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PART A

Part. A.

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Begins: 18/1/89.
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PART A

Chancellor's (Lawson) Papers:

THE BANK OF ENGLAND
QUARTERLY BULLETIN
ASSESSMENT

Disposal Directions: 25 Years

18/10/95.

PO -CH /NL/0283
PART A

1989-01-23 18:10 BANK OF ENGLAND ~ GPS 01 601 4953 P.02

CC:- PS/Chancellor
PS/EST
Sir P. Middleton
Mr Wicks
Mr Scholar
Mr Evans
Mr Sedgwick
Mr Peretz
Mr Riley
Mr Culpin
Mr Grieve
Mr Pickford
Miss O'Mara
Mr Grice
Mrs Chaplin

COMMENTS ASAP PL TO SIR T. BURNS

This was only recei[ved] late this evening original copy seems t[o] have got lost in the Post.

Meena Herst[?]
23/1

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J. S. FLEMMING
EXECUTIVE DIRECTOR
01-601 4963

BANK OF ENGLAND
LONDON EC2R 8AH

18 January 1989

Ch
A very shoddy bit of work. One or two important points of substance
AA

MAJ: Returned b/w with no or few comments from me.

Sir T Burns
HM Treasury
Parliament Street
SW1P 3AG

Dear Terry

I enclose a copy of the draft of the February Assessment (due to be published on the 9th) which has gone to the Governor and will be revised before going to the Chancellor next week.

We hope that comments you might let me have next Monday, for the Governor's meeting early Tuesday, will enable us to send the Chancellor a more satisfactory text.

good thing too.
(we get second bite @ cherry then; this is to clear away more detailed points)

Yours sincerely

John

19. 1.89

COVERING CONFIDENTIAL

THE GOVERNORS

Copies to:
Mr Loehnis*
Mr George*
Mr Quinn
Mr Flemming*
Mr Coleby*
Mr Price
Mr Warland*
Mr Foot
Mr Kent
Mr Plenderleith
Mr Kirby
Mr Allen
Mr Arrowsmith
Mr Clews
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Mr Jenkinson
Mr Dicks
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Mr Mortimer-Lee
Mr Urwin
Mr C B Wright
Mr P A D Wright
GPS
DGPS

FEBRUARY QB ASSESSMENT

I attach (in Mr Flemming's absence) a draft for your meeting* on Tuesday 24 January, after Books. The main changes from the draft discussed at the Deputy Governor's meeting are sidelined. It has also been sent to Sir Terence Burns in accordance with the experimental procedure; his comments should be available before your meeting.

After Mr Flemming discussed this latest draft with me I have added a few further minor changes plus an Introduction, none of which he has seen.

The subsequent timetable is:

Thursday 26 January	Draft to Chancellor
Monday 30 January	Comments from Chancellor
Tuesday 31 January	Governor's final review (after Books)
Thursday 9 February	Publication

Economics Division HO-4
19 January 1989

C T Taylor (4313)

1579B

DRAFT
19.1.89

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FEBRUARY ASSESSMENT

[Introduction]

1 In general, the international economy continues to present a more favourable picture than for some time, but worries about inflationary pressures have led to policy tightening in several countries and this, along with other factors, points to a slowdown in growth this year. However recent forecasts have proved fallible and if growth does not recede, inflation could ~~indeed~~ pick up. Partly because of these inflationary concerns, expansion outside the United States is not seen as a source of relief to the latter's balance of payments, and further progress in reducing the major international payments balances will depend on a continuation of prudent US policies. At home it is now apparent, despite [~~acute~~] defects in the statistics, that demand was stronger last autumn than thought at the time. This contributed to the pick-up in inflation seen last year, despite excellent productivity performance. Concerns about inflation were behind the further interest rate increase in November. The tightening of policy last summer led, after a lag, to a slowdown in money and credit and there are now welcome signs that the effects are spreading to the wider economy. The full effects are bound to take time to come through and meanwhile ~~nevertheless hard to predict and until they become clearer~~ policy has to remain cautious. [The Assessment reviews these issues and also notes disappointing progress in the Uruguay Round of trade negotiations.]

conflates two different points

Should refer to timing

Growth abroad had continued to exceed expectations ...

2 Recent developments in the major foreign economies tend to confirm the generally more favourable picture of the international economy that emerged last year. Output rose sharply in the third quarter following a pause in the second, and later data suggest continued relatively robust growth. Consumer price inflation in a

number of countries rose slightly through last year, but on average has remained moderate. The inflationary tensions apparent in the first half of the year associated with the sharp rise in non-oil commodity prices eased somewhat in the second half, complemented by the fall in the oil price. However, towards the end of the year some external pressures re-emerged as non-oil commodity prices rebounded, in part reflecting the continued strength of demand, and as oil prices rose, reflecting somewhat greater OPEC cohesion. Inflation may also have been restrained in some countries by the strong growth in productivity over the past year, although this probably reflects buoyancy in activity.

3 The strength of output is to be welcomed, but only if it remains consistent with the maintenance of low rates of inflation. The longevity of the current recovery is not in itself a reason for expecting its imminent demise, but capacity pressures are becoming more apparent in the major economies, if to differing degrees. Judgments as to the precise extent of spare capacity, and more generally the rates of output growth likely to be consistent with the absence of inflationary pressures, are notoriously difficult to make, particularly in view of the effect on capacity of the recessions of the 1970s' and early 1980s', and the subsequent restructuring. In nearly all countries the trend growth of capacity [illegible] seemed to fall sharply between the 1960s and 1970s. Few countries have seen an improvement in performance as great as that in the UK. ~~reverted as closely as the UK has to its earlier - albeit comparatively modest - performance. [cf productivity note]~~

a subsequent

?

(V gloomy way of putting it)

... but some slowing is now in prospect ...

4 Despite these uncertainties about underlying trends the authorities in a number of countries have tightened monetary policy in response to a perception that growth since 1987 had exceeded that of capacity and that the threat of inflation was therefore increasing. A slowing of growth in the major foreign economies this year has been a central feature of a number of recent forecasts, which foresaw some policy tightening, including those by the OECD, the IMF and the Bank (see November 1988 Quarterly Bulletin pp 482-483); they also agree that a substantial upturn in inflation is unlikely. These forecasts, which may be

fallible if the 1988 experience is any guide, present in many respects quite a comfortable picture, [and are by no means invalidated by the latest indicators.] ! 8

5 If growth does not weaken, despite the monetary tightening that has occurred, inflationary pressures might become significant in some countries, not least the North American economies, and further action would then be necessary to combat and indeed reverse its upward creep. Policy makers there need to err on the side of caution until there is firm evidence that growth has slowed to a more sustainable rate. Judging whether or not to tighten the monetary stance in a particular case is inevitably difficult, as responses are uncertain in timing and magnitude and indicators often conflict. Raising interest rates by too much runs the risk, for example in Germany and certain other Continental European economies, of damaging the improved business confidence which underlies the welcome increases in business investment there; and elsewhere it might add to fragilities caused by high levels of domestic and international debt.

... as demand patterns have failed to curb imbalances [v clumsy drafting in this para]

6 Although the pattern of domestic demand growth among the major economies probably made some contribution to the adjustment of ~~G3~~ the US, Japanese and German payments imbalances last year, its magnitude is likely to have been only limited, and weakened towards the end when external adjustment slowed. Even in Japan, where domestic demand growth, supported by policy, was particularly opportune, the growth in exports was surprisingly strong and the surplus fell by little in dollar terms, although by more in terms of GNP. The pattern of demand growth in Europe was less helpful. The rise in domestic demand in Germany was much the same or less than in its major European trading partners, and may slow further this year, with implications for the current balance, on account of the tax increases to be implemented by the German authorities. With the favourable competitiveness effects of the sharp decline of the dollar in the two years or so after the start of 1985 now wearing off, and US domestic demand still fairly strong, the US trade deficit has ceased to improve in recent months. Although in 1988 the growth in domestic demand of competitors probably exceeded

that of US domestic demand more strongly than for some years, this gap was not large and needs to widen further if the current account deficit is to fall to more sustainable levels, not least because of the large existing gap between imports and exports.

7 Another risk, to the generally benign forecasts, is that the imbalances between the three largest economies, which act as a constraint on policy makers, might improve even more slowly than is projected. Sustained strong non-inflationary demand growth in competitor countries is helpful in providing opportunities for US exporters to expand sales further. Nevertheless, given existing trade patterns most of any additional stimulus to domestic demand in these countries taken together would be met by their own production with only a small proportion supplied from the US. Thus expansion on the scale needed to offer significant relief to the US would involve unacceptable inflation risks. In fact forecasts suggest that growth in US exports markets is more likely to slow. Higher saving and slower growth in US domestic demand, together with continued moderation in costs to improve competitiveness, are therefore ~~probably~~ the key to more substantial reductions in the US deficit. The prospect of a tighter US fiscal stance is important in achieving this aim and would provide welcome support to monetary policy.

Trade negotiations

8 Further progress towards orderly adjustment of the still large G3 imbalances will be necessary to keep at bay the rising protectionist pressures which, although not reflected in general tariffs, have been a notable feature of the past decade. Nations which are members of the GATT are meanwhile engaged in multilateral negotiations to liberalise trade further, strengthen the rules against protection and extend them into new areas, including agriculture and services. It is important to all countries with an interest in free trade that these negotiations make steady progress towards the goals set in Uruguay in 1986. Even in the relatively favourable international economic environment of the past year it has, regrettably, proved difficult for the leading protagonists - the United States and the EEC - to overcome their starting differences, and an impasse was reached over agriculture at the

9 Progress seems to be held up at the moment because each side expects the other to lead with concessions. This may be a misguided approach, not merely tactically. It is possible to point to cases where even unilateral lowering of trade barriers brings advantages in the face of restrictions elsewhere. For example, the freedom of access which this country has for many years offered to foreign firms to supply banking and other financial services here has benefited consumers in the UK and elsewhere, and aided the development of a thriving UK financial sector. Other countries with emerging financial skills and resources have seen the wisdom of this approach and are following suit. Although the parallels with other kinds of trade may not be close, there is perhaps a moral here for trade negotiators in the USA and the EEC who, under pressure from producers, are reluctant to be the first to move; and also for the poorer participants in the process.

UK interest rates rose to curb domestic demand...

10 Our picture of the development of the domestic economy continues to be obscured by deficiencies in the official statistics which became acute in the estimates for the third quarter, when the CSO felt that the fall in GDP implied by its estimates of expenditure was sufficiently implausible to be excluded from the calculation of the average measure. According to the more reliable output measure third quarter non-North Sea GDP was 6 1/4% higher than a year earlier, and ~~if (as seems likely) the trade figures are broadly correct,~~ domestic expenditure was up [nearly 8%] on the same basis.The strength of demand contributed to the pick up of inflation. Excluding mortgage costs the 12-month increase in the RPI rose from 3.6% in January 1988 to ~~5.2% in October~~ 5.1/2 in December. Manufacturers' output price increases also drifted up through the year, but more gently, barely reaching 5% pa. This increase nevertheless exceeded that of either material inputs or unit labour costs which had been restrained by continuing productivity growth of about 7% pa. Abroad, less dramatic productivity gains have been compatible with falling unit labour costs (in local currencies) in several cases as earnings have risen even less. Here underlying earnings growth

MUST NOT SAY THIS

of almost 9% in the year to October meant that manufacturers' unit labour costs rose - albeit modestly. The rise in profit margins through the year reflects producers' response to buoyant demand. In services the role of earnings growth (at around 9%) in driving up costs and prices in the private sector, has been greater - though the measurement of productivity in these sectors is more difficult.

11 In the fourth quarter of last year it became apparent that domestic demand had been growing even more rapidly than had been recognised when interest rates were raised in the summer. The opportunity was therefore taken to raise them by 1% when October's disappointing trade figures were announced on 25 November. At 13%, base rates were then 4 1/2 percentage points higher than at the beginning of the year. Sterling was initially marked up and proved resilient against European currencies despite 1/2% increases in some continental interest rates in mid-December. It ended 1988 4% higher in effective terms [on the new index] than it opened. In due course, the rise in interest rates last summer contributed to the ending of the acceleration of narrow money and the slowing of lending, particularly for house purchase towards the end of the year. Broad money also slowed, ~~but a significant contribution here came from the (negative) monetary counterpart to the growing balance of payments deficit.~~

Don't like

So what?

... with effects spreading into the real economy

12 With a longer lag the tightening of policy last summer does also seem to be having an effect which is spreading beyond the housing market. Just as house prices flattened out first in the South East, retail sales seem also to have slowed there first, and to have been reduced nationally over the Christmas period. The November trade figures came in with a visible balance exactly half way between those for September and October (between which the allocation had been distorted by the postal dispute). At £4 1/2 bn the three-month deficit on current account was slightly smaller than that of the previous three months, which suggests that it may have stabilised. Only if the improvement through this year were even more rapid than the deterioration through last year, however, would 1989's deficit be lower than 1988's [£14bn

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13 The main effects of the sharp rise in interest rates through the second half of last year, and the mortgage rate increases announced in January (and the earlier increases which have still to be reflected fully in borrowers' payments) should become apparent within the next 3-6 months. It is impossible to be sure at this stage what the full impact will be, but a marked slowdown in consumers' expenditure is ~~thought~~ likely. The uncertainties reflect among other things the unprecedented extent of the personal sector's move into debt over the past few years, which has been much larger than most observers predicted. It is reasonable to expect the effect on expenditure of a given change in interest rates will be larger now than in previous years, because households are on average more heavily geared, and because the proportion of floating to fixed rate debt has risen considerably in recent years. Recent research done in the Bank supports this conclusion and, like similar research elsewhere, points to a heightened response to short term interest rates. [Reference to Technical Paper No 20] Companies are more likely to be influenced by longer term borrowing costs which have risen little, and given their much improved profitability and current utilisation of capacity, investment demand should hold up. As growth slows, profit margins should narrow, however, and ~~while~~ the consequent restraint on prices should in turn reduce pressure for higher pay and help to contain costs. ~~the longer term implications for investment may be less helpful.~~

do they or don't they wish for slow growth slow?

[Conclusion]

Strewth!

14 The medium term orientation appropriate to fiscal policy puts the onus of adjustment to unanticipated interim developments on to monetary instruments. This was particularly appropriate in 1988 when the surprise was the strength of domestic demand financed by reduced saving and, especially, enlarged borrowing, which higher interest rates should remedy. Moreover, it was areas in which heavy mortgage borrowing had fed demand for housing, pushing up its price, that were likely to prove most sensitive to interest rates - and so it has proved. Fiscal policy in terms of the scale of debt repayment and of revenue as a proportion of national income has, in the event, proved to have been tighter than expected.

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15 The situation poses difficult questions for policy, and argues the need for caution on the part of the authorities, until the real indicators fully reflect the slowdown already suggested by the monetary ones. While priority has to be given to securing the predicted downturn in inflation, the importance of maintaining stable financial conditions has also to be borne in mind. By these criteria there is no evidence as yet to support the view that policy has been over-tightened.

[RUBBISH, but [illegible]]

Why? What does this mean?

pretty stupid, but can live with [illegible]

Bank of England
1989 Papers

toa.jw/docs/min34

FROM: D W OWEN

DATE: 20 JANUARY 1989

1. MR PERETZ
2. CHANCELLOR

DLCP 20/1

cc: Economic Secretary
Sir P Middleton
Mr Wicks
Sir T Burns
Mr Scholar
Mr Odling-Smee
Mr Sedgwick
Mr Gieve
Mr Grice
Mr Hibberd
Mr O'Donnell
Miss O'Mara
Dr Kosmin
Ms Ryding
Mr Neilson

Thanks. OK subject to amendments on pp 1 & 3. I see no [illegible] for the proposed amendment on p 18. N.

