0
1986	135.1	132.5	113.3	98.0
1986 1	134.1	129.1	114.9	143.5
2	132.9	131.4	113.5	103.8
3	134.3	132.8	110.8	78.1
4	138.4	136.6	113.8	84.4
December	139.1	135.8	112.9	86.9
January 1987	139.5	133.3	109.6	89.5
February	142.3	133.9	114.7	95.3
% change				
3 mths to Feb on same period year earlier	7½	4½	-½	-41
3 mths to Feb on prev 3 mths	2½	-1	-1	9

* average value indices

INVISIBLES

12. The CSO's balance of payments press notice, published on 5 March, gave a first estimate for the 1986Q4 invisibles balance, together with revised estimates for quarterly balances going back to 1984. The invisibles balance for 1986Q4 is provisionally estimated to have been in surplus by £1.8 billion. For the year as a whole, the invisibles balance is estimated to have been in surplus by £7.2 billion compared with a revised surplus of £5.1 billion in 1985

TABLE 14: INVISIBLES BALANCE

£ billion

	Services	IPD	Transfers	Total
1982	2.6	1.0	-2.0	1.6
1983	3.7	2.4	-2.1	4.0
1984	3.8	4.1	-2.3	5.7
1985	5.7	2.9	-3.5	5.1
1986	5.3	4.3	-2.4	7.2
1986 1	1.2	0.8	-0.1	1.9
2	1.2	0.9	-0.6	1.5
3	1.4	1.3	-0.8	1.9
4	1.5	1.2	-0.9	1.8
1987 1	-	-	-	1.8*

* projection

Net Overseas Assets

13. Net overseas assets are thought to have increased to around £110 billion by end 1986 (28 per cent of GDP), compared with a figure of around £80 billion at end 1985, despite a recorded current deficit. The estimated increase reflects the strength of world stock markets and the effects of sterling's depreciation, although it must be emphasised that the figure for end 1986 is very provisional, and may be subject to substantial revision as more information becomes available.

PROSPECTS

14. The Industry Act forecast published in the FSBR projected a current account deficit of £2½ billion in 1987, falling to £2 billion at an annual rate in the first half of 1988. This compares with independent forecasts which are on average projecting a deficit of £2.7 billion in 1987 and £2.5 billion in 1987, little changed since last month although a number of forecasts have now taken on the implications of recent downward revisions to invisibles. None of the forecasts has yet taken account of the unexpectedly good February trade figures.

TABLE 15: CURRENT ACCOUNT (£ billion)

	1987	1988	1989	1990
CBI (Mar)	-2.0	-2.0		
OECD (Dec)	-3.4	-6.0*	-	-
National Institute (Feb)	-2.6	-4.0	-	-
LBS (March post Budget update)	-1.9	-0.7		
Phillips & Drew (Mar)	-2.8	-3.3	-2.4	-1.7
Goldman Sachs (post Budget)	-2.1	-3.2		
Henley (Mar)	-2.6	-2.9	-2.6	-4.2
Oxford (Jan)	-1.9	-1.1	-1.8	-2.6
Liverpool (Mar)	-1.7	-0.2	-0.8	-0.3
Independent Average+	-2.7	-2.5	-	-
HMT (FSBR)	-2½	-2*		

+ Based on sample used in regular EB comparison
* 1988H1, annualised

INTERNATIONAL COMPARISONS

15. The US current deficit levelled off in the first three quarters of 1986 but increased further in the fourth quarter. The German and Japanese surpluses have shown no sign of falling from the very high levels reached early 1986.

TABLE 16 COMPARISON OF CURRENT ACCOUNTS AS % OF NOMINAL GDP/GNP FOR THE G5

	US	Japan	Germany	France	UK	Total
1982	-0.3	0.6	0.6	-2.2	1.4	0.1
1983	-1.4	1.8	0.6	-1.0	1.0	-0.3
1984	-2.8	2.8	1.1	-0.1	0.4	-0.6
1985	-2.9	3.7	2.1	0.0	0.8	-0.7
1986	-3.3	4.4	4.0	N/A	-0.3	N/A
1986 1	-3.2	3.6	3.9	0.6	0.7	-0.1
2	-3.3	4.9	3.7	0.6	-0.1	-0.0
3	-3.3	4.4	4.7	N/A	-1.0	N/A
4	-3.5	4.8	3.8	N/A	-0.8	N/A

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.80 CONFIDENTIAL

FROM: K F MURPHY
DATE: 1 April 1987

No: it's that [illegible] clear to Fowler at some stage (→ Pension reform) & has got cold feet.

1. ~~MRS LOMAX~~
2. CHANCELLOR

Mr Fowler is said to be very exercised about investor protection: which is why he has not written.

RL 1/4

cc Chief Secretary
Economic Secretary
Sir P Middleton
Sir G Littler
Mr Cassell
Mr Monck
Miss Noble
Mr Ilett
Mr Cropper
Mr Ross Goobey

POLARISATION AND PERSONAL PENSIONS

I understand that you would like to write to Mr Fowler about this today, prior to your speaking to him tomorrow.

2. I attach a draft letter. It concentrates on the impact on building societies, where Mr Fowler's problem is starkest and suggests that single polarisation as required by the SIB is not the only means of ensuring adequate investor protection.

KFM

K F MURPHY

Ch
Did not arrive in time to get it to you before you left for dinner. Will get it round first thing tomorrow AM.

AA

I have read it. But not clear from draft what we are asking Fowler to do...

RC2.80 CONFIDENTIAL

DRAFT LETTER

1 April 1987

Rt Hon Norman Fowler MP
Secretary of State for Social Services
Alexander Fleming House
Elephant and Castle
LONDON SE1

POLARISATION AND PERSONAL PENSIONS

As you know, Sir Gordon Borrie has now given his view that the Securities and Investment Board's recently published draft rules on the regulation of investment business are significantly anti-competitive. This view applied in particular to the doctrine of "polarisation". Paul Channon is now in the process of deciding whether to reject this view in the interests of investor protection.

I am very concerned about the impact which polarisation would have on the development of personal pensions, particularly in relation to building societies. Building societies are ~~very~~ important intermediaries in the insurance market, but are not ~~allowed~~ permitted by law to write their own insurance business. Polarisation would therefore mean that societies~~, whether they choose to be independent intermediaries or tied agents for their insurance business, will~~ would not be permitted to offer their own unit linked personal pensions through their branch network.

We must, of course, ensure adequate protection for the investor in personal pensions, as in other financial products. But polarisation as required by the SIB is not the only, ~~and not~~ nor in my view the best, way of achieving this. ~~An~~ One alternative would be what is called dual polarisation. This would allow building societies to be independent for

This - or any other solution - would of course have to be backed up by adequate

their insurance business and tied agents (to themselves) for pensions. [~~But adequate protection also requires~~] rules on cold calling, cooling off, disclosure and other matters. Much of this is already covered by the SIB~~s~~ rules generally.

You will recall that we specifically chose to give building societies the power to offer personal pensions in the Building Societies Act 1986. And it has always been our intention ~~on~~ for personal pensions, as explained in ~~the~~ your White Paper on the Reform of Social Security, that branch networks would enable bank and building societies to compete effectively and to give advice at the local level. Polarisation would prevent this, at least for building societies. It can only serve only to hamper the spread of personal pensions, [~~I am sure that you will agree that this would be a serious blow to an important plank of Government policy.~~] contrary to Government policy.

[If you are concerned about this, as I am, you or [~~Perhaps we can have a further word in the margins of Cabinet tomorrow~~].

might like to have a word with Paul Channon.]

Draft letter

RA3.12 CONFIDENTIAL

FROM: A C S ALLAN
DATE: 1 April 1987

CHANCELLOR

cc Economic Secretary

POLARISATION

I have checked with Rachel Lomax the point about banks being allowed to have two people at separate desks, one selling the bank's products and one selling everyone else's.

2. Rachel says that this is one of the lines DTI use to argue how reasonable the polarisation proposals really are. The SIB themselves have not yet indicated how the rules would apply in detail, and they are by no means certain to follow the DTI line.

3. She also pointed out that this is not a complete solution: it would certainly work well for largish branches, but not for the very small branch in Oban which could not spare an extra bod.

4. Nonetheless, it seems well worth getting Mr Channon and Mr Howard signed up to this interpretation.

AA

A C S ALLAN

FTM's note on outstand issues is below.

1316

Baker bilateral

FROM: MRS R LOMAX
DATE: 6 April 1987

PRINCIPAL PRIVATE SECRETARY cc: Sir G Littler

US BANKING LEGISLATION

The Chancellor should be aware of a late amendment to the Senate Banking Bill (the "Breaux amendment") which is causing concern on grounds of extra-territoriality. It may also - though this is less certain - have a damaging impact on the non-banking activities of individual British banks operating in the US (grandfathered after the enactment of the 1978 International Banking Act). Richard Allen, the Bank and the BBA are still assessing the nature and extent of the problem, but the time available for lobbying is limited.

2. In our present state of knowledge, the Chancellor will not want to raise the issue substantively with Secretary Baker at his bilateral on Wednesday but he might usefully mention that he is aware of it and/or leave a note behind. (Since the provisions which the amendment overturns were originally introduced with the support of the US Treasury, Secretary Baker is likely to be sympathetic.)

