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Alex Lawson

PART D

SECRET

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PART D

Begins: 13/6/88

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6/9/95

CHANCELLOR'S PAPERS ON
MONEY FIGURES AND
INTEREST RATES

PO -CH /NL/0179
PART D

CC: PPS, CST, PMG, EST
Mr. Culpin
Miss. Hay
Mr. Cropper
Mr. Tyrie

FINANCIAL SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

13th June 1988

Mr. Cull
Mr. O'Connor
PS/IR.

David Blake Esq
Assistant General Manager (Corporate Affairs)
Woolwich Building Society
Equitable House
Woolwich
London SE18 6AB

Dear Mr Blake

You wrote to me on 25 May enclosing a copy of an article about mortgage interest relief. You sent a similar letter to the Economic Secretary. I hope you will accept this reply as covering both letters.

The residence basis of mortgage interest relief was first suggested in the Green Paper on the Reform of Personal Taxation published in 1986. The overwhelming majority of those who responded on this subject supported the suggestion. The existing system under which an unmarried couple are entitled to relief on loans up to £30,000 each whereas a married couple have to share £30,000 between them has been the most widely criticised tax penalty on marriage. We therefore thought it right to put an end to this anomaly at the earliest opportunity.

During the debate in the House of Commons on 10 May on Clause 42 of the Finance Bill, the Paymaster General covered very fully the Government's reasons for abolishing relief on home improvement loans. He also explained that, before abolition, the improver obtained relief for the improvement loan and then sold the improved property. The purchaser then obtained relief on a purchase loan covering the improved property. In future relief will arise only on the purchase transaction. By denying relief to the improver there will be a genuine reduction in the cost of mortgage interest relief.

I should also add that the ceiling of £30,000 limits the amount of mortgage interest relief. People who were obliged to borrow this amount to help them buy a home were unable to obtain any relief for improvements even before abolition.

Yours sincerely

Norman Lamont

NORMAN LAMONT

sw7

FROM: S W MATTHEWS
DATE: 14 June 1988

CHANCELLOR

cc: PS/Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Byatt
Mr Lankester
Mr Monck
Mr Scholar
Mr Evans
Mr Mountfield
Mr Odling-Smee
Mr Peretz
Mr Sedgwick
Mr Turnbull
Mr Bottrill
Mr S Davies
Mr Grice
Mr Hibberd
Mr Mowl
Mr Dolphin
Mr Savage
Mr Allen
Mr Cropper
Mr Tyrie

Copies please (WEP)

WORLD ECONOMIC PROSPECTS: GERMANY

You were interested to know the factors bringing about the difference between the WEP forecast for German real GNP growth of 3 per cent for 1988 and the Germans' own expectation of growth around 2 per cent. There are two main reasons:

a. the evidence of the latest data, which national forecasters may not have had a chance to take on board; and

b. the rapid world trade (and hence German export market) growth that we are forecasting.

The latest data

2. Growth in Germany was poor in the first half of 1987 and picked up in the second half, with the final quarter being particularly strong. Indeed, if real GNP had just maintained its 1987Q4 levels throughout 1988, growth between 1987 and 1988 would still have been 1.4 per cent.

3. In fact preliminary data suggest that real GNP in 1988Q1 was 1½ per cent higher than in 1987Q4. If it just maintained this level through the rest of 1988, year on year growth would turn out at 2¾ per cent.

4. In practice, seasonally adjusted real GNP may fall back a bit in 1988Q2 from its Q1 level, since construction output in particular was boosted in Q1 by the mild winter and lower figures (in seasonally adjusted terms) are likely in Q2. We would then expect renewed growth in the second half of the year taking real GNP growth for the year as a whole to 3 per cent.

5. The Germans appear to be playing down the significance of the preliminary Q1 data, partly because of problems with the trade data (analogous to our own) as well as the mild winter factor. However, given other recent indicators for demand and activity we feel that the Germans may be discounting the Q1 national accounts data too heavily. The volume of new orders for manufacturing industry in 1988Q1 were 6¾ per cent higher than a year earlier (4 per cent for domestic orders, 11 per cent for export orders). Retail sales volumes were 7 per cent higher.

6. Some of these data admittedly behave somewhat erratically, but they lend support to the economic factors that one might expect to lead to stronger demand and economic activity:

<u>Consumers' expenditure</u>. Real personal disposable income (RPDI) has been boosted by the terms of trade gains enjoyed by Germany from the collapse in oil prices and DM appreciation and consumers' expenditure grew faster than GNP in both 1986 and 1987. (This is one reason why there has not been more dissatisfaction within Germany about the country's economic performance). RPDI will be boosted this year by tax cuts and growth of consumers' expenditure of over 4 per cent seems probable.

<u>Private fixed investment</u> was adversely affected by the Deutschemark's appreciation, but, with exports proving more resilient than was feared and consumption strong, a recovery is in prospect.

World economy

7. As the WEP report noted, the strengthening of activity in the second half of 1987 was not confined to the major industrialised countries and world trade appears to have grown very quickly. Such data as are available for 1988, particularly the rise in commodity prices, suggest continued strong expansion.

8. This buoyancy of world demand, combined with the virtual stability of Germany's effective exchange rate over the past year, points to a relatively strong German export performance. Indeed, our doubts about the WEP forecast for Germany are less about the overall GNP growth rate than the risk that, within the expenditure components, exports may be stronger and domestic demand weaker than forecast, producing a smaller reduction in the current account surplus.

Policy implications

9. The German recovery has been brought about largely through a combination of tax cuts, interest rate reductions and resilient exports. After a period of below potential growth, a period of slightly faster growth is to be expected and its strength would not appear to justify the tightening of fiscal policy still envisaged for 1989. Domestic inflationary pressures remain subdued. The risks of inflation come mainly from abroad (eg rising commodity prices, strong pressure of demand in the US) suggesting that the German authorities may in future see Deutschemark appreciation as the most appropriate means to keep inflation low.

SM.

S W MATTHEWS

91/G.LCLD.221.8

SECRET AND PERSONAL

Thanks: Briefing OK

FROM: T PIKE/M H WHEATLEY
DATE: 17 June 1988

1. MR PERETZ
2. CHANCELLOR

No one could derive much comfort from the M0 figure. On the other figures, it might be a month for the standard reminder about not reading too much into one month's figures: the lower lending figure, for example, needs to be seen together with the higher figures in the previous month.

DLP

cc: Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Mr Gieve
Mr Grice
Miss O'Mara o/r
Mr Cropper
Mr Gray (No 10 Personal)

PROVISIONAL MONEY FIGURES - MAY

(All figures are unadjusted unless specified otherwise)

The provisional money supply figures for March will be published by the Bank at 11.30 am on Monday 20 June. As usual M3, M4, and M5 broad money figures are subject to revision.

Summary

Monetary aggregates for May (per cent)

	Annual Growth Rate	Previous Month		Six month Growth (annualised)	Monthly Growth Rate	Previous Month
M0	5.7	5.9			0.1	1.7
	6.2	6.2	s.a.	5.5	0.5	0.9
M3	18.4	19.4			1.2	0.7
			s.a.	16.0	0.5	1.6
M4	16.0	16.0			1.2	0.6
			s.a.	14.2	0.8	1.1
M5	15.3	15.7			1.1	0.5
			s.a.	13.5	0.8	0.8

Lending

		£ billion			Per cent Growth Rates	
		This Month	Last Month	Average Of Last 6 Months	Annual (Monthly) (unadjusted)	Previous Month Annual (Monthly) (unadjusted)
Banks		3.3	4.1	4.4	26.9 (1.5)	26.8 (1.8)
	s.a.	3.3	5.8	4.5		
Banks and building societies		5.7	6.4	6.1	22.3 (1.6)	21.8 (1.8)
	s.a.	5.7	8.2	6.3		
Building Societies		2.5	2.2	1.9	15.1 (1.8)	14.3 (1.6)

Notes

1. Building society lending for May is the largest ever in absolute and annual percentage terms. (Surprise, surprise!)

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

2. Broad money growth was unremarkable in May, the 12 month growth rate of M4 being unchanged at 16 per cent. However, like last month, there happened to be significant overfunding over the relevant 12 month period: about £6¾ billion - equivalent to nearly 2½ percentage points of the M4 annual growth rate. The 12 month growth rate of M3 fell to 18½ per cent, from 19½ per cent in April, but this may in part reflect special factors. Apart from the overfund, the Barclays rights issue (£0.9 billion) and the second call on BAA (£0.7 billion) may have depressed wholesale bank deposits - which fell sharply in seasonally adjusted terms - and building society bank deposits were flat in May, having risen by an average of £0.4 billion per month over the previous year. In contrast, the building societies continued to attract

a high level of retail inflows: £1.2 billion excluding interest credited in May, compared to an average of £1.1 billion per month in the previous six months post-crash and under £0.5 billion per month in the six months before the crash.

3. The credit counterparts to broad money showed a similar pattern, with relatively subdued one month growth of bank lending compared to recent months, but record growth of building society lending. CLSB figures suggest that the main influence on the bank lending figures was a lower level of lending to financial institutions, partly reflecting the unwinding of temporary lending in April. Identified bank lending to persons and to industrial and commercial companies were both at similar levels to April. Taking April and May together, seasonally adjusted bank lending was little changed compared to the average of the three previous months, although there has been a marked acceleration in bank lending over this period, mostly attributable to the pick-up in corporate borrowing. The record level of building society lending in May was no doubt affected by the Budget measures, although building society lending was boosted by societies' purchases of commercial bills, with mortgages alone increasing slightly less than in March and April. Another high level of building society commitments in May suggests a continuation of the recent acceleration in lending for house purchase.

Presentation

4. On the face of it, this is a less troublesome set of figures than the two preceding months. After the very high increases in April, the one month bank and bank and building society lending figures show more moderate growth; the twelve month growth rate of M4 is broadly flat after the fall in April. All the figures are well below market expectations.

5. Some commentators however could point to black linings in the apparently silver clouds. M0 growth continues to be well above the target range; the lending figures still show very high 12-month growth rates; and the increase in building society lending

is again a record, as in March and April. It would be unwise therefore to draw too much public comfort from this set of figures: the February figures showed some moderation in the growth of the aggregates and lending seen in the preceding months and were also below market expectations, but were succeeded by the high March and April figures. The attached press briefing is therefore cautious in tone.

6. We would be grateful for comments on the press briefing at an early stage on Monday morning. The Bank's draft press notice is also attached.

T.P. MHW

T PIKE/M H WHEATLEY

cc Bank of England

Mr George
Mr Thorp (Financial Statistics Division)

TABLE 2

GROWTH RATES OF MONETARY AGGREGATES

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

			1987 JUNE	JULY	AUG	SEP	OCT	NOV	DEC	1988 JAN	FEB	MAR	APR	MAY
M0 -	Monthly change	sa	24	189	39	120	99	49	139	-46	-18	133	139	77
	Monthly % change	nsa	-0.6	2.8	0.1	0.1	-0.2	0.3	7.0	-6.0	-1.0	1.8	1.7	0.1
	Monthly % change	sa	0.2	1.2	0.3	0.8	0.6	0.3	0.9	-0.3	-0.1	0.8	0.9	0.5
	6-month annualised % change	sa	0.2	4.0	6.2	7.0	7.3	7.0	8.5	5.3	4.5	4.6	0.0	0.0
	Annual % change	sa	4.2	5.4	4.7	4.9	5.6	4.9	4.3	4.6	5.3	5.8	6.2	6.2
M3 -	Monthly change	nsa	1943	4268	2147	1658	5798	1207	2583	-2030	522	8846	1341	2284
	Monthly % change	nsa	1.2	2.5	1.2	1.0	3.3	0.7	1.4	-1.1	0.3	4.8	0.7	1.2
	Monthly % change	sa	1.4	2.2	1.3	1.4	3.7	-0.1	1.4	0.6	0.4	3.1	1.6	0.5
	6-month annualised % change	sa	24.4	26.6	25.2	22.0	25.6	21.9	21.8	17.9	15.8	19.6	14.8	16.0
	Annual % change	nsa	19.3	21.0	22.2	19.7	22.5	21.5	22.9	22.5	20.5	21.0	19.4	18.4
M4 -	Monthly change	nsa	4078	5353	2606	2980	5475	1528	4902	424	1229	9850	1911	3964
	Monthly % change	nsa	1.5	1.9	0.9	1.0	1.9	0.5	1.6	0.1	0.4	3.2	0.6	1.2
	Monthly % change	sa	1.5	1.6	1.3	1.2	2.3	0.3	1.3	0.3	0.9	2.3	1.1	0.8
	6-month annualised % change	sa	15.9	18.9	18.4	17.3	18.9	17.3	16.9	14.0	13.2	15.6	12.9	14.2
	Annual % change	nsa	13.9	15.0	15.6	15.0	15.8	15.3	16.3	16.6	16.0	16.8	16.0	16.0
M5 -	Monthly change	nsa	4162	5487	2720	3043	5608	1482	5212	104	954	10789	1617	3639
	Monthly % change	nsa	1.4	1.9	0.9	1.0	1.8	0.5	1.7	0.0	0.3	3.4	0.5	1.1
	Monthly % change	sa	1.5	1.5	1.3	1.2	2.2	0.3	1.3	0.3	0.8	2.3	0.8	0.8
	6-month annualised % change	sa	15.3	18.5	17.9	17.1	18.9	16.8	16.3	13.8	12.8	15.4	12.4	13.5
	Annual % change	nsa	13.6	14.4	15.0	14.4	15.3	14.7	15.9	16.3	15.6	16.6	15.7	15.3
NIBM1 -	Monthly change	nsa	1480	88	-132	338	288	440	390	-1387	858	2150	3	1157
	Monthly % change	nsa	3.5	0.2	-0.3	0.8	0.7	1.0	0.9	-3.1	2.0	4.8	0.0	2.5
	Monthly % change	sa	4.3	0.2	0.2	0.6	3.7	-2.4	-0.2	3.7	1.4	1.2	-0.1	1.2
	6-month annualised % change	sa	15.9	10.0	9.7	13.5	24.7	14.0	4.2	11.4	14.1	15.4	7.2	15.3
	Annual % change	nsa	13.3	11.8	11.8	5.5	11.6	10.2	10.2	11.8	12.6	15.2	13.8	13.4
M1 -	Monthly change	nsa	2138	1089	1030	1568	2969	456	-258	-971	-433	5322	1064	2295
	Monthly % change	nsa	2.6	1.3	1.2	1.8	3.3	0.5	-0.3	-1.1	-0.5	5.9	1.1	2.4
	Monthly % change	sa	2.9	1.4	1.5	1.6	5.0	-1.1	-1.0	2.3	-0.6	3.8	1.2	1.8
	6-month annualised % change	sa	30.9	24.6	28.2	23.2	36.4	24.9	15.6	17.9	13.0	17.9	9.5	16.0
	Annual % change	nsa	23.8	22.6	23.8	20.5	24.9	21.9	23.0	21.9	20.7	21.0	21.2	19.6
WIDER £	Monthly change	nsa	567	5249	1373	1782	7801	-41	3514	647	152	8474	3830	2813
AGGREGATE	Monthly % change	nsa	0.3	2.7	0.7	0.9	3.8	0.0	1.7	0.3	0.1	3.9	1.7	1.2
	Monthly % change	sa	0.5	2.4	0.7	1.3	4.2	-0.6	1.6	1.7	0.2	2.5	2.5	0.6
	6-month annualised % change	sa	22.5	23.5	21.9	20.3	25.1	18.2	20.9	19.4	18.0	20.8	16.8	19.9
	Annual % change	nsa				18.6	22.4	20.5	21.6	21.7	20.0	20.7	20.3	18.6

SECRET AND PERSONAL

TABLE 3:PROVISIONAL BROAD MONEY COMPONENTS

£ million

	MAY	AVERAGE GROWTH IN PREVIOUS 12 MONTHS
Notes and coins in circulation (nbps)	-260	100
Bank deposits (nbps)		
Retail		
non-interest bearing	1417	370
interest bearing	528	460
Wholesale	599	1700
Change in M3	2284	2630
Building society holdings of M3 (-)	9	-400
Buildings society deposits (M4ps)		
Retail	1452	1370
Wholesale	219	50
Change in M4	3964	3650
Money market instruments (M4ps)	-391	20
National Savings Bank (M4ps)	66	100
Change in M5	3639	3770

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

TABLE 4: PROVISIONAL BROAD MONEY COUNTERPARTS

MAY 1988

£ million

	M3	M4	M5
1. PSBR	-623	-623	-623
2. Debt sales to private sector (-)			
Gilts	505	761	761
Treasury bills	-10	44	
National Savings	-64	-64	2
CTD's	115	114	
Other CG debt	2	2	2
LA and PC debt	-169	-275	-391
3. External finance of public sector (-)	337	337	337
4. Public sector contribution (1+2+3)	93	296	88
5. Sterling lending to private sector	3322	5701	5584
6. Externals	-402	-660	-660
7. £NNDLs	-729	-1373	-1373
8. Total change (4+5+6+7)	2284	3964	3639
(Percentage change)	(+0.5)	(+0.8)	(+0.8)

AVERAGE CHANGE IN PREVIOUS 12 MONTHS

	M3	M4	M5
1. PSBR	-550	-550	-550
2. Debt sales to private sector (-)			
Gilts	-260	-250	-250
Other public debt	-70	-130	10
3. External finance of public sector (-)	490	490	490
4. Public sector contribution (1+2+3)	-390	-440	-300
5. Sterling lending to private sector	3980	5350	5330
6. Externals	-590	-680	-680
7. £NNDLs	-370	-580	-580
8. Total change (4+5+6+7)	2630	3650	3770
(Percentage change)	(+2.0)	(+1.0)	(+1.0)

MONEY SUPPLY IN MAY: PRESS BRIEFING

A. FACTUAL

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

per cent

	M0	M3	**M4**	M5
12 month growth rate	**+5.7** **(+6.2)**	+18.4 (+18.8)	**+16.0** **(+15.7)**	+15.3 (+15.1)
Annualised six-month growth	**(+5.5)**	(+16.0)	**(+14.2)**	(+13.5)
one month change	**+0.1** **(+0.5)**	+ 1.2 (+ 0.5)	+ 1.2 **(+ 0.8)**	+ 1.1 (+ 0.8)

(Figures in brackets seasonally adjusted s.a.)

(ii) **MO**

Figures (+5.7 and +6.2 s.a.) above target range, but FSBR recognised this was likely.

(iii) **Broad money**

(a) 1 month growth rates. Seasonally adjusted M4 (and M3) continuing slowdown in growth rates first seen in April; unadjusted higher than April but still well below March.

(b) But 3 and 6 month growth rates still increasing, reflecting high monthly figures earlier in the year.

(c) 12 month growth rates. M4 roughly level after fall in April. M3 fallen for second month running.

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

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12 month growth rate	**+5.7** **(+6.2)**	+18.~~3~~4 (+18.8)	**+16.0** **(+15.7)**	+15.3 (+15.1)
Annualised six-month growth	**(+5.5)**	(+16.0)	**(+14.2)**	(~~+15.1~~ 13-5)
one month change	**+0.1** **(+0.5)**	+ 1.2 (+ 0.5)	+ 1.2 **(+ 0.8)**	+ 1.1 (+ 0.8)

(Figures in brackets seasonally adjusted s.a.)

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

(iv) **Lending**

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

(b) One month changes: increases in bank and bank and building society lending lower than April.

	Bank and building society lending		Bank lending	
	£ billion	%	£ billion	%
March	+7.9 (+6.8)	+2.3 (+2.0)	+6.0 (+4.9)	+2.8 (+2.3)
April	+6.4 (+8.2)	+1.8 (+2.3)	+4.1 (+5.8)	+1.9 (+2.6)
May	+5.7 (+5.7)	+1.6 (+1.6)	+3.3 (+3.3)	+1.5 (+1.5)

(Figures in brackets seasonally adjusted)

(c) Continuing increase in 12 month growth rates (unadjusted), reflecting high monthly figures earlier in the year.

	Bank and building society %	Bank %
December	+18.8	+22.8
January	+20.0	+24.7
February	+19.9	+24.2
March	+20.8	+25.2
April	+21.8	+26.8
May	+22.3	+26.9

(v) **Funding.** Underfund (on new, M4 definition) in May of £0.4 million; PSDR May of £0.6 million

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

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

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

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

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

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

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

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

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

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

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

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

(f) **Chancellor on anti-inflationary policy, Conservative Women's Conference, 24 May**

Chancellor said no risks would be taken with inflation. Battle against inflation remained "at the very core and centre" of policies "as it has done throughout my time as Chancellor, and Geoffrey Howe's before me."

B. DEFENSIVE

(i) Lending

jargon

(a) **Why are increases in lending lower?** Mainly accounted for by fall in increase of ~~CLSB~~ bank lending to financial companies. Some of last month's lending to securities dealers unwinding.

(b) **Why building society lending so high?**

Building Society commitments figures show high commitments in February, March and April, now feeding through into lending. Budget measures (~~on~~ changes to residence basis for mortgage tax relief, and abolition of home improvement loans) have encouraging people to bring forward lending, to beat deadline, which would probably ~~have occurred~~ anyway.

(c) **Taken with previous month's figures, lending figures still high?**

- Experience of number of years shown that high rate of growth of lending and liquidity not inconsistent with lower inflation because increased liquidity willingly held ie held as savings rather than for spending.

- CBI April quarterly survey shows "few signs of overheating". CBI ~~May monthly trends survey shows continuing strong growth in output and order books with~~ little sign of higher inflation, ahead.

- Judgement of monetary conditions and inflationary pressures must take account of whole range of factors, including downward pressure on inflation from exchange rate.

- No sign of resurgence of inflation.

(d) **Consumer credit boom?**

- No evidence that rate of lending to consumers accelerating in recent months: 12 month growth rate close to its average since 1982 of 18 per cent. (Some credit card payments simply displacing cash and cheque payments - over 40 per cent of credit card users settle early so they pay no interest.)

- Vast bulk of personal borrowing takes form of mortgages, which represented 2/3 of outstanding personal debt at end of 1987. Mortgage lending accounts for almost half of all of bank and building society lending. Increase overall as percentage of GDP in 1980s mainly attributable to growth in mortgage borrowing, as result of 2½ million increase in households buying own home.

- Consumer credit only some 15 per cent of total personal debt. Less than 5 per cent of personal debt takes form of credit card lending (including interest-free component). (See Chancellor's speech to FHA, 17 June 1987).

(e) **Why not impose controls on lending?** Direct controls would not be effective given increasing sophistication of modern financial markets. In any case, Government believes lenders and borrowers should be free to make own decisions.

(ii) **Money Supply**

(a) **M0 growth outside target range?** 1988-89 FSBR chapter 3 ~~stated~~ ~~recognised~~ warned that ~~12-month~~ M0 growth ~~may~~ would move ~~to top of or outside~~ above 1-5 per cent target range in early part of 1988-89 but ~~should be~~ would come back within range later in year.

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

(iii) **Interest rate increases 2 and 6 June**

(a) **Why increase rates?** [~~Decided~~] A a further slight tightening of monetary conditions was appropriate.

this has become the normal practice.

(b) **Why movc twice in quick succession? Why didn't you increase a full point on 2 June.** Interest rate movements ~~are normally~~ have been 1/2%: (12 out of last 13), ~~and~~ Exchange market conditions changed very suddenly at the beginning of June; it was only sensible to see how conditions developed.

(or 1/2% for each 5 pfennig change in the DM/£ rate)

(c) **Government applies formula whereby interest rates moved by 1 per cent for each 4 per cent opposite change in exchange rate?** No. Interest rate decisions taken within continuous comprehensive assessment of monetary conditions, taking all evidence into account. Exchange rate a key indicator of monetary conditions, but not the only factor.

(d) **Further movements on the way?** Never speculate. (Leave that to the market!)

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

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

(g) **Treasury model shows that interest rates should be raised by 1 per cent for each 4 per cent fall in the exchange rate?** Interest rate changes are not decided by Treasury model, but by the authorities exercising their judgement as in any other well-conducted country.

(h) **Government being pushed around by the markets?** No. Prime Minister said on 17 May that "it would be a great mistake for any speculator at any time to think that sterling was a one way bet." suggest Events have ~~proved her right.~~ confirm this.

(i) **Why raise interest rates rather than intervene?** Judgement of best course at time.

(j) **Did you intervene as well?** Never comment.

(k) **What does this mean for mortgage rates?** Matter for mortgage lenders - ask them.

(iv) **UK's real interest rates out of line with competitors?** Deflating current three month money rates by recent price indices suggest UK not far above G7 average.

DRAFT

Secret until 1130 am Monday 20 June 88

Provisional estimates of monetary aggregates: May 1988

1 Provisional information suggests the following:

% changes		M0	M3	M4	M5
12 months to May (not seasonally adjusted)		+5.7	+18.4	+16.0	+15.3
May	- not seasonally adjusted	+0.1	+ 1.2	+ 1.2	+ 1.1
	- seasonally adjusted	+0.5	+ 0.5	+ 0.8	+ 0.8

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

£ billions, not seasonally adjusted	M3		M4		M5	
	May	latest 12 months	May	latest 12 months	May	latest 12 months
A PSBR	−0.6	− 7.1	−0.6	− 7.1	− 0.6	− 7.1
B debt sales to private sector (−) (1)	+0.4	− 2.7	+0.6	− 2.9	+0.4	− 1.8
C external flows to public sector (−)	+0.3	+ 3.3	+0.3	+ 3.3	+0.3	+ 3.3
D public sector contribution (A+B+C)	+0.1	− 6.5	+0.3	− 6.7	+0.1	− 5.6
E sterling lending (2)	+3.3	+48.7	+5.7	+66.2	+5.6	+65.6
F other counterparts (3)	−1.1	−11.6	−2.0	−15.2	−2.0	−15.2
Total (D+E+F)	+2.3	+30.6	+4.0	+44.3	+3.7	+44.8
Sterling lending (seasonally adjusted)	+3.3		+5.7		+5.5	
(average of previous 6 months)	+4.5		+6.1		+6.0	

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

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

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

3 The PSBR was reduced in May by privatisation proceeds totalling some £0.9 billion, reflecting receipt of the second payment for BAA shares and redemption of preference shares by British Telecom. Also, a rights issue by Barclays (£0.9 billion) will have increased net non-deposit sterling liabilities (a negative contribution within 'other counterparts').

4 The past series for the PSBR, M3, M4, and M5 have been revised in the light of newly available data for public corporations' holdings of notes and coin (which by definition are excluded from the monetary aggregates other than M0). The revisions to the monetary aggregates are very small, both in individual months and over longer periods (for example none of the revisions to the 1-month and 12-month changes in M3, M4 and M5 during the past year exceeds 0.1 of a percentage point).

5 Full monetary statistics, for May, including revised estimates of the figures in paragraphs 1 and 2 and detailed series incorporating the revisions described in paragraph 4, will be published on 29 June.

Bank of England
20 June 1988

SECRET AND PERSONAL
UNTIL 11.30 AM MONDAY 20 JUNE 1988

MP

FROM: M H WHEATLEY
DATE: 20 June 1988

MR GIEVE

cc: PPS
PS/Chief Secretary
PS/Economic Secretary
Sir P Middleton
Sir G Littler
Sir T Burns
Mr Scholar
Mr Peretz
Mr Grice
Miss O'Mara
Mr Pickford
Mr Bush
Mrs Ryding
Mr Pike/Ms Bronk
Mr Cropper
Mr Hudson (after publication)

MAY: PROVISIONAL MONEY FIGURES

I attach the press briefing for today's provisionals. I have sidelined the amendments.

2. There have been no changes to the main figures circulated in Mr Pike's and my minute of 17 June.

3. I also attach the Bank's Press Notice and the regular monthly statement of the London and Scottish Banks. Questions on this should be directed to the CLSB press office (01-626-8486).

MHW

M H WHEATLEY

MONEY SUPPLY IN MAY: PRESS BRIEFING

A. FACTUAL

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

	M0	M3	M4	M5
	per cent			
12 month growth rate	**+5.7** **(+6.2)**	+18.4 (+18.8)	**+16.0** **(+15.7)**	+15.3 (+15.1)
Annualised six-month growth	**(+5.5)**	(+16.0)	**(+14.2)**	(+13.5)
one month change	**+0.1** **(+0.5)**	+ 1.2 (+ 0.5)	+ 1.2 **(+ 0.8)**	+ 1.1 (+ 0.8)

(Figures in brackets seasonally adjusted s.a.)

(ii) **MO**

Figures (+5.7 and +6.2 s.a.) above target range, but FSBR recognised this was likely.

(iii) **Broad money**

(a) 1 month growth rates. Seasonally adjusted M4 (and M3) continuing slowdown in growth rates first seen in April; unadjusted higher than April but still well below March.

(b) But 3 and 6 month growth rates still increasing, reflecting high monthly figures earlier in the year.

(c) 12 month growth rates. M4 roughly level after fall in April. M3 fallen for second month running.

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

(iv) Lending

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

(b) One month changes: increases in bank and bank and building society lending lower than April.

	Bank and building society lending		Bank lending	
	£ billion	%	£ billion	%
March	+7.9 (+6.8)	+2.3 (+2.0)	+6.0 (+4.9)	+2.8 (+2.3)
April	+6.4 (+8.2)	+1.8 (+2.3)	+4.1 (+5.8)	+1.9 (+2.6)
May	+5.7 (+5.7)	+1.6 (+1.6)	+3.3 (+3.3)	+1.5 (+1.5)

(Figures in brackets seasonally adjusted)

(c) Continuing increase in 12 month growth rates (unadjusted), reflecting high monthly figures earlier in the year.

	Bank and building society %	Bank %
December	+18.8	+22.8
January	+20.0	+24.7
February	+19.9	+24.2
March	+20.8	+25.2
April	+21.8	+26.8
May	+22.3	+26.9

(v) **Funding.** Underfund (on new, M4 definition) in May of £0.4 million; PSDR May of £0.6 million

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

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

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

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

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

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

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

(d) <u>Chancellor on inflation and exchange rates (This Week Next Week interview, 24 April)</u>.

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

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

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

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

(f) <u>Chancellor on anti-inflationary policy, Conservative Women's Conference, 24 May</u>

Chancellor said no risks would be taken with inflation. Battle against inflation remained "at the very core and centre" of policies "as it has done throughout my time as Chancellor, and Geoffrey Howe's before me."

B. DEFENSIVE

(i) Lending

(a) **Why are increases in lending lower?** Mainly accounted for by fall in increase of bank lending to financial companies. Some of last month's lending to securities dealers unwinding.

(b) **Why building society lending so high?**

Building Society commitments figures show high commitments in February, March and April, now feeding through into lending. Budget measures (change to residence basis for mortgage tax relief and abolition of home improvement loans) encouraging people to bring forward lending to beat deadline which would probably have occurred anyway.

(c) **Taken with previous month's figures, lending figures still high?**

- Experience of number of years shown that high rate of growth of lending and liquidity consistent with lower inflation because increased liquidity willingly held ie held as savings rather than for spending.

- CBI April quarterly survey shows "few signs of overheating". May monthly trends survey shows little sign of higher inflation ahead.

- Judgement of monetary conditions and inflationary pressures must take account of whole range of factors, including downward pressure on inflation from exchange rate.

- No sign of resurgence of inflation.

(d) <u>Consumer credit boom?</u>

- No evidence that rate of lending to consumers accelerating in recent months: 12 month growth rate close to its average since 1982 of 18 per cent. (Some credit card payments simply displacing cash and cheque payments - over 40 per cent of credit card users settle early so they pay no interest.)

- <u>Vast bulk of personal borrowing takes form of mortgages</u>, which represented <u>2/3 of outstanding personal debt at end of 1987</u>. Mortgage lending accounts for almost half of all of bank and building society lending. Increase overall as percentage of GDP in 1980s mainly attributable to growth in mortgage borrowing, as result of 2½ million increase in households buying own home.

- <u>Consumer credit only some 15 per cent of total personal debt</u>. Less than 5 per cent of personal debt takes form of credit card lending (including interest-free component). (See Chancellor's speech to FHA, 17 June 1987).

(e) **<u>Why not impose controls on lending</u>**? Direct controls would not be effective given increasing sophistication of modern financial markets. In any case, Government believes lenders and borrowers should be free to make own decisions.

(ii) **<u>Money Supply</u>**

(a) **<u>MO growth outside target range?</u>** 1988-89 FSBR chapter 3 warned that MO growth would move above 1-5 per cent target range in early part of 1988-89 but would come back within range later in year.

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

(iii) Interest rate increases 2 and 6 June

(a) Why increase rates? A further slight tightening of monetary conditions was appropriate.

(b) Why move twice in quick succession? Why didn't you increase a full point on 2 June. 12 out of last 13 interest rate movements have been 1/2%; this has become the normal practice. Exchange market conditions changed very suddenly at the beginning of June; it was only sensible to see how conditions developed.

(c) Government applies formula whereby interest rates moved by 1 per cent for each 4 per cent opposite change in exchange rate, or ½% for each 5 pfennig change in DM/£ range? No. Interest rate decisions taken within continuous comprehensive assessment of monetary conditions, taking all evidence into account. Exchange rate a key indicator of monetary conditions, but not the only factor.

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

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

(i) **Why raise interest rates rather than intervene?** Judgement of best course at time.

(j) **Did you intervene as well?** Never comment.

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(iv) **UK's real interest rates out of line with competitors?** Deflating current three month money rates by recent price indices suggest UK not far above G7 average.

PRESS INFORMATION from Banking Information Service

10 Lombard Street, London EC3V 9AR
Telephone 01-626 8486

NOT FOR PUBLICATION BEFORE 11.30 am
Monday 20th June, 1988

THE COMMITTEE OF LONDON & SCOTTISH BANKERS

MONTHLY STATEMENT: MAY 1988

Sterling advances to the U.K. private sector rose by £1,721 million in May. After allowing for seasonal factors and for transit items, the underlying increase was less than £1,800 million, compared with over £5,300 million in April and the recent monthly average increase of over £2,600 million. However, relative interest rates suggest that, in contrast to last month, corporate borrowing may have switched away from C.L.S.B. advances to market-related borrowing; bill finance increased, with C.L.S.B. acceptances to the private sector rising by over £500 million and holdings of commercial bills up quite strongly.

The analysis of advances, which is not seasonally adjusted, shows that, as a result of the reduced corporate borrowing, lending to persons (+£1,151 million) accounted for two-thirds of the total. Lending for house purchase (+£757 million including +£66 million of bridging finance) continued to rise strongly, the increase being some 40% higher than the increase in May last year; for other personal lending, however, though still rising strongly, the increase of £395 million was no higher than a year ago. Credit card credit accounted for only £32 million of the rise, and it is worth noting that, whereas in the first five months of 1987 credit card credit increased by a net £128 million, in the first five months of this year there have been net repayments of £53 million. Other large changes this month included further strong rises for construction (+£258 million), other services (+£202 million) and, to a lesser extent, to property companies (+£123 million). Manufacturers borrowed £218 million in sterling advances together with nearly £600 million of acceptances and foreign currency borrowing. Security dealers, however, repaid £263 million of last month's borrowing.

Among the banks' other assets, lending to the L.D.M.A. fell by £502 million, and holdings of gilt-edged stock by £321 million; cash and balances at the Bank of England, however, rose by £471 million.

On the liabilities side of the balance sheet, deposits from the U.K. private sector rose by £1,125 million. A large seasonal rise was expected for the whole monetary sector and, after allowing for this and for transit items, there was an underlying fall of nearly £500 million; this compares with an increase of nearly £2,900 million in April and the recent monthly average increase of around £1,200 million. Inflows into high interest personal accounts remained strong, and the fall was more than accounted for by time deposits from wholesale sources. Deposits from overseas residents again rose strongly (+£779 million after +£1,593 million in April), public sector deposits rose by £152 million and the banks raised over £850 million net in the interbank and CD markets. An increase of £593 million in "other liabilities" was more than accounted for by the proceeds of Barclays' rights issue.

Eligible liabilities rose by £3,366 million to £153,251 million.