Ch/ Unfortunately the charts and tables were not provided with this draft.
See amendments proposed
OK?
JIS

BEQB: HOUSING MARKET

I attach a draft article on the housing market for inclusion in the February BEQB. EA, FIM and MG have already commented on an earlier draft, and the current version is a considerable improvement. However, we thought that you would want to see the article before publication given the potential sensitivity.

2. The bulk of the article is concerned with a technical analysis of the housing market, but there are a couple of tricky comments on monetary policy which MG have asked to be removed (see manuscript amendments on pages 1 and 18). If the Bank accept our suggestions, we are content for the article to be published. Indeed, the article gives a useful reiteration of the increased interest sensitivity of the personal sector (especially as strengthened by our comments) which the press office might like to draw on. We do not think this is a suitable article for pre-release and will be putting that view firmly to the bank.

3. The Bank have asked for comments by midday on Tuesday, so we would be grateful for any views that you have by first thing Tuesday morning.

David Owen

D E W OWEN

The Housing Market

Developments in the housing market have important implications for the economy as a whole and for policy. Apart from the direct effects such as investment in dwellings (which accounted for more than 70% of total personal sector savings last year) there are a number of ways in which the housing sector interacts with the rest of the economy. For example, an increase in house prices raises personal sector wealth, thus possibly influencing households' consumption/savings decisions. Recent changes in the mortgage market, following a period of deregulation and intense competition, have made this wealth more accessible. Also, if house prices rise faster than earnings then upward pressure on wage settlements may result, perhaps over and above that which emerges through the contribution of higher housing costs to the Retail Price Index. Variation in the rates of growth of house prices across different regions may also reduce labour mobility, thus reducing the efficiency of the national labour market. There are important and wide-ranging implications for monetary policy of these developments. First, the sensitivity of personal sector behaviour to changes in interest rates ~~may have~~ has almost certainly grown in recent years. Second, the use of interest rates to ~~help~~ reduce inflation ~~by slowing the rate of growth of consumers' expenditure~~ may have repercussions for the housing market as a whole - as regards the demand for and supply of both new dwellings and improvements to the existing stock and the operation of the mortgage and credit markets.

This article[1] examines developments in the housing market over the last two decades, considering the various factors which have been important in explaining changes in house prices, housing starts and completions and housing investment. As well as considering the long-term prospects for the market, a short discussion of likely short-term developments in the light of recent interest rate rises is included: this analysis suggests that the housing market will slow considerably this year. The implications of such a slowdown for the growth of consumers' expenditure and for the labour market are also considered. Finally, the article discusses some of the policy implications of this analysis.

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1 Written by M J Dicks of the Bank's Economics Division.

The Decline of the Rented Sector

Recent developments in the housing market have been dominated by changes in the owner-occupied sector, given the long standing reduction in the private rented stock, and in the 1980s in the public rented stock as well.[2] The recent decline of the private rental market represents little more than a continuation of a long-run trend. At the end of the Second World War around half of the housing stock (more than 6 million dwellings) comprised this type of accommodation, but by 1960 the sector had declined to close to 4 million dwellings, accounting for a quarter of the total stock. Less than half of the increase in the owner-occupied total that occurred during the 1950s came from new building, the rest coming from sales of rented housing (on a scale larger than the public sector sales over the last decade). Table A shows that the decline in the private rental market continued, if at a slightly slower pace, throughout more recent decades, so that by 1987 less than 2 million dwellings were of this tenure. (There has, however, in recent years been an increase in the number of dwellings rented from housing associations. The figures for England show a rise from 300,000 to 482,000 in the ten years to December 1987.) Although much of the decline in the private rented stock is due no doubt to the restriction of rent increases and the curtailment in profit opportunities that this entails,[3] it is also likely to reflect the growth in public sector housing provision which occurred on a large scale immediately after the War and which must have been taken up largely by households who would previously have expected to rent in the private sector. Slum clearance was also an important factor, since it removed over a million dwellings from the private rented sector.

OMIT? suggests that decline has been particularly marked recently which is contradicted by X

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2 This does not mean, however, that attention should be restricted to examining owner-occupation, particularly since the Government in its 1987 White Paper Housing: the Government's proposals) Cm 214 made it clear that it wishes to encourage new investment in the private sector rental market.

3 For a discussions of the numerous changes which have taken place in the regulations relating to the letting of private property in the period see P Minford, M Peel and P Ashton The housing morass: regulation, immobility and unemployment, Hobart Paperback 25, 1987.

tax relief to individuals investing in companies ~~specialising in~~ formed to provide private rented accomodation

Chart 1 shows annual public and private housing completions over the past four decades. Particularly noteworthy is the sharp decline in public sector housebuilding in recent years, which has been accompanied by a policy of increased sales of council houses and the charging of rents that are closer to market levels. This, taken together with last year's extension of the Business Expansion Scheme (which gives ~~some tax relief to private landlords~~) and a Housing Act which puts into place a new legal framework which should permit the private market to operate more freely (through the use of assured and shorthold tenancies - the former with rents freely negotiated but security of tenure protected, the latter with no security beyond the period of the tenancy but with the right for either party to seek registration of an appropriate rent), is designed to encourage growth in the privately rented housing market. The outcome is likely to depend to a large extent, however, on the expected rate of growth of house prices; given the tax advantages which favour owner-occupation and the risks associated with private sector lettings, future expansion of this section of the housing market is likely to be on only a small scale unless house prices are expected to continue rising by landlords and their financial backers.[4] For this reason it seems reasonable to concentrate attention on the market for owner-occupied dwellings, particularly since fluctuations in house prices appear to be generally well-explained by developments in this section of the market.

NO ✓

The Growth of Owner-Occupation

Table A illustrates the growth of owner-occupation that has occurred in recent decades, and the particularly fast rate of increase during the 1980s. Even after allowance has been made for the million or so transfers of ownership as a result of sales of council houses, it is clear that the trend rate of increase has

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4 A much more detailed study of the prospects for this sector of the housing market is contained in C M E Whitehead and M P Kleinman, The viability of the privately rented housing market', to appear in, Housing and the national economy, edited by J Ermisch, to be published by Gower.

accelerated sharply since the early 1980s. In looking for factors which explain this rise, it might be expected that, as in the market for most goods, both demand and supply considerations are important. The housing market needs especially careful consideration, however, since it has a number of features making it unique.

First, housing is a basic necessity to most households, so that changes in the size of the adult population and/or the number of households are likely to be important determinants of the long-run total demand for housing (covering <u>all</u> forms of tenure). Obviously this depends to a large extent on how household is defined, since under some definitions (including that used in the United Kingdom) it is possible for more than one household to share a dwelling. It is also, of course, possible (at least in the short-run) for households to be homeless. Second, one year's supply of new housing generally represents only a small fraction of the total housing stock, arising, in part, from the fact that housing is a durable good. When taken together with the fact that houses generally take between one and two years to build, this implies that short-term fluctuations in demand have a relatively large and immediate effect on house prices, even though the long-run supply price elasticity may be large and, even in the short run, demand (and supply by landlords) may be sensitive to price expectations, which should reflect the stock-adjustment process. Much will depend upon how much land is made available following a rise in the price of housing (and hence on the flexibility with which land can be used for residential rather than other purposes), which will in turn depend upon how quickly applications for planning permission are decided and on the proportion granted.

Finally, owner-occupiers are both consumers of housing services and investors in housing as an asset. The virtual absence of a rental market or of a futures market (either in housing or in instruments linked directly to (regional) house prices) makes it difficult to hedge against risk associated with fluctuations in house prices. (Either, or both, could have a beneficial impact on the efficiency of the housing market, and hence welfare.) Nevertheless, developments in the mortgage market are beginning to open up more opportunities to home-owners, which should allow greater diversification and risk-sharing.[5] Investors wishing to reduce their investment in housing can, of course, trade-down' (by buying a cheaper dwelling), but transaction costs (and associated costs of moving) are high, so that this is in practice seldom done on investment grounds alone. Moreover, the possibility of raising the value of a house by making improvements means that it is easier for owners to increase rather than to decrease their investment in housing.

As owner-occupation has grown and prices have risen, so housing has taken a greater share of the household sector balance sheet. At the same time, mortgage debt has risen considerably faster than incomes.[6] This suggests that developments in the mortgage market are likely to have a large impact on the housing market - indeed the effect may be growing since house purchases are now more often associated with the need for households to borrow large income multiples, especially in the case of first-time buyers' transactions. Hence, both loan-to-income multiples and loan-to-value ratios have tended to rise during the 1980s (see Chart 2). This contrasts with periods in the past when mortgages were often rationed (with changes in loan-to-income multiples and loan-to-value ratios then having been two of the means by which mortgages were rationed) and restricted below levels that would have been desired in a free market, thus constraining households' consumption/saving behaviour.

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5 For example, past capital gains can be realised by withdrawing equity and using this money to invest in assets other than housing. This might reduce the owner-occupier's vulnerability to shocks from changes in house prices if he/she can find assets whose returns are less than perfectly correlated with house prices although, of course, his/her direct exposure to house prices has not changed. It is also now possible for some borrowers to share capital gains (or losses) with lenders, although such practice is normally restricted to certain classes of borrower requiring a large income multiple in order to enter the housing market (eg nurses).

6 For a fuller discussion of recent developments in the balance sheet, see The financial behaviour of the UK personal sector, 1976-85' in the March 1987 Bulletin, pages 223-33.

The Demand for Housing

In the absence of rationing, the total demand for housing will depend upon both the total number of households requiring accommodation and the quantity of housing each household requires. Clearly demographic factors will therefore be an important aspect of total housing demand - not only the overall population but also its age and sex structure. The United Kingdom's population has risen from close to 50 1/4 million in 1951 to around 56 3/4 million in 1986, an increase of some 13%. Within this period, however, there was a significant slowing in the rate of growth during the 1970s with a pick-up in more recent years. One reason for these fluctuations is the changing age structure of the population - between 1951 and 1981 the total population rose by 10%, but the number of persons aged under 18 rose by less than 8% while the number over retirement age rose by 42%. The growth in the number of people aged 60-70 is likely to lead to an increase in trading-down, resulting in a rise in the number of large properties supplied to the market and a simultaneous increase in demand for smaller dwellings.[7] Demand will also be affected, however, by changes in the number of new young households that are formed.

The changing age distribution of the population gives rise to changes in the demand for housing since the process of household formation and dissolution has a fairly rigid, age-specific structure. In addition, however, economic and social factors play some part in determining changes in headship' rates (the ratio of the number of households to the size of the population). The aggregate headship rate has risen from around 34% in 1971 to nearly 39% in 1985, implying an increase in the number of households of more than 3 1/2 million (a little under a fifth) over the period - an interval during which the population rose by

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7 This trading-down may also accentuate regional pressures if many of those wishing to retire want to move to the same area, while a rise in the number of last-time sellers (an increasing proportion of whom are likely to have been owner-occupiers) will lead to a greater volume of bequests, thus influencing younger households' consumption/savings decisions.

only 3/4 million (less than 2%). The economics of household formation can be thought of in the context of a process through which households convert their members' time and goods into non-marketable output' giving their members' satisfaction.[8] At the same time, however, individuals desire privacy, so that optimal household size depends upon the costs of increasing the household by one member (in terms of lost privacy) being balanced by the benefits (in terms of extra output'). Cross-section data provide evidence of strong income effects on household formations, but research carried out using US data has suggested that it is also important to take into account the costs of independence (mainly in terms of housing costs).[9] Time-series evidence for the United Kingdom suggests significant roles for incomes, rents and mortgage costs as well as social factors (such as changes in marriage and divorce rates).[10] Overall roughly half of the rise in the number of households which occurred during the 1970s and the first half of the 1980s appears to have resulted from demographic factors (changes in the population size and its age distribution) and the remainder from economic and social factors. Although population growth is expected to slow significantly during the late 1990s, the slowdown in the rate of household formation is likely to be much less marked (provided incomes, rents and housing costs rise at rates similar to those experienced over the last two decades) - implying that the long-run demand for housing is likely to remain strong. In the short run, however, fluctuations in economic conditions will play an important part in influencing the demand for housing.

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8 For details of such an approach see, for example, J Ermisch, An economic theory of household formation', Scottish Journal of Political Economy, Vol 28, No 1, February 1981.

9 See, for example, A Borsch-Supan, Household formation, housing prices, and public policy impacts', Journal of Public Economics, Vol 30, No 2, July 1986.

10 Detailed results are presented in M J Dicks, The demographics of housing demand; household formations and the growth of owner-occupation', Bank of England Discussion Paper No 32. Of course, changes in marriage and divorce rates which affect the demand for housing may not be independent of changes in its supply.

Since over a short period the number of completions of new dwellings will only be a very small fraction of the total housing stock, changes in the overall demand for housing will play a large part in determining the average price of existing dwellings. Supply conditions will also be important, however, since they will affect price expectations. Overall, demand is likely to depend particularly upon real income per household (and perhaps also changes in its distribution) and housing costs.[11] The latter comprise debt-service costs (or the opportunity cost of funds invested if no mortgage funds are borrowed) plus costs of depreciation and maintenance, plus housing taxes (rates) but minus expected capital gains - all measured for the average' dwelling and in real terms. Most studies assume adaptive expectations in proxying expected capital gains, with more sophisticated approaches yet to yield significantly better results.[12]

Developments in the Mortgage Market

In addition to taking into account those factors which affect the demand for housing (and hence the demand for mortgage finance), it is also necessary to consider changes in the supply of these funds if house prices are to be well explained. Prior to the 1980s, mortgage borrowing was periodically restricted through the building societies' use of informal rationing schemes. (It was also restricted at times by official ceilings and/or lending guidance.) In part this strategy was designed to help protect existing borrowers from rises in the mortgage rate, although it

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11 Some models also permit a role for net household formation. See, for example, R Buckley and J Ermisch, Government policy and house prices in the UK: an econometric analysis', Oxford Bulletin of Economics and Statistics, Vol 44, No 4, November 1982.

12 See, for example, D F Hendry, Econometric modelling of house prices in the United Kingdom', in Econometrics and quantitative economics, edited by D F Hendry and K F Wallis. Note that a correctly specified model needs to include expected supply and demand factors if it is to derive consistent price expectations. Moreover, a model which assumes adaptive expectations is likely to find it difficult to distinguish between the effects of changes in price expectations and lags due to transaction costs.

also helped stabilise the flow of lending. Nevertheless, it sometimes resulted in long mortgage queues and considerable variation in the loan-to-income multiple and loan-to-value ratio. These fluctuations in mortgage supply undoubtedly contributed to the variability in effective housing demand and so played a large part in explaining the two house price booms' which occurred in 1972-73 and 1978-80 and the subsequent slumps' during which falls in real house prices occurred.

