PO-CH/NL/0110

PART A

Part . A.

SECRET

(Circulate under ... otify ...)

Begins : 3/8/87.
Ends : 19/10/87.

PO -CH /NL/0110

PART A

Chancellor's (Lawson) Papers:

THE WORLD FINANCIAL
MARKETS 1987 - 1988

PO -CH /NL/0110
PART A

Disposal Directions: 25 Years

16/8/95.

✓ ✓ [handwritten initials]

SECRET

FINANCIAL MARKETS: NOON REPORT   date: 3 August 1987

Opening	10 AM		NOON	Oil Price (10 AM)	
72.3	72.2	£ERI	72.3		
1.5925	1.5915	$/£	1.5935	Aug	$20.90
2.9632	2.9610	DM/£	2.9642	Sept	$20.70
1.8607	1.8605	DM/$	1.8602	Oct	$20.60
150.10	150.05	Yen/$	150.05		

UK interbank £			Eurodollars	
8 1/8	(-1/8)	7 day	6 5/8	(-)
8 13/16	(+1/16)	1 month	6 3/4	(-)
9 7/16	(+1/16)	3 month	6 13/16	(-)
10	(-)	12 month	7 5/8	(-)

Figures in brackets show change since previous market close

MARKET COMMENT

In the foreign exchange market the dollar opened firmer due to uncertainties in the Gulf. It has remained steady throughout the morning. Sterling opened easier but has since firmed as the oil price rose.
The gilts market showed some recovery after a weak start. R M'Kabbie

MARKET INTERVENTION ($m)

Overnight -40$ (FE)

Today so far -

Total -40$

OTHER COUNTRIES INTERVENTION ($m)

GILTS

	Latest market movements	Price change since previous close
Shorts	Better	-1/32
Mediums	Better	-3/32
Longs	Better	-1/32
Futures (Long Contracts)		+1/32 (Vol:16258)

Gilt Sales since market opening

-£4.0 million

MG1 Division 270 5556/5560

√ prop

SECRET

FINANCIAL MARKETS: NOON REPORT

Tuesday 4 August 1987

Opening	10 AM		NOON	Oil Price (10 AM)	
72.1	72.1	£ERI	72.0		
1.5800	1.5805	$/£	1.5758	Aug	$20.72
2.9604	2.9619	DM/£	2.9578	Sept	$20.62
1.8737	1.8740	DM/$	1.8770	Oct	$20.50
151.60	151.40	Yen/$	151.5		

UK interbank £			Eurodollars	
7 7/8	(-1/4)	7 day	6 5/8	(-)
8 25/32	(-1/32)	1 month	6 13/16	(+1/16)
9 3/8	(-1/16)	3 month	7	(+1/16)
10 1/16	(+1/16)	12 month	7 13/16	(+3/16)

Figures in brackets show change since previous market close

MARKET COMMENT

In the foreign exchange markets the dollar firmed sharply in New York last night on mainly technical reaction to softer sterling and tensions in the Gulf.European markets wary of central bank intervention around current levels and so upward movement today has been limited.Sterling slightly easier at noon, on yesterday's closing levels, after a steady morning.Since New York opening,in last hour,bullish sentiment has carried the dollar higher, sterling suffering as a result.UK reserve figures had no impact.
The Gilts market has been broadly steady until the UK reserves figures were released which were well received.

ICPol

MARKET INTERVENTION ($m)

Overnight -87$(New York)

Today so far -

Total -87$

OTHER COUNTRIES INTERVENTION ($m)

GILTS

	Latest market movements	Price change since previous close
Shorts	Steady	0
Mediums	Better	+5/32
Longs	Easier	+12/32
Futures (Long Contracts)		+11/32 (VOL:11995)

Gilt Sales since market opening

£0 million

MG1 Division 270 5556/5560

SECRET

FINANCIAL MARKETS: NOON REPORT — Wednesday 5 August 1987

Opening	10 AM		NOON	Oil Price (10 AM)	
72.1	72.1	£ERI	72.1		
1.5785	1.5790	$/£	1.5790	Aug	$20.45
2.9613	2.9646	DM/£	2.9669	Sept	$20.35
1.8760	1.8775	DM/$	1.8790	Oct	$20.25
151.60	151.05	Yen/$	150.72		

UK interbank £			Eurodollars	
8 1/8	(+1/4)	7 day	6 11/16	(-)
8 13/16	(-)	1 month	6 13/16	(-)
9 5/16	(-1/32)	3 month	7 1/8	(-)
9 15/16	(-1/16)	12 month	7 7/8	(+1/2)

Figures in brackets show change since previous market close

MARKET COMMENT In the foreign exchange markets the dollar has continued to rise particularly against the Mark. In New York the Fed intervened around DM1.89 to prevent any further rise above that level.
The Bundesbank intervened on London opening around DM1.8825. The dollar then fell back to trade fairly steadily all morning around DM1.8775.
Central Bank resolve may well be tested on New York opening if the dollar again moves significantly above DM1.88.
Sterling on sidelines.
Gilts opened better. £82 million sales secured mainly of 8% 1991 Tap.
Early market strength now checked.

I Pol

MARKET INTERVENTION ($m)

Overnight -

Today so far -

Total -

OTHER COUNTRIES INTERVENTION ($m)

US -50$ agst. DM (New York 4.8)
GERMANY -100$ agst.DM (today)

GILTS

	Latest market movements	Price change since previous close	Gilt Sales since market opening
			+£82.3 million
Shorts	Better	+9/32	
Mediums	Better	+9/32	
Longs	Easier	+18/32	
Futures (Long Contracts)		+26/32 (VOL:14520)	

SECRET

pmg

From : D L C Peretz
Date : 5 August 1987

PPS

cc PS/EST
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr C W Kelly

Noted:

GILT-EDGED MARKET

— with you.

Contrary to the view reported in paragraph 7 of my note of last night, I should report that the Bank of England decided to start supplying the current tap stock (8% 1991) when they were bid for it this morning.

2. In the event the Bank's concern that to refuse to supply the stock when bid for it would risk giving a wrong signal to the market about interest rates - making it look as if we wished strongly to resist any rise in short-term rates - overrode the desire expressed yesterday to wait until after any rise in short-term interest rates.

3. The Government broker sold £400 million (nominal) of the £1 billion stock at the partly paid market price of £17¼, and a further £50 million at £17$^{3}/_{8}$ (even though the market price never reached £17$^{3}/_{8}$, and now stands below £17¼). The £82.3 million of gilt sales reported in today's MG1 noon financial markets report includes the initial payment on these sales, but not the larger part of the payment which will come with the call on 24 August.

DLCP

D L C PERETZ

3885B/12

CONFIDENTIAL

RP

FROM: C W KELLY

DATE: 6 August

CHANCELLOR

cc: Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir G Littler
Mr Cassell
Mr Peretz
Mr Ilett
Mr Culpin
Ms Goodman o/r
Mr Richardson o/r
Mr Cropper

THE MARKETS

The timing of today's move clearly took the markets by surprise, but apparently not the amount of the increase.

2. Midland were the first to move, closely followed by Barclays. Lloyds and NatWest moved in the afternoon.

3. The immediate effect in the **inter-bank market** was for rates to be marked up to around 10 per cent across the maturity range. Subsequently the three month rate settled at around 10 3/32, and the one year rate at 10 5/16. But it appears that not much business is being done at these levels. The banks are still sorting themselves out.

4. The general atmosphere is a bit fragile. There is some nervousness about whether or not 1 per cent will stick. To some extent this is the normal reaction after any increase. But it also reflects concern about what next week's figures will show. One indication of this is that in taking out the shortage at the two o'clock round the Bank had to take more than half in band 4 bills, the houses being anxious to get rid of the longer maturities.

5. The **gilts market** was knocked back immediately after the announcement, falling 2 full points in mediums and 3 in longs. The tap is now yielding just over 10 per cent, though again not much trading was done. Those who bought it yesterday, or first thing this morning, are feeling pretty sick.

6. The Bank bought in about £60 million of IGs, mainly before lunch.

7. The **foreign exchange markets** took the move as a modest buy signal, the bulls attracted by the bigger interest rate differential just about outweighing the bears who took it as a sign that next week's figures must be dreadful. Sterling moved up immediately about half a cent against the dollar. The cross rate was little affected.

8. Later on, attention was focussed on the dollar, which was creeping up against the mark for most of the morning. Just after lunch the Fed intervened noisily, selling about $50 million for DM. The Bundesbank and ourselves each did the same, followed shortly by the French and Belgians selling dollars against their own currencies (though not being widely detected).

9. This slightly ragged concert had the immediate effect of pushing the dollar back below 1.87. Since then it has come up again, presumably reflecting the easing of tensions in the Gulf. But the fact the Fed has now intervened is likely to keep the markets nervous. The Bank think they are ready to come in again at DM 1.8850. If so, the Fed must have sorted out their earlier differences with the US Treasury.

10. The Bank bought some dollars against sterling in the morning in response to approaches from their customers and to offset customer outflows.

11. The **equity market** was hit hard. At close the FTSE 100 was down 59.4 and the FT 30 down 44.8, though both were above

their lowest levels of the day. The oil sector was worst hit, presumably because of the easing in oil prices over the last few days. The BP share price fell to 383 compared with a closing price yesterday of 402.

12. Trading volumes were very heavy, especially during the period immediately after the base rate change. Quotes on SEAQ could not be updated quickly enough, and the obligation to deal at the prices shown was suspended for a 45 minute period.

CWK

C W KELLY

SECRET

MG NOON REPORT

FINANCIAL MARKETS

Friday 7 August 1987

Opening	10 AM		NOON	1 p.m.
72.1	72.0	£ERI	72	72
1.5750	1.5725	$/£	1.5725	1.5930
2.9642	2.9602	DM/£	2.9524	2.9612
1.8820	1.8825	DM/$	1.8820	
151.25	151.25	Yen/$	151.15	

Oil Price (10 AM)

Sept	$19.60
Oct	$19.55
Nov	$19.50

UK interbank £			Eurodollars	
8 7/8	(-3/4)	7 day	6 5/8	(-1/16)
9 11/16	(-1/8)	1 month	6 3/4	(-)
10 1/8	(+1/8)	3 month	7	(-)
10 7/16	(+1/8)	12 month	7 11/16	(-1/16)

Figures in brackets show change since previous market close

MARKET COMMENT The foreign exchange markets are relatively calm after yesterday's rise in base rates. Market sentiment is cautious on the dollar ahead of US (un)employment data out at 1.30PM. Markets expecting a 6.2% level for unemployment and +200,000 for non-farm payroll. Sterling mainly on the sidelines with some bouts of professional selling during morning but now quiet. The gilt market is steady at the lower levels. ~~Sales~~ Purchases were all index linked.

ICPolin

MARKET INTERVENTION ($m)

Overnight	-
Today so far	-10$
Total	-10$

OTHER COUNTRIES INTERVENTION ($m)

FRANCE	-100$
ITALY	-14$
US	-81$ (New York last night) (including -50 yesterday)

GILTS

	Latest market movements	Price change since previous close
Shorts	Better	-6/32
Mediums	Better	-10/32
Longs	Better	-21/32
Futures (Long Contracts)		-12/32 (VOL:15709)

Gilt Sales since market opening

-£18.7 million

NAME: I.C.Polin, MG1 Division
TEL NOS: 270 5556/5560

SECRET

SECRET

RD

From : D L C Peretz
Date : 7 August 1987

PPS

cc PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir G Littler
Mr Cassell
Mr Kelly
Mr Ilett
Ms Goodman o/r
Mr Richardson o/r

MARKETS

The markets continued today to digest yesterday's interest rate move, with the picture complicated by a very strong dollar.

Domestic Markets

2. **Interbank rates** firmed very slightly this morning but then settled at just under 10¼ at three months, and 10½ at one year (compared with $10^3/_{32}$ and $10^5/_{16}$ respectively last night). The Treasury Bill tender today came out at a discount rate of 9.7668 - a little less than a point up from last week's rate, and fully in line with the Bank's bill dealing rate of $9^7/_8$ - with no help from the Bank of England.

3. The **gilts market** started the day continuing yesterday's decline, falling by about a point at the long end. It recovered most of these losses over the day, however, after several fluctuations in both directions. The market makers have been trying to keep their books square after yesterday's trauma, and have been quick to move their prices. There has not been much turnover.

4. The **equity market** also continued yesterday's fall, with the FT 30 index 65 points down at one stage. It later recovered to end up 27.2 points down on the day (after yesterday's 44.8 fall).

5. Generally the domestic markets are now waiting for Tuesday's trade figures.

Exchange Markets

6. After a relatively quiet morning the dollar rose sharply this afternoon after the US employment figures showed a faster than expected fall in US unemployment. Partly because of fear of Fed/Bundesbank intervention this pressure initially showed up most in the £/$ market, and the Bank sold nearly $200m before letting the rate fall below $1.57. The DM/$ rate then rose to around DM 1.89 (from 1.8820 at lunchtime), triggering a bout of concerted intervention in which we (selling $s for DM), the Fed, the French and the Belgians took part. The total amounts (shown in the evening report) were however relatively modest, and the Bundesbank did not take part (though it had sold $10m earlier, at the morning fixing in Frankfurt).

7. The $ ended the day in London at around DM 1.89. Sterling ended at DM 2.96½, and an ERI of 72.0 - having dipped to 71.9 at 3 pm.

DLCP

D L C PERETZ

SECRET

MG NOON REPORT

FINANCIAL MARKETS Monday 10 August 1987

Opening	10 AM		NOON	Oil Price (10 AM)	
71.8	71.9	£ERI	72		
1.5655	1.5660	$/£	1.5676	Sept	$19.30
2.9564	2.9601	DM/£	2.9635	Oct	$19.25
1.8885	1.8902	DM/$	1.8905	Nov	$19.20
151.45	151.55	Yen/$	151.57		

UK interbank £			Eurodollars	
8 1/2	(-5/8)	7 day	6 9/16	(-1/16)
9 11/16	(-)	1 month	6 11/16	(-1/16)
10 1/4	(+1/32)	3 month	7	(-)
10 5/8	(-1/8)	12 month	7 3/4	(+1/16)

Figures in brackets show change since previous market close

MARKET COMMENT Gulf tension overhangs the foreign exchange markets. The dollar,after having firmed in New York as dealers squared their books prior to the weekend,eased slightly in Far East on Japanese trade figures showing a $6.99Bn surplus in July.This morning the dollar has been fairly quiet and steady ahead of New York opening.
Sterling has seen good two way business.It firmed slightly on UK producer price and retail sales figures.Now quiet.

In the Gilt market,early losses have been mostly recovered. ICPolin

MARKET INTERVENTION ($m)

Overnight -8$(New York,Fri)

Today so far -

Total -8$

OTHER COUNTRIES INTERVENTION ($m)

US -400$(Agst.DM)New York,Friday
GERMANY -11$,today

GILTS

	Latest market movements	Price change since previous close	
Shorts	Easier	-10/32	
Mediums	Easier	-7/32	
Longs	Easier	-7/32	
Futures (Long Contracts)		-6/32	(VOL:10656)

Gilt Sales since market opening

£0 million

NAME: I.C.Polin, MG1 Division
TEL NOS: 270 5556/5560

SECRET

MG NOON REPORT

PWP

FINANCIAL MARKETS

Opening	10 AM		NOON	12.50PM (approx)	1.00PM	Oil Price (10 AM)	
72.1	72.0	£ERI	72	72.2	72.1		
1.5770	1.5735	$/£	1.5725	1.5775	1.5765	Aug	$19.55
2.9648	2.9605	DM/£	2.9626	2.9689	2.9685	Sept	$19.55
1.8800	1.8815	DM/$	1.8840	1.882		Oct	$19.50
150.80	150.80	Yen/$	151.03	150.9			

1.00PM	UK interbank £			Eurodollars	
	7 7/8	(-1/8)	7 day	6 11/16	(-)
9 15/16	8 3/4	(-)	1 month	6 3/4	(-)
9 15/16	9 1/4	(-1/16)	3 month	7	(-)
10 1/4	9 29/32	(-1/32)	12 month	7 3/4	(-)

Figures in brackets show change since previous market close

MARKET COMMENT The Bank signalled 1% rise in money market dealing rates soon after noon.
Sterling rose immediately 1/2 cent and is currently around $1.5765 and DM2.9675.
After the Bank signal interbank rates quickly moved up to around 10% across the maturity range. The gilt market weakened on the news: initially at the long end which lost 1 1/2 points within minutes.

1.00 PM — BARCLAYS & MIDLAND HAVE JUST INCREASED THEIR BASE RATES BY 1%.

NB. Second call of about £350M due on 24 Aug. from yesterday's sale of 8% 1991 Tap.

ICP

MARKET INTERVENTION ($m) OTHER COUNTRIES INTERVENTION ($m)

Overnight	-
Today so far	-
Total	-

GILTS

	Latest market movements	Price change since previous close
Shorts	Steady	-3/32
Mediums	Steady	-3/32
Longs	Steady	-9/32
Futures (Long Contracts)		-8/32 (VOL:13714)

Gilt Sales since market opening

+£1.7 million

NAME: I.C.Polin, MG1 Division
TEL NOS: 270 5556/5560

1779.62

SECRET

FROM: H C GOODMAN

DATE: 10 August 1987

PS/SIR P MIDDLETON

cc: PS/Chancellor
PS/Economic Secretary
Mr Cassell
Mr Richardson

MARKETS

We spoke and I promised you a note on market developments in anticipation of the June trade figures to be published tomorrow.

Domestic Markets

2. Despite this morning's press reports of nervousness in all the markets the gilts market was steady over the day with yields prices down up $\frac{1}{8}$-$\frac{1}{4}$ on Friday's close. The equity market firmed; the FTSE 100 reached 2,242.2 up 16.0 points on Friday's close at five o'clock and the FT30 reached 174.26 up 15.7. Generally, both markets are still waiting for the trade figures.

Foreign Exchange Markets

3. Sterling opened down at 71.8 compared with 72.0 at Friday close. The dollar had strengthened further against sterling, moving from \$1.5675 to \$1.5660 at the opening, but moved from \$1.8920 to \$1.8885 against the D-mark. The Fed did further intervention on Friday night bringing their total to -\$400m (against D-mark).

4. This morning the dollar was quiet and steady ahead of the New York opening. Sterling saw good two-way professional business. The producer price index for July was up 0.1% (unchanged for June) and the retail price figure was up 3.2% for June (revised to -3.5% for May). This produced little reaction with sterling rising 10 points on professional buying.

5. Around 1.45pm news that a US operated tanker had hit a mine outside the Strait of Hormuz was not immediately reflected in the oil market (the Department of Energy view is that what matters is reactions to the event), but pushed the dollar up to a high for the day of $1.8975. This triggered a bout of concerted intervention around two o'clock: the Fed sold $100m against D-mark, we sold $50m for D-mark (which is therefore not reflected in the evening report), the Bundesbank bought DM111 for dollars, the Banque de France sold $30 for D-marks. This steadied the dollar which closed at 1.8960 and has come off a little further in the past hour. The markets were not sufficiently confident to test central bank resolve again.

6. The June trade figures to be published tomorrow are within the market's expected ranges. The dealers may have a more pessimistic view than the analysts. Nonetheless at the moment we do not expect any serious problems to arise. Sterling is more likely to rise than fall. Given its current level of DM2.9665, intervention to cream off funds if the rate neared DM3.00 looks unnecessary. The Bank stand ready to offer support, if unexpectedly, there is a disorderly downward movement.

HC Goodman

H C GOODMAN

SECRET

MG NOON REPORT

FINANCIAL MARKETS — Tuesday 11 August 1987

Opening	10 AM		NOON	Oil Price (10 AM)	
72.2	72.2	£ERI	72.1		
1.5715	1.5727	$/£	1.5672	Sept	$19.35
2.9725	2.9748	DM/£	2.9711	Oct	$19.35
1.8915	1.8915	DM/$	1.8958	Nov	$19.30
151.20	151.25	Yen/$	151.73		

UK interbank £			Eurodollars	
9 1/2	(+5/8)	7 day	6 5/8	(-)
9 7/8	(+1/16)	1 month	6 11/16	(-)
10 7/32	(+1/32)	3 month	7	(-)
10 1/2	(+1/16)	12 month	7 3/4	(-)

Figures in brackets show change since previous market close

MARKET COMMENT In the foreign exchange markets the dollar is firmer on continuing tension in the Gulf following yesterday's mine explosion. It is now heading towards the major chart point of DM1.90.
Active trading in Sterling followed release of UK trade figures which were around market expectations. Sterling saw some profit taking but is now steady around $1.5675 and a little lower on the opening index.
Gilts opened slightly better. Confused market following publication of UK trade figures.

Ian Polin

MARKET INTERVENTION ($m) — OTHER COUNTRIES INTERVENTION ($m)

Overnight	-
Today so far	-
Total	-

GILTS

	Latest market movements	Price change since previous close
Shorts	Steady	+7/32
Mediums	Better	+10/32
Longs	Easier	+2/32
Futures (Long Contracts)		+1/32 (VOL:11649)

Gilt Sales since market opening: +£2.7 million

NAME: I.C.Polin, MG1 Division
TEL NOS: 270 5556/5560

SECRET

/.. pwp

MG NOON REPORT

FINANCIAL MARKETS

Thursday 13 August 1987

Opening	10 AM		NOON
72.5	72.6	£ERI	72.5
1.5790	1.5810	$/£	1.5800
2.9867	2.9889	DM/£	2.9870
1.8915	1.8905	DM/$	1.8905
151.37	151.35	Yen/$	151.45

Oil Price (10 AM)

Sept	$19.42
Oct	$19.40
Nov	$19.35

UK interbank £			Eurodollars	
9 3/8	(-)	7 day	6 1/2	(-1/16)
9 3/4	(-)	1 month	6 5/8	(-1/16)
10 1/16	(-)	3 month	6 15/16	(-)
10 7/16	(+1/16)	12 month	7 5/8	(-1/16)

Figures in brackets show change since previous market close

MARKET COMMENT The foreign exchange markets have been quiet and steady so far today. The markets now await the US trade figures out tomorrow for direction on the dollar. US retail sales out at 1.30PM (markets expect +0.5%). Sterling saw some demand in New York last night but is steady today with the UK (un)employment, average earnings and manufacturing cost figures having no effect.
Some EMS tensions today.
The gilts market is slightly easier.

I C Polin

MARKET INTERVENTION ($m)

Overnight	+9$ (New York)
Today so far	-
Total	+9$

OTHER COUNTRIES INTERVENTION ($m)

FRANCE	-180$ (today)
ITALY	-317$ (today)

GILTS

	Latest market movements	Price change since previous close	
Shorts	Easier	-3/32	
Mediums	Steady	-8/32	
Longs	Better	-9/32	
Futures (Long Contracts)		+2/32	(VOL:7643)

Gilt Sales since market opening

£0 million

NAME: I.C.Polin, MG1 Division
TEL NOS: 270 5556/5560

RO

SECRET

MG NOON REPORT

FINANCIAL MARKETS Monday 24 August 1987

Opening	10 AM		NOON	Oil Price (10 AM)	
72.5	72.6	£ERI	72.6		
1.6280	1.6280	$/£	1.6277	Sept	$17.70
2.9662	2.9670	DM/£	2.9689	Oct	$17.80
1.8220	1.8225	DM/$	1.8240	Nov	$17.80
142.75	143.15	Yen/$	142.98		

UK interbank £			Eurodollars	
9 13/16	(+1/16)	7 day	6 9/16	(-1/8)
9 13/16	(+1/32)	1 month	6 3/4	(-)
10 3/16	(-)	3 month	7	(-)
10 11/16	(-)	12 month	7 11/16	(-)

Figures in brackets show change since previous market close

MARKET COMMENT In the foreign exchange market the dollar opened in London firmer due to active short covering and Bank of Japan intervention in the Far East. The dollar has continued to firm this morning, following rumours of planned US and Bank of Japan concerted intervention(BOJ have not yet had a possative response on this from the FED)) Sterling opened firm, but very much on the sidelines. The gilts market is continuing tentative recovery.

L McRobbie

MARKET INTERVENTION ($m) OTHER COUNTRIES INTERVENTION ($m)

Overnight	-	+243$	Japan
Today so far	-		
Total	-		

GILTS

	Latest market movements	Price change since previous close	Gilt Sales since market opening
			£0 million
Shorts	Better	+4/32	
Mediums	Better	+10/32	
Longs	Steady	+15/32	
Futures (Long Contracts)		+20/32 (Vol: 8204)	

NAME: I.C.Polin, MG1 Division
TEL NOS: 270 5556/5560

SECRET

RB

MG NOON REPORT

FINANCIAL MARKETS

Wednesday 26 August 1987

Opening	10 AM		NOON
72.2	72.2	£ERI	72.0
1.6175	1.6165	$/£	1.6132
2.9536	2.9542	DM/£	2.9473
1.8260	1.8275	DM/$	1.8270
142.95	142.97	Yen/$	142.97

Oil Price (10 AM)

Sept	$17.60
Oct	$17.75
Nov	$17.80

UK interbank £			Eurodollars	
9 3/8	(-5/16)	7 day	6 5/8	(+1/16)
9 3/4	(-1/8)	1 month	6 11/16	(-)
10 3/8	(+1/16)	3 month	6 15/16	(-)
10 15/16	(+1/8)	12 month	7 11/16	(-)

Figures in brackets show change since previous market close

MARKET COMMENT In the foreign exchange market the dollar opened firmer on last nights close. It rose in New York after comments by Japanese and West German monetary authorities and the Us Trade Representative Clayton Yeulter. In the Far East it fell on active selling after the sharp rise. Sterling opened quiet but easied after some outward selling on overseas investments(Blue Arrow)and rumours of ERM entry. The rate has now steadied, without intervention by the bank, who will review the situation when the trade figures are available internally.
The gilts market slowly drifted downwards.

RM Robbie

MARKET INTERVENTION ($m)

		OTHER COUNTRIES INTERVENTION ($m)
Overnight	+11$ (NY)	+58$ (Japan)
Today so far	-	
Total	+11$	

GILTS

	Latest market movements	Price change since previous close
Shorts	Easier	-4/32
Mediums	Better	-9/32
Longs	Better	-11/32
Futures (Long Contracts)		-18/32 (Vol:16415)

Gilt Sales since market opening

£0 million

NAME: I.C.Polin, MG1 Division
TEL NOS: 270 5556/5560

CHANCELLOR OF THE EXCHEQUER
HONI SOIT QUI MAL Y PENSE

Ch

David asked for note for PM before bilateral on market, recounting developments since last meeting. Unless you object, I shall commission update of note below

Yes. Let it be in good time [illegible]

AA

SECRET

From: Sir G.Littler
Date: 28 August 1987
(noon)

c.c. Sir P.Middleton
Mr Peretz (o.r.)
Ms Goodman

CHANCELLOR

MARKETS

Welcome back! I attach a note by Ms Goodman and others briefly recapitulating market developments from the time you left for your holiday until last night.

2. Attention continues today to focus on the dollar. There has been some semi-concerted support, which steadied the $/DM rate above 1.82. The Bundesbank, in informing the Bank of England, asked whether we would be willing to help. With my agreement Mr George has offered to do so if need prompts a further round of concerted action (we would probably do $/DM).

3. Sterling and domestic markets quiet, but there is edginess about the possibility of a further interest rate rise and next week's trade figures are being looked for apprehensively. They are in fact just a shade worse than the reported market thinking of -£100 current and -£800 trade. The market is also said now to be expecting no change in reserves, whereas our figure will be around -$450.

4. I shall be at home over most of the weekend and in my office early on Tuesday.

actual figures
visible trade – deficit of £910m
current a/c – deficit of £310.

(Geoffrey Littler)

SECRET

Foreign Exchange Markets

On 14 August, sterling closed at 72.5 on $1.5895 and DM2.9771. The dollar was DM1.8730 and Y149.80. Spot Brent was $19.25. The main influences in the foreign exchange market over the past 10 days have been pessimism over US and UK trade figures, oil prices and reactions to the publication of statistics.

The dollar fell on 14 August when disappointing US trade figures were published showing a deficit in June of $15.7 billion compared with an expectation of $13 billion. During the first 3 days of the following week the trade figures continued to weigh on the dollar. Initially, tension in the Gulf lent the dollar some support, but as reports of overproduction by the Saudis appeared and anxiety over the military position eased the dollar fell throughout the week and on 21 August closed at DM1.8175 and Y142.66. At the end of the week rumours of intervention and actual intervention by the Bank of Japan lifted some of the pressure. (The Japanese bought $152m on 21 August and $243m on 24 August. They did not wish to see the dollar fall below Y141, but were unable to persuade the Fed to carry out any intervention then above the Y140 level, which is still above the Louvre limits). However, Yeutter and Fed Governor Heller both made statements in the middle of this week which helped to break the decline and at close on Thursday, 27 August the dollar was DM1.8157 and Y142.05. Last night both the Bank of Japan and the Fed did some intervention round the Y141.50 level.

On 14 August, sterling shadowing the dollar went down against the D.Mark. At the start of the following week sterling was steady in index terms, but rose to $1.6105. Publication of the UK money numbers on 20 August produced little reaction in the foreign exchange market and the pound was unchanged on the day at 72.4, $1.6172 and DM2.9611. On Friday, 21 August, the dollar's fall took sterling to $1.63. This week opened with sterling mainly on the side lines. But on Tuesday, 25 August weaker oil prices (Spot Brent $17.60) and the outcome of the miners' ballot pushed the pound down to 72.2 on $1.6205 and DM2.9521. On 26 August, sterling came under renewed pressure, partly caused by a large investment order (the Britannia Arrow deal), but also because of briefing by Mitterand which led the markets to think we were planning to join the ERM very shortly. Anxiety about next Tuesday's publication of the June trade figures continues to put sterling under pressure and on 27 August it closed at 72.3 $1.6265 and DM2.9532.

The Bank of England have not done any substantial intervention in the last 10 days.

In the EMS the Italians were under some strain at the beginning of the period and sold $239m. In the last few days they have sold some D.Mark, but have recouped some $175m.

Money Markets

By the close on Friday 14 August interbank rates had settled around the 10 per cent base rate, following the absence of nasty figures in the week. Rates at 1, 3 and 12 months were 9¾, 10 and $10^{9}/_{32}$ per cent respectively.

The following week rates gradually firmed, until the publication of the July provisional on Thursday 20 August promited the 12 month interbank to rise ¼ per cent. At close on Friday 21 August rates at 1, 3 and 12months were $9^{25}/_{32}$, $10^{3}/_{16}$ and $10^{11}/_{16}$ per cent respectively.

This week has seen further firming amid general depression and as sterling has fallen back. At close on Thursday 27 August rates at 1, 3 and 12 months were $9^{13}/_{16}$ $10^{3}/_{8}$ and $10^{7}/_{8}$ per cent respectively.

Gilt-edged

By the close on Friday 14 August gilts had had a tentatively encouraging week in which published figures had revealed none of the horrors that some thought the base rate rise portended. Par yields at 5, 10 and 20 years stood at 9.9, 9.9 and 9.7 per cent respectively, with the index at 86.93.

In the first half of the following week the PSBR figures disappointed and the market was quiet and a little nervous before the July provisionals. Par yields had drifted into double figures in shorts and mediums. The market opened in better heart on Thursday 20 August, but fell 2 points immediately the money figures were announced and came off further in the afternoon. By the end of the day longs had fallen by just under 3 points for the second time in a fortnight, and the index was down to 84.74. Par yields at 5, 10 and 20 years stood at 10.5, 10.4 and 10.2 per cent respectively (the highest par yields since early January).

Gilt recuperated slightly before and after the weekend, but have subsequently drifted off on weaker sterling and the absence of any retail interest. The market remains very quiet and awaits next week's trade figures. At close last night the index was about 84.74, with par yields declining from 10.5 at 5 years to 10.4 at 10 and 10.2 at 20.

SECRET

MG NOON REPORT

FINANCIAL MARKETS

Tuesday 1 September 1987

Opening	10 AM		NOON	Oil Price (10 AM)	
72.5	72.7	£ERI	72.6		
1.6345	1.6365	$/£	1.6368	Sept	$18.45
2.9617	2.9662	DM/£	2.9646	Oct	$18.55
1.8120	1.8125	DM/$	1.8112	Nov	$18.57
141.60	141.85	Yen/$	141.75		

UK interbank £			Eurodollars	
9 7/16	(+1/16)	7 day	6 3/4	(+1/16)
9 7/8	(+1/16)	1 month	7 1/8	(+3/16)
10 1/2	(+1/16)	3 month	7 1/4	(+1/4)
11	(+1/16)	12 month	8	(+1/4)

Figures in brackets show change since previous market close

MARKET COMMENT The foreign exchange markets are now quiet after a busy morning. The dollar eased slightly in the Far East after Yeutter's comment that he sees little prospect of a major improvement in the US trade balance this year. It has been fairly steady this morning.
Sterling saw some commercial demand immediately prior to the release of the trade figures. The Bank's score was done before 11.30PM.
On release of figures which were worse than market expectations it eased to $1.6340 but has since recovered to around noon levels.
The gilt market opened quietly firmer but fell up to 1/2 point on trade figures.