QUARTERLY ANALYSIS OF LENDING
THREE MONTHS TO END-MAY

In the three months to end-May, total advances to U.K. residents (largely private sector and in sterling) rose by £9,761 million compared with £5,463 million in the previous quarter. After allowing for seasonal factors, the underlying increase in sterling advances to the U.K. private sector was over £10,300 million compared with £6,400 million in the previous quarter. However, unlike the previous quarter when acceptances also increased by nearly £2,400 million, there was little net change in acceptance credit in this period.

The analysis, which is not seasonally-adjusted, shows that lending to persons continued to account for about 40% of the total rise: it rose by £3,813 million (+7%) compared with £2,574 million (+5%) in the previous three months. Lending for house purchase rose by £2,408 million (+8%) against £1,895 million (+6%) in the previous quarter, with the higher rate of increase no doubt largely seasonal, and other personal lending rose by £1,405 million (+6%) against only £679 million (+3%) in the previous quarter. Lending to manufacturers rose strongly (+£1,158 million, +9%, with a further nearly £600 million in acceptances and foreign currency advances), as did lending to the financial sector (+£1,156 million, +8%) largely to security dealers, leasing companies and investment and unit trusts. Lending to "other services" (+£1,077 million, +10%), to property companies (+£878 million, +11%) and to construction (+£622 million, +12%) all continued to rise strongly.

For further information, please contact:

John Ecklin, Head of C.L.S.B. Statistical Unit (01-283 8866)

Edwin Lawton, Press and Information Manager (01-626 8486)

CONFIDENTIAL UNTIL 11.30 A.M. ON MONDAY, 20th JUNE, 1988

BALANCES OF C.L.S.B. GROUPS AS AT END-MAY, 1988

These tables cover the business of the offices of members of the Committee of London and Scottish Bankers and their subsidiaries in the United Kingdom (including the Channel Islands and the Isle of Man) which are listed by the Bank of England as falling within the monetary sector. The items are defined as in Table 3 of the Bank of England's Quarterly Bulletin.

£ millions

TABLE 1. AGGREGATE BALANCES

	Total Outstanding		Change on Month	
LIABILITIES				
STERLING DEPOSITS :				
U.K. monetary sector	30,004		+ 220	
U.K. private sector	127,425		+ 1,125	
U.K. public sector	4,239		+ 152	
Overseas residents	19,735		+ 779	
Certificates of deposit	15,199	196,601	+ 1,089	+ 3,366
of which : Sight		84,788		+ 3,147
Time (inc. C.D.'s)		111,813		+ 219
FOREIGN CURRENCY DEPOSITS :				
U.K. monetary sector	16,516		+ 1,059	
Other U.K. residents	8,196		+ 169	
Overseas residents	37,826		+ 1,603	
Certificates of deposit	4,126	66,665	- 226	+ 2,605
TOTAL DEPOSITS		263,266		+ 5,970
NOTES IN CIRCULATION		846		+ 29
OTHER LIABILITIES [a]		48,362		+ 593
TOTAL LIABILITIES		312,474		+ 6,592
ASSETS				
STERLING				
Cash & balances with Bank of England:				
Cash ratio deposits	631		0	
Other balances	2,591	3,222	+ 471	+ 471
Market loans :				
Discount houses	5,317		- 502	
Other U.K. monetary sector	27,225		- 17	
U.K. monetary sector C.D.'s	6,031		+ 462	
Local authorities	1,041		+ 7	
Other	7,102	46,716	+ 364	+ 314
Bills :				
Treasury bills	88		- 42	
Other bills	6,531	6,619	+ 1,284	+ 1,242
Investments :				
British Government stocks	5,203		- 321	
Other	5,301	10,504	- 54	- 374
Advances :				
U.K. private sector	137,950		+ 1,721	
U.K. public sector	391		- 115	
Overseas residents	6,367	144,708	+ 115	+ 1,721
Other sterling assets [a]		19,168		+ 269
FOREIGN CURRENCIES				
Market loans :				
U.K. monetary sector	16,306		+ 854	
Certificates of deposit	410		- 52	
Other	35,731	52,447	+ 1,750	+ 2,553
Bills		289		- 17
Advances :				
U.K. private sector	8,382		+ 174	
U.K. public sector	52		- 66	
Overseas residents	12,648	21,081	+ 341	+ 448
Other foreign currency assets [a]		7,722		- 33
TOTAL ASSETS		312,474		+ 6,592
ACCEPTANCES		8,677		+ 570
ELIGIBLE LIABILITIES		153,251		+ 3,366

(a) includes items in suspense and in transit

FOR TABLE 2 SEE OVER

TABLE 2. INDIVIDUAL GROUP BALANCES

£ million	C.L.S.B. GROUPS	BANK OF SCOTLAND	BARCLAYS	LLOYDS	MIDLAND	NATIONAL WESTMINSTER	ROYAL BANK OF SCOTLAND	STANDARD CHARTERED	TSB
LIABILITIES									
Sterling deposits									
outstanding	196,601	8,185	47,216	27,435	28,327	52,154	11,811	3,910	17,563
change on month	+ 3,366	+ 239	- 1	+ 610	+ 533	+ 1,204	+ 244	+ 2	+ 535
Foreign currency deposits									
outstanding	66,665	1,231	14,654	7,420	12,086	19,564	4,051	6,739	919
change on month	+ 2,605	- 11	+ 773	- 13	+ 345	+ 1,296	+ 170	+ 105	- 61
Total deposits									
outstanding	263,266	9,416	61,871	34,855	40,414	71,718	15,862	10,649	18,482
change on month	+ 5,970	+ 228	+ 772	+ 597	+ 878	+ 2,500	+ 414	+ 108	+ 474
STERLING ASSETS									
Cash and Balances with the Bank of England									
outstanding	3,222	406	573	246	479	626	709	19	164
change on month	+ 471	+ 71	+ 75	+ 1	+ 219	+ 43	+ 66	0	- 4
Market loans :									
U.K. monetary sector									
outstanding	32,542	1,133	5,927	3,420	4,157	10,562	1,890	909	4,544
change on month	- 519	+ 78	- 23	+ 143	- 519	- 386	+ 101	+ 14	+ 73
Other									
outstanding	14,174	183	3,758	1,221	2,014	3,807	618	315	2,258
change on month	+ 833	- 18	+ 537	- 33	+ 183	+ 314	+ 95	- 171	- 75
Bills									
outstanding	6,619	230	1,749	1,483	330	2,059	326	51	391
change on month	+ 1,242	+ 2	- 98	+ 304	+ 193	+ 574	+ 17	+ 4	+ 245
British government stocks									
outstanding	5,203	145	1,163	481	1,020	161	224	277	1,731
change on month	- 321	+ 18	- 411	- 74	+ 146	- 32	0	+ 8	+ 24
Advances									
outstanding	144,708	7,000	36,965	21,165	20,917	36,380	9,237	3,586	9,459
change on month	+ 1,721	+ 153	+ 546	+ 305	- 55	+ 759	- 192	- 52	+ 257
FOREIGN CURRENCY ASSETS									
Market loans and bills									
outstanding	52,736	442	11,522	6,151	8,980	16,396	3,225	5,293	727
change on month	+ 2,535	- 66	+ 1,073	- 119	+ 333	+ 935	+ 132	+ 300	- 53
Advances									
outstanding	21,081	848	3,707	3,042	4,921	4,408	1,290	2,576	288
change on month	+ 448	+ 14	+ 85	+ 89	+ 250	- 30	+ 36	- 13	+ 17
ACCEPTANCES									
outstanding	8,677	365	2,585	353	1,526	2,299	792	257	500
change on month	+ 570	+ 39	+ 400	- 42	+ 16	+ 178	+ 1	- 13	- 9
ELIGIBLE LIABILITIES									
outstanding	153,251	7,041	38,586	23,082	22,187	38,125	9,183	2,887	12,160
change on month	+ 3,366	+ 186	- 253	+ 776	+ 624	+ 1,438	- 48	+ 165	+ 480

COMPOSITION OF GROUPS (U.K. offices only)

The Bank of Scotland Group comprises Bank of Scotland, Bank of Wales plc, North West Securities Ltd. and The British Linen Bank Ltd.

The Barclays Group comprises Barclays Bank PLC, Barclays Bank Finance Company (Jersey) Ltd., Barclays Bank Trust Company Ltd., Barclays de Zoete Wedd Ltd., Barclays Finance Company (Guernsey) Ltd., Barclays Finance Company (Isle of Man) Ltd. and Mercantile Credit Company Ltd.

The Lloyds Group comprises Lloyds Bank PLC, Lloyds Bank Finance (Jersey) Ltd., Lloyds Bowmaker Ltd., Lloyds Merchant Bank Ltd. and The National Bank of New Zealand Ltd.

The Midland Group comprises Midland Bank PLC, Forward Trust Ltd., Midland Bank Finance Corporation Ltd., Midland Bank Trust Company Ltd., Midland Bank Trust Corporation (Guernsey) Ltd., Midland Bank Trust Corporation (Isle of Man) Ltd., Midland Bank Trust Corporation (Jersey) Ltd. and Samuel Montagu & Co., Ltd.

The National Westminster Group comprises National Westminster Bank PLC, Coutts & Co., Coutts Finance Co., International Westminster Bank PLC, Lombard Bank Ltd., Lombard & Ulster Ltd., Lombard Bank (Isle of Man) Ltd., Lombard Banking (Jersey) Ltd., Lombard North Central PLC, National Westminster Bank Finance (C.I.) Ltd., NatWest Investment Bank Ltd., Ulster Bank Ltd., Ulster Bank Trust Company and Ulster Investment Bank Ltd.

The Royal Bank of Scotland Group comprises The Royal Bank of Scotland PLC, Charterhouse Bank Ltd. and RoyScot Trust plc.

The Standard Chartered Group comprises Standard Chartered Bank, Chartered Trust plc and Standard Chartered Merchant Bank Ltd.

The TSB Group comprises TSB England & Wales plc, TSB Northern Ireland plc, TSB Scotland plc, Hill Samuel & Co Ltd., Hill Samuel & Co (Jersey) Ltd., Hill Samuel Personal Finance Ltd. and United Dominions Trust Ltd.

THE COMMITTEE of LONDON and SCOTTISH BANKERS'
STATISTICAL UNIT
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CONFIDENTIAL UNTIL 11.30 a.m. ON MONDAY, JUNE 20TH, 1988

ANALYSIS OF ADVANCES AND ACCEPTANCES TO U.K. RESIDENTS BY THE C.L.S.B. GROUPS AS AT END-MAY, 1988

This table covers advances and acceptances by offices of members of the Committee of London and Scottish Bankers and their subsidiaries which are listed by the Bank of England as falling within the monetary sector.

Loans under the special schemes for shipbuilding, other than those refinanced with the Bank of England, are included within item 3 "Other transport equipment"; but lending under the special export schemes is not included, since this is classified as advances to overseas residents.

£ millions	STERLING ADVANCES		CURRENCY ADVANCES		STERLING ACCEPTANCES	
	Outstanding	Change on Quarter	Outstanding	Change on Quarter	Outstanding	Change on Quarter
1 AGRICULTURE, FORESTRY & FISHING	5,453	+ 208	20	- 4	17	- 7
2 ENERGY & WATER SUPPLY INDUSTRIES						
(a) Oil & extraction of natural gas	438	- 96	583	+ 179	112	- 92
(b) Other energy industries	151	+ 2	18	- 167	136	+ 54
(c) Water supply	52	+ 11	0	0	0	0
Total item 2	642	- 83	601	+ 12	248	- 39
3 MANUFACTURING INDUSTRY						
(a) Extraction of minerals and ores	194	+ 74	169	+ 22	40	- 56
(b) Metal manufacturing	417	- 5	61	- 3	88	- 6
(c) Non-metallic mineral product manufacture	468	+ 17	247	+ 32	45	+ 10
(d) Chemical industry	801	+ 43	151	- 6	199	- 39
(e) Mechanical engineering	1,303	+ 14	153	+ 21	73	- 39
(f) Electrical & electronic engineering	1,508	+ 123	259	+ 8	683	+ 121
(g) Motor vehicles	279	+ 19	15	+ 2	299	+ 149
(h) Other transport equipment	988	- 4	111	+ 66	54	+ 10
(i) Other engineering & metal goods	1,274	+ 41	153	+ 2	158	+ 43
(j) Food, drink & tobacco	2,533	+ 615	285	+ 50	1,111	+ 101
(k) Textiles, leather, clothing & footwear	1,323	+ 80	57	+ 2	118	- 7
(l) Other manufacturing	3,672	+ 141	363	- 76	503	+ 169
Total item 3	14,759	+ 1,158	2,024	+ 122	3,370	+ 457
4 CONSTRUCTION	5,959	+ 622	99	- 21	148	+ 13
5 GARAGES, DISTRIBUTION, HOTELS & CATERING						
(a) Garages & retail motor trade	2,347	+ 97	26	+ 3	106	- 24
(b) Other retail distribution	5,495	+ 224	87	+ 5	734	- 9
(c) Wholesale distribution	3,137	+ 317	393	+ 120	397	- 43
(d) Hotels & catering	3,918	+ 269	532	- 43	141	+ 47
Total item 5	14,897	+ 907	1,039	+ 84	1,378	- 28
6 TRANSPORT						
(a) Air transport	190	- 112	56	- 3	2	+ 2
(b) Other transport	1,703	- 74	208	- 46	45	+ 4
Total item 6	1,893	- 186	264	- 49	47	+ 6
7 POSTAL SERVICES & TELECOMMUNICATIONS	210	+ 34	47	- 13	25	- 213
8 FINANCIAL						
(a) Building societies	129	- 18	0	0	0	0
(b) Investment & unit trusts etc.	3,339	+ 252	1,172	- 60	11	- 1
(c) Insurance companies, pension funds etc.	939	- 66	277	- 137	21	- 21
(d) Leasing companies	5,549	+ 385	15	+ 4	298	+ 49
(e) Other financial	4,144	+ 102	1,466	+ 70	856	- 33
(f) Securities dealers etc.	1,093	+ 500	428	- 69	0	0
Total item 8	15,194	+ 1,156	3,358	- 192	1,186	- 7
9 BUSINESS & OTHER SERVICES						
(a) Central & local government	315	+ 44	6	- 21	0	0
(b) Property companies	8,653	+ 878	250	+ 1	21	+ 9
(c) Hiring of movables	624	+ 33	6	- 3	31	- 1
(d) Other services	12,016	+ 1,077	665	+ 185	347	- 172
Total item 9	21,608	+ 2,031	927	+ 163	398	- 164
10 PERSONS						
(a) Bridging finance for house purchase	1,423	+ 189	0	0		
(b) Other house purchase	32,113	+ 2,219	1	0		
(c) Other advances to persons	24,192	+ 1,405	53	0		
Total item 10	57,728	+ 3,813	54	0		
TOTAL ADVANCES TO U.K. RESIDENTS	138,341	+ 9,659	8,433	+ 102	6,817	+ 18
Overdrafts	37,454	+ 2,341	1,352	+ 22		
Loans	100,886	+ 7,318	7,081	+ 80		

C.L.S.B. Statistical Unit

Provisional estimates of monetary aggregates: May 1988

1 Provisional information suggests the following:

% changes		M0	M3	M4	M5
12 months to May (not seasonally adjusted)		+5.7	+18.4	+16.0	+15.3
May	- not seasonally adjusted	+0.1	+ 1.2	+ 1.2	+ 1.1
	- seasonally adjusted	+0.5	+ 0.5	+ 0.8	+ 0.8

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

£ billions, not seasonally adjusted	M3		M4		M5	
	May	latest 12 months	May	latest 12 months	May	latest 12 months
A PSBR	-0.6	- 7.1	-0.6	- 7.1	- 0.6	- 7.1
B debt sales to private sector (-) (1)	+0.4	- 2.7	+0.6	- 2.9	+0.4	- 1.8
C external flows to public sector (-)	+0.3	+ 3.3	+0.3	+ 3.3	+0.3	+ 3.3
D public sector contribution (A+B+C)	+0.1	- 6.5	+0.3	- 6.7	+0.1	- 5.6
E sterling lending (2)	+3.3	+48.7	+5.7	+66.2	+5.6	+65.6
F other counterparts (3)	-1.1	-11.6	-2.0	-15.2	-2.0	-15.2
Total (D+E+F)	+2.3	+30.6	+4.0	+44.3	+3.7	+44.8
Sterling lending (seasonally adjusted)	+3.3		+5.7		+5.5	
(average of previous 6 months)	+4.5		+6.1		+6.0	

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

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

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

3 The PSBR was reduced in May by privatisation proceeds totalling some £0.9 billion, reflecting receipt of the second payment for BAA shares and redemption of preference shares by British Telecom. Also, a rights issue by Barclays (£0.9 billion) will have increased net non-deposit sterling liabilities (a negative contribution within 'other counterparts').

4 The past series for the PSBR, M3, M4, and M5 have been revised in the light of newly available data for public corporations' holdings of notes and coin (which by definition are excluded from the monetary aggregates other than M0). The revisions to the monetary aggregates are very small, both in individual months and over longer periods (for example none of the revisions to the 1-month and 12-month changes in M3, M4 and M5 during the past year exceeds 0.1 of a percentage point).

5 Full monetary statistics for May, including revised estimates of the figures in paragraphs 1 and 2 and detailed series incorporating the revisions described in paragraph 4, will be published on 29 June.

Bank of England
20 June 1988

MP

FROM: MISS M P WALLACE
DATE: 20 June 1988

MR WHEATLEY

cc PS/Economic Secretary
Mr Peretz
Mr Pike

MONEY BRIEFING

The Chancellor was grateful for your minute of 20 June. As I mentioned to you on the telephone, he was content with the attached briefing, subject to the following comments:

Defensive (i)(a) - change "CLSB" to "bank";

(i)(b) - amend second sentence to read: "Budget measures (change to residence basis for mortgage tax relief, and abolition of home improvements loans) encouraging people to bring forward lending, to beat deadline, which would probably have occurred anyway."

(i)(c) - in second indent, amend second sentence to read: "CBI May monthly trends survey shows little sign of higher inflation ahead."

(i)(d) - amend end of first indent to read: "... over 40 per cent of credit card users settle early so they pay no interest."

(ii)(a) - amend answer to read: "1988-89 FSBR chapter 3 warned that M0 growth would move above 1-5 per cent target range in early part of 1988-89 but would come back within range later in year."

(iii)(a) - delete "decided".

(iii)(b) - amend first sentence of answer to read: "12 out of last 13 interest rate movements have been ½ per cent: this has become the normal practice."

(iii)(h) - amend last sentence to: "Subsequent events have confirmed this."

MPW.

MOIRA WALLACE

CL
You have read this (with Peter + Terry this evening)
AA

SECRET

COPY NO. 11

FROM: P N SEDGWICK
DATE: JUNE 22 1988

PJ

CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
PCC
MEG
Mr Edwards
Mrs Lomax
Mr Moore
Miss Peirson
Mr S Davies
Mr Gieve
Mr Grice
Mr Hibberd
Mr Matthews
Mr Melliss
Mr Mowl
Mr Pickford
Mr Riley
Mr Cropper
Mr Tyrie
Mr Call

Thanks: 2.1 will discuss with Sir TB when I want to.

TREASURY ECONOMIC FORECAST

I attach a copy of the main report on the recent forecasting exercise, which reflects judgements taken at a series of meetings with Sir T Burns.

2. The other detailed reports on this exercise are

World Economic Prospects	Mr Matthews, IF2 (circulated June 10)
Public Finances	Mr Mowl
The Financial Prospect	Mr Mowl

P.N.S

P N SEDGWICK

NB RPI [illegible] GDP [illegible]

TREASURY ECONOMIC FORECASTING EXERCISE

JUNE 1988

TREASURY ECONOMIC FORECASTING EXERCISE

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

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

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

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

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

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

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

(1) MAIN RESULTS

The World economy

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

SECRET

TABLE 1 : SUMMARY OF FORECAST

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

	AUTUMN STATEMENT 1987	JANUARY 1988	FSBR 1988	JUNE 1988
C INFLATION AND MONEY GDP				
7. MONEY GDP (MARKET PRICES) (per cent change on a year earlier)				
1987-88	8½	9.9	9¾	9.8
1988-89	7¼	7.5	7½	10.0
1989-90		7.0	6½	7.9
1990-91			6	6.1
8. RPI (excluding mortgage interest payments in brackets) (per cent change on a year earlier)				
1987 Q4	4(3.7)	4.1(4.0)	4.1(4.0)	4.1(4.0)
1988 Q4	4½(4.4)	4.0(3.8)	4.0(3.9)	5.0(4.5)
1989 Q4		4.4(4.2)	3.0(2.7)	5.6(4.5)
1990 Q4			3.4(3.5)	4.1(3.6)
9. GDP market price deflator (per cent change on a year earlier)				
1987-88	4¼	5.0	5	5.1
1988-89	4½	4.8	4½	5.7
1989-90		4.6	4	5.2
1990-91			3½	4.0
D PUBLIC FINANCES				
10. PSBR - £ billion				
1987-88	1.0	-2.8	-3.1	-3.5
1988-89		-3.4	-3.2	-7.4
1989-90		-3.7	0	-7.4
1990-91			0	-7.4
11. PSBR - % OF GDP				
1987-88	¼	-¾	-¾	-¾
1988-89		-¾	-¾	-1½
1989-90		-¾	0	-1½
1990-91			0	-1½
12. ANNUAL FISCAL ADJUSTMENT - £ billion				
1988-89		4.0	0	0
1989-90		2.4	3.7	2.7
1990-91		0.5	0.7	0.7

	AUTUMN STATEMENT 1987	JANUARY 1988	FSBR 1988	JUNE 1988
E MONETARY CONDITIONS				
13. SHORT TERM INTEREST RATES (per cent))				
1987 Q4	9.5	9.2	9.2	9.2
1988 Q4	9.5	9.5	9.0	9.5
1989 Q4		9.5	8.8	10.5
1990 Q4			8.4	10.5
14. MO (per cent change on a year earlier)				
1987-88	4.9	5.1	5	4.9
1988-89	4.3	5.0	1-5	5.1
1989-90		3.0	1-5	1.9
1990-91			0-4	0.9
15. STERLING INDEX (1975=100)				
1987 Q4	72.5	74.9	74.9	74.9
1988 Q4	72.5	77.4	75.5	76.7
1989 Q4		76.0	74.4	74.3
1990 Q4			74.1	72.9
16. £/DM EXCHANGE RATE				
1987 Q4	2.95	2.99	2.99	2.99
1988 Q4	2.94	2.96	3.00	3.05
1989 Q4	2.87	2.88	2.92	2.90
1990 Q4			2.87	2.80
17. RELATIVE UNIT LABOUR COSTS (1980=100)				
1987	75.1	75.5	76.5	76.7
1988	75.4	79.8	79.5	82.1
1989		80.5	80.4	80.8
1990			80.7	80.1
F TRADE AND CURRENT ACCOUNT				
18. VOLUME OF NON-OIL EXPORTS OF GOODS (per cent change on a year earlier)				
1987	6¾	7.0	6.8	6.7
1988	3	4.3	4.2	2.8
1989		3.6	3.6	6.5
1990			5.4	5.0
19. VOLUME OF NON-OIL IMPORTS OF GOODS (per cent change on a year earlier)				
1987	7	7.9	8.5	8.4
1988	4¾	6.4	6.4	9.5
1989		3.3	4.4	6.1
1990			4.9	3.2
20. CURRENT BALANCE £ billion				
1987	-2½	-2.5	-1.7	-1.6
1988	-3½	-4.6	-3.9	-9.3
1989		-5.3	-4.6	-10.1
1990			-4.3	-9.0

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

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

<u>UK activity</u>

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

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

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

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

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

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

<u>The balance of payments</u>

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

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

and the associated sterling depreciation. The current account deficit is forecast to be £9½b. in 1988 and £10b. in 1989, after which it falls slightly as domestic growth moderates. By 1989 imports are about 20 per cent higher than exports so that exports have to grow by 1½ per cent more than imports just to keep the visible trade deficit constant.

<u>Financial Conditions</u>

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

<u>Inflation and money GDP</u>

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

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

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

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

Public finances

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

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

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

18. Even with a large planning total overrun the rise in the pre-fiscal adjustment tax burden means that tax cuts are feasible in 1989-90. Assuming that the PSDR in 1989-90 stays close to its forecast outturn for 1988-89 - 1½ per cent of GDP - there is a **fiscal adjustment** of £2¾b,

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

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

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

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

*Financial years.

(2) THE WORLD ECONOMY

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

TABLE 3 : G7 (EXCLUDING UK) GROWTH AND INFLATION

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

Note: Figures in brackets are OECD published forecasts for G7 including UK.

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

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

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

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

Figures in brackets are latest OECD forecasts.

(3) TRADE AND THE BALANCE OF PAYMENTS

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

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

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

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

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

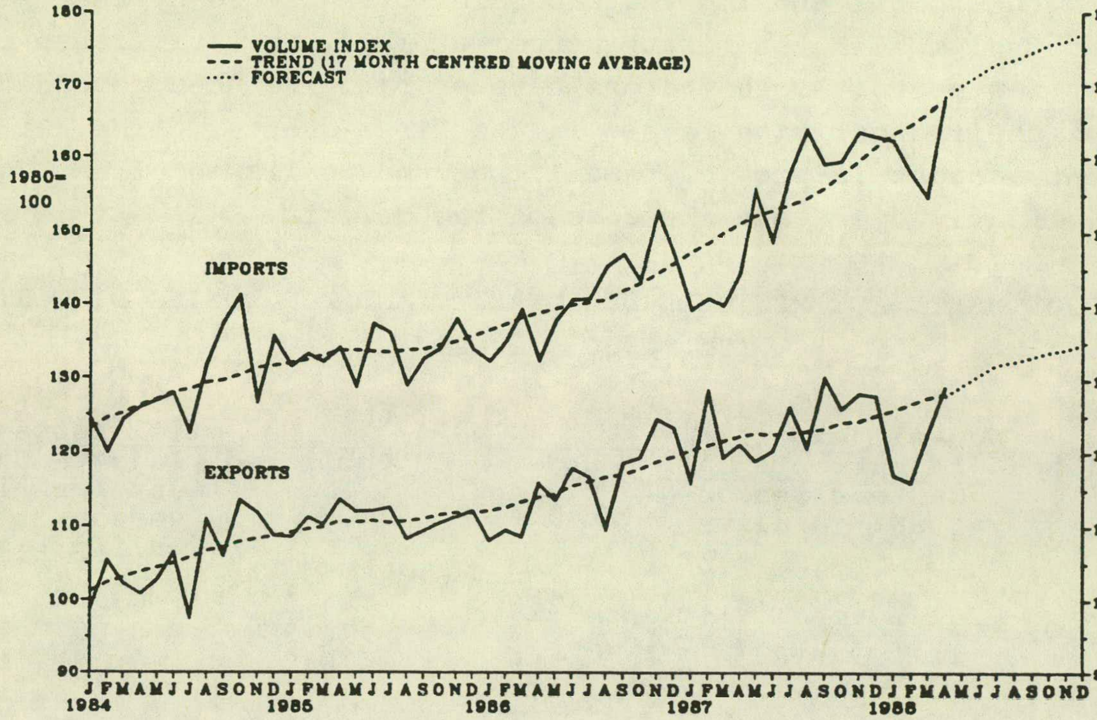
25. Allowing for these distortions, it appears that the growth of export volumes has slowed since the autumn, despite the very rapid growth of world trade. This conclusion is supported by data for manufacturing output in the first quarter, which show slower growth, especially in engineering industries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

Percentage balances, seasonally adjusted

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

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

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



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

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

TABLE 6 : UK CURRENT ACCOUNT (£ billion)

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

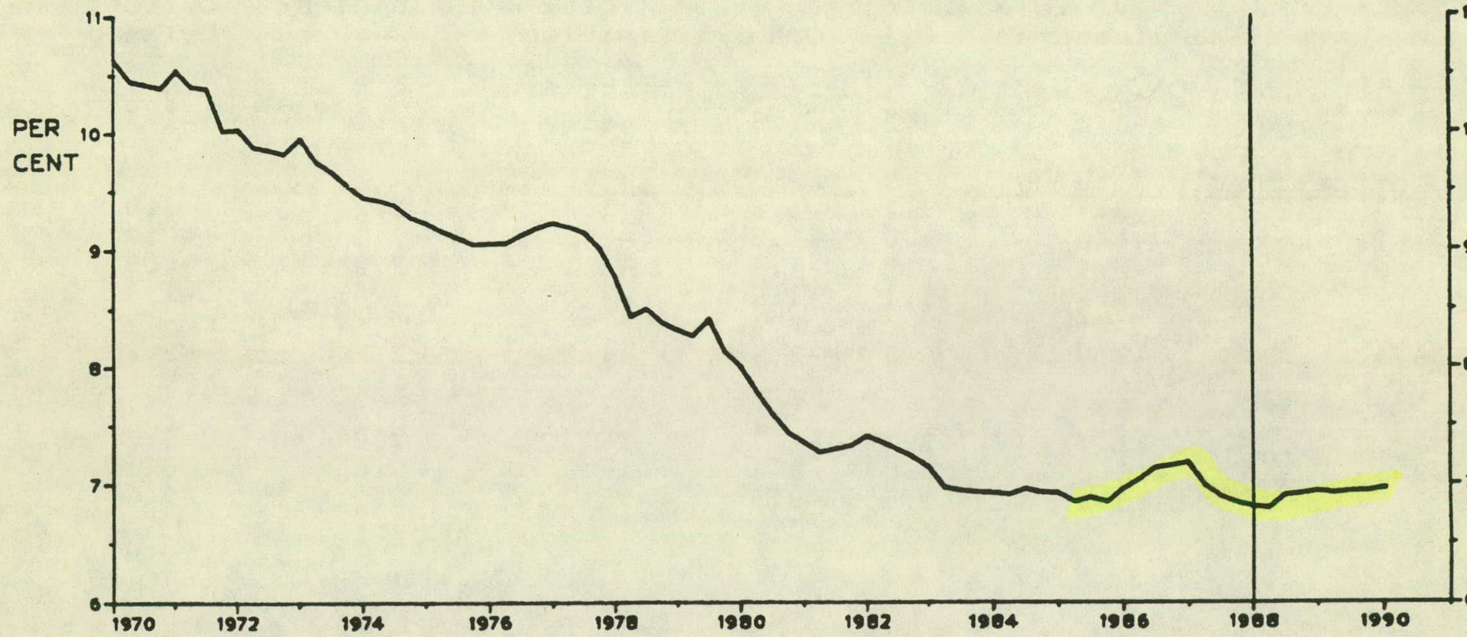
<u>Non oil visible trade</u>

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

TABLE 7 : COMPETITIVENESS

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

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



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

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

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

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

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

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

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

Oil trade

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

TABLE 9 : NORTH SEA OIL

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

* Financial years.

Invisibles

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

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

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

TABLE 10 : INVISIBLES £ billion

	Services	Oil IPD	Total IPD	Non-oil IPD	EC transfers	Other transfers	Total invisibles	Estimated net overseas assets (end-year)
1986	5.7	-1.3	5.0	6.3	-0.7	-1.5	8.6	113
1987	5.8	0.5	5.8	5.3	-1.8	-1.6	8.1	92
1988	4.7	0.7	5.6	4.9	-1.4	-2.0	7.0	92
1989	5.7	1.4	6.9	5.5	-1.8	-2.0	8.8	94
1990	6.4	1.7	7.6	5.9	-1.8	-2.0	10.3	95

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

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

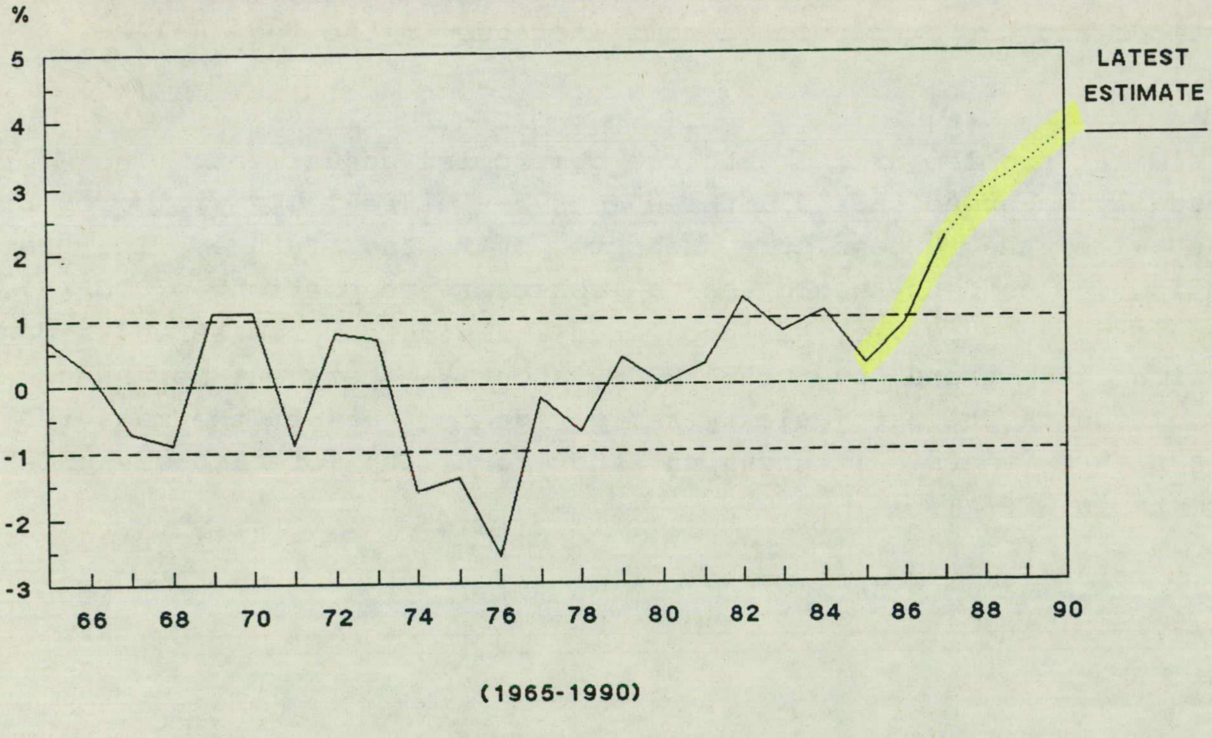
(4) DOMESTIC DEMAND AND ACTIVITY

The State of the National Accounts

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

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

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



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

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

The residual error and compromise adjustment in the forecast

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

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

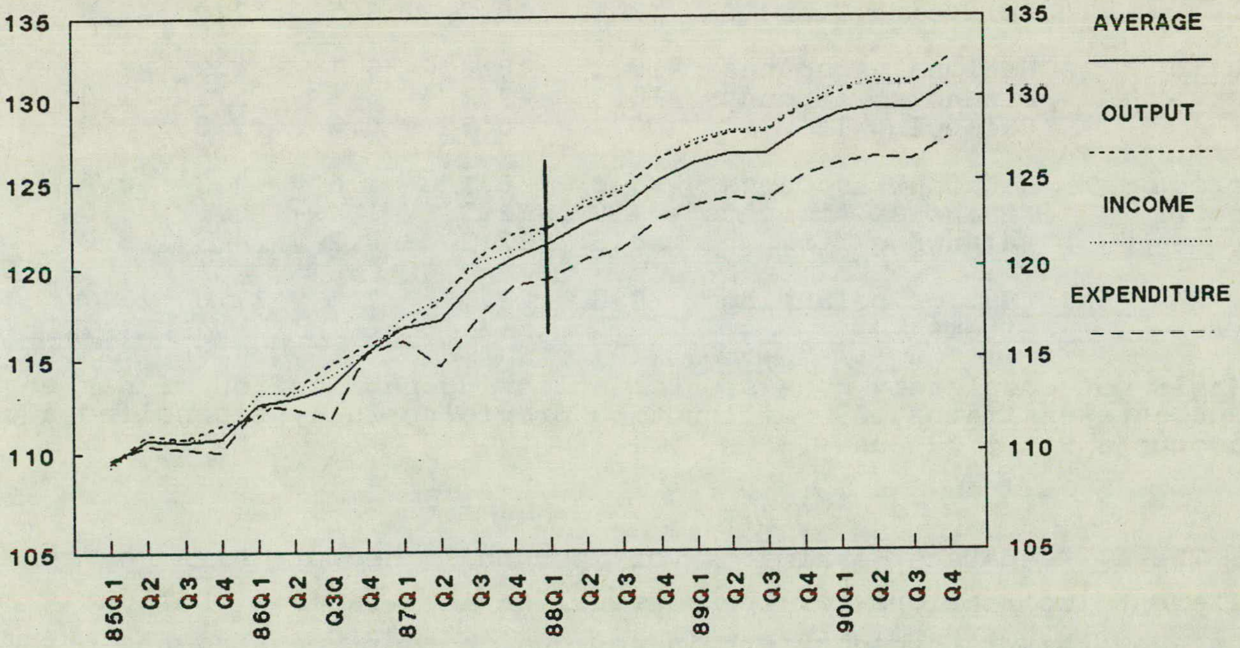
2¾
3½
3¼ ¾
4 } 3½

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

? take GDP(O) (or (O)2(I) avge)

		GDP(O)		GDP(I)	GDP(E)	Average measure of GDP(A)	Compromise adjustment (% of GDP(E))
1984	3¼	3.3	2.7	2.1	1.8	2.5	0.6
1985	3¾	3.8	3.5	3.2	4.0	3.6	0.3
1986	3	2.9	3.2	3.5	2.6	3.0	0.6
1987	4¾	4.8	4.7	4.6	3.3	4.2	1.5
1987Q4		5.4		5.0	3.2	4.4	1.3
1988Q1		4.8		4.4	2.9	4.0	1.8
Forecast 1988	4	3.9	4¼	4.4	3.5	3.9	1.9
1989		3.3		3.3	2.8	3.1	2.2
1990		2.4		2.3	1.9	2.2	2.5

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



Sectoral financial data

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

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

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

Don't understand

A pretty staggering table

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

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

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

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

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

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

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

<u>Indicators of activity in the first half of 1988</u>

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

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

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

TABLE 13 : LATEST INDICATORS OF ACTIVITY

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

[1] At a quarterly rate.