More recently, there has been a period of rapid structural change and innovation in the mortgage market, resulting largely from a number of measures aimed at liberalising financial markets and encouraging greater competition. The abolition of the corset' in 1980 and the banks' re-entry into the mortgage market during 1982 led to the break-up of the building societies' interest rate cartel. Since then, building societies have generally attempted to meet the demand for mortgage funds, taking as given the structure of interest rates. In particular, the fact that building societies have been able to use wholesale funding has allowed a move from asset management to liability management to take place. Increased lending has resulted in reduced mortgage queues and higher loan-to-income multiples and loan-to-value ratios. Indeed most measures of rationing suggest that the market is now free of arbitrary constraints.[13] To some extent, however, this depends on how rationing is defined. Clearly it is still the case that lenders offer maximum loan-to-income multiples rather than charge different interest rates according to the perceived risk of the borrower and/or amount lent. (Indeed, if anything lower rates are available for larger loans, presumably reflecting lower administrative costs per pound.) Moreover, although some insurance contracts associated with default risk are now available (for example, against unemployment) and much

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13 See G J Anderson and D F Hendry, An econometric model of UK building societies', Oxford Bulletin of Economics and Statistics, Vol 46, No 3, August 1984, G P Meen, An econometric analysis of mortgage rationing', Government Economic Service Working Paper No 79, J B Wilcox, A model of the building society sector', Bank of England Discussion Paper No 23 and S G F Hall and R A Urwin, A disequilibrium model of mortgage lending', Bank of England mimeo.

mortgage lending is underwritten, the market is still fairly unsophisticated compared with that which has developed in the United States, so that households' choice remains restricted to some degree.

Despite these caveats it is clear that the gap between notional and effective demand has narrowed. The fact that owner-occupiers tend to move only infrequently (once every four to seven years on average) - because of higher transaction costs - implies that the time taken for full adjustment (to desired levels of capital gearing) might be expected to be long, and it may be that adjustment to changes which occurred in 1982 is perhaps only now nearing completion. The fact that mortgages are set in nominal terms, however, means that a second form of rationing occurs whenever there is inflation, in that households find the real value of mortgage debt is eroded while real earnings growth is likely to be less adversely affected, if at all, since nominal earnings generally rise at least as fast as prices.[14] If the inflation rate varies, and lenders are concerned with loan-to-income ratios of outstanding mortgages, then neither income gearing nor initial loan-to-income ratios are necessarily very good proxies for rationing. However, the severity of this second form of rationing is likely to have been fairly limited in recent years given the low inflation rate and rising income multiples. Moreover, the sharp rise in net cash extraction[15] suggests that households are increasingly easily able to raise capital gearing to desired levels (without necessarily needing to move). The removal of mortgage lending guidance in January 1987 will have facilitated this reduction in liquidity constraints, which in the past impinged heavily on households.

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14 Obviously the ability to service debt depends also upon the interest rate charged, and hence on the monetary authorities' reaction to higher inflation.

15 Defined as the difference between the net increase in the stock of loans for house purchase and the private sector's net expenditure on additions to the stock of owner-occupied houses, including improvements. For a fuller discussion see, The housing finance market: recent growth in perspective' in the March 1985 Bulletin, pages 80-91.

All of these arguments suggest that a model of house prices conditional on mortgage lending among other factors might have performed less well in predicting prices in recent years since, while in the past, changes in mortgage supply would have corresponded almost one-for-one with changes in housing demand (and hence have caused' house price changes[16]), more recently some of the change in supply represents increased demand for financial assets or perhaps for goods and services. Thus, although it is still true that mortgage lending facilitates' house-buying for the majority of buyers, the correlation between changes in housing demand and mortgage supply may well be weaker than in the past.[17]

Explaining Changes in House Prices[18]

Chart 3 shows prices of existing houses (the Department of the Environment mixed-adjusted index based on completed transactions from 1968 onwards - before then the series is not mix-adjusted) for the period 1956 to 1988, and compares the annual rate of growth of this index with that of consumer prices (ie the consumers' expenditure deflator). This serves to illustrate the long-run upward trend in real house prices, although once adjustment is made for quality improvements the rise is somewhat less than has occurred in real incomes. It is clear that there have been marked fluctuations around this trend, as is evidenced by the two house price booms' of 1972-73 and 1978-80 and recent

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16 Note that, even in this situation, we cannot know for certain the direction of causation - it is possible that the demand for housing bids up the demand for mortgages (and not vice versa).

17 A model in which the effect of changes in rationing of mortgage funds on households' demand for housing and consumers' expenditure is presented in J Ermisch's paper Housing trends and issues arising from them': see footnote 0 on page 00.

18 The econometric results contained in this section are based on research presented in more detail in the appendix and in even more detail in M J Dicks, A simple model of the housing market, Bank of England mimeo, 1988.

strong growth. Each of the two previous booms' was followed by a lull - during which nominal house prices remained steady - while consumer prices accelerated.[19] The declines in real house prices which resulted were substantial - of the order of a quarter in 1974-75 and an eighth in 1981-82 - returning the house price/earnings ratio on each occasion to close to 3 (see Chart 4). Obviously there is some interest in whether or not future developments will involve a similar fall.

Econometric research (such as the model presented in the appendix) supports the view that real incomes, real mortgage lending, consumer prices and changes in household income gearing (the ratio of interest payments to disposable income) contribute most to explaining short-run changes in the prices of existing dwellings (with demographics playing a role too, in the longer run). In addition, a small role is found for mortgage rationing, although this effect is sensitive to the proxy used to gauge the severity of rationing. It is also worth mentioning the need to include a cube term in real income if the two house price booms' are to be explained satisfactorily. Such a term may be indicative of speculative activity in the housing market (for a catastrophe theory' justification see the article cited in footnote 0 on page 00). Table B gives details of the short-run (impact) effects of the explanatory variables used, while Chart 5 illustrates how well the model explains the past and predicts over the period 1985 to 1988 (given, of course, the actual values of the explanatory variables).

The stability of the model's parameters, despite the changes which have occurred in the mortgage market, is likely to be due to the fact that both a proxy for mortgage rationing and total mortgage lending have been included as explanatory variables. This

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19 Some commentators have suggested that house prices were likely to have been a causal factor behind the rise in consumer prices. The evidence for this view, however, is debateable - it has been argued, for example, that most of the rise in consumer prices can be attributed to the oil price shocks. See P A Rowlatt, Analysis of the inflation process', Government Economic Service Working Paper No 99.

stability also offers some hope that the model can be usefully employed to predict future developments. Such a forecast depends crucially, however, on what happens to the economy as a whole. As an example, were real earnings growth to slow slightly, interest rates remain at current levels and the stock of outstanding mortgage lending to grow at similar rates as occurred in the first half of the 1980s then the model suggests a substantial fall in real house prices could occur. Several important qualifications need to be borne in mind, however. First, house prices seldom fall in nominal terms - the last occasion on record during which a significant fall occurred was during the early 1950s. One reason for this is that, when downward pressure on prices emerges, potential sellers of property choose not to lower prices but rather to stay in the market longer before selling/withdrawing. Hence it is mainly <u>turnover</u> in the housing market which is depressed, with average house prices little affected. The housing market comprises two sectors which are broadly equal in terms of number of transactions - first-time buyers and existing owners trading-up or down.[20] A substantial part of the first group is likely to be able to postpone entering the market if house prices are thought to be moving in their favour (ie stable in nominal terms), while only a small fraction of existing owner-occupiers will need' to move (say for job-related reasons). This suggests that a substantial reduction in turnover might be possible if downward pressure on nominal house prices were to emerge.

The second caveat that needs considering is the possibility of a response from some lenders to the threat of higher interest rates in order to protect borrowers. Given the increased competition in the mortgage market in recent years, it is likely that some lenders would offer at least some categories of borrower (such as

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20 This is compatible with owner-occupiers moving every four to seven years, provided the total number of advances is rising. For example, on the assumption that first-time buyers currently comprise 50% of the market and that there is a 7 year lag between moving, the total number of advances would have to rise at an annual rate of close to 10% p.a. - close to the actual rise which occurred between 1981 and 1987. Of course, this implies that the market is not at a full steady-state in turnover.

first-time buyers) additional incentives to enter the market were the volume of mortgage lending to diminish. This could, for example, take the form of greater risk-sharing (say through the allocation of more funds to fixed-interest loans) or through more competitive charging (ie reduced mortgage rates for some borrowers).

The Supply of New Housing

Were new and existing houses perfect substitutes and suppliers of new housing competing in a free market (ie one in which they had not even local monopoly power), it might be expected that there would be little if any difference between their prices. Although it is certainly the case that movements in the two house price series are strongly correlated, so that generally this holds true, there have been periods during which gaps have opened up (see Chart 6). These have arisen because the price of new dwellings reflects not only demand factors but also influences from the supply side of the industry - primarily building costs (ie land, labour and raw material prices), which will affect starts; and also costs associated with stock-holding (which are likely to be high given the large stock of uncompleted dwellings and which will affect the rate of completions). This suggests that builders' supply of new dwellings is a function of the uncompleted stock, new house prices and costs of carrying stock (depending positively on the first two and negatively on the third), while the demand for new dwellings is likely to depend upon their price relative to that for existing dwellings (negatively) plus all those factors which influence demand generally (incomes, interest rates etc). Builders also need, however, to consider adjusting their uncompleted stock. This is likely to depend (positively) on the profitability of new building, as well as on their expectations of future demand. Given the identity linking changes in this stock with housing starts and completions (the difference between the two corresponding to the change in the stock), it is possible to envisage builders varying the mean lag between starts and completions as costs and new house prices change. Using such a model (described in more detail in the appendix) it is possible to explain fluctuations in new house prices, housing starts and completions (and hence changes in the uncompleted stock) fairly accurately, as illustrated in Charts 7 and 8.

The main driving force behind changes in the price of new dwellings turns out to be changes in the price of existing houses (see Table C). Nevertheless, temporary deviations between the rates of growth of the two do occur. Hence, during the late 1970s slower real income growth, higher after-tax interest rates and reductions in the stock of completed dwellings all contributed to the gap which opened up (with new house prices growing slightly less quickly than those of secondhand houses). Comparing the 1980s with earlier periods, it is clear that a higher rate of growth of real construction costs (proxied using an index of building materials costs) has tended to increase new house prices, but this has been offset to some extent by the effects of rising interest rates. In recent years strong real income growth has also increased the upward pressure on prices.

Nevertheless, as is clear from Chart 6, whatever happens to the price of second-hand houses over the next year or so, much the same outlook has to be expected for new house prices. For example, were prices to slow then this would reduce the profitability of building new houses - which would reduce the rate of completions significantly, were it not for the fact that interest rate effects in the uncompleted stock equation are so strong. Substantially higher costs of stockholding would give builders a strong incentive to cut back on starts, but keep completions running close to current levels in order to reduce the uncompleted stock as quickly as possible in the short run. Such an outlook is broadly in line with recent forecasts from the industry.[21] It is also supported by historical evidence. If comparison is made between the upswings of demand from the early 1960s to the mid-1980s, the builders' response can be seen to be subject to increasingly long lags, presumably to see how strongly based the up-turn is. Experience in 1973 and 1974 may well have been influential here. In a long delayed response to the boom large numbers of houses were started; but the market turned, sales slumped, builders were left with large amounts of unsaleable

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21 See 'Construction Forecasts 1988-89-90', National Economic Development Office, December 1988.

dwellings financed at interest rates that had risen sharply, and many went bankrupt. Recollections of that experience may explain why the boom of 1977 to 1979 went nearly all into prices and very little into output; and why in the boom of the 1980s private sector completions did not rise decisively beyond the levels of the mid-1970s until 1986.

The implied long-run elasticity of housing starts to house prices, of close to one-half, is considerably smaller that comparable estimates for the United States[22] (which have been as high as 3). This serves to highlight the restrictions on the supply of residential land which exist in this country, particularly in the South East, which have resulted in land prices rising even faster than house prices in boom' periods (as well, of course, as the responsiveness (or otherwise) of builders, many of whom hold stocks of land). Any feedback effects from higher land prices to house prices appears to be very weak (although clearly the profitability of housebuilding must ultimately be affected), as would be expected given the sharply upward-sloping supply curve for new housing. A problem arises for policy-makers who need to decide how much land should be used for residential purposes because of the insider-outsider' problem - those who already own houses (the insiders') benefit from rising house prices if supply is restricted and so have a strong incentive to prevent demand from outsiders' being met by additional supply. Moreover, even if there is general agreement that more houses need to be built, no-one wants them in their own back-yard'.

Interaction Between the Housing Market and the Rest of the Economy

Consumers' Expenditure

Although the tax advantages which favour owner-occupation over other forms of housing are not new, the liberalisation of the credit markets that has occurred during the 1980s has enabled households to build up both sides of their balance sheet - using mortgage debt to finance investment in housing. The limited

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22 See, for example, R Topel and S Rosen, Housing investment in the United States', Journal of Political Economy, Vol 96, No 4, August 1988

supply response, due in part to the restrictions on land available for residential use (which are most severe just where demand for housing has risen quickest), has meant that house prices have risen considerably faster than consumer prices throughout the past five years. The resulting real capital gains have obviously raised households' wealth but it is unclear how big an effect this has had on consumers' expenditure. In the case of spending on durables it is possible to identify a significant effect from the flow of mortgage lending,[23] which is partly the result of complementarity between house-buying and the purchase of such durable goods as furniture and floor-coverings and partly due to net cash or equity withdrawal. Net cash withdrawal (as defined in footnote 0 on page 00) is largely accounted for by sales by last-time sellers. The resulting bequests are likely to be held mainly in the form of financial assets rather than being spent (although the econometric evidence here is fairly weak[24]). That element of net cash withdrawal which is likely to represent "leakage" from the housing market (ie equity withdrawal[25]) is likely to be only a small element of net cash withdrawal. Estimates of equity withdrawal are only available, however, for the period 1977-1984 - an insufficiently long period on which to base econometric evidence. In any case, it is likely that some of these funds have been used to make improvements to the housing stock and that official statistics may, therefore, underrecord the true amount of housing investment that has taken place.[26]

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23 Instrumented or lagged in regression work.

24 For a longer discussion of these issues see M J Dicks, The interest elasticity of consumers' expenditure', Bank of England Technical Paper No 20.

25 For a full definition see A E Holmans, Flow of funds associated with house purchase for owner-occupation in the United Kingdom 1977-1984, and equity withdrawal from house purchase finance', Government Economic Service Working Paper No 92.

26 See P Spencer, UK house prices - not an inflation signal', Credit Suisse First Boston, 1987.

As regards consumers' expenditure on non-durable goods and services, the evidence for an effect from the housing market is much weaker,[27] although it is true that most econometric models fail to predict the strength of spending in recent years. Of course, it is not necessary for households to borrow against increases in real housing wealth in order for their consumption/saving decisions to be affected - some households may simply choose to spend a greater fraction of current income because they feel wealthier. Obviously, the larger are these confidence' effects, the greater the impact of a change in house prices on consumers' expenditure. Against this, however, it has to be noted that it is possible to overstate the likely confidence effects because of problems with reconciling measures of savings derived from different sources of statistics.

There are, however, other reasons for believing that the links between the housing market and consumption have grown more important in recent years. The spread of owner-occupation made possible by the growth in mortgage lending (associated with the liberalisation of the financial markets and the sales of council housing) has reduced the proportion of households that are liquidity constrained. This means that more households are now influenced by changes in interest rates in their consumption/saving decisions, implying a growing (ie more negative) interest elasticity of consumers' expenditure over time. Econometric evidence for these effects[28] (on both durable and non-durables spending) suggests that, ignoring changes in confidence, interest rates may already be high enough to ensure a slowdown in consumers' expenditure during 1989.

Stet

The Labour Market

Much research has been devoted in recent years to improving understanding of the links between the housing and labour

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27 For a discussion of some attempts to do so see the article by M J Dicks cited in footnote 0 on page 00.

