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PREM 19/2085

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PART 17

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SECRET.

CONFIDENTIAL FILING

DOMESTIC MONETARY POLICY

ECONOMIC POLICY

PART 1: MAY 1979

PART 17: JULY 1987

PREM 19/2085

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
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28.12.87							
PART ENDS							

PART 17 ends:-

NLW TO PM 28.12.87

PART 18 begins:-

PG TO HMT 9.1.88

PRIME MINISTER

As you will have heard the $ is under heavy downward pressure. I have been in touch with the Treasury. They tell me that we have not intervened at all, nor are planning to do so. They say too that the Germans have intervened heavily - though the extent is as yet unknown.

I have asked the Treasury to let me know if there is any suggestion of our intervening.

N. L. WICKS

28 December 1987

SUBJECT
cc masters.

SECRET 14 File JA 1BOT

10 DOWNING STREET

LONDON SW1A 2AA

Meeting record.

From the Private Secretary

8 December 1987

THE MARKETS

The Prime Minister this evening discussed intervention policy with the Chancellor.

The Prime Minister expressed her very strong concern about the continued very large scale intervention needed to hold sterling below DM3. Intervention had totalled $27 billion since the beginning of the financial year. We were in effect financing a substantial slice of the US current account deficit and certainly in recent weeks the Germans for example had carried out very little intervention. The fact that we were aiming to hold sterling below DM3 was itself stimulating speculation. There was a clear risk now that the liquidity created by our intervention would lead to renewed inflation. The latest forecast showed MO rising well above 6 per cent in the early months of next year.

The Chancellor argued that the effects of the intervention could be sterilised by extra funding or by intervention in the other direction when sterling came under downward pressure or by a combination of the two. Fears of inflation were exaggerated and any move through DM3 now would be very damaging to business confidence.

After further discussion the Prime Minister agreed that it would be worth attempting in the first instance to hold sterling below DM3 by intervening in DM rather than in dollars, in the hope that the scale of the intervention needed to achieve the objective would then be smaller. Whilst recognising that this would mean breaking the EMS agreement reached between central banks in March 1979, the Prime Minister asked the Chancellor to instruct the Governor, as agent for the Treasury in operating the EEA, to cease all intervention in dollars as from the opening of business in London tomorrow morning and to intervene instead in DM. The Chancellor should also step up the sales of gilts, needed to fund past intervention, preferably through index linked stock.

(DAVID NORGROVE)

Alex Allan, Esq.,
HM Treasury

SECRET

85A/2/cg/15/4508 SECRET 13

DRV

FROM: J W GRICE
DATE: 1 December 1987

1. SIR PETER MIDDLETON
2. CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Economic Secretary
Sir T Burns
Sir G Littler
Mr Cassell
Mr Lavelle
Mr Monck
Mrs Lomax
Mr Odling-Smee
Mr Peretz
Mr Sedgwick
Mr R I G Allen
Mr Bottrill
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 Lankester (Washingt
File: MAMC F1

Prime Minister

You may like to see this internal Treasury paper. The covering minute has some interesting points. Paragraph 27 of the main paper discusses the forecast for MO. →

DRV
10/12.

MONTHLY MONETARY ASSESSMENT: NOVEMBER 1987

This note reports the discussion at Sir Peter Middleton's regular meeting on monetary conditions on 1 December. Attached is the usually Monthly Assessment. There is a special annex on the behaviour of MO.

Sir Peter Middleton's meeting

2. Mr Cassell began the discussion by noting that the exchange rate and domestic monetary indicators were giving conflicting testimony about monetary conditions. Domestic indicators certainly made little case for lowering interest rates:

(i) MO was growing strongly, as it had been for some months, and could be above its target range by Budget time;

(ii) growth in both M4, and more especially M3, had accelerated in October, the main reason being the unsterilised intervention which had taken place. The forecasts suggest that there may be some further acceleration to come; equity issues have collapsed in the wake of the Stock Market fall, and companies may turn to the banking system for finance. By January, M4 and M3 might be about 17 per cent and 23½ per cent, respectively, above their levels 12 months earlier. Against this, the willingness of the private sector to hold liquidity had probably increased after the equity price fall;

(iii) recent indicators of activity were stronger than expected at the time of the Autumn Statement. On the other hand, the combined effect of a higher exchange rate, lower share prices and, offsetting, lower interest rates was probably contractionary. On balance, the Autumn Statement money GDP forecast for 1988-89 was probably still close to central. This would be above the MTFS path, mainly due to higher inflation.

3. But the exchange rate had been strong. The effective rate had risen about 1¾ per cent since the last Assessment (2 November) and on an oil-price adjusted basis, the rise was over 2½ per cent. It was possible that we might soon encounter the familiar problems of having to counter upward pressure on sterling, especially against the deutschemark. If so, there was a strong case for cutting interest rates quickly, rather than adding further liquidity via intervention. But any such interest rate cuts ought equally to be quickly

reversed if the pressures on sterling themselves reversed.

4. Mr George saw little evidence of any downward pressure in inflation for the present. Since the last Assessment, most of the indicators suggested that activity before the equity price fall (19 October) was even stronger than we believed and the contractionary effect of the equity price fall itself was open to question. The immediate issue, however, was how to respond to upward pressure on the pound. This could come about quickly, particularly if the Bundesbank acted to cut its discount rate on Thursday. He agreed with Mr Cassell that market tactics would suggest early reductions in UK interest rates, rather than further heavy intervention, assuming the aim remained to keep the rate below 3.00 DM.

5. Sir Terence Burns took the same view about tactics in the event of upward pressure on the sterling/mark cross rate. But he noted that a stable rate against the mark had been consistent with a rising effective rate index, because of the falling dollar. If the dollar continued to fall, it was possible that the effective rate would remain strong, even if the pound eased away from 3 deutschemarks.

6. Other points to emerge in discussion were:

a. building societies' prospects appeared to have improved after the equity price fall. Both their retail deposits and their share of lending had improved;

b. there was a striking divergence in the sectoral purchases of gilts. Between June and October, the overseas sector had purchased some £5 billion net of public debt, whilst the non-bank private sector had been net sellers over this period. Institutions seemed, rather, to have preferred to buy equities.

7. There followed a discussion of the policy of paying particular attention to sterling's rate against the deutschmark. The discussion focussed on the effectiveness of the policy in reducing inflation and its credibility. The main points were:

(i) it was not necessary for sterling to rise against the mark in order to generate downward pressure on inflation. As in the last month, a falling dollar would lead to a rising effective rate with no change in the sterling - mark cross rate. The dollar probably still had some way to fall;

(ii) the more difficult test of policy, however, would be posed not by any imminent upward pressure on sterling, but by the need to react to downward pressure if sentiment reversed. It would then be crucial to prevent any substantial fall against the mark to maintain the credibility of policy and downward pressure on inflation;

(iii) although a stable cross rate against the mark should ultimately generate pressures towards lower inflation, the lags in the process were unclear. If outside perceptions of inflation were more pessimistic than warranted, then labour costs may rise excessively in the interim. This would make the eventual adjustment to lower inflation all the more painful;

(iv) the credibility of the policy was therefore critical. But it was difficult to demonstrate resolve to prevent an excessive fall against the deutshemark when the actual pressures were the other way;

(v) the fact that the economy was very liquid must increase the risk of a rapid fall in the exchange

rate if confidence weakened.

8. Summing up, Sir Peter Middleton said that the basis for policy was a prolonged linkage of sterling to the deutschemark. The present situation was one of high liquidity, but where any inflationary consequences were checked by the high exchange rate. The outcome was not likely to be an immediate sharp decline in inflation, but the MTFS in any case allowed for a gradual reduction. There seemed to be two conclusions from this. First, every opportunity had to be taken for strengthening the credibility of the policy. Secondly, particularly given the liquidity of the economy, policy action would have to be swift and determined if the exchange rate started to fall.