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

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

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

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

The Forecast

Personal Income and Expenditure

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

TABLE 14 : PERSONAL INCOME, EXPENDITURE AND SAVING

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

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

Company Income and Expenditure

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

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

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

* Includes public corporations

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

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

TABLE 16: THE FINANCIAL POSITION OF COMPANIES

(a) Profit shares and rates of return

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

– highest since when?

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

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

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

** Net of stock appreciation.

Sectoral surpluses and deficits

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

Aggregate Demand and Output

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

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

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

(5) PRICES AND EARNINGS

Producer Prices

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

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

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

TABLE 18 : COSTS AND PRICES IN MANUFACTURING

(percentage changes on previous year)

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

* Excluding food, drink and tobacco.

Retail Prices

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

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

(rises in August, November, January, April according to para 69)

TABLE 19 : COMPONENTS OF THE RETAIL PRICE INDEX

	1986Q4	1987Q4	1988Q4	FSBR	1989Q4	1990Q4
Food prices	3.2	3.4	3.1	2	3.4	4.2
NI prices	3.6	2.3	7.2	6½	5.7	4.5
Housing costs	7.1	7.0	10.8	6¾	14.2	8.5
Other prices						
- petrol	-12.6	1.3	2.0	3½	3.7	2.7
- other items	3.9	4.0	3.8		4.0	2.8
Total RPI	3.4	4.1	5.0	4	5.6	4.1
RPI excluding Mortgage Interest payments	3.4	4.0	4.5		4.5	3.6

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

TABLE 20 NATIONALISED INDUSTRY PRICE INCREASES FOR CONSUMERS

(a) Nominal increases

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

(b) Real increases

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

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

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

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

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

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

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

relative to what?

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

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

Why have forecasts for NI price increases gone up since FSBR?
is food price rise mainly commodity based?

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

	All items RPI			RPI excluding mortgage interest payments	
	FSBR	June		FSBR	June
1988 Apr	3.6	3.9		3.9	4.2
May	3.9	4.2	4¼	3.9	4.4
Jun	4.2	4.5		4.1	4.7
July	4.2	4.7		4.2	4.9
Aug	4.3	5.1	5	4.2	4.9
Sep	4.2	5.1		4.2	4.9
Oct	4.0	5.0		3.9	4.6
Nov	3.8	4.8	5	3.7	4.4
Dec	4.2	5.2		3.8	4.4
1989 Jan		5.6			4.5
Feb		5.9			4.9
Mar		5.9			4.9

The GDP deflator

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

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

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

Earnings

71. Private sector settlements averaged 5¼ per cent in the 1986-87 round, about ½ per cent lower than the previous round. In the manufacturing sector settlements were, on average, ¾ per cent lower than in the previous round. But settlements were clearly on an upward trend through the year to August 1987, and this upward trend seems to have continued. It seems most unlikely that total private sector settlements will turn out at less than 6½ per cent in the current round (their average at the end of the previous round). That is the forecast for 1987-88. But a small fall is expected in the 1988-89 pay round.

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

TABLE 23 : PRIVATE SECTOR SETTLEMENTS AND EARNINGS

(Contributions to changes between third quarters of successive years)

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

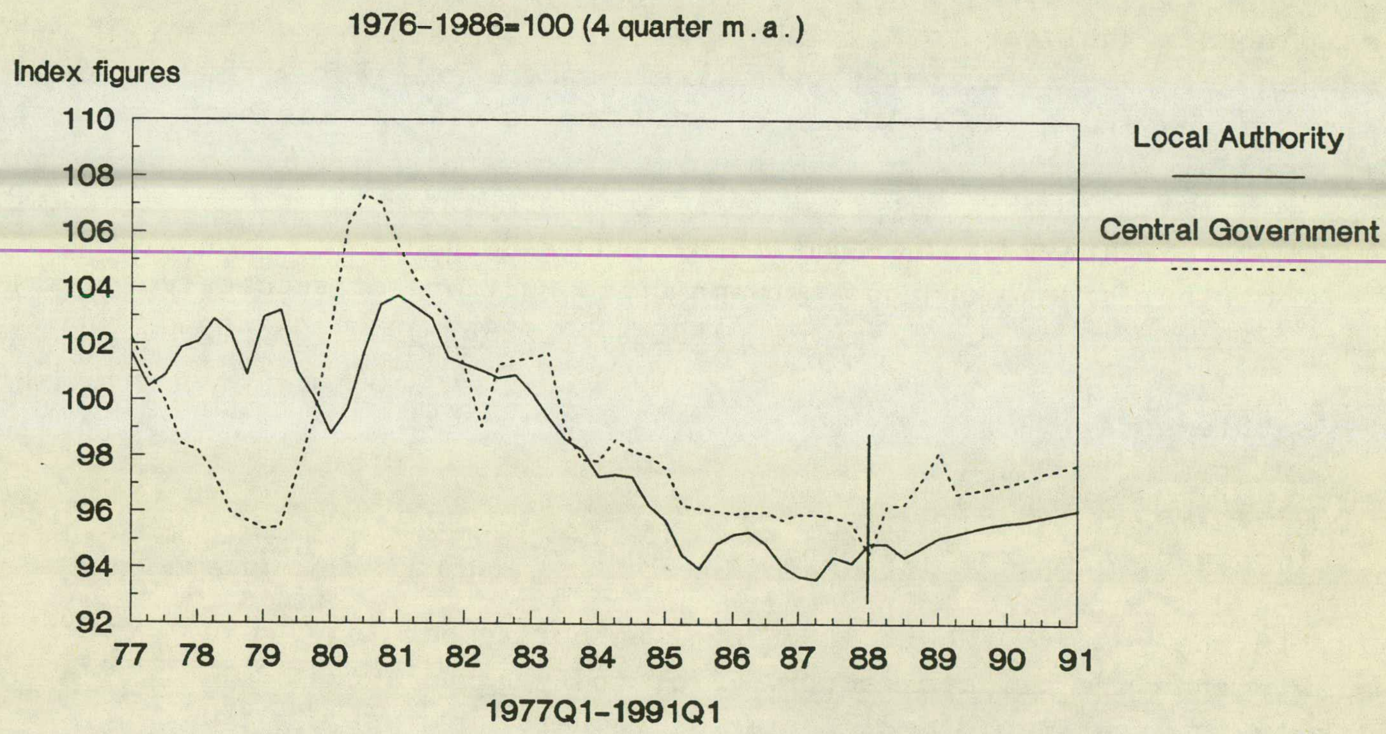
73. In the year to August 1987 local authority earnings grew rather more slowly than the private sector. Over the year to August 1988 they are more likely to grow a good deal faster. Teachers were paid 7½ per cent, as the second step of their 1987 settlement, from October and received another 1 per cent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

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

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

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

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



Labour Costs

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

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

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

(6) EMPLOYMENT, UNEMPLOYMENT AND PRODUCTIVITY

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

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

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

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

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

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

TABLE 27 : LABOUR PRODUCTIVITY GROWTH

(per cent per annum)

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

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

TABLE 28 : PRODUCTIVE POTENTIAL GROWTH

(per cent per annum)

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

(7) FINANCIAL CONDITIONS

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

TABLE 29: EXCHANGE RATES
(End year rates)

Big gamble £

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

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

TABLE 30 : INTEREST RATES

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

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

TABLE 31 : MONETARY AGGREGATES AND CREDIT

(per cent change on a year earlier)

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

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

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

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

TABLE 32 : PSBR AND FUNDING
(£ billion)

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

* non-bank non-building society private sector

† includes foreign currency finance

\+ overfund on M4 definition

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

TABLE 33 : NET EXTERNAL CAPITAL FLOWS
(£ billion)

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

(8) PUBLIC FINANCES

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

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

	1988-89			1989-90			1990-91	
	January Fore-cast	FSBR	June Fore-cast	January Fore-cast	FSBR	June Fore-cast	FSBR	June Fore-cast
General Government Expenditure	183½	183	181	194½	193	194½	201½	205½
General Government receipts	185½*	185	187½	198*	195	204	205	216
Assumed cuts in personal taxes (cumulative)				0*	3½	2½	4½	3½
GGBR	-2½	-2	-6	-3½	1	-7	1	-7½
Public corporations' overseas and market borrowing	-1	-1	-1	-½	-1	-½	-1	0
PSBR	-3½	-3	-7½	-3½	-3½	-7½	0	-7½
(per cent of GDP)	(-¾)	(-¾)	(-1½)	(-¾)	(0)	(-1½))	(0)	(-1½)

* adjusted to post-1988 budget tax rates

(a) 1988-89

88. The PSDR in 1988-89 is forecast to be £7½ billion, compared with £3 billion in the FSBR. The more buoyant forecast for economic activity increases tax receipts and reduces some items of expenditure. On the assumption that BSC is privatised this year, privatisation proceeds are likely to be closer to £6 billion than the £5 billion assumed in the FSBR. Table 35 summarises the revisions.

TABLE 35 : MAIN CHANGES SINCE THE FSBR IN THE PSBR FORECAST FOR 1988-89

	£ billion
Higher General Government Receipts	
- higher North Sea revenues from a higher North Sea oil price;	0.3
- higher ACT reflecting higher dividend payments;	0.5
- higher stamp duty reflecting higher house prices and stock market turnover;	0.6
- higher VAT and specific duties mainly reflecting higher consumer spending;	1.0
- higher interest receipts (largely reflecting removal of presentational adjustments in Budget forecast);	0.7
- higher ECGD trading deficit on the assumption of no refinancing of loans;	-0.6
TOTAL	2.5
Lower General Government Expenditure	
- lower departmental spending	-0.3
- higher privatisation proceeds	-0.9
- lower debt interest payments	-0.2
- changes to other adjustments	-0.3
TOTAL	-1.7
TOTAL CHANGE IN PSBR FORECAST	-4.2

(b) Public Expenditure

89. With the planning total (excluding privatisation proceeds) in 1988-89 forecast to be close, in cash terms, to that in the 1988 PEWP, the higher forecast inflation squeezes expenditure in real terms (see table 36). But higher forecast real growth of expenditure in 1989-90 and 1990-91 produces a forecast level of spending in 1990-91 in real terms that is above the plans.

TABLE 36 : PLANNING TOTAL EXCLUDING PRIVATISATION PROCEEDS

	1987-88	1988-89	1989-90	1990-91
<u>£ billion current prices</u>				
1988 FSBR	151.0	161.8	172.1	181.1
Forecast	151.0	161.5	174.6	186.9
<u>Real growth %</u>				
1988 FSBR	¼	2½	2¼	1¾
Forecast	0	1	2¾	2¾

90. Table 37 compares the forecast of the planning total in cash terms with the PEWP. Local authority current spending accounts for the largest claims on the reserve. Taking defence and health together, about three-quarters of the overspend in cash terms on existing plans is attributable to pay. Forecast overspending on other central government programmes is consistent with some future increase in provision for investment in roads, prisons etc.

TABLE 37 : FORECAST ADDITIONS TO EXPENDITURE PLANS

£ billion

	1988-89		1989-90		1990-91	
	PEWP 1988	Forecast Claims on Reserve	Survey Baseline	Forecast Claims on Reserve	Survey Baseline	Forecast Claims on Reserve
Allocated to programmes						
1. Social Security (including HB)	46.9	0.1	49.5	0.9	52.0	2.6
2. Defence	19.2	0.3	20.0	0.5	20.6	1.0
3. Health	21.8	1.0	22.9	1.9	24.0	2.8
4. Net EC	0.8	0.2	1.5	0.4	1.3	0.3
5. Other CG	29.3	0.5	31.1	1.1	32.0	1.7
6. LA current (excluding HB)	34.9	1.3	35.2	3.8	36.2	6.2
7. LA capital	4.0	-	3.9	0.4	3.8	0.7
8. Nationalised industries	0.7	-0.2	-	0.5	-0.4	1.0
9. Other PCs	0.8	-	1.0	-	1.2	-
10. Total programme	158.3	3.2	165.1	9.5	170.7	16.2
11. Privatisation proceeds	-5.0	-0.9	-5.0	0.0	-5.0	0.0
12. Expenditure met from existing reserve						
(i) allocated to programme baseline	0.0	2.3	0.0	7.0	0.0	10.5
(ii) unallocated	3.5	0.0	7.0	0.0	10.5	0.0
13. Underspend (-) Required Addition to Reserve (+)	0.0	-1.2	0.0	2.5	0.0	5.7
PLANNING TOTAL	156.8	155.6*	167.1	169.6*	176.2	181.9*

*Forecast of the planning total outcome

91. General government gross debt interest payments are forecast to be only a little lower in 1988-89 than in 1987-88 because the need to finance the rise in the foreign exchange reserves has continued to push up the gross stock of debt outstanding. After 1988-89, with large net repayments of debt by general government and a partial unwinding of the rise in the reserves assumed, gross interest payments fall sharply, particularly in 1990-91.

92. The ratio of GGE (excluding privatisation proceeds) to money GDP is forecast to be about one percentage point below that in the FSBR in 1988-89. It is forecast to fall further in 1989-90 and 1990-91 and to remain below the FSBR path.

TABLE 38 : RATIO OF GGE EXCLUDING PRIVATISATION PROCEEDS TO MONEY GDP (per cent)

	1985-86	1986-87	1987-88	1988-89	1989-90	1990-91
1988 FSBR	44½	43¾	41¾	41¼	40¾	40
June forecast	44½	44	41¾	40	39¾	39½

93. Table 39 compares the forecast of GGE excluding privatisation proceeds with earlier internal forecasts, successive PEWPs and the 1988 FSBR. The forecast for 1988-89 is a little lower in both cash and real terms than in the last internal exercise in January. The forecast for 1989-90 is broadly unchanged in cash terms but lower in real terms.

TABLE 39 : PAST AND CURRENT FORECASTS OF GGE EXCLUDING PRIVATISATION PROCEEDS (£ billion)

Forecast	1987-88		1988-89		1989-90		1990-91	
	Current Prices	Real Terms*	Current Prices	Real Terms*	Current Prices	Real Terms*	Current Prices	Real Terms*
PEWP 1986	174	168	179	168	-	-		
June 1986	177	170	186	171	-	-		
PEWP 1987	179	172	185	172	193	174		
June 1987	170	170	190	171	203	174		
PEWP 1988	178	170	188	173	198	176		
Jan 1988	177	169	188	171	200	173		
FSBR 1988	177	169	188	171	198	174	207	175
June 1988	177	169	187	168	200	171	210	173

* 1986-87 prices

(c) Receipts

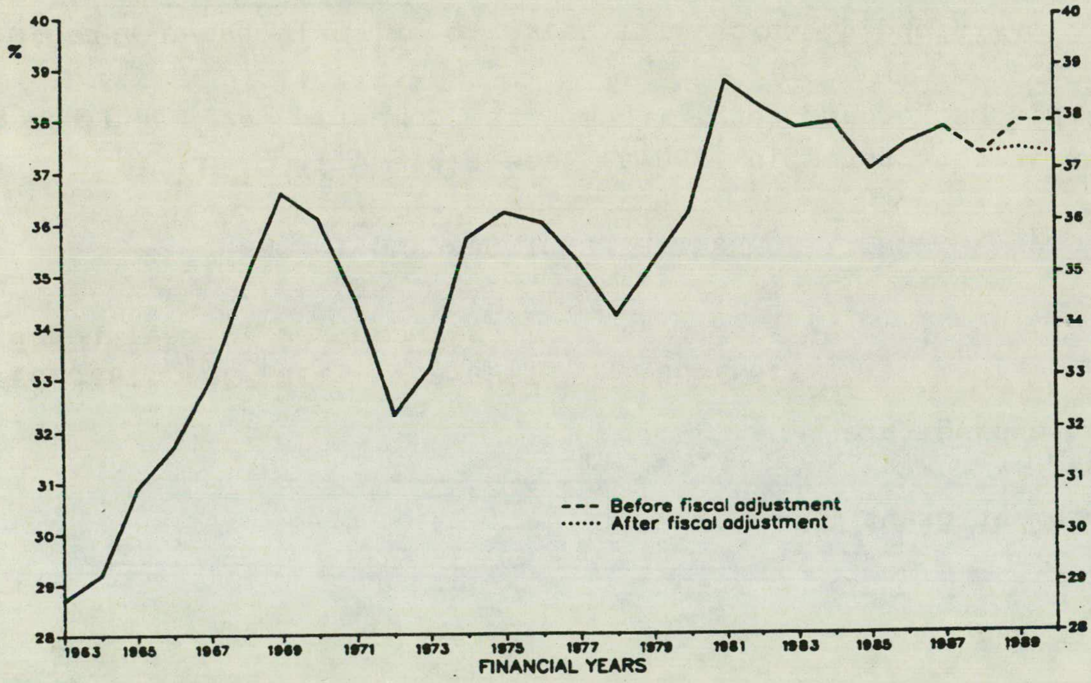
94. The forecast of total taxes and national insurance contributions (NICs) in 1988-89 is some £2 billion higher than in the FSBR. Even so because the level of money GDP is also higher the total and non-oil tax burdens are expected to fall in 1988-89, compared with no change in the FSBR. Before taking account of fiscal adjustments the non-oil burden is forecast to rise by about ½ percentage point in 1989-90 and to be broadly flat in 1990-91. The rise in 1989-90 is more than accounted for by a rise of over 20 per cent in non-North Sea corporation tax which in turn reflects forecast continued strong profit growth into 1988.

95. Table 40 shows that the assumed tax cuts are sufficient to hold the non-oil tax burden roughly flat.

TABLE 40 : NON-OIL TAXES AND NICs AS A PERCENTAGE OF NON-OIL GDP

	1986-87	1987-88	1988-89	1989-90	1990-91
MTFS					
(a) pre-fiscal adjustment	37.5	37.7	37.7	37.7	
(b) post-fiscal adjustment	37.5	37.7	37.7	36.9	36.6
Summer Forecast					
(a) pre-fiscal adjustment	37.5	37.8	37.3	37.9	37.9
(b) post-fiscal adjustment	37.5	37.8	37.3	37.4	37.3

CHART F : THE SHARE OF NON-NORTH SEA TAXES AND NICs IN NON-NORTH SEA GDP



(d) Local authority finances and the LABR

96. The assessment of LA finances is particularly hazardous on this occasion because of the uncertainties associated with the introduction of the local government finance reforms, in 1989 in Scotland and 1990 in England and Wales. The forecast is crucially dependent on assumptions on:

- the growth of LA current expenditure;

- the proportion of expenditure financed by central government grant.

97. Local authorities' budgets for 1988-89 indicate that overspending (compared with PEWP provision) on current expenditure will be lower than previously forecast - current expenditure might rise by 1 per cent in real terms compared with 3½ per cent in 1987-88. Upward pressure on spending is likely to re-emerge from next year on as a result of the costs of implementing the community charge (CC) and the introduction of other initiatives such as the national curriculum. Real increases in current spending of around 4 per cent a year are forecast for 1989-90 and 1990-91.

98. The outturn **central government grant percentage** is assumed to fall slightly in 1989-90. In 1990-91, the first year of the CC in England and Wales, a one per cent rise in the outturn grant percentage is assumed (after continuous falls in the 1980s). This is equivalent to holding the percentage constant at its level in 1989-90 before deduction of grant penalties for overspending which will cease to exist in the new regime.

99. Against this background total income from **domestic rates and the CC** may fall a little in real terms in 1990-91 (see table 41).

TABLE 41 : LOCAL AUTHORITY CURRENT EXPENDITURE AND INCOME

		% increases in real terms		
	1987-88	1988-89	1989-90	1990-91
Total current expenditure	3½	1	4	4½
Income from:				
Central government grant	4	-2½	3	6½
Business rates	2½	3½	7	4
Domestic rates and CC	2½	3½	5½	-1

100. The **LABR** is forecast to be in the £1½-2 billion range throughout the forecast period. (It was £1½ billion in 1987-88.)

SECRET

ANNEX : COMPARISON WITH OUTSIDE FORECASTS

	JUNE FORECAST	AVERAGE OF OUTSIDE FORECASTS (JUNE)
A. ACTIVITY		
1. GDP VOLUME (per cent change on year earlier)		
1988	3.9	3.2
1989	2.9	2.2
2. UNEMPLOYMENT (UK, sa, excluding school leavers in millions)		
1988Q4	2.32	2.38
1989Q4	2.24	2.37
B. INFLATION		
3. RPI (per cent change on year earlier)		
1988Q4	5.0	3.8
1989Q4	5.6	4.7
C. PUBLIC FINANCES		
4. PSBR (£ billion)		
1988-89	-7.4	-3.0
1989-90	-7.4	-1.9
D. MONETARY CONDITIONS		
5. SHORT TERM INTEREST RATES (per cent)		
1988Q4	9.5	8.7
1989Q4	10.5	9.5
6. STERLING INDEX (1975=100)		
1988Q4	76.7	76.4
1989Q4	74.3	73.1
E. CURRENT ACCOUNT		
7. CURRENT BALANCE (£ billion)		
1988	-9.3	-5.2
1989	-10.1	-6.8

CHANCELLOR OF THE EXCHEQUER

MP

<u>Ch</u>

Peter Sedgwick tells me that the provisional retail sales for August are 1/2% up on revised July figure.

Thanks –

AA

53/2/LPD/3754/034

CONFIDENTIAL

29/6

ECONOMIC SECRETARY TO THE TREASURY

FROM: ECONOMIC SECRETARY
DATE: 22 June 1988

CHANCELLOR

cc Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Mr Peretz
Mr Grice
Miss O'Mara
Mr Rich

a
get PEM's views? AA
yes pm

For PEM

NATIONAL SAVINGS INTEREST RATES

You asked me, in the light of Sir Peter Middleton's minute of 1 June, whether we should seek to improve our funding mix by encouraging greater National Savings inflows, offset by the buying in of long gilts.

2. Sir Peter put forward his suggestion in the context of possible measures to take money out of the housing market. I agree that there may well be a case, as earlier this month, for holding National Savings rates up to avoid triggering a fall in mortgage rates. But that danger has now passed for the present - with the general rise in interest rates in recent weeks, National Savings variable rates are now less out of line with the market. I see far fewer attractions in trying to bid mortgage rates up by raising National Savings rates now. Since the higher rates would apply not only to new purchases but also to about half of the existing National Savings stock, such an option could prove very expensive; it would also stimulate inflows into the more liquid National Savings products. I am not sure it would be desirable to sustain a mortgage rate at a higher level than would otherwise be the case by increasing the cost of funding. It would run quite counter to our overall strategy of reducing the cost of improving the quality of National Savings' contribution to funding.

3. That said, I share Sir Peter's concern to buy in long gilts

on a larger scale than we have done to date and to increase the scope for that by increasing sales of good quality shorter instruments. That is one of the reasons why I find the new taxable National Savings instrument we propose to introduce later this year so attractive: it offers us good quality funding on terms which should be significantly better than those we get on long gilts, without the cost of tax forgone that arises with the present tax-free certificate. I should prefer to rest on the introduction of the new product to stimulate higher National Savings inflows rather than raise the current limits for new purchases of the conventional or index-linked National Savings certificate, not least so as to gain the best chance of a successful launch for the new instrument. But we shall in any case be discussing our funding objectives further in the light of the summer forecast at next week's funding meeting.

4. Because of building societies' ready access to wholesale funds, I doubt whether we can expect to have much more than a temporary effect on mortgage rates through National Savings decisions. But I agree there may continue to be occasions when we wish to use National Savings to give a signal to the building societies and the new instrument will provide us with a much more cost-effective weapon to use for that purpose.

PB

PETER LILLEY

90/G.jfw.45/024

CONFIDENTIAL

FROM: T PIKE
DATE: 23 June 1988

Not comforting.
DLP
23/6

1. MR PERETZ

2. ECONOMIC SECRETARY

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

File: MAMC C9

M0 FIGURES

The latest weekly figures for M0, covering the fourth week of June, are attached. They show that the 12 month growth rate of M0 to the latest four week period was 6.9 per cent (7.3 per cent not seasonally adjusted). The sa and nsa 12 month growth rates of notes and coin to the same period were 6.8 and 7.2 per cent, respectively.

2. Six month annualised growth of notes and coin to the latest four week period was 5.7 per cent, compared to 5.6 per cent in May.

3. Based on these figures, the June outturns are expected to show 12 month growth rates for M0 of around 7 per cent (7½ per cent nsa). Part of the explanation for this sharp rise from May's 6.2 per cent sa growth rate is the erratic fluctuation of bankers' balances. Annual growth of notes and coin is expected to rise less sharply - from 6.5 per cent in May to about 6.9 per cent in June. But, in addition, the 12 month comparisons - particularly for nsa M0 - are distorted in June by the fact that there are five reporting weeks in June 1988 but there were only four in June 1987. (When M0 is trending upwards, a five week average will obviously give a higher figure than a four week average.)

The 12 month comparisons to the latest four week period will therefore be a better guide to underlying M0 growth, and these are expected to show annual growth of notes and coin at around 6.7 per cent, compared to 6.5 per cent in the 12 months to May.

4. Looking further ahead, the July M0 figures may be boosted by the effects of the Budget tax rebates on personal disposable incomes, although the 12 month growth rates will be depressed by the unwinding of the distortion to the June figures referred to in para 3, and by a large increase in bankers' balances in July 1987. We therefore expect to see a fall in the annual growth rate of M0 in July, perhaps to around 6¼ per cent, from around 7 per cent in June.

T. Pike

T PIKE

TABLE 16

CONFIDENTIAL (Until Publication)

MO : THE WIDE MONETARY BASE

Monthly data	Level £ million (Change in brackets)						Percentage change on previous month		6 month % growth annualised		Percentage change on previous year			
	Notes and Coin (nsa)	Notes and Coin (sa)		Bankers' Deposits	MO (nsa)	MO (sa)	Notes(sa) and Coin	MO (sa)	Notes & Coin (sa)	MO (sa)	Notes and Coin (nsa)	Notes and Coin (sa)	MO (nsa)	MO (sa)
1987 October	15299	15456	(80)	203	15501	15659 (98)	0.5	0.6	7.4	7.3	5.1	5.2	5.5	5.6
November	15365	15525	(69)	183	15548	15707 (48)	0.4	0.3	7.4	7.0	4.8	4.8	4.9	4.9
December	16447	15661	(136)	186	16633	15846 (139)	0.9	0.9	7.9	8.5	4.7	4.8	4.2	4.3
1988 January	15458	15620	(-41)	181	15638	15801 (-45)	-0.3	-0.3	6.1	5.3	4.7	4.5	4.8	4.6
February	15353	15659	(39)	124	15477	15783 (-18)	0.2	-0.1	5.3	4.5	5.7	5.7	5.3	5.3
March	15588	15753	(94)	162	15750	15916 (133)	0.6	0.8	5.0	4.6	6.9	6.4	6.4	5.8
April	15797	15826	(73)	229	16026	16055 (139)	0.5	0.9	4.8	5.1	5.8	6.1	5.9	6.2
May	15868	15952	(126)	178	16046	16130 (75)	0.8	0.5	5.6	5.5	6.0	6.5	5.7	6.2
June (4/5) a	16029	16101	(149)	157	16186	16257 (127)	0.9	0.8	5.7	5.3	7.2	6.8	7.3	6.9
Latest 4 weeks a	16029	16101	(149)	157	16186	16257 (127)	0.9	0.8	6.4	5.9	7.2	6.8	7.3	6.9

Weekly data	Level £ million (Change in brackets)					Percentage change on previous week
	Notes(sa) and Coin		Bankers' Deposits	MO (sa)		MO (sa)
May						
4th	15965	(103)	155	16120	(-39)	-0.2
11th	15929	(-36)	161	16090	(-30)	-0.2
18th	15969	(40)	247	16216	(126)	0.8
25th	15944	(-25)	148	16092	(-124)	-0.8
June						
1st	16088	(144)	215	16303	(211)	1.3
8th	16050	(-38)	235	16285	(-18)	-0.1
15th	16109	(59)	90	16199	(-86)	-0.5
22nd	16155	(46)	87	16242	(43)	0.3

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

85a/2/cag/4/2915

SECRET

Thanks - Please minute

I thought you would like a note on how the prospects for mortgage rates look now, after this week's base rate rise. It looks as if a rise may be delayed a little longer than we and the Bank and our contacts in the building societies thought when the base rate rise was only a hypothetical possibility. But you will see that a rise is still expected within a few weeks, and would come more or less immediately (and might be larger) if base rates move up again.

[illegible] 24/6

FROM: M M COURTNEY

DATE: 24 June 1988

1. MR PERETZ

2. CHANCELLOR

cc Economic Secretary
Sir P Middleton
Mr Scholar
Mrs Lomax
Mr Grice
Mr Ilett
Miss Noble
Miss O'Mara
Mr Dickson
Dr Kosmin

BUILDING SOCIETY MORTGAGE RATES - LIKELIHOOD OF AN INCREASE

The rise in base rates announced on 22 June has left an unusually narrow margin between base rates at 9% (with 3-month LIBOR at 9 11/32) and building society mortgage rates, which, for the major societies, range from 9.5% to 9.8%. The societies normally aim for a margin of 1¼ to 1½ over base rates. When base rates were last at 9% in January-February, mortgage rates were 10.25%.

2. Nevertheless, the building societies are not under immediate pressure to raise rates. Both the published comments of societies' spokesmen and conversations with building societies reported by officials of the Building Societies Association, point out that with very buoyant retail inflows, the societies can fund most of their mortgage lending without needing to raise their deposit rates. If, as usual, the banks raise their high interest account rates in line with base rates, this will put the societies under greater pressure and narrow the deposit interest rate advantage which building societies enjoy from its current, normal, level of about 1% to closer to ½%. However, substitution between bank and building society deposits is not so great that this will force building societies to raise their rates immediately.

3. Over the slightly longer term - two or three months - the

present configuration of interest rates is unsustainable. Societies are still net borrowers in the wholesale markets, at over £300m a month in aggregate (compared to net lending of just over £2000m a month), and as retail inflows drop away seasonally over August, their wholesale borrowing will increase. A margin of only ½% over wholesale rates means they are losing money on lending financed in this way.

4. The timing of any change is, however, unpredictable. Current market sentiment sees a further raise in interest rates as more likely than a fall, but most societies would probably like to wait and see how the outlook for interest rates develops. Once it looks as if a move upwards will be followed by others and not leave them isolated, individual societies will, however, want to move. Some, such as the Woolwich with a current mortgage rate of 9.5%, will be under pressure to do so sooner than others.

5. On balance, if money-market rates do not change and if market sentiment still sees the next move in interest rates as likely to be upwards, the most likely outcome would be a movement upwards in mortgage rates within the next few weeks.

6. A further ½% base rate rise would almost certainly precipitate an immediate increase in mortgage rates. There would be ample scope for it to be more than ½%. And societies, whose policy of delaying a reaction to base rate moves has been vindicated over the last few weeks, might feel that if they do move, an increase of 1% to restore their normal margin over base rates would be warranted.

Mark Courtney

M M COURTNEY

Rg

SECRET UNTIL ANNOUNCED

INTEREST RATE INCREASE

cc PPS
PS/EST
Mr Scholar
Mr Peretz
Mr Gieve
Miss O'Mara
Mr Bush
Mrs Ryding
Mr Williams
Mr George BoE

FACTUAL

1. At noon today the Bank of England announced a 1/2 per cent increase in its dealing rates. Back to level at time of Budget.

2. Rate and exchange rates since 7 August 1987
[exchange rates noon unless otherwise indicated]

		Base rate	DM£	$£	£ERI
1987	7 August	10%	2.9524	1.5725	72.0
	26 October	9 1/2%	2.9975	1.6935	74.1
	5 November	9%	2.9866	1.7675	75.3
	4 December	8 1/2%	2.9978	1.8130	76.0
1988	2 February	9%	2.9730	1.7600	74.2
	18 March	8 1/2%	3.0891	1.8241	77.0
	11 April	8%	3.1295	1.8587	78.0
	18 May	7 1/2%	3.1675	1.8583	78.2
	2 June	8%	3.1203	1.8055	76.7
	6 June	8 1/2%	3.1017	1.8025	76.4
	22 June	9%	3.1323	1.7770	76.3 10.00am

3. West German securities repurchase rate raised from 3 1/4% to 3 1/2% on 21 June.

4. G7 nominal and real interest rates. UK not far above G7 average.

Country	Nominal	Real*
UK	**9.2**	**4.8**
US	7.6	3.6
Japan	3.8	3.5
Germany	4.0	2.9
France	7.3	4.7
Italy	11.3	6.1
Canada	9.3	5.0
Average	6.9	3.9

* deflated by latest increase in consumer prices index.

SECRET UNTIL ANNOUNCED

LINE TO TAKE

Appropriate to validate rise in market interest rates.

POSITIVE

1. Short term interest rates will continue to be held at the levels necessary to keep monetary conditions on track. Will not take risks with inflation.

DEFENSIVE

1. Why moving three times in quick succession?
13 out of last 14 interest rate movements have been 1/2%; this has become the normal practice. Exchange market conditions changed very suddenly at beginning of June; only sensible to see how conditions developed.

2. Why raise interest rates when May money supply figures better than expected?
Interest rate decisions taken on basis of continuous and comprehensive assessment of all relevant factors, not on basis of single set of figures.

3. Increase a response to trade figures? Labour market statistics? RPI? Etc?
Interest rate decisions not taken on basis of any one factor.

4. Further increases on the way?
Never speculate.

5. Was increase discussed with other G7 ministers at Toronto?
Finance ministers took opportunity to review monetary developments worldwide. Inappropriate to comment on details of discussion.

6. Increase will damage industry?
Industry has more to fear from resurgence of inflation. 1% rise in interest rates, even if sustained for whole year, raises costs by quarter of amount of 1% rise in pay settlements.

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

8. What about interest rate/exchange rate mix?
No mechanical rule.

9.Government applies formula whereby interest rates moved by 1 per cent for each 4 per cent opposite change in exchange rate, or 1/2% for each 5 pfennig change in DM/£ rate?
No. Interest rate decisions taken within continuous and comprehensive assessment of monetary conditions, taking all evidence into account. Exchange rate a key indicator of monetary conditions, but not the only factor.

