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PART D

Part .D.

SECRET

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Begins : 1/5/88.
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PO CH /NL/ 0480.
PT. D.

Chancellor's (Lawson) Papers:
The Governments Monetary Policy -

~~beg~~ DD's: 25 Years

21/2/96.

PO CH /NL/ 0480. PT. A.

CONFIDENTIAL

070362
MDHIAN 1547

Passed on to Miss O'Mara.

Some good pts, & some rather Byzantine points (eg para 7).

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MIPT AND MY TELS NOS 426 AND 427 : EUROPEAN MONETARY COOPERATION

SUMMARY
1. BUNDESBANK PRESIDENT POHL ELABORATED HIS VIEWS ON EUROPEAN MONETARY COOPERATION IN A MAJOR NEWSPAPER ARTICLE PUBLISHED ON 28 MAY. ARTICLE HIGHLIGHTS THE MANY DIFFICULTIES INOVLVED IN CREATING A EUROPEAN CENTRAL BANK.

DETAIL
2. IN A LONG ARTICLE IN FRANKFURTER ALLGEMEINE ZEITUNG, PUBLISHED ON 28 MAY, THE BUNDESBANK PRESIDENT AMPLIFIED HIS VIEWS ON MONETARY COOPERATION OUTLINED AT HIS PRESS CONFERENCE ON 5 MAY (MY TELS NOS 426 AND 427).

3. POHL OBSERVED THAT THE EC WAS ENTERING A NEW PHASE WITH THE APPROACH OF 1992. LIBERALISATION OF CAPITAL MOVEMENTS AND FULL CONVERTIBILITY OF CURRENCIES WERE ESSENTIAL COMPONENTS OF THE SINGLE MARKET AND ALSO THE BASIS OF EUROPEAN MONETARY UNION. AS THE 1970 WERNER REPORT HAD MADE CLEAR, FIXED EXCHANGE RATES WERE ANOTHER PRECONDITION OF MONETARY UNION. IT WOULD BE A SMALL STEP FROM MONETARY UNION TO THE CREATION OF A COMMON CURRENCY. BUT ALL THIS WAS STILL A LONG WAY OFF. THE DIFFICULT POLITICAL DECISIONS INVOLVED IN MOVING TOWARDS FULL EMU COULD NOT BE SIDESTEPPED BY CREATING A PARALLEL CURRENCY, AS THE HISTORY OF THE ECU HAD SHOWN. A PARALLEL CURRENCY COULD ONLY REPLACE NATIONAL CURRENCIES WHEN IT COULD COMPETE WITH THE STRONGEST EC CURRENCY.

4. A EUROPEAN CENTRAL BANK WAS NOT ESSENTIAL TO MONETARY UNION. EUROPEAN CENTRAL BANKS COULD COOPERATE SUCCESSFULLY IF A SUBSTANTIAL DEGREE OF ECONOMIUC CONVERGENCE COULD BE ACHIEVED. BUT A MINIMAL INSTITUTIONAL FRAMEWORK WOULD BE A USEFUL UNDERPINNING. ANY STEP TOWARDS INSTITUTIONALISING MONETARY COOPERATION WITH THE AIM OF CREATING A EUROPEAN CENTRAL BANK POSED A NUMBER OF FUNDAMENTAL

QUESTIONS WHICH HAD TO BE ADDRESSED RIGHT AT THE BEGINNING. FOR EXAMPLE:

A) WHAT SHOULD BE THE OBJECTIVES OF A EUROPEAN CENTRAL BANK? IN POHL'S VIEW ITS PRIMARY OBJECTIVE, AS IN THE CASE OF THE BUNDESBANK, SHOULD BE TO PROTECT THE CURRENCY BY ENSURING PRICE STABILITY. WITH THEIR MEMORIES OF TWO DISASTROUS INFLATIONS, MOST GERMANS COULD ACCEPT THE CONCEPT OF A EUROPEAN CENTRAL BANK ONLY IF THE PRE-EMINENCE OF THIS OBJECTIVE WAS GUARANTEED. THE BANK COULD NOT BE DIVERTED FROM ITS PRIMARY TASK BY OTHER OBJECTIVES RELATED TO EXCHANGE RATE STABILITY, REGIONAL POLICY, EMPLOYMENT CREATION ETC., WHICH MIGHT CONFLICT WITH THIS FUNDAMENTAL OBJECTIVE.

B) HOW COULD ITS INDEPENDENCE BE GUARANTEED? THE TASK OF PROTECTING THE CURRENCY WOULD ONLY BE POSSIBLE IF A EUROPEAN CENTRAL BANK ENJOYED COMPLETE INDEPENDENCE IN DECISION-TAKING NOT ONLY FROM NATIONAL GOVERNMENTS BUT ALSO FROM EC INSTITUTIONS. IN SOME MEMBER STATES THIS WOULD REQUIRE FAR-REACHING CHANGES IN THE CONSTITUTION OF THEIR CENTRAL BANKS. CHANGES WOULD ALSO BE REQUIRED IN THE FRG WITH ITS QUASI TWO-TIER SYSTEM OF REGIONAL CENTRAL BANKS IN EACH OF THE TEN LAENDER AND WEST BERLIN AND A CENTRAL DIRECTORATE IN FRANKFURT.

C) HOW SHOULD IT BE ORGANISED? IN POHL'S VIEW, A EUROPEAN CENTRAL BANK SHOULD BE ORGANISED ON FEDERAL LINES, WITH CENTRALISATION ONLY WHERE ABSOLUTELY NECESSARY, LEAVING AS MANY FUNCTIONS AS POSSIBLE TO NATIONAL COMPETENCE.

D) HOW SHOULD ITS ROLE IN FINANCING PUBLIC BE CIRCUMSCRIBED? A EUROPEAN CENTRAL BANK SHOULD NOT GET INVOLVED IN FINANCING PUBLIC DEFICITS BY INCREASING THE MONEY SUPPLY. WHILE SUCH A ROLE WAS EXPRESSLY FORBIDDEN BY LAW IN THE FRG, THIS PRINCIPLE WAS NOT NECESSARILY TAKEN FOR GRANTED IN OTHER COUNTRIES.

E) TO WHAT EXTENT SHOULD A EUROPEAN CENTRAL BANK BE RESPONSIBLE FOR EXTERNAL EXCHANGE RATE POLICY? EXCHANGE RATE STABILITY COULD NOT BE THE PRIMARY OBJECTIVE OF MONETARY POLICY IF THIS WAS LIKELY TO LEAD TO INFLATION. BUT THERE WOULD BE SOME SCOPE FOR MONETARY COOPERATION WITH COUNTRIES OUTSIDE THE EC. A EUROPEAN CENTRAL BANK WOULD THEREFORE HAVE TO CONTROL AND ADMINISTER PART OF THE NATIONAL CURRENCY RESERVES. THIS REQUIREMENT HAD BEEN FORESEEN WHEN THE EMS WAS CREATED BUT AT THAT TIME MOST MEMBER STATES WERE RELUCTANT TO TRANSFER PART OF THEIR CURRENCY RESERVES TO A SUPRA-NATIONAL INSTITUTION.

F) WHERE SHOULD A EUROPEAN CENTRAL BANK BE SITED? FRANKFURT, PARIS, BRUSSELS AND LONDON WERE ALL POSSIBLE CONSIDERATIONS.

5. IT SEEMED DOUBTFUL WHETHER MEMBER STATES WERE READY TO TAKE SUCH FAR-REACHING DECISIONS AFFECTING NATIONAL SOVEREIGNTY WHEN FOUR MEMBERS OF THE EC, THE UK, SPAIN, PORTUGAL AND GREECE, WERE NOT YET MEMBERS OF THE ERM AND ONE, ITALY, HAD SPECIAL ARRANGEMENTS.

6. NEVERTHELESS, CONSIDERABLE PROGRESS TOWARDS MONETARY INTEGRATION HAD BEEN MADE SINCE THE FOUNDATION OF THE EMS. THE COMMITTEE OF CENTRAL BANK GOVERNORS HAD PLAYED AN IMPORTANT ROLE IN THIS PROCESS AND MIGHT BE GIVEN ENHANCED POWERS, FOR EXAMPLE, THE RIGHT TO TAKE DECISIONS REGARDING CHANGES IN EMS ALIGNMENTS WHICH COULD BE DONE IN A TIMELY AND DISCREET MANNER. BUT SO FAR THIS IDEA HAD BEEN REJECTED BY FINANCE MINISTERS. THE EUROPEAN FUND FOR MONETARY COOPERATION, ON THE OTHER HAND, WAS NOT A SUITABLE BODY TO FORM THE NUCLEUS OF A EUROPEAN CENTRAL BANK SINCE IT WAS DEPENDENT ON THE EC COUNCIL OF MINISTERS.

7. THE STRENGTH OF THE GERMAN ECONOMY HAD ENABLED THE D-MARK TO PLAY A STABILISING ROLE IN THE EMS. THE BUNDESBANK WOULD HAVE TO BEAR THE MAIN BURDEN OF INCREASED INTRA-MARGINAL INTERVENTION AS A RESULT OF RECENT AGREEMENTS (NYBORG ETC). DESPITE DEMANDS BY SOME MEMBER STATES FOR GREATER ''SYMMETRY'', THE EMS WOULD ONLY BE WEAKENED RATHER THAN STRENGTHENED IF THE BUNDESBANK WAS OBLIGED TO TAKE ON EVEN GREATER COMMITMENTS TO INTERVENE IN SUPPORT OF OTHER EMS CURRENCIES, FOR EXAMPLE, BY HOLDING THEIR CURRENCIES IN ITS RESERVES. THE FRG WOULD TAKE STEPS TO REDUCE ITS BALANCE OF PAYMENTS SURPLUS AS A CONTRIBUTION TO EQUILIBRIUM IN THE EMS BUT THIS WOULD BE DONE BY STRENGTHENING DOMESTIC DEMAND NOT BY MONETARY MEANS.

8. EUROPEAN MONETARY UNION WAS A DESIRABLE POLITICAL AND ECONOMIC OBJECTIVE. FULL LIBERALISATION OF CAPITAL MOVEMENTS, WHICH SHOULD BE ACHIEVED BEFORE THE END OF THE GERMAN PRESIDENCY, WOULD BE A MILESTONE IN THAT DIRECTION. SO WOULD PARTICIPATION BY ALL EC MEMBER STATES IN THE ERM WHETHER FURTHER INSTITUTIONAL STEPS TOWARDS MONETARY UNION WOULD BE POSSIBLE WAS IN THE HANDS OF NATIONAL GOVERNMENTS AND PARLIAMENTS. REALISM WAS MORE IMPORTANT IN THIS PROCESS THAN WISHFUL THINKING.

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BANK OF ENGLAND
LONDON EC2R 8AH

E A J. GEORGE
EXECUTIVE DIRECTOR

3 May 1988

cc Sir T Burns
Mr Scholar
Mr Peretz
Mr Odling Smee
Mr Grice
Mr Pike
Mr Sedgwick
Mrs Lomax
Miss O'Mara
Mrs Ryding
Prof B Griffiths (No10)

Sir P Middleton KCB
H M Treasury
Parliament Street
London
SW1P 3AG

Dear Peter,

[illegible] monthly note on interest rates over the next few weeks for our meeting on Thursday afternoon.

Yours sincerely,

[illegible]

Ch

see conclusion in particular

Thanks: Peter spoke 2/5th.

80

SECRET

INTEREST RATES OVER THE NEXT FEW WEEKS

£ millions

1 We have been prepared to buy bills in all maturity bands at discount rates of 7 7/8% since 8 April, when we reduced our stop rates by a further 1/2%.

Market conditions

2 The price of oil firmed during April to a little over $17 a barrel, on market hopes that discussions among OPEC and other producers will lead to some restriction of supply, but has since fallen back to around $16 on disappointment at the outcome of the OPEC meeting.

3 There seems to have been a modest tightening in US monetary policy over the last month, with the Federal funds rate and the 30 year bond yield both having risen by about 3/8%.

4 In the foreign exchange markets, the exchange rate of the dollar has changed little on balance since the last meeting: it weakened sharply around the time of publication of the US external trade figures for February, but has been helped by higher dollar interest rates and by the tension in the Persian Gulf.

5 Sterling has appreciated on balance since the last meeting against both the dollar and the Deutsche Mark, reflecting persistent demand apparently for investment purposes, and with fluctuations reflecting expectations about UK interest rates. Since the last week of April, however, the upward pressure has appeared to diminish, notwithstanding the favourable reaction to the March trade figures. Exchange rate changes since the last meeting are shown in the table below.

	£ERI	£/$	£/DM	$/DM
29 March (date of last meeting)	77.7	1.8705	3.1075	1.6625
3 May	78.0	1.8667	3.1370	1.6805
% change	+0.4	-0.2	+0.9	+1.1

6 In the money market, the reduction in the general level of interest rates to 8% came as a surprise; but the persistent strength of the exchange rate soon engendered hopes of a further reduction. These however evaporated in the light of the March money figures, which were seen as adding to the grounds for concern about the growth of demand in the economy and the outlook for inflation and accordingly prompted a steepening in the money market yield curve. Changes in interbank rates since the last meeting are shown in the table below:

	1 month	3 months	6 months	12 months
29 March (date of last meeting)	8 9/16	8 3/4	8 7/8	9 1/4
3 May	8 1/32	8 13/32	8 13/16	9 9/32
Change	- 17/32	- 11/32	- 1/16	+ 1/32

7 The gilt-edged market, which had been generally quiet, though with steady demand for index-linked stock, has fallen sharply since the March money figures, so that yields on turn of the century stocks have risen to around 9 3/8%. Gross sales for April were 750 of which 370 represented calls due on earlier sales of partly-paid stocks, and 300 was in index-linked form.

Monetary conditions

8 Recent percentage changes in the monetary aggregates (seasonally adjusted) are shown in the table below:

	1987			1988			
	Q2	Q3	Q4	Q1	Feb	March	Year to end-March
M0*	1.1	2.3	1.8	0.4	-0.1	0.8	5.8
nib M1	5.1	1.2	0.9	6.4	1.5	1.5	14.2
M1	6.0	4.6	2.7	5.6	-0.6	4.0	20.4
M2	3.3	2.5	2.2	4.2	1.0	1.6	12.8
M3	5.1	5.1	5.0	4.2	0.4	3.2	20.8
M4	4.0	4.1	3.8	3.6	1.0	2.3	16.4
M5	4.1	4.0	3.7	3.6	0.9	2.4	16.3

*Weekly average

9 After two successive monthly declines, M0 growth resumed in March. Over the year to March, M0 increased by 5.8% in seasonally adjusted terms but by 6.4% unadjusted: the difference reflects the fact that Easter fell at the end of March this year but not in 1987. Notes and coin, seasonally adjusted, rose by 6.4% over the period.

10 M1, and particularly its interest-bearing component, increased very fast in March, as did M2.

11 All measures of broad money grew rapidly, and their 12-month growth rates increased; the March increase included contributions from both retail and wholesale deposits. Banks and building societies both experienced fairly strong retail inflows, at 1,660 and 1,790 respectively. For the banks this included larger-than-usual inflows to their (personal and other) high-interest-bearing accounts. The inflow into building societies' retail shares and deposits was the highest since November and brings the cumulative inflow in the five months since the crash to 7,310, 60% higher than the inflow in the five months before the crash. There are three important influences which may have affected bank and building society retail inflows: first, unit trusts and equities continue to be relatively unattractive; second, the redemption towards the end of March of 2% Index-linked Treasury 1988, which was probably widely held by the personal sector; and third, the pick-up in mortgage lending is likely to have raised the level of equity extraction.

12 Wholesale deposits with banks went up sharply in March, by 3,970, no doubt reflecting the underfunding of the PSBR and the official purchases of foreign exchange.

13 The March PSBR was 1,090, and external and foreign currency finance of the public sector was expansionary by 1,530, largely representing the rise in the reserves. Moreover the gilt holdings of the non-bank private and overseas sectors fell, with the redemption of 2% Index-linked Treasury 1988. The seasonally-adjusted funding position for March and for the whole financial year is shown in the table below:

	March 1988	Financial year 1987/88
"M3" basis	3,730 underfunded	110 overfunded
"M4" basis	3,460 underfunded	1,380 overfunded

14 There was a susbstantial acceleration in sterling lending to the private sector by both banks and building societies, despite the large underfunded PSBR. The March increase of 6,650 may be compared with the 4,220 recorded in February; the January increase of 7,130 coincided with a very large public sector surplus. Within the total, the rate of personal lending, particularly mortgage lending, clearly increased sharply: though there are no very reliable seasonal adjustments the March increase in mortgage lending may have been around £3 3/4 billion, compared with £2 1/4 - 3 billion a month over the six preceding months. There are a number of particular factors which may have contributed to this acceleration - eg the unusually warm weather in March, and the building societies' anxiety to use their stronger inflows to regain share of the mortgage market from the banks. But it is clear that there was a large increase in mortgage demand. The Budget measures are likely to reinforce this increase, and their effect may already be coming evident in the figures for building societies' lending commitments.

15 The three month forecast is for modest growth in M0, bringing the 12-month growth rate down to 5.4% by June; and for fairly rapid growth in broad money driven by a faster rate of lending, despite projected overfunding during the forecast period. The 12 month growth rates of M3 and M4 are expected to fall between end-March and end-June from 20.6% to 19.9%, and from 16.3% to 15.8% respectively.

16 The industrial production figures suggest that output will have been sluggish in the first quarter, and although this would be broadly consistent with the evidence of the external trade figures, it is not corroborated by the latest CBI survey, which suggests that the pace of output growth has been sustained and that business confidence remains very strong. We think it would at this stage be premature to conclude that output has slowed down.

17 The initial estimate of consumers' expenditure in the first quarter suggests an increase of around 6% on the first quarter of 1987.

18 Retail prices rose by 3.5% in the year to March (3.8% excluding mortgage costs), up slightly from February. Recent reductions in mortgage rates are unlikely to affect the index until May. Manufacturers' input prices fell sharply in March (by 0.7%), reversing much of February's rise and taking the rise over the last twelve months to 2.3%. Their output prices rose by 0.5% in March to a level 4.1% above a year ago.

19 The underlying annual increase in average earnings remained at 8 1/2% in February, unchanged from last month. Within the total, earnings growth in manufacturing eased as overtime working fell back, whereas earnings growth in the service sector was higher. Over the three months December-February, unit wage costs in manufacturing were about 2 1/2% higher than a year earlier; this, taken together with the relative rates of increase of manufacturers' output and input prices, suggests that profit margins in manufacturing have widened.

20 House prices (as measured at the approval stage in the Halifax index) rose by 2.7% in March, continuing the faster growth seen in recent months. The twelve month growth rate is now 18% compared with 17% last month. Much of the recent faster growth has come outside the South East.

21 Near term forecasts of inflation taken from our sample of stockbrokers are slightly lower this month and show the 12-month increase in the RPI rising from under 4% now to 4.4% by the end of the year, and 5% next year. Based on these expectations real interest rates are now 4.4% at both three months and one year, both down on last month in line with the reduction in nominal interest rates.

Conclusion

22 There is no real sign that there was any slowdown in domestic demand in the first quarter. Meanwhile the March money figures

are disturbing, in particular because the acceleration in mortgage lending seems more likely to continue than to reverse, and to stimulate further rapid growth in consumer spending and house prices.

23 In order to counter the heightened inflationary threat that these developments pose, policy needs to be tightened. It would be desirable for interest rates to be higher; while a modestly lower exchange rate would help to improve the balance between output and domestic demand. Thus far markets have denied us the possibility of moving in these directions and they may continue to do so. If they do, and with the inflationary danger becoming more urgent, this would mean that we should be prepared to tolerate a larger appreciation of the exchange rate than we earlier had in mind before contemplating a further reduction in interest rates. If on the other hand the exchange rate were to weaken, we would want to look for an early opportunity to raise interest rates.

??

Bank of England

April 1988

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4. 5.88

PWP

THE GOVERNOR'S PRIVATE SECRETARY HO-P
THE DEPUTY GOVERNOR'S PRIVATE SECRETARY HO-P
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MR GEORGE HO-P
MR W A ALLEN HO-P
MR ALTHAUS HO-G
MR A F BUSHELL HO-4
MR CHARKHAM HO-4
MR T A CLARK HO-M
MR COLEBY HO-P
MR FOOT HO-2
MR GILL HO-3
MR GREEN HO-3
MR J G HILL HO-G
MR LATTER HO-2
MR KENT HO-3
MR KIRBY HO-3
MR PLENDERLEITH HO-P
MR PRICE HO-3
MR SMEETON HO-2
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MR BRIAULT/
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MR CARTER HO-M
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MR DE HOEST HO-4
MR G I EVANS HO-2
MR EXETER HO-2
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MS STONEFROST HO-M
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MR TOOLE HO-3
MR URWIN HO-2
MR R G WARE HO-3
MR R P WEBSTER HO-3
DEALERS GIMLET HO-2
GROUP 9, ID HO-2
GROUP 11, ID HO-2
GROUP 12, BSD HO-3
LORD RICHARDSON PADS

US FINANCIAL DEVELOPMENTS

Attached is the latest weekly summary of developments in monetary policy and the financial markets. Some recipients have expressed the feeling that the length of this note had become rather unwieldy. Starting with this week's issue, the note will revert to a more compressed form. Any comments, favourable or not, would be appreciated.

International Division
Group 1, HO-3
4 May 1988

R T Thorne (4385)

RTT

US FINANCIAL DEVELOPMENTS: 25 APRIL-1 MAY

SUMMARY

- Most analysts seem firmly to believe the Fed will tighten shortly, in response to possible inflationary pressures arising from the economy's continued strength. Many believe that, if the April employment figure released this Friday is strong, the Fed will act then.

- Interest rates rose about 10bp last week in response to economic data, particularly the fall in the weekly new unemployment benefit claims series.

- Although one small bank raised its prime rate last week, others did not follow suit. Nevertheless, a more general rise in prime is quite possible in the near future, particularly if the Fed tightens.

POLICY

(a) Expected Fed tightening

1 Since the Fed apparently retightened policy just before Easter, speculation has been growing that it will tighten further in response to continued evidence of a strong economy and possible inflationary pressures. Most analysts now seem firmly to believe the Fed will tighten, and the main point of uncertainty is now the timing of the action. Many believe that if the April employment figure released this Friday shows an increase of much above 200,000 then the Fed will make its move, while others believe it may wait until the next FOMC meeting on 17 May.

2 The real economy rather than the financial markets seem to have been the focus of recent Fed inflationary concerns, to judge by officials' remarks, and a number of further items of strong data were released last week. A fall in the weekly series of new unemployment benefit claims (not a series usually watched closely) had most market impact, but factory orders and construction spending for March were also stronger than expected, a purchasing managers' survey indicated possible inflationary pressure and, within a close-to-expectations Q1 GNP figure, consumption and investment rose briskly. Fed officials have been particularly concerned about the currently high level of capacity utilisation. New York Fed President Gerald Corrigan (who said "the amber light is on" as far as inflation is concerned) and San Francisco Fed President Robert Parry both raised the subject last week, and both also stressed the importance of restraining wage inflation in conditions of high employment, although they agreed that it was under control for the present.

3 It is perhaps noteworthy that, as market expectations of tightening increase, the Administration has refrained from public comment on monetary policy. It is presumably still very conscious of Greenspan's Humphrey-Hawkins warning to the Administration not to try unduly to influence policy.

(b) Prime rate

4 Many believe that a rise in the prime rate could well accompany any further Fed tightening, particularly if that took

the form of a discount rate rise, and speculation that a prime rate rise could even precede a Fed move was heightened last Friday by Riggs National Bank of Washington when it raised its prime rate 25 bp to 8 3/4%. Riggs is a relatively small bank and no other bank has yet followed its move, but its action was seen at the time as being a possible harbinger of a round of rate rises. Riggs said that its move "was the result of upward trends in interest rates and higher costs of funds", and indeed the market data bear this out. The spread between prime and 90 day CDs narrowed from 181 bp just after the last prime rate cut on 2 February to 125 bp last Friday, while the spread between prime and 6 month Eurodollars narrowed from 163 bp to 106 bp. These figures might indicate that a 50 bp prime rate rise could be on the cards, especially if the Fed does tighten, but of course changes in financial markets mean that the prime-CD spread no longer is an accurate measure of banks' interest margins.

MONEY

5 All three monetary aggregates rose by very small amounts (much less than 0.1%) in the week ending 18 April. The rise in M1 was well below that predicted by economists, but some predict a very sharp $8 bn rise next week.

RESERVES

6 Average adjusment and seasonal borrowing from the Fed's discount window fell $215 mn to $300 mn in the week ending 27 April. Both the level of borrowing and the average Fed funds rate of 6.85% were within the Fed's perceived target range since Easter, indicating no change in policy, but the majority of analysts nevertheless believe that policy will be tightened in the next few weeks. A seasonally high level of Treasury balances at the Fed prompted the Fed to add large quantities of reserves for technical reasons during the week, both through customer and system repos and through a coupon-pass totalling $3.1 bn, and the volatility of the Treasury balances also caused the Fed to overestimate its reserve-adding need on the Friday.

7 The average level of extended credit dropped sharply in the week, presumably because of a smaller need for reserves by First RepublicBank, but some analysts said that extended credit would rise again when the banks lose the Treasury's tax receipts recently deposited with them.

MARKET DEVELOPMENTS (25-29 APRIL)

8 Treasury securities yields rose by 10bp fairly evenly across the maturity spectrum last week as long rates rose to their highest level since mid-January. Although the Q1 GNP figure had been expected to be the major piece of economic news, the figure was equal to the average economists' forecast, and the markets reacted more sharply to a fall from 314,000 to 275,000 in weekly unemployment benefit claims. This provoked further fears of future Fed tightening, and this Friday's employment figure for April will be keenly watched in case it precipitates Fed action.

MARKET COMMENT

9 Charles Lieberman of Manufacturers Hanover claimed that the 2.4% (ar) increase in the GNP implicit price deflator in Q1 gave a misleadingly low estimate of inflation. He said that the deflator was overweighted to capital spending on business equipment, primarily computers, which have not risen much in price. In his opinion, the 3.7% rise in the fixed-weight deflator, which gives less weight to business purchases, gives a truer picture.

10 Susan Hering of Salomon said the government's total financing needs in Q2 were likely to be the smallest quarterly figure in "at least seven years". This would reflect a seasonal rise in receipts during the quarter, as well as the more long-term reduction in the budget deficit.

TREASURY AUCTIONS

Monday	2 May	Auction of $12.8 bn of three- and six-month bills, involving a net paydown of $425 mn.
Thursday	5 May	Auction of one-year bills.
Tuesday-Thursday	10-12 May	Quarterly refunding auction of three-year and ten-year notes and 30-year bonds

ECONOMIC INDICATORS

Monday	2 May	Factory orders; March
Friday	6 May	Employment and unemployment; April Consumer instalment credit; February
Thursday	12 May	Retail sales; April
Friday	13 May	Producer price index; April Business inventories; March
Monday	16 May	Industrial production; April
Tuesday	17 May	Capacity utilisation; April Housing starts; April Merchandise trade; March (estimated date)
Friday	20 May	Consumer price index; April

OTHER DATES

Tuesday	17 May	FOMC meeting

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 (18. 4.88)	766.6	+ 0.3	+ 1.2	+13.1	+ 5.1	+ 3.1		
M2 (18. 4.88)	2,991.5	+ 0.6	+ 7.5	+11.6	+10.5	+ 8.4	4-8	3008.3-3124.0
M3 (18. 4.88)	3,760.1	+ 1.3	+ 5.9	+ 7.9	+ 8.8	+ 7.1	4-8	3800.8-3947.0
Credit Aggregate (Dec)	8,299.0	+55.6	+77.2	+ 8.4	+10.3	+ 9.5	7-11	8812.7-9142.2

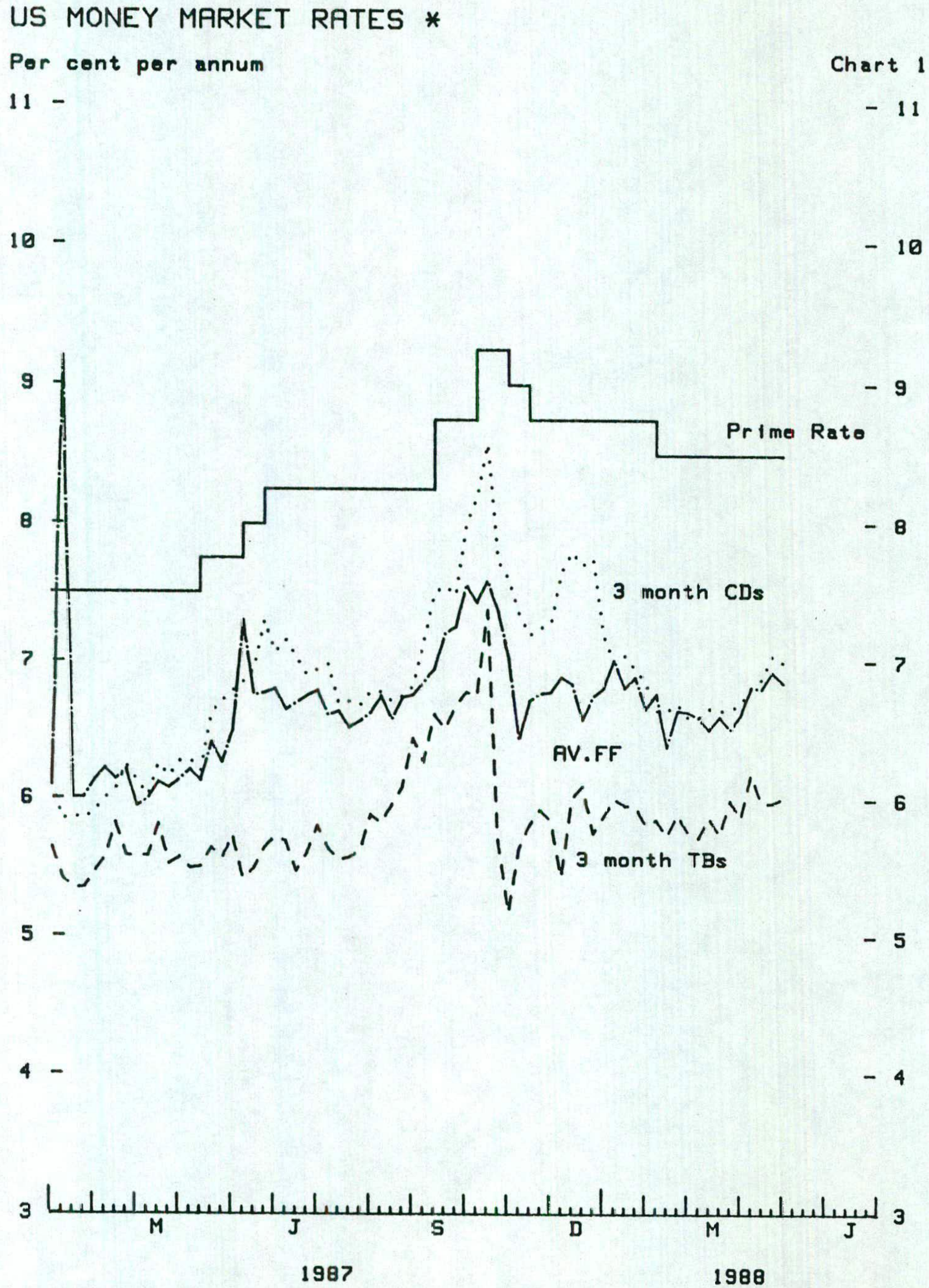
2 FINANCIAL STATISTICS		Level ($ bn)	Change in level ($ bn) Latest week	Previous week	% Change (ar) Latest 4 weekly average over: Previous 4 weeks	4 weeks ended 13 weeks ago
Business loans#	(20. 4.88)	297.4	+1.4	-1.6	+20.2	+8.2
Commercial Paper	(20. 4.88)	397.2	+6.6	+3.3	- 3.0	+15.5*
Money Market Mutual Funds	(27. 4.88)	272.8	-1.6	-0.3	-18.7	+ 5.7

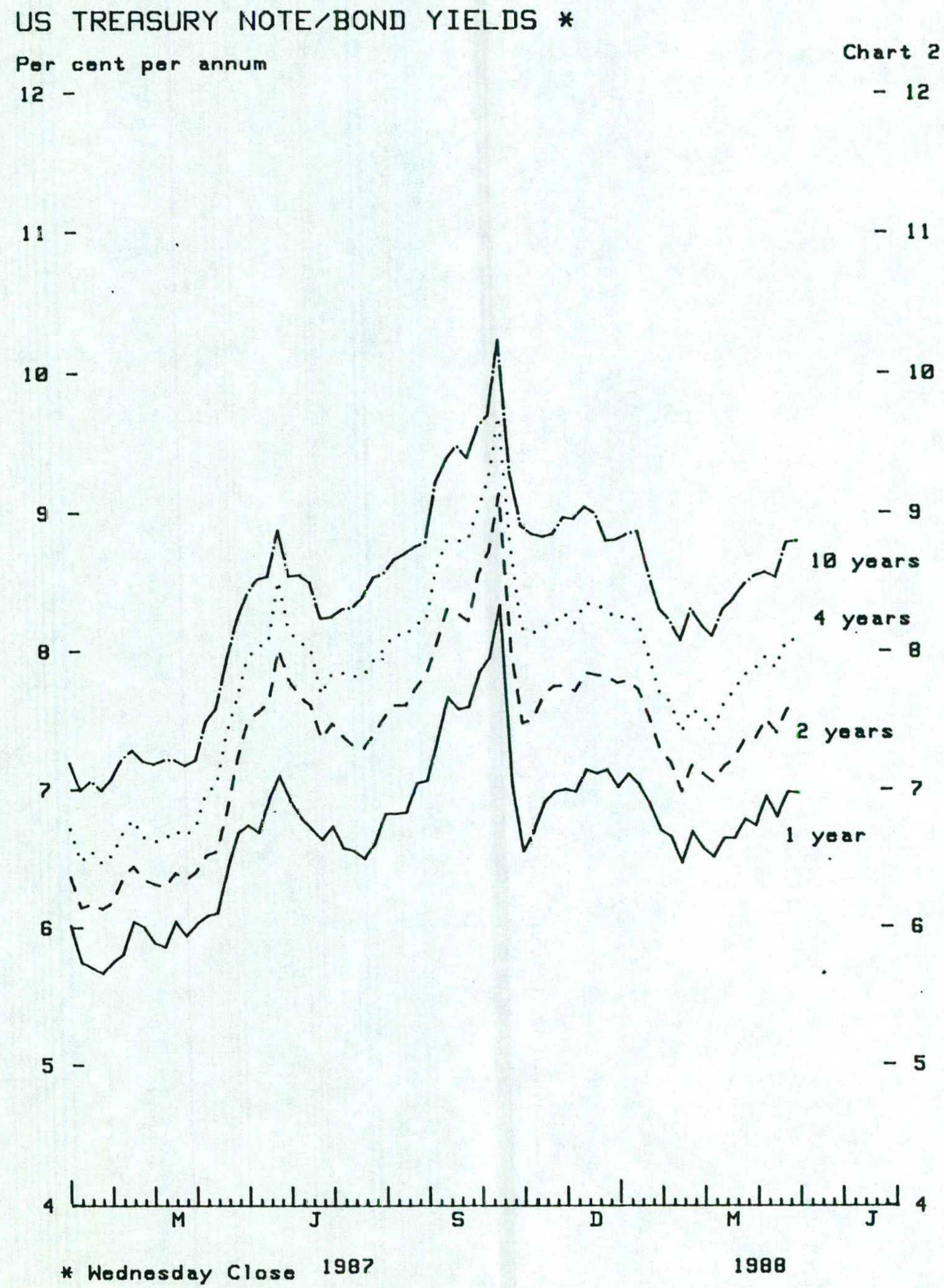
3 RESERVES	TWO WEEK PERIOD TO 20 APRIL Level ($ mn)	Change in level ($ mn) Latest accounting period	LATEST WEEK TO 27 APRIL Level ($ mn)	Changes in Level Latest Week
Discount window borrowing	3,619	+ 802	2,034	-1,638
of which adjustment and seasonal borrowing	342	+ 19	300	- 215
extended credit	3,277	+ 783	1,734	-1,423
Net free (borrowed) reserves	351	- 243		

* Sample of reporting banks changed with effect from 6. 1.88.
Rates of change are estimates only.

