PO-CH/NL/0182 PT A

Alex Lawson

PART A

PO -CH /NL/0182

PART A

CHANCELLOR'S 1988 PAPERS ON THE ECONOMIC PROGRESS REPORT (EPR)

Begins: 8/11/88

Ends: 23/11/88

DD: 25 years

6/9/95

PO -CH /NL/0182 PART A

papers pse (may be on B|F)

From: S D H SARGENT
Date: 8 January 1988

BF 17/2

BF 4/3

BF to Moira 4/2

PS/CHANCELLOR

cc PS/Economic Secretary
Mr Peretz
Mr R I G Allen
Mr Bush
Miss E Edwards

BF 8/3

Alex

Spoke to RIGA, he will speak to Peretz and show us a draft in due course

M.

M3/M4 FIGURES: EPR ARTICLE

The Chancellor asked for Sir Peter Middleton's views on the proposal in Mr R I G Allen's minute of 21 December that there should be a short EPR article in February on the M3/M4 figures. Sir Peter agrees with the Chancellor that such an article should be produced in parallel with the announcement on Budget Day of the new funding rule.

S

S D H SARGENT
Private Secretary

Alex

Deadline 20 March

FROM: SIR T BURNS
DATE: 22 JANUARY 1988

CHANCELLOR

cc Sir P Middleton
Mr Scholar
Mr Culpin
Mr Odling-Smee

CONSERVATIVE ECONOMIC THINKING IN 1951

Recently I came across the attached summary of Conservative economic thinking in 1951. (It is from an internal document written by Alan Holmans in the mid-1960s).

I think you will be amused by his account of doubts "about relying mainly on a large budget surplus to control demand" because of opposition to high taxation - particularly income tax. Instead the proposal was to rely on credit policy to control demand, "both by higher interest rates and a reduction in the volume of lending".

"The general Conservative view can thus be summarised as a disapproval of high tax rates and surplus budgeting as a means of controlling inflation, preferring to rely instead on reductions in the level of Government expenditure and on monetary policy".

T BURNS

DRAFT

CHAPTER I. INTRODUCTION: ECONOMIC POLICIES IN 1952

Before embarking on any detailed analysis of the management of total demand in 1953 and subsequent years, a brief outline of events and policies in 1952 is necessary. Any account of the economic situation in the winter of 1952/53 must make some reference to the developments in 1951 that led up to it; and the way in which the current balance of payments swung back into surplus in 1952 appeared to some observers to justify the confidence that had been placed in the so-called "new monetary policy". Since events in 1952 strengthened the inclination to rely on monetary policy in future years, it is worth considering in some detail what was achieved by monetary policy in 1952, and what it was officially thought at the time to have achieved.

Conservative Views on Economic Policy

A greater reliance on monetary policy, and more particularly on changes in Bank Rate and related short term interest rates, was perhaps the most distinctive feature of Conservative economic policy as compared to the policy of their opponents. Since the Conservative approach to economic policy in post war conditions was worked out while in Opposition it is appropriate to consider here the main strands in Conservative economic thinking as they could be discerned in 1951. For although economic policy is determined far more by the facts of the situation than by party attitudes, the importance of these attitudes is seldom negligible. Examples will be met in the detailed analysis of policy in 1953-58, where Conservative views about the level of taxation and of public expenditure in the aggregate were of special significance.

The Budget Debate of 1951 provides a representative selection of Conservative views; they must be discounted for the tendency, common to all Oppositions, to have things all ways at once, and for the exaggerations that result from the heat of debate; but after making allowance for this a fairly consistent approach to economic policy can be discerned, which differed in important respects from the policy that Sir Stafford Cripps and Mr. Gaitskell had followed. Considerable doubts were expressed about relying mainly on a large budget surplus to control demand; it was considered that the size of the budget was itself an inflationary force in that the taxation needed to offset the high level of expenditure and provide the surplus had secondary effects which were themselves inflationary. High rates of taxation discouraged saving and held down production though adverse effects on incentives, and high rates of ~~tax~~ taxation, both direct and indirect, led to pressure for offsetting wage increases. Instead of relying on high taxation, it was proposed that credit policy should be used to control demand, both by higher interest rates and a reduction in the volume of lending.(1) The general Conservative view can thus be summarised as disapproval of high tax rates and surplus budgeting as a means of controlling inflation, preferring to rely instead on reductions in the level of Government expenditure and on monetary policy. Tax reduction was looked on as a desirable aim of policy in its own right, and not just as a method of regulating the volume of effective demand. This was especially true of the income tax, and created the greatest reluctance to consider increases in it as a means of reducing demand. The combination of policies to which the Conservative views

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(1) H.C. Deb. Vol. 486, especially cols. 1128-9 1133 and 1135-6 (Eccles); 1118-9 (Maudling); 1306 (Assheton); and 1573 (Butler).

pointed was one of reductions in public expenditure wherever possible, accompanied by corresponding reductions in taxation; the use of tax reduction to add to demand when this was needed to maintain a high enough level of employment; and to rely on monetary policy when deflationary measures were required. As will emerge from the detailed description in the following chapters, this is an important part of the story of the management of demand from 1953 to 1958, and the same pattern can be seen in the tax reduction of 1959 and the restrictive monetary measures of 1960.

The role of direct controls, although it was little mentioned in the debate which was referred to above as the source of conservative economic thinking, ~~were~~ was the subject of considerable dispute between the parties. There are grounds for considering that the difference was more one of precept than of practice; but allegations of undue reliance on direct controls and too little use of the market mechanism were an oft-used line of attack by the Conservatives when in Opposition; similarly Labour in Opposition criticised the Government for relying too much on the market mechanism and rejecting direct controls out of political prejudice. In ideological sympathies the parties were far apart, but the differences of practice were small, especially since under the Labour Government, at least until the Korean War and rearmament began to make their impact, the practice was to treat rationing, material allocation schemes and price controls as ad hoc expedients for dealing with temporary shortages, to be withdrawn as soon as the shortages had diminished enough to make this safe.

RC2/50

UNCLASSIFIED

FROM: A C S ALLAN
DATE: 26 January 1988

SIR T BURNS

cc Sir P Middleton
Mr Scholar
Mr Culpin
Mr Odling-Smee

CONSERVATIVE ECONOMIC THINKING IN 1951

The Chancellor was most grateful for your note of 22 January. He thought the summary you attached was very interesting, and a demonstration of how things subsequently deteriorated in the '60s and '70s. Unfortunately, however, the assymmetry of relying on tax reductions to add to demand and monetary policy to reduce it, tended to produce a destabilizing ratchet effect.

ACSA

A C S ALLAN

1135/40

FROM: M NEILSON
DATE: 29 March 1988

FINANCIAL SECRETARY

cc PS/Chancellor
PS/Economic Secretary
PS/Sir P Middleton
Mr Monck
Mr Scholar
Mrs Lomax
Mr Moore
Mr R I G Allen
Mr Ilett
Mr Bent
Miss Simpson
Mr Hall
Mr Hurst
Mr Cropper
Mr Call
Mr MacNichol - Inland Revenue
Miss Dougherty - Inland Revenue

EPR ARTICLE ON SHARE OWNERSHIP SURVEY

I attach a draft article reporting the results of this year's share ownership survey, for publication in the April EPR.

2. We published a similar EPR article with the results of last year's survey in April 1987. This draft has been cleared with the Inland Revenue and IDT.

3. IDT need your approval of the draft by 11 April.

M NEILSON

DRAFT EPR ARTICLE

SHARE OWNERSHIP IN BRITAIN

Share ownership in Britain has continued to rise over the last year despite the worldwide falls in equity prices in October 1987. A detailed survey, sponsored by the Treasury and the Stock Exchange in January and February this years, shows that 9 million people, 20½ per cent of the adult population, now own shares. This compares with 19½ per cent a year ago (since when the British Airways, British Airports Authority and Rolls Royce privatisations have taken place) and an estimated 7 per cent in 1979. This article looks at the survey and analyses its findings.

Main Findings

The survey shows that:-

- 20½ per cent of the adult population held shares at the beginning of 1988, compared with 19½ per cent a year earlier, and about 7 per cent in 1979.

- 13 per cent of all adults, or 6 million people hold shares in privatised companies (15% if the Trustees Savings Bank Group (TSB) is included)

- 6 per cent hold shares only in privatised companies (8% if TSB is included).

- 3 per cent hold shares in the company for which they work.

Share ownership is defined to include all holdings of quoted or unquoted shares, including those held through personal equity plans and employee share schemes. Unit trusts and building society share accounts are explicitly excluded.

Trends

Chart 1 shows the trend in share ownership since 1979. Figures between 1979 and 1985 are taken from regular surveys conducted by Target Group Index, a division of the British Market Research Bureau, and are on a similar definition to that used in the surveys commissioned by the OPCS from NOP in the last 3 years. Evidence from the NOP's Financial Research Survey (FRS), which is based on a narrower definition, probably excluding unquoted shares, and asked in the context of savings, provides evidence on changes in share ownership during 1987. It shows that the crash had little impact, since the level of share ownership immediately before the crash was very much in line with the estimates for both the beginning of 1988 and a year earlier.

Most of the growth in share ownership since 1979 can be attributed to government initiatives

- privatisation of businesses previously state owned.
- favourable tax treatment of employee share schemes.
- introduction of Personal Equity Plans (PEPs).

Privatisation

Privatisation has been the major factor behind the increase in share ownership since 1979. [As can be seen from chart [1], share ownership began to grow substantially with the British Telecom privatisation in 1984 in which [2 million] people bought shares. The BG and TSB flotations in September and November 1985 provided further major boosts attracting (3 million) and (4 1/2 million) shareholders respectively.

The central role of privatisations in extending share ownership can be seen from the fact that **13 per cent of all adults own privatisation shares** (15% if TSB is included). BT, BG, and TSB account for the bulk of the holdings of shares in privatised companies.

The survey shows the overall pattern of privatisation holdings, together with

figures for particular privatisations. The survey tend to produce higher figures for individual privatisations than shown by company registers because the survey includes join share ownership (for example when a single share is owned in the name of a husband and wife), while the register figures are for the number of separate holdings on the register. But both sets of figures show a similar pattern - there has been no noticeable fall in the number of shareholders in the major privatised companies over the last year; on average between $^{2}/_{3}$ and $^{3}/_{4}$ of initial shareholders have retained their shares. Chart 2 shows the size of the share register over time for BT, BG and TSB.

Chart [3] shows the extent to which holdings of privatisation stocks overlap with other equity holdings, such as employee share holdings. Around 40% of shareholders in privatised companies (and TSB) own other shares. About $3\frac{1}{2}$ million people own more than one form of share, with the main overlap - $2\frac{3}{4}$ million - between privatisations and "other" shares (mainly shares traded on the Stock Exchange).

Employee Share Schemes

Growth in the number of employees owning shares in the company for which they work is another major factor behind the rise in share ownership over the past nine years. The survey indicated that about 1½ million people now own such shares.

These figures do not, however, tell the whole story. They do not distinguish between the different ways in which employee shareholdings have been acquired (notably between Inland Revenue approved schemes and other schemes), and they exclude other employee share interests - notably share options. The Inland Revenue estimate that well over 1.5 million employees have benefited under employee share and share option schemes approved for tax relief purposes over the past nine years. When share options granted under approved schemes are taken into account, it is estimated that [between 1½ and 2 million] employees are likely to have held shares or unexercised share options at the time of the survey. This represents some [10] per cent of employment in the corporate sector.

Government policies have actively encouraged employee share ownership. Tax reliefs associated with employee share schemes have now been provided or extended in eight out of the last nine Budgets, including the introduction of two entirely new schemes (the all-employee savings related share option scheme legislation of 1980, and the discretionary share option scheme legislation of 1984). The Government has also encouraged employee share ownership through privatisations, where preferential treatment of applications has led nearly ½ million employees, about 90 per cent of those eligible, to become shareholders.

Personal Equity Plans

In the 1986 Budget the Chancellor announced the introduction of personal equity plans from January 1987. Inland Revenue figures for 1987 plans show that over 266,000 plans were taken out with £466 million invested. Although the exact figures are highly uncertain, because of the small number of PEP holders

interviewed the HMT/Stock Exchange survey suggests that **40 per cent of PEP holders hold no other shares**, and only a quarter hold shares, outside their PEPs, in four or more companies. This implies that PEPs are making a real contribution to both widening and deepening share ownership. In his Budget speech this year the Chancellor announced an increase in the annual PEP limit from £2,400 to £3,000, effective for the 1988 PEP year.

Depth of share ownership

This years survey included, for the first time, a question on the number of different shares held by individuals. This shows that about half of share holders own shares in only one company, while about a fifth own shares in more than four. (see chart 4) Those owning shares in only one company are , in the main, first time shareholders attracted by the privatisation programme. An objective of the Government's wider share ownership strategy is to encourage first time investors to take a continuing interest in the equity market, different of shares.

How Do People Acquire Shares

In addition to asking questions about holdings of privatisation stocks (and TSB), shares held in the company in which people work, and personal equity plans, the survey also asks about how other quoted shares were acquired. Of the 1¾ million people who owned shares other than in privatised companies or the company for which they work over fifty per cent, had acquired shares through new issues, about 40 per cent had bought them 'second hand' through a bank, broker or shareshop. Only around 20 per cent had inherited shares. (about one third of these shareholders have acquired shares through more than one route).

Who owns shares?

The pattern of share ownership across income group, region, class and age is very similar to that found in the 1987 survey. Although share ownership is most concentrated in the professional and managerial classes, where one third

of individuals own shares, two thirds of share owners come from outside these groups. Regionally, share ownership is fairly uniform, with only a slight concentration in the South East where 25% of the adult population owns shares.

Unit Trusts

Unit trust holders are not counted as share holders in the survey totals. But a separate question was asked about unit trusts. This suggests that approximately 2½ million people hold unit trusts - almost 6 per cent of the adult population - of whom around 60 per cent also own shares directly.

International Comparisons

The last few years have seen increases in share ownership in a number of other countries. This has usually been the result of privatisations. Britain is currently second only to the United States in the level of share ownership.

- In the United States a quarter of the adult population (about 47 million people) own shares or mutual funds.
- In France, around 14% of the adult population, or 6 million people, own shares directly and 9½ million own shares or mutual funds.
- In Japan 8½ million people, or 9% of the adult population, hold either shares or mutual funds.
- 4½ million Germans, or 9% of the adult population, own shares or mutual funds.

Some of these figures include mutual funds, equivalent to unit trusts in the UK. The comparable figure for share and unit trust holders in Great Britain is 23% or 10 million adults.

This looks like 21% of the adult pop^n: astonishingly large — is it right?

BOX

SHARE OWNERSHIP SURVEY

The Treasury/Stock Exchange survey of share ownership was commissioned by the Office of Population Censuses and Surveys and carried out by National Opinion Poll Market Research Ltd. between 20 January and 15 February 1988. A total of 7,248 interviews were conducted with adults aged 16 and above, who were selected according to a systematic probability sample designed to be representative of all adults in Great Britain. Respondents were asked to include shares held jointly with others.

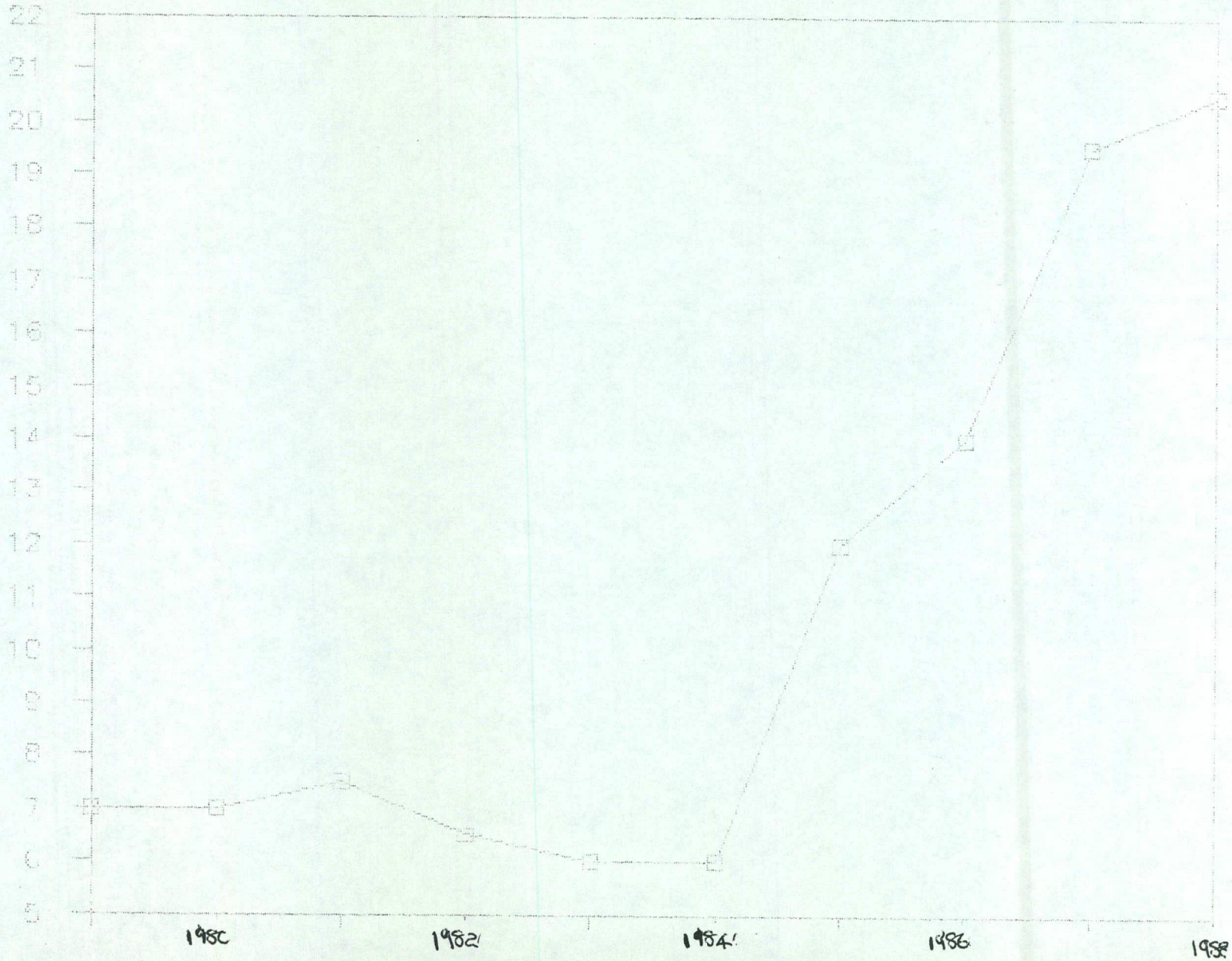
The results of a similar survey carried out in January/February last year were set out in the EPR for March/April 1987 (No.189)

All survey estimates are subject to a margin of error, depending mainly on the size and construction of the sample. In the Treasury/Stock Exchange survey the possible margin of error is around 1 percentage point either way. This applies both to the figure for total shareholders and to figures for groups within that total.

Copies of the Survey are available from HM Treasury Committee Section (tel: 270-4558), price £20. They are also available from the Stock Exchange.

CHART 1

SHARE OWNERSHIP %



CHANGES IN SHARE REGISTERS OF BT, BG AND TSB CHART 2.

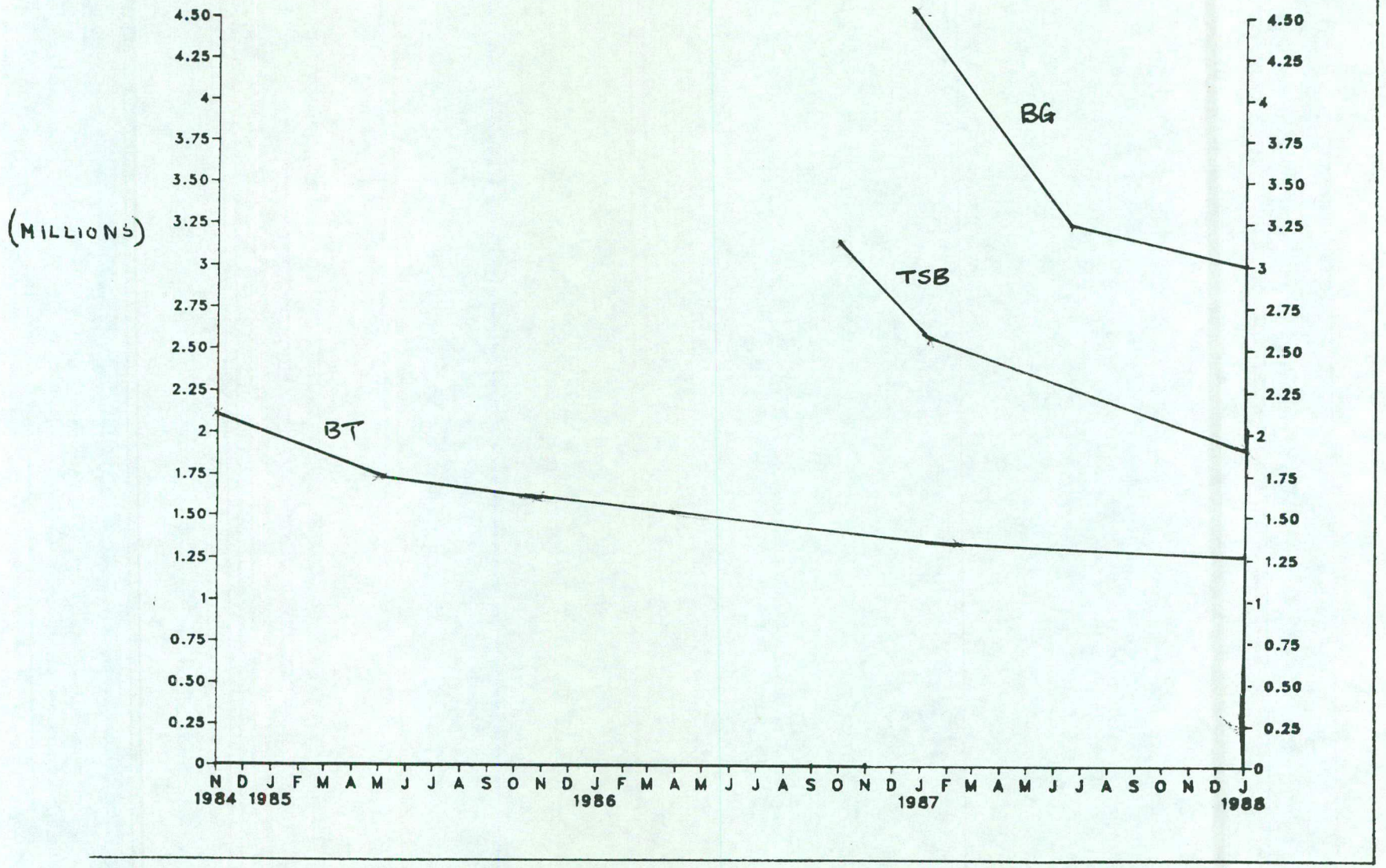
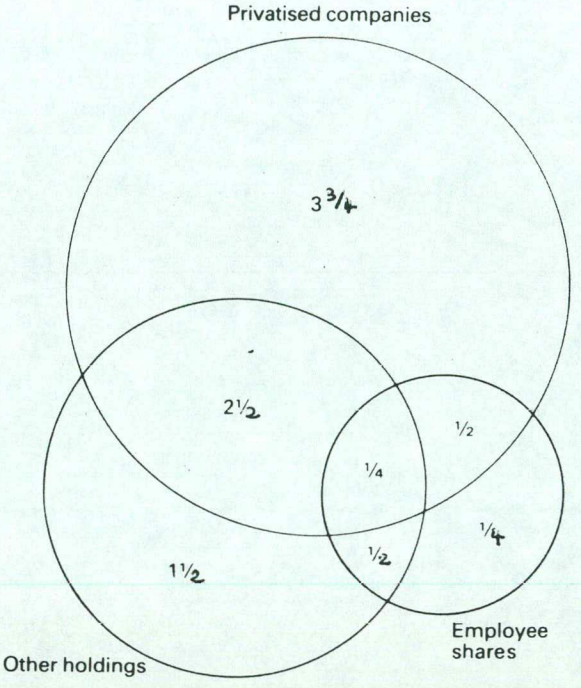


