PO-CH/NL/0335

PART B

Part B.

SECRET

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MANAGEMENT - IN - CONFIDENCE.

Begins : 27/4/88.
Ends : 28/6/88.

PO -CH /NL/0335

PART B

Chancellor's (Lawson) Papers:

ECONOMIC FORECASTING AND POLICY ASSUMPTIONS FOR 1988

DD's : 25 Years

[signature]

8/11/95.

PO -CH /NL/0335
PART B

Midland Bank plc

Poultry
London EC2P 2BX
01-260 7218

Andrew D. Bain
Group Economic Adviser

PRIVATE AND CONFIDENTIAL

Sir Terence Burns
Chief Economic Adviser to the Treasury
HM Treasury
Parliament Street
London SW1P 3AG

27 April 1988

Dear Terry

I attach a slightly edited version of the note I mentioned on property and house mortgages. You may find some of the charts interesting.

On the comparisons of real interest rates now and in 1973, I am not sure I accept your assertion that they are now positive. In the property market, it all depends on what you think will happen to property prices. What proportion of house owners/purchasers share my expectation that house prices in the South will fall?

Money supply conditions are now similar to those post-CCC. There is no control on supply. Too many major players are vying for market share, and are only too happy to meet what seems to them like profitable demand. Not all have thrown caution to the wind, and I am sure I am not the only Jeremiah; but the figures tell their own story. I see no reason to expect the pace of lending to fall until there is a jolt to expectations which affects on the one side demand and on the other perceptions of risk. Better sooner than later.

Yours ever

Andrew

392/4/124

LENDING TO PROPERTY COMPANIES AND MORTGAGE LENDING TO PERSONS

A Property Companies

1. I refer to the paper on Property Companies from GED, dated 15 February 1988. The concluding sentence of the summary bears repeating :-

   "In addition if interest rates were to rise rapidly as a policy response to inflationary pressures, or weakness in sterling, there would be a significant probability of property valuations falling sharply with more serious loan repayment difficulties and defaults resulting."

   It is now very likely that interest rates will be raised sharply at some time in the next six months, in order to break the boom psychology which still prevails in the property and housing markets and to reduce the flows of funds into those markets substantially.

2. We now know that bank lending to property companies continued to rise very rapidly (by £1.7bn) in the three months to February this year, bringing the increase over the previous twelve months to more than £5bn (55%). LSB Group figures show that lending continued at a high level in March, and applications for facilities suggest that demand is not yet drying up. The Bank of England are clearly concerned about the level of lending in general, and to property companies in particular. Figures for lending to property companies and institutional investment in property for the recent period and the run-up to the 1973 boom are shown in chart 1. In the most recent quarter the flow of funds into property has been running at about four times its 1983 level, comparable to the increase between 1971 and 1974.

3. A credit squeeze is likely to lead to much slower growth of the economy in 1989. In my view this combination of squeeze and slower growth must impact on vacancy rates, rental levels and asset values in 1989 and 1990.

B Residential mortgages

4. With the possible exception of London itself, house price inflation in the 'South' appears to have continued unabated in the first quarter of this year. As a result I believe that house prices have now reached dangerously high levels in some areas.

5. Chart 2 shows how national house prices have risen recently, to a level (in real terms) significantly above their previous peak in 1973. The ratio of house prices to real disposable income nationally (chart 3) is now at least 15% above trend, although not yet near the dizzy height of the 1973 peak. This rising trend in house prices has been supported by a huge increase in lending for house purchase (chart 4 - again, comparable to the early 70s experience) and by high advance/income ratios, at the same levels as in the 1971-75 period for first-time buyers and higher for former owner-occupiers. (See table 1 : the figures relate only to building society borrowers and it seems likely that some of the new lenders in the market are employing more relaxed standards.) Further increases in the advance/income ratios are now unlikely - they will probably fall back slightly - and a credit squeeze would lead to a fall in lending for house purchase.

6. House price inflation has varied very substantially between regions. (See charts 5-7, which show the ratios of house prices in various regions to the national average, all indexed to a base of 100 in 1983.) In broad terms, it is a major problem in the 'South' (chart 5 - London, South East, South West and East Anglia Regions); is spreading to some parts of East and West Midlands regions (chart 6); and is not a problem in North, Yorkshire and Humberside, North West and Wales Regions (chart 7).

7. Three notable features emerge from these charts :-

   (i) Over the period 1969 to 1984 as a whole house prices in the 'South' did not rise relative to the national average trend.

   (ii) Prices in the 'South' have generally risen relative to the national average in booms and fallen back in the subsequent recessions; London and the South East have peaked and bottomed out earlier than East Anglia and the South West.

   (iii) Divergencies from the national average are currently much greater than at any previous time in the last 20 years.

8. In every boom apparently good reasons have been advanced why the 'Southern' house price differential should increase permanently and not fall back later. Afterwards, they have proved to be special pleading. On this occasion, however, there may be some force in them. For example, the demise of Regional Policy leaving the price mechanism - of which higher housing costs are an important part - to deal with the regional problem, the substitution of the poll tax for rates, and developments in the road and rail network may all have permanent effects. But even if these special factors may prove to be long-lasting, there is no reason to believe that the ordinary, reversible cyclical factors are absent. Prices in the 'South' may not fall back as far as on previous occasions, but they must be expected to fall; indeed there are signs that prices in the leading region, London, may already be levelling out.

9. With national average house prices now some 15% above trend and the 'Southern' differential increased by between 10% in the South West and over 35% in London, there is scope for considerable price falls when the cycle turns down. Against a background of low general inflation and slower economic growth I therefore expect that house prices in the 'South' will fall. On the basis of past experience but allowing something for special permanent factors, a reasonable estimate of the size of fall might be some 20% on average in the next two years. Prices in those parts of the Midlands which have seen rapid rates of increase recently are also vulnerable. The risk of significant price falls in the rest of the country, where house price inflation has lagged behind in recent years, is generally much less.

A D Bain
26 April 1988

Table 1:

Average Advance/Income Ratios

		First-Time Buyers	Former-Owner Occupiers
Average			
1971-75		2.06	1.86
1976-80		1.77	1.64
1981-85		1.85	1.77
1986	Q1	1.97	1.89
"	Q2	2.02	1.91
"	Q3	2.08	1.96
"	Q4	2.06	1.95
1987	Q1	2.01	1.94
"	Q2	2.03	1.95
"	Q3*	2.05	1.96

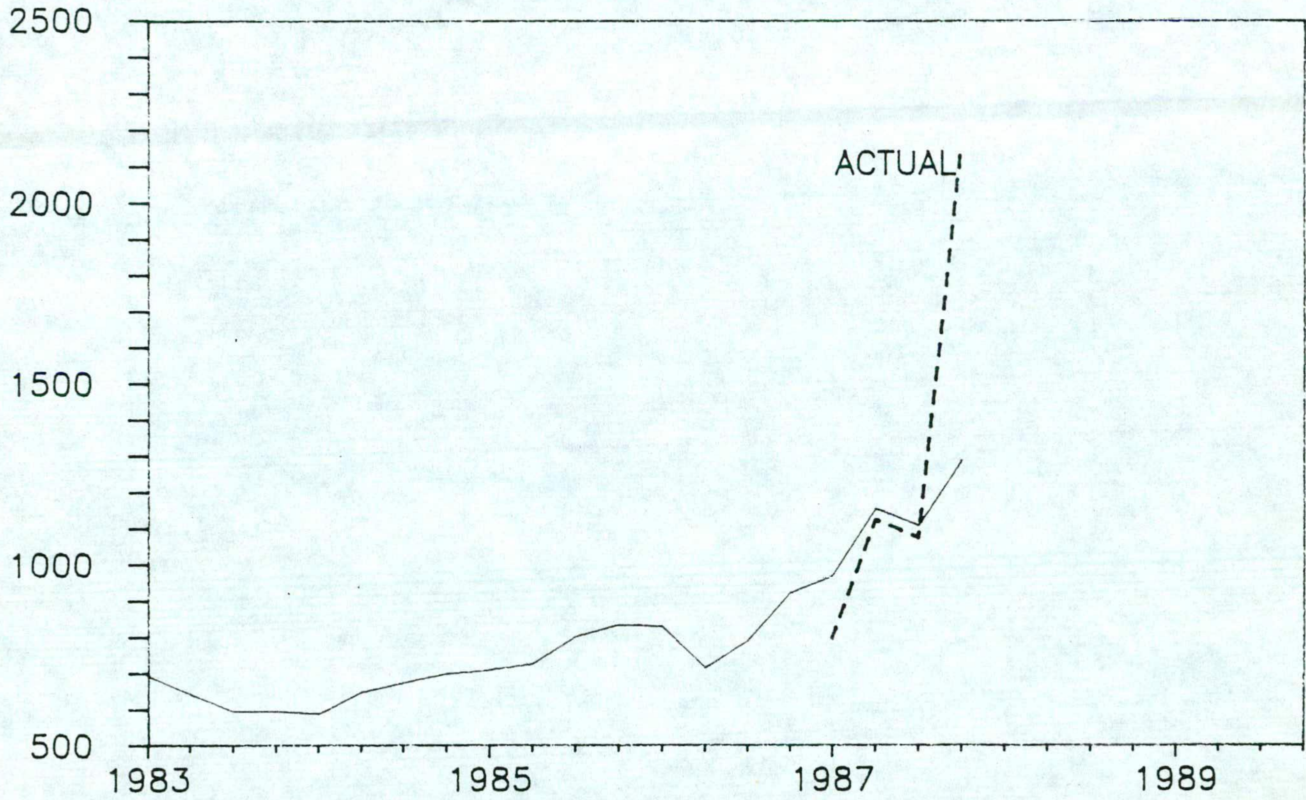
* Latest available data

Source: BSA Bulletin, Tables 12 & 13

CHART 1

FLOWS INTO PROPERTY BY BANKS AND OFIS

FOUR QUARTER MOVING AVERAGE



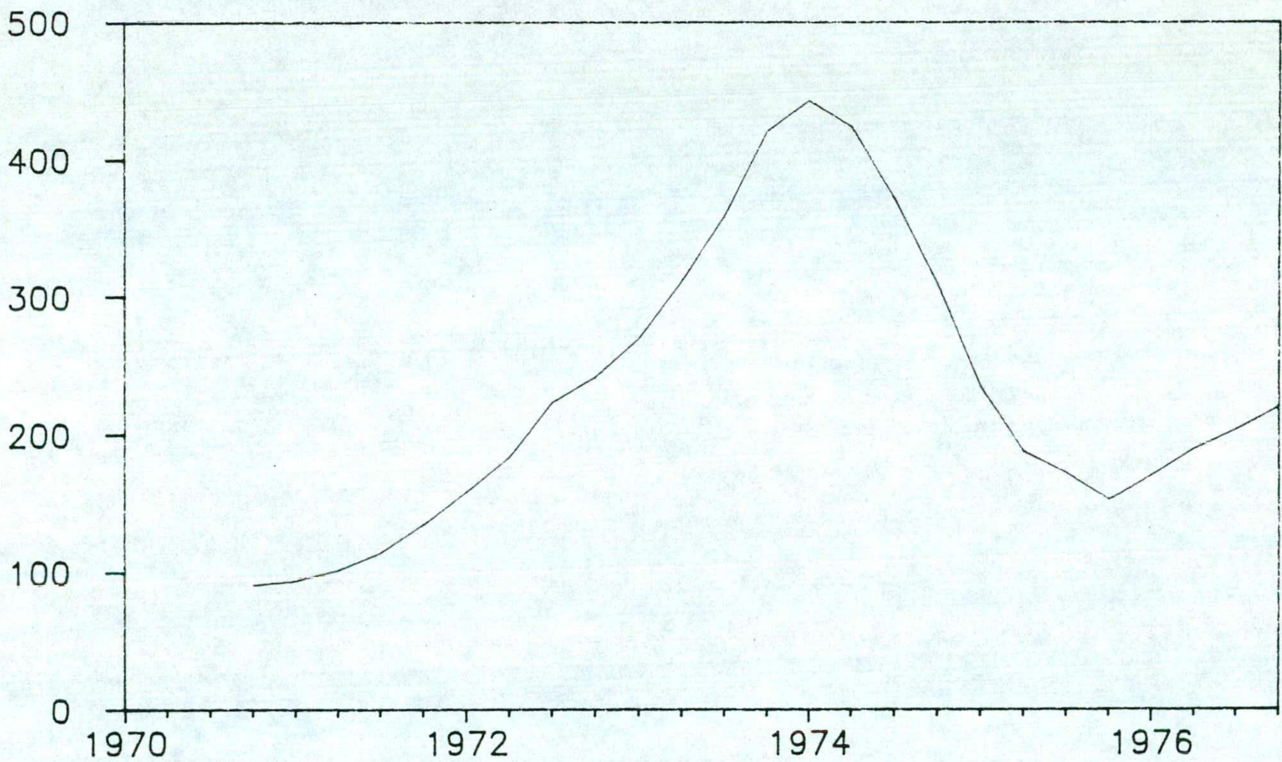


CHART 2

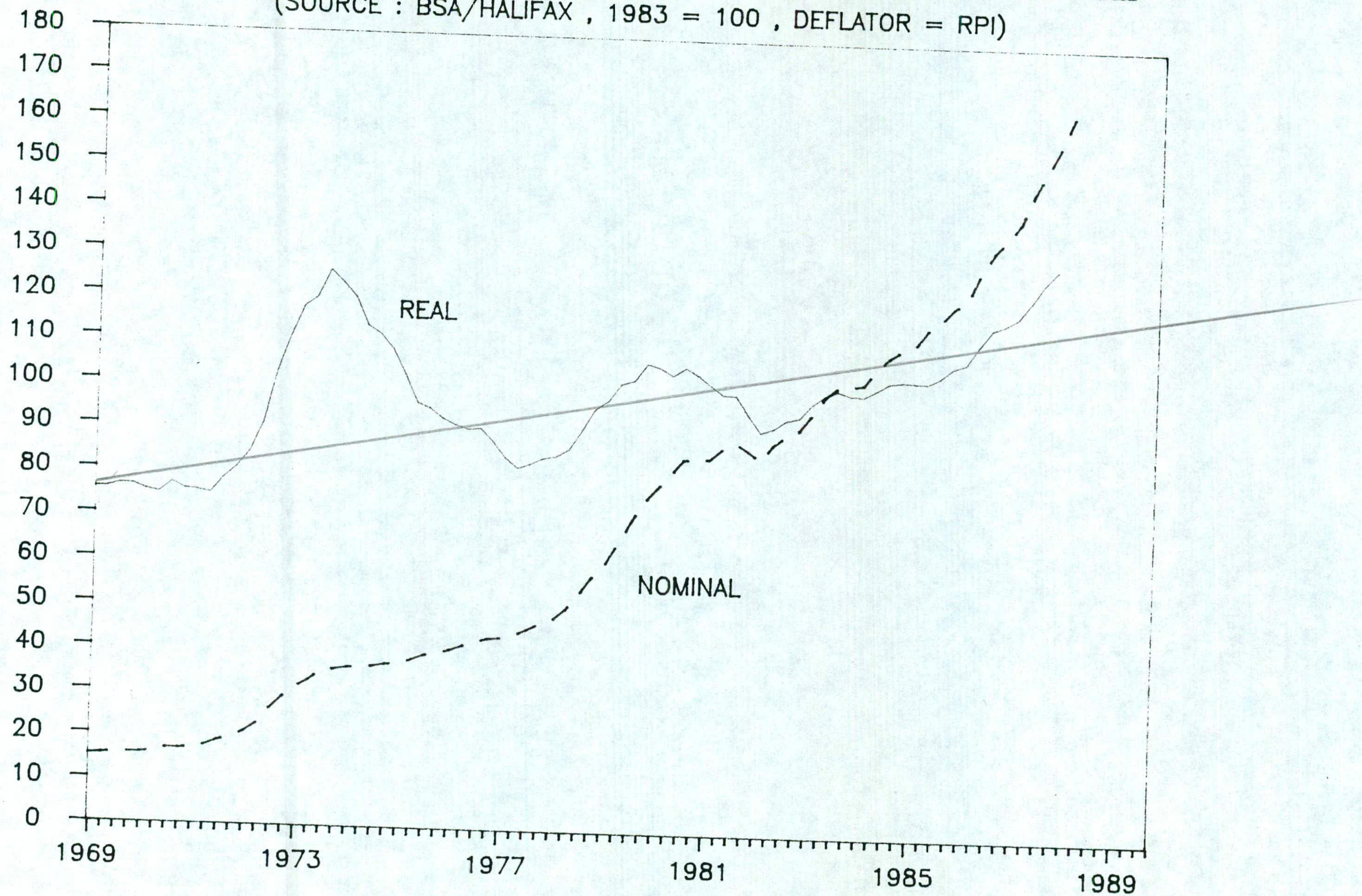


CHART 3

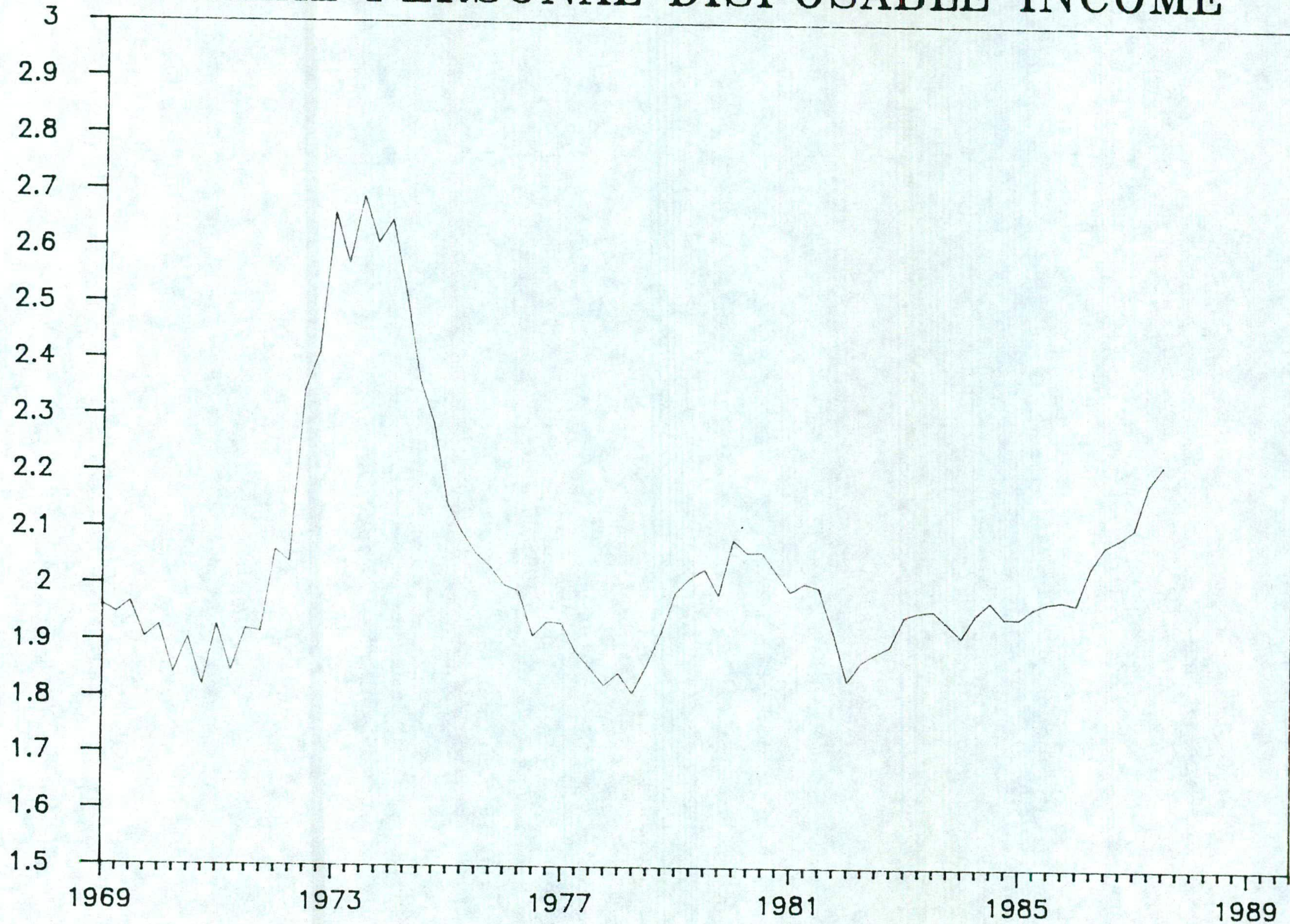
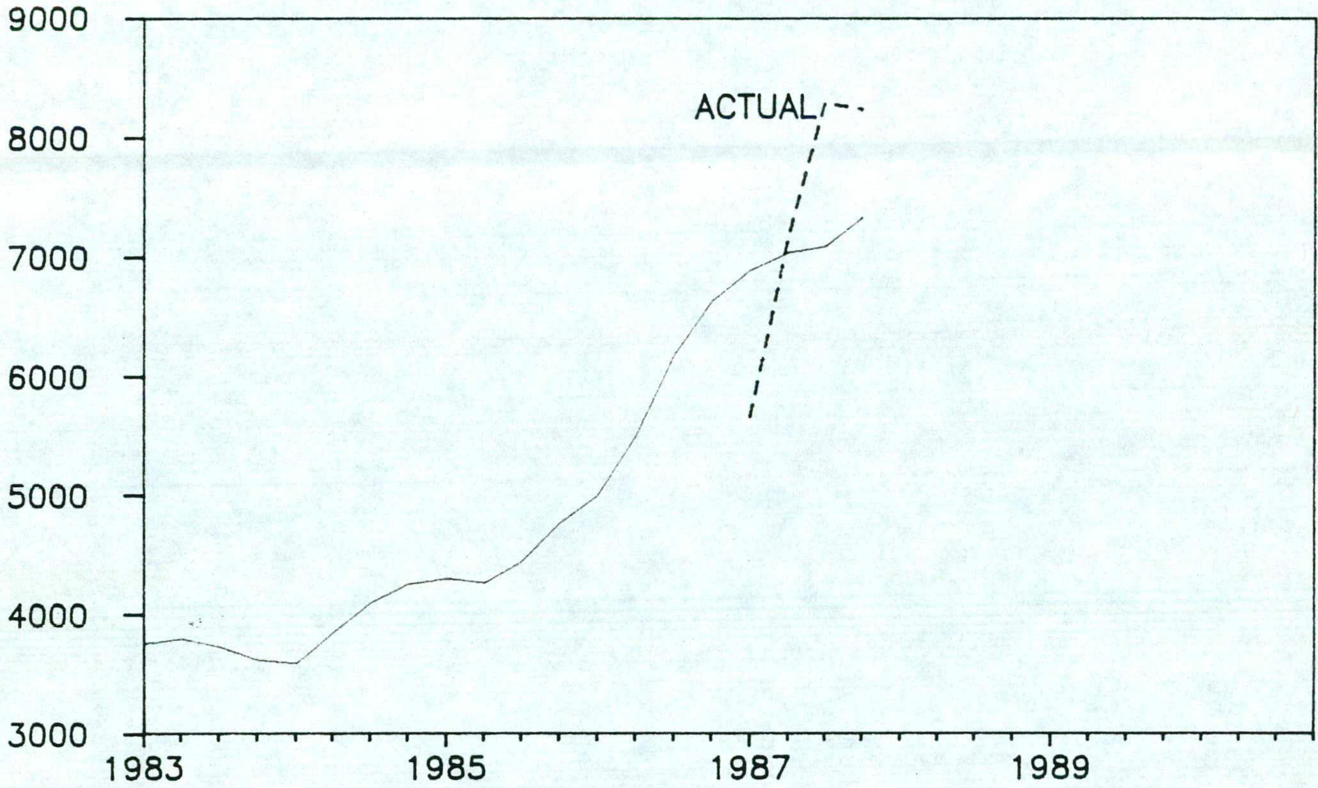


CHART 4

HOUSE MORTGAGE LENDING

FOUR QUARTER MOVING AVERAGE



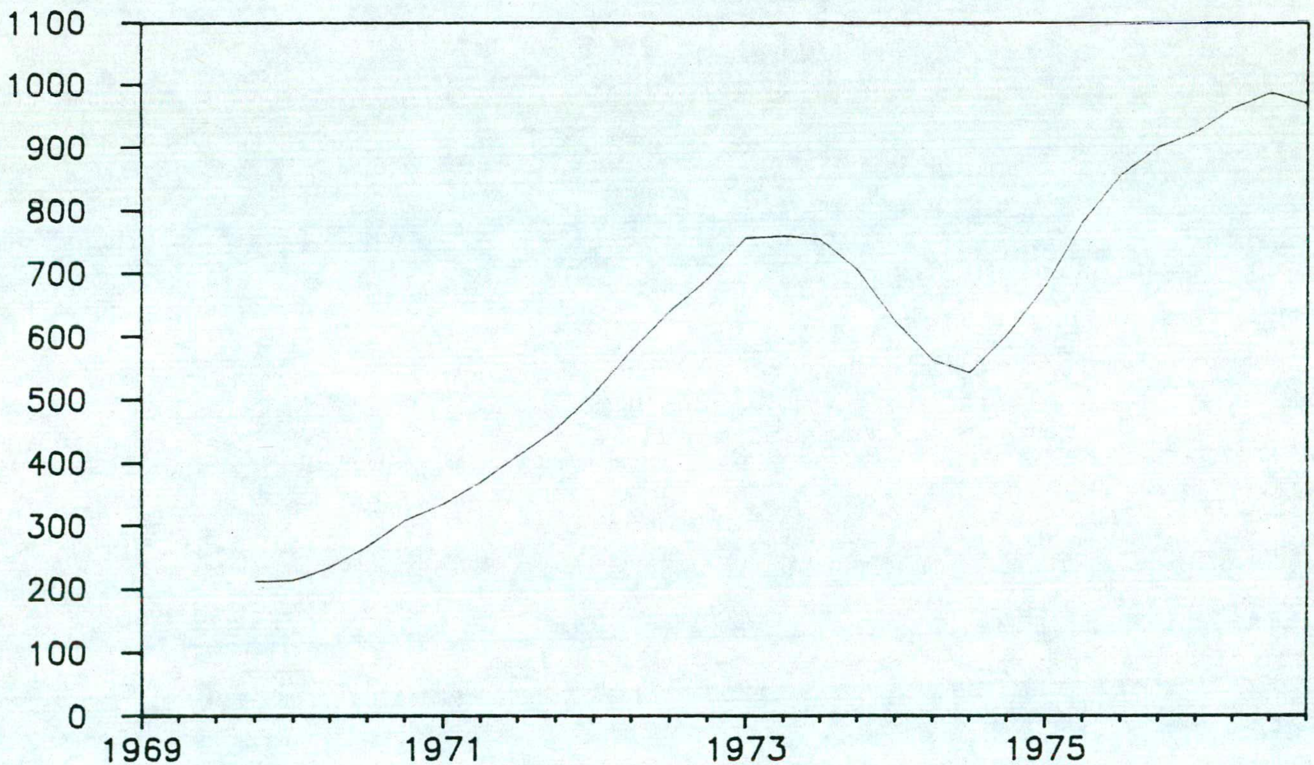


CHART 5

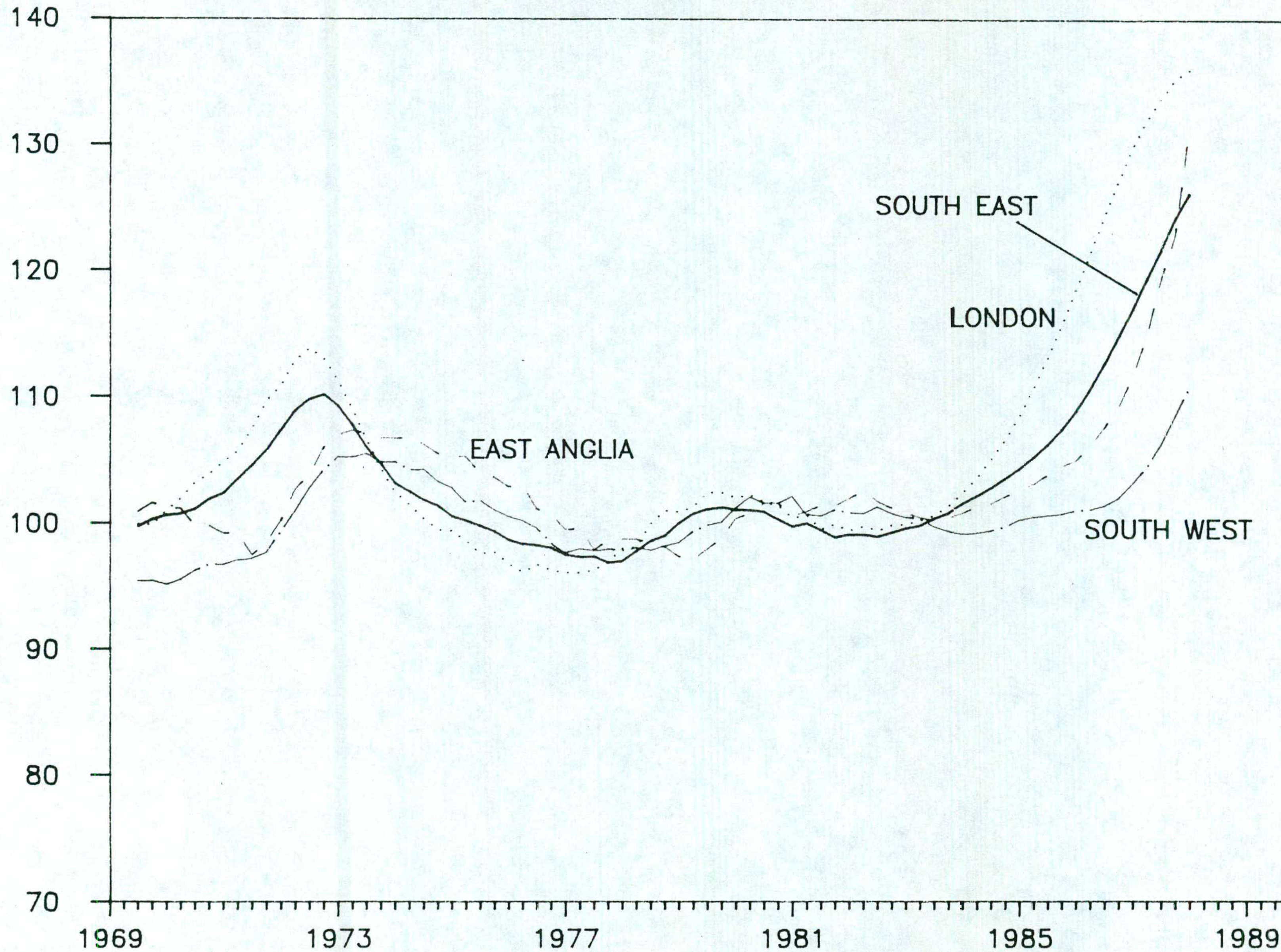


CHART 6

REGIONAL HOUSE PRICE / UK AVERAGE

(MOVING AVERAGES WITH ACTUAL OBSERVATIONS Q4 1987 & Q1 1988)