ICPolin

MARKET INTERVENTION ($m)

Overnight -

Today so far +10$

Total +10$

OTHER COUNTRIES INTERVENTION ($m)

JAPAN +63$ (31.8.87)
" +207$ (Far East 1.9.87)
ITALY +79$ (31.8.87)
US +10$ agst.Yen (31.8.87)

GILTS

	Latest market movements	Price change since previous close
Shorts	Easier	-5/32
Mediums	Easier	-7/32
Longs	Easier	-11/32
Futures (Long Contracts)		-13/32 (VOL:9399)

Gilt Sales since market opening

-£2.0 million

NAME: I.C.Polin, MG1 Division
TEL NOS: 270 5556/5560

SECRET

MG NOON REPORT

FINANCIAL MARKETS — Wednesday 2 September 1987

Opening	10 AM		NOON		
72.8	72.8	£ERI	72.9		
1.6430	1.6440	$/£	1.6460	Sept	$18.60
2.9730	2.9719	DM/£	2.9760	Oct	$18.70
1.8095	1.8077	DM/$	1.8080	Nov	$18.70
141.15	141.15	Yen/$	141.12		

Oil Price (10 AM): Sept $18.60, Oct $18.70, Nov $18.70

UK interbank £			Eurodollars	
9 3/4	(+1/4)	7 day	6 3/4	(-)
9 7/8	(-)	1 month	7 1/8	(-)
10 11/32	(-3/32)	3 month	7 1/4	(-)
10 3/4	(-1/8)	12 month	8	(-)

Figures in brackets show change since previous market close

MARKET COMMENT In the foreign exchange market the dollar opened easier on a NY rumour that Reagan had had a heart attack(not true)but is underpinned by overnight intervention by the BOJ. Continuing bearish sentiment this morning. Sterling on the sidelines but firmer on the weaker dollar and high UK interest rates. The UK Reserve figures had little impact.
The gilts market opened firmer but has easied back to yesterday's close levels and is now steady.

R M'Robbie

MARKET INTERVENTION ($m)

Overnight	-
Today so far	+20
Total	+20

OTHER COUNTRIES INTERVENTION ($m)

+310$ Japan (In Far East)
+50$ Germany

GILTS

	Latest market movements	Price change since previous close
Shorts	Steady	+2/32
Mediums	Better	+1/32
Longs	Better	-5/32
Futures (Long Contracts)		+5/32 (Vol:13635)

Gilt Sales since market opening

£0 million

NAME: I.C.Polin, MG1 Division
TEL NOS: 270 5556/5560

SECRET

PW

SECRET

MG NOON REPORT

FINANCIAL MARKETS — Thursday 3 September 1987

Opening	10 AM		NOON
73.0	73.0	£ERI	73
1.6522	1.6500	$/£	1.6514
2.9748	2.9733	DM/£	2.9733
1.8005	1.8020	DM/$	1.8005
141.15	141.70	Yen/$	141.45

Oil Price (10 AM)	
Sept	$18.35
Oct	$18.50
Nov	$18.50

UK interbank £			Eurodollars	
9 3/4	(-1/8)	7 day	6 3/4	(-)
9 7/8	(-)	1 month	7 1/8	(-)
10 1/4	(-)	3 month	7 1/4	(-)
10 11/16	(+1/8)	12 month	8 3/16	(-1/16)

Figures in brackets show change since previous market close

MARKET COMMENT In the foreign exchange market intervention by the FED in New York did little to halt the continued decline. Action by the BOJ, and short covering in anticipation of the holiday in New York on Monday steadied rates a little to levels where they have remained in a quiet and steady London market. Sterling on the sidelines. In the gilts market a slow but steady improvement throughout the morning .Further sales of the 1991 Tap stock at a higher price of £92.28.

R M Robbie

MARKET INTERVENTION ($m)

Overnight	-
Today so far	-
Total	-

OTHER COUNTRIES INTERVENTION ($m)

+15$ Japan (in Far East)
+150$ agst Yen U S (in New York)
+50$ agst DM U S (in New York)

GILTS

	Latest market movements	Price change since previous close
Shorts	Better	+8/32
Mediums	Better	+12/32
Longs	Better	+12/32
Futures (Long Contracts)		+10/32 (Vol:13376)

Gilt Sales since market opening

+£75.2 million

NAME: I.C.Polin, MG1 Division
TEL NOS: 270 5556/5560

SECRET

ps2/18R

UNCLASSIFIED

PWP

FROM: CATHY RYDING

DATE: 4 September 1987

MR PERETZ

cc Sir P Middleton
Sir G Littler
Mr Kelly
Ms Goodman

MARKETS

The Prime Minister has asked for a report of events in the market since she and the Chancellor last met (which was just before the rise in interest rates). I should be grateful if you could provide a draft by close today, updating the note attached to Sir G Littler's minute to the Chancellor of 28 August.

CR

CATHY RYDING

From : D L C Peretz
Date : 4 September 1987

PS/CHANCELLOR

cc PS/EST
Sir P Middleton o/r
Sir T Burns
Sir G Littler
Mr Cassell o/r
Mr C W Kelly
Ms H Goodman
Mr M Richardson

MARKETS

As requested, I attach a report for the Prime Minister about developments in financial markets since she and the Chancellor met just before the 6 August base rate rise.

DLCP

D L C PERETZ

ok as amended

Ch
OK? I would leave off graphs which look over-dramatic (because of scale).
AA

Lunatic. I want, when it happens, to ask Press Office to try to get the Sunday newspapers to stop using scales that make all markets look the same. But let know the desire of the press to sensationalise: I was not aware that FT so afflicted. Essential to have standard graphs rules on $/£ scale 1.25 to 2.00, DM/£ 2.50 to 4.00, & DM/$ 1.50 to 2.40.
NL

, depleted by assaults on Britain,

, in particular the equity market,

FINANCIAL MARKETS SINCE 5 AUGUST

The attached table and graphs show the main developments in domestic and foreign exchange markets since before the 1% base rate rise on 6 August. Domestic markets have been jumpy at times, with market makers unwilling to take positions and moving prices sharply without ~~there being~~ any great volume of business. In the foreign exchange market the main factor has been the strength of the dollar in early August, partly reflecting Gulf tensions, reaching a peak of over DM 1.89 (with the $/£ rate under 1.56); and its subsequent decline following the disappointing US trade figures on 14 August, to below DM 1.80 (with the $/£ rate above 1.65).

They now appear to have settled down, with share prices some X per cent below their all-time high.

5-7 August

2. Although unexpected, the 1% rise in interest rates announced on 6 August had little impact in the foreign exchange market : the DM/£ rate remained steady at DM 2.96½. Much of the initial comment welcomed the move as a sensible tightening of policy made, as the Chancellor explained, on an assessment of a range of evidence. Nevertheless both gilts and equities fell sharply, with market participants fearing the interest rate rise meant the authorities knew of bad news on the way.

10-14 August

3. There was a particular worry that the June trade figures published on 11 August would be bad. When in the event the June current account deficit turned out to be much less than the £½ billion May deficit the market began to settle down, with both the gilt and equity markets gradually recovering though not to their 5 August levels. By Friday 14 August the three month interbank rate had settled back to 10%.

17-21 August

4. The next ~~important~~ event was publication of the July money figures, on 20 August. Again it was the gilt market, and to some

extent the equity market, which fell sharply - with commentators focussing particularly on the high bank lending figure. Long gilt yields rose well above 10%, reaching the highest level since January. There was little impact on the exchange rate, with the ERI on Friday 21 August standing at much the same level as a week earlier, despite a falling oil price.

24 August-4 September

5. The pre-Bank Holiday week was relatively quiet in all markets, with domestic markets beginning to look ~~forward~~ ahead to the July trade figures published on 1 September. The current account deficit (over £300m) was ~~just higher than~~ at the top end of the range of market expectations, and all markets - including the exchange rate - initially fell a little. But they subsequently recovered on second thoughts about and closer analysis of the trade figures. On the following day the announcement of a larger than expected fall in the reserves in August had no effect; and the Chancellor's remarks on the radio at midday helped take both gilts and the exchange rate ahead (with the Bank taking the opportunity to intervene to steady sterling's rise, and recoup some of the dollars spent defending sterling against the dollar at the beginning of August).

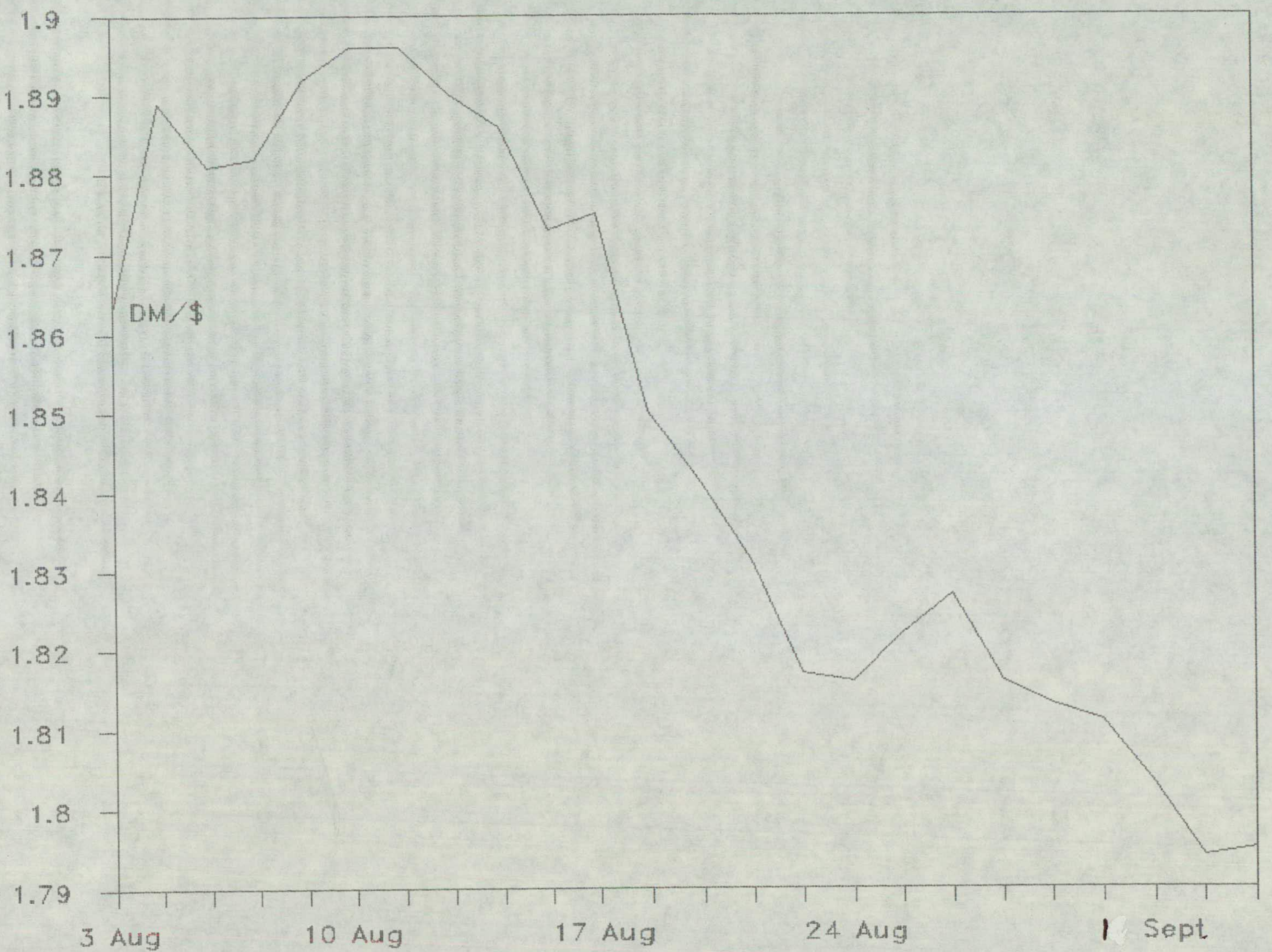
6. The main focus of attention in recent days has been the weakness of the dollar. There has been concerted intervention by central banks (including the Fed) to support the dollar on most days since 28 August, and the Fed raised its discount rate on 4 September by ½%, to 6%, the first change in the discount rate since it was lowered to 5½% in August 1986, and the first increase since 1984. (This move had little immediate impact on the dollar, which remained below DM 1.80).

4th September 1987

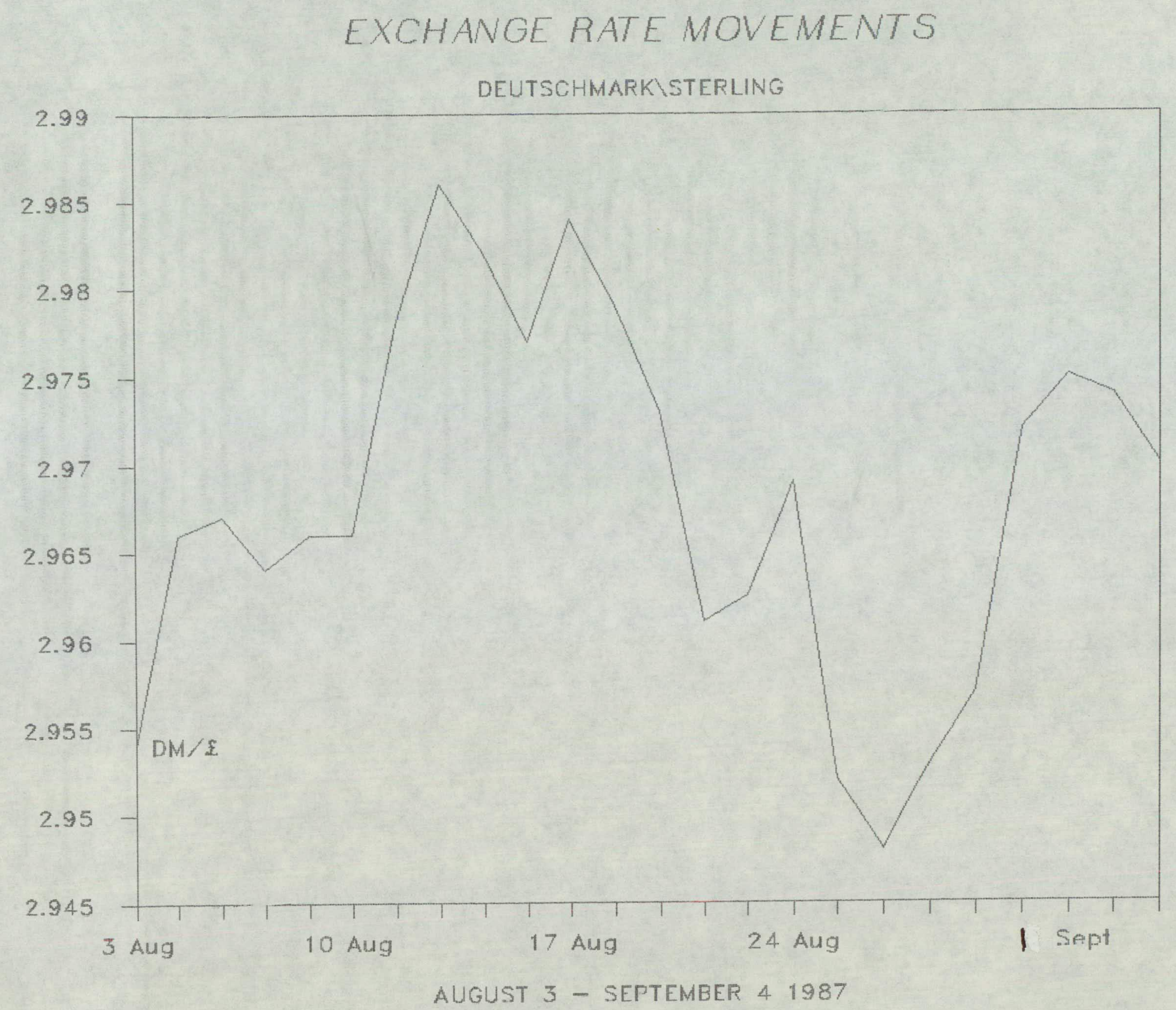
EXCHANGE RATE MOVEMENTS

DEUTSCHMARK\DOLLAR

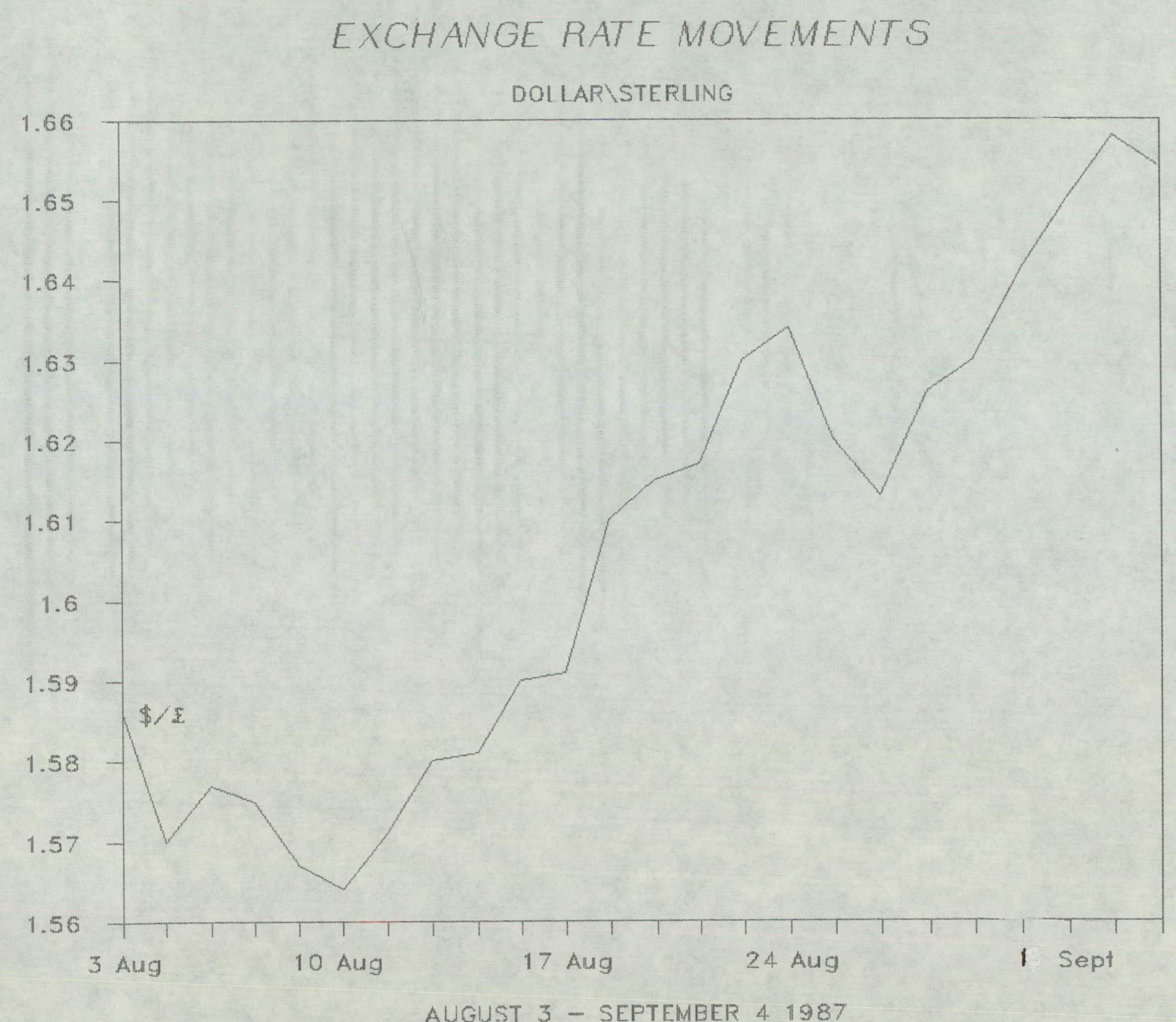
2.50/4
1.25/2
1.50/2.40



AUGUST 3 – SEPTEMBER 4 1987



EXCHANGE RATE MOVEMENTS
DEUTSCHMARK\STERLING
2.99
2.985
2.98
2.975
2.97
2.965
2.96
2.955
2.95
2.945
DM/£
3 Aug
10 Aug
17 Aug
24 Aug
1 Sept
AUGUST 3 – SEPTEMBER 4 1987

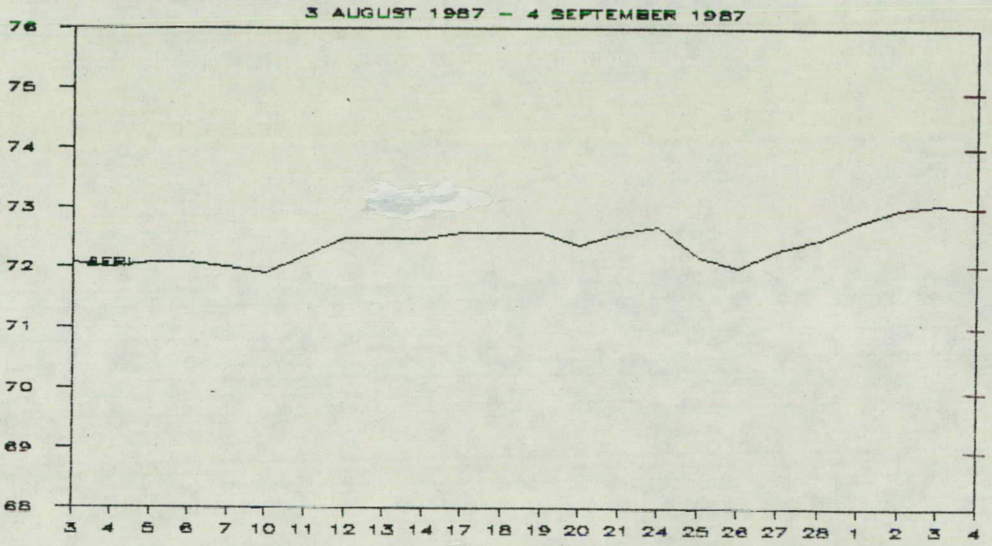

EXCHANGE RATE MOVEMENTS
DOLLAR\STERLING
1.66
1.65
1.64
1.63
1.62
1.61
1.6
1.59
1.58
1.57
1.56
$/£
3 Aug
10 Aug
17 Aug
24 Aug
Sept
AUGUST 3 – SEPTEMBER 4 1987

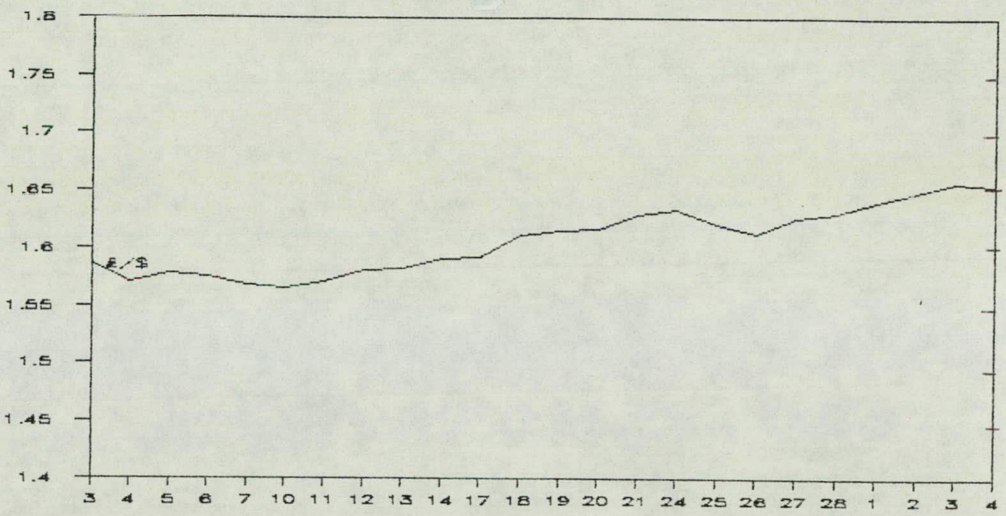
MARKET MOVEMENTS SINCE 5 AUGUST (CLOSING RATES)

	£(ERI)	3 month interbank	gilt index	Equities (FTSE 100 index	Oil Price spot Brent $ per barrel
<u>August</u>					
Wed 5	72.1	$9^{5}/_{16}$	87.63	2317	20.05
Fri 7	72.0	$10^{7}/_{32}$	86.24	2226	19.55
Tues 11	72.2	$10^{1}/_{8}$	86.57	2276	19.20
Fri 14	72.5	10	86.93	2295	19.25
Wed 19	72.6	$10^{3}/_{16}$	86.36	2198	18.60
Thurs 20	72.4	$10^{5}/_{16}$	84.74	2185	18.35
Fri 21	72.6	$10^{3}/_{16}$	85.02	2206	18.40
Fri 28	72.5	$10^{7}/_{16}$	84.87	2250	18.47
<u>September</u>					
Tues 1	72.8	$10^{7}/_{16}$	85.19	2273	18.42
Fri 4	73.0	$10\frac{1}{4}$	85.71	2275	18.20

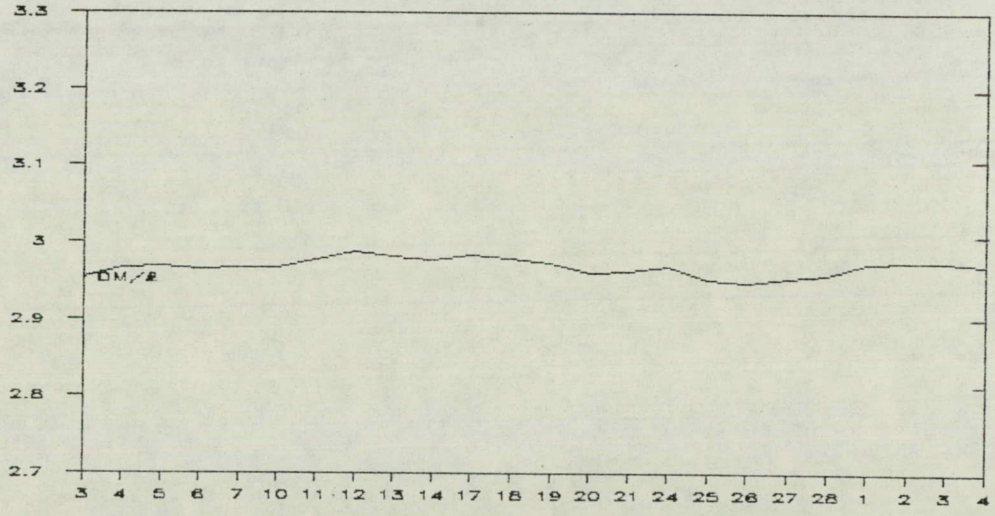
MOVEMENTS IN STERLING

3 AUGUST 1987 – 4 SEPTEMBER 1987

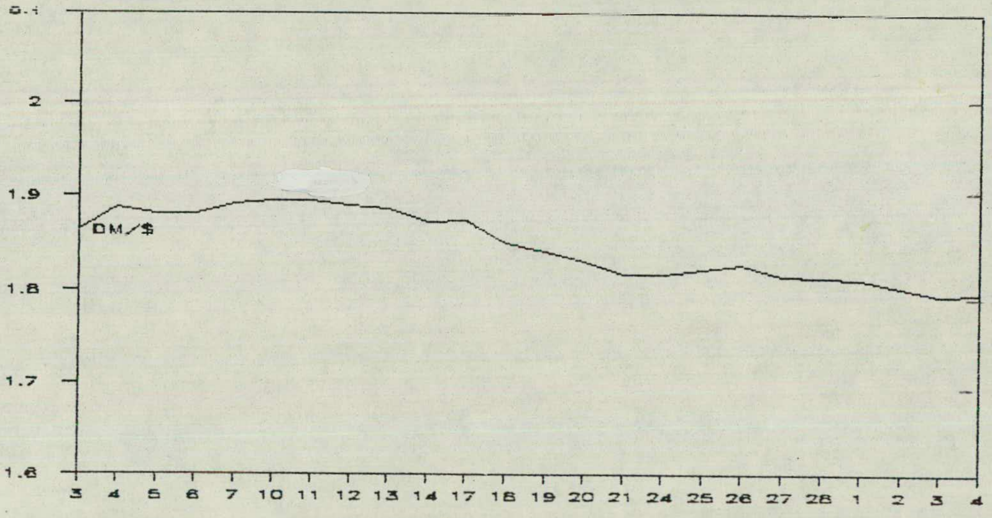




3 AUGUST 1987 – 4 SEPTEMBER



3 AUGUST 1987 – 4 SEPTEMBER



RC2.51 COVERING CONFIDENTIAL

pm, bilateral?
pup

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

7 September 1987

David Norgrove Esq
10 Downing Street
LONDON
SW1

Dear David,

FINANCIAL MARKETS

You asked for a note on developments in the financial markets since the Chancellor and the Prime Minister last met (ie. just before the 6 August base rate rise). This is attached.

Yours
Cathy

CATHY RYDING
Assistant Private Secretary

FINANCIAL MARKETS SINCE 5 AUGUST

The attached table and graphs show the main developments in domestic and foreign exchange markets since before the 1 per cent base rate rise on 6 August. Domestic markets, in particular the equity market, have been jumpy at times, with market makers, depleted by absences on holiday, unwilling to take positions and moving prices sharply without any great volume of business. They now appear to have settled down, with share prices some 7 per cent below their all-time high in mid-July. In the foreign exchange market the main factor has been the strength of the dollar in early August, partly reflecting Gulf tensions, reaching a peak of over DM 1.89 (with the $/£ rate under 1.56); and its subsequent decline following the disappointing US trade figures on 14 August, to below DM 1.80 (with this $/£ rate above 1.65).

5-7 August

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17-21 August

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6. The main focus of attention in recent days has been the weakness of the dollar. There has been concerted intervention by central banks (including the Fed) to support the dollar on most days since 28 August, and the Fed raised its discount rate on 4 September by ½ per cent, to 6 per cent, the first change in the discount rate since it was lowered to 5½ per cent in August 1986 and the first increase since 1984. (This move had little immediate impact on the dollar, which remained below DM 1.80).

4 September 1987

MARKET MOVEMENTS SINCE 5 AUGUST (CLOSING RATES)

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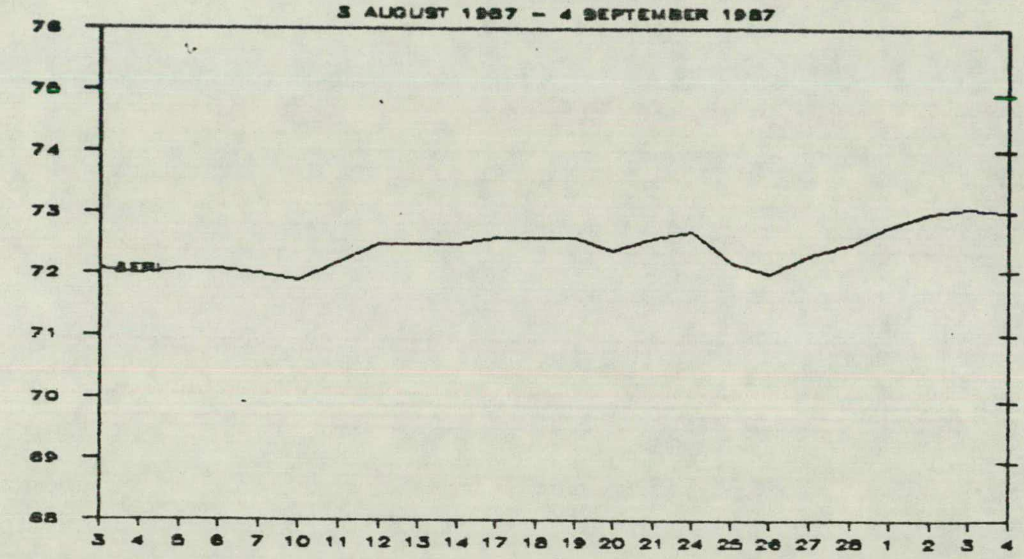
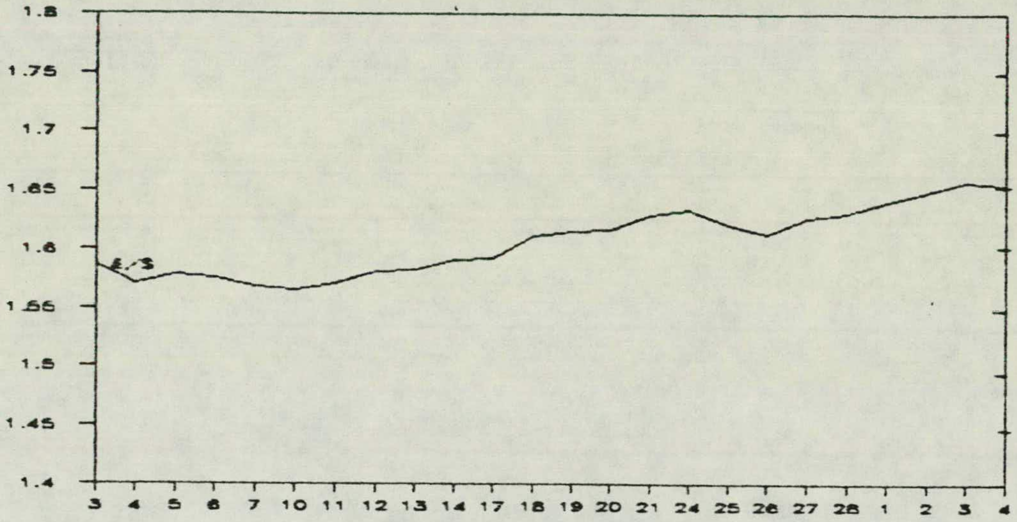
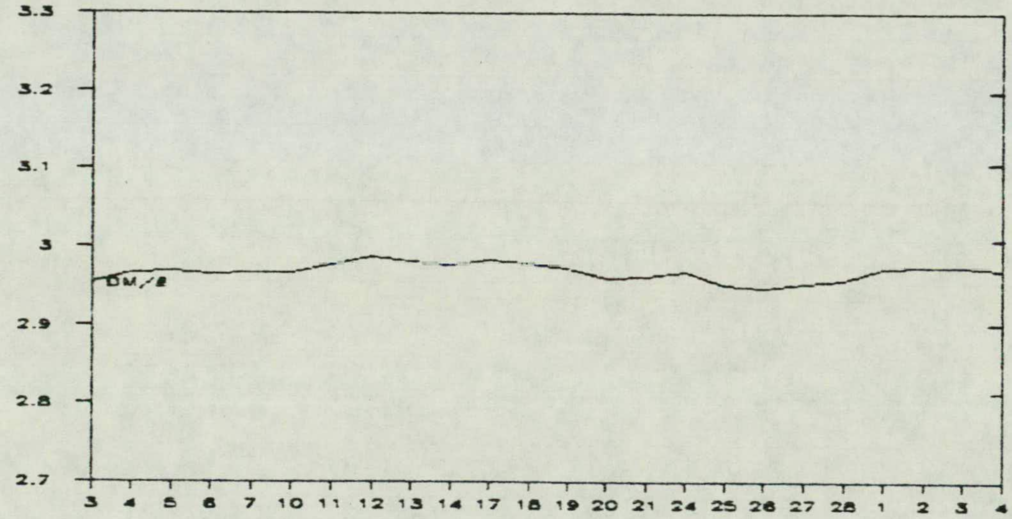
3 AUGUST 1987 – 4 SEPTEMBER 1987

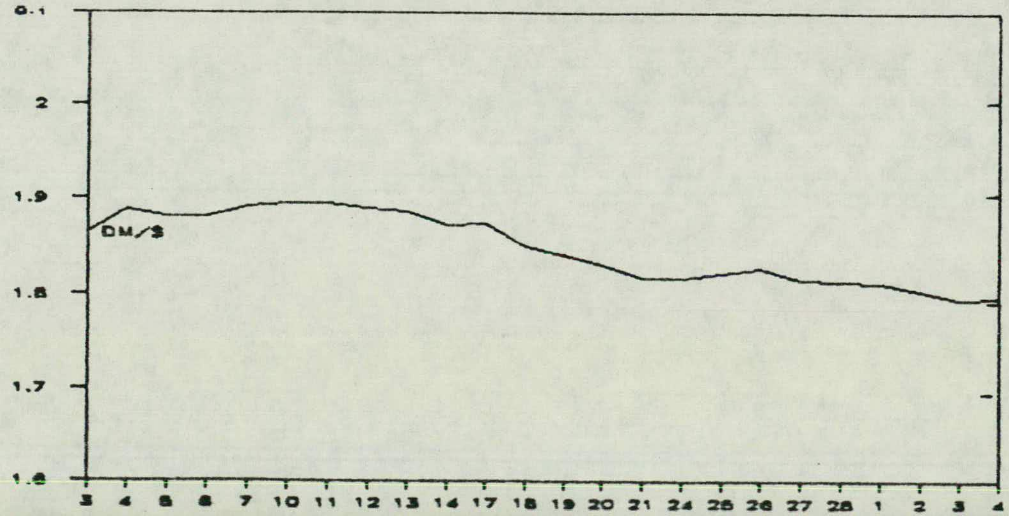




3 AUGUST 1987 – 4 SEPTEMBER



3 AUGUST 1987 – 4 SEPTEMBER



SECRET

MG NOON REPORT

FINANCIAL MARKETS

Monday 7 September 1987

Opening	10 AM		NOON
73.1	73.1	£ERI	73.2
1.6562	1.6565	$/£	1.6583
2.9745	2.9709	DM/£	2.9742
1.7960	1.7935	DM/$	1.7935
141.75	141.55	Yen/$	141.73

Oil Price (10 AM)

Sept	$17.90
Oct	$18.05
Nov	$18.10

UK interbank £			Eurodollars	
9 1/2	(-1/4)	7 day	6 15/16	(+1/8)
9 25/32	(-3/32)	1 month	7 1/4	(+1/8)
10 1/4	(-)	3 month	7 3/8	(+1/16)
10 11/16	(+1/16)	12 month	8 5/16	(+1/16)

Figures in brackets show change since previous market close

MARKET COMMENT In the foreign exhchange market the dollar opened little changed from Fridays close depite the FED's half a point rate rise. The dollar had firmed slightly in New York on short covering ahead of the Labor day holiday but has continued to ease slightly this morning. The London market is quiet with sterling maintaining a steady rate.
The gilts market is very quiet.