Chart 3 *Millions*

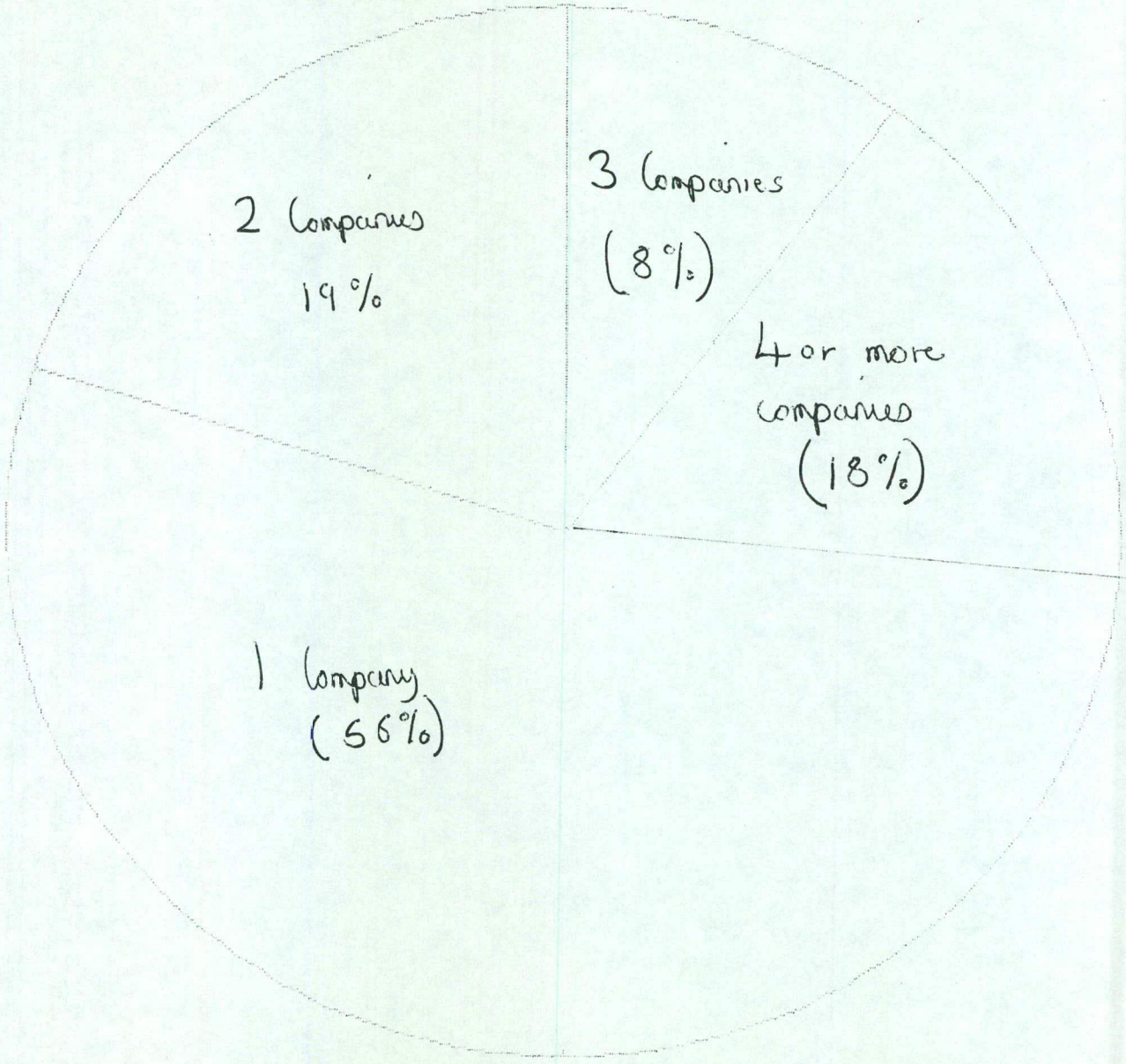
Composition of total shareholding



Note: Total shareholding in each category = total of figures within the relevant circle. Where the circles overlap this indicates the number of individuals holding shares in two, or all three, categories. The overlapping segments are not to scale.

Chart 4

NUMBER OF COMPANIES IN WHICH SHARES HELD (EXCLUDING PEPs)



FROM: ELEANOR EDWARDS
DATE: 30 MARCH 1988

BF to ACSA 8/4

1. MR ALLEN
2. ECONOMIC SECRETARY

I assume Ch read this, even if we didn't!

cc PS/Chancellor
PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Mrs Lomax
Mr Peretz
Mr Odling-Smee
Miss Noble
Miss O'Mara
Mr Pickford
Mr Bush
Mr. Cropper
Mr. Tyrie
Mr. Call

ECONOMIC PROGRESS REPORT - BROAD MONEY ARTICLE

I attach a draft for an article in the next EPR, on the relationships between broad money and inflation. This is the piece originally suggested by Mr Allen some time ago, with the aim of steering commentators and others towards M4 rather than M3 when considering monetary matters.

2. The draft has been cleared in the Treasury, but there may be some comments to come from the Bank.

3. I understand that the draft article on the results of the most recent Treasury/Stock Exchange share ownership survey was put up to Ministers last night.

4. The above two articles are the main ones for the next issue. There remain a couple of shorter pieces for use if space allows - a factual piece on independent taxation, and a note on policy evaluation to mark the publication of the Treasury's new guide to the subject. These will be submitted to Ministers next week.

5. This issue is due to be published on 20 April, with copy going to the printers on 12 April.

ELEANOR EDWARDS

140/25

DRAFT

BROAD MONEY AND INFLATION

The operation of monetary policy, which is central to the control of inflation, requires a continuous and comprehensive assessment of factors influencing monetary conditions such as the exchange rate, narrow and broad money, and other indicators of inflationary pressure such as house prices. The main measures of 'narrow' and 'broad' money currently in use are defined in the box. These measures are adapted as necessary to meet changing circumstances. Narrow money is a good indicator of monetary conditions and a target is set for it, but the wider aggregates are also important. However, broad money - or liquidity - is particularly difficult to interpret in a period of rapid change in financial markets. This article looks at the part played by the growth of broad money in affecting inflationary pressures in the economy. It also explains the relationship with funding policy.

Monetary Policy

The medium term financial strategy (MTFS) sets out a framework within which the Government operates its monetary policy. It is restated each Budget day. The latest version*, published on 15 March, sets a target for narrow money (MO) and describes policy towards the exchange rate. It explains that while there is now no target for broad money, its growth continues to be taken into account in setting interest rates. It also states that it is now sensible to concentrate on measures of broad money that include deposits held with both banks and building societies, such as M4.

Measuring broad money

The measurement of liquidity needs to take account of institutional developments, since assets may become either more or less liquid (more or less likely to be used for spending) as a result of

/ such changes.

* Financial Statement and Budget Report 1988-89 HMSO £7.20

This was recognised in the consultative Green Paper: "Monetary Control" (Cmnd 7858, March 1980). While concentrating on £M3 (now M3) as the key broad monetary aggregate at that time, it went on to say: "This is not to deny that the definition may need to be adjusted from time to time as circumstances change, nor that it will remain the most appropriate aggregate in the face of long term changes in the institutional structure."

Building Societies and Banks

The distinction between building societies and banks has become increasingly blurred, as the societies have taken to providing a range of services formerly the province mainly of banks, and banks have themselves made inroads into the housing mortgage market.

Building Society deposits, formerly regarded mainly as a safe home for savings, are increasingly used as transactions balances. Instant access accounts, cheque book facilities, cheque guarantee cards, and cash point facilities linked to building society accounts have encouraged the trend. At the same time, banks have greatly expanded their mortgage lending. So banks and building societies now compete closely in the same markets both as lenders and deposit takers.

The 1986 Building Societies Act has allowed societies much greater freedom to extend their business beyond lending for housing purposes. They are, for example, now allowed to grant unsecured lending of up to £5000 per applicant, shortly to be raised to £10,000, and to issue credit cards in their own names. And it is now possible for societies to seek incorporation and thus become subject to the same regulation as banks. The Abbey National has recently announced that it proposes to take that route.

Changes in building societies' assets have affected the growth of some measures of broad money. Traditionally, societies have tended to hold their liquid assets in short dated public sector

debt (including gilt-edged securities and local authority debt). But in the last few years they have shifted to holding a greater proportion in the form of bank deposits, possibly because of a change in 1984 to less favourable tax treatment for their holdings of public debt. Between 1985 and 1987 they increased their cash and bank deposits by over £10 billion, but reduced their holdings of public debt by over £4 billion in the same period.

These developments make it sensible to concentrate on measures of broad money - like M4 - which include liabilities of both banks and building societies rather than on measures like M3 which cover only those of banks. Chart 1 compares the growth rates of M3 and M4. In the last few years M4 has been both less volatile than M3 and grown consistently more slowly, reflecting two principal factors:

- building societies' own holdings of bank deposits have grown rapidly because of the change (noted above), in the way they hold their liquidity;

- the banks have competed vigorously for market share, for example with high interest accounts, halting earlier gains made by building societies.

Neither changes in the way building societies hold their liquidity nor variations in bank/building society market share, have any great significance for the economy at large. But they do affect the growth rate of M3. Broader measures, like M4, are not influenced by such factors.

Liquidity and inflation

Chart 1 shows that, with or without building society liabilities, broad money has grown more rapidly than money GDP, which measures the level of activity in the economy in money terms. This raises two related questions: why, if the Government is committed to defeating inflation, has it allowed such apparently rapid growth

in liquidity; and why, given that liquidity has grown quickly, has inflation not re-emerged.

The degree of inflationary pressure does not depend on how fast liquidity is growing but rather on whether its level exceeds the amount that the private sector wishes to hold as such. If people acquire an "excess" of liquidity (which they do not wish to hold as savings), they will spend it on goods and services. The additional demand may produce inflationary pressure.

So the Government aims to keep the growth of liquidity in line with what people wish to hold.

One way to look at this is in terms of savings and spending money. The low rates of inflation reached in the 1980s, together with increased competition between financial institutions following the Government's deregulation of financial markets, have meant that rates of return on savings have been well above the rate of inflation. As a result it has become worthwhile for people to hold some of their savings in a more liquid form (for example in high interest, instant access accounts). Liquidity has grown fast. But as long as it is not spent, it cannot cause inflation. Recent growth in liquidity must be seen in the wider context of rapid growth in the ownership of financial assets generally. Since 1980, the gross financial wealth of the non-bank private sector has increased by around 17 to 18 per cent a year on average. Both M3 and M4 have grown by appreciably less than this - in each case by an average of some 14 per cent a year.

Funding Policy

The importance of keeping liquidity in check is central to the Government's funding policy - in other words the way that it finances borrowing. Governments can cover expenditure by printing money. That would clearly be inflationary. The present Government avoid borrowing in a way which expands liquidity and so generates inflation.

Since April 1986 the aim has been, over each financial year as a whole, to finance the maturing public debt, the PSBR and any

underlying change in the foreign exchange reserves, by sales of public sector debt outside the banking sector. Provided that the liabilities of the banks correspond broadly with the quantity of liquidity in the economy this will not cause inflation. But the liabilities of building societies have become an equally important component of liquidity. That is why in future the intention is to fund public borrowing over each financial year outside the bank and building society sectors, treating the two sets of institutions, in this respect, on the same footing.

It would not be sensible to try to do this month by month, regardless of market conditions. When exchange market intervention adds to (or subtracts from) sterling liquidity this may reflect a temporary increase (or fall) in overseas demand for liquid sterling assets. In that case it may not be appropriate to remove the liquidity by funding it entirely within the course of a single financial year.

Chart 1

M3 M4 AND MONEY GDP

ANNUAL PERCENTAGE GROWTH

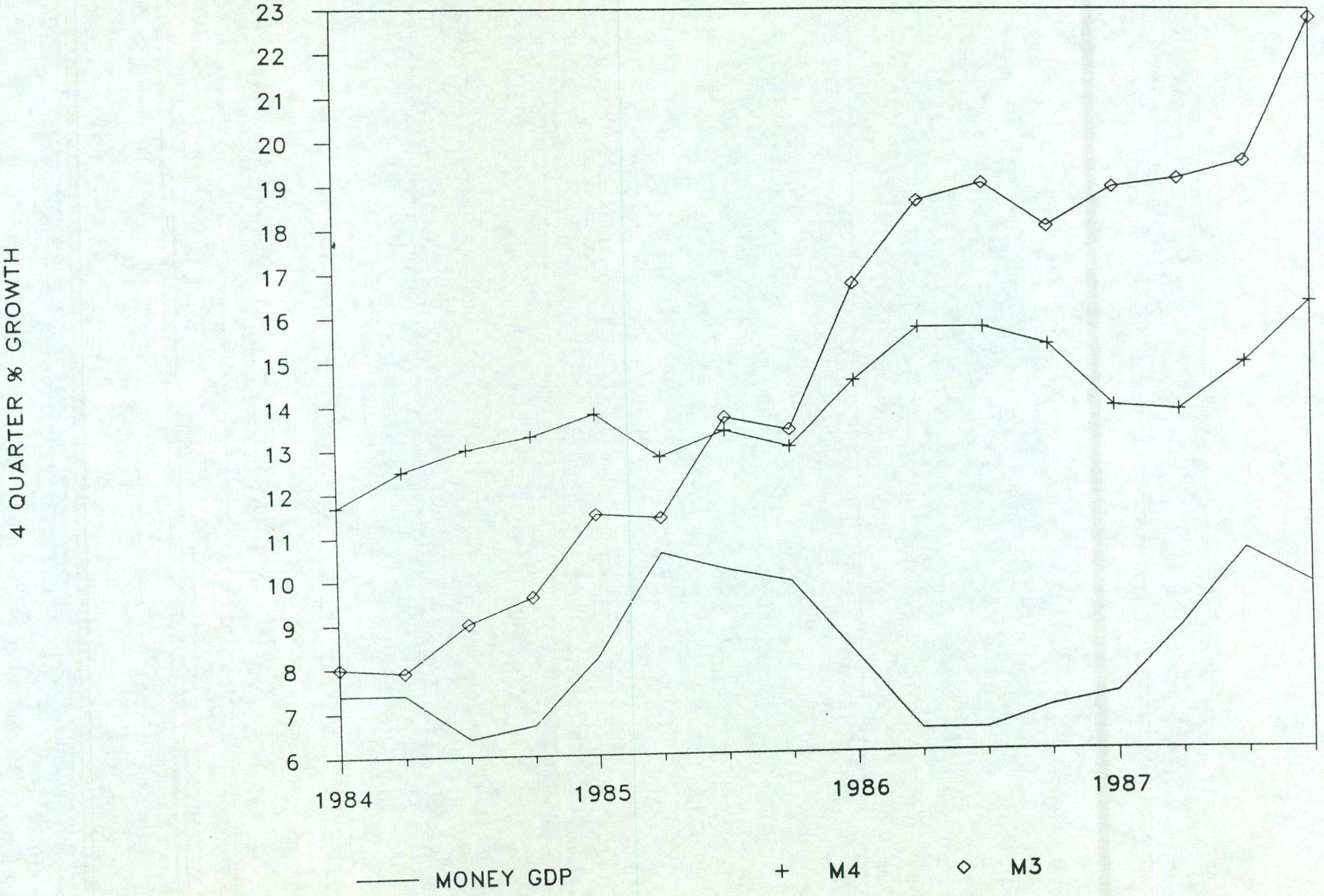


Chart 2

BANK AND BUILDING SOCIETY LENDING

ANNUAL PERCENTAGE GROWTH

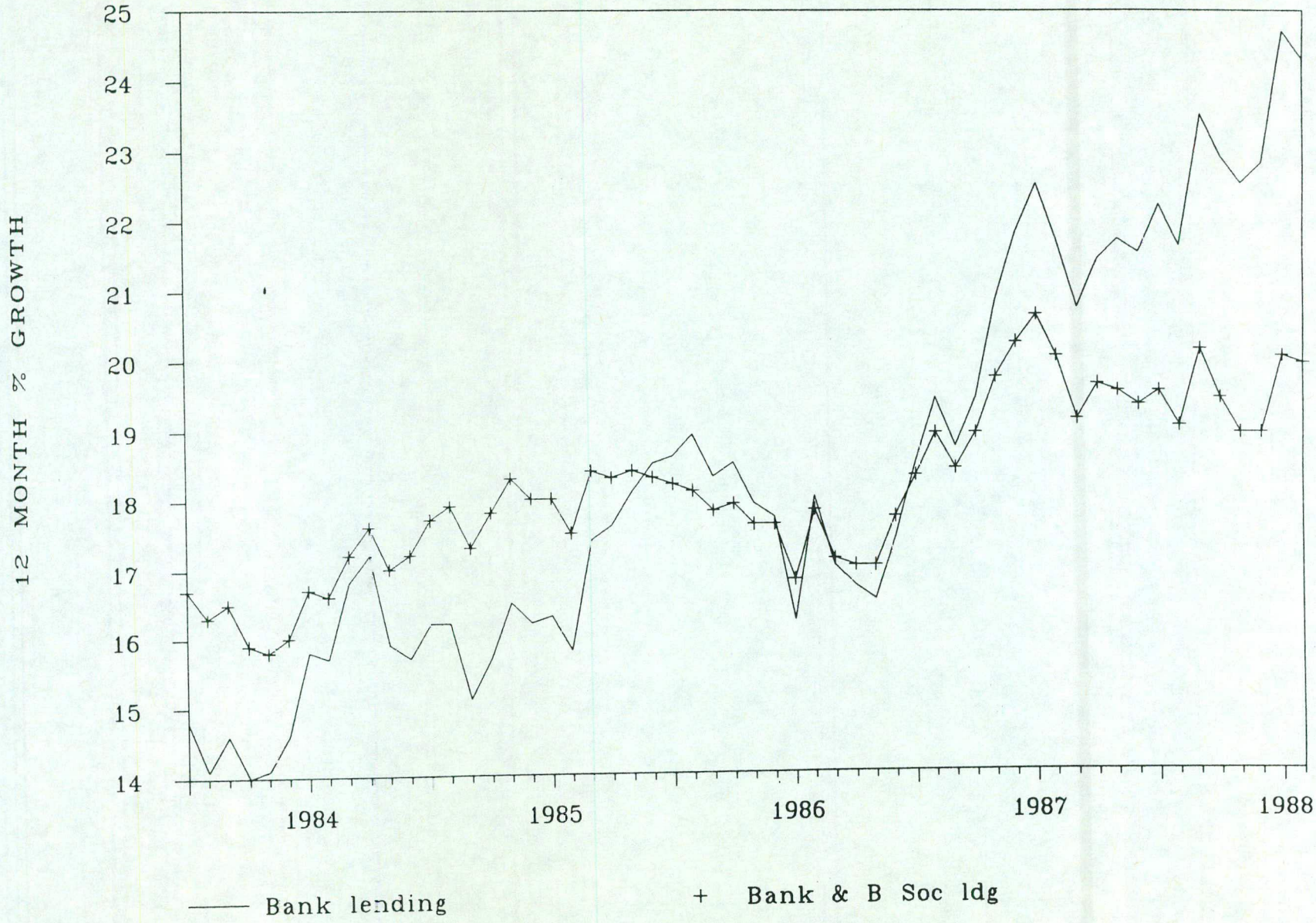


Table.

SHARE OF MORTGAGE LENDING

Percentage Share of Stock End year	Building Societies	Banks	Others
1979	82.2	5.3	12.5
1980	81.7	5.7	12.6
1981	79.1	9.2	11.8
1982	75.0	14.1	10.9
1983	74.5	16.2	9.3
1984	76.2	15.6	8.2
1985	76.5	16.5	7.0
1986	75.6	16.8	7.6
1987*	71.9	19.4	8.6

Box

Main

Monetary aggregates — definitions

Narrow money

'Narrow money' refers to money balances which are readily available to finance current spending, that is to say for 'transactions purposes'.

M0

Notes and coin in circulation with the public
plus banks' till money
plus banks' operational balances with the Bank of England

Broad money

'Broad money' refers to money held for transactions purposes and money held as a form of saving. It provides an indicator of the private sector's holdings of relatively liquid assets — assets which could be converted with relative ease and without capital loss into spending on goods and services.

M3

Notes and coin in circulation with the public
plus private sector sterling sight bank deposits
plus private sector sterling time bank deposits
plus private sector holdings of sterling bank certificates of deposit

M4

M3
plus private sector holdings of building society shares and deposits and sterling certificates of deposit
minus building society holdings of bank deposits and bank certificates of deposit, and notes and coin

M5

M4
plus holdings by the private sector (excluding building societies) of money market instruments (bank bills, Treasury bills, local authority deposits), certificates of tax deposit and national savings instruments (excluding certificates, SAYE and other long-term deposits)

1734/46/sm/94/2

FROM: ELEANOR EDWARDS
DATE: 7 APRIL 1988

1. MR BUSH

2. FINANCIAL SECRETARY

cc PS/Chancellor
PS/Chief Secretary
PS/Economic Secretary
PS/Paymaster General
Mr Culpin
Mr Allen o/r
Mr Pickford
Mr St Clair
Miss Sinclair
Mr Anderson
Mr Cropper
Mr Tyrie
Mr Call

Mr B Mace - IR

ECONOMIC PROGRESS REPORT - APRIL ISSUE

Drafts for the main articles for this issue were put up to Ministers, attached to my minute of 30 March. I now attach copies of cleared drafts for two more pieces for probable use in this issue.

2. A fair deal for the married gives a straightforward explanation of independent taxation and what it will mean for taxpayers, especially the advantages it will have for the elderly.

3. Policy evaluation marks the publication of the Treasury's new guide, due to be published on 12 April.

4. Also attached is a box announcing the availability of Mr Bredenkamp's working paper, Macro-economic Effects of Changes in Fiscal and Monetary Policy.

5. Copy for this issue goes to the printer on Tuesday, 12 April. Approval of the drafts is therefore requested by Monday, 11 April.

ELEANOR EDWARDS

35/3 jf.4.29.3

DRAFT

A FAIR DEAL FOR THE MARRIED

In his Budget, ~~announced~~ on 15 March, the Chancellor proposed a major change in the UK's personal tax system. Independent taxation for husbands and wives is to be introduced in April 1990, the earliest practicable date. Other reforms removing the tax penalties on marriage will come into effect before then (see box). This note explains the changes.

For the first time ever married women will have complete privacy and independence in their tax affairs; no longer will their incomes be regarded for tax purposes as belonging to their husbands. The elderly will benefit especially. Over half of the 1.6 million wives who will pay less tax as a result of the change will be elderly. Altogether over 2 million people are expected to pay less tax, and some will be taken out of the tax system altogether.

The change to independent taxation will cost £1 billion in 1990-91, and three quarters of this will go to those who will be basic rate or non-taxpayers after the reform.

The present system

Under the present system, which goes back to 1805, a married woman's income is treated as her husband's. Husband and wife are treated as one taxpayer. They share a single basic rate band and the married woman has no personal allowance of her own. The present wife's earned income allowance is available only against

her earnings; it cannot be set against her income from savings. These features sometimes result in married couples paying more tax than two single people with the same incomes.

The husband is legally responsible for the couple's tax affairs and for paying any income tax due on their combined income. He has to include his wife's income on any tax return he is asked to complete.

Over the years special provisions have been introduced, including separate assessment and the wife's earnings election, to mitigate the effects of the present system. But neither of these has altered the basic rule that a married woman's income is treated as her husband's for tax purposes.

Separate assessment, introduced in 1914, does not affect the total amount of tax paid. The couple's incomes from all sources are added together to work out their tax bill, which is then divided up roughly in proportion to their incomes, with each paying their own share. Either husband or wife may opt for this arrangement.

The **wife's earnings election,** introduced in 1971, can reduce a couple's tax bill, and both husband and wife must elect jointly for this option. They are taxed as single people as far as earnings are concerned and the husband loses the married man's allowance. This is only worthwhile if the combined incomes are enough to attract a higher tax rate and the lower of the two

incomes is above a certain level. Any investment income of the wife continues to be taxed at the husband's highest rate.

The new system

A new structure of income tax personal allowances will provide:

- a full personal allowance for married women;
- a new married couple's allowance;
- a higher allowance for elderly wives.

Starting with the financial year 1990-91, everyone, single or married, will have the same personal allowance, to be set against all income, from whatever source. Each individual will be responsible for his or her own tax affairs, and will sign his or her own tax return. Any tax repayment or communication from the Inland Revenue (IR) concerning a wife's income will go straight to the wife, not the husband.

Only a minority of taxpayers are in practice required to make a tax return in any one year, and this will continue.

The present and future structures of personal tax allowances are compared in table 1 (as at 1988-89 allowances). Table 2 shows how the new system will work.

New married couple's allowance

This new allowance , equivalent to the difference between the single and married man's allowances in the current system, will go to the husband in the first instance. But if his income is not large enough to make full use of it, he will be able to transfer the unused part of it to his wife. This means that the married man will suffer no reduction in his tax threshold on the change.