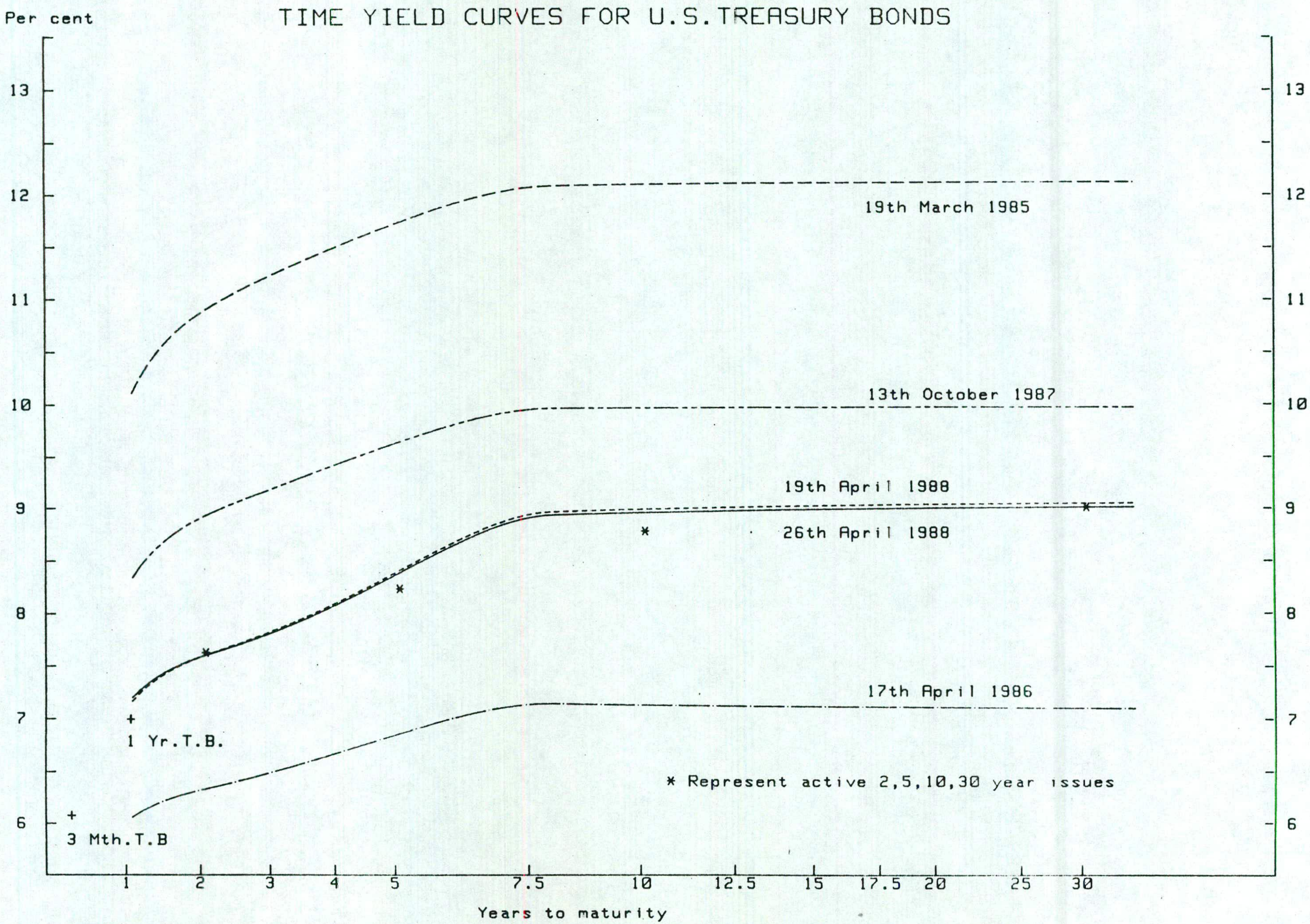
\# Major commercial banks

Target bases (1987 Q4 averages)
M2 2892.6
M3 3654.6
Credit aggregate 8236.2



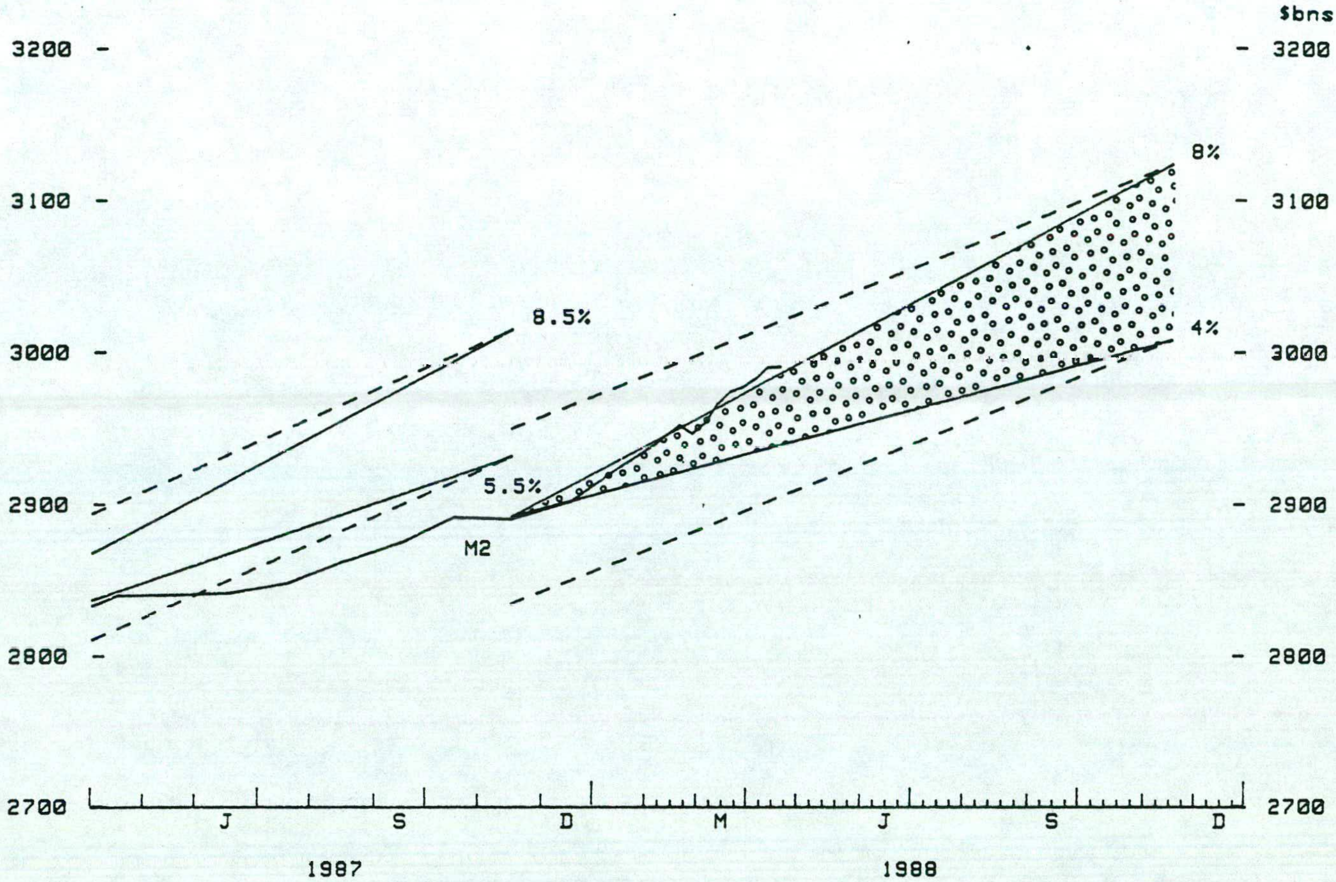


* Wednesday Close


TIME YIELD CURVES FOR U.S.TREASURY BONDS
Per cent
13
12
11
10
9
8
7
6
19th March 1985
13th October 1987
19th April 1988
26th April 1988
17th April 1986
1 Yr.T.B.
3 Mth.T.B
* Represent active 2,5,10,30 year issues
1
2
3
4
5
7.5
10
12.5
15
17.5
20
25
30
Years to maturity

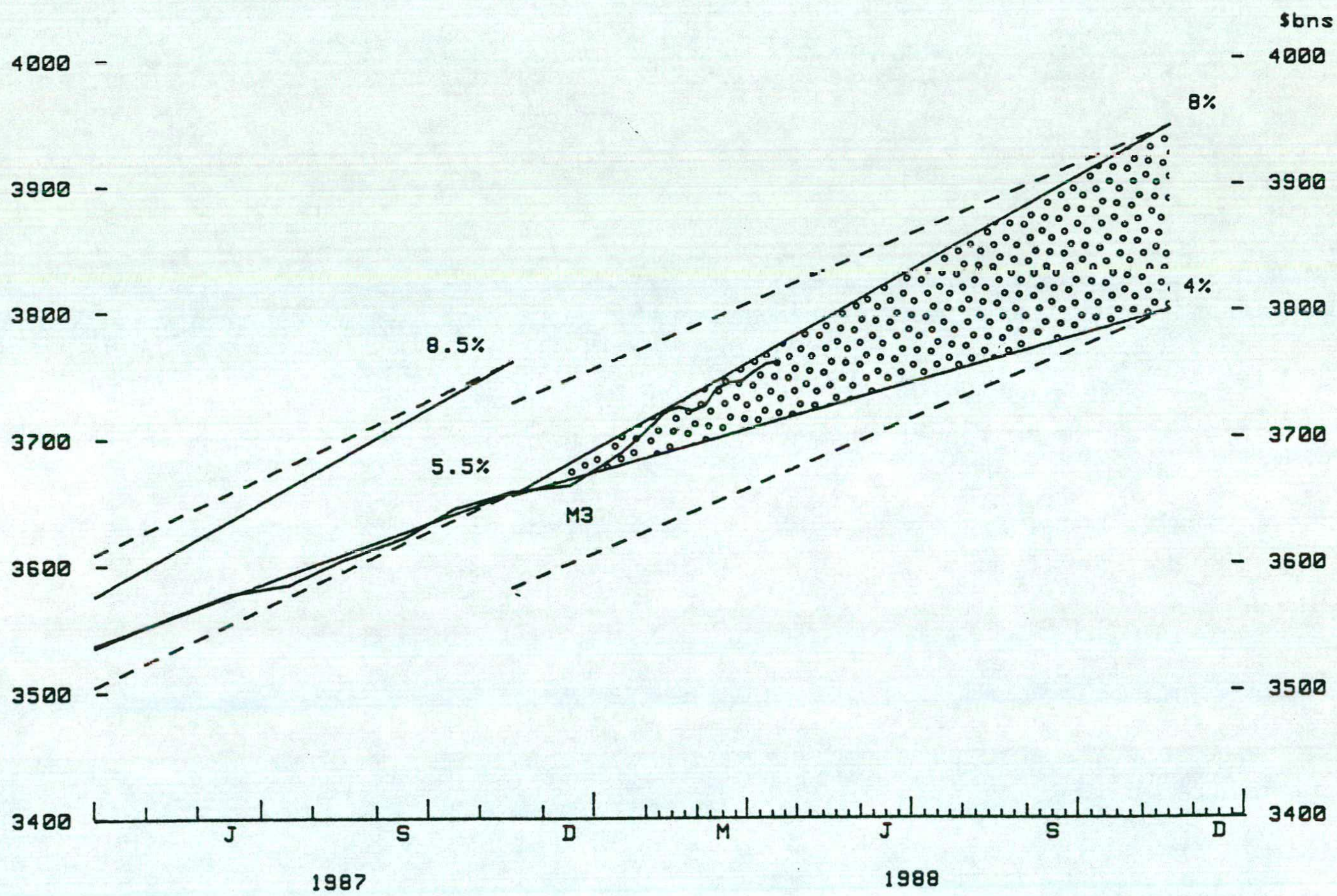
MONEY SUPPLY (M2)

Chart 3



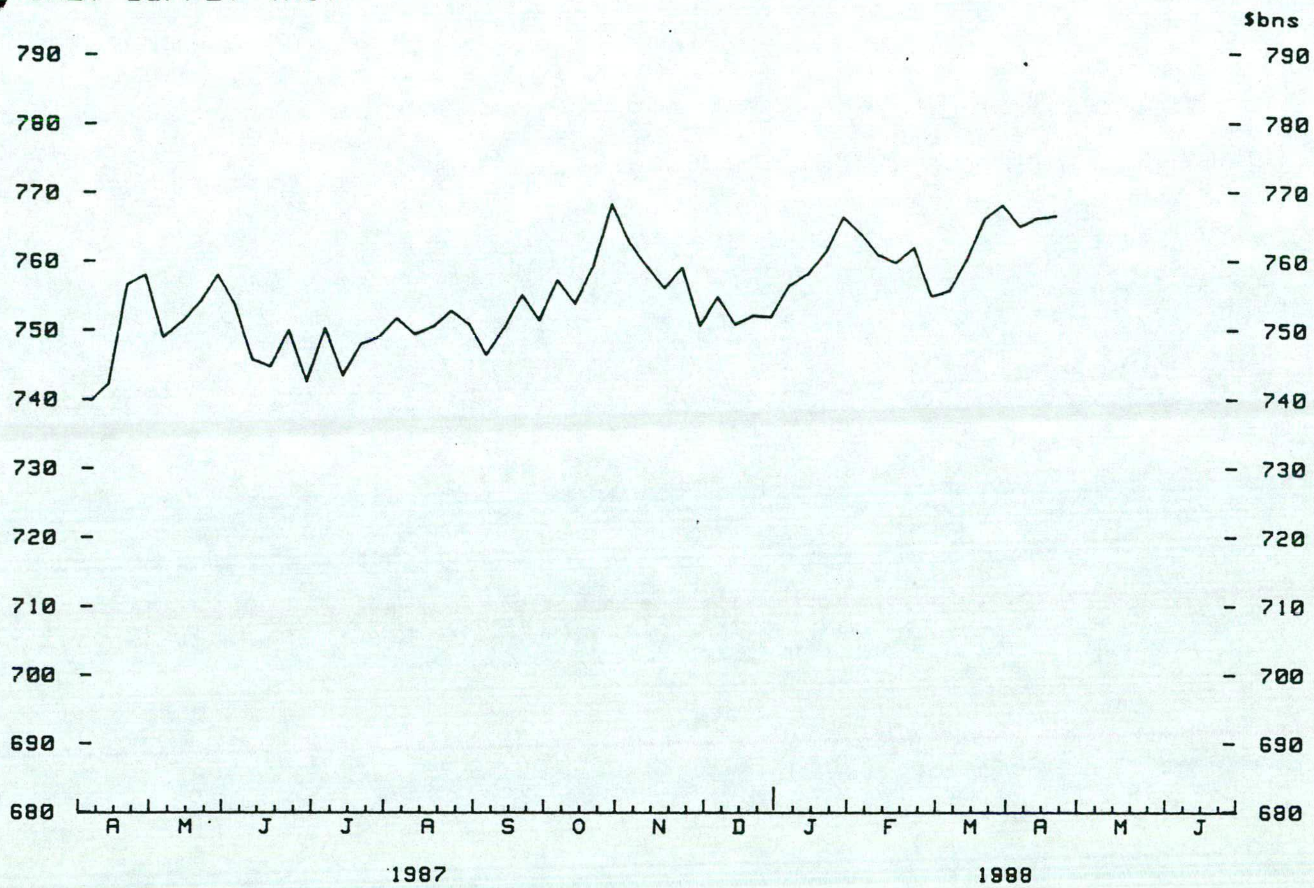
MONEY SUPPLY (M3)

Chart 4



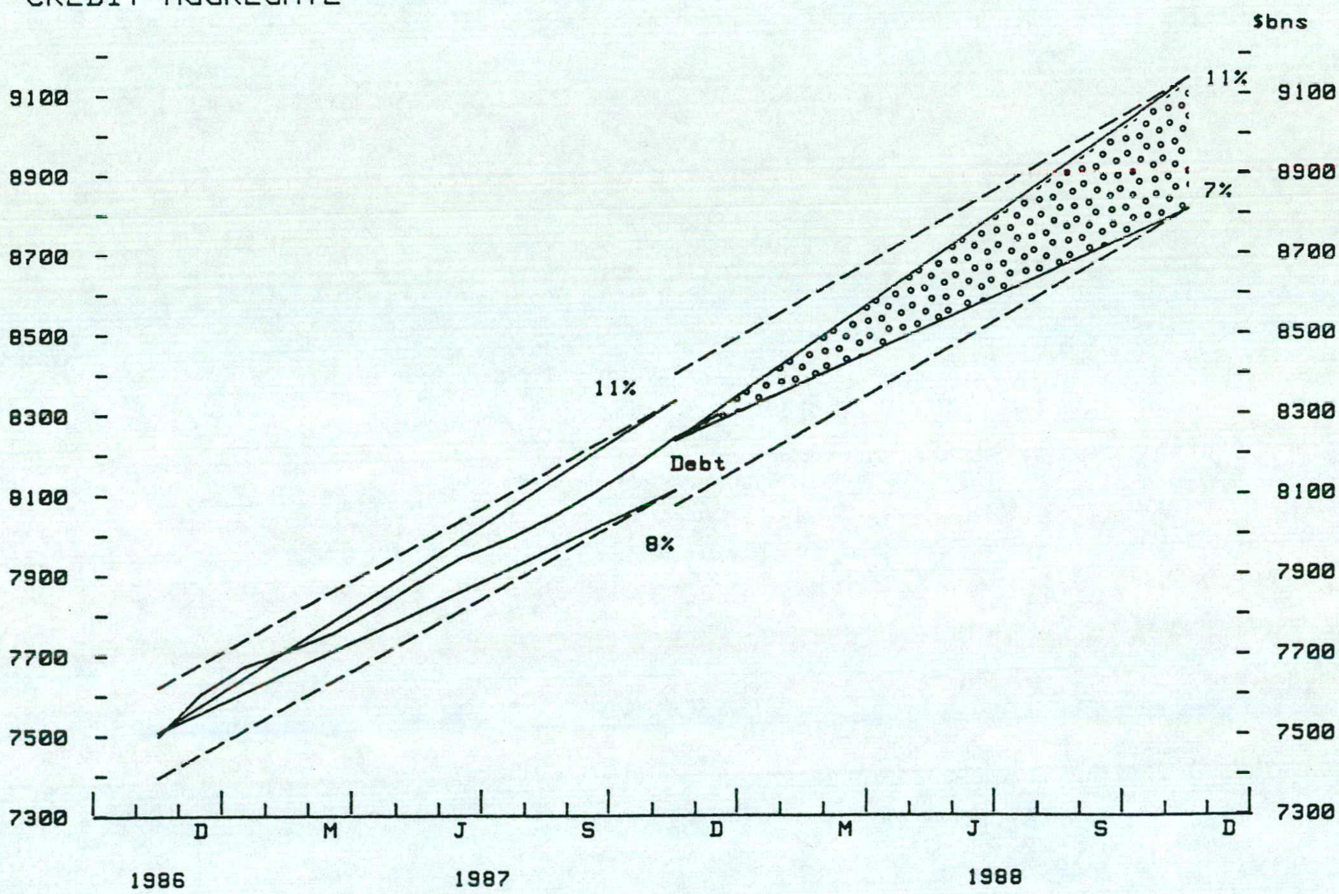
MONEY SUPPLY (M1)

CHART 5



CREDIT AGGREGATE

Chart 6



Miss O'Mara

PPS
PS/Sir P Middleton
Sir G Littler

9/5

SECRET
DEYOU DEVIL
FM HONG KONG
TO IMMEDIATE FCO
TELNO 1710
OF 061100Z MAY 88
INFO PRIORITY PEKING

STRICTLY PERSONAL FOR HUM, HKD, FROM GOVERNOR
PEKING: STRICTLY PERSONAL FOR AMBASSADOR/HEAD OF CHANCERY

YOUR TELNO 1125: DIALOGUE ON FINANCIAL MATTERS

YOU MIGHT FIND IT USEFUL TO HAVE AN UPDATED VERSION OF OUR GAME-PLAN FOR DEALING WITH THE PROPOSED NEW ARRANGEMENTS FOR BETTER MONETARY CONTROL.

2. I WILL NOW ASK PURVES TO DELAY INFORMING HIS BOARD UNTIL AFTER WE HAVE CLEARED OUR LINES WITH THE CHINESE. THE FINANCIAL SECRETARY WILL THEN INITIAL THE AGREEMENT WITH THE HKSB.

3. A DRAFT TAILOR-MADE INFORMATION PAPER FOR THE CHINESE WILL BE SENT TO YOU BY BAG EARLY NEXT WEEK. GRATEFUL IF YOU COULD COMMENT BY TELEGRAM BY 18 MAY AT THE LATEST. WE WOULD LIKE TO HAVE IT PROPERLY TRANSLATED AND SENT TO PEKING IN THE BAG THE FOLLOWING WEEK SO THAT IT CAN BE HANDED OVER TO THE CHINESE AS SOON AS EXCO HAS GIVEN APPROVAL (SEE BELOW).

4. WE WILL CONSULT THE INDIVIDUAL MEMBERS OF THE EXCHANGE FUND ADVISORY BOARD IN THE WEEK BEGINNING 16 MAY. THEIR SUPPORT WILL BE AN IMPORTANT ELEMENT IN TAKING THE MATTER TO EXCO. WE HAVE ALREADY SPOKEN TO ONE MEMBER OF THE COMMITTEE, JOHN MACKENZIE, WHO IS ALSO THE CURRENT CHAIRMAN OF THE HONG KONG ASSOCIATION OF BANKS. HE WAS HAPPY WITH THE PROPOSAL AND FELT THAT THE BANKING COMMUNITY WOULD MOST PROBABLY WELCOME IT.

5. WE WILL ALSO SEPARATELY BRIEF Q W LEE, THE ONLY OTHER BANKER ON EXCO APART FROM PURVES, BEFORE THE ISSUE OF THE EXCO PAPER.

6. WE WILL ISSUE THE EXCO PAPER AROUND 18 MAY FOR CONSIDERATION BY EXCO ON 31 MAY. EXCO WILL BE ASKED TO APPROVE IMPLEMENTATION OF THE NEW ACCOUNTING ARRANGEMENTS ''AS SOON AS PRACTICAL ARRANGEMENTS HAVE BEEN PUT IN PLACE''.

7. ASSUMING EXCO APPROVAL, THE NEXT STEP WOULD BE FOR PEKING TO HAND THE INFORMATION PAPER OVER TO THE CHINESE. WE BELIEVE THAT IT WILL HELP THE CHINESE TO UNDERSTAND WHAT WE ARE TRYING TO DO IF WE ALSO INFORM THE BANK OF CHINA HERE. SUBJECT TO YOUR VIEWS, WE WILL ARRANGE TO DO THIS SIMULTANEOUSLY WITH ACTION IN PEKING.

8. WE HOPE THAT A FAVOURABLE RESPONSE FROM THE CHINESE CAN BE OBTAINED BY EARLY JULY. WE WILL THEN FORMALLY SIGN AGREEMENT WITH THE HKSB AND PURVES CAN THEN INFORM HIS BOARD. THE NEW ARRANGEMENTS WILL SUBSEQUENTLY BE IMPLEMENTED.

9. THERE MAY NEED TO BE A PERIOD OF, SAY, TWO TO THREE MONTHS DURING WHICH OPERATIONS UNDER THE NEW ARRANGEMENT ARE CONDUCTED IN CONFIDENCE TO ENABLE THE HKSB AND THE EXCHANGE FUND TO GET USED TO THEM. THEREAFTER, THE FINANCIAL SECRETARY WILL ANNOUNCE THE ARRANGEMENTS IN A SPEECH TO BE DELIVERED TO THE HONG KONG ASSOCIATION OF BANKS.

10. WE WILL TAKE UP THE MATTER MENTIONED IN PARA 2 OF TUR SEPARATELY.

WILSON

NNNN

LIMITED.

HD/HKD
HD/FED
PS
PS/Lord Glenarthur
PS/PUS
Mr Gillmore
Mr McLaren

Copies to:

Mr Loehnis, Bank of England
Mr Peretz, HM. Treasury

CONFIDENTIAL

cc Sir G. Littler
Miss O'Mara

Silent copy:
Mr A. Allan

1 Jonathan
2 pup.

H M Treasury

Parliament Street London SW1P 3AG

Switchboard 01-270 3000

Direct Dialling 01-270 4460

D L C Peretz
Under Secretary

J O Kerr Esq
Foreign & Commonwealth Office
Room E113
Downing Street (East)
LONDON SW1

6 May 1988

Dear John

You said you had enquiries from Bonn and Paris for a little background about the 3 May Monetary Committee discussion of European Monetary "construction". I have discussed this with Sir Geoffrey Littler, and we are content for you to send a telegram to Bonn, copied to Paris, Rome and The Hague on the following lines :

> "You asked for some background on the 3 May Monetary Committee discussion of European Monetary "construction". The Committee identified a number of technical improvements to the working of the EMS and arrangements for EC monetary co-operation that would be worth further examination in future. As to the concept of a European central bank, there was no support for the idea of a study by "wise men", and general agreement that any further examination would best be carried out in ECOFIN, in the Monetary Committee and in the Committee of Central Bank Governors.
>
> As noted in telno. 171 of 4 May, the Monetary Committee Chairman will be presenting the Committee's views to ECOFIN."

Yours ever

David

D L C PERETZ

MONTHLY MONETARY ASSESSMENT

90/G.j[illegible]

SECRET

Bf next T Burns meeting (again)

FROM: J W GRICE
DATE: 6 May 1988

1. SIR PETER MIDDLETON
2. CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Economic Secretary
Sir T Burns
Sir G Littler
Mr Lankester
Mr Monck
Mr Scholar
Mr H P Evans
Mrs Lomax
Mr Odling-Smee
Mr Peretz
Mr Sedgwick
Mr R I G Allen
Mr Hibberd
Miss O'Mara
Mr Riley
Mr Pike
Mrs Ryding
Mr Cropper
Mr Tyrie
Mr Call

Mr George - B/E

Prof Griffiths No 10

Mr Cassell - Washington

File: MAMC F1

Thanks.

(AA: 9th Ops.)

MONTHLY MONETARY ASSESSMENT: APRIL 1988

This note records the discussion at Sir Peter Middleton's monthly meeting on monetary conditions on 5 May. Attached is the usual Monthly Assessment.

Sir Peter Middleton's Meeting

2. Sir Peter said that two issues needed to be discussed:

(i) in current monetary conditions, what was the extent of any inflationary risk and thus how urgent was any tightening?;

(ii) in this light, what were the tactical considerations? More specifically, could we and should we alter the interest/exchange rate mix?

Current Monetary Conditions

3. Opening the discussion, Mr Scholar suggested that new data on activity over the last month had shed little light on the underlying position. What data there had been - the manufacturing output fall in February and the slight decline in March retail sales, for example - were affected by special factors and open to doubt. The CBI Survey pointed to a continuing buoyant economy. On balance, the evidence suggested some slowdown from the most rapid growth of 1987 but an economy still growing briskly. On the inflation front, there seemed to be some slight drift upwards. But the most striking feature was the rapid acceleration in house prices. The Halifax index had risen sharply for three successive months to show twelve month growth of over 20 per cent in April. It was possible that accelerated house purchases ahead of the change to the residence basis for the mortgage interest relief ceiling, from August, would put some temporary further upward pressure on house prices.

4. Monetary growth had been rapid in March. After falling in January and February, M0 had risen by 0.8 per cent in March and 0.9 per cent in April. It was beginning the new financial year about 1 per cent above the top of its target range. M4 had grown by 2¼ per cent in March, increasing the twelve month growth rate from 16 to 16¾ per cent. Bank and building society lending had been exceptionally high at £7¾ billion and its twelve month growth rate was now 20¾ per cent.

5. Overall, it was hard to argue that there had been any tightening of policy either from October 1987 or since 3 March when sterling was uncapped against the mark. Over either period, sterling had risen by around 4 per cent but this was offset by interest rates about one point lower.

6. Over this whole period we had looked for opportunities to tighten policy, and the case for doing so was stronger now than before. The problem was how to achieve this acceptably, and in particular how to try to engineer at the same time a change in the interest/exchange rate mix. He favoured a gradual approach to increasing interest rates if sterling's recent softness continued, and he wondered if

some more substantial intervention than had been done in recent weeks might offer a way of altering the exchange/interest rate mix.

7. Mr George agreed generally with this assessment. It was not that the policy stance was loosening further but that it had remained inappropriately loose over a lengthening period of time. This was creating its own problems. In particular, it was leading companies back into old bad habits, reducing their resistance to high pay demands. Pay settlements had drifted up by ½-1 per cent over the last year. Whilst the CBI Survey had been reassuring about output, it was more worrying on the subject of pay and costs.

8. There were three specific points to which he wanted to draw attention:

(a) commercial construction was booming and earnings there were rising exceptionally rapidly. This was also true of residential construction. Building societies were flush with funds and, at current market interest rates, it was quite possible that they would reduce their mortgage rate later in the month, thus intensifying pressures in the housing market;

(b) international interest rates had risen and expectations were for further rises;

(c) the sectoral composition of liquidity growth was changing. For most of 1987, much of the growth in M4 came from the financial institutions. More recently, the impetus was from industrial and commercial companies, a development which was more worrying than reassuring. The same change had occurred in the sectoral pattern of credit demand.

9. Sir Terence Burns said he was persuaded that world monetary conditions needed to be tightened. It was now clear that demand had been much stronger in the second half of 1987 than it seemed at the time. The policy relaxations in the autumn needed to be reversed. Commodity prices were beginning to rise quickly.

10. Domestically, there was not a great deal of new information. There were some disturbing signs but the majority of indicators were not yet ringing alarm bells. The fastest period of growth was probably over, though that did not imply that inflationary pressure was declining. He agreed with Mr George that the most worrying developments were in the construction sector and house prices, as would be expected with the present balance of exchange and interest rates. Taken altogether, some tightening was necessary but it was important not to overestimate the urgency or the extent of what was needed.

11. Turning to tactical considerations, Sir Peter Middleton asked whether we were yet able to risk putting up interest rates given exchange rate conditions. The following points were made in discussion:

(i) the short segment of the yield curve was now sharply upward sloping, suggesting the market was expecting an interest rate rise. This reflected both domestic perceptions and the rising trend of international rates. Consequently, interbank rates might not rise by as much as any increase in base rates;

(ii) if the pound were to soften, two ½ per cent increases in interest rates - one above DM 3.10 and one below - would carry less risk of a sharp exchange rate rebound than a single 1 per cent rise;

(iii) if, alternatively, sterling were to strengthen, the tactics should be to resist a fall in interest rates as long as possible so as to produce the desired net tightening. The difficulty would arise if the exchange rate remained steady; in that case, it could be hard to produce tighter conditions;

(iv) we had long wanted a different policy mix - a lower exchange rate and higher interest rates. There could be a case for determined intervention to create the room for raising interest rates;

(v) intervention, however, was only likely to be effective in this way if the market already felt sterling's upward potential to be limited. It was not clear that this was currently true; though it could become so. It might also be right to accompany any rise in interest rates with some modest intervention to give a lead to the market.

12. Summing up, Sir Peter Middleton said the assessment still suggested, as it has for some time, that some tightening of monetary conditions was required. It would be particularly unfortunate, given the pattern of pressures, were mortgage rates to fall further, which remained a danger at current interest rates. The assessment pointed to the need to secure some net tightening whilst moving to a pattern of higher interest rates and a lower exchange rate. The advice was therefore for an approach on the following lines:

(i) if sterling drifted down, the tactics should be gradualist ½ per cent increase in interest rates;

(ii) asymetrically, were sterling to appreciate, there should be no hurry to reduce rates;

(iii) the more difficult scenario was where sterling drifted sideways. Intervention might possibly be a useful weapon in this case - and in the others - in favourable circumstances.

JWG

J W GRICE

NB MG separate submission on National Savings Rates (in sep. folder behind)

SECRET

MONTHLY MONETARY ASSESSMENT : APRIL 1988

Summary Assessment

The indicators suggest some moderation in the growth of economic activity this month, though it remains to be seen if the expected deceleration of activity to more sustainable levels will take place. Sterling has edged higher, although higher oil prices will have largely offset the effect on inflation. Monetary growth, especially M0, has increased, and house prices continue to accelerate.

Main Points

The latest available data on economic activity is consistent with the Budget Forecast of a decline in money GDP growth in 1988-89, to 7½ per cent from 9¾ per cent in 1987-88. Inflation remains little changed. (Paras 12, 13, 16, 17)

Sterling has risen by about 1 per cent in effective terms since the end of March, and by 1½ per cent against the Mark. A rise in oil prices has left the oil adjusted exchange rate only marginally higher. (Paras 20, 22)

MO grew by 6.2 per cent in the year to April, and the 12 month growth rate is expected to remain at about 6¼ per cent in May and June. Thereafter, the rate is projected to fall to below 5 per cent after August as consumer spending slows. (Paras 25, 26)

March broad money and credit growth was relatively high. Building societies continued to benefit from the unpopularity of equities and unit trusts, allowing many societies to bid aggressively for lending market share. Bank lending was also boosted by high demand from companies in the wake of the stock market crash, as equity issues dried up. M4 grew by 16¾ per cent in the year to March (16 per cent in the previous month). Bank and building society lending grew by 20¾ per cent in the year to March (20 per cent in the previous month). (Paras 28-43)

House prices continue to accelerate, with the mix-adjusted Halifax index rising by 20¼ per cent in the 12 months to April, compared to 17¼ per cent in the year to Q1. (Para 15)

Annex: Company Finance Post-Crash.

MG2 Division
6 May 1988

A. External Developments

1. The strong rise in **output** in the second half of 1987 is continuing into 1988. In January industrial production was over 9 per cent higher than a year earlier in Japan, 7 per cent higher in Canada and 6 per cent higher in the US and France. US GNP grew at an annual rate of 2-2½ per cent in the first quarter.

2. **Consumer price inflation** in G5 fell to 2½ per cent in February from about 3 per cent throughout the second half of last year.

3. Narrow money (M1) growth slowed markedly over the past year in all the major countries, particularly in the US where there may have been some unwinding of the effects of previous innovations (eg interest bearing sight deposits). In contrast, the rate of growth of broad money in G5 has remained about constant at 8 to 9 per cent since 1984 (table 1). With the US economy remaining strong, the Federal Reserve seems, to judge from Greenspan's remarks to Congress, less concerned about recession and more concerned about inflation. In the event of renewed downward pressure on the dollar US interest rates would probably rise.

4. **Short term interest rates** are close to their levels at the beginning of the year. Falls in most countries in January were reversed in March and early April (table 2a).

5. The **dollar effective exchange rate** was broadly stable over the first three months of the year, but came under downward pressure when February's disappointing trade figures appeared in mid-April.

Conditions in W Germany

6. The high 12 month rate of increase in industrial production in December and January was somewhat inflated by last year's bad weather. The trade surplus has remained fairly constant in DM terms in 1987 and early 1988 (table 2c).

7. Inflation has remained at about one per cent since October. The new targeted aggregate (M3) has grown at an annual rate of 7¼ per since 1987 Q4 - above its target range of 3-6 per cent. Any further decline in German interest rates seems most unlikely: they might rise.

B. Activity and Inflation

8. Recent indicators of **activity and inflation** are summarised in table 4. Indicators released this month suggest continued expansion in economic activity, but perhaps at a more modest rate than in 1987. Inflation remains little changed, though producer input prices have been weak.

Recent indicators of activity

9. Production figures for February provisionally show a fall of just over 3 per cent in **manufacturing output.** The 3 months to February saw manufacturing output around ½ per cent higher than a quarter earlier - well below the 2-2½ per cent quarter-on-quarter growth rates experienced in mid 1987. The sharp fall in manufacturing production in February partly reflects the Ford dispute, and may also have reflected problems with correctly allowing for the leap year. However, the fall was broadly based across industries and market sectors, and has been matched by a fall in overtime worked (see paragraph 11). On balance, manufacturing activity appears to have moderated in the opening months of 1988. Despite this, CBI survey results remain relatively bullish, and do not suggest-as yet-any sharp downturn in activity. Responses on order books and output prospects, which rose on a seasonally adjusted basis through 1988, have levelled off and begun to edge slowly downwards, but still remain high by historical standards. However, while export order books also remain at a relatively high level, the April quarterly survey confirms the sharp fall in export optimism first reported in the January quarterly survey.

10. Private **housing starts** fell back in February from particularly high levels over the previous three months. But this series is notably erratic and despite the latest outturn the housing construction industry shows no evidence of a downturn. **Retail sales** are provisionally estimated to have fallen marginally in March - back to January levels after a small rise in February. Sales volumes are estimated to have risen by around 1¼ per cent in both the last quarter of 1987 and first quarter of 1988 - below the 2½ per cent quarter-on-quarter increases seen in 1987 Q2 and

Q3. Consumer spending may thus have moderated since mid 1987, though it remains too early to assess whether spending will regain momentum following the Budget tax cuts and the latest fall in interest rates. The preliminary estimate of first quarter consumer spending, published on 22 April, was in line with expectations at Budget time.

11. **Labour market indicators** released this month remain bullish, but are consistent with the message from other indicators - namely that the rate of economic expansion may be somewhat lower than in 1987. Unemployment fell further in March (28 thousand on a seasonally adjusted basis, excluding school leavers) but this reduction fell short of the average monthly fall of nearly 40 thousand over the preceding three months. Vacancies remain high but have continued to edge downwards from peak end 1987 levels: in March vacancies fell 2 thousand. Overtime working in manufacturing also remains at a high level but fell back to end 1987 levels in February after a sharp rise in January.

Inflation

12. **Retail price inflation** rose from 3.3 to 3.5 per cent between February and March. Excluding mortgage interest payments, inflation rose from 3.6 to 3.8 per cent. This increase was slightly higher than expected. RPI inflation will rise further in April - to perhaps a little under 4 per cent - reflecting the Budget measures and scheduled increases in local authority rents and rates.

13. **Producer output prices** (excluding food, drink and tobacco) rose 5.0 per cent in the year to March, a slight increase from the 4.9 per cent February outturn. The April CBI survey of manufacturers - adjusted for seasonal variation - showed inflation expectations back to recent levels after a sharp fall in March. Producer input prices (also excluding FDT) rose 4.0 per cent in the year to March, down from the 5.2 per cent February outturn. Input prices (including FDT) fell by ¾ per cent on a seasonally adjusted basis in March, and have fallen by almost 2 per cent on the same basis over the latest six month period.

14. Underlying growth in **average earnings** remained at 8½ per cent for the third consecutive month in February. Underlying earnings rose at similar rates in both manufacturing (8¼ per cent) and the service sector (8¾ per cent) over the year to February. Private sector settlements in the 1987-88 pay round to date have averaged 5¾ per cent, around 1 per cent above the outturn a year earlier, but only ½ per cent higher than the outturn for the 1986-87 pay round as a whole.

15. Latest figures for **house prices** generally show continuing acceleration, with the percentage change on a year ago on the mix-adjusted Halifax index of 17.3% for Q1 and 20.3% for April (compared to 15.5% for the year to December 1987). On the non-mix adjusted DOE series, the annual increase for Q1 was 24% on approvals (compared to 21% to end 1987). Only the mix-adjusted Nationwide-Anglia index shows a deceleration to 14% in Q1, from 16% at end 1987. (This latter index has been volatile in the past and might have some residual bias towards the South-East and towards cheaper properties.) Regional house price indices and the Royal Institute of Chartered Surveyors Report point to a strengthening of the trend evident since last summer of a wave of price rises spreading out from London: the West Midlands, the South West and Lincolnshire have all had recent sharp rises in prices, while inflation has declined in Greater London and there are signs of reduced pressure on prices in the South East and even in East Anglia. The level of real earnings provides the potential for substantial further increases in house prices in the provinces, while the growth of real disposable incomes and, if they are sustained, lower interest rates will also tend to push up house prices nationally. House-price inflation for 1988 for the UK as a whole is likely to be well over 10% and perhaps close to 1987 levels, though there could be some moderation thereafter as house price-earnings ratios in the provinces move towards those in London.

Projections for money GDP

16. The Budget forecast showed a 9¾ per cent increase in **money GDP** in 1987-88, with deceleration to 7½ per cent in 1988-89. The forecast slowdown in money GDP growth is primarily associated with

more modest real output growth (3 per cent in 1988-89 after 4½ per cent in 1987-88), but also benefits from slightly slower growth in the GDP deflator (down from 5 to 4½ per cent). Information available so far for the first quarter shows consumer spending in line with the Budget forecast, but the contribution from the net trade balance somewhat lower than expected, largely because of the sharp recorded fall in exports of goods. (Imports of goods were also lower than expected, but to a lesser extent.) All in all, and allowing both for the tendency for upward revision to early estimates of activity, and the uncertainty surrounding the recent export figures, developments have been consistent with the deceleration in activity foreshadowed in the Budget forecast. (The Bank too forecast a slowdown in activity this year, but place more emphasis on the prospects for a deterioration in the balance on net trade rather than a slowdown in consumer spending growth.)

17. Following the recent appreciation of sterling, the sterling index now stands 4 per cent higher than assumed in the Budget profile. (The Budget Forecast assumed the ERI rises from about 75 to 76 during 1988-89, reflecting dollar weakness, and a sterling-D Mark rate of 3 DM throughout 1988-89.) Against this, base rates are currently one per cent lower - although 3 month interbank rates are currently only ½ per cent lower - than assumed in the Budget Forecast. If sustained, the combination of a higher exchange rate and lower interest rates is likely to constitute some net tightening of monetary conditions. Calculation of the likely economic impact is uncertain, but other things being equal money GDP growth during 1988-89 may be around ¼ per cent lower as a consequence, largely on account of an improved prospect for inflation. Real activity should, on balance, be less affected - higher consumer spending is likely to largely offset a lower contribution from net trade. (We understand that the Bank model would suggest somewhat more downward pressure on money GDP growth in 1988-89 - of the order of ½ per cent - primarily because of lower activity.) The improved outlook for inflation following the rise in sterling may have contributed to the March fall in producer input prices but does not - as yet - appear to have fed through to output prices or, to any great extent, price expectations. Evidence is mixed as to whether lower competitiveness has had any significant influence on export prospects. CBI survey results

show export order books still relatively buoyant despite some downward drift since end 1987. Export optimism, on the other hand, was low in the April quarterly survey - as in the January survey taken prior to the latest rise in sterling. Those indicators will need to be monitored carefully over the coming months.

C. Public Sector Finances and the Fiscal Stance

18. Table 5 gives the main indicators of the **fiscal stance.** The first provisional estimate of the PSBR in 1987-88 was a net repayment of £3.6 billion. Privatisation proceeds were £5.1 billion. This compares with a 1987 FSBR forecast for 1987-88 of a borrowing requirement of £3.9 billion. Of the difference compared to the 1987 FSBR forecast, central government own account borrowing is £7.1 billion less than forecast - Table 6 gives details. The main explanation of the undershoot on central government borrowing is higher than expected receipts, particularly of Inland Revenue taxes.

19. The provisional outturn for the PSBR in 1987-88 is only slightly further into surplus then the central estimate used in last month's exercise (which was a surplus of £3.3 billion) and there is no obvious reason to change the assessment made then of fiscal stance in 1987-88.

D. UK Exchange Rate and External Accounts

20. **Sterling** was strong over most of April - despite worse than expected February trade figures and a fall in base rates - although it has weakened slightly in May so far as oil prices have fallen and the dollar has recovered a little. There have been rises of 1½ per cent and ½ per cent against the mark and dollar respectively since 28 March whilst the ERI has increased by 1 per cent. (Since sterling was uncapped on 7 March, it has risen by 4¼ per cent and 5¼ per cent against the mark and dollar.) The main factors behind sterling's appreciation are probably:

(i) slightly higher oil prices (see para 22);

(ii) high UK real interest rates, despite the cut in base rates of April 8;

(iii) acceptance by the market that bearing down on inflation continued to be the primary policy objective, following the TCSC evidence of the Chancellor and the Governor;

(iv) a weaker dollar after bad US trade figures and uncertainty about the stance of the Fed's policy.

Publication of an underlying rise in reserves for March of \$2¼ billion underlined sterling's strength. Market **intervention** for April was \$740 million.

21. **UK 3 month interest rates**, which were around 8¾ per cent at the end of March, fell by ¼ per cent on the Bank dealing rate cut and now stand at just under 8½ per cent. Euro-dollar rates have risen above 7 per cent, thereby narrowing differentials to about 1¼ per cent. The interest differential against the DM has narrowed to about 2 per cent, reflecting the fall in UK rates.

22. The Brent oil price, which began the period at \$15.35, rose on Gulf tensions to over \$17 towards the end of April but has since fallen back to \$16 on the failure of OPEC to agree to cuts in production. But with oil prices still slightly higher since the end of March, the counterinflationary thrust of sterling's appreciation has been offset somewhat. The **oil adjusted ERI** has risen by ½ per cent since the end of March.

23. The March **trade figures**, published on 29 April, showed a current account deficit of £254 million compared with a deficit of 720 million in February. This was rather better than City expectations, reflecting a 3½ per cent rise in export volumes recorded, a 1 per cent fall in import volumes and a ½ per cent improvement in the terms of trade. The weakening in export volumes during the first quarter has been far greater than would have been expected given evidence from the CBI April survey and the loss in competitiveness.

24. There is increasing evidence that the pattern of the monthly export figures since December has been distorted by the changes in Customs' procedures introduced on 1 January. The proportion of goods shipped in December that were recorded during the December month of account was the highest ever, suggesting that firms wished to complete documentation before the introduction of the new forms. In January, however, the average delay between shipment and the receipt of documents increased sharply. Partial information on February - less so on March - suggests little distortion. There is little evidence of any distortion to imports.

E. Domestic Monetary and Financial Market Developments
(see Tables 10 to 27)

Narrow Money

25. **M0** continued to grow strongly in April, the seasonally adjusted 12 month growth rate rising to 6.2 per cent, from 5.8 per cent in March. But the 12 month growth rate of notes and coin fell slightly to 6.1 per cent, from 6.4 per cent in March. Annualised six month growth of notes and coin has been falling steadily during 1988, from 8 per cent in December to 4¾ per cent in April.

26. The **forecast** has the 12 month growth rate of M0 little changed, at about 6¼ per cent, in May and June. Thereafter, M0 growth is projected to fall back steadily, to under 5 per cent after August. The slowdown in M0 growth mainly reflects the expected slowdown in the growth of consumer spending during 1988.