JWG

J W GRICE

SECRET

MONTHLY MONETARY ASSESSMENT : NOVEMBER 1987

Summary Assessment

Monetary conditions have tightened over the last month. The exchange rate has risen by about 2½ per cent and, with oil prices falling, the oil adjusted rate has risen still further. Monetary growth tended to accelerate in October, especially M3, which of the broad aggregates was most affected by intervention. But this needs to be seen in the context of increased demand for liquidity in the wake of the equity price fall. The fall in share prices and latest rise in sterling - though partially offset by a one point reduction in interest rates - is, on balance, likely to be contractionary.

Main Points

At world level, the net effect of equity price falls and interest rate reductions has probably been disinflationary. Weak commodity prices suggest that inflationary pressures in the world economy are largely absent (paras 3, 5).

The 12 month growth rate of M0 in November fell back to 4.9 per cent, from 5.6 per cent in October and the growth rate is projected to fall further in December. (paras 25-27 and Annex I).

M4 grew by 15¾ per cent in the year to October, an acceleration of about ¾ per cent compared to September. For M3, the acceleration was greater - from 19½ per cent to 22¼ per cent in the same respective months. Intervention effects probably explain most of this rise (paras 30, 42).

The exchange rate index rose from 74.6 to 76.4 mainly reflecting the weaker dollar. This occurred despite falling oil prices; the oil adjusted index rose by about 3¼ per cent over the month. Nor were interest rates directly helpful; sterling's differential against the overseas basket declined from about 2½ to 2¼ per cent (paras 19-21).

Equity prices trended lower, declining a further 9 per cent. They now stand 36 per cent below the July peak. Institutional liquidity ratios have recovered from the low levels of the third quarter but are by no means exceptionally high (paras 49-52).

An Annex discusses the behaviour of M0. By the time of the next Budget it may be ½ per cent or so above its target range. (Annex I).

MG2 Division
1 December 1987

A. External Developments

The sharp falls in **share prices** since mid-October on all the world's major stock exchanges (table 3) ended the long bull market since 1982. Disappointing US trade figures, increases in interest rates in the US and Germany, and policy tensions among the G7 were factors which initially undermined confidence. But P/E ratios had risen to heights that were probably unsustainable, and an adjustment was likely to come sooner or later.

2. The authorities in most countries responded to the fall in share prices by easing monetary policy. **Short-term interest rates** declined by about 1½ percentage points in the US and by about a point in Germany (table 2). These declines reversed the rises in September and early October, and will act to offset to some extent the effects of the share price falls on aggregate demand. During the last week in November the German rate fell by a further quarter of a point, whereas the US rate rose by half a point. However the net effect is likely to be to reduce the growth of demand and activity in 1988. The Autumn Statement and the OECD's provisional forecast both put real growth at around 2 per cent next year.

3. The **dollar** fell markedly against all major currencies during November (see table 2(b). At the end of the month, the effective exchange rate was 9 per cent below its Louvre Accord level and 4 per cent lower than a month earlier.

4. The 12 month rate of **consumer price inflation** in the G5 has risen from under 1 per cent at end of 1986 to 3 per cent in September (table 1). However this rise is largely attributable to the fact that the effects of last year's falls in oil and other commodity prices have largely worked through. Underlying inflationary pressures do not seem to have grown. Unit labour costs in manufacturing have fallen over the past year in the US, Japan and France, and have hardly risen in Germany. GNP price deflators have not accelerated significantly.

5. The behaviour of **commodity prices** (table 3(b)) is consistent with the judgement that inflationary pressures remain relatively weak. In real terms, they are barely any higher overall than on average in 1986.

B. Activity and Inflation

6. Recent labour market indicators and CBI survey results have been particularly buoyant. Table 4 summarises recent indicators of **activity and inflation.** The Q3 GDP(O) estimate published on 19 November is a little above the Autumn Statement forecast. Retail price inflation was slightly higher than expected in October but is expected to fall back again in the last two months of 1987. Few indicators relevant to the period following the share price fall have been published as yet. Those that have show no signs of having been influenced by recent developments, though this is not unexpected given the likely lags between financial developments and economic activity.

Recent indicators of activity

7. Preliminary estimates show a 1½ per cent rise in the output-based measure of **GDP** between the second and third quarters, with similar growth rates (all in the range 1½ to 1¾ per cent) for the production, service and construction industries. Monthly figures for production industry output show a ½ per cent fall in manufacturing output in September, after sharp rises totalling almost 2 per cent in July and August. The November **CBI survey** of manufacturers (conducted after the share price fall) continues to show buoyant order books and output expectations. After adjustment for seasonal variation, responses on both export order books and output expectations has risen sharply in November, and are only slightly below earlier peak figures seen in July and August respectively.

8. **Retail sales** continue to show strong growth, with a provisional ¾ per cent increase in October. In the three months to October sales were nearly 3 per cent higher than in the previous three months. Private housing starts are provisionally estimated to have fallen 5 per cent in September, after a similar rise in August. Despite having recovered in part from a sharp second quarter fall, housing starts remain below peak first quarter levels. **Business capital expenditure** is provisionally estimated to have fallen back 5 per cent in the third quarter after relatively buoyant outturns in the first half of 1987. Little should be read into this downturn given the volatility of the series and the contrasting message on investment prospects coming from CBI and other business surveys.

Business spending on stocks is provisionally shown to have risen sharply in the third quarter.

9. **Unemployment** fell by 58,000 in October, a somewhat larger fall than in previous months. **Overtime working** rose strongly in September; it is now higher than the previous peak level of June. Vacancies rose 15,000 in October, significantly faster than in recent months.

Inflation

10. The outturn for **retail price inflation** in October was 4.5 per cent, compared to the 4.2 per cent in September. Although some rise had been expected in October, it turned out slightly higher than expected. RPI inflation is expected to fall sharply in November, as the large mortgage rate increase in November 1986 drops out of the year on year comparison.

11. The twelve month increase in the **producer price index** (excluding food, drink and tobacco) in October was 4.8 per cent, up 0.1 per cent from the (revised) estimate for September. CBI survey responses on manufacturers' price expectations - adjusted for seasonal variation - have drifted upwards through 1987 in line with the published figures for output price inflation. The November survey showed a further small rise, though the balance of respondents expecting to raise prices remains, as yet, significantly lower than in the previous peak year of 1984. **Producer input prices** (also excluding FDT) rose by 7.7 per cent in the year to October, down from 10.7 per cent in the year to September. This fall in the annual increase reflects a diminishing influence from the rapid increase in input prices last Autumn, together with a small fall in the level of input prices in the latest month.

12. Underlying growth in **average earnings** in September remained at 7¾ per cent for the sixth successive month. Private sector settlements in the 1986-87 pay round just ended averaged around ½ per cent lower than the outturn for the previous round. However, both manufacturing and service sector settlements have drifted upwards since the end of 1986.

13. The annual rate of **house price inflation** (measured by the Halifax index) rose to 16.2 per cent in November, compared to

14.5 per cent in October, after six successive months at around 14½ per cent. The DoE index for the third quarter showed a rise of 15 per cent over a year earlier, compared with 14.1 per cent in Q2. While the latest figures show an increase in house price inflation, the stock market crash will not yet have been reflected in the London figures and it is too early to say whether house price inflation has started to rise again. The Royal Institute of Chartered Surveyors have reported falling sales and some over-priced properties in and around London recently, but an extremely buoyant market in the provinces. While the evidence is still very weak, some reduction in house price differentials between London and the rest of the UK could be expected following the stock market falls. The DoE housebuilding land price index increased by 48 per cent in the year to 1987 H1, the highest growth rate since the early 1970's property boom.

Projections for Money GDP

14. It has become increasingly clear that stronger than expected real activity would lead to an overshoot of the Budget forecast for 7½ per cent growth in **money GDP** in 1987-88. This was recognised in the Autumn Statement forecast, which showed a revised projection of 8½ per cent growth.