Age allowance

As now, elderly people (65 and over) will be entitled to higher levels of allowance if their incomes do not exceed the age allowance income limit (£10,600 for 1988-89). But for the first time elderly married women will be able to get the higher age-related allowances in their own right (instead of the wife's earned income allowance as at present).

All elderly people, whether single or married, will qualify for a personal allowance on the basis of their own age. Elderly married women will be able to set this allowance against any income - including any National Insurance retirement pension they receive on the basis of their husband's contributions. (At present such pensions are taxed as the husband's income and the wife's earned income allowance cannot be set against them, though it can be set against a pension a wife receives by virtue of her own contributions).

The rate of married couple's allowance will depend on the age of the older partner in the couple. So if, for example, a husband is

under 65 but his wife is over 65 but under 80 he will be entitled to married couple's allowance of £1,855. As for younger couples the married couple's allowance can be transferred to the wife if the husband has insufficient income to use it.

The age allowance (the personal and married couple's allowances for elderly people) will, as now, be subject to an income limit. Husband and wife will , however, each have their own income limit, £10,600 at 1988-89 levels, which will apply separately to their incomes.

Capital gains tax

At present a married couple's capital gains are added together and taxed as the husband's. And the couple have one annual exemption limit between them (£5,000 in 1988-89). Under the new system each will be taxed independently, and each will have an annual exemption limit. ~~One result is that the losses of one can no longer be set against the gains of the other.~~ But transfer of assets within a marriage will be unaffected - as now, no tax will be payable. Similarly transfers between husband and wife will continue to be exempt from Inheritance tax.

Jointly held assets

Husband and wife will normally each be taxed on half of any income for jointly held assets, such as a building society or bank joint account. If they are not entitled to an asset in equal shares they may make a declaration to the tax office specifying their actual entitlement. Any income will be taxed on the basis of their respective shares.

Who benefits most?

When Independent Taxation starts in 1990-91 many married women, and some married men, will find there is less tax to pay on their incomes.

The following estimates give an idea of what will happen. About 1.6 million wives will have less tax charged on their incomes, because they will have their own personal allowances and their incomes will no longer be taxed as if they belonged to their husbands. The average reduction will be about £300 a year. About 1.2 million of these wives will have incomes of less than £5,000 a year and 700,000 of them will be elderly. The average tax reduction for these wives will be over £200 a year but the size of the reduction will be less if the wife has only a small amount of investment income or a small pension.

About 500,000 husbands will gain directly. Some 350,000 husbands in couples previously making the wife's earnings election will pay between £400 and £650 less tax as they will be able to claim the married couple's allowance. Also an additional 130,000 elderly husbands will be able to claim age allowance. Under the present system, these husbands are unable to claim because the couple's combined income is above the income limit.

Overall, over 2 million individuals will find there is less tax to pay on their incomes. About 70 per cent of these have incomes of less than £10,000 a year.

Should say somewhere that nobody loses.

Yes, it will need to explain v. simply transitional protection for those who would otherwise lose in this context.

The changeover

Independent taxation will be a major change, for both the 11 million married couples paying tax, and the Inland Revenue itself. The necessary legislation will be included in this year's Finance Bill, so everyone concerned will have time to become familiar with the new arrangements well in advance. But taxpayers themselves do not need to take any action yet. 1989-90 will be the last year for which the present rules will apply. During that year the IR will be asking for information from some taxpayers, as they create new records for married women, and transfer information about wives from their husbands' tax records.

Further announcements about the transition will be made later on, as they become necessary.

BOX

Other tax penalties removed

By 1990-91 all tax penalties on marriage will have been abolished. Apart from independent taxation, the two main changes concern mortgage interest relief, and the additional personal allowance.

At present an unmarried couple taking out a mortgage on a home can get relief on the interest payments on loans up to £30,000 each. For new mortgages, taken out from 1 August 1988, the limit will apply to the property, and married and unmarried couples will be in the same position.

The additional personal allowance is provided for single parents bringing up children. At present unmarried couples living together with two or more children can each claim this allowance, which means they do better for allowances than a married couple. From April 1989 an unmarried couple living together can get only one additional personal allowance.

Table 1.

Main allowances

	Present System		Independent Taxation	
(a)	Single/wife's earned income allowance	£2,605	Personal allowance (Age under 65)	£2,605
(b)	Single age allowance (Age 65-79)	£3,180	Personal allowance (Age 65-79)	£3,180
(c)	Single age allowance (Age 80 and over)	£3,310	Personal allowance (Age 80 and over)	£3,310
(d)	Married man's allowance	£4,095 (a)+(d)	Married couple's allowance (Age under 65)	£1,490
(e)	Married age allowance (Age 65-79)	£5,035 (b)+(e)	Married couple's allowance (Age 65-79)	£1,855
(f)	Married age allowance (Age 80 and over)	£5,205 (c)+(f)	Married couple's allowance (Age 80 and over)	£1,895

Table 2

How the new system will work

This example shows the tax bill, under the present system and under Independent Taxation, for a couple where the husband earns £10,000; the wife earns £2,000 from a part-time job and has £500 investment income. Tax rates and allowances are shown at 1988–89 levels.

Present system

Husband	£
Own earnings	10 000
Wife's earnings	2 000
Wife's investment income	500
Total income	12 500
less married man's allowance	4 095
less wife's earned income allowance	2 000*
so pays tax at 25% on	6 405
so tax bill is	1 601·25

Wife

Wife's income is taxed as husband's

New system: Independent Taxation

Husband	£
Earnings	10 000
less personal allowance	2 605
less married couple's allowance	1 490
so pays tax at 25% on	5 905
so tax bill is	1 476·25

Wife

Earnings	2 000
Investment income	500
less personal allowance	2 605
so tax bill is	0

Under Independent Taxation, the wife will pay no tax on her income at all, whereas previously her husband had to pay on her £500 investment income.

*Rest of allowance cannot be used.

EPR DRAFT

POLICY EVALUATION

1. On 12 April the Treasury published Policy Evaluation: a Guide to Managers.* The guide makes available to a wider readership lessons learned within government departments, and marks a further step in improving management in the civil service. This note sets the guide in context, and explains what 'evaluation' involves.

2. As with other management changes in the civil service the main responsibility lies with Departments. But the Government's initiative to further policy evaluation processes has been coordinated by the Treasury/Cabinet Office Joint Management Unit, now part of the Financial Management Group in the Treasury.

What is it?

3. Policy evaluation is the examination of a policy (or a programme or project), while it is in progress or following completion, to measure its success or otherwise in meeting its objectives.

The FMI

4. Policy evaluation has been playing an increasingly important role within the Government's financial management initiative (FMI), and the drive to get better value for money and sharpen civil service management and accountability generally. The FMI was launched by the Prime Minister in 1982, to improve allocation, use and control of government resources, through better management practice (see Economic Progress Report, October 1983).

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* Obtainable from HMSO, £2.50. ISBN 011 560015 9

An important management tool

5. Evaluation can be seen as the final stage in a process which begins with the initial appraisal of a new policy, to see whether it is likely to be worthwhile, to set objectives, and to consider the different ways in which it could be carried out. It looks at what has actually happened compared with what was envisaged, whether and how far objectives have been met, and helps managers to assess whether a different policy might have done better.

6. There is nothing new about evaluation as a management tool, and many departments already have well-used evaluation systems. However it is being given more emphasis as good methods, based on work which has been done in Departments are diffused throughout government. Policy evaluation has now to be built into all new government policy initiatives right from the start. All policy proposals must now state what is to be achieved, by what date, at what cost, and how the achievement is to be evaluated. Evaluation is playing an increasingly important part in the annual public expenditure survey and the preparation of the public expenditure White Papers. It is being introduced, or is already in use, in many other countries besides our own, in Europe, North America and elsewhere.

What does it achieve?

7. Evaluation helps management to learn from experience and so improve the way Departments implement policy. Even small improvements, given the scale and range of government activities, can have a large cumulative effect. A commitment to assess results concentrates minds at the start on underlying assumptions and on objectives and how they can be met, and keeps up the pressure for value for money as long as the policy is in force.

8. The Government believe that a good start has been made, and that the new guide will help to maintain momentum.

BCX

New Treasury Working Paper

A new Treasury Working Paper, No.51, Macroeconomic Effects of Changes in Fiscal and Monetary Policy, by Hugh Bredenkamp, is now available . It is No.100 in the Government Economic Service series.

The paper discusses the issues involved in applying model simulation techniques to the analysis of macro-economic policy. It illustrates its points by reference to a wide range of simulations on the Treasury model, covering different policy regimes and alternatives to the standard rational expectations assumption.

Orders, together with cheques, or money/postal orders to cover the handling charge of £1 per copy, made payable to H M Treasury, should be sent to Committee Section, H M Treasury, Parliament Street, London SW1P 3AG.

RJ8.18

UNCLASSIFIED

FROM: J M G TAYLOR
DATE: 8 April 1988

PS/FINANCIAL SECRETARY

cc PS/Economic Secretary
PS/Sir P Middleton
Mr Monck
Mr Scholar
Mrs Lomax
Mr Moore
Mr R I G Allen
Mr Ilett
Mr Bent
Mr Neilson
Miss Simpson
Mr Hall
Mr Hurst
Mr Cropper
Mr Call
Mr MacNichol - IR
Miss Dougherty - IR

EPR ARTICLE ON SHARE OWNERSHIP SURVEY

The Chancellor has seen Mr Neilson's minute of 29 March, and the enclosed draft EPR article.

2. The Chancellor had only one comment on the article. This was that, under the heading "International Comparisons", the indent on France should give the proportion of the adult population (c. 21 per cent) who own shares or mutual funds.

J M G TAYLOR

ps4/7H

UNCLASSIFIED

FROM: A P HUDSON
DATE: 11 ~~February~~ April 1988

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Economic Secretary
PS/Paymaster General
Mr Culpin
Mr R I G Allen
Mr Pickford
Mr St Clair
Miss Sinclair
Mr Bush
Mr Anderson
Mr Cropper
Mr Tyrie
Mr Call
Mr Mace - IR
Eleanor Edwards.

ECONOMIC PROGRESS REPORT: APRIL ISSUE

The Chancellor had the following comments on the draft article on Independent Taxation for the April EPR.

The article should open "In his Budget, on 15 March, the Chancellor proposed ...".

Page 1, second paragraph: "out" instead of "put".

Page 3, the second paragraph should begin: "Starting in the 1990-91 tax year,".

Page 5, second paragraph: delete "One result is ... But".

Page 6: the sub-heading should simply be "Who benefits?". This section should make the point that hardly any couple lose out from the changes, and will need to explain very briefly the transitional protection envisaged in breadwinner wives in this context.

2. The article should also make the point that income splitting will work only if there is an irrevocable transfer of assets.

3. The Chancellor was content with the rest of the material.

A P HUDSON

3633/10

FROM: P J CROPPER
DATE: 27 June 1988

CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Monck
Mr Scholar
Mr Burgner
Mr Culpin
Mr Gieve
Mr Tyrie
Mr Call

STEADY GROWTH - EPR

The argument for steady growth, set out in the June EPR, has direct relevance to Rowntree and Cadbury. The first paragraph of the EPR article says:

> "The benefits of higher economic growth are clear. But the advantages of steady growth are equally important. Small fluctuations in the pace of expansion are unavoidable, and businesses are generally able to cope, for example by adjusting their stock levels. But if an economy swings frequently from periods of slack or falling activity to bursts of strong growth, it becomes very difficult for businesses to operate efficiently. Uncertainty about the future can, in particular, deter investment."

2. Control of Rowntree has left this country because, over decades, the company has grossly underinvested. Possessed of those splendid trade names, it has not expanded its productive capacity, world-wide, on anything like the scale it might have done. Why? Because British industry has, until just recently, not had the confidence to invest. Malign political interference has always been just round the corner.

3. I remember at a Business Economists conference in about 1967, asking Adrian Cadbury why, with wonderful brand names and the world at its feet, Cadbury's were not investing on a massive scale. He gave me a black look, as if to say "Would you risk your family fortune by borrowing to invest in a British-based company at this time?"

4. We might make more of the fact that the loss of Rowntree, and the potential loss of Cadbury, can be traced back directly to the way the British economy was run - continuously - from about 1958 until 1979.

P J CROPPER

ps2/64M

UNCLASSIFIED

FROM: MISS M P WALLACE
DATE: 29 June 1988

MR CROPPER

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Monck
Mr Scholar
Mrs Butler
Mr McIntyre
Miss Noble
Mr Parsonage
Mr Richardson
Mr Bolt
Mrs Pugh
Mr Cropper
Mr Tyrie
Mr Call

EPR ARTICLE ON STEADY GROWTH:
ROWNTREE, CADBURY'S, AND UNDER-INVESTMENT

The Chancellor was grateful for your note of 27 June. He agrees that this is a good point.

MOIRA WALLACE

FROM: ROSIE CHADWICK
DATE: 4 July 1988

PS/CHANCELLOR OF THE EXCHEQUER

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Monck
Mr Scholar
Mr Burgner
Mr Culpin
Mr Gieve
Mr Cropper
Mr Tyrie
Mr Call

Right. It all comes down to management. Ours was lousy - now generally v. much better.

STEADY GROWTH - EPR

The Paymaster General has seen Mr Cropper's minute of 27 June.

There is, he suspects another discussion which must not be shuffled under the carpet by Mr Cropper's very rational alibi, and that is a lack of vision. There were periods when individual UK manufacturers (eg Land Rover) had the world as their oyster and failed to make it their oyster bed. Unavailability of product encouraged others in.

The old PIB report in 1968 on motorcycles is a seminal document. Volume inhibited R&D, whereas expanding Japanese volume fed R&D (and thus then destroyed us).

To borrow from Mr Cropper's example, old Forrest Mars built the Mars Company (which the Paymaster thinks is still private) on the basis of "get the product right, then volume solves everything". Sadly, the Paymaster supposes the preferential Commonwealth market rendered less urgent the pre-emptive strike, whereas for the Japanese all markets were equally strange, so they went for the lot.

REC

ROSIE CHADWICK
Assistant Private Secretary

NH6/30M

UNCLASSIFIED

FROM: MISS M P WALLACE
DATE: 5 July 1988

APS/PAYMASTER GENERAL

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Monck
Mr Scholar
Mr Burgner
Mr Culpin
Mr Gieve
Mr Cropper
Mr Tyrie
Mr Call

STEADY GROWTH - EPR

The Chancellor has seen your minute of 4 July. He agrees with the points the Paymaster makes, and has commented that everything comes down to management: ours was generally poor, but now is very much better.

MPW.

MOIRA WALLACE

FROM ELEANOR EDWARDS

4 October 1988

1. MR. GIEVE JC

2. CHANCELLOR

cc Economic Secretary
Sir T. Burns
Mr. H.P. Evans
Mr. Mountfield
Mr. R.I.G. Allen
Mr. Bottrill
Mr. Bush
Mr. Hudson
Mrs. Thomson
Ms. Symes
Mr. Parkinson

C. Content with text on tax harmonisation in minute/SSA box (I have amended a bit), a selection from main speech? as amended by Jonathan

EPR - OCTOBER ISSUE

OK as amended by you. [illegible]

You asked (Mr. Hudson's minute of 3 October) for a box to be included in the October issue on the successful completion of your initiative on sub-Saharan debt. I attach a draft, contributed by Mr. Mountfield, who points out that it might also be possible to leave it till the next issue and do a longer piece then about one or two real cases. You may prefer us to do both.

No

Yes, why not? The Berlin agreement is news now.

2. I also attach a draft containing quotes from your IMF speech of 28 September, concerning current account imbalances, which could also be included in the October issue.

3. You asked for a paragraph to be prepared for you and the Economic Secretary to see, expanding the reference to proposed tax harmonisation. Mr. Parkinson has suggested the following, which has been cleared with other officials concerned. I give the whole paragraph with the new matter underlined:

'The Government believe that for the EC to gain the maximum benefit individual measures should be designed and implemented

within a clear framework which allows markets as much freedom as possible and avoids unnecessary bureaucratic intervention. For example in relation to the proposed harmonisation of VAT and excise duties, the Government consider that the Commission's proposals are unnecessary. They have put forward an alternative approach involving reducing frontier controls and increasing travellers' allowances. This would allow market forces to exert greater influence over tax rates, tending to produce greater convergence over time. But continuing restrictions may be necessary in the case of tobacco and alcohol, for reasons of health policy.'

4. Changes can be made to EPR material at galley proof stage tomorrow, Wednesday 5 October, or at latest on Thursday, 6 October.

Sub-Saharan Africa debt

Final agreement has now been reached on a substantial measure of relief on debt owed by the poorest African countries to government creditors (see **Economic Progress Report** August 1988).

2. The need for such relief was first recognised in a speech by the Chancellor of the Exchequer, Mr. Nigel Lawson, in April 1987. The present scheme, which builds on the Chancellor's proposals, has now been agreed by all the government creditors who meet in the Paris Club. The final details were settled by the finance ministers of the Group of Seven at their meeting in West Berlin in September.

3. When a poor African country has difficulty in servicing its debt to western governments, it presents a case to the Paris Club and asks to be given more time to pay. Its debts are then said to be 'rescheduled'. But until now, these debts have continued to carry a commercial rate of interest. When the debtor country could not pay even the interest on its debt, this was added to the capital sum outstanding, which often grew faster than the debtor country's own exports. This made it almost impossible for such countries ever to repay their debts.

4. Recognising this, the Chancellor proposed that certain very poor and 'debt-distressed' countries, who were pursuing sound economic adjustment programmes, approved by the IMF, should

receive concessional terms when their debt was rescheduled . Following the new agreement, creditors will choose from a 'menu' of three options when rescheduling debt:

- reducing the interest charged on the rescheduled debt by 3½ percentage points (or halving it, if that is less than 3½ percentage points);

- writing off one third of the total volume of the debt;

- rescheduling the debt over a very long period (25 years, compared with the normal 10).

The first option, which is close to the Chancellor's original proposal, is the one which the UK will normally adopt.

The effect of the scheme

5. The combined effect of the three options is to reduce the debtor country's debt-service obligations to a manageable level, and hence to give the country a realistic chance of getting on top of its debt burden. Speaking to the IMF annual meeting in Berlin after the Group of Seven meeting the Chancellor said 'I am particularly delighted that agreement has now been reached by all the creditors in the Paris Club on the scheme'.

6. The first debt negotiations under these new arrangements should be completed later this year.

OR, instead of this single sentence, could quote what you said at the Dev. Ctee:

"Speaking at the [Dev. Ctee] the Chancellor welcomed the new agreement and commented,

'The next step is to implement the scheme as quickly as possible on a country by country basis.'

Current account imbalances

In his speech on 28 September to the Joint Annual Meeting in Berlin of the International Monetary Fund and the International Bank for Reconstruction and Development (the World Bank), the Chancellor of the Exchequer discussed the present current account imbalances among the major countries. Some extracts from his speech appear below.

2. ' A widespread concern at these meetings has been the existence and scale of the current account imbalances between the major countries. Over the postwar period, it has not been unusual for many of the smaller industrial countries to run current account deficits or surpluses for many years.

3. 'But between the postwar 'dollar gap' and 1983 there was virtually no experience of significant and sustained imbalances among the major industrial economies. Since then the picture has changed dramatically. The Federal Republic of Germany has had a current surplus of over 2½ per cent of GDP every year since 1985, and Japan every year since 1984. Conversely the United States has had a current deficit of over 2½ per cent of GDP in every year since 1984. This year the United Kingdom also seems likely to have a current deficit of this size, and there is some concern about how long that, too, will persist.

Capital flows

4. 'When we look at the balance of payments it is important to consider not merely the current account but also the capital account. Net capital flows are an equal and opposite counterpart to a current account imbalance. A country that is attracting net inflows of capital from overseas to supplement domestic savings

must, by definition, be running a current account deficit. Conversely, a country in current account surplus must by definition be engaged in net investment overseas.

5. 'In other words, the current account reflects the difference between domestic savings and domestic investment.

Changing capital markets

6. 'What has emerged over the past five years has been the sustained use of Japanese and German savings to make good the shortfall of savings in the United States, and to finance investment there. This has been made possible by the profound changes that have taken place in world capital markets.

7. ' Today there is clearly no reason why, with free access to world capital markets, domestic investment should be limited to what can be financed from domestic savings. The recent imbalances have continued because capital markets have brought together investment opportunities and savers in different countries.

8. 'Despite the evidence that current account imbalances can persist, there is an understandable concern that they cannot continue unchecked. A particular worry is the arithmetic of debt accumulation and debt service costs. Persistent large imbalances do become a problem as flows compound .... But even for deficits of the size we have seen recently in the major countries, this problem emerges quite slowly. ... the effective constraint is not so much the size of a current account imbalance as a country's overall creditworthiness.

9. There is also a concern that long before this constraint is reached , financial markets will take fright. Given the wellknown volatility of these markets, it is clearly necessary for governments not just to pursue sound financial policies, but also

to be prepared from time to time to exercise a stabilising influence... this applies as much when the current account is in surplus as when it is in deficit.

The role of government

10. 'The government has a responsibility to curb inflation by maintaining a sound monetary policy. If monetary conditions are too lax, the authorities have to tighten them. A tightening of monetary policy, through higher interest rates, will boost savings and hence reduce the current account deficit. But that is not the object of the exercise. And current account imbalances would occur even in a world of zero inflation.

The exchange rate

11. 'The conduct of monetary policy also has implications for the exchange rate, and the exchange rate itself is an important factor in monetary policy decisions. It follows that the exchange rate cannot be assigned the task of balancing the current account, and it is a mistake to think that the automatic response to a current account deficit should be a lower exchange rate.

The budget

12. 'Governments do ... have a clear role when a current account deficit is accompanied by a budget deficit. In those circumstances they have a responsibility over time to reduce, and possibly eliminate, the deficit, and hence their call on private sector savings. The position is totally different when, as in the United Kingdom, there is no budget deficit at all and the current account deficit is entirely the result of private sector decisions... not least because private sector behaviour is by its nature self-correcting over time.

13. 'To the extent that the deficit is the result of higher private sector investment ... the future returns will finance the original investment. To the extent that the deficit is the result of low net private sector savings, this too should correct itself in time. The main source of fluctuations in net savings is change in the amount of borrowing by the private sector. There is a limit to the amount of debt which the private sector will be willing - or can afford - to undertake. Once that limit has been reached , the savings ratio will rise again. ... Higher consumption now is at the expense of consumption in the future.

14. It is only in the unlikely event that the self-correcting mechanisms threaten to stretch over so long a period that the creditworthiness constraint to which I have alluded comes into play that it would be appropriate for the government to run a larger budget surplus in order to offset the lack of private sector savings.

The United Kingdom

15. 'Some may be puzzled why the existence of a current account deficit is so newsworthy in the United Kingdom. The truth is that we are prisoners of the past, when UK current account deficits were almost invariably associated with large budget deficits, poor economic performance, low reserves, and exiguous net overseas assets. The present position could not be more different. The output and productivity of the United Kingdom are both growing strongly. The official reserves are high, and net overseas assets are greater as a proportion of GDP than in any other major industrial country. And the public sector finances are in sizable surplus. By any standards, the United Kingdom's creditworthiness is high.

3776/23

Pers pl

ECONOMIC SECRETARY TO THE TREASURY

FROM: S M A JAMES
DATE: 6 October 1988

MR HUDSON

cc PS/Chancellor
Sir T Burns
Mr M P Evans
Mr Mountfield
Mr R I G Allen
Mr Gieve
Mr Bottrill
Mr Bush
Mrs Thomson
Miss Edwards
Ms Symes
Mr Parkinson

EPR - OCTOBER ISSUE

The Economic Secretary has seen Miss Edwards' minute of 4 October and the Chancellor's comments (your minute of 5 October). The Economic Secretary suggests that at the end of the new material on tax harmonisation as amended by the Chancellor we might add "unless the Community can agree that members must set their duty rates above a fairly high minimum level."

i.e. at (A) below

C.

What do you think? Jonathan (who, as you know, largely wrote the passage in question) thinks this is ~~unnecessa~~ unhelpfully specific - should not feature.

AH
6.10.

S M A JAMES
Private Secretary

B.

CHANCELLOR OF THE EXCHEQUER

HONI SOIT QUI MAL Y PENSE

C.

[Not so: private public have [also gone...]]

1. Your note below.

2. Pub. sector / general govt. ~~receipts~~ saving is defined as gen. govt. receipts <u>less</u> current expenditure. The <u>net</u> figures takes account of depreciation and stock appreciation.

3. The reason why the paper says (para 17) that the fiscal consolidation of the 1980s was largely a reduction in investment is substantially council house sales, which count as negative investment.