3. The expert on this is Richard Allen, who will provide further advice (and a note, if required) at the briefing dinner on Tuesday evening. In the meantime, I attach a line to take and background note by the Bank.

RL

RACHEL LOMAX

2705D 6. 4.87

LINE TO TAKE ON SENATOR BREAUX'S AMENDMENT TO THE DRAFT SENATE BANKING LEGISLATION

1 Point out that we have not yet been able to analyse fully the likely effects of the Breaux amendment, which was inserted at a late stage in the Senate's consideration of the bill.

2 But note that, at first sight, the amendment seems likely to cause difficulties for British and other foreign banks. It also overrides carefully negotiated sections of the International Banking Act 1978.

3 The first part of the amendment appears, though vaguely worded, to constrain, for the next year, the non-banking activities of certain foreign banks in the US - grandfathered after the enactment of the International Banking Act of 1978.

4 The second part of the amendment is more complex and may cause problems of an extraterritorial nature. In particular, it appears to disallow, for a year, foreign banks from certain share purchases in non-banking firms even outside the US.

5 We would, therefore, look to the Administration for support in arguing against the proposed amendment, on much the same basis as at the time of the enactment of the International Banking Act in 1978.

NOTE: In the light of further information Richard Allen may wish to suggest some modification of the above/ to turn it into a note for Secretary Baker.

2703D

6. 4.87

FROM: S R ILES

MR LOEHNIS

Copies to GPS
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Mr D W Green
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Mr Sweeney
Group 1

Mrs Lomax HMT

US LEGISLATION: THE COMPETITIVE EQUALITY BANKING ACT 1987

1 The Senate has approved the above entitled omnibus banking bill which includes both the much needed measures to recapitalise the Federal Savings and Loan Insurance Corporation (FSLIC) and provisions to restrict the spread of non-bank banks. In the final stages of the Senate's consideration of this bill (discussed on 27 March), Senator Breaux introduced an amendment, following pressure from the Sears non-bank bank lobby in Congress and aimed primarily at the Japanese banks, which may disadvantage other foreign bank operations in the US and elsewhere. At first sight, the amendment which is in two parts could cause problems, partly of an extraterritorial nature, for both British and other European banks who have operations in the US.

2 The House Banking Committee is also considering its own quite different banking legislation and a Senate-House conference to agree a joint bill is likely to take place in the near future although probably not before Congress recesses for Easter on 10 April. The probable timetabling of the legislation is such that any fuller analysis of the bill and any more formal lobbying, if that proves to be necessary, will have to be done within the next few weeks. (A presidential veto is also a possibility,

th[illegible]gh for US domestic reasons.) In the meantime, Richard Allen at the Washington Embassy is trying to clarify the intentions of the legislators and co-ordinating a lobbying effort with colleagues from other European countries, with, so far, the French, German, Belgian, Danish and Swiss seeming supportive. The British Bankers' Association are also currently considering the likely impact of the amendment on individual banks and have said that they will report back to us any action that they intend to take. The remainder of this note assesses, as far as is possible, the impact of the proposed amendment to the draft banking legislation and provides briefing (see also attached documents) which may be useful in lobbying in the US for those attending the Washington meetings later this week.

3 The Senate banking bill would impose a one-year moratorium on banks undertaking any new types of non-banking activities which the Federal Reserve Board might approve. Breaux's amendment extends the moratorium specifically to certain non-banking activities of foreign banks. The first part of the latter amendment relates to the International Banking Act of 1978 and states that a foreign bank covered by Section 8(c) of the IBA "shall not expand any (non-bank) activity in which it is engaged pursuant to that sub-section, and no such bank or company shall commence any new such activity". Section 8(c) states that foreign banking organisations in the United States may engage in non-banking activities if these activities were grandfathered under the terms of the 1978 act, and a number of the British merchant banking-type establishments have continued to operate their securities affiliates in the United States.

4 It is, however, not at all clear whether this part of the legislation would have any major impact on British institutions as nearly all of the UK banks with affiliates grandfathered in 1978 have since ceased to hold banking licences. Nevertheless, the Institute of Foreign Bankers are of the opinion that it might impinge on the non-bank activities of the Royal Bank of Scotland as a result of their takeover of the Charterhouse Japhet group in the US. The possible impact on individual banks is being further considered by the BBA who, themselves, have only learnt about the amendment within the last few days. By contrast to the way in

While the draft legislation might affect foreign banks, the bill before the Senate is meant only to restrict US domestic banks for a period of one year from entering into any <u>new</u> type of securities, insurance or real estate business ie there is no constraint under the amendment on the expansion of any existing non-banking business. The proposed restrictions on foreign banks thus appear more severe in nature than those on US domestic banks.

5 The <u>second</u> part of the Breaux amendment is more complex and may be considerably more far reaching in its impact. At present, under the provisions, as later revised, of the Bank Holding Company Act 1956, foreign banks whose business is largely conducted outside the US can buy shares in non-banks incorporated outside the US, if the activities of the non-bank business are not principally in the US. The provision, included at the behest of the Federal Reserve Board and with the concurrence of the US Treasury, was meant to limit the extraterritorial nature and reach of the Bank Holding Company Act. The latter US legislation was, therefore, drafted so that foreign banks could engage in merchant banking-type activities (or other non-bank activities allowed in a foreign bank's home country) outside the US even though US regulation would normally prevent such activities in the US. (To the extent that the non-bank activities occurred in the US they could not, in any case, include any securities business prohibited to US bank holding companies - unless grandfathered in 1978 - and a foreign bank would need FRB permission for any banking or financial operations.)

6 The newly proposed amendment states that for a period of one year foreign banks will not be able to purchase any additional shares in non-banks outside the US, if the latter have any US activities, as currently allowed by Section 2(h)(2) of the Bank Holding Company Act. <u>This elimination of the Bank Holding Company Act exemption would, we believe, effectively mean that British banks with operations in the US would not be permitted to acquire more than 5% of the shares of any non-bank company wherever situated if it also had some operations in the US</u> (unless a US bank holding company were allowed to hold shares in a US domestic company engaged in similar non-banking business.)

7 The drafting of both parts of the amendment is vague and it is not at all clear what the practical effect on British and other European banks would be. Richard Allen has requested an analysis from the Federal Reserve Board, if available. Whatever the practical impact on UK banks and other companies, the extraterritorial nature of the amendment is, in any case, of concern.

8 A suggested line to take in conversations with members of the US administration is attached.

International Division HO-3
6 April 1987

S R Iles (4825)

PERSONAL

PWP

Mr. Allan

<u>Inland Revenue's note on CT</u>

= You might like to see the attached manuscript comment.

= As far as I can see there is nothing potentially harmful in the Inland Revenue note, though I do not agree with the implication that they attached to the request by Mr. Higgins for a note on the forecast, rather than how to get the figures for accumulated losses.

= I do not think that it is worth making a fuss about this unless the Chancellor believes it is important not to provide the TCSC with written notes that are at all longer than necessary.

R.N.J

2.IV

PS If the Chancellor does want a shorter note please don't attribute it to me, otherwise our relationship with IR will suffer considerably!

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INLAND REVENUE
STATISTICS DIVISION
SOMERSET HOUSE

From: J R Calder
Date: 1 April 1987

This version has most of the unwise statements in the earlier

CHANCELLOR OF THE EXCHEQUER

draft removed, and is a distinct improvement. I still think, however, that a much shorter note dealing solely with the point raised* on how to get any to deal

CORPORATION TAX FORECAST: NOTE TO THE TCSC

estimates of accumulated losses would be better. I'd believe that the note must cover the forecasting of CT in

When Treasury officials appeared before the TCSC on 25 March, the Committee asked for a note from Inland Revenue describing how the corporation tax forecasts are produced (Q105-111 attached). At your own oral session on Monday the subject of CT receipts and the special point about accumulated losses was raised again by Mr Wainwright. The Committee has asked for the note on these topics by noon on Friday. A draft is attached for your consideration.

Most of the note deals with our forecasting model and the data on which it is based. Paragraph 9 deals with Mr Wainwright's point on agreed tax losses. For the sake of completeness we have included two paragraphs at the end of the note on the procedures adopted for monitoring receipts during the year, but you may feel that they are not required.

* by Wainwright

We have consulted Treasury officials in the preparation of the draft note.

general because of the remark by Higgins in Q111. The detailed questions did not cover the question of how the forecast is done.

J R CALDER

cc	PS/FST	Mr Painter
	Mr Sedgwick	Mr Calder
	Miss Sinclair	Mr McGivern
	Mr Mowl	Mr Fitzpatrick
		Mr J H Reed
		Mr D Shaw
		Mr Greenslade
		Mr Twiss
		Mr Beighton
		PS/IR

R.N.S

35/34

ps2/15R

UNCLASSIFIED

PWP

FROM: CATHY RYDING
DATE: 2 April 1987

MR PERETZ

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Kelly
Mr Culpin

BRIEFING FOR NO.10 :
CHANCELLOR'S REMARKS YESTERDAY AT NEDC ON EXCHANGE RATE

The Chancellor was grateful for your minute of earlier today. The briefing has been amended slightly from that attached to your minute, and a copy as it was sent to No.10 is attached for information.