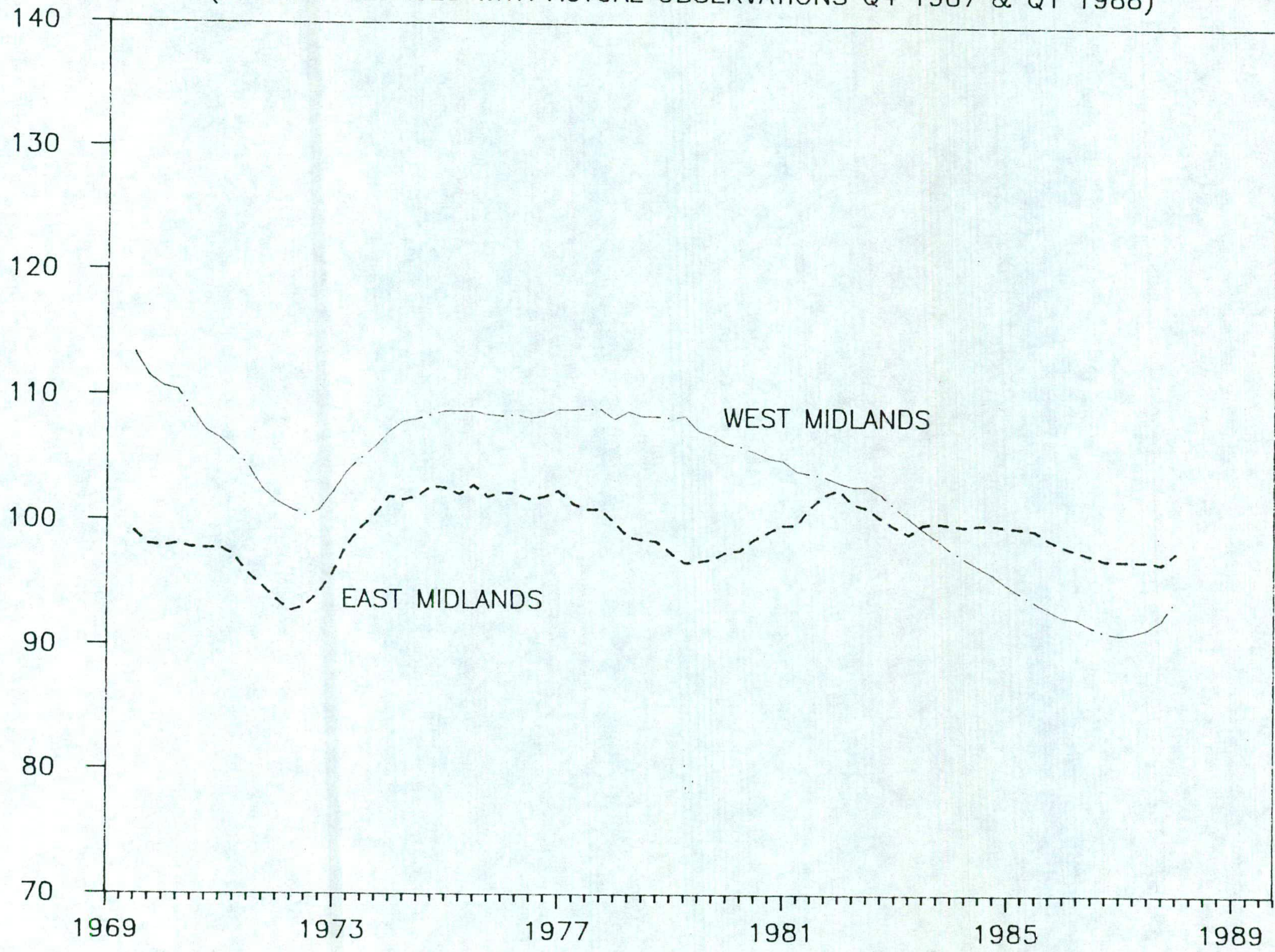
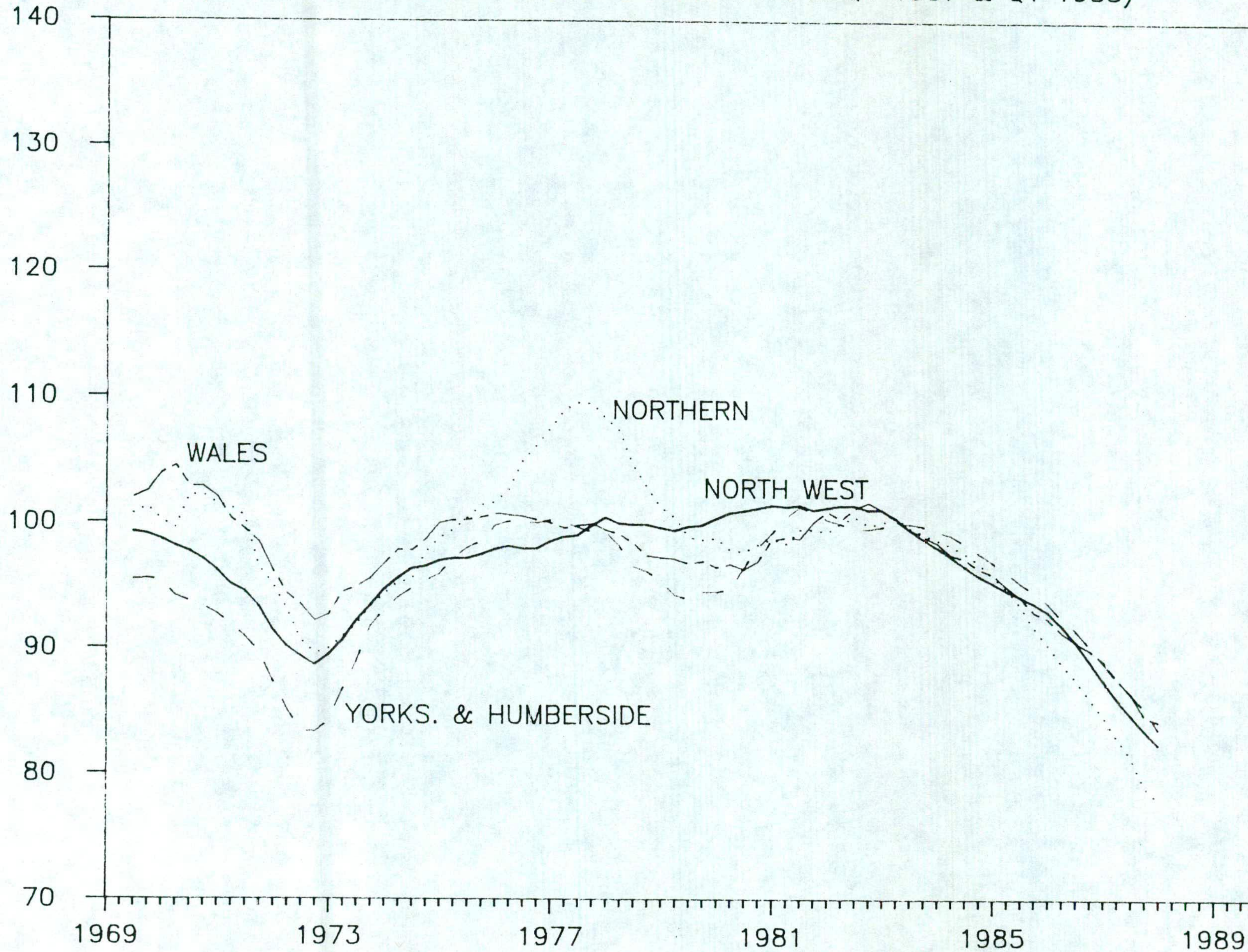


CHART 7



Group Economics Department

PROPERTY COMPANIES:

REPEATING 1973/74?

Prepared by: UK Section
Group Economics Department
Ext. 37223/37216

15 February 1988

Midland Bank plc

PROPERTY COMPANIES: REPEATING 1973/74?

Introduction and Summary

Concern about the property market has been prompted by the fact that bank lending to property companies rose by 45% in the year to November 1987 and the stockmarket crash and subsequent sackings in securities houses have indicated a likely reduction in demand for office property in the City. Those with memories of the property crash of 1973/74 and the subsequent 'lifeboat' operation by the Bank of England may well be looking for parallels in the current situation.

This note examines the size and sources of funds going into the property industry with an emphasis on comparing current experience with that of 1973/74. It is clear that a substantial increase in bank lending to property companies is the dominant feature of both periods. In 1987, however, funds have been heavily supplemented by issues of new capital, a phenomenon not seen in the 1970s, and bank lending has been heavily supported in the past year by foreign banks, a marked difference from the 1970s.

One major difference between the current position of property companies and that in 1973/74 concerns their gearing ratios. Analysts have argued that debt to income ratios appear to be considerably lower now, with the implication that a re-run of history seems unlikely if the economy experiences a gradual slowdown without inflationary pressures. This does not mean, however, that there is no possibility of insolvencies, particularly when considered against a background of lower stockmarket activity. In addition if interest rates were to rise rapidly as a policy response to inflationary pressures, or weakness in sterling, there would be a significant probability of property valuations falling sharply with more serious loan repayment difficulties and defaults resulting.

Sources and Uses of Funds

The estimated flow of funds into property is shown in Chart 1. Total funds are approximated by the sum of (net) bank lending to property companies, net acquisition of property by other financial institutions (OFIs), and new capital issues by property companies. The use of capital issues was unimportant in the mid-1970s but is a major feature of the current scene.

Chart 1 shows clearly the way in which bank lending fuelled the 1973 boom and that it has again provided the main impetus for the growth of funds in 1986/87. One interesting feature of the present increase in bank lending is that foreign banks have played a substantial part, matching the retail banks' expansion over the last year from a much lower base. This is illustrated in Chart 2. The fact that much of the riskier lending (innovative limited recourse loans etc.) has been undertaken by the foreign banks, and that the bulk of lending by domestic banks has been undertaken by the securely capitalised clearers, makes it unlikely that the domestic consequences of a repeat of the financial crisis seen in 1973/74 would occur in the event of a property crash. This increased foreign involvement, whilst implying a limited domestic exposure, presents a new risk; that of foreign parent companies ordering UK branches to pull out of the property market more quickly than domestic banks would. Such actions could quickly depress prices and rents causing debt service problems across the market.

It is always difficult to predict turning points in economic activity but the growth in new capital issues shown in Chart 1 has already slowed. After the crash other financial institutions are likely to be building up their property portfolios and run down their equity holdings. This will probably replace the funds lost from a lower level of new capital issues. The main uncertainty concerns bank lending which would be expected to reduce its rapid growth as lenders become more cautious in evaluating the pay-back risks on propositions.

Chart 3 provides information on the relative size of funds by showing the 'real' flow of funds into property. To derive these 'real' values the nominal values have been deflated by a composite index of property rental prices. This is of course only an approximate method because the property market covers a wide range of different types of property both commercially and geographically. The chart does show, however, that in real terms the flow of funds into property fell in the late 1970s, but in 1986/87 has risen sharply to a level only slightly above that of 1973/74.

Chart 4 shows the movement over time of the components of the composite rental price index. The very rapid growth of retail and office rentals in the past three years clearly appears unsustainable. A slowdown in this growth is very likely. The repetition of a fall as in 1974 could not be ruled out if interest rates were raised sharply to counter inflationary pressure.

An important question about this rise in funds concerns the extent to which it has been matched by expenditures which will generate future funds. In the 1970s, the basic problem was that property companies borrowed heavily to finance speculative office developments which, after the oil-price rise, were left unoccupied in a large number of cases, hence causing a financial squeeze. In the recent past the equivalent activity has been in building offices for financial concerns to meet needs caused by 'Big-Bang'.

The present cause of concern is that following the stock-market crash, low trading volumes will reduce profitability and cause staff reductions (at least 3,000 job losses have been announced since June) thus freeing existing space. The clear danger is that developments at present underway or proposed will not find occupiers, or that those vacating premises to move to new sites will experience problems in disposing of their old properties. Slightly more than half of the City developments currently under construction are reportedly prelet, thus the risk of developer bankruptcy appears limited. Should serious financial difficulties emerge within the financial services sector however, the threat may reappear as rental income dries up and cash flow problems endanger repayments. Looking towards the end of the decade, the risks look more considerable because of the boost to supply from the London Bridge City and Canary Wharf developments. The lower rents offered by these will restrain the growth of City rates, implying that new City developments should be judged to be viable at today's rental levels rather than at higher projections.

The possibility of rents falling cannot be ruled out entirely, but the willingness of other financial service companies (accountants, insurance companies etc.) to return to City locations should they do so, suggests that an effective floor on rents exists at a comfortable level. The market is further complicated by the open floorspace requirements of many financial services companies. Owners of modern high quality office space are not likely to be left without tenants but less adequate properties may face problems even in the less contractionary scenario. The accelerated obsolescence of existing buildings will make it prudent to examine carefully the valuation of existing space offered as security for new lending.

However, it should be noted that property investment is not just occurring in London. The recent emphasis on office relocation outside London and the growth of investment in housing, shopping centres and out-of-town retail developments has meant that property development is more diversified than it was in 1973/74. This in turn should reduce the likelihood of a repetition of a crash if the industry is not over-exposed in any one area. Again the risk attached to lending appears small in the mild slowdown scenario. Reports suggest continued strong demand for retail space, but ambitious out-of-town developments appear less secure than traditional high street projects.

Chart 5 illustrates the extent of commercial construction work being undertaken and also the increase in recent years of private housebuilding. The public sector of the housing market has, of course, been making only a small contribution to new housing starts in the recent past. This provides some reassurance as it is evidence that part of the flow of funds into property has a 'real' counterpart in the form of expanded activity, and therefore limits the proportion which may be largely speculative.

A further activity that property companies have been undertaking is illustrated in Chart 6. Merger and takeover activity in the economy generally has been running at very high levels in 1986 and 1987 and it is clear that the property industry has been no exception. To the extent that lower stockmarket prices have caused companies to reconsider the wisdom of some of their previous takeover activity the property industry will be no exception. Insofar as the growth in bank lending has been to finance takeovers, particularly in the first half of 1987, and, given that this activity is likely to have peaked, bank lending can be expected to slow. Takeover activity may well artificially inflate the flow of funds into property as the funds borrowed or raised on capital markets will, to some extent, have leaked out of property through former shareholder's acquisitions of non-property assets.

It is difficult to judge how far property companies would be able to meet their obligations should demand and prices fall sharply. Evidence presented for leading property companies by Warburgs (see table 1) shows that their gearing (debt to equity) ratios have not risen excessively since 1982, the inference being that they have a relatively stronger financial base from which to withstand a price fall. Two factors serve to qualify this reassuring feature.

Firstly the denominator of the ratio is variable and is more likely to fall than rise, through revaluations, as prices flatten out. Secondly, these averages may conceal a considerable range within the industry. If bank exposure was heaviest amongst the highly geared companies (often the aggressive younger ones whose innovative financial arrangements render simple gearing ratios an understatement of the true position) then these ratios would provide little comfort.

Table 1 : Property Companies Total Borrowings as % of Total Book Assets

Year	1982	1983	1984	1985	1986	1987
Gearing Ratio	23.9	22.4	23.0	25.4	26.4	27.3

Source: Warburg Securities Property Annual Review, January 1988

Conclusion

Superficially the current experience of property company finances looks very similar to 1973/74, and is therefore worrying. The similarity includes the rapid growth of bank lending in financing the expansion in both periods, and the sharp rise in rental prices. **However there are also differences between the** two periods - the demand for financial industry office space due to 'Big Bang', and the prominance of foreign banks in lending to property companies, and the recent takeover activity. **Given a relatively stable economic environment there is nevertheless some downside risk in this area, but the risk does not appear to be substantial.** Non-bank financial institutions can be expected to increase their flow of funds into property as they adjust their portfolios to reduce their equities holdings. This will partly offset a fall in funds from new capital issues and lending from banks. Rental growth can be expected to slow and real yields should tend to fall.

However, **the real risk lies in the possibility of a financial squeeze.** This is not a highly likely event, and would be occasioned by interest rates rising sharply to resist inflationary pressures or weakness in sterling. A squeeze would be expected to be relatively short-lived, unlike the effect of the oil price rise in 1973. The likely result in the property market would be that tenants' demand would dry up and rents would fall rather than merely slow their growth, with subsequent effects on the ability of property companies to service their debt.

CHART 1

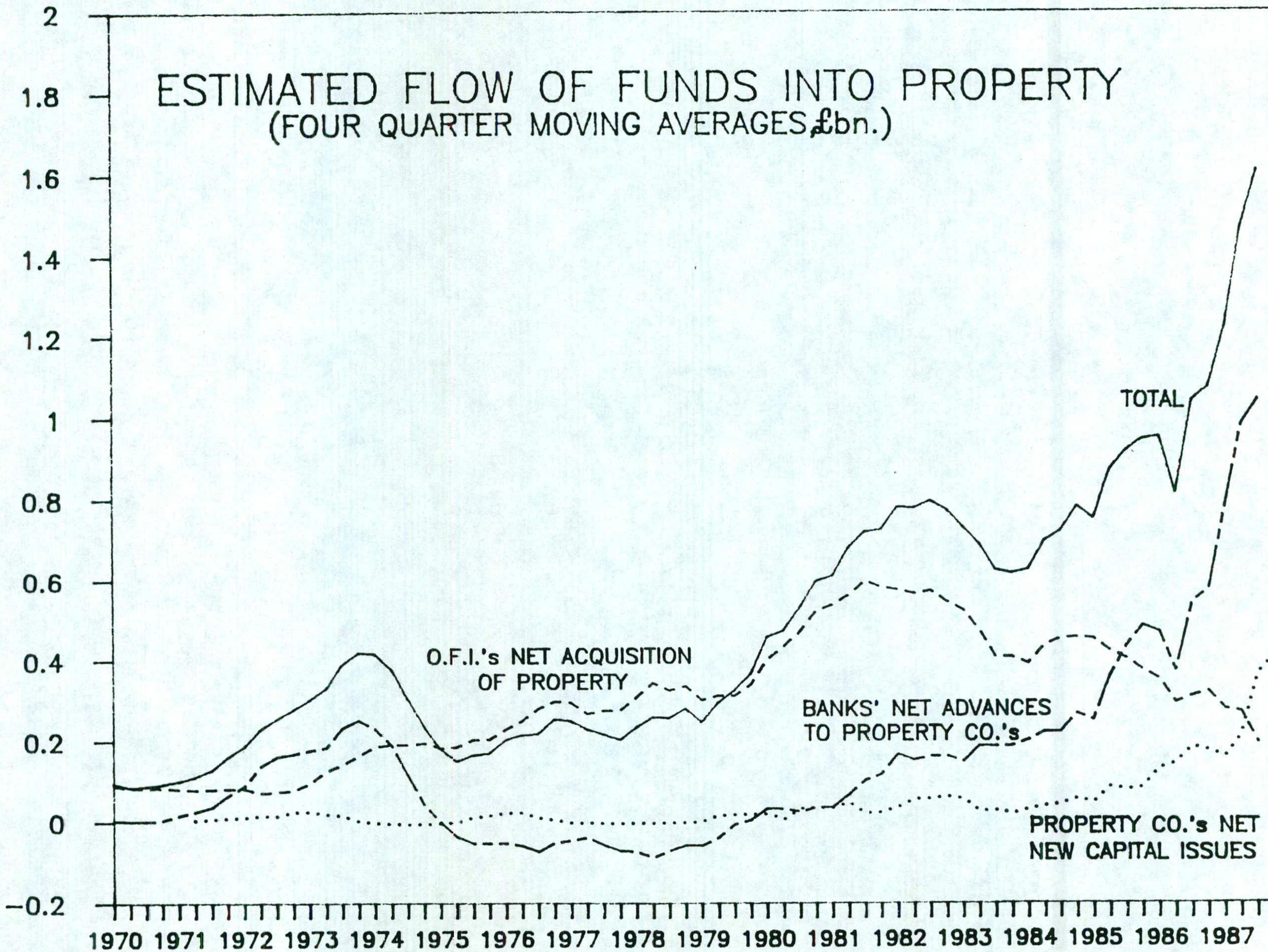


CHART 2

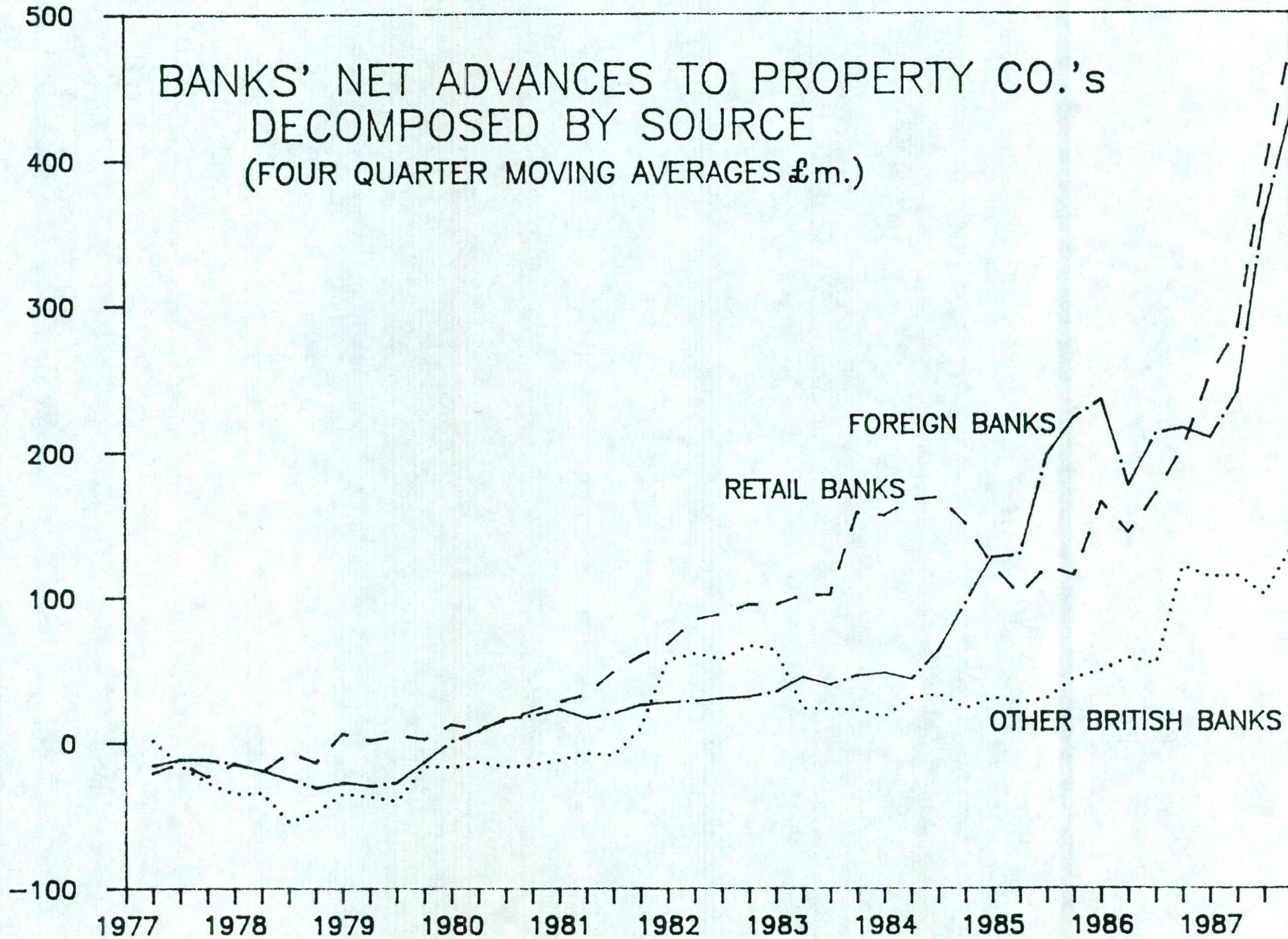
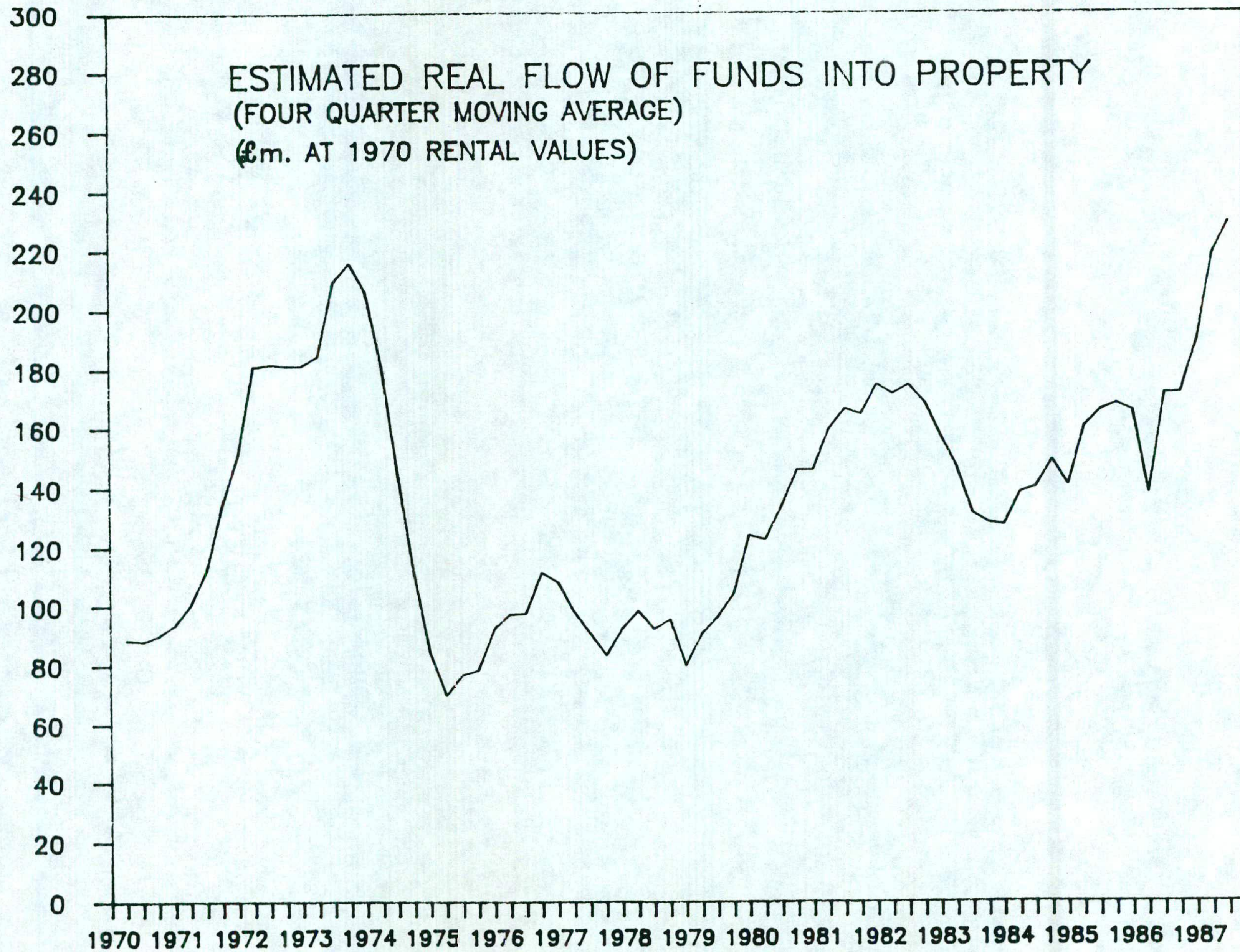