27. The annual growth rate of **M1** increased by ¼ per cent in March, to 20¾ per cent, the large one month rise of 6 per cent most likely reflecting a build-up of bank deposits by the private sector in the face of large seasonal underfunding (see paragraph 44) and also probably includes a boost due to the redemption of 2% Index-Linked stock which returned £1.2 billion to holders (largely small private investors) at the end of March. The annual rate of M1 growth in 1988 so far has been below the rates of 22-23 per cent seen throughout 1987.

Broad Money

28. Twelve month growth rates of broad money rose in March, the main influence within the counterparts being the substantial underfund. There is little evidence of unwinding of recent months' bill arbitrage, and much of this is expected to unwind in April. Building society retail deposits continued to grow strongly and the 12 month growth rate of M4 rose by ¾ percentage point, to a record 16¾ per cent. The rise in bank and building society lending was exceptionally high, with the 12 month growth rate rising to 20¾ per cent from the norm of 19-20 per cent prevailing since mid 1986. There is now more evidence that the acceleration of lending in recent months owes something to the substitution of bank lending by companies which are no longer issuing equities (see paragraph 38 and Annex).

29. **M4** grew by £10.1 billion (3.3 per cent) in March and at an annual rate of 16¾ per cent, compared to 16 per cent in February. **M3** rose by £9.1 billion (4.9 per cent) and the annual rate rose to 21 per cent, from 20½ per cent in February.

30. Within the **M4 components,** holdings of M3 by the non-building society private sector rose by £8.6 billion. Retail inflows to building societies, at £1.1 billion (plus £0.4 billion interest credited), continued their strong showing, evident since November. Wholesale funding of the building societies by the private sector was negligible.

31. The **sectoral analysis of M4** growth in Q1 shows a very marked slowdown in financial (excluding building society) companies' deposits, some moderation in deposits of industrial and commercial companies (ICC's), and an acceleration in personal sector deposits. Overall, the year on year growth rate of M4 continued to rise, to 16¾ per cent in Q1 from 16¼ per cent in Q4 1987 and 14 per cent in the first half of 1987. Financial companies' sterling deposits grew by 3.1 per cent in the latest quarter, compared with 7 per cent in Q4 1987 and an average of 9 per cent per quarter last year. ICCs sterling deposits grew by 1.9 per cent in Q1, compared with 7¼ per cent in Q4, but the annual rate rose to 27½ per cent, from

around 26 per cent throughout most of 1987. Personal sector deposits rose by 4.5 per cent in Q1 compared with average growth of 2.8 per cent during 1987, bringing the annual rate of growth to 13¾ per cent, from 11¾ per cent in Q4.

32. Within the **M3 components** in March, retail bank deposits rose by £2.8 billion and wholesale deposits by £5.2 billion, both figures being boosted by seasonal underfunding.

33. In addition to **building societies'** strong retail inflows in March, **net wholesale inflows**, at £0.3 billion, are beginning to show the effects of the large borrowing programmes announced so far this year. There is some evidence however that the new Euro- and syndicated credit facilities are being used in part to repay existing wholesale deposits. Building societies have not yet announced reductions in retail deposit rates to match the reductions in mortgage rates which will take effect for existing borrowers from 1 May, but most societies have ample liquidity and may if anything want to increase their margins. Thus, their retail deposit rates are likely to be reduced by about ½%, in line with the most recent reductions in base rates, leading to a roughly unchanged competitiveness position vis-a-vis the banks.

Credit

34. **Bank and building society lending** rose by £7.8 billion (2.3 per cent) in March, the percentage increase being ¼ per cent higher than the average of the three previous interest charging months. The 12 month growth rate rose to a record 20¾ per cent, from 20 per cent in February. Annual growth is still thought to be inflated by bill arbitrage undertaken in January, which is expected to unwind in April.

35. **Sterling bank lending** grew by 2.7 per cent in March, a growth rate similar to the previous three interest charging months. But the annual rate increased to 25¼ per cent, from 24¼ per cent in February. It is unlikely that March's rise was affected by unwinding bill arbitrage from December or January since the total of commercial

bills outstanding was unchanged. But the recorded lending figure was depressed by an increase of £½ billion in bills held by the private sector.

36. Clearing banks (CLSB) figures - which covered about 75 per cent of the total increase in advances in March - show a sharp increase in borrowing by ICC's of £2.4 billion, compared with an average of £1.8 billion in September and December. Within this, lending to property companies and to 'other services' (mostly small businesses) remained very strong.

37. The latest quarterly sectoral analysis of sterling bank lending also shows an acceleration in borrowing by ICCs, which accounted for 53 per cent of the total increase in lending in Q1 1988 compared with 37 per cent in Q4 1987 and 33 per cent in Q3. Annual growth of lending to ICCs jumped to 24¾ per cent, from 15¾ per cent in Q4.

38. It is likely that some of this acceleration in company borrowing is due to substitution by companies from equity borrowing since the crash, as substantial syndicated bank credit facilities have been announced since October. It is not possible to quantify this effect however because the syndicates include overseas banks, and the amount and timing of drawn-down of the facilities is not known.

39. Of the remainder of CLSB banks' lending in March, there was a rise of only £0.1 billion in lending to financial companies. In Q1 as a whole, sterling lending to financial companies continued its steady decline, growing by 4.2 per cent compared with an average of 6.4 per cent in 1987 and 10.2 per cent in 1986.

40. CLSB **lending to persons for house purchase** in March rose by £1.0 billion and their lending to persons for consumption rose by £0.6 billion, both of these figures being similar to the increases in previous interest charging months. In Q1 as a whole, bank lending for house purchase eased slightly from the very high levels seen in 1987, but this slowdown reflects loss of market share to building societies, whose lending recovered sharply in Q1 (see paragraph 42). In total, bank and building society lending for house purchase

accelerated in Q1, growing by 4.6 per cent compared with 4.2 per cent in the previous two quarters. The annual rate rose to 18 per cent, from 17¼ per cent in Q4, but this is still below the rates of 19-20 per cent prevailing before the second half of 1987. Figures for other mortgage lenders in Q1 1988 are not yet known.

41. It is not likely that the ending of tax relief on house improvement loans announced in the Budget boosted mortgage lending in March, since only a commitment rather than a draw down of borrowing was needed before 5 April to qualify for relief. Furthermore, buoyant lending was already evident in the first half of March before the change was announced.

42. **Building Societies' mortgage lending** in March was a record £2.3 billion. (The monthly average in 1987 was £1.2 billion and in 1986 £1.6 billion.) The March figure may be exceptional following February's dip below trend, but mortgage commitment figures are high, and building society mortgage lending is forecast to continue at just over £2.0 billion a month. Compared with the 1987 situation, this represents in part a recapture of market share from the banks and new mortgage lenders, but also indicates an increase in total mortgage demand. Interest rate changes announced by building societies point to a reduction in mortgage interest rates from an average of 10.25% to about 9.7%. This cut has been fully matched by the banks and new mortgage lenders', and there is some evidence of a price war developing in mortgages, with some building societies following the other lenders' in offering Libor-related mortgages and lower rates for large mortgages.

43. Bank lending to the private sector in foreign currency also rose strongly in March, by £2.2 billion, compared with falls averaging about £0.1 billion per month over the previous six months (although currency borrowing has fluctuated erratically over the period). In the quarter as a whole, foreign currency borrowing rose by £2.0 billion and this was entirely accounted for by ICCs.

Funding

44. There was a £5.6 billion underfund in March, mainly reflecting the PSBR of £3.8 billion, intervention of £1.1 billion and gilt

redemptions of £0.7 billion to the private sector (largely reflecting the redemption of the Index Linked gilt). This gives an overfund of £0.1 billion in 1987-88 as a whole, or an underfund of £0.2 billion allowing for the 1986-87 underfund. On the basis of the funding rule for 1988-89 - which is based on funding with respect to the M4 private sector - underfunding was £5.3 billion in March, giving an M4 overfund of £1.4 billion in 1987-88 as a whole.

45. The **external counterparts** to M4 were £1.3 billion in March, mainly reflecting an increase of £1.5 billion in the public externals due to intervention of over £1 billion in early March (prior to sterling exceeding DM3 on 7 March). Banks and building societies' external transactions were minus £0.2 billion, within which the banks switched into sterling assets (net of sterling liabilities) by £1.3 billion, and the overseas sector increased its net sterling borrowing by £1.1 billion.

46. Broad money growth is **forecast** to drop back significantly in April, with annual growth of M4 falling from 16¾ per cent to 15¾ per cent and M3 growth from 20¾ per cent to 18¾ per cent. The main factors (shown in Table 24) behind the slowdown are the expected unwinding of bill arbitrage undertaken in January, and overfunding of about £1 billion, reflecting the forecast PSBR surplus. Building society retail inflows are expected to remain high, benefitting from continued very low unit trust inflows, although the third call on British Gas shares may have a small downward effect.

47. Bank and building society lending is forecast to rise strongly again in April with annual growth remaining at about 20¾ per cent. Annual growth of bank lending is expected to remain at 25¼ per cent. There are some large offsetting factors underlying the forecast (shown in Table 25). Unwinding bill arbitrage - against both sterling deposit and foreign currency - is expected to have a depressing effect. But there will also be a boost from continued strong borrowing by companies, perhaps in substitution for equity borrowing, accompanied by further steady growth in mortgage

borrowing, as recent very high commitments figures feed through and the temporary impetus from joint borrowers ahead of the 1 August tax relief deadline begins to be felt.

Money Markets and Interest Rates

48. **Money market rates** began April ranging from 8.6 per cent at one and three months to 9.1 per cent at 12 months. The cut in base rates to 8 per cent on 8 April steepened the yield curve, which was accentuated by fading hopes of a further cut following the release of the money figures, and a slight easing of sterling. Rates currently range from 7.9 per cent at one month to 9.3 per cent at 12 months.

49. The stock of **money market assistance** fell by £3¾ billion during March to £9¾ billion, largely reflecting March's underfund (see Table 27), but rose to £10 billion at the end of April. It is projected to fall to about £9 billion in May and £8 billion in June.

Gilts

50. **Gilts** began April with the index at 91.0 and 5,10 and 20 year par yields at 8.7, 9.1 and 9.0 respectively. The market rose slightly during the first half of the month, but has fallen back on the money figures and a slight easing of the exchange rate. The cut in interest rates had little impact. The index currently stands at 89.8, with par yields at 9.1, 9.5 and 9.3 respectively.

51. Real yields on **index-linked stock** began April at around 3.8 (3.6 at the very long end) and remained steady around this level throughout the month. Break-even inflation rates for index-linked Treasury 1990 and 2006 are currently 4.0 and 5.5 respectively compared with 4.4 and 5.2 at the end of March. The **equity dividend yield** (based on the all share index) stands at 4.2, down from 4.4 at the start of April.

Capital Markets and Corporate Finance

52. The annex looks at the implications of the crash for company finance. It concludes that, with the drying up of equity issues, companies may rely increasingly on their stocks of liquid assets and bank borrowing (resulting in further increases is credit growth) during 1988. In addition, companies may turn more to the bond markets - although issues may be limited to the larger companies.

53. **Equity prices** have risen by 3 per cent since the end of March, mostly reflecting the base rate cut on 8 April and the strength of world stock markets over this period. The all share index currently stands at 925, 18 per cent above its post-crash trough in November and 25 per cent down on its July peak. New issues (and the equity queue) remain depressed, while **eurosterling issues** continue to strengthen - although most issues in April have been by overseas companies.

54. There were net inflows into **unit trusts** of £58 million in March, which continues the depressed level of inflows post-crash. (Before the crash, inflows were averaging £660 million per month during 1987.) **Sterling commercial paper** outstanding rose again in March to £2.9 billion, having risen steadily from £2 billion at the end of December. Within the total, ICC's paper rose by £0.2 billion to £2.1 billion. Monetary sector holdings were unchanged at £0.7 billion.

MG2 Division
6 May 1988

SECRET

Monetary developments since last month's report

	Latest outturns available at time of:		
	Oct Report	Mar Report	Apr Report
Monetary aggregates (12 month % growth)	**(Sept)**	**(Feb)**	**(Mar)**
M0 (sa)	4.9	5.3	5.8 (6.2)+
M3	19.6	20.4	20.9
M4	15.0	16.0	16.8
M5	14.4	15.6	16.7
Bank lending	23.6	24.3	25.2
Bank & building society lending	20.0	19.9	20.8
Interest rates (%)	**2 Nov**	**28 Mar**	**4 May**
3 month interbank	9.3	8.8	8.4
20 year gilt-edged (par yield)	9.3	9.2	9.3
Yield gap	0.0	-0.4	-0.9
UK real 3 month interbank	4.9	4.7	4.3
Equity dividend yield (all-share)	3.3	4.4	4.2
IG yield (2001) assuming 5% inflation	4.5	3.9	3.8
3 month UK interest differential with:			
Germany	5.2	5.4	5.0
US	1.6	1.9	1.2
World basket	2.6	2.5	2.1
Exchange rate			
DM/£	2.98	3.09	3.13
ERI	74.6	77.1	77.9
Oil adjusted ERI	102.1	108.7	109.3
(Oil-adjusted reference index)	(73.1)	(70.9)	(71.3)
Asset prices			
FT-A Index (% pa)	8.0	-10.5	-11.1
FT-A Level (July peak: 1239)	876	899	925
Halifax house index (% pa)*	14.5	18.2	20.3

+ April outturn

* figures are for October, March and April.

SECRET

ANNEX

COMPANY FINANCE POST-CRASH

This annex looks at the implications of the stock market crash for company finance and, in particular, for liquidity and credit.

Company finance, pre-crash

2. Table 1 shows the various sources of external finance of UK industrial and commercial companies since 1980. The table shows that total external finance has risen from around £10 billion in 1980 to £35 billion in 1987, an increase of about 260 per cent (130 per cent in real terms). Over the same period, internal finance rose from £18½ billion to an estimated £42 billion, a rate of increase of around half that of external finance.

3. Table 1(b) shows that since 1980, companies' bank borrowing has declined as a percentage of total external finance, from an average of 64 per cent between 1980 and 1984 to 38 per cent in 1987. In contrast, over the same period domestic equity issues have risen from about 15 per cent to 38 per cent of total external finance. Other sources - largely overseas investment which includes overseas banks (see footnote to table) - have remained roughly constant, at just over 20 per cent.

4. Several factors underlie this shift towards securitisation:

- First the downgrading of banks' credit ratings in the light of their exposure to LDC debt has left many of them with no comparative advantage over commercial companies in raising finance.

- Second investment banks and securities houses have gained competitiveness against the commercial banks in the corporate finance market.

- Finally, the acceleration of UK equity prices during the 1980's - reducing dividend yields to around 3 per cent in the first half of 1987 - will have encouraged companies to increase their equity finance relative to other sources, including bank borrowing.

5. Table 2 shows the growth of ICC's liquid assets - which are held mainly as bank deposits - since 1980. The table shows that the rapid growth of companies' demand for funds (see para 2) has been matched by comparable growth of their liquid assets, which have risen by 180 per cent between 1980 and 1987 compared to the growth of companies' internal and external sources of finance of 170 per cent.

Company finance, post-crash

6. Table 1(a) shows that since the stock market crash in October. Institutions' appetite for equities has diminished, though the fall in equity values caused by the crash itself reduced their portfolio proportions. For example, between Q3 and Q4 1987, the proportion of life assurance and pension funds' portfolios held in UK equities is estimated to have fallen from 58 to 52 per cent, whilst the share of gilts rose from 13 to 17 per cent (together with a small increase in their liquidity ratios to just over 4 per cent). The funds that they have provided have been largely limited to calls on obligations entered into before the crash.

7. With a much lower level of gilt sales projected in 1988-89 (the Budget Forecast had gross sales of about £2-3 billion, compared to £13½ billion in 1987-88), institutional demand may shift from public sector, to private sector, debt. If so, the upward trend in companies' eurosterling issues - which has continued during 1988 so far (see table 3) - could gather momentum during the current financial year, as companies substitute debt for equity finance. But generally only larger well-known companies are able to make use of these markets. Smaller companies often do not have the credit standing to be able to do so.

8. In contrast to equity issues, bank borrowing by UK ICC's has risen sharply in Q1 1988, to around 84 per cent of total external finance, from 38 per cent in 1987. While the contribution of bank borrowing in Q1 is unlikely to be sustained at such a high level in the rest of 1988, there are several reasons why company borrowing can be expected to remain well above 1987 levels:-

(a) Despite a Budget Forecast of slower output growth this year, business investment is expected to grow strongly with a continued high level of takeover and merger activity expected in 1988. Until equity issues recover, bank borrowing is likely to remain the primary source of external finance.

(b) Announcements of syndicated bank credits, which seem to have inflated bank borrowing during Q1 (see para 38 of main report), have grown rapidly in 1987 and 1988 so far. Whilst announcements of credit facilities may not always be taken up subsequently, and syndicates will normally include overseas (ie non-monetary sector) banks, facilities arranged by UK companies in the international capital markets have increased from a negligible amount in 1986 to $7½ billion per quarter in 1987 and Q1 1988.

9. Finally, table 2 shows that - as yet - the crash does not seem to have reduced the growth of companies' liquid assets, which would be expected if companies were increasingly financing their activities from their stocks of liquidity.

Conclusion

10. The crash is likely to have significant effects on the sources of company finance, at least in the short-term, which has already began to be reflected in the credit figures. Assuming that new issues on the Stock Exchange remain at much lower levels than before the crash and that investment remains buoyant:

(i) companies may turn increasingly to internal sources of finance, running down their liquid assets. This may produce a slower recorded growth of broad money but no great comfort would derive from this since the quantum of willingly held liquidity would correspondingly have fallen;

(ii) companies could turn to the bond market again. But only a small proportion of companies - the larger ones - are probably able to make issues. Despite the intense activity in the eurosterling market recently, funds raised by UK industrial companies from this source remain quite low;

(iii) banks are likely to increase their share of new company finance. This re-intermediation will put upward pressure on recorded credit growth.

TABLE 1: SOURCES OF NEW COMPANY FINANCE (external)

(a) £ billion

	TOTAL	BANK			CAPITAL ISSUES			OTHER(3)
		Total	£	Fc	UK Ord	Other(1)	O'seas(2)	
1980	9.8	6.3	5.1	1.2	0.9	0.5	-	2.1
1981	10.0	5.8	3.2	2.6	1.7	0.7	-	1.8
1982	10.0	6.6	5.7	0.9	1.0	0.2	-	2.2
1983	6.5	1.6	1.1	0.5	1.9	0.6	-	2.4
1984	6.8	7.4	7.0	0.4	1.1	0.2	0.3	- 2.2
1985	13.2	7.8	5.2	2.6	3.4	0.9	0.8	0.3
1986	21.3	10.0	8.7	1.3	5.6	0.7	1.5	3.5
1987	35.8	13.4	10.0	3.4	13.4	0.7	3.9	4.4
1986 Q1	4.8	3.9	3.8	0.1	0.5	0.1	0.3	-
Q2	3.1	- 0.2	- 0.3	0.1	1.4	0.3	1.0	0.6
Q3	3.0	1.1	-	1.1	1.4	0.3	-	0.2
Q4	9.7	5.2	5.2	-	2.3	-	0.2	2.0
1987 Q1	5.0	3.2	1.2	2.0	1.5	- 0.8	0.8	0.3
Q2	6.8	1.5	0.7	0.8	2.3	0.4	1.7	0.9
Q3	12.8	3.6	3.7	- 0.1	5.9	0.8	0.7	1.8
Q4	11.2	5.1	4.4	0.7	3.7	0.3	0.7	1.4
1988 Q1	11.0*	9.3	7.1	2.2	0.3	- 0.1	n/a	n/a

Notes

(1) preference shares and loan capital raised in the UK

(2) foreign currency issues

(3) mostly overseas investment, including borrowing from overseas banks, etc.

* estimate

Source: Financial Statistics, table 8.2, and Bank of England

TABLE 1: SOURCES OF NEW COMPANY FINANCE (external)

(b) % of total finance

	TOTAL	BANK	UK ORD SHARES	OTHER
1980	100	64	9	27
1981	100	58	17	25
1982	100	66	10	24
1983	100	25	29	46
1984	100	109	16	- 25
1985	100	59	26	15
1986	100	47	26	27
1987	100	38	38	24
1986 H1	100	47	24	29
H2	100	50	29	21
1987 H1	100	40	32	28
H2	100	36	40	24
1988 Q1	100	84	3	13*

* estimate

TABLE 2: LIQUID ASSETS OF INDUSTRIAL AND COMMERCIAL COMPANIES

£ billion

	Bank and building society deposits Total	£	Fc	Other liquid assets	Total	(increase, % pa)
1980	17.4	13.9	3.5	4.0	21.4	
1981	23.6	18.0	5.6	3.0	26.6	(24)
1982	26.4	18.6	7.8	4.3	30.7	(15)
1983	32.8	22.4	10.4	4.5	37.3	(21)
1984	36.3	25.3	11.0	4.7	41.1	(10)
1985	38.8	28.3	10.5	4.8	43.6	(6)
1986	47.8	37.1	10.7	4.4	52.2	(20)
1987	55.4	47.1	8.3	4.0	59.4	(14)
1986 Q1	40.3	29.8	10.5	4.2	44.5	(9)
Q2	43.8	32.4	11.4	4.2	48.0	(18)
Q3	47.0	36.0	11.0	4.4	51.4	(20)
Q4	47.8	37.1	10.7	4.4	52.2	(20)
1987 Q1	48.7	37.7	11.0	3.7	52.4	(18)
Q2	50.7	40.7	9.8	3.5	54.3	(13)
Q3	53.4	44.5	8.9	4.1	57.5	(12)
Q4	55.4	47.1	8.3	4.0	59.4	(14)
1988 Q1	56.6	48.2	8.4	4.0*	60.6	(16)

* estimate

Source: Financial Statistics, table 8.4

TABLE 3 : EUROSTERLING ISSUES (Fixed and Floating Rate)

£ billion

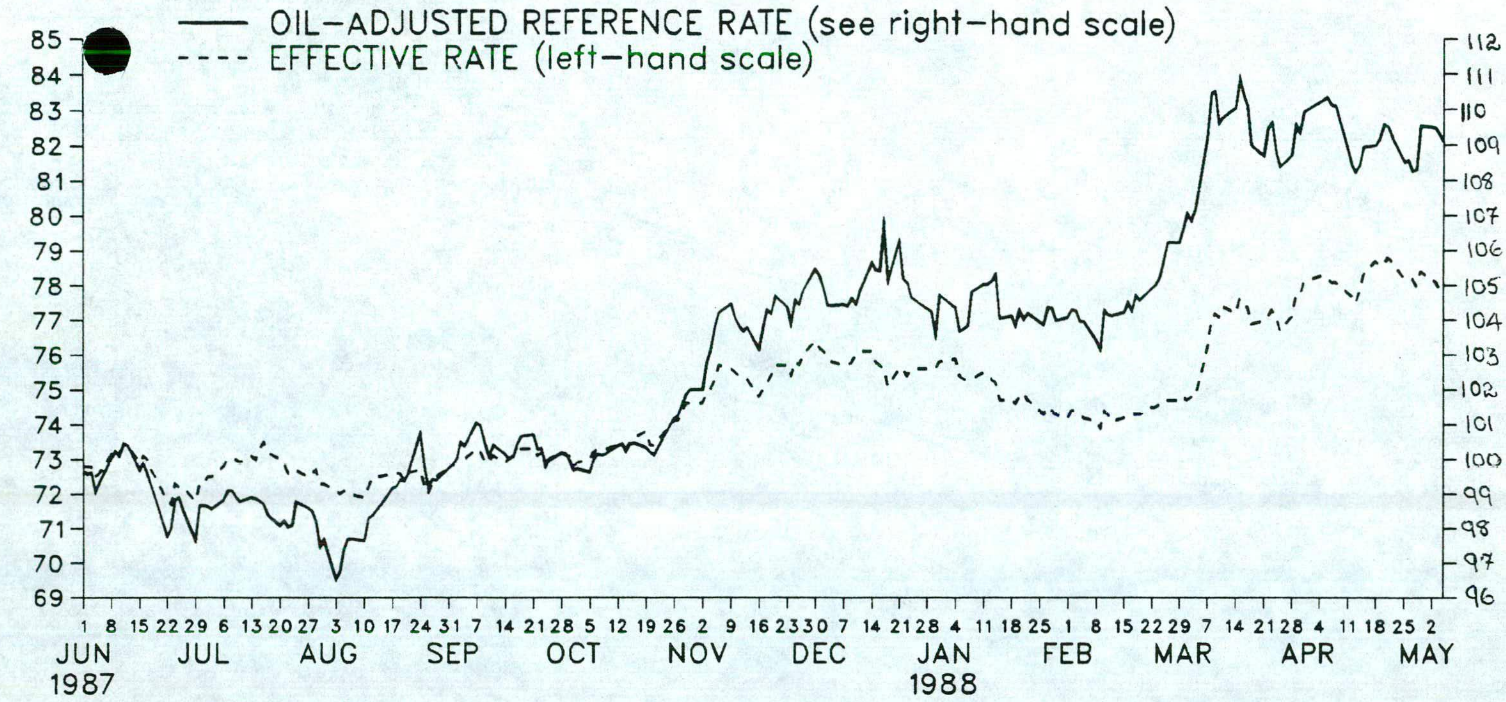
	UK ICC's	Other UK*	Overseas	Total
1980	-	-	0.3	0.3
1981	-	-	0.1	0.1
1982	-	-	0.5	0.5
1983	0.1	-	1.3	1.4
1984	0.2	0.3	2.5	3.0
1985	0.6	1.4	2.6	4.6
1986	1.4	4.6	1.6	7.6
1987	2.7	2.3	4.3	9.3
1986 Q1	0.7	1.1	0.5	2.3
Q2	0.4	1.7	0.7	2.8
Q3	0.1	1.7	0.2	2.0
Q4	0.2	0.1	0.2	0.5
1987 Q1	1.2	0.6	1.7	3.5
Q2	0.7	0.5	1.3	2.5
Q3	0.6	0.5	0.5	1.6
Q4	0.2	0.7	0.8	1.7
1988 Q1	0.9	1.8	1.3	4.0
April	0·2	0·5	1·1	1·8

* most

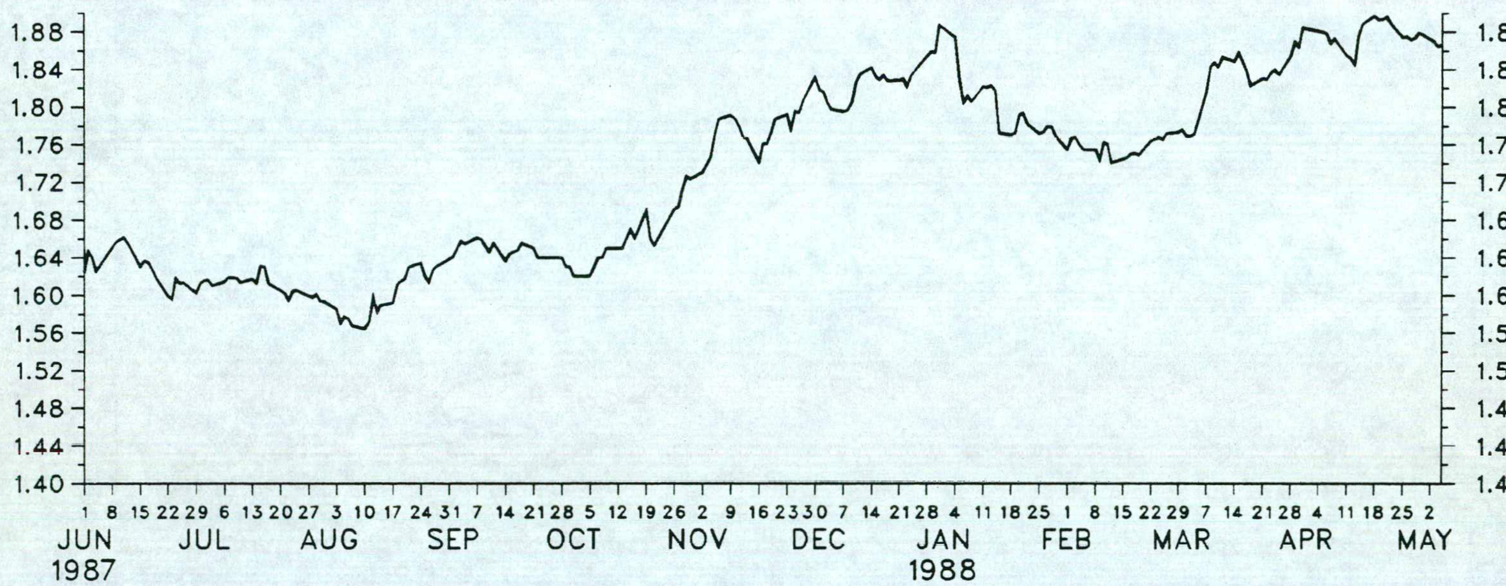
SECRET

MONTHLY MONETARY REPORT : CHARTS

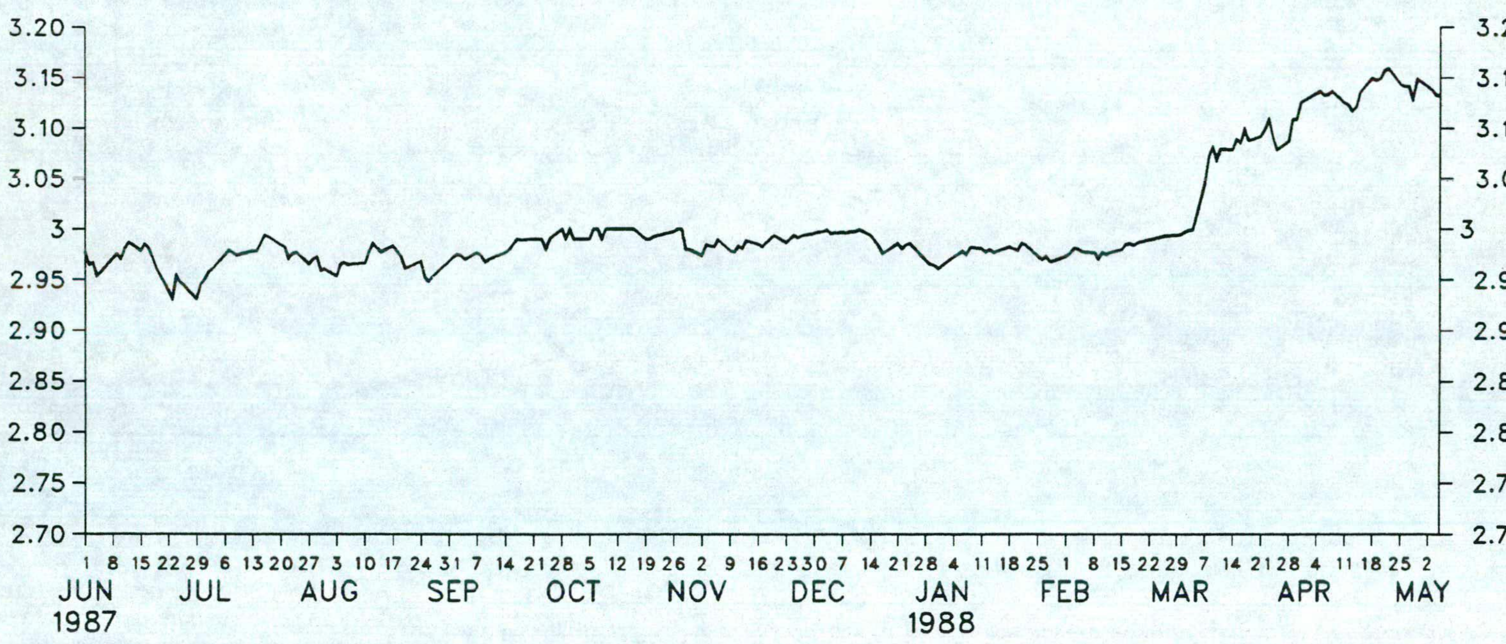
CHART I:EXCHANGE RATE



STERLING/DOLLAR



STERLING/DEUTSCHEMARK



UK/US INTEREST RATE DIFFERENTIAL

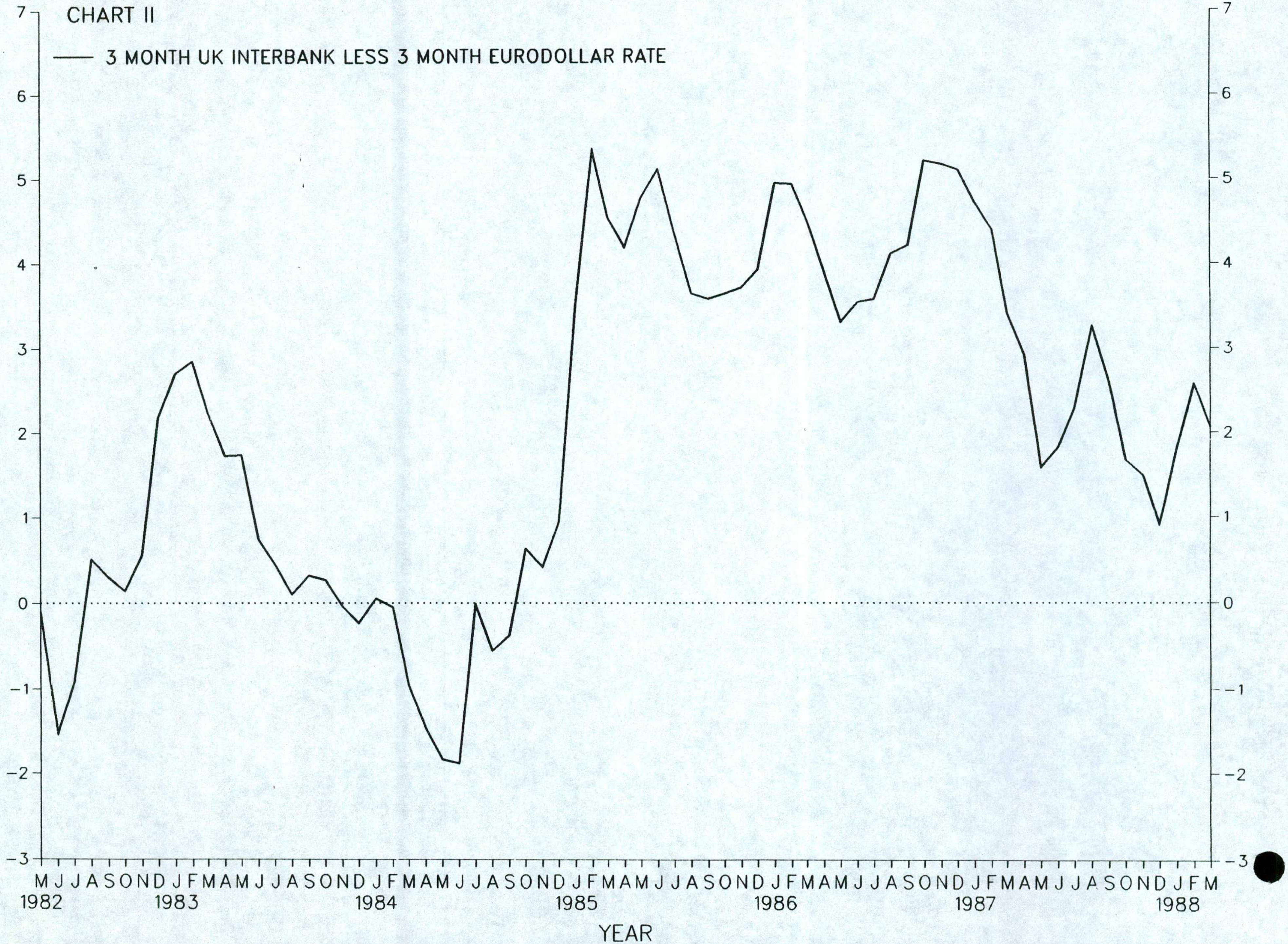


CHART III NARROW MONEY

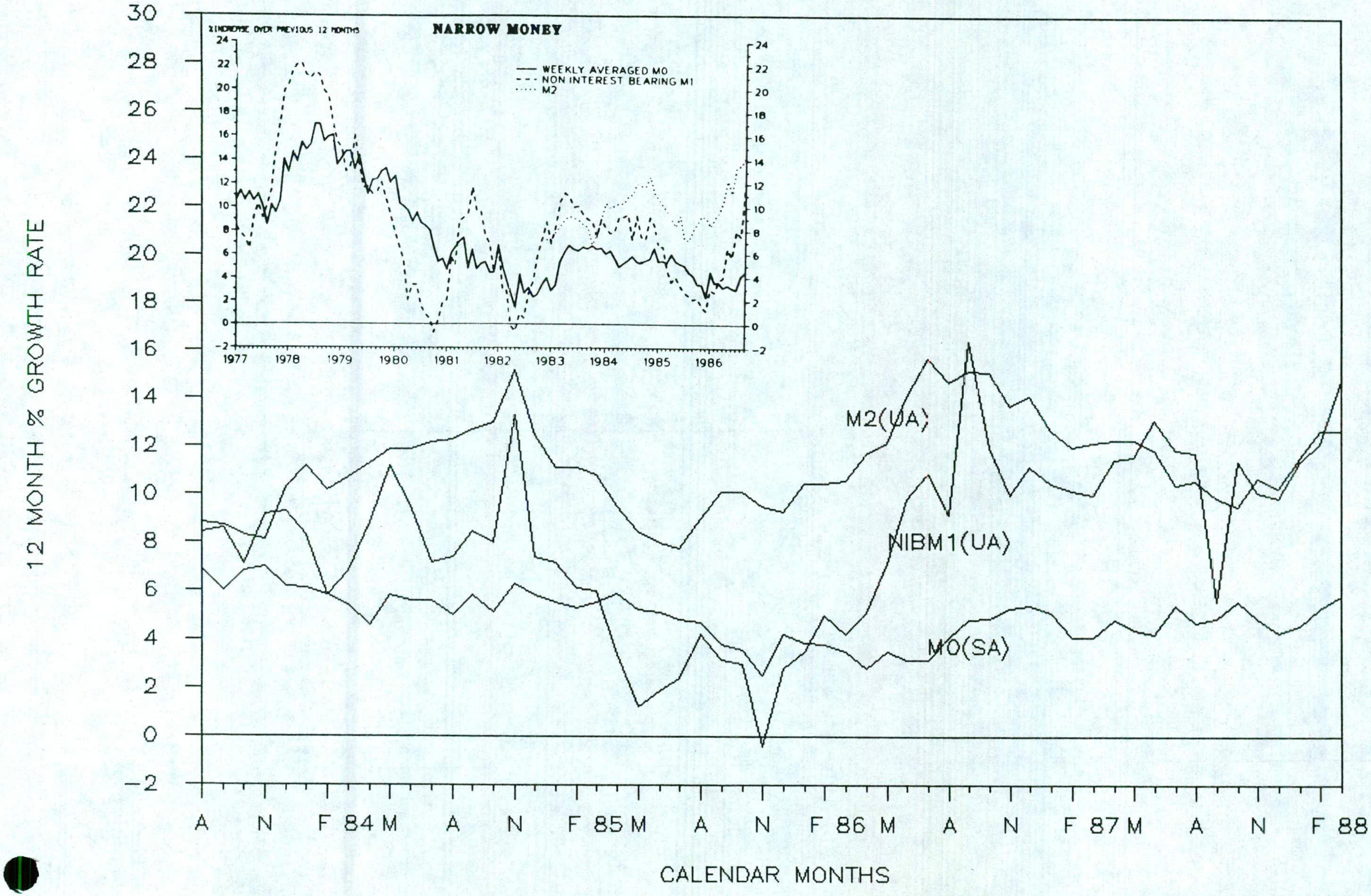


CHART IV BROAD MONEY

Annual percentage growth (ua)