4. Perhaps we can have a word on Monday?

OK.

AH

5.1

*

PSF lecture
Lose the definition
of public sector / gen
govt gross/net

Sorry

M.


DIEU ET MON DROIT

D460

BF 22/12

APH
PS8 SJD

FROM: S J DAVIES
DATE: 21st December 1988

CHANCELLOR

cc Chief Secretary
Sir P Middleton
Sir T Burns
Mr Byatt
Mr Monck
Mr Scholar
Mr Culpin
Mr Peretz
Mr Riley
Mr Sedgwick
Mr Gieve
Mr Pickford
Mr Tyrie

C.
Some interesting stuff in thick paper attached. I'd like to give a bit more thought, to get J. Gieve's views on EPR article.
APH

PRIVATE SECTOR SAVING

You asked (Mr Taylor's minute to Mr Scholar of 28 November) for a note on what could be done to publicise the overall private sector saving ratio.

2. A draft of an article for the EPR - which could appear in the February issue - is attached. The article sets out the basic facts about what has happened to private sector saving, which can be drawn on in other contexts as desired. At the same time, the article acknowledges that comparisons of private saving at different periods are affected by, for example, the privatisation programme which has transferred saving worth perhaps 1 per cent of GDP from the public to the private sector.

3. There is perhaps some tension between wanting to argue that, on the one hand, the current saving level is normal and satisfactory and that, on the other hand, saving is likely to rise in future (so that the balance of payments current account deficit will eventually disappear). The EPR article points out that private saving may take time fully to adjust to the increased economic role of the private sector of the last decade, and is for that reason likely to rise in the future.

4. An earlier EPR article on personal saving is attached for reference.

5. Also attached, as background, is a paper on saving which goes into the figures in more detail, provides some international comparisons, and discusses some of the influences on the level of UK saving. It lists various distortions affecting saving that government intervention in the economy may involve, and provides some quantification of the effect of one or two of these distortions.

6. Some explanation is needed of the estimates of saving and investment shown in the draft article and in the background paper. For the purpose of the current forecasting round EA have made adjustments to published CSO data to reduce the gaps between total expenditure, income and output. This adjusted data has been used by Sir Terence Burns in his paper "The Background to the 1989 Budget".

7. We are not likely to want to use this adjusted data in public before you have finalised decisions on what data to use for the forecast published in the FSBR. Thus the draft EPR article uses published data (and Autumn Statement forecast estimates for 1988).

8. The background paper also uses published data; but to illustrate the uncertainties also shows the implications of making different assumptions about the allocation of the national accounts residual error.

9. A final point on the data. The charts in the draft EPR article all show saving and investment as a proportion of nominal GDP at factor cost. Elsewhere (including in the background paper) we have shown saving in relation to nominal GDP at market prices, "money GDP". In terms of analysing the trends, the choice between factor cost or market price GDP makes no difference; but using factor cost GDP as the denominator produces a higher series for the saving/investment share. For the EPR article it makes sense to show saving and investment as a proportion of GDP at factor cost.

S J DAVIES

D476

Generally doesn't say anything about influence of high borrowing on saving ratio.

TRENDS IN PRIVATE SAVING

An article published in the November/December 1986 issue of the Economic Progress Report discussed developments in consumers' expenditure and saving; and in particular reasons for the fall in the personal sector's saving ratio. The present article returns to the subject of saving, but puts personal saving in the context of development in saving by the whole of the private sector (ie by companies as well as persons).

Uses of company and personal income

2. Saving is one of the uses to which personal and company income is put: table 1 summarises the allocation of income of persons and companies between different uses in 1987. Some of personal and company income goes to pay taxes or make other payments to the government; some is transferred to various other categories of recipients. The remaining income is divided - in the case of personal income - between spending on acquiring goods and paying for services - "consumers' expenditure" - and personal saving. In the case of companies, income remaining after payments to the government, profits due abroad and transfers is divided between payments to those who hold companies' liabilities, dividend and interest payments and company saving.

3. Personal saving in 1987 was equal to about 4 per cent of total personal income or around 5 per cent of personal disposable income, ie income after deduction of taxes, social security contributions and net transfers. By contrast, companies saved almost 50 per cent of their income; the total amount of saving by companies in 1987 was more than 3½ times the size of personal saving.

Table 1: What happened to persons' and companies' income in 1987

(a) Persons	£ billion	per cent share of income
Income*	347.9	100
Taxes and social security contributions	72.5	21
Net transfers paid	2.1	1
Consumers' expenditure	258.4	74
Saving*	14.9	4

(b) Companies**	£ billion	per cent share of income
Income*	111.6	100
Taxes, royalties and licence fees	16.2	15
Profits due abroad	5.5	5
Transfers to charity	0.2	0
Dividends and interest payments	34.5	31
Saving*	55.2	49

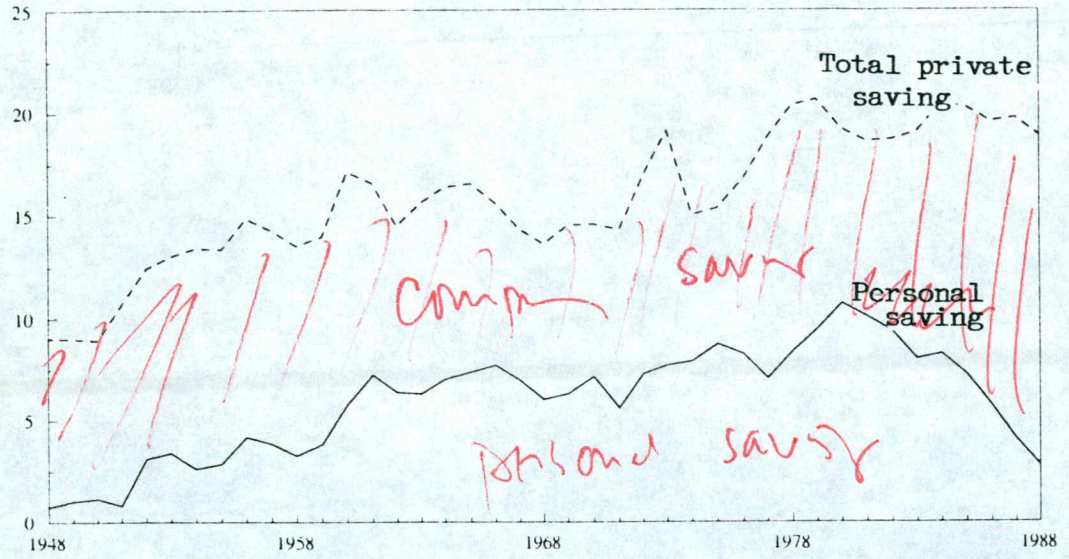
* net of stock appreciation

** including financial institutions

Saving

4. Chart 1 gives the post-war history of total private saving, and shows how this has been distributed between companies and persons. (The estimate for 1988 is consistent with the forecast published in the Autumn Statement.) Private saving in the 1980s has fluctuated between about 18½ and 20½ per cent of GDP at factor cost, over 2 percentage points above the average of the 1970s. Looking back at the whole post-war period, it is clear that private saving was on a rising trend in relation to GDP until about the end of the 1970s, and since then has been fluctuating around a more or less constant share of GDP. The time path of saving has been affected by the rise in inflation during the 1960s and 1970s and its subsequent fall: the higher the rate of inflation, the more people need to save to offset the erosion of the value of existing savings that inflation causes. Thus inflation probably raised private saving to a considerable extent in the 1970s, but to a smaller extent in recent years when inflation has been at much lower levels.

CHART 1: Private saving (per cent of GDP)

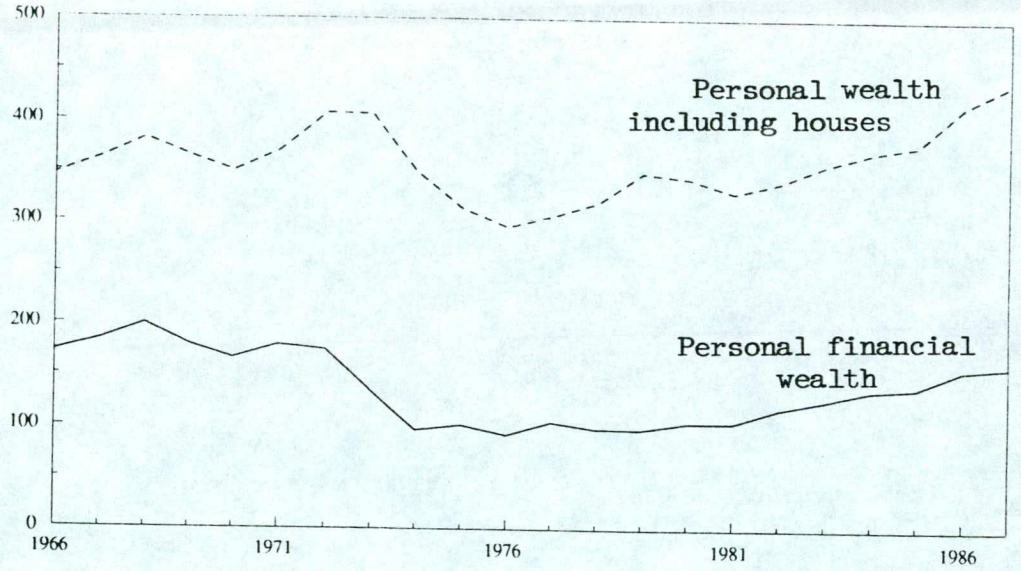


5. Within the total of private sector saving there has been a marked shift in the shares of personal and company saving. Company saving fell in the mid-1970s, as company profitability bore the brunt of the UK's poor economic performance and the unfavourable world environment. By contrast personal incomes were better protected and personal saving rose to make good some of the damage that inflation was doing to existing wealth. In the 1980s, company profitability has recovered sharply, and company saving has risen along with profitability. Personal saving has been in decline throughout the 1980s partly reflecting the fall in inflation: some other influences on personal saving were discussed in the 1986 EPR article.

6. One of the things that affects personal saving is what happens to the value of personal sector assets. Chart 2 shows that in spite of the much reduced level of personal saving, personal net financial wealth (holdings of financial assets much as building society deposits less liabilities such as mortgage. loans and consumer credit) has been rising steadily as a share of GDP in the 1980s. Bringing the value of houses into the picture shows a still larger rise in personal wealth. If people find they are wealthier than they had expected to be, they are likely to feel less need to save, so that buoyant equity and housing markets

have probably contributed to the fall in the saving ratio. Less buoyant conditions in these markets are likely to see a recovery in personal saving.

CHART 2: Personal wealth (per cent of GDP)



7. One of the developments that was discussed in the earlier article was the spread of company pension fund "contribution holidays": temporary suspensions of (or reductions in) contributions paid to pension funds (it is primarily employers' rather than employees' contributions that have been affected). Employers' contributions to pension funds count as part of personal income, so reductions in contributions reduce personal income and hence personal saving (assuming the reductions have no effect on consumer spending); but they do not necessarily reduce private sector saving in total.

8. The effect on private saving depends on what companies do with the money that they no longer have to contribute to their pension funds. If they save all of it (to finance physical investment or acquire new financial assets or reduce financial liabilities) the contribution holidays have no net direct effect ,

on private saving. If, on the other hand, the reduction in pension contributions is distributed in higher dividends, private sector saving would be reduced on the assumption that not all the extra dividends would be saved by their recipients. It is likely that companies are cautious about raising dividends to pass on temporary reductions in pension contributions: they would not want to risk having to cut dividends when the contribution holidays were over, since dividend reductions tend to be seen as evidence of management failure. Thus there are reasonable grounds for thinking that companies save ~~at least some~~ most of the money available from contribution holidays; so to a ~~considerable~~ substantial extent the contribution holidays redistribute private saving between personal and company saving rather than ~~simply~~ reduce it.

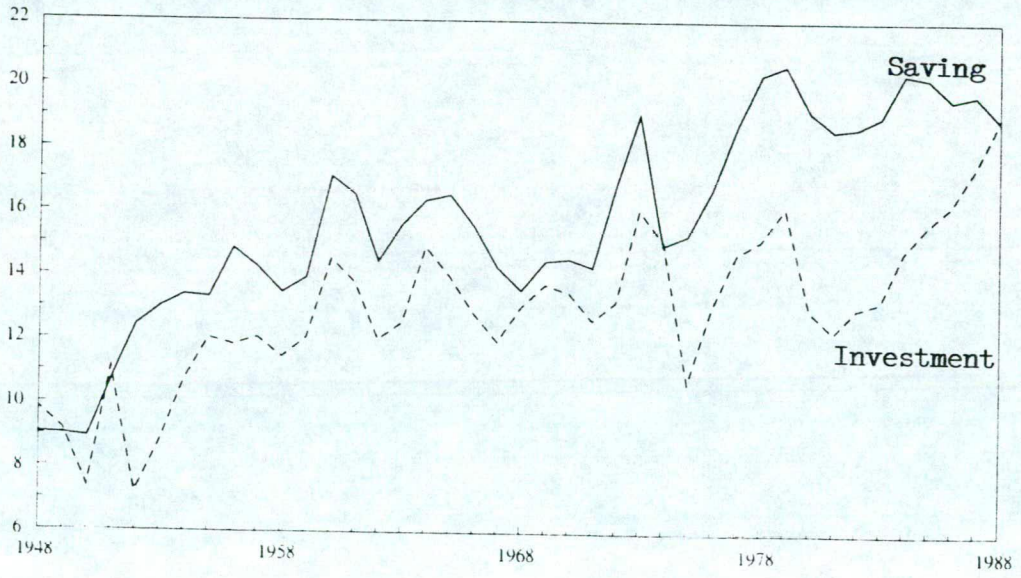
Might want to look for evidence of this - a bit provocative as it stands.

(ws this ignores Inc. Corp Tax, wh. feeds into PSBR)

Saving and investment

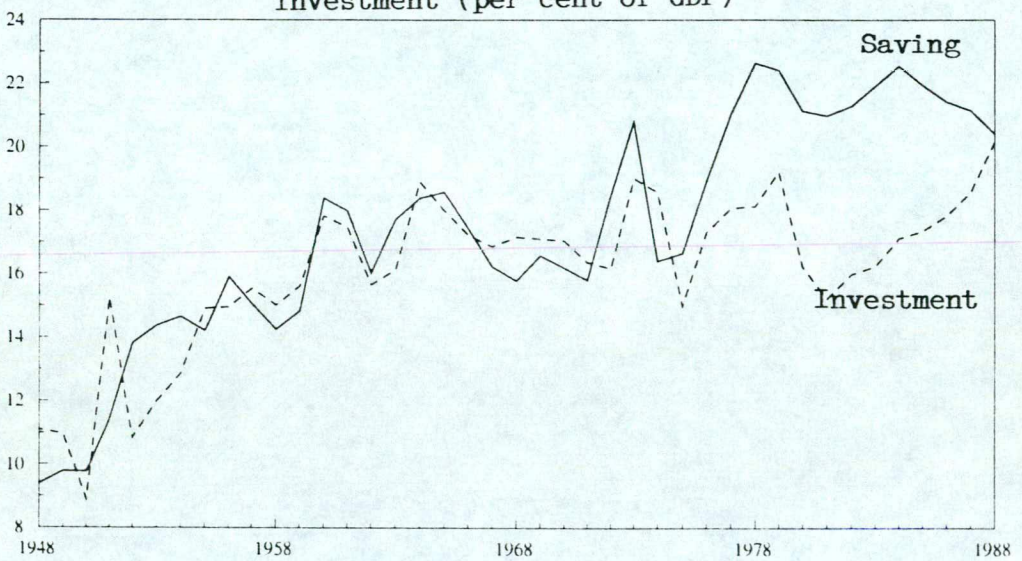
9. While private saving has been on a rising trend in relation to GDP for most of the period since the war, private sector investment has also risen, and more so than saving in the last few years (see chart 3). The Autumn Statement forecast for 1988 implies private sector investment overtaking private saving for the first time since the early 1950s. Moreover, the rise in investment relative to saving may have been even steeper than the published statistics so far indicate: the "residual error" in the national accounts of over 3% of GDP means that the published statistics must be overrecording saving and/or underrecording domestic investment and/or overstating the current account deficit.

CHART 3 : Private saving investment (per cent of GDP)



10. Some of the recent rise in the share of private investment in GDP reflects the present Government's policies of increasing the role that the private sector plays in the economy. The privatisation of several important public corporations has directly raised the private share of national investment. It is interesting to look at figures that are not affected by the reclassification of privatised companies from the public to the private sector - this is done in chart 4 which shows saving and investment for the private sector plus public corporations. Taking these sectors of the economy together, the level of saving has generally been very close to that of investment. Since the late 1970s saving has consistently exceeded investment by a large margin, but the Autumn Statement forecast for 1988 suggests that the sharp surge in investment has brought it almost back into line with saving in 1988.

CHART 4: Private sector plus public corporations' investment (per cent of GDP)



11. The spread of owner occupation (to which the "right to buy" programme has given an extra impetus during the 1980s) has also raised the share of private sector investment and saving in GDP. However, the main boost to saving from the recent extension of owner occupation is probably still to come. If purchase of property is largely financed by borrowing, the transaction involves little or no direct effect on saving. Likewise in the early years of a mortgage, the monthly mortgage payments mainly go to pay interest, so that only a small fraction of the mortgage

payments constitute saving. Later on an increasing share of the mortgage payments is taken by repayment of capital, which does constitute saving. Thus it may well be the case that the "right to buy" programme will lead to an upward shift in personal saving, but that much of this shift has still to occur.

Summary and implications

12. While personal saving has been falling in recent years, company saving has been rising and is now by far the dominant element of private saving. In total, private saving has been a more or less stable proportion of the GDP since the end of the 1970s; private investment has been rising and seems now to be overtaking saving. Assuming that the public sector budget is close to balance, an excess of private investment over saving will be financed from overseas (ie the current account will be in deficit). This should cause no problems, given the prudent economic policies of the Government; but in any case private saving may start to rise again over the next few years.

Might end here, or redraft this.

EPR Nov/Dec 1986

Consumers' expenditure and saving

Saving by the personal sector currently accounts for around 40 per cent of total UK saving, while consumer spending constitutes around 60 per cent of UK domestic expenditure. Consumers' expenditure and saving therefore have an important influence on the course the economy takes, and have been the subject of much analysis by economists. This article considers the factors behind recent movements in spending and saving in the personal sector, and looks at recent trends in and prospects for the level of consumption and saving.

Income allocation

How much people spend and save in total depends firstly on their income (what they earn at work, for example, or the pensions they receive, or interest payments on bank or building society deposits), and secondly on the deductions that are made from that income (primarily income tax and national insurance contributions). The sum of incomes for the whole of the personal sector, net of deductions, is called *personal disposable income*. For most people who are at work, by far the most important component of their total income is the payment they receive from their employers, or the money they make for themselves if they are among the growing number of self-employed workers. Indeed, as chart 1 shows, wages and salaries and self-employment income together account for about two thirds of personal income. But other elements, including social security payments, such as state retirement pensions, and net investment income on cumulated savings, are also quite important. Some personal income takes forms of which many of its recipients may be only vaguely aware: the contributions made by their employers to the National Insurance Fund and to occupational pension funds, the income earned on the assets of these pension funds, and the income from the investment in their houses that the government statisticians impute to owner occupiers.

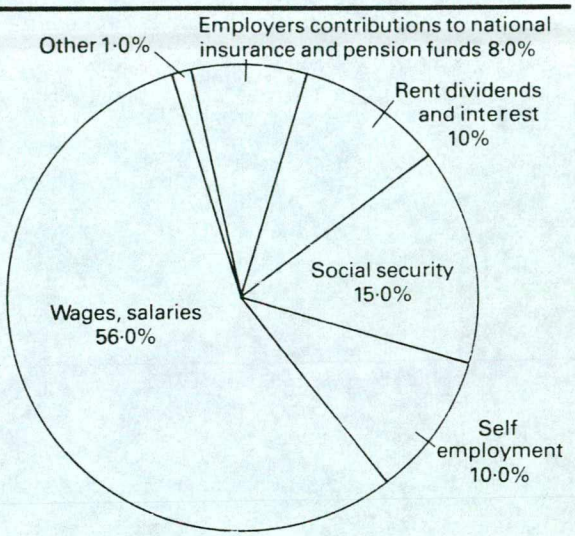
Of total personal sector income around one fifth is currently taken by *deductions* (UK taxes on incomes, national insurance and other contributions, and net transfers of income abroad). The remaining four fifths is allocated between:

- *consumers' expenditure* — personal sector spending on goods and services such as food, furniture, transport, and so on; and
- *saving* — that part of personal sector disposable income not allocated to consumers' expenditure.

The table summarises the personal sector accounts for 1985. The relationship between personal sector spending and saving in these accounts is measured by the *personal saving ratio*, defined simply as the proportion of personal disposable income allocated to saving.

Chart 1

Personal sector income



Personal sector saving covers saving made directly by households (and on behalf of households by the life assurance and pension fund industry) together with the operating surpluses of various organisations which are included within the personal sector in the national accounts. These organisations include unincorporated businesses, sole traders, partnerships and private non-profit making bodies (such as charities and universities). In practice the saving behaviour of the personal sector is dominated by the decisions of households and life assurance and pension funds.

Summary personal sector accounts

	1985	£ billion
	Total personal income	**303.9**
less	Deductions from income	64.1
equals	**Total personal disposable income**	**239.8**
less	Consumers' expenditure:	
	non-durable goods and services	192.2
	durable goods	21.0
equals	**Personal sector saving**	**26.6**
	Personal sector saving ratio	**11.1%**

Reasons for saving

Economists have suggested several reasons why individuals save or dissave. One important reason for saving is that it can rarely be advantageous for people to match the timing of their expenditure exactly with the timing of receipts of income. Just as people who receive a monthly salary cheque, say, do not normally go out and spend all their pay the day they receive it but spread their spending out over the month till the next cheque is due, so longer term fluctuations in income may be smoothed out by accumulating or running down savings. In particular people may save during their working lives in order to maintain their standard of living at a high level after retirement. A second reason for saving, particularly relevant if it is difficult for people to borrow at a reasonable

cost, is to provide a margin for unexpected contingencies (major repairs to a house or a car, or loss of earnings due to illness). A third reason why people may save is so that they can have the satisfaction of knowing that when they die their children and heirs will be well provided for.

There is quite a step from explaining the saving behaviour of individuals to explaining the movement of aggregate personal saving in the economy. Total personal saving represents the sum of saving decisions made by individuals throughout the country. Of these individuals at any particular time some will have incomes that are currently below normal (and so may be dissaving) while others will currently have abnormally high incomes (and be saving part of their incomes). The personal saving ratio would obviously only be positive if the amount of saving by individuals exceeded the amount of dissaving. Supposing that the only motive for saving were to provide for retirement, a situation could be imagined in which saving of those at work and dissaving by the retired cancelled out. Although all individuals might save for much of their lives, the saving ratio for the personal sector as a whole might often be close to zero, or even negative. In fact in the UK, as in other industrial countries, the saving ratio is strongly positive. One explanation for this is that in a growing economy each successive generation has a larger income than the previous one. Those currently at work save more than those now in retirement had saved earlier on, so that the new saving outweighs the dissaving of the retired.

Influences on the ratio

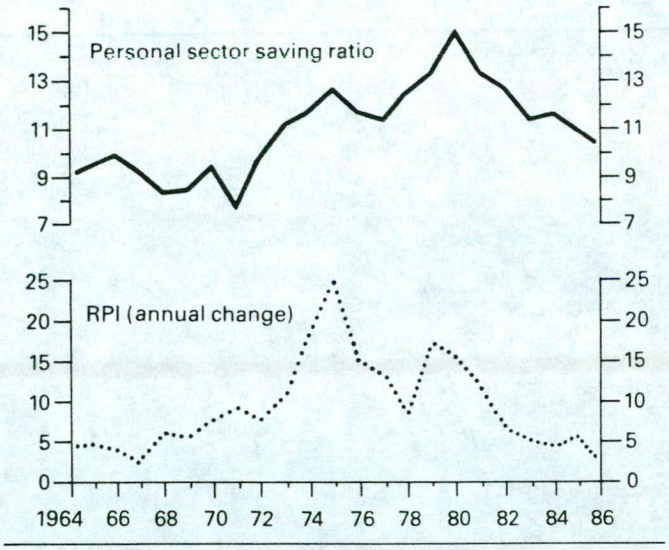
The UK saving ratio has varied over a wide range in the last 20 years. Between 1970 and 1980 it rose from around 9 per cent to 15 per cent, while more recent years have seen a downward trend, reaching 11 per cent in 1985. The level of the saving ratio is likely to be affected by a variety of institutional factors. Individuals' saving for retirement will be influenced, for example, by the sort of provisions made under the state pension scheme and by the normal age of retirement. But these sort of factors are unlikely to have contributed much to the fluctuations in the saving ratio over the last two decades; attempts to explain these fluctuations have generally concentrated on a limited number of economic factors.