CHART 3



LOG SCALE

CHART 4

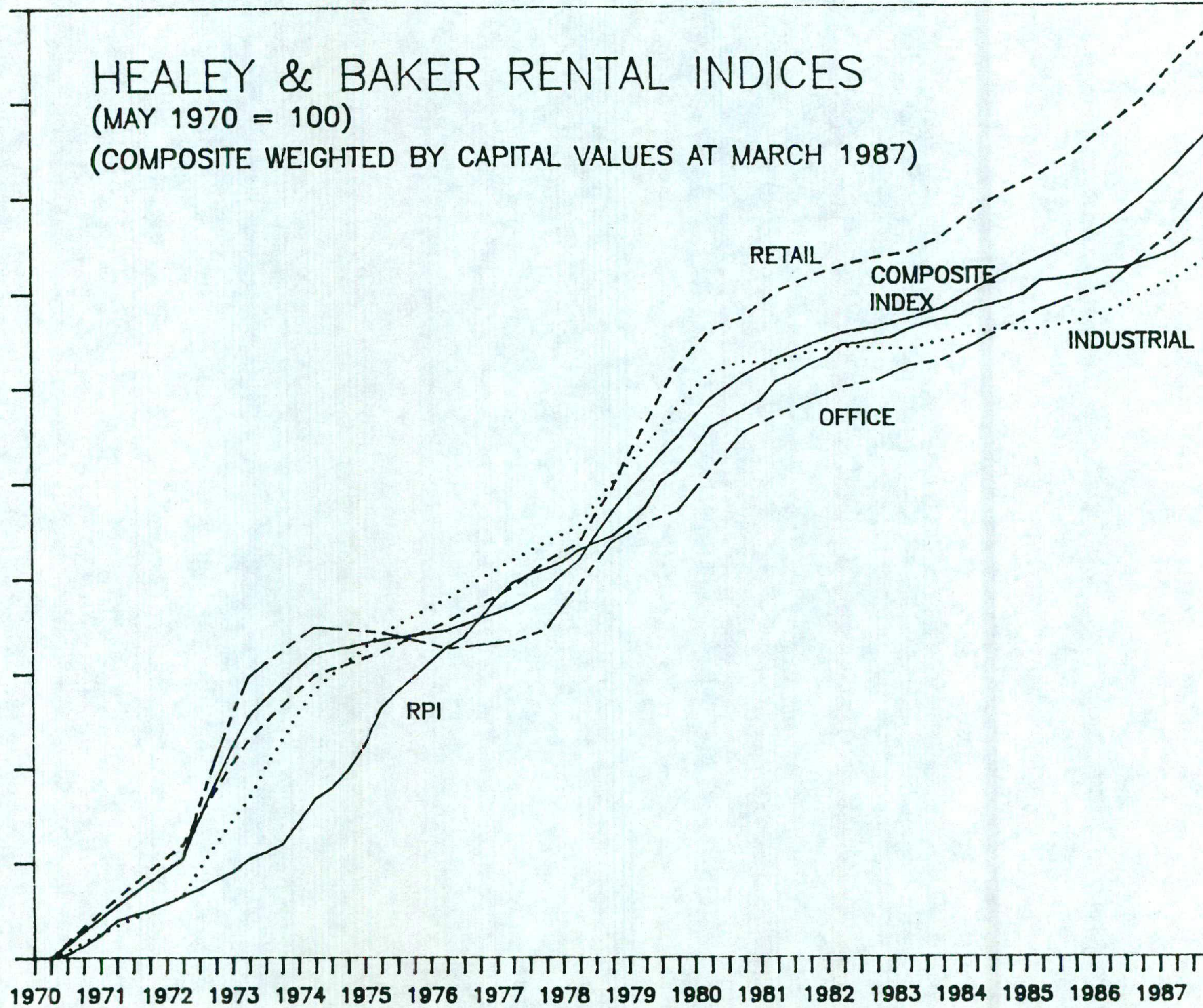


CHART 5

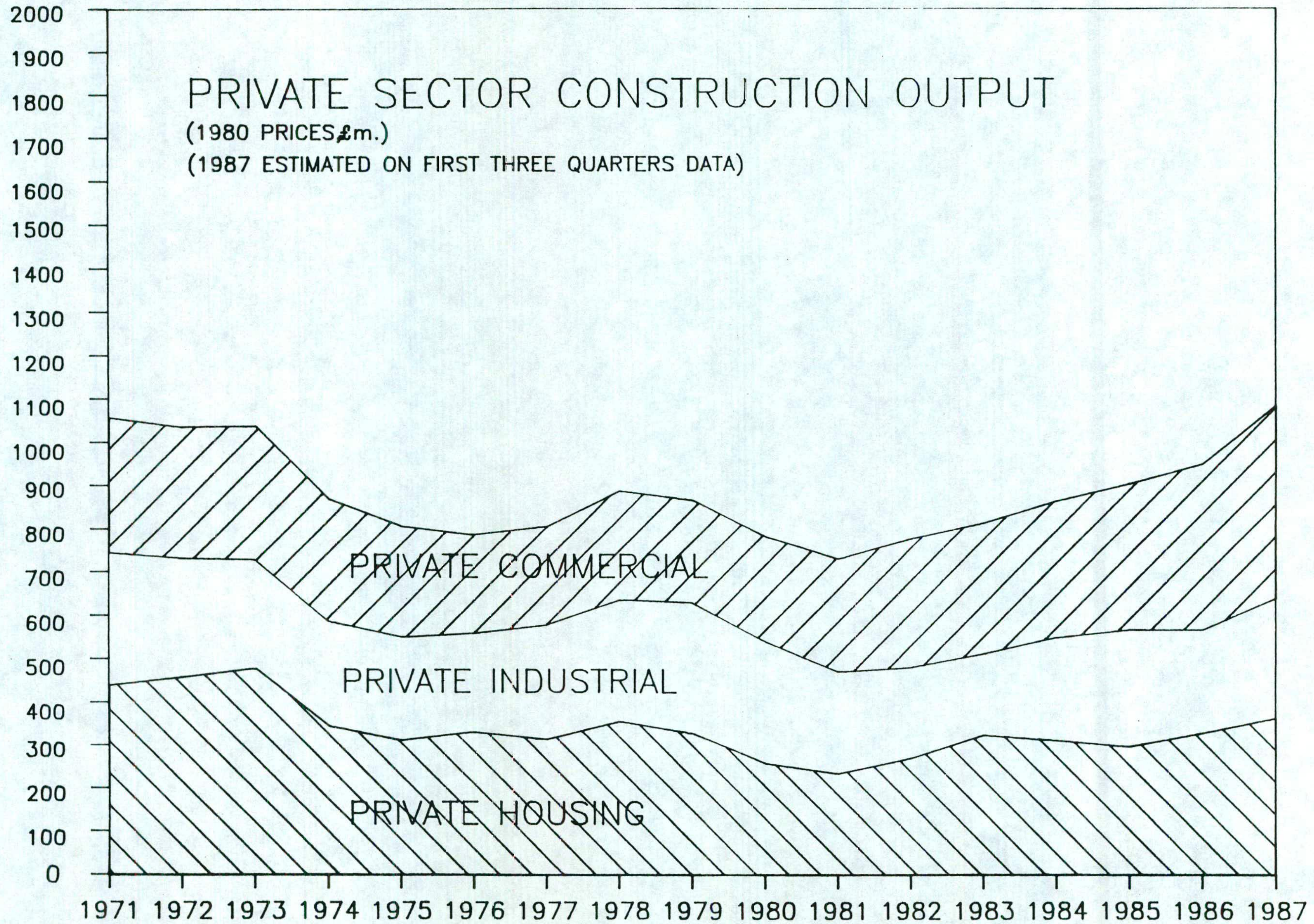
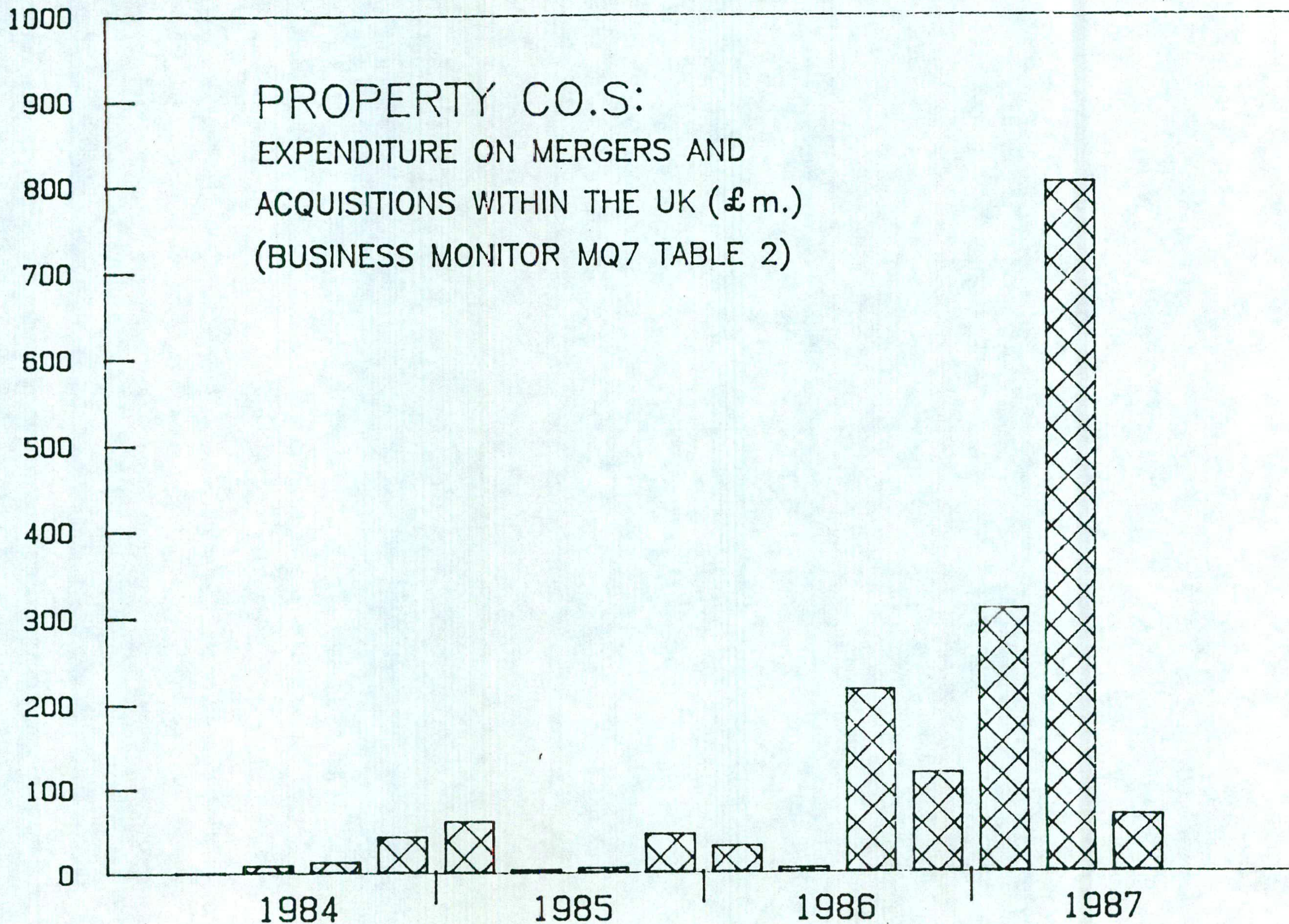


CHART 6



CONFIDENTIAL

FROM: SIR T BURNS
DATE: 4 MAY 1988

CHANCELLOR

cc Sir P Middleton
Sir G Littler
Mr Scholar
Mr Peretz
Mr Odling-Smee
Mr Grice

Sir T.
4/5

THE UK ECONOMY: GORDON PEPPER ARTICLE

1. You will be interested to see the attached article sent to me by Gordon Pepper. He asked me to send you a copy.

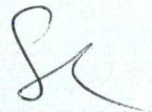
2. I agree with him that there are some signs that the peak growth of demand has passed. I find it harder to predict the effects of the Budget although it is possible that the housing market will be strong until August because of the move to the residence basis for MIR.

3. Although the faster growth of the monetary aggregates was consistent with the growth of output I do not see that it necessarily predicted overheating. As you know I am still somewhat sceptical about the claims for overheating.

4. He misunderstands the arguments about the appropriate approach to the private sector. We do not wash our hands of it. But our response has to take account of the exchange rate. With a strong exchange rate we will have lower interest rates than otherwise might have been the case. (Interestingly he scarcely mentions the exchange rate). Put another way there is a sufficient capital inflow to finance the current account and push up the exchange rate. If the capital inflow slows, and the exchange rate weakens, interest rates will rise. I would also argue that we don't need to worry about the investment/ consumption split in the private sector - that is a matter for the capital markets. Of course we do have to consider the split of public sector expenditure between consumption and investment but as we know it is very difficult to make much operational use of the distinction.

5. Finally we are not ignoring monetary growth outside the public sector. But the appropriate response is interest rates, not overfunding. And interest rates have to be considered in the light of the exchange rate as well as domestic monetary growth.

6. Midland Montagu have obviously decided to run the overheating story. I also attach a letter and note from Andrew Bain on the current state of the property and housing markets. I have asked Mr Grice for comments on this.



pp T BURNS

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THE UK ECONOMY

An Article by Gordon Pepper for the

June edition of Economic Affairs

At the time of writing this article in April, the economy appears to be growing at well over four per cent per annum which is very rapid by past UK standards. The fall in the stockmarket in October has not dampened it down as expected. A good part of the growth is probably due to the Government's supply-side measures. Such growth is, by definition, not overheating. Nor is the phenomenon of prices rising in one part of the country and falling in another part; it is a sign rather of desirable flexibility in the economy. It is nevertheless clear that there is some overheating, especially rising house prices but also increased wage settlements, certainly in London and the South East, and the area affected has probably now extended to include at least East Anglia, the East Midlands and as far west as Bristol.

The cause of the overheating is clearly not a relaxation of fiscal policy; the budget deficit has not risen but has fallen sharply. (Even on a constant employment basis the budget deficit cannot explain the acceleration in the economy.) Neither can last winter's acceleration of the economy be attributed to a reduction in interest rates, in either nominal or real terms, because they remained high until recently. Base rates at the beginning of March were 9%, the same as at the start of August.

In Keynesian language, the overheating is caused by too sharp a fall in personal savings; the savings ratio has fallen to 4.3 compared with 6.6 a year ago. In Monetarist language, it is caused by excessive monetary growth and the main reason for this is very buoyant bank lending to individuals as distinct from that to companies.

The two explanations are in fact the same. Data for savings in the National Income Accounts are for gross savings less dis-saving. Borrowing to finance consumption is a most important form of dis-saving. The main reason why net savings have fallen is the increase in borrowing. This is a typical pattern; changes in net savings often occur because of an alteration in borrowing rather than in gross savings.

It is interesting to note that the Monetarist approach to economic forecasting predicted the overheating. Our Monetary Bulletin last August was entitled Alarm Bells and asserted "for the first time since Mrs. Thatcher became Prime Minister the behaviour of the money supply is beginning to give serious cause for concern". (Particular attention was drawn to the relationship between non-interest bearing M1 in real terms and unfilled job vacancies; the behaviour of the former suggested a sharp rise in the latter.) This should be compared with the average of independent forecasts published by the Treasury. In August the consensus was that there would be 3.2% growth of GDP in 1987 and 2.5% in 1988. In the February/March survey this had increased to 4.1% in 1987 and 2.7% in 1988. An April Financial Times survey suggested a further rise in 1988 to 3.1%.

This assertion about the success of a Monetarist's prediction will come as a surprise to those people who consider that the technique has been discredited by experience in the early 1980's. Monetarism has certainly become unfashionable. The mechanistic technique of focussing attention on merely one measure of money has indeed been discredited, and rightly so. I have always argued that regard should be paid to all the monetary indicators and, if any are behaving in a peculiar way, the cause should be investigated.

In the early 1980's the broader aggregates were heavily influenced by an increase in the demand for money for savings purposes, whilst the narrower aggregates, which are dominated by transactions demand, were distorted by the introduction of high interest chequing accounts. There is growing evidence that the period of unusual distortion has come to an end. For example, the various monetary indicators are tending to point in the same direction and the rates of interest on bank deposits are no longer extremely attractive relative to those on competing homes for savings. The behaviour of the various definitions of the money supply is once again providing a very important clue as to the performance of the economy.

The most recently published monetarist indicators for the UK suggest that the economy was probably decelerating slightly on the eve of the Budget. The six month rate of growth of Mo fell from 8½% per annum at the end of

December to $4\frac{1}{2}$% per annum at the end of February. That for M4 which is now the government's preferred definition of broad money, fell from 17% per annum to just over 13% per annum. The Budget has, however, given a boost to confidence. This is likely to encourage more borrowing and, therefore, the deceleration may cease. There is no evidence giving one confidence that the current overheating will wane of its own accord.

Viewed through Keynesian eyes, the problem with the economy at the moment is an age old one. During a business upswing, capacity utilisation rises and industrialists respond by increasing investment. Room needs to be made for it. At least in the present cycle the government is not making matters worse by competing for additional resourses. Nevertheless, consumer expenditure needs to be reined back. The trouble is that this is difficult to do without discouraging the additional industrial investment which is the object of the exercise.

Viewed through Monetarist eyes, measures should be taken to curtail the excessive growth of bank lending to individuals. The difficulty here is that the demand for such loans is relatively insensitive to price, i.e. a modest rise in interest rates would have little effect, certainly in the short run. Such a rise would have a greater impact on industry, both because the cost of funds would increase and because sterling would rise as a result of the higher interest rates. A tightening of monetary policy in this way would help to damp down the economy overall but the effect would not be focussed on consumer expenditure where it is needed.

I argue that the origin of the bank lending problem is on the supply rather than the demand side. Far too many financial institutions are competing aggressively to sell personal loans; some are using high pressure sales techniques. A way should be found to discourage them. Furthermore, I am concerned about the amount of additional capital resources being committed to this business. One example is the move by building societies into the field and the additional capital they will raise if they become public companies and issue shares. Another is Barclay's £920m rights issue. The additional capital employed in the industry means that loans may grow even faster in the future.

1X

This brings me to a final and general point which is giving me increasing cause for concern. It is the way in which the Government appears to be uninterested in the control of the private sector. If a problem is not caused by the public sector, the authorities appear to wash their hands of it. If it is a problem within the private sector, the attitude of some officials is that it would be almost immoral to interfere.

One example of this is the official attitude to the deterioration which is occurring in the current account of the balance of payments. If it was a mirror image of a budget deficit (as it is in the US) the authorities would be concerned. As the private sector is the cause they profess not to be. They do not seem to distinguish between a deficit which is the counterpart of excessive consumer spending and one which is due to a boom in industrial investment. The latter can be beneficial but surely the former is

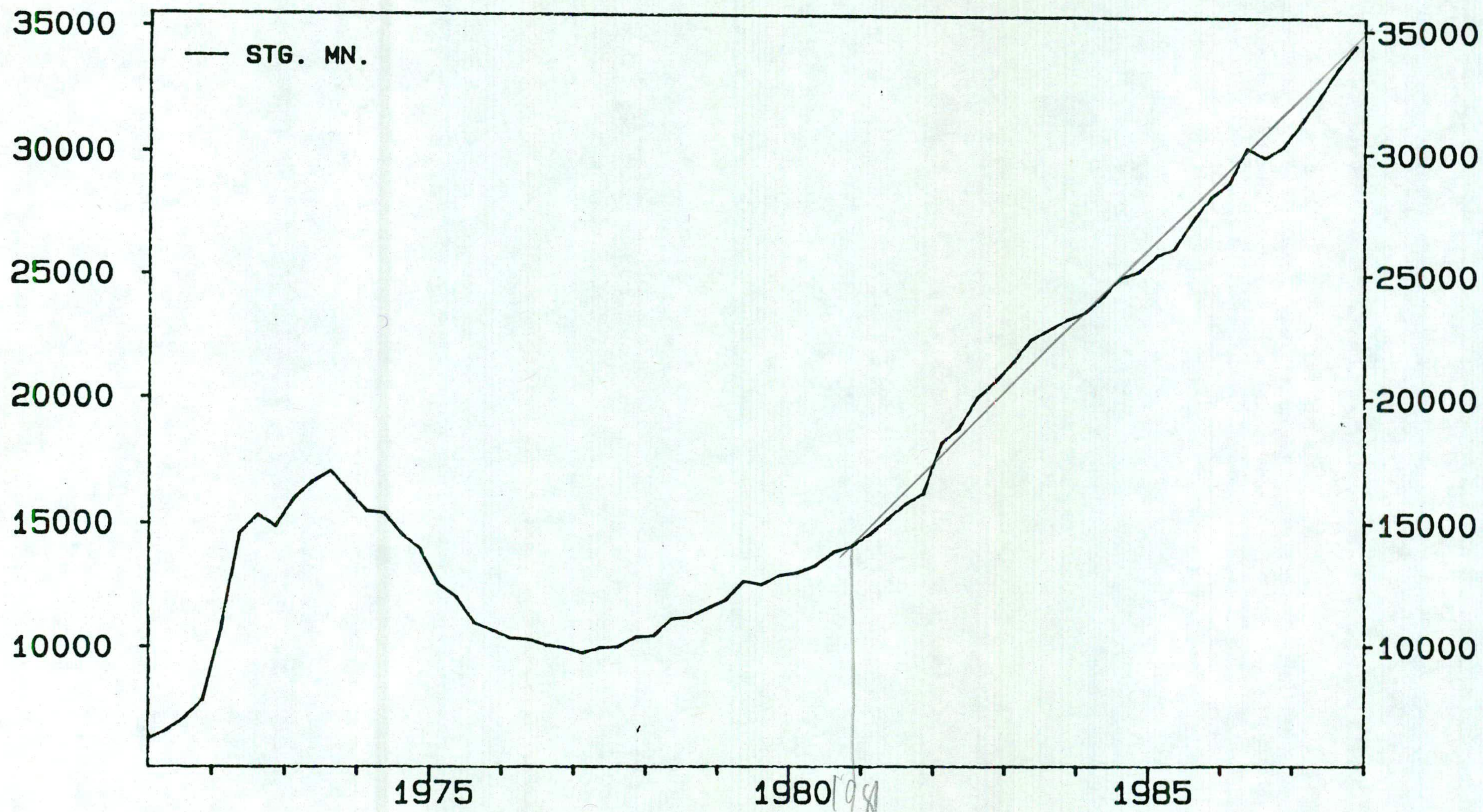
usually undesirable?

Another example is the way the authorities are currently ignoring excessive monetary growth which is not caused by the public sector. They used to take countervailing action if M3 was growing too rapidly because of buoyant bank lending; they increased their sales of gilt-edged stock. In October 1985 the Chancellor announced the suspension of this policy of "overfunding". The suspension was right in the circumstances but these have now changed.

The Institute of Economic Affairs stands for less government. But one can have too much of a good thing. Central banks existed and had an important role to play long before the invention of fiscal policy by Keynes and the growth in the role of governments. At the very least officials should re-read some of the history of central banking, particularly those periods when there was a speculative financial bubble followed by a collapse in asset prices. But perhaps this last remark is better addressed to the US rather than the UK authorities.

Gordon Pepper

18 April 1988



Source: Datastream.

psl/46A CONFIDENTIAL

BF 13/5

FROM: A C S ALLAN
DATE: 6 May 1988

ACSA 6/5

SIR T BURNS

cc Sir P Middleton
Sir G Littler
Mr Scholar
Mr Peretz
Mr Odling-Smee
Mr Grice

THE UK ECONOMY: GORDON PEPPER ARTICLE

The Chancellor was grateful for your minute of 4 May.

2. He noted that Gordon Pepper argues that the origin of the bank lending problem is on the supply rather than the demand side, with far too many financial institutions competing aggressively to sell personal loans, some using high pressure sales techniques; he concludes "A way should be found to discourage them". The Chancellor wonders what Pepper would suggest - the article gives no hint.

3. The Chancellor would be interested to see Gordon Pepper's graph of bank lending to the personal sector in 1980 prices redone on a log scale.

ACSA

A C S ALLAN

GORDON PEPPER

CONFIDENTIAL

BF T Burns

FROM: SIR T BURNS
DATE: 12 MAY 1988

CHANCELLOR

Mortgage ?
(Business ?)

cc Sir P Middleton
Sir G Littler
Mr Scholar
Mr Peretz
Mr Odling-Smee
Mr Grice
Mr Pike

THE UK ECONOMY: GORDON PEPPER ARTICLE

You observed that Gordon Pepper seemed to be advocating measures to directly control the activities of high pressure credit salesmen and wondered what he had in mind.

2. I am afraid I have very few clues. Indeed I do not think Pepper has any clear ideas. The last time I spoke to him he said he had commissioned a student to do some research in the LSE library on the old "usury laws". He has also complained about the attempt by Barclays to raise money to pursue market share. This has been a continuing theme of Pepper's. You may recall that when he was advocating MBC he used to argue that we needed a disincentive for the salesmen to pursue business at all costs and hoped MBC would help. (We were always totally sceptical about this mechanism).

3. As promised I attach a minute from Mr Grice commenting on Andrew Bain's letter. He notes Bain's increasing alarm, the suggestion that present monetary control techniques are inadequate and points out that he offers no alternative. As it happens I bumped into Andrew Bain at the Camdessus lecture and asked him what he had in mind to deal with his unease. He replied: "an immediate 2 per cent increase in base rates accompanied by massive intervention". I also took the opportunity to ask him what he thought Gordon Pepper had in mind and he replied: "search me. I can never understand him".

4. As requested I attach a graph of bank lending to the personal sector in 1980 prices on a log scale.

T BURNS

ENCS

90/G.jfw.4569.027

FROM: J W GRICE
DATE: 10 May 1988

SIR TERENCE BURNS

cc Mr Courtney
Mr Hurst
Mr Pike

File: MAMC T5

ANDREW BAIN ON THE PROPERTY MARKET AND MONETARY POLICY

You asked for comments on Andrew Bain's letter to you of 27 April and its attachments.

3. Bain's circle of concern seems to be widening with time. The original note by his Group Economic Department "Property Companies : Repeating 1973/74?" makes the following points:

(a) bank lending to property companies has been rising rapidly, just as in 1973 - by 45 per cent in the year to November 1987. (On the later figures now available, growth was 55 per cent in the year to February 1988);

(b) after the Stock Market correction, demand for office space is likely to fall. If weakness in property prices were to be exacerbated by a sharp rise in interest rates, property companies could have loan repayment problems; but

(c) unlike in 1973, property companies had not relied solely upon bank finance but had also raised new capital. Accordingly, their gearing ratio was in good shape. As a proportion of their total book assets, total borrowings had risen from 24 per cent in 1982 to only a little over 27 per cent in 1987.

3. Bain's own note of 26 April "Lending to Property Companies and Mortgage Lending to Persons" effectively reiterates points (a) and (b) and, on the assumption that interest rates will have to be raised sharply sometime in the next 6 months, stresses the possibilities of serious defaults amongst property companies. He does not mention the rather more reassuring point (c), that property company gearing ratios have moved up only modestly.

189/5/1

4. His concern has also expanded to residential mortgages. He believes that prices have risen to "dangerously high levels" in some regions, both absolutely and relative to real personal disposable income. Consequently, there may be a fall in the South at least, perhaps of 20 per cent on average over the next two years. Bain does not say why this development would be disturbing but presumably he is concerned at the difficulties that mortgagers would experience as they found themselves with more than 100 per cent mortgages. These difficulties would be all the more acute if interest rates were sharply increased at the same time.

5. His covering letter of 27 April is even wider in its concern:

(i) money supply conditions are now similar to those after Competition and Credit Control - there is no control on supply. Lenders are fiercely competing for new business with little overall perception of the dangers to which this might lead. The credit boom will continue until either there is a "jolt to expectations" - presumably either much higher interest rates or wholesale defaults;

(ii) real interest rates are not necessarily positive now, let alone high. With expectations of property price inflation probably running high, many of those borrowing to purchase property probably perceive rates to be negative.

Assessment

6. Taking first Bain's general concern about monetary conditions, the first point must be to agree that we have no direct controls on the supply of credit. Our monetary policy technique is one of "control from the demand side". We set short term interest rates so as to generate the monetary conditions consistent with our inflation objective. With market interest rates at that level, financial institutions are largely free to attract deposits and advance credit as they see fit. If Bain is criticising this technique, he must mean, logically, either that we should move to monetary base control and influence the supply of credit that way or that we should re-introduce direct controls. It is difficult

to believe that he means to advocate the former but equally it would be odd to propose the latter. Not only would direct controls run counter to the Government's philosophy of removing distortions and barriers to competition but they would also be unlikely to be effective. Experience with the Corset suggested that evasion of such controls occurs quite quickly. With the increased sophistication of financial markets and the abolition of exchange controls in 1979, direct controls nowadays would be even less likely to have any genuine effect.

7. Alternatively, Bain may be criticising not the technique of monetary control but simply the level of current interest rates. His thesis seems to be that if a substantial increase in interest rates is not brought about now, then a very sharp rise will become inevitable in a few months time. If this is his view, he may be basing it on an overly-mechanical evaluation of the credit growth figures. Credit growth in its own right is not of great concern. What matters is the liquidity which comprises the assets of the corresponding lenders: whether it is being firmly held or whether, instead, spilling over into inflationary demand for goods and services. Judging this issue is, of course, at the heart of our regular assessment of monetary conditions, against which interest rate decisions are taken.

8. As often, the current evidence does not all point in one direction. So it is debatable whether monetary conditions overall need tightening or not. Some indicators - the behaviour of monetary and credit growth and of house prices, included - can be adduced to support a case for a tighter stance. But other factors are to the contrary:

(a) the behaviour of the exchange rate (not mentioned at all by Bain) currently suggests excess demand for sterling liquidity rather than the reverse;

(b) there is no real sign that the demand for goods and services is putting upward pressure on inflation. If anything the growth in demand seems to have been easing, not increasing in the last few months;

(c) whilst house and property prices have been moving up rapidly, equity prices have not. They have recovered by only around 5 per cent since the October correction and remain about 11 per cent below the levels of a year ago.

9. Balancing the various factors, there seems no case for a major tightening of monetary conditions, such as Bain seems to be after. (There is a rather separate argument that it would be desirable to have higher interest rates and a lower exchange rate within the same overall stance. But that does not seem to be Bain's argument.) Whether nominal interest rates are higher or lower than the expected rate of increase of house prices is largely beside the point. There are always likely to be some prices in the economy which are increasing more rapidly than prices in general - and others less rapidly. Equity prices rose at rates in excess of the nominal interest rate for most of the period from 1974 to October last year. But it would be wrong to infer from this that real interest rates were negative throughout this time; still less that monetary conditions were too loose.

10. If Bain is being alarmist about monetary conditions in general, the same would seem to apply to his views on the property and housing markets. On the former, he fails to take into account the gearing figures quoted in the paper attached to his own letter. Property companies' gearing is not high either in relation to historic levels for the sector or, for that matter, in relation to that typical of other sectors. It may well be that the aggregate figures conceal much higher gearing in one or two property companies than in others. But it is no part of macroeconomic policy to prevent any single property company from failing. The property market is intrinsically risky and capital invested in it must take that into account. No doubt that risk is reflected in the market return.

11. Doubtless, it is also true that some banks and financial institutions are more exposed to property companies than others. But the prudential supervision of financial institutions has improved out of all recognition since 1973-74 when difficulties in the property market did threaten the financial system as a

whole. There is no evidence to suggest that the property market constitutes such a threat in present circumstances.

12. So far as lending for house purchase is concerned, several points need to be noted:

(i) building societies and other lenders for house purchase are generally well aware of the dangers to their security which a sharp fall in house prices would represent. 100 per cent and other high percentage loans do not constitute the major part of their portfolios. Indeed, the average advance has remained around 70 per cent of purchase price in recent quarters with no significant rise occurring. At these levels, average percentage advances are below the levels in the early 1970s;

(ii) most lenders require indemnity insurance on the top slice of high percentage mortgages, often that part in excess of 80 or 85 per cent of the purchase price. Any risk from a collapse in house prices is therefore spread more widely than just to lenders for house purchase alone;

(iii) the real risk to mortgagees occurs when not only do mortgages rise to more than 100 per cent of the corresponding house price but when also the monthly repayment to income ratio increases. Bain's proposal of a sharp increase in interest rates runs the risk of bringing about just such a situation. Not only would mortgage repayments rise with interest rates but there would also be a risk, particularly if the interest rate jump was unwarranted, of inducing a sharp fall in nominal incomes.