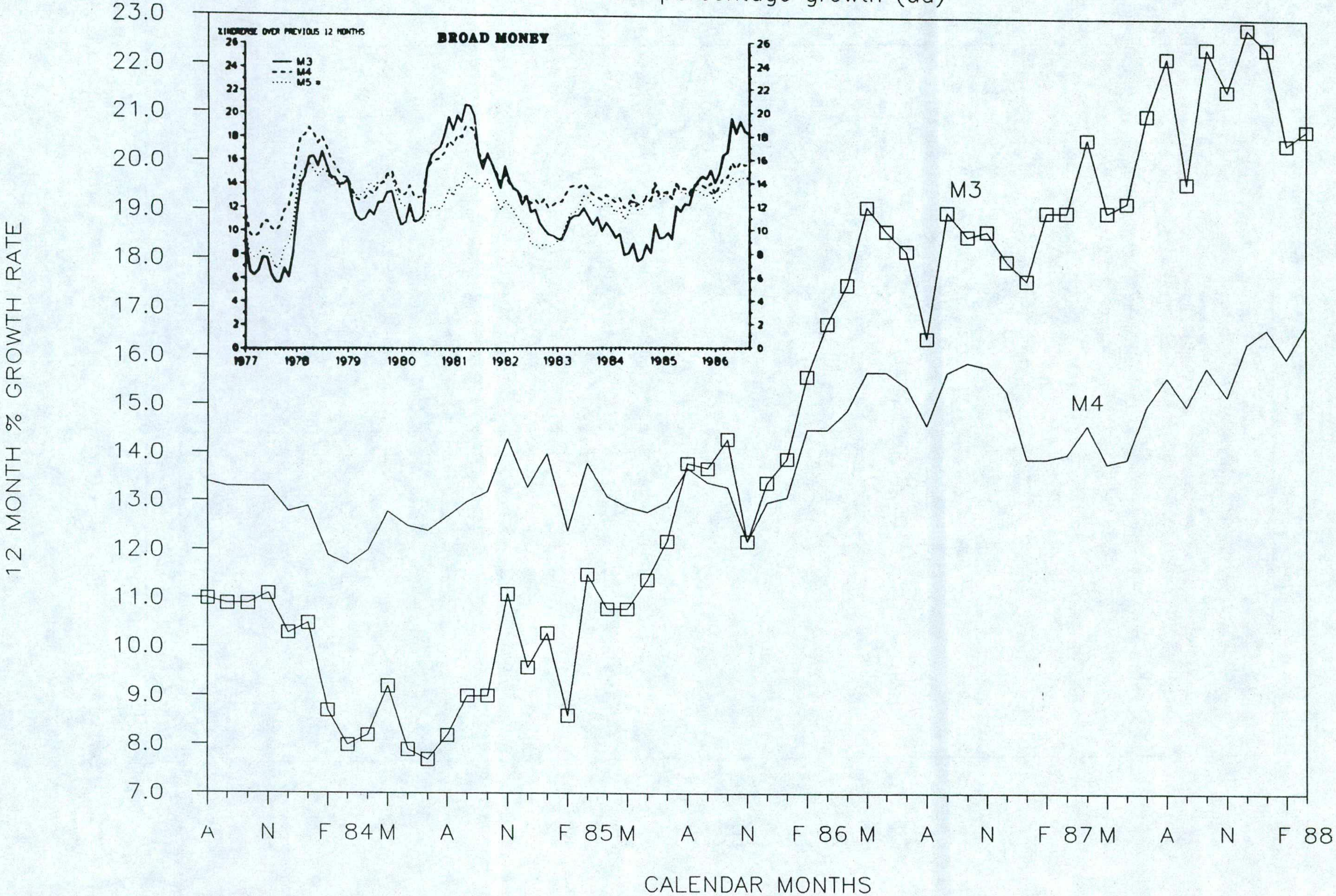


CHART V REAL M0

Annual percentage growth (sa)

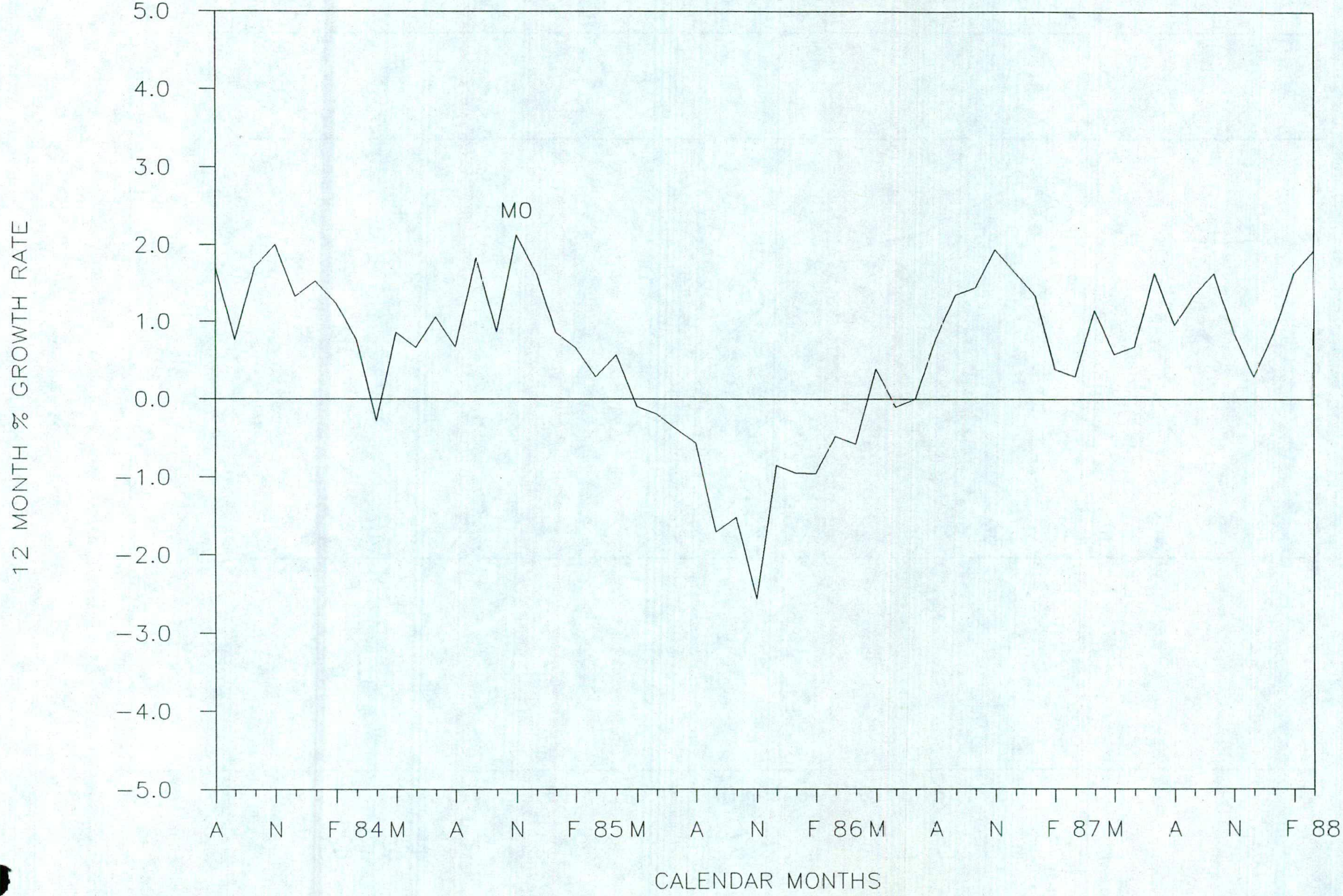
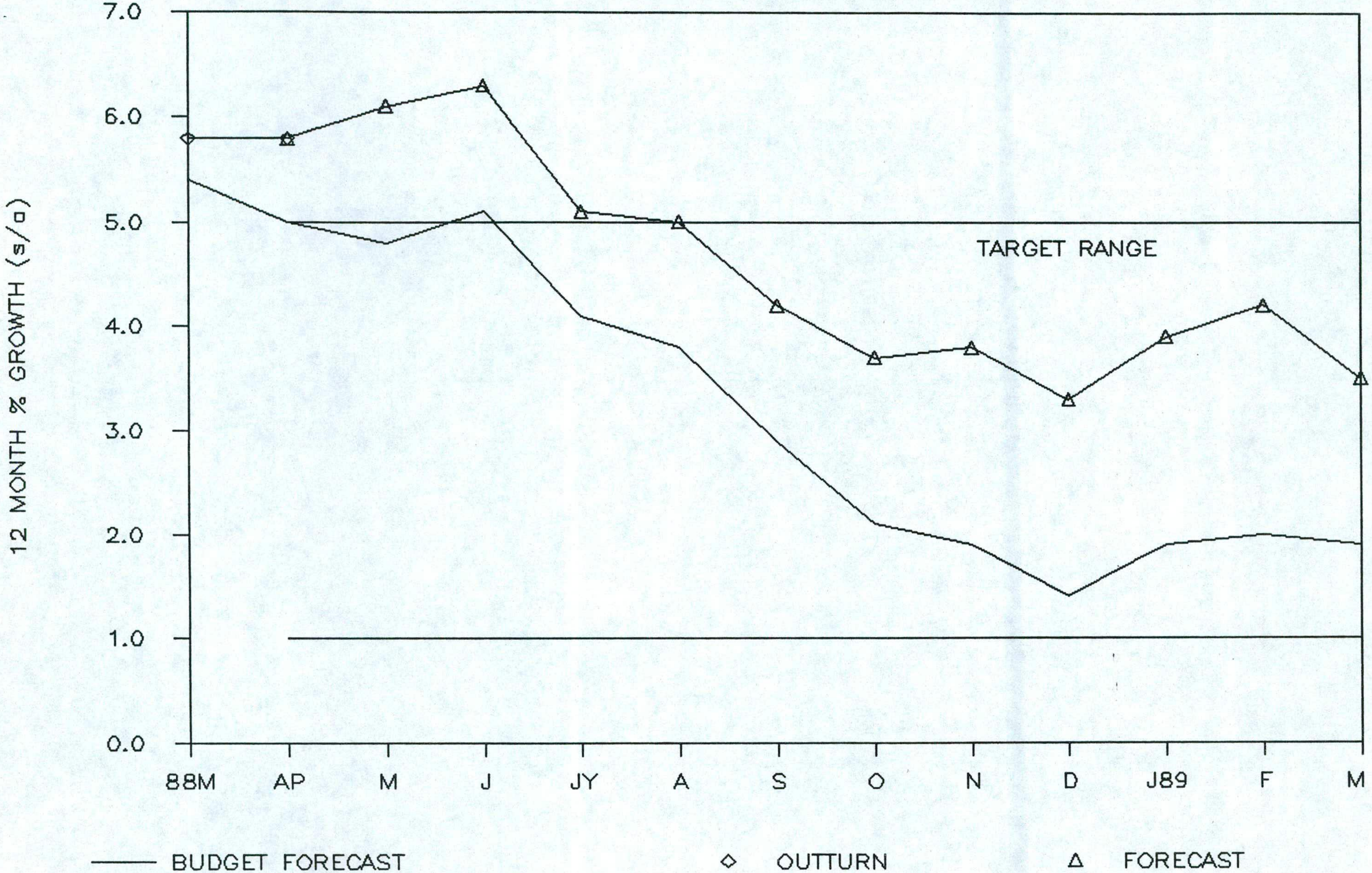


Chart VII M0 : 1988 BUDGET FORECAST

COMPARED WITH OUTTURN & LATEST FORECAST



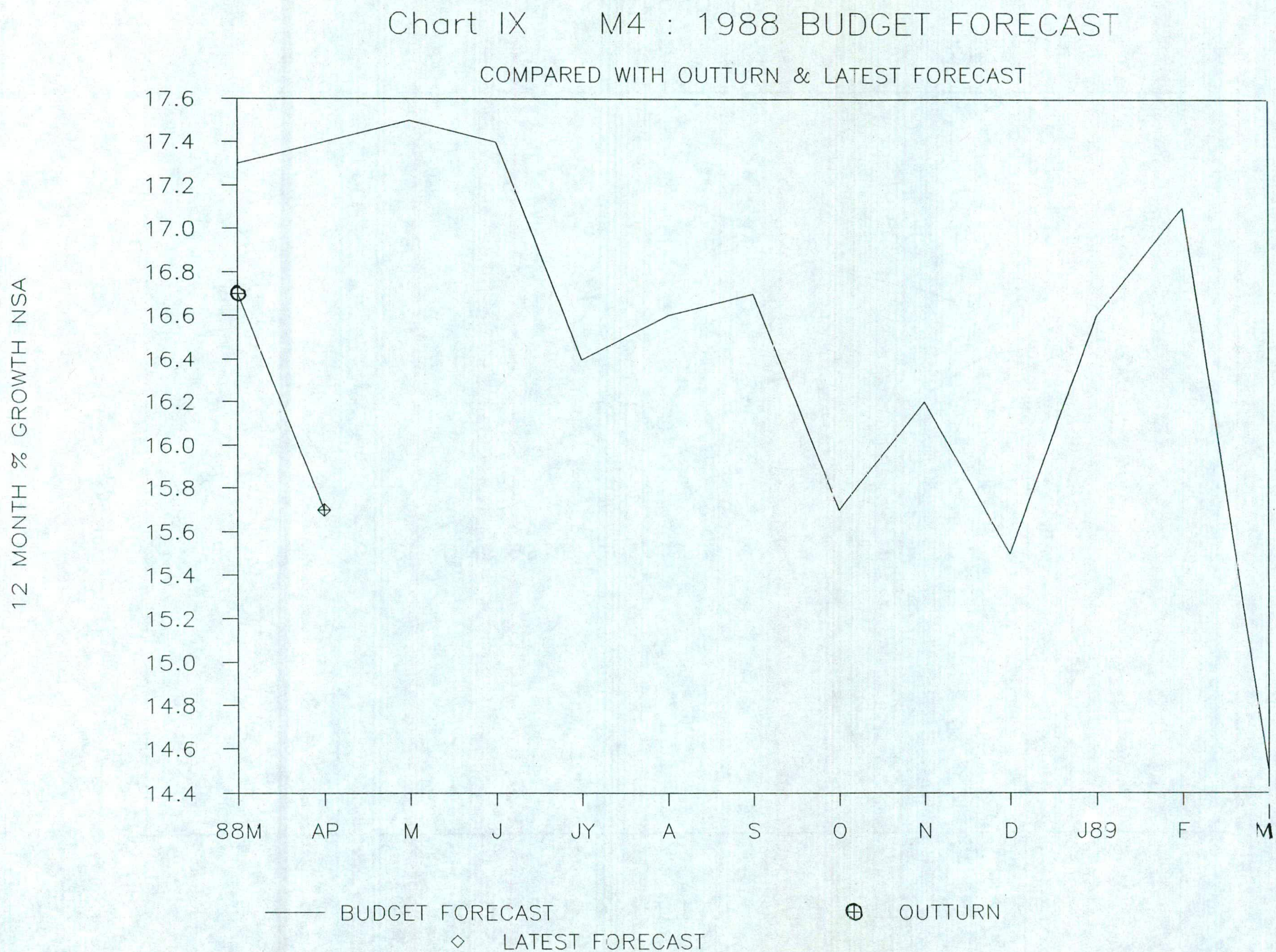


Chart IX M4 : 1988 BUDGET FORECAST
COMPARED WITH OUTTURN & LATEST FORECAST
12 MONTH % GROWTH NSA
17.6
17.4
17.2
17.0
16.8
16.6
16.4
16.2
16.0
15.8
15.6
15.4
15.2
15.0
14.8
14.6
14.4
88M
AP
M
J
JY
A
S
O
N
D
J89
F
M
BUDGET FORECAST
OUTTURN
LATEST FORECAST

CHART X RETAIL DEPOSITS

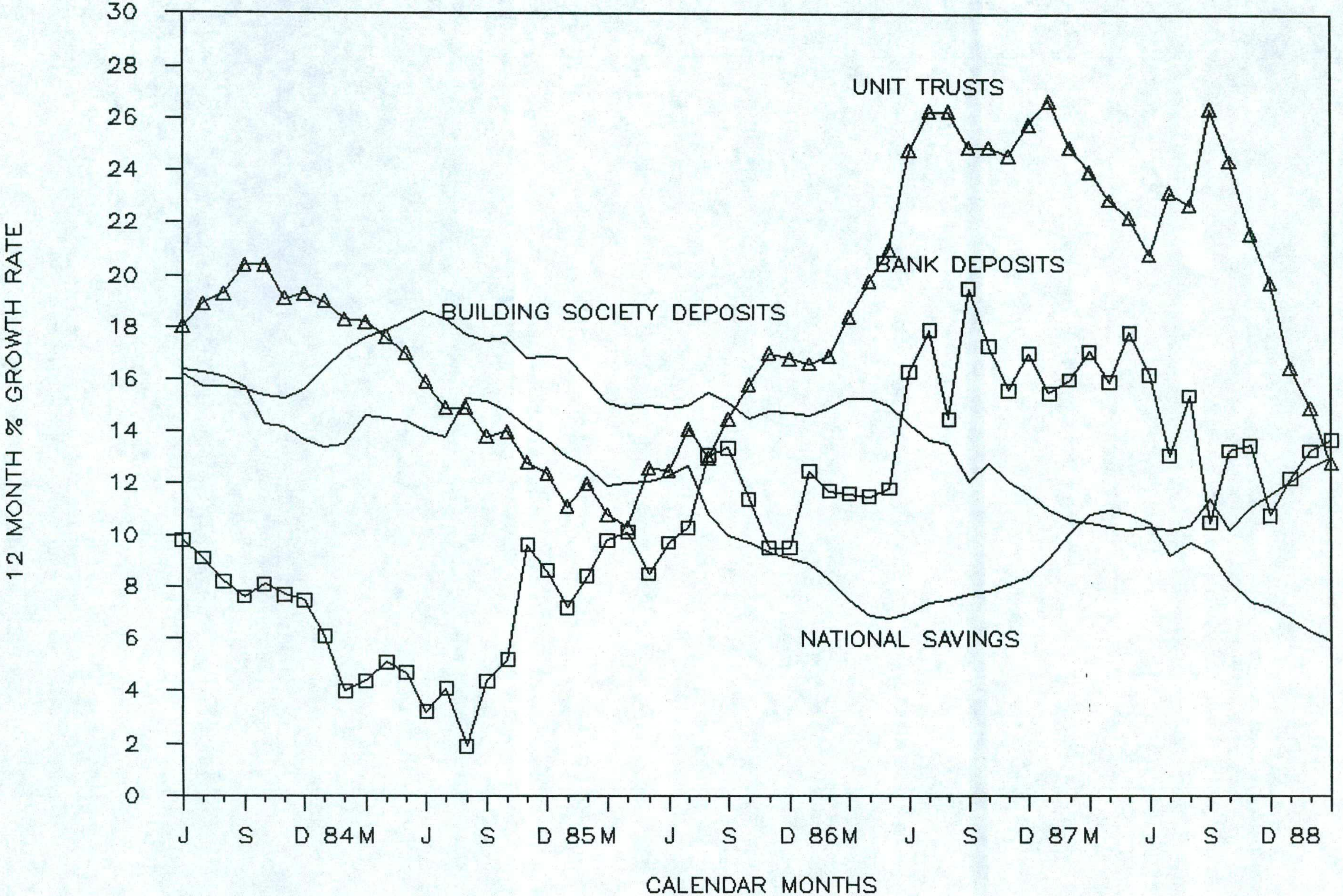


CHART XI

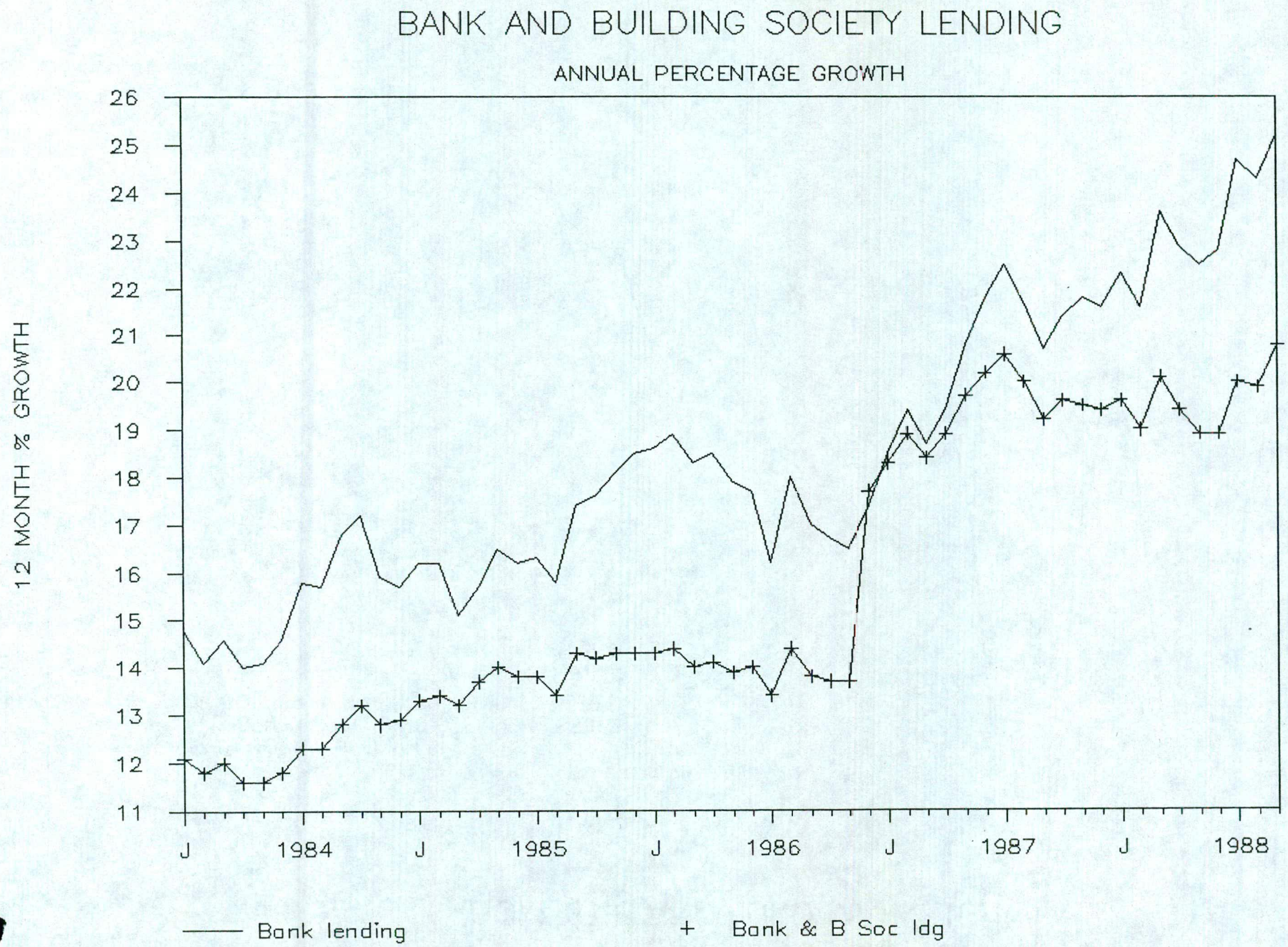

BANK AND BUILDING SOCIETY LENDING
ANNUAL PERCENTAGE GROWTH
12 MONTH % GROWTH
26
25
24
23
22
21
20
19
18
17
16
15
14
13
12
11
J
1984
J
1985
J
1986
J
1987
J
1988
Bank lending
+ Bank & B Soc ldg

CHART XII

STERLING BOND ISSUES BY UK AND OVERSEAS INSTITUTIONS (DOMESTIC AND EURO MARKETS)

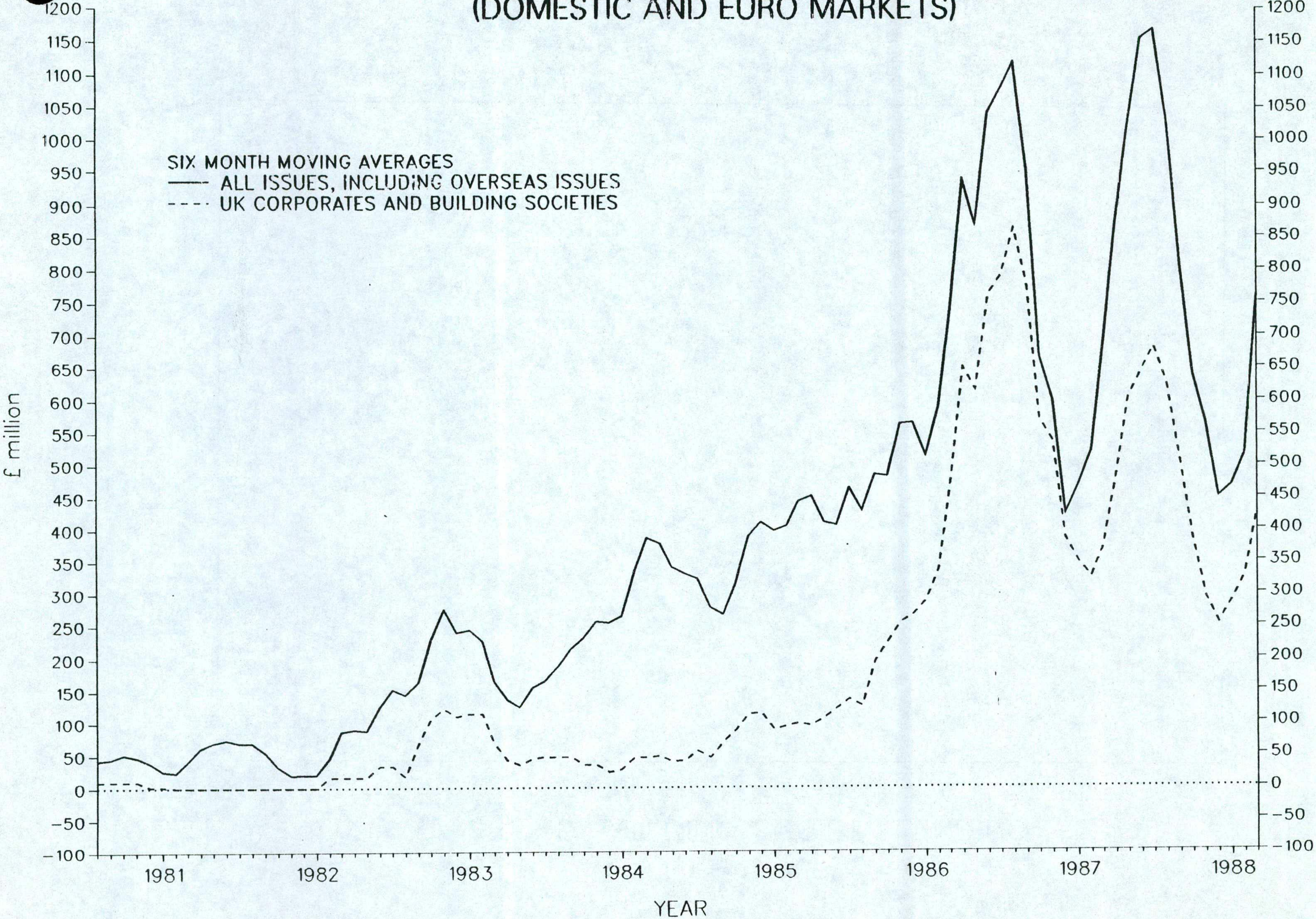
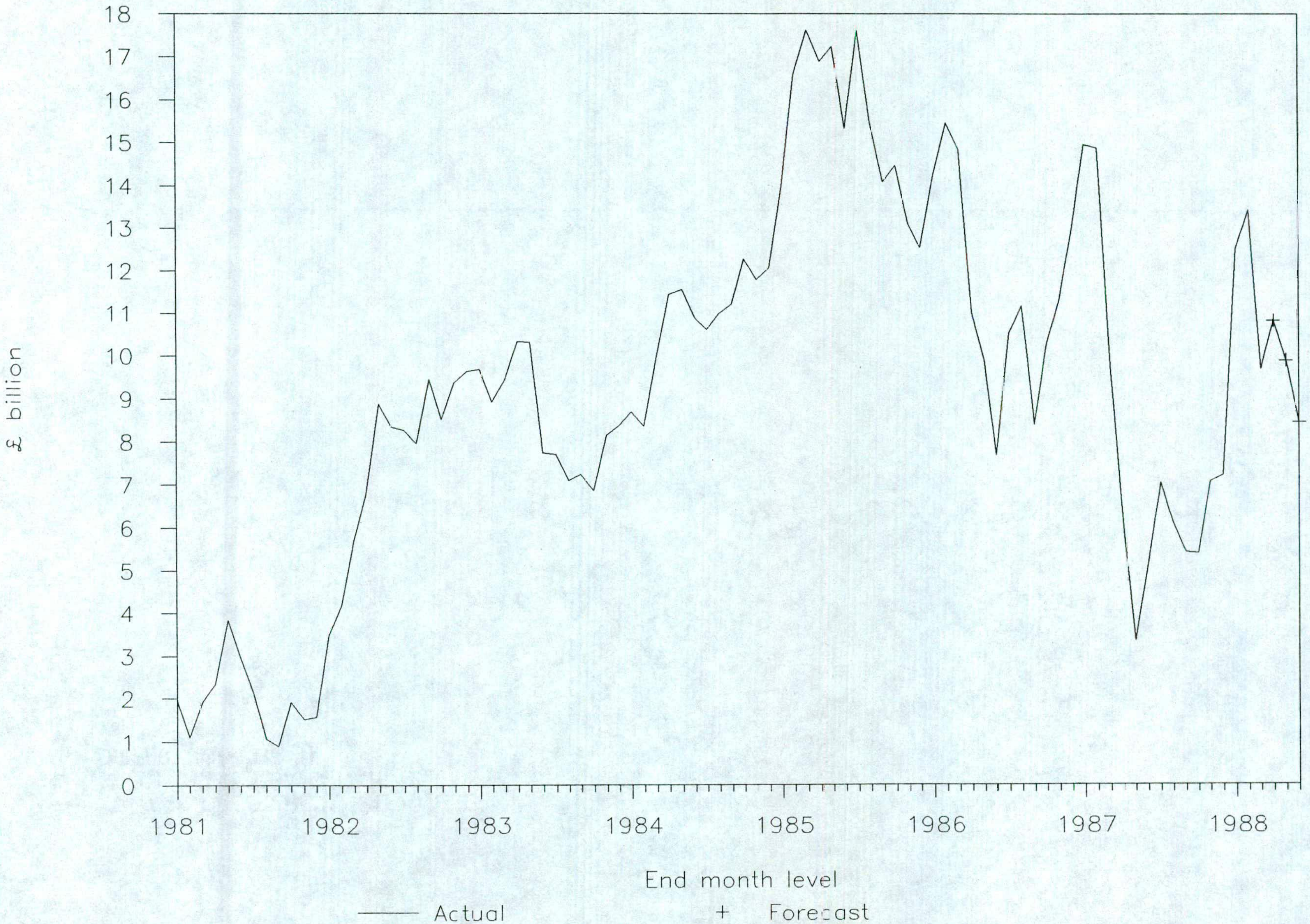
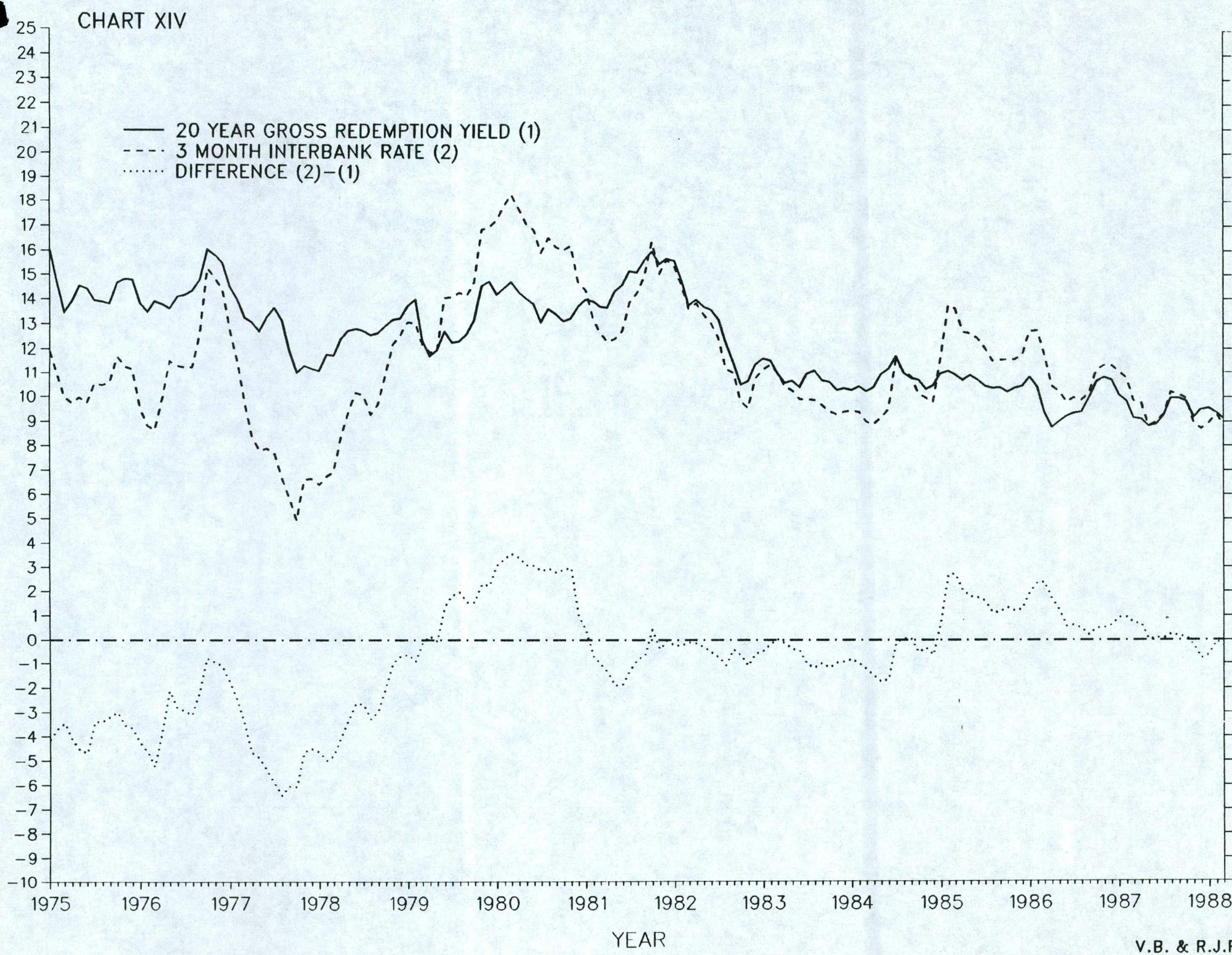


CHART XIII – MONEY MARKET ASSISTANCE

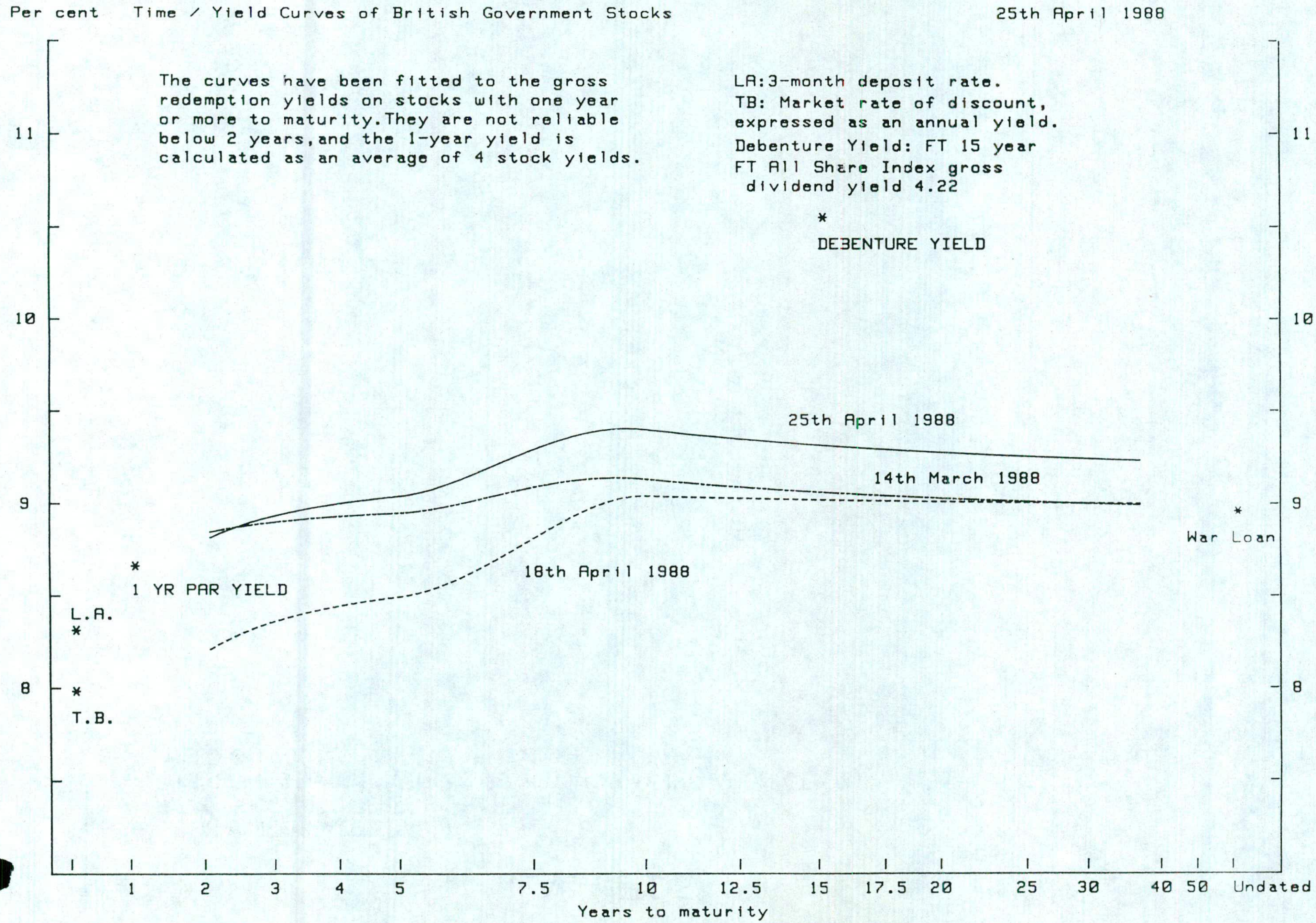


NOMINAL INTEREST RATES



V.B. & R.J.P

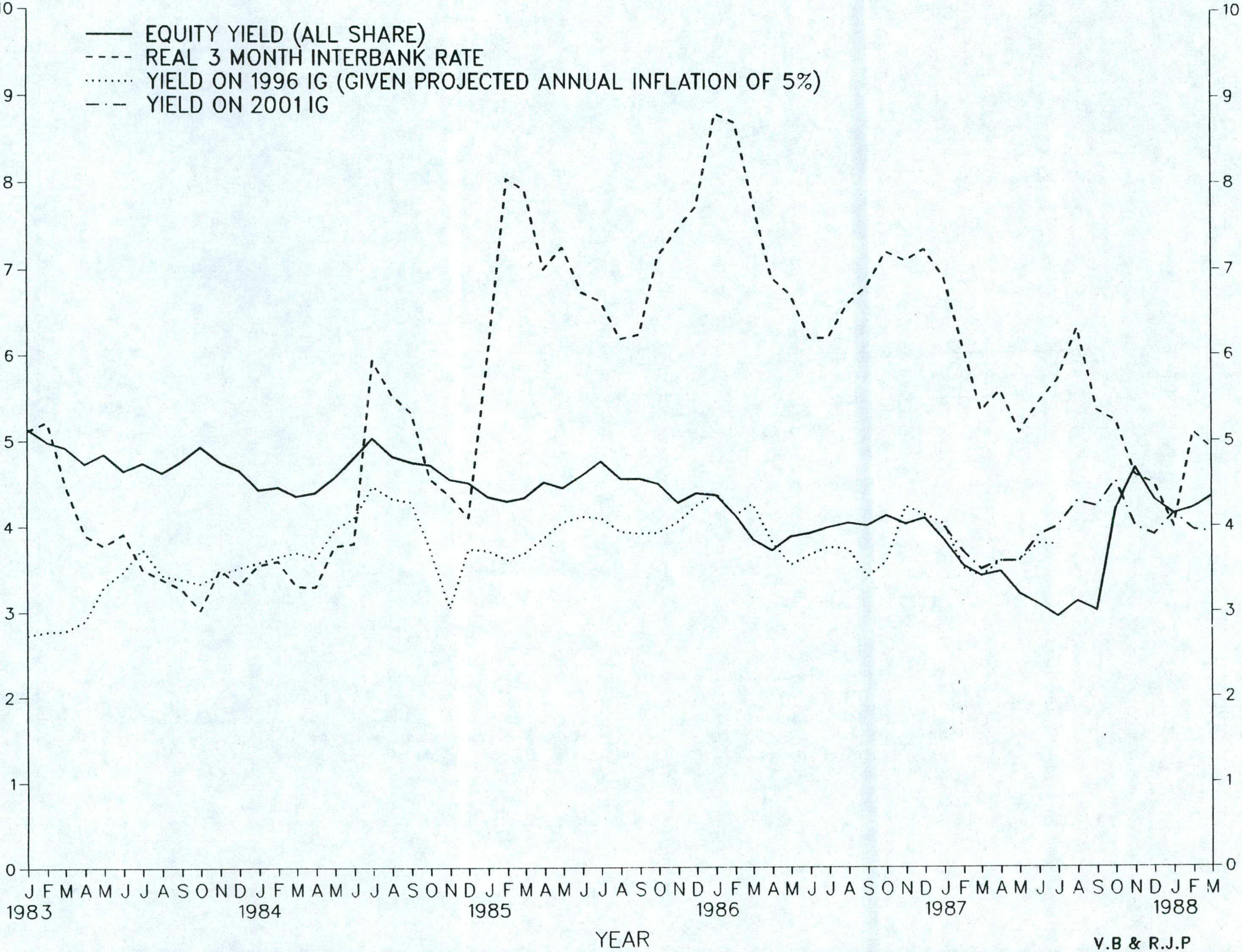
CHART XV



Per cent
Time / Yield Curves of British Government Stocks
25th April 1988
The curves have been fitted to the gross redemption yields on stocks with one year or more to maturity. They are not reliable below 2 years, and the 1-year yield is calculated as an average of 4 stock yields.
LA:3-month deposit rate.
TB: Market rate of discount, expressed as an annual yield.
Debenture Yield: FT 15 year
FT All Share Index gross dividend yield 4.22
DEBENTURE YIELD
25th April 1988
14th March 1988
18th April 1988
1 YR PAR YIELD
L.A.
T.B.
War Loan
11
10
9
8
1
2
3
4
5
7.5
10
12.5
15
17.5
20
25
30
40
50
Undated
Years to maturity