15. The fall in share prices and consequent policy response will affect economic prospects through 1988. Relatively little influence on activity or inflation is expected this year. The Autumn Statement forecast, which took account of the fall in share prices and the first half-point reduction in interest rates, assumed that, on balance, these factors would prove contractionary. This, coupled with some independent deceleration of real activity after above trend growth this year, was projected to yield 7¼ per cent money GDP growth in 1988-89 following 8½ per cent growth in 1987-88.

16. Prospects have not been fully re-assessed following the second half-point reduction in interest rates and the recent rise in sterling (the sterling effective index is currently about 5 per cent higher than As projections). However, it seems likely that, on balance, the combination of a 30 per cent fall in share prices, 10 per cent reduction in the level of interest rates (from 10 to 9 per cent), and 5 per cent appreciation of sterling remains

contractionary. Together these factors might be expected to lead to lower money GDP in 1988-89 than assumed in the Autumn Statement forecast. But against this, recent indicators of activity have proven stronger than expected. Overall, the Autumn Statement forecast probably remains close to a central one.

C. Public Sector Finances and the Fiscal Stance

17. Table 5 gives the main indicators of the fiscal stance. The **PSBR** in October was a surplus of £1.0 billion, as compared with a forecast of a surplus of £1.2 billion. However, net privatisation proceeds were £0.6 billion lower than forecast, as a result of some of the proceeds from the BP sale expected in October being delayed until November. This brings the PSBR for the first seven months of 1987-88 to £0.5 billion, which is £3.1 billion below the Budget profile. Of this difference, central government own account borrowing is around £2.3 billion below profile - Table 6 gives details. Local authorities' borrowing is about £0.5 billion below, and public corporations' borrowing about £0.4 billion below, profile. Comparison of the outturn so far this year with the previous year is affected by significant changes in the level and pattern of privatisation proceeds. If privatisation proceeds are excluded, borrowing in April to October has been around £3 billion lower than for the same period in 1986-87.

18. The October outturn for the PSBR does not cast any major doubt on the internal October forecast of a PSBR surplus of about £1 billion for 1987-88 as a whole. Thus last month's assessment of the **fiscal stance** in 1987-88 still stands, subject to the provision that any use of the BP buy-back option will increase the PSBR. Since most investors will wait until close to the expiry date of the option before selling shares to the Bank, the extent of the Bank's liability remains unknown, although the maximum £1½ billion is unlikely to be reached given the Kuwaiti's increased share holding recently. In any case, the PSBR appears to be turning out considerably tighter than envisaged at Budget time, even after allowing for the automatic tightening associated with higher than expected activity, and so fiscal policy would not appear to be contributing directly to the higher than expected growth of output.

D. UK Exchange Rate and External Accounts

19. The **sterling index**, which rose by 2½ per cent during October as the dollar fell in the wake of the stock market fall, has risen a further 2½ per cent, to 76½, since the beginning of November as the dollar has continued to weaken. Against the Deutschemark the rate has been relatively steady, rising to just over 2.99 from 2.98 at the beginning of November.

20. The rise in the sterling index in November occurred despite a further slight narrowing of the interest rate differential against the world basket, to 2¼ per cent. UK three month **interbank rates** have fallen by nearly ½ percentage point since the beginning of November. Over the same period US and German rates have fallen by a similar amount but Japanese rates have been relatively steady and French rates have risen by ½ percentage point, even after the recent concerted ¼ point reduction in European rates.

21. A further fall in the Brent spot oil price over the past month may have helped to remove some of the upward pressure on the DM/£ rate which was evident in September and October. The Brent price has fallen by nearly $1 a barrel since early November, to around $17¾ a barrel, largely in response to an easing of Gulf tension and excessive supplies in stock and in transit to North America and Europe. As a result the **oil adjusted reference ratio** has risen by a further 3¼ per cent. However given the weakness of the dollar over this period, which implies a larger fall in the oil price in sterling than in dollar terms, the conventional oil adjusted reference ratio may understate the downward effect on inflation of oil price and exchange rate movements in November.

22. In the absence of strong upward pressure on sterling against non-dollar currencies, spot and forward market **intervention** in November amounted to $ 180 million.

23. The October **trade figures**, published on 24 November, showed a current account deficit of £282 million compared with a deficit of £17 million in September. The rise in the deficit reflects some fall in export volumes while import volumes were little changed. The underlying upward trend in non-oil import volumes remains faster than the upward trend in exports.

E. Domestic Monetary and Financial Market Developments

(see Tables 10 to 26)

24. The development of domestic monetary indicators needs to be seen in the light of the sharp fall in equity prices. This will have had two related effects. First, the fall in private sector wealth and the implied increase in company borrowing costs will have reduced demand for goods and services in money terms. Secondly, there is likely to have been some upwards shift in liquidity preference, or perhaps more generally away from equities towards assets such as gilts and property, as well as money. This is liable to last at least until the equity market looks less fragile, the implication being that the volume of liquidity which will be willingly held has probably risen appreciably.

Narrow Money

25. MO developments since the last assessment are much as expected, with buoyant notes and coin growth continuing in November, albeit at a slower pace than the rapid growth of recent months. The annual growth rate of MO in October and November was about 1½ percentage points above what was anticipated at Budget time (see chart 7), providing further evidence that activity is currently well above the Budget projections. With interest rates falling by a further ½ per cent during November, leaving them below the Budget projection, the overshoot of MO growth is expected to increase over the rest of the financial year, despite some moderation in the pace of MO growth in Q1 1988. Annex I examines in more detail the likely factors reponsible for the current overshooting of MO growth relative to the Budget projections and the outlook for the rest of 1987-88, together with an assessment of the implications for monetary conditions. Broadly, most of the overshoot can be accounted for by the increased level of real activity compared to what was expected at Budget time. Some of this excess is probably cyclical, but a part of it may represent improved supply side performance, which in principle might have allowed us to set the target range ½ per cent or so higher. This may be an important consideration in a presentational context because by the 1988 Budget MO might be about

½ per cent above the top of its target range.

26. **M0** (seasonally adjusted) rose by 0.3 per cent in November, and the 12 month growth rate fell back to 4.9 per cent, from 5.6 per cent in October. The fall in the 12 month rate reflects both the brisk growth of M0 in November 1986 and erratic movements in bankers' balances a year ago. The annualised growth rate of notes and coin (and M0) in the latest 3 months was about 7¼ per cent, compared to 8 per cent in the 3 months to October.

27. The **forecast** assumes very buoyant growth of M0 in December - partly reflecting seasonal influences - although the 12 month growth rate falls back to about 4¼ per cent, reflecting the exceptional growth of M0 in December 1986. But the twelve month rate of M0 is forecast to rise rapidly during Q1 1988, exceeding the target range in February, as the falls in the level of M0 during Q1 1987 drop out of the 12 month comparisons. The overshoot compared with the Budget projections is expected to rise steadily from its current 1½ percentage points in November to 2½ points in March.

28. **NIB M1** rose by £0.2 billion (£1.5 billion seasonally adjusted) in October and the annual growth rate rose to 12.0 per cent, from 6.1 per cent in September, the low September figure reflecting the upward distortion of the TSB sale on NIB M1 in September 1986. Interest-bearing sight deposits rose by £2.5 billion in October - the largest increase since March, although it is likely any effects of the BP sale (see below) will have been concentrated in IB sight deposits. Together with the £0.2 billion increase in NIB M1, this gives a £2.7 billion (£4.1 billion seasonally adjusted) increase in M1, with the 12 month growth rate jumping up to nearly 24½ per cent in October, from 20¼ per cent in September.

Broad Money

29. Broad money growth in October was the highest since March and 12 month growth rates of all the broad aggregates rose, partly reflecting the effects of the TSB share sale on the broad aggregates a year ago. The demand for money is likely to have been boosted

by sterling's firmness during October and possibly, to a lesser extent, by the stock market falls inducing a portfolio shift towards liquidity. The sterling supplied by the authorities through the record level of intervention during October does not seem to have led to any loosening of monetary conditions, as the fall in short rates during October suggests that the increased supply of sterling was being held willingly.