(iv) Bain seems to regard it as a major catastrophe should house prices in the South begin to fall. House prices in the South East were, of course, the subject of a paper* coordinated by Mr Byatt at the end of last year. The conclusions of that paper were just the opposite of what Bain suggests. It argued that prices in the South East were

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* Mr Byatt's minute to Sir Peter Middleton, 8 December 1987: "House Prices in the South East."

not likely to fall quickly relative to other house prices and, moreover, that this was "a cause of concern because of its adverse effects on inter-regional resource allocation and on income distribution". If Bain is correct, therefore, in thinking that Southern house prices will fall, then that would bring advantages probably greater than any difficulties to which it might give rise.

Conclusion

13. Some of the developments to which Bain draws attention are important and they need to be watched carefully. Certainly, house prices rising at annual rates of around 20 per cent or lending to property companies increasing by more than half in 12 months, are not features to be ignored and the implications need to be assessed carefully. But Bain's implicit prescription - either increase interest rates now or suffer a very large forced jump in a few months time - is a very long step from this and the evidence to support the proposition is just not there. Moreover, if such an alarmist course were followed, the prudential consequences could be just the ones that Bain (and we) want to avoid.

14. There is just a hint in his covering letter that he thinks our present monetary control technique is an inadequate one. This is becoming quite a fashionable view amongst the commentators. The problem is that Bain is no exception in not telling what he would prefer as an alternative. It may be that we need to challenge him to say what, if anything, he has in mind.

JWG

J W GRICE

90/G.jfw.4569.033

FROM: T PIKE

DATE: 10 May 1988

SIR T BURNS

cc Mr Peretz
Mr Grice

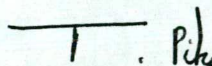
File: MAMC Q2

THE UK ECONOMY : GORDON PEPPER ARTICLE

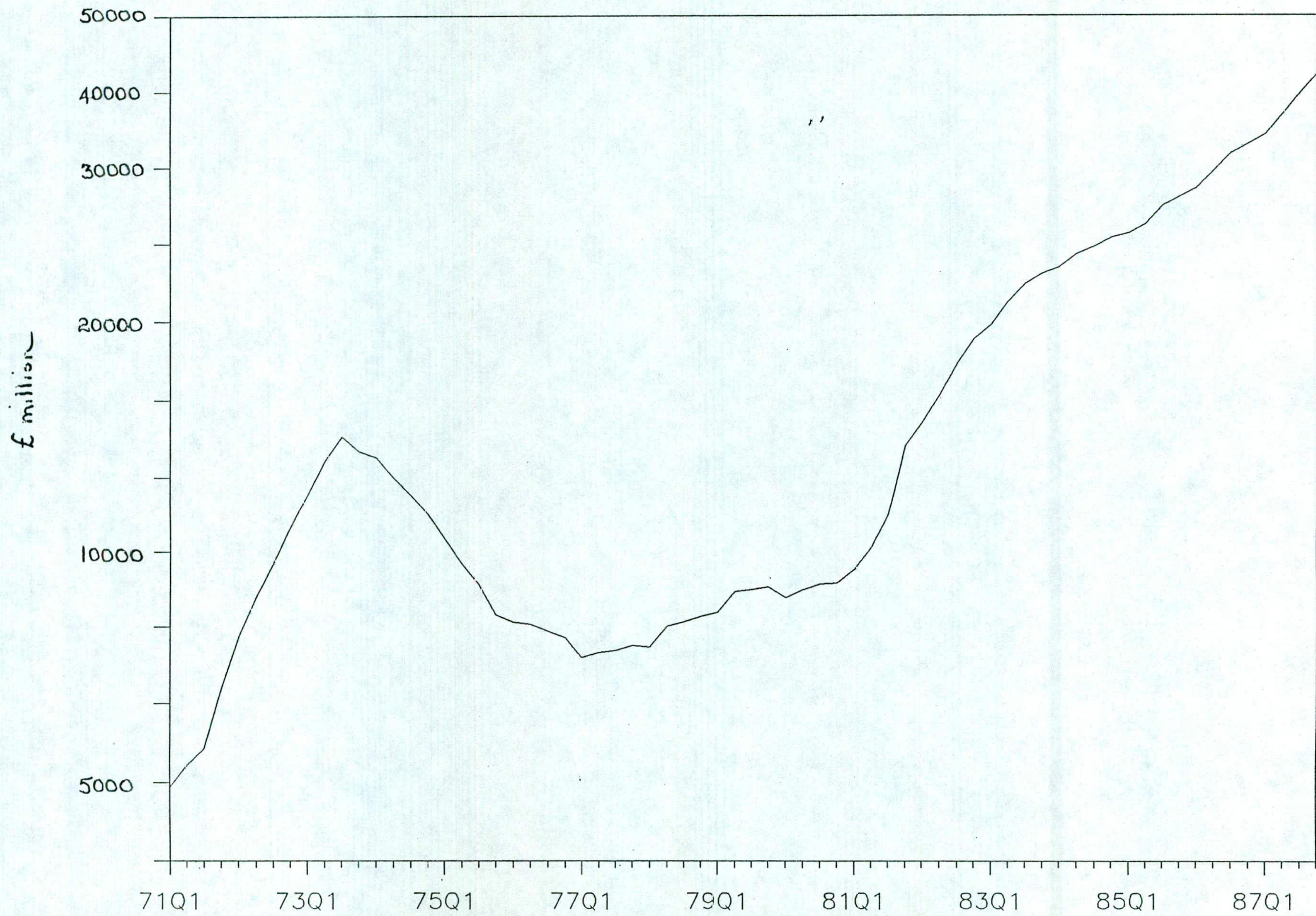
You asked for a chart showing bank lending to the personal sector on a log scale, along the lines that the Chancellor had requested.

2. Gordon Pepper's chart is, in fact, lending to the household sector rather than to the personal sector (which includes unincorporated businesses). The comparable chart on a log scale is attached. Bank lending is deflated using the GDP deflator.

3. The chart shows that real bank lending to persons has indeed accelerated throughout most of the 1980's. This largely reflects the growth of bank lending to persons for house purchase, which has increased in real terms by an average of 30 per cent per annum since the end of 1979. In contrast, real bank lending to persons for consumption has grown at an average annual rate of under 15 per cent over this period. However, the growth of bank lending to persons for house purchase is clearly affected by the banks' gaining market share at the expense of the building societies. Bank and building society lending to persons for house purchase has grown at an average annual rate of 12 per cent in real terms since the end of 1979. (This compares with an average annual rate of about 10 per cent from 1970-73.)



T PIKE


BANK LENDING TO PERSONS-1980 PRICES*
50000
40000
30000
20000
10000
5000
£ million
71Q1
73Q1
75Q1
77Q1
79Q1
81Q1
83Q1
85Q1
87Q1
* using the GDP deflator

35/1/31/5015/LN

Julie
Papers please
Alex

CONFIDENTIAL

FROM: W HOOD
DATE: 17 MAY 1988

MR EVANS

cc:
PS/Chancellor
Sir T Burns
Sir G Littler
Mr Lankester

Mr Peretz
Mr Matthews
Ms Symes
Mr Edmonds

"MANAGING THE DOLLAR: FROM THE PLAZA TO THE LOUVRE"

As you know, a book with the above title by Yoicho Funabashi was published last week in the US. The publication of the book has aroused some interest in the press here - for example, the attached articles in the Guardian and the Financial Times. We have now obtained a copy of the book via the Embassy in Washington. I understand that the Chancellor and Sir Geffrey Littler also have copies.

2. Mr Funabashi is a journalist by training, and his technique for this book appears to have been to interview everyone he could - the list of individuals interviewed runs to 4½ pages - and to attempt to construct a coherent story from these interviews and the public statements of the participants. Most of the interviewees were American or Japanese, and only three were from the UK (Sir Geoffrey Littler, Anthony Loehnis and Nicholas Bayne). Of the G5 Finance Ministers, all were interviewed except the Chancellor.

3. The result appears on a quick reading to be a well informed and detailed account of the views, actions and motivation of the participants as seen mainly from their own points of view, and there is a lot of (not always accurate) detail of the negotiations not previously made public; but the interpretation and assessment of the Plaza/Louvre process itself is distinctly weak.

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4. On the detail of the Louvre negotiations, Mr Funabashi explains at length how the phrase "around current levels" emerged as the formula for the exchange rate target, and gives figures for the central yen/dollar and DM/dollar rates. He explains the significance of the 2½ per cent and 5 per cent margins and the difficulties this caused the Japanese, for whom a yen-dollar rate no lower than 150 was at that time considered to be a political imperative. He also gives figures for the April 1987 yen rebasing, but is rather hazy about a DM rebasing which he says did not occur in October 1987, only (de facto) in December. (The author quotes "a West German official" as saying that the December "rebasing" should be regarded as an "accepted present rate" and not a rebasing).

(not - surprised)

5. The book contains several pages on the negotiations of the intervention arrangements at the Louvre, and even gives some figures of actual dollar intervention by various authorities, although this "information" comes from a Bundesbank official. Quoted in June 1987, he was clearly keen to show that not all central bank intervention was motivated to defend the Accord: "[European countries] like to buy dollars in order to increase their reserves. It is voluntary. The British bought more than $10 billion. The Japanese $15 billion. Even Sweden bought $3 billion. France and Italy too. They love it!" According to Mr Funabashi, central banks "reportedly" bought about $140 billion of dollar assets in 1987.

6. This is all good journalism and, to be fair, the book comes closer to the truth than anything else in the public domain. It also contains much interesting detail on the views of the various participants which merits further study. As mentioned before, however, the overall assessment of the Plaza/Louvre process is disappointing. The final chapter is rambling and it is hard to follow where it is leading. In the end it becomes clear that the author sees the "failure" of the Louvre Accord as being due almost entirely to a failure of monetary and fiscal policy coordination, and he urges the G7 to work to strengthen this aspect of the process. (Earlier it appears that the author has as his paradigm something very similar to the Williamson/Miller

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"target zones" proposal.) Even the indicator system, initiated at the Tokyo summit, is not sufficient for Mr Funabashi - explicit domestic policy coordination is what is required!

Warwick Hood

W HOOD

EXTRACT FROM THE GUARDIAN
DATED: 10 MAY 1988.

Lawson tied pound to DM for 'smooth entry to the EMS'

Alex Brummer in Washington

THE CHANCELLOR, Mr Nigel Lawson, linked the pound to the Deutschemark at the Plaza in 1985 and later supported reference ranges to link currencies as a means of smoothing Britain's entry into the European Monetary System, according to a new book released in Washington yesterday.

The study, Managing the Dollar: From the Plaza to the Louvre, is based on firsthand interviews with most of the major figures involved in reshaping the international monetary system. It also discloses the size of intervention funds established to massage the dollar and other currencies as well as the trading ranges established at the Plaza and Louvre meetings.

According to the author Mr Yoichi Funabashi the Group-of-Five Finance Ministers, who met to lower the dollar in September 1985, established an intervention fund of $18 billion of which maximum daily operations in each participating market were to be "on the order of $300-400 millions."

The lion's share of the intervention fund was to be provided by the US and Japan which each chipped in 30 per cent, Germany provided 25 per cent, France 10 per cent and Britain 5 per cent.

The initial Plaza goal was to drive the dollar down by 10-12 per cent within six weeks. The subsequent Louvre accord of February 1987, aimed at stabilising exchange rates within a range of 2.5 to 5 per cent. The author speculates that the most recent telephone accord — in December 1987 — allowed wider base ranges for intervention.

Although the Chancellor, Mr Lawson, was eventually to become an enthusiastic backer of reference ranges for currencies, as outlined in his speech to the IMF in the Autumn of 1987, Britain was initially a reluctant partner in the Plaza process, according to the study.

The author who interviewed Sir Geoffrey Littler, Second Permanant Secretary at the Treasury but not the Chancellor in the course of his wide ranging interviews with Group-of-Five and Group-of-Seven participants, argues that each country had its own goals in agreeing to Plaza and subsequent accords. "The British," he writes, "wanted to link the pound sterling to the Deutschemark and later found virtue in pursuing a reference range strategy to strengthen monetary relationships with EMS countries in preparation for future entry into the EMS."

The Chancellor's backdoor strategy, aimed at creating a new international exchange rate regime and bringing the UK within the purview of EMS, apparantly bit the dust earlier this year when Mrs Thatcher insisted on allowing the pound to rise, despite the Chancellor's apparently better judgment.

The West German goal in signing up for the Plaza was soft landing for the dollar; the French wanted to pressure the Germans into more growth and a target zone system for currencies while the Japanese hoped to deflect pressure for fiscal stimulus — a goal in which they failed. The US, for its part, wanted to prevent a lurch into protectionism.

Lombard

Reflections on Plaza/Louvre

By Anthony Harris

WHAT REALLY happened at the Plaza and the Louvre? Why has the international management of exchange rates, which looked so successful for a time, apparently lost its grip? And if anyone knows, are they likely to tell us?

It is customary to sneer at "instant history"; and when such a history tries to describe a string of negotiations which is still in progress, the dangers are obvious. All the same, Yoichi Funabashi's account of the Louvre and Plaza process* largely disarms this doubt. He has seen the secret documents, and talked to virtually everyone who mattered (hardly any of whom were British). The result is not only a lot of new detail, but a new perspective.

What seems clearest is that economic summitry has rather little to do with economics, and everything to do with politics. The Plaza process started with politics; Mr Baker's warnings about protectionism in Congress were sincere. His aim was not only to re-start the dollar devaluation which had stalled in the summer of 1985, but to show that he was in control, and that international co-operation was the way to produce results.

The communique spoke of co-operation; but all that was really achieved was an agreement to intervene in the markets. There was not even a shadow of the general policy co-ordination Baker sought. Indeed, the Japanese saw the intervention pact as a way to avoid a fiscal stimulus; the Germans were concerned to slow the dollar's decline for fear that the shock of a hard landing would smash the EMS.

All this was partly visible at the time; but there are a couple of real surprises. One is the hidden precision of the pact: quite narrow exchange rate targets were set, and there was a budget for intervention, neatly shared out. Thanks largely to luck, this worked: the markets were sufficiently impressed to fall into line without much pressure.

The second surprise is the biggest: the ministers at the Plaza barely mentioned monetary policy in their talks. Yet now, in the dying days of the Reagan administration, there is little which the governments can co-ordinate apart from monetary policy.

The myth of monetary autonomy survives, all the same; only a few weeks ago the American Bankers' Association was denouncing Mr Alan Greenspan for suggesting that the exchange rate should be among the targets of monetary policy. Meanwhile tension has reappeared between the big three. The Germans and the Japanese appear alarmed because heavy intervention has swollen their money supply numbers, while the Fed has been sitting on its hands until this week partly because US monetary growth looks modest, for the same reason. Do they ever really learn?

This doubt is reinforced by Funabashi's revelation of the exchange of political favours between Mr Baker and Mr Miyazawa, his Japanese opposite number, who managed interest rates and currencies in each other's electoral interests. The barely-concealed hostility between Washington and Bonn is also discouraging, and so is Washington's persistent bilateralism.

Since the parties cannot even begin to agree about fiscal policy, as they have quite different views about how it works, and since the agreements they do make are dangerously ambiguous, as Funabashi shows, has the whole process come to the end of its useful life? The market evidently think so. Funabashi, however, evidently shares the view of Mr David Mulford of the US Treasury that policy co-ordination is simply in its early stages, and needs stronger backing and more precision.

One of the strengths of his book is that the reader is free to draw different conclusions. It is hard to imagine the process here described delivering the right policies, or delivering them in time to be useful. It has at least made all the governments concerned more aware that they cannot make policy without considering its international implications, and informing themselves of what their trade partners are planning. If it takes regular meetings to keep that awareness alive, they are worth holding; but it seems over-idealistic to expect much more.

* *Managing the Dollar: from the Plaza to the Louvre. Institute for International Economics, 11 Dupont Circle NW, Washington DC 20036, $19.95*

FROM: P N SEDGWICK
DATE: 18 MAY 1988

CHANCELLOR

cc Chief Secretary
PCC
Mr Moore
Miss Peirson
Mr Peretz
Mr Turnbull
Mr Hibberd
Mr Mowl
Mr Potter

POLICY ASSUMPTIONS FOR THE FORECAST

I attach a note, which was discussed at PCC yesterday, on the policy assumptions for the forthcoming forecast. I would be grateful if you could let me know if you are content with these.

P.N.S

P N SEDGWICK

Thanks. I am not clear what rates x proposes. Tax assumption should be that Entire fiscal adjustment is allocated to reductions in basic rate (until 20p has been reached). The only new assumption for 1989-90 PSBR: new procedure in para 8 ok. But might be [illegible] to have 2 variants: one with zero PSBR, the other with PSBR unchanged in cash terms from 1988-9 outturn. Otherwise content.

N

POLICY ASSUMPTIONS FOR THE SUMMER FORECAST

Note by EA and PSF

The summer forecast is an internal Treasury exercise. It will cover the period to end 1990 (to 1990-91 for public finances). The main forecast report will be circulated on Friday 24 June.

Monetary Policy

2. The forecast will illustrate the implications for money GDP and interest rates of maintaining the exchange rate against the DM at or around the range of the last 18 months, provided this can be achieved without relaxing counter-inflationary pressure from monetary policy. The level of interest rates will also take account of the paths for money GDP, the forecast of MO relative to its target ranges, and other indicators of monetary conditions.

3. Assumptions about intervention will be made in the light of forecast pressures on the exchange rate. Some partial rundown of the earlier rise in reserves could be assumed if pressures on the exchange rate seemed likely to be downwards and vice versa in the event of upward pressure.

4. It will be assumed that from 1988-89 onwards the PSBR is fully funded through debt sales outside the banking and building society sectors, unless significant foreign exchange market intervention is projected towards the end of 1988-89, in which case some carry over to 1989-90 will be assumed. The contribution assumed from national savings from 1988-89 onwards will depend on the overall level of funding required, but is likely to be £½ billion a year or less.

5. During the forecasting exercise the forecasters will consult Sir Terence Burns and Mr Scholar on the precise implementation of monetary policy.

Fiscal Policy

6. The forecast will include a revised assessment of the PSBR in 1988-89, taking into account both the latest monthly information on borrowing and fresh information on likely developments in the rest of the financial year.

7. The forecast will assess the scope for cuts in personal taxes in 1989-90 and 1990-91 given the assumed level of the PSBR, and after making allowance for the forecasters' best view of the likely path for public expenditure and of the buoyancy of government revenues.

8. The forecast will assume that the PSBR will return to zero as in the 1988 MTFS. Whether it reaches zero by 1989-90, as assumed in the MTFS, or more gradually will depend in part on the results of the forecasting exercise. If a large public sector debt repayment seems likely in the current financial year a more gradual reversion to zero would ensure that the assumed tax cuts in particular years were not too large. The forecasters will review the assumption on the PSBR/PSDR with Sir T Burns and Mr Scholar as the forecasting exercise progresses.

9. In previous forecasts assumed cuts in personal taxes have been allocated to increases in personal allowances above revalorisation, with the basic rate by assumption unchanged. But in recent Budgets income tax cuts have been largely concentrated on reductions in income tax rates, and there is now a public commitment to reduce the basic rate eventually to 20p. In view of this and the rather different direct effects of cutting the basic rate compared with increasing allowances, on the RPI for example, it is proposed to make the stylised assumption that half of any assumed cut in personal income tax is allocated to reductions in the basic rate and half to increases in allowances. In fact such an assumption would be not very different from the average composition of income tax cuts over the past seven years. On the basis of current MTFS projections it would have the effect of increasing allowances by almost the amount needed to offset real fiscal drag, allocating remaining tax cuts to reductions in the basic rate.

Taxation and other government receipts

10. The forecast for pre-fiscal adjustment taxes will assume full revalorisation in the 1989 and 1990 Budgets of all the income tax allowances and thresholds, and of specific duties.

11. The forecast will assume the extension of VAT to spectacles following the European Court Judgement already announced.

12. National insurance contribution rates will be assumed to remain at current levels. The lower and upper earnings limits will be assumed to be increased in April 1989 and April 1990 in line with the forecast increase in the RPI in the year to the previous September.

13. The Community Charge will be assumed to be introduced in full in April 1989 in Scotland and in April 1990 for all but ten authorities in England and Wales. National non-domestic rates will be assumed to be introduced in England and Wales from April 1990; the level at which they are introduced will be discussed with LG. In Scotland business rates will be assumed to rise in line with the RPI from April 1989.

Public Expenditure

14. The forecast of public expenditure for 1988-89 will take account of the (small amount of) information on expenditure and borrowing so far this year, GEP's latest assessment of claims on the Reserve, and the effects of changes in economic assumptions and other pressures on spending.

15. The forecast of public expenditure in 1989-90 and 1990-91 will take account of the existing plans, bids received during the current Survey, changes in economic assumptions implied by the rest of the forecast, and other pressures on expenditure.

16. As usual detailed public expenditure judgements and assumptions will be discussed during the forecast with the appropriate Treasury divisions.

(i) After consultation with Pay division the forecasters will make their best forecast of public sector pay.

(ii) The forecast of the net contribution to the EC will assume implementation of the Brussels agreement and be based on advice from EC division.

(iii) With one exception social security benefit rates will be assumed to be uprated in April 1989 and 1990 in line with the forecast rise in the RPI (or RPI excluding housing costs) in the year to the previous September. The exception is that child benefit will be assumed to be uprated in April 1989 by about 1½

percentage points less than inflation (reflecting a hidden saving in the current public expenditure plans).

(iv) The Treasury Supplement to the National Insurance Fund will be assumed to be reduced by 2 percentage points a year ie. to be 3 per cent in 1989-90 and 1 per cent in 1990-91. It is possible that even after allowing for these reductions the forecast will show larger flow surpluses on the Fund than have been experienced for a sustained period in the past. Figuring underlying the MTFS showed, on the same assumption about the Treasury Supplement, flow surpluses of about £1½ billion a year. It will be assumed that it will be possible to live with such large surpluses (which in effect will increase the scope in the forecast for income tax cuts). The alternative would be to assume cuts in national insurance contribution rates or increases in thresholds above revalorisation (see paragraph 12 above) or greater benefit upratings (paragraph 16(iii)) or some combination of these.

(v) The sale of Rover group to British Aerospace will be assumed to go ahead in 1988-89 at a net cost of up to £650 million (advice on the precise amount will be sought from IAE before the forecast is finalised).

(vi) Privatisation proceeds in 1988-89 will be the best available estimate assuming that BSC is sold before the end of the year. Proceeds will be assumed to be £5 billion a year in 1989-90 and 1990-91. For the purposes of adjusting EFLs the following timing of new privatisations will be assumed:

1988	
November	BSC
1989	
November	Water I
1990	
Summer	Electricity Distribution
Autumn	CEGCO
1991	
January	Water II
Summer	Scottish Electricity
Autumn	GENCO

(vii) The forecast of local authorities' Aggregate Exchequer Grant will assume that the outturn percentage of grant to expenditure in 1989-90 will be a little lower than the forecast outturn for 1988-89; the outturn percentage will be assumed to rise in 1990-91 when there will no longer be any underclaim of grant because of overspending.

Changes since last forecast

17. A number of changes compared with the assumptions used for the Budget projections are proposed, some of which reflect different conventions in internal and published forecasts. The main changes are:

- in published forecasts exchange rates and interest rates are by convention assumed to be broadly unchanged from recent levels; in internal exercises they may vary from recent levels, (see paragraph 2);

- the PSBR may not be assumed to return to zero as early as 1989-90 as in the MTFS if the implied cuts in income tax are too large in particular years;

- part of the assumed cuts in personal income tax are to be allocated to basic rate reductions instead of entirely to increases in personal allowances;

- the public expenditure path will be the forecasters' best view rather than constrained to published plans.

One aspect of this is that privatisation proceeds in 1988-89 will not be constrained to £5 billion but will be PE's best estimate.

108/G/GBH/3890/50

SECRET

FROM: MISS M O'MARA
DATE: 20 MAY 1988

CHANCELLOR OF THE EXCHEQUER

cc Economic Secretary
Sir P Middleton
Sir G Littler o.r
Mr Scholar
Mr Peretz
Mr R I G Allen
Mr Polin

Thanks. Content.

MAY RESERVES FIGURE

We are now at the stage when we need to decide what figure we wish to publish at the end of the month for the underlying change in the reserves.

2. On the assumption that there is no further market intervention this month and the size of the forward book remains unchanged from April, we would show an underlying rise in the reserves of around $900 million. We think that on this occasion there would be some advantage in publishing the true figure. The Prime Minister told the House on 17 May "We use the available levers, both interest rates and intervention, as seems right in the circumstances" and we see some advantage in reinforcing this message by publishing a figure which indicates that intervention took place on a substantial scale during May. It is too early for the market to have formed any view on the likely underlying change but we have no reason to think that publishing a figure of around $900 million would come as any surprise. Indeed, the figure now has to be a long way from expectations to cause any ripple in the market at all.

3. The Bank support this recommendation.

4. Would you be content for us to publish the "true" underlying change this month?

MOM

MISS M O'MARA

niesr/May-88

CONFIDENTIAL

FROM: J S HIBBERD
DATE: 24 MAY 1988

CHANCELLOR OF THE EXCHEQUER

cc : Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Sir G Littler
Mr Anson
Dame A Mueller
Mr Byatt
Mr Scholar
Mr Monck
Mr Culpin
Mr Evans
Mr Odling-Smee
Mr Peretz
Mr Sedgwick
Mr Turnbull
Mr R I G Allen
Mr S J Davies
Mr Melliss
Mr C Mowl
Mr Pickford
Mr Bush

passed to TBT

NATIONAL INSTITUTE ECONOMIC REVIEW

The May National Institute Economic Review comes out at 9 pm on Wednesday, 25 May. It contains, among other things, the Institute's latest forecasts for the UK and world economies.

2. The main features of the new central forecast are:

- GDP growth of 3.5 per cent growth (3.9 per cent, excluding oil) for 1988. This is higher than their February forecast of 2.9 per cent (3.3 per cent non-oil). The Institute still forecast a marked slowdown in growth through 1988; GDP is expected to rise by 2.2 per cent in the year to 1988Q4.

- RPI inflation at 3.8 per cent in 1988Q4.

- The current account in deficit by £6.2 billion in 1988.

- A negative PSBR (or a PSDR) of £4.5 billion in 1988-89.

The Forecast in detail

3. The main features of the forecast are set out in Table 1 and the rest of this section considers some of the detail underlying the main aggregates.

TABLE 1: COMPARISON OF NIESR AND FSBR FORECASTS

per cent changes on previous year	NIER MAY FORECAST 1988	FSBR FORECAST (MARCH 1988) 1987
Gross domestic product (output measure)	3.5	3*
Consumers' expenditure	4.8	4
Total fixed investment	7.5	6½
General government consumption	2.0	1
Change in stockbuilding (contribution to GDP)	0.2	0
Exports of goods and services	1.6	3
Import of goods and services	6.0	6½
Manufacturing output	4.0	5
World trade in manufactures	5.7	3½
RPI in Q4	3.8	4
Current Account (£billion)	-6.2	-4
PSBR (£billion financial year)	-4.5	-3

* Average measure of GDP

4. **Consumer spending** is forecast to grow faster than real personal disposable income (3.6 per cent) in 1988, and the savings ratio is expected to fall to an average 4.5 per cent for the year. Within **total fixed investment**, growth in **private housing investment** is forecast to pick up to 13 per cent, after an estimated 7 per cent in 1987. The National Institute now forecast an 11 per cent increase in **manufacturing investment** in 1988, after a forecast of 7 per cent in the February Review. The greater buoyancy reflects recent bullish CBI Investment Intentions Surveys and, belatedly, the December DTI Intentions Survey, which the Institute heavily discounted in February in the wake of the stock market crash. The Institute's forecast for **investment by distribution and service industries** is for a 10 per cent increase.

5. The Institute note that the volume of **UK exports of manufactures** rose faster than world trade last year, and significantly faster than their forecasting equations would suggest. They also discount the poor export performance revealed by official figures for the first quarter of 1988 on the grounds that"...the timing of recorded exports between the fourth and first quarters may have been at fault". There may also have been some problems associated with the new reporting procedures introduced from 1 January. The Institute's forecast for **manufactured exports** in 1988 is better than their model alone would suggest (ie they make some allowance for the underprediction of exports last year), and better than the first quarter outturn would indicate. Nonetheless, the forecast for 1988 is held back by the recent appreciation of sterling. Manufactured exports are forecast to increase by 2½ per cent in 1988, against the background of world trade growth of 5¾ per cent. (The Institute's world trade forecast now looks on the low side in the light of recent data.) The slack growth in manufactured exports is partly the result of the first quarter outturn; exports grow through the rest of 1988, but do not exceed 1987Q4 levels until the end of the year. The **sterling index** is assumed to stay close to recent levels over the rest of 1988. **Manufactured import volumes** are expected to increase by almost 9½ per cent in 1988.

6. The deterioration in the **current account** deficit is largely accounted for by a worsening balance on visible trade.

7. There is little change in the National Institute's employment forecast compared to February. **UK unemployment** is expected to fall steadily through this year, before stabilising at 2.3 million by end-1988.

8. On wages and earnings, the National Institute note that average earnings growth has hardly varied outside the range 7-8 per cent a year since 1983. It has been largely unaffected by movements in retail prices or unemployment. For 1988 they forecast **earnings growth** of 7.8 per cent. **Wholesale price** inflation is expected to turn out at bout 5½ per cent by 1988Q4, and **consumer price** inflation at 5 per cent. **RPI inflation** is projected at 3.8 per cent for 1988Q4 compared to the 4½ per cent predicted in the February Review. The revised RPI forecast is mainly due to lower import prices and mortgage rates.

Medium Term Prospects

9. The Institute offer two sets of medium term projections to 1992. The **main** case is a continuation of the short term prospect. The main feature is an effective sterling depreciation of 10 per cent through 1989. It is predicated on the assumption that recent bullish market sentiment about sterling will reverse. This is despite some rise in interest rates; the Treasury Bill rate rises from 7.7 per cent at end-1988 to 11 per cent by end-1989, and mortgage interest rates rise from 9.5 to 12.7 per cent over the same period. Growth slows from 3½ per cent in 1988 to around 1 per cent in 1992, averaging 2 per cent a year over 1989-92 (2.4 per cent excluding oil). The depreciation switches resources out of domestic demand, especially consumption, into net exports. Even so, the current account deficit rises to £11 billion in 1992. The cumulative deficit over 1988-92 is £43 billion. Depreciation and rising interest rates imply a pick up in RPI inflation, to 6.9 per cent at end-1989.

10. The **second variant** assumes that confidence in sterling is sustained; the effective exchange rate is held constant throughout the medium term. Growth still averages close to 2 per cent a year between 1988 and 1992. Consumer price inflation is markedly lower. But the most significant impact is on the current account. The deficit increases from £9 billion in 1989 to £16 billion by 1992, with a cumulative deficit of about £57 billion over 1988-92. Such an outcome, which is mainly the result of continued buoyant consumer demand, is regarded as implausible and unsustainable by the Institute. This explains why they plump for the depreciation variant as their main case.