10. Treasury model shows that interest rates should be raised by 1 per cent for each 4 per cent fall in the exchange rate?
Interest rate changes are not decided by Treasury model, but by the authorities exercising their judgement.

11. Is Government operating a floor at DM3.10 [or any other level]?
Not helpful to talk about any specific level. But Government has made it clear on numerous occasions that it will not allow sterling to depreciate to accommodate excessive increase in domestic costs.

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

13. Monetary conditions too loose?
No. Interest rate decisions based on continuous and comprehensive assessment of monetary conditions so as to ensure downward pressure on inflation. Will not take risks with inflation.

14. Economy overheating?
No.

- Judgement of monetary conditions and inflationary pressures must take account of whole range of factors, including downward pressure on inflation from exchange rate.
-CBI June monthly trends survey indicated that demand, although remainin healthy, could now be earing back from levels experienced over recent months. Percentage of firms expecting to raise average prices below balances reported earlier in the year and similar to expectations a year ago.
- Experience of number of years shown that high rate of growth of lending and liquidity consistent with lower inflation because increased liquidity willingly held, i.e. as savings, rather than for spending.

15. Why raise interest rates rather than intervene?
Judgement of best course at time.

16. Have you intervened as well?
Never comment.

17. What does this mean for mortgage rates?
Matter for mortgage lenders - ask them.

MG1 Division
22 June 1988

FROM: COLIN MOWL
DATE: 24 JUNE 1988

Pnp

ECONOMIC SECRETARY

cc Chancellor of the Exchequer
Chief Secretary
Financial Secretary
Sir Peter Middleton
Sir Terence Burns
Sir Geoffrey Littler
Mr Scholar
Mr Monck
Mrs Lomax
Mr Odling-Smee
Mr Sedgwick
Mr Hibberd
Mr S Davies
Mr Grice
Miss O'Mara
Miss Noble
Mr Hurst
Mr Courtney
Mr Pike
Mr Allum
Mr Lyon

What happens to the forecast on [illegible], & to the peak in [illegible]? If 10½% base rates are reached late in 1990 (Q1), as here, but say 1988 (Q3) & then? would [illegible]

FINANCIAL FORECAST

The attached note on the Summer Financial Forecast, largely written by Martin Hurst and Michael Lyon, complements that on the Treasury Economic Forecast circulated by Mr Sedgwick on 22 June. The forecast examines the prospects to the end of the financial year 1990-91.

Colin Mowl

COLIN MOWL

FINANCIAL FORECAST

SUMMARY OF MAIN POINTS

- short term interest rates are forecast to rise to 10½ per cent as sterling falls back against the DM; long rates are expected to be below short rates;

- equity prices and turnover volumes are both expected to recover in real terms as market confidence returns;

- MO growth falls back sharply as a result of higher interest rates and, after this year, slower growth in consumer spending;

- broad money and credit growth may decelerate due to slower growth of incomes and house prices, high real interest rates and a rising debt service burden;

- with high PSDRs and some run down in the foreign exchange reserves <u>gross</u> gilts sales could be very small or even negative.

- the switch of personal sector investment away from unit trusts and equities to capital certain assets such as building society deposits, following the stock market crash, may continue;

- companies are switching from equity finance to debt and bank borrowing;

- although inward direct and portfolio investment should play a part, the main contribution to financing the balance of payments current account deficit is expected to come from net inflows to UK banks; the forecast interest differential in favour of sterling is considered sufficient to generate these flows.

<u>Exchange rates and interest rates</u>

2. The forecast envisages downward pressure on sterling from persistent balance of payments deficits. The effect of this is assumed to be somewhat tempered by defensive intervention and increases in interest rates but sterling is forecast to depreciate slowly to DM2.80 by end 1990. This is consistent with a sterling effective of 72.9 and a three cents fall against the dollar.

Table 1 The Exchange Rate

	Dollar Effective 1975=100	Sterling Effective 1975=100	DM/£	$/£	DM/$
1986-87	110.6	71.5	3.05	1.49	
1987-88	98.7	73.9	2.99	1.70	
1988 Q1	94.2	75.4	3.01	1.80	1·67
Q2	93.9	78.6	3.15	1.84	1·71
Q3	93.3	77.1	3.10	1.84	1·68
Q4	92.7	76.7	3.05	1.84	1·66
1988-89	93.1	77.1	3.08	1.84	1·67
1989-90	91.4	74.8	2.93	1.82	1·61
1990-91	89.6	73.1	2.81	1.81	1·55

3. The forecast rises in base rates and LIBOR to 10½ per cent imply a widening in interest differentials with OECD countries, even with most OECD countries increasing their interest rates at some stage. UK long rates are forecast to be depressed by the shortage of new issues and would be unlikely in any case to match moves in base rates one for one. The forecast thus has a significant inversion in the yield curve. Mortgage rates move in line with base rate changes.

Table 2 Interest rates

	Interest Rates			Short Rate Differential with			
	Base Rate	Mortgage Rate	Long Rate	Euro-Dollar Rate	Germany	Japan	World Basket
1987Q4	9.2	11.0	9.6	1.3	5.1	5.3	2.4
1988Q1	8.8	10.3	9.4	2.1	5.6	5.2	2.8
Q2	8.0	9.8	9.3	0.7	4.5	4.2	1.7
Q3	9.0	10.3	9.3	0.8	5.4	5.0	2.3
Q4	9.5	10.8	9.5	1.3	5.7	5.3	2.7
1989Q1	10.0	11.3	9.5	1.3	6.0	5.8	2.9
1990Q1	10.5	12.0	9.5	1.1	6.5	6.5	3.1

Equity Prices

4. Equity prices to date have recovered about one third of the fall incurred in the crash. The market remains nervous, with turnover below pre-crash levels, but recovering, and few new issues appearing. In the absence of further major shocks confidence can be expected slowly to return and, to the extent that equity prices are still depressed by confidence effects, we can expect some real increase in equity prices over the next year or so. Turnover volume is now forecast to be more buoyant than in the Budget forecast. Exact forecasts of this are of course subject to wide margins of error.

Chart 1 Real Equity Prices

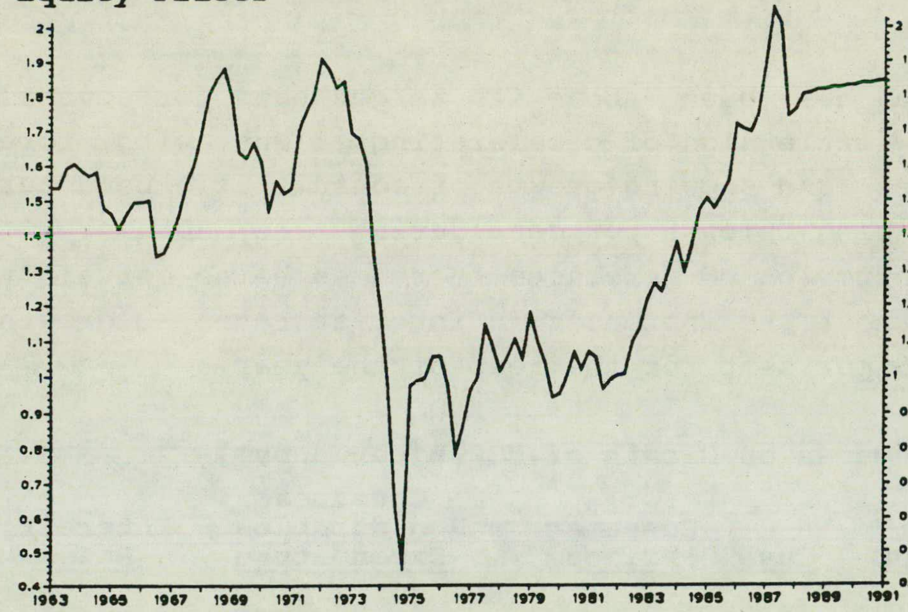
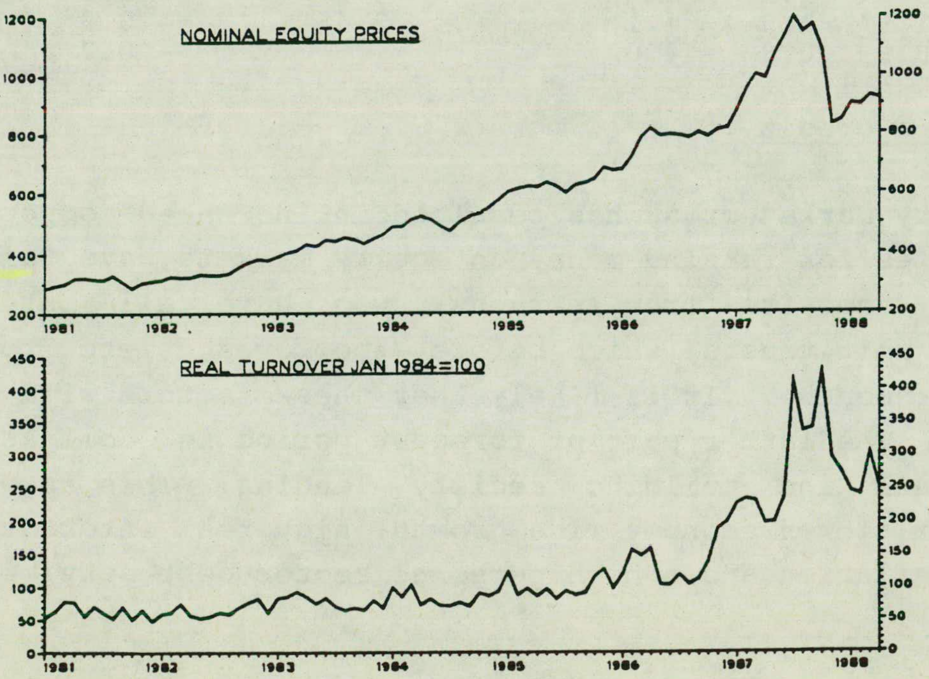


Chart 2 Equity Market Turnover



Monetary aggregates and credit

Table 3 Monetary aggregates and credit: Average growth rates over year earlier

				Personal Borrowing		Bank and Building
	MO	M2	M4	Mortgage	Other*	Society lending
1986-87	4.3	14.0	15.6	20.0	13.6	18.3
1987-88	4.9	11.6	15.4	19.7	16.0	19.6
1988-89	5.2	14.0	15.6	20.2	17.7	20.4
1989-90	1.9	10.9	12.1	15.4	12.8	15.1
1990-91	0.9	10.0	11.1	13.2	9.4	13.1

* Includes trade credit

Narrow Money

5. MO growth has been above its target band for several months, and at present shows little sign of decelerating. But with forecast rises in interest rates and slowing growth of consumers' expenditure the forecast has growth falling below 5 per cent during the autumn. Given previous margins of error on MO forecasts there can be no certainty that this will occur, and without the increases in interest rates MO growth would probably remain above 5 per cent for the rest of the year.

Table 4 Influences on Growth of MO (% per annum)

	MO	Cash	Consumer Prices	Consumers Non-durables Expenditure	Interest Rates	Innovation
1986-87	4.2	4.2	3.9	3.9	0.2	- 4.2
1987-88	4.8	4.8	4.0	3.6	1.3	- 4.1
1988-89	5.0	5.1	4.0	4.2	1.3	- 4.5
1989-90	1.9	1.9	4.1	2.4	- 0.9	- 3.8
1990-91	0.9	0.9	4.0	1.5	- 0.7	- 3.9

Broad money and credit

6. The equity market crash has resulted in increased corporate borrowing, as opportunities for raising money on equity markets have diminished, and in increased deposits from persons, who have all but ceased net new investment in unit trusts (which before the crash were taking in over £1 billion per month). It is likely that these factors will take some time to disappear. The latter part of forecast period is dominated by slower growth in bank and building society lending. This is occasioned by a combination of slower economy wide growth, high real interest rates, slower house price inflation and a high personal sector debt service ratio.

Table 5 M4 Deposits And Lending average % growth over year earlier

	Deposits				Lending				
	Persons	ICCs	OFIs	Total	House Purchase	Other Persons	ICCs	OFIs	Total
1986-87	12.9	26.4	23.9	15.6	20.3	15.8	10.7	31.1	18.3
1987-88	11.1	25.1	37.6	15.4	18.3	17.0	15.8	38.4	19.6
1988-89	14.7	17.2	14.7	15.6	18.8	19.0	20.4	28.5	20.4
1989-90	11.8	12.4	13.4	12.1	14.4	14.3	11.3	25.2	15.1
1990-91	10.8	11.2	14.8	11.1	12.3	10.5	9.8	23.5	13.1

Funding and Money Market Assistance

Table 6 Gilt Sales and Money Market Assistance

	1986-87	1987-88	1988-89	1989-90	1990-91
Gilts sales to nbnbsps*	3.6	2.4	- 7.4	- 9.0	- 8.6
Gilt sales overseas	2.7	5.0	- 0.4	- 1.0	- 1.0
Gilt sales to banks and building societies	-0.6	-0.6	- 0.5	- 0.5	- 0.5
Total net gilt sales	5.7	7.0	- 8.2	- 10.5	- 10.1
Redemptions	8.8	6.5	8.3	11.9	7.5
Gross gilts sales	14.6	13.4	0.1	1.5	- 2.6
Outstanding Money market assistance:X	9.7(7.1)	9.7(9.5)	8.2(8.0)	6.5(6.3)	5.5(5.4)

* non bank building society private sector

X bill mountain in brackets.

7. The outlook for funding is dominated by persistent large public sector debt repayments. The forecast sees this as being reflected mainly in considerably lower net gilt sales, with up to £10½ billion of net repurchases per year. Even in years when heavy redemptions are due, there will be scope for only limited gross sales, and in other years assumed zero overfunding is likely to require significant buying in. This profile takes account of reduced net inflows to national savings (£1 billion inflows in each of the next two years, down from £2¼ billion in 1987-88 even with the new instrument) and heavy redemptions of CTDs in 1988-89.

8. Net sales of gilts by the monetary sector, taken with the outlook for OPS debt and notes and coin, result in a need to provide negative money market assistance. The bill mountain therefore falls steadily over the forecast period declining from £9.5 billion to £5.4 billion in 1991 quarter one.

Sectoral Flow of Funds

9. The data discrepancies in the national accounts, including the large sectoral balancing items, discussed in the main report (paras 38-48) pose severe problems in assessing sectoral flows of funds. Even so a number of important issues for each sector can be identified.

Persons financial behaviour

10. The dominant trends over recent years in the personal sector have been those of reduced rates of saving and increased investment in physical assets, both of which may be attributed to rapidly rising house prices. These trends, which result in a falling saving ratio and a rising debt to income ratio are forecast to continue throughout 1988-89, but to subside thereafter as house prices start to stabilise, and after interest rates have risen to their plateau of 10.5 per cent. Persons' debt interest burden, which has remained fairly constant at 8½ to 9½ per cent of disposable income since 1985 will rise steadily to over 12 per cent by 1991. We do not think on the scenario set out in the forecast that this will entail substantial default risk, but such risk could emerge if interest rates were to go still higher, and house prices to fall.

11. Persons net total wealth (which includes the value of housing stock) rose significantly faster than personal disposable incomes in 1987, largely as a result of house price growth. Over the future net wealth remains historically high, though growing somewhat less rapidly than PDI. The slowing in growth is not likely to depress personal sector borrowing or consumption significantly.

12. Table 7 gives selected sources and uses of funds for the personal sector. On the sources side, mortgage lending grows especially strongly in 1988-89 as a result of high real personal disposable income growth, rapid increases in house prices and the relatively low level of mortgage interest rates. Some of this lending is likely to be for the purpose of equity withdrawal. Non-house purchase borrowing also continues recent behaviour in growing strongly during 1988-89. The effects of the budget restrictions on mortgage interest tax relief for multiple borrowers are not thought to have a significantly large effect across the sector as a whole. The rate of growth of borrowing slows substantially after 1988-89, although it remains above the growth rate of disposable income with the consequence that the personal sector's debt to income ratio continues to rise.

Chart 3 Personal Sector Wealth

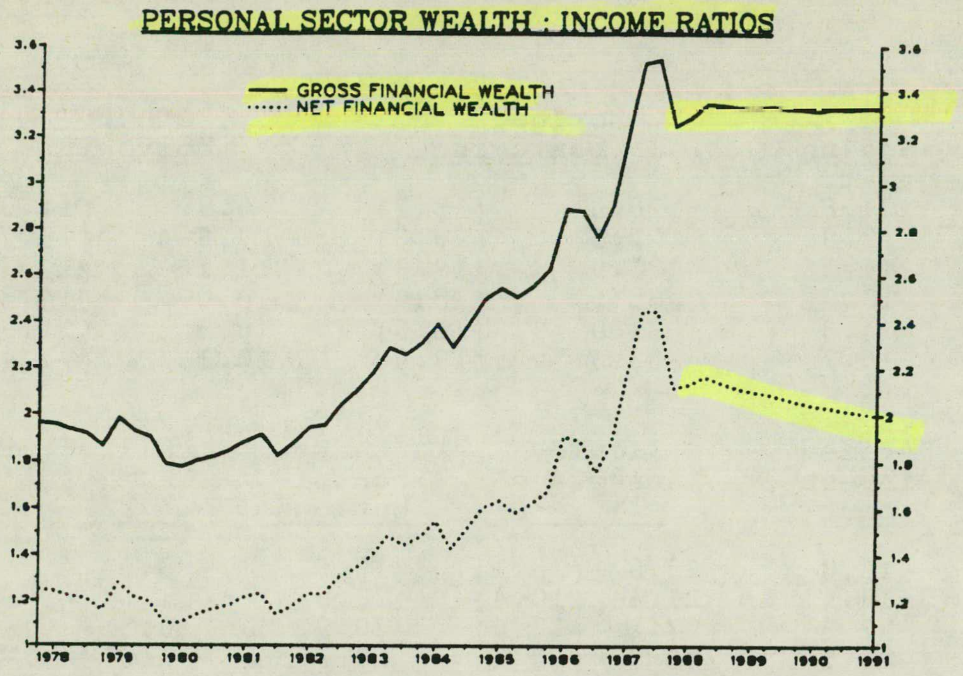


Chart 4 Personal Sector Income Gearing

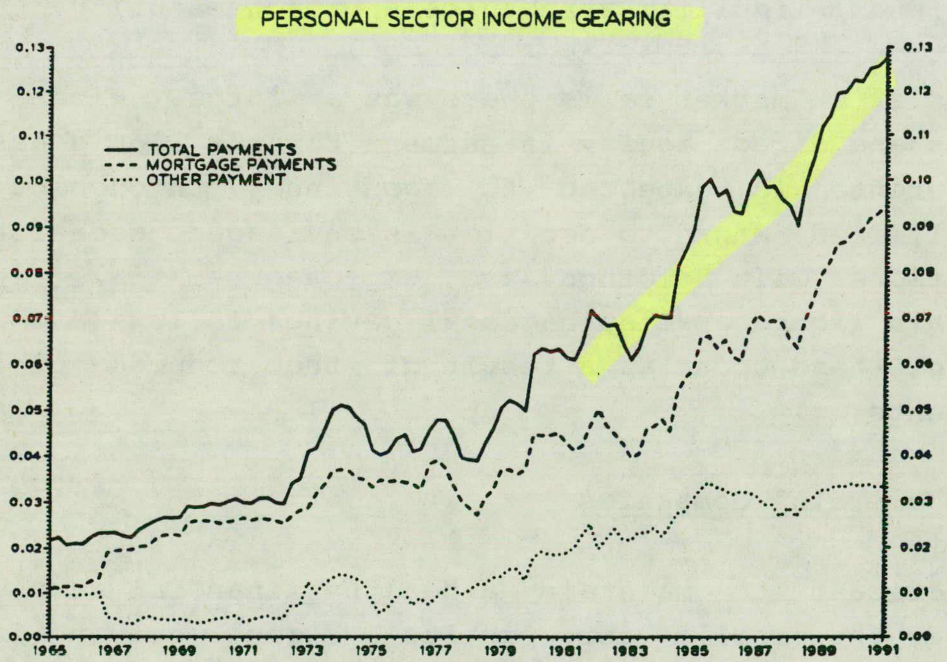


Table 7 Persons selected sources and uses of funds (rates of growth in brackets, per cent over year earlier)

£ bn

Sources	Saving	Mortgage borrowing		Other borrowing	
1985-86	21.6	20.0	(18.2)	6.9	(14.3)
1986-87	17.8	27.5	(20.8)	7.6	(13.7)
1987-88	14.2	31.9	(19.9)	11.1	(17.7)
1988-89	13.8	35.5	(18.4)	10.0	(14.3)
1989-90	14.3	31.0	(13.6)	10.5	(11.9)
1990-91	15.7	33.6	(13.0)	10.1	(7.4)

Uses	Fixed investment	liquid assets		LAPF contributions	Gilts	Equities, unit trusts
1985-86	15.8	23.8	(13.1)	19.6	- 0.5	2.0
1986-87	18.4	21.4	(10.4)	20.5	1.0	1.1
1987-88	22.5	27.2	(12.0)	20.9	0.5	5.6
1988-89	25.5	30.7	(12.1)	19.9	- 1.0	- 0.9
1989-90	28.1	28.8	(10.1)	19.2	- 2.0	- 0.3
1990-91	28.8	29.4	(9.4)	17.7	- 2.0	0.6

13. On the uses side there is a reduction in net inflows into life assurance and pension funds, due to reduced employers' contributions arising from pension fund surpluses, and also to demographic factors whereby pension funds' liability structures approach maturity.

14. Following the stock market falls there was a large switch in 1987Q4 from unit trusts and direct equity investment towards liquid assets. This switch in preference is expected to continue throughout 1988-89. Thereafter, a limited return to equities is envisaged, occasioned in part by new privatisations. Gilt holdings are expected to fall in absolute terms, while within liquid assets, national savings inflows are expected to decline. Both of these occur as a result of the reduced public sector funding requirements.

Industrial and commercial companies

15. ICCs are forecast to maintain a healthy financial surplus over the forecast period as the profile for profits - strong growth in 1988-89, slower growth thereafter - is broadly balanced by that for physical investment. The equity market crash has meant that new equity issues, recently a major source of finance for ICCs (£13 billion in 1987) have all

but dried up. Although ICCs have turned to debt issuance and bank borrowing to make up some of the shortfall, they are likely to have fewer funds at their disposal for use in domestic and overseas merger activity and for investment in liquid assets. These items are thus forecast to decrease somewhat from the very high levels of 1987.

Table 8 Selected Financial Transactions of ICCs (£ billion)

	Financial Surplus	Cash Expenditure on domestic mergers	Investment Abroad	Borrowing requirement	Equity Issues	Debt Issues	Bank Borrowing (£&fc)	Liquid Assets (increase -)
1986-87	- 7.6	2.4	7.2	10.6	7.0	1.5	9.1	- 7.9
1987-88	-11.3	7.3	10.8	24.7	13.4	4.3	11.9	-11.0
1988-89	- 8.6	4.0	6.1	16.1	3.5	5.0	10.1	- 8.0
1989-90*	- 8.3	4.0	5.8	17.1	4.0	5.0	9.2	- 7.5
1990-91*	-11.9	4.0	5.6	15.3	4.5	5.0	8.0	- 8.6

* Includes transfer of privatised companies from the public corporation sector.

Banks

16. In 1987 banks made significant provisions against their loans to problem countries. Although the scale of these provisions led to unprecedented negative profits for some UK banks it was accompanied by improvements in banks' domestic business. In particular, the profitability of their retail business continued to grow, and the loss of business to securitisation was somewhat reversed, especially with post-crash reintermediation.

17. The main change over the forecast period relates to the banks' role in financing the current account deficit. The last few years have seen rising net sterling and foreign currency liabilities to the overseas sector, but these are fairly insignificant in comparison with the forecast period. Given the forecast exchange rate profile, the need to attract such funds supports the forecast of prolonged positive differentials between domestic and overseas interest rates.

Building societies

Table 9 Building Societies Summary Table

	Interest Rate Differentials							
	Mortgage Rate less gross share rate (margins)	Mortgage Rate less base rate	Net Share less net bank deposit rate	% growth in retail inflows	Share of new mortgages	% growth in total mortgage demand	Liquidity ratio %	Wholesale ratio %
1986-87	1.35	1.17	1.28	10.4	69.2	18.9	15.1	9.7
1987-88	1.32	1.80	2.00	12.4	51.2	18.2	15.7	10.3
1988-89	1.38	1.29	1.67	12.9	59.9	16.9	16.0	13.5
1989-90	1.38	1.46	1.67	11.4	59.8	12.8	16.0	13.9
1990-91	1.38	1.50	1.64	10.5	59.7	12.2	16.0	14.7

18. After a poor year in 1987, when slow growth of retail inflows, occasioned inter alia by competition from equity linked products, severely limited their activity in the mortgage markets, building societies now find themselves in a much improved position. Retail inflows have been boosted by the crash, which all but halted new investment in unit trusts, and the raising of the limit on wholesale funding has further increased their flexibility. As a result societies have been able to compete vigorously in the mortgage market regaining share at a time when total mortgage business is accelerating. The forecast does not explicitly consider incorporation, but it seems likely that several societies will have taken that route by the end of the forecast period.

Institutions

19. In the aftermath of the equity market crash, institutions disinvested heavily from overseas securities. This enabled them both to move into liquid assets and to satisfy large underwriting commitments on UK company securities such as BP and Eurotunnel. Over the forecast period, although total inflows to life assurance and pension funds are expected to decline, and we expect only slow recovery in inflows to unit trusts the effect of these is more than offset by the large net redemptions of gilts, and the reduced levels of capital issues by UK companies. Institutions are therefore expected to return to investing in overseas securities. Mortgage finance companies are forecast to continue their growth, raising funds from capital issues and from bank lending.

Capital Account

20. Financial transactions with the overseas sector are summarised in table 10. Over the recent past there have been several unusual developments: the large balancing item in 1986 related in part possibly to

pre-Big Bang investments in securities houses; large official intervention against sterling in 1987, and in 1987Q4 very large disinvestment from overseas portfolio investments as a result of the stock market crash. Over the forecast period the current account moves sharply into deficit. This is financed by net inflows into UK banks, and by inward direct and portfolio investment also by a reduction in the **reserves**.

21. Net outflows on **direct investment** fall from the exceptional 1987 levels, but still remain high. This is due largely to the positive unremitted profits flow resulting from the large stock of UK net overseas direct investment. Against this, there is also expected to be a rising autonomous trend of overseas direct investment in UK companies as sterling falls. **Outward portfolio** investment is expected to resume in 1988, as institutions are assumed to seek slowly to re-establish the pre-crash proportions of overseas securities in their portfolios. **Inward portfolio** investment (excluding **gilts**) is expected to grow more strongly so that the net balance, though negative, improves after 1988.

22. **Banks** bear much of the burden of funding the non-bank sectors' net requirement for funds, with both their net **sterling** and net **foreign currency** liabilities to the overseas sector rising strongly. These will have a contractionary effect on the broad money measures, exert downward pressure on sterling, and are likely to require continued positive interest differentials with world rates.

23. Transactions of **general government** comprise mainly of positive intervention flows (£2bn a year) offset partly by a net rundown of overseas holdings of **gilts** (£1bn a year).

Table 10 : **Overseas sector capital account**

	1986	1987	1988	1989	1990
Direct investment					
inward	4.2	5.7	6.3	7.1	7.8
outward	-11.6	-15.7	-12.1	-13.1	-13.6
Net	**- 7.3**	**-10.0**	**- 5.8**	**- 6.0**	**- 5.9**
Non-bank portfolio					
inward (excl.gilts)	5.2	7.3	3.5	5.6	6.2
outward	-16.1	7.4	- 7.0	- 6.7	- 6.8
Net	**-10.9**	**14.8**	**- 3.5**	**- 1.1**	**- 0.6**
Banks: **Net sterling**	**- 0.4**	**3.9**	**5.2**	**5.1**	**3.3**
Net FC	**2.8**	**-0.9**	**4.3**	**3.2**	**3.2**
General government					
gilts	2.1	5.4	0.2	- 1.0	- 1.0
other liabs	1.3	0.9	- 0.4	0.0	0.0
reserves	- 2.9	-12.0	- 0.2	2.0	2.0
Net	**0.6**	**- 5.7**	**- 0.4**	**1.0**	**1.0**
Other transactions, net	**- 2.9**	**- 0.7**	**- 2.2**	**2.9**	**3.0**
Net Capital flows	**-12.3**	**1.3**	**2.0**	**5.0**	**4.0**
Balancing item	12.2	0.2	7.3	5.0	5.0
Current account	0.1	- 1.6	- 9.3	-10.0	- 9.0

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DATE: 24 June 1988

CHANCELLOR cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
PCC
Mr Sedgwick
Mr Edwards
Mr Culpin
Mr Luce
Mr Moore
Miss Peirson
Mr Peretz
Mr Turnbull
Mr Robson
Mrs Butler
Mr Hibberd
Mr MacAuslan
Mr Mortimer
Mr M G Richardson
Mrs M Brown
Mr Potter
Mr McIntyre
Mr S J Davies
Mr Riley
Mr Ritchie
Mr Franklin
Mrs Todd
Mr Cropper
Mr Tyrie
Mr Call

TREASURY ECONOMIC FORECAST: PUBLIC FINANCES

I attach the report on the forecast for the public sector finances. It provides more detailed explanation of the forecasts of expenditure and receipts summarised in section 8 of the main forecast report circulated by Mr Sedgwick on 22 June (copies of section 8 attached for those who have not seen it).

Colin Mowl

COLIN MOWL

SECRET

TREASURY ECONOMIC FORECAST

PUBLIC FINANCES

SUMMER 1988

CONTENTS

TREASURY ECONOMIC FORECAST: PUBLIC SECTOR FINANCES

I. PUBLIC EXPENDITURE

1. The first section considers the prospects for expenditure on pay which forms a high proportion of a number of central government programmes. Thereafter the focus is on broad categories of expenditure by function.

<u>Central Government Pay</u>

2. The forecast of central government average earnings growth in each financial year is set out in Table I. Broadly speaking, earnings growth in the financial year reflects the outcome of the pay round beginning the previous September. In the 1987-88 pay round, central government average earnings appear to have increased faster than the private sector average, boosted in particular by the nurses settlement. The forecast assumes that central government earnings as a whole will grow a little faster than the private sector in subsequent rounds.

3. The projections of pay increases for the main groups <u>within</u> central government are less firm than those for central government as a whole. But some disaggregation is required to assess the pressures on the separate programmes. Earnings of health service employees in 1988-89 are influenced by the recent double-digit nurses' pay award and other NHS settlements at or around the private sector average. The large proportion of health workers covered by pay review bodies - around 75 per cent - is a factor in forecasting earnings growth above the central government average.

4. By contrast, average pay of the armed forces has grown by about 2 per cent below the private sector average in recent pay rounds and this trend is expected to continue, albeit to a lesser extent. With civil service pay assumed to grow in line with private sector earnings after being squeezed for a number of years up to the current pay round, average earnings in defence (including civilians) converges to the private sector average in 1990-91.

TABLE I: CENTRAL GOVERNMENT AVERAGE EARNINGS GROWTH - %

	(Weights)	1988-89	1989-90	1990-91
Defence*	(29)	6	6½	7
Health**	(45)	12¾	8¾	8
Other	(26)	5¾	8	7¾
Average CG	(100)	9	8	7¾
Average Private Sector		8½	7½	7

*   Includes MOD civilians
** Excludes GPs and dentists

Defence

5. Following the end of the NATO commitment, which boosted defence spending in the early 1980s, defence expenditure has been falling in real terms. The forecast initially continues and then reverses this trend, on the basis that (i) the scope for continued real reductions in procurement is becoming somewhat limited and (ii) real defence earnings rise, even if by less than the other parts of the CG pay bill. Table II shows projected overspends on current plans rising to £1 billion in 1990-91. The driving force behind this is pay which accounts for over three-quarters of the overspends.

6. Under special arrangements, MOD can carry forward significant amounts of underspend on final cash limits into the following year. It is estimated that this end year flexibility (EYF) will allow them to increase 1988-89 cash limits by around £½ billion. The forecast implies that slightly over half of this is used to accommodate the overspend on plans in 1988-89, with around £0.2 billion carried forward into 1989-90. This amount would prove insufficient to cover the projected overspend which would imply a further claim on the Reserve (over and above that sanctioned through EYF arrangements) unless expenditure plans are increased.

TABLE II: DEFENCE EXPENDITURE

	Estimated outturn 1987-88	Forecast 1988-89	1989-90	1990-91
£ billion current prices				
Forecast	18.9	19.5	20.5	21.5
Planned*	18.8	19.2	20.0	20.6
Forecast overspend	0.1	0.3	0.5	1.0
(of which pay)		(0.3)	(0.5)	(0.8)
Real growth rates (%)				
Forecast	-1¼	-2¼	0	1
Planned*		-2½	¼	0

* 1987-88 from 1987 PEWP, later years from 1988 PEWP

Health

7. Health expenditure is forecast to rise on average by about 4 per cent a year in real terms, much the same rate as over the past two years but significantly faster than in the current plans. The forecast reflects the real pay increases for health workers described earlier and the view that other spending will rise at the same rate in real terms as over the past five years.

TABLE III: HEALTH EXPENDITURE

	Estimated outturn 1987-88	1988-89	1989-90	1990-91
£ billion current prices				
Forecast	20.7	22.8	24.8	26.8
Planned*	20.0	21.8	22.9	24.0
Forecast overspend	0.7	1.0	1.9	2.8
(of which pay)	(0.3)	(0.8)	(1.4)	(2.1)
Real growth (%)				
Forecast	4½	4¼	3¼	4
Planned*		1	1½	1¾

* 1987-88 from 1987 PEWP, later years from 1988 PEWP

Social Security Expenditure

8. The forecast of social security benefit expenditure has been derived by:

(a) adjusting 1988 PEWP plans for differences between the forecast for unemployment and upratings, and the corresponding assumptions underlying the PEWP;

(b) making some modest additions to expenditure to allow for possible future policy changes;

(c) making upward adjustments to produce a realistic 'underlying' growth rate (ie. growth after allowing for the effects of upratings, changes in unemployment and policy, demographic factors etc).

9. There is still little firm information on the level of expenditure under the new benefit system introduced in April. The latest assessment from DHSS's in-year monitoring system implies a fall in the underlying growth of expenditure from 4 per cent in 1987-88 to 1½ per cent in 1988-89. Even if the relatively high 1987-88 growth is partially discounted, the DHSS projection looks too low. The forecast assumes underlying growth of 3 per cent in 1988-89 and 2½ per cent thereafter.

Underlying growth in social security expenditure - %

	1986-87	1987-88	1988-89	1989-90	1990-91
1988 PEWP			¾	1¼	1½
Forecast	3¼	4	3	2½	2½

10. Table IV shows that the resulting forecast of expenditure is reduced compared to the PEWP because of lower unemployment (table V). However this is more than offset by higher upratings, the adoption of a higher underlying growth and the allowance for policy changes. The forecast rate of inflation in September 1988, which determines the April 1989 uprating, is particularly high at 5.1 per cent but this is crucially dependent on uncertain assumptions about the timing of mortgage rate increases.

TABLE IV: EFFECTS OF ECONOMIC AND OTHER FACTORS ON THE SOCIAL SECURITY FORECAST

£ billion

	1987-88	1988-89	1989-90	1990-91
Forecast overspend*	0.2	0.1	0.9	2.6
Due to:				
(a) Economic Assumptions:				
(i) Unemployment	- 0.9	- 0.8	- 1.0	- 1.0
(ii) Upratings	-	-	0.3	1.3
(b) Policy changes	0.1**	0.1	0.3	0.4
(c) More realistic underlying growth	1.0	0.8	1.4	1.8

* relative to 1987 PEWP for 1987-88 and to 1988 PEWP thereafter
** additional payment following the RPI error.