30. **M4** rose by £5.2 billion (1.8 per cent) in October and the 12 month growth rate rose to 15¾ per cent, from 15 per cent in September. **M3** rose by £5.5 billion (3.1 per cent) whilst its 12 month growth rate rose sharply to 22¼ per cent, from 19½ per cent in September.

31. With respect to the **M4 components**, holdings of M3 by the private sector excluding building societies rose by £4.1 billion, compared to an average of £2.0 billion over the previous twelve months. Bank deposits may have been inflated by several factors connected with the BP sale: the CG payment to BP of £1.5 billion for part of the share issue (which took place late on 30 October, BP placing most of this on deposit); a build-up of deposits by underwriters prior to paying £1.5 billion early in November; and possibly an earlier build-up of deposits by potential BP investors not reversed by the end of the month. In addition, recorded reserves rose by £3.9 billion in October and much of this is likely to have fed through into M3 (see para 42). There is no firm evidence that the October money figures are affected by the stock market crash, although the unit trusts may have been building up liquidity in anticipation of withdrawals (see para 50). Private sector retail deposits with the building societies rose by £1.1 billion in October, while their wholesale deposits were unchanged.

32. With respect to the **M3 components**, apart from the £4.1 billion increase in M3 by the non-bank non-building society private sector, building societies increased their bank deposits by £1.4 billion - the largest increase on record - which largely explains the higher M3 flow than of M4 in October. Some of this increase in building society bank deposits may have been in

anticipation of withdrawals for the BP sale, which in the event did not occur, although the societies have been accumulating liquidity fairly steadily over the past year, their bank deposits rising by an average of £0.4 billion per month in the year to September.

33. Building society **retail inflows** in October were, at an estimated £750 million excluding interest credited, the highest so far this year. This can be attributed largely to seasonal factors, although whether in the light of equity market developments such factors apply as in former years is open to question. The much vaunted boost to societies from the flight from, and continued unattractiveness of, equity and unit trusts (plus the short term return of funds set aside for BP) probably figured somewhat (possibly £150 million) in the October figures, but the major benefit has been felt in the first three weeks of November when over £720 million was taken by the 15 largest societies. Societies also borrowed heavily (£535 million) in October on the wholesale markets. Most of this will represent packages set up prior to the falls in equity prices to cope with heavy expected outflows from the BP sale, although some borrowing may also have occurred in expectation of a lifting in the 20 per cent limit on non-retail funding by societies close to that limit. The period since the stock market falls has seen fairly heavy redemptions by societies of wholesale liabilities.

34. As a result of these factors, societies ended the month with a substantial (£700 million) build up of liquid assets, especially bank deposits. Societies also made net disposals of £¾ billion gilts. In market conditions favouring gilts investment this was unexpected, particularly since it is rumoured that at least two large societies were net purchasers. A number of factors may underlie this, including the following:

- Some societies may have been profit-taking from substantial investment over the summer following the rise in gilts prices with the October base rate cut.

- Selling to provide extra cover against BP related outflows.

- The prospective redemption of the 12/87 gilt and the movement to XD status of £2.6 billion of 1988 gilts in October and November will have triggered selling since societies hold predominantly short dated gilts and tend to sell those prior to such events. Societies did not fully reinvest the proceeds within October.

35. The M3 and M4 **forecasts** are tentative because of uncertainties over the monetary effects of the shake-out in equity prices and the BP sale. It is assumed that the fall in equity prices will have an expansionary effect on broad money as liquidity preferences increase, with the counterpart being substitution into bank borrowing from equity finance by companies. It is assumed that the expansionary effect of the BP sale in October will unwind in November. On these assumptions annual growth rates of M3 and M4 are forecast to remain unchanged in November at 22 per cent and 15¾ per cent respectively.

Credit

36. **Bank and building society lending** rose by £4.1 billion (1.3 per cent) in October, compared with an average of about 1½ per cent over the previous 12 months. The annual growth rate of lending is estimated at 19.2 per cent in October, compared to 20.0 per cent in September.

37. **Sterling bank lending** grew by 1.5 per cent in October and at an annual rate of nearly 23 per cent, compared to 23½ per cent in the 12 months to September. One known special factor - the unwinding of a temporary loan made in September - will have depressed the October lending figure of £2.9 billion by £½ billion. Allowing for this special factor, bank lending was at its average rate of increase in October compared to the previous twelve months. However, foreign currency lending rose sharply (by £3.5 billion) compared to an average rise of £1 billion over the previous 12 months. It is likely that at least some of this increase in foreign currency borrowing by the private sector represents either speculative or hedging activity, with the private sector increasing its net currency bank borrowing and switching into sterling (a counterparty being

the EEA) on the expectation of sterling's appreciation.

38. Within sterling bank lending, advances increased by £2.8 billion, lending to GEMM's rose by £0.4 billion and lending via monetary sector holdings of commercial bills fell by £0.5 billion - the latter possibly reflecting the unattractiveness of fixed rate bill finance to companies when rates are falling. Returns from the London and Scottish retail banks show that of their total sterling advances of £1.7 billion, lending for house purchase rose by £0.7 billion - much in line with recent months - while other personal lending (£0.2 billion) was the smallest rise since February. Of the CLSB banks' total foreign currency advances of £1.5 billion, most was accounted for by hotels and catering (£0.7 billion - largely for overseas investment) and by unit trusts, insurance companies and pension funds (£0.8 billion - possibly reflecting hedging activity).

39. When account is taken of seasonal factors, **building societies' mortgage lending**, of £1.5 bn unadjusted, continued its slow recovery in October as the final boost of August's return to price competitiveness with the banks was felt. Lending may have been somewhat restrained in early October as the possibility of a loss of funds to the BP sale induced caution. But the possibility of a change in the limit on non-retail funding may have encouraged societies to avoid further losses of market share, as evidenced by their willingness to indulge in substantial wholesale borrowing (see para 33) and to sell their less liquid non-mortgage assets.

Other Broad Money Counterparts

40. A PSBR surplus of £1.0 billion was **underfunded** by £1.8 billion, largely reflecting a £3.9 billion recorded increase in the reserves and CG debt sales of £1.3 billion overseas, with no change in public sector debt sales to the non-bank private sector. Cumulative underfunding has been £3¾ billion in 1987-88 so far. The building societies made large (£¾ billion) disposals of gilts in October (see para 34). Hence, the **public sector contribution to M4** was,

at £1.1 billion, less expansionary than to M3. The cumulative public sector contribution to M4 is £2½ billion in 1987-88 so far. The M4 **externals** were expansionary by £3.3 billion and **£NNDL's** of the banks and building societies were contractionary by £0.6 billion.

41. Public and banking sector **external transactions** were expansionary by £3.4 billion in October, largely reflecting the £3.9 billion recorded increase in the reserves. The effect of the intervention on broad money growth is examined below.

Intervention and the External Counterpart of M3 in October

	£ billion
Recorded change in reserves*	3.9
Change in the Forward book*	0.9
Total Intervention	4.8
External Counterparts to M3	3.4
"Usual" external counterparts	-0.3
Abnormal external counterparts	3.7

* Including swaps and off-market transactions

42. The effect of the intervention on M3 in October, as measured by the "abnormal external counterparts", was less than the total intervention itself. Part of the explanation will have been that some of the sterling sold by the EEA will have been taken up by overseas residents and banks - which switched out of foreign currency in October and into sterling assets (see para 43) - and hence will not have added to M3. On the other hand, it seems likely that the counterparties to the swaps carried out by the EEA - namely buying sterling spot but selling it forward, which reduces recorded intervention compared to the total - were largely banks, which switched out of sterling to the extent of £2.7 billion in October. The spot sterling sold by the banks to the EEA as part of the swap will not have reduced M3. Hence it seems likely that most of October's intervention has fed through directly into M3.