The Institute's Appraisal

11. The Appraisal section normally attracts some press attention. The Institute highlight their main case with its assumed 10 per cent depreciation during 1989, and the increase in interest rates. In particular they stress the inflation implications, with RPI inflation rising to almost 7 per cent by the end of next year. They also note that the higher the exchange rate goes now, the worse the inflation outlook when (and if) depreciation does eventually come. The Institute goes on to note that the major problem with their alternative scenario,

e assuming a constant exchange rate, is the rapidly rising current account deficit. Since the deficit is largely accounted for by buoyant consumer demand "...it is questionable whether this is an outcome for the economy which policy should encourage".

12. The Appraisal section also includes short discussions of the aims and instruments of policy, and of the MTFS. The Institute endorses a more supply oriented approach to policy but feels the MTFS has retreated from what "began as an admirable attempt to say clearly what the points of policies were". The Institute is keen on EMS membership as a help to achieving low inflation, but is dubious about targeting money GDP.

EMS

13. There is some commentary on the European Monetary System in Chapter II - The World Economy - of the Review. Figures are presented to show that intra-EMS exchange rate volatility has decreased since 1979, while the volatility of EMS currencies against non-EMS currencies has increased. (The base period for comparison is 1971-78). These are not surprising conclusions given developments in the exchange rates of the dollar and sterling since 1979. The Review does not claim that the EMS is responsible for this increase in volatility, but nor does it point out that it may well have occurred whether or not the EMS had been formed. Although no figures are presented by the Institute, Yen/$ and $/£ exchange rate volatility has been higher since 1979 than it was in the period 1971-78.

Other Articles

14. There are a number of other articles in the Review. There is a short piece surveying recent public sector pay settlements and earnings, and the outlook for 1988-89. The Institute see public sector earnings rising in line with private sector earnings, at about 7¾ per cent. This prospect for the public sector looks a little on the low side for 1988-89.

15. All the other articles in the Review celebrates the 50th anniversary of the National Institute with surveys, from authors of widely different ages and backgrounds, of some of the issues on which the Institute has specialised.

Fifty years of economic research: A brief history of the National Institute of Economic and Social Research 1939-88 — Kit Jones

The National Institute: The Early Years — Austin Robinson

Research on Productivity and the Productivity Gap — R C O Matthews

Growth Through Liberalisation — Herbert Giersch

The Institute and the Microeconomics of Public Policy — A B Atkinson

Can Financial Markets form 'Rational' Expectations? — Gavyn Davies

The National Institute and Understanding Technical Change — D K Stout

Line to take on the Forecast

Positive

(i) The National Institute project healthier growth in 1988 than they did in February.

(ii) Also welcome optimistic outlook for employment and unemployment.

(iii) Welcome low inflation prospect for end-1988

Defensive

(i) **Medium term prospects gloomy. Slowing output growth in main case, with rising interest rates and inflation, and persistent large current account deficits.**

Medium term forecasting even more hazardous than short-term forecasting. The Institute, itself, in an article in the November 1987 Review (The British Economy since 1979) notes how wrong (and pessimistic) their medium term projections turned out to be.

(ii) **Outlook for current account in 1988 worse than FSBR predicted.** Institute note that poor export figures for first quarter probably an aberration. Still too soon to draw conclusions about current account for 1988.

Jim Hibberd

J S HIBBERD

FROM: P F L ALLUM
DATE: 24 MAY 1988

1. MR BUSH

2. CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir Terence Burns
Mr Scholar
Mr Odling-Smee
Mr Sedgwick
Mr R I G Allen
Mr Hibberd
Mr Pickford
Miss Edwards

There's the germ of a good article here, but this draft is some way off what's wanted. I've scribbled a number of comments, incl some from EB. If you can glance at it, & let me have any further quick reactions, I will redraft.

PROPOSED EPR ARTICLE ON STEADY GROWTH

I attach a proposed article for the June Economic Progress Report. It has been adapted from a note on "the UK's Recent Growth Performance" which you saw shortly before the Budget. This earlier note provided the basis for the claim in your Budget speech that:

> "the six years to 1987 have been the longest period of steady growth, at a rate averaging 3 per cent a year, for half a century."

2. The proposed EPR article, which has benefited from comments by Sir Terence Burns and Mr Sedgwick, sets out the record for the 1980s - as currently recorded by the official statistics - and compares this with that for earlier years. It is intended to provide a relatively short summary of the key facts: it does not attempt to explain how strong, steady growth has been achieved. (Paragraph 6 notes, however, that the Government does not attempt to "fine-tune" economic growth, a tradition which may have been destabilising in previous decades.)

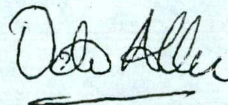
3. The article, as currently drafted, comprises 11 paragraphs and 3 charts. A further 3 paragraphs cover the technical question of how to measure the steadiness of growth and will be included as a subsidiary box-article.

4. Chart 3 of the attached draft summarises the average growth record and the variance of annual rates of growth for successive six-year periods from 1949-1954 to 1983-1988. This chart was included in the pre-Budget note on the UK's recent growth

performance and you suggested that it would be worth publishing it in an EPR article. Annex A presents an alternative version of the chart and some extra text that would have to accompany it. However, the end result is arguably less clear than the original chart. It also has the drawback that the particular six-year period shown for the earlier years are essentially arbitrary. We could be accused, with this chart, of attempting to present a misleading picture.

I agree. AH
So does PEM - see minute attached. AH

6. We would be grateful for publication approval together with any comments on the attached draft by, if possible, close Friday 27 May.



P F L ALLUM

STEADINESS OF THE CURRENT ECONOMIC UPSWING

Steady, sustained economic growth has been the ambition of every government since the war. During the six year period to 1987 the UK economy achieved average real growth of a little over 3 per cent a year. This represents a clear improvement on the 1970s. Furthermore, the six years to 1987 saw the steadiest period of growth of six years or more at a satisfactory 3 per cent rate since the War. This article contrasts recent growth with the record for earlier periods.

Steady growth

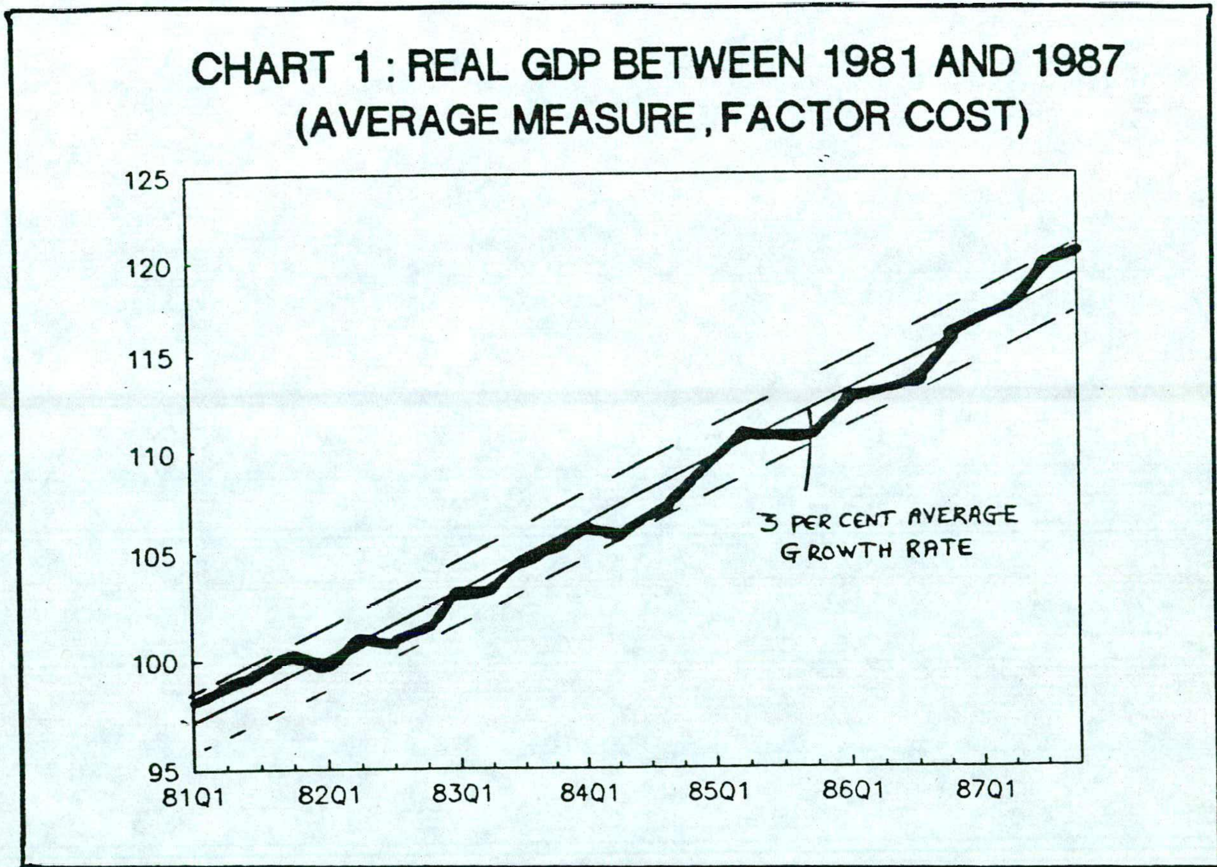
2. The benefits of higher average growth are clear. There are more resources for households to spend on the goods and services they desire, more for businesses to invest in new plant and machinery, and more for public spending on priority services. The advantages of steady growth are less directly quantifiable but still important. If an economy swings frequently from periods of slack or falling activity to periods of strong growth, it is difficult for businesses to operate efficiently. Uncertainty about the future can, in particular, deter business investment: the business risk may be too large to justify the investment costs.

3. Uneven expansion is likely to prove inefficient not only for individual producers but also for the economy as a whole. Periods of strong growth have, in previous upswings, resulted in upward pressure on prices. Inflation has then been difficult to reduce - because of rigidities in the economy, especially in the labour market - even during subsequent periods of below average growth. So, uneven "stop-go" growth tended to lead to a ratchet-effect continually raising the rate of inflation, with all the economic costs that this entailed.

The recent record

4. Chart 1 shows the quarterly level of real GDP in the six years to 1987. Over this period output rose on average at 3 per cent a year. While output fell slightly in a few quarters, and sometimes rose strongly, there were no sustained periods

of flat or falling output, or of output growth much stronger than trend.



5. Table 1 shows that year-on-year growth rates during this period varied within the relatively narrow range of 1½ to 4½ per cent.

[This doesn't sound v. narrow to the reader - 50 per cent either side. Better to say, for 4 out of 6 yrs, growth between 2¼ & 3¾; one year below 2, one year above 4; or show a longer run of years.]

This is v. striking! The steadiness started in 1983: from 1983 to 1987 inclusive growth was always within 1% of 3½%.

Table 1: Real GDP growth (average measure, factor cost)

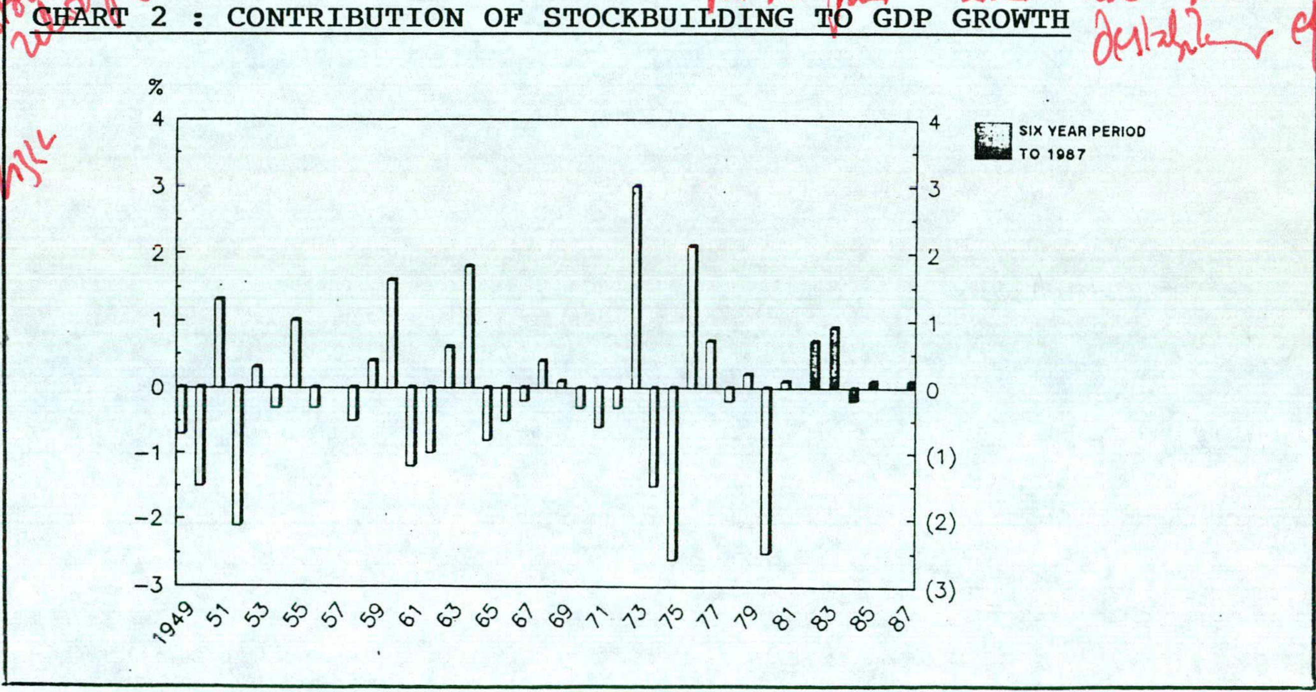
1982	1.6
1983	3.3
1984	2.4
1985	3.7
1986	3.0
1987	4.4
Average growth	3.1

6. This steadiness of growth compares favourably with any equivalent post-war period. It is, in particular, a considerable improvement on the record of the 1970s, notwithstanding the

tradition of "fine-tuning" the economy by governments in earlier decades. Fine-tuning can, as often as not, introduce fresh disturbances rather than create steady expansion. For example, time lags associated with monitoring economic developments and making fine-tuning adjustments mean that policies designed to counter an observed slowdown often had their greatest effect just as growth had resumed. The present government does not use fiscal or monetary policy to attempt to regulate demand in the short term. Policy is set in a medium term framework which helps to generate more confident expectations.

7. As a result there is less need for precautionary behaviour against unexpected surges or shortfalls in growth. One result of the reduced business uncertainty over the latest upswing has been the fall in firms' stock-output and stock-sales ratios. Strong stock cycles were a prominent feature prior to the current upswing. But greater confidence, together with more efficient stock control techniques, mean that stock changes played only a minor role in economic activity over the six-year period to 1987 (see Chart 2).

CHART 2 : CONTRIBUTION OF STOCKBUILDING TO GDP GROWTH



Earlier periods

8. Latest estimates of annual GDP growth, for each year since 1949, have been used to calculate the average rate of growth for earlier post-war periods. The volatility of growth for

The point of all the arrows is to make all the points on the rate of growth before the ones on steadiness. AH

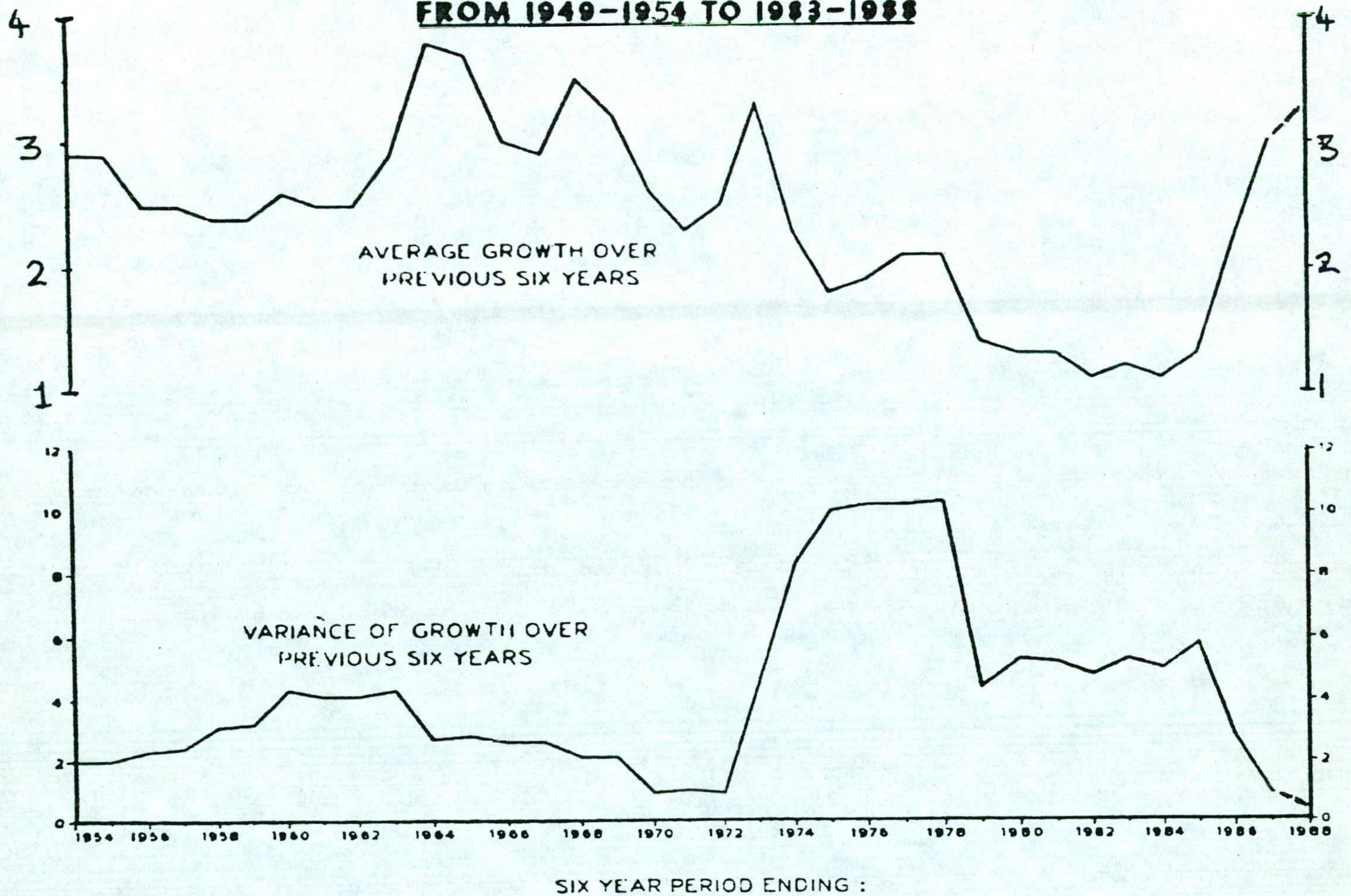
the same periods has been measured by the "variance" (see box article). The annual figures have been sub-divided into overlapping six-year periods for comparability with the six-year period to 1987. The potential outturn for the six years ending in 1988 has been calculated using the FSBR forecast of 3 per cent growth.

9. The variance measure of the volatility of growth rates - as noted in the box article - highlights in particular large divergences from average growth. There are good reasons for this: businesses and households can cope with small fluctuations in sales and incomes - by drawing on unsold stocks or savings, for example - while larger cycles require more fundamental changes to plans. Furthermore, inflationary pressures may rise more than proportionately as output and activity growth rise relative to the underlying trend.

The lower the variance, the steadier the growth. This measure

10. The top half of Chart 3 illustrates how the average rate of growth changed between successive overlapping six-year periods; the lower section of the chart shows how the variance of growth changed in these six-year periods. The average growth profile shows that the 1950s and 1960s saw consecutive six-year periods marked by average growth of 2½ to 3½ per cent. During the 1970s this average fell sharply, to between 1 and 2 per cent. More recently the six-year average rate of growth has risen to its current figure of a little over 3 per cent. For the six years to 1988 average growth is expected to rise a little further.

This makes some of the same points as 2 + 3, + has the same flaw on inflation. But worth stressing the point that, though small fluctuations don't matter much, large ones carry a real cost to the economy.



11. The lower half of Chart 3 shows that the variance of annual rates of growth proved relatively low in consecutive six-year periods during the 1950s and 1960s. Growth became more volatile during the 1970s, when the sharp surge in activity in 1972-73 was rapidly followed by a dip in the average rate of growth. More recently growth has become more stable, and for the six-year period to 1987 was quite exceptionally stable by post-war standards. In fact, it was only matched in two earlier six-year periods, ending in 1970 and 1972. But these periods saw average growth of just 2½ per cent. No six-year post-war period of 3 per cent average growth has been as steady as that ending in 1987. Furthermore, if the 3 per cent growth forecast for 1988 is achieved the six years to 1988 will have proven steadier, ie shown a smaller growth variance, than any earlier post-war period - whether of faster or slower average growth.

BOX ARTICLE

Measuring the volatility of growth

1. A measure of the volatility of growth frequently used by statisticians is the variance, based on the extent to which a group of figures differ individually from the average. This has advantages over the "range" of growth outturns which does not measure the extent to which growth rates have varied within that range.

2. In calculating the variance, differences between each individual number and the average are recorded, and these differences squared. The variance is the average size of these squared differences.[1]

3. By squaring the deviations from the average value the variance accords a large weight to single years of either very strong or particularly sluggish growth and a smaller weight to years of smaller divergence even when on a similar overall scale.

---

[1] Technical note: For a series X1....Xn the variance is defined as $[(X1-a)^2+...+(Xn-a)^2]/n$ where a is the series average.

ANNEX A : ALTERNATIVE CHART 3 AND ACCOMPANYING TEXT (TO REPLACE EXISTING PARAGRAPHS 8 AND 9)

8. The top half of chart 3 shows how the average rate of growth, measured over six year periods, has changed; the lower chart illustrates changes in the variance of growth during these six year periods. Changes in average growth are summarised in the upper bar chart. The right-hand bar represents the six-year period to 1987, while the earlier bars cover preceding six-year periods spanning, in total, some 30 years. Growth averaged around 2½ to 3 per cent during the 1950s and 1960s but fell sharply, to between 1½ and 2 per cent in the 1970s. Over the the latest six-year period average growth was around 3 per cent.

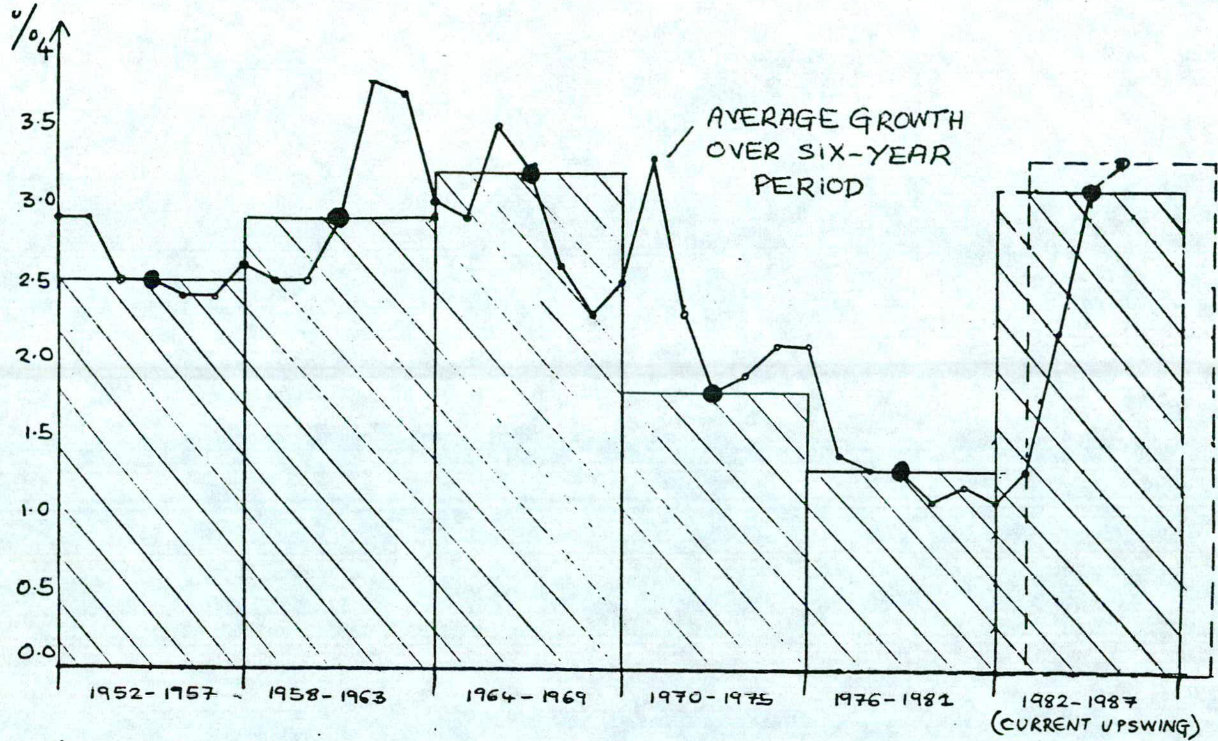
9. The average rates of growth for all six-year periods - ie including those overlapping the periods highlighted in the bar chart - are also shown in the upper chart. This detailed record shows that for the six year period to 1988 the average rate of growth is expected to rise further to over 3 per cent.

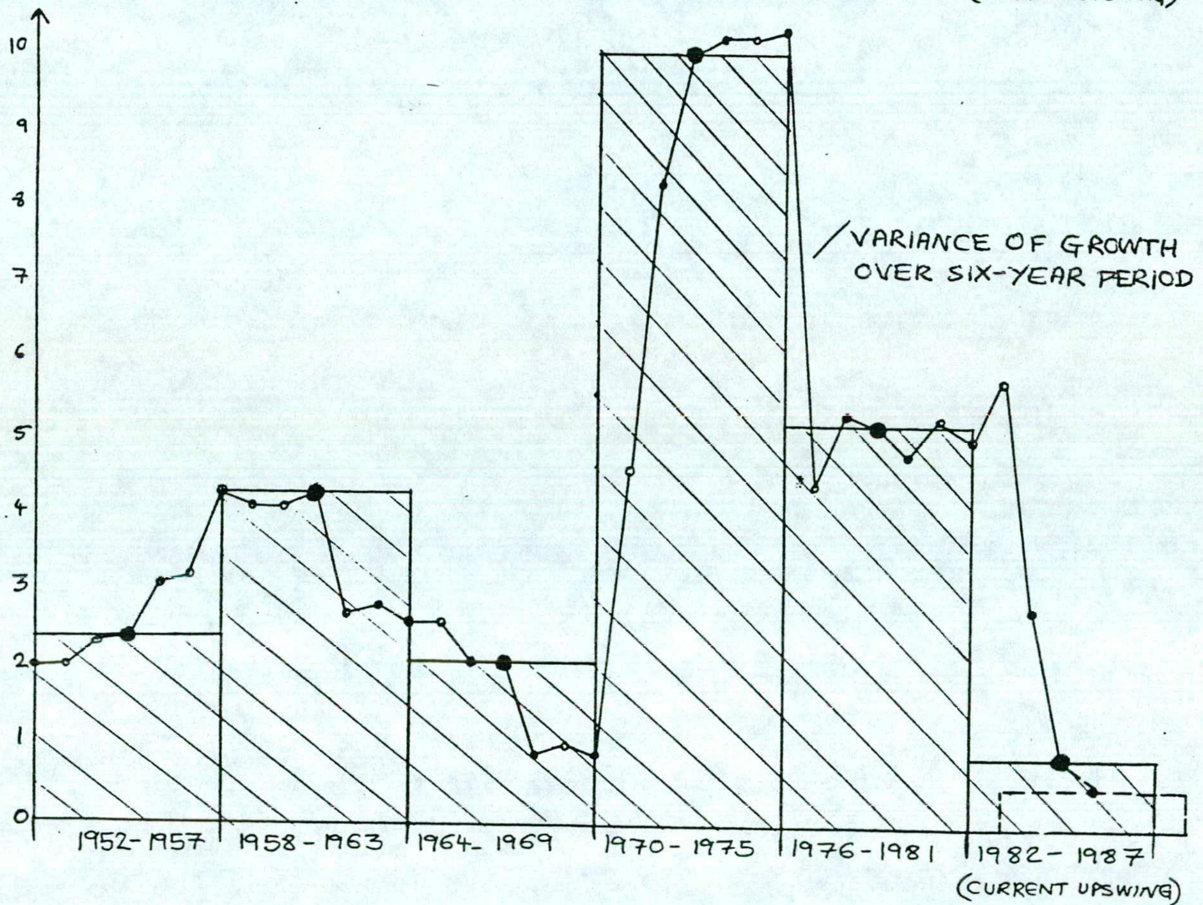
10. The bar chart in the lower half of chart 3 shows that the variance of annual rates of growth proved relatively low in the 1950s and 1960s. Growth became more volatile during the 1970s, when the sharp surge of activity in 1972-73 was rapidly followed by a dip in the average rate of growth. More recently growth has become more stable.

11. Chart 3 includes a detailed analysis of the variance of growth over all earlier six year periods, including those covered by the bar chart. The steadiness of growth, as measured by the variance, is shown to have been quite exceptional over the six-year period to 1987. In fact, it has been matched in only two earlier six-year periods, ending in 1970 and 1972. But these periods saw average growth of just 2½ per cent. No six-year post-war period of 3 per cent average growth has been as steady as that ending in 1987. Furthermore, if the 3 per cent growth forecast for 1988 is achieved the six years to 1988 will have proven steadier, ie shown a smaller growth variance, than any earlier post-war period - whether of faster or slower average growth.

ANNEX A

CHART 3 GROWTH AND VARIANCE IN SIX-YEAR PERIODS FROM 1949-1954 TO 1983-1988





ps4/82H

Pl. type tape + amend text below. 24/5/88

UNCLASSIFIED

C:
You will recall the earlier draft (below) which I have now redone.

SECOND REVISED DRAFT EPR ARTICLE ON STEADY GROWTH

STEADINESS OF THE CURRENT ECONOMIC UPSWING

Steady, sustained economic growth has been the ambition of every government since the War. During the six year period to 1987, the UK economy achieved average real growth of a little over 3 per cent a year - the best performance for 15 years. Even more striking is the steadiness of this growth. The six years to 1987 were the steadiest six-year period of growth averaging 3 per cent since the War. This article contrasts recent growth with the record for earlier periods.