28 Again see the article cited in footnote 0 on page 00.

markets. One of the least controversial results to come out of this work is that the existing council house system reduces the movement of manual workers between regions.[29] This is partly because the local authorities' policy of keeping rents below market levels results in excess demand for this form of accommodation (and hence queues). Were households free to move between regions then this would not be a problem. However, existing housing mobility schemes operate on such a small scale that council tenants have little option but to restrict job search to their local area, so as to not risk losing the advantage of subsidised rents. Obviously, the government's policy of increasing rents and selling council property will raise mobility to some extent, but it has also been suggested that the proportion of the public housing stock which local authorities should make available to inward migrants should be raised.[30]

More controversial than these findings is the suggestion that the efficiency of the labour market has been reduced in recent years by the large gap that has opened up between house prices in southern and northern regions.[31] This argument relies upon the deterrent effect of high house prices in the booming' region (ie the South') on potential migrants to the region, so that even if a new equilibrium is reached in the long run the costs associated with the over-shooting' of house prices are high.[32] Time-series evidence is, however, somewhat at odds with that from cross-sectional studies. These suggest that house prices have no effect on migration, over and above their effects on real

29 See, for example, G A Hughes and B McCormick, Do council housing policies reduce migration between regions?', The Economic Journal, Vol 91, December 1981.

30 See footnote 0 on page 00. For econometric evidence of these effects see P Minford, P Ashton and M Peel, The effects of housing distortions on unemployment', Centre for Economic Policy Research Discussion Paper No 191.

31 See, for example, O Bover, J Muellbauer and A Murphy, Housing, wages and UK labour markets', Centre for Economic Policy Research Discussion Paper No 268.

32 An illustration of a model with these features is contained in the paper cited in footnote 0, page 00.

wages.[33] If high regional house price differentials do restrict migration then clearly government attempts to encourage the expansion of the private sector rental market could help improve the functioning of the labour market. Regional house price differentials seem likely to narrow as the rate of growth of prices in London and the South East looks set to fall much faster than elsewhere.

Conclusions

This article has examined developments in the housing market over the past two decades, suggesting that short-run fluctuations in the demand for housing are largely responsible for changes in house prices. Growth in the number of households and in real incomes explains much of the long-run trend in house prices, with starts responding only very slowly to changes in the profitability of house-building, largely because of restrictions on the supply of land available for residential use and the limited response of builders (many of whom hold stocks of land). During the 1960s and 1970s mortgage rationing by the building societies meant that the supply of mortgage funds available for house purchase was an important determinant of house prices combining with strong real income growth. One implication of higher capital gearing is an increase in the proportion of households for whom interest rate changes are important although, since rents too would respond to real interest rates in due course, the spread of owner-occupation is unlikely to have made much difference (if any) to the long-run effects of real interest rates on household behaviour. (There may be short-run effects, however, if the effects on owner-occupiers are quicker than on renters.) The high sensitivity of the housing market to interest rates is such that, once the recent mortgage rate rises feed through to households' debt-service costs,[34] a

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33 Anyway the real problem may be not the regional variation in house prices as such, but the lack of such variation in wages (see, Regional labour markets in Great Britain' in the August 1988 Bulletin, pages 367 - 75).

34 This might have been expected to have occurred when the interest rate rises were announced. However, many households will not have faced increases in their mortgage payments until the spring of this year; some no doubt will not have anticipated the effects fully until faced with the new

reduction in activity in both the housing and the mortgage markets (including housebuilding) is likely. As well as reducing turnover, the slowdown could be sufficient to reduce house prices, certainly in real terms. Although housing starts might then fall, completions would probably still be held close to current rates since builders would seek to reduce their stocks of uncompleted dwellings.

The growing sensitivity of households' decision-making to interest rate changes suggests that the rate of growth of consumers' expenditure is also likely to slow significantly this year. Gauging the precise impact is difficult, however, since although it has been suggested that the recent buoyancy of spending is related to housing activity, there are good reasons for doubting that there are strong links between consumers' expenditure on non-durable goods and services and the housing market.

Finally, a slowdown in the housing market is likely to help improve labour mobility since it can be expected to help narrow regional house price differentials. It has been suggested that faster growing house prices in the South relative to the North is one of the factors explaining the rigidity of nominal earnings growth - although here too the evidence is less than clear. One rather more commonly held view which points to improved labour mobility, however, is that policy to encourage a resurgence of the private sector rental market, combined with sales of council housing and the raising of public sector rents, should improve the functioning of the housing market. These effects may well be fairly limited , however, particularly as the viability of a private rental market may well depend to a large extent on expectations of capital gains.

Appendix

A simple model of the housing market

Four equations and one identity are used to explain the price of existing dwellings (PH), the price of new houses (PN), housing starts (HS), housing completions (HC) and the uncompleted stock of dwellings (U). The latter evolves according to the simple identity;

$$\Delta U = HS - HC \qquad (1)$$

Next, models for ΔU ~~ΣU~~ and HC are given (so that HS has to be derived using (1)). Changes in the uncompleted stock are determined by the price of new houses relative to that for existing dwellings (pn-ph), after-tax interest rates (r(1-T)), real income per household (y-ho) and mean daily air temperature (WT). The precise specification is;

$$\begin{aligned} \Delta U_t = \; & U_{t-1} \times \phi_0 + \phi_1 \Delta^2 U_{t-1} - \phi_2 (u-y)_{t-4} \\ & + \phi_3 \; WT_t - \phi_4 \; WT_{t-1} \\ & - \phi_5 \; (pn-ph)_{t-1} - \phi_6 \; (r(1-T))_{t-1} \\ & + \phi_7 \; B(y-ho)_t + \text{dummies} \end{aligned} \qquad (2)$$

where lowercase variables denote that logs have been taken and

$$B(x) = \frac{1}{4} \sum_{i=0}^{3} x_{t-i}$$

Housing completions are modelled conditional on the existing uncompleted stock (ie $K_t = HC_t/U_{t-1}$ is the dependent variable in the completions equation). This ratio is posited as depending upon real income per household, the relative price of new houses relative to that for existing dwellings, the real price of new dwellings (pn-p), the ratio of the number of owner-occupied houses to the uncompleted stock (H/U), changes in the number of households (ho), the number of households per dwelling (ho-h), the differential between earnings of manual and non-manual workers (DEARN), the unemployment rate (UR), real construction costs (cc-p) and real land prices (lp-p). The detailed specification is;

$$
\begin{aligned}
K_t = {} & \psi_0 + \psi_1 \Delta K_{t-1} + \psi_2 K_{t-2} \\
& + \psi_3 \Delta(y-ho)_t + \psi_4 (y-ho)_{t-1} \\
& - \psi_5 (pn-ph)_{t-4} - \psi_6 B(pn-p)_{t-1} \\
& + \psi_7 (H/U)_{t-1} + \psi_8 B(\Delta ho)_t \\
& + \psi_9 (ho-h)_{t-4} + \psi_{10} B(DEARN)_t \\
& - \psi_{11} (UR)_t - \psi_{12} (cc-p)_{t-1} \\
& - \psi_{13} (lp-p)_{t-1} + \text{dummies} \qquad (3)
\end{aligned}
$$

where $K_t = (HC_t/U_{t-1})$.

The price of existing dwellings is determined largely by changes in income per household, retail prices (p), the real mortgage stock (m-p), capital gearing per household (m-ph-h-ho), household income gearing (GIGH) and mortgage rationing (MR). In order to track the two house price booms a cube term is necessary in lagged income (although throughout much of the remainder of the sample this term's contribution is close to zero). The precise specification is;

$$
\begin{aligned}
\Delta ph_t = {} & \beta_0 + \beta_1 \Delta ph_{t-2} + \beta_2 A_2 (\Delta(y-ho)_t) \\
& + \beta_3 (\Delta(y-ho)_{t-1})^3 + \beta_4 \Delta p_t + \beta_5 (m-p)_t \\
& + \beta_6 (m-ph-h-ho)_{t-4} + \beta_7 (y-ho)_{t-1} \\
& + \beta_8 GIGH_t + \beta_9 \Delta_2 MR_t + \text{dummies} \qquad (4)
\end{aligned}
$$

where $A_n(x) = \frac{2}{n(n+1)} \sum_{i=0}^{n} (n-i)\, x_{t-i}$,

Finally, the price of new dwellings is determined given the price of existing houses. Deviations between the two occur as a result of movements in the uncompleted stock, income per household, real construction costs, after-tax interest rates and the number of completed but unsold dwellings (ud). The precise specification is;

$$\Delta pn_t = \alpha_0 + \alpha_1 \Delta ph_t - \alpha_2 (pn-ph)_{t-1} - \alpha_3 u_{t-2}$$
$$+ \alpha_4 A_4 (\Delta(y-ho))_t + \alpha_5 (cc-p)_{t-4}$$
$$- \alpha_6 (R(1-T))_{t-1} - \alpha_7 (u-y-ho)_{t-4}$$
$$- \alpha_8 B(ud)_t + \text{dummy} \qquad (5)$$

More details of the theory behind the model, (and the econometric results obtained in trying to estimate it) are contained in the article cited in footnote 0, page 00. Table D gives the parameter estimates obtained, together with the relevant standard errors and summary statistics of the model's performance.

est.ld/james/23 Jan/PS CHX

ECONOMIC SECRETARY TO THE TREASURY

FROM: S M A JAMES
DATE: 23 January 1989

PS/CHANCELLOR

cc: Sir P Middleton
Mr Wicks
Sir T Burns
Mr Scholar
Mr Odling-Smee
Mr Peretz
Mr Sedgwick
Mr Gieve
Mr Grice
Mr Hibberd
Mr O'Donnell
Miss O'Mara
Dr Kosmin
Ms Ryding
Mr Neilson
Mr Owen

BEQB : HOUSING MARKET

The Economic Secretary has seen Mr Owen's minute of 20 January attaching a draft article for the February BEQB.

See flag

2. He has commented that the press may well pick up: "house prices to fall" says Bank.

S M A JAMES
PRIVATE SECRETARY

BANK OF ENGLAND
LONDON EC2R 8AH

27 January 1989

A C S Allan Esq
Private Secretary to
The Chancellor of the Exchequer
HM Treasury
London
SW1

Clean copy

Dear Alex

I enclose the February Quarterly Bulletin Assessment and would be grateful to have any comments the Chancellor may wish to make by midday Monday 30 January.

Yours

John

J R E Footman
Private Secretary
to the Governor

CONFIDENTIAL

FEBRUARY ASSESSMENT

[Introduction]

1 In general, the international economy continues to perform more strongly than expected, as it has since the end of 1987, but worries about inflationary pressures have led to policy tightening in several countries and this, along with other factors, points to a slowdown in growth this year. However recent forecasts have proved fallible and if growth does not recede, inflation could pick up. Partly because of these inflationary concerns, expansion outside the United States is not seen as a source of relief to the US balance of payments, and further progress in reducing the major international payments balances will depend on prudent US policies. At home it is now apparent, despite defects in the statistics, that demand was stronger last summer and autumn than was thought at the time. This contributed to the pick-up in inflation seen last year, despite excellent productivity performance. This Assessment reviews these issues as they contributed to the decision to raise interest rates further in November. The tightening of policy last summer led, after a lag, to a slowdown in money and credit, and there are now welcome signs that the effects are spreading to the wider economy. The full effects both of the earlier and the more recent tightening are bound to take time to come through; meanwhile policy has to remain cautious.

Growth abroad had continued to exceed expectations ...

2 Recent developments in the major foreign economies tend to confirm the generally more favourable picture of the international economy that emerged last year. Output rose sharply in the third quarter following a pause in the second, and later data suggest continued relatively robust growth. Consumer price inflation rose slightly in a number of countries through last year, but on average has remained moderate. The inflationary tensions apparent in the first half of the year associated with the sharp rise in non-oil commodity prices eased somewhat in the second half, and

falling oil prices reinforced this tendency. However, towards the end of the year some external pressures re-emerged as non-oil commodity prices rebounded, in part reflecting the continued strength of demand, and as oil prices rose, reflecting somewhat greater OPEC cohesion. Inflation may also have been restrained in some countries by the strong growth in productivity over the past year, probably reflecting buoyancy in activity.

3 The strength of output is to be welcomed, but only if it remains consistent with the maintenance of low rates of inflation. The duration of the current period of growth is not in itself a reason for expecting its imminent demise, but capacity pressures are becoming more apparent in the major economies, if to differing degrees. Judgments as to the precise extent of spare capacity, and more generally the rates of output growth likely to be consistent with the absence of inflationary pressures, are notoriously difficult to make, particularly in view of the effect on capacity of the recessions of the 1970s and early 1980s, and the subsequent restructuring. In nearly all countries the trend growth of capacity output seemed to fall sharply between the 1960s and 1970s. Few countries have seen a subsequent recovery in performance as good as that in the United Kingdom.

... but some slowing is now in prospect ...

4 Despite these uncertainties about underlying trends, the authorities in a number of countries have tightened monetary policy in response to a perception that output growth since 1987 had exceeded that of capacity and that the threat of inflation was therefore increasing. A slowing of growth in the major overseas economies this year has been a central feature of a number of recent forecasts, including those by the OECD, the IMF and the Bank (see the November 1988 Bulletin pages 482-3) all of which allow for some policy tightening; they also agree that a substantial upturn in inflation is unlikely. These forecasts, which were exceeded in 1988, present in many respects quite a comfortable picture.

5 If despite the monetary tightening that has occurred, growth does not weaken, inflationary pressures might become significant in some countries, not least the North American economies, and further action would then be necessary to combat and indeed reverse its upward creep. Policymakers there need to err on the side of caution until there is firm evidence that growth has slowed to a more sustainable rate. Judging whether or not to tighten the monetary stance in a particular case is inevitably difficult, as responses are uncertain in timing and magnitude and indicators often conflict. Raising interest rates by too much would add to fragilities caused by high levels of domestic and international debt.

... as demand patterns have failed to curb imbalances

6 Although the pattern of domestic demand growth among the major economies probably made some contribution to the adjustment of payments imbalances between the United States, Germany and Japan last year, its magnitude is likely to have been only limited, and weakened towards the end of the year as external adjustment slowed. Even in Japan, where the strength of domestic demand expansion was particularly opportune, exports are surprisingly strong and the surplus fell by little in dollar terms, although by more as a proportion of GNP. The pattern of demand growth in Europe was less helpful. The rise in domestic demand in Germany was much the same or less than in its major European trading partners, and may slow further this year (on account of the tax increases to be implemented by the German authorities), with implications for the current balance. With the favourable competitiveness effects of the sharp decline of the dollar in the two years or so after the start of 1985 now wearing off, and US domestic demand still fairly strong, the US trade deficit has ceased to improve in recent months. Although in 1988 the growth in domestic demand of its competitors probably exceeded that of US domestic demand more strongly than for some years, this gap was not large and needs to widen further if the US current account deficit is to fall to more sustainable levels, not least because of the large existing gap between imports and exports.

7 Sustained strong non-inflationary demand growth in competitor countries is helpful in providing opportunities for US exporters to expand sales further. Nevertheless, given existing trade patterns, most of any additional stimulus to domestic demand in these countries taken together would increase pressure on their own production with only a small proportion supplied from the United States. Thus expansion on the scale needed to offer significant relief to the United States would involve unacceptable inflation risks. In fact forecasts suggest that growth in US exports markets is more likely to slow. Higher US saving and slower growth in US domestic demand, together with continued moderation in costs to improve competitiveness, are therefore the key to more substantial reductions in the US deficit. The prospect of a tighter US fiscal stance is important in achieving this aim and would provide welcome support to monetary policy.