43. Apart from the overseas sector increasing its net sterling bank deposits (by about £2 billion) in October, it also made a further net purchase of over £1¼ billion of gilts and Treasury bills. Between June and October, the overseas sector has made net purchases of £5 billion of public sector debt, in contrast to the private sector which has been a net seller of gilts and TB's over the period.

44. The **£NNDL's** counterpart to M4 was contractionary by £0.6 billion in October, reflecting the large wholesale funding of the building societies during the month. The £NNDL's counterpart to M3 was expansionary in October by £0.1 billion.

M5

45. M5 grew by £5.3 billion (1.7 per cent) in October and at an annual rate of 15 per cent, compared to 14¼ per cent in September. The lower annual growth rate of M5 compared to M4 is explained by a £1 billion fall in private sector holdings of local authority debt and tax instruments over the past twelve months.

Money Markets and Interest Rates

46. **Money market rates** started November at 9.4 per cent across the yield curve, falling to about 9 per cent after the base rate cut on 4 November. Rates have since held fairly steady and currently range from 8.9 per cent at one month to 9.1 per cent at twelve months.

47. The stock of **money market assistance** was little changed at £5.4 billion in October, with the £4 billion increase in the reserves offset by several factors, including a CG surplus (£¾ billion) and strong purchases of gilts (£1½ billion), CTDs (£¼ billion) and Treasury bills (£½ billion). The rise in market holdings of Treasury bills reflected the introduction of an extra tender of £500 million of 9 week Treasury bills at the end of October, and with the continuation of the tender in November the market is forecast to purchase a further £1¾ billion this month. When the bills mature, the need for commercial bill purchases will be reduced by about

£½ billion in December and £1½ billion in January, thereby smoothing the money-market assistance profile. The level of assistance is forecast to rise to £7¼ billion in November and in December before rising to about £10¾ billion by the end of January (see Table 25).

48. **Gilts** began November with the index at 90.1, and 5, 10 and 20 year par yields at 9.1, 9.5 and 9.3 per cent respectively. Prices were lifted by the base rate cut on 4 November, with the index reaching a peak of 92.8 on 9 November, before falling back again to end the month little changed. The Gilt Index now stands at 90.3, and the 5, 10 and 20 year par yields at 8.8, 9.3 and 9.3 per cent respectively. Yields have fallen slightly at the short end, steepening the yield curve, during November. Index-linked stock has been in demand. Real yields on index-linked have fallen by around ½ per cent to around 2.6 per cent at the short end, 3.8 per cent at the long end. Breakeven inflation rates of Index-linked Treasury 1990 and 2006 are currently 3.8 and 5.5 per cent respectively, compared with 3.2 and 4.9 per cent at of October. The equity dividend yield (based on the all-share index) has risen to around 4.7, having begun the month at 4.2.

Capital Markets and Corporate Finance

(see tables 20-21)

49. **Equity prices** (measured by the FT All Share Index) continued to slide in early November, the index reaching a low of 785 on 10 November, with falls often reflecting events in the US and Japan. Equity prices had then fallen by one-third since 16 October and were back to their levels of October 1986. Prices recovered slightly in mid-November but have since fallen back again, reflecting the weakness of the dollar. The index now stands at 796, 36 per cent below its July peak.

50. Net sales of **unit trusts** fell back sharply in October to £¼ billion, having been a record £1¼ billion in September and £3 billion in the third quarter. Assuming that net sales remained high until the middle of October it is likely that unit trusts experienced net withdrawals of some £¼ billion in the second half of October. Nevertheless, unit trusts' liquidity may be

exceptionally high if, as press reports suggest, they have sold large volumes of company securities in response to the stock market crash. Assuming sales of £2 billion of securities, units trusts' liquidity ratio in mid November might have jumped to about 15 per cent, from about 7¼ per cent in Q3 and an average of about 5 per cent since 1979.

51. The latest firm data for the liquidity of **pension funds and life companies** relate to the second quarter of 1987. At that point their liquidity ratio was historically quite low at about 3 per cent for pension funds and 2½ per cent for life companies, although their liquid assets stood at high levels (£8¼ billion and £5 billion, respectively). It is likely that pension funds' liquidity ratio fell further in the third quarter, perhaps to about 3 per cent, due to purchases of some of the record £8 billion of net capital issues. Early estimates of life companies' investments in the third quarter suggest that their liquidity may have risen a little, to about 2¾ per cent. Since Q3, there has been a further £1 billion of net capital issues in addition to the BP sale, and anecdotal information suggests that pension funds and life companies have not been heavy sellers of equities since the stock market crash. Thus, although the fall in equity prices will have raised liquidity ratios by reducing the value of total assets, it is unlikely that they have yet risen much above 4 per cent, which is probably well below the institutions' desired level.

52. Pressure on institutions' liquidity from capital issues is likely to have eased very considerably since early November, with negligible equity issues and only a moderate pick-up in Eurosterling issues since then (see paras 53-54). No further equity issues are expected in November and December.

53. UK commercial companies raised a total of £1.7 billion net sterling finance in October from the domestic capital and eurosterling markets, compared to £2.5 billion in September and a monthly average of £1.5 billion in the rest of 1987. The fall in capital market issues since September largely reflects the decline in equity net issues, which fell to £1.4 billion in October, from

£2.0 billion the previous month (the October figure including £0.5 billion raised by BP in the form of a partly paid £1½ billion rights issue). Equity issues in the first half of November were negligible, and it seems likely that in the face of continuing stock market weakness, they will remain subdued for some time. In addition, the total of capital issues in the queue and those announced but not raised has fallen back by over £4½ billion between 1 October and 20 November, to stand at £4 billion, and little of this is expected to go ahead in the remainder of 1987. With companies expected to have a healthy demand for finance in the rest of the financial year, the weakness of the stock market may lead companies to increase their bank borrowing at least temporarily reversing the observed trend towards securitisation since 1984.

54. Eurosterling issues by UK companies in October were £250 million, most of which was by mortgage companies in the floating rate market. Mortgage companies have issued £1 billion of floating rate notes so far this year, reflecting their increasing share of the mortgage market (currently estimated to be about 10 per cent). In November so far, UK financial companies have raised a further £525 million. In the wake of the stock market falls and lower interest rates, activity in the euromarkets is likely to remain at higher levels in the coming months.

55. The stock of **sterling commercial paper** (SCP) outstanding rose by £150 million in October, to £2.3 billion, with net issues by UK companies of £110 million pushing the stock up to £1.6 billion. Monetary sector holdings of SCP rose by £50 million to £0.7 billion.

MG2 Division
1 December 1987

4555/22

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Monetary developments since last month's report

	Latest outturns available at time of: Apr Report	Oct Report	Nov Report
Monetary aggregates (12 month % growth)	**(Mar)**	**(Sept)**	**(Oct)**
M0 (sa)	4.1	4.9	5.6(4.9)+
M3	19.0	19.5	22.2
M4	13.9	14.9	15.7
M5	13.4	14.3	15.1
Bank lending	20.7	23.5	22.7
Bank & building society lending (est)	19.1	20.0	19.2
Interest rates (%)	**30 Apr**	**2 Nov**	**30 Nov**
3 month interbank	9.3	9.3	8.9
20 year gilt-edged (par yield)	8.8	9.3	9.3
Yield gap	0.5	0.0	0.4
3 month overseas basket	6.3	6.7	6.7
3 month interbank/euro dollar differential	2.3	1.6	1.0
Real 3 month interbank	5.1	5.1	4.7
Equity dividend yield (all-share)	3.3	4.2	4.7
IG yields (2001) assuming 5% inflation	3.7	4.5	3.9
Exchange rate			
ERI	73.2	74.6	76.4
Oil adjusted reference index	72.8	73.1	72.4
ERI/reference rate ratio*	100.5	102.1	105.5
Asset prices			
FT-A Index (% pa)	25.4	8.0	-1.4
FT-A Level (July peak: 1239)	1024	876	796
Halifax house index (% pa)**	14.5	14.5	16.2

+ Provisional November outturn

* indicates what ERI would be if exchange rate simply responded to oil prices in the ratio 1:4. In determining the reference rate the base taken is the Jan '83 - Nov '85 average for the ERI and oil price.