CR

CATHY RYDING

Chancellor's comments at NEDC, 1 April, on the exchange rate

Line to take

Press comments about what the Chancellor said are mistaken. What he said is not news. He was repeating what he has been saying for some time: that he would like the £ to stay around "current levels". (All he did on this occasion was to remind his audience roughly what current levels are).

In the "Louvre accord" of 22 February, the Finance Ministers of six major industrial nations "agreed to cooperate closely to foster stability of their exchange rates around current levels".

FROM: DAVID PERETZ
2 April 1987

CHANCELLOR c/content?

CR 2/4

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Kelly
Mr Culpin

BRIEFING FOR NO 10: CHANCELLOR'S REMARKS YESTERDAY AT NEDC ON EXCHANGE RATE

No 10 have asked for urgent briefing on today's newspaper stories, for Question Time this afternoon. They have asked in particular for a reply to the question why is it that we can have an explicit target for sterling outside the EMS, but not in it.

2. I attach a suggested line to take. And a reply to the specific EMS question.

3. I suggest that IDT might use the final, approved, version of this in talking to the press after today's reserves figures. And no doubt you will want to say something also when you hold your press briefing this afternoon.

DLCP

D L C PERETZ

Chancellor's comments at NEDC, 1 April, on the exchange rate

Line to take

Press ~~reports of~~ comments about what the Chancellor said are ~~exaggerated~~ mistaken. He was repeating what he has been saying for some time: that he would like the £ to stay around "current levels". (All he did on this occasion ~~he~~ was to remind~~ed~~ his audience roughly what current levels are). What he said ~~This~~ is not news. ~~It is~~

In the "Louvre accord" of 22 February, ~~in which~~ the Finance Ministers of six major industrial nations "agreed to cooperate closely to foster stability of their exchange rates around current levels."

Why can we have a target outside the EMS, but not in it?

We cannot. It only makes sense to have an explicit target range when part of a formal international agreement like the exchange rate mechanism of the EMS, with mutually agreed support mechanisms.

(pencil are Roberts amendments.)

30/3070

FROM: DAVID PERETZ
2 April 1987

CHANCELLOR – OK [illegible]

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Odling Smee
Mr Scholar
Mr Kelly
Mr Ross Goobey

TCSC: EXCHANGE RATE POLICY

I understand that Mr Higgins asked the TCSC Clerk this morning to telephone Michael Scholar to question him about the apparent contradiction between the press reports today of your comments yesterday at the NEDC, and the line on the exchange rate that you took on Monday at the TCSC (and, indeed, which I took last week).

2. Michael Scholar replied in the terms of the agreed line. But the Clerk said that Mr Higgins would be grateful for something on paper from the Treasury. Although you dealt with this at your press briefing today, which will no doubt be reported tomorrow, I think it would probably be as well if Mr Scholar or Miss Evans wrote to the Clerk, re-iterating the agreed line - on the lines of the attached draft. In fact this might form part of a covering letter for the various papers we are due to send the TCSC tomorrow. Do you agree?

Ch
see also letter from Peter Dixon below
AA

DLCP

D L C PERETZ

30/3070

DRAFT

FROM: MR SCHOLAR

TO: MR MACKAY, CLERK TO THE TCSC

You telephoned me yesterday to ask about the press reports of the Chancellor's comments on the exchange rate at the monthly meeting of the National Economic Development Council on 1 April.

2. I thought it might be helpful for members of the Treasury and Civil Service Select Committee if I were to write to confirm what I told you on the telephone. The press comments about what the Chancellor said were mistaken, as the Chancellor himself confirmed at a press briefing yesterday afternoon.

exactly the same as

The points he made to NEDC were exactly the same as those

3. ~~What he said was not new, and followed closely the remarks~~ he made to the Committee on Monday. ~~He told the NEDC that he would like sterling to stay around its current levels. As you know,~~ in the "Louvre accord" of 22 February the Finance Ministers of six major industrial nations "agreed to cooperate closely to foster stability of their exchange rates around current levels." ~~The Chancellor then went on to remind his audience roughly what current levels are.~~ This seems to have been blown up by the press out of all proportion.

He reported to NEDC that

He then referred to what he had said to the Committee, repeating that he would like to see sterling remaining around its current level, and reminding ~~his audience~~ the Council roughly what the current level was.

4. Attached to this letter is the ~~I am also enclosing a the~~ note requested by the Committee on credit cards and private sector borrowing. ~~On the question of the tax~~ Your letter of 31 March also asked about the effect of the proposed change in the tax treatment of ~~Lloyd~~ ~~LR~~ Lloyd's reinsurance to close arrangements. *

4552/008

CONFIDENTIAL
covering UNCLASSIFIED

5489.

FROM: J W GRICE
DATE: 2 APRIL 1987

1. MR PERETZ

DUP 2/4

2. PRINCIPAL PRIVATE SECRETARY

cc: PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Scholar
Mrs Lomax
Mr Odling-Smee
Mr Riley
Mr C W Kelly
Miss C Evans
Mr M Brown

Mr Willmott - C&E

OK as is

TCSC: PRIVATE BORROWING

Your minute to Mr Peretz of 30 March (attached) asks us to draft a note the for TCSC, following the Chancellor's evidence.

2. The attached draft, agreed with MP and FIM, is in response. The data contained in it supports the Chancellor's points.

3. Perhaps, for future reference, I should point out, however, that it is not entirely easy to corroborate the points in Mr Knox's note of 15 December from publicly available sources:

(i) the Bank of England figures referred to are, we understand, those in table 3 of the draft note. They do indeed show that the net increase in bank card credit outstanding is less than 10 per cent of gross advances. But it does not follow, logically, that 90 per cent credit card balances are repaid within the interest-free period. Barclaycard claim that, on average, borrowing is over a period of four months. This was noted in the attached article from last Sunday's "Observer" and may have been the source of Mr Sedgemore's remarks during the Chancellor's evidence;

X

This is true, but are X & Y consistent?

Y

(ii) the DTI advice that "as many as 40-45 per cent of credit cards are being used in effect as charge cards" was based on oral conversation with the credit card companies. Whilst this is no doubt accurate, there are no published statistics to confirm it.

JWG

J W GRICE

4552/003

Supplementary Note by H M Treasury

Credit Cards and Private Sector Borrowing

This note provides some further information about the use of credit cards in the context of private sector borrowing generally.

2. Table 1 shows private sector borrowing ~~broken~~ split down into mortgage borrowing and other forms. It shows that in recent years mortgages have been growing at a rate which, expressed as a proportion of GDP, entirely explains the rise in total private sector borrowing. Thus, for example, since ~~1979-80~~ 1976-77 mortgages have risen from ~~3.2~~ 2.9 per cent of GDP to an estimated 6.6 per cent in 1986-87. Other forms of private sector borrowing were equivalent to ~~4.6~~ 4.2 per cent of GDP in ~~1979-80~~ 1976-77 and 4.1 per cent in 1986-87.

comparison should be consistent with table & either 76-77 or 80-81

3. Table 2 shows the growth of the main individual components of personal sector debt in recent years. ~~broken down into the main categories.~~ Outstanding borrowing on monetary sector credit cards (Access and Visa) amounted to 2.3 per cent of GDP in the third quarter of 1986, the latest period ~~of the latest~~ for which available data is. In addition, a part of the borrowing from consumer credit companies and other companies (mainly retailers) will be through credit and charge cards, although the exact proportion is not available. The total borrowed on all forms of credit cards is likely to be well under 5%.

4. Table 3 shows year by year figures for the net increase in bank credit card debt outstanding (after allowing for repayments), as a proportion of gross credit advanced by this means during each year. This proportion is generally ~~The net increase in credit is generally~~ less than 10 per cent. ~~of gross new lending.~~ showing that most

Ch

Since the statistics on this last point are rather obscure (& possibly not v. helpful), it may be better to let it stand as drafted (rather than adding words like "demonstrating that most advances are paid off very quickly").

AA

2 April 1987

4498/038

Ch
Only question is whether to make cut off at start-date 76-77 or 80-81.
Keep as is (1976-77)
AA

TABLE 1

PRIVATE SECTOR BORROWING

	Private Sector Borrowing		of which: Mortgage		Other	
	£ billion	(% of GDP)	£ billion	(% of GDP)	£ billion	(% of GDP)
1976-77	9.2	(7.1)	3.8	(2.9)	5.4	(4.2)
1977-78	9.9	(6.6)	4.7	(3.1)	5.2	(3.5)
1978-79	11.8	(6.8)	5.6	(3.2)	6.2	(3.6)
1979-80	16.2	(7.8)	6.6	(3.2)	9.6	(4.6)
1980-81	17.3	(7.3)	7.8	(3.3)	9.5	(4.0)
1981-82	25.4	(9.8)	10.2	(3.9)	15.2	(5.9)
1982-83	24.4	(8.6)	15.1	(5.3)	9.3	(3.3)
1983-84	25.6	(8.4)	14.3	(4.7)	11.3	(3.7)
1984-85	28.4	(8.7)	17.1	(5.2)	11.3	(3.5)
1985-86	33.1	(9.2)	19.6	(5.4)	13.5	(3.8)
1986-87*	40.9	(10.7)	25.4	(6.6)	15.5	(4.1)

Notes

* Treasury estimates consistent with Chart 2.4 in the FSBR.