Trade negotiations

8 Further progress towards orderly adjustment of the still large imbalances between the largest economies will be necessary to keep at bay the rising protectionist pressures which, although not reflected in general tariffs, have been a notable feature of the past decade. Nations which are members of the GATT are meanwhile engaged in multilateral negotiations to liberalise trade further, strengthen the rules against protection and extend them into new areas, including agriculture and services. It is important to all countries with an interest in free trade that these negotiations make steady progress towards the goals set in Uruguay in 1986. Even in the relatively favourable international economic environment of the past year it has, regrettably, proved difficult for the leading protagonists - the United States and the EC - to overcome their starting differences, and an impasse was reached over agriculture at the Montreal meeting in December.

9 Progress seems to be held up at the moment because each side expects the other to lead with concessions. This may be a misguided approach, not merely tactically. It is possible to point to cases where even unilateral lowering of trade barriers brings advantages in the face of restrictions elsewhere. For example, the freedom of access which this country has for many

years offered to foreign firms to supply banking and other financial services here has benefited consumers in the United Kingdom and elsewhere, and aided the development of a thriving UK financial sector. Other countries with emerging financial skills and resources have seen the wisdom of this approach and are following suit. Although the parallels with other kinds of trade may not be close, there is perhaps a moral here for trade negotiators in the United States and the EC who, under pressure from producers, are reluctant to be the first to move; and also for the poorer participants in the process.

UK interest rates rose to curb domestic demand...

10 The deficiencies in the United Kingdom official statistics intensified in the third quarter. While the sum of the recorded components of domestic demand implied growth of rather over 3% on a year earlier, the CSO felt that the implied fall in GDP was sufficiently implausible to be excluded from the calculation of the average measure. According to the more reliable output measure, third quarter non-North Sea GDP was 6 1/4% higher than a year earlier, and if to go to the other extreme, the whole of the residual error in the accounts were attributed to domestic demand, that would be up by more than 8% in the same period.

11 The strength of demand contributed to the pick-up of inflation. Excluding mortgage costs the 12-month increase in the RPI rose from ~~3.6%~~ 3.7% in January 1988 to 5.1% in ~~October.~~ December. Manufacturers' output price increases also drifted up through the year, but more gently. The increase nevertheless exceeded that of ~~either material inputs or~~ unit labour costs which had been restrained by continuing productivity growth of about 7% per annum. Despite this productivity growth, UK manufacturers have had more rapidly rising unit labour costs (in local currencies) than most of our major competitors, reflecting the rapid growth in hourly compensation of employees in UK manufacturing, which grew in underlying terms by almost 9% in the year to October (and less to November). The rise in profit margins through the year reflects producers' response to buoyant demand. In services the role of earnings growth (at around 9%) in driving up costs and prices in the private sector, has been greater - though the measurement of productivity in these sectors is more difficult.

12 In the fourth quarter of last year it became apparent that domestic demand had been growing even more rapidly than had been recognised when interest rates were raised in the summer. The opportunity was therefore taken to raise rates by a further 1% when October's disappointing trade figures were announced on 25 November. At 13%, base rates were then 4 1/2 percentage points higher than at the beginning of the year. Sterling was initially marked up and proved resilient against European currencies despite 1/2% increases in some continental interest rates in mid-December and mid-January. It ended 1988 4% higher in effective terms (on the new index) than it opened. The rise in interest rates last summer contributed, after a lag, to ~~the ending of the~~ a significant ~~acceleration~~ deceleration of narrow money and the slowing of lending, particularly for house purchase, but also for consumption, towards the end of the year. Broad money also slowed slightly. ~~but a significant contractionary contribution to its counterparts came from the external side.~~

... with effects spreading into the real economy

13 With a longer lag, the tightening of policy last summer does also seem to be having an effect that is spreading beyond the housing market. Just as house prices flattened out first in the South East, retail sales also seem to have slowed there first, and to have been reduced nationally over the Christmas period. Smoothing the current balance between September and October (between which the allocation had been distorted by the postal dispute) produces a deficit in the fourth quarter of between £4 1/4 and £4 1/2 bn as in the third, which suggests that it may have stabilised. Only if the improvement through this year were even more rapid than the deterioration through last year, however, would 1989's deficit be lower than 1988's [£14]billion.

14 The main effects of the sharp rise in interest rates through the second half of last year and the mortgage rate increases announced in January (and the earlier increases which have still to be reflected fully in some borrowers' payments) should become apparent within the next 3-6 months. A slowdown in consumers' expenditure, possibly quite marked, is likely. The uncertainties

reflect among other things the unprecedented extent of the personal sector's move into deficit over the past few years, which has been much larger than most observers predicted. It is reasonable to expect that the effect on expenditure of a given change in interest rates will be larger now than in previous years, because households are on average more heavily geared, and because the proportion of floating to fixed-rate debt has risen considerably in recent years. Recent research done in the Bank supports this conclusion and, like similar research elsewhere, points to a heightened response to short-term interest rates. [Reference to Technical Paper No 20] Companies are more likely to be influenced by longer-term borrowing costs (which have risen little), and, given their much improved profitability and current utilisation of capacity, investment demand should hold up. As growth slows, profit margins should narrow, however, and the consequent restraint on prices should in turn reduce pressure for higher pay and help to contain costs.

[Conclusion]

15 The medium-term orientation appropriate to fiscal policy puts the onus of adjustment to unanticipated interim developments on to monetary instruments. The use of monetary policy was particularly appropriate in 1988 when the unexpected element was the strength of domestic demand financed by reduced saving and, especially, enlarged borrowing - which higher interest rates should remedy. Moreover, it was areas in which heavy mortgage borrowing had fed demand for housing, pushing up its price, that were likely to prove most sensitive to interest rates - and so it has proved. Fiscal policy, in terms of the scale of debt repayment, in the event, proved to have been tighter than expected. This is due both to lower public expenditure and higher revenue as a proportion of national income.

16 The evidence to date does not suggest that policy has been tightened too much given the priority of securing the predicted downturn in inflation. This consideration also suggests that the authorities should be cautious until the indicators (provide stronger ~~confirm that~~ confirmation that the slowdown is under way.

J. S. FLEMMING
EXECUTIVE DIRECTOR
01-601 4963

CH/EXCHEQUER

REC.	14 FEB 1989
ACTION	
COPIES TO	

BANK OF ENGLAND
LONDON EC2R 8AH

14 February 1989

A Allen Esq
Private Secretary to the Chancellor
HM Treasury
Parliament Street
SW1P 3AG

Dear Alex

BANK OF ENGLAND QUARTERLY BULLETIN - MAY 1989

Following our normal timetable, the May Bulletin would be published on Thursday, May 11. This would involve our sending the text to the Chancellor on 27 April for return on 2 May. Would this present him or you with any difficulty?

Yours sincerely

John

~~→ Sir T Burns~~

Terry,

Ch's comments marked. Please return to me when finished with.

Alex.

Please return to

Alex.

Moira

2. BF to Moira 28/4.

Ch
Mostly OK but some v odd bits.

AA

Conclusion OK, but a number of changes including [illegible] to that: see my marks.

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BANK OF ENGLAND
LONDON EC2R 8AH

J. S. FLEMMING
EXECUTIVE DIRECTOR
01-601 4963

c. Chancellor
Sir P Middleton
Mr Scholar
Mr Peretz
Mr ~~[illegible]~~ Davies
Mr Hibberd
Mr O'Donnell

21 April 1989

Sir T Burns
HM Treasury
Parliament Street
SW1P 3AG

I would welcome comments by first thing Monday morning. Remember this is the preliminary version that we see before the Chancellor receives the 'official' version.

TB

Dear Terry

I enclose a copy of the draft of the May Assessment (due to be published on the 11th) which has gone to the Governor and will be revised before going to the Chancellor next week.

We hope that comments you might let me have next Monday, for the Governor's meeting early Tuesday, will enable us to send the Chancellor a more satisfactory text.

Yours sincerely

J Flem.

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MAY ASSESSMENT

Introduction

Activity in the major economies has continued to exceed expectations as the effects of a general tightening of monetary policy last year takes time to work through. In the meantime inflationary pressures have intensified leading to further rises in interest rates in the US and Germany this year. Oil prices have risen sharply, while other commodities are only a little off their peak. This assessment considers these developments, proposals for the next steps in handling ldc debt and the UK's domestic situation. The picture of the economy in 1988 is now clearer with better identified demand components and a more plausible profile for savings. ~~Productivity and~~ Unit labour costs are now ~~less encouraging~~ rising more rapidly. Together with uncertainty about the precise effect of ~~response to~~ earlier policy steps the picture of strengthened demand and higher cost inflation warranted a cautious Budget. Monetary policy also has to remain restrictive.

than when?

Policy has been tightened in response to widespread inflationary pressures...

Which country/countries does this refer to?

1 In most of the major industrial countries there are as yet only tentative signs of the effects of the tightening of monetary policy during the past year. In general growth of demand and output has continued robust, although there are emerging indications of [some deceleration] in the United States (and more clearly in the United Kingdom) where action began earlier. Much of the tightening has occurred only in the last two quarters, as it became apparent that momentum was even stronger than expected and the inflationary threat greater, and it will take time for the interest rate increases to have their full effect.

2 Inflationary pressures have intensified recently in the major economies. Measures of capacity utilisation suggest that utilisation in many countries is now at or even above the peaks of the late 1970s. Unemployment has fallen to a fifteen year low in the United States and to the levels of the early 1980s in Japan

Surely the big NSF was in the first ½ of 1988?

and Canada; and even in continental Europe, where rates remain historically high, labour markets have tightened. Non-oil commodity prices, having risen substantially in the second half of 1988, have fallen back only modestly. Although spot prices may have peaked markets for many commodities are tight, with relatively low levels of stocks, and prices remain vulnerable to supply shocks or continued strong growth of demand. Oil prices have risen quite sharply during the past six months as cutbacks in OPEC output gained credibility, and supply has been subject to a series of disruptions. Moderation of demand, and the additional supply capacity expected to come on stream later in the year, may cause prices to fall back, but some of the recent strength has yet to feed through fully into output prices in the major economies - as is also the case for non-oil commodities. While there are no signs that inflation is about to accelerate in the exceptional manner of the 1970s, when oil prices were a powerful special factor and policy was more accommodating, inflation rates have nevertheless drifted up recently: consumer prices have risen almost 4% in the latest twelve months in the major six overseas economies as a group, compared to an average of 3 1/4% in 1988. The short-term prospect is for further edging up, until the pace of demand growth clearly recedes. [See Box on World Economic Prospects page 000.]

Can this really be true?

...and needs to remain firm for a time, both in the United States, where there are local debt concerns ...

3 Governments in the industrial countries are alive to the dangers of inflation and at the recent Washington meetings reaffirmed the importance of its control. Although the tightening of policy that has occurred should be sufficient to slow the growth of demand and output to a more sustainable rate, it remains to be seen whether this will be enough [to quell inflation]. The visible commitment by the major countries to consult and co-operate to reduce inflation increases the likelihood of achieving this goal. The prevalence of flat, or even downward sloping, yield curves is consistent with expectations that policy will succeed in reducing inflation. Firm policy will also give signals to wage bargainers that faster increases will not be accommodated. Some pickup has occurred in the rate of wage inflation, but to date the increases have been relatively modest despite the tightening in labour markets.

4 Amid signs that inflationary pressures in the United States had increased, the Federal Reserve tightened monetary policy again at the end of February, emphasising its resolve to counter the threat, despite concerns about domestic and international debt. These have been separately addressed by the US authorities. At the beginning of February a wide-ranging plan was proposed to resolve the problems of the savings and loan industry, including the issue of $50 bn of bonds (through an off-budget vehicle) to finance the liquidation and sale of insolvent thrifts. In addition, procedures have been put in place to increase the monitoring and regulation of corporate borrowing. The wider aims of US policy would be more satisfactorily achieved if agreement between the Administration and Congress, on a path for specific action to reduce the fiscal deficit along the lines of the Gramm Rudman Hollings legislation, took a form which commanded the respect of the markets. Tighter fiscal policy would help to raise domestic savings and would assist in freeing resources currently absorbed by domestic demand, contributing to a necessary further and sustained reduction in the external deficit, without adding to pressures on inflation.

needs updating (or is it deliberately v vague?)

...and in the other major countries, including those in external surplus

5 In the major surplus countries the macroeconomic policy stance appears broadly appropriate and there seems little case for an additional stimulus to demand while rates of resource utilisation remain high. In present circumstances pursuit of firm monetary policy in Germany (where interest rates were raised by half a point in mid April) and Japan simultaneously bears down on domestic inflation and can help to sustain an appropriate pattern of exchange rates (to which the Group of Seven countries have restated their commitment) between the dollar and other major currencies. Structural policies also have an important contribution to make. Although, as in deficit countries, the primary aim of the continuing process of structural reform is to enhance efficiency and flexibility and to increase the rate of sustainable non-inflationary growth, some structural policies may also help to promote external adjustment. As reaffirmed in Washington, the full benefits of international competition will only accrue if the trading system is liberalised further. The

recent resolution of the difficulties that arose in the mid term review of the Uruguay GATT round is a very welcome sign, though difficult negotiations still lie ahead. Welcome too is the European Commission's clarification last month of its proposed Second Banking Directive, which should do much to allay fears that the Community's market in financial services will be other than liberal and outward-looking after 1992.

New initiatives are being considered to lighten the burden of debt repayment by less developed countries

6 Necessary though the policy tightening by industrial countries is to securing sustainable growth in the longer term, it will not immediately alleviate the problems facing debtor countries in Latin America and elsewhere, and new initiatives to lighten the burden of servicing their debt are being considered. The proposals by the US Treasury [see page 000 of this Bulletin] build on the approach emerging from last September's Berlin IMF-IBRD Annual Meetings. An increasing role for voluntary, market-based debt reduction (such as debt buybacks, debt-for-bonds exchanges at a discount, and debt:equity swaps) was then acknowledged, with the proviso that there should be no transfer of risk from the banks to official creditors. A central part of Secretary Brady's proposals is the suggestion that money from the international institutions might be linked more explicitly than hitherto with debt reduction where there were appropriate policy programmes. They might also provide some limited guarantee of debtors' interest payments in cases of concessionary debt restructuring; commercial banks would contribute by forgiving a portion of their claims in exchange for such guarantees, or by withdrawing at a discount. The compatability of these proposals with the spirit of the Berlin communique depends on the precise terms, since it can be argued that the greater the reduction in commercial bank claims, the better are the chances that remaining debt, including obligations to official creditors, will be fully serviced.

This is vodd; focusses on US proposals instead of what G7 Interim Committee agreed

7 ~~Aside from cases involving official guarantees,~~ the balance of advantage to banks in forgiving their claims depends very much on the particular circumstances. To the extent that debt reduction stimulates higher rates of investment it could, increase debtors' capacity to pay, possibly to such an extent that the banks were

better off in the long run. The new proposals therefore emphasise strong IMF programmes and the importance of attracting non-debt sources of capital, such as direct investment and a reversal of capital flight. Were, however, the additional resources to be spent on consumption debt relief might be seen as encouraging the profligate with detrimental effects on the incentives for countries which hitherto have faithfully serviced their debts. The proposals have already aroused considerable, and probably unrealistic, expectations amongst debtors regarding the scale of relief on offer. It will be important to establish firm ground rules quickly if the existing, orderly, framework for debt negotiations is not to be impaired.