If economic growth and inflation stayed at a constant rate from year to year the personal sector might save a roughly constant proportion of its disposable income every year, and the value of cumulated savings might rise closely in line with living standards. But the real world is more complicated than this. Individuals do not know how their income will change from year to year, and the value of their savings can rise or fall unexpectedly. Savings are held in a variety of forms, such as building society and bank accounts, shares, bonds, unit trusts and national savings certificates. The real value of this wealth will vary depending upon the price level in the economy, movements in the stock market and (in the case of foreign currency denominated assets) the level of the exchange rate.

Changes in the real value of cumulated savings, whatever the reason, are likely to affect how much of current income is saved. If people suffer a fall in the real value of their wealth they will save more out of current disposable incomes until assets are rebuilt, while an unplanned rise in wealth may lead to a temporary fall in the saving ratio.

Chart 2 %

RPI and personal saving ratio



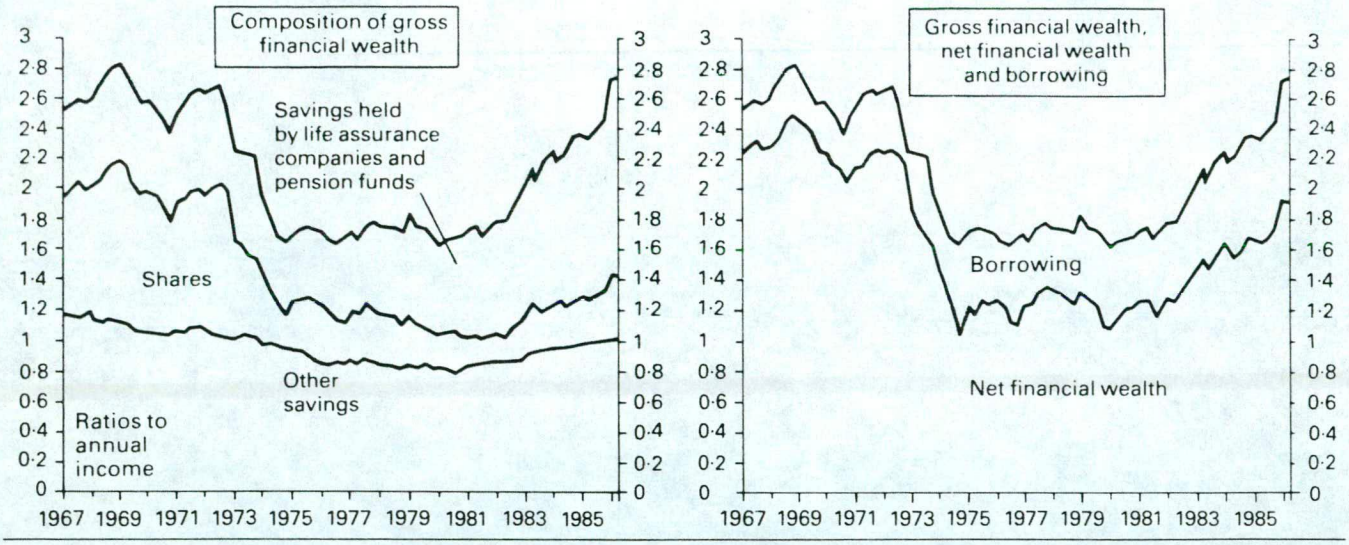
Much of personal sector savings is held in assets with fixed money values, for example in bank accounts. The real value of these assets is directly affected by the general price level. As prices rise a given amount of money in the bank will buy fewer and fewer goods. Thus an unexpected rise in the price level will make the real value of personal wealth lower than intended, and lead to higher saving; and, the faster prices continue to rise, the more individuals need to save to offset the effect of inflation on the value of their existing savings. On the other hand for a given level of nominal interest rates higher inflation reduces the real return on savings and might be expected to encourage people to spend sooner rather than later. As chart 2 shows, the former effect of inflation has been the dominant one — the level of nominal interest rates has, of course, varied with the rate of inflation to some extent — and periods of relatively high inflation have been associated with a relatively high rate of personal saving.

A second major influence on the real value of the wealth of the personal sector is the level of share prices. Chart 3 (on page 8) shows personal sector financial wealth relative to disposable income, and how much of the stock of savings is held directly as shares, how much is invested through life assurance and pension funds (much of which is also in the form of share holdings) and how much is in other assets. The rise in the stock market in recent years has led to a recovery in the value of personal sector savings, to a level in relation to income that is comparable with that seen before the large fall in equity prices that started in 1972.

Borrowing by the personal sector has also grown strongly in recent years, but this has been more than offset by the rise in value of savings shown in chart 3. The increase in personal sector holdings of financial wealth net of borrowing seems likely to have contributed to the reduction in the saving ratio since 1980.

Empirical research, both within the Treasury and by economists elsewhere, has confirmed the importance of inflation and net wealth in explaining consumer spending and saving behaviour. Research also shows that personal saving responds to *real rates of interest* and *changes in income growth*. The real rate of interest measures the cost of borrowing and return on saving, and the research results suggest that high real rates of interest lead the ersonal sector to reduce expenditure, particularly on

Personal sector financial wealth



consumer durables, which are frequently bought on hire purchase or other forms of credit. The proportion of income saved also tends to increase during periods of rapid income growth. This is illustrated in chart 4, which shows that while growth in consumer spending is strongly correlated with that of disposable income, sharp increases in income growth often produce a less than equivalent response in spending and hence a rise in the saving ratio, for example in 1972-73 and 1978-79. This link between income growth and the saving ratio may reflect both delays in consumers' adjustment to changed circumstances, and a reluctance to adjust spending behaviour to what may prove to be only a temporary change in purchasing power. One interesting feature of chart 4 is the fall in the saving ratio over recent years, which has occurred despite relatively high growth in disposable incomes (and also high real interest rates). The overriding influence in recent years appears to have been the decline in the rate of inflation.

Forms of saving

Personal income is saved either by acquiring financial assets, such as deposits in building societies or banks, or by purchasing investment goods (in the case of the personal sector this is mainly houses and flats). Money

ECONOMIC INDICATORS[1]

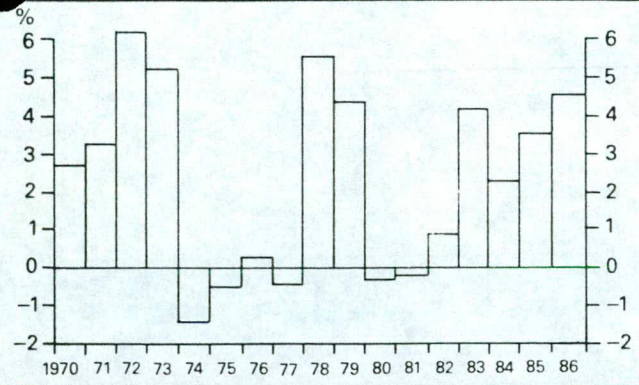
Published monthly		**1982**	**1983**	**1984**	**1985**			**1986**		
						Q1	**Q2**	**Q3**	**Sep**	**Oct**
Output of production industries	1980 = 100	98.4	101.9	103.2	108.2	109.3	108.9	110.6	111.3	—
Unemployment (adult)	million	2.63	2.87	3.00	3.11	3.17	3.21	3.21	3.19	3.17
Sterling index[2]	1975 = 100	90.7	83.3	78.8	78.7	75.6	76.0	71.9	70.4	67.8[3]
PSBR[5]	£ billion	8.9	9.8	10.2	5.9	−1.9	2.2	3.5	2.1	0
Interest rate: 3 months interbank[2]	%	12.3	10.1	10.0	12.2	12.3	10.2	10.0	10.2	11.1
Volume of retail sales	1980=100	102.2	107.1	110.7	115.3	118.0	120.2	122.1	123.2	123.1
M0[2 4]	% increase	3.1	7.0	5.5	3.8	4.1	3.2	4.8	4.8	4.9
£M3[2]	over same	8.9	10.3	9.6	13.4	16.7	18.4	18.8	18.8	18.4
Retail prices index–	period a	8.6	4.6	5.0	6.1	4.9	2.8	2.6	3.0	3.0
Average earnings, whole economy[6]	year earlier	9½	7¾	7½	7½	7½	7½	7½	7½	—

Published quarterly		**1982**	**1983**	**1984**	**1985**		**1986**	
						Q1	**Q2**	**Q3**
Balance of payments, current account[8]	£ billion	3.9	3.1	1.2	3.6	0.6	0.4	0.8
Personal saving ratio[7]	%	12.8	11.5	11.7	11.1	10.8	10.5	—
Employed labour force	million	23.3	23.1	23.5	23.8	24.0	24.1	—
GDP (average)[8]	1980 = 100	100.3	103.8	106.7	110.5	112.1	112.4	—
GDP (average)[8]		1.6	3.5	2.8	3.6	2.4	1.4	—
Total fixed investment[8]		4.3	5.7	9.1	1.8	−2.6	3.1	—
Consumers' expenditure[8]	% increase	0.9	4.0	2.1	3.5	3.9	5.1	—
Exports of goods and services[8]	over same	0.8	2.2	6.7	6.2	−0.9	−0.6	—
Imports of goods and services[8]	period a	5.4	5.5	9.2	3.0	0.7	3.2	—
Productivity: whole economy	year	3.8	3.9	1.4	2.3	1.1	1.0	—
Gross trading profits of industrial and commercial companies[9]	earlier	15.4	20.9	22.9	16.9	0.6	−14.7	—

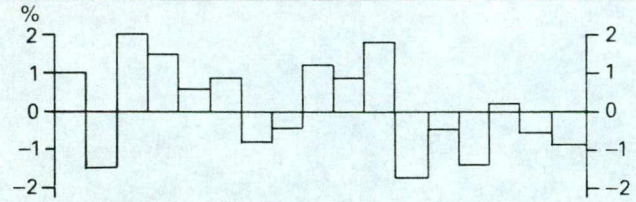
1. Seasonally adjusted unless otherwise stated. Many of the most recent figures are provisional and subject to revision. 2. Not seasonally adjusted. 3. Nov. 68.5. 4. M0 quarterly data based on last calendar month in quarter compared with same month a year earlier. 5. Annual figures refer to financial years ending in the following March. 6. GB, underlying series. 7. Personal saving as a percentage of personal disposable income. 8. Constant prices. 9. Net of stock appreciation.

Chart 4

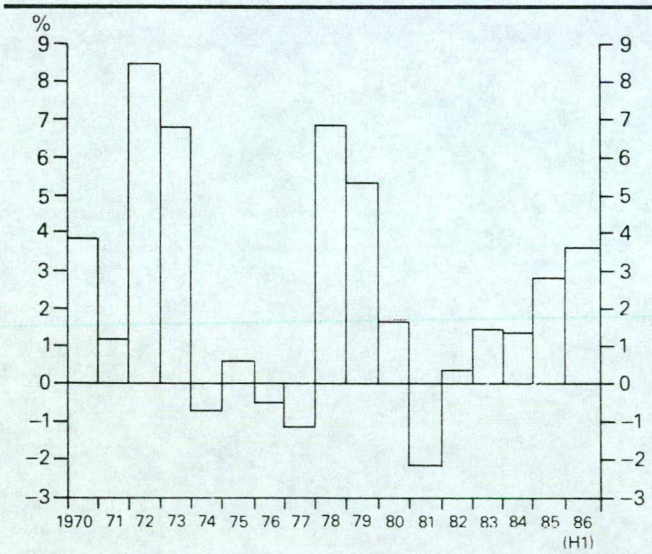
Consumer expenditure annual change



Personal saving ratio annual change



Personal disposable incomes annual change



spent on buying a house or on renovating an existing dwelling will provide a long-lasting return (in the form of shelter and comfort), in much the same way as investing in a financial asset yields returns in the form of interest payments or dividends. This treatment could in principle be extended to other long-lasting goods held by the personal sector — consumer durables such as cars, furniture and audio equipment. However, expenditure on durables has traditionally been counted as part of consumers' current spending by government statisticians.

Chart 5 shows how personal sector financial savings were held at the end of 1985. It does not include holdings of investment goods, which at the end of 1984 were estimated to be worth as much again as holdings of all forms of financial assets.

One interesting feature of trends in saving behaviour has been the increase in saving through *life assurance and pension funds* (LAPFs). In 1975 roughly a quarter of the personal sector's financial assets were held by LAPFs. At the end of 1985 this proportion had risen to over 40 per cent, while around two thirds of all new personal saving was channelled through LAPFs in that year. At the same time more people are investing directly in shares. Over the last seven years the number of individual shareholders has more than doubled.

Life assurance and pension funds invest pension and other contributions made by the household sector (together with contributions made by employers), and use the investment and the returns from it to pay out pension and other benefits as the need arises. Saving through LAPFs is equal in any given period to the difference between inflows of contributions and investment income and outflows of pension and other benefits together with the costs of administering the scheme. Changes in any of these flows will influence total saving through LAPFs. Contributions are often governed by, for example, the rules of company pension schemes, or by saving conditions imposed by life assurance companies, and they typically change relatively slowly over time. (Saving which is governed by contractual or other obligations of this nature is sometimes called 'committed saving', in contrast to 'discretionary saving' which is more readily adjusted in the short term.) Pension and other benefits claims also change relatively slowly, and as chart 6 shows, saving

Chart 5

Allocation of personal sector savings

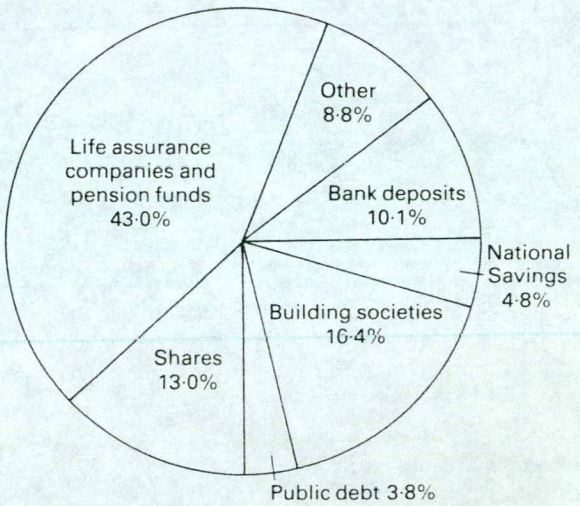
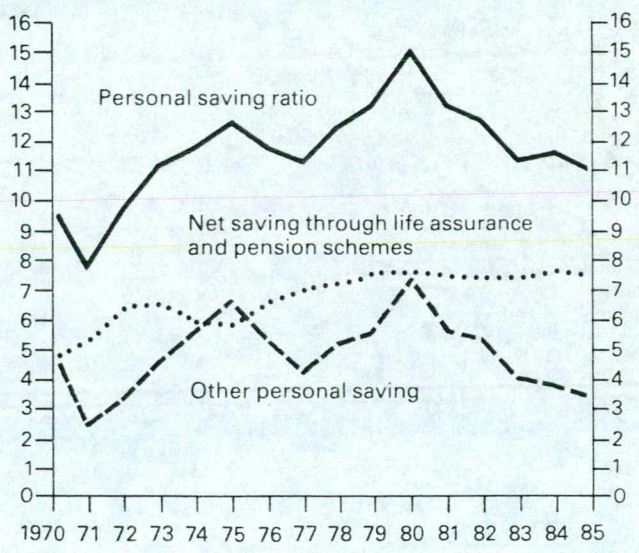


Chart 6 %

Personal saving



through LAPFs has fluctuated much less from year to year than other personal saving.

There are signs that saving through LAPFs may fall back somewhat in the next few years. The value of the assets held by pension funds has benefited greatly from the rise in share prices of recent years (as shown in chart 3). Many funds now have assets whose value is considerably in excess of what will be needed to meet the costs of paying out pensions over the future. Some of these funds are currently taking steps to reduce their surpluses by declaring 'contribution holidays' (a temporary reduction in or cessation of pension contributions). In his Budget earlier this year the Chancellor announced new rules affecting pension funds, which may lead to a reduction of some surpluses through a combination of increased pension benefits, contribution holidays for employers or employees, and refunds to the employer.

Prospects

As this article has shown, the prospects for the saving ratio over the immediate future will depend upon the outcome for a variety of factors. With inflation this year having fallen to levels not seen since the sixties and forecast to remain low, there is unlikely to be a marked increase in households' propensity to save. Whether the saving ratio will fall further over the next few years will depend on what happens to real interest rates, the speed with which further reductions in inflation are achieved, and on the extent to which the decisions of LAPFs lead to a lower level of committed saving. The forecast published in the Autumn Statement (see page 4) was for a broadly unchanged saving ratio next year.

IT in Government

Central government was a pioneer in the use of computers in Britain. It has now become probably the largest user in the UK of information technology (IT — computers, integrated with advanced telecommunications and office systems). Total spending on government information technology, including equipment, people, development and running costs, was almost £1,500 million in 1985-86. Some 20,000 staff are employed, running over 1,000 medium to large computer systems nationwide.

The Treasury has particular responsibility for seeing that public money is effectively used by government departments, both on manpower and equipment. This includes money spent on IT. The Central Computer and Telecommunications Agency (CCTA), which advises and supports departments in their deployment of IT, has been part of the Treasury since 1981 (see *Economic Progress Report,* October 1984). This article looks at how government IT has developed: making government more efficient; providing better, quicker and more flexible services to the public; enhancing the jobs of staff; and getting better value for public money generally.

Beginnings

Most of the earliest computers in government were used for scientific and statistical work. By the late 1950s, a number of machines had begun to be used in the rather more traditional administrative areas of departments' work. Many of the basic clerical tasks carried out were particularly suitable for computerisation. There were obvious benefits to be obtained in speed, and saving of staff time, where large volumes of data were run in batches according to a defined schedule, as in the processing of pay, purchasing of stores and payment of bills.

The first wave of real growth occurred during the 1960s. The Department of Health and Social Security (DHSS), for example, built up one of the largest computer installations in Europe, at what was then the Ministry of Pensions and National Insurance, Longbenton. There, a massive computer suite held records for every working and retired person in the UK. By the end of the decade, most departments had one or more computer centres.

Change in the 1970s

During the 1970s, basic computer technology changed significantly. The machines themselves became physically smaller and cheaper while their processing capabilities increased dramatically; and for the first time, significant processing power could be provided in a normal office, outside the specialised environment of the computer hall.

The 1980s

The 1980s have seen the technologies of computing and telecommunications continue to advance and converge. Costs are falling still; and the advent of the microcomputer is making the use of IT much more widespread, because opportunities are being opened up for innovative use of IT to provide new, improved or cheaper services.

As departments depend more on their IT facilities to meet their business aims and objectives efficiently and effectively, the importance of top level, longer term planning for IT has become increasingly apparent. This has led to a significant increase in strategic planning for IT within departments. Departmental strategic plans address: the role of technology in meeting the business needs of departments; building for the future as well as coping with the legacy of the past; the need to be firm yet flexible in deciding priorities with real regard for costs, benefits and value for money.

All departments now have top level committees on how they use IT. CCTA sits on all these committees, providing advice and guidance to help departments obtain best value for money from their investment.

The Manpower Services Commission (MSC) provides a good example of how strategic planning for IT is used to support departmental aims, objectives and business needs. Within the MSC's IT strategy, a significant objective is to enable staff to draw upon information contained in any of their IT systems, from any terminal. This will mean better management information and decision making, as well as greater operational efficiency.

SAVING

I INTRODUCTION

In the mid 1980s, the behaviour of personal saving and consumption in the UK was generally felt to be reasonably well understood. In the ten years up to 1970 personal saving was almost always between 8 and 9½ per cent of personal disposable income. Between the early 1970s and mid 1980s the personal saving ratio first rose and then fell by 4-5 percentage points: a development that was related to the rise in inflation during the 1970s and its subsequent decline in the first half of the 1980s.

2. Since 1985, however, the personal saving ratio has continued to fall while inflation has been more or less stable. Current estimates and forecasts suggest that between 1985 and 1988 the personal saving ratio has fallen by about 6 percentage points, declining fairly steadily by about 2 points a year. This fall was not generally predicted in advance of the event, nor is it entirely understood with the benefit of hindsight.

3. There has been a certain amount of popular and academic concern expressed about the low level of saving; in particular, widespread concern has been expressed about the rising current account deficit, which is an important counterpart of the decline in personal saving. If low personal saving and a sizeable current account deficit persist, there is likely to be an increasingly widely held view that low saving has become a structural problem in the UK economy.

4. However, what has often been overlooked in discussion of personal saving is that much of the fall in personal saving has been offset by a rise in company saving, so that aggregate private saving has been relatively stable. In purely presentational terms, this gives the Government two options. Firstly it might try to allay concern about saving trends by giving more prominence to what has been happening to aggregate private saving. Alternatively it might take advantage of worries that saving is too low, in order to:

- introduce tax reforms which alleviate some present disincentives to saving. While it is not our view that the net effect of the present system is such as seriously to discourage saving (see below), it would certainly be possible to encourage saving further. As examples, a further large switch from direct to indirect taxation (including the introduction of VAT on items currently zero rated) might possibly be feasible; another possible measure would be the introduction of a lower rate of tax on income from all forms of savings - an "investment income" relief.

- justify planning on the basis of a large PSDR over the medium term

5. The purpose of this paper is, firstly, to look at wider measures of saving and to consider whether aggregate saving is in some sense too low; and, secondly, to discuss and, to some extent, quantify the influences on the rate of saving in the UK.

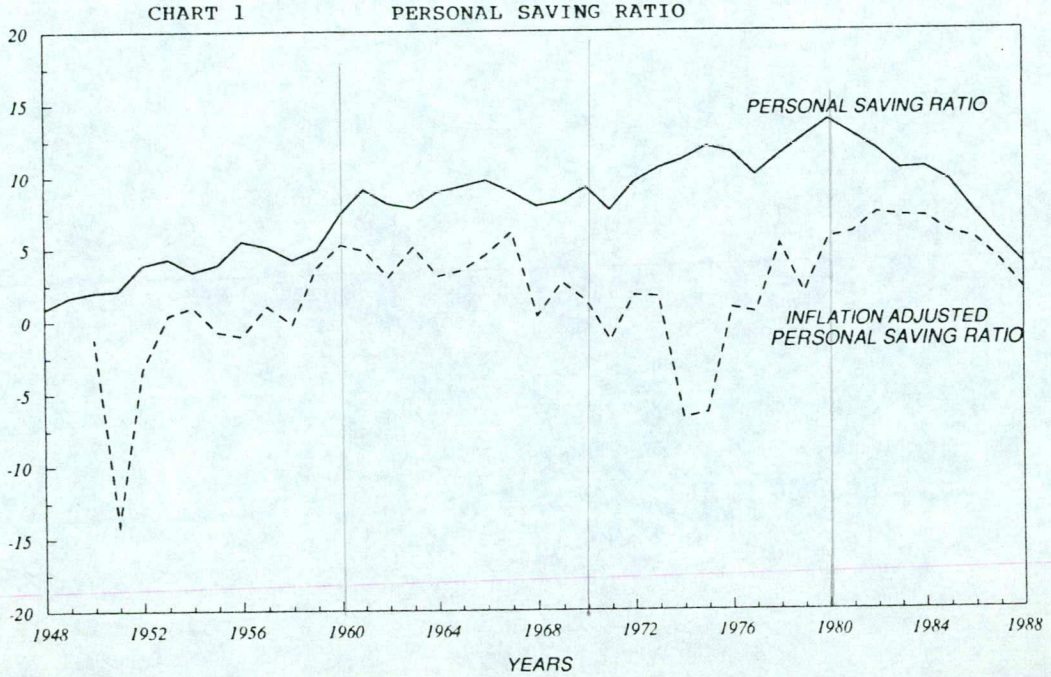
6. The sharp fall in the personal saving ratio has clearly already affected the setting of some policy instruments: the rise in interest rates this year has been in response to fast growth in activity and upward pressure on inflation whose origin lies partly in the fast rate of growth of consumer spending. This paper is not concerned with such short term effects of changes in saving, but with medium to longer term implications. The philosophy of the MTFS is to set tax rates primarily on the basis of longer term trends in the economy: a short term fluctuation in saving would not therefore call for changes in the instruments of fiscal policy, while a long term shift in the level of saving might justify a change in fiscal policy.