CHART XVI

REAL YIELDS



V.B & R.J.P

ANNUAL HOUSE PRICE INFLATION : I

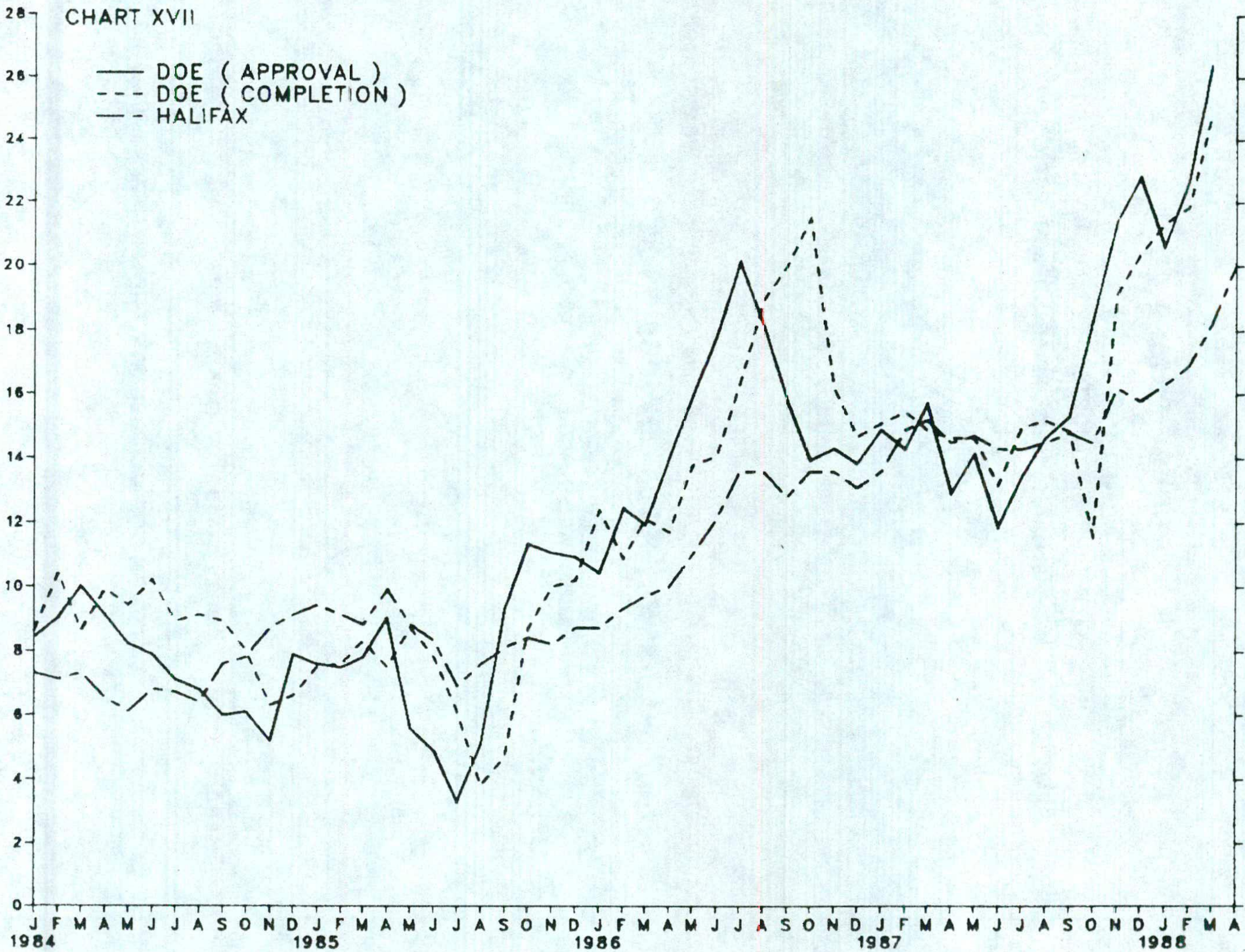
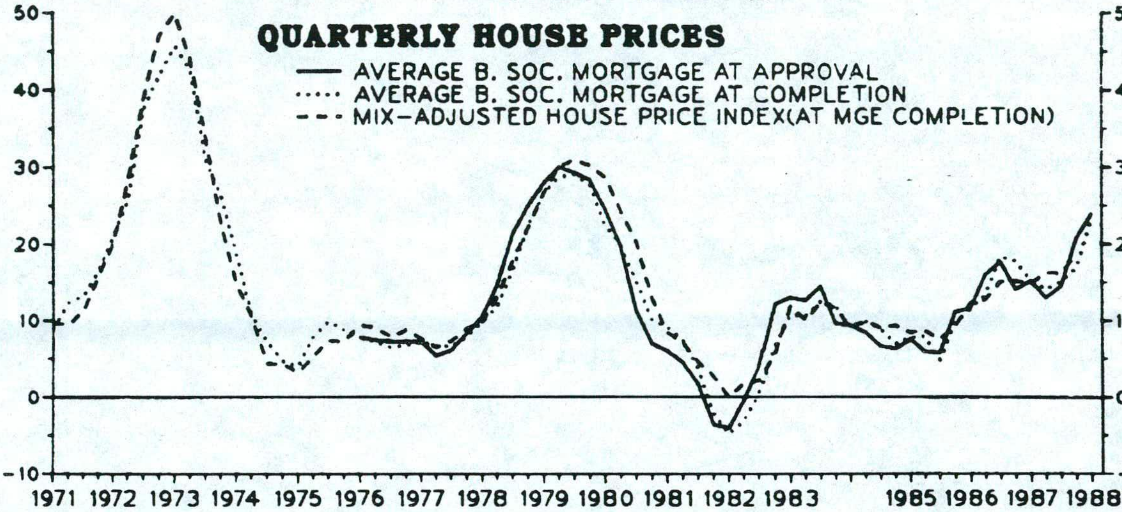
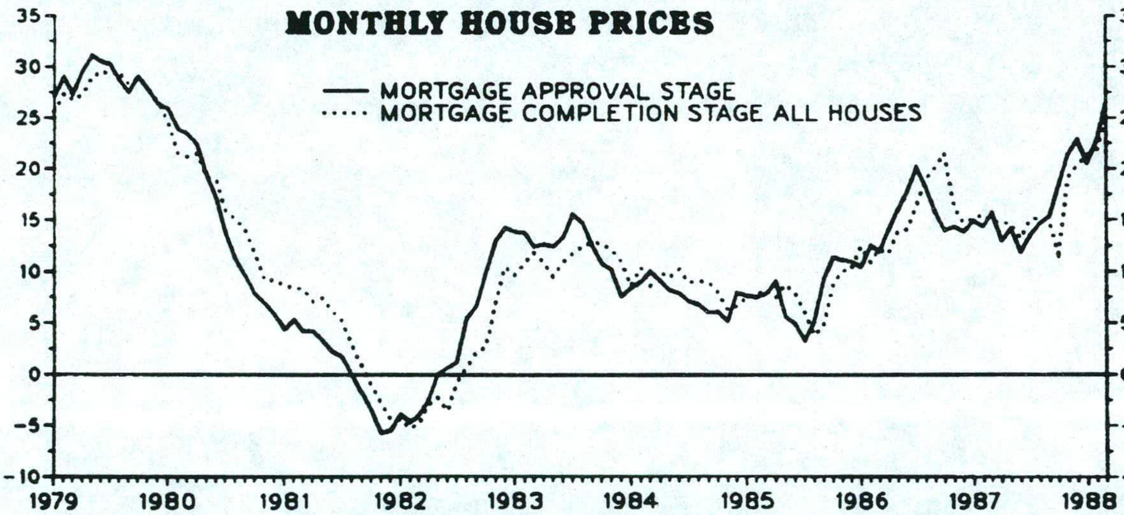


CHART XVIII

HOUSE PRICES 2





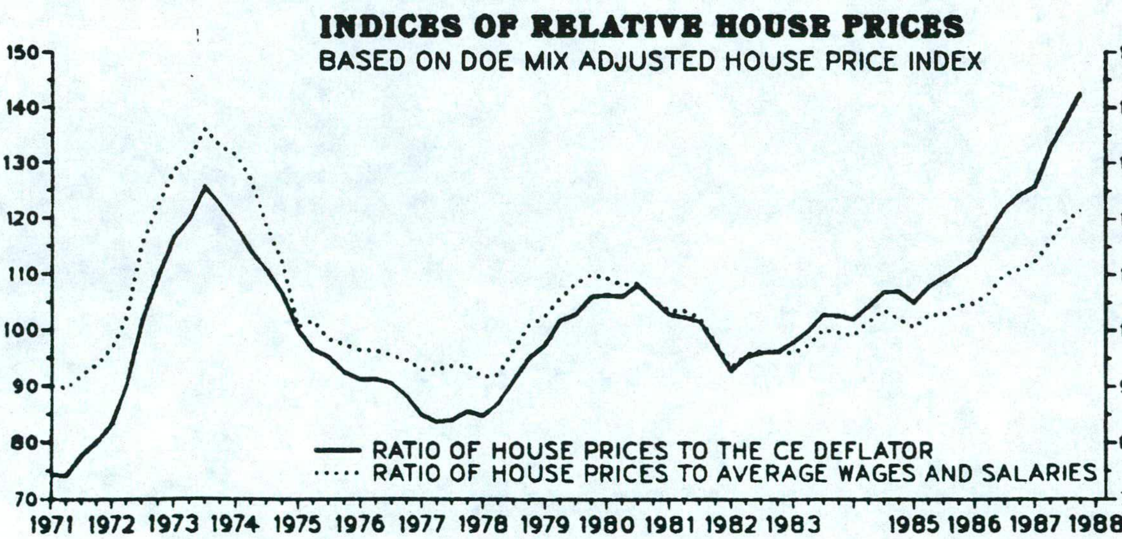
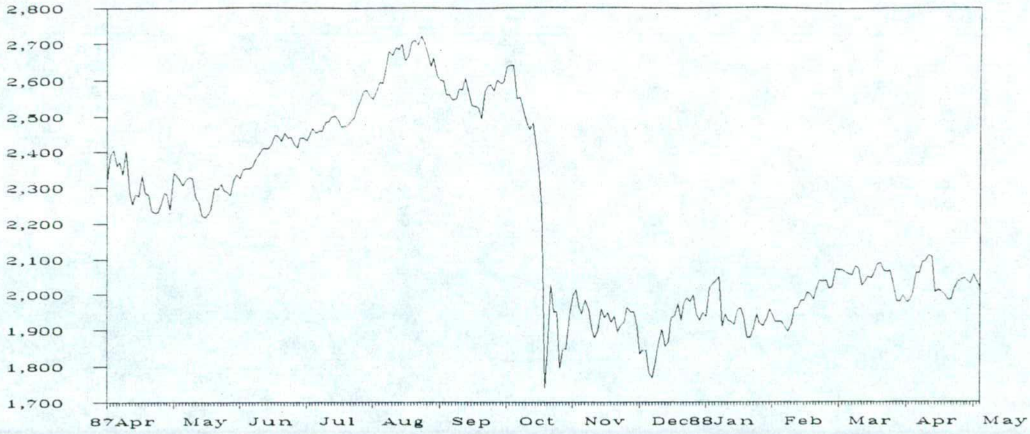
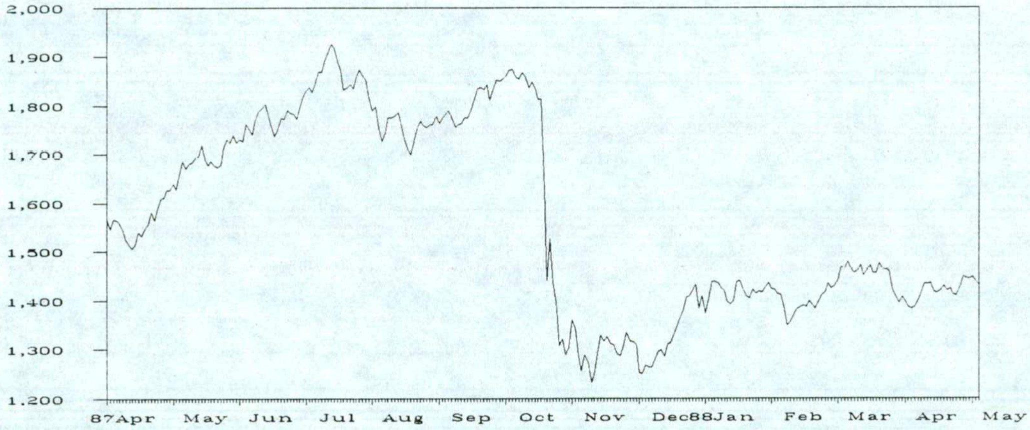


CHART XIX

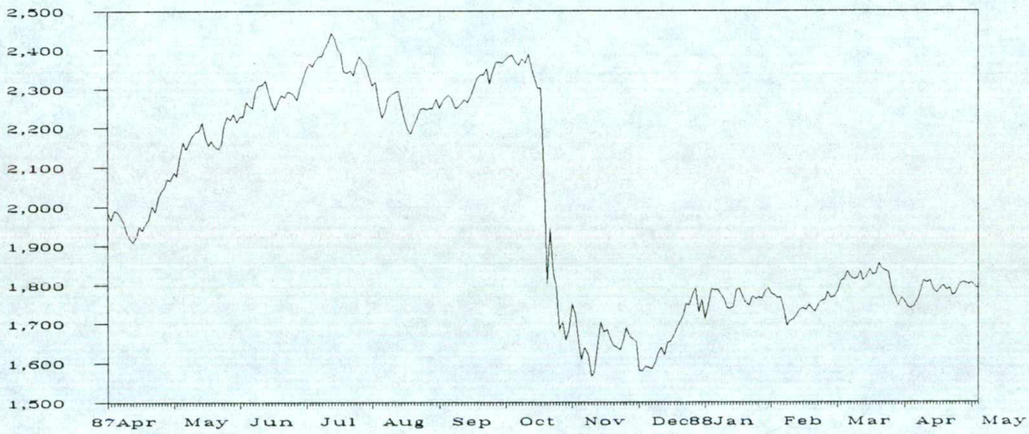
Dow Jones Industrial Average



FT Ordinary Index



FTSE 100



Gilt Index

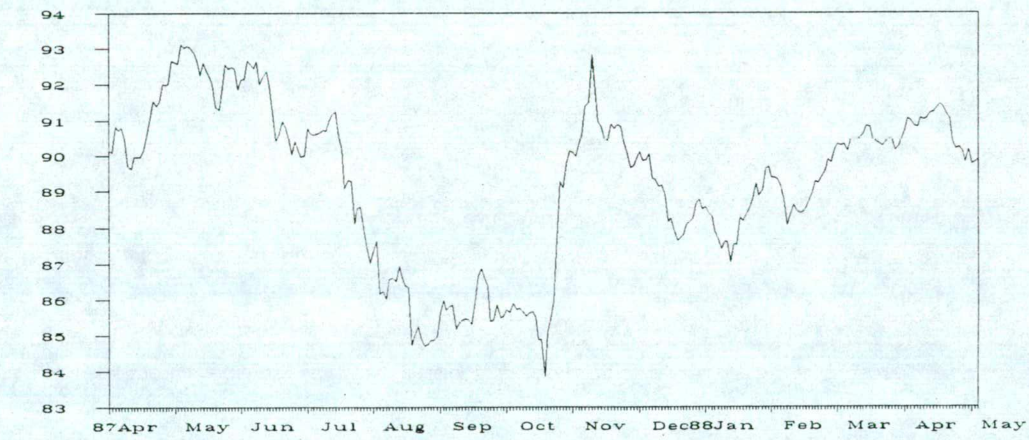


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Table 1: Developments in the G5 (including UK)*

	Activity			Money supply		Costs and prices		
	Nominal GNP	Real GNP	Industrial production	M1	M2/M3	Unit labour costs	Consumer prices	GNP deflator
1984	8.6	4.9	8.1	6.6	8.6	-0.8	4.1	3.6
1985	6.6	3.2	3.0	8.2	8.4	0.5	3.5	3.3
1986	5.6	2.7	0.9	11.5	8.1	1.0	1.5	2.9
1987	5.4	2.9	3.0	11.1+	8.7+	-	2.5	2.4
1987 Q1	5.0	2.5	0.9	13.7	8.9	0.1	1.5	2.4
Q2	4.7	2.3	2.0	12.5	9.0	-0.6	2.5	2.5
Q3	5.6	3.2	3.7	10.1	8.3	-1.7	2.9	2.2
Q4	6.3	3.7	5.4	8.0	8.5	-	3.0	2.5
1987 Jul			2.8	10.6	8.5		2.6	
Aug			4.2	10.4	8.4		3.0	
Sep			4.0	9.4	8.1		2.9	
Oct			5.0	10.0	8.7		3.1	
Nov			5.7	8.2	8.5		3.0	
Dec			5.8	5.9	8.2		3.0	
1988 Jan			6.3	6.4+	8.3+		2.7	
Feb			-	-	-		2.6	

* Percentage changes on a year before.

\+ Partly estimated.

Table 2

GERMANY: KEY FIGURES

	INDUSTRIAL PRODUCTION %pa	INDUSTRIAL PRODUCTION index	CONSUMER PRICES %pa	TRADE SURPLUS* $bn	MONEY SUPPLY (M3) %pa
1984	3.4		2.4	1.7	3.3
1985	5.4		2.2	2.2	3.8
1986	2.1		- 0.2	4.5	4.2
1987	0.2		0.3	5.5	6.7
1987J	- 1.9	104	- 0.8	4.8 (4.5)	6.7
F	0.0	106	- 0.5	6.1 (4.7)	7.1
M	- 0.9	106	- 0.2	4.8 (4.9)	6.6
A	- 0.9	107	0.1	5.3 (5.0)	7.9
M	2.9	108	0.2	6.0 (5.2)	8.5
J	- 0.9	107	0.2	4.6 (5.1)	7.4
J	- 2.8	106	0.7	5.6 (5.1)	6.7
A	2.8	110	0.8	4.9 (5.1)	6.5
S	0.9	108	0.4	5.8 (5.2)	5.8
O	0.9	108	0.9	4.8 (5.2)	5.8
N	0.9	108	1.0	6.1 (5.3)	5.5
D	3.6	109	1.0	6.8 (5.5)	5.8
J	4.9	109	0.7	6.5 (5.6)	5.8
F			0.9		6.1
M			1.0		

* Yearly figures are monthly averages. Monthly figures in brackets are average of past 12 months.

TABLE 3A

THREE MONTH INTEREST RATES IN THE G5 COUNTRIES*

	United States	Japan	Germany	France	UK
1983	9.1	6.5	5.8	12.5	10.1
1984	10.1	6.3	6.0	11.7	9.9
1985	8.1	6.5	5.5	10.0	12.2
1986	6.5	5.0	4.6	7.8	11.0
1987	6.9	3.9	4.0	8.2	9.7
1987 Jan	5.8	4.3	4.6	8.4	11.0
Feb	6.1	4.0	4.0	8.5	11.0
Mar	6.2	4.0	4.0	8.0	10.0
Apr	6.5	3.9	3.9	8.0	9.8
May	7.0	3.8	3.8	8.2	8.8
June	7.0	3.7	3.7	8.2	9.0
July	6.7	3.7	3.9	7.9	9.2
Aug	6.8	3.7	4.0	7.9	10.1
Sept	7.4	3.8	4.0	7.9	10.1
Oct	8.2	3.9	4.8	8.2	9.9
Nov	7.4	3.9	3.9	8.6	9.0
Dec	7.8	3.9	3.6	8.7	8.7
1988 Jan	7.0	3.9	3.4	8.3	8.9
Feb	6.6	3.8	3.4	7.6	9.2
March	6.7	3.8	3.4	8.0	8.8
April	6.9	3.8	3.4	8.1	8.3
May 4	7.2	3.8	3.5	8.4	8.4

* CD rate for US, Gensaki for Japan, Interbank rates for rest.

35/3 lb 3567/002

TABLE 3b

EFFECTIVE EXCHANGE RATE INDICES (1975 = 100)

	United States	Japan	Germany	France	UK	YEN/$	DM/$
1980	93.7	126.4	128.8	94.4	96.0	225.8	1.82
1981	105.6	142.9	119.2	84.3	94.8	219.5	2.25
1982	118.0	134.6	124.4	76.6	90.4	248.8	2.43
1983	124.8	148.4	127.1	70.0	83.2	237.4	2.55
1984	134.6	156.7	123.8	65.7	78.6	237.5	2.85
1985	140.7	160.5	123.6	66.3	78.2	238.4	2.94
1986	114.8	203.1	137.3	70.1	72.8	168.3	2.17
1987	101.2	219.6	147.6	71.8	72.7	144.7	1.80
1986 Q1	121.2	186.8	133.1	71.0	75.1	187.8	2.35
Q2	116.0	202.8	134.7	69.0	76.0	169.9	2.24
Q3	111.4	214.8	138.6	69.5	71.9	155.9	2.09
Q4	110.5	208.0	142.6	70.8	68.3	160.4	2.01
1987 Q1	104.2	210.1	147.7	71.9	70.2	155.2	1.84
Q2	101.1	222.9	146.9	71.6	72.7	142.6	1.81
Q3	102.5	218.0	146.4	71.4	72.7	147.0	1.84
Q4	97.0	227.4	149.4	72.3	75.2	134.0	1.71
1988 Q1	94.2	240.2	149.6	71.9	75.3	128.0	1.68
1987 Jan	105.5	209.4	147.5	71.8	68.9	154.6	1.86
Feb	103.9	209.3	148.4	72.3	69.0	153.4	1.82
Mar	103.3	211.7	147.1	71.8	71.9	157.5	1.84
Apr	101.0	222.7	146.6	71.6	72.3	142.9	1.81
May	100.4	225.3	147.2	71.7	73.3	140.6	1.79
June	101.8	220.8	146.8	71.5	72.6	144.4	1.82
July	103.3	213.7	146.6	71.6	72.8	150.[illegible]	1.85
Aug	103.3	218.2	146.0	71.1	72.3	147.6	1.86
Sept	100.8	222.1	146.7	71.4	73.0	143.1	1.81
Oct	100.6	221.4	147.1	71.5	73.6	143.3	1.80
Nov	96.5	228.4	150.9	72.3	75.4	135.3	1.68
Dec	93.9	232.4	150.2	73.1	76.6	123.4	1.65
1988 Jan	93.9	239.5	150.4	72.5	74.9	127.8	1.65
Feb	95.0	239.5	149.1	71.8	74.3	129.2	1.70
March	93.6	241.6	149.3	71.5	76.8	127.1	1.68
April	92.7	245.0	148.9	71.3	78.2	124.9	1.67
May 4	92.8	245.3	148.7	71.1	77.9	124.9	1.68
% Change since dollar peak (Feb 85)	- 41	+ 56	+ 27	+ 14½	+ 11	- 52	- 51
% Change since Plaza (Sept 85)	- 33½	+ 56½	+ 18½	+ 6	- 5	- 48	- 41
% Change since Louvre Accord (Feb 87)	- 11	+ 17½	+ ½	- 1½	+ 13	- 19	- 8
% Change since Stock market crash (16 Oct 1987)	- 7½	+ 10½	+ 1	- ½	+ 6	- 12½	- 6½

TABLE 3C

Economist Commodity Price Indices

1985=100

		All items indices			SDR indices		
Annual	SDR	Dollar	Sterling	Real*	Food	Nfa**	Metals
1980	104.4	133.7	74.0	115.6	96.7	106.2	118.6
1981	99.3	115.2	73.5	105.3	93.7	104.7	106.2
1982	91.8	99.9	73.4	94.3	89.3	96.0	93.8
1983	107.2	112.7	95.7	110.4	102.0	116.6	110.1
1984	110.3	111.5	107.2	113.1	112.3	111.6	106.2
1985	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1986	89.8	103.7	90.6	86.4	92.8	90.0	85.4
1987	87.4	111.5	87.1	82.3	101.7	103.2	100.5
Quarterly							
1986 Q2	93.5	106.8	90.8	90.6	97.7	92.1	87.3
Q3	84.6	100.2	86.2	81.8	85.1	85.5	83.1
Q4	84.2	100.1	89.5	80.2	82.2	91.0	82.8
1987 Q1	81.0	100.8	83.5	76.5	73.2	95.2	84.3
Q2	84.9	108.2	84.4	80.0	73.2	102.6	92.1
Q3	90.2	113.4	90.0	85.3	70.7	111.9	108.0
Q4	93.4	123.7	90.3	87.0	74.7	103.3	117.9
1988 Q1	99.8	134.6	95.9	93.3	77.6	105.5	133.4
Monthly							
May	85.0	109.3	84.0		74.5	101.5	91.1
June	86.7	109.7	86.3		73.4	105.9	95.7
July	89.3	111.5	88.9		71.9	109.4	104.4
August	91.4	114.2	91.8		69.6	115.0	111.7
September	90.1	114.5	89.3		70.7	111.4	107.9
October	93.5	119.3	92.3		74.2	106.8	117.0
November	91.3	121.3	88.1		74.2	101.4	113.3
December	94.8	129.1	90.5		75.6	102.1	122.4
January	97.4	132.2	94.1		78.1	102.7	126.6
February	98.2	131.2	95.6		78.0	106.5	126.7
March	103.8	140.3	98.0		76.8	107.3	147.0
April	106.4	144.9	99.1		77.3	110.5	152.8
Weekly							
February 9	97.1	129.4	95.0		77.2	106.2	124.3
16	99.8	133.2	97.7		78.2	106.6	131.6
23	100.1	133.4	96.8		79.0	107.3	130.8
March 1	99.8	133.8	96.5		77.2	107.0	133.0
8	101.3	136.9	95.2		76.9	106.3	139.0
15	100.5	136.7	94.5		75.7	106.7	138.2
22	107.5	144.7	101.4		76.6	108.0	159.5
29	109.8	149.6	102.5		77.6	108.6	165.4
April 5	110.9	151.6	103.4		77.0	109.2	169.6
12	106.6	144.3	99.9		77.6	110.4	153.3
19	103.1	140.8	95.3		76.9	110.6	142.0
26	105.0	143.0	97.8		77.6	111.8	146.5
May 3 (prov)	104.8	142.5	97.6		77.0	110.9	147.7

* In relation to prices of manufactured exports. Recent figures are estimated.

** Non-food agriculturals.

CONFIDENTIAL

CONFIDENTIAL

TABLE 4A RECENT INDICATORS OF ACTIVITY AND INFLATION

(per cent changes on year earlier)

	MONEY GDP
1985-86	9.7
1986-87	6.9
1986 2	6.5
3	6.6
4	7.0
1987 1	7.3
2	8.9
3	10.6
4	9.8
1988 1*	10.1
1987-88*	9.8
1988-89*	7.6

	OUTPUT		PRICES AND UNIT LABOUR COSTS					
					Producer Prices***		Unit Wage Costs	
	GDP(O)	Manufacturing Output	RPI	RPI excluding mortgage payments	Output	Input	Manufacturing	Whole economy
1986	2.9	0.3	3.4	3.6	4.3	-10.8	4.7	5.4
1987	4.8	5.5	4.1	3.7	4.5	5.3	n/a	n/a
1986 1	2.2	- 1.7	4.9	4.6	5.0	-11.9	8.7	6.4
2	2.2	- 1.3	2.8	3.3	4.3	-12.4	6.9	6.8
3	3.5	0.8	2.6	3.3	4.0	-13.0	3.7	4.7
4	3.9	3.8	3.4	3.4	4.0	- 5.6	1.4	5.1
1987 1	4.3	4.4	3.9	3.7	4.1	- 1.7	0.8	4.0
2	4.4	5.1	4.2	3.6	4.5	4.6	0.8	4.3
3	5.1	6.7	4.3	3.6	4.7	12.9	0.7	3.8
4	5.2	5.5	4.1	4.0	4.7	6.2	2.1	4.3
1988 1	-	-	3.4	3.7	4.9	4.6	-	-
1987 March		5.2	4.0	3.8	4.1	0.4	- 0.1**	
April		4.4	4.2	3.6	4.3	3.0	- 0.4	
May		5.8	4.1	3.8	4.5	3.4	0.0	
June		5.1	4.2	3.5	4.5	7.2	0.8	
July		5.8	4.4	3.7	4.7	13.4	1.2	
August		8.4	4.4	3.7	4.7	14.5	1.0	
September		6.2	4.2	3.5	4.7	10.8	0.7	
October		5.6	4.5	3.9	4.7	7.6	0.8	
November		5.3	4.1	4.0	4.8	4.8	1.8	
December		5.5	3.7	4.0	4.9	5.0	2.1	
1988 January		8.9[1]	3.3	3.7	4.8	4.6	1.1	
February		2.7	3.3	3.6	4.9	5.2	2.0	
March		-	3.5	3.8	5.0	4.0	-	

1 Figure boosted by around 3 per cent on account of low output level during exceptionally cold January of 1987.

* 1988 FSBR forecast

** Wage cost figures show averages for three months ending in month indicated.

*** Excluding food, drink and tobacco.

\- Not yet available.

TABLE 4(b) UNDERLYING RETAIL PRICE INFLATION

% change on a year earlier

		RPI	RPI exc mortgages	RPI exc both mortgages and petrol
1983	Q1	4.9	6.3	6.2
	Q2	3.8	4.6	4.4
	Q3	4.6	5.0	4.9
	Q4	5.0	4.6	4.6
1984	Q1	5.2	4.5	4.4
	Q2	5.2	4.9	5.0
	Q3	4.7	4.2	4.4
	Q4	4.8	4.1	4.1
1985	Q1	5.5	4.8	4.6
	Q2	7.0	5.3	4.9
	Q3	6.3	5.4	5.2
	Q4	5.5	5.2	5.3
1986	Q1	4.9	4.6	5.2
	Q2	2.8	3.3	4.8
	Q3	2.6	3.3	4.8
	Q4	3.4	3.4	4.5
1987	Q1	3.9	3.7	4.3
	Q2	4.2	3.6	3.6
	Q3	4.3	3.6	3.5
	Q4	4.1	4.0	4.1
1987	July	4.4	3.7	3.6
	Aug	4.4	3.7	3.5
	Sept	4.2	3.5	3.6
	Oct	4.5	3.9	4.0
	Nov	4.1	4.0	4.2
	Dec	3.7	4.0	4.1
1988	Jan	3.3	3.7	3.8
	Feb	3.3	3.6	3.9
	March	3.5	3.8	4.1

TABLE 5 :INDICATORS OF FISCAL STANCE

(a) Annual data

	PSBR		PSBR EXCLUDING PRIVATISATION PROCEEDS		PSFD (1)	
	Cash £ billion	Ratio to GDP (per cent)	Cash £ billion	Ratio to GDP (per cent)	Cash £ billion	Ratio to GDP (per cent)
1970-71	0.8	1.5	0.8	1.5	-0.2	-0.4
1971-72	1.0	1.6	1.0	1.6	0.7	1.1
1972-73	2.4	3.6	2.4	3.6	2.0	3.0
1973-74	4.3	5.8	4.3	5.8	3.5	4.6
1974-75	8.0	9.0	8.0	9.0	6.0	6.7
1975-76	10.3	9.3	10.3	9.3	8.1	7.3
1976-77	8.3	6.4	8.3	6.4	7.5	5.7
1977-78	5.4	3.6	5.9	3.9	6.6	4.4
1978-79	9.2	5.3	9.2	5.3	8.3	4.8
1979-80	10.0	4.8	10.4	5.0	8.0	3.9
1980-81	12.7	5.4	13.1	5.5	11.7	5.0
1981-82	8.6	3.3	9.1	3.5	5.2	2.0
1982-83	8.8	3.1	9.3	3.3	8.3	2.9
1983-84	9.7	3.2	10.9	3.5	11.5	3.7
1984-85*	10.2	3.1	12.3	3.7	13.1	4.0
1985-86*	5.7	1.6	8.5	2.3	8.1	2.2
1986-87	3.4	0.9	7.8	2.0	9.4	2.4
1987-88	-3.6	-0.8	1.5	0.3	2.8	0.7
Budget forecast						
1988-89	-3.1	-3/4	1.8	1/2	1.4	1/4

*If adjusted for coal strike, PSBR and PSFD ratios to GDP roughly 0.9 per cent lower in 1984-85 and 0.2 per cent lower in 1985-86.

(b) Quarterly Data

£ billion		PSBR		PSBR excluding privatisation		PSFD	
		sa*	ua	sa*	ua	sa+	ua
1985	Q2	1.2	2.6	2.5	3.9	2.9	4.6
	Q3	1.9	2.9	2.4	3.4	1.5	1.9
	Q4	1.5	2.1	2.1	2.6	2.1	0.7
1986	Q1	1.1	-1.9	1.5	-1.5	2.0	1.0
	Q2	2.1	2.3	3.2	3.4	2.2	3.6
	Q3	2.1	3.6	2.1	3.6	3.0	4.2
	Q4	-1.3	-1.6	0.9	0.5	1.5	0.0
1987	Q1	0.5	-0.8	2.8	1.6	2.5	1.9
	Q2	0.0	1.0	1.6	2.6	1.5	3.2
	Q3	-0.1	0.4	1.1	1.5	0.8	1.7

*financial year - constrained
+calendar year - constrained

9[illegible]/G/jfw/4555/55

Table 6: CGBR(O) 1987-88 Comparison with 1987 Budget Profile

	£ billion
Receipts	
Inland Revenue	+ 3.4
Customs and Excise	+ 1.0
National Insurance contributions	+ 0.6
Privatisation proceeds	+ 0.1
Interest and dividends	+ 0.2
Other receipts	+ 0.5
Total receipts	+ 5.9
Expenditure	
Interest payments	- 0.3
Departmental expenditure [1]	- 0.9
Total expenditure	- 1.2
Net effect on CGBR(O)	- 7.1

[1] on a cash basis, net of certain receipts and on-lending

\+ = higher receipts, higher borrowing and higher expenditure

\- = lower receipts, lower borrowing and lower expenditure wpu.srl.5

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TABLE 7

EXCHANGE RATES

		Exchange Rate Index*	Real Exchange Rate @	ERI/(Oil Price Adjusted ERI)-/	Dollar: Sterling exchange rate	D-Mark: Sterling exchange rate	Index against EMS currencies*	US-UK Interest rate differential	Brent spot price ($/bl)
1985	(1)	72.1	80.1	0.908	1.12	3.63	95.2	+4.1	27.7
	(2)	78.9	88.9	1.001	1.26	3.88	102.3	+4.4	27.0
	(3)	82.1	93.3	1.040	1.38	3.92	103.8	+3.6	27.4
	(4)	79.8	91.6	1.001	1.44	3.71	98.7	+3.5	28.3
1986	(1)	75.1	88.3	1.037	1.44	3.38	90.9	+4.5	17.8
	(2)	76.1	92.1	1.101	1.51	3.39	91.4	+3.2	12.8
	(3)	71.9	88.2	1.049	1.50	3.10	84.9	+3.8	12.4
	(4)	68.3	84.0	0.970	1.43	2.87	79.0	+5.1	14.8
1987	(1)	69.9	86.9	0.967	1.54	2.83	78.8	+4.3	17.9
	(2)	72.8	90.9	0.996	1.64	2.96	82.6	+2.1	18.6
	(3)	72.7	90.7	0.992	1.62	2.97	83.0	+2.8	19.0
	(4)	74.9	94.0	1.030	1.76	2.99	83.8	+1.2	18.1
1987	March	71.9	89.4	0.991	1.59	2.92	81.2	+3.4	18.0
	April	72.3	90.3	0.994	1.63	2.95	82.1	+2.9	18.2
	May	73.3	91.7	1.002	1.67	2.98	83.1	+1.6	18.8
	June	72.7	89.8	0.991	1.63	2.96	82.6	+2.1	18.9
	July	72.8	90.7	0.985	1.61	2.97	82.9	+2.6	19.8
	August	72.3	90.0	0.988	1.60	2.97	82.8	+3.2	18.9
	September	73.1	91.2	1.004	1.65	2.98	83.2	+2.6	18.3
	October	73.6	92.0	1.006	1.66	2.99	83.5	+1.7	18.8
	November	75.4	94.6	1.040	1.78	2.99	83.9	+1.0	17.8
	December	75.7	95.2	1.045	1.83	2.98	84.0	+0.9	17.7
1988	January	74.8	94.7	1.038	1.78	2.98	83.5	+1.8	16.7
	February	74.3	94.1	1.047	1.75	2.98	83.7	+2.6	15.6
	March	76.5	97.9	1.087	1.82	3.06	86.4	+2.1	14.8
	April	78.4	na	1.097	1.88	3.14	88.3	+1.2	16.4
	May 5th	77.9	na	1.091	1.87	3.13	88.3	+1.0	16.3

-/ Oil price adjusted ERI has roughly the same inflation implications as does an ERI of 80 given an oil price of $29 (their average values for January 1983 - November 1985). The ratio shown therefore indicates whether movements in the ERI are inflationary or otherwise, relative to the period Jan-1983 - Nov 1985, having allowed for oil prices.

* 1975=100

@ Figures for latest months are tentative forecasts based on extrapolated producer price indices

TABLE 8 : NOMINAL AND REAL INTEREST RATES

		NOMINAL RATES				REAL RATES				
		Three month interbank	Three month Eurodollar	Base Rate	Long Rate (20 year Gilts)	Expected inflation over 12 months*	Real 3-month interbank rate	Yield on Index-linked Gilts** 1990	2001	2011
1985	(1)	13.0	8.9	12.9	10.9	5.7	6.9	4.4	3.5	3.2
	(2)	12.6	8.2	12.6	10.8	5.6	6.6	4.3	3.8	3.4
	(3)	11.7	8.1	11.7	10.4	5.3	6.1	4.3	3.8	3.5
	(4)	11.6	8.1	11.5	10.3	4.2	7.1	4.1	3.9	3.6
1986	(1)	12.4	7.9	12.3	10.2	3.9	8.2	4.3	4.2	3.8
	(2)	10.2	7.0	10.4	9.0	3.6	6.5	3.6	3.6	3.4
	(3)	10.0	6.2	10.0	9.7	3.4	6.5	3.7	3.9	3.5
	(4)	11.2	6.1	11.0	10.7	4.1	6.8	3.7	4.1	3.8
1987	(1)	10.6	6.3	10.8	9.6	4.3	6.0	3.0	3.7	3.5
	(2)	9.2	7.1	9.4	9.0	3.8	5.2	2.4	3.8	3.6
	(3)	9.9	7.1	9.7	9.8	3.7	6.0	2.6	4.2	3.9
	(4)	9.2	7.8	9.0	9.5	4.0	4.7	2.4	4.1	3.8
1987	January	11.0	6.1	11.0	10.0	4.1	6.6	3.5	4.0	3.7
	February	10.8	6.4	11.0	9.8	4.3	6.2	3.0	3.7	3.5
	March	9.9	6.5	10.4	9.1	4.5	5.2	2.5	3.5	3.4
	April	9.8	6.9	10.0	9.2	4.2	5.4	2.6	3.6	3.4
	May	8.8	7.2	9.1	8.8	3.7	4.9	2.1	3.6	3.6
	June	9.0	7.1	9.0	8.9	3.5	5.3	2.3	3.9	3.7
	July	9.3	6.9	9.0	9.3	3.4	5.7	2.2	4.0	3.8
	August	10.2	7.0	10.0	10.0	3.9	6.1	2.6	4.3	4.0
	September	10.1	7.5	10.0	10.0	4.0	5.9	3.1	4.2	4.0
	October	10.0	8.3	9.5	9.8	4.2	5.6	3.1	4.5	4.3
	November	8.9	7.4	9.0	9.2	3.8	4.9	1.9	4.0	3.3
	December	8.7	7.8	8.5	9.5	3.9	4.6	2.3	3.9	3.9
1988	January	8.9	7.1	8.5	9.6	4.1	4.6	2.3	4.2	4.1
	February	9.3	6.7	9.0	9.4	4.2	4.9	2.2	4.0	3.9
	March	8.9	6.8	8.5	9.1	3.9	4.8	2.2	3.9	3.9
	April	8.4	7.2	8.0	9.1	na	na	1.7	3.8	3.8
	May 5th	8.3	7.3	8.0	9.3	na	na	2.1	3.7	3.8

* Unweighted average of forecasts by Phillips and Drew, National Institute and the London Business School; the expected rate of inflation for a given month is the change in the price level between six months earlier and six months ahead. This is assumed to approximate roughly to average inflation expectations over the three months immediately ahead.

** Average of yields calculated for each Friday of month and quarterly for last Friday in each month. Assumes inflation averages 5 per cent per annum to redemption.