At home, the extent of the exceptionally rapid growth of domestic demand last year is now clearer ...

8 National Accounts statistics released around the time of the Budget present a rather more coherent picture of last year's developments in the economy and reinforce the impression of exceptionally strong growth of demand and output for much of the year, particularly in the third quarter - as also in the preceding year. The expenditure figures show rapid (7%) growth of domestic demand in the year to the fourth quarter, rather closer to the path implied jointly by the output measure of GDP and the trade figures. The upward revisions to demand earlier in the year were concentrated in fixed investment, now estimated to have increased by nearly 12% in the year as a whole. This more buoyant profile for investment is more consistent not only with survey evidence but also with the perception of high corporate profitability, high utilisation of existing capacity, and rapid growth of imports of capital and intermediate goods. Moreover as pointed out in the CSO's investigation into balancing the UK's national and financial accounts, the unidentified element in the corporate sector's accounts suggests that fixed investment has been consistently under-recorded.

... while personal incomes rose more rapidly than thought earlier

9 Incomes in the personal sector are now estimated to have risen by over 10% last year and real disposable incomes by nearly 5%. As with expenditure, these new income figures seem more plausible than the previous, lower, estimates in several important

respects. Upward revisions to income from employment are consistent with the preliminary results of the 1988 Labour Force Survey, which found that employment had grown considerably faster through 1987 and 1988 than previously thought. In conjunction with lesser revisions to consumption, they also imply a rather higher prsnl savings ratio than previously estimated: the downward trend over the past five years is still apparent, but the new figures suggest much less of a fall in the prsnl savings ratio to the middle of last year, ~~But~~ and the latest figures show a small rise between the third quarter and the fourth. This profile may reflect the effects of rising inflation and the tightening of monetary policy in the second half of 1988. Despite the sustained fall in the prsnl savings ratio, personal sector wealth has roughly doubled in real terms since the start of the decade. This reflects rising asset prices, and makes the fall in measured savings less surprising; indeed it may partly explain it, although the evidence is not clear cut.

10 Company profits were also generally strong last year, although these have been revised down; while underlying profitability remained high compared with preceding years, non North Sea industrial and commercial companies' trading profits actually fell a little in the fourth quarter, as output growth decelerated and margins came under pressure. Such was the momentum of their fixed investment and stockbuilding that ICCs [moved quite heavily into financial deficit in the quarter, for the first time since the early 1980s]. This augurs less well for a continuation of the marked and prolonged investment upswing. The expenditure measure of GDP still shows a distinctly smaller increase in the year as a whole (2 1/2%) than the income and output measures (4 1/4 - 4 1/2%). It is therefore possible that certain components of expenditure could be revised up yet again at some stage.

The extent of the slowing of demand this year is not yet clear ...

11 Data for the first months of 1989 support the view that domestic demand has been slowing, although to an extent that is not entirely clear. Having dipped in January, retail sales bounced back in February and were flat in March but trend growth

seems virtually to have ceased since last October. Borrowing by the personal sector, particularly borrowing on mortgage, has fallen away in recent months. While the trend in import volumes has continued to be strongly upwards, growth in the first quarter was faster in capital and intermediate goods than consumer goods; manufactured exports have also performed well which suggests that the problem continues to be one of excess demand rather than competitiveness. [~~despite the fact that on the new labour cost figures this is now seen to have been more than had been thought.~~]

(update)

better omitted

?

12 There is, for the time being, little good news on inflation; wage settlements continue to creep upwards, and earnings growth, at 9 1/4%, is uncomfortably high. The results from the 1988 Labour Force Survey mean that productivity growth has been rather less good than previously thought: for the year to the third quarter of 1988 whole economy productivity growth was revised down from 2.6% to 1.0% (and the corresponding increase for unit wage costs was revised upwards from 5.7% to 7.3%); the rise was further boosted by a fall in estimated productivity in the fourth quarter. Cost performance in manufacturing has been markedly better than this, but the 12-month increase has edged upwards to around 3%. Profit margins in manufacturing probably widened further in 1988, but less strongly than in 1986 and 1987. [~~To the extent that unit wage costs have risen more strongly than previously thought it would seem that relatively greater moderation in wage settlements will be required as activity slows, if inflation is to be held under control.~~]

This is not true: other variables

No jobs

non-seas adj

& profits

current account deficit in the first quarter of [illegible] was less than

13 The ~~monthly trade figures so far~~ this year ~~have broadly stabilised at~~ the high levels of the fourth quarter of 1988, but a further reduction in [illegible] the course of the year will [illegible] [~~Although if the level were to be sustained this year's current account deficit would be considerably higher than last year's £14 1/2 bn, a decline in the monthly deficit through the year could deliver a similar total.~~] Sterling, [whose ~~strength~~ has restrained inflation,] has depreciated slightly in effective terms since the beginning of the year [~~despite some intervention~~], partly on worries about domestic inflationary pressures and partly in response to a narrowing of favourable interest differentials. [~~more particularly against the US dollar, against which sterling's depreciation has been more pronounced~~]

requiring the current account deficit this year to come out at the same as last year's £14 1/2 billion.

update

add bit about your firm statements about no depreciation ✓

... and this uncertainty called for caution in the Budget

14 Against this background, the Budget was appropriately cautious, implying net tax cuts of just under £2 bn (1/2% of GDP) compared with an indexed base this fiscal year, although somewhat larger in a full year. At £14 bn, the PSDR projected for 1989/90 remains at about last year's level, ~~broadly~~ maintaining the considerably tighter fiscal stance that emerged then. The cut in employees' national insurance contributions, while being convenient as to the timing of its effect, should boost the supply of labour by improving incentives among the lower paid, and so may among other things have a useful moderating effect on pay increases. Apart from that, the Budget implies only minor modifications in the immediate economic outlook. According to the forecasts, output growth should slow perceptibly in the next 12 months but not by as much as domestic demand. The 12-month rate of retail price inflation should begin to fall more rapidly in the autumn, reflecting the timing of mortgage rate increases last year.

15 The Budget Red Book reaffirmed the Medium Term Financial Strategy as the framework for policy dedicated to restoring the steady downward trend in the growth of money income and expenditure, with price stability as the ultimate objective. The target range for M0 is unchanged at 1-5%. The objective of fiscal policy continues to be the achievement of approximate fiscal balance in the medium term which is seen as a necessary support for monetary policy as well as furthering structural aims. The large fall projected for the PSDR through the next few years reflects ~~some reduction in the pace of privatisation,~~ both further net tax reductions, and a decline in the effective tax rate as incomes grow more slowly.

Monetary policy seems to be bearing down on the household sector ...

16 As with the real economy, monetary developments have been mixed, but tend to support the view that demand growth has slowed, albeit so far mainly in the household sector. Last year's rise in interest rates would be expected to have a bigger effect on narrow and non-interest bearing money (M0) than on broader definitions;

M0 growth has indeed slowed down considerably since last summer. If higher interest rates had merely led people to economise in their use of cash for making transactions that would offer scant comfort, but the deceleration in M0 will also reflect the slower growth in the value of transactions, seen also in the statistics for retail trade. For both M0 and retail sales there is, however, some evidence of a changing seasonal pattern not fully reflected in the seasonal adjustments used. Neither the pace of expansion last summer nor the extent of the slowdown since may have been quite as great as the statistics suggest.

[The following two paragraphs may need revision when figures become available.]

17 Broad measures of credit and liquidity were still expanding at a high rate in the first quarter of this year. Reduced growth in demand for credit from the household sector for both mortgages and consumer credit has been offset by a more rapid growth in ~~ever more vigorous~~ lending to business, perhaps reflecting in part the deterioration in companies' financial position mentioned earlier. The fall in mortgage lending has been particularly sharp, and has been reflected in both lower turnover in the housing market and lower house price increases. Admittedly the mortgage and housing markets had been exceptionally buoyant and the slowdown has been largely ~~fairly~~ concentrated in the South East; in the country as a whole house prices were still rising at an annualised rate of over 15% in the first quarter, and the ratio of house prices to earnings was thus still rising. Nevertheless the regional impact of policy appears to be helpful, with a relative slowing of activity in the South East, where unemployment is comparatively low, and the momentum being maintained elsewhere.

... but less so on the company sector

18 It is good news that lending to businesses should have been less affected by the present level of interest rates than that to households, not least since this seems to reflect the carrying out of previously planned investment, despite the actual or prospective slowing in consumer demand. However the scale of lending to business in the first quarter was [unprecedented]:

Really? cf 1980-81

growth of total lending to the private sector at an annual rate of [20%-25%] in the quarter must be a cause for concern, however commendable its composition. That broad money grew less rapidly owed a lot to the continuing inflow of funds from overseas to the banking system, a reflection of the large external ~~structural~~ deficit.

[Conclusion]

19 Recent experience underlines the inevitable uncertainties in economic forecasts and the need for vigilance in the interpretation of economic data, as well as for flexibility and caution in the conduct of policy. The uncertainties about the current outlook may now seem less extreme than they were 12 months ago, for there have been no disturbances in the recent past comparable to the stock market crash of October 1987, but there are still fragilities in the world's financial markets and questions about domestic economic performance yet to be resolved. There remain uncertainties, too, about the precise impact of the policy tightening that has occurred.

20 So far the financial markets, despite the mixed news on the economy in the past few months, seem to accept that an appropriate degree of restraint has been placed on demand and activity and that improvement in the inflation rate and balance of payments should come through in due course. It would be widely agreed that the principal need now, both here and overseas is resolute control of inflation as a pre-condition for sustainable growth. The tightening of monetary policy in the second half of last year and the maintenance of a tight fiscal stance in the Budget together amount to a firm demonstration of resolve. The balance of evidence so far is consistent with its having the desired effect. On this evidence the thrust of policy seems broadly right, and much better news on inflation and the balance of supply and demand in the economy would be needed before any modification of that thrust could be contemplated.

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MAMC: N1

FROM: **J W GRICE (MG2)**
DATE: **28 April 1989**
x5509

MISS M P WALLACE

cc Mr Peretz
Miss O'Mara
Ms Ryding

MAY QUARTERLY BULLETIN ASSESSMENT

A few comments on the draft May Assessment which the Bank have sent over to Alex Allan.

Page 6, end of para ~~10~~ 9: The draft should make the point that personal sector wealth has ~~a~~risen in real terms because of sustained low inflation as well as higher asset prices.

Page 7, para 12: Replace in the first sentence "little good news on inflation" by "few signs of a decisive downturn in inflation". In the second sentence, replace "rather less good" by "lower".

Page 8, para 15: In the fourth sentence, replace "large fall projected for the PSDR" by "the projected decline in the PSDR back towards Budget balance".

Page 9, para 16: Replace second sentence by "last year's rise in interest rates would be expected to have a bigger effect on narrow and non-interest bearing money than on broader definitions. M0 has displayed markedly lower growth since the Autumn." It is probably not wise to undermine the importance of M0 by suggesting that its seasonal adjustment is faulty. The penultimate sentence would be better deleted.

Page 10, para 18: The draft could usefully make the point that the downward sloping yield curve has also probably helped to direct the major restraining influence of higher interest rates on to persons rather than companies. We would not want to suggest that the modest deceleration in broad money was only a consequence

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of the external deficit. So the last sentence would be better deleted.

Page 10, para 20: Replace "mixed news" by "difficulties in interpreting the evidence".

JWG

J W GRICE

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FROM: KEVIN DARLINGTON (EA1)
DATE: 28 APRIL 1989
Extn: 5405

PPS/CHANCELLOR

cc Sir T Burns
Mr Davies
Mr Hibberd o/r

MAY QUARTERLY BULLETIN ASSESSMENT

1. You asked for comments on the Bank's May Assessment. I am replying in Mr Hibberd's absence.

2. Para. 12 discusses the effect on measured productivity growth of the recent upward revisions to the employment statistics. These followed the incorporation of the results of the 1988 Labour Force Survey. This is illustrated by showing the fall in the productivity growth rate of the non-oil economy in 1988Q2 on a year earlier to 1.6 per cent following the revisions. The growth in non-oil productivity for 1988 as a whole on 1987 was 1.9 per cent (data for the whole year are now available). HMT recently published this figure in the April EPR. The figure of 1.6 per cent could be associated with the non-oil economy's overall productivity growth performance in 1988. It would be helpful if a line could be inserted pointing out that non-oil productivity grew by 1.9 per cent in 1988 as a whole on 1987.

OK if we had an earlier figure to compare with - the equivalent of the 3.4. But presumably we don't?

M.

Kevin Darlington
KEVIN DARLINGTON

1989-04-28 11:15 BANK OF ENGLAND ~ GPS 01 601 4953 P.01

Ms Wallace

Some suggestions.

MCS 28/4

BANK OF ENGLAND
LONDON EC2R 8AH

28 April 1989

CH/EXCHEQUER	
REC.	28 APR 1989
ACTION	Sir T Burns
COPIES TO	Sir P Middleton Ms Grieve
	Mr Scholar, Mr HP Evans,
	Mr Peretz, Mr SJ Davies,
	Mr Hibberd, Mr O'Donnell,
	Miss O'Mara.

A C S Allan Esq
Private Secretary to
The Chancellor of the Exchequer
HM Treasury
London
SW1

for comments by 6.00 pm today, pse.

MPW.

Dear Alex,

I enclose the May Quarterly Bulletin Assessment and would be grateful to have any comments the Chancellor may wish to make by midday Tuesday 2 May.

Yours sincerely,

Debbie

pp P M W Tucker
Private Secretary
to the Governor

Ch/ Terry is pretty much content with this. Most of yr comments have been taken on board, but I have marked where they have not.

Wisdom of the rest of the office scribbled in.

How much of this do you want passed on, and, any other pts?

MPW.

Insist on the deletions @ X & Y, & [illegible] the [illegible].

0008A

CONFIDENTIAL 26.4.89

MAY ASSESSMENT

Introduction

Activity in the major economies has continued to exceed expectations as the effects of a general tightening of monetary policy last year take time to work through. In the meantime inflationary pressures have intensified, leading to further rises in interest rates in the United States and Europe this year. Oil prices have risen sharply, while other commodities are only a little off their peak. This Assessment considers these developments, proposals for the next steps in handling ldc debt and the United Kingdom's domestic situation. The picture of the UK economy in 1988 is now clearer, with better identified demand components and a more plausible profile for savings. Labour costs are, however, now rising more rapidly. Together with uncertainty about the precise effects of earlier policy steps, the picture of strengthened demand and higher cost inflation warranted a cautious Budget. Monetary policy also has to remain restrictive.

Policy has been tightened internationally in response to widespread inflationary pressures ...

1 In most of the major industrial countries there are only tentative signs of the effects of the tightening of monetary policy during the past year. In general, growth has continued robust, although there are emerging indications of some deceleration in the United States and (more clearly) in the United Kingdom where action began earlier. Much of the tightening has occurred only in the last two quarters, as it became apparent that momentum was even stronger than expected and the inflationary threat greater, and it will take time for the interest rate increases to have their full effect.