Steady growth

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

1988

3. In previous decades, most noticeably in the 1970s, governments tried to achieve steady growth by "fine-tuning" the economy, with frequent adjustments to fiscal and monetary policy in pursuit of "demand management". However, this approach can, as often as not, introduce fresh disturbances, rather than assist steady expansion. For example, the time lags associated with monitoring economic developments and making fine-tuning adjustments mean that policies designed to counter an observed slow-down often had their greatest effect just as growth had resumed. In practice, artificial boosts to demand led to problems with inflation and the balance of payments, which meant that demand had to be reined back again, thus creating the phenomenon known as "stop-go".

4. The present Government has therefore adopted a different approach, designed to create the conditions for steady, sustainable growth. No attempt is made to regulate demand in the short-term. Policy is set within the framework of the Medium-Term Financial Strategy. Downward pressure on inflation is maintained by a firm monetary policy, buttressed by a tight fiscal policy. And to facilitate healthy growth, the Government have concentrated on removing restraints on the supply side of the economy.

The recent record

5. Chart 1 shows the path of real GDP since 1981. Over the six years to 1987 - that is, the period since the economy emerged from the recession of 1980-81 - output rose on average at a little over 3 per cent a year.

6. Table 1 shows the year-on-year growth rates during this period. Since 1983, annual growth has always been within one percentage point of 3½ per cent. [OR In four out of the six years, growth has been within ¾ of a percentage point of the average.]. Though there were inevitably fluctuations, there were no sustained periods of slack or falling output, or of output growth much stronger than trend. This steadiness of growth means there is less need for businesses to take precautions against unexpected surges or shortfalls in growth.

Table 1: Real GDP growth (average measure, factor cost)

1982	1.6
1983	3.3
1984	2.4
1985	3.7
1986	3.0
1987	4.4
Average growth	3.1

7. Improved business confidence, among other things, has meant there have been only minor changes in stockbuilding over the current period of expansion. This contrasts, as Chart 2 shows, with the marked de-stabilising effect of strong stock cycles in earlier years. Over the 1980s, positive real interest rates,

often at historically high levels, combined with better stock control techniques and the abolition of stock relief in 1984, have meant that stocks have stayed low relative both to output and to sales. This is both a consequence of steady growth, and a factor which makes for continued stability.

Earlier periods

8. Latest estimates of annual GDP growth, for each year since 1949, have been used to calculate the average rate of growth for earlier post-War periods. The annual figures have been divided into overlapping six-year periods, so that they can be compared with the six years to 1987. The outturn for the six years ending in 1988 has also been calculated, using the Budget forecast of 3 per cent growth this year.

9. Chart 3 [use here the top half of the existing Chart 3] illustrates the average rate of growth for successive overlapping six-year periods. The 1950s and 1960s saw a series of six-year periods with average growth of between 2½ and 3½ per cent. During the 1970s, this average fell sharply, to between 1 and 2 per cent. More recently, it has risen to its current figure of a little over 3 per cent. For the six years to 1988, average growth is expected to rise a little further.

10. The steadiness of growth for the same periods has been measured by the "variance" (see box article). The

lower the variance, the steadier the growth. Chart 4 [ie the bottom half of existing Chart 3] shows the variance of growth over six-year periods since the 1950s. This proved relatively low during the 1950s and 1960s, but rose in the 1970s, when growth became a good deal more volatile.

11. Chart 4 shows that growth in the six-year period to 1987 was exceptionally steady by post-War standards. And if growth in 1988 is 3 per cent, as forecast, that six year period will be steadier still.

12. The steadiness of growth in the six years to 1987 has only been matched in two other six-year periods, those ending in 1970 and 1972. But both these periods saw average growth of just 2½ per cent. So no six-year period since the War, has been such a favourable combination of strong and steady growth.

4

From: S D H SARGENT
Date: 25 May 1988

MR P ALLUM

cc Chancellor
Economic Secretary
Sir T Burns
Mr Scholar
Mr Odling-Smee
Mr Sedgwick
Mr R I G Allen
Mr Hibberd
Mr Pickford
Mr Bush
Miss Edwards

PROPOSED EPR ARTICLE ON STEADY GROWTH

Sir Peter Middleton has seen your minute of 24 May. He has commented that he did not find Chart 3 very clear - but he agrees that the alternative is no improvement, for the reasons given in your minute.

S D H SARGENT
Private Secretary

NH13/38AL

UNCLASSIFIED

FROM: A P HUDSON
DATE: 27 May 1988

MR ALLUM

cc PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Odling-Smee
Mr Sedgwick
Mr R I G Allen
Mr Hibberd
Mr Pickford
Mr Bush
Miss Edwards

PROPOSED EPR ARTICLE ON STEADY GROWTH

The Chancellor has seen the article attached to your 24 May minute.

2. He had a number of points, which I have incorporated in the attached redraft. Please could I have any comments by lunchtime on Thursday 2 June.

A P HUDSON

SECOND

REVISED DRAFT EPR ARTICLE ON STEADY GROWTH

Pl. amend

STEADINESS OF THE CURRENT ECONOMIC UPSWING

Steady, sustained economic growth has been the ambition of every government since the War. During the six year period to 1987, the UK economy achieved average real growth of a little over 3 per cent a year - the best performance for 15 years. Even more striking is the steadiness of this growth. The six years to 1987 were the steadiest six-year period of growth averaging 3 per cent since the War. This article contrasts recent growth with the record for earlier periods.

Steady growth

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

3. In previous decades, ~~and particularly the 1970s,~~ governments tried to achieve steady growth by "fine-tuning" the economy. The policy of demand management entailed adjusting fiscal and monetary policy in an attempt to regulate demand in the short-term. However, this approach can, as often as not, introduce fresh disturbances, rather than assist steady expansion. For example, the time lags associated with monitoring economic developments and making fine-tuning adjustments mean that policies designed to counter an observed slow-down often had their greatest effect just as growth had resumed. Boosts to demand led to problems with inflation~~, which were tackled partly by direct controls, but partly by reining back demand,~~ thus creating the phenomenon known as "stopp-go".

4. The present Government has therefore adopted a different approach, designed to create the conditions for steady, sustainable growth. Policy is set ~~in~~ the ~~medium-term~~ framework of the Medium-Term Financial Strategy. Inflation is ~~controlled~~ by a firm monetary policy, buttressed by a tight fiscal policy. No attempt is made to regulate demand in the short-term. To facilitate healthy growth, the Government have concentrated on removing restraints on the supply side of the economy.

The recent record

5. Chart 1 shows the ~~quarterly movements in~~ [path of] real GDP since 1981. Over the six years to 1987 - that is, the ~~current upswing [need to explain why we are using six year periods - is this the reason?]~~ [period since the economy emerged from the ~~World~~ recession of 1980-81] - output rose on average at a little over 3 per cent a year. While output fell slightly in a few quarters, and sometimes rose strongly, there were no sustained periods of slack or falling output, or of output growth much stronger than trend.

[6. Table 1 shows the year-on-year growth rates during this period. Since 1983, annual growth has always been within one percentage point of 3½ per cent. [OR In four out of the six years, growth has been ~~within~~ within ¾ of a percentage point of the average.]

Table 1: Real GDP growth (average measure, factor cost)

Year	Growth
1982	1.6
1983	3.3
1984	2.4
1985	3.7
1986	3.0
1987	4.4
Average growth	3.1

]

7. This steadiness of growth ~~compares favourably with any equivalent post-War period. It is, in particular, a considerable improvement on the record of the 1970s. As a result,~~ [means] there is less need for businesses to take precautions against unexpected surges or shortfalls in growth.

8. Improved business confidence, among other things, has meant there ~~has~~ [have] been ~~no stock cycle in the latest~~ [only minor changes in stockbuilding over the current period of expansion.]

upswing. As Chart 2 shows, strong stock cycles were a prominent feature prior to the current upswing, and had a marked de-stabilising effect. But over the 1980s, positive real interest rates, often at historically high levels, improved stock control techniques, and the abolition of stock relief in 1984 have meant that stocks have stayed low relative both to output and to sales. This is both a consequence of steady growth, and a factor which makes for continued stability.

[Please show Chart 2 using annual data, rather than six month periods.]

Earlier periods

9. Latest estimates of annual GDP growth, for each year since 1949, have been used to calculate the average rate of growth for earlier post-War periods. The annual figures have been sub-divided into overlapping six-year periods, so that they can be compared with the current upswing over the six years to 1987. The potential outturn for the six years ending in 1988 has also been calculated, using the Budget forecast of 3 per cent growth this year.

10. Chart 3 [please use here the top half of the existing Chart 3] illustrates how the average rate of growth changed between successive overlapping six-year periods. The 1950s and 1960s saw a series of six-year periods with average growth of between 2½ and 3½ per

cent. During the 1970s, this average fell sharply, to between 1 and 2 per cent. More recently, the six-year average rate of growth has risen to its current figure of a little over 3 per cent. For the six years to 1988, average growth is expected to rise a little further.

11. The <u>steadiness</u> of growth for the same periods has been measured by the "variance" [see box article]. The lower the variance, the steadier the growth. Chart 4 [ie the bottom half of existing Chart 3] shows how the variance of growth changed over six-year periods since the 1950s. It proved relatively low during the 1950s and 1960s. Growth became more volatile during the 1970s, when the sharp surge in activity in 1972-73 was rapidly followed by a dip in the average rate of growth.

12. The Chart also shows how growth in the six-year period to 1987 was quite exceptionally steady by post-War standards. In fact, it was only matched in two earlier six-year periods, ending in 1970 and 1972. But these periods saw average growth of just 2½ per cent. So no six-year post-War period of 3 per cent average growth has been as steady as that ending in 1987. Furthermore, if the 3 per cent growth forecast for 1988 is achieved, the six years to 1988 will have proved steadier than any earlier post-War period, whether of faster or slower average growth.

ps4/82H

2/6/88.

UNCLASSIFIED

REVISED DRAFT EPR ARTICLE ON STEADY GROWTH

STEADINESS OF THE CURRENT ECONOMIC UPSWING

Steady, sustained economic growth has been the ambition of every government since the War. During the six year period to 1987, the UK economy achieved average real growth of a little over 3 per cent a year - the best performance for 15 years. Even more striking is the steadiness of this growth. The six years to 1987 were the steadiest six-year period of growth averaging 3 per cent since the War. This article contrasts recent growth with the record for earlier periods.

Steady growth

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

3. In previous decades, and particularly the 1970s, governments tried to achieve steady growth by "fine-tuning" the economy. The policy of demand management entailed adjusting fiscal and monetary policy in an attempt to regulate demand in the short-term. However, this approach can, as often as not, introduce fresh disturbances, rather than assist steady expansion. For example, the time lags associated with monitoring economic developments and making fine-tuning adjustments mean that policies designed to counter and observed slow-down often had their greatest effect just as growth had resumed.

4. The present Government has therefore adopted a different approach, designed to create the conditions for steady, sustainable growth. Policy is set in the medium-term framework of the Medium-Term Financial Strategy. Monetary policy, buttressed by fiscal policy, is used to control inflation. No attempt is made to regulate demand in the short-term. The Government have concentrated in liberalising the supply side of the economy, to remove impediments to growth.

The recent record

5. Chart 1 shows the quarterly movements in real GDP since 1981. Over the six years to 1987 - that is, the current upswing [need to explain why we are using six year periods - is this the reason?] - output rose on average at 3 per cent a year. While output fell slightly in a few quarters, and sometimes rose strongly, there were no sustained periods of slack or falling output, or of output growth much stronger than trend.

6. Table 1 shows the year-on-year growth rates during this period. Since 1983, growth has always been within one percentage point of $3\frac{1}{2}$ per cent.

Table 1: Real GDP growth (average measure, factor cost)

1982	1.6
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7. This steadiness of growth compares favourably with any equivalent post-War period. It is, in particular, a considerable improvement on the record of the 1970s. As a result, there is less need for businesses to take precautions against unexpected surges or shortfalls in growth.

8. Improved business confidence, among other things, has meant there has been no stock cycle in the latest upswings. As Chart 2 shows, strong stock cycles were a prominent feature prior to the current upswing, and had a marked de-stabilising effect. But over the 1980s, positive real interest rates, often at historically high levels, improved stock control techniques, and the abolition of stock relief in 1984 have meant that stocks have stayed low relative both to output and to sales. This is both a consequence of steady growth, and a factor which makes for continued stability.

[Please show Chart 2 using annual data, rather than six month periods.]

Earlier periods

9. Latest estimates of annual GDP growth, for each year since 1949, have been used to calculate the average rate of growth for earlier post-War periods. The annual figures have been sub-divided into overlapping six-year periods, so that they can be compared with the current upswing over the six years to 1987. The potential outturn for the six years ending in 1988 has also been calculated, using the Budget forecast of 3 per cent growth this year.

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11. The steadiness of growth for the same periods has been measured by the "variants" [see box article]. The lower the variants, the steadier the growth. Chart 4 [ie the bottom half of existing Chart 3] shows how the variants of growth changed over six-year periods since the 1950s. It proved relatively low during the 1950s and 1960s. Growth became more volatile during the 1970s, when the sharp surge in activity in 1972-73 was rapidly followed by

a dip in the average rate of growth. The Chart also shows how the six-year period to 1987 was quite exceptionally stable by post-War standards. In fact, it was only matched in two earlier six-year periods, ending in 1970 and 1972. But these periods saw average growth of just 2½ per cent. So no six-year post-War period of 3 per cent average growth has been as steady as that ending in 1987. Furthermore, if the 3 per cent growth forecast for 1988 is achieved, the six years to 1988 will have proved steadier than any earlier post-War period, whether of faster or slower average growth.

FROM: PFL ALLUM
DATE: 2 June 1988

MR HUDSON 13/2

CC Mr Sedgwick
Mr Hibberd
Mr Bush
Miss Edwards

EPR ARTICLE ON STEADY GROWTH

I have no problem with the general structure of your re-draft to this article. However, I have several minor points, detailed below.

Paragraph 5: I prefer 'profile of' or 'path of' or 'level of' to 'movements in' since Chart 1 shows the index level of whole economy output not changes or 'movements'.

Paragraph 5: In hindsight I think we should try to avoid the word 'upswing' since this suggests an eventual 'downswing'. The choice of six year periods is for consistency with the six-year period of growth to 1987, ie the period after the sharp 1980-81 contraction. I don't think there are any more sophisticated explanations we can offer.

I thus suggest we re-draft as –

" Chart 1 shows the path of real GDP since 1981. Over the six years to 1987 output rose ..... "

Paragraph 8 There has been a minor stock cycle in the latest six-year period: stocks picked up in 1982 and 1983 at the start of the period. I thus suggest the following, again avoiding 'upswing':

" Improved business confidence, among other things, has meant that there has been only minor changes in stockbuilding over the latest period of expansion. This contrasts, as chart 2 shows, with the marked de-stabilising effect of strong stock cycles in earlier years."

Oops. Chart 2 does use annual rather than six-monthly data.

✓ Paragraph 9 delete "the current upswing over".

Paragraph 12, first sentence redraft as "Chart 4 also shows that growth
✓ in the six-year period to 1987 was exceptionally steady ..."

Para 12, last sentence This should, for accuracy, be drafted as ".. any earlier, post-War period of six-years'
✓ duration, whether of faster or slower average growth."

[signature]

P F L AZLUM

pp.67:2

CONFIDENTIAL
until 23:00 hrs on Thursday 9 June
then UNCLASSIFIED

FROM: P L PATTERSON
DATE: 8 June 1988

1. MR PICKFORD

2. MR GIEVE

cc: Chancellor (+1 for No. 10)
Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Mr H P Evans
Mr Odling-Smee
Mr Sedgwick
Mr Hibberd
Miss O'Mara
Mr Matthews
Mr Bush
Mr Dyer
Mr Owen
Mr Savage
Mr Cropper
Mr Tyrie
Mr Call
JB/003

In many ways the forecast for the UK is favourable, with continuing growth and low inflation. But the press are likely to focus on the current account forecast and on the OECD's comments on monetary policy.

[signature] 8/6

OECD ECONOMIC OUTLOOK: JUNE 1988

The OECD's latest Economic outlook has been sent to the press, embargoed until 2300 hours on Thursday 9 June. It could conceivably be reported on late radio and TV transmissions tomorrow evening, and will appear in Friday's newspapers.

2. We have as usual had some opportunities to comment on earlier drafts and the Secretariat have taken on board many of our comments.

3. On the whole, the Outlook is to be welcomed. I attach a note on the world outlook (prepared by Mr Savage). The UK section will probably attract most press attention, and this is discussed in more detail below.

UK Economy

Factual

a) Policy assumptions

- On monetary policy, OECD point to the difficulties the UK authorities have had in finding a satisfactory monetary target. "While a target still exists for MO" the Outlook says that "the Bank of England has been more concerned with other indicators of

the evolution of demand" and "for most of the past year, put considerable emphasis on stabilising the sterling/DM rate". The UK authorities pay "particular attention to the combined effects of interest-rate and exchange-rate changes" in assessing whether nominal spending is expanding at a sustainable, non-inflationary rate. It goes on to say that "with the surge of sterling above 3 marks in the Spring of 1988, the status of the various intermediate indicators of UK monetary policy has not been conducted within a framework of binding intermediate expectations" and "hence accentuate the need for clear progress on actual price level performance to convince the public that policy is indeed on a disinflationary course." This is clearly of some concern to the OECD who, in their overall summary, remark "Predictable policies are especially important now, since markets remain jittery".

- OECD remain concerned about strong monetary expansion mainly reflecting "buoyant private sector credit demand", particularly to the personal sector. They project some edging up of interest rates over the next year "as external account trends may lead to some downward pressure on the exchange rate", but this judgement was made before the two half-point rises in base rates in June. [They make their usual technical assumption of unchanged exchange rates from those prevailing on 14 April, when £ = $1.87 and £ = DM3.12]

- OECD acknowledge the sharp move of the PSBR into surplus in 1987-88, mainly reflecting "the effects of higher-than-expected economic growth and oil prices" and "rising profitability". On the basis of FSBR figures, OECD say the general government financial deficit will fall to around ¾ per cent of GDP in both 1988 and 1989, which they interpret as implying "a broadly neutral fiscal stance in the three years to 1989".

(b) Outlook (see table below)

- The OECD's summary of the UK position is that "depending on the future course of sterling, the economy could face either a rising current account deficit or a pick-up of inflation, even though unemployment is still high".

- OECD are forecasting real GDP growth of 3½ per cent in 1988, slightly faster than the FSBR forecast. However real GDP growth is forecast to slow to 2¼ per cent in 1989, although this is higher than the 1¾ per cent growth they were expecting in their last Outlook in December 1987.

- OECD acknowledge the stronger-than expected economic performance in 1987, which "helped to make substantial inroads into unemployment" while inflation "has shown few signs of acceleration" because of "brisk productivity growth" and a strong exchange rate. They note the steep fall in the saving ratio but observe that "business investment might have been expected to grow more strongly", given high levels of profitability and capacity utilisation. They mention the possibility that part of the discrepancy between the output and the expenditure measures of GDP may be due to under-recording of fixed and inventory investment.

- However they note the "deteriorating current account position" and say that "Despite the improved supply response, the pace of demand has to decelerate if the emergence of inflationary pressures and external constraints are to be avoided". With "special factors" affecting recent export figures and mixed evidence on capacity utilisation, it is too early to judge on the "central issue" of whether the economy will slowdown autonomously or whether "fears of overheating may still prove justified".

- Domestic demand growth is forecast by rise by 5 per cent in 1988, with slower private consumption growth than in the past two years while "business investment should remain strong in the near term" according to evidence from investment intentions surveys. (Note that OECD will not have been aware of the latest DTI Investment Intentions Survey results).

- Following gains in market share in 1987, manufacturing exports are projected to grow more slowly than rapidly expanding markets, mainly because of delayed competitiveness effects from the rise in sterling. Real GDP growth is therefore expected to

decline significantly during the course of 1988. Coupled with some squeezing of profit margins, this may influence business investment plans and further reduce growth in 1989. "This could entail a slight increase in unemployment."

- "Easier labour market conditions" in the period ahead may lead to some slight downward drift in wage increases but cyclical productivity developments may give rise to a temporary acceleration in unit labour costs. OECD think, however, that this is more likely to lead to a squeeze in profit margins than any acceleration in inflation.

- With import volumes forecast to rise appreciably faster than export volumes, further deterioration in the trade balance is expected. OECD are forecasting current account deficits of £5½-6 billion in 1988 and about £7½ billion in 1989 (some 1½ per cent of GDP).

Line to take

Welcome OECD's recognition of general strength of UK economy, with strong growth in activity but few signs of any acceleration in inflation. Forecast shows further steady growth in 1988 and 1989, with continuing low inflation, sound monetary and fiscal policies, and sustainable current account deficits, still small relative to GDP - all very much in line with FSBR forecast.

Prospects for 1989 uncertain at this stage. OECD's forecasts for UK growth for following full years consistently turned out too pessimistic; forecast for 1989 already revised up since last Economic Outlook (December 1987).

Positive

1. "The United Kingdom has proved able to generate brisk domestic demand growth,and it faces no government deficit problem".

2. "Economic activity in 1987 ... grew at a rate not experienced since the 1970s. ... helped to make substantial inroads into unemployment".

3. "Inflation ... has shown few signs of acceleration".

4. "Private consumer demand is projected to expand at a slower pace than in the past two years. ... business investment should remain strong in the near term".

Defensive on specific points

1. Current account deficit deteriorating. [Reflects OECD model of economy (slower growth in output and therefore productivity results in faster unit labour cost increases, therefore loss of market share of manufactured exports and higher current account deficit)]. Current account forecasting always hazardous and subject to wide margin of error. Good supply performance, boosted by large increase in investment indicated by DTI's new Investment Intentions Survey, should allow manufacturers to take advantage of rising world trade. Even on OECD forecast, current account deficit remains small relative to GDP. Forecast for 1989 only around 1½ per cent of GDP, much smaller than deficits in mid-1970s (3-4 per cent GDP).

2. Monetary policy not conducted within clear framework: fails to give clear anti-inflationary signals to markets. Nonsense. Both Prime Minister and Chancellor have made Government's position perfectly clear on number of occasions. Markets should be in no doubt about government's firm commitment to maintaining downward pressure on inflation. OECD themselves not expecting any resurgence in inflation.

Peter Patterson

P L PATTERSON

UNITED KINGDOM

Demand, output and prices

Percentage changes from previous period, seasonally adjusted at annual rates, volume (1980 prices)

	1982 current prices billion £	1985	1986	1987	1988	1989	1987 I	1987 II	1988 I	1988 II	1989 I	1989 II
Private consumption	168.2	3.9	6.0	5.2	5	3¼	3.7	8.3	4¼	3¼	3¼	3¼
Government consumption	60.4	0	1.2	1.2	1¼	1½	–0.2	3.7	0	1½	1½	1½
Gross fixed investment	44.8	3.0	–0.3	3.5	6¾	4	–0.4	8.2	7¼	5	4	3½
Public[a]	11.4	–14.3	0.7	–9.0	–¾	0	–13.1	–2.7	0	0	0	0
Private residential	6.8	–5.2	9.6	6.7	11¼	4	–11.8	27.2	7¾	4½	4	4
Private non-residential	26.6	12.7	–2.6	7.2	8	5¼	7.0	7.6	9¼	6½	5	4¼
Final domestic demand	273.3	2.9	3.9	4.1	4½	3	2.2	7.4	4	3¼	3	3
* change in stockbuilding	–1.2[b]	0.1	0	0.1	½	0	–0.5	1.8	¼	–¼	¼	0
Total domestic demand	272.1	3.0	3.8	4.2	5	3	1.6	9.2	4¼	3	3¼	3
Exports of goods and services	73.0	5.9	3.2	5.6	2	2	2.9	7.5	–½	2	2	1¾
Imports of goods and services	68.0	2.7	6.3	7.5	7¾	4¼	–2.4	20.6	3½	4½	4½	3¾
* change in foreign balance	5.0[b]	0.9	–0.8	–0.5	–1¾	–¾	1.5	–3.5	–1¼	–¾	–¾	–¾
* compromise adjustment	0.8[b]	–0.3	0.3	0.9	¼	0	1.0	0.5	0	0	0	0
GDP at market prices[c]	277.9	3.6	3.3	4.5	3½	2¼	4.2	6.0	3	2¼	2¼	2¼
GDP implicit price deflator	–	5.9	3.7	4.4	4¾	4½	4.3	5.3	4¾	4½	4½	4¼
Memorandum items												
Consumer prices[d]	–	5.2	3.7	3.3	3¼	3¼	3.2	3.4	3	3¼	3½	3
Industrial production	–	2.9	0.4	5.5	5	2½	3.7	8.6	4½	2½	2½	2½
Unemployment rate	–	11.7	11.8	10.4	9½	9¾	10.9	9.9	9¼	9½	9½	9¾

* As a percentage of GDP in the previous period.

a) Including nationalized industries and public corporations.

b) Actual amount of stockbuilding, foreign balance and compromise adjustment.

c) Data for GDP in the past are based on a compromise estimate which is the average of the expenditure, output and income estimates of GDP. The compromise adjustment is the difference between compromise GDP and the expenditure estimate of GDP.

d) National accounts implicit private consumption deflator.

ds8

FROM: D SAVAGE
DATE: 7 June 1988

MR PICKFORD 97/2

cc: Mr Evans
Mr Matthews
Mr Dolphin
Ms Symes

OECD ECONOMIC OUTLOOK NO.43: JUNE 1988
WORLD ECONOMIC PROSPECT AND POLICIES

Line to take

a. Broadly agree with the OECD's assessment of the current position and prospect. The world economy is currently growing strongly, and expansion is likely to continue during the remainder of this year and in 1989.

b. Agree that co-operation among the major countries to achieve greater stability of exchange rates and to reduce trade imbalances must be maintained.

c. Agree that, with activity so strong and US economy close to full employment, inflation is a bigger risk than recession. Agree that for the United States the biggest priority should be to reduce the Federal budget deficit. Failing such a reduction, US monetary policy may need to be tightened in order to contain inflation and to ensure that resources are available to enable the current account to improve.

d. Agree that the solution to relatively slow growth in Continental Europe lies with more rigorous pursuit of micro reforms and not with more expansionary macro policies.

e. Agree that in Japan structural reforms can make an important contribution to re-orientating the economy away from exports and towards domestic demand.

Factual

Forecast

1. Table 1, below, compares the OECD's current forecasts with those it made in December - which were heavily influenced by the October stockmarket collapse. Table 2, attached, gives more details of the current forecast.

Table 1: Comparisons of Current and Previous OECD Forecasts

	December 1987			June 1988		
	1987	1988	1989	1987	1988	1989
Major seven countries:						
Real GNP	2¾	2½	1¾	3.1	3	2½
Real domestic demand	3	2	1½	3.4	3	2½
Consumer prices	3	3¼	3¼	2.9	3	3¼
Real world trade:						
Total	3¾	4½	3½	5.2	6¾	6
Manufactures	4¾	5¼	4	6.5	8¼	7

2. Growth in demand, output and trade in 1987 was significantly stronger than the OECD had recognised last December. Forecasts for 1988 and 1989 have been revised upwards substantially.

3. It is expected that output growth in the major countries will be as strong this year as it was in 1987. Only a modest slowing down is expected in 1989.

4. Inflation in the major countries is expected to remain constant this year (at about 3 per cent) and to pick up only slightly (mainly in the US) in 1989.

5. The average unemployment rate in the OECD is expected to decline from about 8 per cent in 1987 to 7½ per cent in 1988.

6. The current account imbalances of the three largest countries are expected gradually to decline.

7. All these forecasts are dependent upon the assumption of unchanged policies - in particular no further measures to cut the US budget deficit, and constant nominal exchange and interest rates.

Policy recommendations

- Major countries should: continue to co-operate to foster greater stability of exchange rates; such co-operation should be 'supported by sustained fiscal and structural policy actions in order to reduce imbalances and relieve the burden on monetary policies'.

- The US should: tighten macro policy - preferably by cuts in its budget deficit, otherwise by tightening monetary policy; seek to strengthen private saving.

- Japan should: pursue a flexible fiscal policy; deregulate land use; reduce agricultural protection; reform its import distribution system.

- European countries should: further reform taxes to reduce distortions and enhance incentives; reduce subsidies to industry and agriculture; seek to improve flexibility of labour markets; exploit in full the opportunities created by the movement towards completion by 1992 of a unified EC market.

DS.

D SAVAGE

TABLE 2

Summary of projections[a]

Seasonally adjusted at annual rates

	1986	1987	1988	1989	1987 II	1988 I	1988 II	1989 I	1989 II
	Percentage changes from previous period								
Real GNP									
United States	2.9	2.9	2¾	2½	4.0	2¾	2	2¾	2¾
Japan	2.4	4.2	4¼	3¾	5.9	4	3¼	4	3¾
Germany	2.5	1.7	2¼	1¾	4.3	1¾	1½	1¾	1¾
OECD Europe	2.7	2.8	2½	2	3.6	2¼	2	2	2
Total OECD	2.8	3.1	3	2½	4.2	2¾	2¼	2¾	2¾
Real total domestic demand									
United States	3.9	2.5	2	1¾	4.0	1½	¾	2	2½
Japan	4.0	5.1	5½	4¼	7.7	5¼	4	4½	4¼
Germany	3.8	2.9	2¾	2¼	4.3	2½	2	2¼	2¼
OECD Europe	4.1	3.7	3¼	2¼	4.3	3	2¼	2½	2¼
Total OECD	3.8	3.4	3	2½	4.8	2¾	2	2½	2¾
Inflation (GNP/GDP deflator)									
United States	2.6	3.0	3¼	4	3.0	3¼	3¾	4	4½
Japan	1.9	−0.2	1¾	2½	0.9	2	2¼	2½	2½
Germany	3.1	2.1	1½	1½	0.5	1¾	1¾	1½	1¼
OECD Europe	5.4	4.2	4¼	3¾	4.3	4½	4¼	3¾	3½
Total OECD	3.8	3.2	3½	3¾	3.4	3¾	3¾	3¾	3¾
	$ billion								
Current balances									
United States	−141.3	−160.7	−150	−132	−164.9	−156	−144	−134	−130
Japan	85.8	87.0	85	80	82.0	89	81	80	80
Germany	37.9	44.3	47	42	44.1	49	44	43	41
OECD Europe	51.0	37.5	24	9	35.1	33	16	12	6
Total OECD	−22.3	−53.5	−58	−64	−67.3	−52	−65	−62	−65
OPEC	−27.6	−3.9	−10	−4	3.7	−15	−4	−4	−4
Non-oil developing countries	−9.0	8.5	5	−2	15.8	6	4	0	−5
	Per cent of labour force								
Unemployment									
United States	7.0	6.2	5½	5½	5.9	5½	5½	5½	5¼
Japan	2.8	2.8	2½	2¾	2.7	2½	2½	2¾	2¾
Germany	8.0	7.9	8	8	7.9	8	8	8	8¼
OECD Europe	10.9	10.7	10¾	11	10.6	10½	10¾	10¾	11
Total OECD	8.3	7.9	7½	7½	7.7	7½	7½	7½	7½
	Percentage changes from previous period								
World trade[b]	5.0	5.2	6¾	6	11.0	5	6¼	6	5½

a) Assumptions underlying the projections include :
- no change in actual and announced policies;
- unchanged exchange rates from 14th April 1988; in particular $1 = Y 126.0, DM 1.69.
- Dollar price (OECD fob imports) for internationally traded oil of $15 per barrel for 88 I and $16 after.

b) Arithmetic average of the growth rates of the world import volume and the world export volume.