Private Sector Borrowing is defined as identified borrowing by persons and by industrial and commercial companies, from financial companies, and the public and overseas sectors.

Sources

Financial Statistics, March 1987, and Economic Trends, Annual Supplement 1987.

4498/039

TABLE 2

COMPOSITION OF PERSONAL SECTOR DEBT

end year:	1982		1983		1984		1985		1986	Q3
	£ bn	(%)	£ bn	(%)	£ bn	(%)	£ bn	(%)	£ bn	(%)
TOTAL STOCK:	104.9	(100)	125.1	(100)	146.9	(100)	173.4	(100)	198.2	(100)
of which										
1. Mortgages	76.3	(72.8)	91.4	73.1)	108.4	(73.8)	127.4	(73.5)	146.2	(73.8)
2. Consumer Credit:	16.0	(15.3)	18.9	(15.1)	22.0	(15.0)	25.9	(14.9)	29.4	(14.8)
-overdrafts & personal bank loans	10.6	(10.1)	12.2	(9.8)	14.2	(9.7)	16.3	(9.4)	18.7	(9.4)
-monetary sector credit cards	2.0	(1.9)	2.6	(2.1)	3.2	(2.2)	4.0	(2.3)	4.6	(2.3)
-consumer credit companies	1.3	(1.3)	1.8	(1.4)	2.2	(1.5)	2.8	(1.6)	3.4	(1.7)
-other*	2.1	(2.0)	2.3	(1.8)	2.4	(1.6)	2.7	(1.6)	2.7	(1.4)
3. Other Borrowing	12.5	(11.9)	14.8	(11.8)	16.5	(11.2)	20.2	(11.6)	22.6	(11.4)

* retailers and insurance companies.

Source: Financial Statistics, March 1987, Table 9.3

TABLE 3

NET INCREASE IN CREDIT CARD DEBT OUTSTANDING AS A PERCENTAGE OF GROSS CREDIT ADVANCED

	NET INCREASE IN CREDIT CARD DEBT OUTSTANDING £ million	GROSS CREDIT ADVANCED ON BANK CREDIT CARDS £ million	(COL 1) / (COL 2) %
1980	252	2883	8.7
1981	385	3726	10.3
1982	450	4898	9.2
1983	571	6396	8.9
1984	607	8043	7.5
1985	853	10500	8.1

Sources: Col 1 - Financial Statistics, March 1987, and Abstract of Banking Statistics, May 1986, published by the Statistical Unit of the Committee of London Clearing Bankers

Col 2 - Abstract of Banking Statistics

THE COSTS OF BORROWING

The cruel truth about credit card charges

While base rates follow their downward course, credit card interest remains obstinately constant. GEORGE PITCHER reports

THE credit card operators are notable by their absence in the clamour surrounding cheaper rates of borrowing. As bank base rates fall to 10 per cent, the interest charged on plastic loans remains doggedly high.

Access and Barclaycard charge 2 per cent a month, or a 26.8 per cent annual percentage rate (APR). During the past two years, base rates have fallen from a peak of 14 per cent to the current 10 per cent, a fall of some 30 per cent. Not once during the period have credit cards cut their rates.

Cardholders do not need to be overendowed with financial acumen to conclude that the margin between operators' own borrowing and that of their customers has grown lucratively wider.

Card operators claim in their defence that they borrow from the wholesale money markets, which follow base rates only sluggishly; that they can only take long-term views on interest rates; and that customers enjoy many weeks of interest-free credit.

The graph on the right, however, tells a simple story. Straight comparison between credit-card APRs and base rates is unfair — the base rate is not compounded. But it shows how base rates can trend down, leaving card rates static.

Further, it is difficult to accept the card companies' argument that they must be sure that market interest rates have settled before revising their own rates. They are quick enough to raise their charges when base rates are on the climb.

Early in 1985, for instance, Barclaycard and Access were charging 23.1 per cent APR and the base rate stood at 10.5 per cent. On 14 January, base rate moved to 12 per cent and on 28 January to 14 per cent.

The plastic cards jacked up their rates to 26.8 per cent promptly in February, and have stayed there as base rate has fallen back since.

'Obviously we look closely at the overall rates of borrowing,' said Barclaycard last week.

'But we can only move our rates by a minimum of 0.25 per cent a month because of our computer systems. So we're not going to react to every change in base rates.

'And to move rates we have to change all our literature, which is a considerable expense.

'While 26.8 per cent sounds high, bear in mind that that rate represents the worst possible turnout for a borrower. On average, borrowing is over four months, which works out at around 19 per cent APR.'

Access is operated by four major clearing banks, NatWest, Lloyds, Midland and Royal Bank of Scotland. There is officially no rate-fixing cartel and they are free to set their own rates. In practice, they do not.

But there is some encouragement from Lloyds: 'If there are further falls in base rate, it is likely that credit card rates will also fall.'

The banks mitigate their current credit card rates by pointing to what they see as the greater calumnies of store-cards. While several wrongs do not make the rates any more right, they do have a point.

At Marks & Spencer a 29.8 per cent APR operates, made all the more painful by the store's refusal to accept Barclaycard and Access: 'We have no plans to change rates.'

At Debenhams, part of the Burton Group, 29.8 per cent APR is charged if statements are settled by direct debit, 34.5 per cent if settled by cash. Burton charges even more — 34.5 per cent APR for standing orders — although its rates recently fell from a stratosphere approaching 40 per cent.

'We are certainly reviewing our charges — there is no question of that,' says Chris Chadwick, marketing director of Burton Group Financial Services.

'I would very much like to see rates fall. We must remain competitive and we do have plans to offer more value in other ways.'

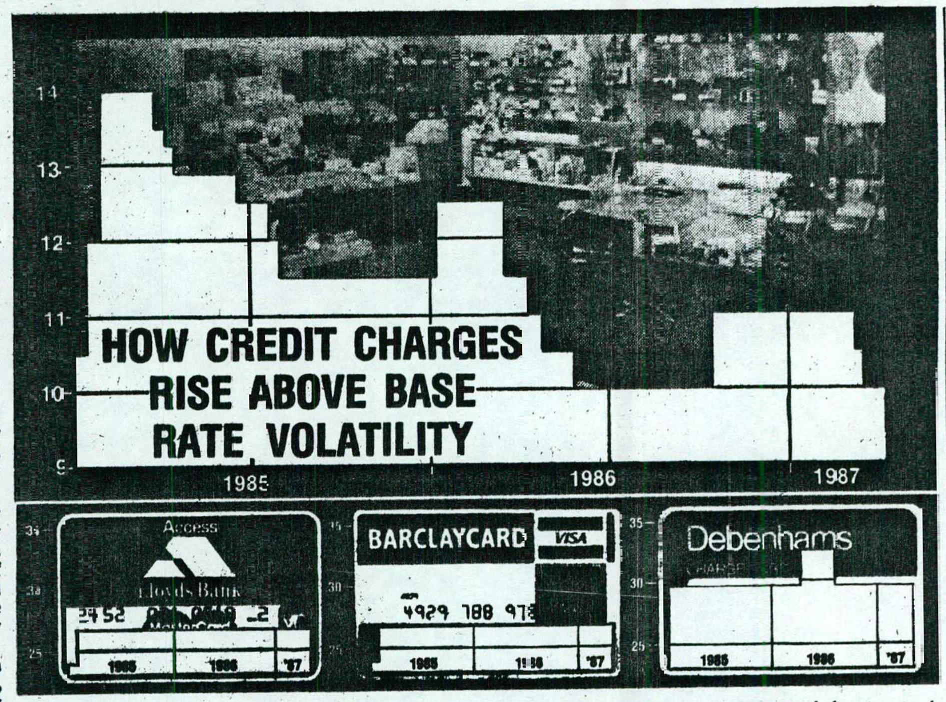
An announcement is expected shortly concerning the nature of an added value to Burton's plastic.

The message is overwhelmingly one of 'rates may fall, but not now.' Yet there is a ray of hope for cardholders in the form of a rates war in the United States.

American Express has launched a revolving (regular deposits, automatic credit) charge card called Optima aimed at undercutting the plastic competition. Bankers reckon it is only a question of time before it arrives to shake up rates in Europe.

Meanwhile, shoppers are advised to check whether their bank's card is cheaper than a store card.

Or, for longer-term borrowing for larger purchases, to check whether bank or building personal loans can outperform their plastic.



FROM: A C S ALLAN
DATE: 30 March 1987

MR PERETZ

cc PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mrs Lomax
Mr Odling-Smee
Mr Grice
Mr Riley Miss C Evans
Mr M Brown
Mr Willmott - C&E

TCSC: PRIVATE BORROWING

The Chancellor made several points about private borrowing at the TCSC today:

(i) all of the growth in private sector borrowing as a percentage of GDP was accounted for by the growth in mortgage borrowing as a percentage of GDP;

(ii) less than 5 per cent of personal sector debt was accounted for by credit card debt;

(iii) most people use credit cards as transaction cards, and pay off the balance before any interest charges are incurred.