R McRobbie

MARKET INTERVENTION ($m)

Overnight	-
Today so far	-
Total	-

Ch

Will close up

AA

OTHER COUNTRIES INTERVENTION ($m)

+38$ Japan (In Far East)

GILTS

	Latest market movements	Price change since previous close
Shorts	Easier	-1/32
Mediums	Steady	-2/32
Longs	Better	+1/32
Futures (Long Contracts)		+3/32 (Vol:4397)

Gilt Sales since market opening

£0 million

NAME: I.C.Polin, MG1 Division
TEL NOS: 270 5556/5560

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MG NOON REPORT

FINANCIAL MARKETS — Tuesday 8 September 1987

Opening	10 AM		NOON		Oil Price (10 AM)
73.3	73.2	£ERI	73.1		
1.6622	1.6610	$/£	1.6575	Oct	$17.80
2.9757	2.9757	DM/£	2.9719	Nov	$17.90
1.7902	1.7915	DM/$	1.7930	Dec	$17.97
141.65	141.75	Yen/$	141.85		

UK interbank £			Eurodollars	
9 1/2	(-1/4)	7 day	7	(+1/16)
9 23/32	(-)	1 month	7 5/16	(+1/16)
10 5/16	(+3/32)	3 month	7 1/2	(+1/8)
10 5/8	(+1/16)	12 month	8 7/16	(+1/8)

Figures in brackets show change since previous market close

MARKET COMMENT The foreign exchange markets are generally quiet awaiting New York opening. The dollar eased to DM1.79 at which point the Bundesbank led a bout of coordinated central bank intervention, (details below) the Bank also took part hence the current BOE score. This prevented the dollar from easing below DM1.79 and has been helped also, in the last hour, by a small bout of professional selling of sterling.
In the gilt market an early rally petered out to leave the market broadly unchanged on the day.

MARKET INTERVENTION ($m)

Overnight	-
Today so far	+25$
Total	+25$

OTHER COUNTRIES INTERVENTION ($m)

JAPAN	+40$ (Far East)
IRELAND	+10$ agst DM
BELGIUM	+10$ agst DM
HOLLAND	+15$
GERMANY	+50$
SWITZ.	+25$
FRANCE	-167DM agst Ffr
SWEDEN	+40$
SPAIN	+32$

GILTS

	Latest market movements	Price change since previous close
Shorts	Easier	-2/32
Mediums	Easier	-2/32
Longs	Easier	-2/32
Futures (Long Contracts)		-3/32 (VOL:10303)

Gilt Sales since market opening: -£4.6 million

NAME: I.C.Polin, MG1 Division

MG NOON REPORT

FINANCIAL MARKETS

Friday 11 September 1987

Opening	10 AM		NOON
73.0	73.1	£ERI	73.1
1.6475	1.6485	$/£	1.6478
2.9729	2.9755	DM/£	2.9751
1.8045	1.8050	DM/$	1.8055
142.50	142.70	Yen/$	142.82

Oil Price (10 AM)

Oct	$18.45
Nov	$18.50
Dec	$18.55

UK interbank £			Eurodollars	
9 1/8	(-3/4)	7 day	7 1/8	(-)
9 11/16	(-)	1 month	7 7/16	(-)
10 7/32	(-)	3 month	7 1/2	(-)
10 11/16	(-)	12 month	8 1/2	(-)

Figures in brackets show change since previous market close

MARKET COMMENT In the foreign exchange market the dollar opened little changed from last nights close. It has remained steady throughout the morning as the markets await the US trade figures due out at 1.30pm. The market is expecting a deficit of $16.0bn compared with $15.7bn last month. Sterling has firmed slightly on technical corrections but is generally quiet.

The gilts market remains quietly firmer.

ICPolin

MARKET INTERVENTION ($m)

Overnight	-
Today so far	+20$
Total	+20$

OTHER COUNTRIES INTERVENTION ($m)

-138DM France

GILTS

	Latest market movements	Price change since previous close
Shorts	Steady	+3/32
Mediums	Steady	+4/32
Longs	Easier	+5/32
Futures (Long Contracts)		+12/32 (Vol:6588)

Gilt Sales since market opening

£0 million

NAME: I.C.Polin, MG1 Division
TEL NOS: 270 5556/5560

MG NOON REPORT

f: ND

FINANCIAL MARKETS — Monday 14 September 1987

Opening	10 AM		NOON
73.0	73.0	£ERI	72.9
1.6420	1.6415	$/£	1.6377
2.9740	2.9769	DM/£	2.9760
1.8112	1.8135	DM/$	1.8172
143.90	144.00	Yen/$	144.35

Oil Price (10 AM)

Oct	$18.15
Nov	$18.20
Dec	$18.25

UK interbank £			Eurodollars	
9 1/4	(-1/4)	7 day	7 3/16	(+1/16)
9 11/16	(-)	1 month	7 3/8	(-1/16)
10 1/16	(-5/32)	3 month	7 7/16	(-1/8)
10 5/8	(-1/16)	12 month	8 7/16	(-1/8)

Figures in brackets show change since previous market close

MARKET COMMENT The foreign exchange markets are fairly active today. The dollar has recovered strongly to Friday's fall after US trade data was released. New York dealers pushed it higher on book-squaring ahead of weekend and European dealers have been scrambling to buy $ today. Mainly technical rally in absence of no new factors. Sterling on sidelines, easier on firmer dollar but slightly firmer on Mark. UK figures had no impact. EMS quieter with the ERM band width at under 1 1/2% on opening after weekend meetings.
The Gilt market is quiet and steady at slightly higher levels. ICPolin

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MARKET INTERVENTION ($m)

Overnight	-
Today so far	-
Total	-

OTHER COUNTRIES INTERVENTION ($m)

FRANCE +55DM

GILTS

	Latest market movements	Price change since previous close
Shorts	Better	+3/32
Mediums	Steady	+6/32
Longs	Better	+6/32
Futures (Long Contracts)		+8/32 (VOL:7701)

Gilt Sales since market opening: £0 million

NAME: I.C.Polin, MG1 Division
TEL NOS: 270 5556/5560

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MG NOON REPORT

FINANCIAL MARKETS

Tuesday 15 September 1987

Opening	10 AM		NOON	Oil Price (10 AM)	
72.9	73.0	£ERI	73		
1.6360	1.6360	$/£	1.6398	Oct	$18.35
2.9775	2.9783	DM/£	2.9707	Nov	$18.40
1.8200	1.8205	DM/$	1.8177	Dec	$18.45
144.40	144.68	Yen/$	144.17		

UK interbank £			Eurodollars	
9 1/2	(+5/16)	7 day	7 3/16	(+1/16)
9 11/16	(-)	1 month	7 3/8	(-)
10 1/16	(-)	3 month	7 1/2	(+1/16)
10 5/8	(-)	12 month	8 1/2	(+1/8)

Figures in brackets show change since previous market close

MARKET COMMENT The foreign exchange market are generally quiet. The dollar having found the top of it's current range around DM1.8225(a significant chart point)has begun to ease so as the markets can find the bottom of the range.A day of "range trading" in prospect.US retail sales and industrial production figures out at 1.30PM(markets expecting +2.0% [fairly bullish] and +0.2% respectively).
Sterling on sidelines.
The Gilt market is quiet ahead of the expected auction announcement.

Ian Polin

MARKET INTERVENTION ($m)

Overnight -

Today so far +15$

Total +15$

OTHER COUNTRIES INTERVENTION ($m)

CANADA +17$ (on 14.9.87)

GILTS

	Latest market movements	Price change since previous close
Shorts	Better	+3/32
Mediums	Better	-1/32
Longs	Better	-4/32
Futures (Long Contracts)		-3/32 (VOL:11719)

Gilt Sales since market opening

£0 million

NAME: I.C.Polin, MG1 Division
TEL NOS: 270 5556/5560

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MG NOON REPORT

FINANCIAL MARKETS — Friday 18 Septewmber 1987

Opening	10 AM		NOON	Oil Price (10 AM)	
73.2	73.3	£ERI	73.3		
1.6520	1.6520	$/£	1.6545	Oct	$18.25
2.9893	2.9909	DM/£	2.9930	Nov	$18.30
1.8095	1.8105	DM/$	1.8090	Dec	$18.30
142.70	142.90	Yen/$	142.8		

UK interbank £			Eurodollars	
9 13/16	(-)	7 day	7 3/8	(+3/16)
9 13/16	(+1/32)	1 month	7 1/2	(-)
10	(-)	3 month	7 5/8	(-)
10 7/16	(-1/8)	12 month	8 5/8	(-)

Figures in brackets show change since previous market close

MARKET COMMENT The foreign exchange markets were active this morning. The dollar trading in narrow range awaiting 1.30PM Q2 2nd revise GNP figure (last revise 2.3%).Sterling firm this morning after reaching DM2.9925 at New York close.It reached a high of $1.6550 and DM 2.9935 when UK money figures were released but has since steadied around noon rates.
The Gilt market started strongly and went up further on UK money figures.Further sales of low coupon taps.

ICPol

MARKET INTERVENTION ($m)

Overnight	+16$(New York)
Today so far	+45$
Total	+61$

OTHER COUNTRIES INTERVENTION ($m)

JAPAN	+15$(Far East)
SPAIN	+150$

GILTS

	Latest market movements	Price change since previous close
Shorts	Better	+7/32
Mediums	Better	+16/32
Longs	Better	+29/32
Futures (Long Contracts)		+29/32 (Vol:11182)

Gilt Sales since market opening

+£32.8 million

NAME: I.C.Polin, MG1 Division
TEL NOS: 270 5556/5560

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MG NOON REPORT

FINANCIAL MARKETS — Monday 21 September 1987

Opening	10 AM		NOON	Oil Price (10 AM)	
73.3	73.3	£ERI	73.3		
1.6535	1.6530	$/£	1.6532	Oct	$18.25
2.9912	2.9916	DM/£	2.9931	Nov	$18.22
1.8090	1.8098	DM/$	1.8105	Dec	$18.22
143.05	143.20	Yen/$	143.25		

UK interbank £			Eurodollars	
9 3/4	(-1/16)	7 day	7 1/4	(+1/8)
9 13/16	(+1/32)	1 month	7 1/2	(-)
10	(-)	3 month	7 5/8	(-)
10 5/8	(+3/16)	12 month	8 5/8	(+1/16)

Figures in brackets show change since previous market close

MARKET COMMENT The foreign exchange markets are in a wait and see mood and generally quiet. The dollar firmed in the Far East after report that G7 will maintain unofficial Yen "band" at Y140 to Y146 at next weekend G7 meetings. Markets now await G7 meetings and are reluctant to push the dollar too far either way. Reagan/Nakasone meet this PM. Sterling firm on the index and against the Mark.
The Gilt market has been quietly firm. Further sales of low coupon tap made.

Ian Polin

MARKET INTERVENTION ($m) — OTHER COUNTRIES INTERVENTION ($m)

Overnight	+33$ (New York 18.9.87)
Today so far	-
Total	+33$

— Bank know your views but say they are waiting for opportunities in quiet markets.

GILTS

	Latest market movements	Price change since previous close	Gilt Sales since market opening
			+£71.2 million
Shorts	Steady	+1/32	
Mediums	Steady	+2/32	
Longs	Steady	+7/32	
Futures (Long Contracts)		+6/32 (VOL:14294)	

NAME: I.C.Polin, MG1 Division
TEL NOS: 270 5556/5560

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MG NOON REPORT

FINANCIAL MARKETS — Friday 25 September 1987

Opening	10 AM		NOON	Oil Price (10 AM)	
73.0	72.9	£ERI	73.0		
1.6385	1.6375	$/£	1.6380	Oct	$18.60
2.9821	2.9811	DM/£	2.9823	Nov	$18.50
1.8200	1.8205	DM/$	1.8207	Dec	$18.45
143.25	143.75	Yen/$	143.80		

UK interbank £			Eurodollars	
10	(+1/16)	7 day	7 1/2	(-)
9 31/32	(+1/32)	1 month	7 1/2	(-)
10 1/8	(-)	3 month	7 5/8	(-)
10 1/2	(-)	12 month	8 1/2	(+1/16)

Figures in brackets show change since previous market close

MARKET COMMENT In the foreign exchange market the dollar opened firmer, after drifting overnight in New York on profit taking. Sterling has continued mainly steady this morning in a quiet market ahead of the G7 meeting starting tommorrow.
The gilts market opened unchanged and has traded in a narrow range round that level all morning.

R McRobbie

MARKET INTERVENTION ($m) — OTHER COUNTRIES INTERVENTION ($m)

Overnight -

Today so far -

Total -

GILTS

	Latest market movements	Price change since previous close
Shorts	Easier	+2/32
Mediums	Better	+1/32
Longs	Easier	0
Futures (Long Contracts)		+3/32 (Vol:11214)

Gilt Sales since market opening: -£5.0 million

NAME: I.C.Polin, MG1 Division
TEL NOS: 270 5556/5560

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FINANCIAL MARKETS: NOON REPORT

Tuesday 30 September 1987

Opening	10 AM		NOON	Oil Price (10 AM)	
73.1	73.1	£ERI	73.1		
1.6305	1.6295	$/£	1.6297	Oct	$18.67
2.9952	2.9950	DM/£	2.9954	Nov	$18.60
1.8370	1.8380	DM/$	1.8380	Dec	$18.57
146.37	145.95	Yen/$	146.05		

UK interbank £			Eurodollars	
10 3/16	(+1/16)	7 day	7 7/16	(-)
10 1/16	(+1/32)	1 month	7 5/8	(-)
10 9/32	(+1/16)	3 month	8 1/16	(-)
10 19/32	(+1/32)	12 month	8 13/16	(-)

Figures in brackets show change since previous market close

MARKET COMMENT

The foreign exchange market is quiet and steady today.

The dollar opened easier after profit-taking in the Far East, and on reports this morning that the Bank of Japan may raise its discount rate. It had edged higher towards the close in New York, pushing sterling towards DM3.
In the Gilt market there was a small recovery after an early fall.

MARKET INTERVENTION ($m)

Overnight	+204$	New York
Today so far	-	
Total	+204$	

OTHER COUNTRIES INTERVENTION ($m)

None

GILTS

	Latest market movements	Price change since previous close
Shorts	Steady	-4/32
Mediums	Steady	-6/32
Longs	Steady	-7/32
Futures (Long Contracts)		-19/32 (Vol:12258)

Gilt Sales since market opening

- £5.5 million

MG1 Division 270 5556/5560

Rℓ

SECRET

MG NOON REPORT

FINANCIAL MARKETS — Friday 2 October 1987

Opening	10 AM		NOON	Oil Price (10 AM)	
72.9	72.9	£ERI	72.9		
1.6240	1.6220	$/£	1.6235	Oct	$18.65
2.9882	2.9853	DM/£	2.9881	Nov	$18.62
1.8400	1.8405	DM/$	1.8405	Dec	$18.62
146.25	146.37	Yen/$	146.32		

UK interbank £			Eurodollars	
10 1/16	(-1/16)	7 day	7 7/16	(-1/32)
10 1/16	(-)	1 month	7 5/8	(-)
10 9/32	(+1/32)	3 month	8 1/4	(+1/16)
10 9/16	(-)	12 month	8 3/4	(-1/8)

Figures in brackets show change since previous market close

MARKET COMMENT The foreign exchange markets are quiet today after much activity in recent days. The dollar having seen quiet sessions in New York and the Far East overnight has remained steady today. Markets now await US (un)employment figures out at 1.30PM today(markets expect 6%[unchanged] and +190,000 respectively). Sterling also steady but has firmed since last night's close. UK reserves figures had no impact.

The Gilt market is quiet.

Ian Polin

MARKET INTERVENTION ($m) — OTHER COUNTRIES INTERVENTION ($m)

Overnight -

Today so far -

Total -

GILTS

	Latest market movements	Price change since previous close
Shorts	Better	+2/32
Mediums	Steady	+2/32
Longs	Easier	+2/32
Futures (Long Contracts)		+4/32 (VOL:7006)

Gilt Sales since market opening

£0 million

NAME: I.C.Polin, MG1 Division
TEL NOS: 270 5556/5560

SECRET

ps2/3R UNCLASSIFIED

RD

FROM: CATHY RYDING

DATE: 2 October 1987

MR PERETZ

cc Mr C W Kelly

MARKET REPORTS

Could you please pass on our thanks to all of MG for their efforts in producing the noon and evening market reports in record time! Last night's evening report arrived at 6.15 and today's noon report at 12.15. This is an enormous help to us and we are most grateful.

CR.

CATHY RYDING

221.27

FROM: H C GOODMAN

DATE: 5 October 1987

MR KELLY

cc: PS/Chancellor
Mr Peretz
Mr Richardson - or
Mr Brook
Mr Nelson
Mr Bowden
Mr Polin
Miss Mc Robbie - or

MARKET REPORTS

You asked us to ensure that the timeliness of the market reports was improved.

2. This note sets out the new modus operandi to ensure this. We intend to stabilise the timing around current levels, having pulled the time forward to a level at the end of last week which reflects underlying reporting conditions and constraints.

3. We will have a target zone for both the noon and evening reports, some fluctuations either side will be tolerated, but if it appears that we are getting too close to acceptable limits there will be intervention by the principals. (I intend to concert this with Mr Richardson on his return).

4. Initially, these zones will not be published since we do not want to give recipients of the report any opportunity for speculation - but as confidence and credibility improve we will consider this.

H C Goodman.

H C GOODMAN

CHIEF SECRETARY
-7 OCT 1987

Mr P Davis
CX Mr Butler
Sir Geoffrey Littler
Mr Lavelle Mr Monck
Mr Burgner Mr Mountfield

6/10/87.

Mrs Case
Treasury Solicitor.

FCS/87/210

SECRETARY OF STATE FOR TRADE AND INDUSTRY

1. Thank you for your letter of 28 September in which you recommend that we should now agree to eventual signature of the new INRA. I agree with your proposed course of action.

2. When we endorsed a deregulatory approach to commodity problems last year, we recognised that circumstances could arise in which, for reasons of Community competence, the UK would be forced to maintain its participation in commodity agreements with market-intervention provisions. This is clearly one such case. I agree that, given how remote the possibility is of mustering a blocking minority against Community signature, we should accept the inevitability that the UK will also have to sign. We can have some satisfaction from the fact that, as Lynda Chalker noted in her letter to Paul Channon of 1 April, our tough negotiating line resulted in an Agreement with significantly more realistic and market-oriented economic provisions than its predecessor: indeed one which met all our negotiating requirements.

3. I can also agree with your proposals as to our tactical approach within the Community. We should certainly insist that the Community and Member States sign the Agreement simultaneously: this is no more than strict application of the Community's own long-accepted procedures. And so far as ratification or provisional application is concerned, we should find support from our partners in arguing that Community action should not precede that of other leading consumers.

/I

4. I am copying this minute to the recipients of your letter.

(GEOFFREY HOWE)

Foreign and Commonwealth Office
6 October 1987

SECRET

MG NOON REPORT

FINANCIAL MARKETS — Thursday 8 October 1987

Opening	10 AM		NOON	Oil Price (10 AM)	
73.3	73.3	£ERI	73.3		
1.6430	1.6415	$/£	1.6420	Oct	$18.82
2.9927	2.9933	DM/£	2.9937	Nov	$18.72
1.8215	1.8235	DM/$	1.8232	Dec	$18.67
145.15	145.50	Yen/$	145.25		

UK interbank £			Eurodollars	
9 3/4	(-)	7 day	7 1/2	(+1/8)
9 3/4	(+1/32)	1 month	7 1/2	(+3/16)
10 1/4	(+1/32)	3 month	8 1/2	(+1/16)
10 1/2	(+1/16)	12 month	9 1/16	(+1/16)

Figures in brackets show change since previous market close

MARKET COMMENT In the foreign exchange markets the sterling/deutschmark rate was tested in New York last night when most of the Bank's score was done. The dollar later drifted downwards on technical reaction to recent highs and on a report in Newsweek that Greenspan says that in the short-term the $ will steady but in the longer-term it will go lower. The easier dollar helped ease the pressure on the £/DM cross rate. Markets not expected to move the dollar significantly before next Wednesday's US trade data. Markets generally quiet and steady today. The gilt market is steady.

I Polin

MARKET INTERVENTION ($m) — OTHER COUNTRIES INTERVENTION ($m)

Overnight	+323$ (New York)
Today so far	-
Total	+323$

GILTS

	Latest market movements	Price change since previous close	Gilt Sales since market opening
			£0 million
Shorts	Steady	+3/32	
Mediums	Steady	-1/32	
Longs	Better	0	
Futures (Long Contracts)		+1/32 (VOL:6190)	

NAME: I.C.Polin, MG1 Division
TEL NOS: 270 5556/5560

SECRET

COVERING
SECRET

BF to Alex
for Thursday
meeting.

PCC(87)35th MEETING

PG

HER MAJESTY'S TREASURY

POLICY CO-ORDINATING COMMITTEE

MEETING NOTICE

There will be a meeting of the Committee at 9.30 am on Tuesday, 13 October 1987 in Sir Peter Middleton's room, 80/2nd.

AGENDA

I CURRENT DEVELOPMENTS

II INDUSTRY ACT FORECAST: PCC(87)10
Paper circulated herewith

R SAUNDERS

MISS C EVANS

9 October 1987

SECRET COPY NO.

FROM: **P N SEDGWICK**
DATE: 9 OCTOBER 1987

CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
PCC
MEG
Mr Hawtin
Mr Luce
Mr Moore
Miss Peirson
Mr Grice
Mr Matthews
Mr Melliss
Mr Mowl
Miss O'Mara
Mr Riley
Mr Cropper
Mr Tyrie
Mr Call

TREASURY ECONOMIC FORECAST

I attach a copy of the main report of the recent forecasting exercise, which reflects judgements taken at a series of meetings with Sir T Burns. The assumptions in the forecast on monetary policy and the fiscal stance were taken in consultation with Sir T Burns and Mr Cassell as the results of the forecast emerged.

2. The other detailed reports on this exercise are

World Economic Prospects (Mr Matthews, IF2)

Public Finances (Mr Mowl, PSF)

The Financial Prospect (Mr Bottrill, EA2).

P.N.S

P N SEDGWICK

TREASURY ECONOMIC FORECASTING EXERCISE

OCTOBER 1987 REPORT

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TREASURY ECONOMIC FORECASTING EXERCISE

REPORT BY EA AND PSF

(1) SUMMARY

The forecast covers the period to the end of 1989 (1989-90 for public finances). Table 1 summarises the results and compares them with earlier exercises and with the current average of outside forecasts.

(i) Main results

(a) Following the latest CSO upward revisions, in the Blue Book and subsequently, the growth of **money GDP** in 1986-87 is, at 6½ per cent, very close to that envisaged in the 1986 MTFS. With only limited data available on the early quarters of 1987-88 the prospect is for money GDP growth of 9 per cent, over a point above the figure in the 1987 MTFS. This overshoot could be greater if, following past practice, the CSO revises up the GDP data for the early part of the financial year. The forecast is for overshoots of the MTFS growth rates for money GDP that average almost 2 percentage points in 1988-89 and 1989-90. Both higher real growth and higher inflation than assumed in the MTFS contribute to these overshoots.

(b) Both real **GDP** and **domestic demand** appear to be growing at higher rates in the UK than in the rest of the G7. The forecast is for growth of consumers' expenditure of 4¾ per cent in 1987 and 4½ per cent in 1988, lower than the very high rate of 5¾ per cent recorded for 1986. This deceleration of consumers' expenditure is, however, offset by a strong rise in investment. Total domestic demand grows at 4 per cent in 1987 and 1988, before dropping to 3 per cent in 1989. UK domestic demand growth in 1987 and 1988 is on average 1 per cent higher than the average for the rest of the G7.

The latest forecast is for GDP growth of 4 per cent in 1987 - in line with the June forecast, but above the FSBR forecast of 3 per cent. With nearly all indicators suggesting that activity continues to be strong in the second half of 1987, forecast GDP growth in 1988 is 3 per cent (half a percent higher than in the FSBR and the June forecast) and 2½ per cent in 1989. Growth of **manufacturing output** could be over 5 per cent in 1987, though somewhat lower thereafter. **Unemployment** should continue to fall at a rapid rate in the near future, though as output growth moderates the rate of decline is likely to be less.

(c) **RPI** inflation in 1987(4) is likely to be very close to the FSBR forecast of 4 per cent, though above the 1986 Autumn Statement forecast of 3¾ per cent. The forecast is for a pick up to 5¼ per cent by

1988(4). This owes something to the rise in short term interest rates - and therefore the mortgage rate - that is judged necessary to keep the sterling index constant while the UK economy is relatively so buoyant. However, most of the rise in RPI inflation between the fourth quarters of 1987 and 1988 is the result of

the assumed **revalorisation of specific duties** in the 1988 budget after the standstill this year,

a large rise in **LA rates** in 1988-89, given the forecast of their current expenditure and the recent RSG settlement,

and some substantial increases in certain **nationalised industry prices** (plus BGC), following a period in which nominal prices have hardly risen and real prices have fallen substantially.

These factors, together with a gradual increase in unit labour costs, will have an increasing influence on the RPI from the second quarter of 1988.

With the exception of the assumed rise in the mortgage rate nearly all the factors that are forecast to cause a rise in RPI inflation between 1987(4) and 1988(4) will cause the inflation rate of the **GDP deflator** (at market prices) to rise between 1987-88 and 1988-89. The GDP deflator is also likely to be boosted by rising costs and margins in the construction industry, where the recent boom in output seems likely, on the strength of a recent further surge in orders, to continue for some while. The forecast is for construction prices to accelerate a little later than suggested in the June forecast, from early 1988 onwards.

The forecast has the relatively satisfactory recent performance of **unit labour costs in manufacturing** continuing, although growth in the range of 2½-4 per cent throughout the period is slightly above average growth in the UK's principal competitors. Strong productivity growth and the continued fall in employers' pension contributions keep growth of unit labour costs in manufacturing some 5 percentage points below growth in average earnings. Indeed these factors probably reduce the incentive for employers to press for more moderate growth in earnings.

(d) **GNP growth of the major 7** (less the UK) is likely to remain close to the 2¾ per cent recorded for 1986. There has, however, been an upturn in the growth of industrial production and world trade in manufactures which should continue in 1988. Short term interest rates are forecast to rise further in the US - with rates in Japan and Germany remaining unchanged - to moderate the likely fall in the dollar exchange rate.

(e) It is extremely difficult to analyse the recent behaviour of the **current account**, a difficulty compounded by frequent and large revisions to the 'recorded' data for invisibles and doubts about the seasonal adjustment of visible trade. The visible balance was surprisingly favourable in the early months of the year. Since then there has been a sharp deterioration.

Internal forecasts for 1987 made during much of 1986 and the early part of 1987 showed relatively small current account deficits (as a proportion of GDP) on the basis of rather less domestic demand and output in the UK economy than has in the event occurred. At the same time the world economy has been less buoyant than forecast. For given activity at home and abroad the current account has so far been better than expected. As with the June exercise, the present forecast attempts to take account of this record.

In both 1988 and 1989 North Sea production is forecast to fall by about 5 per cent. With a constant (indexed) oil price at $18 this will produce falls in the **balance of trade on oil** of just under £1b. in each year. Over the forecast period UK labour costs rise slightly more than those in competing economies (in domestic currencies), so that, with short term interest rates set to keep the sterling index at 72.5, there is a small deterioration in measured competitiveness over the period. This, together with higher growth of domestic demand and output in the UK than in the rest of the G7, produces a £2½b. deterioration in **the non-oil current account** between 1986 and 1988, producing overall current account deficits of £2½b. and £4½b. in 1987 and 1988 respectively. While the growth of domestic demand falls in 1989 it remains above growth in the rest of the G7, contributing to a further deterioration in the current account.

(f) The emergence of a growing current deficit coupled with continued outward investment flows implies a need for substantial offsetting **capital account** inflows. The forecast is that UK companies and banks are able to attract these at the projected interest rates, and that confidence in sterling is sufficient to keep the sterling index constant. (With the dollar assumed to fall gradually, the assumption of a flat sterling index implies a very small fall in the £/DM rate over the period.) A weakening of sentiment would make it more difficult to finance the projected current deficit, and put upward pressure on interest rates.