The cut-off date for other information used in the compilation of the projections was 2nd May 1988.

cc PPS
Sir T Burns
Mr Anson
Mr C D Butler
Mr Odling-Smee

H M Treasury
Parliament Street London SW1P 3AG
Switchboard 01-270 3000
Direct Dialling 01-270 4360

Sir Peter Middleton KCB
Permanent Secretary

BF to A/CSA 13/6

MANAGEMENT IN CONFIDENCE

Sir Robin Butler KCB CVO
Cabinet Office
70 Whitehall
LONDON
SW1

10 June 1988

Dear Robin

GOVERNMENT ECONOMIC STATISTICS

We spoke about the remaining points that need to be settled before the review is launched.

We are agreed that the review needs rather higher level leadership. I have looked at the various possibilities and suggest that Stephen Pickford, the Head of our Economic Briefing Division, is best placed to do the job. He will need to keep an eye on EB while the review is carried out, but will be in a position to devote the great bulk of his energies to the review over the scrutiny period.

As far as the announcement of the review is concerned, we need to take account of the recommendation of the Treasury and Civil Service Committee that:

> "The Government undertakes an investigation into the operation of the various departments involved in the collection of national accounts statistics with a view to improving their reliability".

Although we were planning the review long before this recommendation was made, I believe it would be best to announce it as part of the response to the TCSC. It would cause unnecessary offence if we were to announce the review in advance of our response to the TCSC, which is now ready to issue and must be made before 24 June. I therefore suggest that we reply to the Committee in the following terms:

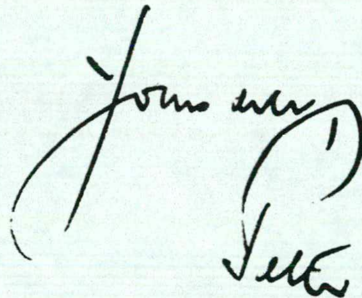
> "The Government shares the Committee's concern about the quality of national accounts statistics. It has been considering this and the related issue of minimising

the burden on those who provide statistics, and has established a review with the following terms of reference:

> "To examine the present inter-departmental arrangements for the production of Government economic statistics and to make recommendations for achieving cost-effective improvements where necessary"."

The reply could be accompanied by a press notice issued on the same day.

I hope that you and Brian Hayes, Geoffrey Holland, John Flemming and Jack Hibbert, to whom this letter is copied, will be content to proceed in this way. I know that we are all anxious to press ahead as quickly as possible.



P E MIDDLETON

35/3 ba 4431/36

FROM: D SAVAGE
DATE: 10 June 1988

MR J GIEVE

cc PPS/ Chancellor 12/2
PS/EST
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Lankester
Mr Evans
Mr Odling-Smee
Mr Peretz
Mr Matthews
Mr C Kelly

WHY ECONOMIC POLICIES CHANGE COURSE

This study by the OECD will be published on Tuesday 14 June. It is unlikely to attract much immediate press interest but could possibly be picked up by the features writers.

2. The study examines eleven separate historical episodes when, for one reason or another, an apparently unsustainable economic situation had developed. The episodes are drawn from the experiences of different OECD economies over the period 1975-85. Each chapter gives a chronological narrative of the main events leading up to the unsustainable situation and describes the way in which economic policy makers eventually responded.

3. The UK chapter is attached. It focuses on the events that led up to the 'sterling crisis' of 1976 and the conclusion of a standby agreement with the IMF. This chapter, like the rest of the study, is entirely the responsibility of the OECD. [HM Treasury saw the chapter in draft but commented only on strict matters of fact.]

4. A number of particular points emerge from the episodes.

i. Delays in remedial policy action were not usually due to inaccuracies of data or errors in forecasting (so much for the indicators!).

ii. Eventual action was often precipitated by exchange rate changes.

iii. The timing of exchange rate changes was very unpredictable in relation to economic fundamentals.

5. More generally, many of the episodes are a history of the gradual acceptance of the need for a strong commitment to low inflation; for curbing excessive growth of public spending; and for conducting fiscal policy with regard to the consequences for the growth of public debt.

6. Line to take: useful series of studies, from which can be drawn interesting and valuable conclusions, relevant to today. UK study covers difficult, controversial and unsuccessful period 1972-76: not for us to comment on. Factual material checked with HM Treasury; conclusions the responsibility of OECD.

DS.

D SAVAGE

Chapter 6

UNITED KINGDOM: THE STERLING CRISIS OF 1976

Introduction

This chapter focuses on the specific events and broader economic processes that led up to the sterling "crisis" of 1976 and subsequent changes in United Kingdom macroeconomic policy, followed by the conclusion of a standby agreement with the International Monetary Fund.

This episode must be seen in the context of policies and events which took place over a period stretching back practically to the beginning of the 1970s and which witnessed a series of shocks unprecedented in recent history -- the flare-up of commodity prices, generalised floating and the first oil shock. This new international environment sharply increased the degree of uncertainty and greatly complicated the task of policy makers. Many well-established policy rules and theoretical underpinnings seemed no longer valid. Policies had to be framed under the pressure of events and in a somewhat tentative way as the authorities were groping for new points of reference and operational guidelines. For instance, the potential dangers of floating, especially the risk of a spiral between depreciation and inflation, may not have been fully appreciated early in this episode.

The deterioration of the economic performance of the United Kingdom in the mid-1970s -- notably in terms of real growth and inflation -- was worse than the OECD average, a result apparently to be ascribed essentially to domestic conditions. At a time when a high degree of flexibility was needed to carry out the structural adjustment required by the oil shock and the related terms-of-trade losses, in the United Kingdom a lack of social consensus, periods of government with no clear majority, and belligerent trade unions -- which called a number of disruptive national strikes -- interacted to make it difficult to find the right balance for macroeconomic policy among competing objectives. In this context, and perhaps because the United Kingdom, unlike certain other OECD countries, had had no traumatic experience with hyper-inflation in its recent history, the political and social resolve to tackle inflation was slow to materialise. As discussed in more detail below, up to 1976 the basic macroeconomic approach was to use fiscal policy to try to support real demand, while the fight against inflation was left almost entirely to incomes policy. The role of monetary policy is more difficult to characterise: normally it supported fiscal policy, but occasionally the interest rate weapon was used to counter undesired exchange-rate pressure. The exchange rate may have been seen primarily as a variable affecting output and employment and, despite the inflationary risk of this approach, it was

generally allowed to depreciate to preserve competitiveness. The role of sterling as a reserve currency, however, affected the interplay between internal and external factors, first alleviating balance-of-payments discipline following the first oil shock and then, in 1976, aggravating pressure on sterling.

The episode

With an expansionary budget in 1972 and accommodating monetary policy, the United Kingdom, like other OECD countries, recorded a strong economic expansion in 1972-73. Unemployment fell to its lowest level in years (2.2 per cent) but when the first oil shock hit in late 1973 the current account was already deteriorating and inflation increasing. In November 1973, "stage 3" of the Conservative government's incomes policy brought into effect the "threshold agreements" -- with very unfortunate consequences, as these agreements turned out to act as a fast-triggering form of wage indexation in the face of a negative terms-of-trade shock. A general election returning a minority Labour government followed the calling of the miners' strike in early 1974, but threshold agreements remained in place, triggering payments up until November 1974. Another general election in October saw a small overall Labour majority, and after the expiry of threshold agreements the government relied on voluntary wage restraint to fight inflation. Thus, while the economy cooled off in 1974 and real GDP actually fell, the rate of inflation soared to 15 per cent in terms of the GDP deflator, and the current account deficit widened to nearly $8 billion or 4 per cent of GDP. Domestic financial conditions deteriorated and the stock market dropped sharply, with one index falling by some 50 per cent from January to December 1974 (which was the trough). The current account deficit was practically all financed through an increase in liabilities to foreigners, essentially the result of borrowing abroad by local authorities and state enterprises under the foreign exchange cover scheme ("compensatory financing") and a build-up of sterling balances by OPEC and other foreign monetary authorities. The pound sterling, which had been allowed to float in June 1972 and had depreciated significantly until mid-1973, remained relatively stable in 1974. The public sector borrowing requirement (PSBR) increased from 5 3/4 per cent of GDP in fiscal 1973-74 to 9 per cent in 1974-75 and there was an increase in the ratio of general government expenditure to GDP from 42 1/2 to 48 per cent.

Stagflation continued in 1975: real GDP fell for the second year in a row and unemployment rose to nearly 4 per cent. Inflation continued to accelerate (reaching over 25 per cent). Fiscal policy was little changed and left the PSBR very high but monetary policy was eased early in the year. The "corset" (a control on banks' liabilities), introduced in December 1973, was removed in February 1975, and the minimum lending rate (MLR) was reduced in several steps from 11 1/2 in January to 9 3/4 per cent in April. But then it was again progressively increased to 12 per cent in October. Threshold agreements were terminated at the end of 1974, and a new "£6 per-week" incomes policy (which although voluntary was backed up by cash limits in the public sector and sanctions on employers) was introduced in July 1975. For the year as a whole, the current-account deficit was more than halved to $3 1/2 billion, but capital inflows, including compensatory financing, were just sufficient to provide its financing and a rundown of official sterling balances resulted in a roughly equivalent decrease in gross official reserves (some $1 1/2 billion). Sterling depreciated by nearly 10 per cent from end-1974 to end-1975.

In late 1975-early 1976, economic activity picked up moderately and the inflation rate dropped somewhat (but was still well above the OECD average). The current account deficit was further reduced, in the face of quickening expansion abroad. Unemployment, however, continued to rise. The MLR was cut in several steps from 12 per cent in November 1975 to 9 per cent in early March 1976. The last cut coincided with a sudden run on sterling which was followed by intermittent waves of selling pressure. Mr. Wilson resigned as Prime Minister in mid-March, and Mr. Callaghan took over in April. The Budget in April 1976 envisaged a PSBR of well over 10 per cent of GDP in 1976-77, including cuts in income taxes conditional on agreement to a second stage incomes policy. PSBR restraint was not forthcoming until the substantial measures contained in the July package, and soon after the stage II incomes policy came into effect. Sterling depreciated by over 10 per cent in the Spring and reached a record low for the time of $1.70 in early June. A $5.3 billion credit from G-10 countries was provided on the understanding that the Government would apply to the IMF if it was not repaid in December. In fact, most of this credit remained unused. After a lull of a couple of months strong downward pressure resumed in September. MLR was raised and by the end of September the Government had applied to the IMF. MLR was further increased to 15 per cent in early October -- a record for that time -- the pound reached its trough ($1.56) before the end of the month, and the "corset" was reimposed in November. In December, the U.K. government signed a letter of intent with the IMF setting out fiscal and credit targets that formalised the shift to a significantly more restrictive macroeconomic policy (1). The situation turned round sharply in early November and the exchange rate rebounded as private funds began to move back into sterling. The authorities intervened heavily, this time to prevent an excessive appreciation of the currency. As a result, the capital account was in small surplus for 1976 as a whole. With the current account deficit reduced to less than $2 billion, a large rundown of official sterling balances ($2 billion) was financed through drawings from the IMF ($1.8 billion) and use of reserves ($1 1/2 billion). The substantial depreciation of sterling over the year (17 per cent) resulted in a significant improvement of international cost competitiveness.

Heavy upward pressure on sterling and official market intervention continued in 1977, despite a sharp reduction in interest rates (the minimum lending rate dropped from 15 to 5 per cent). To help maintain control of domestic monetary conditions, at end-October sterling was allowed to appreciate. Its appreciation over the year as a whole approached 7 per cent. The current account was practically back in equilibrium, and massive capital inflows (some $15 billion) combined with further precautionary drawings from the IMF (some $2 billion) resulted in an impressive increase in gross official reserves (nearly $17 billion). Economic growth was moderate in 1977-78 and unemployment remained above 5 per cent. Inflation decreased progressively, reflecting the stabilization of the exchange rate and moderation in wage settlements. The PSBR was reduced from 9 1/4 per cent of GDP in fiscal 1975-76 to 6 1/2 per cent in 1976-77 and 3 1/2 per cent in 1977-78 (or 4 per cent excluding the contribution of the BP share sale).

Main policy considerations

The dominant aspect of this episode was the emergence of unsustainable internal imbalances, essentially as a result of domestic policies. Until the exchange-rate crisis of 1976, priority was given to real domestic objectives,

primarily support of activity and employment. The fight against inflation was largely left to incomes policy. On the external side, exchange-rate policy was caught between two conflicting considerations. On the one hand, relative stability of the nominal exchange rate, given an inflation rate above the OECD average, would have implied an appreciation in real terms, with negative repercussions on output and employment. On the other hand, a depreciation of sterling would have aggravated the problem of inflation, particularly in view of the *de facto* wage indexation scheme in effect in 1973-74. Also, in 1975-76, considerable importance was attached to incomes policies and there were worries that they might be unhinged by exchange-rate depreciation. While all these aspects were taken into consideration in managing the exchange rate, over the longer run a depreciation of sterling was apparently seen as the lesser evil, given the overriding priority of employment as the ultimate macroeconomic objective.

Demand management policy thus remained broadly expansionary practically until early-1976, despite accelerating inflation and a large current account deficit. Monetary policy allowed a large proportion of the growing PSBR to be financed by the banking system and, despite the "corset", domestic liquidity increased rapidly. Fiscal policy between 1974-75 and 1975-76 changed little in terms of the outturn of the PSBR as a percentage of GDP, but monetary policy was further eased in 1975 and early-1976 -- a move considered by many as one of the proximate causes of the March 1976 run on sterling. This stance of policy in the early part of the episode must however be seen in the context of that time, and the widespread view, held particularly strongly in the United Kingdom, that owing to their special character "oil deficits" had to be largely accepted (i.e. financed) until structural changes and longer-term corrective measures would reabsorb them. Similarly, it was widely acknowledged that to avoid an excess of world savings and a global recession, oil-importing countries should support domestic demand as much as possible. On the domestic side, given the socio-political situation sketched above, pressure for public expenditure and defence of employment was hard to resist. Growth in the PSBR reflected not only deliberate policy actions but also a number of inflationary features and rigidities embodied in the system. Furthermore, the monetary authorities in 1974 were much concerned with the state of corporate finances, which militated against any decisive tightening of monetary policy.

These policies and institutional features largely set the stage for the run on sterling of 1976, but tensions and imbalances were greatly compounded by external factors. Some of them -- like the oil shock and the general increase in commodity prices -- were clearly outside the control of the United Kingdom authorities, but others -- like compensatory financing, the exchange rate and even the role of sterling as a reserve currency -- were, in varying degrees, the responsibility of the authorities. Foreign currency borrowing by the public sector under the exchange cover scheme seemed for a few years to offer a way around traditional balance-of-payments discipline: as the creditworthiness of the United Kingdom was excellent, this technique could assure the financing of some of the current account without a need to raise domestic interest rates. The knowledge that North Sea oil was forthcoming may possibly also have contributed to official willingness to finance the deficits. Official sterling balances seem to have been a major determinant of both the size and timing of the exchange-rate crisis. For a couple of years, the tendency of a number of OPEC countries with strong economic and political ties with the United Kingdom to invest a large proportion of their surplus oil funds virtually automatically in sterling provided a buffer for the current

account deficit, masked the vulnerability of the United Kingdom external position, and reduced the pressure to adjust.

By early 1975, the United Kingdom economic situation was apparently already perceived by the authorities as being unsustainable. Their primary concern was with internal imbalances, essentially inflation and the PSBR. They thus started a process of reshaping incomes policy and fiscal policy with a view to gradually correcting these imbalances. In addition the authorities seem to have felt by late 1975 that a significant further depreciation of sterling was desirable -- possibly necessary -- to offset more fully the unfavourable inflation differential, restore competitiveness, and boost demand and output.

What exactly precipitated the first run on sterling in March 1976 and the subsequent waves of pressure remains a question of some controversy. It can be argued that market sentiment had already begun to turn against sterling in 1975. Despite a narrowing current account deficit, private capital inflows progressively dried up and official sterling balances began to decline. (The sterling guarantee arrangements had expired at end-1974, and in October 1975 Kuwait announced that it would no longer accept sterling in payment for oil.) From this perspective, the exchange-rate shock came surprisingly late. It is also argued that the timing of the shock reflected market perceptions that the Bank of England was actively seeking to bring down the exchange rate, though there is no evidence that such actions were actually taken by the authorities. Still others assign a particular importance to decisions by certain holders of sterling balances. If stepped-up liquidation of sterling balances was not the trigger, it certainly greatly accentuated the pressure, not so much because of the amounts directly involved but because it received a lot of publicity and provided a powerful signal to private investors. Sterling soon fell below a level considered appropriate on competitiveness grounds but, due to a lack of resources, a credible defence through official intervention was hardly possible. Official reserves were at a low, and a massive loan from international markets at that stage might well have carried conditions unacceptable to the United Kingdom since they would have sanctioned a loss of creditworthiness.

During 1976, the exchange-rate crisis escalated into a general crisis of confidence affecting practically all facets of economic policy. Under the pressure of events a new policy strategy was put into place. Monetary policy and notably interest rates were assigned the most immediate task of defending the exchange rate and giving the market an unequivocal signal of the overriding priority of this objective. Inflation was to be tackled through a more stringent form of incomes policy combined with further cuts in the PSBR, scheduled over a few years. Reference to the expected growth of the money supply was explicitly made for the first time. Finally, the agreement with the IMF later that year was supposed to assure the credibility of the entire policy package through the customary IMF "seal of good housekeeping". Moreover, if exchange-rate pressure had not turned around as fast as it did, IMF drawings would have provided the resources for repaying that part of the G-10 loan that had been drawn and possibly financing further market intervention. Finally, the discipline of the IMF was probably deemed useful for the implementation of socially and politically contentious policies like those decided upon in 1976.

In terms of fiscal policy and incomes policy, the changes which took place as a result of the events of 1976, while important, were more an

accentuation of trends already underway than a break with the past. On the other hand, the tightening of monetary policy and the announcement of a monetary target, clearly represented a quantum change: along with the involvement of the IMF it was seen by the market as a watershed, and may have been the key factor responsible for the rapid regain of confidence. This in turn allowed the authorities to lower interest rates substantially within a few months. But norms for the expansion of domestic credit and monetary targets remained in force. Along with the tightening of fiscal policy and incomes policy they continued to affect the economy well after this episode.

Assessment

With hindsight, few would dispute that by early 1975 the situation was unsustainable and that it was primarily domestic unsustainability of domestic origin. The deep-seated causes of the problem, as noted, were probably a complex interplay of socio-political factors. But the more proximate cause was the policy of trying to support real demand at levels which were excessive in view of the failure of incomes policy to contain inflation. Especially after the oil shock, too much emphasis was put on preserving economic activity and the standard of living, and because of the "threshold agreements" the first-round or mechanical impact of higher oil price was compounded by large increases in nominal wages. As a number of other OECD countries adopted a more cautious approach, the United Kingdom may have been somewhat out of line with the international business cycle, with negative implications for its current account position. The nature of the fiscal stimulus was also largely inappropriate. The sizeable increase in the PSBR over the 1972-74 period stemmed too much from an increase in wages in the public sector, and too little from a reduction of social contributions for private industry -- which would have been a way to reduce costs and preserve disposable personal income despite the large terms-of-trade loss. In the event, costs increased and profits were squeezed.

The handling of the external sector was also open to question. Even allowing for the special character of the current account deficit, financing was, on balance, excessive and adjustment insufficient. First, foreign currency borrowing by the public sector started well before the oil shock and combined with the rapid build-up of official sterling balances, for a time greatly exceeded the oil-deficit component of the U.K. balance of payments. Second, since depreciation was seen primarily as a way to support output and employment, rather than as part of the adjustment process, it was not accompanied by the necessary reorientation of domestic policies. Hence, the progressive slide of sterling contributed to inflation, and little permanent improvement of competitiveness could be achieved. On both accounts, normal balance-of-payments discipline was largely avoided, which greatly increased the risk of a violent market reaction.

It is an open question whether the gradualist approach to adjustment already being implemented by the government by early 1976 could have succeeded if only the exchange rate had been handled more skilfully; or whether, alternatively, a more aggressive tightening of policy was necessary in any case. A more general question raised by this experience is whether in a regime of floating a country can engineer a depreciation of its currency without the process getting out of hand, especially when, like the United Kingdom in 1976, the country in question runs a reserve currency. The precise timing of the March run on sterling may well have been determined by specific

factors or policy actions, but the apparent causality should not be over-emphasized. Financial markets are notoriously prone to discontinuities; that is, they often tend to treat emerging imbalances generously for a time, but then react suddenly and violently. In a way, the first stage of the currency crisis in early 1976 was only the tip of the iceberg. It probably got out of hand and snowballed into a full-fledged confidence crisis mainly because of fears of an uncontrollable spiral between depreciation and inflation. This forced the authorities to implement, and the unions and the country at large to accept, a policy package that entailed a major shift of priorities from defence of employment to the stabilization of the exchange rate and the reduction of inflation. At that stage there was, fundamentally, no longer any conflict between internal and external objectives, even though the need to "play it safe" and rapidly restore external confidence probably obliged the authorities to adopt a stronger and faster adjustment that they would have chosen on purely domestic grounds.

In conclusion, conditions were allowed to deteriorate for so long and become unsustainable either because the inflationary consequences of expanding nominal demand were not appreciated -- perhaps because of an undue faith in incomes policy -- or because it was felt that given the socio-political situation it was impossible to really cure inflation by deflating demand. It may be true that the necessary measures could not be taken until conditions deteriorated to a crisis point and the need for remedial action, on the internal as well as on the external side, became evident. On a more technical level, there seems to have been an inadequately integrated view during this period of all the facets of the problem -- including the exchange rate and supply side considerations -- and insufficient co-ordination between monetary policy and fiscal policy. The introduction of targets for broad money in 1976 was, at least in part, directed to achieving some control on the PSBR and assure the necessary co-ordination between fiscal policy and monetary policy. In terms of indicators and forewarnings, the gravity of domestic imbalances was clearly portrayed by cost-price data well before 1976; and, due to their forward looking nature, an even earlier indication of possible future problems was provided by the near-collapse of stock prices in 1974. On the other hand, because of the role of sterling as a reserve currency, the special nature of "oil deficits" and prospects for North Sea oil, the assessment of the external position and its sustainability was less unambiguous. But the market eventually developed a strongly negative view, perhaps because it weighted actual conditions -- notably inflation -- more than uncertain longer-term trends and prospects.

NOTE

1. In fact, the letter of intent merely reinforced the change in policy that the government had already announced. This included: a cut in PSBR; a strengthening of incomes policy (second stage); and a non-accommodating monetary policy (framed for the first time in terms of an official guideline for money supply growth).

SECRET

COPY NO. 1

FROM: P N SEDGWICK
DATE: JUNE 22 1988

CHANCELLOR

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

TREASURY ECONOMIC FORECAST

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

2. The other detailed reports on this exercise are

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

P.N.S

P N SEDGWICK

psf.sp/fst/june88/m

SECRET

COPY NO. 1

FROM: COLIN MOWL
DATE: 24 June 1988

CHANCELLOR

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

TREASURY ECONOMIC FORECAST: PUBLIC FINANCES

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

Colin Mowl

COLIN MOWL

SECRET

TREASURY ECONOMIC FORECAST

PUBLIC FINANCES

SUMMER 1988

CONTENTS

Page

I. Public expenditure

- central government pay 1
- defence 2
- health 3
- social security expenditure 4
- the national insurance fund 5
- net EC contributions 6
- other central government expenditure 6
- local authorities 7
- nationalised industries and the PCBR 10
- debt interest 12

II. General Government Receipts

- income tax 15
- non-North Sea corporation tax 17
- VAT 18
- specific duties 20
- North Sea revenues 20
- Stamp duties and capital taxes 21
- national insurance contributions and other receipts 22

TREASURY ECONOMIC FORECAST: PUBLIC SECTOR FINANCES

I. PUBLIC EXPENDITURE

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

<u>Central Government Pay</u>

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

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

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

TABLE I: CENTRAL GOVERNMENT AVERAGE EARNINGS GROWTH - %

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

* Includes MOD civilians
** Excludes GPs and dentists

Defence

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

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

TABLE II: DEFENCE EXPENDITURE

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

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

Health

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

TABLE III: HEALTH EXPENDITURE

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

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

Social Security Expenditure

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

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

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

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

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

Underlying growth in social security expenditure - %

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

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

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

£ billion

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

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

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

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

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

The National Insurance Fund

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

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

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

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

Net EC Contributions

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

TABLE VII: NET EC CONTRIBUTIONS (£bn)

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

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

Other Central Government Expenditure

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

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

TABLE VIII: 'OTHER' CG EXPENDITURE

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

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

Local Authorities

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

TABLE IX: LA EMPLOYMENT AND PAY

% increases

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

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

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

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

TABLE X: LOCAL AUTHORITY CURRENT ACCOUNT EXPENDITURE AND RECEIPTS

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

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

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

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

LABR - £ billion

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

Nationalised Industries and the PCBR

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

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

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

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

TABLE XI: NATIONALISED INDUSTRY TRADING PERFORMANCE AND INVESTMENT*

% increases

	1985-86	1986-87	1987-88	1988-89	1989-90	1990-91
Output	2¾	2	2½	2½	2¼	1¾
Employment	- 7¼	- 5½	- 4½	- 2¾	- 2	- 2
Productivity	10¾	8	7½	5½	4¼	4
Real Prices	- 1	- 1¼	- 2	¾	- ¾	- ¾
Profits**	28½	7	15¼	22½	10¾	5¾
Investment Volume	- 5½	- 1½	- 1½	14½	5¾	3¾

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

** gross of depreciation

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

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

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

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

<u>Debt Interest</u>

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

TABLE XIII: GENERAL GOVERNMENT GROSS DEBT INTEREST PAYMENTS

£ billion

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

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

TABLE XIV: GENERAL GOVERNMENT NET DEBT INTEREST PAYMENTS

£ billion

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

II GENERAL GOVERNMENT RECEIPTS

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

TABLE XV: GENERAL GOVERNMENT RECEIPTS - % changes

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

* including gross trading surpluses of general government bodies.

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

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

Income Tax

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

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

TABLE XVI: EFFECTIVE RATES OF INCOME TAX

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

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

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

TABLE XVII: 1988 BUDGET EFFECTS ON INCOME TAX

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

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

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

Corporation Tax

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

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

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

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

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

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

VAT

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

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

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

TABLE XIX: VAT RECEIPTS FORECAST

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

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

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

Specific Duties

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

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

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

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

North Sea Revenues

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

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

TABLE XXI: GOVERNMENT REVENUES FROM THE NORTH SEA

£ billion

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

Stamp Duties and Capital Taxes

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

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

TABLE XXII: STAMP DUTY AND CAPITAL TAXES

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

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

National Insurance Contributions and Non-Tax Receipts

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

TABLE XXIII: EFFECTIVE RATES FOR NICS (%)

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

TABLE XXIV: NON-TAX RECEIPTS

£ billion

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

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

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

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

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

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

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

NH3/17AL

SECRET

MINUTES OF A MEETING IN NO 11 DOWNING STREET
AT 5 PM ON MONDAY 27 JUNE

Present: Chancellor
Sir P Middleton
Sir T Burns

JUNE FORECAST

Sir T Burns said that he believed output growth had probably slowed down recently: it had been over 5 per cent in the second half of 1987 but now was probably about 3-4 per cent. The curiosity was the strength of domestic demand. The investment boom was reasonably well founded and was what might be expected at this stage in the cycle, with capacity utilisation and profits both high. The growth in consumer spending (and the fall in the savings ratio) was much more puzzling and much more worrying. The rise in interest rates would probably not have much of an effect until 1989, although if it pricked the house price bubble it could have an earlier effect.

2. On the balance of payments, there were clear measurement problems. But there had undoubtedly been a deterioration. We were probably seeing some effect of competitive pressures, and this was supported by the sluggish growth in export and import prices. And there were probably capacity problems in some sectors. It seemed that there had been a bit of a hiccup in supply performance in the car industry and perhaps also in the investment goods industry. But the fundamental reason for the change in the current account was the strength of domestic demand: it was most unusual to be in a position where domestic demand was growing so fast and the exchange rate was appreciating.

3. On inflation, the RPI excluding mortgage interest payments was now ½ per cent above the Budget profile. It was a bit suspicious that every component was coming out higher, but the various changes seemed reasonably well founded: the increase in nationalised industry prices, for example, reflected more up-to-date information on charges for electricity, water and postal services. Wages had been reasonably well behaved given the sharp fall in unemployment. Inflation was always likely to rise at this stage of the cycle, and would be reinforced by a rise in mortgage rates. In some ways we were facing a pattern rather similar to 1985. The Chancellor commented that it would be worth bringing this out, to stop people drawing parallels with 1973.

4. Sir T Burns said we had thought for a long time that monetary conditions were too easy. We had not been able to tighten before, but now had the opportunity. In some ways the danger was moving from feast to famine: we had been seeing a bubble of personal expenditure, financed from overseas. It was clear that the private sector could be pretty volatile, especially while people were learning to deal with credit being demand-determined rather than supply-determined.

5. On other policy implications, he thought that even with hindsight it was difficult to put much blame on fiscal policy. It was possible we had held on to 3DM cap for too long, especially given the surge in commodity prices.

6. The Chancellor thought that the long period of exchange rate stability had helped to increase expectations of future stability. Sir T Burns noted that there was clearly a danger that people would start to say that the exchange rate should come down because of the current account position. But it was perfectly clear that an exchange rate depreciation was definitely not the answer.