You will be able to check the exact references against the transcript.

2. The Chancellor promised a note on all this, and I should be grateful if you could co-ordinate this, in consultation with FIM and MP.

3. The source for (i) were figures Mr Riley had given me updating those in his minute of 23 March. The source for (ii) was the attached table provided for me by Mr Brown (the figure for bank credit cards in 1985 is in fact only 2 per cent, and although information about store cards is scanty, the number of these is very much smaller). The source for (iii) was the general

17/46

information provided by Customs last Autumn (I discover, for example, that the paper attached to Mr Knox's note of 15 December said that "Bank of England figures suggest that 90 per cent of additions to credit card balances are repaid within the interest-free period, whilst DTI advise that at any one time as many as 40-45 per cent of credit cards are being used in effect as charge cards".

ACSA

A C S ALLAN

TABLE 1: LENDING FOR HOUS

Net Mortgage Advances
(£ million)

	Banks	Building Societies	Others	Total
1983	3560	10928	81	14569
1984	2043	14572	357	16972
1985	4092	14321	4	18417
1986 H1	1824	8856	93	10773

TABLE 2: GROWTH OF PERSONAL SECTOR DEBT

Annual % Change

	Mortgages	Consumer Credit	Other Borrowing
1982	16.6	19.6	27.5
1983	19.1	18.1	18.4
1984	18.7	16.4	11.4
1985	17.1	17.8	22.3

Table 3: The Composition of Personal Sector Debt in 1985

	£ billion	Share of total (%)
Total Stock	172.8	100
of which		
1. Mortgages	126.7	73
2. Consumer Credit	16.4	10
- overdrafts and personal bank loans	4.0	2
- monetary sector credit cards	2.8	2
- consumer credit companies	2.7	2
- other*		
3. Other borrowing	20.2	12

4552/003

Supplementary Note by H M Treasury

Credit Cards and Private Sector Borrowing

This note provides some further information about the use of credit cards in the context of private sector borrowing generally.

2. Table 1 shows private sector borrowing broken down into mortgage borrowing and other forms. It shows that in recent years mortgages have been growing at a rate which, expressed as a proportion of GDP, entirely explains the rise in total private sector borrowing. Thus, for example, since 1976-77 mortgages have risen from 2.9 per cent of GDP to an estimated 6.6 per cent in 1986-87. Other forms of private sector borrowing were equivalent to 4.2 per cent of GDP in 1976-77 and 4.1 per cent in 1986-87.

3. Table 2 shows the growth of the main individual components of personal sector debt in recent years. Outstanding borrowing on monetary sector credit cards (Access and Visa) amounted to 2.3 per cent of total personal debt outstanding in the third quarter of 1986, the latest period for which data is available. In addition, a part of the borrowing from consumer credit companies and other companies (mainly retailers) will be through credit and charge cards, although the exact proportion is not available. The total borrowed on all forms of credit cards is likely to be well under 5 per cent.

4. Table 3 shows year by year figures for the net increase in bank credit card debt outstanding (after allowing for repayments), as a proportion of gross credit advanced by this means during each year. This proportion is generally less than 10 per cent.

2 April 1987

4498/038

TABLE 1

PRIVATE SECTOR BORROWING

	Private Sector Borrowing		of which: Mortgage		Other	
	£ billion	(% of GDP)	£ billion	(% of GDP)	£ billion	(% of GDP)
1976-77	9.2	(7.1)	3.8	(2.9)	5.4	(4.2)
1977-78	9.9	(6.6)	4.7	(3.1)	5.2	(3.5)
1978-79	11.8	(6.8)	5.6	(3.2)	6.2	(3.6)
1979-80	16.2	(7.8)	6.6	(3.2)	9.6	(4.6)
1980-81	17.3	(7.3)	7.8	(3.3)	9.5	(4.0)
1981-82	25.4	(9.8)	10.2	(3.9)	15.2	(5.9)
1982-83	24.4	(8.6)	15.1	(5.3)	9.3	(3.3)
1983-84	25.6	(8.4)	14.3	(4.7)	11.3	(3.7)
1984-85	28.4	(8.7)	17.1	(5.2)	11.3	(3.5)
1985-86	33.1	(9.2)	19.6	(5.4)	13.5	(3.8)
1986-87*	40.9	(10.7)	25.4	(6.6)	15.5	(4.1)

Notes

* Treasury estimates consistent with Chart 2.4 in the FSBR.

Private Sector Borrowing is defined as identified borrowing by persons and by industrial and commercial companies, from financial companies, and the public and overseas sectors.

Sources

Financial Statistics, March 1987, and Economic Trends, Annual Supplement 1987.

4498/039

TABLE 2

COMPOSITION OF PERSONAL SECTOR DEBT

end year:

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	£ bn	(%)	£ bn	(%)	£ bn	(%)	£ bn	(%)	£ bn	(%)
TOTAL STOCK:	104.9	(100)	125.1	(100)	146.9	(100)	173.4	(100)	198.2	(100)
of which										
1. Mortgages	76.3	(72.8)	91.4	73.1)	108.4	(73.8)	127.4	(73.5)	146.2	(73.8
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-other*	2.1	(2.0)	2.3	(1.8)	2.4	(1.6)	2.7	(1.6)	2.7	(1.4
3. Other Borrowing	12.5	(11.9)	14.8	(11.8)	16.5	(11.2)	20.2	(11.6)	22.6	(11.4

* retailers and insurance companies.

Source: Financial Statistics, March 1987, Table 9.3

4498/043

TABLE 3

NET INCREASE IN CREDIT CARD DEBT OUTSTANDING AS A PERCENTAGE OF GROSS CREDIT ADVANCED

	NET INCREASE IN CREDIT CARD DEBT OUTSTANDING £ million	GROSS CREDIT ADVANCED ON BANK CREDIT CARDS £ million	(COL 1) / (COL 2) %
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1981	385	3726	10.3
1982	450	4898	9.2
1983	571	6396	8.9
1984	607	8043	7.5
1985	853	10500	8.1

Sources: Col 1 - Financial Statistics, March 1987, and Abstract of Banking Statistics, May 1986, published by the Statistical Unit of the Committee of London Clearing Bankers

Col 2 - Abstract of Banking Statistics

5-24

cc. Chancellor
Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P. Middleton
Sir T. Burns
Mr F E R Butler
Sir G. Littler
Mr Cassell
Mr Lavelle
Mr Monck
Mr Odling-Smee
Mr Peretz
Mr Scholar
Mr Sedgwick
Mr Turnbull
Mrs Lomax
Mr Culpin
Miss O'Mara
Mr Cropper
Mr Ross Goobey
Mr Tyrie

H M Treasury

Parliament Street London SW1P 3AG

Switchboard 01-233 3000
Direct Dialling 01-233 ....

M C SCHOLAR
Under Secretary

W R MacKay ESq
Clerk to the Treasury & Civil
Service Select Committee
House of Commons
LONDON SW1A 0AA

3 April 1987

Mr Spence -IR
Mr McManus -IR

Dear Bill,

You telephoned me yesterday to ask about the press reports of the Chancellor's comments on the exchange rate at the monthly meeting of the National Economic Development Council on 1 April.

I thought it might be helpful for members of the Treasury and Civil Service Select Committee if I were to write to confirm what I told you on the telephone. The press comments about what the Chancellor said were mistaken, as the Chancellor himself confirmed at a press briefing yesterday afternoon.

The points he made to NEDC were exactly the same as those he made to the Committee on Monday. He reported to NEDC that in the "Louvre accord" of 22 February the Finance Ministers of six major industrial nations "agreed to co-operate closely to foster stability of their exchange rates around current levels." He then referred to what he had said to the Committee, repeating that he would like to see sterling remaining around its current level, and reminding the Council roughly what the current level was. This seems to have been blown up by the press out of all proportion.

Attached to this letter is the note requested by the Committee on credit cards and private sector borrowing. Your letter of 31 March also asked about the effect of the proposed change in the tax treatment of Lloyd's reinsurance to close arrangements. It was explained in the FSBR (footnote to Table 4.1) that no figure could be given for the yield of the proposed legislation on Lloyd's reinsurance to close because "details of measure subject to consultation, so no estimate possible at present." The commentary in the Annex to Chapter 4 said (end of item 14) that "the estimate of receipts depends on the details of the new arrangements". The Committee may find it helpful to have a more detailed explanation of why it is not possible at present to estimate a yield for the proposed legislation.

Under the present law, it is not possible for the Revenue to apply effectively to reinsurance to close the normal criteria which govern the tax deductibility of provisions for outstanding liabilities by insurance companies and comparable provisions by other financial traders. Under these criteria provisions are tax deductible if they are based on adequate specific evidence or else computed by reference to acceptable statistical methods, but otherwise are not allowable for tax purposes.