TABLE 1 : SUMMARY OF FORECAST

	FSBR 1987	SUMMER 1987	OCTOBER 1987	AVERAGE OUTSIDE FORECAST SEPTEMBER 1987
A THE WORLD ECONOMY				
1. GNP (MAJOR 7 EXCLUDING UK) (per cent change on a year earlier)				
1986	2.6	2.5	**2.7**	
1987	2.6	2.3	**2.5**	
1988	3.0	2.8	**2.6**	
1989	3.0	2.8	**2.4**	
2. DOMESTIC DEMAND (MAJOR 7 EXCLUDING UK) (per cent change on a year earlier)				
1986	3.8	3.7	**3.8**	
1987	3.0	2.6	**2.6**	
1988	3.2	2.8	**2.6**	
1989	3.0	2.8	**2.5**	
3. WORLD TRADE IN MANUFACTURES (weighted by UK market shares: per cent change on a year earlier)				
1986	2.4	2.1	**1.3**	
1987	3.4	2.6	**2.6**	
1988	4.1	3.2	**3.4**	
1989	5.0	4.3	**3.8**	
B UK ACTIVITY AND DEMAND				
4. GDP VOLUME (non-North Sea GDP in brackets) (per cent change on a year earlier)				
1986	2.6(2.7)	2.8(2.9)	**3.1(3.2)**	
1987	3.0(3.1)	3.9(4.1)	**4.1(4.5)**	3.2
1988	2.4(2.9)	2.3(2.8)	**3.0(3.5)**	2.4
1989	2.4(2.8)	1.7(2.1)	**2.4(2.8)**	
5. VOLUME OF DOMESTIC DEMAND (per cent change on a year earlier)				
1986	3.2	3.5	**3.8**	
1987	3.5	3.6	**3.9**	
1988	2.4	3.3	**4.1**	
1989	2.2	2.0	**2.9**	
6. UNEMPLOYMENT (UK S.A. EXCLUDING SCHOOL LEAVERS million)				
1986 Q4	3.14	3.14	**3.14**	
1987 Q4	2.88	2.73	**2.74**	2.84
1988 Q4	3.01	2.58	**2.52**	2.82
1989 Q4	2.94	2.61	**2.54**	
C INFLATION AND MONEY GDP				
7. MONEY GDP (MARKET PRICES) (per cent change on a year earlier)				
1986-87	6.1	6.3	**6.6**	
1987-88	7.5	8.8	**8.9**	
1988-89	6.4	7.9	**8.5**	
1989-90	6.1	7.1	**7.8**	

	PSBR 1987	SUMMER 1987	OCTOBER 1987	AVERAGE OUTSIDE FORECAST SEPTEMBER 1987
8. RPI (excluding mortgage interest payments in brackets) (per cent change on a year earlier)				
1986 Q4	3.4(3.4)	3.4(3.4)	**3.4(3.4)**	
1987 Q4	3.9(3.4)	3.8(3.6)	**3.9(3.7)**	4.0
1988 Q4	3.3(3.0)	5.1(4.4)	**5.3(4.6)**	4.6
1989 Q4	3.3(3.2)	4.2(3.9)	**4.3(3.9)**	
9. GDP market price deflator (per cent change on a year earlier)				
1986-87	3.2	3.0	3.0	
1987-88	4.5	5.0	4.6	
1988-89	4.0	5.7	5.4	
1989-90	3.6	5.1	5.2	
D PUBLIC FINANCES				
10. PSBR - £ billion				
1986-87	4.1	3.3	**3.5**	
1987-88	3.9	1.0	**-1.2**	3.4
1988-89	4.4	0.8	**-5.0**	
1989-90	4.9	0.8	**-5.4**	
11. PSBR - % OF GDP				
1986-87	1.1	0.9	**0.9**	
1987-88	1.0	0.2	**-0.3**	
1988-89	1.0	0.2	**-1.1**	
1989-90	1.0	0.2	**-1.1**	
12. ANNUAL FISCAL ADJUSTMENT - £ billion				
1988-89	3.2*	7.4*	**13.6***	
1989-90	1.7*	1.1*	**2.8***	
allocated to				
(a) reducing personal taxes				
1988-89	3.2	3.7	**4.1****	1.8
1989-90	1.7	0.5	**2.0**	
(b) reducing PSBR				
1988-89	0.0	3.7	**9.5**	
1989-90	0.0	0.6	**0.8**	

*Assuming PSBR ratio of 1 per cent as in 1987 MTFS.
**This is one third of the fiscal adjustment remaining after the higher than previouslyassumed level of privatisation receionts has been used to reduce the PSBR.

	PSBR 1987	SUMMER 1987	OCTOBER 1987	AVERAGE OUTSIDE FORECAST SEPTEMBER 1987
E MONETARY CONDITIONS				
13. SHORT TERM INTEREST RATES (per cent))				
1986 Q4	11.2	11.2	**11.2**	
1987 Q4	10.3	9.5	**10.5**	9.5
1988 Q4	10.1	10.5	**11.0**	8.9
1989 Q4	9.7	10.5	**11.0**	

	FSBR 1987	SUMMER 1987	OCTOBER 1987	AVERAGE OUTSIDE FORECAST SEPTEMBER 1987
14. MO				
(per cent change on a year earlier)				
1986-87	4.3	4.3	**4.3**	
1987-88	4.0	4.3	**5.1**	
1988-89	3.4	4.0	**4.4**	
1989-90	3.0	3.4	**3.4**	
15. STERLING INDEX (1975=100)				
1986	72.8	72.8	**72.8**	
1987	70.3	71.7	**72.0**	71.8(Q4)
1988	69.3	72.0	**72.5**	70.5(Q4)
1989	67.3	72.0	**72.5**	
16. £/DM EXCHANGE RATE				
1986	3.19	3.19	**3.19**	
1987	2.78	2.93	**2.95**	
1988	2.67	2.86	**2.94**	
1989	2.52	2.77	**2.87**	
17. RELATIVE UNIT LABOUR COSTS (1980=100)				
1986	77.6	77.7	**77.3**	
1987	74.0	75.2	**74.8**	
1988	73.5	77.1	**76.7**	
1989	70.1	78.6	**76.9**	
F TRADE AND CURRENT ACCOUNT				
18. VOLUME OF NON-OIL EXPORTS OF GOODS AND SERVICES (EXCL. ERRATICS)				
(per cent change on a year earlier)				
1986	1.9	1.9	**2.0**	
1987	5.8	4.4	**6.1**	
1988	4.0	3.6	**2.6**	
1989	5.1	4.5	**3.0**	
19. VOLUME OF NON-OIL IMPORTS OF GOODS AND SERVICES (EXCL. ERRATICS)				
(per cent change on a year earlier)				
1986	5.5	5.4	**5.7**	
1987	6.9	3.9	**7.2**	
1988	1.9	4.7	**4.8**	
1989	2.7	3.5	**2.9**	
20. CURRENT BALANCE				
£ billion				
1986	-1.1	-0.1	**-1.0**	
1987	-2.7	-0.5	**-2.4**	-1.1
1988	-1.7	-0.9	**-4.3**	-2.3
1989	-0.4	-2.3	**-5.6**	

(g) The prospects for **public finances** are again better than in earlier forecasts. The cumulative PSBR in the first six months of 1987-88 is about £3½b. below the budget profile. The major part of this shortfall is on the CGBR(O), with higher tax receipts the main explanation, but with central government expenditure below profile. Local authority borrowing has also been below profile. For 1987-88 the forecast is for a <u>negative</u> PSBR of £1b.

The forecasters attempt to predict the level of **public expenditure** that will occur. The forecast therefore implicitly includes judgements <u>both</u> on the results of the current round of Ministerial discussions (and for 1989-90 the results of the autumn 1988 discussions) <u>and</u> on the influence of the forecast evolution of the economy on demand led public expenditure. (Annex I summarises the assumptions on public expenditure.) The forecast has the outturn for the **planning total** (less privatisation receipts) in 1988-89 and 1989-90 respectively £5b. and £10b. above the previously announced plans (including the reserve). The emerging outcome for 1987-88 and the forecast for public expenditure in the later years implies that the ratio of general government expenditure (excluding privatisation receipts) to GDP starts off 1¾ percentage points below the value in the last PEWP and continues to fall further in 1988-89 and 1989-90.

Even with their current spending likely to exceed provision at much the same rate as in recent years and with the proportion of expenditure financed by central government grant falling, **local authorities' borrowing** should be close to its 1986-87 level during the forecast period as a result of a large increase in rates and buoyant capital receipts. **Public corporations' finances** benefit from the buoyant level of activity over the forecast. Nevertheless rising real levels of investment lead to an increased requirement for external finance, despite positive real price increases.

With the forecast levels of nominal and real demand and output higher than in earlier forecasts, forecast **tax receipts** (pre-fiscal adjustment) are higher. More real fiscal drag has contributed to slight upward revisions since June to the effective tax rates for PAYE and onshore CT. The share of <u>pre</u>-fiscal adjustment non-North Sea taxes in non-North Sea money GDP rises over the forecast period.

With the shares of public expenditure and pre-fiscal adjustment government revenues in GDP behaving so differently there are large fiscal adjustments. The forecast makes the stylised assumption that - after adjusting the PSBR for the higher than previously assumed level of privatisation receipts - for 1988-89 one third of the available fiscal adjustment is allocated to cuts in personal taxes and the other two thirds to reduce further the PSBR below the level in the 1987 FSBR. In 1989-90 the PSBR ratio is maintained at the assumed level for the previous year and the additional fiscal adjustment that is available is allocated to cuts in personal taxes. This produces cuts in personal taxes of £4¼b. and £2b. in 1988 and 1989 budgets. Even with these assumed cuts the share of post fiscal adjustment government revenues in money GDP does not change over the forecast period. The PSBR adjusted for privatisation receipts and the PSFD are - as proportions of money GDP - lower in 1988-89 and 1989-90 than at any time since the war except in the late 1940s and early 1950s and in 1969-70 and 1970-71. (See Annex II.)

(h) The forecast for public finances in the UK implies a markedly greater ex post tightening of fiscal policy than in the rest of the G7 taken together, as shown by the **general government deficit** - the only comparable measure of fiscal stance available for all G7 countries.

TABLE 2 : GENERAL GOVERNMENT FISCAL DEFICITS AS A SHARE OF GDP (%)

	1979-85	1986	1987	1988	1989
UK	3.1	2.6	2.9	1.4	0.6
G7 (less UK)	3.1	3.1	2.8	2.7	2.7

(ii) Main issues and risks

2. It is invidious to label individual judgements as particularly important or vulnerable. Nevertheless in the current exercise there has inter alia been detailed discussion of

- **the likely extent of the fall in the private sector surplus,**
- **the prospects for pay,**
- **the short term prospects for the current account,**

and - **the robustness of the projections for public sector finances.**

(a) The forecast implies a decline in the **financial surplus of the private sector** from its current high level. (Annex II sets out the data for sectoral surpluses and deficits over a long historical period.) Some fall in the company sector surplus seems very likely given the good prospects for capital investment revealed in intentions surveys. Indeed there must be a significant risk that, following the recent buoyancy of the economy, investment will be stronger than in the forecast.

The prospect for the personal sector is particularly uncertain. The personal sector accounts include companies' pension funds which, following the strong rise in equity markets at home and abroad, have found themselves with assets well in excess of their liabilities. The principal reaction of companies has been to attempt to rein back their surpluses by cutting employers' contributions. This reduces measured personal sector (though not household sector) saving. This process is likely to continue, particularly as companies will be taking steps to meet the requirement, introduced in the 1986 budget, that pension funds' surpluses, measured on the Government Actuary's assumptions, should not exceed 5 per cent of liabilities. To allow for this the forecast has the personal saving ratio declining slightly, even though there is a rise in the savings ratio if employers' contributions are ignored. (See Chart C on page .)

In normal circumstances the personal sector saving ratio would rise significiantly at a time of strong growth in disposable income. This does not appear to have happened either in 1986 or - on the basis of available data - in 1987. But despite this it is possible that, contrary to what is forecast some rise could occur in 1988, producing lower growth of domestic demand and a more favourable current account than now forecast.

While such a development is possible there is a greater risk that personal saving, adjusted for the fall in employers' contributions, will not rise as much as envisaged in the forecast. The drop in the growth of consumers' expenditure from the 5¾ per cent recorded for 1986 to the forecasts of 4¾ and 4½ per cent in 1987 and 1988 depends critically on the judgement that the saving ratio, when adjusted for the fall in employers' contributions, will rise to a level over 1½ percentage points above the recorded 1986 level. Some rise in saving by households would be expected as both inflation and interest rates rise next year, but the extent of the forecast rise does mark a major break with behaviour so far in the 1980s. A faster than forecast growth of consumers' expenditure or company spending in 1987 and 1988 would have adverse consequences for the current account and domestic inflationary pressures.

(b) While there are already signs that private sector **pay settlements** and **average earnings** have begun to accelerate, the record on **labour costs** has been satisfactory. With the economy growing rapidly and RPI inflation rising there is a risk that the acceleration of earnings could be greater than the very slight upturn envisaged in the forecast.

(c) The very strong productivity growth in recent years does suggest that the UK's industrial performance has improved relatively to the rest of the G7 and that as a result a significant trend deterioration in **trade performance** is less likely. The evidence on this is, however, far from conclusive. A stronger than forecast surge in imports in response to strong domestic demand growth in the second half of 1987 and 1988 could be evidence that the forecast is too optimistic about industrial performance. This would mean both weaker GDP growth (with net exports lower) and a worse current account than forecast.

(d) The continuous improvement in recorded and forecast **public finances** since mid 1986-87 almost strains credulity. The prospect for onshore corporation tax is particularly important with increases on a year earlier of £3-3½b. forecast for both 1987-88 and 1988-89. By 1989-90 forecast CT receipts are approximately three times the 1984-85 level. If public expenditure were to over run the last published plans by less than the forecast assumes the improvement in public finances would be even more marked and the scope for fiscal adjustment correspondingly greater.

Most of the improvement since the June forecast in the overall prospect for public finances in 1988-89 and 1989-90 is the result of a higher forecast level of activity. The share of pre-fiscal adjustment of non-oil taxes in money GDP is about ½ a percentage point higher in both 1988-89 and 1989-90, whereas the level of real GDP is 2 per cent higher in 1989. If growth were less than forecast the ex post fiscal position would obviously be a good deal less favourable. Nevertheless, with a total fiscal adjustment in 1988-89 of £13½b. there would still be scope for some combination of further reductions in borrowing and tax cuts, even if taxes were markedly less buoyant than in the forecast.

(2) THE WORLD ECONOMY

3. There was a slowdown in the first half of 1987 in domestic demand growth in the United States, Germany and France that was not offset elsewhere among the major industrial countries. Exports of the group as a whole are, however, picking up and their import growth is slowing, so that the gap between domestic demand growth and real GNP growth in 1987 should be much lower than in 1986. Stockbuilding was particularly strong in the major countries in the first half of 1987 and, to the extent that this was involuntary, subsequent destocking could depress growth. This could be offset by the effects of the Japanese Government's fiscal package and, in 1988, tax cuts in Germany. The WEP sees real domestic demand in the other

major countries as a whole growing by 2.6 per cent in 1987, and real GNP growing by 2.5 per cent, with similar growth rates over the next two years. This is broadly in line with our latest estimates of growth in productive potential.

4. The forecast for the world economy incorporates the judgement that downward pressure on the dollar exchange rate will be fairly mild. This would enable the Federal Reserve to keep interest rate rises to the minimum necessary to control domestic inflationary pressures. With only a modest reduction in the Federal budget deficit in prospect (despite the new Gramm-Rudman deficit reduction programme), the resulting forecast shows the US current account deficit declining only gradually. There is a significant risk that such a slow turnaround would lead to a serious weakening of confidence in the dollar and a sharp drop in its exchange rate, causing the Fed to raise US interest rates substantially. In Japan and Germany the monetary authorities remain very reluctant to lower interest rates, and they may want to raise them for domestic reasons. Nevertheless strong upward pressure on their exchange rates might force them into further modest cuts. The forecast has German and Japanese short rates at their current levels, which with the assumed rise in US rates, involves a small rise in average world short rates.

5. Prospects for **oil prices** are clouded by developments in the Gulf and doubts about OPEC's ability to restrict production. The forecast is that the oil price (North Sea average) will be around $18 per barrel in the period to end-1988, and that the real price will be constant thereafter. **Non-oil commodity prices** have been rising in real terms during 1987. The forecast is for a further gradual rise in real non-food commodity prices until the end of 1988 as world industrial production strengthens, but food prices are expected to remain weak.

TABLE 3 : G7 (excluding UK) GROWTH AND INFLATION
(IMF World Economic Outlook in brackets)

Percentage changes on a year earlier	**1986**	**1987**	**1988**	**1989**
Real GNP	2.7	2.5(2.5)	2.6(2.7)	2.4
Domestic Demand	3.8	2.6(2.6)	2.6(2.7)	2.5
Industrial Production	0.9	2.8	4.4	4.3
Consumer prices	1.8	2.6(2.9)	3.0(3.4)	2.8

Note: IMF figures include UK

6. Total imports grew by almost 5 per cent in 1986 when oil trade was very buoyant following the fall in the price. Imports of manufactures are estimated to have grown by only 2 per cent. In 1987 the forecast is for

lower total world import growth, of about 3½ per cent, but a pick up in the growth of imports of manufactures to around 4 per cent. In later years world trade is expected to pick up as NODCs, and to a much lesser extent OPEC, increase their imports.

7. Total world trade in manufactures continues to grow more quickly than developed countries exports of manufactures throughout the forecast period because it is assumed that developing countries, and the Asian NICs in particular, will continue to increase their market share. Weighting developed countries exports by UK market share also reduces their growth, because OPEC is a relatively important UK market. Of the difference in 1987-88 and 1988-89 between growth in total world trade in manufactures and the UK market weighted version of developed countries trade in manufactures roughly two thirds results from the difference of coverage (ie the developed countries' loss of share to the NICs) and one third from the weighting.

TABLE 4 : THE VOLUME OF WORLD VISIBLE TRADE

(IMF World Economic Outlook in brackets)

percentage change on year earlier	1986	1987	1988	1989
Total world imports	4.7(4.9)	3.5(3.6)	4.2(4.5)	4.0
of which:-				
- Major seven	9.1	4.9	3.9	3.3
- OPEC	-20.5	-10.1	0	2.5
- Non-OPEC developing countries	1.2	3.3	5.5	6.0
Total world imports of manufactures	1.9	3.8	4.9	4.8
Main developed countries' exports of manufactures weighted by UK market share	1.3	2.6	3.4	3.8

(3) TRADE AND THE BALANCE OF PAYMENTS

8. The current balance, which recorded a surplus in the first four months of the year, returned to deficit in May and has shown average monthly deficits since then averaging £400 million, although individual monthly figures have been erratic. A return to deficit in the latter half of the year had always seemed likely. The scale of the deterioration, however, has been greater than expected at the time of the June forecast, although the current account for the year as a whole could still be close to the £2½ billion deficit forecast in the FSBR.

TABLE 5 : UK CURRENT ACCOUNT (£bn)

	Visible trade balances			Net invisibles			Current
	Manufactures	Oil	Other	Services	IPD	Transfers	balance
1986	-5.5	4.1	-7.0	5.0	4.7	-2.2	-1.0
1987	-7.9	4.3	-6.4	5.6	5.5	-3.4	-2.4
1988	-10.2	3.3	-6.3	5.5	6.8	-3.4	-4.4
1989	-11.6	2.4	-6.2	5.7	7.6	-3.5	-5.8

9. The forecast current deficit of £2½ billion for 1987 compares with a revised estimated deficit of £1 billion in 1986. The widening in the deficit is more than accounted for by a larger deficit on trade in manufactures, which is offset only in part by a higher surplus on oil trade, a smaller deficit on trade in other goods, and a modest improvement in invisibles. In 1988 the forecast is for the current account deficit to increase to around £4½ billion followed by a further widening to £5¾ billion in 1989, with an increasing deficit on manufactured trade and a worsening in the oil balance more than offsetting a rise in the invisibles surplus.

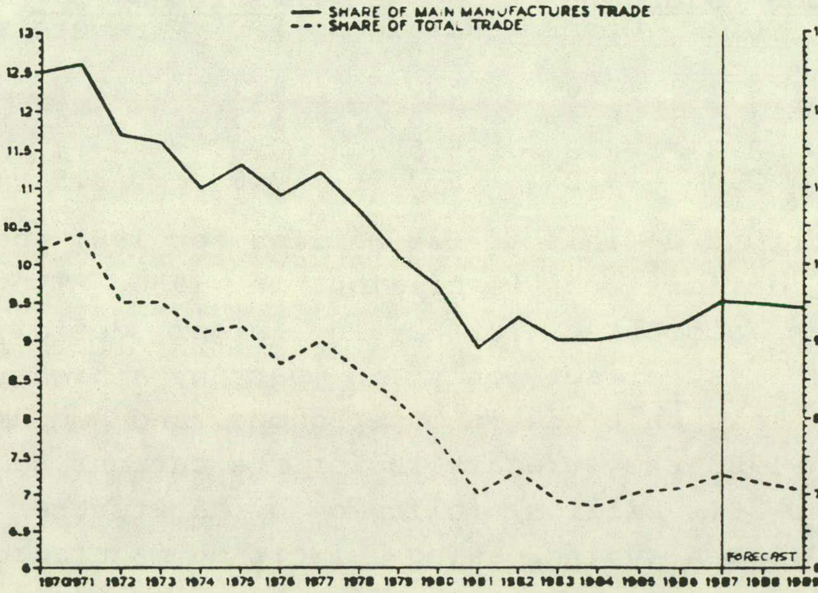
<u>Non-oil visible trade</u>

10. The rising deficit on trade in manufactures in 1987 and 1988 mainly reflects faster domestic growth in the UK compared to overseas. While labour cost competitiveness has deteriorated since the end of 1986, it is still significantly better than the average for 1984 and 1985. Over the forecast period there is a slight deterioration. (See Table 26.)

11. The volume of manufactured exports, which remained flat in the first half of 1987 after the surge towards the end of last year, appears to have begun rising again in recent months. Recorded growth, which may benefit from residual seasonal factors in the rest of this year, seems likely to continue at a modest rate to the end of next year, reflecting the slow rise in the world trade and the effects of the competitiveness loss during 1987. Growth may quicken thereafter as world trade rises more rapidly.

12. The UK's share of developed countries' exports of manufactures, which rose during 1986, may be slipping slightly during 1987, with further small falls forecast for 1988 and 1989. The forecast is for a slight fall also in the UK's share of the wider measure of world manufactured trade which includes NICs' exports. (See Chart A.). This projected share performance reflects mainly an assumption that the loss of competitiveness early this year has tended to restrain export growth fairly quickly, despite the fact that the forecast gives weight to the UK's improved export supply performance since 1981.

CHART A : UK VOLUME SHARES OF TRADE IN MANUFACTURES



13. The volume of manufactured imports which fell sharply in the first quarter of 1987, has risen rapidly again since April. Some of this volatility may reflect residual seasonal factors, but a strong rise in domestic demand for manufactures, rising capacity utilisation, and some loss of recorded competitiveness since the end of 1986 have probably been important factors. The erratic nature of the monthly figures makes difficult the assessment of the underlying trend. The forecast has a further rise in imports during the rest of this year followed by a more gradual rise during 1988 and 1989 as domestic growth falls.

14. Non-manufactured exports and imports have fallen back recently, following the exceptionally rapid growth of trade in wheat and olive oil towards the end of 1986 and in early 1987. (This rapid growth of imports and exports, largely the result of the peculiarities of the CAP, had little effect on the current balance.) Exports are projected to resume growth in 1988 and 1989 as world demand rises, but imports may be rather sluggish as the recent surge in basic material imports ends and imports of food, drink and tobacco return to their modest trend growth.

15. The non-oil terms of trade rose sharply in the first half of this year from the trough at the end of 1986 reflecting partly sterling's appreciation and partly the weakness of world food prices. The forecast is for little change in 1988 and 1989.

Oil trade

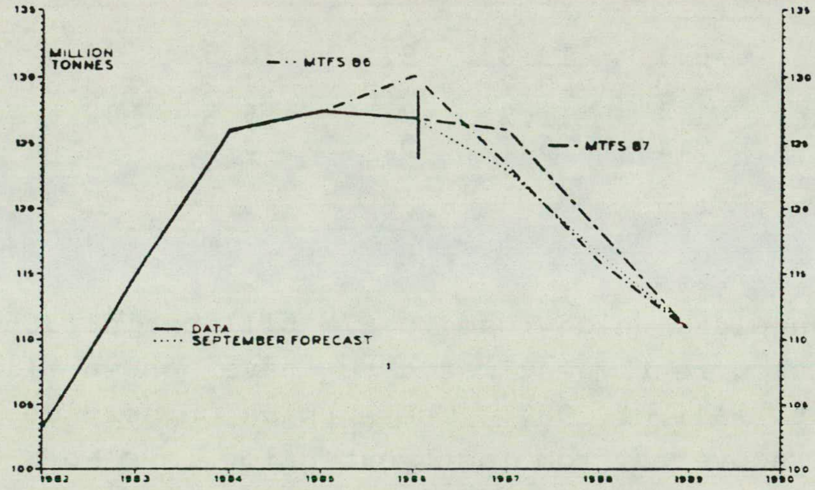
16. The strengthening in world prices during the first half of 1987 has helped to offset a lower than expected volume of North Sea output. On the assumption that oil prices remain close to their present level for the rest of the year and that some - but not all - of the production shortfall is made good, the oil trade balance should be a little higher than last year's £4 billion surplus.

TABLE 6: NORTH SEA OIL

	Average N.Sea oil price $/barrel	Average N.Sea oil price £/barrel	N.Sea output mn.tonnes	Oil trade balance £ bn	N.Sea* taxes £ bn
1986	14.2	9.7	126.9	4.1	4.8
1987	17.7	11.0	122.9	4.3	4.6
1988	18.0	10.7	116.5	3.3	4.5
1989	18.7	10.8	110.8	2.4	4.5

* financial year totals

CHART B : FORECASTS FOR NORTH SEA OIL PRODUCTION



17. The forecast that the average North Sea oil price will remain at $18 a barrel until the end of 1988 and then rise in line with world inflation implies a small fall in North Sea sterling prices next year as the dollar weakens and little change in 1989. North Sea output falls by 5 per cent a year in 1988 and 1989. The fall will largely be reflected in lower exports. The oil trade surplus is forecast to fall by about £1 billion in 1988 and a further £0.9 billion in 1989.

18. Table 7 summarises the forecast for trade volumes. Changes in aggregate exports and imports of goods and services mask divergent movements in components. The projected 3½ per cent a year growth in the volume of manufactured exports excluding erratics in 1988 and 1989 is offset partly by lower arms shipments to Saudi Arabia, a fall in oil exports and a reduction in the recent exceptionally high level of gold exports, together with a more modest growth in services credits, so that total exports only rise by 1½ per cent a year. Total imports are forecast to rise less rapidly than manufactured imports excluding erratics. This reflects mainly a decline in non-manufactured imports partly as a result of the ending of exceptional trade in olive oil and a fall in gold imports (offsetting the fall in exports).

TABLE 7 : EXPORTS AND IMPORT VOLUMES
(per cent changes on previous year)

	Manufactures excl. erratics	Erratics	Oil	Other goods	Total goods	Services	Total goods and services
Exports							
1986	1.1	28.0	2.0	5.5	3.7	1.0	3.1
1987	6.6	2.4	-0.6	6.9	5.2	4.5	5.0
1988	3.5	1.9	-4.0	0.7	1.5	1.9	1.6
1989	3.5	1.6	-6.5	2.2	1.6	1.8	1.6
Imports							
1986	5.6	-0.1	13.8	8.5	6.5	4.9	6.2
1987	9.6	+4.0	0.2	1.6	7.2	3.3	6.5
1988	7.5	-1.4	11.2	-3.0	5.3	3.6	5.0
1989	4.0	0.1	6.7	-0.7	3.2	2.6	3.1

10. Invisibles

19. The invisibles surplus, which rose to £7½ billion in 1986' compared to £5 billion in 1985, is currently estimated to have shown little further growth in the first half of 1987. The surplus on services has risen as travel earnings have recovered from last year's low level and earnings from financial services are estimated to have continued to rise. Net earnings from interests, profits and dividends (IPD), however, have fallen from the high level of late-1986 as the pound's appreciation has reduced the sterling value of overseas earnings, and margins on banks' overseas business have been squeezed.

TABLE 8 : THE BALANCE OF INVISIBLES (£ billion)

	Services	N.Sea IPD	Other IPD	EC transfers	Other transfers	Total invisibles
1986	5.0	-1.6	6.3	-0.7	-1.5	7.5
1987	5.6	-1.7	7.2	-1.7	-1.7	7.6
1988	5.5	-1.2	7.8	-1.6	-1.8	8.7
1989	5.7	-0.2	8.2	-1.7	-1.9	9.6

20. The invisibles surplus is forecast to rise from about £7½ billion this year to £8¾ billion in 1988 and £9½ billion in 1989. The services surplus is unlikely to rise in 1988 as UK growth remains buoyant compared to overseas, but may improve in 1989 as the growth gap narrows. The main increase in the invisibles surplus seems likely to reflect falling payments abroad, North Sea oil companies - as oil output declines - and a rise in other net IPD earnings as portfolio yields rise abroad and banks' margins return to more normal levels. Net transfers to the European Community are projected to show little change in 1988 and 1989 from this year's level. The precise profile of payments and receipts will of course depend on a number of factors on which decisions have not yet been taken.

(4) DOMESTIC DEMAND AND ACTIVITY

(a) Personal income and expenditure

21. Published figures for the first half of 1987 and retail sales for the year to August show consumer spending relatively sluggish at the start of the year, but picking up strongly since the spring. However, discrepancies in the national accounts for the first half of 1987 indicate a significant underrecording of one or more components of expenditure, so that growth of consumer spending growth may well not have fallen to 4 per cent as the recorded figures currently suggest. The figures for retail sales show growth as high as in 1986. Consumer spending seems to have been very strong in the third quarter of the year, and car registrations in August were 6 per cent higher than in August 1986.

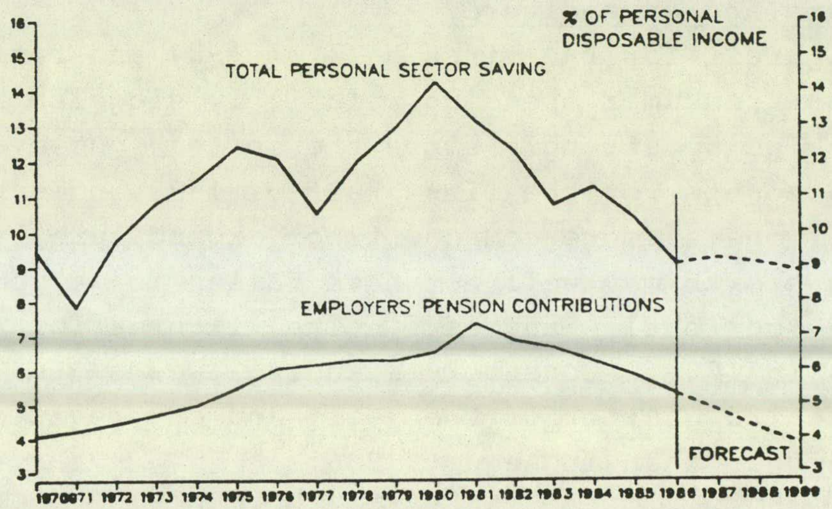
TABLE 9: RETAIL SALES AND CONSUMERS EXPENDITURE

		Retail Sales			Consumers' expenditure	
			Percentage change on			
		1980=100)	previous period	year earlier	(£ billion 1980)	(percentage change on year earlier)
1986	Q1	119.3	1.7	4.3	39.5	5.1
	Q2	121.3	1.7	4.7	40.1	6.6
	Q3	123.7	2.0	5.5	40.7	5.8
	Q4	126.5	2.3	7.3	40.9	5.6
1987	Q1	125.4	- 0.9	5.1	41.1	4.1
	Q2	128.2	2.3	5.8	41.8	4.2
	Q3*	131.9	3.2	7.0		
	Jan	123.6	- 2.4	4.6		
	Feb	127.0	2.8	7.1		
	Mar	125.5	- 1.2	3.8		
	Apr	130.0	3.6	7.7		
	May	125.4	- 3.5	4.8		
	June	129.4	3.2	5.0		
	July	131.2	1.4	7.0		
	Aug	132.5	1.0	6.9		

* Average of July and August

22. Between 1980 and 1986 the personal saving ratio has fallen by about a third, and it is currently close to the levels recorded in the latter part of the 1960s and in the early 1970s, before the dramatic rise in inflation. Part of the recent fall in the saving ratio (and part of its rise in the second half of the 1970s) is probably attributable to the behaviour of employers' contributions to pension funds. (See Chart C). Employers' pension contributions are recorded as part of personal income, but short-term fluctuations in them are unlikely to affect personal expenditure to anything like the extent that changes in after tax wages and salaries do. Instead they are likely to show up in fluctuations in the personal saving ratio.

CHART C. EMPLOYERS' PENSION CONTRIBUTIONS AND THE PERSONAL SAVING RATIO

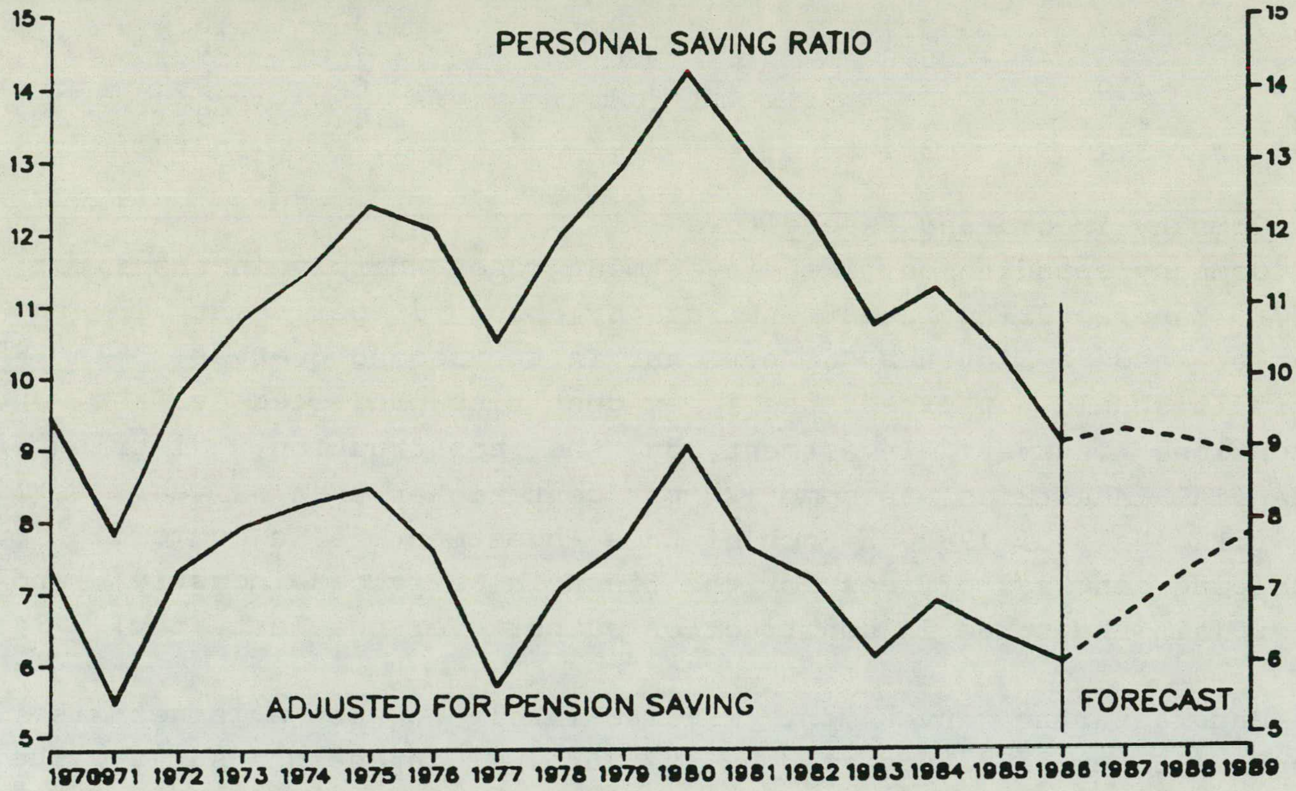


23. The rise to 1981 in pension fund contributions as a proportion of personal disposable income reflected expanding coverage of schemes and topping up payments made to cover actuarial deficits caused by the rise in inflation and the plunge in the stock market in the mid 1970s. In 1980 and 1981 there was also a rise in redundancy payments and an effect from the composition of employment. The fall in employment in this period particularly affected manual workers who would be less likely to be covered by private pension schemes.