TABLE 9 CURRENT ACCOUNT

percentage change on previous year

		Export Volume less oil and erratics	Import Volume less oil and erratics	Terms* of Trade(AVI) 1980=100	Current balance £mn
1982		0.7	8.9	0.6	4480
1983		-0.6	10.1	-0.7	3753
1984		9.5	11.0	-2.0	2009
1985		6.8	4.1	1.8	3276
1986		2.3	5.8	-0.7	46
1987		7.3	8.8	+1.1	-1679
1986	Q3	2.9	7.5	-2.4	-747
	Q4	8.6	8.6	-4.9	-556
1987	Q1	10.0	3.8	-1.3	799
	Q2	6.0	9.2	+1.9	-300
	Q3	8.9	11.5	+1.2	-896
	Q4	4.7	9.7	+3.0	-1282
1988	Q1	-0.4	12.6	+4.8	-1818
1987	Jan	6.5	4.5	-2.7	73
	Feb	16.3	6.0	-2.0	430
	Mar	7.1	0.7	+0.6	296
	April	9.8	9.6	+1.7	208
	May	5.3	13.8	-0.1	-387
	June	4.3	5.1	+2.0	-121
	July	7.6	10.6	+0.2	-253
	Aug	8.7	13.4	+0.6	-687
	Sep	10.8	10.5	+3.2	43
	Oct	4.0	10.7	+1.8	-353
	Nov	3.6	7.4	+3.5	-488
	Dec	6.4	11.1	+3.8	-441
1988	Jan	3.7	16.3	+5.9	-844
	Feb	-7.9	10.8	+4.7	-720
	March	3.5	10.9	+3.8	-254

* excluding oil and erratics.

tables
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SECRET

TABLE 10

Key Monetary Indicators

	1986-87						1987-88						
	Mar	**April**	**May**	**June**	**July**	**Aug**	**Sept**	**Oct**	**Nov**	**Dec**	**Jan**	**Feb**	**Mar**
MONETARY AGGREGATES 12 month % change (ua)													
MO	3.5	5.3	4.4	4.2	5.3	4.5	5.2	5.5	4.9	4.2	4.8	5.3	6.4
M3	19.0	20.5	19.0	19.2	21.0	22.2	19.6	22.4	21.5	22.8	22.4	20.4	20.9
M4	14.0	14.6	13.8	13.9	15.0	15.6	15.0	15.8	15.2	16.3	16.6	16.0	16.8
M5	13.5	14.1	13.4	13.5	14.4	15.0	14.4	15.2	14.7	15.8	16.3	15.6	16.7
STERLING LENDING 12 month % change (ua)													
Banks	20.7	21.4	21.8	21.6	22.3	21.6	23.6	22.9	22.5	22.8	24.7	24.3	25.2
Banks and building societies	19.1	19.5	19.4	19.3	19.5	18.8	20.0	19.3	19.0	18.8	20.0	19.9	20.8
OVER(-)/UNDER (+) FUNDING financial year to date:£mm	395	3,216	5,160	2,371	1,912	2,215	2,010	3,790	1,183	2,408	-4171	-5688	-106
MONEY MARKET ASSISTANCE≠ Level outstanding £mn	9,742	6,126	3,340	5,132	7,078	6,114	5,421	5,403	7,073	7,221	12507	13425	9673
INTEREST RATES													
3 months*	9.9	9.8	8.8	9.0	9.3	10.2	10.1	10.0	8.9	8.7	8.9	9.3	8.9
20 yearϕ	9.1	9.2	8.8	8.9	9.3	10.0	10.0	9.8	9.2	9.5	9.6	9.4	9.1
EFFECTIVE EXCHANGE RATE	71.9	72.3	73.3	72.7	72.8	72.3	73.1	73.6	75.4	75.7	74.8	74.3	76.5

* Inter bank

ϕ par yield

≠ banking months until August thereafter end calendar months

TABLE 11

SECRET

£ million

GROWTH RATES OF MONETARY AGGREGATES

			1987 MAY	JUNE	JULY	AUG	SEP	OCT	NOV	DEC	1988 JAN	FEB	MAR
M0 -	Monthly change	sa	68	24	189	39	120	99	49	139	-46	-18	133
	Monthly % change	nsa	0.3	-0.6	2.8	0.1	0.1	-0.2	0.3	7.0	-6.0	-1.0	1.8
	Monthly % change	sa	0.4	0.2	1.2	0.3	0.8	0.6	0.3	0.9	-0.3	-0.1	0.8
	6-month annualised % change	sa	2.9	0.2	4.0	6.2	7.0	7.3	7.0	8.5	5.3	4.5	4.6
	Annual % change	sa	4.4	4.2	5.4	4.7	4.9	5.6	4.9	4.3	4.6	5.3	5.8
M3 -	Monthly change	nsa	3298	1907	4262	2220	1670	5690	1256	2580	-2137	568	9059
	Monthly % change	nsa	2.0	1.1	2.5	1.3	1.0	3.2	0.7	1.4	-1.1	0.3	4.9
	Monthly % change	sa	1.5	1.4	2.2	1.4	1.4	3.6	0.0	1.4	0.5	0.4	3.2
	6-month annualised % change	sa	22.0	24.2	26.5	25.2	21.9	25.5	21.8	21.7	17.8	15.6	19.7
	Annual % change	nsa	18.7	19.0	21.0	21.8	19.9	23.2	22.0	23.0	22.0	20.3	20.8
M4 -	Monthly change	nsa	3490	4042	5347	2679	2992	5367	1577	4899	322	1280	10069
	Monthly % change	nsa	1.3	1.5	1.9	0.9	1.0	1.8	0.5	1.6	0.1	0.4	3.3
	Monthly % change	sa	0.9	1.5	1.6	1.3	1.2	2.2	0.3	1.3	0.3	1.0	2.3
	6-month annualised % change	sa	13.7	15.8	18.9	18.4	17.2	18.8	17.3	16.8	13.9	13.1	15.6
	Annual % change	nsa	13.8	13.9	15.0	15.6	15.0	15.8	15.2	16.3	16.6	16.0	16.8
M5 -	Monthly change	nsa	4106	4126	5481	2793	3055	5500	1531	5209	30	999	11115
	Monthly % change	nsa	1.4	1.4	1.8	0.9	1.0	1.8	0.5	1.7	0.0	0.3	3.5
	Monthly % change	sa	1.2	1.5	1.5	1.3	1.2	2.1	0.3	1.3	0.3	0.9	2.4
	6-month annualised % change	sa	13.2	15.2	18.5	17.9	17.0	18.9	16.7	16.3	13.7	12.7	15.5
	Annual % change	nsa	13.5	13.5	14.4	15.0	14.4	15.2	14.7	15.8	16.3	15.6	16.7
NIBM1 -	Monthly change	nsa	1148	1444	82	-93	384	184	493	391	-1523	874	2321
	Monthly % change	nsa	2.8	3.4	0.2	-0.2	0.9	0.4	1.1	0.9	-3.3	2.0	5.2
	Monthly % change	sa	2.1	4.2	0.2	0.3	0.7	3.4	-2.2	-0.2	3.3	1.5	1.5
	6-month annualised % change	sa	7.9	15.3	9.9	9.7	13.3	24.1	13.8	4.3	10.8	13.3	15.2
	Annual % change	nsa	13.1	13.1	11.9	11.8	5.6	11.4	10.1	9.9	11.4	12.2	15.0
M1 -	Monthly change	nsa	2949	2102	1083	1104	1579	2864	508	-258	-1106	-416	5494
	Monthly % change	nsa	3.7	2.5	1.3	1.3	1.8	3.2	0.6	-0.3	-1.2	-0.5	6.0
	Monthly % change	sa	3.4	2.8	1.3	1.6	1.6	4.8	-1.0	-1.0	2.2	-0.6	4.0
	6-month annualised % change	sa	20.0	30.4	24.4	28.2	23.0	36.0	24.7	15.6	17.5	12.5	17.8
	Annual % change	nsa	23.5	23.6	22.6	23.7	20.4	24.7	21.7	22.7	21.7	20.5	20.8
WIDER £	Monthly change	nsa	5047	531	5243	1448	1791	7690	3	3506	529	197	8635
AGGREGATE	Monthly % change	nsa	2.7	0.3	2.7	0.7	0.9	3.8	0.0	1.7	0.2	0.1	4.0
	Monthly % change	sa	2.2	0.5	2.4	0.8	1.3	4.1	-0.6	1.6	1.7	0.2	2.6
	6-month annualised % change	sa	23.5	22.4	23.5	21.9	20.2	24.9	18.2	20.9	19.2	17.8	20.8
	Annual % change	nsa					18.6	22.3	20.4	21.5	21.6	19.9	20.6

TABLE 12

REAL PERCENTAGE GROWTH RATES OF MONETARY AGGREGATES

	RPI less Mortgage Element	Weekly Averaged M0	M3	M4	M5
FINANCIAL YEARS (12 month % changes to calendar March)					
1981-82	9.8	-6.5	4.2	3.7	3.0
1982-83	5.9	-0.6	5.4	7.9	8.0
1983-84	4.6	0.8	3.3	6.8	6.1
1984-85	5.2	0.3	6.0	8.2	8.2
1985-86	4.0	-0.5	12.2	10.1	9.1
1986-87	3.8	0.3	14.6	9.8	9.3
12 MONTH % CHANGES (ua except M0)					
1987 MARCH	3.8	0.3	14.6	9.8	9.3
APRIL	3.6	1.2	16.3	10.6	10.1
MAY	3.8	0.6	14.6	9.6	9.3
JUNE	3.5	0.7	15.2	10.0	9.7
JULY	3.7	1.6	16.7	10.9	10.3
AUGUST	3.7	1.0	17.8	11.5	10.9
SEPTEMBER	3.5	1.4	15.6	11.1	10.5
OCTOBER	3.9	1.6	17.8	11.5	10.9
NOVEMBER	4.0	0.9	16.8	10.8	10.3
1988 DECEMBER	4.0	0.3	18.1	11.8	11.3
JANUARY	3.7	0.9	18.0	12.4	12.2
FEBRUARY	3.6	1.6	16.2	12.0	11.6
MARCH	3.8	1.9	16.5	12.5	12.4

TABLE 13

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MO : THE WIDE MONETARY BASE

Monthly data	Level £ million (Change in brackets)								Percentage change on previous month		6 month % growth annualised		Percentage change on previous year			
	Notes and Coin (nsa)	Notes and Coin (sa)		Bankers' Deposits	MO (nsa)	MO (sa)			Notes(sa) and Coin	MO (sa)	Notes & Coin (sa)	MO (sa)	Notes and Coin (nsa)	Notes and Coin (sa)	MO (nsa)	MO (sa)
1987 September	15349	15376	(118)	185	15534	15561	(121)		0.8	0.8	7.8	7.0	5.3	5.0	5.2	4.9
October	15299	15456	(80)	203	15501	15659	(98)		0.5	0.6	7.4	7.3	5.1	5.2	5.5	5.6
November	15365	15525	(69)	183	15548	15707	(48)		0.4	0.3	7.4	7.0	4.8	4.8	4.9	4.9
December	16447	15661	(136)	186	16633	15846	(139)		0.9	0.9	7.9	8.5	4.7	4.8	4.2	4.3
1988 January	15458	15620	(-41)	181	15638	15801	(-45)		-0.3	-0.3	6.1	5.3	4.7	4.5	4.8	4.6
February	15353	15659	(39)	124	15477	15783	(-18)		0.2	-0.1	5.3	4.5	5.7	5.7	5.3	5.3
March	15588	15753	(94)	162	15750	15916	(133)		0.6	0.8	5.0	4.6	6.9	6.4	6.4	5.8
April	15797	15826	(73)	229	16026	16055	(139)		0.5	0.9	4.8	5.1	5.8	6.1	5.9	6.2
May (1/4) @	15947	15948	(122)	160	16107	16108	(53)		0.8	0.3	5.5	5.2	6.5	6.4	6.1	6.1
Latest 4 weeks @	15756	15855	(59)	203	15959	16058	(77)		0.4	0.5	5.0	5.1	4.7	5.9	4.5	5.7

Weekly data	Level £ million (Change in brackets)					Percentage change on previous week
	Notes(sa) and Coin		Bankers' Deposits	MO (sa)		MO (sa)
April						
6th	15832	(5)	263	16095	(87)	0.5
13th	15775	(-57)	97	15872	(-223)	-1.4
20th	15834	(59)	259	16093	(221)	1.4
27th	15862	(28)	297	16159	(66)	0.4
May						
4th	15948	(86)	160	16108	(-51)	-0.3

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

TABLE 14

SECRET

BUILDING SOCIETY BALANCE SHEET FLOWS

Unadjusted # million

	Total Flow	ASSETS: Net Mortgage Advances & Unsecured Lending	ASSETS: Liquid Assets	ASSETS: Fixed Assets	LIABILITIES: Retail principal	LIABILITIES: Interest credited	LIABILITIES: Wholesale funds	LIABILITIES: Other (eg reserves)
1985 *	1497	1226	244 (18.0)	27	621	497	205	174
1986 *	1593	1589	-19 (16.4)	23	553	508	498	34
1987 *	1621	1235	343 (16.9)	43	634	570	281	136
1986 Q1*	953	1271	-341 (17.5)	23	740	461	167	-415
Q2*	1518	1645	-150 (16.6)	23	478	521	321	198
Q3*	1740	1884	-165 (15.7)	21	56	402	1099	183
Q4*	2160	1556	581 (16.4)	23	938	647	403	172
1987 Q1*	1324	1120	126 (16.1)	78	484	523	279	38
Q2*	1573	1240	313 (16.2)	20	612	457	182	322
Q3*	1516	1272	200 (16.1)	44	410	515	364	227
Q4*	2069	1306	734 (16.9)	29	1028	785	299	-43
1988 Q1*	1666	1696	-80 (16.5)	50	1026	625	172	-157
Jan	1152	1526	-424 (16.5)	50	895	1373	68	-1184
Feb	1743	1297	396 (16.6)	50	1094	109	102	438
Mar	2368	2265	53 (16.4)	50	1090	394	347	537
Forecast								
1988 Apr	2620	1977	593 (16.5)	50	1323	275	300	722

* Monthly averages
+ Estimated ; part data
Figures in ( ) are end period liquidity ratio, unadjusted

TABLE 15

THE COMPONENTS OF M3

	NOTES AND COINS	BANK DEPOSITS RETAIL NIB	BANK DEPOSITS RETAIL IB	BANK DEPOSITS WHOLESALE	M3
% CHANGES					
Financial years (ua)					
1984-85[1]	5.2	6.5	7.7	19.1	11.5
1985-86[1]	3.7	4.5	16.8	26.1	16.7
1986-87[1]	2.2	16.9	17.5	25.8	19.1
Over 12 months (ua)					
1987 APRIL	6.2	14.1	17.4	28.0	20.5
MAY	3.3	15.9	19.3	23.1	19.0
JUNE	3.6	17.5	15.7	25.4	19.2
JULY	6.0	14.8	12.5	32.6	21.0
AUGUST	4.0	15.7	15.6	33.0	22.2
SEPTEMBER	5.7	5.5	14.7	32.1	19.6
OCTOBER	4.5	14.7	12.9	35.3	22.4
NOVEMBER	1.3	14.3	13.5	33.5	21.5
DECEMBER	5.8	11.9	10.7	38.5	22.8
1988 JANUARY	5.1	14.5	11.1	35.8	22.4
FEBRUARY	2.5	16.9	10.9	30.9	20.4
MARCH	13.7	15.6	12.4	29.2	20.9
Over 6 months (sa)					
1987 OCTOBER	6.8	32.7	12.2	34.3	25.5
NOVEMBER	7.0	16.9	13.6	31.1	21.8
DECEMBER	11.3	1.4	8.3	40.4	21.7
1988 JANUARY	7.6	12.2	9.4	26.5	17.8
FEBRUARY	6.3	16.4	7.2	21.6	15.6
MARCH	12.4	16.5	11.0	27.1	19.7
CHANGES £ MILLION					
monthly average (sa)					
1984-85[1]	42	56	238	683	1017
1985-86[1]	17	90	161	556	1565
1986-87[1]	4	359	538	1255	2157
Over 1 month (sa)					
1987 OCTOBER	253	1239	179	4728	6399
NOVEMBER	-71	-939	612	329	-69
DECEMBER	217	-311	-611	3224	2519
1988 JANUARY	82	1384	936	-1464	938
FEBRUARY	-69	736	95	3	765
MARCH	383	323	1335	3968	6009

[1] March on March

TABLE 16 SECRET

T[illegible] COMPONENTS OF M4 AND M5

	M3	BUILDING SOCIETIES: RETAIL[1]	BUILDING SOCIETIES: WHOLESALE	BUILDING SOCIETIES: HOLDINGS OF M3	M4	MONEY MARKET INSTRUMENTS	M5
% CHANGES							
Financial years (ua)							
1984-85[3]	11.5	15.1				13.8	13.8
1985-86[3]	16.7	15.3	52.6	94	-0.1	13.5	14.5
1986-87[3]	19.1	10.8	11.4	50	-15.6	13.5	12.9
Over 12 months (ua)							
1987 APRIL	20.5	16.1		50.3	14.6	4.4	14.1
MAY	19.0	17.9		54.7	13.8	8.0	13.5
JUNE	19.2	16.4		63.7	13.9	7.3	13.5
JULY	21.0	13.4		64.2	15.0	4.6	14.4
AUGUST	22.2	15.6		63.2	15.6	4.1	15.0
SEPTEMBER	19.6	10.8		58.1	15.0	5.0	14.4
OCTOBER	22.4	13.6		58.3	15.8	5.8	15.2
NOVEMBER	21.5	13.8		66.0	15.2	5.3	14.7
DECEMBER	22.8	11.2		63.2	16.3	8.1	15.8
1988 JANUARY	22.4	12.4		57.0	16.6	11.3	16.3
FEBRUARY	20.4	13.2		47.8	16.0	7.9	15.6
MARCH	20.9	13.6		39.5	16.8	13.6	16.7
Over 6 months (sa)							
1987 OCTOBER	25.5	9.7		23.4	18.8	19.2	18.9
NOVEMBER	21.8	11.6		21.0	17.3	6.1	16.7
DECEMBER	21.7	11.2		31.3	16.8	6.5	16.3
1988 JANUARY	17.8	11.3		39.5	13.9	10.1	13.7
FEBRUARY	15.6	11.4		31.9	13.1	6.3	12.7
MARCH	19.7	13.9		35.2	15.6	13.8	15.5
CHANGES £ MILLION							
monthly average (sa)							
1984-85[3]	984	1034	42	-28	139	2221	2090
1985-86[3]	1565	1207	50	-362	-118	2480	2557
1986-87[3]	2157	938	17	-372	51	2791	2975
Over 1 month (sa)							
1987 OCTOBER	6399	720	0	-618	6501	68	6569
NOVEMBER	-69	2080	-355	-796	860	33	893
DECEMBER	2519	1221	325	-248	3817	249	4066
1988 JANUARY	938	1124	50	-1298	814	223	1037
FEBRUARY	765	1557	12	596	2930	-189	2741
MARCH	6009	1805	-34	-630	7150	617	7767

[1] Net in flow including Term sharesand SAYE.
[2] Treasury bills, bank bills, LA temporary debt, CID's and some national savings accounts.
[3] March on March.

TABLE 17

RETAIL DEPOSITS

	BANKS	BUILDING SOCIETIES[1]	NATIONAL SAVINGS[2]	TOTAL
% CHANGES				
Financial years (ua)				
1984-85[3]	7.1	15.1	11.9	12.0
1985-86[3]	11.6	15.3	7.5	12.9
1986-87[3]	17.2	10.8	10.8	12.7
Over 12 months (ua)				
1987 APRIL	16.1	10.3	11.0	12.2
MAY	17.9	10.2	10.8	12.6
JUNE	16.4	10.3	10.5	12.2
JULY	13.4	10.2	9.2	11.1
AUGUST	15.6	10.4	9.7	11.9
SEPTEMBER	10.8	11.4	9.3	10.7
OCTOBER	13.6	10.2	8.2	10.9
NOVEMBER	13.8	11.1	7.4	11.3
DECEMBER	11.2	11.6	7.2	10.5
1988 JANUARY	12.4	12.1	6.8	10.9
FEBRUARY	13.2	12.6	6.3	11.2
MARCH	13.6	13.0	5.9	11.3
Over 6 months (sa)				
1987 OCTOBER	19.8	9.7	5.3	10.8
NOVEMBER	14.9	11.6	4.4	10.8
DECEMBER	5.6	11.2	4	8.3
1988 JANUARY	10.5	11.3	4.5	8.2
FEBRUARY	10.8	11.4	4.4	9.3
MARCH	13.1	13.9	4.7	11.2
CHANGES £ MILLION				
monthly average (sa)				
1984-85[3]	42	1034	683	1759
1985-86[3]	255	1207	1093	2555
1986-87[3]	871	938	266	2075
Over 1 month (sa)				
1987 OCTOBER	1418	720	-63	2075
NOVEMBER	-327	2080	69	1822
DECEMBER	-922	1221	262	561
1988 JANUARY	2320	1124	307	3751
FEBRUARY	831	1557	207	2595
MARCH	1658	1805	197	3660

NOTES

1 Total retail funds, including terms shares and SAYE.
2 Total inflows.
3 March on March.

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TABLE 18

Breakdown of Bank Lending by instrument

		Advances	Commercial Bills	Investment[1]	Other[2]	Total (unadjusted)	Total s/a
1984-1986							
% change[3]							
1984-85		15.5	27.7	18.0	n/a	17.5	17.5
1985-86		17.9	-7.4	81.3		16.9	16.8
Monthly average[3]							
1984-85		1131	186	25	91	1433	1452
1985-86		1438	56	157	11	1661	1692
Monthly changes							
1987	March	4643	-1969	339	420	3433	2529
	April	1726	-420	210	-398	1118	2190
	May	3622	-2068	295	497	2346	2560
	June	5144	771	3	-1206	4712	4009
	July	2139	1627	-57	890	599	4486
	August	2847	-1544	119	-288	1134	2633
	September	5460	12	-19	66	5519	4329
	October	2507	-489	139	804	2961	2920
	November	2309	819	235	-62	3301	3274
	December	3955	1544	120	-165	5454	4986
1988	January	2569	2485	-220	254	5088	5585
	February	2077	392	-32	63	2500	2595
	March	5627	-525	241	508	5894	4779

1. Investment by banks in private sector
2. Market loans, shipbuilding repos, CD's and time deposits of building societies, commercial paper, and transit items.
3. April on April

TABLE 19

FUNDING : FINANCIAL YEAR OUTTURN 1987/88 26/4/88

£ million

	APRIL 87 - FEB 88	MARCH 88	FINANCIAL YEAR 1987/88
PSBR AND FUNDING TARGET			
1 PSBR excl asset sales	-2251	3820	1569
2 Asset sales (sales-)	-5117	-1	-5118
3 PSBR	-7368	3819	-3549
4 Adjustment for 1986/87 underfund			314
FINANCED BY:			
5 OPS debt sales to nbps (sales-)	1289	-165	1124
6 National Savings (sales-)	-1847	-189	-2036
7 CTDs (sales-)	41	14	55
8 Treasury bills etc (sales-)	-73	-57	-130
9 Intervention (reserves inc+)	10031	1111	11142
10 Public sector externals excl intervention and gilts (inc-)	463	234	697
11 NET GILT SALES TO NBPS & OVERSEAS NEEDED FOR FULL FUND (sales+)	2536	4767	7617
GILT SALES:			
12 Net purchases by nbps and overseas (purchases+)	8222	-813	7409
13 Net purchases by monetary and other public sector (purchases+)	-535	129	-406
14 Maturities	5476	976	6452
15 GROSS OFFICIAL SALES	13163	292	13455
16 OVER(-)/UNDER(+)FUNDING	-5686	5580	208

Relationship between lines:

3 = 1 + 2
11 = 3+4+5+6+7+8+9+10
15 = 12 + 13 + 14
16 = 11 - 12

Table 20:- BORROWING BY PRIVATE SECTOR EXCLUDING BUILDING SOCIETIES (£ million)

		BANK/BUILDING SOC. STERLING BORROWING			OTHER STERLING BORROWING					ALL BORROWING		
		Banks	Building Societies	TOTAL	Sterling Commercial Paper	Ordinary Shares	Pref & Bonds	Euro-Sterling (*)	TOTAL	Sterling	Foreign Currency	TOTAL
Change in Quarter												
1984	Q1	5141	3007	8148		163	44	25	232	8380	1102	9482
	Q2	2781	4076	6857		429	75	0	504	7361	808	8169
	Q3	3285	4087	7372		288	59	100	447	7819	1047	8866
	Q4	4535	3402	7937		249	73	210	532	8469	1948	10417
1985	Q1	7093	3189	10282		924	170	235	1329	11611	3225	14836
	Q2	4158	3748	7906		1092	327	230	1649	9555	1382	10937
	Q3	4148	3560	7708		873	274	130	1277	8985	-806	8179
	Q4	4803	4232	9035		525	89	200	814	9849	939	10788
1986	Q1	7431	3867	11298	0	471	209	350	1030	12328	2362	14690
	Q2	5465	5083	10548	0	1369	344	325	2038	12586	1575	14161
	Q3	5764	5592	11356	69	1431	290	231	2021	13377	3688	17065
	Q4	10433	4667	15100	65	2338	-52	281	2632	17732	591	18323
1987	Q1	7119	3619	10738	368	1553	-782	1231	2370	13108	7152	20260
	Q2	8692	4240	12932	651	2259	352	655	3917	16849	4717	21566
	Q3	10855	3889	14744	298	5950	732	570	7550	22294	-1191	21103
	Q4	10884	3746	14630	-89	3735	423	105	4174	18804	-128	18676
1988	Q1	13182	4948	18130	722	325	-115	915	1847	19977	1914	21891
Average per quarter												
1984		3936	3643	7579	0	282	63	84	429	8007	1226	9234
1985		5051	3682	8733	0	854	215	199	1267	10000	1185	11185
1986		7273	4802	12076	34	1402	198	297	1930	14006	2054	16060
1987		9388	3874	13261	307	3374	181	640	4503	17764	2638	20401
1988		13182	4948	18130	722	325	-115	915	1847	19977	1914	21891
Change in Month												
1987	APRIL	1258	1590	2848	192	828	110	355	1485	4333	1234	5567
	MAY	2316	1295	3611	171	415	184	150	920	4531	2703	7234
	JUNE	5118	1355	6473	288	1016	58	150	1512	7985	780	8765
	JULY	4403	1302	5705	131	1840	182	210	2363	8068	-2234	5834
	AUGUS	1023	1269	2292	9	2090	390	150	2639	4931	1023	5954
	SEPTE	5429	1318	6747	158	2020	160	210	2548	9295	20	9315
	OCTOB	2517	1510	4027	165	2535	195	45	2940	6967	3459	10426
	NOVEM	3209	1266	4475	-16	975	55	60	1074	5549	-1529	4020
	DECEM	5158	970	6128	-238	225	173	0	160	6288	-2058	4230
1988	JANUA	4980	1466	6446	212	48	41	450	751	7197	735	7932
	FEBRU	2547	1385	3932	339	219	123	355	1036	4968	-956	4012
	MARCH	5655	2097	7752	171	58	-279	110	60	7812	2135	9947

*Gross Issues announced by U.K. ICC's.

Table 21:- NET FINANCE OF U.K. INDUSTRIAL AND COMMERCIAL COMPANIES AND BUILDING SOCIETIES (£ million)

	BANK BORROWING				OTHER BORROWING						ALL BORROWING
	Sterling		Foreign		Sterling	Ordinary	Pref &	Euro-Sterling(*)			
	ICC's	BSOC's	Currency	TOTAL	Commercial Paper	Shares	Bonds	ICC's	BSOC's	TOTAL	TOTAL
Change in Quarter											
1984											
Q1	2905	-86	-895	1924		163	44	25	0	232	2156
Q2	559	-56	-193	310		429	75	0	0	504	814
Q3	1219	533	-74	1678		288	59	100	0	447	2125
Q4	2312	408	1433	4153		249	73	210	0	532	4685
1985											
Q1	3386	6	-352	3040		924	170	235	0	1329	4369
Q2	747	248	207	1202		1092	327	230	0	1649	2851
Q3	229	161	1371	1761		873	274	130	600	1877	3638
Q4	874	343	1377	2594		525	89	200	475	1289	3883
1986											
Q1	3807	346	108	4261	0	471	209	350	935	1965	6226
Q2	-356	442	108	194	0	1369	344	325	1075	3113	3307
Q3	28	1800	1128	2956	69	1431	290	231	1575	3596	6552
Q4	5223	390	-21	5592	65	2338	-52	281	2632	5264	10856
1987											
Q1	1185	353	2008	2294	368	1553	-782	1231	290	2660	4954
Q2	710	-516	756	100	651	2259	352	655	50	3967	4067
Q3	3747	397	-94	4826	298	5950	732	570	100	7650	12476
Q4	4379	832	682	5211	-89	3735	423	105	0	4174	9385
1988											
Q1	7148	257	2169	7405	722	325	-115	915	625	2472	
Average per quarter											
1984	1749	200	68	2016	0	282	63	84	0	429	2445
1985	1309	190	651	2149	0	854	215	199	269	1536	3685
1986	2176	745	331	3251	34	1402	198	297	1554	3485	6735
1987	2505	267	838	3610	307	3374	181	640	147	4649	8259
1988	7148	257	2169	7405	722	325	-115	915	625	2472	9877

Change in Month

	Sterling Commercial Paper	Ordinary Shares	Pref & Bonds	Euro-Sterling ICC's	Euro-Sterling BSOC's	TOTAL
1987 APRIL	192	828	110	355	0	1485
MAY	171	415	184	150	50	970
JUNE	288	1016	58	150	0	1512
JULY	131	1840	182	210	0	2363
AUGUST	9	2090	390	150	0	2639
SEPTEMBER	158	2020	160	210	100	2648
OCTOBER	165	2535	195	45	0	2940
NOVEMBER	-16	975	55	60	0	1074
DECEMBER	-238	225	173	0	0	160
1988 JANUARY	212	48	41	450	50	801
FEBRUARY	339	219	123	355	150	1186
MARCH	171	58	-279	110	425	485

* Gross Issues announced by U.K. ICC's and Building Societies

NOTE: Bank borrowing figures include monetary sector holdings of 'Other Borrowing' instruments, giving rise to some double counting in the 'All Borrowing' figures.

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Table 23

M0 FORECAST, 1988-89

Seasonally adjusted

		Levels (£ million)		6 month growth rate (%)		12 month growth rate (%)	
		Notes and Coin	M0	Notes and Coin	M0	Notes and Coin	M0
Actual							
1988	January	15 620	15 801	6.1	5.3	4.5	4.6
	February	15 659	15 783	5.3	4.5	5.7	5.3
	March	15 753	15 916	5.0	4.6	6.4	5.8
1987-88[1]		15 371	15 553	n/a	n/a	5.0	4.9
	April	15 825	16 054	4.8	5.1	6.1	6.2
Forecast							
	May	15 920	16 110	5.2	5.2	6.2	6.1
	June	15 975	16 165	4.1	4.1	6.0	6.3
	July	15 995	16 185	4.9	4.9	5.5	5.1
	August	16 015	16 205	4.6	5.4	5.0	5.0
	September	16 030	16 220	3.5	3.9	4.3	4.2
	October	16 060	16 250	3.0	2.5	3.9	3.8
	November	16 110	16 300	2.4	2.4	3.8	3.8
	December	16 180	16 370	2.6	2.5	3.3	3.3
1989	January	16 230	16 420	3.0	2.9	3.9	3.9
	February	16 255	16 445	3.0	3.0	3.8	4.2
	March	16 280	16 470	3.2	3.1	3.4	3.5
1988-89[1]		16 073	16 266	n/a	n/a	4.6	4.6

[1]average of 12 months

Table 24

Broad Money forcast

		OUTTURN 1988 MARCH		FORECAST	APRIL
		M3	M4	M3	M4
(i)	Underlying increase	3509	4519	2000	2550
(ii)	Estimated Special Factors	5550	5550	- 1500	- 1300
	Arbitrage: bills against deposits	-	-	- 500	- 500
	Over(-)/Under(+)funding	5550	5300	- 1000	- 1050
	Liquidity rundown to replace equity issues	- 250	- 250	- 250	- 250
	Low unit trust inflows	250	500	250	500
(iii)	Total Increase	9059	10069	500	1250
	Monthly % change	4.9	3.3	0.3	0.4
	Annual % change	20.9	16.8	18.9	15.8
	Annual % change expected at 1988 Budget time	22.5	17.3	22.0	17.4

Line (iii)=(i)+(ii)

Table 25

Lending forecasts

		OUTTURN 1988 MARCH			FORECAST APRIL		
		Bank lending	B Soc lending	M4 Counterpart	Bank lending	B Soc lending	M4 Counterpart
(i)	Underlying increase (sa)	5[illegible]29	1618	6631	3645	1550	5095
(ii)	Estimated Special factors	- 430	450	20	- 300	450	150
	Arbitrage: bills against deposits	-	-	-	- 500		- 500
	bills against foreign currencies	- 200	-	- 200	- 250		- 250
	PSBR offset	- 400	-	- 400	-	-	-
	Bill leak	- 530	-	- 530	-	-	-
	Bank borrowing to replace equity issues	750	-	750	500	-	500
	Bank/building society competition	- 150	150	-	- 150	150	-
	Buoyant housing market	100	300	400	100	300	400
(iii)	Lending increase (sa)	47[illegible]	2068	6651	3345	2000	5245
	Lending increase (nsa)	589[illegible]	2097	7795	1625	1975	3500
	Annual % change (nsa)	25.2	13.9	20.8	25.[illegible]	14.1	20.8
	Annual % change expected at Budget time	24.9	13.[illegible]	20.4	26.0	13.[illegible]	20.9

Line (iii)=(i)+(ii)

SECRET

TABLE 26 : BROAD AGGREGATES COUNTERPARTS AND FORECAST

£ million

OUTTURN: MARCH 1988

	M3	M4
PSBR	3819	3819
LA and PC debt sales to NBPS (-)	-165	-64
CG debt sales to NBPS (-)	402	43
o/w Gilts	(634)	(427)
Treasury bills etc	(-57)	(-56)
National Savings	(-189)	(-188)
CTDs	(14)	(-140)
Public sector external & fc finance (-)	1524	1524
OVER(-)/UNDER(+)FUNDING	5580	5322
Sterling lending to NBPS	5894	7795
(seasonally adjusted)	(4779)	(6651)
Banks'/B socs' externals	-218	-193
Banks'/B socs' £NNDLs	-2197	-2855
TOTAL	9059	10069
Monthly % growth nsa	4.9	3.3
sa	3.2	2.3
Annual % growth nsa	20.9	16.8

FORECAST: APRIL 1988

	M3	M4
PSBR	-475	-475
LA and PC debt sales to NBPS (-)	0	-50
CG debt sales to NBPS (-)	-400	-400
o/w Gilts	(-250)	(-250)
Treasury bills etc	(0)	(0)
National Savings	(-200)	(-200)
CTDs	(50)	(50)
Public sector external & fc finance (-)	-125	-125
OVER(-)/UNDER(+)FUNDING	-1000	-1050
Sterling lending to NBPS	1625	3500
(seasonally adjusted)	(3345)	(5245)
Banks'/B socs' externals & £NNDLs	-125	-1200
TOTAL	500	1250
Monthly % growth nsa	0.3	0.4
sa	1.1	0.9
Annual % growth nsa	18.9	15.8
Annual % growth sa	19.6	15.7

		M4
BUILDING SOCIETIES:	Retail inflows	1325
	Interest credited	100
	Wholesale inflows from NBPS	0
	Holdings of M3 (-)	-675

TABLE 27: MONEY MARKET ASSISTANCE £ million

	Outturn 1988 MAR	APR	Forecast MAY	JUN
A. Money market influences				
(i) CGBR excl bank deposits (+)	3649	-829	750	1475
(ii) Reserves etc (+)	1044	184	-75	-75
(iii) Notes and coin (-)	-1062	234	50	0
(iv) National Savings (-)	-188	-180	-100	-125
(v) CTDs (-)	-2	47	0	50
(vi) Gilts (-)	683	-200	325	100
(vii) Other Exchequer items etc	-278	314	0	0
A. TOTAL MONEY MARKET INFLUENCES (Market surplus + / shortage -)	3846	-430	950	1425
B. Money market operations				
(i) Commercial bills (purchase +):				
Issue Department - outright	-4079	-1609		
- repos	1753	1797		
Banking Department	132	-266		
(ii) LA bills (purchase +)				
Issue Department	-86	120		
Banking Department	-30	-24		
(iii) Treasury bills (purchase +)	-232	53		
(iv) Market advances	-131	362		
(v) Treasury bill Repos	0	21		
(vi) Export Credit/Shipbuilding Repos	-979	0		
(vii) Gilt Repos	-332	0		
B. TOTAL MONEY MARKET OPERATIONS	-3984	454	-950	-1425
C. Change in bankers balances = A + B	-138			
D. TOTAL ASSISTANCE OUTSTANDING	9673	10074	9125	7700
of which commercial bills	9529	9448		

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TABLE 28

SECRET

GOVERNMENT SHARE SALES TIMING

1988/89

Gas debt		11 April
BGC III		19 April
BT Prefs		10 May
BAA II		19 May
BP II		30 August
BSC I	Proposed	22 November

1989/90

BP III		27 April
BSC II	Undecided	

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OUR TELNO 171 TO UKREP: 3 MAY MONETARY COMMITTEE

1. YOU SHOULD KNOW THAT THE 3 MAY MONETARY COMMITTEE DISCUSSION OF EUROPEAN MONETARY 'CONSTRUCTION' WENT WELL. THE COMMITTEE IDENTIFIED A NUMBER OF TECHNICAL IMPROVEMENTS TO THE WORKING OF THE EMS AND ARRANGEMENTS FOR EC MONETARY COOPERATION THAT WOULD BE WORTH FURTHER EXAMINATION IN FUTURE. AS TO THE CONCEPT OF A EUROPEAN CENTRAL BANK, THERE WAS NO SUPPORT FOR THE IDEA OF A STUDY BY 'WISE MEN', AND GENERAL AGREEMENT THAT ANY FURTHER EXAMINATION WOULD BEST BE CARRIED OUT IN ECOFIN, IN THE MONETARY COMMITTEE AND IN THE COMMITTEE OF CENTRAL BANK GOVERNORS.

2. AS NOTED IN TUR, THE MONETARY COMMITTEE CHAIRMAN WILL BE PRESENTING THE COMMITTEE'S VIEWS TO ECOFIN.

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<u>ADDITIONAL</u> 1

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Mr Allan - 12/2

U.S. APRIL UNEMPLOYMENT 5.4% AFTER 5.6% IN MARCH, LOWEST SINCE JUNE 1974. News agencies reported from Washington that U.S. April unemployment dropped 0.2% to 5.4%, the lowest level since June 1974. Non-farm employment rose only 174,000 in the month after a 296,000 rise in March, but economists said the figures could fan fears of rising inflation and higher interest rates.

DOLLAR MOVES NARROWLY AFTER UNEMPLOYMENT FIGURES. News agencies reported that the U.S. dollar moved narrowly after the announcement of lower-than-expected 5.4% U.S. unemployment (compared with 5.6% in March). Dealers said a small 174,000 rise in non-farm employment indicated less strain on the labor market and thus less fear of inflationary pressures. Exchange rates included: German mark 1.6795 (1.6780), yen 124.70 (124.90), sterling $1.8655 (1.8675), French franc 5.7110, Canadian dollar 81.15c, lira 1254, Swiss 1.4005, guilder 1.8830, and Belgian franc 35.12. Gold fell 75c to $444.90. The SDR was $1.37914 (1.37988).

JAPANESE INVESTORS RELUCTANT TO PARTICIPATE IN U.S. TREASURY AUCTION. Kyodo reported from Tokyo that investment sources said many Japanese life insurance companies and investment trusts are reluctant to participate actively in next week's $26B quarterly U.S. Treasury auction, because of fears of higher interest rates to avert inflation. The Bank of Japan and Finance Ministry are closely monitoring the stance of Japanese investors to the U.S. auction, because of a possible renewed dollar decline if Japanese interest is low.

U.S. CONGRESSIONAL PANEL REJECTS REQUEST FOR IBRD CAPITAL INCREASE. AP-DJ reported from Washington that a U.S. House Appropriations subcommittee turned down Treasury Secretary James Baker's request for an initial $70M contribution to an IBRD capital increase and also decided against new U.S. funding for the IADB. The panel approved $1.36B in funding for other international lending agencies.

BRITISH LOCAL VOTING PLEASES GOVERNMENT, LABOUR. Reuters reported from London that Britain's governing Conservative Party and main opposition Labour Party hailed the result of local council elections, in which the big losers were the minority Liberals and Social Democrats. In the first electoral test since the Government won a third term of office last June, the Conservatives lost only five seats and gained overall control of five councils while Labour won three more councils.

SCHLESINGER SAYS BUNDESBANK MUST TRY FOR MONEY SUPPLY TARGET. AP-Dow Jones reported from Frankfurt that Bundesbank Vice President Helmut Schlesinger said the Bank must try to reach its money supply target this year. He told Rheinischer Merkur/Christ und Welt there is a possibility of a tighter credit policy if money supply growth does not slow this year. M3 money supply rose at an annual rate of 7.5% in the first quarter, against the Bundesbank's 3% to 6% target. Schlesinger said there are several foreign economic influences in the way of meeting the target. If the outflow of foreign capital in the first quarter continued during the year, monetary expansion would be dampened. The current stability of the U.S., without the help of central bank intervention, is the strongest evidence of stable conditions. Despite an acceleration of worldwide inflation rates, Schlesinger said there is a good chance that German inflation will remain below 2% in 1988. The future course of German interest rates will depend on inflationary fears and U.S. interest rate trends.