II MEASURES OF UK SAVING

7. This section is primarily concerned to set out the facts about what has happened to saving in the UK, and makes some comparisons with the experience of other industrial countries. It also suggests some reasons why saving has developed as it has.

8. The indicator of saving that is most widely referred to, at any rate in more popular discussion, is the personal sector saving ratio, ie the ratio of gross personal saving to personal disposable income. Chart 1 shows the post-war history of the personal saving ratio; it also shows an "inflation adjusted" ratio, as much of the rise in personal saving in the 1970s as well as the fall at the beginning of the 1980s is attributable to the pick up in inflation during the 1970s and subsequent fall in inflation.

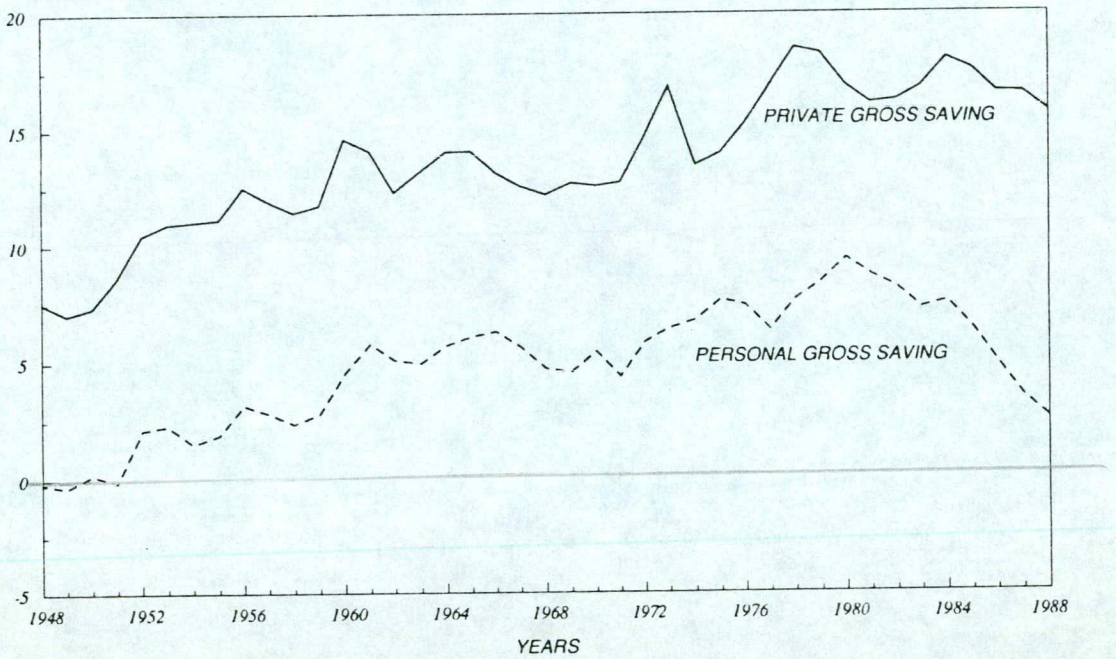
CHART 1 PERSONAL SAVING RATIO



9. Personal saving was very low at the end of the 1940s as households had accumulated financial assets and purchased relatively few goods during the war (partly because of rationing). As the period of adjustment to de-rationing ended, saving recovered during the early 1950s; at the end of the 1950s saving again rose significantly towards the 8-9½ per cent range of the 1960s; this rise was partly attributable to higher institutional saving (ie extension of occupational pensions) while the spread of owner occupation also played a part. On current estimates, personal saving in 1988 is back down to levels not recorded since the first half of the 1950s.

10. Personal saving is only a part of the total of saving in the economy. A substantial proportion of saving is done by companies (the post-tax profits that they do not distribute as dividends). The more investment firms finance from their own resources the less they need to call on the saving of the personal sector; as far as financing future productive capacity (or the acquisition of foreign assets) is concerned, there is no difference between the two components of private saving. Chart 2 shows personal and total private saving (both as a proportion of GDP).

CHART 2 PERSONAL AND PRIVATE GROSS SAVING (% of GDP



11. The time path of total private saving in the UK is rather different from that of personal saving. The sharp decline in personal saving in recent years has, according to the published statistics, been offset to a substantial extent by a corresponding rise in company saving. Private saving is below the peak it reached in the second half of the 1970s but is significantly higher than in the 1960s and the first half of the 1970s. It has changed little since 1980: there seems to be no recent "saving problem" after all.

Must be gross.

12. Saving measures are, however, very suspect for the recent past because of the large residual error in the national accounts. This error means that, as they stand, the statistics for the recent past

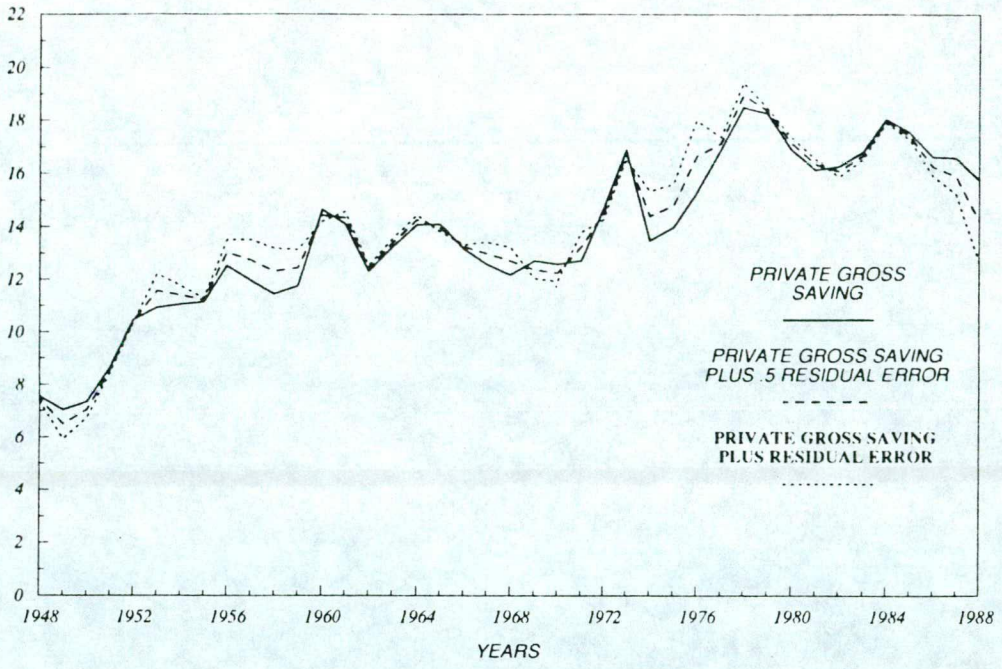
- overstate saving and/or
- understate domestic investment and/or
- overstate the current account deficit.

13. We have no firm basis on which to allocate the residual error between these three possibilities. There is, however, some indication from the sectoral financial accounts that personal saving may actually be understated in the income and expenditure accounts for recent years; so that while company saving could be overstated there is some presumption that investment and the current account provide the major counterpart of the residual error, rather than an overstatement of aggregate saving. But in order to illustrate the range of uncertainty affecting the saving figures chart 3 below shows private gross saving respectively:

- as in the published statistics
- corrected on the basis that <u>half</u> the residual error corresponds to an error in the measurement of saving
- corrected on the basis that <u>all</u> the residual error corresponds to an error in the measurement of saving.

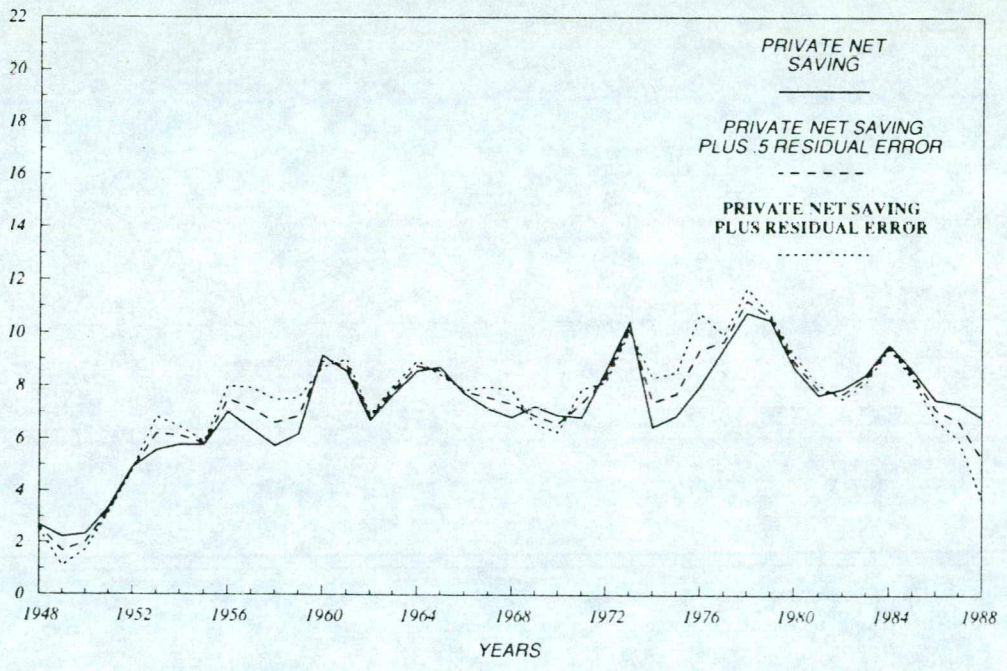
These corrections have been made as appropriate to the data for all years, not just for recent years. For some earlier years, the corrections involve adding to the published measure of saving.

CHART 3: PRIVATE GROSS SAVING (% of GDP)



14. So far the measures of saving illustrated have all been gross of depreciation. However, it is only to the extent that saving exceeds depreciation that provision is being made for increased capacity in the economy. Depreciation of the private capital stock is estimated to have risen relative to GDP since the 1960s, mainly because asset lives are believed to have shortened. This means that saving net of depreciation has fallen more than gross saving. Chart 4 shows private net saving, with the same "corrections" to the published figures as made in the previous chart.

CHART 4: PRIVATE NET SAVING (% of GDP)



15. While questions about whether the UK is doing "too little" saving certainly ought ideally to be answered in terms of what has been happening to net saving, uncertainty about the calculation of depreciation means that net saving may be measured less accurately than gross saving. If, as is generally believed, official statistics overstate the current level of the capital stock, they will overstate depreciation and hence understate the current level of net saving - by an amount which could be as much as 1 per cent of GDP. However, even if the maximum possible corrections are made, it is only in 1988 that net private saving looks low relative to the range within which it has fluctuated since the late 1950s (particularly bearing in mind the possibility that depreciation is being overstated).

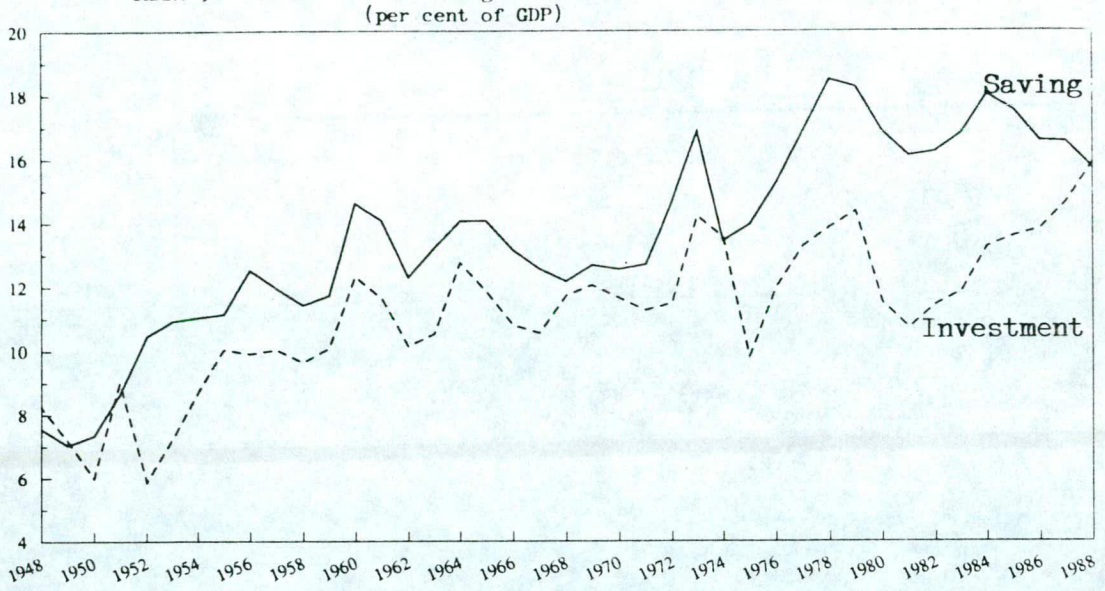
16. This relative stability of total private saving is less reassuring than it might initially appear. The privatisation programme has transformed substantial sectors of economic activity from the public to the private sector. As investment of privatised companies now needs to be financed by the private sector an increase in private saving is called for (and would be expected to arise from the undistributed profits of those privatised companies: the saving of privatised companies transferred from the public to the private sector could be worth roughly 1 per cent on gross private saving and off public saving). Other aspects of the retrenchment of the public sector in the 1980s, particularly the cut back in the local authority rented sector and the consequent increase in owner occupation, might have been expected to raise private saving relative to public saving. In the absence of a rise in private saving, the strong growth of private sector investment has been reflected in a widening deficit on the balance of payments current account.

Always was, in effect, by the taxpayer. Other things being equal, privatisation would have led to a reduction in the tax burden equivalent to the investment programme of the privatised companies ?

Sorry. On re-reading, a daft comment!

AH

CHART 5: Private sector saving and investment
(per cent of GDP)



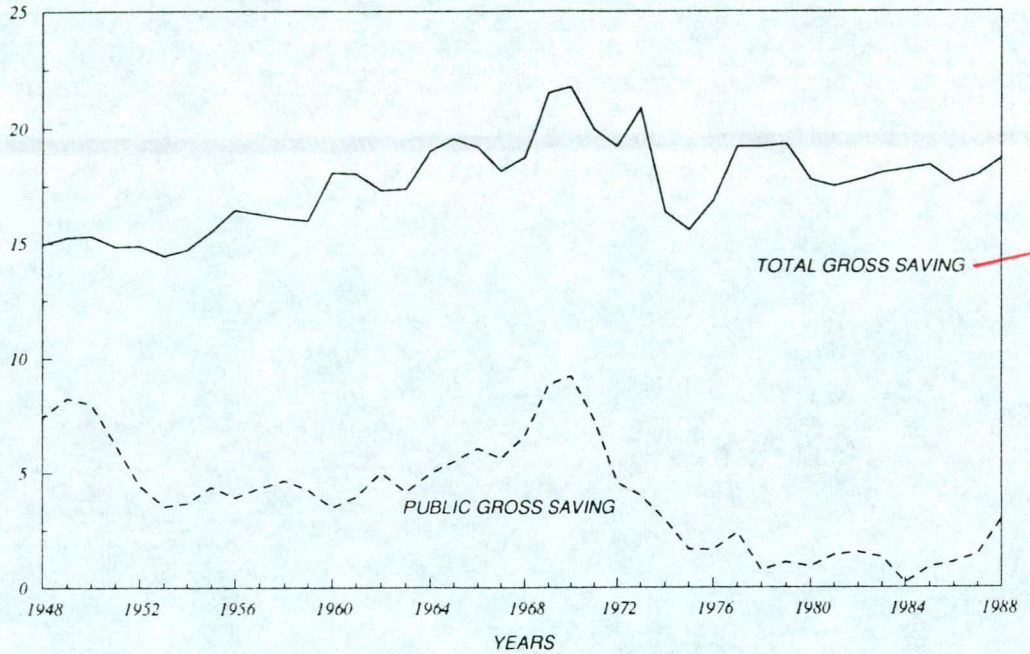
17. However, a further component of national saving not so far considered is saving by the public sector. Public saving fell sharply after the first oil shock, and from almost 10 per cent of GDP in 1970 had declined to about zero at the end of the decade. Until recently it had barely recovered, as the fiscal consolidation of the 1980s has consisted primarily of a reduction in investment. In the current year, however, there has been a marked rise in public saving, although it still remains well below the levels of the 1960s and early 1970s.

18. Just as it has been argued that the switch in economic activity from the public to the private sector should have lead to a rise in private saving, it is correspondingly reasonable for public saving to have fallen. Moreover, some public investment in the earlier part of the period (eg in British Steel) was not very productive, and would better be regarded as a form of public consumption. Thus the statistics overstate the decline in effective public saving.

19. Comparing the 1960s and early 1970s with the 1980s shows a decline in public saving over the period that was larger than the increase in private saving, so that total national saving fell as a proportion of GDP. In the first eight years of the present

decade the share of total national saving in GDP has been about 2 per cent lower than it was on average in the decade before the first oil shock. National saving and the contribution of public saving are shown in chart 6.

CHART 6: GROSS SAVING (% of GDP)



figs for 1979 - 1988?

International comparisons of saving

20. How does the UK compare with other industrial countries? Because of cross-country differences in the degree of public ownership of industry, in international comparisons it may be misleading to look at private sector saving on its own, and it is more useful to consider private and public corporation saving together. Table 1 shows private and public corporation net saving in 11 industrial countries in the decades before and after the first oil shock and in the most recent three years for which data is readily available for all these countries.

21. In the decade prior to the first oil shock the share of private sector saving in GDP was substantially lower in the UK than in any of the major seven industrial countries; but was in

∝ PCs?

the same range as in the Scandinavian countries - slightly above the Scandinavian average, in fact. In the following decade saving fell as a proportion of GDP in the four largest industrial countries, and also in Scandinavia, but was virtually unchanged in the UK. Over this period on average the UK private and public corporation saving rate was only a little below the US, French and German rate and well above the Scandinavian average. In the mid 1980s, private saving has collapsed in Scandinavia and has also fallen in Germany, France, and the US; the UK saving rate has been close to the German rate on average, and a little above the US and French rates. (It should be borne in mind that all these comparisons can be affected by differences in accounting conventions between countries, eg different depreciation rates.)

Table 1: Private and public corporation net saving since the mid 1960s

(per cent of GDP)

	10 years to 1973*	10 years after 1973	1984	1985	1986
US	9.5	8.4	8.3	7.2	6.8
Japan	16.9	16.2	13.8	13.6	14.0
Germany	11.9	8.8	7.8	7.4	9.2
France	10.6	8.5	5.8	5.8	6.8
UK	7.2	7.3	8.3	8.2	7.4
Italy	17.1	18.0	18.7	18.0	17.7
Canada	8.2	11.5	13.2	12.7	10.4
Denmark	8.0	7.4	8.0	5.6	3.1
Norway	6.0	4.5	7.0	3.3	-0.0
Sweden	5.2	5.1	6.5	7.4	5.4
Finland	6.6	5.6	7.1	6.2	4.1

* Japan: 9 years to 1973; Denmark: 3 years to 1973; Sweden: 4 years to 1973.

Source: OECD Annual National Accounts database.

22. Adding in general government saving, the UK falls to virtually the bottom of the international saving league (see table 2). In the decade prior to the first oil shock UK saving was lower than in any of the other countries shown, apart from the US. In the following decade and subsequently there has been net dissaving by the UK general government sector (though the US, Canadian and Italian general government sectors have dissaved more). In recent years US net national saving has fallen to very

low levels; the UK still comes second from bottom, perceptibly below even the Scandinavian countries, but the gap between the UK and most other countries is considerably smaller than it used to be.

Table 2: National net saving since the mid 1960s

(per cent of GDP)

	10 years to 1973	10 years after 1973	1984	1985	1986
US	9.7	6.4	4.4	3.2	2.5
Japan	22.4	19.1	17.0	18.0	18.0
Germany	17.0	10.3	9.2	9.4	11.1
France	15.1	10.9	6.3	6.3	7.3
UK	11.1	6.3	6.2	6.9	6.0
Italy	16.5	12.7	11.3	11.0	11.0
Canada	11.2	10.7	8.4	7.6	6.6
Denmark	16.2	8.2	5.8	5.8	7.7
Norway	13.9	11.6	17.2	16.1	8.6
Sweden	14.8	7.4	6.4	6.1	6.9
Finland	13.7	10.3	9.9	8.9	7.2

Source: OECD Annual National Accounts database.

23. The ordering in the international saving league table prior to 1973 correlates fairly well with growth performance; for example, Japan had very high growth and a high saving rate, the US and UK had low growth and saving. Both growth rates and saving ratios fell after the first oil shock. The UK's improved position in the international saving league is in the direction one would expect given the change from being a relatively low growth country to one of the fastest. But it still remains a low saving country, with only the US much below it in the league.

24. In a closed economy - with no possibility of capital flows between countries, so that saving has to equal domestic investment - the saving rate and the growth rate would be expected to be closely related in the long run. If the capital/output ratio were constant, the accounting identity that saving equals investment would entail that the share of saving in GDP equals the capital/output ratio times the growth rate.

25. Provided that there are capital flows between countries, an individual country's saving does not have to equal its domestic

investment, so that while world saving and world growth are related there is no necessary relationship between saving and growth in individual countries. A fast growing country can have a low saving rate, if it is a net recipient of capital inflows, ie if it runs a current account deficit. In practice, with the exception of some of the smaller industrial countries and of the period since 1983, there have not been persistent current account disequilibria corresponding to differences in national growth rates. Investment and growth rates have been correlated with saving rates rather than with current account balances.

OK, but interesting question – Berlin speech etc – is whether we are now in a new world, given global inbs.

And since 1983?

26. The saving/growth equation provides one way of answering the question of how much the UK needs to save if its growth is not to be financed by a current account deficit. Given a net capital stock/output ratio currently at just over 3, the saving/growth equation implies that if the trend growth rate is 2½ per cent the net national saving rate needs to be around 7½ per cent. For a trend growth rate of 3 per cent, the required net national saving rate would be 9 per cent. The estimated national net saving rate in 1988 of 7½ per cent seems thus only sufficient to support a growth rate around the bottom end of the range of estimates of growth in productive potential. (However, for reasons noted earlier this calculation needs to be heavily qualified. The figure for net national saving may be an overestimate - because some of the residual error may represent overrecorded saving - or an underestimate - because depreciation is probably overstated. The capital output ratio is probably overstated, so that the saving rate actually required for any given growth rate may be less than it appears.)

Influences on saving: (i) demography

27. One factor that may account for changes in saving over time and for international differences in national saving rates is population structure. The relation between demography and saving will obviously depend on the extent to which individual saving is determined by "life cycle" considerations rather than by other motives such as the desire to leave bequests.

28. Most empirical studies of the effects of demography on saving focus on international cross section data, not least because demographic variables usually change too slowly over time to enable demographic effects to be detected from time-series data. International cross section studies reviewed by Sturm* confirm that high dependency ratios tend to lower the private sector saving rate, although the size of the estimated effect varies a lot depending on the other variables included in estimation. These studies also show a fairly robust positive association between growth rates and private saving rates, and account for the major part of the observed international variation in private saving rates. For example, Modigliani was able to account for about 80 per cent of the variation in the ratio of saving to disposable income between twenty four countries in terms of labour productivity growth and young and old-age dependency ratios using annual averaged data over the period 1952-60. However, note that all the studies reported by Sturm use pre 1975 data.

29. Our own fairly elementary attempts to reproduce these sorts of results on more recent data have proved completely unsuccessful. For twenty one OECD countries we looked at annual average data over the period 1975-79 for the ratio of both private sector and total national saving (net and gross) to GDP, and tried to account for the variation between countries in terms of annual average GDP growth over the same period and three dependency ratio variables. Dependency rates explained only a small proportion of the international variation in gross saving rates and appeared to have a perverse effect on net saving rates.