24. The subsequent fall in pension contributions relative to wages and salaries must reflect in large part the impact on pension funds of the recovery in profitability and stock markets and the fall in inflation experienced since 1981. This has led to large actuarial surpluses, and an increasing number of firms have temporarily stopped making pension contributions. The 1986 Budget, which required reductions in actuarial surpluses where these exceeded liabilities by more than 5 per cent, and the

continuing rise in profitability and dividends are likely to ensure a further fall in pension contributions relative to pay. This in turn is likely to mean that the personal saving ratio is likely to fall a little further between 1987 and 1989, even though higher inflation and interest rates may be tending to restrain spending (see chart D). (The apparent rise in the recorded personal saving ratio so far in 1987 may be an illusion, reflecting under-recording of consumer spending.)

CHART D : PERSONAL SAVING ADJUSTED FOR PENSION FUND CONTRIBUTIONS



25. The published figures show real personal investment in dwellings weak in the first half of 1987, falling some 4 per cent from the second half of 1986. Spending on both improvements and investment in new dwellings was apparently lower than a year earlier in the second quarter of 1987, a development that is hard to understand given the general buoyancy of personal spending and in particular given the rise in the rate of house completions over the last year.

26. Nevertheless it does look as though housing starts, which were rising through 1986 and into the first quarter of 1987, have now flattened out. Even so for 1987 as a whole housing starts may be at least 5 per cent higher than last year. Completions should go on rising into 1988. In spite of the surprising investment figures for the first half of 1987, the forecast is for a 10 per cent rise in investment in dwellings in the year as a whole, followed by a 6 per cent rise in 1988. By 1989 investment in new dwellings may have stopped rising, although expenditure on improvements should continue to grow quite strongly.

27. Fast growth in both house prices and real personal investment combined with a falling saving ratio mean that the personal sector's financial surplus, which has already declined from about 6 per cent of GDP in 1[illegible]0 to just over 1 per cent in 1986, is likely to fall further.

TABLE 10: REAL PERSONAL INCOME AND EXPENDITURE

	Real personal disposable income	Real consumers' expenditure	Real investment in dwellings	Persons' net acquisition of financial assets	Personal saving ratio	Saving ratio excluding pension saving
	(Percent changes on previous year)			(£ bn)	(per cent)	(per cent)
1985	2.7	3.7	-3.9	9.0	10.4	6.4
1986	4.3	5.8	11.8	4.7	9.1	6.0
1987	4.9	4.7	9.4	3.6	9.2	6.7
1988	4.4	4.6	6.1	2.6	9.1	7.3
1989	3.1	3.4	3.9	1.4	8.8	7.8

(b) **Company income and expenditure**

28. Company spending on fixed investment rose sharply in the first half of 1987. Manufacturing investment rose by about 7 per cent in the first quarter and a further 6½ per cent in the second quarter. In 1987 as a whole it should now exceed the 4 per cent rise projected by the June DTI intentions survey. Investment by the construction, distribution and financial industries was some 12½ per cent higher than a year earlier in the first half of 1987. Much of this investment is in commercial building (shopping centres, offices for the financial services industry) and helps to explain the surge in construction output over the last year.

29. Manufacturing investment is also likely to show a larger rise in 1988 than the 6 per cent suggested by the June DTI intentions survey. The latest quarterly CBI survey indicated a substantial upward revision during the summer to intended expenditure on both buildings and plant and machinery. Other private sector business investment may also rise quite strongly again next year, and the build up of work on the Channel Tunnel will contribute to a further rise in construction work. Table 11 summarises the forecast for investment. Nationalised industry investment is much less buoyant than private sector investment, and reduces the growth of "other business" investment shown in table 11.

TABLE 11: GROSS FIXED CAPITAL FORMATION

(percentage changes on previous year)

	1986	1987	1988	1989
Business	- 3	6½	5½	3½
of which				
North Sea	- 14½	- 20	4	- 4½
Manufacturing	- 5	7	10½	8
Other business	- 1	8½	4	2½
Private dwellings	7½	7	5½	3
General government	5½	- 2½	- 3	0
Total	½	5	4½	3

30. Manufacturers reduced their stocks during the first half of 1987. Some of this destocking may have been unintended: by the summer manufacturers were telling the CBI for the first time this decade that on balance they no longer held excessive stocks. This year has also seen a decline in the balance of firms expecting stocks to fall. Distributors' stocks rose during the first half of 1987, though not enough to prevent a fall in the ratio of stocks to sales. The rise in consumer goods imports in the third quarter may indicate a stronger rebuilding of stocks. The forecast is for some further gradual fall in the stock output ratio, but at a slower pace than recorded in recent years. (The main reaction to the tax changes in the 1984 which raised the cost of stockholding should now have taken place.) This implies an increased rate of stockbuilding over the forecast period, though stockbuilding remains on a modest scale compared with many years of the 1960s and 1970s.

31. Non-North Sea industrial and commercial companies' profits net of stock appreciation rose by 13 per cent between the first halves of 1986 and 1987. Part of this rise is accounted for by reallocation of newly privatised companies (especially BGC) to the private sector. Excluding the profits of such companies the growth of profits was probably 10-11 per cent over this period - a slower rate of growth than recorded in recent years but still above the growth of money GDP. For 1987 as a whole the underlying growth of non-North Sea ICCs' profits is forecast to be similar to that experienced in the first half of the year. Profit growth may slow further in 1988, as output growth slows down and the rate of increase in costs rises slightly. This outlook for profits, at a time when company expenditure is likely to be rising strongly, implies a fall in companies' financial surplus - not, however, to an extent that should pose any general financial problems for companies.

TABLE 12: THE FINANCIAL POSITION OF INDUSTRIAL INDUSTRIAL AND COMMERCIAL COMPANIES

	Profits as a share of money GDP (per cent)		Rate of return on assets, non-oil ICCs' (per cent)	Net acquisition of financial assets (£ bn) (all ICCs)	Borrowing requirement (£ bn) (all ICCs)
	Total	Non-oil			
1973-85 average	12.0	8.9	5.5	2.2	3.6
1986	15.0	12.5	8.9	6.4	6.1
1987	15.9	13.2	9.6	9.3	14.0
1988	15.2	13.0	9.2	4.2	11.0
1989	15.2	13.2	9.3	4.5	10.0

32. Table 13 shows the forecast for industrial and commercial companies' gross trading profits. The table also shows companies' net income - which is net of interest payments and receipts and corresponds roughly to the base for corporation tax. The slowing of net income growth in 1988 partly reflects the rise in interest rates forecast for the start of the year.

TABLE 13: PROFITS OF INDUSTRIAL AND FINANCIAL COMPANIES

(percentage changes on previous year)

	Non-North Sea Industrial and Commercial Companies*		Financial Companies
	Gross Trading Profits	Net Income	Net Income
1986	19 (16)	26	21
1987	16 (13)	18½	19
1988	7½	3½	16½
1989	7½	6	6½

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

(c) **Aggregate demand and output**

33. The average estimate of GDP grew by 3¾ per cent between the first halves of 1986 and 1987, while the output estimate grew by around 4¼ per cent (4¾ per cent non-North Sea). Output growth was particularly strong in the construction sector (up by 7½ per cent), and manufacturing output also recorded a rise of 5 per cent. The full extent of the rise in output is not explicable in terms of recorded expenditure. The expenditure estimate of GDP shows less than a 2½ per cent rise over the same period.

34. For 1987 as a whole the output measure of GDP seems likely to record a rise of 4 per cent or a little more. It is likely that the

average estimate of GDP will eventually show a similar increase. But there is some risk that, if the problems with the expenditure measure persist into the second half of the year, recorded growth could be a little under 4 per cent on the average estimate when the first figures for calendar 1987 are published by the CSO at around the time of the Budget. Given the record of upward revisions to GDP at the times of fast output growth it is quite likely that recorded growth for the average measure of GDP in 1987 will eventually settle down at a figure above 4 per cent.

35. Growth is expected to fall back to around 3 per cent in 1988 (3½ per cent non-North Sea). This slowing down is caused by a worse trade performance and by some deceleration in personal spending. After two years of above trend growth in 1987 and 1988, 1989 could see somewhat slower growth if the investment cycle has started to turn down by then.

TABLE 14: EXPENDITURE AND OUTPUT

(percentage changes on previous year)

	1986	1987	1988	1989
Domestic demand	3.8	3.9	4.1	2.9
Exports of goods and services	3.1	5.0	1.6	1.6
Imports of goods and services	6.2	6.5	5.0	3.1
Compromise adjustment	0.4	0.8	0	0
GDP(A)	3.1	4.1	3.0	2.4
Non-oil GDP(O)	3.1	4.5	3.5	2.8
Manufacturing output	1.1	5.2	2.9	3.2

(5) INFLATION

36. RPI inflation is likely to average close to 4 per cent in the fourth quarter of 1987, in line with the forecast published in the FSBR. Producer output prices, on the other hand, seem likely to rise some ½ per cent more on average this year than forecast at Budget time, principally as a result of higher input prices. In the third quarter of 1987 materials and fuel input prices were some 7 per cent higher than forecast at Budget time. Inflation as measured by the main national accounts deflators, however, was actually lower in the second quarter than expected at Budget time. There is currently an unusually large difference between inflation as measured by the RPI and inflation as measured by the national accounts consumption deflator. The national accounts deflators are subject to revision, and revisions tend to be upward.

Producer prices

37. Productivity growth of around 7 per cent has left manufacturers' unit labour costs virtually unchanged over the last year. In spite of the rise in materials costs over the last year, manufacturers' total unit costs are still no higher than they were at the start of 1985. Over the forecast period there is likely to be a modest rise in unit labour costs, as productivity growth reverts to its estimated underlying rate of increase, and real commodity prices may continue a gradual recovery from their exceptionally depressed levels of 1986. However, with a stable exchange rate for sterling, manufacturers will find it difficult to raise profit margins to anything like the extent they have done over the last three years. A slight reduction in inflation is expected during 1988, and inflation may fall further in 1989 if the economy slows down as forecast and competitive pressures intensify.

TABLE 15: MANUFACTURING COSTS AND PRICES

(percentage changes on previous year)

	Unit labour costs	Cost of materials and fuels	Estimated total costs	Domestic producer output prices*
1986 Q4	0.2	- 5.6	- 0.4	3.9
1987 Q4	0.9	7.7	2.2	4.8
1988 Q4	3.0	2.2	2.9	4.4
1989 Q4	2.8	3.1	2.4	3.2

* excluding food, drink and tobacco

Retail prices

38. Although retail price inflation in the fourth quarter of 1987 may turn out marginally below the Budget forecast, inflation is likely to rise during the first half of 1988 to around 5¼ per cent by the end of the year. This rise in inflation reflects in particular substantial electricity and gas price increases, a large rise in local authority rates, the loss of the benefits of the non-revalorisation of specific duties in the 1987 Budget, and a forecast rise in mortgage rates, as well as the effect of faster growth of unit labour costs.

39. Table 16 sets out changes in **nationalised industry** prices charged to domestic consumers over the year to 1987 Q4 and 1988 Q4, and gives real price increases over a run of financial years.

TABLE 16 : NATIONALISED INDUSTRY PRICES

(a) Nominal price increases for consumers

	Year to 1987 Q4	Year to 1988 Q4
Post	2.6	4.5
Rail	5.7	5.0
Electricity	- 0.3	8.0
Coal and coke	- 0.1	2.2
Bus	4.9	4.3
Water	5.6	6.4

(b) real price increases (weighted average for consumers and industry)

	1983-4	1984-5	1985-6	1986-7	1987-8	1988-9	1989-90
British Coal	2.3	0.0	- 1.9	- 3.1	- 4.5	- 2.9	- 2.4
Electricity	- 3.8	- 2.0	- 2.2	- 1.9	- 3.9	2.9	0.0
BSC	- 8.1	1.1	- 4.6	- 1.8	- 1.6	- 2.3	- 1.7
Post Office	- 2.0	- 1.5	- 4.2	- 2.0	- 0.8	- 0.4	- 1.0
Water	1.5	1.0	4.7	4.4	1.7	1.4	2.0
LTR	-15.7	- 3.2	1.5	2.2	2.1	4.4	4.1
British Rail	- 4.5	0.4	0.0	2.8	1.2	- 0.2	- 0.9

* Nominal changes deflated by the RPI

40. The larger increases in nationalised industry prices charged to consumers in 1988 will raise RPI inflation in 1988(4) by about ¼ per cent compared with inflation in 1987(4). Other factors that contribute to the rise in RPI inflation between 1987(4) and 1988(4) are as follows:

(i) The formula relating **gas prices** to oil prices and the RPI should give almost a 4 per cent rise in domestic prices next year, following a 4½ per cent fall this year (the difference is worth about 0.2 per cent on inflation).

(ii) The rate support grant settlement is assessed as implying an 12 per cent rise in average **local authority rate** poundages next year, compared with 7¾ per cent this year (the difference is worth 0.18 per cent on inflation).

(iii) A 1 point rise in **mortgage rates** compared with their end September level means that the path of mortgage interest payments adds about 0.4 per cent more to RPI inflation next year than this.

(iv) The assumed **indexation of specific duties** in the 1988 Budget will add a little over 0.3 per cent to RPI inflation in the latter part of 1988 compared with the latter part of 1987.

(v) **Food** prices are also likely to rise a little faster over the next year. Although world food prices are expected to remain relatively weak, a partial recovery in tropical beverage prices means that the prices of the foods the UK buys on world markets will rise a little more in 1988 than in 1987, and the faster rise in UK labour costs will also tend to put up food retail prices inflation.

(vi) **Petrol** prices have been unexpectedly low during the summer - the normal seasonal rise did not occur - in spite of the strength of crude oil prices. Over the next year there may be little change in petrol prices, other than that resulting from the assumed indexation of petrol duties in the 1988 Budget.

(vii) **Other private sector prices** have risen by 3½ per cent over the last year. (They would have risen by about 4 per cent but for the non-indexation of duties in the 1987 Budget.) Making a small allowance for the possibility that some of the acceleration of producer output prices in recent months has still to feed through into these prices and for the effect of the recent rise in pay settlements, these prices could rise by around 4¼ per cent over the next year.

41. The forecast for the RPI is summarised in table 17.

TABLE 17: COMPONENTS OF THE RETAIL PRICE INDEX

(Percentage changes on previous year)

	1986 Q4	1987 Q4	1988 Q4	1989 Q4
Food prices	3.2	3.4	3.9	3.5
NI prices	3.7	2.3	6.3	4.3
Housing prices	7.1	7.5	11.4	8.1
Other prices	2.6	3.4	4.1	3.5
- of which petrol	3.4	-12.6	1.8	3.4
- other items	3.8	3.4	4.2	3.4
All items RPI	3.4	3.9	5.3	4.3
RPI excluding mortgage interest payments	3.4	3.7	4.6	3.9

42. The annual rate of increase in the RPI should fall below 4 per cent in November when the mortgage rate increase that occurred in November 1986 drops out of the twelve month comparison. The inflation rate will rise again early next year on the assumption that the mortgage rate rises at the beginning of the year. Inflation is likely to rise quite sharply after March as post Budget increases in specific duties and rates and electricity price increases show up in the index. The forecast monthly path of retail price inflation up to the end of 1988 is shown below.

TABLE 18: MONTHLY PATH OF RPI INFLATION

		All items RPI	RPI excluding mortgage interest payments			All items RPI	RPI excluding mortgage interest payments
1987	**August**	4.4	3.7	**1988**	**April**	4.5	4.2
	September	4.2	3.4		**May**	4.9	4.3
	October	4.3	3.6		**June**	5.1	4.4
	November	3.8	3.7		**July**	5.2	4.5
	December	3.7	3.7		**August**	5.3	4.6
					September	5.5	4.7
1988	**January**	3.9	3.6		**October**	5.4	4.6
	February	3.9	3.6		**November**	5.3	4.5
	March	4.1	3.7		**December**	5.3	4.5

(c) <u>The GDP deflator</u>

43. The national accounts deflators published for 1987Q2 are surprisingly low. The CSO are currently looking at some aspects of the figure for the deflator for consumers expenditure, and have indicated that it is quite likely that the figure will be revised up. The latest published figure for the GDP deflator (showing a 4.1 rise in the GDP deflator at market prices over the year to 1987Q2) does not suggest any overrun of the Budget forecast for the current financial year which was for a 4½ per cent rise in the GDP deflator.

44. For 1988-89 most of the factors tending to push up the RPI (other than the path of mortgage rates) will also affect the GDP deflator. The GDP deflator will also be affected to the extent that the current boom in construction output feeds into construction prices and the forecast has a modest allowance for this effect in 1988-89.

SECRET

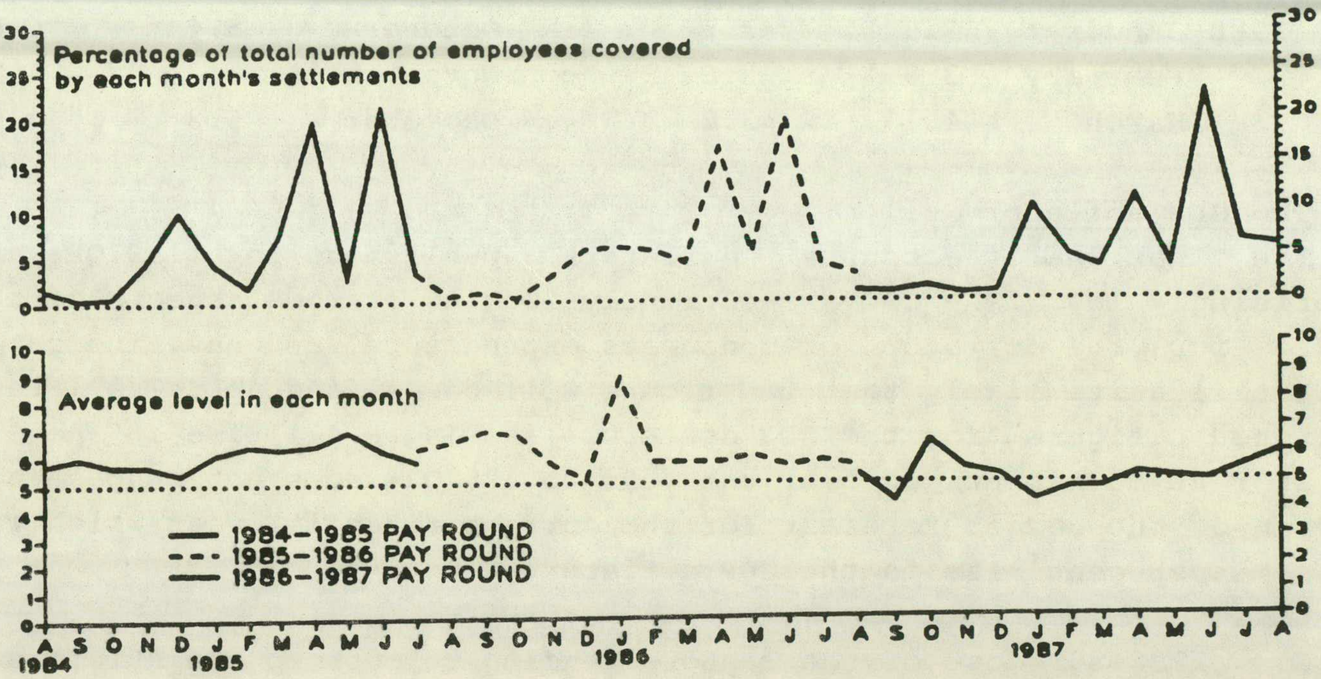
TABLE 19: FORECASTS FOR THE DEFLATOR FOR GDP AT MARKET PRICES

	1986-87	1987-88	1988-89	1989-90
MTFS				
Total	3	4½	4	3½
non-oil	6	4¼	3¾	3¼
Autumn forecast				
Total	3	4½	5½	5¼
non-oil	5¾	4	5½	5

(d) **Earnings**

45. Over the twelve months to August 1987, private sector pay settlements monitored by Department of Employment averaged 5 per cent, about ¾ per cent less than during the previous twelve month period. Settlements fell during the second half of last year, but appear to have bottomed out at around the beginning of 1987, and in the most recent month settlements averaged 6 per cent (see Chart E).

CHART E: PRIVATE SECTOR PAY SETTLEMENTS



46. Other evidence on settlements, such as that from the CBI's pay databank, tells a similar story. Although a relatively small number of employees are covered by the most recent settlements, the upward trend seems well established and it is not likely that as major settlements are concluded over the autumn they will generally be at rates below 6 per cent. This forecast assumes 6 per cent settlements on average over the next twelve months. Settlement rates may thereafter rise further (reflecting inflation at around 5½ per cent in mid 1988), but fall back in the second half of 1989 as the economy slows further and price inflation falls.

47. Overtime has been very high in recent months - at around record levels in relation to the number of operatives - and is currently estimated to be responsible for around ½ percentage point of the 8 per cent growth of private sector earnings over the last year. Over the next two years cyclical effects will tend to reduce earnings growth, and will offset the effect of rising pay settlements.

TABLE 20: PRIVATE SECTOR SETTLEMENTS AND EARNINGS

(Contributions to changes between third quarters of successive years)

	1986-87	1987-88	1988-89
Settlements	5¼	6	6½
Drift	2¾	2	1½
Increase in average earnings	8	8	8

48. Over the twelve months to August growth in local authority earnings has been roughly in line with private sector, while central government earnings has been a little lower. Over the following twelve months, local authority pay seems likely to rise somewhat faster than private sector pay. The teachers are already due for 8.2 per cent from October and a further 1 per cent next April. The forecast assumes that they receive only 4½ per cent "new money" on top of this in the light of Cabinet's decision not to pay more than the increase in the RPI. Local authority manuals have already agreed an increase of 10½ per cent. Local authority construction workers may also do well, particularly given the pressures from construction workers' pay in the private sector (up over 10 per cent in the year to June). It seems likely that some important groups of local authority workers will continue to do better than the private sector. While others (eg further education teachers) may do worse, local authority pay on average looks likely to rise a little faster than private sector pay.

49. On the other hand, central government earnings are likely once again to rise more slowly than private sector earnings over the next year. If there is a relatively high settlement for health service employees, it could well be staged, while a settlement for civil servants below the private sector average is expected. In later years central government pay is expected to rise more closely in line with private sector pay.

TABLE 21 : PUBLIC AND PRIVATE SECTOR UNDERLYING AVERAGE EARNINGS

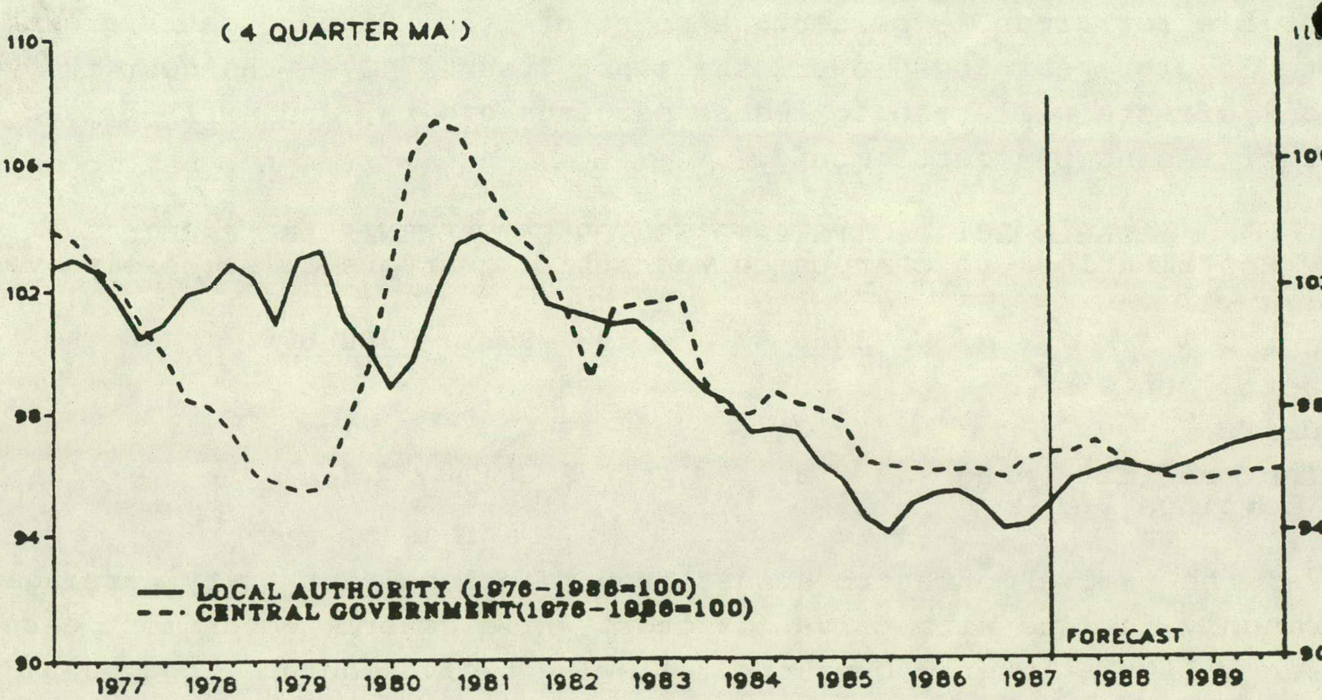
(percentage changes over years to August)

	Central Government	Local authorities	Private sector**
1986-87	7	8 (7)*	7½
1987-88	7	9½(9¼)*	8
1988-89	8	9 (8¾)*	8½

* figures in brackets excluding settlements for primary and secondary teachers

** adjusted for changes in overtime hours.

CHART F : RATIO OF LOCAL AUTHORITY AND CENTRAL GOVERNMENT EARNINGS TO PRIVATE SECTOR AVERAGE



(e) Labour costs

50. The forecast for private sector earnings combined with the forecast for productivity (discussed in section 6 below) produces forecast increases in labour costs in manufacturing that are modest by past standards, and close to those forecast for competitor countries.

TABLE 22 : LABOUR COST INCREASES IN MANUFACTURING
(percentage increases on previous year)

	UK	Major 7 (less UK)
1986	3.4	2.3
1987	0.0	1.3
1988	3.3	1.6
1989	2.6	2.3

(6) PRODUCTIVITY, EMPLOYMENT AND UNEMPLOYMENT

51. The latest upward revisions to manufacturing output mean that manufacturing productivity is now estimated to have risen by around 7 per cent in the first seven months of this year compared with a year earlier. While much of the recent rise in productivity is the result of a cyclical increase in the intensity of use of labour (as indicated by the rise in overtime hours), it seems that underlying productivity growth may have been a little higher recently than has been previously assumed. For this forecast the projection of underlying productivity

growth has been raised from 4 to 4¼ per cent a year.

52. Employment outside manufacturing rose by over 130,000 during the first quarter of 1987. Current indications are that the second quarter showed an increase of around 120,000. Growth in output per man outside manufacturing was unusually strong during 1986 - reflecting, among other things, redundancies in the coal industry and good productivity gains in other public corporations -, but as far as can be discerned has been much slower this year. Underlying growth in private sector non-manufacturing productivity is projected at around 1¾ per cent a year (about 2½ per cent a year in terms of full time equivalents).

TABLE 23: RECORDED AND FORECAST GROWTH OF OUTPUT PER HEAD

Annual averages, percentage changes

	1964-73	1973-79	1979-86	1986-89
Manufacturing	5¾	¾	3¾	5
Non-manufacturing*	3	½	1¼	1½
Total non-oil economy	2¾	½	1¾	2¼
Whole economy	2¾	1	2	1¾

* Includes private sector and nationalised industries other than in manufacturing and oil.

53. Labour supply is forecast to grow by about 680 thousand over the three years to 1989, about 200 thousand less than in the previous three years. This projection is somewhat higher than growth shown in the projections published in the Employment Gazette because the UK's relatively strong economic performance is likely to lead to both higher net inward migration and higher participation ratios than allowed for in the Department of Employment's projections.

TABLE 24: PRODUCTIVE POTENTIAL

(Annual averages; percent changes)

	Trend non-North Sea productivity growth	**Labour supply**	**Non-North Sea productive potential**	**Contribution of North Sea**	**Whole economy productivity potential**
1973-79	1	½	1½	½	2¼
1979-86	1½	½	2	¼	2¼
1986-89	2	¾	2¾	- ½	2½

54. Growth in the "working population" - the sum of employment and unemployment - has been very low over the past year: around 40,000 between mid 1986 and mid 1987, below the projected growth in labour supply, and down from increases of over 500,000 a year between mid 1983 and mid 1985. This is the phenomenon publicised by Layard and Clarke. The employment programmes which have been expanding recently and other measures such as Restart have tended to reduce the working population. (This is not the case with the Community Programme, whose participants are generally counted as employees and so remain in the working population).

55. But government programmes and Restart are not the only factors responsible for the recent slow growth of the working population. One important factor has been that the composition of employment growth has changed somewhat in favour of areas where most of the jobs are filled by men. Construction employment has started to rise, manufacturing employment has flattened out, and the programme of redundancies in the coal industry has - at least for a while - come to an end. Thus a higher proportion of new jobs have been going to claimants, and a smaller proportion to non-claimants. Moreover, the growth of the "working population" between 1983 and 1985 was quite exceptional relative to growth in the population of working age. It was never likely to be sustained and does not provide a reasonable benchmark against which to assess the impact of Restart and other recent measures. Between mid 1986 and mid 1987 the shortfall of growth in the working population relative to the projected increase in population of working age was some 130,000 - much less than the fall in unemployment over this period (roughly 290,000 including school-leavers). As shown in table 25, on our estimates of the effects of the various measures, about two thirds of the improvement in the adult unemployment trend as between the year to mid 1986 and the year to mid 1987 is attributable to underlying economic factors rather than to the effect of measures.

56. Unemployment is likely to fall more slowly during the forecast period. This is primarily because the 5 per cent growth in manufacturing output and 7 per cent rise in construction output forecast for this year are not forecast to be repeated over the next two years and so male employment growth will slow down. Nevertheless, helped by the removal from the count in September 1988 of everyone under 18, unemployment could go on falling into 1989.

TABLE 25 CHANGES IN ADULT UNEMPLOYMENT

(seasonally adjusted 000s)

	Unemployment	Effects of employment and training measures, restart and availability testing	Underlying unemployment
1985(2)-1986(2)	+ 88	- 64	152
1986(2)-1987(2)	- 238	- 173	- 65
1987(2)-1988(2)	- 322	- 117	- 205
1988(2)-1989(2)	- 135	- 64	- 71

(7) FINANCIAL CONDITIONS

57. WEP has a rise in US interest rates during 1988, which is judged sufficient to limit the fall in the dollar exchange rate to modest proportions. With interest rates in the other major economies flat the average world interest rate rises. Because this rise in the average world interest rate is the consequence of likely downward pressure on the dollar exchange rate there could be some upward pressure on sterling against the dollar. However, the prospect that the UK current account deficit will widen in 1988 and 1989 could raise expectations of some decline in the sterling exchange rate with a need for an increase in interest rates in order to achieve a constant sterling index.