BIG IMPROVEMENT IN LAST FRENCH TRADE FIGURES BEFORE ELECTION. Reuters reported from Paris that the French Economy Ministry announced that the French March trade surplus of 1.8B francs was the largest in 15 months, contrasted with a 5.2B franc deficit in February. The trade swing, largely reflecting a sharp rise in industrial exports, was the third piece of good news within 24 hours for Prime Minister Jacques Chirac in the final days of his presidential campaign ahead of Sunday's second round vote. On Wednesday evening, the last three French hostages in Beirut were freed after three years captivity and on Thursday, French troops freed 23 gendarmes held hostage by militants in New Caledonia.

CHINA LIFTS CONTROLS ON MAJOR FOOD PRICES. Reuters reported from Beijing that the Chinese Communist Party daily Renmin Ribao announced China will no longer set sale prices for four major staples -- vegetables, eggs, pork and sugar -- but will give subsidies to most of its 200M city dwellers to buy non-staple foods. It said the policy change will enable people to understand state policies better and help reduce the government's financial burden, adding that it spends dozens of billions of yuan each year on food subsidies. AFP reported from Beijing that the China Daily said a UN official forecast China's population will reach 1.287B by 2000 on current trends, 84M more than the official target. He told an international conference on population problems that China's birth rate rose to 21.1 per thousand last year from 17.8 in 1985 despite the official policy of one child per family.

YUGOSLAV FINANCE MINISTER PREDICTS TOUGH TIMES WHEN PRICE FREEZE ENDS. Reuters reported from Belgrade that Yugoslav Finance Minister Svetozar Rikanovic told businessmen that a pending economic package will be painful but must be implemented consistently despite obstacles and temptations. He predicted hard times when the Government lifts a price freeze on May 15 under an agreement with the IMF to help pay foreign debts, saying the new policies could cause social problems, but there should be some improvement by the yearend. The agency said inflation is already 160%, adding that Yugoslavs went on a buying spree ahead of the end of the freeze.

POLAND TO BAN ALL FORMS OF PROTEST UNDER SPECIAL POWERS. Reuters reported from Warsaw that a draft Polish special-powers law to be debated by Parliament May 11 bans all forms of protest until the end of the year, suspends all legal proceedings for labor disputes and grants the Government sweeping powers to override existing economic regulations and to force enterprises to adapt to the economic reform program.

WESTERN BANKERS, ECONOMISTS WATCH UNREST IN POLAND. Reuters reported from London that bankers and economists are watching Poland's wave of labor unrest for effects on its relations with foreign creditors. A spread of the factory strikes of the past 11 days would aggravate Poland's existing difficulties in repaying its $39.5B foreign debt. The current strikes, triggered by steep price increases introduced under the government's economic reform program, are the most serious since the Solidarity free labor union was suppressed under martial law in 1981. One analyst predicted that the government would give in to the demands of the strikers, thus fueling the rate of inflation and further strikes. An economist said Poland's parliament is scheduled to meet next week to discuss a draft law which would give the government undefined special powers to defend its reforms, which have the backing of the IMF and IBRD. Sources in Paris added that talks are to begin soon to revise the position between Poland and its Paris Club creditors.

IVORY COAST DEBT ACCORD COULD SET PRECEDENT. Reuters reported from London that bankers are trying to clear the way to link interest payments on Ivory Coast debt to new loans in an effort to persuade reluctant smaller institutions to continue lending money to LDCs. They think that can get around legal barriers to such a link by reclassifying debt, and set a precedent for future agreements. Legal agreements for LDC loans say all banks should be treated equally, while U.S. and British laws say banks that do not receive interest payments may sue any banks that do. The package effectively reclassifies the Ivory Coast's existing debt and converts it into a new loan with new legal paperwork which could clear the way for different treatment of banks that do not lend additional money to the Ivory Coast. Banks that agree to lend more can count on a fixed schedule of repayments of their existing loans, if not, they can take their chances, and could end up either losing money on those loans or being forced to set aside still more profits to cover possible losses. The agency reported from London that banks will not be sure how much is being rescheduled until all the creditor banks have responded, which is likely to be by next month. The interest rate would be 1-1/4% above the London interbank rate, down from the 1-5/8% margin the Ivory Coast had been paying. The country stopped servicing its debt and asked for a new rescheduling in April 1987 because of falling cocoa and coffee prices. WSJ, p17.

PHILIPPINE CREDITORS SAY RULE CHANGES HAVE NEARLY KILLED DEBT/EQUITY SWAPS. WSJ, p17, said in a Manila report that a Philippine ruling in February to limit foreign debt-equity swaps to loans made to private companies dealt a near-mortal blow to the program, and foreign bankers see little chance it can be saved.

PHILIPPINE FOREIGN DEBT RISES TO $30.1B. Kyodo reported from Manila that Philippine Budget Secretary Guillermo Carague told a Senate committee that higher interest rates and the sharp decline of the U.S. dollar raised Philippine foreign debt to $30.1B in April from $28.6B in December. The agency noted that several Senators have supported moves to limit debt servicing to 10% of the annual budget.

FED VICE CHAIRMAN SAYS U.S. SEEKING FLEXIBLE SOLUTIONS TO LATIN DEBT. AP-DJ reported from Rio de Janeiro that U.S. FRB Vice Chairman Manuel Johnson told newsmen that the U.S. favors flexible new solutions to help Latin America meet its huge foreign debt. Debt/equity and debt/bond swaps are part of a menu of flexible items and are important steps to reducing debt, noting that the Fed encourages such operations. Johnson was attending a meeting of Latin American central bank governors.

ISRAEL IMPORT LEVY ANGERS U.S., EEC. Ldn Fin Times, May 5, p5, reported from Jerusalem a growing disagreement between Israel and its major trading partners, the U.S. and the EEC, over Israeli purchase taxes and ad hoc levies said to discriminate against imports. The two trading partners, together responsible for 70% of Israeli imports, are informally coordinating their approaches to Israel. Both have wide-ranging preferential trade agreements with the country, and both protested separately last week over an import levy and the local purchase tax on which the levy is based. The levy is used as a cost equalization device to protect local manufacturers.

WALL STREET EERILY QUIET AS INSTITUTIONS WITHDRAW. NYT, pD1, in a New York report discussed a withdrawal of institutional investors from the New York stock market, said this has changed the nature of trading which is now dominated by program trading, takeover speculation and other short-term strategies, and commented that it has left the market more susceptible to sudden and sharp price moves on thinner volume.

PAYE SAYS EUROPEAN COUNTRIES WILL BEAR FIRST IMPACT OF U.S. EXTERNAL ADJUSTMENT. AFP reported from Paris that OECD Secretary General Jean-Claude Paye told newsmen that the world economy is in better shape than predicted at the end of 1987, but trade and financial imbalances among major countries, protectionist pressures, and unemployment remain major concerns. Adjustment of the U.S. deficit and of German and Japanese surpluses is under way and western Europe is likely to feel the first impact.

MARTENS TO FORM BELGIAN GOVERNMENT, ENDING EIGHT MONTH CRISIS. Agencies reported.

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FRAME ECONOMIC

COMMISSION/PRESIDENCY MEETING: 10 MAY: MONETARY ISSUES

SUMMARY

1. AT HIS PRESS CONFERENCE KOHL APPEARS TO POUR COLD WATER ON THE IDEA OF A GROUP OF WISE MEN TO CONSIDER THE POSSIBILITY OF SETTING UP A EUROPEAN CENTRAL BANK.

DETAIL

2. AT A JOINT PRESS CONFERENCE WITH DELORS AFTER THE MEETING CHANCELLOR KOHL REPLIED TO A QUESTION ON WHETHER HE AGREED WITH GENSCHER'S VIEWS ON A EUROPEAN CENTRAL BANK BY SAYING THAT, GIVEN ITS SUPPORT FOR THE SINGLE MARKET, GERMANY WAS IN FAVOUR OF DOING EVERYTHING POSSIBLE IN THE MONETARY FIELD, INCLUDING THE QUESTION OF CONTROL OF CAPITAL MOVEMENTS, STRENGTHENING THE EMS AND IMPROVING COLLABORATION BETWEEN NATIONAL BANKS. THE LATTER COULD BE DONE VERY QUICKLY. A CENTRAL BANK WAS PERHAPS NOT FOR TOMORROW AND DISCUSSION WAS NEEDED ON WHETHER IT WOULD BE LINKED TO GOVERNMENT MACHINERY OR TOTALLY INDEPENDENT LIKE THE BUNDESBANK. THE SUGGESTION OF SETTING UP A GROUP OF WISE MEN MIGHT PROVE TO BE A WAY OF POSTPONING A DECISION. THERE WOULD BE DISCUSSION IN HANOVER BUT HE COULD NOT SAY IN WHAT TERMS.

3. WE WILL REPORT FURTHER ON THIS AND OTHER ISSUES DISCUSSED AT THE MEETING WHEN WE HAVE BEEN ABLE TO GET A READ OUT FROM OUR CONTACTS. IT IS CLEAR THAT A GERMAN ATTEMPT TO PUT PRESSURE ON THE COMMISSION OVER TRANSPORT LIBERALISATION OCCUPIED A GOOD PART OF THE MEETING. COMMISSIONER CLINTON-DAVIS' CHEF DE CABINET (MEADOWS) HAS ASSURED US THAT CLINTON-DAVIS STOOD FIRM AND WILL BE WRITING SOON TO COLLEAGUES WITH THE COMMISSION'S COMPROMISE TEXT.

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ADDITIONAL 1

FRAME

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MINUTES OF A MEETING IN THE CHANCELLOR'S ROOM
HM TREASURY AT 4.45PM ON THURSDAY, 12 MAY

Those present

Chancellor
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Mr Lankester
Mr H P Evans
Mr Peretz
Miss O'Mara
Mr Tyrie

EUROPEAN MONETARY INTEGRATION

The meeting discussed the paper attached to Mr Peretz's minute of 10 May.

Objectives

2. The objectives proposed by Mr Peretz were generally agreed. On cross-holdings of currencies, the Chancellor said that the furthest we could reasonably go was as suggested in paragraph 4 of Mr Peretz's note of 13 May: to propose that all obstacles should be removed - including both the Bundesbank's self-denying ordinance on holding currencies other than dollars, and their attempted veto on other countries acquiring deutschmarks; and to establish a presumption that over some period countries should aim to build up their holdings of other Community currencies and ecus. Mr Peretz would work up a proposal on these lines in more detail; it should include a third leg: the greater use of ecus for intervention and as well as a component of reserves.

3. On the potential UK proposals:

(a) we should encourage others to follow our example and carry out more of their intervention in private ecus;

(b) an attempt to get it clearly established that there were no constraints on intervention between national currencies and ecus would concede too much to the Germans, by implying that we accepted that there were constraints on our purchases of deutschmarks. Our line should simply be that there were no constraints at all on purchases of ecus.

(c) greater use of the private ecu as a reserve asset was worth pushing. We would not want to take an initiative on promoting greater sovereign ecu borrowing, since it was not yet clear that we ourselves would wish to do any. We should encourage the Community to make more of its own transactions in ecus.

(d) in practice, bringing together the private and official ecu meant making the official ecu convertible. The present arrangements were hardly very sensible, but it was not something worth making a major fuss about.

(e) re-weighting the ecu was for the future. An initiative on functions currently carried out by the BIS did not seem worth bothering with.

Tactics

4. On the proposals for a European Central Bank, the Chancellor said the position he would take at ECOFIN would be that we considered that the whole idea was premature. Therefore it did not make sense for ECOFIN to set up any kind of study. But it seemed almost inevitable that the subject would be discussed by Heads of State/Government at the European Council at Hanover. If they decided that this subject should be studied further, then we felt very strongly that it should not be discussed by "wise men", but instead by ECOFIN, the Monetary Committee, Central Bank Governors etc.

5. On the capital liberalisation directive, the Chancellor said he was concerned that the new French Government might raise

difficulties. They might seek to make links with progress on tax harmonisation and on UK membership of the ERM. If this happened, the Chancellor proposed to take the line that it was in fact better for the UK if the French (and others) kept exchange controls: London gained immeasurably from having free movement of capital while other centres did not. This line would head off any attempt by the French to use agreement to the capital liberalisation directive as a negotiating card.

6. There was some discussion about monetary policy co-ordination within the EC. It was agreed that we should avoid any sort of ECOFIN surveillance, particularly if the Commission tried to play a role. ECOFIN already had discussions on these issues when it considered the EC Annual Report.

7. On developments of the ERM, we could not, of course, accept any timetable for our joining the ERM. There were some minor improvements we could support. But we should not necessarily support the French in getting Article 15 amended: it was better to get it agreed that Article 15 could be breached.

A C S ALLAN

13 May 1988

Distribution

Those present
PS/Economic Secretary
Mr Cropper

LESS

cc: PPS/ 12/2
Sir P. Middleton
Mr Scholar
Mr Peretz
Miss O'Mara
RA, MB, GS, MG, JF, RE

ANGELL SAYS FED MAY NOT NEED TO TIGHTEN FURTHER NRNF

WASHINGTON, MAY 12, REUTER - FEDERAL RESERVE BOARD GOVERNOR WAYNE ANGELL SAID IT WOULD BE APPROPRIATE FOR U.S. MONEY SUPPLY TO GROW LESS RAPIDLY.

BUT HE TOLD THE INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA THAT FINANCIAL MARKETS SHOULD NOT NECESSARILY ASSUME THAT THE FEDERAL RESERVE WILL HAVE TO TIGHTEN MONETARY POLICY FURTHER TO ACHIEVE THE SLOW DOWN IN MONEY GROWTH.

12-MAY-1455 SEC152 MOND

CONTINUED ON - NRNG

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FX - SEE FRED 1615

ANGELL SAYS FED =2 WASHINGTON NRNG

IN THE 1970S, THE FEDERAL RESERVE'S MONETARY POLICY CHANGES LAGGED CHANGES IN INFLATION. THIS WAS NO LONGER THE CASE, SO THE FIRST SIGN OF A TIGHTER FED POLICY NOW WAS NOT NECESSARILY THE BEGINNING OF A TREND.

"I HOPE AND THINK THAT THAT EXPECTATION (OF A FURTHER TIGHTENING) IS NOT WORTH ITS VALUE AS A PREDICTIVE TOOL," ANGELL SAID.

HE SAID HE WAS "SOMEWHAT SATISFIED" WITH THE CURRENT RATE OF ECONOMIC GROWTH AND DID NOT WORRY ABOUT THE ECONOMY OVERHEATING.

12-MAY-1501 SEC158 MOND

CONTINUED FROM - NRNF

ENDS

P

FX - SEE FRED 1615

THATCHER, LAWSON SIDESTEP POUND POLICY QUESTIONS NRNL

LONDON, MAY 12, REUTER - PRIME MINISTER MARGARET THATCHER AND CHANCELLOR OF THE EXCHEQUER NIGEL LAWSON BOTH SIDESTEPPED QUESTIONS ON THE GOVERNMENT'S STERLING POLICY DURING PARLIAMENTARY QUESTIONS ON THURSDAY.

"THE CHANCELLOR RUNS THE ECONOMY EXTREMELY WELL," THATCHER TOLD OPPOSITION LABOUR LEADER NEIL KINNOCK WHEN HE ASKED HER TO EXPLAIN EXCHANGE RATE POLICY.

LAWSON SAID STERLING'S POPULARITY REFLECTED OVERSEAS CONFIDENCE IN THE ECONOMY.

"THE TEMPORARY BALANCE OF PAYMENTS...DEFICIT WE ARE GOING THROUGH...IS NOT A MATTER THAT SHOULD CAUSE ALARM," HE SAID.

12-MAY-1457 MON932 MOND

CONTINUED ON - NRNM

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FX - SEE PRED 1615

THATCHER, LAWSON =2 LONDON NRNM

"IT IS STRIKING HOW OVERSEAS OPINION HAS CONFIDENCE IN THE ECONOMY," LAWSON SAID.

HE DID NOT RESPOND TO REPEATED CALLS TO EXPLAIN POUND POLICY FROM LABOUR ECONOMICS SPOKESMAN JOHN SMITH, WHO CLAIMED THATCHER WAS NOW IN CHARGE OF EXCHANGE RATE DECISIONS.

LABOUR WAS JOINED BY SOME CONSERVATIVE PARLIAMENTARIANS IN QUESTIONING THE THREAT TO BRITISH INDUSTRIAL COMPETITIVENESS FROM A HIGHER POUND.

STERLING HAS RISEN 16 PFENNIGS VERSUS THE MARK SINCE A MARCH 4 GOVERNMENT DECISION TO STOP INTERVENING TO HOLD IT BELOW THREE MARKS, A YEAR-OLD POLICY THAT WAS INITIATED BY LAWSON.

12-MAY-1506 MON938 MOND

CONTINUED FROM - NRNL ENDS

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FX - SEE PRED 1615

a 13/5/88. pg

see X (last page)

Mr Allan –

12/2

S'tg experts, nor massive violence, but demonstrations on a sufficient scale to get worldwide TV attention!

(Headline missing. VH) FROM BRITEMB WTON 05/13/88 05:07 P.3 ... WSJ, pp1,2, reported from New
York that the U.S. Treasury and international banks are nearing a compromise that could help clear the way for restructuring most of Brazil's foreign debt and provide $5.2B of new loans. Banks failed to get an IBRD guarantee for part of the $5.2B, which was vigorously opposed by the Treasury. The full $5.2B is now likely to be even more difficult to raise than banks feared. Many banks, particularly Japanese and some U.S. and European institutions, had counted on IBRD guarantees in the financing. Brazil's agreement with banks will include many new features to try to make the loan more attractive and creditworthy, including 6% exit bonds, and an option to take bonds convertible into indexed Brazilian treasury bonds. But an increasing number of banks have sold their LDC loans and are likely to shun the proposed Brazilian settlement whatever it looks like, the paper said. Brazilian Finance Minister Mailson da Nobrega is expected soon to announce a new economic program, and Brazil's debt negotiators are apparently eager to conclude the settlement shortly after the announcement.

PETRICIOLI SAYS PESO WILL NOT BE DEVALUED. AP-DJ reported from Mexico City that Mexican Finance Secretary Gustavo Petricioli said the peso exchange rate will remain stable this year, adding that a devaluation would be the worst thing that could happen. He said devaluation would mean restarting a cycle of depreciation, inflation and imbalance in finances. The healthy level of Mexico's international reserves means an ample cushion for President Miguel de la Madrid to finish his six-year term to the end of November without any more economic surprises. Petricioli denied that reserves are being used to support the peso. Budget Secretary Pedro Aspe said an economic solidarity pact between the Government, business and labor is working, and that a 1% monthly inflation rate by the end of the year is feasible.

MEXICO CONFIDENT OF INFLATION SUCCESS. Ldn Fin Times, May 11, p4, reported from Mexico City that Mexican officials believe they can achieve their radical anti-inflation target this year six months ahead of schedule, after reducing monthly price inflation to 3.1% in April, the lowest level in 34 months. The April increase contrasts with record 15.5% inflation in January, the first month of a shock plan to cut the monthly rate to 2% by December. Bank of Mexico officials expect the May inflation rate to be at or near the December target.

PERUVIAN PRIME MINISTER, CABINET RESIGN. News agencies reported from Lima that Peru announced that Prime Minister Guillermo Larco Cox and his 14-member Cabinet resigned. President Alan Garcia said the Cabinet will be restructured. Government officials said the shake-up is aimed at strengthening economic policy and the fight against the growth of leftist insurgency in Peru. They predicted replacement of the Finance and Interior Ministers.

PHILIPPINES SAYS IT NEEDS $21B FOR DEVELOPMENT FINANCE. AP-DJ reported from Manila that Philippine Economic Planning Secretary Solita Monsod told a press conference that the country needs at least $21B to meet its 1987/92 development plan, with a financing gap of $7B. She said the country's debt problem can be met either by debt relief from creditors or by increasing inflows from abroad. The long-term result of new foreign money for development is to push the debt problem further away, she noted.

LDCs ACCEPT NO MAGIC CURE FOR DEBT CRISIS, AT MEETING WITH EEC. Reuters reported from Port Louis that the EEC convinced LDC debtors from the African, Pacific and Caribbean Group this week that there is no quick-fix cure to the debt crisis, but laid the groundwork to speed up aid outlays. The debt crisis, ravaging economies struggling to cope with mass poverty and hunger, dominated annual EEC/APC ministerial talks. APC President Almoustapha Soumaila of Niger said it would not be very pragmatic to hope to find a panacea in just one session. But he stressed that comprehensive and durable solutions to the debt crisis are needed urgently.

KAUNDA URGES WEST TO WRITE-OFF LDC DEBT. AP-DJ reported from Lusaka that Zambian President Kenneth Kaunda urged industrial nations to write-off LDC debt. He also criticized industrial nations for paying low prices for LDC exports while demanding soaring prices for oil, technology and manufactured goods.

CROW SAYS CANADA NOT DRIVING DOLLAR UPWARDS. Ldn Fin Times, May 11, p4, reported from Ottawa that Bank of Canada Governor John Crow said the Bank's shift to a more restrictive monetary stance does not involve a deliberate strategy of driving the Canadian dollar upward. The Bank has no specific target for the currency, he said, adding that it is not dissatisfied with the current balance of higher interest rates and a higher exchange rate.

TAKESHITA SEES POLITICAL ISSUES DOMINATING G7 MEETING. Handelsblatt, May 9, p10, reported from Bonn that visiting Japanese Prime Minister Noboru Takeshita told a news conference that political themes will dominate the annual meeting of G7 leaders in Toronto in June, with less attention paid to economic matters. He cited east-west relations, the situation in Asia, and world peace as the dominant questions.

BAKER SAYS FARM SUBSIDY REFORM TO BE RAISED AT G7 MEETING. Kyodo reported from Washington that U.S. Treasury Secretary James Baker told Japanese Ambassador Nobuo Matsunaga that farm reform will be one of the key topics at a June meeting of G7 leaders in Toronto. Baker predicted better-than-expected economic results for improving the world's economic structure from the Toronto meeting.

TOP MEXICAN CANDIDATE VOWS RISKY REFORMS, OFFERS OPENING TO OTHER PARTIES. WP, pA23.

UN NAMES SADRUDDIN KHAN TO COORDINATE AFGHAN RELIEF, REFUGEE EFFORTS. NYT, pA13.

DOLLAR MOVES NARROWLY IN HOLIDAY MARKET. News agencies reported that the U.S. dollar moved narrowly in thin exchange trading, with most European centers closed for Ascension Day. Prime rate increases by U.S. banks to 9% from 8.5% announced yesterday were a minor stimulus, dealers said. Exchange rates included: German mark 1.6825 (1.6775), yen 124.55 (124.20), sterling $1.8790 (1.8870), French franc 5.7050, Canadian dollar 81.27c, lira 1251 and Swiss franc 1.4005. Gold was $448.85. The SDR was $1.37952 (1.38257).

U.S. BANKS RAISE PRIME RATE TO 9%, FURTHER RISE EXPECTED. WSJ, pp1,3, reported from New York that major U.S. banks raised prime lending rates to 9% from 8.5%, the first increase since October. Bankers predicted further increases this summer, noting that the Federal Reserve is worried about inflation and is likely to tighten credit even further in coming months. NYT, pA1, said the prime rate increase was prompted by growing fears at the Fed and on Wall Street that inflation is now a greater threat than recession. Stock markets worldwide sold-off after the rate increase, but credit markets had largely discounted the move.

U.S. DOES NOT FAVOR RISE IN GERMAN INTEREST RATES. WSJ, p3, reported from Washington that U.S. officials said they would view unfavorably any increase in German Bundesbank interest rates following recent Federal Reserve tightening. They said there is no plan for coordinated interest rate increases by the U.S., Germany and Japan. But there is speculation that other countries might act individually now that the Fed has led the way. WP, pA20, said in an editorial that the Fed is clearly correct to tighten money a little. The paper noted signals of rising inflation this spring and said if currency dealers thought U.S. policy was immobilized by election-year politics, the dollar would rapidly start sliding downward again.

JAPANESE INVESTORS BOUGHT 35% TO 40% OF U.S. 10-YEAR NOTES. Kyodo reported from New York that bond market sources said Japanese institutional investors bought an estimated 35% to 40% of 10-year U.S. Treasury notes sold yesterday to yield 9.06%, the highest in two and a half years, and about in line with market expectations. But the agency said Japanese interest in today's auction of $8.75B of 30-year bonds is unclear, given concern of rising inflation and higher interest rates.

IMF CHIEF CHALLENGES BANKS. Ldn Fin Times, May 11, pp1,7, reported from London that IMF Managing Director Michel Camdessus said in a speech that efforts by debtor countries to follow sound economic policies are being imperilled by the failure of commercial banks to lend them more money. Banks have a crucial role in the debt crisis, but their slow response to the challenge calls into question the notion that the IMF's strategy for debtor economic recovery is a cooperative one directed at growth. Camdessus was positive in his assessment of efforts made by debtors to adjust their economies. He said the speed of adjustment is not as fast as many would like, but faster than the international community is prepared to acknowledge.

WEST BERLIN OFFICIALS SAY TALK OF RADICAL VIOLENCE AT IMF MEETING IRRESPONSIBLE. Handelsblatt, May 3, p1, said in a Duesseldorf report that West Berlin officials called reports and speculation of massive violence by radical groups at the September IMF/IBRD annual meetings irresponsible. A spokesman for the city's Interior Ministry said there is no concrete evidence of such action. But federal justice and police officials said some disruptions and attacks must be expected during the meetings.

YUGOSLAVIA DELAYS ECONOMIC REFORMS FOR LACK OF FOREIGN LOANS. AP-DJ reported from Belgrade that Yugoslav Deputy Prime Minister Milos Milosavljevic told a Central Committee meeting that Yugoslavia failed to secure expected western credits, and will have to delay the scheduled May 15 end of a partial wage/price freeze. dpa reported that he said the completion of a standby agreement with the IMF must also be delayed, since the IMF wants to wait for the result of a Parliamentary confidence vote this weekend. Reuters reported Milosavljevic said the IMF has delayed ratification of a recently-completed accord on rescheduling Yugoslavia's $21B of foreign debt, pending parliamentary debate on the Government's performance. The Yugoslav Community Party held an emergency meeting yesterday on economic policy and Prime Minister Branko Mikulic dropped plans for a major government overhaul. He faces a move by prosperous Croatia and Slovenia to oust him for incompetence. WSJ, p18.

POLAND'S NEED FOR RADICAL REFORM. Ldn Independent, May 9, p23, said in a Warsaw commentary that the grim charade of economic reform in Poland has been played out against a background of rising debt. World-weary analysts of such "reform", the IMF and IBRD, have been duly observing. An IBRD mission is due again in Warsaw, but Poland is still far short of any kind of agreement with the IMF, even the "shadow" program the IMF would like to agree first. Latin America is slowly moving with its bankers towards a realistic devaluation of its outstanding debt, while Africa has simply gone so blatantly bankrupt that most western governments have been nearly brought to recognize the fact. But Poland is still slogging around the same bleak track of arguing about margins on its latest effort at rescheduling. Reuters reported from Warsaw that the Polish Parliament voted overwhelmingly to pass a special powers act, enabling the Government to freeze prices and wages, lay-off workers and fire managers until the end of the year. The act limits workers' protests against its implementation. The special powers are intended to help control inflation sparked by price rises introduced to balance supply and demand.

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AA
Wyn pl. draft a
suitable acknowledgement
& consider re attachment
to PSM/EST/TB/MCS/SecP. N.

ROBERT V. ROOSA
59 WALL STREET
NEW YORK, N.Y. 10005

May 17, 1988

Dear Nigel,

I hope you will have a minute to glance through this reprint. It comes from a festschrift just being published in honor of Johannes Witteveen. I wrote this shortly before I heard your really great address at the IMF in Washington last fall. I hope you will find in this enough synergy with the themes you expressed so well that you may consider supporting the notion that Interim Committee annointing of the G-5 (or even G-7) approach to coordinating underlying economic policy can be the answer to the monotonously repeated calls for a world monetary conference to promote exchange rate stability.

I do not have any visible early opportunity to come to London to visit with you about this. Perhaps there may be a brief momentary opportunity when we get to Berlin in September.

With high esteem and warm regards,

Sincerely,

Bob

The Rt. Hon. Nigel Lawson
Chancellor of the Exchequer
H. M. Treasury
Parliament Street
London SW1P 3AG

Mr Allan
12/2

FEARS OF INFLATION MODERATE U.S. TRADE EUPHORIA IN MARKETS. News agencies reported that the U.S. dollar was steady in cautious exchange markets after its sharp gains yesterday following the announcement of a drop in the U.S. trade deficit in March to $9.75B from $13.83B in February. Dealers said markets now feel the deficit drop indicated the U.S. economy is expanding too fast and that interest rates may have to rise to dampen inflation. Sterling was easier after yesterday's half point bank base rate cut to 7.5%, at $1.8580 (1.8625) and 3.168 marks (3.178). Exchange rates: German mark 1.7045 (1.7020), yen 125.55 (124.80), French franc 5.7695, Canadian dollar 80.79c, lira 1265, Swiss franc 1.4210, guilder 1.9090 and Belgian franc 35.60. Gold fell $2 to $452.75. The SDR was $1.37004 (1.37834).

BAKER CRITICIZES LARGE ASIAN SURPLUSES AT OECD MEETING. AP-DJ reported from Paris that U.S. Treasury Secretary James Baker criticized large external surpluses of Asian newly industrial countries for impeding the adjustment of global imbalances and adding to protectionist pressures. He told the OECD annual meeting that Korea and Taiwan need significant structural changes to improve the balance between foreign and domestic demand and that these changes would be in the long-term interest of the countries. He noted solid reasons for optimism on reducing external imbalances and promoting growth in a climate of low inflation. The agency reported earlier that Baker said the narrower $9.75B U.S. trade deficit in March shows trade results have started to improve in nominal, as well as volume, terms. The unexpectedly strong trade result should give a major boost to Baker and four other Cabinet-level officials at the OECD meeting. This is expected to focus on ways to reduce the U.S. trade deficit and curb the trade surpluses of Japan, Germany and newly-industrial countries of Asia.

U.S. TRADE BILL VETO COULD BE DELAYED TO NEXT WEEK. AP-DJ reported from Washington that White House spokesman Marlin Fitzwater said President Ronald Reagan's veto of the U.S. trade bill could slip to next week. Administration sources said Reagan does not want to send up the veto before the Senate ratifies the pending intermediate nuclear arms treaty. Fitzwater said yesterday's report of a sharp drop in the U.S. trade deficit (to $9.75B in March) shows this is the worst time for bad trade legislation. He said the trade bill would stymie job creation. The agency added that the favorable trade figures played into the hands of U.S. officials pushing for a trade bill veto.

JAPAN WELCOMES U.S. TRADE DEFICIT REDUCTION. Kyodo reported from Tokyo that Japanese Finance Ministry and Bank of Japan officials welcomed a narrower-than-expected $9.75B U.S. trade deficit in March. The U.S. trade picture is steadily improving, although the sharp drop in the monthly deficit may not mean the U.S. has completely ended its dependence on imports, the official said.

JAPANESE APRIL TRADE SURPLUS FELL LESS THAN EXPECTED. Ldn Fin Times, May 14, p3, said in a Tokyo report that Japan's April trade surplus of $6.35B, down from $6.55B in March, was well above private forecasts ranging as low as $4.9B. The April surplus was little changed from December's $6.36B. Economists were surprised by the continuing strong demand for Japanese exports, especially of capital equipment. The Economic Planning Agency warned recently the pace of decline in Japan's exports is slowing, although the Finance Ministry said the trade surplus is likely to shrink further in coming months.

THATCHER SAYS SHE, LAWSON IN AGREEMENT ON ECONOMIC MANAGEMENT. News agencies reported from London that British Prime Minister Margaret Thatcher told a Parliamentary questioner that she and Chancellor Nigel Lawson are in agreement on management of the economy. She added that yesterday's half point cut (to 7.5%) in British bank lending rates will not have an inflationary impact on the economy, since the rising pound has tightened monetary conditions. She said interest rates are a part of total economic policy, and that they were cut Tuesday because of the pound's strength. Ldn Fin Times, p1, said Thatcher bowed to political and market pressures to reduce uncertainty over exchange rate policy by publicly backing Lawson. WSJ, p27, said basic differences remain between Thatcher and Lawson, although both will try to paper over the controversy. It noted speculation over Thatcher's motives in talking forthrightly about such a sensitive topic as exchange rates, noting that her earlier warnings against bucking market trends sent the pound higher.

SUMITA SAYS JAPAN TO MAINTAIN CURRENT MONETARY POLICY. Kyodo reported from Tokyo that Bank of Japan Governor Satoshi Sumita told Prime Minister Noboru Takeshita that the Bank thinks continuation of its current monetary policy is appropriate for the moment, although prices and exchange rates need to be closely watched. He said there is no immediate need to worry about a revival of inflation, although price trends must be watched closely because of Japan's high money supply and tight labor market.

FRENCH OPINION POLL GIVES SOCIALISTS SLIM LEAD OVER CENTER/RIGHT. Reuters reported from Paris that a Paris Match opinion poll gave the governing Socialists 42% of the likely vote in June 5/12 parliamentary elections, compared with 40.5% for center-right opponents. The poll was conducted before President Francois Mitterrand called the snap parliamentary elections after failing to form a broad-based Government with a majority in Parliament. The opinion poll gave the ultra-right National Front 7% and the Communist Party 6.5% of the likely vote.

BEREGOVOY SAYS STRENGTHENING THE FRANC HIS FIRST CONCERN. Le Monde, May 15/16, p17, reported from Paris that newly-appointed French Economy Minister Pierre Beregovoy told newsmen that his priorities include cutting interest rates and inflation, and helping industrial investment. His first concern will be to strengthen the franc in the EEC monetary system, he said, adding that he has no major differences with his predecessor, Edouard Balladur, on the EEC.

9410718 .. Reuters reported 19.05.88
Beijing that Chinese leader Deng Xiaoping told Mozambican President Joaquim Chissano
that China must pursue its economic reforms despite the problem of inflation. China
made leftist mistakes for 20 years until the end of the Cultural Revolution in 1976,
but Chinese leaders are fairly satisfied with progress over the last decade, he said.
<u>BRAZILIAN GOVERNORS FAVOR IMF DEAL</u>. <u>Ldn Fin Times</u>, p6, reported from Brasilia that
Brazil's powerful state governors endorsed negotiation of a full standby with the IMF,
including long-opposed provisions for monitoring the economy. President Jose Sarney
sought the backing of governors as part of an attempt to force the dominant PMDB to
share responsibility for further tough measures. Businessmen reacted skeptically to a
new austerity plan announced yesterday, saying it lacked detail and that most of its
policy changes had been covered in previous announcements. One observer called it a
document designed solely to impress the IMF.
<u>BRAZIL, CREDITORS NEAR ACCORD; NEW IMF ROLE SEEN</u>. <u>Reuters</u> reported from London that
bankers said Brazil and its creditor banks are near agreement on a $62B debt package
based on a new and less public role for the IMF. New bank loans of $5.2B in the
package would not depend on disbursements by the IMF. Bankers said the IMF was
unwilling to link its loan disbursements to those of creditor banks, to avoid
pressures for a waiver if Brazil were out of compliance with its IMF program. A
"shadow program" is the key to satisfying both the IMF desire for economic reform and
Brazil's hopes of avoiding political upheaval, allowing creditor banks to lend to
Brazil even if the country did not meet all economic targets set by the IMF. <u>Ldn Fin</u>
<u>Times</u>, May 17, p4, reported from London that bankers said loss of planned IBRD loan
guarantees because of U.S. Treasury opposition will not make a Brazilian package
easier to sell to commercial banks.
<u>BRAZILIAN PRESS SEE SOME IMF SKEPTICISM OVER GOVERNMENT GOALS</u>. <u>AFP</u> in a Rio de Janeiro
report discussed a pending Brazilian Letter of Intent to the IMF, said Brazil's main
aim is to reduce the public sector deficit to 4% of GDP from 7%, and added that the
implied major cut in public spending apparently induced some skepticism in the IMF
mission currently in Brazil. <u>O Estado de Sao Paulo</u> said the IMF mission questioned
whether Brazil had not overestimated the real impact of some deficit-reduction
measures planned. <u>Reuters</u> reported from Brasilia that a presidential spokesman said
Sarney will refuse a court order to explain his attacks on a Senate inquiry into
corruption in government. Sarney accused the inquiry of moral terrorism against his
Government. A joint suit by the committee will ask the Supreme Court to call Sarney to
explain his attacks on the inquiry.

MOBUTU SAYS CREDITOR GOVERNMENTS USE IMF TO KEEP LDCs DEPENDENT. Reuters reported from Kinshasa that Zairean President Mobutu Sese Seko said in a three-hour speech to the ruling party that creditor governments are using the IMF to keep poor countries in a state of dependency. Unidentified governments are making money-grabbing demands totally irrelevant to their excellent political and diplomatic relations with Zaire, he said. Lending governments are deceitful in demanding that international financial bodies be involved in debt repayments, as a way of keeping debtors in dependency. The agency commented that Zaire, once considered an IMF model, defied creditors in 1986 by limiting foreign debt payments to 10% of export earnings. But painstaking talks with the IMF and donors led to a landmark May 1987 agreement, allowing Zaire to delay debt repayments. Mobutu also accused Zairean officials of abusing their positions for personal enrichment, and dragging their feet to block party policies.

SOMALIA TO RENEW TALKS WITH IMF ON LOAN AGREEMENT. Reuters reported from Mogadishu that Somalian Planning Minister Ahmed Habib Ahmed said Somalia will hold fresh talks with the IMF later this month with the aim of reaching a new loan agreement. Official sources said an IMF mission is due Saturday to follow up preliminary discussions held in March. Somalia suspended its last IMF standby in September, imposing wide-ranging price controls and replacing an IMF-sponsored foreign exchange auction with a fixed exchange rate. The IMF last week declared the country ineligible for further lending because of $37M in loan arrears. Diplomatic sources said western donors would help Somalia pay the arrears, if it agrees on a new IMF economic restructuring program.

IMF SAYS HUNGARY WILL CUT CONSUMER SUBSIDIES, REORGANIZE BANKING SYSTEM. AP-DJ reported from Washington that the IMF said Hungary has embarked on the first phase of a three-year economic adjustment program, including reduced financial support for loss-generating enterprises, cutting consumer subsidies, tax reform, continued reorganization of the banking system and major price liberalization moves. The IMF approved a $366M loan to Hungary to support economic adjustment over the next 12 months.

GERMAN POLICE CHIEF SAYS LEFT EXTREMISTS WANT TO DISRUPT IMF MEETING. dpa reported from Munich that German Federal Criminal Police Office head Heinrich Boge told a security meeting that left extremists want to stage spectacular disruptive actions during the IMF annual meeting in West Berlin this September. He said these actions will be aimed at hindering the meetings, at capturing press headlines, and at damaging Germany internationally.

LAWSON SAYS FURTHER DOLLAR DEPRECIATION NOT NEEDED. AP-DJ reported from Paris that British Chancellor Nigel Lawson told the OECD annual meeting that further U.S. dollar depreciation is not needed to reduce the current BOP deficit. He urged instead a slowing of U.S. domestic demand which is currently rising uncomfortably fast. The main economic danger seems to be some resurgence of inflation, although not on the scale of the 1970s, he added.

psl/74A

Alex Do you want to BF this for the Annual Meetings?

Julie 26/5

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

24 May 1988

Robert V Roosa Esq
59 Wall Street
New York
N.Y. 10005
U.S.A.

Dear Bob

Many thanks for your letter of 17 May and for the copy of the reprint of your article, which I read with interest. I very much agree with you that we need to consider how we can build further on what we have already achieved in the G5 and G7. I hope we have an opportunity to have a word about all this in Berlin in September.

Yours
Nigel

NIGEL LAWSON

psl/82A

UNCLASSIFIED

pay

FROM: A C S ALLAN
DATE: 26 May 1988

SIR T BURNS

cc Sir P Middleton
Sir G Littler
Mr Scholar
Mr Peretz

INTERNATIONAL MONETARY REFORM

... You may be interested to see the attached piece which Robert Roosa sent the Chancellor.

ACSA

A C S ALLAN

Restoring stability within a system of floating exchange rates

ROBERT V. ROOSA

Amid the welter of complaints about exchange rate oscillations over recent years, someone is always emerging with an air of profound discovery to declare that the world is sliding down a treacherous monetary slope and that financial disruption lies immediately ahead unless and until a great new Bretton Woods style of worldwide conference can be promptly assembled to produce a basic reform of the international monetary system. In my own contrarian and optimistic way, however, I insist that every relevant element of potential revolutionary reform is already in front of us. Our need, that is, the need faced by all of us financial aficionados in every country, is simply to identify and recognize the potential of the profound changes already underway and to begin shaping an integration among these elements that can produce results which fully qualify as a new international monetary system. I do not suggest that enough is yet in place to permit a sudden christening of the new system. Instead the emerging elements now beginning to appear must have time to evolve to the point where their role and credibility have become so clearly evident that they can be definitely woven into a widely supported, formally identified structure.

Before giving further substance to my provocative assertion, I think it useful to be reminded of those characteristics of the old Bretton Woods monetary system that made possible the remarkable worldwide economic growth that occurred during the halcyon quarter century from 1945 to 1970. I am indulging in this introductory retrospective because it should help to set in focus, by comparative analogy, the formulation that I will later suggest concerning the prospects for the newly emerging system.