TABLE V: ECONOMIC ASSUMPTIONS UNDERLYING THE FORECAST OF SOCIAL SECURITY EXPENDITURE

	1988-89	1989-90	1990-91
1. Unemployment* (GB, million)			
PEWP 1988	2.6	2.6	2.6
Forecast	2.2	2.2	2.2
2. Upratings (% pa)			
(i) RPI			
PEWP 1988	4.2	4½	3¼
Forecast	4.2	5.1	6.0
(ii) ROSSI**			
PEWP 1988	3.2	3½	3
Forecast	3.2	4.2	4.0

* Latest assumption for 1988-89 issued to DHSS is 2.35m
** RPI less housing costs

The National Insurance Fund

11. Forecast earnings growth continues to drive National Insurance Contributions up at a faster rate than National Insurance benefit expenditure, which is also reduced by the continued fall in unemployment. This produces large flow surpluses on the National Insurance Fund (GB) as shown in table VI.

12. Given the prospect of otherwise much larger surpluses, the forecast assumes that the Treasury Supplement will be reduced by two percentage points per annum; the maximum reduction possible without primary legislation. If the Treasury Supplement were maintained at 5 per cent, the flow surpluses would be £¾ billion and £1½ billion higher than forecast in 1989-90 and 1990-91 respectively. After 1990-91 any further reduction would imply eliminating the Treasury Supplement altogether in the next year.

TABLE VI: NATIONAL INSURANCE FUND (GB) SURPLUSES - £ billion

	1987-88	1988-89	1989-90	1990-91
Surplus: flow	1.4	2.2	2.0	1.3
: level end-year	7.1	9.3	11.3	12.6
Treasury Supplement	2.1	1.6	1.0	0.4
(rate %)	(7)	(5)	(3)	(1)

Net EC Contributions

13. Table VII shows the forecast of total net payments to EC institutions and compares this with the PEWP.

TABLE VII: NET EC CONTRIBUTIONS (£bn)

	1987-88	1988-89	1989-90	1990-91
1988 PEWP		0.8	1.5	1.3
Forecast	1.6	1.0	1.9	1.6

14. The forecast is aligned with EC division's latest view and takes account of the Brussels European Council decision in February to increase the ceiling on EC own resources from 1.4 per cent of community VAT to 1.2 per cent of GNP.

Other Central Government Expenditure

15. This broad category includes expenditure on transport, agriculture, employment, industry, education etc. Real growth in 1988-89 is boosted by the assumed expenditure on Rover and by a low 1987-88 estimated outturn. Thereafter this category is generally projected to grow in real terms in line with existing plans. But in

addition some real increases in spending compared with plans are assumed, for example for extra investment in roads and prisons. The major contribution to the forecast overspend (see table VIII) therefore comes from the assumption that higher inflation than assumed in the plans will lead to additional cash spending.

TABLE VIII: 'OTHER' CG EXPENDITURE

	Estimated outturn 1987-88	1988-89	1989-90	1990-91
£ billion current prices				
Forecast	26.2	29.7	32.1	33.6
Planned*	27.3	29.2	31.1	31.9
Forecast overspend	- 1.1	0.5	1.1	1.7
Real growth (%)				
Forecast	- 4¾	7	3	½
Planned*		2½	2¾	- ¼

* 1987-88 from 1987 PEWP, later years from 1988 PEWP

Local Authorities

16. The forecast of local authority (LA) current expenditure in 1988-89 gives a lot of weight to local authorities' own budgets which in recent years have proven to be a good guide. Pay accounts for about three-quarters of local authority current expenditure. Information on settlements suggests that LA average earnings will rise by 8½ per cent in 1988-89. Given their budgets, this implies virtually no increase in manpower. If this were to happen it would be the first year since 1982-83 that LA employment has not grown. Average growth over the 1980s of about 1 per cent a year has been very high compared both with long term trends and the rest of the economy, suggesting some scope for rationalisation. In particular, councils' administrative and manual staffs appear vulnerable to central government pressure to widen competitive tendering and contracting out. Against this, there may be further small increases in police and social services.

TABLE IX: LA EMPLOYMENT AND PAY

% increases

	1986-87	1987-88	1988-89	1989-90	1990-91
Staff numbers (headcount)	2¼	1½	0	1½	1½
LA average earnings	8¼	8½	8½	8½	7½
Memo: Private sector earnings	8	7¾	8½	7½	7

17. In later years, employment growth is forecast to resume partly because of extra staffing to implement community charge (CC) and other reforms such as the national curriculum. LA average earnings are forecast to increase a little faster than the private sector average. Current expenditure as a whole might rise in real terms in 1989-90 and 1990-91 at about 4 per cent a year.

18. The forecast assumes a small fall in outturn percentage of expenditure financed by central government grant in 1989-90, after a sharp fall in 1988-89. It allows for an increase in outturn grant percentage in 1990-91 (after continuous falls since 1981-82) because the planned reforms contain no allowance for grant holdback - the forecast percentage in 1990-91 is no higher than likely level in 1989-90 <u>before</u> holdback.

19. Income from rates (including CC in Scotland) is forecast to rise by over 10 per cent in 1989-90, a significant real increase. In 1990-91 even with a sizeable real increase in expenditure, income from <u>domestic</u> rates and CC might fall in real terms. This partly reflects the assumed real increase in grant. It also reflects the fact that even if the business rate poundage rises by no more than the RPI income from business rates will be boosted by the buoyancy of commercial property investment.

TABLE X: LOCAL AUTHORITY CURRENT ACCOUNT EXPENDITURE AND RECEIPTS

PES terms, GB				£ billion
	1987-88	1988-89	1989-90	1990-91
Expenditure				
Total relevant expenditure	35.0	37.3	40.7	44.2
Total current expenditure	35.3	37.6	41.1	44.6
Memo: Overspend on Plans	1.2	1.3	3.8	6.2
Receipts				
Grant (cash)	16.3	16.7	18.1	20.1
Rates	18.8	20.5	22.0	13.6
of which:				
Domestic	8.8	9.6	9.7	0.4
Non-domestic	10.0	10.9	12.2	13.2
Community charge	-	-	1.0	10.6
Drawings from balances	0.3	0.4	0.1	0.3
Total finance	35.3	37.6	41.1	44.6
Grant percentage (accruals)	45.6	44.8	44.5	45.5
		Annual percentage changes		
Cash				
Total current expenditure	8.8	6.6	9.3	8.5
Grant	9.4	2.9	8.4	11.0
Rates & community charge	8.0	9.3	11.7	5.4
of which:				
Domestic	8.0	9.3	10.9	2.4
Non-domestic	8.0	9.3	12.4	8.1
Real terms				
Total current expenditure	3.4	0.8	3.8	4.3
Grant	4.0	-2.7	3.0	6.7
Rates & community charge	2.7	3.4	6.2	1.4
of which:				
Domestic	2.7	3.4	5.4	-1.5
Non-domestic	2.7	3.4	6.8	3.9

20. The main feature of the capital account in the recent past is the unexpectedly high level of capital receipts - from council house sales and repayment of LA mortgages etc - in 1987-88. The forecast assumes that receipts are maintained at the 1987-88 level in real terms,

implying substantially more receipts than planned. Gross capital expenditure, including grants and lending as well as acquisition of physical assets, is assumed to rise by 2½ per cent this year and 1 per cent a year thereafter in real terms, also well above plans. The net result is a negligible overspend on LA capital this year (after a big underspend last year) but growing overspends in later years.

21. The forecast of LA borrowing - the LABR - in 1988-89 gives weight both to the projections of LA income and expenditure and to provisional outturns for borrowing so far this year. The latter suggests higher borrowing than the former although in previous years monthly borrowing patterns have been erratic. The forecast of the LABR thereafter mirrors projected movements in the balance of income and expenditure. The rise in borrowing forecast for 1990-91 can be seen as partly reflecting an assumed unexpected shortfall in CC receipts in its first year in England and Wales. It also reflects the assumption that net capital spending will rise in real terms.

LABR - £ billion

1986-87	1987-88	1988-89	1989-90	1990-91
¼	1½	2	1½	2

Nationalised Industries and the PCBR

22. The forecast assumes that BSC is privatised in autumn 1988, the water authorities in autumn 1989, electricity distribution in summer 1990, the larger generating company in autumn 1990 and Scottish electricity early in 1991. The forecast of aggregate external finance allows for the loss of these companies' negative external finance from the date of privatisation. (Table XI however includes steel, electricity and water throughout.) The forecast of central government interest and dividend receipts also allows for dividend receipts from residual shareholdings in water and electricity and for interest receipts on water and gas debt.

23. In line with past experience NIs' output growth in 1987-88, at 2½ per cent, was less than the growth of the economy as a whole. It is forecast to fall back to under 2 per cent by 1990-91.

[illegible]. Although prices charged by NIs' to domestic consumers are forecast to rise in real terms, particularly in 1988-89, competitive pressures will almost certainly continue to produce real reductions in prices charged to industry. NI prices as a whole may therefore rise only slightly in real terms in 1988-89 and fall in real terms thereafter.

25. Strong labour productivity growth has been a noteable feature of NIs' performance in the 1980s and is an important explanation of the relatively fast growth of NIs' profits over the same period. The scope for reducing overmanning in most NIs is now more limited, so labour productivity growth is likely to decelerate over the future. Combined with real price falls from 1989-90 onwards this implies more modest growth in NIs' profits compared with the recent past.

TABLE XI: NATIONALISED INDUSTRY TRADING PERFORMANCE AND INVESTMENT*

% increases

	1985-86	1986-87	1987-88	1988-89	1989-90	1990-91
Output	2¼	2	2½	2½	2¼	1¼
Employment	- 7¼	- 5½	- 4½	- 2¾	- 2	- 2
Productivity	10¾	8	7½	5½	4¼	4
Real Prices	- 1	- 1¼	- 2	¾	- ¾	- ¾
Profits**	28½	7	15¼	22½	10¾	5¾
Investment Volume	- 5½	- 1½	- 1½	14½	5¾	3¾

* The figures relate to the current composition of the NI Sector and adjust for the coal strike.

** gross of depreciation

TABLE XII: EXTERNAL FINANCE AND THE PCBR (£bn)

	1987-88	1988-89	1989-90	1990-91
External Finance				
1988 PEWP		0.7	0	- 0.4
Forecast	0.4	0.7	0.7	0.7
PCBR				
1988 Budget Forecast	- 1.4	- 0.8	- 1.1	- 1.4
Forecast	- 1.6	- 0.8	- 0.6	- 0.4

26. Table XII shows the forecast of external finance and the PCBR. Given the general buoyancy of the economy NIs as a whole should have little difficulty staying within their EFL in 1988-89, even if there is a large overshoot by British Coal. Thereafter the outturn for external finance could be well above existing plans, partly because of over-optimistic profit projections, partly because of increased investment needs, but also because those industries due to be privatised, particularly steel and electricity, will no longer be making negative contributions to external finance.

27. The PCBR in 1988-89 is forecast to be the same as at Budget time, a net repayment of £¾ billion; in the first two months of the year it was close to the Budget profile. Subsequently, although external finance is forecast to be flat from 1988-89 onwards, the PCBR is expected to rise (ie. the net repayment to become smaller) because CG grant and subsidy are assumed to make a smaller contribution.

Debt Interest

28. General government gross debt interest payments in 1988-89 are now forecast to be £200 million lower than in the FSBR, or about the same as our central view at Budget time, even though the GGBR is now more negative. This is because gross gilt sales turned out higher than forecast in 1987-88 in order to finance the build-up of reserves. However, with some rundown of reserves now assumed, gross borrowing is now forecast to be more negative than net borrowing, adding to downward pressure on gross debt interest in later years despite higher interest rates.

TABLE XIII: GENERAL GOVERNMENT GROSS DEBT INTEREST PAYMENTS

£ billion

	1987-88	1988-89	1989-90	1990-91
1988 PEWP	17.4	17.8	18.0	18.0
FSBR	17.5	17.5	17.1	16.7
Forecast	17.4	17.3	16.9	15.5

[redacted]. The counterpart of the large rise in official reserves last year is a big increase in interest receipts and thus a fall in <u>net</u> debt interest payments. In 1990-91 net payments are also reduced by dividend receipts from residual shareholdings in the privatised electricity and water industries.

TABLE XIV: GENERAL GOVERNMENT NET DEBT INTEREST PAYMENTS

£ billion

	1987-88	1988-89	1989-90	1990-91
1988 PEWP	11.4	12.3	13.0	13.0
FSBR	11.2	11.8	11.7	12.0
Forecast	11.5	11.0	10.5	9.5
(% of GDP)	(2¾)	(2¼)	(2)	(1¾)

II GENERAL GOVERNMENT RECEIPTS

30. Table XV sets out details of the forecast of general government receipts in the format of FSBR Table 1.2. All the figures in this section of the report are before taking account of the fiscal adjustment.

TABLE XV: GENERAL GOVERNMENT RECEIPTS - % changes

	Shares in 1988-89	1986-87	1987-88	1988-89	1989-90	1990-91
Income Tax	0.23	7½	7½	1½	7	6½
Corporation Tax (excl. North Sea)	0.10	34½	23	27½	23	7
Capital Taxes	0.03	21	34½	26	2	- 3
VAT Receipts	0.14	10½	13	11	9	7
Local Authority Rates and CC	0.10	13	8½	12½	11½	4
Stamp Duties	0.01	51½	30	3½	20	11½
Other Expenditure Taxes	0.15	7½	2½	6	7½	5½
North Sea Revenues	0.02	- 64½	10½	- 27½	10	- 7
Other Taxes	0.00	- 6½	- 51	- 5½	- 31½	- 12½
Total Taxes and Royalties	0.77	5	10	8	10	5½
National Insurance Contributions	0.17	8	9½	8½	8½	7
Interest and Other Receipts*	0.06	8	- 9½	- 2	- ½	3½
General Government Receipts	1.00	6	8½	7½	9	6
Memo:- Money GDP		7	10	10	8	6

* including gross trading surpluses of general government bodies.

31. General government receipts are forecast to rise by 7½ per cent in 1988-89, below the forecast growth rate for money GDP. This largely reflects the Budget tax changes, which reduced 1988-89 receipts by £4 billion (2 per cent of GG receipts) as compared with an indexed base. Apart from income tax those receipts whose growth is expected to be below that of GDP include North Sea revenues, expected to fall in absolute terms, stamp duties, depressed by the stock market crash, and 'other' receipts, reduced by the deterioration in ECGD's trading surplus. Those receipts expected to grow significantly more than GDP are non-oil corporation tax and capital taxes.

32. The forecast non-oil tax burden is summarised in Table 40 of the main report.

Income Tax

33. Income tax revenues for 1987-88 turned out substantially higher than forecast in the 1987 FSBR. It is difficult to know what interpretation to put on this. It may be the case that the apparent higher than expected effective tax rate for PAYE is an indication that the wages and salaries bill is likely to be revised upwards. Or it may be that the original estimates of the revenue costs of the 1987 Budget changes to income tax rates and allowances were too high. Further possibilities are that higher than expected tax receipts reflect an unanticipated shift in income distribution, or perhaps improved compliance.

34. The effective rate for PAYE income tax is projected to fall by some 1¼ percentage points in 1988-89, as a result of the Budget tax cuts. But the uncertainties about 1987-88 must increase the margins of error around the current forecast.

TABLE XVI: EFFECTIVE RATES OF INCOME TAX

	1986-87	1987-88	1988-89	1989-90	1990-91
PAYE Accruals as a % of wages and salaries	19.2	18.9	17.6	17.8	17.8
Total Income Tax Accruals as a % of personal income	13.3	13.4	12.7	12.7	12.7

35. For 1989-90 and 1990-91, the forecast assumes indexation of allowances in line with RPI inflation. With real growth in incomes, these assumptions would usually be expected to lead to a rising effective tax rate, as a result of real fiscal drag. For PAYE, this is indeed the case for 1989-90. But the revenue cost of the introduction of independent taxation in 1990-91 is sufficient to offset the effect of real fiscal drag for that year, with the result that the effective tax rate for PAYE is projected to remain flat between 1989-90 and 1990-91.

36. The 1988 Budget changes to income tax seem likely to have effects on economic behaviour, which may lead to further gains or losses in tax revenues, in addition to the familiar estimates of revenue cost/yield, calculated on the basis of no change in economic behaviour. In contrast to the forecast in the FSBR, the current forecast takes on board our best - admittedly very tentative - estimates of these effects. Table XVII shows these estimates, which are consistent with those produced before the Budget, though not used in the FSBR. The most important in quantitative terms over the forecast period are the effects of the Budget changes to the higher rates, assumed to yield an extra £400 million by 1990-91, mainly from a combination of increased labour supply from higher rate taxpayers, substitution of (taxable) cash income for (tax-deductible) expenses or benefits in kind, and decreased use of tax shelters. The introduction of independent taxation in 1990-91, on the other hand, may lead to some loss in revenue (over and above the direct costs of the change) as a result of income splitting and asset switching (from husband to wife).

TABLE XVII: 1988 BUDGET EFFECTS ON INCOME TAX

(All estimates are differences from an indexed base) **£ million**

	1986-87	1987-88	1988-89	1989-90	1990-91
Direct effects on receipts*	-	-	- 3545	- 5385	- 6805
Behavioural effects					
- car scales and home improvement loans	-	-	15	30	45
- higher rates	-	-	40	240	400
- independent taxation	-	-	-	-	- 100
Total Budget effects	-	-	- 3490	- 5115	- 6460
(% of total income tax receipts)	-	-	7.5	10.3	12.3
Memo: Income tax paid by top 5% (% of total liability)	29.0	30.0	28.5	28.8	28.9

(* Budget-time estimates, based on incomes as in FSBR/MTFS forecast)

Corporation Tax

37. Non-North Sea corporation tax (CT) receipts increased by 23 per cent in 1987-88. For mainstream corporation tax (MCT), the increase was over 30 per cent, following a rise of over 50 per cent in 1986-87. The rapid growth in CT receipts over the past two years mainly reflects buoyant profits growth in 1985 and 1986. But the rise in tax receipts over this period has been significantly higher than in profits in the period to which the tax (mainly) relates; the effective tax rate for MCT has risen from 11 per cent in 1985-86 (1984 accruals) to nearly 15½ per cent in 1987-88 (1986 accruals).

38. Table XVIII shows the forecast for non-North Sea CT. Profits were again buoyant in 1987 and this growth is forecast to continue through 1988. As a result, further substantial rises (25 to 30 per cent per annum) in MCT receipts are projected for 1988-89 and 1989-90. However, the forecast increases in the effective tax rate over the next two years are small, in comparison with the previous two years. One reason for this is the 1984 Budget changes to investment allowances, which had the effect of substantially reducing the value of allowances, for given profits and investment, for tax accruals over the period 1984 to 1986, but which will be having the opposite effect (although not on the same scale) for accruals from 1987 onwards. A substantial slow-down in profits growth is forecast for 1989; this is projected to lead to much slower growth in MCT receipts in 1990-91.

TABLE XVIII: DETERMINANTS OF NON-NORTH SEA CORPORATION TAX AND EFFECTIVE RATES

	Percentage Growth Rates for:-				Effective Tax Rates (%)	
	Revenue		Tax determinants			
	MCT+ Receipts	ACT	Company Incomes (previous calendar year)	Dividends (Calendar year)	MCT*	ACT
1986-87	+ 57	+ 17	+ 26	+ 25	13.2	56.0
1987-88	+ 35	+ 11	+ 18	+ 40	15.4	44.4
1988-89	+ 30	+ 16	+ 26	+ 30	15.6	39.7
1989-90	+ 26	+ 13	+ 18	+ 13	16.3	39.7
1990-91	+ 9	+ 6	+ 9	+ 6	16.2	39.9

[* numerator is tax accruals for previous year]
[+ includes MCT on capital gains]

39. Buoyant profits growth has led to large rises in dividends over the past three years, but the reductions in the basic rate of income tax in the last two Budgets - which implies parallel reductions in the ACT rate - meant that the rises in ACT receipts will be substantially smaller. For 1988-89, the forecast increase in ACT receipts is 16 per cent, only around half the forecast rise in dividends in calendar year 1988.

VAT

40. The recorded rise in VAT receipts in 1987-88 is significantly larger than can be explained by present estimates of consumers' expenditure. Even when adjusted for special factors such as the impact of the Keith report changes to collection procedures and the 1987 Budget measures (in particular, the tighter rules on partial exemption), underlying VAT receipts are estimated to have increased by 12½ per cent. Consumers' expenditure for calendar year 1987 (the most relevant period for financial year VAT receipts, given payment lags) is currently estimated to have risen by 9 per cent, implying a rise in the effective tax rate of over ¼ percentage point (from 8.87 per cent to 9.17 per cent). This apparent rise in the effective rate has, however, not been given any weight in the forecast. At this time last year, the figures were suggesting a substantial rise in the effective tax rate for 1986-87, but subsequent upward revisions to the consumers'

expenditure data caused this rise to disappear; on present data, the effective tax rate for VAT now appears to have fallen a little in 1986-87. It seems likely that data revisions this year will follow a similar pattern, and that current estimates of consumers' expenditure in 1987 will be revised upwards - bringing the growth rate of expenditure closer into line with that of VAT receipts.

41. Table XIX shows the forecast for VAT. The forecast is based on the assumption of a flat underlying effective tax rate at 1987-88 levels, after adjusting for special factors such as the Keith report changes, Budget effects and European Court judgements. However, an implication of our belief that consumers' expenditure growth in the recent past is currently underrecorded is that the forecasts of consumers' expenditure growth based on the recorded data are probably downward biased. In constructing the forecast of GDP, a correction for this bias has been made in the projection of the GDP compromise adjustment. In order that this bias correction in the expenditure forecast should feed through to the forecast of taxes, a small upward adjustment - worth about £60 to 70 million a year, or ¼ per cent of VAT receipts - has been made to the VAT forecast. As a result, the effective tax rates shown in Table XIX, which are measured using the unadjusted forecasts of consumers' expenditure, show small rises in the effective rate over the forecast period.

TABLE XIX: VAT RECEIPTS FORECAST

	Percentage Growth Rates in:-			Forecast Levels (£bn)		
	VAT Receipts (Underlying)	Consumers' Expenditure+	Effective Tax Rate (%) (Underlying)	Underlying Receipts	Special Factors*	Total Receipts
1986-87	9.2	10.0	8.87	21.0	0.4	21.4
1987-88	12.5	8.9	9.17	23.6	0.5	24.1
1988-89	11.1	10.7	9.20	26.2	0.6	26.8
1989-90	9.0	8.8	9.22	28.6	0.6	29.2
1990-91	6.6	6.4	9.24	30.9	0.7	31.2

[* reduction of arrears from Keith; 1987 Budget effects]
[+ Calendar year]

42. The forecast takes into account Customs and Excise latest estimates of the effects of the Keith report changes (Stage III is due to be implemented in 1989) and of the effects of the 1987 and 1988 Budgets. The forecast also takes account of the extension of VAT to spectacles, as a result of a recent European Court judgement. (This is only worth around £20 million a year.) The forecast does not, however, take any account of the latest European Court judgement requiring the extension of VAT to non-domestic new construction. To have done so would have raised the fiscal adjustment.

Specific Duties

43. Table XX shows the forecast for specific duties. It assumes revalorisation of all duty rates in line with RPI inflation in future Budgets.

TABLE XX: SPECIFIC DUTIES FORECAST: RATIO OF DUTY YIELD TO CONSUMERS' EXPENDITURE

	Tobacco	Alcoholic drink	Hydrocarbon oils	Total
1986-87	2.0	1.7	3.1	6.8
1987-88	1.8	1.7	3.0	6.4
1988-89	1.7	1.6	3.0	6.3
1989-90	1.7	1.5	3.0	6.2
1990-91	1.7	1.5	3.0	6.3

44. For tobacco and alcoholic drink, duty receipts have generally been rising more slowly than consumers' expenditure over recent years. These trends are forecast to continue. For hydrocarbon oils (which means for the most part petrol), duty receipts have approximately kept pace with consumers' expenditure growth. The forecast implies a similar pattern in the future.

North Sea Revenues

45. Government revenues from the North Sea in 1988-89 are projected at £3.6 billion, £0.3 billion higher than in the FSBR forecast. The sterling oil price and North Sea production are forecast to be higher in 1988 than assumed in the FSBR, but this is partly offset by the switch to taking royalties in cash (RIC) which leads to a one-off reduction in receipts of £0.1 billion this year.

[illegible]. In 1989-90, despite a further fall in oil production North Sea revenues are expected to rise slightly to £3.7 billion, reflecting a rise in the oil price and the ending of repayments of APRT (the latter are expected to reduce net receipts by £0.4 billion in 1988-89). Thereafter revenues are expected to decline as production falls.

TABLE XXI: GOVERNMENT REVENUES FROM THE NORTH SEA

£ billion

	1987-88	1988-89	1989-90	1990-91
FSBR 1988	4.7	3.3	2.9	2.6
June 1988	4.7	3.6	3.7	3.4
Change	-	0.3	0.7	0.8
of which:				
£ oil price		0.4	0.8	0.8
production		0.1	0.2	0.2
RIC		- 0.1	-	-
other (mainly effects of higher expenditure)		- 0.2	- 0.3	- 0.2

Stamp Duties and Capital Taxes

47. Stamp duties and capital taxes (capital gains tax - CGT; inheritance tax - IHT; CT on capital gains) have been among the fastest growing categories of tax receipts over the past few years. A major factor has been the bull market in stocks and shares, which - along with rising house prices - was responsible for rapidly rising receipts from stamp duties on transactions, and has also led to substantial increases in receipts from taxation of capital gains (CGT and CT). The stock market crash last October had a fairly immediate impact on receipts from stamp duties, but payment lags mean that there will have been no effect up to now on the yield of capital taxes.

48. The forecast for stamp duties and capital taxes is set out in Table XXII. Stamp duties from transactions in shares in 1988-89 are forecast to be around 25 per cent down on 1987-88, but this is expected to be offset by a large increase in stamp duties from housing market transactions. As a result, total stamp duties may still record a small rise this year. Although the present rapid growth in house prices is assumed to slow down markedly next year, the forecast assumptions of a fairly steady rise in the volume of stock market turnover, together with some rise in equity prices, produce increases in stamp duties from transactions in shares of 15 to 20 per cent per annum for 1989-90 and 1990-91.

TABLE XXII: STAMP DUTY AND CAPITAL TAXES

	1988-89 Forecast (£m)	% Growth rates 1986-87	1987-88	1988-89	1989-90	1990-91
STAMP DUTIES	2500	5½	30	3½	20	12
of which:						
land and buildings	1660	43½	50½	54	21½	10
shares	645	55½	7	-25	16½	18
CAPITAL TAXES	4703	21	34½	26	2	- 3
of which:						
capital gains tax	1900	17	29½	38	-5½	-11
inheritance tax	1050	12	9½	- 3	0	9½
companies tax on gains	1753	47½	47	39½	11	- 1½
MEMO:						
New house prices		15½	19	20½	7½	½
Equity prices		26	18½	- 4	6½	5
Stock market volume		48	81	10	10½	11½

49. The forecast for capital taxes shows a rather different profile from that of stamp duties. The October crash came over half way through the 1987-88 financial year. Tax on capital gains realised in 1987-88 will mostly be paid in 1988-89; thus a further substantial rise in receipts from taxes on capital gains can be expected this year from gains realised at pre-crash prices. However, no further significant increase in receipts from taxes on capital gains is forecast in 1989-90 and 1990-91, when lower post-crash stock market prices will have their full impact.

National Insurance Contributions and Non-Tax Receipts

50. Table XXIII shows the forecast for National Insurance Contributions (NICs) in terms of effective tax rates (denominator - wages and salaries). Table XXIV sets out some details of the forecast of non-tax receipts.

TABLE XXIII: EFFECTIVE RATES FOR NICS (%)

	Employees	Employers	Total Accruals	Total Receipts
1986-87	6.9	7.4	14.3	14.3
1987-88	7.0	7.4	14.4	14.1
1988-89	6.7	7.5	14.3	14.3
1989-90	6.7	7.6	14.3	14.2
1990-91	6.7	7.7	14.3	14.2

TABLE XXIV: NON-TAX RECEIPTS

£ billion

	1986-87	1987-88	1988-89	1989-90	1990-91
Interest and Dividend Receipts	6.0	5.9	6.3	6.4	6.0
Gross Trading Surplus and Rent	3.2	3.5	3.2	3.6	3.9
Capital Consumption	2.6	2.8	3.0	3.2	3.4
Other Miscellaneous Receipts	1.3	1.1	0.9	0.9	1.0
Accruals Adjustments	0.4	- 0.5	0.4	- 0.5	-0.1
Miscellaneous Financial Transactions (including balancing items)	- 0.7	- 0.9	- 1.1	- 1.0	- 1.0
Total Other Receipts	12.9	12.0	12.7	12.5	13.1

51. The main points of interest on these forecasts are:-

(i) a switch in 1988-89 in the burden of NICs (accruals basis) from employees to employers, reflecting changes in the rate structure introduced in April this year.

(ii) a rise in interest and dividend receipts for 1988-89, reflecting among other things higher interest receipts arising from the recent rise in the level of the official reserves.

(iii) a fall in gross trading surplus and rent for 1988-89, as a result of a significant increase in ECGD's trading deficit, reflecting an assumption of no debt re-financing by ECGD during the course of this year.

(iv) a change of nearly £1 billion in accruals adjustments (increasing receipts) for 1988-89, which is fully reversed in 1989-90. The main contributing factors are the accruals adjustments on NICs and income tax; in each case, the gap between accruals and receipts is unusually small in 1988-89 because of the lagged impact on receipts of changes in income tax rates and the introduction in April 1988 of incentive rebates on NICs for personal pensions.

(v) negative miscellaneous financial transactions of £1 billion a year, as a result of carrying forward a substantial discrepancy between identified expenditure and receipts in the 1987-88 local authorities accounts.

ps7/19L

SECRET

FROM: A A DIGHT

DATE: 27 June 1988

MR M M COURTNEY

BUILDING SOCIETY MORTGAGE RATES - LIKELIHOOD OF AN INCREASE

The Chancellor has seen and was grateful for your minute of 24 June.

A A Dight

A A DIGHT

mp A, B, C, C1. PPS 12/2.

PRIME MINISTER - COMMENT ON INTEREST RATE RISE

Transcript from: BBC Radio 4, World at One, 28 June 1988

PRESENTER: (NICK WORREL:) This morning's 1/2% rise in interest rates to 9 1/2% is the fourth such rise this month. It follows yesterday's trade figures which showed a record trade deficit of £1.2 billion. There are worries too that inflation is heading towards 5%, that the economy is growing too fast, and that the consumer credit boom is sucking in more imports than the country can afford. In the last few minutes Mrs Thatcher, who is at the EEC summit in Hanover, commented briefly on the interest rate rise.

PRIME MINISTER: As you know, it is our prime objective to keep downward pressure on inflation. We do not want to return to inflation. And we have therefore had a number of increases in interest rates recently at 1/2% a time. The trade figures were deeply disappointing, they were bad, and they had an effect on the exchange rate. And we have therefore put up the interest rates by a further 1/2% to make it quite clear that we're dead serious about keeping down inflation.

90/G.jfw.45/024

CONFIDENTIAL

FROM: T PIKE
DATE: 30 June 1988

PMP

1. MR GRICE

2. ECONOMIC SECRETARY

The final June figures are rather worse than we expected.

JWG

30.6.88

cc PS/Chancellor
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Mr Sedgwick
Mr Culpin
Mr Peretz
Mrs Lomax
Miss O'Mara
Ms Ryding
Mr Hurst
Ms Bronk

File: MAMC C9

M0 FIGURES

Provisional figures show that the 12 month growth rate of M0 in June was 7.3 per cent (7.7 per cent not seasonally adjusted). The sa and nsa 12 month growth rates of notes and coin in June were 7.1 and 7.5 per cent respectively. These figures are not expected to be revised.

2. Six month annualised growth of notes and coin in June was 6.2 per cent.

T. Pike

T PIKE

TABLE 16 CONFIDENTIAL (Until Publication)

M0 : THE WIDE MONETARY BASE

Monthly data	Level £ million (Change in brackets)					Percentage change on previous month		6 month % growth annualised		Percentage change on previous year			
	Notes and Coin (nsa)	Notes and Coin (sa)	Bankers' Deposits	M0 (nsa)	M0 (sa)	Notes(sa) and Coin	M0 (sa)	Notes & Coin (sa)	M0 (sa)	Notes and Coin (nsa)	Notes and Coin (sa)	M0 (nsa)	M0 (sa)
1987 October	15299	15456 (80)	203	15501	15659 (98)	0.5	0.6	7.4	7.3	5.1	5.2	5.5	5.6
November	15365	15525 (69)	183	15548	15707 (48)	0.4	0.3	7.4	7.0	4.8	4.8	4.9	4.9
December	16447	15661 (136)	186	16633	15846 (139)	0.9	0.9	7.9	8.5	4.7	4.8	4.2	4.3
1988 January	15458	15620 (-41)	181	15638	15801 (-45)	-0.3	-0.3	6.1	5.3	4.7	4.5	4.8	4.6
February	15353	15659 (39)	124	15477	15783 (-18)	0.2	-0.1	5.3	4.5	5.7	5.7	5.3	5.3
March	15588	15753 (94)	162	15750	15916 (133)	0.6	0.8	5.0	4.6	6.9	6.4	6.4	5.8
April	15797	15826 (73)	229	16026	16055 (139)	0.5	0.9	4.8	5.1	5.8	6.1	5.9	6.2
May	15868	15952 (126)	178	16046	16130 (75)	0.8	0.5	5.6	5.5	6.0	6.5	5.7	6.2
June (5/5) @	16073	16142 (190)	174	16246	16316 (186)	1.2	1.2	6.2	6.0	7.5	7.1	7.7	7.3
Latest 4 weeks @	16033	16150 (162)	164	16197	16314 (133)	1.0	0.8	6.1	5.8	6.9	6.9	7.0	6.9

Weekly data	Level £ million (Change in brackets)			Percentage change on previous week
	Notes(sa) and Coin	Bankers' Deposits	M0 (sa)	M0 (sa)
May				
4th	15965 (103)	155	16120 (-39)	-0.2
11th	15929 (-36)	161	16090 (-30)	-0.2
18th	15969 (40)	247	16216 (126)	0.8
25th	15944 (-25)	148	16092 (-124)	-0.8
June				
1st	16110 (166)	215	16325 (233)	1.4
8th	16072 (-38)	235	16307 (-18)	-0.1
15th	16132 (60)	90	16222 (-85)	-0.5
22nd	16177 (45)	87	16264 (42)	0.3
29th	16220 (43)	242	16462 (198)	1.2

@ The latest week's figure includes an estimate for coin.

CONFIDENTIAL

For 11.00 meeting tomorrow

PMP

FROM: SIR T BURNS
DATE: 1 JULY 1988

CHANCELLOR

[IR/XR] [MO]
[exports] [own labour]

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Anson
Sir G Littler
Dame Anne Mueller
Sir A Wilson
Mr H Phillips
Mr Byatt
Mr Scholar
Mr Lankester
Mr Monck
Mr Culpin
Mr H Evans
Mrs Lomax
Mr Odling-Smee
Mr Peretz
Mr Sedgwick
Mr Spackman
Mr Turnbull
Mr A Allan
Mr S Davies
Mr Gieve
Mr Grice
Mr Hibberd
Mr S Matthews
Mr Melliss
Mr Mowl
Mr Riley
Mr A Hudson
Mr Call
Mr Cropper
Mr Tyrie

Ch
[for Tuesday's meeting.
You will be familiar with all this (pretty well put) – but helpful for wide Tsy circulation to read: worth commending to Ministers & advisers @ Prayers?]

Yes

AA

V. good.
(esp para 28 – end)

(PCC discussion below)

TREASURY ECONOMIC FORECAST - JUNE 1988

You have seen the main forecast report. In this minute I comment on the interpretation of recent events, the prospects and policy implications.

2. It has been a difficult forecasting round and this forecast shows some significant differences from the forecast we published in the FSBR:

- output growth is higher in both 1988 and 1989;

- domestic demand growth is substantially higher in 1988;

- money GDP growth is faster in 1988-89 and 1989-90;

- the inflation rate is higher;

- the current account deficit is about double;

- the PSBR is a yet larger negative figure.