2 Inflationary pressures have intensified recently in the major economies. Measures of capacity utilisation are now at or even above the peaks of the late 1970s. Unemployment has fallen to a

you queried these last time

fifteen year low in the United States and to the levels of the early 1980s in Japan and Canada; and even in continental Europe, where unemployment rates remain historically high, labour markets have tightened. Non-oil commodity prices rose again at the end of 1988 and have fallen back only modestly. With relatively low levels of stocks, prices remain vulnerable to supply shocks or continued strong growth of demand. Oil prices have risen quite sharply during the past six months as cutbacks in OPEC output gained credibility, and supply has been subject to a series of disruptions. Moderation of demand, and the additional supply capacity expected to come on stream later in the year, may cause prices to fall back, but some of the recent strength has yet to feed through fully into output prices in the major economies - as is also the case for non-oil commodities. In response to

rapid

IF exceptional demand growth consumer prices have risen almost 4% in the latest twelve months in the major six overseas economies as a group, compared with an average of 3% in 1988. The short-term prospect is for further edging up, until the pace of demand growth clearly recedes in response to the tighter stance of policy. [The Bank's latest forecasts of world economic prospects are summarised on pages 000-00.]

... and needs to remain firm for a time, both in the United States, where there are local debt concerns ...

3 Governments in the industrial countries are alive to the dangers of inflation and at the recent Washington meetings reaffirmed the importance of its control. Although the tightening of policy that has occurred should be sufficient to slow the growth of demand and output to a more sustainable rate, it remains to be seen whether this will be enough to reverse the rise of inflation quickly. The prevalence of flat, or even downward sloping, yield curves is consistent with expectations that in the longer term policy will succeed in reducing inflation. Firm policy will also give signals to wage bargainers that faster increases will not be accommodated. Some pick-up has occurred in the rate of wage inflation, but to date the increases have been relatively modest despite the tightening in labour markets.

4 Amid signs that inflationary pressures in the United States had increased, the Federal Reserve tightened monetary policy again at the end of February, emphasising its resolve to counter the threat, despite concerns about domestic and international debt. These concerns have been separately addressed by the US authorities. At the beginning of February a wide-ranging plan was proposed to resolve the problems of the savings and loan industry, including the issue of $50 billion of bonds (through an off-budget vehicle) to finance the liquidation and sale of insolvent thrifts. In addition, procedures have been put in place by bank regulators to increase the monitoring of corporate borrowing. The wider aims of US policy would be more satisfactorily achieved if specific actions which commanded the respect of the markets were undertaken to reduce the fiscal deficit along the lines of the Gramm Rudman Hollings legislation within the framework recently agreed between the Administration and Congress.

rejigged but still a bit curious

... and in the other major countries, including those in external surplus

5 In the major surplus countries the macroeconomic policy stance appears broadly appropriate. In present circumstances firmer monetary conditions in Germany (where interest rates were raised by half a point in mid-April) [and Japan (where short-term market rates have tended to edge up recently)] simultaneously bear down on domestic inflation and can help to sustain an appropriate pattern of exchange rates (to which the Group of Seven countries have restated their commitment) between the dollar and other major currencies. Structural policies also have an important contribution to make. Although, as in deficit countries, the primary aim of the continuing process of structural reform is to enhance efficiency and flexibility and to increase the rate of sustainable non-inflationary growth, some structural measures may also help to promote external adjustment. As reaffirmed in Washington, the full benefits of international competition will only accrue if the trading system is liberalised further. The recent resolution of the difficulties that arose in the mid-term review of the Uruguay GATT round is a [very] welcome sign, though difficult negotiations still lie ahead. Welcome too is the European Commission's clarification last month of the proposed

IF (minimal only)

IF

reciprocity provisions in its Second Banking Directive, which should do much to allay fears that the Community's market in financial services will be other than liberal and outward-looking after 1992.

New initiatives are being considered to lighten the burden of debt repayment by less developed countries

6 In the short run the policy tightening by industrial countries will aggravate the problems facing debtor countries in Latin America and elsewhere, but new initiatives to lighten the burden of servicing their debt are being considered. The proposals by the US Treasury Secretary [see also page 000] build on the approach emerging from last September's Berlin IMF-IBRD Annual Meetings in Berlin. An increasing role for voluntary, market-based debt reduction (such as debt buybacks, debt-for-bonds exchanges at a discount, and debt/equity swaps) was then acknowledged, with the proviso that there should be no transfer of risk from the banks to official creditors. A central part of Secretary Brady's proposals
IF is the suggestion that limited resources money from the international financial institutions (ifis) might be linked more explicitly than hitherto with debt reduction where there were fundamental and convincing economic reform programmes. He suggested that The institutions might also provide some limited support for debtors' interest payments in cases of if they had negotiated with the commercial bank concessionary debt restructuring; commercial banks would contribute by forgiving a portion of their claims in exchange for such support, or by withdrawing at a discount. The compatability of these proposals with the spirit of the Berlin communique depends on the precise terms offered: it can be argued, for
IF example, that the greater the reduction in commercial bank claims, the better are the chances that remaining debt, (including obligations to official creditors) will be fully serviced. It was subsequently agreed at the Washington meetings to set aside a portion of existing funds available from the ifis to facilitate debt reduction for countries undertaking sound economic reforms, and to examine closely proposals for interest support. It was stressed, however, that official creditors should not substitute for private lenders.

7 The balance of advantage to banks in forgiving their claims depends very much on the particular circumstances. To the extent that debt reduction stimulated higher rates of investment, it could increase debtors' capacity to pay, possibly to such an extent that the banks were better off in the long run, and the emphasis in the new proposals on strong economic programmes and attracting non-debt sources of capital, such as direct investment and a reversal of capital flight, should help towards this end. IF Were, however, additional resources to be made available or were they to be spent on consumption, debt relief would might be seen to be as encouraging the profligate, with detrimental effects on the incentives for countries which hitherto have faithfully serviced their debts. The proposals have already aroused considerable, and probably unrealistic, expectations amongst debtors regarding the scale of relief on offer. It will be important to establish firm ground rules quickly so that substantive negotiations between individual countries and the banks can begin.

At home, the extent of the exceptionally rapid growth of domestic demand last year is now clearer ...

8 National accounts statistics released around the time of the Budget present a rather more coherent picture of last year's developments in the economy and reinforce the impression of exceptionally strong growth of demand and output for much of the year - particularly in the third quarter - as also in the preceding year. The expenditure figures show rapid (7%) growth of domestic demand in the year to the fourth quarter, rather closer to the path implied jointly by the output measure of GDP and the trade figures. The upward revisions to demand earlier in the year were concentrated in fixed investment, now estimated to have increased by nearly 12% in the year as a whole. This more buoyant profile for investment is more consistent not only with survey evidence but also with the perception of high corporate profitability, high utilisation of existing capacity, and rapid growth of imports of capital and intermediate goods. Moreover, as pointed out in the CSO's investigation into balancing the United Kingdom's national and financial accounts, the unidentified element in the corporate sector's accounts suggests that fixed investment has been consistently under-recorded.

... and it is apparent that personal incomes rose more rapidly than thought earlier

9 Incomes in the personal sector are now estimated to have risen by over 10% last year and real disposable incomes by nearly 5%. As with expenditure, these new income figures seem more plausible than the previous, lower, estimates in several important respects. Upward revisions to income from employment are consistent with the preliminary results of the 1988 Labour Force Survey, which found that employment had grown considerably faster through 1987 and 1988 than previously thought. In conjunction with lesser revisions to consumption, they also imply a rather higher personal saving ratio than previously estimated: the downward trend over the past five years is still apparent, but the new figures suggest much less of a fall in the personal saving ratio to the middle of last year; and the latest figures show a small rise between the third quarter and the fourth. This profile may reflect the effects of rising inflation and the tightening of monetary policy in the second half of 1988. Despite the sustained fall in the personal saving ratio, personal sector wealth has roughly doubled in real terms since the start of the
Grice decade. This reflects both sustained low inflation and rising asset prices, and makes the fall in measured savings less surprising; indeed it may partly explain it, although the evidence is not clear cut.

10 Company profits, though revised down, were also generally strong last year; while underlying profitability remained high compared with preceding years, non North Sea industrial and commercial companies' trading profits actually fell a little in the fourth quarter, as output growth decelerated and margins came under pressure. Such was the momentum of their fixed investment and stockbuilding that these companies moved quite heavily into financial deficit in the quarter, for the first time on any scale since the early 1980s. This could augur less well for a continuation of the marked and prolonged investment upswing though reported intentions are holding up. The expenditure measure of GDP still shows a distinctly smaller increase in the year as a whole (2 1/2%) than the income and output measures (4 1/4% - 4 1/2%). It is therefore possible that certain components of expenditure could be revised up yet again at some stage.

The extent of the slowing of demand this year is not yet clear ...

11 Data for the first months of 1989 support the view that domestic demand has been slowing, although to an extent that is not entirely clear. Having dipped in January, retail sales bounced back in February and were flat in March but trend growth seems virtually to have ceased since last October. Borrowing by the personal sector, particularly borrowing on mortgage, fell away after last August but recovered somewhat in March. While the trend in import volumes has continued to be strongly upwards, growth in the first quarter was faster in capital and intermediate goods than consumer goods. Manufactured exports have also performed well, which suggests that the problem continues to be one of excess demand rather than competitiveness [despite the fact that the revised labour cost figures are higher than had been thought.]

AA?

you wanted this out?

JGrice

12 There ~~is~~ are, for the time being, [little good news on inflation;] few signs of a decisive downturn in inflation wage settlements continue to creep upwards and earnings growth, at 9 1/4%, is uncomfortably high. The results from the 1988 Labour Force Survey mean that productivity growth has been rather [less good] lower than previously thought: for the year to the second quarter of 1988 productivity growth in the non-oil economy was revised down from 3.4% to 1.6% with a corresponding increase in unit wage costs; the rise in labour costs was further boosted by a fall in estimated productivity between the third and fourth quarters. Cost performance in manufacturing has been markedly better than the rest of the economy, but the twelve-month increase has edged upwards to around 3%. Profit margins in manufacturing probably widened further in 1988, but less strongly than in 1986 and 1987.

Grice

see Darlington minute behind

AA: NB "one month's figures"

13 The current account deficit for the first quarter is estimated to be significantly smaller than in the fourth quarter of last year. The March figures are particularly encouraging and, though they owe something to erratic elements in non-oil exports, a decline in the monthly deficit through the year (reflecting the slowing of domestic demand and recovery in North sea oil output) could lead to a figure for the year similar to that for 1988. Sterling, whose earlier strength has tended to restrain inflation,

Not quite what you drafted.

AA MCS

and which rose in effective terms towards the end of last year, has since slipped back a little ~~despite indications of resistance on the part~~ of the authorities.

X

... and this uncertainty called for caution in the Budget

14 Against this background, the Budget was appropriately cautious, implying net tax cuts of just under £2 billion (1/2% of GDP) compared with an indexed base this fiscal year, although somewhat more in a full year. At £14 billion, the PSDR projected for 1989/90 remains at about last year's level, maintaining the considerably tighter fiscal stance that emerged then. The cut in employees' national insurance contributions, will have a delayed ~~conveniently timed~~ effects on demand, ~~and~~ should boost the supply of labour by improving incentives among the lower paid, and so may among other things have a useful moderating effect on pay increases. Apart from that, the Budget implies only minor modifications in the immediate economic outlook. According to the forecasts, output growth should slow perceptibly in the next twelve months but not by as much as domestic demand. The twelve-month rate of retail price inflation should begin to fall more rapidly in the autumn, reflecting the timing of mortgage rate increases last year.

MCS

15 The Financial Statement and Budget Report reaffirmed the medium-term financial strategy as the framework for monetary policy dedicated to restoring the steady downward trend in the growth of money income and expenditure, with price stability as the ultimate objective. The target range for M0 is unchanged at 1%-5%. The objective for fiscal policy continues to be the achievement of approximate fiscal balance in the medium term which is seen as a necessary support for monetary policy as well as furthering structural aims. The projected decline in [large fall projected for] the PSDR back towards balance through the next few years reflects some reduction in the planned receipts of privatisation, further net tax reductions, and a decline in the effective tax rate as incomes grow more slowly.

?

Grice

Monetary policy seems to be bearing down on the household sector ...

16 As with the real economy, monetary developments have been mixed, but tend to support the view that demand growth has slowed, so far mainly in the household sector. Last year's rise in interest rates would be expected to have a bigger effect on narrow and non-interest-bearing money (M0) than on broader definitions;

Grice

displayed markedly lower growth since the Autumn

M0 [growth] has [indeed slowed down considerably since last summer.] Although to some extent reflecting responses to higher interest rates, the deceleration in M0 also reflects the slower growth in the value of transactions, seen in the statistics for retail trade. [For both M0 and retail sales there is, however, some evidence of a changing seasonal pattern not fully reflected in the seasonal adjustments used.] Neither the pace of expansion last summer nor the extent of the slowdown since may have been quite as great as the statistics suggest.

J Grice

17 Broad measures of credit and liquidity were still expanding at a high rate in the first quarter of this year. Reduced growth in demand for credit from the household sector for both mortgages and consumer credit has been offset by a more rapid growth of lending to business, perhaps reflecting in part the deterioration in companies' financial position mentioned earlier. The fall in mortgage lending has been particularly sharp, and has been reflected in both lower turnover in the housing market and lower house price increases. Admittedly the mortgage and housing markets had been exceptionally buoyant and the slowdown has been largely concentrated in the South East; in the country as a whole house prices were still rising at an annualised rate of over 15% in the first quarter, and the ratio of house prices to earnings was thus still rising. Nevertheless, the regional impact of policy appears to be helpful, with a relative slowing of activity in the South East, where unemployment is comparatively low, and the momentum being maintained elsewhere.

... but less so on the company sector

18 It is good news that lending to businesses should have been less affected by the present level of interest rates than that to households, not least since this seems to reflect the carrying out of previously planned investment, despite the actual or prospective slowing in consumer demand. However, the scale of lending to business in the first quarter was very large: total lending to the private sector growing by more than 20% in the quarter must be a cause for concern, however commendable its composition. [That broad money grew less rapidly owed a lot to the continuing inflow of funds to the banking system from overseas, a reflection of the external deficit.] JGrice

Year queried cf 80-81

[Conclusion] Grice adds: make pt that downward sloping yield curve helps to direct major restraining influence to ~~group~~ persons not companies.

19 Recent experience underlines the inevitable uncertainties in economic forecasts and the need for care in the interpretation of economic data, as well as for flexibility and caution in the conduct of policy. The uncertainties about the current outlook may now seem less extreme than they were twelve months ago, for there have been no disturbances in the recent past comparable to the stock market crash of October 1987, but there are still fragilities in the world's financial markets and questions about domestic economic performance yet to be resolved. There remain uncertainties, too, about the precise impact of the policy tightening that has occurred.

Grice: difficulties in interpreting the evidence

MCS omit? 20 [So far the financial markets, ~~despite the mixed news on the UK economy in the past few months,~~ seem to accept that an appropriate degree of restraint has been placed on demand and activity and that improvement in the inflation rate and balance of payments should come through in due course.] It would be widely agreed that the principal need now, both here and overseas, is resolute control of inflation as a pre-condition for sustainable growth. The tightening of monetary policy in the second half of last year and the maintenance of a tight fiscal stance in the Budget together amount to a firm demonstration of resolve. The balance of evidence so far is consistent with its having the desired effect. IY

MCS

CONFIDENTIAL

On this evidence the thrust of policy seems broadly right, and 11
~~much better~~ sustained good news on inflation and the balance of supply and demand
in the economy would be needed before any loosening of policy
could be contemplated.