** figures are for April, October and November

THE BEHAVIOUR OF M0

Recent Monthly Assessments have drawn attention to the disturbing signs that M0 have been showing in the last few months. In the past, M0 has been a good current indicator of money GDP - and is available some months before the money GDP data itself. It may also be a useful forward indicator of monetary conditions though the evidence is less clear-cut. Reflecting this, M0 is now the only monetary aggregate to have target status so it has considerable presentational importance as well. This annex looks at its recent and prospective behaviour in more detail.

The Brisk Growth of Recent Months

2. Table 1 shows how M0 has moved in the current financial year to date. Month to month growth rates are liable to be affected by erratic movements in bankers' balances and so it also looks at the behaviour of notes and coin alone, which is probably a better guide to underlying conditions.

Table 1: Growth of M0 in 1987-88 to Date

Seasonally adjusted, per cent

	12 month growth		3 month annualised growth	
	M0	**Notes & Coin**	**M0**	**Notes and Coin**
April	4.8	4.6	0.5	-0.8
May	4.4	4.5	5.6	4.6
June	4.2	4.6	4.6	7.3
July	5.4	4.7	7.6	6.9
August	4.7	4.6	6.8	7.5
September	4.9	5.0	9.5	8.2
October	5.6	5.2	6.9	7.9
November	4.9	4.8	7.1	7.2

3. M0's 12 month growth rate has remained within the 2-6 per cent target range, as has that for notes and coin. But this owes much to the relatively rapid increase in M0 in the second half of 1986. Three month annualised growth rates, perhaps a better indicative of current behaviour, have been around 7-9 per cent consistently over the last few months. In consequence, M0 is now appreciably above the level indicated by its expected growth profile at Budget time; by November to the extent of about 1½ percentage points. (See Chart 7 of the main paper).

The Prospects for the Rest of the Financial Year

4. In the immediate future, there seems little prospect of a significant reversal of the current brisk growth in M0. Table 2 shows the expected path over the rest of the year.

Table 2: M0 Prospects for the Rest of the Year

		Percentage Change Over 12 Months		
		Current forecast*	**FSBR Projection**	**Change**
	December	4.3	2.3	2.0
1988	January	5.4	3.2	2.2
	February	6.6	4.3	2.3
	March	6.5	4.1	2.4

* Projections produced by MP1 Division based on the Autumn Statement forecast but modified to allow for the efffect of the equity price falls.

As table 2 reveals, by the end of the year M0 is expected to be growing by about 6½ per cent over the previous year. This would be about 2¼-2½ per cent greater than expected at the time of the 1987 Budget and ½ per cent above the top of the target range.

Reasons for the Faster M0 Growth

5. Several factors are likely to have contributed to the unexpectedly rapid growth of M0:

(i) Activity has been rising at a faster rate than the Budget projections allowed for. By 1988 Q1 real GDP is expected to be 4¼ per cent higher than a year before against 2¼ per cent in the Budget projections. Consumer spending, which is particularly relevant to M0, is now expected to rise by 6½ per cent between 1987 Q1 and 1988 Q1: the corresponding increase in the Budget forecast was 3¾ per cent;

(ii) inflation, by contrast, is expected to be little different over the year as a whole. Consumer prices, which are probably the most important to M0, have been recorded

to date as lower than expected at Budget time (though this seems not wholly plausible and later upward revision cannot be ruled out). Some acceleration is expected by the end of the year and by 1988 Q1 consumer prices are projected to be 3½ per cent higher than a year previously, the same increase as in the Budget forecast;

(iii) interest rates in the financial year to date have been below the Budget projections, by an average of about ¾ per cent. This has reduced the incentive to economise on non-interest bearing assets such as those included in M0 and has thus added to the rise;

(iv) taken together these factors account for only part of the excess rise in M0. Some of the remainder may have risen because of unanticipated changes in the pace of financial innovation - a process which, so far as M0 is concerned, is likely to be uneven over time. But there is no reliable or timely data to confirm or refute this.

6. Using what is known about the determinants of M0, it is possible to make a rough quantitative assessment of the impact of the various factors discussed above.

	Nov 1987	Mar 1988
M0 12 Month Growth Rate:		
Expected at Budget Time	3½	4
Outturn/Current Expectation	5	6½
Excess	1½	2½
Due to:		
Higher Activity	+ ½	+1¼
Higher Prices	-1	-
Interest Rates	+ ½	+ ½
Financial Innovation/Unexplained	+1½	+ ¾

Implications

7. The substantive implications of the overshoot in M0 are not straightforward. In one sense, all of the excess growth

to the end of November is unexplained. Higher activity and lower interest rates than expected at Budget time each explain about ½ per cent of extra M0 growth. But this is exactly offset by the effect of the recorded lower consumer prices. On the other hand, it seems possible that both real consumer spending and the consumer price level may be revised up in future CSO estimates. That would leave a lower unexplained component, with buoyant real activity as the major factor accounting for the high M0 growth.

8. On present estimates, higher prices directly have not contributed to the M0 overshoot and unless future upward revisions to consumer price estimates are very large then that looks likely to continue to hold. If one also takes the view that the higher real activity reflects, at least in part, a better supply side performance than seemed probable at Budget time, so that it is sustainable and not a harbinger of future inflation, then the M0 overshoot would not be a cause of major concern. With hindsight there might, on that view, have been a case for a higher M0 target range since faster M0 growth would have proved consistent with the Government's inflation objectives. On the other hand, if the real activity is purely cyclical storing up inflationary pressures, then M0's behaviour must be a matter of more concern.

9. This is a critical issue and also a difficult one. The good trade performance in the early part of the year led some outside commentators to conclude that there had been a significant upward shift in productive potential. But the more recent deterioration in net trade performance suggests that any such shift is probably quite small. The behaviour of productive potential will obviously have to be assessed in detail in preparation for the 1988 MTFS. But, on present evidence, the warranted increase in the MO range for 1987-88 looks to be modest: perhaps of the order of ½ per cent. It seems more likely, therefore, that the extra activity is temporary and ultimately unsustainable. It may be that the inflationary pressure that this might have been expected to generate has been masked to date by a higher exchange rate than would have been anticipated given domestic monetary indicators . But the continuation of the high exchange rate cannot be taken for granted and, to this extent, the rapid growth in MO is disturbing.

10. Apart from these substantive worries, there may also be a presentational problem. On present projections, the last published figures before the next Budget (for February 1988) will show M0 outside the target range.

ANNEX II

BROAD MONEY FORECAST

1A. The M3 And M4 forecasts are tentative because of uncertainties over the monetary effects both of the shakeout in equity prices and the BP sale. Using the assumptions listed below, M3 and M4 are forecast to grow in November by 1.4 percent and 1.1 per cent respectively, with annual growth remaining unchanged at 22 per cent for M3 and 15 3/4 per cent for M4. Annual growth rates are expected to rise further in the following two months.

2A. Special factors affecting the forecast are set out in Table 1. It is assumed that the fall in equity prices will have an expansionary effect on broad money, as liquidity preferences increase. The counterpart to the increased liquidity preference is assumed to be increased bank borrowing by both the private sector and the overseas sector (with expansionary effects on lending and the externals respectively) as companies substitute bank borrowing for equity finance. It is assumed that the effect on bank lending to the UK private sector is £¼ billion per month on the basis that, with equity issues falling to zero from an average of £1½ billion per month (see main text), two-thirds of companies will postpone borrowing for three months, while of the remainder, half will substitute into bond issues and half into bank borrowing. It is assumed that the effect on overseas companies' sterling bank borrowing will also be £¼ billion per month. With respect to BP, it is assumed that the expansionary effect in October will unwind in November as the remaining proceeds are paid over. It is further assumed that the Bank of England will not buy significant amounts of shares under the support arrangements.