3. Interpreting recent events has been particularly difficult because of data inconsistencies and some unexpected statistics for the first few months of this year. The current account picture has also received considerable attention. The published figures for exports are surprisingly low and combined with the residual error cast doubt on the scale of the current account deficit. Even so there is little doubt that we have seen a significant deterioration.

Recent Events and the Forecast

4. Over the past year we have experienced a substantial capital inflow with continued pressure for a higher exchange rate and lower interest rates. The balance struck between the exchange rate and interest rates has reflected a policy choice aimed at maintaining downward pressure on inflation whilst avoiding an excessive appreciation of sterling. The forecast is based on the judgement that the pressure from the inflow of capital will ease but that the reversal will not be too abrupt. It is assumed that the same policy framework will apply. As a result the exchange rate is projected to decline a little (5 per cent over the next 18 months) and interest rates to rise to 10½ per cent. This combination helps to reverse some of the pressures on domestic demand and cost competitiveness.

5. Piecing together the data and making a few guesses suggests there has been some slowdown in output growth compared with the exceptionally rapid growth in the second half of last year. A range of indicators point in this direction both official - for example the industrial production figures and trade figures - and unofficial - for example the CBI indicators. However it is unlikely that the growth slowdown has been very marked; maybe from a rate in excess of 5 per cent in the second half of last year to between 3 and 4 per cent in the first half of this year. After revisions it would not surprise me if the latest figures turned out to be underestimates.

6. The forecast shows a continuation of growth at this reduced pace into the second half of 1988 so that growth for the whole of 1988 is expected to turn out very close to 4 per cent.

7. The most striking feature of the forecast for this year is the rapid growth of domestic demand - at almost 6 per cent it comfortably exceeds the growth of output:

- we now seem to be in the process of a considerable investment boom. In itself this is welcome and in time should help to ease some potential capacity constraints;

- but consumer spending continues to grow at a rapid and worrying pace. This is not easily explicable although made much more complicated by data difficulties which may understate the growth of personal incomes. There are various possible explanations - the housing boom, the expansion of credit, the high level of financial wealth (reflecting capital gains and high real interest rates). We now estimate that consumer spending in the first half of the year is approaching 20 per cent higher than 3 years ago.

8. This rapid growth of domestic demand is expected to continue into the second half of this year before slowing down in the first half of next year. The continued rapid growth of investment seems

to be well founded - both in relation to previous cyclical patterns, and the investment intentions data. The pattern of consumer spending is possibly less certain if only because of our inability to explain recent behaviour. At some stage the durables cycle will run its course and the personal sector will decide it has taken on enough credit. In recent forecasts we have taken the view that a higher savings ratio was likely at some stage. But there is no sign in recent figures that this is imminent.

9. The large imbalance between domestic demand and the growth of supply potential inevitably means that the net trade position has deteriorated sharply. It is possible that the statistics overstate the scale of the problem. The widening compromise adjustment reflects a low growth of expenditure components in aggregate in relation to output data. In part this may reflect an understatement of exports although it is likely that the bulk of this reflects increased domestic expenditure components - particularly investment. In addition to the statistical problems there are two points to note:

- competitive pressures from the higher exchange rate have probably played some part in the weakening current account. Last year exports performed rather better than expected; possibly reflecting the exchange rate depreciation of 1986. This year we may be losing that advantage as the exchange rate has risen. The slow growth of prices of exports (and imports) of manufactures is some evidence of the strength of competitive pressures. One reason for the scale of the current account deterioration has been the strength of the capital inflows; they have added to the strength of domestic demand and the exchange rate.

- it is probable that to some extent output growth has been constrained by productive potential with excess demand slopping over into net imports. There is some evidence of pressures on capacity. The CBI Survey shows a record small number of firms reporting excess capacity. This may have led to a diversion of exports to the home market and an encouragement of imports. But this is difficult to square with the subdued growth of import and export prices; and the sector showing the most evident signs of capacity pressure is the construction industry which is largely (but by no means exclusively) non-tradeable.

10. The forecast shows a sharp recovery of exports from the low first quarter figure but the projected continued growth of domestic demand at a pace rather faster than growth potential means that no improvement in the current account is expected. On these figures we are heading for a current account deficit of about 2 per cent of GDP, which has only been exceeded on two occasions since the war - 1951 and 1974. — thanks to Lawson!

11. Inflationary pressures have been reasonably subdued in the face of the strength of demand and output. The normal pattern is for inflation to pick up at this stage in the cycle and to peak some time after the top of the output cycle. The higher exchange rate seems to have constrained the growth of traded goods prices and import prices have grown slowly although there are now large commodity price increases in the pipeline. Earnings have increased faster but settlements have grown by less than might have been expected given the strength of the labour market. Even so inflation is running ahead of our Budget profile; by May the gap for the index, excluding mortgage interest payments, was 0.5 per cent.

12. With the projected increase in mortgage rates this takes the inflation rate to 5 per cent by the end of the year compared with the 4 per cent shown in the FSBR. The RPI excluding mortgage rates is expected to grow at between 4½ and 5 per cent until the beginning of 1990 before falling back to below 4 per cent. The mortgage profile means that actual RPI inflation could top 6 per cent in mid-1989 - before falling to 4 per cent in 1990.

13. By contrast the public sector finances seem to have been better than expected. Whatever the cause of the domestic spending boom it is difficult to put it down to an easing of fiscal policy. We now project a PSDR of £7 billion for this year. Maintaining it at that level leaves room for cumulative fiscal adjustment of £3½ billion over the next two years. — from £2½ – real fiscal drag

not policy but mainly [illegible] assumption

Policy Issues

14. The contribution of policy to developments over the past year has been complicated and is difficult to assess:

- the fiscal stance has been unambiguously tightened. The PSFD has fallen by 2½ per cent of GDP over the last two years. Although the personal tax ratio has declined the overall tax burden has been little changed thanks to the buoyancy of company taxes. Although this changing mix of the tax burden between personal and company sectors may have stimulated demand a little there can be very little in it;

- the combined effect of the exchange rate and interest rates has been broadly neutral; lower interest rates have offset a higher exchange rate. In terms of money GDP these effects probably cancel out although clearly they have had an adverse effect on the current account and have stimulated consumption.

15. Despite this relatively cautious approach to monetary and fiscal policy, problems have been emerging. The growth of money GDP seems to be significantly faster than the guidelines set out in the MTFS for the second year running; MO growth is well above target; and domestic demand is growing much faster than can be justified by underlying productive potential. There is some pressure upon capacity, the current account has been deteriorating quickly, and there are some - albeit modest - signs of inflationary pressure. A rising mortgage rate could lead to a pronounced surge in the RPI inflation rate.

16. It is interesting to look back to the stance of policy over the past year or so and ask whether policy should have been tighter. The first point to recognise is that we failed to anticipate the strength of private sector demand - particularly in the wake of the share price crash. We also understated the strength of the exchange rate. It is worth pointing out that the combination of the two is an unusual state of affairs. There are very few periods which have combined exceptionally strong domestic demand growth with an exceptionally strong exchange rate.

17. But even taking into account the growth of domestic demand, in hindsight should policy have been very different? It can be argued that we hung onto the 3DM exchange rate ceiling for too long, particularly in the light of the sharp commodity price rises that emerged. This kept interest rates lower than they might have been had we been prepared to tolerate a higher exchange rate at an earlier stage. There may be something in this but the scope for manoeuvre was very small. With a strong exchange rate it would have been very easy to generate expectations of appreciation and a damaging exchange rate bubble with consequences for the company sector for some time to come.

18. A case can also be made that fiscal policy should have been even tighter. The argument is that the decline of the private sector savings ratio should have been matched by a bigger increase in public sector savings. The weaker form of the argument would be in terms of short-term demand management. A stronger form of the argument would run as follows: that private sector savings may be abnormally low for a number of years and there is a case for a medium-term tightening of fiscal policy. One counter-argument is that a tighter fiscal policy might have done little to help the exchange rate/interest rate dilemma and indeed could have made the position worse if greater confidence in public sector finances had pushed sterling higher. I think there is something in this in the short run. A second counter-argument is that a larger fiscal surplus might have been offset by lower private sector savings or higher investment. I think there is less in this argument.

Although there may be some effects from public to private sector borrowing I doubt if it would have entirely offset the effects of the fiscal tightening and the result would have been a slower growth of money GDP. On the other hand I am conscious that your main motive with the Budget package was to improve supply performance and that it would have been difficult to do it in stages.

19. The policy problem now is to identify the source of the strength of demand, to assess how long it is likely to last, and to judge how to respond. The view set out earlier in this note is that it has been generated essentially by private sector behaviour and that there can be no certainty that it is about to slow down.

20. In contemplating policy action it is necessary to distinguish between two potential problems: inflationary pressure, and the widening balance of payments deficit. As I outlined earlier there are signs of some re-emergence of inflationary pressure. This is evident in various indicators and points to the need for an early tightening of monetary conditions. The balance of payments deficit may gain more attention because of the speed of change but in my view is less of a problem. It is the result of private sector behaviour that should tend to reverse itself in time providing the pressures for higher inflation are dealt with. The process of adjustment may be gradual but should emerge through the interplay of private sector behaviour and international capital flows.

21. We have known for some time that a tightening of monetary policy was needed. This has not occurred until recently because of the strength of sterling. In recent months the inflation indicators have been flashing even more clearly. Fortunately the pressure on sterling has abated and we have had the opportunity to increase interest rates significantly.

22. It is not clear how far interest rates will have to rise. If we are to sustain the argument about the current account it will be necessary to get MO back within its target range reasonably

soon. The forecast shows this being achieved with interest rates at 10½ per cent by the first quarter of 1989. But they may have to rise faster and higher. If necessary we should be prepared to think in terms of a higher level for the exchange rate although continuity of policy is important and there is no case for encouraging a rapid or substantial appreciation. In particular it will be important to avoid any significant depreciation of the exchange rate - I will come back to this later.

23. The threat of inflationary pressure will be reduced if the tightening of monetary policy succeeds in dampening down the housing boom. That is one of the worrying indicators of potential inflationary pressure although I accept that this may be difficult to deliver outside London. In part the housing boom may be being sustained by the rush to complete mortgages before the August 1 deadline, but another important aspect is the normal pattern of price increases spreading out from London to the rest of the country.

24. There are some who argue that higher interest rates will do little good. They cite the very high rates of interest that people are prepared to pay on credit cards and point out that the cash flow of the personal sector as a whole is not much affected by higher interest rates. I doubt this interpretation. The cash flow effect upon net borrowers can have a significant effect on disposable income. And borrowers are likely to respond much faster than net depositors. In addition our analysis suggests that there are significant effects from higher interest rates on housebuilding and the pace of accumulation of inventories.

25. Even with some tightening of monetary policy now it will be some time before it has a significant effect upon inflation. It is not unusual for inflation to rise for some time after the peak of the output cycle and commodity prices could be putting pressure upon inflation in the months to come. And in the short term, of course, the effect of higher interest rates is to make the RPI picture worse.

26. There are some similarities with the temporary inflation spurt in 1985. Pressures from the rapid growth in 1984 produced a distinct rise in the inflation rate measured by the RPI excluding mortgage rates. This coincided with sterling falling sharply. The subsequent interest rate hike (4-4½ percentage points) and recovery of sterling amounted to a sharp tightening of monetary conditions. Inflation peaked in Autumn 1985 at over 7 per cent (partly because of mortgage rate effects) but fell back quickly. The growth of the RPI excluding mortgage interest rates also moderated.

no!

27. The policy implications of the current account deficit are less clear. In the short term it may receive more attention from commentators but providing the anti-inflationary nominal framework is not allowed to slip too far it should be a less urgent problem. Some of the reasons for the sharp increase in the current account deficit are likely to be temporary; in particular the strength of sterling which was partly related to the weakness of the dollar and the pressure upon capacity from the rapid growth of demand. Other reasons for the current account deterioration may be longer-lived and will become the focus of attention.

28. In particular a major issue for discussion in the months ahead is likely to be the appropriate policy response to a balance of payments deficit generated by a private sector financial deficit. We have discussed this on a number of occasions over the past year. But it may be worth setting down some of the key points:

- a sustained private sector deficit would be exceptional by past standards and, we think, unlikely to persist;

- part of this private sector deficit reflects a higher investment ratio. This adds to capacity and as it comes on stream will add to output potential and the net trade balance;

- part of it reflects some reduction of the private sector savings ratio and particularly the low personal sector savings ratio. While we expected low inflation to reduce the personal savings ratio we cannot account for the extent of the fall. Our view is that there are some temporary factors at work; the sudden and unexpected growth of personal wealth (the adjustment to which is partly reflected in pension contribution holidays); and the financial liberalisation of the 1980s. Once consumption has adjusted to both these events it should fall back to a more normal relationship with income;

- the largest part reflects a growth of the residual error and cannot be accounted for within this framework. The published figures and the forecasts do not show a private sector deficit. But as the public sector financial deficit is virtually zero, either the current account deficit is much less, the private sector savings ratio is lower or (most likely) the investment ratio is higher than recorded.

29. The corollary of a succession of current account deficits is that private sector capital flows have to be available to finance them. However, insofar as investment is the cause of the private sector financial deficit there should be no long-term problem providing the investment is profitable. As far as consumption is concerned it is a matter to be resolved between the UK personal sector and world capital markets. If doubts arise, capital flows hesitate and the exchange rate comes under financial pressure, interest rates will rise until the private sector deficit is removed and/or higher rates of return are available.

30. The main risks emerging from the need for sustained capital flows relate to the possibility of dislocation emerging from alternative periods of feast and famine. If capital flows are abundant and finance higher levels of debt the process becomes reinforcing. Lower interest rates mean higher asset prices, capital gains, and a willingness of consumers to take on more debt. Eventually lenders decide the process has gone too far and the circle is broken. We then see a vicious spiral in reverse - capital outflows, higher interest rates, mortgage difficulties and a sharp adjustment of consumption or investment.

31. To some degree I fear we have been living through the "feast" stage. Consumers have had little experience of coping with an unregulated financial market. They have taken on larger amounts of debt as interest rates have fallen. If there is a sharp upward adjustment of interest rates the financing costs of the debt will begin to bite. We could soon find ourselves going through the "famine" stage with many of the pressures in reverse. Consumers would then learn the salutary lesson that in a market economy it is necessary to take into account the prospect of higher as well as lower interest rates.

32. The necessary policy response falls into two categories: to ensure that inflationary pressures doe not emerge; and to emphasise that the current account deficit will not be resolved by currency depreciation but by the adjustment of flows of expenditure in response to market signals. An expectation of currency depreciation is the most likely way of disturbing the steady flow of private capital and would help to bring forward the depreciation markets fear. Part of the reason for emphasising the sustainability of the external position is to persuade markets that the Government is determined to avoid the route of currency depreciation.

33. I have no illusions that at times this will be a bumpy and uncomfortable ride. Questions will be asked as to whether fiscal policy should be taking a larger burden of the adjustment and we shall need to consider this ourselves in the run up to the Budget. It will be argued by some that the problems of personal indebtedness demonstrate that it is not possible to have an unregulated financial system. A period of sustained high interest rates will produce calls from companies for credit controls. It should be possible to carry the argument on both issues but it will require patience, a willingness to raise interest rates when necessary, and being prepared to sit out an amount of adverse comment.

TB.

T BURNS

SECRET

For forecast meeting tomorrow (Tues)

FROM: P N SEDGWICK
DATE: 1 JULY 1988

CHANCELLOR

Thanks.

cc Sir P Middleton
Sir T Burns
Mr Anson
Mr Scholar
Mr Odling-Smee
Mr Peretz
Mr Hibberd
Mr Allum
Mr Hurst

TREASURY FORECAST : EFFECTS OF A QUICKER RISE IN INTEREST RATES

You might like to see the implications for the forecast of a quicker rise in base rates to the level of 10½ per cent that they reach in the forecast by April 1989. The table below shows the interest rate assumptions for both the main forecast and for the variant. For this exercise we have assumed that the higher interest rates between now and the beginning of next year go with the same exchange rate path as in the main forecast.

2. It is worth bearing in mind that base rates at 9½ per cent are already ½ per cent higher than the level assumed in the forecast for the whole of the third quarter. The short term prospects for the mortgage rate and RPI inflation are therefore already less favourable than in the forecast, even before the effects of a further rise in base rates are considered.

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

3. Because the difference between the two cases is in the <u>timing</u> of the rise in base rates the economic effects are fairly modest. With the higher interest rates **consumers' expenditure** and **real GDP** are approximately ¼ per cent lower in 1988. The effects on the **current account** and the **PSDR** come through after a short lag, so that most of the effects are in 1989, when both the current account deficit and the PSDR are between £¼-½b. lower (on the assumption that the exchange rate is fixed).

4. With the exchange rate path the same as in the main forecast and little change in activity, the effect on the **RPI** of the faster rise in short term interest rates therefore depends critically on the behaviour of the mortgage rate. (The RPI less mortgage interest payments is little changed in the variant.) With their retail inflows so strong it looks as if building societies, rather than their competitors, will determine the size and timing of the next increase in mortgage rates (though with very buoyant mortgage demand even the societies are having to resort to wholesale funding at the margin).

5. The current level of mortgage rates is not sustainable. With base rates at 9½ per cent the large societies' mortgage rates now vary from zero to one third of a point above base rates compared to the normal differential of a 1¼-1½ points. The reason for this is clear; changing rates is costly and societies are waiting for further developments. But even without another rise in base rates societies are likely to announce changes in rates to existing borrowers effective from August 1. With no further rise in base rates from 9½ per cent our judgement, based on informal contacts with the Bank and earlier with the Building Societies Association (Mr Courtney's note to you of June 24), is that mortgage rates would probably rise by around 1½ points. The extra half point over what is strictly required at the moment is to allow for the societies belief that there will be a further rise in base rates (to 10 per cent), which market interest rates are already discounting. Should a half point rise in base rates to 10 per cent occur before 1 August and a further rise to 10½ per cent be expected, mortgage rates would probably move by two points. This is the assumption in the variant This compares with the June forecast, which had mortgage rates reacting, with one month lags, to half point rises in base rates occurring on the first day of each quarter. (The final level of 12 per cent for mortgage rates in the June forecast, reached in May 1989, is ¼ point higher than

that in the forecast variant. This is because the establishment of the full 1½ point differential between base and mortgage rates embodied in the June forecast is not thought likely in the light of the latest information.)

6. The table below shows the monthly path for RPI inflation. With the earlier rise in the mortgage rate in the variant, inflation reaches 5¾ per cent in the third quarter of 1988 (including the crucial uprating month of September) and goes above 6 per cent in the first quarter of 1989. But the boost to RPI inflation also drops out more quickly than in the June forecast. By the Autumn of 1989 the monthly profile is lower in the variant than in the June forecast. From the second quarter of 1990 the two inflation paths would be identical.

RPI INFLATION

	June forecast	Variant	
1988			
August	5.1	5.7	
September	5.1	5.7	
October	5.0	5.5	
November	4.8	5.2	5½
December	5.6	5.9	
1989			
January	5.6	5.9	
February	5.9	6.2	6
March	5.9	6.2	
April	6.1	6.1	
May	6.2	6.2	6¼
June	6.3	6.3	
July	6.4	6.4	
August	6.0	5.3	5¾
September	6.0	5.3	

P.N.S.

P N SEDGWICK

pry

90/g.jfw

SECRET

FROM: T PIKE

DATE: 4 July 1988

PS/CHANCELLOR

cc Sir P Middleton
Sir T Burns
Mr Anson
Mr Scholar
Mr OdlingSmee
Mr Sedgwick
Mr Peretz
Mr Grice
Mr Hibberd
Mr Allum
Mr Hurst

Thanks

M0 FORECAST

You asked to see a monthly profile for M0 through 1988-89 based on the June Forecast assumptions and on the assumption of a quicker rise in interest rates (as in Mr Sedgwick's note to the Chancellor of 1 July).

2. Tables 1 and 2 attached show these forecasts. You should note that, based on the latest available outturns, these forecasts have a higher outturn for M0 in Q2 1988 (by nearly 0.4 percentage points) than was assumed in the June and 'Variant' Forecasts. This difference has been projected forward throughout the whole of 1988-89.

3. Tables 1 and 2 show that the effect of a quicker rise in base rates to 10½ per cent than assumed in the June Forecast is to reduce annual M0 growth by about ¾ percentage point by the end of 1988-89, with the annual rate falling to 3¾ per cent in March 1989 compared to 4½ per cent under the June Forecast.

T. Pike

T PIKE

SECRET

TABLE 1

MONTHLY M0 FORECASTS BASED ON JUNE FORECAST AND VARIANT ASSUMPTIONS (12 month growth rates, sa)

	JUNE FORECAST	'VARIANT'	DIFF (col 1 - col 2)
1988			
JUNE (prov)	7.3	7.3	0.0
JULY	6.4	6.4	0.0
AUGUST	6.3	6.3	0.0
SEPTEMBER	5.7	5.6	0.1
OCTOBER	5.2	5.0	0.2
NOVEMBER	5.2	4.9	0.3
DECEMBER	4.7	4.2	0.5
1989			
JANUARY	4.7	4.1	0.6
FEBRUARY	5.0	4.3	0.7
MARCH	4.5	3.8	0.7

(forecast report says "M0 growth falls below 5 per cent during the autumn" — ie 4·8% in October, since then revised up by 0·4% to 5·2%. So faster rise in IR brings things back to where we thought they were).

NOTE

'Variant' has base rates at 10 per cent in July, and 10½ per cent from August onwards.

June Forecast has base rates at 9 per cent in July, rising to 9½ per cent in October and 10 per cent in January 1989.

Figures for June are provisional outturns

TABLE 2

MONTHLY MO FORECASTS BASED ON JUNE FORECAST AND VARIANT ASSUMPTIONS (Levels , sa)

	JUNE FORECAST	'VARIANT'
JUNE (prov)	16 316	16 316
JULY	16 380	16 380
AUGUST	16 420	16 410
SEPTEMBER	16 450	16 430
OCTOBER	16 480	16 450
NOVEMBER	16 520	16 480
DECEMBER	16 590	16 520
1989		
JANUARY	16 540	16 450
FEBRUARY	16 570	16 460
MARCH	16 640	16 520

PAM53

CONFIDENTIAL

FROM: A C S ALLAN
DATE: 5 JULY 1988

MR G F DICKSON

cc PS/Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Mr Peretz - or
Mrs Lomax
Mr Sedgwick
Mr Gieve
Mr Hibberd
Miss Noble
Miss O'Mara
Mr Courtney
Mrs Ryding
Mr Cropper

MORTGAGE RATES

We discussed on the phone this morning the way in which building societies are likely to set their mortgage rates in response to the rises in bank base rates.

2. You told me that the way mortgage rates were set varied among the different institutions. Some (especially the smaller building societies) needed a longish period of notice. But, at the other extreme, the Halifax were geared up to make instantaneous changes in rates (see further below).

3. Since we spoke, I have seen an Abbey National spokesman quoted as saying "There will probably be a rise in August 1 but we want to set a viable rate and we don't have to make an announcement until the middle of the month". And Barclays have announced that their mortgage rate is rising from 9.75% to 11.1% with effect from tomorrow.

4. The Chancellor would be grateful for a considered view of when this month the bulk of the building societies and banks are likely to set their new 1 August rates.

5. You also told me that the Halifax now have a system whereby they fix borrowers' monthly payments on 1 January each year, and do not change them for the rest of the year. Interest rate changes can be made at any time, but affect only the level of payments from the start of the next year, when the monthly payments are recalculated. The Chancellor would be grateful to know how widespread this practice is, and whether you see this as the likely way in which other societies will go. He would also be grateful for comments from Mr Sedgwick about the implications for the RPI. If monthly repayments do not change when the mortgage rate changes, it seems even more absurd to use a notional mortgage rate in computing the monthly RPI.

ACSA

A C S ALLAN

Py

FROM: G F DICKSON
DATE: 6 July 1988

1. MRS ~~LOMAX~~ RL 6/7.
2. CHANCELLOR

PS/Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Mr Peretz or
Mr Sedgwick
Mr Gieve
Mr Hibberd
Mrs Noble or
Mrs O'Mara
Mr Courtney
Mr Ryding
Mr Kroll
Mr Cropper

Ch
see also note below on RPI
AA

MORTGAGE RATES

You asked for a view on when the bulk of building societies and banks will set their mortgage rate for 1 August.

2. The third week of July (18-22) seems the most likely time for the bulk of building societies and banks to have decided. It is likely that most building societies will hold out as long as possible before setting a rate. They will hope to see interest rates peak before announcing their mortgage rate. However, the larger societies appear to be aware of their importance in the market and should move within two weeks.

3. Some building societies can act very quickly in making a change. The Abbey and Halifax require only the decision of a senior executive. Nevertheless, they will probably require a week to ensure the change takes effect on 1 August. The rivalry between the two societies suggests they will each wait for the other to move first. The remaining societies tend to follow their lead.

4. A few medium sized societies may be tempted to hold out for

another month. The Nationwide have said they see no need to move quickly and there is no lack of retail funds at present. However, August is usually a slack month for lending which is a good reason for raising rates on 1 August; the Spring buyers have been captured.

5. Banks are in a similar position but following Barclays unexpected announcement of a 1.35 per cent rise, they may move more quickly. The Mortgage Corporation announced a 1.5 per cent rise yesterday. The other new lenders should follow closely.

Annual Review of Interest

6. You also asked about the extent to which lenders operate annual review of interest schemes.

7. The Building Societies Association recently told us that about 35 per cent of societies' borrowers are on these schemes. None of the banks appear to operate annual schemes. It is a practice which is likely to expand. It is popular with societies since it greatly reduces the cost of changing their mortgage rate. About 80 per cent of the Halifax's borrowers are on an annual scheme and I believe one society has imposed it on all borrowers.

8. I believe the Halifax calculate the outstanding mortgage debt at their year end (31 January). Any difference between the actual interest rate during the past year and the annual rate is added or subtracted at that time.* The prevailing interest rate is applied to the outstanding capital sum to repay the debt in the agreed mortgage term. The monthly payment is calculated and fixed for the year. Borrowers are notified of the new payment in February and it takes effect in April. Other societies' schemes may differ and will be on a different time cycle, depending on their year end.

Graeme Dickson

GRAEME DICKSON

*we're not clear whether the monthly payment or the outstanding debt is adjusted for this difference - but the delaying effect of interest rate changes is much the same RL 6/7 sp/jh-ch-mtge

CONFIDENTIAL

FROM: S PRICE
DATE: 6 JULY 1988

Tim Hibberd 6/7.

1. MR HIBBERD
2. CHANCELLOR OF THE EXCHEQUER

cc : PS/Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Sir G Littler
Mr Scholar
Mr Peretz o/r
Mrs Lomax
Mr Sedgwick
Mr Gieve
Mr Dickson
Miss Noble
Miss O'Mara
Mr Courtney
Mrs Ryding
Mr Cropper
Mr Deane

MORTGAGE INTEREST RATES AND THE RPI

In Mr Allan's note to Mr Dickson he asked Mr Sedgwick for comments about the impact of the Halifax Building Society mortgage payment scheme.

2. The method of payment does not affect the treatment of mortgage interest payments in the RPI. What affects the RPI is the **interest rate** component of mortgage payments - repayments of capital are disregarded. When interest rates change, under the Halifax system, the mortgage account attracts a higher interest charge. Because the monthly payment is fixed, this means that the **capital** repayment alters. (An adjustment to the monthly repayment is made each year to ensure that the debt is finally paid off at the end of the mortgage term.) This means that the relevant cost of this component of the RPI is indeed directly related to the actual interest rate.

3. The interest rate used is a weighted average of the rates applied by the top twenty building societies, who have more than 85 per cent of all building society loans. Other lenders - banks, and the new mortgage specialists - have about 30 per cent of the total market. But their rates are, in fact, close to the building societies', so there is no reason to think that the interest rate used in the RPI is incorrect.

?? I strongly suspect that for MIRAS purposes the interest component of the payments is fixed at the start of each year.

Tim Hibberd pp

S PRICE

cc PS/EST
Sir G Littler
Miss O'Mara
Mr Grieve

THE TIMES

EEC urged to co-ordinate interest rates

28/

By Colin Narbrough

Mr Francis Maude, the Corporate Affairs Minister, yesterday called for greater European co-ordination on interest rate changes as a way of fostering financial and monetary co-operation between EEC countries.

Clarifying Britain's stance on the single European market, after the Prime Minister's rejection last week of a European central bank and a single EEC currency, he told MEPs in Strasbourg that it was better to concentrate on areas where progress could be made rather than pursue "grand ideas" for a central bank.

As to the need for a single currency after 1992, he said the EEC already had a "common currency" in the European Currency Unit, an artificial unit based on a basket of real currencies.

"We should be looking actively at ways to encourage greater use of the private ECU and improving co-ordination of financial and monetary policy, for example on interest rate changes," he said.

Despite press reports, saying Britain was "isolated" on EEC policy, he said the Government's commitment to the single European market was "clear and unequivocal".

While Britain's commitment on some issues seemed to be measured by its ability to say yes, the Government needed to be clear on what it was agreeing to before saying yes on monetary co-operation, merger control and tax approximization, Mr Maude stressed.

He said the effects of proposals on Community-wide merger control were by no means clear. The Government had a number of real concerns about the issues and objectives, and wanted the principle to be clearer before agreeing to it.

BF to Alex 8/7

S

Ch

NA v clever

Issues us [illegible] make representations to PS.

AA

Mr Maude's

Mp

LAWSON SAYS U.K. RATE BALANCE MORE COMFORTABLE NRIM

LONDON, JULY 7, REUTER - THE BALANCE OF BRITAIN'S EXCHANGE AND INTEREST RATES IS CLEARLY MORE COMFORTABLE THAN IT WAS IN THE SPRING, CHANCELLOR NIGEL LAWSON SAID.

BRITISH BANKS' BASE LENDING RATES HAVE RISEN FIVE TIMES IN AS MANY WEEKS WITH THE LATEST INCREASE THIS WEEK, TO 10 PCT, POISED TO TRIGGER A ROUND OF MORTGAGE RATE RISES.

A RISE IN HOME LOAN RATES WILL GIVE INFLATION A TEMPORARY BLIP, LAWSON SAID, BUT HE ADDED THAT THE GOVERNMENT'S COMMITMENT TO BEAR DOWN ON INFLATION IS ABSOLUTE.

LAWSON WAS SPEAKING IN REMARKS PREPARED FOR DELIVERY TODAY TO THE CITIES OF LONDON AND WESTMINSTER ANNUAL LUNCH.

AAEE 1624 VENEZUELA CUTS MEDIUM, HEAVY CRUDE OIL PRICES BY ABOUT 70 CENTS--INDUSTRY SOURCE CONTINUED ON - NRIN

P

DEALING-SEE AADA 1705

LAWSON SAYS =2 LONDON NRIN

"...LET ME BE QUITE CLEAR. WE ARE DETERMINED TO TAKE NO RISKS WITH INFLATION," HE SAID.

LAWSON SAID IT HAD MADE SENSE TO OFFSET THE EXCEPTIONAL UPWARD PRESSURE ON STERLING LAST SPRING BY TEMPORARILY LOWERING INTEREST RATES.

"IT WAS CLEAR THAT THE RESULTING MIX OF POLICY, WITH A HIGHER EXCHANGE RATE AND LOWER INTEREST RATES, WAS NOT IDEAL," HE SAID.

"THE PRESENT BALANCE OF INTEREST AND EXCHANGE RATES IS CLEARLY A MORE COMFORTABLE ONE," HE ADDED.

07-JLY-1406. MON075 MONH

CONTINUED FROM - NRIM CONTINUED ON - NRJH

P

DEALING-SEE AADA 1705

LAWSON SAYS =3 LONDON NRJH

BASE RATES HAD FALLEN TO 7-1/2 PCT WHILE STERLING HAD RISEN TO AROUND 3.20 MARKS AND 1.90 DLRS COMPARED WITH AROUND 3.12 MARKS AND 1.71 DLRS TODAY.

LAWSON DEFENDED HIS USE OF MONETARY RATHER THAN FISCAL POLICY TO CURB INFLATION.

"INFLATION IS PRE-EMINENTLY A MONETARY PHENOMENON AND INTEREST RATES ARE THE ESSENTIAL INSTRUMENT OF MONETARY POLICY," HE SAID.

"THERE ARE SOME WHO ARGUE THAT INTEREST RATES SHOULD NOT BE ASKED TO BEAR SO MUCH OF THE BURDEN OF COUNTER-INFLATIONARY POLICY, AND THAT FISCAL POLICY SHOULD PLAY A LARGER ROLE."

07-JLY-1419. MON097 MONI

CONTINUED FROM - NRIN CONTINUED ON - NRJI

P

DEALING-SEE AADA 1705

CONTINUED FROM - NRIN CONTINUED ON - NRJI
P
DEALING-SEE AADA 1705

LAWSON SAYS =4 LONDON NRJI
"BUT THAT DISPLAYS A FUNDAMENTAL MISCONCEPTION ABOUT THE ROLE OF FISCAL POLICY," HE ADDED.
"THE NOTION THAT FISCAL POLICY COULD OR SHOULD BE USED TO FINE-TUNE DEMAND IS TO HARK BACK TO THE FAILURES OF THE 60S AND 70S. WHAT IS NEEDED IS TO PUT A FIRM FISCAL STANCE IN PLACE AND STICK TO IT, THUS UNDERPINNING MONETARY POLICY."
LAWSON HAS ALREADY RULED OUT THE IDEA OF A MINI-BUDGET THIS YEAR TO DAMPEN THE CONSUMER DEMAND WHICH IS FUELLING INFLATION.
HE DEFENDED HIS MARCH TAX CONCESSIONS AND REPEATED HIS PREDICTION THAT THE BUDGET SURPLUS THIS FISCAL YEAR ENDING NEXT APRIL IS LIKELY TO BE OVER THE FORECAST THREE BILLION STG.
07-JLY-1427. MON115 MONI
CONTINUED FROM - NRJH CONTINUED ON - NRKH
P
DEALING-SEE AADA 1705

LAWSON SAYS =5 LONDON NRKH
ON MORTGAGES, LAWSON SAID, "I CAN UNDERSTAND THAT MANY PEOPLE WILL NOT WELCOME THE HIGHER MORTGAGE RATES WHICH ARE NOW IN PROSPECT. BUT THEY WILL HELP TO DAMP DOWN SOME OF THE RATHER FEVERED DEMAND IN THE HOUSING MARKET, WHICH IS CLEARLY DESIRABLE."
HE SAID BRITAIN'S PRESENT CURRENT ACCOUNT DEFICIT DOES NOT DETRACT FROM THE STRENGTH OF THE ECONOMY.
THE DEFICIT IS WHOLLY DIFFERENT FROM THOSE BRITAIN RAN IN THE 1960S AND 1970S WHICH WERE ASSOCIATED WITH EXCESSIVE GOVERNMENT SPENDING AND BORROWING, HE NOTED.

07-JLY-1436. MON124 MONI
CONTINUED FROM - NRJI CONTINUED ON - NRKI
P
DEALING-SEE AADA 1705

LAWSON SAYS =6 LONDON NRKI
GOVERNMENT FINANCES ARE TO ALL INTENTS AND PURPOSES IN BALANCE, HE SAID.
"... THE CURRENT ACCOUNT DEFICIT IS ENTIRELY A PRIVATE SECTOR PHENOMENON, WITH BRITISH BUSINESS IN EFFECT INVESTING ON AN UNPRECENDENTED SCALE AND FINANCING THIS IN PART FROM FUNDS FROM OVERSEAS," HE ADDED.

07-JLY-1437. MON127 MONI
CONTINUED FROM - NRKH ENDS
P
DEALING-SEE AADA 1705

mg2.jw.mofigs

CONFIDENTIAL

FROM: T PIKE
DATE: 7 July 1988

1. MR GRICE TJG 7-7-88

2. ECONOMIC SECRETARY

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

File: MAMC C9

PP

M0 FIGURES

The latest weekly figures for M0, covering the first week of July, are attached. They show that the 12 month growth rate of M0 to the latest four week period was 7.1 per cent (7.0 per cent not seasonally adjusted). The sa and nsa 12 month growth rates of notes and coin to the same period were 7.0 and 6.9 per cent respectively.