To be sure, there were shortcomings of the old system, too, that produced recurrent currency crises in one country or another, with wide reaching repercussions, and there were also frequent short recessions that ricocheted across much of the world. Moreover, countries running balance of payments surpluses could then often shift most of the burden for correcting sustained imbalances onto the deficit countries. Yet despite those aberrations, many of

Wietze Eizenga et al. (eds.), The Quest for National and Global Economic Stability

us even even now look back nostalgically to the years when trade flourished because, from the viewpoint of any single country, most of the world could be viewed as one market. Decisions on selling or buying goods and services across one's frontier could be rather confidently based on a translation of prices and costs from one currency area to another at terms that reflected fairly well the comparative advantages of any transactions that were actually undertaken.

Those conditions of supportive stability were achieved because all the participants in the system accepted certain behavioral norms. Countries had to gear their own exchange rates to an acknowledged centerpiece of constant value in the middle of the system, and the United States maintained that value by committing to the IMF that it would always buy and sell ounces of gold at the $35 price. Holding that price came to be identified as the defense of the dollar, and the United States had to adapt its domestic and external economic policies to support that position, just as other countries with declared par values had to adjust their own performance in order to keep their own exchange rates and their reserves of foreign exchange under control.

In effect, during those postwar years, exchange rates measured in terms of the dollar served a dual function. One, of course, was to serve as the mechanism, the common denominator, through which prices could be converted from their denomination in currency of one economy to that of another. But second, the even more impelling other function of incipient movements in a country's exchange rate (and the related changes in its reserves) was to serve as a signal to the country that it must make adaptive changes within its own economy in order to remain viable in terms of its external trade and capital flows. In this second function, exchange rate changes pointed toward what was then widely recognized as the pattern of domestic performance required by the 'adjustment process'. But in 1971 the United States reached the end of its ability to hold the fixed gold price as a firm benchmark for currencies and the world was soon released into the unorganized arena of floating exchange rates for which many economists had long been hoping.

When exchange rates then came presumably to be determined by market forces, the expectation was that they would soon settle down into a reasonably orderly pattern reflecting the relation of each country's prices to those of all other countries in the world. Of course there would be some fluctuations, but as Milton Friedman said in a debate that he and I had in 1976, 'If countries follow stable internal policies, exchange rates, while free to move, will be highly stable. Stability is not rigidity'. [*The Balance of Payments: Free versus Fixed Exchange Rates* (Washington, 1967), p. 97.]

What went wrong? The same internationalization which in the case of trade had promoted an unprecedented rate of economic growth in the world had also spread through the world's capital markets. Offshore markets in dollars, and eventually also in other leading currencies, created magnitudes nearly comparable in size to the domestic supplies of each currency, most notably the US dollar. As a consequence, in the new floating rate environment, international money flows from one country to another, or merely on the books of offshore banks, overwhelmed price relationships as determinants of exchange rates. Perversely, another of the expectations which Professor Friedman expressed in the same debate was disappointed. He had said [*Ibid.*, p. 105.] 'Actual and potential exchange rate fluctuations inhibit capital movements, so that with flexible rates you are less likely to have volatile capital movements than with fixed rates.' The actual record of wide swinging capital flows from the mid 1970s onward is now, of course, too well known to require prolonging this prologue to my main theme.

By a fortunate turn of the wheel of history, the pattern of developments that has emerged since the Plaza Accord of September 1985 now points toward a reviving recognition of the same concerns that contributed so impressively toward creating the conditions for freely flowing trade, and for promoting a productive international division of labor, during the years from 1945 to 1970. Initially the appraisals underlying the Plaza Accord identified exchange rate distortions that had been influencing patterns of trade since 1982 in ways that led to balance of payments surpluses in some countries and deficits in others which were creating unsustainable imbalances in holdings of foreign exchange reserves. As these distortions were clearly caused by an overvaluation of the dollar — an overvaluation which had become so extreme that the self-generated actions of the currency markets had already begun to turn rates around in February 1985 — concerned consultations had to begin among the leading countries. By September the five countries whose currencies had been chosen at the beginning of 1981 by the 150 members of the IMF to form the SDR, and thus to represent the central core of currency values for the world monetary system — i.e., France, Germany, Japan, the US, and the UK — had concluded and formally recognized that their economies were performing in such ways as to create overvaluation-undervaluation dichotomies which had disruptive consequences for their own trade and for that of much of the world.

The first moves of the five countries in September 1985 were simply designed to accentuate the internal processes in the currency markets that had already begun in February to reduce the dollar's overvaluation. By May of 1986, when the Heads of State of the five countries were joined with those of Canada and Italy in the Tokyo Summit, the dollar's overvaluation was shrinking toward undervaluation. The communiqué then implicitly recognized the second function of exchange rates — that of serving as the lens through which needed actions on the part of all seven countries could be indentified. The Heads of State instructed their financial officials to refocus their concern over exchange rates. Much as exchange rate stability was to be desired, that could not be achieved solely by intervention in the exchange markets, nor could any mere manipulation of exchange rates assure that all suitable corrections of deficits and surpluses would occur. The Finance Ministers and central bank governors were instead directed to identify the indicators underlying the basic performance of each country, and to react to those tendencies among them that were found to be causing any of these countries to move away from a desired tendency toward a harmonious equilibrium.

The financial officials have thus been authorized to establish a framework for confidential consultation in which currency exchange rates, and the primary forces bearing upon the performance of the countries responsible for each of the currencies, will be kept under continuing review. In effect, the second function of exchange rates (carried forward from the experience of the postwar years) is now expected to direct attention toward those distortions that may arise in any given country to cause the deployment of its own productive facilities, or the allocation of its human and material resources, to get so far out of balance that it can no longer earn, with its own exports of goods or sales of services, enough to cover the cost of the imports on which its population has come to depend, or to service its desired inflows or outflows of capital. And of this condition, the United States has become the prime example, as its twin huge deficits (domestic and foreign), low savings rate, and strong domestic demand are paradoxically accompanied by shrinkage in its traditional export sectors, manufacturing and agriculture.

Correspondingly, the policies and performance of countries experiencing large and continuing surpluses must come under a scrutiny of mutual, critical examination, as the din of comment directed to Germany and Japan bears ample witness. Both have enjoyed remarkable export-led surpluses, while their exchange rates were comparatively low. And their various reactions subsequently have begun to be reflected in a rise of their exchange rates, matching a decline of the dollar.

The newly established process of mutual appraisal within a negotiating framework should crystalize recognition of those primary forces which each country must address, particularly if the five countries whose currencies determine the SDR are to move toward a harmonized convergence of economic performance. Moreover, the continuity of contact and appraisal can preclude any fixation on rigid or unmovable ranges for exchange rates that could impair the 'flex' which must still remain the floating exchange rate system in order to permit the market-induced shifts in some exchange rates that will be appropriate over time to reflect any basic changes which creative innovation may bring about in the comparative advantage of the productive sectors of any of the five economies.

What the Heads of State have now set in motion is a process which can re-create in the functioning of the international monetary system a replacement for the role that the Bretton Woods System once provided. The five currencies which now form the SDR embody in their own individual behavior the greater part of all of the major surges of influence that affect the currency environment of the world as a whole. By collaborating in the common development of programs of economic convergence or harmonization, they can be capable of providing a degree of stability at the center of the monetary system that should help to smooth the trading intercommunication among all nations.

The new G-5 and G-7 processes epitomize those elements of potential revolutionary developments that I foreshadowed in my opening comment. For I do believe that all the essential ingredients have surfaced. The need now is for a more clear-eyed determination by various official bodies to put all of the pieces in place, and to implement their use, in order to create a proxy for the best of the Bretton Woods System within the IMF world of today.

This is not so simple as merely to call for the managing of exchange rates, in order to imitate the comparative stability of the old par value system. There are now, though, three key elements within the range of possibility. One is that the five-country SDR can become a relatively stable central core for the system, if the five participants follow the injunctions of their Heads of State, as more explicitly formulated at the Tokyo Summit and since repeated at the June 1987 Summit in Venice. In turn, once a relatively stable SDR is in being, all member countries, by notifying the IMF of their currency values in terms of SDRs, would have reference to a common basing point that could serve as a meaningful successor to the old gold-dollar standard. Indeed, a logical sequence, which began with the original valuation of the SDR in 1969 in terms of gold and dollars, and then continued through successive multi-currency valuations, has now culminated in a five-currency combination which is moving toward a convergence among its components that can provide a composite stability. There are not yet, of course, fully agreed procedures for the measurement and use of the 'indicators' mentioned in the Summit communiques, but a challenge has been thrown out to the Ministers, Governors, and their deputies to develop workable procedures. Their work can in time be reinforced by the various academic studies of a 'convergence process' that are already underway. As this is being written, a very auspicious study on international macroeconomic policy coordination is being initiated under the direction of Professor Peter Kenen at Chatham House in collaboration with the Group of Thirty.

A second element is that individual countries, in seeking a relatively reliable exchange rate relation with the rest of the world, will be able to fix a notional peg on the SDR. Eventually, if all goes well, the SDR may attain the same degree of importance that was formerly attached to the gold-dollar base, and exchange rate movements can occur within national bands around the parities pegged to that as a base. The results of divergences between actual rate movements and the notional pegs should appear as signals for governments to take the kinds of corrective actions identified as accepting the 'discipline of the exchanges'. Without the rigidities or formalities of the old Bretton Woods par value commitment for all of the Article VIII countries, each country can establish a criterion from which deviations in the market for its currency can lead it to gauge or detect aspects of its own conduct that need correction or adaptation if the freely movable rate is to settle back into close conformity with the notional pegs or guidelines. There may well also be evidence appearing that the notional range should itself be shifted. In effect, the old 'adjustment process' can, in a context of voluntary actions, be restored to meaningful significance in broad conformity with the new Article IV of the IMF agreement.

A third element, as more and more countries follow the path just outlined, will be to assure relatively steady cross rates within a fairly moderate range. That is, the ready transposition of prices from one country to another will open wider again that zone of interchangeability that fostered the productive international division of labor in the more prosperous years of the great quarter century (1945–70).

There is still, even if all those elements become well established, the troublesome question of speculative, bandwagon swings in capital flows, with cumulative effects in pushing market rates of exchange away from any notional zone around the peg to the SDR that a country might wish to use. And it is not satisfactory, indeed it becomes a solipsistic circularity, to assert that so long as countries behave as the three-element outline proposes there would be no cause for speculative forays. But even when there is a disruptive exchange rate impact from those capital flows which are a phenomenon of the world's internationalized financial markets, there may also be a market driven answer. For if exogenous forces were, for example, to cause a rapidly rising exchange rate which portends loss of markets and a balance of payments deficit for the affected currency country, the authorities of the country would still have access to the world market in order to conduct retaliatory action by selling added supplies of its own currency, which it could if necessary sterilize for use as additional liquidity in the home economy. It should be able to nudge the exchange rate back to a market-determined relationship freed of the overlays of speculative capital flows.

As a contrasting example, in the case of a currency dropping in value because of external adverse speculation, there are three already tested methods of countering bandwagon runs through market action — quite in addition to any domestic action to put a country's domestic house in order that might be appropriate in the circumstances. One would be to borrow other currencies through central banks or inter-government swaps, and to use those to purchase the affected currency in the market. A second would be to issue bonds denominated in strong currencies (as agreed by the financial officials of those countries) and then use the proceeds to buy the home currency in the market. Still a third, which would depend on foresight, would be to have available a substantial holding of other strong currencies in the affected country's reserves, and to use some of these currencies in the market to purchase the currency suffering a bear squeeze. A corollary of this third approach is the suggestion that I and others have often made that any country, when its currency is strong, should use the opportunity to build its reserves of other leading currencies.

To be sure, neither a general recognition nor a somewhat formalized rendering of the approaches implied by all three elements — stabilizing the SDR, using deviations from notional pegs set in SDRs to signal policy adjustments, and aiming for relatively steady cross rates — are yet on the horizon. But even so, the institutional framework for the equivalent of an international monetary conference to appraise and perhaps endorse those concepts is also already in being. The Interim Committee of the IMF, at its annual or more frequent meetings since its founding in 1974, is so constituted that its 20-odd members do in fact represent all 150 members of the IMF. This same body which proposed the five-country valuation for the SDR in 1980 is surely well placed to give support and authoritative credibility to any of the three elements now within reach under the floating-rate regime.

Once developments have progressed far enough for crystalization in recommendations by the Interim Committee, there could be a useful purpose served by converting a subsequent meeting of the IMF into the long sought international monetary conference. The review and debate at such a conference by financial officials from the entire IMF membership should provide the understanding and acceptance necessary on a world scale if a new system of orderliness is to be established among the congeries of currencies that still remain floating. The desire for stability may be strong enough to bring worldwide recognition that the needed elements for reform are already within reach.

Restoring stability within a system of floating exchange rates

ROBERT V. ROOSA

Amid the welter of complaints about exchange rate oscillations over recent years, someone is always emerging with an air of profound discovery to declare that the world is sliding down a treacherous monetary slope and that financial disruption lies immediately ahead unless and until a great new Bretton Woods style of worldwide conference can be promptly assembled to produce a basic reform of the international monetary system. In my own contrarian and optimistic way, however, I insist that every relevant element of potential revolutionary reform is already in front of us. Our need, that is, the need faced by all of us financial aficionados in every country, is simply to identify and recognize the potential of the profound changes already underway and to begin shaping an integration among these elements that can produce results which fully qualify as a new international monetary system. I do not suggest that enough is yet in place to permit a sudden christening of the new system. Instead the emerging elements now beginning to appear must have time to evolve to the point where their role and credibility have become so clearly evident that they can be definitely woven into a widely supported, formally identified structure.

Before giving further substance to my provocative assertion, I think it useful to be reminded of those characteristics of the old Bretton Woods monetary system that made possible the remarkable worldwide economic growth that occurred during the halcyon quarter century from 1945 to 1970. I am indulging in this introductory retrospective because it should help to set in focus, by comparative analogy, the formulation that I will later suggest concerning the prospects for the newly emerging system.

To be sure, there were shortcomings of the old system, too, that produced recurrent currency crises in one country or another, with wide reaching repercussions, and there were also frequent short recessions that ricocheted across much of the world. Moreover, countries running balance of payments surpluses could then often shift most of the burden for correcting sustained imbalances onto the deficit countries. Yet despite those aberrations, many of

Wietze Eizenga et al. (eds.), The Quest for National and Global Economic Stability

us even even now look back nostalgically to the years when trade flourished because, from the viewpoint of any single country, most of the world could be viewed as one market. Decisions on selling or buying goods and services across one's frontier could be rather confidently based on a translation of prices and costs from one currency area to another at terms that reflected fairly well the comparative advantages of any transactions that were actually undertaken.

Those conditions of supportive stability were achieved because all the participants in the system accepted certain behavioral norms. Countries had to gear their own exchange rates to an acknowledged centerpiece of constant value in the middle of the system, and the United States maintained that value by committing to the IMF that it would always buy and sell ounces of gold at the $35 price. Holding that price came to be identified as the defense of the dollar, and the United States had to adapt its domestic and external economic policies to support that position, just as other countries with declared par values had to adjust their own performance in order to keep their own exchange rates and their reserves of foreign exchange under control.

In effect, during those postwar years, exchange rates measured in terms of the dollar served a dual function. One, of course, was to serve as the mechanism, the common denominator, through which prices could be converted from their denomination in currency of one economy to that of another. But second, the even more impelling other function of incipient movements in a country's exchange rate (and the related changes in its reserves) was to serve as a signal to the country that it must make adaptive changes within its own economy in order to remain viable in terms of its external trade and capital flows. In this second function, exchange rate changes pointed toward what was then widely recognized as the pattern of domestic performance required by the 'adjustment process'. But in 1971 the United States reached the end of its ability to hold the fixed gold price as a firm benchmark for currencies and the world was soon released into the unorganized arena of floating exchange rates for which many economists had long been hoping.

When exchange rates then came presumably to be determined by market forces, the expectation was that they would soon settle down into a reasonably orderly pattern reflecting the relation of each country's prices to those of all other countries in the world. Of course there would be some fluctuations, but as Milton Friedman said in a debate that he and I had in 1976, 'If countries follow stable internal policies, exchange rates, while free to move, will be highly stable. Stability is not rigidity'. [*The Balance of Payments: Free versus Fixed Exchange Rates* (Washington, 1967), p. 97.]

What went wrong? The same internationalization which in the case of trade had promoted an unprecedented rate of economic growth in the world had also spread through the world's capital markets. Offshore markets in dollars, and eventually also in other leading currencies, created magnitudes nearly comparable in size to the domestic supplies of each currency, most notably the US dollar. As a consequence, in the new floating rate environment, international money flows from one country to another, or merely on the books of offshore banks, overwhelmed price relationships as determinants of exchange rates. Perversely, another of the expectations which Professor Friedman expressed in the same debate was disappointed. He had said [*Ibid.*, p. 105.] 'Actual and potential exchange rate fluctuations inhibit capital movements, so that with flexible rates you are less likely to have volatile capital movements than with fixed rates.' The actual record of wide swinging capital flows from the mid 1970s onward is now, of course, too well known to require prolonging this prologue to my main theme.

By a fortunate turn of the wheel of history, the pattern of developments that has emerged since the Plaza Accord of September 1985 now points toward a reviving recognition of the same concerns that contributed so impressively toward creating the conditions for freely flowing trade, and for promoting a productive international division of labor, during the years from 1945 to 1970. Initially the appraisals underlying the Plaza Accord identified exchange rate distortions that had been influencing patterns of trade since 1982 in ways that led to balance of payments surpluses in some countries and deficits in others which were creating unsustainable imbalances in holdings of foreign exchange reserves. As these distortions were clearly caused by an overvaluation of the dollar — an overvaluation which had become so extreme that the self-generated actions of the currency markets had already begun to turn rates around in February 1985 — concerned consultations had to begin among the leading countries. By September the five countries whose currencies had been chosen at the beginning of 1981 by the 150 members of the IMF to form the SDR, and thus to represent the central core of currency values for the world monetary system — i.e., France, Germany, Japan, the US, and the UK — had concluded and formally recognized that their economies were performing in such ways as to create overvaluation-undervaluation dichotomies which had disruptive consequences for their own trade and for that of much of the world.

The first moves of the five countries in September 1985 were simply designed to accentuate the internal processes in the currency markets that had already begun in February to reduce the dollar's overvaluation. By May of 1986, when the Heads of State of the five countries were joined with those of Canada and Italy in the Tokyo Summit, the dollar's overvaluation was shrinking toward undervaluation. The communiqué then implicitly recognized the second function of exchange rates — that of serving as the lens through which needed actions on the part of all seven countries could be indentified. The Heads of State instructed their financial officials to refocus their concern over exchange rates. Much as exchange rate stability was to be desired, that could not be achieved solely by intervention in the exchange markets, nor could any mere manipulation of exchange rates assure that all suitable corrections of deficits and surpluses would occur. The Finance Ministers and central bank governors were instead directed to identify the indicators underlying the basic performance of each country, and to react to those tendencies among them that were found to be causing any of these countries to move away from a desired tendency toward a harmonious equilibrium.

The financial officials have thus been authorized to establish a framework for confidential consultation in which currency exchange rates, and the primary forces bearing upon the performance of the countries responsible for each of the currencies, will be kept under continuing review. In effect, the second function of exchange rates (carried forward from the experience of the postwar years) is now expected to direct attention toward those distortions that may arise in any given country to cause the deployment of its own productive facilities, or the allocation of its human and material resources, to get so far out of balance that it can no longer earn, with its own exports of goods or sales of services, enough to cover the cost of the imports on which its population has come to depend, or to service its desired inflows or outflows of capital. And of this condition, the United States has become the prime example, as its twin huge deficits (domestic and foreign), low savings rate, and strong domestic demand are paradoxically accompanied by shrinkage in its traditional export sectors, manufacturing and agriculture.

Correspondingly, the policies and performance of countries experiencing large and continuing surpluses must come under a scrutiny of mutual, critical examination, as the din of comment directed to Germany and Japan bears ample witness. Both have enjoyed remarkable export-led surpluses, while their exchange rates were comparatively low. And their various reactions subsequently have begun to be reflected in a rise of their exchange rates, matching a decline of the dollar.

The newly established process of mutual appraisal within a negotiating framework should crystalize recognition of those primary forces which each country must address, particularly if the five countries whose currencies determine the SDR are to move toward a harmonized convergence of economic performance. Moreover, the continuity of contact and appraisal can preclude any fixation on rigid or unmovable ranges for exchange rates that could impair the 'flex' which must still remain the floating exchange rate system in order to permit the market-induced shifts in some exchange rates that will be appropriate over time to reflect any basic changes which creative innovation may bring about in the comparative advantage of the productive sectors of any of the five economies.

What the Heads of State have now set in motion is a process which can re-create in the functioning of the international monetary system a replacement for the role that the Bretton Woods System once provided. The five currencies which now form the SDR embody in their own individual behavior the greater part of all of the major surges of influence that affect the currency environment of the world as a whole. By collaborating in the common development of programs of economic convergence or harmonization, they can be capable of providing a degree of stability at the center of the monetary system that should help to smooth the trading intercommunication among all nations.

The new G-5 and G-7 processes epitomize those elements of potential revolutionary developments that I foreshadowed in my opening comment. For I do believe that all the essential ingredients have surfaced. The need now is for a more clear-eyed determination by various official bodies to put all of the pieces in place, and to implement their use, in order to create a proxy for the best of the Bretton Woods System within the IMF world of today.

This is not so simple as merely to call for the managing of exchange rates, in order to imitate the comparative stability of the old par value system. There are now, though, three key elements within the range of possibility. One is that the five-country SDR can become a relatively stable central core for the system, if the five participants follow the injunctions of their Heads of State, as more explicitly formulated at the Tokyo Summit and since repeated at the June 1987 Summit in Venice. In turn, once a relatively stable SDR is in being, all member countries, by notifying the IMF of their currency values in terms of SDRs, would have reference to a common basing point that could serve as a meaningful successor to the old gold-dollar standard. Indeed, a logical sequence, which began with the original valuation of the SDR in 1969 in terms of gold and dollars, and then continued through successive multi-currency valuations, has now culminated in a five-currency combination which is moving toward a convergence among its components that can provide a composite stability. There are not yet, of course, fully agreed procedures for the measurement and use of the 'indicators' mentioned in the Summit communiques, but a challenge has been thrown out to the Ministers, Governors, and their deputies to develop workable procedures. Their work can in time be reinforced by the various academic studies of a 'convergence process' that are already underway. As this is being written, a very auspicious study on international macroeconomic policy coordination is being initiated under the direction of Professor Peter Kenen at Chatham House in collaboration with the Group of Thirty.

A second element is that individual countries, in seeking a relatively reliable exchange rate relation with the rest of the world, will be able to fix a notional peg on the SDR. Eventually, if all goes well, the SDR may attain the same degree of importance that was formerly attached to the gold-dollar base, and exchange rate movements can occur within national bands around the parities pegged to that as a base. The results of divergences between actual rate movements and the notional pegs should appear as signals for governments to take the kinds of corrective actions identified as accepting the 'discipline of the exchanges'. Without the rigidities or formalities of the old Bretton Woods par value commitment for all of the Article VIII countries, each country can establish a criterion from which deviations in the market for its currency can lead it to gauge or detect aspects of its own conduct that need correction or adaptation if the freely movable rate is to settle back into close conformity with the notional pegs or guidelines. There may well also be evidence appearing that the notional range should itself be shifted. In effect, the old 'adjustment process' can, in a context of voluntary actions, be restored to meaningful significance in broad conformity with the new Article IV of the IMF agreement.

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There is still, even if all those elements become well established, the troublesome question of speculative, bandwagon swings in capital flows, with cumulative effects in pushing market rates of exchange away from any notional zone around the peg to the SDR that a country might wish to use. And it is not satisfactory, indeed it becomes a solipsistic circularity, to assert that so long as countries behave as the three-element outline proposes there would be no cause for speculative forays. But even when there is a disruptive exchange rate impact from those capital flows which are a phenomenon of the world's internationalized financial markets, there may also be a market driven answer. For if exogenous forces were, for example, to cause a rapidly rising exchange rate which portends loss of markets and a balance of payments deficit for the affected currency country, the authorities of the country would still have access to the world market in order to conduct retaliatory action by selling added supplies of its own currency, which it could if necessary sterilize for use as additional liquidity in the home economy. It should be able to nudge the exchange rate back to a market-determined relationship freed of the overlays of speculative capital flows.

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Once developments have progressed far enough for crystalization in recommendations by the Interim Committee, there could be a useful purpose served by converting a subsequent meeting of the IMF into the long sought international monetary conference. The review and debate at such a conference by financial officials from the entire IMF membership should provide the understanding and acceptance necessary on a world scale if a new system of orderliness is to be established among the congeries of currencies that still remain floating. The desire for stability may be strong enough to bring worldwide recognition that the needed elements for reform are already within reach.

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pp

FROM: A C S ALLAN
DATE: 26 May 1988

MR PERETZ

cc Sir T Burns
Miss O'Mara

GLESKE ON INTERNATIONAL MONETARY REFORM

Sir T Burns passed on to the Chancellor a copy of Gleske's piece in the BIS Review.

2. The Chancellor noted that his remarks on page 4 give some useful ammunition against the Germans:

> "the deutschmark ... has become ... an anchor of stability for the EMS as well as its leading currency for intervention, investment and reserve purposes. ... a national currency does not assume such a function at the volition of the country of issue of the currency in question but does so as a result of the independent decisions taken by the other members of the monetary system."

(The Chancellor's emphasis.)

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A C S ALLAN

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FRAME GENERAL

WALL'S LETTER OF 12 MAY TO THORPE : HANOVER EUROPEAN COUNCIL

SUMMARY
1. STAVENHAGEN ALIGNS HIMSELF WITH BUNDESBANK/FINANCE MINISTRY THINKING ON HOW MONETARY POLICY SHOULD BE HANDLED AT HANOVER SUMMIT. THIS IS KOHL'S LIKELY TENDANCY, BUT FRAU ADAM-SCHWAETZER CONTINUES TO SUPPORT GENSCHER LINE. GERMAN RELUCTANCE TO SEEK DECISIONS ON TAX HARMONISATION AND BROADCASTING DIRECTIVE. UNEMPLOYMENT POLICY AND HARMONISATION OF STATISTICS A LIKELY TOPIC: ALSO THE SOCIAL DIMENSION POST 1992.

DETAIL
2. I CALLED ON STAVENHAGEN (MINISTER OF STATE, FEDERAL CHANCELLERY) ON 30 MAY TO HAND OVER THE PRIME MINISTER'S REPLY TO THE KOHL MESSAGE ON A SINGLE MARKET PACKAGE. HE REITERATED THAT THE PRECIDENCY INTENDED TO AVOID DETAILED NEGOTIATION OR CROSS-SUBJECT BARGAINING BY NOTING THE SINGLE MARKET PACKAGE AT HANOVER THE DETAILS SHOULD HAVE BEEN SETTLED BY THE SPECIALIST COUNCILS AND CROSS-SUBJECT BARGAINING WAS IMPOSSIBLE WITHOUT GETTING SUCKED INTO DETAIL.

3. HIS MOST SIGNIFICANT REMARKS WERE ON MONETARY POLICY. THE COMMISSION WERE LIKELY TO WANT TO SEE IT RAISED, BUT THE PRESIDENCY SAW THIS AS A DISCUSSION NOT SO MUCH ON WHETHER THERE SHOU LD BE A EUROPEAN CENTRAL BANK AND IF SO HOW, AS ON THE ''MONETARY DIMENSION'' IN GENERAL. THE GERMANS WERE CONSIDERING WHETHER A GROUP SUCH AS CENTRAL BANK GOVERNORS SHOULD BE ASKED FOR AN OPINION ON HOW TO DEVELOP THIS DIMENSION FURTHER. THE SINGLE MARKET REQUIRED CAPITAL LIBERALISATION BUT WE MUST ALSO LOOK BEYOND THAT TO MONETARY POLICY IN GENERAL. THOSE WHO SUPPORTED THE CENTRAL BANK AND COMMON CURRENCY IDEA HAD TO EXPLAIN WHAT THEY REALLY WANTED AND HOW THEY INTENDED TO GET THERE. STAVENHAGEN'S PERSONAL VIEW WAS THAT WE WOULD END UP WITH AN INCREASINGLY CLOSE NETWORK OF NATIONAL BANKS AND HE

CONFIRMED THAT IN SAYING THIS HE WAS DELIBERATELY ALIGNING HIMSELF WITH THE VIEWS OF THE BUNDESBANK. I ASKED HIM IF THERE WAS LIKELY TO BE A FRANCO/GERMAN INITIATIVE CALLING FOR A DECLARATION ON MONETARY COOPERATION, PREARRANGED FOR EXAMPLE AT THE IMPENDING KOHL/MITTERRAND MEETING AT EVIAN-LES-BAINS. HE ASSURED ME IN MEASURED TONES THAT THERE WAS NO QUESTION OF THIS, ALTHOUGH THE FRENCH AND GERMANS AGREED ON THE NEED TO LOOK INTO WAYS OF MAKING PROGRESS ON MONETARY COORDINATION.

4. STAVENHAGEN'S LINE SUGGESTS STRONGLY THAT KOHL WILL PROPOSE AT HANOVER THE COMMISSIONING OF A STUDY ON THE WHETHER AND HOW OF FURTHER MONETARY COOPERATION IN GENERAL, AND THAT GENSCHER'S IDEA OF GETTING WISE MEN TO DO IT HAS LOST GROUND. A TALK I HAD WITH THE PRESIDENT OF THE BUNDESBANK ON 31 MAY (SEPARATE TELEGRAM) POINTS THE SAME WAY. BUT THE GENSCHER CAMP HAVE NOT GIVEN UP. FRAU ADAM-SCHWAETZER, WITH WHOM I TALKED ON 30 MAY, ADMITTED THAT NO FINAL GERMAN DECISION HAD BEEN TAKEN ON THE RIGHT PROCEDURAL DEVICE THAT HANOVER SHOULD CHOOSE TO TAKE MONETARY COOPERATION FORWARD. IT SHOULD NOT BE ECOFIN. THE PRESIDENCY WAS WORKING ON A DRAFT MANDATE FOR WHATEVER FORUM WAS CHOSEN REQIRING FURTHER RECOMMENDATIONS WITHIN THE ONE YEAR. SHE THEN REFERRED TO AN IDEA ALLEGEDLY PUT FORWARD BY THE PREVIOUS FRENCH GOVERNMENT THAT FUTURE EUROPEAN MONETARY COOPERATION SHOULD BE CONSIDERED AND LED BY THE FULL MEMBERS OF THE EMS ONLY. (SHE ASSERTED, WRONGLY I THINK THAT THIS WAS PART OF BALLADUR'S PROPOSAL. SHE WAS AT PAINS TO CLAIM THAT THE IDEA WAS A FRENCH AND NOT A GERMAN ONE, BUT CLEARLY WANTED TO USE IT TO SHIVER MY TIMBERS.

5. OTHER POINTS RAISED BY STAVENHAGEN INCLUDED A REJECTION OF BOTH TAX HARMONISATION AND THE BROADCASTING DIRECTIVE AS SUBJECTS FOR DECISION ON HANOVER. ON THE FIRST, THE DIFFICULTIES HAD BEEN MADE PLAIN AT TRAVEMUENDE. THERE WAS STILL MUCH WORK TO BE DONE. ON THE LATTER, THE GERMANS HAD NO OBJECTIONS TO A FRAMEWORK FOR EUROPEAN BROADCASTING, BUT THEY COULD NOT ACCEPT FURTHER BARRIERS WITHIN THE GERMAN-SPEAKING AREA. WHILE THE COUNCIL OF EUROPE PROPOSAL COULD INCLUDE SWITZERLAND AND AUSTRIA, AND SOME IN BRUSSELS BELIEVED AN EC DIRECTIVE COULD BE MADE TO HARMONISE WITH THAT, OTHERS ASSERTED THE PRECEDENCE OF EC LAW.

6. ONE SUBJECT WHICH KOHL THOUGHT POTENTIALLY SUITABLE FOR HANOVER WAS UNEMPLOYMENT POLICY, ESPECIALLY THE PROBLEMS OF MISLEADING AND UNHARMONISED NATIONAL STATISTICS. NOBODY SERIOULSY BELIEVED THAT ALL ON UNEMPLOYMENT REGISTERS WERE GENUINELY OUT OF AND SEEKING WORK, AND WE NEEDED A COMMON EC APPROACH TO THE DEFINITION AND ASSESSMENT

OF UNEMPLOYMENT. WE HAVE HEARD THIS PROPOSAL FROM OTHERS HERE AS WELL.

7. FINALLY, STAVENHAGEN AND OTHERS HAVE REFERRED TO THE NEED FOR A DISCUSSION ON THE ''SOCIAL DIMENSION'' OF THE EC WITH ESPECIAL REFERENCE TO 1992. THIS IS A SUBJECT ON WHICH I AM UNSIGHTED AND IT WOULD BE HELPFUL TO KNOW HOW YOU WOULD WISH US TO RESPOND TO SUCH SUGGESTIONS.

MALLABY

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INFO ROUTINE WASHINGTON, UKDEL OECD, TOKYO
INFO SAVING CGS IN THE FRG AND BERLIN

FRAME ECONOMIC

MY TELNO 519: EUROPEAN MONETARY COOPERATION.

SUMMARY
1. BUNDESBANK PRESIDENT POEHL TELLS ME THAT HE WELCOMES PUBLIC DEBATE ON EUROPEAN MONETARY UNION AND EUROPEAN CENTRAL BANK, SINCE IT SHOULD BRING OUT THE DIFFICULTIES AND FOSTER REALISM. HE EXPECTS KOHL AT THE HANOVER EUROPEAN COUNCIL TO PROPOSE A STUDY OF FURTHER MONETARY COOPERATION INCLUDING WHETHER MONETARY UNION AND A EUROPEAN CENTRAL BANK ARE DESIRABLE, WHAT THEY WOULD INVOLVE AND ALL THE IMPLICATIONS. STUDY PROBABLY TO BE DONE BY COMMITTEE OF CENTRAL BANK GOVERNORS. POEHL'S VIEWS ON HARMONISATION OF TAXATION NOT FAR FROM OURS. HE AGREES THAT SOME STIMULATION OF DOMESTIC DEMAND IS DESIRABLE IN FRG.

2. POEHL'S DOUBTS ON MONETARY UNION AND EUROPEAN CENTRAL BANK ELABORATED IN A MAJOR NEWSPAPER ARTICLE (SEE MIFT).

DETAIL.
3. POEHL, WHOM I VISITED ON 31 MAY, SAID THAT HE WELCOMED THE PUBLIC DISCUSSION OF MONETARY UNION AND A CENTRAL BANK, SINCE IT WOULD SHOW UP THE MANY DIFFICULTIES AND FOSTER MUCH NEEDED REALISM. WHEN HE HAD EXPLAINED THE SUBJECT AT A RECENT MEETING IN THE FEDERAL CHANCELLERY, KOHL HAD SAID THAT HE HAD NOT PREVIOUSLY REALISED THAT THE MATTER WAS SO COMPLICATED OR THAT THE IMPLICATIONS OF A CENTRAL BANK WERE SO FAR REACHING.

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X & Y are characteristic [illegible] attempts [illegible] Bundesbank [illegible] German constitution [illegible] govs. In all other countries monetary policy is ultimately the responsibility of Finance Ministers, an integral part of finance policy. ~~& [illegible] Ecofin~~ Thus the 'monetary' [illegible] ministers also ~~should~~ should be involved & behind the committee [illegible] of Ecofin or to Finance Ministers.* *as per EMS

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5. POEHL SPOKE IN FAVOUR OF ''HORIZONTAL DEVELOPMENT'' OF THE EMS, NOT ONLY THROUGH BRITISH PARTICIPATION IN THE ERM BUT ALSO THROUGH ASSOCIATION OF AUSTRIA AND PERHAPS SWITZERLAND.

6. WHEN I DESCRIBED OUR POSITION ON HARMONISATION OF TAXATION, POEHL AGREED THAT FREEDOM OF CAPITAL MOVEMENTS WOULD EXERT PRESSURE TOWARDS SIMILAR LEVELS OF TAXATION IN SOME FIELDS AND THAT DIFFERING LEVELS IN OTHER FIELDS WOULD NOT PREVENT A SINGLE MARKET FROM FUNCTIONING (AS TODAY IN USA AND SWITZERLAND). HE THOUGHT HOWEVER THAT CENTRAL DIRECTIVES MIGHT BE NEEDED IN A FEW TAXATION MATTERS, TO NUDGE THE MARKET TOWARDS REDUCTION OF DIFFERENCES IN TAXATION AND THUS HEAD OFF UNWANTED DISTORTIONS.

7. POEHL EXPECTS THE FEDERAL CHANCELLOR AT THE EUROPEAN COUNCIL IN HANOVER TO PROPOSE THAT A STUDY BE COMMISSIONED OF FURTHER STEPS IN MONETARY COOPERATION INCLUDING WHETHER MONETARY UNION AND A CENTRAL BANK ARE DESIRABLE, WHAT THEY WOULD INVOLVE AND WHAT ALL THE MANY IMPLICATIONS WOULD BE. THE MANDATE MIGHT BE IN GENERAL TERMS OR MORE SPECIFIC. THE FORUM DOING THE STUDY MIGHT BE THE COMMITTEE OF
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8. ASKED ABOUT THE MEETING OF THE FRANCO-GERMAN ECONOMIC COUNCIL ON 30 MAY, POEHL SAID THAT BEREGOVOY WAS NOT INTERESTED IN A EUROPEAN CENTRAL BANK. FRANCE WAS INTERESTED IN ''SYMMETRY'', WHICH IN EFFECT MEANT, AMONG OTHER THINGS, REDUCTIONS IN IMBALANCES IN TRADE IN THE EC, WHICH IN TURN MEANT STIMULUS OF GREATER DOMESTIC DEMAND IN THE FRG. IN POEHL'S VIEW DECISIONS CONCERNING FRENCH IDEAS FOR MUTUAL SUPPORT OF CURRENCIES IN THE EMS COULD NOT LEGALLY OR APPROPRIATELY
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ANNUM. BUT THE D-MARK WAS LOSING VALUE IN REAL TERMS, FUELLING THE IMBALANCE IN TRADE EG WITH FRANCE. I DREW ATTENTION TO THE FRG'S SURPLUS OF DM 17 BILLION IN TRADE WITH UK IN 1987.

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FROM: J M G TAYLOR
DATE: 2 June 1988

PMP

MR PERETZ

cc Sir G Littler
Mr Lankester

EUROPEAN MONETARY CO-OPERATION

... The Chancellor has seen Bonn TelNo.520 (attached).

2. He has noted Poehl's comments that "ECOFIN" is an unsuitable forum for the study, since the Community as such has no competence in monetary matters, and that decisions concerning French ideas for mutual support of currencies in the EMS could not legally or appropriately be taken by the European Council. He has commented that these are characteristic Bundesbank attempts to impose the German constitution on the rest of us. In all other countries monetary policy is ultimately the responsibility of Finance Ministers, and an integral part of economic policy. Thus the Monetary Committee must also be involved, and both Committees should report either to ECOFIN or to Finance Ministers (as with EMS).

J M G TAYLOR

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TO IMMEDIATE FCO
TONO 520
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INFO IMMEDIATE PARIS, UKREP BRUSSELS
INFO PRIORITY OTHER EC POSTS
INFO ROUTINE WASHINGTON, UKDEL OECD, TOKYO
INFO SAVING CGS IN THE FRG AND BERLIN

FRAME ECONOMIC

MY TELNO 519: EUROPEAN MONETARY COOPERATION

SUMMARY
1. BUNDESBANK PRESIDENT POEHL TELLS ME THAT HE WELCOMES PUBLIC DEBATE ON EUROPEAN MONETARY UNION AND EUROPEAN CENTRAL BANK, SINCE IT SHOULD BRING OUT THE DIFFICULTIES AND FOSTER REALISM. HE EXPECTS KOHL AT THE HANOVER EUROPEAN COUNCIL TO PROPOSE A STUDY OF FURTHER MONETARY COOPERATION INCLUDING WHETHER MONETARY UNION AND A EUROPEAN CENTRAL BANK ARE DESIRABLE, WHAT THEY WOULD INVOLVE AND ALL THE IMPLICATIONS. STUDY PROBABLY TO BE DONE BY COMMITTEE OF CENTRAL BANK GOVERNORS. POEHL'S VIEWS ON HARMONISATION OF TAXATION NOT FAR FROM OURS. HE AGREES THAT SOME STIMULATION OF DOMESTIC DEMAND IS DESIRABLE IN FRG.

2. POEHL'S DOUBTS ON MONETARY UNION AND EUROPEAN CENTRAL BANK ELABORATED IN A MAJOR NEWSPAPER ARTICLE (SEE MIFT).

DETAIL.
3. POEHL, WHOM I VISITED ON 31 MAY, SAID THAT HE WELCOMED THE PUBLIC DISCUSSION OF MONETARY UNION AND A CENTRAL BANK, SINCE IT WOULD SHOW UP THE MANY DIFFICULTIES AND FOSTER MUCH NEEDED REALISM. WHEN HE HAD EXPLAINED THE SUBJECT AT A RECENT MEETING IN THE FEDERAL CHANCELLERY, KOHL HAD SAID THAT HE HAD NOT PREVIOUSLY REALISED THAT THE MATTER WAS SO COMPLICATED OR THAT THE IMPLICATIONS OF A CENTRAL BANK WERE SO FAR REACHING.

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