3A. The lending forecast assumes that underlying seasonally adjusted bank lending grows by 1.6 per cent (about £3 1/4 billion), and building society lending by 1.1 per cent (about £1 1/2 billion), per month. Special factors superimposed on the underlying forecast are set out in Table 2. It is assumed that the stock market crash will boost bank lending by about £1/4 billion per month (as explained above). It is assumed that BP will use some of the £1.5 billion held in cash on 30 October to repay bank borrowing undertaken early in 1987 when BP purchased SOHIO, but that distress borrowing by BP underwriters will offset this effect within total lending.

4A. In the absence of further movements in base rates, other building societies are likely to follow the lead of the Halifax (which cut its rate to 10.3%) and announce cuts in mortgage rates of around one point effective from 1 December or 1 January. The Abbey announced a cut shortly after the Halifax but have only recently confirmed the new rate, which is to be 10.1% (The Woolwich have also announced a move to 10.2% from December). Societies may also take the opportunity to raise margins by lowering retail deposit rates by more than one point since their increased inflows following the fall in equity prices have removed the need for violent competition for retail funds, a factor which may be strengthened if the limit on a wholesale funding is raised.

5A. Given the prospect of competitive mortgage rates, and the ability to compete in the mortgage market on non-price factors such as income multiples, societies are likely to emerge from the doldrums of the past six months and regain some of the ground lost to banks and Mortgage Finance vehicles (most of these have however already announced cuts in rates). But the full effect of this, given the lag between approvals and completions, is unlikely to emerge until towards the end of the forecast period and any lowering in mortgage demand as a result of equity price falls may nullify higher market share.

6A. The main uncertainty in the forecast is of the size of the benefit to retail inflows from the equity price crash, and from the temporary gain in competitiveness in November via-a-vis the banks, which have cut deposit rates rather than mortgage rates with the falls in base rates. In November we have allowed an extra £150m for competitiveness, £100m for BP effects, plus £350m and £300m for gains from unit trust and equities respectively. In future months, the effects diminish somewhat but the forecast for November through January of £1400m, £1100m, and £950m respectively is for very high inflows relative to the average over the year so far of around £550m per month. As a result, liquid assets grow sharply, with a possible reversal to net gilt purchases of around £100m a month being the main feature.

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ANNEX TABLE 1

Broad Money Forecasts

£ million not seasonally adjusted

	1987 OCTOBER		NOVEMBER		DECEMBER		1988 JANUARY	
	M4	M3	M4	M3	M4	M3	M4	M3
(i) Underlying Increase*	2055	2380	4200	3450	4100	2150	-1325	-3150
Special Factors								
Privatisations	1500	1500	-1500	-1500	200	200	400	400
Bank/Building Society Lending	-	-	175	175	-	-	500	500
Stock market correction	-	-	500	500	500	500	500	500
Intervention	1600	1600	-	-	-	-	-	-
(ii) Total Special Factors	3100	3100	-825	-825	700	700	1400	1400
(iii) Total Increase	5155	5480	3375	2625	4800	2850	75	-1750
% Change on previous month	1.8	3.1	1.1	1.4	1.6	1.5	0.0	-0.9
% Change on previous year	15.7	22.2	15.8	22.1	16.8	23.6	17.0	23.5
Memo								
Underlying % Change on previous year	13.9	19.0	14.3	19.5	15.0	20.6	14.7	19.5
% Change expected at Budget time	14.2	16.0	14.3	15.9	15.2	17.0	15.6	16.8

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

*Based on the following assumptions:

(a) Underlying bank lending rises by £3.2 billion per month and building society lending rises by £1.5 billion per month, both seasonally adjusted

(b) The public sector contribution to M4 and M3 is as follows:

	September	October	November	December
M4	1084	-1650	150	-4950
M3	1816	-1750	150	-4850

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ANNEX TABLE 2

Lending Forecasts

£ million

	1987 OCTOBER			NOVEMBER			DECEMBER			1988 JANUARY		
	Bank Lending	Building Society Lending	Lending Counterpart to M4*	Bank Lending	Building Society Lending	Lending Counterpart to M4*	Bank Lending	Building Society Lending	Lending Counterpart to M4*	Bank Lending	Building Society Lending	Lending Counterpart to M4*
(i) Underlying Increase	2908	1448	4047	3180	1450	4630	3225	1450	4675	3270	1300	4770
Special Factors												
PSBR offset	780	-	780	-	-	-	-	-	-	400	-	400
Bill leak	-294	-	-294	-	-	-	-	-	-	100	-	100
Take-overs	-500	-	-500	500	-	500	-	-	-	-	-	-
Stock market correction	-	-	-	250	-	250	250	-	250	250	-	250
Other identified	-	-	-	-325	-	-325	-	-	-	-	-	-
(ii) Total Special Factors	-14	-	-14	425	-	425	250	-	250	750	-	750
(iii) Total Increase (seasonally adjusted)	2894	1448	4033	3605	1450	5055	3475	1450	4925	4020	1500	5520
Total Increase	2935	1510	4136	3625	1625	5250	3950	1150	5100	3575	1225	4800
% Change on previous year	22.8	13.9	19.2	22.6	13.7	19.2	22.0	13.6	18.8	23.0	13.3	19.3
Memo												
Underlying % Change on previous year	23.4	13.9	19.2	22.3	13.7	19.0	21.6	13.6	18.6	22.2	13.3	18.8
% Change expected at Budget time	20.3	15.9	18.1	19.3	15.8	17.5	18.5	15.8	16.9	18.9	16.0	17.1

*Excludes bank lending to building societies (which is included under Bank Lending)

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ANNEX TABLE 3 BROAD AGGREGATES FORECAST

£ mn u/a

	OUTTURN 1987 OCT	FORECAST NOV	DEC	1988 JAN
1. CG (OA) (SURPLUS-)	-531	-725	475	-5675
2. LABR	-390	-450	200	75
3. PCBR	-63	-225	25	-75
4. PSBR(1+2+3)	-984	-1400	700	-5675
5. NET DEBT SALES TO NBPS (-)				
GILTS	109	200	-400	-350
TREASURY BILLS etc	72	-500	100	500
NATIONAL SAVINGS	42	0	-50	-125
CTDs	-166	50	200	1000
OPS DEBT	-45	300	0	0
TOTAL	12	50	-150	1025
6. EXTERNAL FINANCE OF PUBLIC SECTOR (INC-)	2786	-400	-400	-200
7. OVER (-)/UNDER (+) FUNDING (4+5+6)	1814	-1750	150	-4850
8. STERLING LENDING TO NON-BANK PRIVATE SECTOR	2935	3625	3950	3575
(seasonally adjusted)	(2894)	(3605)	(3475)	(4025)
9. PRIVATE NET EXTERNALS AND NET NON-DEPOSIT LIABILITES	731	750	-1250	-475
10.M3 (7+8+9)	5480	2625	2850	-1750
BUILDING SOCIETIES:				
11. RETAIL DEPOSITS	1058	1050	2900	2250
12. WHOLESALE DEPOSITS NBPS	-2	0	150	150
13. HOLDINGS OF M3 (-)	-1381	-300	-1100	-575
14.M4 (10+11+12+13)	5155	3375	4800	75

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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
1983	7.1	2.9	3.7	9.8	8.6	-0.7	3.8	4.1
1984	8.6	4.9	8.0	6.6	8.6	-0.7	4.1	3.5
1985	6.6	3.2	3.0	8.2	8.4	0.3	3.5	3.3
1986	5.6	2.7	1.0	11.5	8.1	1.4	1.5	2.8
1987 Q1	5.0	2.5	1.0	13.5	8.8	0.5	1.5	2.4
Q2	4.7	2.2	2.1	12.4	8.9	-0.8	2.5	2.5
Q3							2.9	
1987 Jan			-0.1	14.4	9.0		1.0	
Feb			1.0	13.8	8.9		1.4	
Mar			2.0	12.4	8.6		2.0	
Apr			0.9	13.0	9.0		2.5	
May			2.6	12.7	9.0		2.5	
Jun			2.7	11.4	8.7		2.7	
Jul			2.7	10.6	8.5		2.6	
Aug			4.0				3.1	
Sep							2.9	

* Percentage changes on a year before.