30. It is quite possible that with different manipulation of the data better results might emerge, but the initial results obtained give no encouragement. National saving rates in the second half of the 1970s may reflect policy reactions to the first oil shock more than the long run fundamental determinants of saving. But clearly the suggestion from earlier work of the dominant importance of demographic factors should be treated with great

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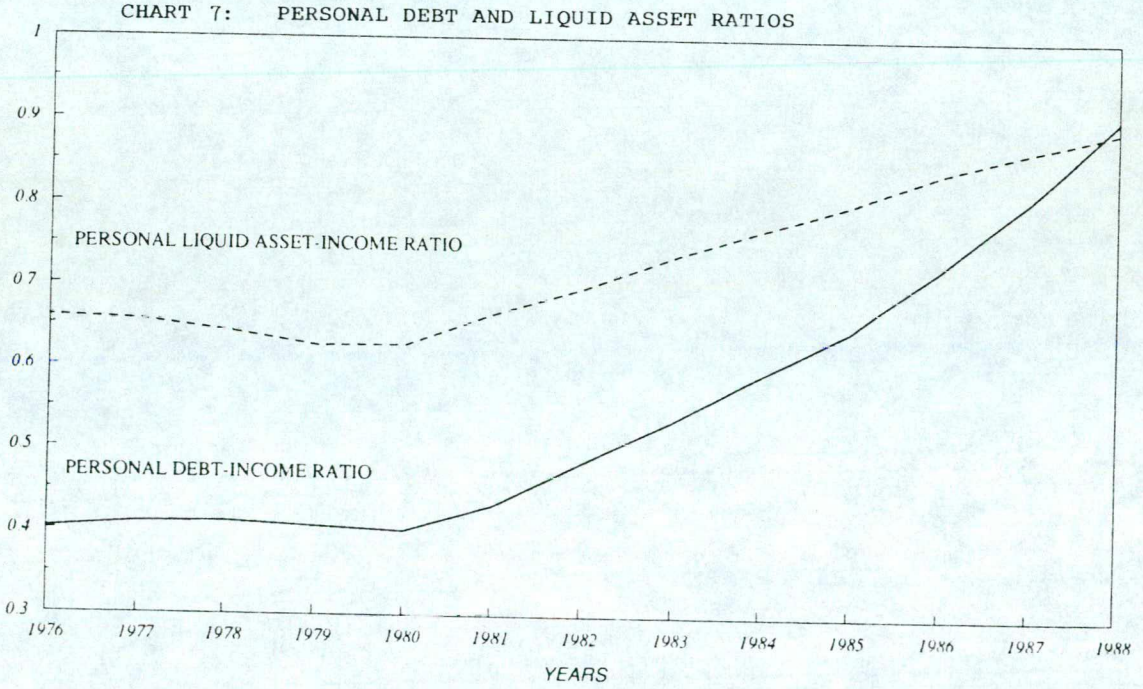
* Sturm, P. H. (1983), "The determinants of saving: theory and evidence", OECD Economic Studies, No 1 pp. 147-196.

caution, and certainly we would not have confidence in any quantification of the contribution of demographic factors to current international differences in saving rates.

Influences on saving: (ii) financial market deregulation

31. It is widely believed that financial liberalisation has been an important factor behind the decline in the UK personal saving ratio in the 1980s. The abolition of the "corset" in 1980 encouraged banks to compete aggressively for personal lending business, and this was followed by the ending of restrictions on consumer instalment credit in 1982 and move recently by changes which have allowed building societies to participate fully in the market for consumer credit. The UK personal debt/income ratio has more than doubled since 1980 (see chart 7). The effect of financial liberalisation has been felt in some other countries as well. Norway in particular experienced a massive consumption boom, with substantial dissaving by the personal sector in 1986, following financial liberalisation in the early 1980s.

CHART 7: PERSONAL DEBT AND LIQUID ASSET RATIOS



32. The UK debt income ratio has now caught up with the US debt income ratio, having been only half as large eight years ago. It is still only about three quarters the size of the Swedish debt income ratio, but is more than three times the size of the Japanese debt income ratio and several times larger than, for example, the Spanish and Italian debt income ratios. Countries with low debt income ratios generally show other indications of major capital market imperfections, eg high downpayment/mortgage ratios for first time house buyers.

33. The last few years share some features in common with the period immediately after the war. In the earlier period saving was temporarily depressed as rationing of goods was eased and people ran down assets that they had accumulated because of the lack of goods available for purchase. The last few years can be seen as a similar period of transition with saving temporarily depressed by the greater availability of credit.

34. In 1988 the ratio of personal debt to income is estimated/forecast to rise by 10 percentage points. Stabilisation of the ratio would thus mean a large reduction in the flow of credit to the personal sector, with consequent large changes in counterpart flows (consumer spending and acquisition of real and financial assets by the personal sector). The increased supply of credit has fairly clearly affected asset holding as well as consumer spending. Chart 7 shows the rise in holdings of liquid assets in the 1980s - roughly a 25 percentage point rise over a period when the debt income rate has risen by 50 points. Holdings of other financial assets such as shares may also have been affected. If we assume that all of the rise in the rate of persons' liquid asset holdings to GDP since 1980 is due to financial liberalisation it would mean that at least half of the rise in debt has been accounted for by higher gross acquisition of financial assets, with half or less accounted for by higher consumer spending and investment. Stabilisation of the debt income ratio relative to this year's 10 percentage point rise would thus add rather less than 5 points to the saving ratio, probably bringing it most of the way back to the 8-9½ per cent range of the 1960s.

Influences on saving: (iii) taxation

35. Another potential influence on saving is the tax system. The choice between consumption and saving will be undistorted when the marginal rate at which current resources can be transformed into future resources equals the marginal rate at which the private sector is willing to trade off future for present consumption. But taxes can drive a wedge between these two rates, distorting the choice between consumption and saving.

36. An income tax, in theory, discourages private saving, as saving is out of taxed income and the returns are also taxed. The post-tax return is lower than the pre-tax return; this is conventionally defined as a "positive tax wedge". An expenditure tax, on the other hand, does not distort the consumption/saving decision. The tax wedge is zero for, although the returns to saving are taxed, the saving itself is made out of untaxed income. (However, the expenditure tax still distorts other choices, such as between income and leisure, and perhaps more than an income tax, since if saving is removed from the tax base, tax rates may need to be higher. The distortion of the choice between income and leisure can itself indirectly affect the rate of saving.) A zero tax wedge would also obtain if, instead, saving is out of taxed income, whilst the returns are exempt. If the tax system subsidises saving, then a negative wedge results.

37. Most existing studies tend to support the view that the interest elasticity of aggregate personal saving is positive, but small. Thus making the tax treatment of saving more favourable would probably result in only a relatively small increase in aggregate saving.

38. The current tax system is a hybrid of elements of both the income and expenditure tax. Three broad groupings of savings media may be identified according to the tax treatment each receives:

i) non-privileged media - such as bank and building society deposits, gilts and shares, which have positive tax wedges;

ii) moderately privileged media - some (such as PEPs) are removed from the tax system altogether, and thus have zero tax wedges; others (such as most occupational pensions, and owner-occupied housing) receive moderate encouragement, and have small negative wedges;

iii) highly privileged media - are strongly encouraged by the tax system, having large negative tax wedges; examples include BES, the lump-sum element of pensions, and heavily mortgage-financed housing.

39. In general, mortgage interest relief is presumed to encourage investment in owner-occupied housing. But in recent years, consumption may have also been stimulated, through increased equity withdrawal. Ordinarily, borrowing for consumption does not attract interest relief, but additional mortgage finance may replace equity, which can then be consumed elsewhere (effectively getting the benefit of the tax relief). In this way, the tax system may indirectly discourage saving.

40. Table 3 gives the tax wedges for a number of the main savings media. They are based on stylised assumptions and so do not capture the full complexity of the present system. But they do give an indication of the size of the effects on rates of return induced by the tax system. Although durables are not considered as savings in the National Accounts, it may be noted that they receive expenditure tax treatment.

Table 3: Tax wedges (assuming 8% nominal return and 4% inflation)

	Income tax rates 25%	40%
Bank and building society deposits	1.70	2.90
Gilts - conventional	2.00	3.20
- low coupon (1)	0.93	1.48
- indexed (2)	0.60	0.96
Shares - yielding income	2.00	3.20
- capital gain	0.00	1.60
Pension - 20 years (3)	-0.43	-0.84
Housing - 25% mortgage (4)	-0.67	-1.07
- 70% mortgage	-4.67	-7.47

Notes:

(1) Assuming a 3% coupon on a five year gilt.
(2) Assuming 60% of the real return comes as income.
(3) The calculation for a 20 year pension provides an average wedge for an individual building up rights over a 40 year working life.
(4) Figures exclude local authority rates. If rates are equal to 1% of capital value, the wedges become:

25% mortgage	0.67	0.27
70% mortgage	-1.33	-4.13

All the figures neglect trading costs and stamp duty, and assume that only higher rate tax payers are liable for CGT. Pensions calculation assumes 25% of the entitlement is taken as a tax free lump sum.

41. The varying degrees of privilege accorded to different assets has undoubtedly influenced the pattern of savings over time. Table 4 shows that the relatively favoured media - housing, life assurance, and pensions - have all tended to increase their share of the aggregate personal sector portfolio. This has probably led to some inefficiency in the pattern of investment, for example too much owner-occupied housing.

Table 4: Percentage of selected financial and physical assets, end year (1)

	1957	1962	1967	1971	1976	1979	1983	1987
Housing (2)	19.3	23.0	29.0	31.2	45.4	50.3	41.8	41.0
Notes, coins and deposits	24.2	21.2	23.2	23.1	22.2	19.6	18.6	16.3
National Savings	12.1	9.1	5.9	4.0	3.4	2.4	3.3	2.6
Gilts and marketable debt	11.5	9.0	4.5	4.8	2.6	2.2	2.3	2.0
Shares and unit trusts	19.1	24.2	21.2	20.1	9.7	8.1	8.5	10.7
Life assurance and pensions	13.8	13.5	16.2	16.8	16.6	17.4	25.5	27.3

(1) Excludes consumer physical assets other than housing, overseas assets and miscellaneous financial assets. In 1987, the assets included accounted for around 80 per cent of personal sector assets.
(2) Net of loans for house purchase.

42. The individual wedges are stylised calculations sensitive to changes in assumptions. Aggregating these tax wedges to give an indication of the overall effect of the tax system is very difficult (because of the need to choose what weights to use for each asset, and for different rates of tax, because of capital gains versus income, limits to particular investments, the assumed behaviour of rates of return and so on). But it would seem that with elements of tax subsidy and tax privilege, the present treatment of savings, in aggregate, is closer to that of the expenditure tax than the income tax. Once local authority rates are excluded, this conclusion becomes even more clear.

43. Thus there is ~~be~~ no strong reason to suppose that the choice between consumption and saving in aggregate is badly distorted by the tax system at present, except insofar as tax-relieved lending for house purchase is in practice leaking into consumption.

However it is not possible to be certain how much effect the income/leisure distortion is having on saving, nor how much the differential treatment of different savings media matters.

44. Differences in the overall level and structure of taxation in different countries may account for some of the international variation in saving propensities. The low private saving propensities in Scandinavian countries reflect in part tax systems that discourage saving and encourage borrowing: they all have high marginal income tax rates and allow tax relief on consumer credit (even though in Denmark this relief is now partly offset by a consumer credit tax, the typical tax payer there would still get net relief equal to 30 per cent of interest payable.) Japan is the polar opposite case, with high private saving reflecting in part tax breaks for saving and relatively low rates of income tax for the majority of tax payers.

Influences on saving (iv): PAYG state pensions

45. If an important reason why people save is to provide for retirement, provisions made by the state for pensions are likely to affect saving behaviour. The introduction of an unfunded Pay As You Go (PAYG) state pension scheme would be expected to reduce the rate of national saving for a substantial period of time after it was introduced. In the long run a PAYG scheme will not necessarily reduce the flow of saving; but the stock of savings, and hence the national capital stock and/or net stock of overseas assets will be permanently lower as a result of the existence of the scheme.

46. Like other industrial countries (but to a lesser extent than almost all the others) the UK is facing an ageing of its population structure over the next 30 to 40 years. The gradual introduction of rights built up under the State Earnings-Related Pension Scheme (SERPS) will tend to make the eventual state pensions of those currently in work more generous than the pensions that the state currently pays the elderly. Because the pension contributions of those in work are determined by current outgoings on pension payments and not on expected future outgoings

(ie contributions are not related to the accruing value of pension rights) the demographic prospects and the build up of SERPS would suggest that the current generation of contributors are paying too little for their accruing pension rights. This would mean that they are able to spend more now than if the state system were actuarially fair; so that the rate of private and national saving is below what it would be with an actuarially fair scheme. In the long run (when SERPS has matured, and when the population structure has settled down to a more elderly pattern), contribution rates would be much higher than they are now.

47. However, the above analysis misses out one crucial feature of the situation, which is the effect of uprating the basic state pension in line with prices rather than earnings. This reduces the value of pension payments over time relative to the overall output of the economy. On its own, this would tend to lead present contributors to be paying too much rather than too little.

48. Table 5 below, which reproduces projections by GAD that were published in Cmnd. 9711, shows the crucial difference made by price uprating.

Table 5: Estimated joint rates of contribution* in respect of employed earners (before reduction for those in contracted-out employment)

(per cent of earnings)

	Revised scheme for SERPS		
	Ultimate additional numbers contracted out		
Year	½ million	2 million	5 million
Price uprating			
1993-94	14.6	14.8	15.2
2003-04	14.1	14.3	14.6
2013-14	14.3	14.4	14.6
2023-24	14.4	14.5	14.6
2033-34	14.5	14.4	14.3
2043-44	12.2	12.1	11.8
2053-54	10.8	10.6	10.4
Earnings uprating			
1993-94	15.9	16.1	16.5
2003-04	17.0	17.2	17.5
2013-14	18.9	19.0	19.2
2023-24	20.9	21.0	21.1
2033-34	23.2	23.1	23.0
2043-44	21.0	20.9	20.6
2053-54	20.0	19.9	19.7

* Excluding Redundancy Fund, Maternity Pay Fund and NHS Act contributions.

The "notional" contribution rate in 1986-87 based on the same assumptions on unemployment etc as those used to compute the figures in table 5 was 15.7 per cent. Thus if we assume price-uprating continues indefinitely, contribution rates will fall from now on and go on falling, in spite of the build up of SERPS and the unfavourable demographic changes in prospect. (A fall in contribution rates has only been avoided in the last few years by reducing and finally abolishing the Treasury supplement.)

49. This leaves the question whether it is reasonable to assume that price uprating of basic state pensions will continue indefinitely (and - crucial to the question of the effect on the current rate of national saving - what those at work expect about the future value of state pensions). On the one hand, it seems quite likely that at some stage governments will be elected to power with a commitment to restoring earnings uprating. On the

other hand, as the build up of rights under SERPS and the wider provision of occupational and personal pensions increases, the pressure to maintain the value of the basic pension may ease.

50. Even in the case of uprating fully in line with earnings, the rise in contribution rates in the UK will be much less than in most other industrial countries. The UK now has a relatively elderly population by international standards; on the assumptions about future fertility rates used in a recent OECD WP1 paper (CPE/WP1(88)6), the UK's population in the first half of the next century will be relatively young by international standards then prevailing.

Table 6: OECD projections of old age dependency ratios in major industrial countries (population of 65+/population 15-64)

(per cent)

	1990	2010	2030	2050
United States	18.7	18.5	31.7	31.8
Japan	16.6	27.5	31.8	37.6
Germany	22.5	30.3	43.4	42.3
France	21.0	24.0	35.9	37.8
United Kingdom	23.1	22.1	31.3	30.4
Italy	20.3	25.6	35.3	37.8
Canada	16.8	21.3	37.2	36.4

51. It is of some interest to consider further the extreme case of full earnings uprating. With full earnings uprating the "actuarially fair" level of contributions (on the basis of the calculations in table 5) might be - on the basis of rather approximate calculations - around 3-4 percentage points above the current contribution rate. Such an increase in the contribution rate would increase contributions now by an amount roughly equivalent to 1 per cent of GDP. On the life-cycle hypothesis, current contributors will be spending now some of their gain relative to an "actuarially fair" system. It would be necessary

to raise the contribution rate by 3-4 per cent to offset the effect of "demographic transition" on national saving. But, to repeat, this calculation only applies to the case of full earnings uprating.

Influences on saving (v): the National Health Service

52. State provision of health care may reduce private saving for two reasons:

(i) to meet their needs for health care in old age (either high expenditure or high insurance premia) individuals would have to save during their working lives

(ii) precautionary saving because of individuals' uncertainty over their future need to spend on health care.

The second of these reasons would not apply provided there was comprehensive provision of medical insurance by the private sector in the absence of the national health service.

53. It is obviously very difficult to estimate how much people would choose to save to provide for health needs in old age in the absence of state provision, and any guess is bound to be subject to an enormous margin of error. Table 7 shows estimated per capita public expenditure on health and personal social services at various age levels. The life expectancy of a person at age 65 is about fifteen years. On average over these fifteen years public spending on his health comes to some £900 or so a year (at 1986-87 prices): roughly half the level of the state pension paid to a single pensioner. Health expenditure per capita might be expected to rise in line with earnings (at least). Thus the health service effect on saving working through the "demographic transition" may be roughly half the pensions effect calculated on the basis of earnings uprating.

Table 7: Health and personal social services public expenditure, £per capita (England, 1986-87)

Births	0-4	5-15	16-64	65-74	75+
1300	370	255	205	615	1570

Influences on saving (vi): other benefits

54. The provision of unemployment, disability and sickness benefits by the state probably reduces precautionary saving to some extent, although precautionary saving may not be necessary when people are saving for other reasons and so have assets available to finance emergencies (or if they are able to borrow to cover periods of temporary difficulty). We have not attempted to quantify effects on saving of these various state benefits.

Influences on saving: (vii) income distribution

55. Rich people save more than poor people - for various reasons, one being that they live longer. Income distribution from the rich to the poor through taxes, benefits, and other public expenditure is likely therefore to reduce total private saving. However the tax/expenditure regime changes not only the post-tax distribution of income, but also the pre-tax distribution, as pre-tax incomes adjust to the regime. It is,therefore, not feasible to estimate the size of the impact on saving of the current scale of distribution.

Influences on saving: (viii) inflation

56. One of the ways the government influences the level of private sector saving is through the inflation tax. To achieve a particular set of objectives for real wealth and future consumption, the private sector has to save a larger proportion of its income the more that inflation erodes the value of existing assets.

57. In the 1970s the inflation tax on the private sector amounted at times to around 10 per cent of GDP. But it is much smaller now because

- inflation has fallen

- the government's liabilities are much smaller relative to GDP than they were in the 1970s.

58. Our estimate is that the inflation tax is now averaging around 1½ per cent of GDP: obviously if the borrowing and inflation objectives of the MTFS are achieved it will become increasingly insignificant over the medium term.

III CONCLUSIONS

59. In spite of some improvement relative to other countries over the last two decades, UK national saving is still low by international standards. The UK's movement up the international growth league table probably requires a rather bigger rise up the international saving league table than has actually occurred if all of our growth is to be financed from domestic resources. Subject to the large uncertainties involved, it seems that the UK national saving rate is barely adequate to support growth around the bottom of the range of estimates of current growth in UK productive potential.

60. One approach to public saving would be to count up the possible distortions to private saving that state intervention in various aspects of life causes, and for the public sector to save enough to offset all these distortions.

61. The "financial liberalisation" effect on saving does not count as a distortion for this purpose: it reflects people moving to a preferred level of debt and assets, having previously been constrained by credit rationing to a less satisfactory lifetime pattern of spending. Table 8 below summarises the other influences on saving that have been discussed: government interventions in the economy which may change the level of private saving.

Table 8: Summary of distortions to private saving

Nature of distortion	Comment
Tax system	Probably little net effect.
PAYG pensions	Uncertain: under extreme assumption of full earnings uprating in future, contributions might need to rise by about 1 per cent of GDP to remove negative distortion to saving during demographic transition.
National health service	Perhaps reduces saving by ½ per cent of GDP during demographic transition.
Other benefits	Negative effect on saving.
Income redistribution	Negative effect on saving.
Inflation	+1½ per cent of GDP at current inflation rate.

62. In total it is conceivable that the forms of government intervention identified could be reducing private saving by a significant amount; and would be more likely to do so if inflation fell back from its current rate as planned in the MTFS. In any case, the nature of the inflation distortion is rather different from the other distortions. The distortion can be reduced or eliminated by appropriate macroeconomic policy, and it is the present Government's objective to do that and not to live with the present rate of inflation.

63. One way of offsetting the overall negative distortion to private saving would be to have positive general government net saving. However, in recent years general government net saving has generally been negative though in 1988-89 there may be small positive net saving (0-½ per cent of GDP). A case can be made for at least maintaining and perhaps further increasing this year's rate of net general government saving.

Thanks. Subject to EST's views, OK as [illegible] by you & me. But [illegible] article [illegible] taken on CBI Survey Report, spent taking on later (Nov) CBI Survey Report.

→ APH

[illegible] Bush 23/11/88.

FROM ELEANOR EDWARDS

23 November 1988

1. MR. GIEVE

2. ECONOMIC SECRETARY

C

To try to save you some work (!) I've asked EST to look at this particularly thoroughly. You may like, nonetheless, to glance at Investment, and Commodity Prices (attached below).

cc Chancellor
Chief Secretary
Financial Secretary
Paymaster General
Sir T Burns
Mr. Odling-Smee
Mr. Peretz
Miss O'Mara
Mr. Hibberd
Mr. S.J. Davies
Mr. Pickford
Mr. Kelly
Mr. Bush
Mr. Patterson
Mr. Darlington
Mr. N. Williams
Mr. Hudson

ECONOMIC PROGRESS REPORT - DECEMBER ISSUE

The next issue of EPR is due to be published on Wednesday, 7 December, with copy going to the printer on Tuesday, 29 November.

2. You have already seen copies of Mr. Savage's draft on Commodity prices and inflation, and Miss Simpson's draft on The Autumn Statement. Drafts of further articles intended for this issue are attached to this minute.

BELOW

Already commented.

3. The main item is Business investment: recent trends, (EA1, Mr. Darlington) which looks at the improvements of recent years in investment, both in quantity and in quality, and the current outlook, set against the background of the past twenty years or so.

4. The new exchange rate index (MG1, Mr. Williams) explains briefly the prospective change to the new index in January.

5. ECU Treasury Bill programme (MG1, Mr. Williams) is a revised version of the box prepared for the last issue of EPR, left out then for lack of space, and updated now to refer to the success of the first two tenders.

Ellen Edwards

Business investment: recent trends

The economy has experienced strong and steady growth for the last seven years. The pace of this accelerated in the twelve months up to the second quarter of 1988 with growth in the output measure of GDP of over 5½ per cent on a year earlier. Over the same period the volume of business capital formation, that is investment, increased by almost 10 per cent to reach its highest level ever. Business investment in 1987 stood at £40.9 billion (1985 prices), 30 per cent above its level in 1981. Furthermore, the quality of investment appears to have improved in the 1980s. Growth in investment, in both expanding capacity and improving efficiency, will reinforce the impressive progress being made on the supply side of the economy. This article examines recent trends in business investment and surveys the outlook.

What is business investment?

2. Investment in fixed capital formation (as opposed to investment in financial assets) represents additions to physical productive assets that yield a continuous service beyond the period in which they are purchased, for example vehicles, plant, machinery and office equipment. Business is defined broadly here as that sector engaged in marketable activities. Hence, investment by public corporations is included, whilst general government investment is not. It also excludes personal sector

investment in dwellings. In 1987 business investment, in volume terms, accounted for about 64 per cent of total investment (gross fixed domestic capital formation).

Recent trends

3. Chart 1 shows the quarterly path of business investment from 1965 to the second half of 1988. It shows the strong upswing since the trough of the early 1980s. Since 1982 annual* growth has averaged 5 per cent. Most recently, in the year up to the second quarter of 1988, investment grew by almost 10 per cent, while consumption grew by less than 5 per cent. Thus an increasing part of demand has recently been aimed at capacity expansion and/or enhanced efficiency rather than one-off consumption.

4. Manufacturing investment is also shown in chart 1. In the second quarter of this year it stood at its highest level ever recorded. However, the declining share of manufacturing industry in total output is reflected in a reduced share in total business investment. It accounted for only 26 per cent of total business investment, its share having peaked at 34 per cent in 1970.

The quality of investment

5. So far we have focused on the trends in the quantity of investment. All too often any assessment of investment ends there,

*Quarters on corresponding quarters a year ago previously

without considering the quality of investment. It is one thing to spend more money on the acquisition of new machinery; it is quite another to utilise it in an efficient and effective way.

6. There is evidence to suggest that the economy has improved its capital productivity (output per unit of capital) - though problems in measuring the capital stock mean that calculations should be treated with some caution. Central Statistical Office data for the gross capital stock suggest that capital productivity has improved markedly relative to the 1960s and 1970s. Furthermore a recent study by the OECD (Economic Studies no.10, Spring 1988) showed the average annual growth in capital productivity between 1979 and 1986 in the UK's business sector to have been better than that of most other major economies. This tends to confirm a picture of an investment performance in the 1980s which has added to both the quantity **and** quality of the capital stock.