CHART G : STERLING AND THE CURRENT BALANCE

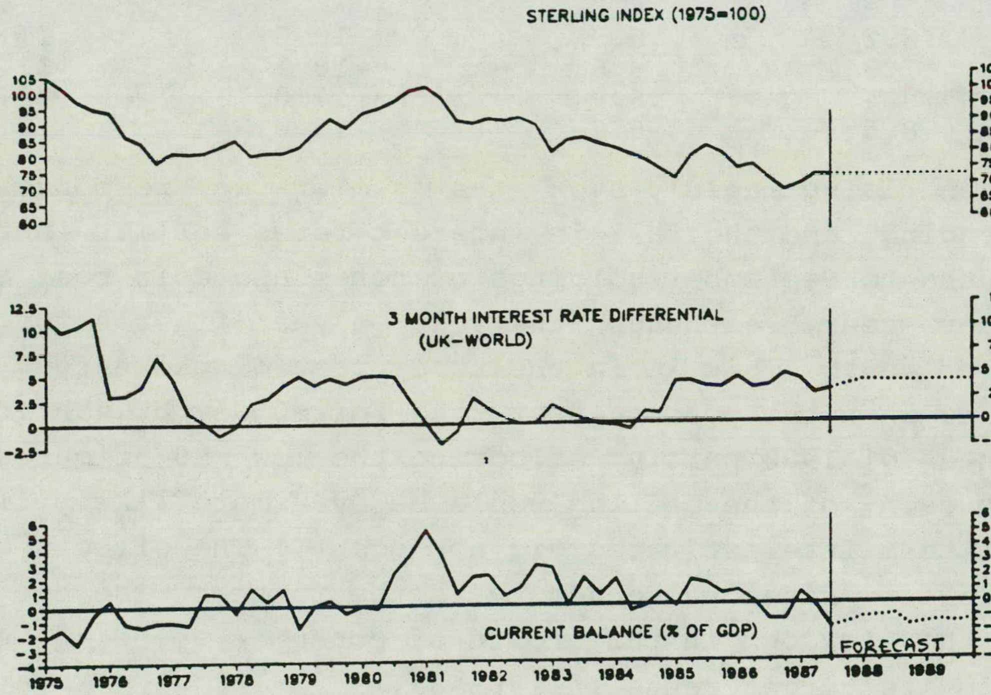


TABLE 26: EXCHANGE RATES AND COMPETITIVENESS
(average yearly rates)

	US dollar index (1975=1000)	Sterling index (1975=100)	$/£	DM/£	Relative unit labour costs (1980=100)
1984	134.6	78.6	1.34	3.79	82.9
1985	140.7	78.2	1.30	3.78	84.5
1986	114.8	72.8	1.47	3.19	77.3
7 Oct	101.5	73.3	1.64	2.998	75.4
1987	102.4	72.0	1.61	2.94	74.8
1988	98.1	72.5	1.68	2.94	76.7
1989	94.6	72.5	1.73	2.87	76.9

58. Domestic factors also point to upward pressure on interest rates. M0 will be very close to the top of its target range in the near future, reflecting strong growth in consumers' expenditure. Money GDP growth is expected to overshoot the objectives set in the 1987 FSBR in every year in the forecast period. Continued strong credit demand from the private sector - both companies and persons - tends to offset the decline in the needs of the public sector. The forecast has short-term interest rates rising over the next few months to reach 11 per cent by the middle of 1988Q1. This rise, however, is not sufficient to bring the growth of money GDP back to its MTFS path.

TABLE 27: INTEREST RATES

	3-month US interest rates	3-month world rates	3-month sterling LIBOR	Mortgage rate
7 October	7.9	6.9	10.2	11.3
1986-87	6.2	6.3	10.5	11.7
1987-88	7.3	6.6	10.1	11.5
1988-89	8.4	6.9	11.0	12.3
1989-90	8.5	6.9	11.0	12.3

59. M0 has been rising rapidly over the summer in response to buoyant consumer spending and the fall in interest rates earlier in the year. In the three months to September holdings of notes and coin rose at an annual rate of 8 per cent, although the year on year figures for M0 have been closer to 5 per cent. This is in the upper part of the target range, and the forecast is that the year-on-year rate for M0 may breach its ceiling in the early months of 1988 partly reflecting the low M0 figures in early-1987. (A breach of the ceiling would be even more likely if the assumed rise in short term interest rates did not occur.) The effects of the recent rise in interest rates together with the further rise projected in the forecast and the slowdown in the growth of consumer spending should bring M0 back within its target range in 1988-89.

TABLE 28: MONETARY AGGREGATES AND CREDIT

(per cent change on a year earlier)

	M0 MTFS range	M0 Actual forecast	M3	M4	Lending by banks and building societies
August 1987	-	4.7	22.1	15.6	18.8
1986-87	2-6	4.3	19.0	14.9	18.5
1987-88	2-6	5.1	20.4	14.9	18.9
1988-89	1-5	4.4	16.2	13.8	17.2
1989-90	1-5	3.4	13.0	12.7	14.8

60. Broad money has continued to grow rapidly, with M3 increasing by 22 per cent in the year to August reflecting a continued strong rise in deposits by persons, ICCs, and building societies with some slowdown in deposits by other financial institutions after the surge early in the year. The forecast is that M3 growth may slow next year. Persons' deposits may continue to rise rapidly reflecting rising personal incomes and the relative attractiveness of high-interest bank accounts. Companies' deposits, however, may increase less rapidly than in the recent past as their investment in real asset rises. Deposits by financial institutions may grow markedly less quickly than recently as a result of lower inflows to pension funds and a slower rise in their total portfolio. The growth of M4 which contains a greater proportion of personal sector deposits, continues to rise less rapidly than M3 initially, but the gap closes later in the forecast period.

61. Lending by banks and building societies which rose by 19 per cent in the year to August, is forecast to rise by a further 17 per cent in 1988-89 before slowing in 1989-90. Lending to companies is projected to rise as less buoyant securities markets limit at least to some extent companies' scope to rely on equity issues. Lending to persons is also projected to rise steadily for both housing and other purposes. Competitive pressures on building societies and the limit on their access to wholesale funds continues to erode their share of new mortgage advances.

62. The PSBR is assumed to be funded fully outside the banking system, but the move to a negative borrowing requirement leads to net gilt repayments of £7 billion in 1988-89 and £6½ billion in 1989-90 - even on the assumption that receipts from National Savings are reduced to £1 billion a year. Gross gilt sales fall from £9½ billion in the current financial year to £3½ billion in 1988-89 and £1½ billion in 1989-90.

63. The emergence of a growing current account deficit coupled with continued net direct investment outflows and further portfolio investment abroad by financial institutions implies the need for substantial

offsetting capital inflows. The precise form of these is difficult to judge. The forecast assumes that corporate security issues on both the euro currency and US commercial paper market will play a significant role. Banks are also assumed to increase both their foreign currency and sterling borrowing from abroad for on-lending to residents. Net overseas sales of gilts are projected at zero. The forecast assumes that £1 billion of the intervention so far in 1987-88 is unwound before the end of the financial year with a further £1 billion in 1988-89.

TABLE 29: NET EXTERNAL CAPITAL FLOWS

	Direct invest -ment††	Non bank port-folio*	Banks' foreign currency†	Banks' ster-ling	Other	Official reserves	Balan-cing item	Current balance
1986	-6.0	-7.1	2.9	-0.4	2.8	-2.9	11.7	-1.0
1987	-10.0	7.1	6.2	3.8	2.8	-5.7	-1.8	-2.4
1988	-5.3	0.8	2.2	2.2	2.1	1.3	1.0	-4.3
1989	-5.5	0.9	4.2	2.2	2.5	0.3	1.0	-5.6

* includes gilts
† includes securities
†† includes oil

(8) PUBLIC FINANCES

64. Table 30 summarises the forecast and compares it with the numbers in the FSBR, and with the internal June forecast. The projections in the FSBR were on the basis of certain conventional assumptions and not a central forecast.

TABLE 30 : PUBLIC SECTOR EXPENDITURE, REVENUE, AND BORROWING (£ billion)

	1986-87 Outturn	1987-88 FSBR	1987-88 June Forecast	1987-88 Oct. Forecast	1988-89 FSBR	1988-89 June Forecast	1988-89 Oct. Forecast	1989-90 FSBR	1989-90 June Forecast	1989-90 Oct Forecast
General Government Expenditure	165	174	173	**172½**	180	185	**184**	188	198	**197**
General Government receipts	160	169	172	**173**	178	187	**192**	187	201	**206**
Assumed cuts in personal taxes (cumulative)					3	3	**4**	5	5	**6**
GGBR	5	5	2	**-½**	5	2	**-3**	6	2	**-4**
Public corporations' overseas and market borrowing	-1½	-1	-1	**-½**	-1	-1	**-2**	-1	-1	**-2**
PSBR	3½	4	1	**-1**	4	1	**-5**	5	1	**-5**
(per cent of GDP) brackets)	(1)	(1)	(¼)	**(-¼)**	(1)	(¼)	**(-1)**	(1)	(¼)	**(-1)**

(a) <u>1987-88</u>

65. The PSBR for 1987-88 is now forecast to be a <u>surplus</u> of £1b. The

margins of error attached to PSBR forecasts made at this time of the year, whilst lower than those for the Budget forecast, are still very high. The average absolute error is around 0.8 per cent of GDP (£3b.).

66. The latest forecast represents an undershoot on the FSBR forecast of £5b., and a reduction of £2b. from the June forecast. Table 31 shows the main components of the £5b. reduction in the PSBR forecast since the Budget. Over three-quarters of the predicted undershoot of the FSBR forecast is accounted for by lower central government own account borrowing, with most of the remainder due to lower local authorities' borrowing. The forecast of public corporations' market and overseas borrowing is little changed. Looked at another way three-quarters of the downward revision to the forecast has been on general government receipts, and one-third to general government expenditure.

TABLE 31 : CONTRIBUTION TO THE CHANGE IN THE 1987 PSBR FORECAST SINCE JUNE AND THE FSBR

	£ billion Changes since	
	FSBR	June
- higher North Sea revenues from a higher North Sea oil price;	-¾	-
- higher non-North Sea corporation tax reflecting upward revisions to 1986 profits data and higher dividend payments (generating ACT) in 1987;	-1	-½
- higher income tax, in line with experience to date and mainly reflecting higher money incomes;	-¾	-¾
- higher national insurance contributions, reflecting higher money incomes;	-	-½
- higher VAT, in line with outturn to date, and reflecting buoyant expenditure and - we think - a larger than expected reduction in arrears as a result of the Keith reforms;	-½	-½
- higher stamp duty as a result of the buoyant housing and stock markets;	-	-½
- higher privatisation proceeds;	-¼	-¼
- a lower public expenditure planning total (excluding privatisation proceeds);	-1	-1¼
- offsetting increases, mainly lower 'other' receipts and higher national accounts adjustments	+¼	+1¼
TOTAL CHANGE IN PSBR FORECAST	-5	-2

67. Lower expenditure and higher receipts have contributed roughly equally to the £2b. reduction in the PSBR since June. The main upward revisions on the receipts side have been to income tax, non-North Sea corporation tax and VAT. On the expenditure side the main reduction is lower local authority net capital spending, reflecting higher capital receipts, but the forecasts of social security spending and nationalised industries' EFLs have also been reduced.

(b) <u>Fiscal adjustment and PSBR in 1988-89 and 1989-90</u>

68. The MTFS assumption of PSBRs of one per cent of GDP would, on present projections, imply a massive fiscal adjustment in 1988-89 of around £13½b., with a further annual fiscal adjustment of £3b. in 1989-90. The forecast makes the stylised assumption that higher than previously planned privatisation proceeds are used to reduce the PSBR and that one third of the remaining available fiscal adjustment for 1988-89, calculated on this basis, reduces personal taxes, with the remaining two thirds reducing the PSBR to a surplus equivalent to about 1 per cent of GDP. The assumed cut in taxes is a little larger than in the June forecast. In 1989-90 the PSBR is maintained at the arbitrary surplus of 1 per cent of GDP, and there is scope for a further cut in personal taxes of £2b.

(c) <u>Public expenditure</u>

69. The forecast of the planning total excluding privatisation proceeds in 1987-88 has been revised down since June, and instead of a small overspend of the 1987 PEWP plans, a £1b. undershoot is now forecast. Substantial overspends of the PEWP totals are forecast for 1988-89 and 1989-90, only a little less than those forecast in June. The forecast for these years takes account both of the differences between the economic assumptions used in the PEWP and of the economic prospects in the forecast, together with other pressures on programmes which past experience suggests are likely. The forecast is in effect attempting to anticipate not only the final outcome of the current survey (and in the case of 1989-90 the next survey as well), but also any eventual over or underspend on the finally agreed planning totals. The forecast incorporates some modest additions to expenditure in 1989-90 following the buoyant performance of the economy in general and public finances in particular in 1987 and 1988. Privatisation proceeds of £5¼b. are assumed for 1987-88, in line with PE's latest assessment. Proceeds of £6b. a year are assumed for 1988-89 and 1989-90.

70. Table 32 sets out forecast increases in actual programme spending compared with the 1987 PEWP in terms of economic rather than departmental categories. About half the projected excess above current programme plans is accounted for by social security and local authority current expenditure. These are areas over which the Government has limited direct control.

TABLE 32 : FORECAST ADDITIONS TO PROGRAMME BASELINES

£ billion

	1987-88		1988-89		1989-90	
	PEWP 1987	Forecast Claims on Reserve	PES 1987 Base-line	Forecast additions to baseline	PES 1987 Base-line	Forecast additions to baseline
Allocated to programmes						
1. Social Security (including HB)	44.7	0.5	46.1	2.2	48.0	4.1
2. LA current (excluding HB)	32.5	1.1	33.7	2.9	34.6	5.2
3. CG pay	24.8	0.5	25.8	1.5	26.6	2.9
4. CG procurement	24.6	0.1	25.0	1.4	25.9	2.3
5. LA capital	4.3	-0.7	4.0	-0.2	4.1	0.0
6. EC	0.9	0.4	0.4	0.9	1.1	0.6
7. Nationalised industries	0.7	-0.1	0.3	0.3	-0.1	0.7
8. Other	17.8	0.6	18.3	0.9	18.8	1.5
9. Total programmes	150.1	2.5	153.7	9.9	9.0	17.3
10. **Expenditure met from existing reserve**						
(i) allocated to programme baseline	0.0	2.5	0.0	5.5	0.0	7.5
(ii) unallocated	3.5	0.0	5.5	0.0	7.5	0.0
11. **Underspend (-) Addition to Reserve(+)**	0.0	-1.0	0.0	4.4	0.0	9.8
12. PLANNING TOTAL excluding privatisation proceeds	153.6	-1.0	159.2	4.4	166.5	9.8

71. The forecast of social security spending assumes that the underlying growth in spending - ie the growth after allowing for the effects of changes in unemployment, upratings, policy changes, demographic factors etc - which is projected to have risen rapidly in 1987-88, falls back somewhat in 1988-89 and 1989-90. The forecast of local authority current spending, most of which is pay, assumes that numbers employed will rise at much the same average rate as in the last 2-3 years and that earnings increases will be somewhat above the private sector average (see para 48). This, together with the RSG settlements announced in July, implies average rates increases of about 11 per cent in 1988-89.

72. The forecast of central government pay assumes little change in numbers and earnings increases averaging below the private sector in 1988-89 and much the same as the private sector in 1989-90 (see para 49). The forecast of central government procurement assumes that non-defence spending will rise in real terms at much the same rate as over the past 5 years, and that defence spending will rise at ½ per cent a year in real terms. Local authority capital receipts and gross capital spending are assumed to be higher than in the 1987 PEWP, but by roughly equal amounts in 1988-89 and 1989-90. The forecast has partially smoothed out the projected dip in net EC contributions in 1988-89 and the rebound in 1989-90.

73. The large upward revision to the planning total forecasts for 1988-89 and 1989-90 since the Budget are largely matched by a higher inflation forecast. Consequently the increase in the planning total in real terms is less than the cash increase. In real terms the planning total and GGE (see table 33) are much the same as earlier internal forecasts. The forecast of GGE in real terms is almost identical to that made a year ago for 1988-89 and less than 1 per cent higher for 1989-90.

TABLE 33 PAST AND CURRENT FORECASTS OF GGE EXCLUDING PRIVATISATION PROCEEDS

£ billion

Forecast	1986-87 Current prices	1986-87 Real Terms*	1987-88 Current Prices	1987-88 Real Terms*	1988-89 Current Prices	1988-89 Real Terms*	1989-90 Current Prices	1989-90 Real Terms*
Jan 1986	169	169	176	169	186	169	-	-
June 1986	169	169	177	170	186	171	-	-
Oct 1986	170	170	178	171	188	172	200	173
Jan 1987	170	170	179	171	190	173	202	175
FSBR 1987	169	170	179	171	185	171	193	172
June 1987	169	169	179	170	190	171	203	174
Oct 1987	170	170	178	170	190	172	203	175

* in 1986-87 prices

74. The ratio of GGE (excluding privatisation proceeds) to money GDP is forecast to show a sharp fall in 1987-88 and more modest falls in 1988-89 and 1989-90. It is below the PEWP/MTFS paths in all three years.

TABLE 34 : RATIO OF GGE EXCLUDING PRIVATISATION PROCEEDS TO MONEY GDP

per cent

	1985-86	1986-87	1987-88	1988-89	1989-90
1987 PEWP	44¾	44½	44	42¾	42½
1987 FSBR	44¾	44¼	43½	42½	41¾
Oct forecast	44¾	44	42¼	41¾	41¼

(d) General Government Receipts

75. The recent history of forecasts of general government receipts has been a series of successive upward revisions. The current forecast continues this pattern, with substantial upward revisions to 1988-89 and 1989-90

compared the with June forecast. The upward revision since June to the forecast for 1987-88 has been smaller (about £1b.), though this still leaves the 1987-88 forecast of revenues £4b. higher than that in the FSBR.

76. Part of the upward revision to 1987-88 receipts since the FSBR can be attributed to higher economic activity, including stronger than expected stock and housing markets, which have boosted stamp duty receipts. Higher non-North Sea corporation tax for the most part reflects stronger than previously estimated activity and profits in 1986. Higher non-North Sea corporation tax is the most important single factor behind the higher total receipts now forecast for 1988-89 and 1989-90, accounting for around half of the revision since June to 1988-89 and one-third of the revision to 1989-90. The revision to the forecasts partly reflects higher profits growth for 1987 (and thus higher tax receipts for 1988-89). The remainder of the upward revision since June to the receipts forecasts for 1988-89 and 1989-90 are for the most part attributable to higher income and expenditure (income tax, VAT and NICs account for between one-third and half of the total upward revision in each year), but the forecast of local authorities rates has been raised by between £¾ to £1b. in each year.

TABLE 35: COMPARISON OF FORECASTS OF GENERAL GOVERNMENT RECEIPTS (PRE-FISCAL ADJUSTMENT FOR 1988-89 AND 1989-90)*

£ billion

Forecast:	1986-87		1987-88		1988-89		1989-90	
	Cash	Real Terms	Cash	Real Terms	Cash	Real Terms	Cash	Real Terms
January 1986	157	153	166	159	178	162	188	164
June 1986	156	156	164	158	179	164	188	166
October 1986	156	156	165	159	181	165	196	169
January 1987	158	158	169	162	184	168	197	171
FSBR 1987	159	159	169	162	178	164	187	167
June 1987	159	160	172	164	187	168	201	172
October 1987	160	160	173	165	192	174	206	178

* Forecasts made before this and last year's Budgets have been adjusted to be consistent with current tax rates and allowances. Real terms figures are at 1986-87 prices.

77. Table 36 shows non-oil taxes and national insurance contributions (NICs) as a percentage of non-oil GDP. The changes to the tax forecast since the FSBR mean that the forecast now shows a substantial rise in the pre-fiscal adjustment tax burden for 1988-89, but this is offset by the assumed cut in taxes. The projected rise for 1989-90 is smaller, and is

again offset by the assumed tax cut. Thus with the stylised assumption used here on the allocation of the fiscal adjustment, the tax burden for 1989-90 is the same as the level for 1987-88. With oil revenues as a percentage of GDP expected to be broadly flat at the projected 1987-88 level, the ratio of <u>total</u> taxes to money GDP is forecast to follow a similar pattern to the non-oil ratio.

TABLE 36: NON-OIL TAXES AND NICs AS A PERCENTAGE OF NON-OIL GDP

	1985-86	1986-87	1987-88	1988-89	1989-90
FSBR					
(a) pre-fiscal adjustment	37.2	37.3	37.8	37.9	37.7
(b) post fiscal adjustment	37.2	37.3	37.8	37.1	36.6
June Forecast					
(a) pre-fiscal adjustment	37.3	37.7	38.0	38.4	38.8
(b) post fiscal adjustment	37.3	37.7	38.0	37.5	37.9
October Forecast					
(a) pre-fiscal adjustment	37.0	37.5	38.0	39.1	39.4
(b) post-fiscal adjustment	37.0	37.5	38.0	38.0	38.0

ANNEX I: PUBLIC EXPENDITURE ASSUMPTIONS

The forecast of public expenditure in 1987-88 takes account of the latest monthly data on expenditure, the expected evolution of the economy over the rest of the year (which affects such programmes as social security) and Treasury expenditure divisions' assessments of the likely final outturn. For 1988-89 and 1989-90 the forecasters attempt to predict the level of public expenditure that will occur (as opposed to the programme plans which will eventually be agreed). The forecast therefore implicitly includes judgements both on the results of the current round of Ministerial discussions (and for 1989-90 the results of the autumn 1988 discussions) and on the influence of the forecast evolution of the economy on demand led public expenditure.

2. In constructing the forecast it is necessary to make detailed assumptions in certain areas. The main ones were as follows:

(i) The outturn percentage for local authorities' Aggregate Exchequer Grant, which on the basis of the forecasters' view of relevant expenditure, is forecast to fall from 45¾ per cent (GB, accruals) in 1987-88 to 45¼ per cent in 1988-89, is assumed to fall a further ½ percentage point in 1989-90.

(ii) The forecast assumes an increase in the VAT ceiling for EC own resources contributions from 1.4 to 1.6 per cent with effect from 1 January 1988 and that a Community Budget is agreed before 31 March 1988.

(iii) Privatisation proceeds are assumed to be £6 billion per annum in 1988-89 and 1989-90. For 1987-88 PE's latest best estimate of £5¼ billion is used.

(iv) The Treasury Supplement to the National Insurance Fund is assumed to be reduced by 2 per cent in 1988-89 and a further 2 per cent in 1989-90, to a level of 3 per cent.

3. The table below compares the forecast with the main economic assumptions used in the 1987 PEWP, the 1987 MTFS, and with assumptions which have either already been agreed, or proposed (Mr Davies' minute of 2 October to the Chancellor) for use in the forthcoming Autumn Statement and PEWP.

	1986-87	1987-88	1988-89	1989-90	1990-91
GDP Deflator (%)					
1987 PEWP	3	3¾	3½	3	
1987 MTFS	3¼	4½	4	3½	
October Forecast	3	4½	5½	5¼	
Proposed New Assumption	3	4½	5	3½	3
Money GDP (%)					
1987 PEWP	5½	7	6	5½	
1987 MTFS	6	7½	6½	6	
October Forecast	6½	9	8½	7¾	
Money GDP (£b)					
1987 PEWP	380.2	407.0	431.4	455.2	
1987 MTFS	382.4	411.0	437.2	463.8	
October Forecast	385.3	419.5	455.1	490.4	
Unemployment (Adult, GB millions)					
1987 PEWP	3.1	3.05	3.05	3.05	
October Forecast	3.0	2.7	2.5	2.5	
Agreed New Assumption	3.0	2.7	2.6	2.6	
RPI* (%)					
1987 PEWP			3¾	3½	
October Forecast			4.2	5¼	
Proposed New Assumption			4.2	5	3¼
Average Earnings (%)					
March Assumptions		6½	6	5½	5
October Forecast	8	8¼	8	8	
Agreed New Assumption		7½	6½	5½	5
UK 3 month LIBOR					
March Assumptions		9¾	9½	9½	9
October Forecast		10	11	11	
Proposed New Assumption		10	10	9½	9
UK 20 year gilt rate					
March Assumptions		9	9	9	9
October Forecast		10	11	11	11
Proposed New Assumption		10	10	9	9
6 month dollar LIBOR					
March Assumptions		7	8½	9	9½
October Forecast		7¾	8¾	9	
Proposed New Assumption		7½	8½	9	9

* increases in year to previous September

ANNEX II : SECTORAL SURPLUSES AND DEFICITS

Table IIA compares sectoral net acquisition of financial assets by sector (sectoral surpluses and deficits) as proportions of money GDP since 1948. The overseas sector surplus is the current account deficit with the sign changed. Similarly the public sector's surplus is the PSFD with the sign changed.

The large forecast residual error reflects and continues discrepancies between the measures of GDP in the first half of 1987. Normally the residual error comes down as the CSO reduces measurement of errors for a particular period.

For 1988-89 and 1989-90

(i) The **total private sector surplus** is lower than in any year since 1974-75. It is not particularly low compared with earlier experience.

(ii) The **personal sector surplus** is low in comparison with experience in the years from 1960. It is not low in comparison with the earlier period.

Table IIB shows the PSBR, the PSBR adjusted for privatisation receipts, and the PSFD (public sector financial deficit) as proportions of money GDP.

For 1988-89 and 1989-90

(i) The **PSBR** ratio, at -1 per cent, is lower than in every year since 1952 except 1969-70.

(ii) The **PSFD** ratio is lower than in every year except 1968-69, 1969-70, and the three years to 1950.

SECRET

TABLE IIA: NET ACQUISITION OF FINANCIAL ASSETS BY SECTOR (AS PER CENTAGE OF GDP)

	Personal (1)	ICC (2)	Financial (3)	Total Private Sector (4)	Public (5)	Overseas (6)	Residual Error (7)
Calendar Years							
1948	- 2.8	1.8	0.3	- 0.7	2.2	- 1.4	- 0.2
1949	- 2.6	2.1	0.3	- 0.1	2.4	- 1.2	- 1.1
1950	- 2.1	3.1	0.3	1.3	2.6	- 3.3	- 0.6
1951	- 3.2	2.5	0.3	- 0.4	- 1.6	2.2	- 0.2
1952	0.1	4.0	0.5	4.6	- 3.4	- 1.0	- 0.1
1952	- 0.4	3.7	0.3	3.7	- 4.1	- 0.8	1.2
1954	- 1.6	3.6	0.4	2.3	- 2.4	- 0.6	0.7
1955	- 1.4	2.1	0.4	1.1	- 2.0	+ 0.8	0.1
1956	0.2	2.0	0.3	2.6	- 2.6	- 1.0	1.0
1957	0.0	1.5	0.4	1.9	- 2.4	- 1.0	1.5
1958	- 0.6	2.1	0.3	1.8	- 1.9	- 1.6	1.7
1959	- 0.3	1.8	0.2	1.6	- 2.2	- 0.7	- 1.3
1960	1.1	0.9	0.2	2.3	- 2.7	+ 0.9	- 0.4
1961	2.3	- 0.2	0.2	2.4	- 2.6	- 0.2	0.5
1962	2.0	0.0	0.2	2.1	- 1.8	- 0.5	0.2
1963	1.9	1.4	- 0.2	3.0	- 2.6	- 0.4	0.0
Financial Years							
1963/64	1.9	1.8	- 0.3	3.4	- 3.3	0.0	- 0.1
1964/65	2.6	- 0.6	- 0.5	1.5	- 2.4	1.0	- 0.1
1965/66	3.6	- 1.0	- 0.5	2.1	- 1.7	0.2	- 0.6
1966/67	2.5	0.8	- 0.7	2.6	- 2.6	- 0.4	0.4
1967/68	2.0	1.6	- 0.8	2.8	- 4.2	1.1	0.2
1968/69	1.2	0.5	- 1.1	0.6	- 0.8	0.3	- 0.1
1969/70	1.5	0.7	- 1.6	0.6	1.7	- 1.5	- 0.8
1970/71	2.1	0.8	- 1.2	1.7	0.4	- 1.1	- 1.0
1971/72	0.1	2.4	- 0.7	1.8	- 1.1	- 1.7	1.1
1972/73	1.4	2.5	- 0.5	3.3	- 3.0	0.4	- 0.7
1973/74	3.4	0.0	- 0.7	2.7	- 4.6	2.0	- 0.1
1974/75	4.3	- 1.7	- 0.7	2.0	- 6.7	3.6	1.2
1975/76	4.1	0.9	- 0.7	4.3	- 7.3	1.0	2.0
1976/77	3.4	- 0.5	0.2	3.1	- 5.7	1.1	1.5
1977/78	2.6	1.1	0.3	4.0	- 4.4	0.0	0.4
1978/79	4.5	0.3	0.2	5.0	- 4.8	- 0.3	0.1
1979/80	4.4	- 0.3	0.2	4.2	- 3.9	0.1	- 0.4
1980/81	6.6	0.3	- 0.3	6.6	- 5.0	- 2.5	0.8
1981/82	4.9	0.3	- 0.2	5.0	- 2.0	- 1.8	- 1.2
1982/83	3.5	2.0	0.1	5.6	- 2.9	- 1.6	- 1.0
1983/84	2.9	2.4	0.4	5.7	- 3.7	- 0.9	- 1.1
1984/85	3.2	2.2	0.0	5.4	- 4.0	0.0	- 1.4
1985/86	2.3	1.9	0.3	4.6	- 2.3	- 1.1	- 1.2
1986/87	1.3	1.7	1.4	4.5	- 2.5	0.2	- 2.2
Forecast							
1987/88	0.5	1.9	0.9	3.2	- 1.0	1.0	- 3.1
1988/89	0.5	0.8	1.1	2.4	- 0.5	1.0	- 3.0
1989/90	0.2	1.0	0.9	2.1	- 0.3	1.2	- 3.0

NB: Columns 1 + 2 + 3 = 4
Columns 4 + 5 + 6 + 7 = 0

SECRET

Table IIB: PUBLIC SECTOR BORROWING as a percentage of GDP

	PSBR	PSBR less Privatisation proceeds	PSFD
1948			-2.2
1949			-2.4
1950			-2.6
1951			1.6
1952	5.0		3.5
1953	3.4		4.1
1954	2.0		2.4
1955	2.4		2.0
1956	2.7		2.6
1957	2.2		2.4
1958	2.1		1.9
1959	2.3		2.2
1960	2.7		2.7
1961	2.5		2.6
1962	1.9		1.8
1963	2.7		2.6
1963-64	3.3		3.4
1964-65	2.7		2.4
1965-66	2.6		1.7
1966-67	2.9		2.6
1967-68	4.9		4.2
1968-69	0.8		0.8
1969-70	-1.2		-1.7
1970-71	1.5		-0.4
1971-72	1.6		1.1
1972-73	3.6		3.0
1973-74	5.8		4.6
1974-75	9.0		6.7
1975-76	9.3		7.3
1976-77	6.4		5.7
1977-78	3.6	3.9	4.4
1978-79	5.3	5.3	4.8
1979-80	4.8	5.0	3.9
1980-81	5.4	5.5	5.0
1981-82	3.3	3.5	2.0
1982-83	3.1	3.3	2.9
1983-84	3.2	3.5	3.7
1984-85	3.1	3.7	4.0
1985-86	1.6	2.3	2.3
1986-87	0.9	2.0	2.5
		Forecast	
1987-88	-0.3	1.0	1.0
1988-89	-1.1	0.2	0.5
1989-90	-1.1	0.1	0.3

4·2?

SECRET

MG NOON REPORT

FINANCIAL MARKETS — Monday 12 October 1987

Opening	10 AM		NOON	Oil Price (10 AM)	
73.4	73.4	£ERI	73.4		
1.6500	1.6510	$/£	1.6524	Oct	$18.82
2.9964	2.9957	DM/£	2.9958	Nov	$18.62
1.8160	1.8145	DM/$	1.8130	Dec	$18.57
143.80	143.70	Yen/$	143.60		

UK interbank £			Eurodollars	
9 9/16	(-1/4)	7 day	7 5/8	(+1/16)
9 13/16	(-1/16)	1 month	7 15/16	(+1/16)
10 3/16	(-3/32)	3 month	8 13/16	(+1/16)
10 11/16	(-)	12 month	9 1/4	(-1/8)

Figures in brackets show change since previous market close

MARKET COMMENT In the foreign exchange market the dollar opened little changed from Fridays close and has remained steady this morning. It had eased a little in New York on Friday night due to the softer bond and stock market but picked up again in the Far East on short covering ahead of todays holiday in New York. Sterling opened firmer on Friday's close and has remained steady in a quiet London market. The gilts market is slightly better.

R L McNobbs

MARKET INTERVENTION ($m) — OTHER COUNTRIES INTERVENTION ($m)

Overnight	+165$	New York
	+130$	Far East
Today so far	-	
Total	+295$	

GILTS

	Latest market movements	Price change since previous close
Shorts	Steady	+3/32
Mediums	Steady	+6/32
Longs	Better	+5/32
Futures (Long Contracts)		+7/32 (Vol:7657)

Gilt Sales since market opening

£0 million

NAME: I.C.Polin, MG1 Division
TEL NOS: 270 5556/5560

SECRET

Chancellor, Some suggestions. None of these Statements has been checked yet - but I think they are 'broadly' accurate

12/10/87.

PMP

THE WORLD ECONOMY

1. The fall in the stock market has been sudden and alarming. After a long period of rising share prices a sizeable correction was not unexpected or unprecedented. What has attracted attention is the speed of correction.

2. Not sure that it is ever possible to explain spasms like this. Very often a number of underlying factors at work that are triggered by one or more specific events. No intention of trying to provide one comprehensive explanation: instead look at the background factors: how international economy has been developing; possible implications for world economy of stock market fall; and the appropriate policy responses of governments.

The Emergence of Imbalances

3. Not possible to understand tensions in financial system without picture of the imbalances that have emerged.

4. From broad balance in early 1980s have now moved to a position where US current account deficit of 3 per cent of GDP. And surpluses in Japan and Germany of similar magnitude. Thee problems did not appear overnight. Emerged over many years; domestic demand in the US has risen faster than underlying growth of the economy; in Japan and Germany have seen the mirror image.

5. Fiscal policy has been very different between countries; in the mid-80s saw a huge increase in US budget deficit, far beyond their capacity to finance it from internal savings. In Germany and Japan saw reductions in budget deficits that went beyond any reduction of domestic savings.

6. Also noticeable that economies recovered from second and third oil price shocks at different speeds. US has adjusted well; absorbed large increase in labour supply and unemployment back to levels not out of line with past. Germany and Japan have been slow to adjust; albeit in different ways. Germany has grown slowly throughout the 1980s; its supply performance has not adjusted in the same way as the US - or the UK for that matter. Whilst Japan continues to be slow in opening its markets to foreign goods and distorts the pattern of production to this end.