BANK OF ENGLAND
LONDON EC2R 8AH

J. S. FLEMMING
EXECUTIVE DIRECTOR
01-601 4963

23 May 1989

A Allen Esq
Private Secretary to the Chancellor
HM Treasury
Parliament Street
SW1P 3AG

Dear Alex

BANK OF ENGLAND QUARTERLY BULLETIN - AUGUST 1989

Following our normal timetable, the August Bulletin would be published on Thursday, August 10. This would involve our sending the text to the Chancellor on 27 July, for return on 31 July. Would this present him or you with any difficulty?

Yours sincerely

John

CH/EXCHEQUER
REC. 24 MAY 1989
ACTION
COPIES TO

BANK OF ENGLAND
LONDON EC2R 8AH

J. S. FLEMMING
EXECUTIVE DIRECTOR
01-601 4963

14 July 1989

Pups please.

A C S Allan Esq
Principal Private Secretary to the Chancellor
Treasury Chambers
Parliament Street
SW1P 3AG

Dear Alex

QUARTERLY BULLETIN - August 1989

In your letter of 24 May you asked us to Fax the Assessment to you early on 27 July as you "might in practice" want to return it by Friday evening. It now appears that this would suit us very well. If we get it to you by 10am on the 27th could you get it back by 5pm on the 28th?

Please note that under the present arrangements, Terry Burns will have seen it the previous week.

Yours sincerely

chex.dc/aa/30

Moira ←

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

20 July 1989

J S Flemming Esq
Executive Director
Bank of England
LONDON
EC2R 8AH

Please watch out for and process this.
(1) We should get ~~Terry A~~ drafted ~~Terry~~ Terry tonight. Make sure we do, & put it into Ch's weekend box with any comments you have.

Dear John

see below

QUARTERLY BULLETIN - AUGUST 1989

Thank you for your letter of 14 July. As I have told your office, we will do our level best to get our comments back to you by 5pm on the 28th, but there is an outside chance we might not be able to meet that.

Yours
Alex

A C S ALLAN
Principal Private Secretary

(2) Make sure we do get proof by 10AM Thursday; whizz it round to relevant officials with a close of play Thursday deadline & then try to get Ch to clear it overnight. Else may be able to clear during day on Friday. Alex

pmp

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BANK OF ENGLAND
LONDON EC2R 8AH

J. S. FLEMMING
EXECUTIVE DIRECTOR
01-601 4963

20 July 1989

Comments first thing Monday morning (24.7.89) PI.

cc:- Chancellor
Sir Peter Middleton
Mr Wicks
Mr Scholar
Mr H.P. Evans
Mr Peretz
Mr Melliss, Mr O'Donnell
Mr S.J. Davies, Mr Hibberd
Mr Grice, Miss O'Mara

Sir T Burns
HM Treasury
Parliament Street
SW1P 3AG

Dear Terry

I enclose a copy of the draft of the August Assessment (due to be published on the 10th) which has gone to the Governor and will be revised before going to the Chancellor next week.

We hope that comments you might let me have next Monday, for the Governor's meeting early Tuesday, will enable us to send the Chancellor a more satisfactory text. which, on this occasion, we hope he can turn round in 24 hours.

Yours sincerely

John

Ch/ some scribbles, from Alex and me.
Any comments to feed into Terry's response?
(We will get the 'final' draft for you to clear first thing on Thursday)

MPW.
21/7

A few pts & question marks

1703B

CONFIDENTIAL DRAFT (20.7.89)

QB ASSESSMENT - AUGUST 1989

INTRODUCTION

1 The last quarter has been marked by volatility in currency markets. For much of the period the US dollar was unexpectedly strong against both the yen and the deutschemark. In part this may have reflected political factors. A persistently strong dollar would be likely to weaken activity in the United States, where it is already slowing, and stimulate it in Europe and Japan, both of which have tightened monetary policy in the face of inflationary pressures. A stronger dollar is also unhelpful to the adjustment of international imbalances in the longer term. Against this background, this Assessment discusses developments in the UK domestic economy, the policy response to sterling's weakness against currencies other than the dollar, and to the emerging picture of the responses of domestic demand and output to earlier measures.

Interest differentials narrow as the US dollar strengthens and activity slows in North America ...

2 While there are clear signs of an emerging slowdown in North America in response to earlier monetary tightening, growth in Japan and the major continental European economies continues to exceed expectations. If sustained, at levels reached earlier in the quarter, the strength of the dollar would tend to reinforce this regional pattern of growth. It might also tend to put some upward pressure on inflation in the major economies as a group, partly because some commodity prices exhibit some short-term stickiness in respect of changes in the dollar, and perhaps also because inflation in the continental European economies may be more responsive to a positive stimulus from import prices than is the United States inflation, to negative stimulus. Official interest rates in Japan have been raised by 3/4% and in Germany by a further 1/2% over the last three months to contain the

inflationary threat arising from strong growth and from the rising costs of imports. (Consumer price inflation, which has also been raised in both countries by consumer taxes, reached 3% in Germany and edged towards this figure in Japan.) These interest rate increases, and earlier tightening in Germany, will help to slow domestic demand somewhat, and limit the response of wages to prices. They should also help to strengthen the yen and the deutschemark - which is an important part of the transmission of tighter monetary policy.

3 Recently there have been signs that this process is beginning to work, as the narrowing of interest differentials in favour of the dollar, and large scale co-ordinated intervention, have succeeded in bringing the dollar back from its peak levels, although it remains [7%] higher in effective terms than at the start of the year. A slight reduction of US interest rates in the last two months has assisted the process; this is the first reversal of a series of tightening moves which began early last year.

4 The reduction in US interest rates occurred against a background of slowing and better-balanced demand, slower monetary growth and a strong dollar. Consumer spending and residential investment have weakened considerably, although healthy business investment and good export performance have helped to maintain total demand. Despite signs of slowing growth and the strong dollar, measured inflation in the United States has continued to increase, as capacity remains quite tight and earlier pressures from higher oil and commodity prices have fed through. Encouragingly, wages have to date shown little sign of acceleration despite the tight labour market, although, as output growth eases, slower growth in productivity may add to pressures on unit costs. Progress on inflation in the United States would be threatened by any further easing of monetary policy there.

... elsewhere monetary policy remains tight while co-ordinated intervention has influenced exchange rates ...

5 Given the critical importance of not only stabilising but reducing inflation in the major economies as the seven major countries re-emphasised at the Paris Summit, monetary policy must remain tight. Trends in the main external influences are difficult to interpret but give grounds for some encouragement. Oil prices, which are, of course, themselves influenced by prospects for activity in the industrial countries , fell back from earlier peaks after the June OPEC meeting, [although recently prices have rebounded somewhat], while spot non-oil commodity prices, which had shown no trend in the early part of the year in SDR terms, may be turning down. Greater efficiency in the use of energy and raw materials has reduced the impact on the major economies of oil and commodity prices, while rapid growth of trade between the major economies has increased the importance to each of developments in the others. As there is pressure on capacity in each of the major economies, this increased interdependence raises the risk of spreading inflation and emphasises the need for close economic co-operation. Within Europe, as the process of liberalising capital movements and the internal market programme near completion, such co-operation will assume particular importance. Indeed, in late June the Madrid meeting of the European Council called for a strengthening of economic and monetary policy co-operation initially on lines identified by the Delors Committee. (see the Governor's IEA lecture, pp). Indeed! (see Frankfurt Gov folder)

6 Co-ordinated exchange market intervention has helped to give signals about the appropriateness of exchange rates. The difference between the initial and longer-term effects of exchange rate changes makes it difficult to interpret recent trends in the payments positios of the three major economies. Although the relative slowdown of US domestic demand has helped to reduce the US trade deficit so far this year below last year's average this may in part be related to the initial J-curve effects arising from the strength of the dollar and may thus be more than reversed later. Although in a world of deregulated capital markets external surpluses and deficits may simply reflect adjustment to desired savings and investment positions and be quite smoothly

What does that mean?

proposals may be hard to sell. There may also be difficulties in reconciling the total amount of debt or debt service reduction offered with the limited resources available for providing the associated collateral.

implying what?

or this?

Monetary tightening at home is having continuing effects ...

9 It is now (well) over a year since monetary policy began to be tightened. It was expected that the effect on the economy would be spread over more than twelve months, with some forms of expenditure affected before others and some asset prices more immediately responsive to policy while those of other goods would react only to a slackening of demand. Developments so far have ~~not upset~~ been in line with those expectations. At what is still an intermediate stage not all the objectives of the tightening of policy have yet been achieved. Assessment of the stance of policy needs to take account of both how rapidly the economy was expanding when policy was first tightened and how much of the effect of past tightening has still to come through. Perceptions of the former have undoubtedly been revised upwards in relation both to activity and its inflationary implications. As to the latter, although the economy may have become more responsive, the balance of evidence is strongly that adjustment to last year's tightening is by no means yet complete. The mechanism, however, is working as expected.

10 Against a background judgement on the extent of adjustment in the economy, policy has also had to respond to some sharp changes of mood in financial markets in recent months. The strength of the exchange rate into the early part of this year had been an important factor contributing to tight monetary conditions. The subsequent weakening reflected in part the resurgence of the US dollar and the effect of political events elsewhere. Nevertheless, the speed and scale of the fall in sterling in late May were such as to threaten the prospective reduction in inflation, both directly through import prices, and by reducing pressure on UK price setters. Interest rates were raised by a further 1% in late May to counter that threat. Subsequent downward pressure in the exchange market, which was indeed to prove transient, was met with heavy intervention.

hostage to fortune

11 The housing market was the first to react to policy tightening, most noticeably in the South-East, where high house prices and heavy mortgage borrowing had made borrowers most exposed to interest rate increases. Prices continue to rise away from the South East but now at a more subdued rate and by June, taking account of normal seasonal movements, prices in the country as a whole had stopped rising. Mortgage lending has remained subdued, but with the building societies gaining market share, as, until April, they had been able to attract relatively cheap retail funds and the balance of activity shifted towards lower priced property.

... more on demand for consumers' than for producers' durable goods

12 Consumer spending slowed further in the first quarter and spending on durable goods - most likely to be affected by the slowdown in the housing market - was lower than in the third quarter of last year. Spending on non-durables appears to have been erratic from month to month. While a number of indicators (retail sales, M0, consumer credit) pointed to a sharp recovery in May, the provisional figures for retail sales in June are consistent with a moderating growth of consumption. Stockbuilding responded to the slowing in consumer demand, with distributors reducing in the first quarter stocks which they had involuntarily built up in the previous three months, in part at the expense of manufacturers, who saw their stock levels rise. Distributors and manufacturers alike have reported their stocks as too high, and further adjustments have probably been in train.

?

13 It had been expected that the growth of industrial investment, which has recovered strongly in recent years, would respond only with some considerable lag to the slowing of consumer demand. Thus the cessation of growth reported in the first quarter was surprising, and is further questioned by surveys ~~which~~ continue to suggest that, in 1989 as a whole, investment growth, though slower than last year, may still be of the order of 13%. A downturn ~~An~~ adjustment next year is, however, likely; companies' financial position has weakened and in many past periods of slower economic growth investment has fallen.

? (M)

14 Overall, evidence continues to accumulate that domestic demand has slowed from the excessive growth of last year. Measured from its components, domestic demand is estimated to have fallen in the first quarter; measured indirectly, from output and the trade balance, its growth was minimal. Less reassuring is some of the evidence on the balance between domestic demand and output more recently. Manufacturing output is recorded as being virtually flat this year, while retail sales continued to grow (particularly in May). But the external trade statistics, which may be a better guide, suggest a more favourable outturn, with the current account balance (in volume as well as value terms) showing further improvement even allowing for possible anticipatory effects of the dock strike. The subdued growth of imports in the most recent months may however be compatible with domestic demand having been met to a considerable extent from stocks.

The labour market remains tight ...

15 So far, as would be expected, slower growth in the economy has not had very marked effects in the labour market. Manufacturing employment, however, has resumed its decline in recent months, and the rate of fall of unemployment is not as great as it was. Underlying earnings growth has not advanced further and the earlier acceleration had been less than that which occurred following similar periods of high demand pressure in the past. Settlements, however, continue to rise, notably in services, where they reached 8 1/2% in the second quarter. The growth of industrial disputes reflects both pressure for, and resistance to, higher settlements, following the acceleration of prices.

productivity

16 Earnings have grown at broadly similar rates in different sectors and have not reflected differences in growth of productivity. In manufacturing, where ~~it~~ Prod--? has continued to grow rapidly, unit wage costs are growing at around 3% per aannum. For services the statistics are not so up to date, but, with output apparently slowing, productivity is likely to grow very slowly, and unit wage costs in services may be rising by as much as 8 1/2% per annum. In the longer term there may be scope for faster growth of productivity outside manufacturing, but the differential is unlikely to be eroded; on the other hand there

evidence?

are likely to be limits to extent to which earnings growth in different sectors can diverge. Inflation of 2 1/2%, as envisaged for the medium term in the FSBR, would necessitate very low or even negative growth of unit labour costs (and prices) in the sectors, such as manufacturing, where productivity grows relatively fast. This is indeed the experience of our most successful competitors, on whose rate of inflation we wish ours to converge. ~~? do we need/want all this?~~

?

... as price inflation peaks

17 Prices, unlike earnings, do reflect productivity differences, so that manufacturers' output prices are now rising at less than 5% per aannum, which probably also indicates some [lessening of the rate at which margins have widened, if not an actual] reduction. ~~of margins~~ But faster increases in the price of services appear to be responsible for much of the acceleration in retail prices overall (excluding mortgages) from 4 1/2% to 6% over the past year. Inflation, as measured by the RPI including mortgages, is likely now to have peaked. Much of the earlier acceleration and of the prospective deceleration reflects the mortgage element. Excluding that, the rise in inflation has been slower, and so too may be the reduction. Nevertheless, with a period of slower economic growth in prospect, for a time below the potential growth of the economy, underlying inflation should fall, with reduced profit margins providing the earlier contribution, followed in the next pay round by the further consequences of an easing in labour market pressures. Slower domestic demand will also help to reduce the current deficit, but again slowly.

18 There are risks to this prospect. Slow adjustment of the current balance, accompanied by continued tight fiscal policy, implies a continued private sector financial deficit of unprecedented scale. So far private sector confidence seems [remarkably] robust but expenditures might be adjusted more rapidly, bringing about a faster reduction in inflation (and in the current account deficit), at a greater immediate cost in terms of output and employment. On the other hand, despite the improving balance in the economy, sterling might come under renewed downward pressure, and thus again imperil the prospective reduction in

inflation. [In this case, even though short-term interest rates in this country are already high in real terms, they might have to rise again, or stay high longer than had been hoped.] ~~If this threatens, it will be important that monetary conditions are kept sufficiently tight [and interest rates kept as high as necessary for as long as necessary].~~

BF John 5/9

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PLP

J. S. FLEMMING
EXECUTIVE DIRECTOR
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24 August 1989

7/9

CH/EXCHEQUER

REC.	24 AUG 1989
ACTION	SIR T BURNS
COPIES TO	SIR PE M
	MR O'DONNELL
	MR RITCHIE
	MR SCHOLAR
	MR PERETZ

J Gieve Esq
Private Secretary to the Chancellor
HM Treasury
Parliament Street
SW1P 3AG

Dear Mr Gieve

BANK OF ENGLAND QUARTERLY BULLETIN - NOVEMBER 1989

Following our normal timetable, the November Bulletin would be published on Thursday, November 9. This would involve our sending the text to the Chancellor on 26 October, for return on 30 October. Would this present him or you with any difficulty?

Yours sincerely

John Flemming

NB Near Autumn Statement

NML! I have said 26 October is OK but asked about flexibility of publication day given its proximity to AS.
JG