7. The impact of better quality investment, improved efficiency in the use of all resources (including labour), and the generally more buoyant economic environment of the 1980s can be seen in the steady rise in the net rate of return on capital employed. Chart 2 shows the net operating surplus of companies [(profits and rent minus capital consumption) before tax expressed] as a percentage of their net capital stock [(plus the book value of stocks)]. The net rate of return of industrial and commercial companies, excluding North Sea oil activities, rose continuously between 1981 and 1987 to reach 10.2 per cent, its highest level since 1969. The recent

published in the Autumn Statement (see article starting on page 0) ~~projected~~ shows the net rate of return rising still higher this year.

8. One of the reasons for the improved quality of investment has been The supply side of the economy has benefited from the removal of distortions in the tax system. The Budget measures of 1984*, ~~such as~~ and in particular the ending of 100 per cent first-year capital allowances, improved the allocation of resources to investment, by greatly reducing unwarranted tax incentives. These incentives distorted the post-tax rate of return on a project relative to pre-tax return, and so encouraged investment which would not otherwise have been judged viable. The ~~Budget measures~~ lower CT rates and reduced first-year allowances were phased in between 1984 and 1986. Their announcement in 1984 had the one-off effect of bringing forward some investment, which can be seen in the jump in investment in the first quarter of 1985 and its subsequent temporary fall (see chart 1).

The outlook for investment

9. The Industry Act Forecast ~~projected significant growth in~~ is for ~~business investment for both 1988 and 1989 of 13½ and 7½ per cent respectively.~~ to grow by 13½ per cent in 1988, and 7½ further 7½ per cent in 1989. Other indicators support this view.

10. The latest Investment Intentions Survey from the Department of Trade and Industry, published in June this year, indicated a rise of around 12 per cent in investment by the manufacturing, construction, distribution and selected service industries in 1988

*See Economic Progress Report, March-April 1984.

[Better explain what they were: CT rate fell from...; capital allowances reformed...]

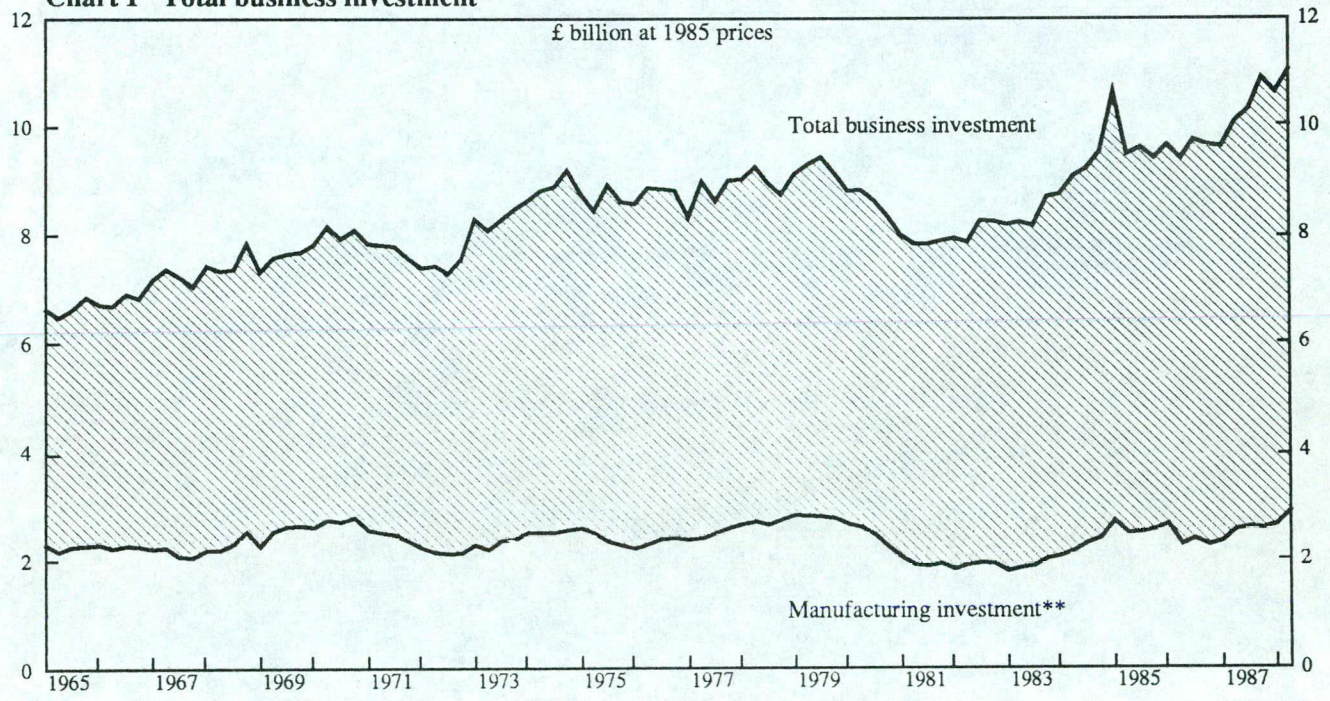
to be followed by further, though smaller, growth in 1989. The latest CBI Industrial Trends Survey published in October showed the balance of firms expecting to increase investment is well above its historic ~~mean~~ average (charts 3 and 4). Not sure we need 4, as well as 3. agree -

11. The quarterly path of investment can be erratic, and initial estimates subject to substantial revision. However, with economic growth continuing and business optimism high, the outlook for investment remains good. Higher interest rates are unlikely to alter this picture. The CBI Survey shows only 14 per cent of firms regard the cost of finance as a potential constraint on investment. This is not surprising in a period of strong profits growth. Businesses are far more concerned with realising an adequate rate of return on investment, something which has become easier in the enterprising climate of the 1980s.

Why not incl. forecast? (Chart 2 does, in the approved way)

I agree.

Chart 1 Total business investment*



* including public corporations
** including assets leased to manufacturers

Chart 2 Companies' net rates of return

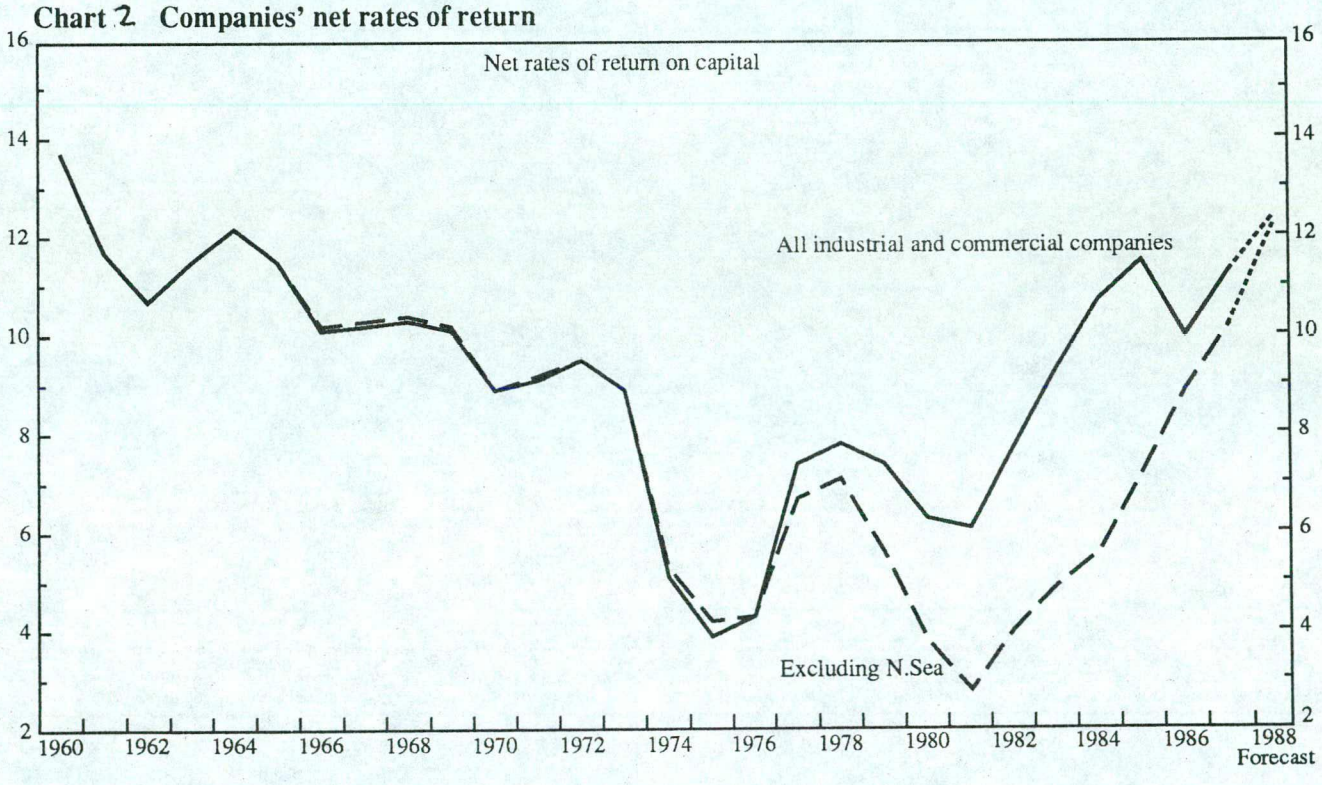
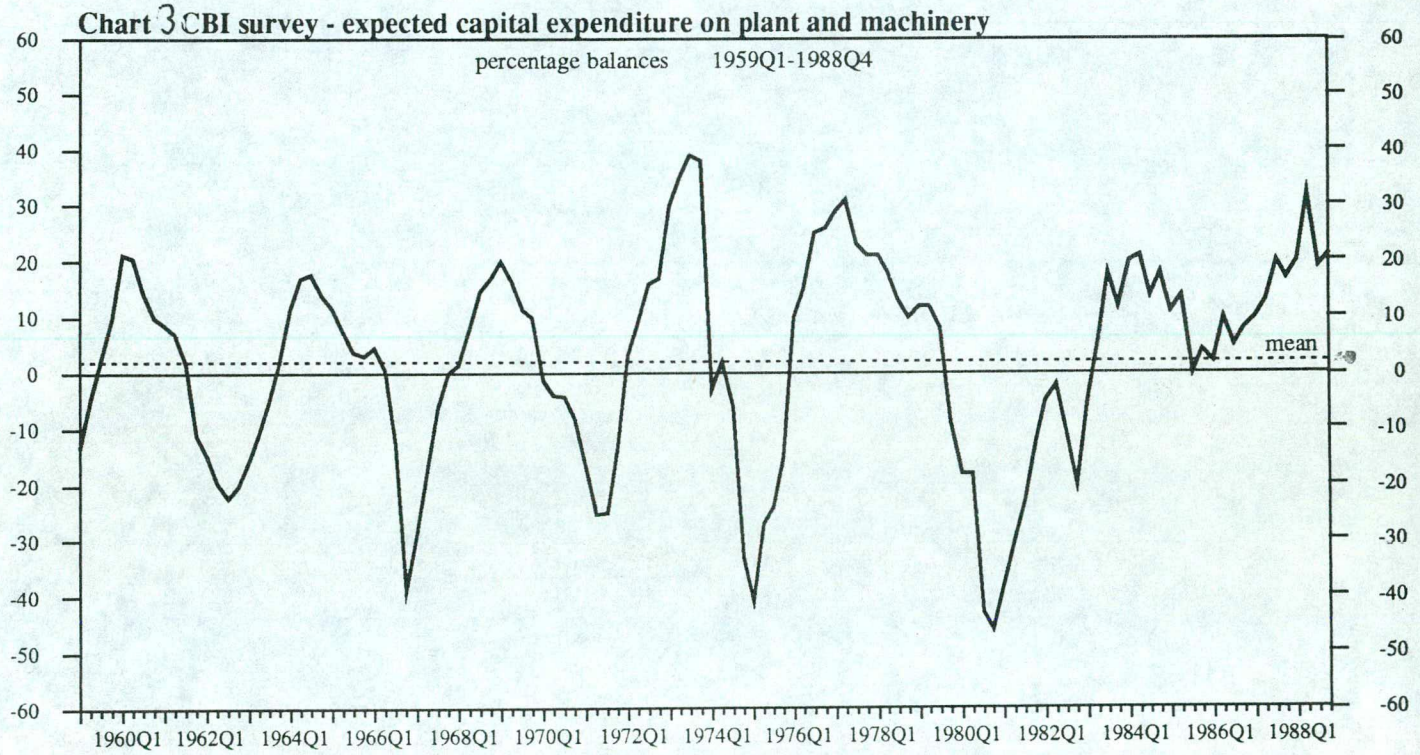


Chart 3 CBI survey - expected capital expenditure on plant and machinery



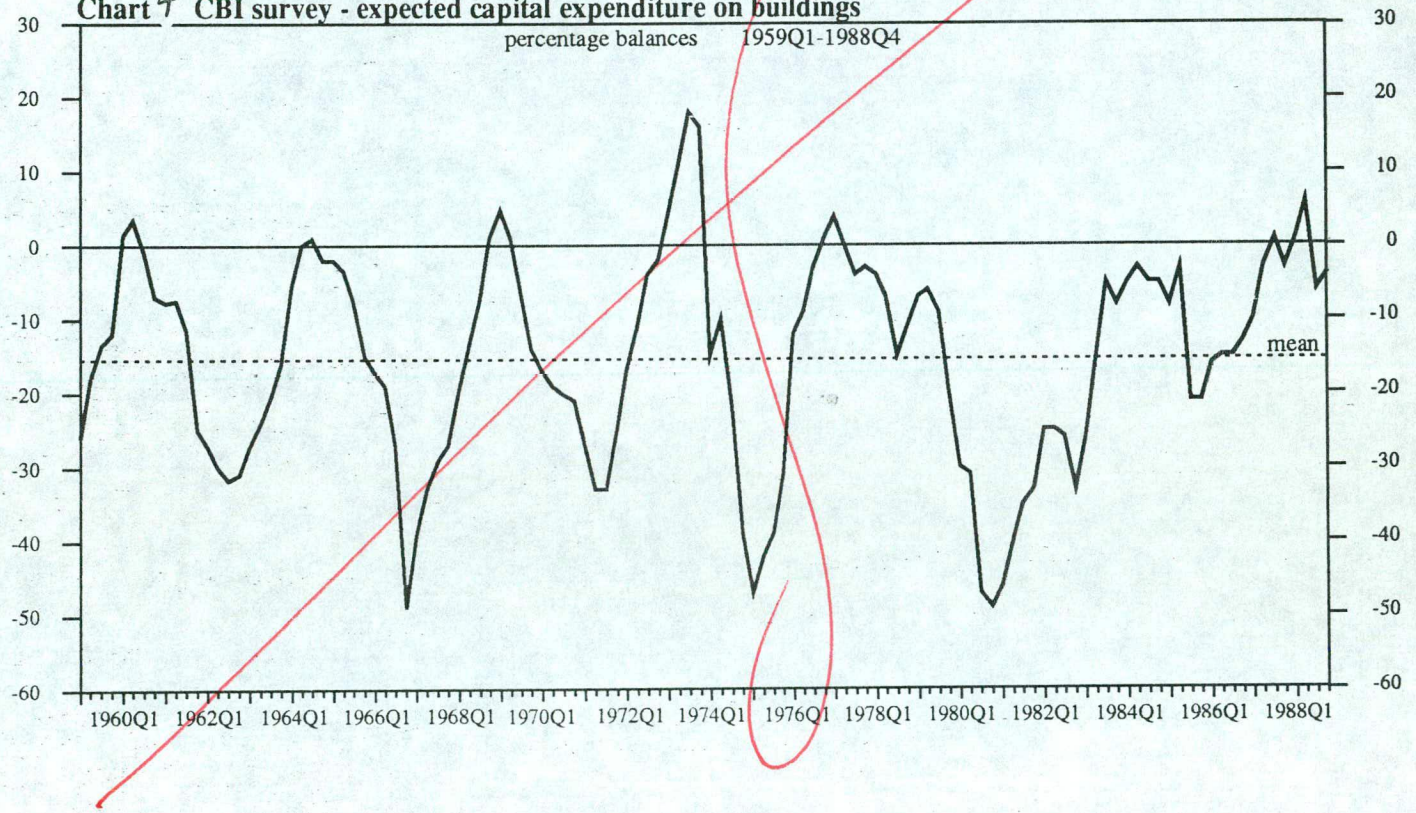


Chart 4 CBI survey - expected capital expenditure on buildings
percentage balances
1959Q1-1988Q4
30
20
10
0
-10
-20
-30
-40
-50
-60
mean
1960Q1
1962Q1
1964Q1
1966Q1
1968Q1
1970Q1
1972Q1
1974Q1
1976Q1
1978Q1
1980Q1
1982Q1
1984Q1
1986Q1
1988Q1

eri

The new exchange rate index

A new official effective exchange rate index (ERI) for sterling is to be published by the Bank of England from 3 January 1989. The change was first announced in the November edition of the Bank of England Quarterly Bulletin. This article explains why a change is being made, and describes the new index.

2. An effective exchange rate index measures the value of a currency against a 'basket' of other currencies. For convenience this average exchange rate is expressed as an index with the base date, 1975 in the case of the existing ERI, equal to 100.

The present ERI

3. The weight of each currency in an ERI basket can be calculated in different ways, giving different results. The weights in the current ERI were calculated by the International Monetary Fund (IMF) using its Multilateral Exchange Rate Model (MERM - see Economic Progress Report, March 1981 and October 1984). The weights are so designed that a 1 per cent increase in the index will have the same effect on the UK's visible trade balance whatever combination of exchange rate changes brings it about. Though this may seem to be precise there is a great deal of uncertainty about the economic relationships in the MERM used to derive the weights, and the data used in the calculations have become increasingly out of date.

The new ERI

4. In July the IMF started to publish new effective exchange rate indices for 16 industrialised countries in International Financial Statistics. The new index published for the UK will form the basis for the new ERI. The weights used in the new index reflect the relative importance of other countries as competitors to the UK in both domestic and overseas markets, and are constructed using disaggregated data for manufacturing trade in 1980. The new index will be a significant improvement on the present ERI in that it will be better at 'capturing' competitiveness effects, based on more recent data, and use a methodology which does not rely on the uncertain economic relationships of the MERM.

5. The table compares the new weights with those used in the present index. The major changes are a fall in the weight of the US dollar from 24.6 per cent to 20.4 per cent, and a rise in the weight of European Community currencies from 47.5 per cent to 55.6 per cent, largely due to the increase in the weight of the deutschemark from 14.1 per cent to 20 per cent. These differences reflect both changing trade patterns and the different methods of calculation.

Base date

6. The base date for the new ERI is 1985 = 100, as compared with 1975 = 100 for the existing index. A change in base date influences the scale of the index. Percentage changes between dates in the index are unaffected. It does not, of itself,

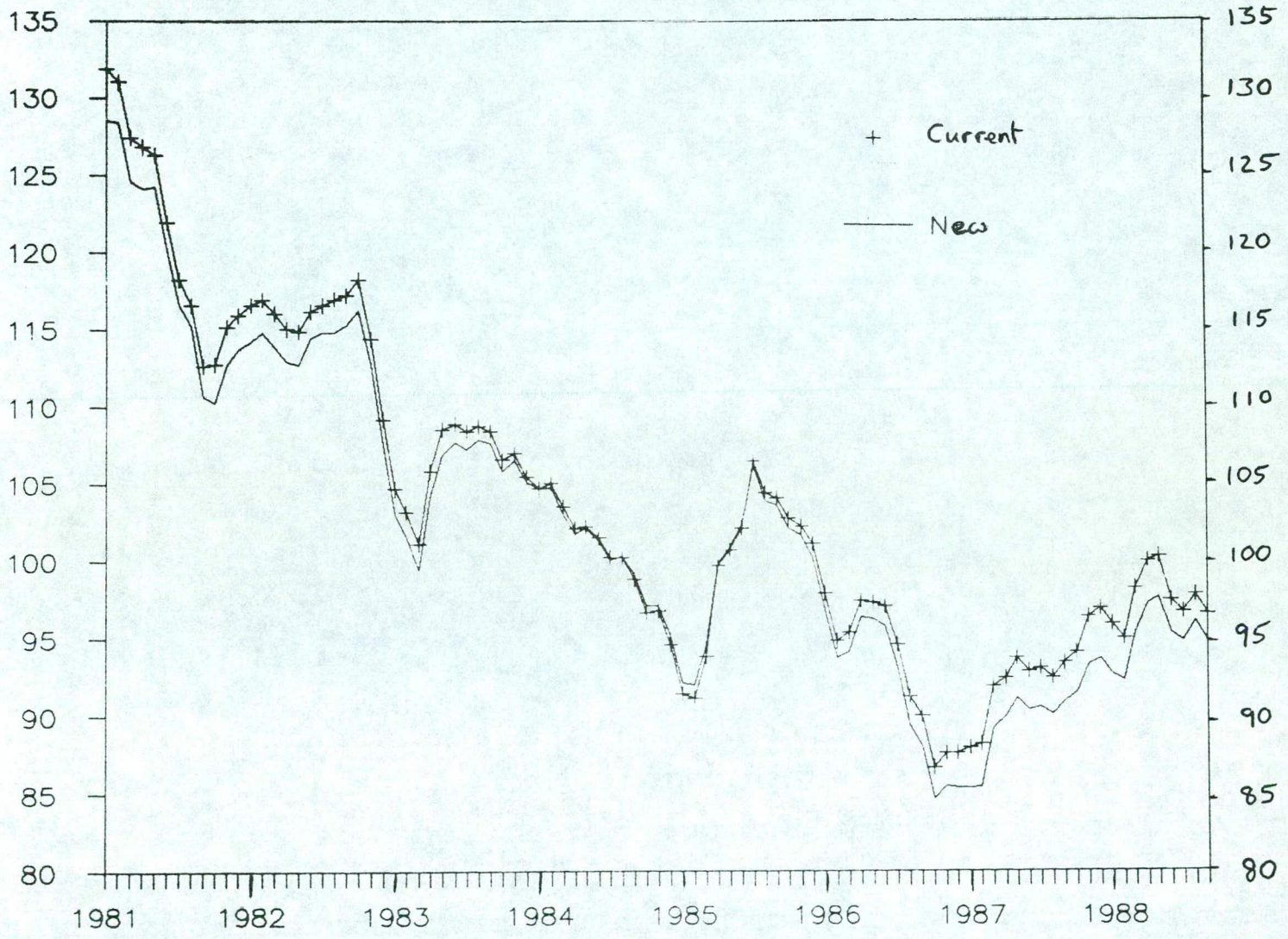
require any alteration to the weights used in the calculation. The chart shows movements in the new ERI alongside the existing ERI, which for ease of comparison has been rescaled to 1985=100.

Percentage weights in new and old official ERIs

	New	Old
United States	20.44	24.63
Germany	20.01	14.08
France	11.75	10.39
Japan	8.83	13.67
Italy	7.66	7.18
Switzerland	5.48	3.00
Belgium	5.25	4.04
Netherlands	5.00	4.80
Sweden	3.79	3.73
Republic of Ireland	2.42	4.05
Spain	2.02	1.86
Canada	1.90	1.51
Denmark	1.45	1.09
Finland	1.45	0.85
Norway	1.31	2.11
Austria	1.24	1.00
Australia	-	1.99

1985 = 100

Current and new exchange rate indices



Source : Bank of England

ECU TREASURY BILL PROGRAMME

The Chancellor announced in August (see Economic Progress Report of that month) that the Government would be launching a new programme of issues by tender of UK ECU Treasury Bills this autumn. As he said then, the programme will widen the options for managing the UK's foreign exchange reserves and will establish London's position as the centre of the ECU market, which the Government wish to see develop further.

2. ECU Treasury Bills are similar in form to sterling Treasury Bills but they are denominated and payable in ECU (see Economic Progress Report, October edition, for a description of the ECU.) Like sterling Treasury Bills, they are issued on a discount basis. Tenders are open to anyone but each tender at each yield must be for a minimum of ECU 500,000 (approximately £330,000). Successful applicants are allotted Bills at the yield at which they tendered. All payments are made without withholding or deduction of any UK tax.

3. Full details of the arrangements for applications in the initial series of six tenders, to be held monthly by the Bank of England, were set out in an Information Memorandum published by the Bank on 14 September. The Memorandum also listed 29 banks and securities houses which would act as market-makers in the initial series of tenders and when the Bills change hands in the secondary market. The Bank of England has undertaken to sell Bills into the secondary market only through these institutions and, at least

for the initial series of tenders, to make a price to them for any Bills they may offer.

4. In the first two tenders, held on 11 October and 8 November, Bills for 1, 3 and 6-month maturities were on offer to a total value of ECU 900 million and ECU 750 million respectively. Both tenders were very successful. They were heavily oversubscribed at all three maturities and the Bills on offer were allotted in full and on favourable terms (3/16-¼ per cent below London interbank bid rates).