The purpose of the Chancellor's proposals is to ensure that reinsurance to close will in future be subject to scrutiny, and adjustment where appropriate, broadly in line with the normal criteria for the deductibility of provisions for tax purposes. The legislation will first take effect for premiums paid for the 1985 Account, which closes at the end of 1987 (and for which tax first becomes payable on 1 January 1989).

As the Chancellor said in his Budget Speech, the details of the legislation are subject to the outcome of discussion with Lloyd's. The tax yield will depend on the effect of the detailed legislative rules - when these have been determined - when these are applied to the examination of individual syndicate reinsurance to close figures for the 1985 Account (which will not be determined by syndicates until 1988). So at present it is not possible to estimate a yield for the provisions.

Yours sincerely

Michael Scholar

M C SCHOLAR

Spoke to AB/CST
MGP 7/4

CONFIDENTIAL

BIF with advice 4

Pse tell Jill
CST will have to
deal with this
in C's absence

SECRETARY OF STATE FOR EDUCATION AND SCIENCE

CH/EXCHEQUER
REC. 6 APR 1987 6/4
ACTION MR GILMORE
COPIES TO CST
SIR P MIDDLETON
MR F E R BUTLER
MR ANSON
MR TURNBULL
MR BURR
MR POTTER
MR CROPPER
MR TYRIE
MR ROSS GOOBEY

PRIME MINISTER

Financial delegation to schools

1. Following your meeting on 25 February I have revised my proposals for delegated budgets to schools. These proposals are set out in some detail in Annex A.

2. I propose initially to give the governors of all secondary schools and of large primary schools with more than 200 pupils delegation over all the recurrent expenditure for the school. The only items not delegated will be the central administrative costs of the LEA and certain educational and supporting services which are provided on a local authority-wide basis for all schools. Among the latter are two quite separate cases - school meals and school transport. As regards meals, the law is changing in April 1988 so that LEAs' duty to provide free meals is confined to those families on Income Support. Four LEAs have stopped funding a paid meals service. We also propose to legislate to require local authorities to contract out their school meals service. Against that background I propose that schools should be permitted to furnish their own school meals service if they want to do so and if they can do so at a lower cost. As to school transport, costs arise not directly in relation to the individual school but as a consequence of parental choice and I believe that it would be simpler to exclude these costs from the delegated scheme.

3. You were particularly concerned that governors should be free to appoint those staff which they (rather than the LEA) thought most suitable within a maximum complement fixed by the employing LEA. This is achieved by the proposals in para 9 (3) and (4) of Annex A.

SECRETARY OF STATE FOR EDUCATION AND SCIENCE

4. Delegated budgets, and recurrent expenditure at those schools where there is no delegated budget, will be determined by a per capita formula for the LEA in question which the Secretary of State has to approve - see paras 4-6 of Annex A. This will ensure that the LEA cannot destroy a good school by discriminating against it in the allocation of resources. This was a risk that you asked me to eliminate. The per capita formula has to vary from LEA to LEA as long as we leave the LEA to determine the overall level of expenditure on education ie the level of community charge that will arise in respect of education. This is the critical power which a local authority will retain if we allow it to remain as a provider of education, as we have decided to allow for the time being.

5. I am addressing the Secondary Heads Association this Friday and I would like to make that the occasion for a speech which outlines our intentions and objectives for wider financial delegation as an essential element of our policies for improving quality.

6. I am sending copies of this minute to the Chancellor of the Exchequer and the Secretaries of State for the Environment, Employment, Wales, Scotland and Northern Ireland and to Sir Robert Armstrong.

KB

6 April 1987

Department of Education and Science

C O N F I D E N T I A L

FINANCIAL DELEGATION TO SCHOOLS

Objectives of the reform

1. The reform, which would require legislation, would have the following objectives.

(1) To give to the governing body maximum practicable control over the school's budget.

(2) To prevent the LEA from acting arbitrarily in the determination of the budget of any school.

(3) To base the total of each school's budget on a per capita funding formula.

LEA delegation schemes

2. Each LEA would be required to submit within one year of enactment for the Secretary of State's approval a scheme setting out:

(1) The formula it would use for allocating expenditure to be incurred at the schools it maintains; where the governing body of the school had control over a delegated budget, the expenditure covered by the allocation formula would constitute the delegated budget. Initially there would be delegated budgets only for secondary schools and primary schools with more than 200 pupils and for other schools to which the LEA wished to extend them. The Secretary of State would have power to make regulations requiring such an extension by stages.

(2) The provisions governing delegated budgets.

(3) The timetable and stages for implementing the scheme.

3. The LEA would be required to implement the scheme in accordance with the time-table for it once the scheme was approved by the Secretary of State. If by a prescribed date the LEA had not submitted to the Secretary of State a scheme which he could approve, he would have the duty to substitute his own scheme which the LEA would be required to implement. The scheme could subsequently be varied with the approval of the Secretary of State if the LEA wished to change it or if changes became necessary eg because delegated budgets were extended to all primary schools.

The allocation formula

4. The LEA would be required, for every year, to determine the total expenditure relating to the schools it maintains. It would determine this total in the light of its statutory duties and the revenue available to it. From this total expenditure the LEA would allocate money to each school in accordance with the allocation formula in its scheme (see para 2 (1) above). The formula would determine the expenditure to be incurred at each school, and the delegated budget where there was one, by reference to the number of registered pupils at the school and would specify:

(1) the basis of calculating the basic sum per pupil in the 5-11, 11-16, and 16-18 age ranges.

(2) the basis of calculating the automatic adjustments to the basic sums to be made in respect of differences in the size of school, or to take account of objective indicators relating to the composition of the pupils eg indicators of social deprivation, ethnic mix, or special educational needs.

(3) The extent, if any, of the LEA's discretion to make further adjustments to the automatic application of the formula under (1) and (2) above.

When the LEA submitted its scheme for approval, it would be required to illustrate its allocation formula by reference to a specified year.

5. The Secretary of State would publish criteria in relation to the contents of allocation formulae against which he would judge the LEA schemes. These criteria might include the items of expenditure which should be covered in the basic sums per pupil, the factors which should be taken into account in making adjustments, and the maximum adjustments the LEA would be able to make on an automatic basis under its scheme, beyond which the Secretary of State's further specific approval would be required to each individual case. The criteria would seek to establish a sensible balance between a formula which was so crude as to be incapable of coping with variations in circumstances and one which was so refined or so discretionary as to frustrate the objectives of a per capita funding basis.

6. Once a LEA's scheme has been approved, or imposed by the Secretary of State, the LEA would require the Secretary of State's approval for any variation in the formula.

Delegated budgets

7. The LEA's scheme would have to conform to certain statutory rules governing delegated budgets. These are set out in paras 8-13 below.

8. The delegated budget would have to include all expenditure incurred by the LEA in respect of the school except:

(1) capital expenditure and associated debt charges.

(2) The LEA's own administrative costs in relation

to the school and the cost of certain other support services to schools organised centrally eg in-service training, projects supported by Education Support Grants, peripatetic teachers: these items would be kept to a minimum when schemes are approved by the Secretary of State.

(3) The cost of home to school transport.

Provision would be made to enable schools to run their own school meals service if they wish to do so and if they could demonstrate to the LEA that they could do so at a lower cost.

9. The governing body would be free to spend the delegated budget at their discretion on any item which it covered subject only to the following constraints.

(1) The governors would be under a duty to manage the budget efficiently, and, in the case of a county or controlled school, to act in support of the LEA's duty to keep the premises in a satisfactory state of repair.

(2) The governors would be under a duty to have regard to any legal requirements relating to the curriculum.

(3) The governors could not, without the consent of the LEA, appoint a total (full-time equivalent) number of staff in excess of the maximum complement for the school determined by the LEA as an integral part of the per capita formula for the year in question. The LEA would determine that maximum as the employer and/or paymaster of the staff. It would adjust the maximum staff complement from year to year to take account of changes in pupil numbers. The governors would need to keep an eye on what they spent on staff within that maximum to ensure that it was compatible with the total sum at their disposal under the allocation formula.

If they acted recklessly they would risk withdrawal of the delegation - see para 13 below.

(4) Subject to (3) above, the governors could appoint staff for service at the school and remove them from that service. In the case of county and controlled schools, staff so appointed would have to be taken into employment by the LEA. Where the governors wished to remove staff, it would fall to the LEA to redeploy or to dismiss but in the case of dismissal any costs of redundancy or penalties for unfair dismissal would have to be met from within the school's delegated budget. The LEA could refuse to take into its employment, or pay the salaries of, such staff only on the grounds that the persons concerned were not adequately qualified or otherwise suitable for the work in question. That would also be the only ground on which the LEA could dismiss, or refuse to pay the salaries of, such staff whom the governors wished to serve at the school. It should be noted that this would give to governing bodies with delegated budgets a new power to prevent the LEAs from appointing a candidate whom it judges to be more suitable than the governors' candidate, and from redeploying a suitable teacher whose post has disappeared eg as a result of falling rolls.

(5) The governors would be under a duty to cooperate with consortium arrangements (eg for the TVEI or in-service training) made by the LEA between schools; and to comply with conditions attached to centrally earmarked funds (eg TVEI).