7. If this was not enough we have also had to cope with hugely exaggerated swings in key exchange rates. Between 1980 and the early months of 1985 the dollar rose by 50 per cent. Since then it has fallen by almost as much. Such swings set up their own tensions and pressures. Economies can only adjust slowly to large swings in real exchange rates. The key feature of real exchange rate changes is the incentive it sets up to change the direction of output from the home to overseas markets. In turn this means directing resources into different products, markets and industries. And we know that change takes time.

The Policy Response

8. There have been long-standing concerns and Finance Ministers of the major countries have been involved in a major co-operative effort to smooth the path of adjustment. And there have been a number of achievements:

- US has ben reducing its budget deficit down from $221 billion in 1986 to $148 billion in 1987.

- Japan has taken some important steps to open its markets and has made some adjustment to fiscal policy to encourage domestic demand growth, [particularly in the construction industry].

- Germany has put in place a tax reform programme that should also help to sustain the growth of domestic demand.

9. In addition we have seen a major co-operative effort to manage the necessary adjustment of the dollar at a pace that the world economy could live with.

10. The first milestone was the Plaza meeting at which the Finance Ministers of the G5 agreed to co-operate to bring about a substantial depreciation of the dollar.

11. The second milestone was the Louvre meeting. By then the dollar had declined by [ ] per cent from its 1985 peak. The Finance Ministers agreed at the Louvre to co-operate to bring about a period of stability for the dollar, to allow time for the major economies to adjust to the depreciation that had taken place.

<u>The Louvre and later</u>

12. At the time of the Louvre agreement there was widespread scepticism. And yet between February and the recent turbulence in markets exchange rates were broadly stable.

13. Having been wrong about the outcome for exchange rates, critics have now changed tack; they now agree that the achievement of the Louvre agreement has de-stabilised monetary policies; and that it has somehow or other been responsible for the fall in equity prices and that the dollar should now fall far enough to guarantee current account balance in the US.

14. I would like to comment on each of these suggestions.

15. The success of the Louvre agreement has been based upon a willingness of countries to give a significant weight to exchange rates in the conduct of monetary policy. It is not

at all surprising or worrying that following the huge dollar depreciation monetary growth in Japan and Germany has quickened whilst in the US it has slowed. The essential principle is that changes in exchange rates themselves exercise a significant influence over monetary conditions. A substantial exchange rate depreciation itself loosens monetary conditions and **ceteris paribus** points to a need for slower growth of domestic monetary indicators; and **vice versa**. Obviously there is no simple rule but the aim must be to maintain a balance between external and internal indicators.

16. Intervention has also been a necessary part of the agreement. In turn this has implications for domestic monetary aggregates. In the longer term these flows will either have to be reversed or sterilised; in the short run there is much less urgency.

17. I have seen suggestions that the Louvre agreement has been responsible for the fall in share prices. I have to say that I see the position almost exactly in reverse; that it was the threat of a breakdown of the Louvre agreement that was so alarming to many market participants.

18. The world would be ill-served by a vicious downward spiral of the dollar. As we have seen exchange rate movements easily feed upon themselves. Imagine an undershooting of the dollar on the scale that we saw in reverse in 1984-5. Inflation and interest rates would be forced up in the US. There would be further dislocation in the key economies as they sought to adjust between production for the home and overseas markets. As the experience of recent years has shown, in all likelihood this would have caused another sharp slowdown in activity.

The Impact of the Fall of Share Prices

19. While there may be some dispute about the cause of the fall in share prices I see general agreement with the proposition that the effect will be to tighten monetary conditions around the world.

20. Financial wealth in the main industrial countries will be adversely affected. This is likely to dampen spending. It is impossible to say by how much. But there have been signs this year that the strength of financial markets has been a factor in keeping spending buoyant, particularly in the US, UK and Japan - the countries where equity markets play the biggest role. This effect will be reversed.

21. We are also likely to see a reversal of some of the side effects of the equity price boom, particularly in the housing markets of the main financial sectors of the world. In itself this is not at all alarming.

22. The overall result is that the balance of risks in the world economy has now changed: both output growth and inflation are likely to be lower in 1988 than we previously thought. Already see signs in weaker commodity prices.

23. Key is that this should not become exaggerated by a blow to industrial confidence. This requires that the major countries follow policies designed to cushion the impact of the equity price falls. In 1929 the response to the stock market crash was a tightening of monetary policy and beggar-my-neighbour trade policies. It is vital that we do not repeat that disastrous combination. And international co-operation will be essential. One of the lessons of the 1930s is that beggar-my-neighbour ended up as beggar-myself. That would be equally true today.

24. The United States authorities have been quick to inject liquidity into their economy and have made clear that an excessive tightening of monetary policy does not take place. In the UK we have also moved to reduce interest rates - and it goes without saying that the liquidity of the system will be protected.

25. What is needed now is a complementary international response. There are several vital components:

- the United States, a clear and credible programme to continue the reduction in the budget deficit - credibility if it includes tax increases and addresses later years;

- in Germany and in Japan a greater willingness to recognise changed circumstances and need to reduce interest rates at least for the time being in the interests both of exchange rate stability and of maintaining domestic demand growth. If their interest rates were correct two weeks ago, they can't be now.

- build upon Finance Ministers' co-operation, above all on exchange rate and economic policies, begun at Plaza.

26. The system of managed floating being worked out has already proved its worth; need to develop further. Set out in IMF Speech key components:

- agreement on appropriate exchange rate bands.

- global surveillance to ensure no bias towards inflation or deflation.

etc

C7/2

PWP

STOCK MARKET INDICES CLOSE 18/11/87 (or latest)

Index	(a) year earlier	(b) 1987 high	(date of high)	(c) 15 October 1987
	% change on			
FTSE 100	+ 3	-32	(16 July)	-28
Dow Jones Industrial (5pm)	+ 4	-30	(25 August)	-19
Nikkei Dow	+32	-15	(14 October)	-14
CAC General (France)(17 Nov)	-21	-35	(26 March)	-18
Commerzbank (Germany) (17 Nov)	-31	-34	(17 August)	-29
Hang Seng (Hong Kong)	+ 2	-42	(1 October)	-38
All Ordinaries (Australia)	- 2	-44	(21 September)	-40

STOCK MARKETS

	LONDON Level	LONDON Change	NEW YORK Level	NEW YORK Change	TOKYO Level	TOKYO Change
November						
Wednesday 11	1639		1899		21037	
Thursday 12	1702	+63	1960	+61	21547	+510
Friday 13	1678	-24	1935	-25	22488	+941
Monday 16	1685	+ 7	1949	+14	22615	+127
Tuesday 17	1660	-25	1922	-27	22344	-271
Wednesday 18	1664	+ 4	1897(*)	+25	22734	+390
Changes on week earlier		+25		- 2		+1697
Earlier weeks (ending Thursdays)						
October 15	2302		2355		26428	
October 22	1833	-469	1950	-405	24404	-2024
October 29	1682	-151	1938	- 12	22034	-2370
November 5	1639	- 43	1985	+ 47	22630	+ 596
November 12	1702	+ 63	1960	-25	21547	-1083

(*5pm)

C7/1

EXCHANGE RATES
(London Close)

	DM/$	Y/$	$/£	DM/£
November				
Wednesday 4	1.7080	137.00	1.7467	2.9834
Thursday 5	1.6845	135.55	1.7705	2.9824
Friday 6	1.6730	135.05	1.7870	2.9897
Monday 9	1.6628	134.45	1.7912	2.9784
Tuesday 10	1.6655	134.50	1.7875	2.9771
Wednesday 11	1.6760	135.30	1.7800	2.9833
Thursday 12	1.6860	135.70	1.7680	2.9808
Friday 13	1.6920	136.02	1.7665	2.9889
Monday 16	1.7142	137.05	1.7415	2.9853
Tuesday 17	1.6935	135.70	1.7610	2.9823
Wednesday 18	1.6955	135.95	1.7610	2.9867

C7/2

pw

STOCK MARKET INDICES CLOSE 17/11/87 (or latest)

% change on

Index	(a) year earlier	(b) 1987 high	(date of high)	(c) 15 October 1987
FTSE 100	+ 2	-32	(16 July)	-28
Dow Jones Industrial (7pm)	+ 2	-30	(25 August)	-19
Nikkei Dow	+30	-16	(14 October)	-15
CAC General (France)(13 Nov)	-23	-37	(26 March)	-20
Commerzbank (Germany)	-31	-34	(17 August)	-29
Hang Seng (Hong Kong)	+ 2	-42	(1 October)	-38
All Ordinaries (Australia)	- 2	-44	(21 September)	-40

C7/3

STOCK MARKETS

	LONDON		NEW YORK		TOKYO	
	Level	Change	Level	Change	Level	Change
November						
Tuesday 10	1573		1878		21686	
Wednesday 11	1639	+66	1899	+21	21037	-649
Thursday 12	1702	+63	1960	+61	21547	+510
Friday 13	1678	-24	1935	-25	22488	+941
Monday 16	1685	+ 7	1949	+14	22615	+127
Tuesday 17	1660	-25	1904* (*7.30)	-44	22344	-271
Changes on week earlier		+87		+22		+658
Earlier weeks (ending Thursdays)						
October 15	2302		2355		26428	
October 22	1833	-469	1950	-405	24404	-2024
October 29	1682	-151	1938	- 12	22034	-2370
November 5	1639	- 43	1985	+ 47	22630	+ 596
November 12	1702	+ 63	1960	-25	21547	-1083

C7/1

EXCHANGE RATES
(London Close)

	DM/S	Y/$	$/£	DM/£
November				
Wednesday 4	1.7080	137.00	1.7467	2.9834
Thursday 5	1.6845	135.55	1.7705	2.9824
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Monday 16	1.7142	137.05	1.7415	2.9853
Tuesday 17	1.6935	135.70	1.7610	2.9823

FROM: **COLIN MOWL**
DATE: 12 OCTOBER 1987

PPS/CHANCELLOR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
PCC
MEG
Mr Hawtin
Mr Luce
Mr Moore
Miss Peirson
Mr Grice
Mr Matthews
Mr Melliss
Miss O'Mara
Mr Riley
Mr Cropper
Mr Tyrie
Mr Call

TREASURY ECONOMIC FORECAST: CORRIGENDA

There were some mistakes in the forecast reports circulated on 9 October.

Main Report

("Treasury Economic Forecast" - Mr Sedgwick's minute of 9 October)

P.5 Table 2 - the figures for the UK General Government Fiscal Deficit in 1987 and 1988 were wrong. The table should have read as follows:

TABLE 2 : GENERAL GOVERNMENT FISCAL DEFICITS AS A SHARE OF GDP (%)

	1979-85	1986	1987	1988	1989
UK	3.1	2.6	1.8	1.1	0.6
G7 (less UK)	3.1	3.1	2.8	2.7	2.7

P.24 Table 18 - the figure published last week for the increase in the RPI excluding mortgage interest payments was 3.5 per cent not 3.4 per cent.

P.34 Table 31 - the two columns of figures for the 4th and 6th rows (ie NICs and stamp duty) should be transposed as follows:

	Changes since	
	FSBR	**June**
- higher NICs........	-½	-
- higher stamp duty	-½	-

Annex I - in para 2(i) the AEG percentage in 1988-89 should be 45 not 45¼.

Public Finances Report

("Treasury Economic Forecast, October 1987 : Public Finances - Mr Mowl's minute of 9 October).

P.2 Table II - the average increase in private sector average earnings in 1989-90 pay round is 7½ per cent not 8½ per cent.

P.5 Table V - the ROSSI uprating in the October Forecast for 1988-89 is 3.2 per cent not 3.6 per cent.

Colin Mowl

C MOWL

3766/27

FROM: G R WESTHEAD
DATE: 13 October 1987

ECONOMIC SECRETARY TO THE TREASURY

PS/CHANCELLOR

cc: PS/Sir P Middleton
Mr Cassell
Mrs Lomax
Mr Murphy
Mr Pickford
Mr Flitton

Mr Bridgeman, BSC
Mr Watson, BSC

BUILDING SOCIETIES: ECONOMIC SECRETARY'S SPEECH TO SALOMON BROTHERS - THURSDAY 15 OCTOBER 1987

I attach a near-finalised version of the Economic Secretary's after-dinner speech to Salomon Brothers' Building Society Seminar on Thursday.

2. I would be grateful for any comments that the Chancellor might have on the speech and also the attached draft Treasury Press Release. If possible, I would be grateful for these during the course of tomorrow.

Guy Westhead.

GUY WESTHEAD
Assistant Private Secretary

Ch
I have just one comment (flagged X)
AA

I (strongly) agree with 1/2 your comment. I have also initialled one other change.
Mr. Westhead is best [illegible] to [illegible] the EST's [illegible] in future.

3766/004

ECONOMIC SECRETARY TO THE TREASURY

INTRO

THE ACT AND ITS OBJECTIVES

I have been asked to speak to you on how the government expects the legal framework within which Building Societies operate to evolve.

The Building Societies Act which gained Royal Assent in July 1986 was the first comprehensive reform of the law affecting building societies since 1874.

The passage of time alone made a new Act desirable. But, even more important, the very rapid pace of change in financial services meant a much more flexible legal framework was needed. The new Building Societies Act was an essential part of the trilogy of Acts also covering Banking and Financial Services.

The Act is deliberately designed to be flexible. By that I mean it gives considerable scope to vary detailed provisions by secondary legislation. Whether or not the Act will last quite as long as its predecessor, it will provide the basic framework within which building societies will evolve for the foreseeable future.

The old 1962 Building Societies Act limited societies to being mutual institutions engaged almost exclusively in the provision of residential mortgages, funded by personal deposits. Originally these limitations were no problem since that was how and why building societies had been established. But the old definition of a society became a straitjacket as the financial market place became more sophisticated. Societies' members increasingly wanted ancillary services in conjunction with savings and borrowing facilities. Other financial institutions were able to offer such ancillary services whereas building societies were prevented from doing so. Other institutions also had access to sources of funds which could be cheaper or more flexible than retail funds on which building societies were almost exclusively reliant.

The problem was intensified as other financial sectors were to some extent deregulated. Once banks in particular were freed from the corset they began to enter the market for housing finance competing directly with building societies.

So the primary purpose of the Building Societies Act is to allow societies to extend the range of services they offer while remaining predominantly engaged as mutual institutions in their traditional business of mortgage lending financed from retail savings. It was certainly not the objective of the Act to induce building societies to abandon their traditional business and structure.

At the same time it was recognised that the normal benefits of competition would flow from allowing an increase in the number of players and extending the frontiers of competition in the provision of financial services. Those benefits are, of course, improved services for borrowers and lenders provided with the optimum use of resources.

In most industries greater competition can be achieved by simply abolishing regulations entirely. But that is not appropriate for financial institutions generally, including building societies, because of the need to protect investors, another main plank of the Act. This requires regulation for a number of reasons:

- building societies as a whole depend on confidence which would be undermined by the failure of any individual society,

- building societies are quintessentially the guardians of the small and less sophisticated saver who most needs protection and

- building societies had been prevented from developing expertise outside their narrow specialism.

So the new regulatory framework had to allow building societies greater freedom whilst ensuring that they were not compelled by competitive pressures to run before they could walk. The Act therefore opened up a range of new activities immediately and gave the authorities the opportunity to extend the boundaries further as societies digest the initial change and build up expertise

The range of new activities permitted from January of this year under the new Act was quite extensive:

- lending on non-residential property

- unsecured lending,

- ownership of land,

- wider borrowing from wholesale markets,

- money transmission services

- provision of personal pensions and PEPs,

- ownership of estate agents.

In addition, a number of changes, some still subject to Parliamentary approval, have been announced under secondary power conferred by the Act. For example:

- to offer credit cards as principals,

- to give advice on a wide range of investments,

- power to pass unit trust orders direct to unit trust managers.

The question is - how fast should the pace of change be from now on?

We must certainly continue to bear in mind the dangers of societies, under pressure of competition, trying to run before they can walk and tripping up through lack of expertise.

Equally important, we must try to avoid hamstringing societies which have developed the expertise to cope with further change.

Experience so far suggests three lessons:

First, there is a wide dispersion of management ability and ambition to extend into new activities. There is no reason why every society should move at the same pace or pursue the same strategy of diversification. So it would be wrong to hold everyone back to the pace of the slowest. Consequently if we continue to extend the frontiers at a pace with which the most experienced societies can cope, the role of the BSC in ensuring prudential restraint by the less experienced societies will become more important. To some extent this is already happening. For example the BSC agrees with each society an appropriate limit on its borrowing from the wholesale market based on its expertise and control systems. In many cases, this is below the current 20% maximum permitted by the Act. I look forward to receiving before long from the BSC their recommendations on the BSA's proposal to raise the wholesale funding limit.

Jolt

The second lesson of recent experience is that the financial world as a whole, including banks and other institutions which compete with building societies, is changing very rapidly. It is up to building societies themselves to develop their activities so as to compete successfully. The Government's role is to ensure that there are no artificial constraints in the Act which will hamper them. This we are doing.

The third lesson of experience so far is that by no means all the change taking place involves diversification into wholly new fields. Much of it involves changing the detailed ways of carrying out activities which the Act envisages being undertaken by building societies. At present the Act is framed so as to prevent societies from undertaking new financial services activities unless they are expressly provided for in Schedule 8. This creates problems because the detailed terms of the Schedule may not correspond exactly to the best commercial way of doing things. Hence the review of schedule 8 which I announced recently.

This Review will be undertaken jointly by the Treasury and the Building Societies Commission, but in full consultation with representatives of the building society movement.

It will do two things. First, we will seek to revise the structure of Schedule 8, so that it describes in broad terms what societies can do and specifies within that those activities expressly forbidden. This would change the presumption at the margin that societies can do things rather than they cannot do them and thus, I hope, remove as far as possible many of the irritations societies have experienced in operating within their new powers. Of itself, redrafting the schedule will not extend the range of activities in which societies may engage.

But secondly we will also take the opportunity to look at the various requests societies have made for extensions of their powers into new areas.

It is important that any changes which might be made as a consequence of this review do actually succeed in reducing the difficulties with the present schedule and do not simply create a whole set of new problems. For this reason, the review may take a little time. I know societies are anxious that any new powers should be ready for adoption in their Spring AGMs. We will, of course, proceed with all the speed that we can. But I know that you will support us in our desire to be as thorough as is necessary.

The changes which have been made by the Act itself and subsequent secondary legislation extend the frontiers of competition between building societies and banks and other financial institutions. But building societies remain different animals from banks. The Building Societies Act enshrines three distinctive characteristics which define a building society. They are:

mutuality
specialisation~~, primarily,~~ in housing finance and
reliance, primarily, on personal savings.

These are reflected in the Act's "nat~~ive~~ure limits", such as the restrictions on the volume of assets representing new activities. Any society wishing to abandon these characteristics must obtain the permission of its members to convert. That route will become available under the Act from 1 January 1988. The BSC is currently considering responses to its draft proposals on the detailed procedures. Perhaps I could make a few general points.

The view has recently been expressed that building societies will feel compelled to convert more or less against their will to escape from what are perceived to be unnecessary limitations imposed upon them by the Act. Can I make it clear that the Government has no intention of artificially inducing societies to convert to company status by unnecessarily hampering their development into activities compatible with their defining characteristics. So no society should feel compelled to convert for that reason.

Another widespread, but in my view mistaken, opinion is that if one or two major societies choose to convert virtually every major society will be compelled to follow suit. This ignores the experience of the insurance world where mutual funds compete alongside companies. The fact is that mutuality and specialisation have considerable advantages as well as limitations. The public has great confidence in and even affection for building societies because of their mutual status.

And many societies will wish to exploit that even if others choose to forego it in order, for example, to link up with a banking group. Likewise specialisation has advantages to compare with those of diversification. It is normal in many markets for some producers to exploit the advantages of specialisation alongside others who go for diversity.

Do we want to highlight either of these?

Finally it should be remembered that conversion to banking status has disadvantages as well as advantages. For example, Banks have more onerous capital adequacy requirements on mortgage assets than do building societies. ~~And they are, of course, more open to takeover than a mutual society which may cherish its independence.~~ So we do not envisage all societies converting en masse even though some may do so.

There was a time, less than a decade ago, when the mortgage market was almost exclusively the province of building societies. Those days have passed, and passed for good. The mortgage market today is perhaps one of the most competitive in the financial services field. Not only have new players entered the market, but market innovations are leading to the application of new techniques to the provision of mortgage finance.

Competition and innovation is leading to new combinations and specialisations of mortgage provision. For example, insurance brokers and estate agents are playing an increasing role as introducers of new borrowers often to new providers of funds. The new mortgage companies have entered the field as originators of mortgages. New ways of splitting credit risk between a range of institutions are being devised. And we have seen the issue of mortgage backed securities as one of a number of ways of tapping wholesale funds for mortgage lending.

This unbundling of mortgage provision focusses production on the most efficient and least cost providers of each service, and it is likely to continue. Building societies are responding to this challenge. In the future, some societies may find a role in offering different combinations of mortgage services such as credit assessment of borrowers and servicing of mortgages without necessarily providing a full integrated mortgage service. The exact combination of activities may vary from society to society.

Some of these developments were barely discernible when the Building Societies Act was being formulated. The Act needs to, and can, evolve, to cope with these changes. One immediate example is that the Commission propose to make an order in the near future to enable societies to refer borrowers both to other societies and to purpose built finance vehicles designed to issue mortgage backed securities. Societies' power to administer mortgages as agents will also be clarified. This order is intended to be part of an evolutionary process, enabling societies to compete more effectively in the unbundled mortgage market.

The use of finance vehicles and securitised forms of finance raises a number of difficult issues concerning the capital adequacy treatment of off-balance sheet lending. I am glad to see that the Building Societies Commission has released today a consultative paper on this subject. I know that the Commission will welcome comments and suggestions from the industry and from others on this paper and on the issues raised by securitisation generally.

In conclusion, the development of the mortgage market and the retail financial services market generally poses both risks and opportunities for societies. The Building Societies Act is designed to protect investors while allowing societies the scope to exploit these opportunities. Its provision will evolve over time as societies and markets change. But the continued success of the society movement is down to you, the practitioners. I wish you well.

3766/26

DRAFT PRESS RELEASE

Speaking today at a dinner for building society chief executives, the Economic Secretary to the Treasury, Peter Lilley MP, said that "the primary purpose of the Building Societies Act 1986 is to allow societies to extend the range of services they offer while remaining predominantly engaged as mutual institutions in their traditional business of mortgage lending financed from retail savings. One lesson of recent experience is [that] the financial world is changing very rapidly ... . It is up to societies themselves to develop their activities so as to compete successfully. The Government's role is to ensure that there are no artificial constraints in the Act which will hamper them. This we are doing".

Referring to the recently announced review of Schedule 8 of the Act, Mr Lilley said that "at present the Act is framed so as to prevent societies from undertaking new financial services activities unless they are expressly provided for in Schedule 8. This creates problems because the detailed terms of the Schedule may not correspond exactly to the best commercial way of doing things. The review will do two things. First, we will seek to revise the structure of Schedule 8 so that it describes in broad terms what societies can do, and specifies within that those activities expressly forbidden. This would change the presumption at the margin that societies can do things, rather than they cannot do them, and thus, I hope, remove as far as possible many of the irritations societies have experienced in operating within their new powers. We will also take the opportunity to look at the various requests societies have made for extensions of their powers into new areas".

The Economic Secretary also drew attention to changes in the way in which the mortgage market was developing. "There was a time less than a decade ago, when the mortgage market was almost exclusively the province of building societies. Those days have passed, and passed for good. The mortgage market today is perhaps one of the most competitive in the financial services field. Not only have new players entered the market, but market innovations are leading to the application of new techniques to the provision of mortgage finance. Building societies are responding to this challenge."

"Some of these developments were barely discernible when the

Building Societies Act was being formulated. The Act needs to, and can, evolve, to cope with these changes. One immediate example is that the Building Societies Commission propose to make an order in the near future to enable societies to refer borrowers both to other societies and to purpose built finance vehicles designed to issue mortgage backed securities."

"The use of finance vehicles and securitised forms of finance raises a number of difficult issues concerning the capital adequacy treatment of off-balance sheet lending. I am glad to see that the Building Societies Commission has released today a consultative paper on this subject. I know that the Commission will welcome comments and suggestions from the industry and from others on this paper and on the issues raised by securitisation generally."

In conclusion, the Economic Secretary stressed that the Government saw a future for the building society movement, and that "the Government has no intention of artificially inducing societies to convert to company status by unnecessarily hampering their development into activities compatible with their defining characteristics. No society should feel compelled to convert for this reason."

<u>Notes for Editors</u>

The review of Schedule 8 of the Building Societies Act 1986 was announced on 2 October. Over recent months, there have been a growing number of occasions in which particular activities which societies have wished to undertake have been found to fall outside the powers in Schedule 8 of the Act because of legal technicalities. Societies have also asked for various extensions to the powers. The review will be conducted jointly by the Treasury and the Building Societies Commission in consultation with representations of the building society movement.

The Building Societies Commission published today a draft consultative paper on the capital adequacy requirements for various forms of off balance sheet lending. The paper suggests that, where a society can demonstrate that it is absolved from any continuing credit risk in respect of a mortgage loan or group of loans, the society need not carry capital against losses arising on such loans. The paper also sets out circumstances in which a partial capital weighting might be considered.

1316/56

CONFIDENTIAL

FROM: MRS R LOMAX
DATE: 13 October 1987

MR CASSELL

cc: PPS
PS/Economic Secretary
Sir P Middleton
Sir G Littler o/r
Mr Ilett o/r
Mr Neilson
Mr Pickford

* Not good: Pls reconsider urgently our pos'n on Japanese banks & others. N.

TOKYO STOCK EXCHANGE

In Geoff Littler's absence, Anthony Loehnis rang this afternoon to draw my attention to an article in last Saturday's Economic Journal of Japan, containing apparently well-informed speculation about the outcome of the TSE expansion this autumn. In short, the EJJ predicts 19 admissions, of which 15 might be foreign firms, including 6 from the US, 4 from the UK and 2 each from West Germany and Switzerland. The 4 British firms named were Kleinworts, Barings and Schroders (the "Howard 3"), plus County NatWest. The notable exclusion is BZW (or Barclays as it is for these purposes; the Japanese do not seem to have heard of BZW).

2. None of this comes as a great surprise, but Anthony Loehnis commented that failure on our part to react would be taken as acquiescence, which would be a bit premature. We therefore agreed that he should ring the Bank of Japan, while I rang Mr Esawa at the Japanese Embassy, to underline the oft repeated point that we are looking for the admission of <u>all</u> suitably qualified candidates - amongst which we would expect to number Barclays.

3. When I rang Esawa, he took the opportunity to take me through the timetable, which goes as follows:

October 16: TSE Committee on membership makes recommendations about number of new members, and criteria for admission. There is likely to be a press announcement.

October 20: decisions by TSE Board of Directors.

November 4: plenary meeting of TSE members to amend statute. Applications to be invited from candidate firms, for final decision before Christmas.

4. I registered our points on the EJJ article. In reply, Esawa emphasised that nothing had been decided; that it was "disturbing and embarrassing" of us to up our demands after Mr Howard's visit; and that Barclays were most unlikely to meet TSE criteria, since they had only just obtained their securities licence. I noted that Barclays were a major British financial institution, with a serious commitment to the Japanese market. This might be their last chance for some time. Our attitude to their exclusion would inevitably be coloured by our assessment of the prospects for future TSE admissions, say next year.

5. Esawa refused to be drawn about future prospects, but commented that he saw "very little chance" that Barclays would meet the criteria for admission. He also went out of his way to note that County was "a problem", because it was "a late addition"; to which I gave a suitably robust reply.

6. None of this is very startling, but we can expect some fairly active lobbying from Barclays. I cannot see that we can press their case very hard with the Japanese authorities, at this stage. But that need not stop BZW from being active on their own behalf. (A possibility that might be worth exploring is "delayed entry". That is, they might apply now, for admission in the second half of next year.) Barclays have already suggested that we should substitute them for one of the other names on the Howard list. I cannot see how we could agree to this. DTI are predictably hostile.

7. On a separate point, I have outlined to David Smith at the DTI the Bank's proposed approach to Japanese GEMMs. He foresaw no problems - in fact he was positively enthusiastic.

But he will take wider soundings within the DTI, and let me know as soon as possible if there are likely to be any objections. I have told Anthony Loehnis what we are up to.

RL

RACHEL LOMAX

psl/18A

FROM: A C S ALLAN
DATE: 13 October 1987

CHANCELLOR

(no problem the usual figs: (a) market m-power (b) transfers etc)

MARKETS MEETING

We originally started to fix this meeting because of worries that the rate was knocking against 3DM with the Bank doing nothing! (David Peretz's note of 6 October). But the problem now is massive inflows - \$4½ billion in last few weeks.

2. This meeting will no doubt be a chance for Eddie (and Frank?) to say this can't go on, and we must uncap. But few are likely to lend him any support.

3. The formal papers on the agenda are:

(i) David Peretz's minute of 13 October with latest figures for intervention etc;

(ii) the Governor's letter of 7 October on the monetary situation;

(iii) the monthly monetary assessment attached to Mr Grice's note of 2 October.

4. The discussion is very likely to focus largely on funding/sterilization of intervention. It is hard to see this as a major problem since the PSBR forecasts are dropping so sharply. There is also the note by David Peretz about funding policy and the forward book.

5. If there is time, this is a convenient cast for a slightly more general discussion of funding policy - a maturity basis or an M4 basis etc. You and the Economic Secretary have expressed rather different views on this - he does not want to make a move on gilt sales to building societies.

A C S ALLAN

From : D L C Peretz
Date : 13 October 1987

CHANCELLOR

cc Chief Secretary
Economic Secretary
Sir P Middleton
Mr Cassell
Mr Kelly
Mr R I G Allen
Mr Cropper

MARKETS MEETING : 14 OCTOBER

You might like to have the attached table of recent movements in financial markets, and intervention figures, as background for tomorrow's meeting with the Governor.

2. Mr Grice's minute of 2 October, below. gave our most recent assessment of monetary conditions. Since then, we have seen the "first guess" for the September money and bank lending figures (Mr Brook's minute of 12 October) – below; and the market developments shown in the attached table.

DLCP

D L C PERETZ

Date	ERI	DM/£	$/£	Market intervention	Brent oil spot	3 month interbank	3 month Eurodollar	Gilt future*
September								
24 (August trade figures)	72.9	2.9806	1.6375	+ 40	18.65	$10\frac{1}{8}$	$7\frac{5}{8}$	113.29
25	73.0	2.9862	1.6397	+ 2	18.60	$10\frac{3}{16}$	$7\frac{11}{16}$	114.08
28 (Louvre reaffirmed on 26/9)	73.2	2.9958	1.6420	+329	18.65	$10\frac{5}{32}$	$7\frac{3}{4}$	114.28
29	73.1	2.9943	1.6282	+786	18.52	$10\frac{7}{32}$	$8\frac{1}{16}$	113.31
30	73.1	2.9957	1.6290	+235	18.75	$10\frac{9}{32}$	$8\frac{1}{4}$	114.21
October								
1	72.8	2.9850	1.6170	+355	18.60	$10\frac{1}{4}$	$8\frac{3}{16}$	114.07
2 (September reserves figures)	72.9	2.9869	1.6220	- 10	18.70	$10\frac{1}{4}$	$8\frac{1}{4}$	114.08
5	73.0	2.9917	1.6222	+ 15	18.95	$10\frac{5}{32}$	$8\frac{1}{4}$	114.26
6	73.2	2.9967	1.6335	+ 48	18.85	$10\frac{3}{16}$	$8\frac{1}{4}$	114.12
7	73.3	2.9971	1.6407	+285	18.82	$10\frac{7}{32}$	$8\frac{5}{16}$	114.20
8	73.3	2.9926	1.6425	+325	18.87	$10\frac{3}{16}$	$8\frac{1}{2}$	114.11
9	73.3	2.9955	1.6495	+ 7	18.82	$10\frac{9}{32}$	$8\frac{3}{4}$	114.01
12	73.4	2.9970	1.6535	+764	18.72	$10\frac{3}{16}$	$8\frac{13}{16}$	114.04
13	73.3	2.9991	1.6465	+1251	18.52	$10\frac{5}{32}$	$8\frac{13}{16}$	114.13

Total market intervention 24 September-13 October = $4432 million.

Notes

All rates at London Close
Intervention measured London Close - London Close
* decimal point indicates 1/32nd.

RC6.26

UNCLASSIFIED

FROM: CATHY RYDING

DATE: 14 October 1987

APS/ECONOMIC SECRETARY

cc PS/Sir P Middleton
Mr Cassell
Mrs Lomax
Mr Murphy
Mr Pickford
Mr Flitton

Mr Bridgeman - BSC
Mr Watson - BSC

BUILDING SOCIETIES: ECONOMIC SECRETARY'S SPEECH TO SALOMON BROTHERS - THURSDAY 15 OCTOBER 1987

The Chancellor has seen your minute of 13 October.

2. The Chancellor suggests that the first paragraph on page 9 be redrafted as follows:-

> "Finally it should be remembered that conversion to banking status has disadvantages as well as advantages. For example, banks have more onerous capital adequacy requirements on mortgage assets than do building societies. So we do not envisage all societies converting en masse even though some may do so." (ie. an amendment to the second sentence and deletion of the third sentence.)

The Chancellor also suggests that ", primarily," should be deleted in the second indent of the third paragraph on page 7.

CR

CATHY RYDING

Chanceller
12/2

CHANCELLOR - INTERVIEW ON BP SHARE SALE PRICE

Transcript from: BBC 1 TV, News Afternoon, 15October 1987

This exchange is about the hitch at the "unveiling" ceremony.

INTERVIEWER: (JAMES LONG) ... I suggested to BP chairman that it hadn't gone exactly smoothly

BP CHAIRMAN: ... . of a climax because there is a bit of apprehension about it all. I think it sort of builds up the anticipation in a way that nobody could have planned.

INTERVIEWER: With your heart in your mouth?