2. Six month annualised growth of notes and coin to the latest four week period was 6.8 per cent, which continues the trend of rising growth in recent months. The six month annualised growth rate of notes and coin is very likely to rise further in the rest of July - as is evident from the 8½ per cent growth rate in July so far - reflecting an abnormally low level of notes and coin in January.

T Pike

T PIKE

CONFIDENTIAL (Until Publication)

MO : THE WIDE MONETARY BASE

Monthly data	Level £ million (Change in brackets)							Percentage change on previous month		6 month % growth annualised		Percentage change on previous year			
	Notes and Coin (nsa)	Notes and Coin (sa)		Bankers' Deposits	MO (nsa)	MO (sa)		Notes(sa) and Coin	MO (sa)	Notes & Coin (sa)	MO (sa)	Notes and Coin (nsa)	Notes and Coin (sa)	MO (nsa)	MO (sa)
1987 November	15365	15525	(69)	183	15548	15707	(48)	0.4	0.3	7.4	7.0	4.8	4.8	4.9	4.9
December	16447	15661	(136)	186	16633	15846	(139)	0.9	0.9	7.9	8.5	4.7	4.8	4.2	4.3
1988 January	15458	15620	(-41)	181	15638	15801	(-45)	-0.3	-0.3	6.1	5.3	4.7	4.5	4.8	4.6
February	15353	15659	(39)	124	15477	15783	(-18)	0.2	-0.1	5.3	4.5	5.7	5.7	5.3	5.3
March	15588	15753	(94)	162	15750	15916	(133)	0.6	0.8	5.0	4.6	6.9	6.4	6.4	5.8
April	15797	15826	(73)	229	16026	16055	(139)	0.5	0.9	4.8	5.1	5.8	6.1	5.9	6.2
May	15868	15952	(126)	178	16046	16130	(75)	0.8	0.5	5.6	5.5	6.0	6.5	5.7	6.2
June	16072	16142	(190)	174	16246	16316	(186)	1.2	1.2	6.2	6.0	7.5	7.1	7.7	7.3
July (1/5) @	16283	16262	(120)	212	16495	16474	(158)	0.7	1.0	8.4	8.7	6.6	7.2	6.4	7.0
Latest 4 weeks @	16115	16197	(173)	158	16272	16355	(120)	1.1	0.7	6.8	6.0	6.9	7.0	7.0	7.1

Weekly data	Level £ million (Change in brackets)					Percentage change on previous week
	Notes(sa) and Coin		Bankers' Deposits	MO (sa)		MO (sa)
June						
1st	16110	(166)	215	16325	(233)	1.4
8th	16072	(-38)	235	16307	(-18)	-0.1
15th	16131	(59)	90	16221	(-86)	-0.5
22nd	16177	(46)	87	16264	(43)	0.3
29th	16219	(42)	242	16461	(197)	1.2
July						
6th	16262	(43)	212	16474	(13)	0.1

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

SECRET AND PERSONAL

FROM: T PIKE

DATE: 12 July 1988

1. MR GRICE JWG 12-7-88

2. CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Peretz o/r
Miss O'Mara
Mrs Ryding
Mr Wheatley
Ms Bronk
Mr Gray No 10

MONEY SUPPLY IN JUNE: "FIRST GUESS" FOR M3 AND OUTTURN FOR MO

(All figures are unadjusted unless specified otherwise)

Table 1 summarises the Bank's "first guess" at the M3 figures for June, which are still subject to significant revision, and shows the confirmed outturn figures for MO that were circulated on 7 July.

Table 1: Growth of Monetary Aggregates in June

per cent

	MO	M3**
Annual growth rate*	7.7 (7.3)	20.3 to 21.1
Change in month*	1.2 (1.1)	2.8 to 3.6 (2.6 to 3.4)
Target range	1-5	-

* Figures in brackets are seasonally adjusted

** The actual outturn has been within the range forecast on this basis in 15 of the last 20 months.

2. 12 month growth of M3 in June of around 20¾ per cent compares with 18½ per cent in the 12 months to May. The high outturn for 12 month M3 growth suggested by these figures may reflect in part the effects of the Budget - related tax rebates. Because of the

tax rebates, companies made higher than normal net wage payments in June, offset in July when they make smaller tax payments to CG. This may have increased personal notes and coin holdings and bank deposits by more than company deposits fell, particularly if the latter temporarily increased their borrowing (see para 4 below). Within the M3 counterparts, the PSBR exceeded sales of public debt outside the banking system by £1.2 billion, which may also have increased the M3 growth rate marginally.

3. There are as yet no figures for M4, but another month of strong retail inflows to building societies (probably about £2 billion sa, including interest credited, compared to £1¾ billion in May) suggests that M4 growth will also have been brisk.

4. The increase in sterling bank lending in June is likely to be in the range £4.9-6.9 billion, another exceptionally high month, although this partly reflects seasonals factors. The 12 month growth rate of bank lending is expected to be between 26¾ and 28 per cent in June, compared to 27 per cent in May. Bank lending may have been inflated by temporary company borrowing to pay employees' tax rebates, before the CG reimburses them in July. There are no figures as yet on banks' mortgage lending, which may have been boosted by the Budget measures.

M3 components and counterparts

5. Table 2 compares the changes in M3 components underlying the "first guess" with the average monthly change over the previous 12 months. Table 3 provides a similar comparison for M3 counterparts.

Timetable

6. We expect to receive provisional June figures on Friday 15 July. They will be published on Wednesday 20 July. Full money and banking figures for June will be published on Friday 29 July.

T. Pike

T PIKE

SECRET AND PERSONAL

TABLE 2: M3 COMPONENTS - JUNE 1988

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

£ millions

	First Guess	Average monthly change in previous 12 months
Notes and coins in circulation	260	60
Non-interest bearing sight	180	420
Interest bearing sight	1440	880
Time deposits (including CDs)	3560	1190
Grossing up to full population	760	-
Change in M3	6200	2550

SECRET AND PERSONAL

TABLE 3 : M3 COUNTERPARTS - JUNE 1988

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

£ millions

		First Guess		Average change in previous 12 month
CGBR (O) (ex bank deposits)		537		-640
Other public sector: LABR) PCBR) OPS debt sales)		23		110
Modified PSBR*		560		-530
CG debt: Gilts	1243		-150	
Treasury bills	17		-10	
National Savings	-105		-160	
CTD's etc.	33		30	
Total CG debt sales (-)		1188		-290
External and fc finance of public sector (-)		-589		280
Wide over(-)/under(+)funding		1159		-540
Sterling lending to nbps (incl Issue Dept commercial bills)		5944 #		4060
Net private externals		-869		-610
Residual (includes NNDLS and reporting differences)		-38		-360
Change in M3		6196		2550
(Monthly percentage change)		(3.2%)		(1.4%)
(12 month percentage change)		(20.7%)		(20.9%)

* Modified PSBR equals PSBR less OPS debt sales

\# £4864 million after seasonal adjustment.

NH6/52M

UNCLASSIFIED

Mp.

FROM: MISS M P WALLACE

DATE: 13 July 1988

MR PIKE

cc Mr Grice

MONEY SUPPLY FIRST GUESS

The Chancellor was most grateful for your minute of 12 July.

MPW.

MOIRA WALLACE

CHANCELLOR OF THE EXCHEQUER

Alex

Ch

PM should be warned
- she uses this frequently

AA

See Defensive (a)(v.) on the relative costs to industry of interest rate & wage increases & attached note for Mr Brooks.

MG1 think that the 1988Q1 estimates are not published & so no-one would be able to spot that the 1:4 ~~cold~~ comparison is wrong. But to avoid some people saying 1:4 & others saying 1:3, it may be better not to use the point at all for the time being. You may like to alert CEx.

J.S.

not published
- altho' components are.
letter to Rick to one
story :. don't use
either.

from S. Brooks

Mr Pickford

~~Miss Simpson~~

cc Mr Sedgwick
Mr Grice
Mr Hibberd
Ms O'Mara
Mr Harst
Mr Patterson
Mr Wheatley
Mr Curwen
Mr O'Brien
Mr Hudson

Costs of Interest Rate Changes and Pay Rises

We have in the past said that the cost to firms of a 1% rise in pay was four times as great as the cost of an increase of 1 percentage point on interest rates. This estimate remains correct for 1987Q4. But more recent data from DTI indicates a substantial rise in firms net liabilities in 1988Q1. This has had the effect of raising the cost of a rise in interest rates. A 1% rise in pay now (ie in 1988Q1) costs industry 3 times as much as a rise of 1 percentage point in interest rates. We should therefore amend briefing lines as necessary.

2. I understand this may have implications for one PQ for answer tomorrow. I believe the reply was drafted by Mr Wheatley.

[signature]

13/7/88

69

Inland Revenue

Policy Division
Somerset House

pcp

→ Jonathan
(pcp)

FROM : B O'CONNOR
13 July 1988

Financial Secretary

MORTGAGE INTEREST RELIEF : HOME IMPROVEMENT LOANS
LETTER 13 JUNE FROM NORTHERN IRELAND BANKERS' ASSOCIATION

A suggested reply to this letter is attached.

The Parliamentary Under Secretary of State for Northern Ireland has asked for a copy and a letter to him is also attached.

B O'CONNOR

cc. PS/Chancellor
PS/Paymaster General
Mr Culpin
Mr Tyrie

Mr Painter
Mr Johns
Mr Gray
Mr O'Connor
PS/IR

FINANCIAL SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

July 1988

Rafton Pounder Esq
Secretary
Northern Ireland Bankers' Association
Stokes House
17-25 College Square East
Belfast BT1 6DE

Peter Viggers has sent me a copy of your letter of 13 June about home improvement loans.

I should like to assure you that the decision not to extend protection to replacement loans was reached after very full consideration. The issue was raised in the Committee of the Whole House debate on Clause 42 of the Finance Bill on 10 May. Similar points were discussed during the debate on Clause 41 (the residence basis) in Standing Committee A on 9 June.

When we decided to abolish relief for home improvement loans we thought it right to protect existing borrowers who had committed themselves on the understanding that interest payable would qualify for tax relief. Such borrowers are now enjoying a tax privilege denied to other people who might wish to take a loan to improve their home. It would be quite wrong to extend that privilege further by allowing relief on replacement loans negotiated in the full knowledge of the new rules about mortgage interest relief.

The new rules apply to all lenders and borrowers and should not affect the relative competitive position of lenders for new business. I accept that any change in the law might involve some transitional administrative costs but these should be short term. Loans for improvements made on or after 6 April do not qualify for tax relief and the residence basis will apply to purchase loans made on or after 1 August. This means that from 1 August loans made will qualify for relief under MIRAS only if they are for purchase of the only or main residence and the relief will be allowable on the residence basis.

It is true, as you say, that a purchaser can obtain relief when acquiring a property which might very well have been improved by the previous owners. Before abolition of home improvement relief the improver obtained relief for an improvement loan and sold the improved property. The purchaser then obtained relief on a purchase loan covering the improved property. In future relief will arise only on the purchase transaction. The ceiling of £30,000 limits the amount of relief. People who were obliged to borrow this amount to help them buy a home were unable to obtain any relief for improvements even before abolition.

NORMAN LAMONT

Treasury Chambers, Parliament Street, SW1P 3AG

July 1988

Peter Viggers Esq MP
Parliamentary Under Secretary of State
Department of Economic Development
Netherleigh
Massey Avenue
Belfast BT4 2JP

You wrote to me on 4 July enclosing a letter you had received from the Secretary of the Northern Ireland Bankers' Association about the abolition of tax relief on home improvement loans.

I have sent a reply to the Secretary and attach a copy.

NORMAN LAMONT

DEPARTMENT OF ECONOMIC DEVELOPMENT

NETHERLEIGH
MASSEY AVENUE
BELFAST
BT4 2JP

Telephone 63244

12 JUL 1988

FINANCIAL SECRETARY
REC. 12 JUL 1988
ACTION Mr B. O'Connor IR
COPIES TO PPS, PMG
Miss Peirson, Mr Culpin,
Mrs. Lomax, Mr Cropper
Mr Tyrie, Mr Call,
Mr Johns IR, PS/IR.

The Rt Hon Norman Lamont MP
The Financial Secretary
Her Majesty's Treasury
Parliament Street
LONDON

4th July ~~June~~ 1988

Dear Norman,

TAX RELIEF ON HOME IMPROVEMENT LOANS

I enclose a letter I have received from the Secretary to the Northern Ireland Bankers' Association, drawing attention to the adverse effect on the local banks of the Finance Bill provision dealing with tax relief on home improvement loans.

Clearly this is a matter for your consideration and I would not wish to comment on the merits of the Association's case. Enclosed is a copy of my reply to the Association and I should be grateful if you could copy to me any response which you make.

Yours ever,

Peter.

PETER VIGGERS
Parliamentary Under
Secretary of State

Northern Ireland Bankers' Association

Stokes House, 17-25 College Square East, Belfast BT1 6DE

Secretary:
Rafton Pounder

Telephone:
(0232) 327551

13 June 1988

Peter Viggers, Esq., M.P.,
Parliamentary Under-Secretary of State,
Northern Ireland Office,
Stormont House,
Belfast, 4.

Dear Peter,

When some representatives of the Member Banks of this Association had the pleasure of meeting you in your office at Netherleigh a couple of months ago for a most useful exchange of views, you kindly suggested that if there were any issues of concern to the local banks you would wish to be advised thereof.

There is a particular matter which is currently causing some disquiet although I am conscious that the topic has a national as well as a local dimension - I refer to the alteration to the treatment of tax relief on home improvement loans which has been contained in the Finance Bill.

As a consequence of this change in the rules which had pertained hitherto, it is no longer feasible for persons to avail of certain special low-interest deals currently on offer, particularly in relation to mortgages which incorporate an element of home improvement loan.

In effect, homeowners who decide to switch lenders to take advantage of enticing low-rate mortgage offers stand to lose out. That is, if part of their mortgage was taken out prior to 6 April 1988 to make home improvements, they will lose the tax relief on that portion of the loan upon transfer, and the balance will fall outside MIRAS.

Incidences such as this have given considerable cause for concern amongst Member Banks. The disquiet is essentially fourfold, namely:

(i) the impact of the Finance Bill proposal, with regard to tax-relief on home improvements, will be detrimental to free competition between financial institutions. This is particularly so in relation to the attractive mortgage interest rates which are currently being offered by the banks, and I am fully aware of your views on any restrictions which might impose on free competition;

contd.

(ii) the local banks were late entrants into the field of home mortgages and, as you are aware, at least two of the Member Banks have been actively promoting their home loan packages. Thus the Finance Bill proposal is hitting the local banks proportionately harder than their cross-channel counterparts who have been involved in home loans for a much longer period;

(iii) the implications of such a proposal inevitably increases administration costs and is obviously unwelcome within the very significant context of cost containment;

(iv) a curious anomaly of the situation is that if an improved property is sold and another is bought, the full £30,000 tax-relief allowance can be retained. Similarly, purchasers buying the 'improved' home can avail of the full £30,000 tax-relief allowance. The change, therefore, is only detrimental if a homeowner wishes to stay put and remortgage.

In view of the obvious disparity of the situation, I felt that I should draw the concern of the Member Banks to your attention.

Is there any possibility of a minor amendment to the relevant clause of the Finance Bill being acceptable to the Government whereby the transfer of mortgages (including, where relevant, any top-up) which had been granted prior to 6 April 1988, would be permitted to be transferred to the new mortgagee on or after 6 April without loss of tax relief under MIRAS in those instances where the transfer did not involve any increase in the amount lent? Indeed, a time limit of, say, six months could be imposed on the period of the moratorium if an open-ended take-up date was unacceptable.

I am also writing to the Committee of London & Scottish Bankers in a similar vein.

Kind regards.

Yrs ever.

Rafton Pounder

RAFTON POUNDER
Secretary

DEPARTMENT OF ECONOMIC DEVELOPMENT

NETHERLEIGH
MASSEY AVENUE
BELFAST
BT4 2JP

Telephone 63244

Rafton Pounder Esq
Secretary
Northern Ireland Bankers' Association
Stokes House
17-25 College Square East
BELFAST

5th July ~~June~~ 1988

Dear Rafton,

Thank you for your letter of 13 June, regarding the effects of the Finance Bill on the banks' efforts to attract existing mortgage/home improvement loan business.

I appreciate that the Northern Ireland banks now find themselves at some disadvantage in developing this market. As you say, they were late entrants to the field, for whatever reason.

The problem, however, is not one for me but for the Financial Secretary to the Treasury who is responsible for taxation matters on a UK-wide basis. I have, therefore, written to him with a copy of your letter.

Peter

PETER VIGGERS MP
Parliamentary Under
Secretary of State

cc [illegible]

mg2.jw.mofigs

CONFIDENTIAL

MP

FROM: T PIKE
DATE: 14 July 1988

1. MR GRICE JWG 14-7-88

2. ECONOMIC SECRETARY

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

File: MAMC C9

M0 FIGURES

The latest weekly figures for M0, covering the second week of July, are attached. They show that the 12 month growth rate of M0 to the latest four week period was 6.8 per cent (6.7 per cent not seasonally adjusted). The sa and nsa 12 month growth rates of notes and coin to the same period were 7.1 and 6.9 per cent respectively.

T Pike

T PIKE

HIF

TABLE 16

CONFIDENTIAL (Until Publication)

M0 : THE WIDE MONETARY BASE

Monthly data	Level £ million (Change in brackets)							Percentage change on previous month		6 month % growth annualised		Percentage change on previous year			
	Notes and Coin (nsa)	Notes and Coin (sa)		Bankers' Deposits	M0 (nsa)	M0 (sa)		Notes (sa) and Coin	M0 (sa)	Notes & Coin (sa)	M0 (sa)	Notes and Coin (nsa)	Notes and Coin (sa)	M0 (nsa)	M0 (sa)
1987 November	15365	15525	(69)	183	15548	15707	(48)	0.4	0.3	7.4	7.0	4.8	4.8	4.9	4.9
December	16447	15661	(136)	186	16633	15846	(139)	0.9	0.9	7.9	8.5	4.7	4.8	4.2	4.3
January	15458	15620	(-41)	181	15638	15801	(-45)	-0.3	-0.3	6.1	5.3	4.7	4.5	4.8	4.6
1988 February	15353	15659	(39)	124	15477	15783	(-18)	0.2	-0.1	5.3	4.5	5.7	5.7	5.3	5.3
March	15588	15753	(94)	162	15750	15916	(133)	0.6	0.8	5.0	4.6	6.9	6.4	6.4	5.8
April	15797	15826	(73)	229	16026	16055	(139)	0.5	0.9	4.8	5.1	5.8	6.1	5.9	6.2
May	15868	15952	(126)	178	16046	16130	(75)	0.8	0.5	5.6	5.5	6.0	6.5	5.7	6.2
June	16072	16142	(190)	174	16246	16316	(186)	1.2	1.2	6.2	6.0	7.5	7.1	7.7	7.3
July (2/5) @	16312	16239	(97)	191	16503	16430	(114)	0.6	0.7	8.1	8.1	6.8	7.1	6.4	6.7
Latest 4 weeks @	16206	16219	(155)	178	16384	16396	(160)	1.0	1.0	6.8	6.1	6.9	7.1	6.7	6.8

Weekly data	Level £ million (Change in brackets)					Percentage change on previous week
	Notes (sa) and Coin		Bankers' Deposits	M0 (sa)		M0 (sa)
June 1st	16110	(166)	215	16325	(233)	1.4
8th	16072	(-38)	235	16307	(-18)	-0.1
15th	16131	(59)	90	16221	(-86)	-0.5
22nd	16177	(46)	87	16264	(43)	0.3
29th	16219	(42)	242	16461	(197)	1.2
July 6th	16262	(43)	212	16474	(13)	0.1
13th	16216	(-46)	169	16385	(-89)	-0.5

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

p/folder

CONFIDENTIAL

FROM: SIR T BURNS
DATE: 15 JULY 1988

MR ALLAN

OK.

cc Sir P Middleton
Mr Scholar
Mr Sedgwick o r

MORTGAGE COSTS AND THE RPI

The minutes of the meeting held on 5 July to discuss the June Economic Forecast say that "it was agreed that it would be worth trying again to persuade Department of Employment to reopen the way housing costs were calculated in the RPI".

2. I do not think that we should even raise this with Department of Employment until the treatment of the community charge is finally settled. We are very short of time to resolve the community charge treatment and any further distraction could cause serious problems.

3. This would point to approaching the Department of Employment next Spring after the Budget. Is the Chancellor content?

T BURNS

FIM5/9

CONFIDENTIAL

FROM: G F DICKSON

DATE: 15 July 1988

1. MRS LOMAX RL 15/7.

2. CHANCELLOR

cc PS/Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Mr Peretz
Mr Sedgwick
Mr Gieve
Mr Hibberd
Miss Noble o/r
Miss O'Mara
Mr Courtney
Mrs Ryding
Mr Kroll
Mr Cropper

Tony D please

MORTGAGE RATES

I believe you asked to be kept up to date on the large building societies' intentions on their mortgage rates.

2. The Building Societies Commission supervisors of the Halifax and the Abbey expect them to make a decision on 1 August rates next week. The Halifax is predicted to fix a rate of 11 per cent, with the Abbey following closely.

3. Although the societies are very reluctant to disclose their intentions, there are a number of signs which point towards an early change. The large societies are quite aware that the Government expects them to increase their rate before the end of the month. They are also beginning to see increased competition for retail funds from the banks; an increase in rates to investors would let the societies keep their competitive edge. One large society has now reached the limit of lending that its administrative system can efficiently process. The society is not seeking to increase further its market share and would not suffer from an increase in its mortgage rate.

4. In recent discussions the societies also made some other points which may be of interest. Their present view is that mortgage rates will reach 11.5 to 12 per cent in the Autumn and the coming period is seen as an opportune time to increase their

margins. ~~The~~ Any surge in lending caused by the change of MIRAS to a residence basis was not apparent in the overall increase in lending. One society did notice the effect of the income tax changes feeding through in late June. In the first few days of each month they expect to see a net withdrawal of £50 million each day. In early July the highest net withdrawal was only £15 million. They suggest, therefore, that much of their members tax bonus was retained in savings. The overall weekly figures for all societies do not reflect this phenomenon. I will attempt to confirm the anecdotal evidence with other societies.

GRAEME DICKSON

mjd 3/24m

CONFIDENTIAL

FROM: MISS M P WALLACE
DATE: 18 July 1988

SIR T BURNS

cc Sir P Middleton
Mr Scholar
Mr Sedgwick o/r

PWP

~~BF 20/3/89~~

MORTGAGE COSTS AND THE RPI

The Chancellor has seen your minute of 15 July. He is content to leave the approach to D. Employment until next Spring, as you suggest.

~~Alex~~

~~Alex where do we stand on this now?~~

MPW

MOIRA WALLACE

BF 30/4

NH5/54Ju

CONFIDENTIAL

FROM: A A DIGHT

DATE: 19 July 1988

MR G F DICKSON

MORTGAGE RATES

The Chancellor has seen and was grateful for your minute of 15 July.

A A Dight

ANTHONY DIGHT

91/G.LCLD.221.8

SECRET AND PERSONAL

FROM: T PIKE/CATHY RYDING

DATE: 19 July 1988

1. MISS O'MARA Seen in draft CR 19/7
2. CHANCELLOR

cc: Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Mr Peretz O/R
Mr Gieve
Mr Grice
Mr Bush
Mr Cropper
Mr Gray (No 10 Personal)

Thanks. [illegible] pt: I take it you have spoken to John Gieve [illegible] (AA)

PROVISIONAL MONEY FIGURES - JUNE

(All figures are unadjusted unless specified otherwise)

The provisional money supply figures for June will be published by the Bank at 11.30 am on Wednesday 20 July. As usual M3, M4, and M5 broad money figures are subject to revision.

Summary

Monetary aggregates for June (per cent)

	Annual Growth Rate	Previous Month		Six month Growth (annualised)	Monthly Growth Rate	Previous Month
M0	7.7	5.7			1.2	0.1
	7.3	6.2	s.a.	6.0	1.1	0.5
M3	20.3	18.6			2.6	1.3
			s.a.	18.8	2.4	0.6
M4	16.9	16.1			2.1	1.3
			s.a.	15.8	1.9	0.9
M5	16.1	15.5			2.0	1.2
			s.a.	14.9	1.8	0.9

Lending

		£ billion			Per cent Growth Rates	
		This Month	Last Month	Average Of Last 6 Months	Annual (Monthly) (unadjusted)	Previous Month Annual (Monthly) (unadjusted)
Banks		7.2	3.1	4.7	27.6 (3.1)	27.0 (1.4)
	s.a.	6.1	3.1	4.7		
Banks and building societies		9.7	5.4	6.7	22.9 (2.7)	22.3 (1.5)
	s.a.	8.5	5.4	6.7		
Building Societies		2.9	2.5	2.1	16.2 (2.0)	15.1 (1.8)

2. The seasonally adjusted 12 month growth rate of M0 rose sharply in June, to 7¼ per cent from 6¼ per cent in May. The nsa 12 growth rate rose even more sharply, to 7¾ per cent from 5¾ per cent in May. But this reflects the distortionary effects of the timing of the end of May Bank Holiday (which will have inflated nsa M0 at the beginning of June 1988, because the Bank Holiday was at the end of May, but will not have affected M0 in June 1987, because the Bank Holiday was a week before the end of May).

3. Part of the explanation for the high seasonally adjusted growth rate was that bankers' balances were unusually low a year ago. The 12 month growth rate of notes and coin (the other component of M0) was lower in June, at just over 7 per cent. In addition, M0 may have been boosted by the Budget tax rebates. Despite these special factors, M0 is clearly growing very strongly at the moment.

4. Broad money and credit accelerated in June, the 12 month growth rate of M4 rising to 16¾ per cent (from 16 per cent in May) and 12 month growth of bank/building society lending rising to 23 per cent (from 22¼ per cent in May). Like M0, broad money may have been boosted by the tax rebates. Because of the tax rebates, companies made higher than normal net wage payments in

June, which will be offset in July when they make smaller tax payments to CG. This may have increased personal bank and building society deposits in June by more than company deposits fell, particularly if the latter temporarily increased their borrowing (see para 6 below). The impact of the tax rebates was evident in both bank and building society retail deposits: for example, bank retail deposits rose by 15½ per cent in the 12 months to June, compared to 12 per cent in May. In addition, building society deposits are still clearly benefiting from the low inflows to National Savings and unit trusts.

5. Within the M4 counterparts, there was an underfund of £0.6 billion, which may also have increased M4 growth marginally. The underfund reflected a gilt redemption in mid-June of £0.8 billion and this may have inflated bank wholesale deposits, which also grew strongly in June.

6. Both bank and building society lending were at record levels again this month, nsa. Bank lending may have been inflated by temporary company borrowing to pay employees' tax rebates, which may unwind in July when companies make smaller tax payments to CG. Other influences on the June figures are the same as in recent months:

(i) CLSB figures - which cover 85 per cent of total bank lending - indicate a very high level of company borrowing, which is likely to reflect in part the after-effects of the stock market crash on corporate financing.

(ii) Mortgage lending - particularly by building societies - was also very high. This reflects both the current high level of housing demand, as is evident from the nationwide acceleration in house prices in the second quarter, and no doubt the temporary effects of the Budget measures.

Building society lending was boosted (by £0.4 billion) by increased building society holdings of commercial bills. Finally, foreign currency bank lending also rose strongly in June. The lending was spread amongst a number of banks and there are no known special factors.

Presentation

7. There is quite a lot of 'news' in these figures. The difficulty is that on the face of it, at least, it is rather bad news. The headline stories will be M0 and lending.

8. M0 should not be unexpected, but it is a large rise in the growth rate, which is now well outside the target range. The line we have suggested is that while this was expected, we are determined to bring M0 back within the range in the coming months, as recent interest rate rises have shown. The recent increases in rates will not yet have affected the figures significantly, but should begin to restrain M0 growth in the next few months.

9. The lending figures will come as a surprise. They are at least £1½ billion higher than our figures for the average market expectation. One of the key points to make is that the bank lending figures reflect in large part strong investment and switching from equity finance to bank borrowing post crash. As far as we can tell at this stage, much of the increase in lending was to non-financial companies (eg manufacturing). Also, we think that lending has been inflated temporarily by some employers financing tax rebates by borrowing, and this should unwind next month. However, lending to persons is still high (and the record building society lending is very largely to persons). The main defence here is the budget measures, which will be having some temporary boosting effect.

10. One other point is that on the latest figures, a 1 per cent rise in interest rates costs industry one third of the amount of a 1 per cent rise in wage settlements. You will remember that the ratio used to be 1:4. The main reason for the change is that

X I am taking up the short-term/long-term point!

the different pattern of company finance post crash has increased company net interest bearing liabilities.

11. We should be grateful for comments on the briefing first thing tommorrow morning.

T Pike Cathy Ryding

T PIKE/CATHY RYDING

cc <u>Bank of England</u>

Mr George
Mr Thorp (Financial Statistics Division)

TABLE 3: PROVISIONAL BROAD MONEY COMPONENTS

£ million

	JUNE	AVERAGE GROWTH IN PREVIOUS 12 MONTHS
Notes and coins in circulation (nbps)	240	60
Bank deposits (nbps)		
Retail		
non-interest bearing	230	410
interest bearing	2621	450
Wholesale	2073	1650
Change in M3	5164	2570
Building society holdings of M3 (-)	-271	-360
Buildings society deposits (M4ps)		
Retail	1911	1430
Wholesale	67	80
Change in M4	6871	3720
Money market instruments (M4ps)	-194	-60
National Savings Bank (M4ps)	75	100
Change in M5	6752	3760

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

TABLE 4: PROVISIONAL BROAD MONEY COUNTERPARTS

JUNE 1988 £ million

	M3	M4	M5
1. PSBR	38	38	38
2. Debt sales to private sector (-)			
Gilts	720	722	722
Treasury bills	18	-22	
National Savings	-134	-135	-60
CTD's	33	29	
Other CG debt	4	4	4
LA and PC debt	310	83	117
3. External finance of public sector (-)	-167	-167	-167
4. Public sector contribution (1+2+3)	822	552	654
5. Sterling lending to private sector	7158	9686	9465
6. Externals	-1933	-2349	-2349
7. £NNDLs	-883	-1018	-1018
8. Total change (4+5+6+7)	5164	6871	6752
(Percentage change)	(2.6	2.1	2.0)

AVERAGE CHANGE IN PREVIOUS 12 MONTHS

	M3	M4	M5
1. PSBR	-580	-580	-580
2. Debt sales to private sector (-)			
Gilts	-220	-190	-190
Other public debt	-70	-110	-20
3. External finance of public sector (-)	330	330	330
4. Public sector contribution (1+2+3)	-540	-550	-460
5. Sterling lending to private sector	4060	5530	5480
6. Externals	-610	-720	-720
7. £NNDLs	-350	-540	-540
8. Total change (4+5+6+7)	2560	3720	3760
(Percentage change)	(1.4	1.3	1.2)

MONEY SUPPLY IN JUNE: PRESS BRIEFING

A. FACTUAL

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

per cent

	M0	M3	**M4**	M5
12 month growth rate	**+7.7** **(+7.3)**	+20.3 (+20.3)	**+16.9** **(+16.3)**	+16.1 (+15.6)
Annualised six-month growth	**(+6.0)**	(+18.8)	**(+15.8)**	(+14.9)
one month change	**+1.2** **(+1.1)**	+ 2.6 (+ 2.4)	+ 2.1 **(+ 1.9)**	+ 2.0 (+ 1.8)

(Figures in brackets seasonally adjusted s.a.)

(ii) **MO**

Figures (+7.7 and +7.3 s.a.) above target range, but FSBR recognised this was likely.

(iii) **Broad money**

(a) 1 month growth rates. Higher than April and May.

(b) 3 and 6 month growth rates. Lower than April and May for 3 months, but higher for 6 month.

(c) 12 month growth rates. M3 and M4 growth rate up on April and May, but M3 growth lower than end of 1987 and beginning of 1988 (see table below).

12 month growth rates

Month	M3 u/a	M3 s/a	M4 u/a	M4 s/a
Jan	22.5	(22.2)	16.6	(16.4)
Feb	20.6	(20.5)	16.1	(15.8)
Mar	21.0	(20.8)	16.8	(16.4)
Apr	19.4	(20.1)	16.0	(15.9)
May	18.6	(19.1)	16.1	(15.8)
Jun	20.3	(20.3)	16.9	(16.3)

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

(iv) **Lending**

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

(b) One month changes: All £ billion figures are records, but seasonally adjusted, only very slightly above April. Bank and building society lending unadjusted £1¾ billion up on previous record (March).

	Bank and building society lending		Bank lending	
	£ billion	%	£ billion	%
March	+7.9 (+6.8)	+2.3 (+2.0)	+6.0 (+4.9)	+2.8 (+2.3)
April	+6.5 (+8.2)	+1.8 (+2.3)	+4.4 (+6.1)	+2.0 (+2.7)
May	+5.4 (+5.4)	+1.5 (+1.5)	+3.1 (+3.1)	+1.4 (+1.4)
June	+9.7 (+8.5)	+2.7 (+2.3)	+7.2 (+6.1)	+3.1 (+2.6)

(Figures in brackets seasonally adjusted)

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

	Bank and building society %	Bank %
January	+20.1	+24.7
February	+19.9	+24.3
March	+20.9	+25.2
April	+21.9	+26.9
May	+22.3	+27.0
June	+22.9	+27.6

(v) **Funding.** underfund (on new, M4 definition) in June of £550 million; PSBR in June of £-38 million.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

B. DEFENSIVE

(i) Lending

(a) **Why are increases in lending so high?**

- lending to industrial and commercial companies remains high as equity markets still subdued. Post crash accelerated borrowing by manufacturing industry consistent with strong investment.

- Seasonally adjusted, June increase not much worse than April [NB Unadjusted, figures much higher than previous record in March]

- June is an interest charging month, which will have inflated unadjusted figures by over £1 billion

- Tax rebates paid in June temporarily financed by employers may have boosted lending. Effect may be offset next month as companies make smaller tax payments to CG.

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

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

Also:-

- Foreign currency borrowing high.

- Building society lending boosted by increased holding of commercial bills.

Instead of what normally?

(b) **Credit card boom?**

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

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

(c) **Mortgage lending out of control?** The housing market has been rather buoyant recently, although some signs that London prices are stabilising. Recent action on interest rates will be reflected in large increases in mortgage rates next month. Taken with changes in tax relief from 1 August, should cool housing market.

(d) **Why not impose controls on lending**? Direct controls would not be effective given increasing sophistication of modern financial markets. An obvious difficulty with all controls (even mortgage multiples for example) is that they could not be imposed on overseas lenders. In today's sophisticated markets and with no exchange controls, it would be a simple matter for borrowers to go straight to the overseas lender (perhaps having been referred by a branch in the UK). But, in any case, Government believes lenders and borrowers should be free to make own decisions.

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

(ii) **Money Supply**

(a) **Why M0 growth so high**?

- Tax rebates in June may have inflated figures, particularly for cash-paid employees.

- Bankers balances were abnormally low a year ago.

(b) **M0 growth outside target range?** 1988-89 FSBR chapter 3 said that M0 growth would return to within target range later in year and that is what we aim to do. As result of considered judgement of all relevant indicators, have raised interest rates 3% since beginning of June.

(c) **Why growth in broad money aggregates higher in June than in April and May?** 1 month figures may have been boosted by £0.6 billion underfund in June, compared with £0.3 billion underfund in May and £1.5 billion overfund in April. Also, possibly some temporary boost from Budget - related tax rebates together with lower rate of tax applicable from June.

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

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

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

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

(iii) **Interest rate increase since beginning of June**

(a) **Why increase rates?** [Interest rates edging up worldwide.] Tightening of [UK] monetary conditions needed to [stop excessive growth developing with higher] inflation. Base rates now ½ percentage point above level before stock market collapse last October.

keep bearing down on

(b) **More than ½% needed to create impact on economy?** [Successive small rises likely to be reflected in largest rise in mortgage rates since 1984. That will certainly be noticed.]