10. There would be rules about the limits to and treatment of the carry-over of under-spending and over-spending by the governors.

11. It would be for the governors to decide what administrative arrangements eg a qualified bursar they require to manage their delegated budget. They would also need to develop financial management information systems: these would need to be approved by the LEA so that it could satisfy itself that the governors were adequately equipped to control the delegated budget - see para 13 below. The LEA would be under a duty to supply financial information reasonably required by the governors and to offer them training: initially such training schemes might be supported by Education Support Grant.

12. The governors would be free to sub-delegate expenditure from the delegated budget to the head teacher and such sub-delegation is likely to be extensive in practice. The head teacher would retain his present right to veto the purchase of any textbooks or other materials which in his professional judgment were incompatible with the school's curriculum.

13. The audit of the delegated budget would be added to the responsibilities of the LEA's auditors. The LEA would need to strengthen its arrangements for internal audit. If it was satisfied that the governors had shown themselves incapable of managing their delegated budget under the scheme, it would have the right to withdraw the delegation until such time as it judged that it could be restored. The governors would have a right to appeal to the Secretary of State against the LEA's withdrawal of, or failure to restore, delegation.

Implementation Timetable

14. Each LEA's scheme would contain an implementation timetable. This might vary between LEAs, given that some have made more progress with financial delegation under existing arrangements than others. All LEAs would be required to begin implementation by 1 April 1990 and to complete it by 1 April 1993. The timetable would need to specify the preparatory work, and the stages by which complete delegation could be established. The Audit Commission and the LEAs who have done most so far to delegate agree on the need for preparation and staging

if delegation is to be successful.

Articles of government

15. In schools with delegated budgets the governing body will have new functions and the LEA's powers and duties in relation to the governing body will be reduced. These changes would need to be reflected in each school's articles of government.

Visibility of the new arrangement

16. To ensure that all concerned (including governing bodies) could see the effect for each LEA and school of the move towards per capital funding and delegated budgets the LEA would be required to publish:

(1) The average per capita expenditure per pupil arising from its total expenditure on the schools it maintains.

(2) The allocation formula and the per capita expenditure per pupil in each school which results from it, whether or not the school had a delegated budget.

(3) The public examination results for each secondary school, and for all schools the results of the tests it is proposed to introduce at key ages in connection with the national curriculum.

Resources

17. These reforms would lead to an allocation of resources between schools which better reflected their ability to attract pupils as well as efficiency gains from better decisions about the use of resources at schools. But it would not be realistic to expect them to produce public expenditure savings. They would give rise to additional administrative costs. There would be an initial cost in setting up the new arrangements in schools (for example setting up the financial

management information system and training governors and staff) and in the LEAs (the setting up of the new schemes) which together might amount to £20-£30m. There would be continuing extra staff expenditure at the schools in operating the delegated budgets and in the LEAs in operating the schemes. The Department intends to commission a quick management consultants' study to develop models of financial delegation for schools to assist LEA action and to examine further and in detail likely costs at school level and the scope for long-term savings in LEA administration.

18. There would also be an increased requirement for central manpower for the necessary legislation, the approval of LEA schemes, and the monitoring of their implementation including attempts to subvert them and governors' appeals against the withdrawal of delegation.

PUP

cc Mr ACS Allan
Sir P Middleton
Mr Peretz

Miss Evans

Mr Howell telephoned me &
suggested he write to Treasury
Ministers about R/C (he agreed).

MCS 8/4

COMMITTEE OFFICE
HOUSE OF COMMONS
LONDON SWIA OAA
01-219 3285 (Direct Line)
01-219 3000 (Switchboard)

TREASURY AND CIVIL SERVICE COMMITTEE

7 April 1987

Dear Michael

I am writing on behalf of Mr Higgins and on my own part to thank you and your colleagues very much for the letter of 6 April in which informal comments on the draft Report on the Budget were put forward. Pending publication of the Report itself, I cannot of course say anything about the outcome of the advice which was given, but I was particularly asked to pass on the Chairman's appreciation of the care which had been taken to draw matters to his attention.

I have also to thank you for the letter of 3 April and the annexed note on credit cards and private sector borrowing. I do not think it would be a serious breach of privilege were I to say that the latter will be printed and the former will not, though you may receive a letter from Mr Ralph Howell asking whether you would be able to write to him on the issue of reinsurance to close in a form which he would be able to use publicly. As you will appreciate, your letter to me is unreported Committee evidence, and therefore not available to Mr Howell.

I am writing separately to express the Committee's thanks to the Inland Revenue for their assistance in providing a paper.

Yours sincerely

Bis.

W R MCKAY
Clerk to the Committee

Michael Scholar Esq
HM Treasury
Parliament Street
SW1P 3AG

1/10/4

SENATE BANKING BILL

From: R I G Allen
Date: 7 April 1987

PPS/Chancellor

c. Sir G Littler
Mr Loehnis
Mr Lankester

SENATE BANKING BILL: BREAUX AMENDMENT

I enclose a copy of an Aide Mémoire which the Chancellor may care to give to Secretary Baker at their bilateral tomorrow morning. The idea of the paper was, I believe, mentioned by Rachel Lomax in a minute she put to the Chancellor last night. I can explain more of the background, as necessary, at this evening's briefing supper.

RA

R I G Allen

Enc: 1

Ch
Top copy below for you to give Baker. Additional copy attached.

AA

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HC/2376P

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REC. 10 APR 1984
ACTION Mrs Noble
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Sir P Middleton
Sir G Littler
Mr Cassell
Mr Monck
Mr Ilett Mrs Lomax
Mr Cropper
Mr Rees Goobey

DEPARTMENT OF HEALTH AND SOCIAL SECURITY

Alexander Fleming House, Elephant & Castle, London SE1 6BY

Telephone 01-407 5522

From the Secretary of State for Social Services

Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
H M Treasury
Parliament Street
LONDON
SW1

April 8

Dear Nigel.

POLARISATION AND PERSONAL PENSIONS

Thank you for your letter of 2 April about the problems for personal pensions and building societies which you believe will result from the Securities and Investments Board's polarisation rules.

I have given this a lot of thought, and I do understand your concern and that of the building societies. But, on balance, I do not think it necessary for me to press Paul Channon to have the Board's proposal amended. My reasons are set out in the enclosed copy of a letter I have sent to him.

Yours Norman

NORMAN FOWLER

Let us have another word if you wish.

(no point)

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MS0149t

DEPARTMENT OF HEALTH & SOCIAL SECURITY
Alexander Fleming House, Elephant & Castle, London SE1 6BY
Telephone 01-407 5522
From the Secretary of State for Social Services

Rt Hon Paul Channon MP
Secretary of State for Trade and Industry
1-19 Victoria Street
LONDON
SW1

April 8

Dear Paul.

FINANCIAL SERVICES ACT: POLARISATION

As you know, a number of building societies have made representations to me about the effects of the Securities and Investments Board's polarisation policy on their ability to sell personal pensions. I have been giving careful thought to their arguments, taking account also of a recent discussion in my Advisory Group on Personal Pensions to which both Mark Weinberg and Mark Boleat contributed. And I have seen Ian Stewart's letter of 23 February to Michael Howard, as well as your minute of 20 March to the Prime Minister.

My interest is in a successful launch of personal pensions. I want to see them made widely available and taken up by as many people as possible. We recognised - as a Government - the important role of bank and building society branches in achieving this objective in our Social Security White Paper. So, clearly, I must have some misgivings about a proposal which restricts the ability of building society branches to sell personal pensions.

Having said that, I recognise the difficulty you are in. I certainly do not want to urge on you a course of action that could put in jeopardy the timetable for implementing the Financial Services Act. And I do accept the merits of polarisation as an investor protection measure. I can of course well understand why building societies would want to opt for independent intermediary status, given the valuable income they earn from selling life insurance products.

E.R.

But I think the Building Societies Association is overstating the difficulties that polarisation will create for the societies themselves, as far as personal pensions are concerned. As independent intermediaries they will be able to sell their own deposit-based personal pensions through their branches. They also have the prospect of being able to sell their own unit trust personal pensions if they can satisfy the "demonstrably better" test; meanwhile, these can be marketed by mailshot to what the societies regard as one of their biggest assets, their customer base. And they can continue to earn commission by selling through their branches other providers' insurance policies and unit trusts, including the option of negotiating special terms with a particular provider. In this context it is worth remembering that, although the Building Societies Association makes much of our White Paper commitment about the role of societies' branch networks in selling personal pensions, less emphasis has been given to the White Paper statement that "Building Societies will act in conjunction with other financial institutions, to ensure the reasonable spread of long-term investments necessary for pension provision."

Though building societies have the power to set up subsidiaries to provide unit trust personal pensions, I am not certain that all of them are likely to have the necessary expertise. What they do have is expertise in marketing and selling relatively straightforward products through their branches, and we should recognise this. So, in the interests of implementing the Financial Services Act framework within the timescale necessary to enable personal pensions to get off to a good start, I do not propose to press you to make any exemption from the polarisation rules for personal pensions or building societies.

I am sending a copy of this letter to Nigel Lawson.