BP CHAIRMAN: It was a bit I'm afraid yes but I knew it would come out all right in the end as all this will too.

INTERVIEWER: The price was finally clear for all to see, a price which spells a big profit for the Government on the £2million it originally invested back in 1908.

CHANCELLOR: At the end of the day the Government will probably net something like £5 1/2 thousand million. This is the biggest share sale not just in Britain but anywhere in the world. But I'd like to make it absolutely clear we're not doing this primarily for the money. What we're doing with this, because we don't think it makes sense for Government's to hold shares in industrial companies. It makes a great deal more sense to try and spread share ownership as widely as possible among the British people and that's what we're seeking to do.

INTERVIEWER: Now the serious business of selling BP begins with application forms going out in the next few days and the closing date in 13 days time. Whether more than 6 million people really do apply may be affected by what happens to the share price in the meantime and whether £3.30 continues to look like an attractive discount.

Chancellor

PK/2

CHANCELLOR - INTERVIEW ON BP SHARE SALE PRICE

Transcript from: ITV, 12.30 NEWS, 15 October 1987

INTERVIEWER: (ED MITCHELL) .... was the Chancellor of the Exchequer bothered by the drop in the market?

CHANCELLOR: It's true we haven't sold the shares at probably the peak price. But it's still a very much better price than it was some time ago and very substantially better than the prices which the Labour Government sold the first tranche of BP shares about 10 years ago.

INTERVIEWER: With 6 1/4 million people having registered their interest, the big institutions are obviously keen on BP and the price at £3.30 this issue is not likely to fail. Today's razamataz was just to make absolutely sure of success.

Chancellor 12/12

CHANCELLOR - INTERVIEW ON BP SHARE SALE PRICE

Transcript from: BBC Radio 4, World at One, 15 October 1987

PRESENTER: ... It was against this background that our economics editor, Dominic Harrod, asked the Chancellor, Mr Nigel Lawson, whether it had been necessary to spend quite so much money on TV and press advertising and the accompanying ballyhoo?

CHANCELLOR: It is if you're engaged in what we are engaged in, and that is a massive spread of share ownership throughout the British people going far beyond anything that's ever happened before, far beyond the existing institutions or the minority of fairly wealthy people who've always held shares. And the proof of the pudding is in the eating. We have trebled the number of shareholders in this country. Something like 1 in 5 of the adult population - that's even before BP - and this is I think highly desirable and we are determined to continue with it.

INTERVIEWER: (DOMINIC HARROD) Well now you talk about continuing with it, how are you going to meet your targets of £5 billion a year for the next 4 years, that's £20 billion and I know BP is big at £6 billion, but where are you going to find things to sell to meet that target?

CHANCELLOR: We have a number of big things quite apart from other things which might be candidates for privatisation. But the most obvious big things apart from BP are our commitment to privatise the water industry, our commitment to privatise the elctricity industry, those are both massive industries. And of course we still own something like 49% of British Telecom which is not a long term holding which we will in due course we shall get rid of.

INTERVIEWER: And there's one other thing, as you've been increasing the number of people holding shares in these and other enterprises you've been selling them into what has turned out to be a very strongly rising stock market and at prices which the market has judged afterwards to be a pretty large discount so that Telecom doubled after the issue and so on, isn't this a rather untypical way to introduce a new class of people to shareholding when in fact shares go down as well as up as we all know?

CHANCELLOR: Well I don't think it would have been sensible for us to say well because the market's rising we mustn't sell the shares. And it's true that it's been a rising market and markets don't rise forever. But I don't beleive that even if the market were to cease rising that that would in any way inhibit the privatisation programme.

INTERVIEWER: The market was down a bit at the start this morning and indeed Wall St fell sharply yesterday. Is there a danger that higher interest rates in the United States and on the Continent might actually cause us to have to follow suit and that might upset the market even while the BP shares are still in the process of being sold?

CHANCELLOR: I see no sign of that at the present time. Our interest rates as you know are considerably higher than the United States interest rates despite their recent rise and they have certain problems with their economy which we don't have fortunately.

INTERVIEWER: So you think that the market is fairly well underpinned at least by the interest rate increase that you made in the summer?

CHANCELLOR: I think that all the signs are , if you look at the foreign exchange market which is often a good guide, that there is a very high degree of confidence, worldwide confidence, in the British economy at the present time and I hope that that will continue.

INTERVIEWER: One final point about the new class of shareholders, you are introducing them, particularly now at this moment and have been perhaps over the last year, into a market where the headlines almost daily carry stories of one scandal or another. Should one be introducing amateures into a world of professionals, some of them with pretty sharpelbows?

CHANCELLOR: That's why we put on the statute book the Financial Services Act in order to provide a system which does give the greatest degree of investor protection which we can secure. And I think that the fact that these scandals are coming to light is showing the effectiveness of the processes that we now have in place.

LB Spoke ✓

Chancellor
12/12

CHANCELLOR - INTERVIEW ON BP SHARE PRICE

Transcript from: ITV CHANNEL 4, Business Daily, 15 October 1987

BP - Ch4

PRESENTER: ... this morning Mark Rogerson asked the Chancellor of the Exchequer, Nigel Lawson, whether 330 pence might not prove just too expensive?

CHANCELLOR: We shall just have to see. I mean there are risks, that is why we always have these offers underwritten. If there were no risk at all we wouldn't go to the trouble of having it underwritten but we do. But as I say, I think it idle to speculate, we shall just have to see at the end of the day what the take up is.

INTERVIEWER: What do you say to the people who say frankly you're overhyping this share? In the market they say quite frankly Shell is a better buy?

CHANCELLOR: Well we haven't got any Shell shares to sell. What has happened is for historical reasons the British Government has been left with 31% of BP. There's no reason on earth why the British Government should have 31% of BP, we don't need it for any governmental purpose whatever. Much better that these shares are spread as widely as possible among the British people and that's what we're engaged in doing.

INTERVIEWER: Are you concerned at all that you may be blown off course between now and the end of the month by events elsewhere in the world? We're seeing higher interest rates in Germany, probably in America, probably in Japan, can we insulate ourselves from all that?

CHANCELLOR: I don't see any great traumas. The British economy certainly is doing extremely well at the present time. And although there are these slight increases in interest rates in the rest of the world they've only been very modest so far and I don't think that they really indicate anything to cause alarm in the world economy or alarm to people who thinking of buying BP shares.

INTERVIEWER: You're feeling under no pressure to follow suit?

CHANCELLOR: No, we're very comfortable with the position we're in at the present time.

INTERVIEWER: Now even at 330 pence a share you stand to make about £6 billion on the BP issue. What are you going to do with the money, lower taxes, lower PSBR?

CHANCELLOR: No, we shall have to take a decision on taxation - I shall have to take a decision on taxation when the Budget comes and it's some months away now - in the normal way. What this certainly does mean is that we need to borrow much less because we're raising the money in this way. Although of course not all of that £6 billion will be raised this year, as you know, it's being spread over 3 years.

INTERVIEWER: Do you think you can get the PSBR down to the balanced figure that many in the market are starting to talk about?

CHANCELLOR: We shall have to see. What we have shown is that we have already brought the public sector borrowing requirement down very considerably and that the public finances are under very tight control. Which is a healthy sign and what is also interesting is that despite that the economy is growing faster than any other economy in the world.

INTERVIEWER: What would you say to private investors who may be very worried by the big swings that they're seeing in stock markets around the world and be thinking perhaps this isn't actually the time to buying shares in BP at all?

CHANCELLOR: I don't want to persuande anybody to buy BP shares against their will. They've got to make up their own minds. We have given a great deal of publicity to this sale in order to makeeverybody aware that it's there. But it is people who've got to make up their own minds and I am not going to try and persuade them one way ortheother.

INTERVIEWER: Do you think it's, to say the least, unfortunate that this sale comes at a time when the reputation of the City and of sharedealing is taking something of a knock from the various court cases that appear to be imminent?

CHANCELLOR: I can't really talk about the court cases except I think it is wrong to say that these court cases are court cases exclusively concerning the City. I mean the problem is both a wider one in one sense, it goes beyond the City, and in another sense it is something which affects a samll minority, a tiny minority, of individuals. The City has a reputation second to none throughout the world. It's the largest financial centre in the world. It is doing better now than it's done ever before and it's reputation is very high. There are one or two cases which tarnish that reputation, I deeply regret that and we're doing everything we can to maintain the highest standards in the City.

1317/39

CONFIDENTIAL

FROM: MRS R LOMAX
DATE: 16 October 1987

pup

NOTE FOR THE RECORD

cc: PPS
PS/Economic Secretary
Sir P Middleton
Mr Cassell
Mr Peretz
Mr Kelly
Mr Ilett
Mr Watts
Mr Board

Miss Wheldon, T/Sol

CLEARING SETTLEMENTS

In the absence of Sir P Middleton and Mr Cassell, Mr George rang me this morning to say that in the Bank's judgement the effect of last night's bad weather on City services and levels of staffing was so severe that there was no realistic prospect that normal settlement could be effected in the money, gilts and foreign exchange markets. The Bank therefore wanted, at an early hour, to dispel uncertainty by issuing a market notice, released to the wire and broadcasting services. They were consulting Freshfields about the terms of the notice. I agreed to ask Treasury Solicitor to consider whether it would be appropriate to exercise Treasury powers under the Banking and Financial Dealings Act 1971 (para 2).

2. I subsequently spoke to Miss Wheldon, who was dubious about the use of Treasury powers, and agreed that it was not necessary to take a decision one way or the other before the Bank issued its notice: but that she should discuss the matter further with Freshfields and DTI lawyers.

3. I then told the Chancellor what the Bank were minded to do, and read over the market notice (as attached). I said Treasury Solicitor was unable to advise on whether the use of Treasury powers in support of the Bank's notice was necessary or desirable. The Chancellor said DTI should be given an

opportunity to comment, but that, subject to their views, he would be content for the Bank to issue a notice on their own authority. In the absence of any legal advice he could give them no assurances about the use of Treasury powers.

4. Accordingly Mr Allan contacted Mr Kenneth Clarke's office in the DTI, and I spoke to Mr David Smith in Financial Services Division of DTI. Neither raised any points, and I therefore told Mr George that the Chancellor had raised no objections to the Bank issuing the notice on their own authority; but, since it had not proved possible to take legal advice on the use of Treasury powers in the time available, we could give no assurances about whether they would be exercised. Mr George said he was content to go ahead on that basis. I said we understood that it would probably still be possible to lay an Order under the 1971 Act later in the day, and we would consider the options with Freshfields and Treasury Solicitor as a matter of urgency.

5. I was able to debrief Sir P Middleton at around 1 pm.

RL

RACHEL LOMAX

In view of the physical dislocation of the City it is in the Bank of England's view impossible to carry out effective clearing settlements today. They see no alternative to the postponement of settlement until Monday.

SECRET

MG NOON REPORT

FINANCIAL MARKETS

Friday 16 October 1987

London close 15.10	11 AM		NOON	Oil Price (10 AM)
73.5	73.5	£ERI	73.5	
1.6650	1.6620	$/£	1.6615	Nov $18.90
2.9953	2.9974	DM/£	2.9962	Dec $18.87
1.7990	1.8035	DM/$	1.8033	Jan $18.80
142.00	142.50	Yen/$	142.5	

Opening effective rates not available.

UK interbank £			Eurodollars	
9 11/16	(-)	7 day	7 7/8	(-)
9 7/8	(-)	1 month	8 1/4	(+1/8)
10 5/16	(-)	3 month	9 3/16	(-)
10 11/16	(-)	12 month	9 13/16	(-)

Figures in brackets show change since previous market close

MARKET COMMENT The London markets severely disrupted by adverse weather conditions. The dollar has firmed slightly since opening today on Gulf tensions and now awaits US September PPI figures this afternoon. Baker's comment last night that further adjustments in Louvre Accord could be accomodated was contrary to earlier comments by Miyazawa Baker's comment was interpreted to mean the US wants to see a lower $. Sterling eased against the dollar despite better than expected PSBR figures. It is slightly firmer against the Mark.
Very thin trading and confusion reigns.

Ian Polin

MARKET INTERVENTION ($m)

OTHER COUNTRIES INTERVENTION ($m)

Overnight)	+82DM	Far East and
)	+63$	Germany
Today so far)		
Total	+82DM +63$	

GILTS (Market has ceased trading)

	Latest market movements	Price change since previous close
Shorts	Not available	Not available
Mediums	"	"
Longs	"	"

Gilt Sales since market opening

£ million

Not available

Futures (Long Contracts) +8/32 (Vol:1868)

NAME: I.C.Polin, MG1 Division
TEL NOS: 270 5556/5560

SECRET

ps3/40R

CONFIDENTIAL

FROM: CATHY RYDING
DATE: 16 October 1987

MRS LOMAX

cc PS/Economic Secretary
Sir P Middleton
Sir G Littler
Mr Cassell
Mr Ilett
Mr Neilson
Mr Pickford

TOKYO STOCK EXCHANGE

The Chancellor has seen your minute to Mr Cassell of 13 October and has commented that this is not good. He thinks we should urgently reconsider our position on Japanese GEMMs in the light of this.

CR

CATHY RYDING

1317/15

FROM: **MRS R LOMAX**
DATE: **16 October 1987**

NOTE FOR THE RECORD

cc: Principal Private Secretary
PS/Economic Secretary
Sir P Middleton
Sir G Littler
Mr Cassell
Mr R I G Allen
Mr Ilett
Mr Neilson

TOKYO STOCK EXCHANGE

Mr Ezawa of the Japanese Embassy rang this morning to inform me of the contents of the TSE Press Release, announcing the Special Membership Committee's recommendations on the forthcoming expansion of the Tokyo Stock Exchange. The release makes three points:

- there will be **22 new seats** (including one which has become available as the result of a merger of existing firms);

- the **criteria** for new members are vaguely worded but include financial resources (size of company, capital, net assets, profitability etc) and experience in Tokyo market (including volume of trading in stocks and shares, commissions received and paid etc);

- the **price** of seats is likely to be about the same as on previous occasions - that is, about 1 billion yen (consisting of special membership fee of about ½ billion yen, plus special payments of one sort and another).

2. The statement draws no distinction between foreign and domestic firms, and this will formally be determined later when applications have been received. Mr Ezawa thought the TSE President might be giving off-the-record press guidance on this subject, but he was not more specific.

3. Mr Ezawa repeated the point he has made several times in the past few days, namely that it is most unlikely indeed that BZW will get a seat this time round. I repeated our line about the importance of a further expansion in 1988, and thought I detected some softening in his attitude on this point. I noted that Sir Martin Jacomb would be visiting the Japanese Embassy this afternoon, and we would naturally be interested in what transpired.

RL.

RACHEL LOMAX

SECRET

From : D L C Peretz
Date : 19 October 1987

CHANCELLOR

cc Sir P Middleton
Sir T Burns
Mr Cassell
Mr H P Evans

In Sir Geoffrey Littler's absence, I took a telephone call from David Mulford (US Treasury) around 6 o'clock today.

2. He said he was ringing to "touch base" about the markets. He said that Baker had spoken to Stoltenberg to say that he very much hoped the Germans would not raise their interest rates any further; and that if they did the US would not follow - he was not prepared to follow the Germans into a "deflationary spiral". Mulford said they were not looking to the Germans to reverse their recent interest rate moves : but would very much like a signal to be given to the market that no further increase was in prospect.

3. He asked whether you would be prepared to speak to Stoltenberg on the same lines.

4. I said I understood that you were hoping to have a telephone conversation with Mr Baker, later today. We left it that you and he could discuss things further then.

5. I probed Mulford a little on Baker's recent statements and on the US attitude to the Louvre Accord, reminding him of the importance that you attach to Louvre.

6. He said that he knew that Baker continued to attach great importance to maintaining a period of exchange rate stability. He claimed that Baker's recent statements were certainly <u>not</u> an attempt to talk the dollar down! (though he accepted that they might have been so interpreted). He went on to say, however, that it might be possible to envisage a managed step down in the dollar/DM rate in the same kind of way as the $/yen rate was managed down in April. And he said that he did not see the current $/DM rate (which in fact is below the bottom

1·8250 - 2½% = 1·7790

of the inner Louvre band) as being inconsistent with the "spirit of Louvre".

7. As I say, we left it that you and Baker would probably be having a telephone discussion later today.

DLP

D L C PERETZ

RESTRICTED

034664
MDHIAN 1798

RESTRICTED
FM WASHINGTON
TO IMMEDIATE FCO
TELNO 2227
OF 192330Z OCTOBER 87
AND TO IMMEDIATE CGS IN USA

NEW YORK STOCK MARKET COLLAPSE

1. THE US STOCK MARKET TODAY EXPERIENCED ITS LARGEST EVER ONE-DAY DECLINE. THE DOW JONES FELL BY OVER 500 POINTS (OR 23 PER CENT). THE STANDARD AND POORS COMPOSITE INDEX - A BROADER MEASURE OF STOCK PRICES - FELL BY 20 PERCENT. INTEREST RATES ROSE INITIALLY BUT ENDED THE DAY WELL DOWN ON FRIDAY' S CLOSE. THE DOLLAR WEAKENED IN THE MORNING BUT RECOVERED IN LATER TRADING.
2. AFTER LAST WEEK'S 10 PERCENT FALL IN THE DOWN JONES, A NUMBER OF COMMENTATORS - INCLUDING FOR EXAMPLE KAUFMAN - WERE EXPECTING SOME RECOVERY TODAY. NOT EVEN THE MOST BEARISH COMMENTATORS EXPECTED THE PANIC SELLING WE HAVE SEEN.
3. THE FACTORS THAT LED TO LAST WEEK'S SELL-OFF HAVE CONTINUED TO DRIVE THE MARKET DOWN: CONCERN OVER THE TRADE DEFICICJJRRISING INTEREST RATES, THE POSSIBLE RESURGENCE OF INFLATION AND OVER THE DOLLAR. WORRIES ABOUT THE DOLLAR WERE INTENSIFIED BY REMARKS BY SECRETARY BAKER OVER THE WEEKEND IMPLYING THAT HE WOULD BE PREPARED TO SEE THE DOLLAR FALL AGAINST THE DM. HEAVY DECLINES IN NON-US MARKETS BEFORE WALL STREET OPENED ALSO NO DOUBT PLAYED A PART: AND AS WITH LAST WEEK, TODAY'S FALL WAS PROBABLY AGGRAVATED BY PROGRAMME TRADING. BUT ONLY PSYCHOLOGY AND HERD INSTINCTS CAN EXPLAIN THE EXTENT OF TODAY'S COLLAPSE.
4. THE BOND MARKET AND THE DOLLAR RECOVERED IN RESPONSE TO THE NEWS THAT SECRETARY BAKER HAD MET STOLTENBERG AND POEHL IN BONN AND HAD REAFFIRMED THEIR COMMITMENT TO THE LOUVRE ACCORD: LON INTEREST RATES, WHICH HAD CLOSED ON FRIDAY AT 10.19 PERCENT, REACHED A PEAK AT 10.4 PERCENT BEFORE DECLINING TO 9.7 PERCENT. THE DOLLAR BEHAVED IN A SIMILAR FASHION, REACHING LOWS OF DM 1.7687 AND YEN 141.00 BEFORE RETURNING TO THE LEVELS OBSERVED AT THE COLSE ON FRIDAY.
5. THE ADMINISTRATION HAS TRIED TO PUT ON A BRAVE FACE BUT IS CLEARLY VERY CONCERNED. THE WHITE HOUSE PUT OUT A STATEMENT THIS EVENING SAYING THAT QUOTE THE PRESIDENT HAS WATCHED TODAY WITH CONCERN THE CONTINUED DROP IN THE STOCK MARKET UNQUOTE. THE STATEMENT WENT ON TO EMPHASISE THE UNDERLYING STRENGTH OF THE US ECONOMY.
6. RUDER (CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION) SAID

034664
MDHIAN 1798

THAT A BRIEF TRADING HALT HAD BEEN DISCUSSED IN ORDER TO RESTORE ORDER TO THE STOCK MARKET, BUT THE IDEA HAD BEEN REJECTED. PHELAN (CHAIRMAN, NYSE) CONFIRMED THIS EVENING THAT THE MARKET WOULD OPEN TOMORROW.

7. SHETHNESS (ASSISTANT SECRETARY, TREASURY) TOLD US THAT NYSE AND SEC HAVE BEEN MONITORING THE POSITION OF THE SECURITIES HOUSES CLOSELY AND THAT THERE SEEMED NO IMMEDIATE CAUSE FOR ALARM. MOST OF THEM HAD SUBSTANTIALLY TRIMMED THEIR STOCK PORTFOLIOS LAST WEEK, AND STOCK LOSSES WOULD BE OFFSET BY TODAY'S GAINS IN BOND PRICES. EF HUTTON PUT OUT A STATEMENT DENYING A RUMOUR THAT THEY ARE IN TROUBLE.

8. FCO PLEASE ADVANCE TO PS/CHANCELLOR, SIR P MIDDLETON, PERETZ AND LOMAX (TREASURY), PS/GOVERNOR, GEORGE, WALKER AND GREEN (BANK), HILTON (DTI) AND RICHARDSON (ERD).

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FINANCIAL NAD

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SECRET

MG NOON REPORT

FINANCIAL MARKETS — Monday 19 October 1987

Opening	10 AM		NOON	Oil Price (10 AM)	
73.8	73.7	£ERI	73.7		
1.6845	1.6822	$/£	1.6828	Nov	$19.15
2.9883	2.9984	DM/£	2.9870	Dec	$19.15
1.7740	1.7765	DM/$	1.7750	Jan	$19.10
141.28	141.50	Yen/$	141.25		

UK interbank £			Eurodollars	
9 1/2	(-3/16)	7 day	7 7/8	(-)
9 7/8	(-)	1 month	8 1/16	(-1/16)
10 3/8	(+1/16)	3 month	9 1/16	(-1/8)
10 7/8	(+3/16)	12 month	9 5/8	(-3/16)

Figures in brackets show change since previous market close

MARKET COMMENT In the foreign exchange market the dollar opened sharply down on Friday's close. This is mainly due to Baker's comments on Friday/Saturday that the US would not be expected to put its interest rates up and that the Louvre accord should be looked at again. The dollar has steadied this morning helped by a BOJ statement that the Louvre accord was still in place.Sterling opened very firm on the easier dollar but is on sidelines.Markets generally very nervous. The gilts market is week, influenced by fall in US and equity market (FTSE100 down 224 points at 11.50).

R McRobbie

MARKET INTERVENTION ($m) — OTHER COUNTRIES INTERVENTION ($m)

Overnight	+224$	New York	-
Today so far	-		
Total	+224$		

GILTS

	Latest market movements	Price change since previous close
Shorts	Easier	-15/32
Mediums	Easier	-32/32
Longs	Better	-59/32
Futures (Long Contracts)		-66/32 (Vol:18004)

Gilt Sales since market opening: -£13.6 million

All Index linked

NAME Miss R J McRobbie, MG1 Division

TEL NOS: 270 5557/5560

1531/016

FROM: R N G BLOWER

DATE: 19 October 1987

MTON 19/10

1. MR NEILSON

2. PS/CHANCELLOR

cc: PS/CST
PS/FST
PS/EST
PS/PMG
Sir P Middleton
Mr Cassell
Mr Moore
Mrs Lomax
Mr Peretz
Mr Ilett
Mr Neilson

TODAY'S STOCK MARKET : MONDAY 19 OCTOBER

As I have told you several times today the market has been falling throughout, recovering some ground before closing.

2. The FTSE 100 was at one point down 302.1, a 13 per cent fall but has now recovered in the last hour to end down 245 points at 2056.9, a fall of 10.6 per cent (a post-war record). The FT30 was down 183.7 at 1629.7.

3. Developments on Wall St have dominated. Today's fall in London reflects 2 days developments, since London was effectively closed on Friday at a time when Wall Street was falling rapidly (100 points +) on the US trade figures. Having opened sharply down (5%) this morning, London fell steadily throughout the morning and was further weakened by Wall Street opening down. Wall Street reached a low of 212 points down after the announcement of the US attack on Iranian oil rigs, but recovered somewhat and at 5.30pm was down 154 at 2091.87.

4. All sectors of the London market have been hit hard with insurance suffering from Thursday night's hurricane. BP closed at 317p, a 13p discount on the offer price, and 33 pence down on the day, broadly in line with the marekt as a whole.

Gilts

5. The fall in equity prices imparted on the Gilts Edged Market.

Gilts opened only a little easier than at the end of last week, but then fell rapidly despite the firmness of the pound. The long future quickly lost two points from Friday's close of 113-04 and remained around 111 during the middle of the day. A brief lunchtime rally was quashed by the Wall Street opening, and at one time longs had lost over 2½ points on the day. The late afternoon saw a stronger rally as cheap stock attracted buyers and as equities came off their worst. At close however the long future had still lost 2 points on the day; shorts were down ¾, mediums 1 point and longs 1¾. Index linked fared rather worse, losing over 2 points in all next century maturities; thus today, they seem to have suffered rather than benefited, from the fall in equities. The report of developments in the gilt market has been provided by MG.

Bob Blower

R N G BLOWER

cc. PPS.
Mr Cassell
Mr Watt.

BARCLAYS de ZOETE WEDD
L I M I T E D

Now attached

Ch
Earlier papers
with you.
AA

Sir Geoffrey Littler KCB
H M Treasury
Treasury Chambers
Parliament Street
London SW1P 3AG

19th October 1987

Dear Geoffrey,

What we wanted to get [illegible] a commitment (a) that BZW will be in the next tranche & (b) that that will be [illegible] no more than a year from now.

TOKYO STOCK EXCHANGE MEMBERSHIP

The signals coming from Tokyo are, from our point of view ominous in the extreme. It seems clear that the Japanese authorities are going to admit only four British houses to membership of the exchange and those firms will not include BZW.

I cannot overstate how serious this is from our point of view. Tokyo is the most important market for us outside London, and to make a success of our overall strategy it is crucial that we can compete there on level terms with our international competitors. If they are members and we are not, we are at a significant and important competitive disadvantage. If this were to persist for any length of time, ie, if there were no definite date by which we could attain membership, then we may have to rethink our entire strategy.

We have made an enormous investment in Tokyo. We have over 110 people employed there, in premises fully equipped up to the most modern standards; we have invested appropriately in settlement systems and in graduate recruitment, (we have just recruited 25 graduates from Japanese universities). This was done in the expectation that we would in due course achieve the securities licence (which as you know we have), and thereafter TSE membership.

I can understand why the Japanese authorities might be embarrassed at giving us TSE membership now, so soon after the grant of the licence. Some delay might be appropriate to demonstrate that "we have the necessary experience", and I accept that. But what is really serious is the prospect of the award of four places to British houses now, and no committed date for any further admissions. This is what Mr Ezawa told me was likely to be the case when I saw him last Friday.

8/3/20

(I revert to my conversation with him below.) When I saw you in Washington we very briefly discussed the situation as it was emerging and you asked me whether it would be acceptable if BZW were excluded from this tranche provided there was a committed date for the next tranche which would include us. I said it would be disappointing but understandable, but that the committed date for our membership was essential. Otherwise it is completely impossible to plan or go on investing in the prospect of membership with no guarantee that this will prove possible in the near term.

I saw Mr Ezawa at the Japanese Embassy on Friday, as I have said. He was very frank, and explained what was going to happen. Naturally I expressed extreme disappointment, explaining how serious it was. He then went on with the generality, for instance he referred to the absence of the Banking licences for Nikko and Yamaichi; and explained how the Japanese authorities did not like having demands made upon them. I explained that of course I was not making a demand; (he was not suggesting that I personally was). I was obviously in no position to do so. He said that the authorities in Tokyo felt insufficiently "appreciated". I explained how I am on record as saying in speeches both in London and in New York that I think the Japanese authorities have proceeded more quickly and more elegantly with the relevant steps towards deregulation of the Tokyo securities market in the last two or three years than has been the case with the U.S. authorities. He seemed grateful.

He then said, reverting to the instant case, that major U.S. commercial banks had just been granted securities licences at the same time as us, and that they wanted TSE membership too. I therefore explained that there was all the difference in the world between Barclays and BZW on the one hand, and, say, Morgan Guaranty on the other. I explained that BZW was one of the biggest, if not <u>the</u> biggest, houses in the U.K. equity market, one of the biggest in the U.K. gilt market, and taking the two together, by any objective test, was one of the most important houses in the U.K. securities market. None of this applies to any U.S. commercial bank. I also explained how long Barclays itself has been established in Tokyo.

I did not comment at all on the other British houses. That would have been inappropriate. However, although I am far from disinterested, it looks to me as though the British interest is not going to be well served by this move by the Japanese. Privately I myself wonder whether all the houses in question are necessarily going to remain British indefinitely; indeed one of them has I believe a substantial non-British element in its securities side already. And I wonder whether all of them really aim or intend to meet full international competition across the whole range of business.

Whatever the merits of the four houses, and no doubt they are many, and no doubt all have fully earned TSE membership, none of them occupies anything like the position in London which we do. Thus we face the prospect of one of the strongest British securities houses being disadvantaged in its quest to become a serious global competitor. I do not see how we at BZW can retain our aim to be a global competitor, if we are forced to remain in the disadvantaged category indefinitely.

Any help you can give us (and I know it is considerable) will be enormously welcomed. I am comforted somewhat by the knowledge that you do still have important cards to play.

Yours ever,

Martin

Martin W Jacomb

c.c. Mrs Rachel Lomax

1531/015

CONFIDENTIAL

I think we should stick to the course suggested by Sir G. Littler. That should give us as much leverage as we can hope to get. A dramatic rebuff to the Nomura and Daiwa at this stage could be counter-productive in the context of the negotiations with Japan — and run against our own best interests for the development of the gilt-edged market.

FROM: N J ILETT
DATE: 19 October 1987

1. MR CASSELL
2. CHANCELLOR OF THE EXCHEQUER

cc: Economic Secretary
Sir P Middleton
Sir G Littler o.r
Mr Cassell
Mrs Lomax
Mr Peretz
Mr R I G Allen
Mr C W Kelly
Mr Neilson
Mr Cropper

OK

GEMMS AND THE JAPANESE

Mrs Ryding's minute of 16 October records your view that we should urgently reconsider our position on Japanese GEMMs in the light of the news that BZW will almost certainly not get Tokyo Stock Exchange membership.

2. Mr Cassell has gone over the ground again with Mr George and Mr Loehnis and has spoken to Mr Mountfield (DTI). What follows reflects those discussions. In the meantime, Mr Quinton has called on Lord Young to ask for HMG's support.

3. The TSE decision is disappointing, but no worse than we were expecting. But Treasury and Bank officials think it would be difficult, and may be counter productive, to take immediate reciprocal action in response.

4. The heart of the difficulty is that Mr Michael Howard told the Japanese that our immediate requirement was for three seats for the three named houses. Subsequently, we have laid as much emphasis as possible on the expectation that all qualified UK applicants should be admitted, and the Japanese are apparently going to concede a fourth seat - County. It was clearly understood that the quid pro quo was the two further Japanese banking licences in this country. We are not therefore on strong ground in

increasing our immediate demands.

5. A further difficulty is that BZW are late arrivals. They have only held a Securities Branch licence in Tokyo for a few weeks - whereas the Japanese authorities would usually require at least one years' experience before candidature for Stock Exchange membership. In this respect, BZW's preparations in Tokyo have not kept step with BZW's emergence - which is recent - as the leading UK contender in the global market stakes. Maybe if we were starting from scratch we might take the view that it was more in UK plc's interests to have three seats including BZW than four seats without, but that is not now practical politics.

6. The other argument against immediate action on GEMMs is the likelihood that the Japanese would retaliate against UK interests in Tokyo. As Sir G Littler's submission of 9 October recorded, the view of the UK houses already operating in Tokyo is, not surprisingly, that we should do nothing which might undermine their growing and increasingly profitable business. If the Japanese authorities feel that we are acting in bad faith in stepping up our demands, action of this kind is more likely. The Japanese have moved quite a long way, by their standards, in recent months, and have their own political problems. They will robustly defend the crit~~i~~eria - experience in the Tokyo market - that BZW fail, as being non-discriminatory, and will point out that 4 US firms who received SBLs at the same time as BZW w~~a~~ill be treated in the same way.

7. We think therefore that the arguments strongly favour letting the Japanese GEMM applications take their natural course, as set out in Sir G Littler's 9 October submission, and ~~to~~ concentrating on obtaining an early indication that there will be a further TSE expansion as soon as the present expansion has been digested. BZW would be our lead candidate.

8. The Bank would very soon indicate willingness to entertain applications from Nomura and Daiwa, ideally in the next day or two, so as not to give the impression of delaying things until the last possible moment on 27 October. But they would make it

clear there would be no final decisions before the end of the year. Once the invitations are issued, GEMM status will clearly have to follow at some time, but timing is adjustable to some extent and provides something of a lever. Perhaps more significant levers would come from the wish of the the remaining two major houses, Yamaichi and Nikko, to become GEMMs. Here, the Bank would now indicate readiness to start discussions, but make no promises. Beyond Nikko and Yamaichi, there is the prospect of one or more Japanese banks seeking GEMM status, on which the Bank proposes to be totally non-committal for the time being. Reciprocal action under the Financial Services Act on the securities side will become an option during the course of next year once the FSA apparatus is finally up and running. And the ambition of the Japanese regional banks to establish a banking presence in London should also produce some helpful levers. So there is a fair amount of ammunition for the future.

9. In short, neither our negotiating position nor that of BZW is robust enough to justify immediate and explicit retaliation for the TSE decision. If we did so retaliate established and future UK interests in Japan would be likely to suffer. We think it would be more productive to concentrate on working towards a further TSE expansion as soon as possible. Timing is uncertain, but it would not be realistic to expect anything in less than a year from now given that the new members of the TSE will not start trading until May 1988.

M

N J ILETT