7. Sir P Middleton said that he had no doubt that monetary conditions were too lax and there was a risk of inflation. So the correct response should be to raise interest rates. It would be helpful if the exchange rate were a bit lower, but he would not want to see the rate fall as far as 3DM: there had clearly been a case for a realignment. With a tightening of monetary policy he would hope that MO could be brought within its target range.

A C S ALLAN

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THE GOVERNOR'S PRIVATE SECRETARY HO-P
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GROUP 11, ID HO-2
GROUP 12, BSD HO-3
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US FINANCIAL DEVELOPMENTS

Attached is the latest weekly summary of developments in monetary policy and the financial markets.

International Division
Group 1, HO-3
28 June 1988

R T Thorne (4385)

TREASURY AUCTIONS

Monday	27 June	Auction of $12.8 bn of three- and six-month bills, raising $175 mn of new cash.
Thursday	30 June	One-year Treasury bill auction

ECONOMIC INDICATORS

Wednesday	29 June	Leading indicators; May
Thursday	30 June	Factory orders; May
Friday	1 July	Construction spending; May
Friday	8 July	Employment and unemployment; June Consumer credit; May
Thursday	14 July	Retail sales; June
Friday	15 July	Merchandise trade; May Business inventories; May Industrial production; June Producer price index; June

OTHER DATES

Wednesday-Thursday	29-30 June	FOMC meeting
Friday	1 July	May FOMC minutes released
Monday	4 July	Public holiday; Independence Day
Wednesday	13 July	Greenspan's Humphrey-Hawkins testimony to the Senate Banking Committee

SUMMARY: 20-26 JUNE

- The market remains undecided about whether the Fed has slightly tightened policy over the last fortnight by raising its Fed funds rate target from 7 3/8% to 7 1/2%. Although the Fed funds rate has been in the 7 1/2%-9/16% band over the last week or so, some analysts ascribe this to technical factors. They expect the FOMC to leave policy unchanged at its meeting this week, although authorising a further tightening if there are any extra indicators of inflationary pressures in future weeks.

- The dollar's sharp rise last week caused a fall of 15-20 bp in long rates, while short rates rose a little. The dollar's rise was apparently precipitated by large dollar purchases by Japanese institutions.

- The Administration revised up its year-on-year GNP growth forecast for 1988 from 2.9% to 3.5%, but left its inflation unchanged at 4.3%. It also revised up its interest rate forecast by half a percentage point.

- The US authorities indicated that they believed there was room for the dollar to rise at present while still remaining stable in the long term, and also that they were not troubled by the Bundesbank's raising of its securities repo rate.

- The FRBNY added Dillon Read, S G Warburg and Wertheim Schroder to its list of primary dealers in government securities, but omitted Yamaichi, thus adding further evidence that it is delaying Japanese applications because of reciprocity considerations. Also last week, First Interstate voluntarily withdrew from the list of primary dealers.

POLICY

(a) Fed domestic policy

1 The market remained undecided last week about whether the Fed has slightly tightened policy over the last fortnight. Some continued to feel that it had nudged up its Fed funds rate target form 7 3/8% to 7 1/2%, although others thought that the rise in the rate was largely due to technical factors. Whatever the case, the Fed has not gone out of its way to clear up the market uncertainty over its stance, although Fed officials did say that they have not made any significant policy changes lately.

2 The Fed's other policy moves so far this year have all been a good deal less ambiguous, which tends to support the view that, at most, the Fed has acquiesced in a rise in market rates brought on by technical factors. The FOMC meets on Wednesday and Thursday this week, and the most popular forecast is that it will leave policy unchanged for the moment but will authorise further tightening if there are any extra indications of inflationary pressures in future weeks.

(b) Administration economic forecast

3 The Administration revised its economic forecast for 1988 which it had made last February. Although it revised up its year-on-year GNP growth figure from 2.9% to 3.5% following the stronger than expected activity so far this year, it left its CPI inflation forecast unchanged at 4.3%. This is in line with earlier comments by members of the Administration that they have seen no signs of a significant increase in inflation, despite the likelihood of a temporary rise in prices because of the drought. The administration raised its interest rate forecast for the year by half a percentage point (short rates have risen by about three quarters of a point so far this year) although it expected rates to soften later this year, as economic growth slowed down.

(c) The G7 agreement and policy co-ordination

4 For the US authorities, as for most observers, the outcome of last week's Toronto summit was much as expected, with the US proposals to set up commodity-price indicators and to extend policy co-ordination to include structural reforms accepted. On the dollar, G7 also reproduced the exact form of words used in its December communique, namely "that either excessive fluctuation of exchange rates, a further decline of the dollar, or a rise in the dollar to an extent that it becomes destabilising to the adjustment process, could be counterproductive by damaging growth prospects in the world economy". The fact that the wording was unchanged was interpreted by some analysts as a sign that the G7 authorities were not very concerned about the dollar's recent strength, since they had not taken the opportunity to toughen the wording relating to a possible rise in the dollar. Meanwhile, US officials (among others) indicated that they believed that there was room for the dollar to rise while still maintaining a long-term pattern of stability.

5 The US authorities also indicated that they were not troubled by the Bundesbank's raising of its securities repo rate last week. Treasury Secretary James Baker commented that the Bundesbank move was a technical reaction to changes in market rates, and was consistent with its G7 obligations. He further commented that the Bundesbank was striking a proper balance between preserving growth and remaining vigilant against inflation. Other US officials noted the widening of US-West German rate differentials following the US tightening of policy three times in recent months.

(d) Official reserves

6 US official reserves fell $781 mn in May to $41,949 mn following a $456 mn fall in April. Foreign currency reserves fell $363 mn to $10.91 bn (presumably largely because of currency changes), while holdings of SDRs fell $46 mn to $9.54 bn, the US IMF reserve position fell $372 mn to $10.43 bn and its holdings of gold remained unchanged at $11.06 bn.

(e) Primary dealerships

7 The FRBNY added three extra firms to its list of primary dealers in US government securities: Dillon, Read & Co, S G Warburg Securities and Wertheim Schroder & Co, (which is 50%-owned by Schroders plc). Thus the additions include one and a half UK dealerships. Kleinwort Benson, Lloyds and Midland Montagu already have dealerships. Yamaichi Securities were notable for their absence from the announced additions. Yamaichi have been reporting daily trading activity to the Fed for almost a year, which is about the same length of time as Dillon Read and Wertheim Schroder and about three months longer that S G Warburg, and were said to be disappointed by their omission. They hope to become a dealer at a later date.

8 Market comment attributed Yamaichi's failure to gain the dealership to continued US sensitivity over Japan's slowness in opening up its own government bond market to US firms. In particular, some believe that the Fed does not want to antagonise Congress, which may still pass a measure imposing reciprocity requirements on foreign firms applying for dealerships. Although the trade bill which contained that measure failed to override the President's veto, the measure is still part of the new trade bill which is being considered. Under the measure, Fed approval of Yamaichi's application would have to be withdrawn. The Fed's own public statement on its approach to applications is highly ambiguous, since it says, "We are committed to a policy of national treatment, and that commitment is conditioned on a steady flow of complementary policy actions in key markets abroad."

9 Also last week, First Interstate Capital Markets Inc voluntarily withdrew from the list of US primary dealers. This previously announced move followed from the purchase of the government securities subsidiary by Printon Kane Government Securities which is scheduled to be completed this week. Meanwhile, following its acquisition by Sanwa Bank, Brophy, Gestal, Knight & Co changed its name to Sanwa BGK Securities. The week's changes to the dealers' list means that there are now 44 primary dealers.

(f) Other Congressional issues

10 Congress did not take the opportunity to include in the technical corrections to the 1986 Tax Reform bill two measures on which there has been speculation recently. Firstly, the House Ways and Means Committee dropped its proposal to impose a 5% withholding tax on interest payments to foreign holders of newly-issued US bonds. This followed US Treasury opposition to the proposal. Secondly, these was no proposal to increase the Treasury's authority to issue long-term bonds. Since $268 bn of the current $270 bn authority has already been used, the 30-year auction as part of the August refunding will have to be cancelled unless the authority is raised. Possibly reflecting this news, the differential between 30-year and 10-year bond yields closed from 9bp to 1bp last week.

MONEY

11 M1, M2 and M3 all fell in the week ending 13 May, after each rising briskly in the week before. M2 and M3 remain toward the upper end of their 4-8% target ranges for 1988. Chairman of the Council of Economic Advisers Beryl Sprinkel declared himself very satisfied with the Fed's control of monetary growth, which he said was being held between the midpoint and the upper end of the target ranges.

RESERVES

12 The Fed's activities in the reserves markets over the last week have failed to settle analysts' disagreement over whether it has slightly tightened over the last couple of weeks. Those who argue that the Fed has edged up its Fed funds rate target from 7 3/8% to 7 1/2% pointed to the 7.54% average Fed funds rate target over the week ending 22 June, and in particular its failure to provide reserves on the last day of the week. Others, however, noted that technical factors have caused Treasury balances at the Fed to rise, thus draining reserves from the system, and that this is the reason why the Fed funds rate has risen, rather than any Fed action. The Fed also made one substantial overestimate of reserves availability on Thursday of that week, thus contributing to the reserves shortage.

13 The Fed has added reserves on most days over the last two weeks, mostly through customer repos, which has prompted some to suggest that by not adding reserves more aggressively through system repos the Fed has shown its willingness to accept a higher Fed funds rate. Last Thursday, though, the Fed did conduct 4-day system repos. Over the last fortnight its market interventions have mostly been with funds in the 7 1/2% -9/16% range, thus perhaps indicating that this is the top of its target band.

MARKET DEVELOPMENTS (20-24 June)

14 The dollar's sharp rise last week, from DM 1.75 to DM 1.82 and Y126 to Y131, caused a fall of 15-20 bp in long bond rates, while short rates, if anything, rose a little, thus causing a flattening of the yield curve. The dollar's rise was apparently precipitated by large dollar purchases by Japanese institutions, as continued optimism on the dollar's future prospects following the April US trade figure combined with the high yield differential in favour of the US currency (despite rises in West German and UK short rates) to generate foreign demand. The jump in the dollar was sustained by the relative absence of central bank intervention to cap its rise, contributing to a perception that the G7 was content with the currency's recent strength.

15 Other factors supporting bond prices last week were the smaller than expected 0.3% rise in May's CPI and a 2.2% drop in durable goods orders. There are suggestions, though, that domestic investors are more bearish about the bond market than foreign investors are. Some concern that the Fed might have tightened slightly seemed to cause the rise in bill rates.

0341c

US: MONEY AND BANKING STATISTICS

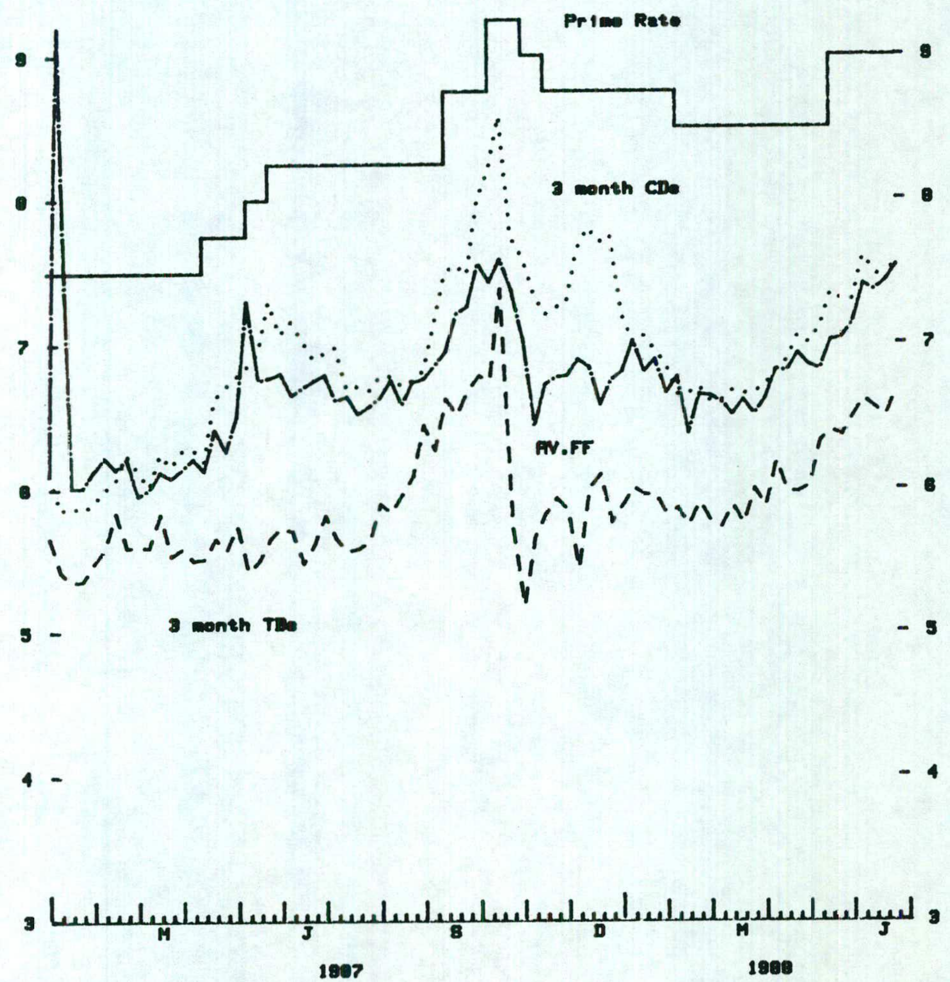
1 MONETARY AGGREGATES	Level ($ bn)	Change in level ($ bn) Latest week/ month	Previous week/month	% change (ar) Latest 4 weekly average over: Previous 4 weeks	weeks ended 13 weeks ago	target base	target range (1988) % growth	$ bn
M1 (13. 6.88)	771.8	- 2.1	+ 2.8	-2.5	+ 7.1	+ 4.5		
M2 (13. 6.88)	3,012.9	- 4.8	+ 7.1	+5.8	+ 7.9	+ 7.3	4-8	3013.3-3129.2
M3 (13. 6.88)	3,793.9	- 1.8	+10.5	+6.5	+ 6.8	+ 6.9	4-8	3799.4-3945.6
Credit Aggregate (Mar)	8,523.1	+70.4	+75.6	+10.5	+10.2	+10.2	7-11	8830.4-9160.5

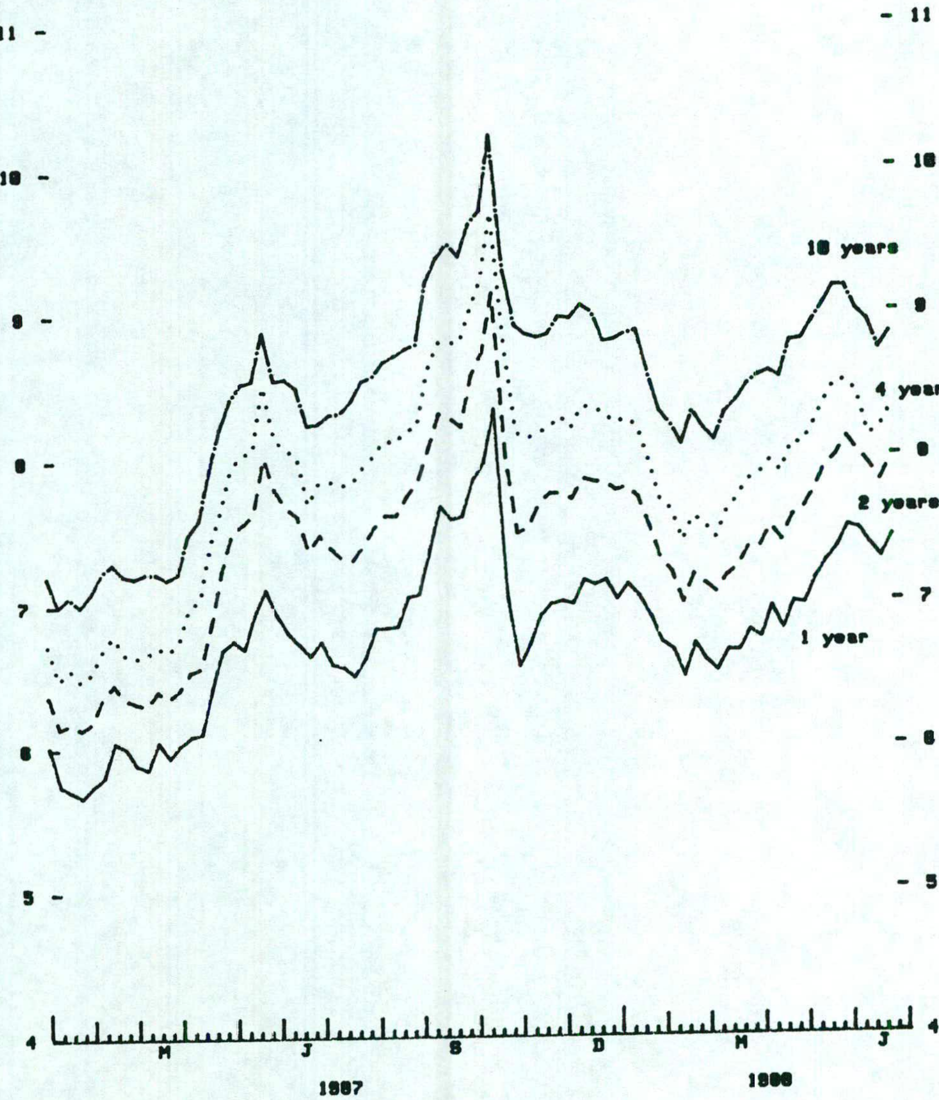
2 FINANCIAL STATISTICS	Level ($ bn)	Change in level ($ bn) Latest week	Previous week	% Change (ar) Latest 4 weekly average over: Previous 4 weeks	4 weeks ended 13 weeks ago
Business loans# (15. 6.88)	300.6	+0.7	+0.6	- 1.9	+11.3
Commercial Paper (15. 6.88)	413.5	-0.5	-0.5	+12.7	+25.9
Money Market Mutual Funds (22. 6.88)	266.3	+0.9	-1.9	-25.7	-16.5

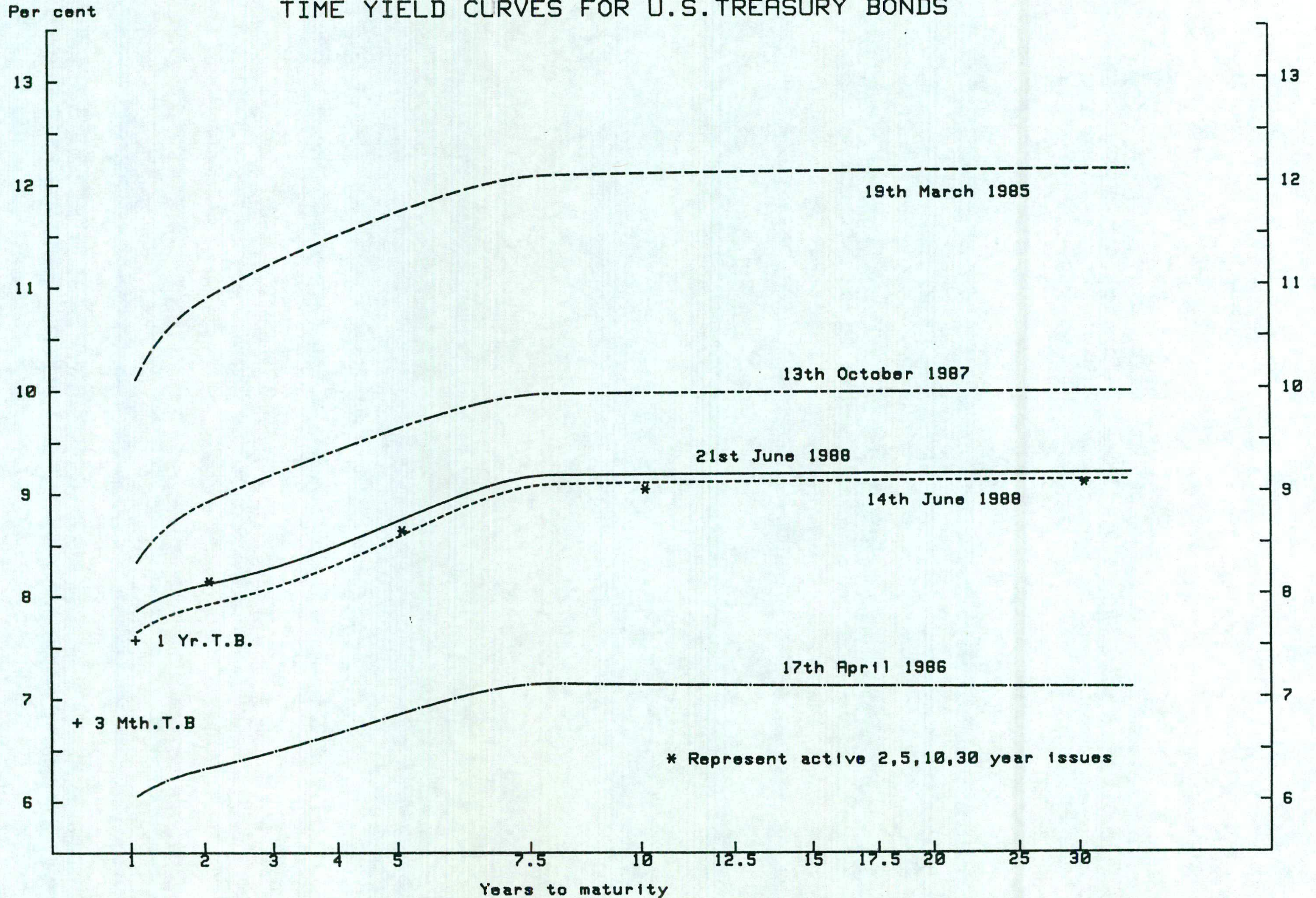
3 RESERVES	TWO WEEK PERIOD TO 15 JUNE Level ($ mn)	Change in level ($ mn) Latest accounting period	LATEST WEEK TO 22 JUNE Level ($ mn)	Changes in Level Latest Week
Discount window borrowing	3,465	+ 345	3,034	- 617
of which adjustment and seasonal borrowing	479	- 103	498	- 64
extended credit	2,986	+ 448	2,536	- 553
Net free (borrowed) reserves	218	- 354		

Target bases (1987 Q4 averages)
M2 2897.4
M3 3653.3
Credit aggregate 8252.7

Major commercial banks

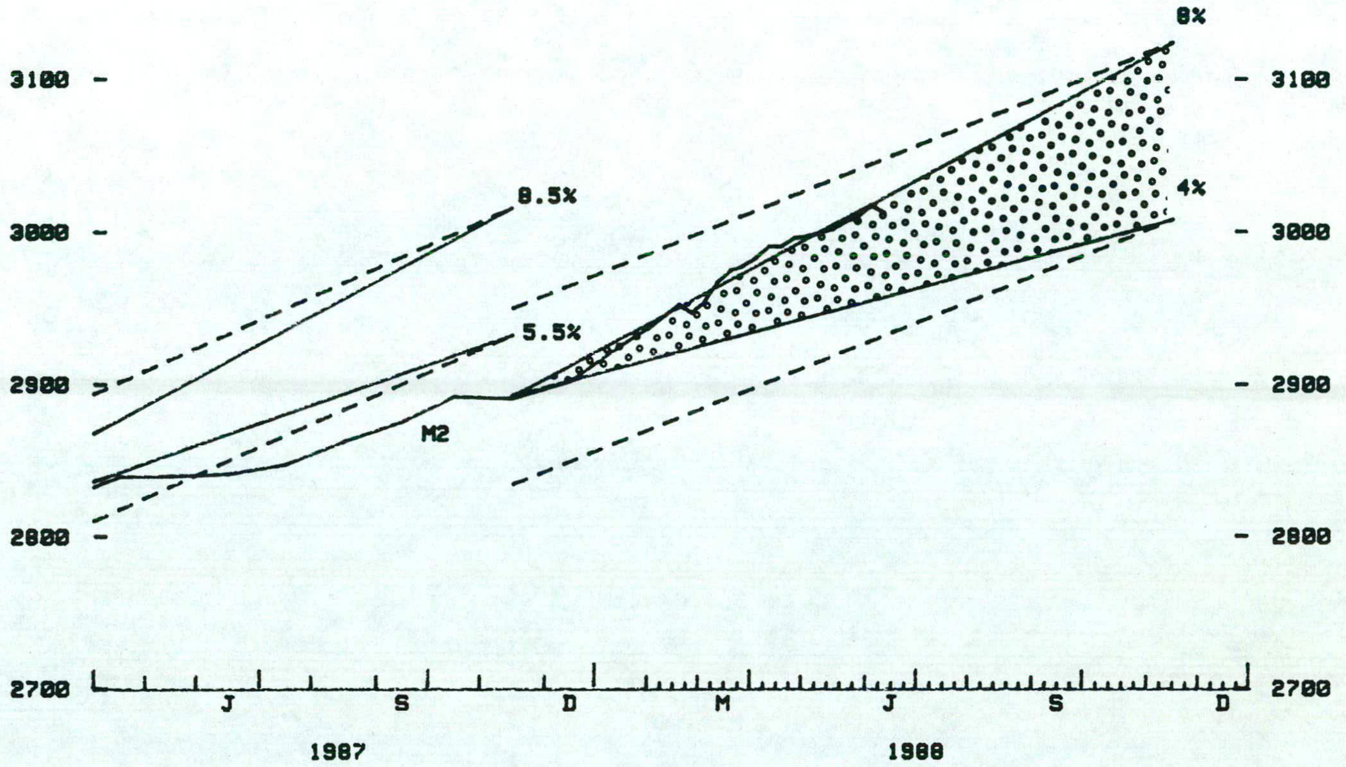

US MONEY MARKET RATES *
Chart 1
Per cent per annum
11
10
9
8
7
6
5
4
3
Prime Rate
3 month CDs
AV.FF
3 month TBs
M
J
S
D
M
J
1987
1988
* Wednesday Close Except AV.FF


US TREASURY NOTE/BOND YIELDS *
Per cent per annum
12
11
10
9
8
7
6
5
4
10 years
4 years
2 years
1 year
M
J
S
D
M
J
1987
1988
* Wednesday Close


TIME YIELD CURVES FOR U.S.TREASURY BONDS
Per cent
13
12
11
10
9
8
7
6
1
2
3
4
5
7.5
10
12.5
15
17.5
20
25
30
Years to maturity
19th March 1985
13th October 1987
21st June 1988
14th June 1988
17th April 1986
+ 1 Yr.T.B.
+ 3 Mth.T.B
* Represent active 2,5,10,30 year issues

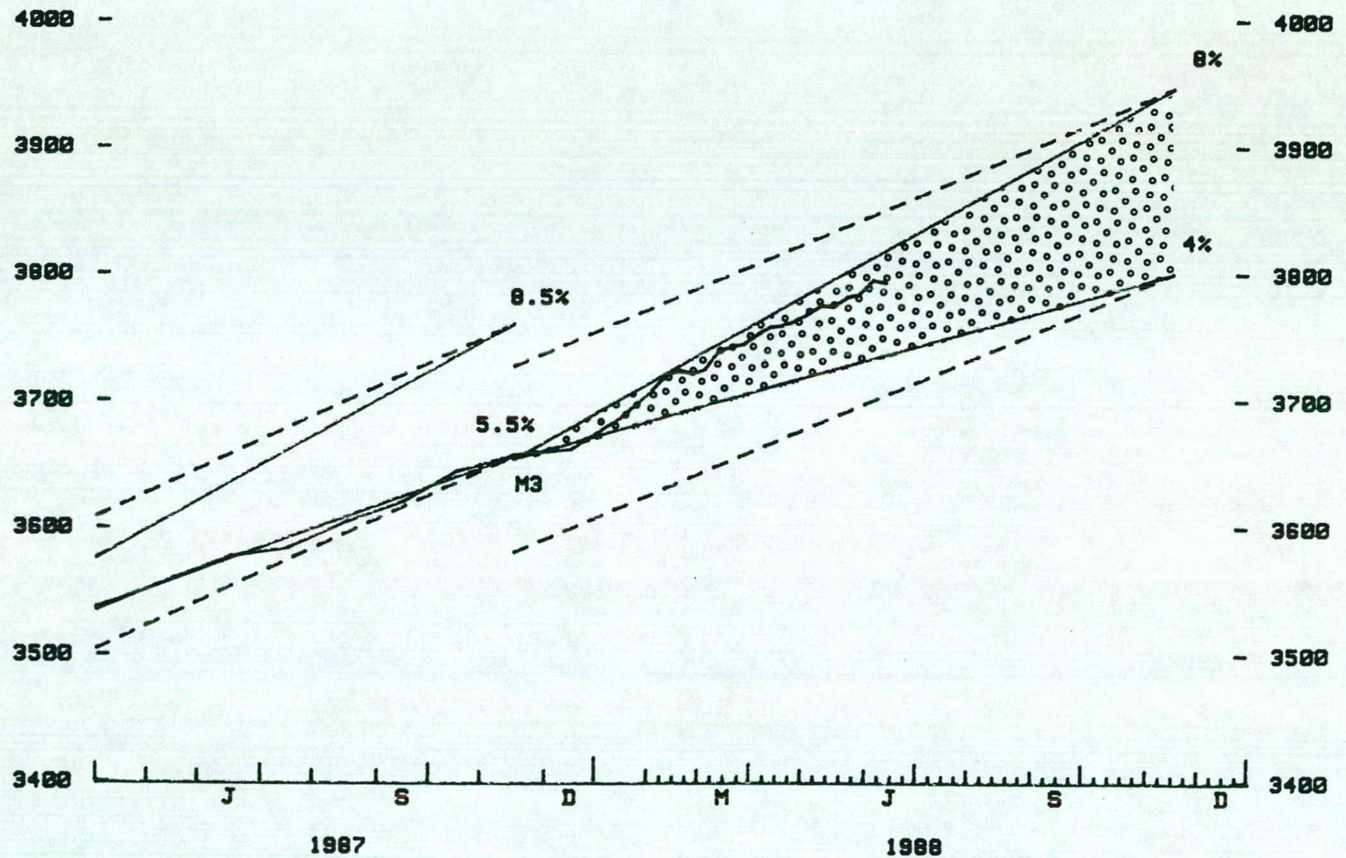
MONEY SUPPLY (M2)

Chart 3



MONEY SUPPLY (M3)

Chart 4



MONEY SUPPLY (M1)

CHART 5