Yours ever
Norman

NORMAN FOWLER

Inland Revenue

Policy Division
Somerset House

FROM: P A MICHAEL

DATE: 8 APRIL 1987

PS/ECONOMIC SECRETARY

POST-BUDGET LOBBYING - COUNTER BRIEFS

1. In your note to PS/Chancellor of 6 April the Economic Secretary asked for an explanation of the statement in Mr Ross Goobey's minute dated 3 April that most life assurance companies "offset management expenses against their capital gains which are therefore largely sheltered from Corporation Tax".

2. The life assurance companies incur large management expenses in the course of carrying on their business. These expenses (commissions and overheads) are deductible in calculating profits for tax purposes and there are special rules whereby a significant proportion of management expenses may be set-off against capital gains attributable to policyholders' funds. In all cases the effect of this is to substantially reduce and, therefore, "shelter" policyholders' gains from tax. Indeed, some life companies have in recent years paid no tax at all on such gains.

PAM

P A MICHAEL

---

cc	PS/Chancellor of the Exchequer	Mr Isaac
	PS/Financial Secretary	Mr Houghton
	PS/Minister of State	Mr Cayley
	Mr Cropper	Mr Michael
	Mr Ross Goobey	PS/IR
	Mr Tyrie	

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ACTION MR POTTER
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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

9 April 1987

Dear Mike,

LOCAL AUTHORITY NEEDS INDICATORS

The Chancellor, some while ago, mentioned to the Prime Minister his view that the present system for assessing local authorities' needs was excessively complicated and that it sometimes produced unforeseen and perverse results. The Prime Minister invited the Chancellor to have a note prepared, and the note attached was the result.

The intention under the new system is that the needs grant should be simpler and more stable. However, some colleagues in charge of spending departments and their officials are likely to resist a move to a simple system, and the Prime Minister would be most grateful if the Lord President could consider this problem and how best the objective might be achieved. It would also be useful to consider how the basis of the calculation could be simplified under the present system in view of the length of the transitional period, even though that may be shortened.

I am copying this letter to Alex Allan (HM Treasury) and Trevor Woolley (Cabinet Office).

Yours,

David

(DAVID NORGROVE)

Mike Eland, Esq.,
Lord President's Office.

CONFIDENTIAL

SIMPLER NEEDS ASSESSMENTS

The present system for assessing local authorities needs - their grant related expenditure assessments (GREs) - starts with the worthiest of motives, to achieve objectivity and fairness. But the quest for these has become bogged down in complexity. That complexity in turn means the system produces unforeseen and sometimes perverse results. The resulting shifts in grant - often quite large - destroy the link between what the authority spends and what the local taxpayer pays. That is bad for local accountability.

2. The Green Paper, "Paying for Local Government" sets the objective of basing the new lump-sum needs grant on simpler and more stable GREs. This note reports on how that might be achieved.

The present system

3. The starting point of the present system is the Government's decision on how much local authorities need to spend in total and on each of their services and sub-services. Statistical indicators are then applied to determine each local authority's share. Over 70 such indicators are used at present. Some are straightforward, like numbers of school children. But others are obviously spurious and some are manifest absurdities.

- shopping floor space is used to estimate the need for spending on museums
- there were prolonged arguments recently about whether the need for spending on winter road maintenance would be better measured by the numbers of days of air frost or the number of days of grass frost.

The attached extract from the Rate Support Grant Report for 1986-87 gives some idea of the complexities of the present system.

4. Each year, GREs are re-examined in detail by working groups of officials from central and local government. But the system is so complex that one minor change can have quite unintended consequences. Last year it was decided to increase the needs

assessment for Newcastle's metro: the consequence was a shift of grant into London and higher rate rises in the shires.

A new system

5. Treasury officials have been looking to see if there is a viable alternative to this system. Existing GREs range from £353 per head in Tandridge, Surrey to £770 per head in Islington. Preliminary work here suggests that 94 per cent of that variation can be explained by using just 6 of the present indicators:

- the total number of school children;
- the number of children under 5;
- the population over 65;
- population density;
- the mileage of local authority roads;
- a general social conditions indicator.

For two-thirds of authorities this simple assessment was within 5 per cent of the GRE produced by the 70 complex indicators used at present.

6. Local authorities would inevitably criticise a simpler system as presenting rougher justice. There would be gainers and losers (though the effects are likely to be much less significant than those which will flow from the removal of resource equalisation as rates are abolished). There would be a few significant losses causing vociferous complaints, although the transitional safety net arrangements would phase the effects in over several years.

7. Once fully established, the advantages of a new system could be considerable:

- a simpler system would be much more transparent; unforeseen distributional consequences arising from technical tinkering should be a thing of the past;
- the system should therefore be much more stable.

8. There will inevitably be opposition to these changes, but transparency and stability are vital if we are genuinely to have a

grant system which reinforces rather than undermines local accountability. In principle local authorities should welcome these objectives. But they have grown addicted to the annual haggle to refine GREs. And Whitehall Departments will be suspicious: they fear that a system which is no longer based on a separate needs indicator for each individual service will undermine their influence over local authorities. But their influence under the present system is very limited.

9. The Green Paper reforms offer the obvious chance to implement such changes. The Treasury believes that that opportunity should be used to move once and for all to a system of simple and stable needs assessments. The aim should be to set up a simple system and forswear tinkering with it for several years.

HM Treasury

17 March 1987

3785/20

CONFIDENTIAL AND PERSONAL

A good forecast – for a notoriously difficult month! C.

FROM: COLIN MOWL
DATE: 9 April 1987

1. MR CASSELL

2. CHANCELLOR OF THE EXCHEQUER

cc Sir P Middleton
Sir T Burns
Mr Peretz
Mr Sedgwick
Mr Ritchie
Mr Devereux
Dr Clark

Thanks. I remain deeply suspicious abt what the LAs have been up to – & what they will be up to this yr. N.

C/ David Norgrove has asked for the figures. He would normally be told the day before publication ie Wed. I don't think we can stall that long – Sir P's view (with which I agree) is that we tell him the figure on Monday. content?

OK – . CR 10/4

PSBR IN MARCH AND 1986-87

1. The first provisional outturn for the PSBR in March is borrowing of £3.3 billion. This is £0.7 billion below the forecast implicit in last month's FSBR and £0.1 billion above our central internal forecast (Mr Sedgwick's minute to the Chancellor of 10 March, 'The PSBR in 1986-87 and 1987-88'). The average of the market forecasts currently available is for borrowing just under £4 billion, with a range of £3½ to £4½ billion. Most commentators appear to have based their expectations on the FSBR estimate. The outturn is subject to revision before publication at 11.30am on Thursday 16 April.

2. There have been small downward revisions, totalling £0.1, to borrowing in earlier months. The first provisional estimate of borrowing in 1986-87 as a whole is therefore £3.3 billion, which just rounds down to ¾ per cent of money GDP. Excluding privatisation proceeds the percentage is 2 per cent. The table below gives further details:

£ billion

	Central Internal Forecast	1987 FSBR	First provisional Outturn
CGBR(O)	4.6	5.0	4.5
LABR	0.3	0.5	0.1
PCBR	-1.6	-1.4	-1.4
PSBR	3.3	4.1	3.3

The error in the 1987 FSBR estimate is slightly lower than the average error of £1 billion in FSBR forecasts for the year just ending. The average error was given in FSBR table 3.13.

3. The table attached compares the March outturn with the forecast implicit in this year's FSBR, and the outturn for 1986-87 with the forecast underlying the 1986 FSBR. The estimate of the CCBR(O) in March is the same as reported in Mr Devereux's minute of 2 April. As noted there Inland Revenue receipts were slightly higher than forecast in this year's FSBR (£0.2 billion, mainly PAYE and ACT) and Customs and Excise receipts slightly lower than forecast (£0.1 billion). Vehicle excise duty and oil royalties together were £0.1 billion above forecast. Very provisional estimates for supply expenditure suggest that it may have been lower than forecast.

4. The LABR in March is the lowest March figure in current prices since 1982 and in real terms the lowest figure since monthly figures began in 1977-78.

5. There is at this stage relatively little detail on the industry breakdown of the PCBR in March. As expected the electricity industry made a net repayment but the estimate for the PCBR as a whole implies that this was more than offset by borrowing by other industries.

6. Further analysis of the March outturn, together with forecast profiles for the whole of 1987-88, will appear in the monthly note to be circulated in draft on Tuesday 14 April. The monthly note will compare the outturn with the FSBR figures only as the internal forecast of 10 March was given a very restricted circulation.

Colin Mowl

COLIN MOWL

CONFIDENTIAL & PERSONAL

£ billion

	March 1987			1986-87			1985-86
	Provisional outturn	1987 Budget (implicit) forecast	Difference	Provisional outturn	1986 Budget forecast	Difference	Outturn
CGBR(O)	2.3	2.8	- 0.5	4.5	6.1	- 1.6	4.1
LABR	0.8	1.2	- 0.4	0.1	1.6	- 1.5	1.7
PCBR	0.2	-	0.2	- 1.4	- 0.6	- 0.8	-
PSBR	3.3	4.0	- 0.7	3.3	7.1	- 3.8	5.8

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