No reason to make larger moves. Appropriate to move cautiously and assess situation constantly.
[In earlier periods large interest rate jumps were sometimes needed

either to stabilise the exchange rate or to turn expectations in the gilts markets to help funding needs. Neither circumstance applies now]

(c) **Why raise interest rates when exchange rate DM 3.14?** Although pay particular attention to exchange rate against DM, not exclusive attention. Rate against dollar also important, and rather lower now than in June. All part of process of tightening since beginning of June.

(d) **Interest rates increased because of concern about money figures?** Interest rate decision taken on basis of continuous and comprehensive assessment of all relevant factors, not on basis of single set of figures. But money figures are one of the factors taken into account.

(e) **Why move rates in ½ point steps in quick succession?** 17 out of last 18 interest rate movements have been 1/2%; this has become the normal practice.

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

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

(h) **Increase will damage industry?** Industry has more to fear from resurgence of inflation. 1% rise in interest rates, even if sustained for whole year, increases costs by only much less than one third of amount by which 1% rise in pay settlements increases them. [Ratio now 1:3 rather than 1:4 because of effect of different pattern of company finance post crash on companies net interest bearing liabilities.]

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

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

(k) **Mortgage rate increase harmful?** As Chancellor said recently [Cities of London and Westminster Conservative Luncheon, 2 July] "I can understand that many people will not ~~favour~~ the higher mortgage rates which are now in prospect. But they will help to dampen down some of the rather fevered demand in the housing market, which is clearly desirable".

X welcome

(l) **Increases in interest rates do not affect demand for consumer credit?** Consumer credit only small part of total personal debt. Certainly some borrowers not responsive to interest rate changes, but by no means all, and interest rate changes do influence borrowers' behaviour overall. In any case, high rate of growth of lending and liquidity consistent with lower inflation because increased liquidity willingly held, ie as savings rather than for spending.

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

(iv) **UK's real interest rates out of line with competitors?**

Real interest rates bound to move higher when base rates have increased 3% since beginning of June (now 1.8 percentage points above G7 average (see table below)). Recent interest rate movements demonstrate Government's determination to keep a downward pull on inflation.

Country	Nominal	Real*
UK	11.1	6.2
US	8.1	4.0
Japan	3.9	3.7
Germany	5.0	3.9
France	7.4	4.7
Italy	11.4	6.2
Canada	9.4	5.1
Average	7.4	4.4

* deflated by latest increase in RPI or equivalent.

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CONFIDENTIAL

PMP

FROM: MS V F BRONK

DATE: 21 July 1988

1. MR GRICE

2. ECONOMIC SECRETARY

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

File: MAMC C9

The July outturn now looks likely to be well below the June figure but mainly because of erratic bankers' balances effects.

JWG

21-7-88

MO FIGURES

The latest weekly figures for MO, covering the third week of July, are attached. They show that the 12 month growth rate of MO to the latest four week period was 6.8 per cent (6.7 per cent not seasonally adjusted). The 12 month growth rate of notes and coin to the same period was 7.1 per cent (7.0 per cent not seasonally adjusted).

2. Six month annualised growth of notes and coin to the latest four week period was 7.3 per cent, compared with 6.2 per cent in June.

Vyvien Bronk

MS V F BRONK

A
OK to send to Paul
means Grice manuscript?

AA OK

TABLE 16 CONFIDENTIAL (Until Publication)

M0 : THE WIDE MONETARY BASE

Monthly data	Level £ million (Change in brackets)							Percentage change on previous month		6 month % growth annualised		Percentage change on previous year			
	Notes and Coin (nsa)	Notes and Coin (sa)		Bankers' Deposits	M0 (nsa)	M0 (sa)		Notes(sa) anc Coin	M0 (sa)	Notes & Coin (sa)	M0 (sa)	Notes and Coin (nsa)	Notes and Coin (sa)	M0 (nsa)	M0 (sa)
November	15365	15525	(69)	183	15548	15707	(48)	0.4	0.3	7.4	7.0	4.8	4.8	4.9	4.9
December	16447	15661	(136)	186	16633	15846	(139)	0.9	0.9	7.9	8.5	4.7	4.8	4.2	4.3
1988 January	15458	15620	(-41)	181	15638	15801	(-45)	-0.3	-0.3	6.1	5.3	4.7	4.5	4.8	4.6
February	15353	15659	(39)	124	15477	15783	(-18)	0.2	-0.1	5.3	4.5	5.7	5.7	5.3	5.3
March	15588	15753	(94)	162	15750	15916	(133)	0.6	0.8	5.0	4.6	6.9	6.4	6.4	5.8
April	15797	15826	(73)	229	16026	16055	(139)	0.5	0.9	4.8	5.1	5.8	6.1	5.9	6.2
May	15868	15952	(126)	178	16046	16130	(75)	0.8	0.5	5.6	5.5	6.0	6.5	5.7	6.2
June	16072	16142	(190)	174	16246	16316	(186)	1.2	1.2	6.2	6.0	7.5	7.1	7.7	7.3
July (3/4) a	16359	16246	(104)	164	16524	16410	(94)	0.6	0.6	8.2	7.9	7.1	7.1	6.6	6.6
Latest 4 weeks a	16309	16239	(116)	184	16493	16423	(144)	0.7	0.9	7.3	7.1	7.0	7.1	6.7	6.8

Weekly data	Level £ million (Change in brackets)					Percentage change on previous week
	Notes(sa) and Coin		Bankers' Deposits	M0 (sa)		M0 (sa)
June						
1st	16110	(166)	215	16325	(233)	1.4
8th	16072	(-38)	235	16307	(-18)	-0.1
15th	16131	(59)	90	16221	(-86)	-0.5
22nd	16177	(46)	87	16264	(43)	0.3
29th	16219	(42)	242	16461	(197)	1.2
July						
6th	16262	(43)	212	16474	(13)	0.1
13th	16216	(-46)	169	16385	(-89)	-0.5
20th	16259	(43)	112	16371	(-14)	-0.1

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

mg2.cc/Tim/91g12.20.7

CONFIDENTIAL

pup

FROM: T PIKE

DATE: 22 July 1988

MR GIEVE

cc EST
Sir P Middleton
Sir T Burns
Principal Private Secretary
Mr Scholar
Mr Peretz o/r
Mr Grice
Miss O'Mara
Mr Bush
Mrs Ryding
MAMC C9

MO IN JULY

You spoke to Mr Grice on Wednesday about the odds on June being a peak in MO growth. You might like to see the likely range for the outturn 12 month growth rate of MO in July.

2. The table below sets out the MO outturns for June, and July so far (3 weeks of 4), together with the outturns for June and July a year ago:

not seasonally adjusted

	Levels (£mn)			12 month growth rate	
	Notes and Coin	Bankers' Deposits	MO	Notes and Coin	MO
June 1987	14946	137	15083		
July 1987	15271	235	15506		
June 1988	16073	174	16247	7.5	7.7
July 1988 (3 of 4)	16360	164	16524	7.1	6.6
July 1988: Central Forecast	16400	170	16570	7.4	6.9
Likely Maximum	16420	190	16610	7.5	7.1

3. The table shows that 12 month notes and coin growth in July so far is 7.1 per cent, and is expected to be 7.4 per cent in July as a whole - little changed compared to the 12 month growth rate

in June. However, because bankers' balances are much lower in July so far than their average level a year ago, annual MO growth is expected to be lower than notes and coin growth, at just under 7 per cent in July. The opposite happened in June, when bankers' balances were above their average level of a year ago, so that MO annual growth was boosted to 7.7 per cent, compared to 7.5 per cent growth of notes and coin. Hence, erratic movements in bankers' balances means that 12 month growth of MO is likely to be about ¾ percentage point lower in July than in June. Even on very pessimistic assumptions for the final week of July, 12 month growth of MO will still be over ½ percentage point lower in July than in June.

4. For the rest of the financial year, we certainly expect the trend in MO growth to be downwards. But, as I believe Mr Grice mentioned to you, that assumes, of course, that money GDP grows at the rates projected in the June Forecast. We are preparing new monthly projections for the rest of the year in the course of the July Monthly Monetary Assessment.

T Pike

T PIKE

psl/78A

cc Sir P Middleton
Sir T Burns
Mr Sedgwick
Mr Gieve
Mr P F L Allum
Mr S J Davies
Mr Matthews
Mr S Brooks

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

25 July 1988

The Rt Hon Norman Fowler MP
Secretary of State for Employment
Department of Employment
Caxton House
Tothill Street
LONDON
SW1H 9NA

Dear Norman

THE RPI AND MORTGAGE INTEREST PAYMENTS

We had a word about this recently, and you agreed to look again at publishing figures for the RPI excluding mortgage interest payments alongside the other material you publish.

You may remember that I raised this with you a year ago, and gave you the attached note. We are certainly not seeking to do this for short-term reasons now that the mortgage rate has gone up: we have been pressing this for years! And we are not suggesting re-opening the composition of the RPI itself, simply that the figures for the RPI excluding mortgage interest payments should be made more widely available.

We have consistently used the RPI excluding mortgage interest payments in our briefing, but it is a source of considerable frustration to many of our customers that it is almost impossible for them to get hold of this information regularly, since it is not in the official statistics. I am sure it should be.

Yours
Nigel

NIGEL LAWSON

Final

THE RPI AND MORTGAGE INTEREST PAYMENTS

The UK and Canada are now alone among major countries in including changes in mortgage interest payments in their consumer price indices. The US dropped them from its consumer price index in 1983, while other countries have never included them. But in the UK the RPI is liable to show significant fluctuations simply because of changes in short-term interest rates.

2. This is perverse: it means that if we tighten monetary policy so as to put downward pressure on inflation, the short term result is an increase in recorded inflation. And it clearly makes a nonsense of international comparisons of inflation.

3. It also makes the RPI path misleadingly volatile. In the 1970s, when inflation was high, the effect of changes in mortgage interest rates was a relatively minor matter. But with our success in reducing inflation to its current level of around 4 per cent, changes in mortgage interest rates can bring about quite disproportionate fluctuations. This is clearly demonstrated in the chart and table attached. The chart shows the monthly series, with and without mortgage interest payments, over the period since 1975; and the table gives figures for the two series over the four years from June 1983 to June 1987.

4. We are unlikely to be able to persuade the RPI Advisory Committee (RPIAC) to change the construction of the RPI itself: they recommended only last year that changes in mortgage interest payments should continue to be reflected in the RPI as a proxy for owner occupiers' so-called "shelter costs". But there is no reason why we should not use figures for the RPI excluding mortgage interest payments in our briefing. Indeed, the Treasury already does so, although Department of Employment have been resistent to this.

5. We used the figures for the RPI excluding mortgage interest payments, for example, in last year's Autumn Statement (paragraphs 1.45 and 1.51) to stress that the dip in RPI last summer exaggerated the underlying fall in inflation, and - conversely - we have pointed out that we have pointed out the rise in the RPI since then has provided a misleading guide to the trend of inflation. It is clearly most unhelpful to get a public perception that inflation is accelerating when the underlying path is in fact pretty stable.

HM Treasury
27 July 1987

mjd 1/11A

DRAFT LETTER FROM CHANCELLOR TO NORMAN FOWLER

Please type for signature

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We have consistently used the RPI excluding mortgage interest payments in our briefing, but it is a source of considerable frustration to many of our customers that it is almost impossible for them to get hold of this information regularly, since it is not in the official statistics. I am sure it should be.

NIGEL LAWSON

RA7.53

Final

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The UK and Canada are now alone among major countries in including changes in mortgage interest payments in their consumer price indices. The US dropped them from its consumer price index in 1983, while other countries have never included them. But in the UK the RPI is liable to show significant fluctuations simply because of changes in short-term interest rates.

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HM Treasury
27 July 1987

psl/74A

UNCLASSIFIED

FROM: A C S ALLAN

DATE: 27 July 1988

BF ~~1/9~~ 1/9

MRS RYDING

cc PS/Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Mr Peretz
Mr Sedgwick
Mr Gieve
Mr Grice
Mr Hibberd
Miss O'Mara
Mr S Brooks
Miss Simpson
Mr Cropper

5/9.

Please chase 4612 progress on this AB 5/9

Alex Cathy is on leave for 2 weeks so her division is looking in it Sarah

Sarah Please keep chasing - surely something has happened since 27 July! Alex

COST OF INTEREST RATE CHANGES AND PAY RISES

In your note on the provisional money figures for June (not copied to all) you made the point that on the latest figures, a 1 per cent rise in interest rates now costs industry one-third of the amount of a 1 per cent rise in wage settlements. The change from the previous figure of one-quarter was because the more recent data from DTI indicated a substantial rise in firms' net interest-bearing liabilities in 1988 Q1, reflecting the different pattern of company finance post-crash. Mr Brooks had made a similar point in a manuscript note to Mr Pickford just before First Order Questions earlier this month (again, not copied to all).

2. The Chancellor would be grateful for advice on the extent to which firms' "net liabilities" are at short-term or long-term rates of interest. The recent rise in interest rates has primarily been in short-term rates, and long-term rates have not moved much.

3. In the meantime, the Chancellor does not feel that we should use the new ratio of 3 to 1: we can instead say "far more" for the time being.

ACSA

A C S ALLAN

PWP

CHANCELLOR OF THE EXCHEQUER

HONI SOIT QUI MAL Y PENSE

Thanks.
Also
I have
continued to
make [illegible]
I am thinking.

Ch/

DISCOUNT RATES

I expect officials will want a steer on how far you want to go towards advocating, say, 6% for public monopolies. I have drafted a new paragraph, circled, behind. It ends very tentatively. Do you want to propose a lower number in so many words? And is draft otherwise on right lines?

MPW.

chex.rm/mw/54

Jean could you type up the tape and do this draft letter - keep as draft

M.

<u>Draft letter from the Chancellor to Ministers in charge of Departments</u>

DISCOUNT RATES

Our officials have been meeting under the chairmanship of Ian Byatt to review the level and use of discount rates used in the public sector. They concluded that the general discount rate should be raised from 5 per cent to 8 per cent reflecting the rise in private sector profitability which is currently well over 10 per cent. Both the RRR for nationalised industries and public sector trading bodies and the general test discount rate in the public services would be 8 per cent. Separate analysis should always be undertaken of the risks specific to particular projects, including any optimism bias.

The Byatt group's recommendation that we move to a higher RRR for nationalised industries and trading organisations is clearly consistent with all we have done to put the public trading sector on a more commercial basis. I am quite content to accept this recommendation as far as <u>non-monopoly</u> nationalised industries and trading bodies are concerned. The 8 per cent rate would be an important factor in setting new financial targets, but there would be no impact on pricing during the life of existing financial targets.

¶ However, I do not think we should underestimate the difficulties of a similar increase in the RRR for those natural monopolies still in the public sector. The MMC's report on British Gas demonstrated very clearly the risk of the Government's being accused of endorsing or encouraging pricing policies in the public sector which are then decried as excessive or anti-competitive when the industries concerned are privatised ~~transferred to the private sector~~. This awkwardness inclines me to the view that ~~[we should consider whether]~~ a more modest increase in the RRR might be appropriate in the case of the ~~natural monopoly~~ monopoly public utilities still in the public sector, perhaps 6 per cent. ~~I should be interested in colleagues' views on this point.~~

~~There could of course~~

I have also looked carefully at the question of what discount rate should be used in the non-trading parts of the public sector. Since it is proposed that risk should be analysed separately and not usually taken into account in a premium on the discount rate, I see a case for aligning the discount rate used in the non-trading sector with the cost of low-risk capital to the private sector. I therefore propose a rate of 6 per cent for the non-trading public sector.

I would like to go beyond the Byatt Report in specifying how risk and optimism bias should be handled. In particular I propose that the amount of risk associated with a particular proposal should be weighed up alongside the quantifiable returns. There will be cases where it is better to choose the apparently higher cost option because it is less risky than the lower cost one. The more risky alternatives should demonstrate a correspondingly higher reward.

In proposals to introduce private finance into public sector programmes, I propose that the 6 per cent discount rate should be the starting point for the public sector cost of capital. But in large or complex projects it will be necessary to establish the extent to which risk is being transferred to the private sector. If little risk is transferred, a rate close to the government's cost of borrowing might be appropriate. Where the transfer of risk is substantial, a higher rate than 6 per cent might be used.

I am conscious that the use of a discount rate in the non-traded sector lower than the RRR in the traded sector may lead to accusations that we are pampering the public sector and trying to minimise private participation in public sector activities (by under estimating the cost of the public sector option). However, this is not so. The appraisal of public projects would be no less demanding in the non-trading sector than it would be in the trading sector. Use of a low-risk cost of capital in the non-trading sector combined with risk analysis and the requirement that risky projects should earn correspondingly higher returns will lead to the greatest efficiency.

As regards private participation, the Government may judge that any additional profit built into a private sector tender is a reasonable price to pay for some innovatory element or unique quality (eg special management skills); or that a cost of private finance higher than 6 per cent is reasonable in view of the risks transferred to the private financier. But in most cases the cost of low-risk capital of 6 per cent provides the right basis - together with the proper treatment of risk - for appraising projects with potential private participation in the non-trading sector.

My officials will be in touch with yours about the details of these proposals.

FROM: **KEVIN DARLINGTON**
DATE: 4 AUGUST 1988

MR ALLAN 12/2

cc PS/Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Mr Peretz
Mr Sedgwick
Mr Gieve
Mr Grice
Mr Hibberd
Miss O'Mara
Mr S Brooks
Mrs Ryding
Miss Simpson
Mr Cropper

COST OF INTEREST CHANGES AND PAY RISES

In your note of 27 July you requested advice on the extent to which UK industry's interest-bearing net liabilities are at short-term or long-term rates. This was in connection with the upward revision to the estimate of the cost to industry of a 1 per cent rise in UK interest rates following the rise in net liabilities in 1988Q1.

2. The estimate of interest rate costs is made by the DTI; we are generally content with their methodology. In making the estimate, DTI statisticians attempt to identify those financial assets and liabilities which are directly affected by changes in UK base rates. Allowance is also made for those assets or liabilities for which the effect is delayed. Very long-term liabilities, like firms' loan stock, are excluded altogether. In fact, of the liabilities identified at the end of 1988Q1 about 90 per cent were accounted for by bank lending. Similarly on the asset side almost 90 per cent of the total was accounted for by interest-bearing bank deposits. The estimated cost of a 1 per cent change in UK bank base rates on firms' finances in a full year, as net liabilities stood at the end of 1988Q1, was £430m. Of this, £377m was accounted for by those net liabilities directly affected by changing interest rates and £53m by those - mostly commercial bills - experiencing a delayed effect. This implies that the ratio between the cost to industry of a 1 per cent rise in wage settlements and the interest rate cost has fallen from 4 to 1 to 3 to 1.

3. I think it is wise, as para.3 of your note states, to avoid immediate briefing use of this new ratio of 3 to 1 until it has become more established. Indications are that industry's bank borrowing has continued strongly since 1988Q1, but the wage cost calculation depends on extrapolation of 1986 data. We will have to revise this anyway in September when we will have the latest Blue Book covering 1987.

Kevin Darlington

KEVIN DARLINGTON

22/3654

BF 15/8

From: SIR PETER MIDDLETON

Date: 5 August 1988

CHANCELLOR

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

*with report

Mary
As PEM suggests, Ch/x will need a mtg. afterwards. I shd be grateful for names of Mins + advisers for this discussion on an issue on which we should [illegible] a particular view on privatisation [illegible] [illegible] PS @ Chx

DISCOUNT RATES

No issue in recent times has caused so much debate within the Treasury - and outside - as the appropriate discount rate for investment appraisal in the public sector. What follows is an attempt to find a way through strongly held views and provide a solution which should produce the results we require - that there should be a bias neither towards nor against investment in the public sector and that those investments where there is no revenue stream should be adequately appraised and compared.

2. In the past it has been the practice to have one discount rate across the public sector which is the same as the rate of return expected on the generality of assets in the public traded sector. It is based on the average rate of return in the private sector - admittedly an ex post concept. The justification for turning this into a rate of discount for appraising individual projects - an ex ante concept - and applying it across the board is twofold: it is simple and it has an appealing (but certainly not flawless) presentation. By and large anyone wanting to achieve an ex post return of some given amount on all their assets would be unlikely to undertake many investments promising much lower rates of return.

3. Mr Byatt has been conducting an interdepartmental study, the results of which are in the attached report. He recommends sticking to the existing approach and raising both the required rate of return and the discount rate to 8% from the present 5%, to take account of the increased real rate of return in the private sector.

4. Though there are those who agree with Mr Byatt, this approach has not found general favour. It has been pointed out that with privatisation, contracting out, attempts to improve investment appraisal within the non-traded sector, and an incessant debate about private finance, a discount rate derived from the average rate of return in the private sector is not always appropriate - especially if it carries the implication that nothing further need be done to analyse risk.

5. I believe that there is force in these arguments; we have already been driven to consider different rates especially when examining proposals for private finance. So we have made a distinction between the trading and non-trading parts of Government and suggested what the discount rate should be in each instance while leaving some latitude to act differently in special cases.

6. The attached note sets out this approach. It suggests an RRR of 8% and a presumed discount rate of 8% for trading purposes, and a lower discount rate in the non-trading area based on the private sector's cost of capital for low-risk projects. This would I think be widely accepted in the Treasury, though there are those who would ideally like to see a lower rate - closer to the Government's own cost of capital - for the non-trading sector, those who would prefer a lower rate everywhere, those who see a case for a higher rate for the trading sector, and of course those who would prefer a uniform rate.

7. There is, in my view, a good case for making the RRR 9% if it was thought that we could get away with it, because the private sector rate of return - in real terms on a sustainable basis - seems higher than 8%, a number chosen by the Byatt group partly to try to squeeze everything within a single discount rate. But the 8% has been agreed interdepartmentally and I should be inclined to stick to it rather than push for another 1%.

8. I expect that you will wish to discuss this with us and hear the range of views at first hand - you will find there is a well honed set of arguments on both the theory and the practical results. Having gone through them at great length you have my recommendations.

[illegible signature]

p.p.

P E MIDDLETON

Approved by Sir Peter Middleton and signed in his absence

P.S. I will also want, in advance of the mtg, a note setting out what practical difference the proposed change wd have made had it been introduced, say, two years ago.

NL.

DISCOUNT RATES

The public sector needs to take investment decisions so that within the sector capital is used to maximum advantage. It also has to ensure so far as possible that the public sector does not use capital which could be used more efficiently in the private sector. There are two important elements in investment decisions where a judgement has to be taken: the appropriate cost of capital to be used in investment appraisals and the balance between risk and the prospective return. In the absence of both financial and product market disciplines of the sort which exist in the private sector, it is necessary to provide some broad principles to guide public sector decisions.

2. The appropriate cost of capital for use in investment decisions is embodied in the discount rate. Different approaches are indicated in the case of trading activities where proximity to the private sector is closest, and non-trading activities.

Trading Bodies

3. In nationalised industries and other trading bodies financially at arm's length from the Government, targets can be set in the form of a required rate of return (RRR) on the totality of their activities. The RRR expresses the average return on investment to be recovered in revenue. This return should clearly be set in relation to the equivalent measure for the private sector, which is the average rate of return on capital. The average rate of return has risen considerably since the present RRR of 5% was set on a similar basis. It is therefore proposed that the RRR should be raised to 8%. This is a cautious approach to the improvement in the long-run rate of return in the private sector where the currently achieved rate is around 10½%.

4. As at present, the choice of discount rate to appraise individual projects would be a matter for the industry or trading body, subject to the understanding that the return to be expected on the investment programme as a whole would be sufficient to provide the required rate of return. Where a discount rate is required for the

appraisal of large projects or where the Government is asked for a view of the appropriate discount rate, there is a presumption that the rate should not be lower than the RRR so that the return on the programme as a whole is not put at risk.

Non-Trading Bodies

5. In the public services, the central Government controls investment decisions directly. There is often no stream of revenue which could be used to establish a required rate of return regime as is used in trading bodies. In order to secure consistency in the appraisal of the costs of different alternatives, a standard rate of discount which would act as a proxy for the cost of capital should be used. This will help in deciding whether to go ahead with particular projects and in comparing alternative ways of achieving desired ends. As risk would be appraised separately, the appropriate discount rate for this purpose is the pre-tax long-term cost of capital for low risk purposes in the private sector. This should mean that investments in the public sector will be undertaken at roughly the same rate as they would be in the private sector.

6. There will be certain cases where a higher rate of discount might be justified. Such cases include roads where there is a system of appraising benefits which enables a close proxy for a rate of return on the programme as a whole to be established; and where it is also desirable to have regard to the direct comparison with rail which is subject to a required rate of return. Here the presumed rate of 8% would be appropriate.

7. Special considerations also apply to proposals to finance privately parts of public sector programmes. The 6% discount rate should be the starting point for the public sector cost of capital. But in large or complex projects it will be necessary to establish the extent to which risk is being transferred and the incidence of tax involved in the project. If little risk is transferred the rate closer to the Government's cost of capital might be appropriate. On the other hand where the transfer of risk is very great a rate above 6% could be considered.

Risk

8. In both trading and non-trading bodies, particular attention should be paid to the assessment of risk. Alternative outcomes should be identified and the sensitivity of the project to key assumptions should be tested. Where significant risks are identified, careful consideration should be given to whether the project should be undertaken at all. More risky alternatives should demonstrate a correspondingly higher return.

9. This approach is judged preferable to the alternative which would involve applying different discount rates to different public sector bodies according to the assumed riskiness of their operations. There is no simple distinction in terms of risk between trading and non-trading organisations. Most bodies engage in a mixture of high and low risk activities, and these risks are best made explicit by the above approach.

Some awkward questions

10. **The most common justification for having more than one discount rate is a difference in risk. Why is this not the basis of the distinction between the activities subject to the two rates?**

Differences in risk do matter, and should be allowed for on the basis described in paragraph 8 above in both trading and non-trading bodies. Trading bodies will set their own discount rates for particular applications, in consultation with sponsor departments. It might sometimes be appropriate for them to take account of risk by adjusting the discount rate. Both trading and non-trading bodies should generally undertake a separate risk analysis. The riskier projects should only be adopted if they are judged to offer a correspondingly high reward.

11. It is not feasible to apply a different discount rate to different public sector bodies on the basis of the average riskiness of their activities. There is no simple distinction such as trading means high risk and non-trading means low risk. Most bodies engage in a mixture of both high and low risk activities. In central government this is best managed by insisting on a separate risk

analysis in each case. In trading bodies, which are financially at arms length from government (even when part of a departmental structure), the government will encourage the use of risk analysis and may accept the use of different discount rates where circumstances justify it.

12. **If risk is not the basis for the distinction between the use of the higher and lower discount rates, what is?**

The distinction is based on the relationship of the public sector body carrying out the activity to the government and the nature of the financial regime under which it operates. Where the body operates financially at arms length from government (even where part of a departmental structure) and is given financial targets which it has to achieve (eg nationalised industries and other trading bodies and funds which are subject to the RRR), these targets will be based on private sector returns. Where bodies are not at arms length financially, the Government is directly involved in the appraisal of investment opportunities. For this purpose a discount rate, based on a low-risk cost of capital to the private sector, is indicated.

13. The rationale for this distinction is that the financial target of a trading body relates to its performance as a whole. It should therefore be set in relation to the equivalent measure for the private sector, which is the rate of return on capital. This has risen considerably since the present RRR of 5% was set on a comparable basis, and so the new RRR also needs to be increased. However, the activities of non-trading bodies within government cannot be monitored in terms of a financial target, and investments are the subject of individual government decisions. As risk would be separately assessed, each project can be appraised using a low-risk cost of capital (6%). Like the return on capital, the cost of capital has also risen in the private sector since the discount rate was last set, but by a smaller amount.

14. **If trading bodies can set more than one discount rate, why not allow non-trading bodies to do the same?**

On one view different discount rates for different amounts of risk are acceptable. But risk is very difficult to measure for activities which do not have private sector analogues. Different (usually higher) discount rates would only be justified in those (not very common) circumstances where this was judged to be the best way of offsetting a bias towards optimism or taking account of specific risks. Given the need to promulgate instructions to the large number of people dealing with the appraisal of projects in government departments, a standard rate is necessary for appraising the general run of such cases in the non-trading field. Projects should anyway always be subjected to a risk analysis with results which would be implicitly equivalent to allowing for differing amounts of risk in the discount rate.

15. **If the private sector does not appraise projects at its own cost of capital, why should public non-trading bodies?**

We do not know the exact rates at which private companies appraise projects. Hurdle rates for new ventures can be high, probably because there is a need to offset optimism bias or to allow for specific risks. Both of these are best handled separately in the public sector, although it may sometimes be convenient to add something to the general discount rate to bring about parity with private sector practice. The discount rates used by private sector companies for cost-minimisation appraisals within an agreed business strategy are often lower than those for new ventures. Since most appraisals in non-trading bodies are cost-minimisation, this points to using a lower rate there.

16. More generally, the case for basing the discount rate on the market cost of capital is that it will lead to the greatest efficiency in both the private and public sectors. Although we cannot be sure that the private sector always operates like this, it makes good sense for the public sector to do so.

17. **The private sector does not make pricing and investment decisions so as to achieve a particular rate of return, so why should public trading bodies?**

Private firms operating in competitive conditions must accept market prices and appraise investment accordingly. Nationalised industry and other public sector trading bodies who are "price takers" should behave similarly; financial targets are set on this basis. Trading bodies with some monopoly power - the price makers - should set prices in relation to costs, including capital costs.

18. **How can you justify setting prices in trading bodies to achieve an RRR of 8%, and in other bodies on the basis of a cost of capital of 6%? Doesn't this mean that when a non-trading body is converted into a trading body it will suddenly have to raise its prices?**

We want trading bodies to achieve rates of return comparable to average returns in the private sector, hence 8% for the RRR. Public sector trading bodies should achieve their financial targets and, where they are price makers, set prices which cover total costs. They should also relate the structure of their prices to the structure of their costs (to avoid cross subsidisation).

19. The prices charged by non-trading bodies will reflect a variety of considerations, which is one of the reasons why these bodies do not have trading status. Sometimes it will be appropriate to charge what the market will bear. Sometimes prices will be set so as to bring demand and supply into balance. At other times social considerations will dominate and prices will be set so as to make a contribution to the total cost of the service.

20. A decision to put a service on a trading basis implies that the body should be run as far as possible on private sector lines. In practice a public sector body would only be considered for conversion if it was already partly operating in the market place and thus pricing some of its activities so as to yield rates of return which would be acceptable in the private sector. But, depending on what was happening before, some prices could go up, down or remain much the same.

21. **If non-trading bodies can set charges to earn a long-run marginal cost return of 6% why should not trading bodies do the same?**

We want trading bodies to achieve rates of return comparable to average returns in the private sector, which means that at least some of their products must be priced to earn above the cost of capital. This reflects private sector behaviour.

22. **How should capital be costed in non-trading bodies in contracting-out cases and when costing services within Government?**

In contracting-out cases, where the government is choosing between itself and a private supplier, efficiency and value for money considerations point to costing capital at its marginal cost ie the 6% rate. The same arguments apply to costing within government, when the aim is to decide how government services should most efficiently be provided, and more generally to the costing of government inputs.

23. **How do we explain to a nationalised industry that it has to earn 8% when a rate of 6% is being used for appraisals in the public services?**

There is no conflict. The rate of 8% is a target overall return for selling in fair competition to the private sector. The rate of 6% is a low-risk cost of capital which is used for a different purpose. Industry appraisal can face a degree of risk or, on the basis of past experience, optimism, which may justify a high discount rate. They may feel that it would be prudent to use the RRR as a minimum rate.

24. **In 1978 the government said that a discount rate higher than the opportunity cost of capital (the principal elements being the actual and prospective pre-tax return on capital in the private sector) should be used for project appraisal in the non-trading public services. Why does it now suggest a lower rate for non-trading than for trading bodies?**

The higher rate for the non-trading public services was justified by the "absence of market forces and greater risk of appraisal optimism for projects whose returns are primarily non-financial". Since 1978, we have developed our techniques of project appraisal and we now generally tackle risk and appraisal optimism outside the discount rate. For projects to be undertaken, higher risk projects should promise correspondingly higher rewards.

25. **If the 6% rate is based on an estimate of a low risk cost of capital to the private sector, how can the capital costs of higher risk activities in the non-traded public services be assessed?**

The separate analysis of risk will also be applied to the costing of higher risk non-trading activities. The higher risk activities will need to earn correspondingly higher rewards to be accepted.

26. **How can you possibly treat roads as though they were trading when they do not earn income?**

Roads need to be appraised on the same basis as railways, which are trading. If we could charge for them we would want to treat them like trading bodies. In practice road appraisals are very similar to investment appraisals in trading bodies in that they discount benefits as well as costs. Finally, roads are now appraised at 7% (ie above the 5% used elsewhere) and it would be right to maintain this general relationship with other discount rates.

27. **How do you justify using the higher rate for launch aid and other grants and subsidies to the private sector?**

Since the private sector is trading, the associated grants and subsidies should also be treated like trading activities. Moreover, experience has shown that appraisals in this field are often too optimistic. One reason why certain industrial interventions are now subject to appraisal at a rate of 10% is to offset some of this optimism bias.

28. **A low discount rate in contracting out applications will unfairly favour public sector provision over private contractors.**

No. Private contractors will take account of their own cost of capital when tendering for the work. If they build in a larger profit margin than this justifies then it is quite right that it should count against them. But the Government may judge that the additional profit was a reasonable price to pay for some innovatory element or unique quality (eg special management skills).

29. **How can you justify departing from the 6% discount rate in the private finance context?**

In most cases there would be no departure: 6% fairly reflects the comparative costs of public and private capital. But particularly for the more complex projects, while initially appraising them at 6%, it is necessary to examine whether the difference between the discount rate implicit in the private contractor's offer and the government's cost of borrowing is consistent with the risks transferred and the incidence of taxation in each case. The use of information about the project-specific risks transferred and taxation may indicate a cost of capital higher or lower than 6%.

30. **You call 6% the minimum discount rate to be used in non-trading bodies. What criteria govern the use of higher discount rates?**

The minimum discount rate would, subject to a de minimis rule, be accompanied by an analysis of risk. The more risky options would have to show a corresponding cost advantage if they were to be accepted. This is a superior method to adopting a higher discount rate. For some categories, however, it may prove appropriate to recognise this explicitly using a higher discount rate; but this would not remove the need for a proper risk analysis.

31. **Why an RRR of only 8% when the rate of return earned by non-oil ICCs in 1987 was 10½% and this is more likely to rise in future than to fall?**

A sharp rise in the RRR from 5% will anyway be disruptive for some trading bodies. We want to minimise the risk that this disruption will be unnecessary because it turns out at the next review that the RRR has to be revised down again. It is therefore sensible not to raise the RRR right up to the current or prospective level of the private sector rate of return, in case the latter falls short of what is expected. The proposed increase to 8% is therefore a cautious response to the increase in private sector returns since the RRR was set at 5%.

32. **How can you possibly justify a private sector cost of capital as low as 6%?**

The pre-tax cost of capital to the private sector is a weighted average of the cost of debt and the cost of equity. The real government borrowing rate is about 4% and so the real cost of debt is about 5%. The cost of equity finance for a low risk (beta = 0.8) company is about 7% (see below). Assuming that a low risk company has 40% debt and 60% equity, its average pre-tax cost of capital will be about 6%.

33. There are two alternative ways of estimating the cost of equity finance, as the sum of a risk-free real interest rate and the equity risk premium, or as the sum of the dividend yield and the expected growth of real dividends. The government borrowing rate of 4% is a good approximation of the risk-free interest rate. The equity risk premium for a low-risk company is about 3% (4% for an average-risk company). The figure of 4% for an average-risk company is below the historical average, which is justified by the argument that unanticipated inflations will not recur on the scale of those of the past. The pre-tax dividend yield is about 5½%, and the expected growth of dividends is about 2½%, indicating a cost of equity finance of 8% for an average risk company and 7% for a low risk company. Both measures of the cost of equity finance produce about 7%.