TABLE 2: INTEREST AND EXCHANGE RATES IN G5

a. THREE MONTH NOMINAL INTEREST RATES IN THE G5 COUNTRIES*

	United States	Japan	Germany	France	UK
1983	9.1	6.5	5.8	12.5	10.1
1984	10.4	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 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 1st	7.8	3.9	3.7	8.7	8.9

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

TA[redacted]2

b. EXCHANGE RATES

EFFECTIVE EXCHANGE RATE INDICES (1975 = 100)

						CROSS RATES	
	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
1985 Q1	149.7	154.3	119.3	63.4	72.1	257.5	3.26
Q2	145.8	155.2	121.6	65.2	78.9	250.6	3.08
Q3	138.4	157.6	125.0	67.2	82.1	238.6	2.85
Q4	128.8	174.9	128.5	69.3	79.8	207.4	2.59
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
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	150.2	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 30th	94.4	231.0	152.2	72.7	76.4	132.4	1.64
% Change since dollar peak (Feb 85)	- 40	+ 47	+ 30	+ 16½	+ 9	- 49½	- 52
% Change since Plaza (Sept 85)	- 32½	+ 47½	+ 21½	+ 8	- 7	- 45	- 42½
% Change since Louvre Accord (Feb 87)	- 9	+ 10½	+ 2½	+ ½	+ 10½	- 14	- 10½

psl(aa)

Table 3 (a): Share Prices for the Major Countries

	US St.& Poor Ind.	Japan Tokyo SE New	Germany Commerz -bank	France CAC Gen.	UK FT. All share	Italy Banca Com Ital	Canada Toronto Comp.	Australia All ord.	H.Kong Hang Sang Bank	S'pore Straits Times Index
1986 (Ave.)	262.3	1322.7	1998.8	361.5	778.5	694.0	2999.5	1207.4	1258.8	732.3
1987 Jan	297.0	1644.0	1888.0	415.2	880.1	718.0	3255.6	1529.0	1643.5	937.1
Feb	319.2	1744.8	1719.7	416.8	952.7	689.1	3492.1	1558.9	1770.0	1013.1
Mar	335.2	1848.0	1710.6	446.1	1001.3	694.8	3705.8	1644.2	1796.4	1061.2
Apr	335.2	2035.9	1832.4	451.5	989.2	739.7	3774.8	1725.3	1727.9	1097.2
May	336.2	2119.7	1773.5	440.6	1070.0	716.2	3750.6	1814.3	1846.9	1187.4
Jun	348.8.	2190.2	1791.2	410.7	1134.4	527.5	3705.6	1776.8	2009.7	1238.2
Jul	361.0	1982.0	1921.3	413.2	1194.0	683.3	3925.7	1910.6	2136.1	1349.0
Aug	384.3	2093.3	2024.5	410.2	1150.6	629.2	4042.7	2102.1	2300.0	1459.2
Sep	372.4	2088.7	1979.4	424.1	1174.0	619.3	3919.4	2232.2	2442.1	1417.9
Oct	314.9	2014.5	1802.4	364.9	1079.4	616.4	3132.7	1857.1	3357.3	1216.0
15 Oct	343.6	2158.6	1902.6	366.1	1189.9	665.5	3674.9	2146.4	3695.5	1426.1
30 Nov	263.2	1847.0	1322.6	293.9	796.3	528.4	2978.3	1328.7	2138.4	800.0
Percentage changes										
1986-25 Nov	+0.4	+39.6	-33.8	-18.7	+2.3	-23.9	-0.7	10	+69.9	+9.2
15 Oct - 25 Nov	-23.4	-14.4	-30.5	-19.7	-33.1	-20.6	-19.0	-38.1	-42.1	-43.9

The monthly figures are averages of weekly rates.

7/003 TABLE 3(b)

ECONOMIST COMMODITY PRICE INDICES **1980=100**

	All items indices				SDR indices		
	SDR	Dollar	Sterling	Real*	Food	Nfa**	Metals
Annual							
1980	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1981	95.1	86.2	99.4	91.1	96.9	98.6	89.5
1982	87.9	74.7	99.2	81.6	92.3	90.4	79.1
1983	102.7	84.3	129.4	95.5	105.5	109.8	92.8
1984	105.7	83.4	144.9	97.8	116.1	105.1	89.5
1985	95.8	74.8	135.2	86.5	103.4	94.2	84.3
1986	86.9	77.7	124.0	74.5	97.3	85.0	70.5
Quarterly							
1985 Q4	90.1	74.7	121.0	80.3	101.4	86.9	75.0
1986 Q1	93.7	80.9	130.8	81.7	109.7	87.1	73.6
Q2	91.0	81.1	125.0	79.5	104.9	86.9	71.8
Q3	81.4	75.2	117.4	70.3	88.8	80.1	68.3
Q4	82.4	76.4	123.9	70.1	87.4	86.5	68.4
1987 Q1	81.6	79.2	119.2	68.9	82.4	91.0	69.0
Q2	86.8	86.4	122.2	73.3	85.5	98.0	75.2
Q3	91.4	89.6	128.9	75.9	82.6	107.1	87.5
Monthly							
December	81.9	76.1	122.7		85.4	87.5	68.4
January	80.3	77.0	118.8		82.5	88.8	66.7
February	81.7	79.6	120.5		82.6	91.7	68.5
March	82.9	81.0	118.2		82.1	92.4	71.8
April	84.2	83.8	119.0		83.2	94.8	72.6
May	87.3	87.6	122.0		87.1	97.2	74.8
June	88.9	87.8	125.2		86.2	101.7	78.3
July	90.7	88.4	127.8		84.0	105.1	84.7
August	92.2	89.8	130.9		81.2	109.7	90.2
September	91.4	90.6	128.2		82.7	106.6	87.6
October	94.8	94.2	132.2		86.7	101.9	94.3
November (prov)	93.6	97.0	127.6		86.5	97.2	93.8
Weekly							
September 8	90.4	90.3	126.4		81.8	107.2	85.7
15	91.3	90.4	127.8		83.1	107.8	86.0
22	91.8	91.0	128.8		82.8	104.5	89.8
29	93.5	91.9	131.1		84.4	103.9	92.8
October 6	95.7	94.1	134.1		86.6	105.2	95.2
13	96.1	95.4	134.7		86.7	102.5	97.9
20	93.4	93.3	131.0		86.2	101.1	91.5
27	93.9	94.2	129.1		87.2	98.9	92.7
November 3	91.0	93.6	124.9		84.3	96.8	89.8
10	92.1	96.5	125.5		85.3	95.4	92.3
17	94.8	97.8	128.8		87.3	98.3	95.4
24 (prov)	96.5	100.1	131.2		89.2	98.3	97.7

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

** Non-food agriculturals

TABLE 4: RECENT INDICATORS OF ACTIVITY AND INFLATION
(per cent changes on year earlier)

	MONEY	OUTPUT		PRICES AND UNIT LABOUR COSTS					
			Manufacturing		RPI excluding	Producer Prices***		Unit Wage Costs	
	GDP	GDP(O))	Output	RPI	mortgage payments	Output	Input	Manufacturing	Whole economy
1985-86	9.8	1985 3.7	2.9	6.1	5.2	6.3	4.4	5.6	5.1
1986-87	6.7	1986 3.0	1.0	3.4	3.6	4.3	-10.7	4.6	5.4
1986 2	6.4	1986 1 2.3	- 0.9	4.9	4.6	5.0	- 11.9	7.5	6.0
3	6.5	2 2.3	- 0.6	2.8	3.3	4.3	- 12.4	6.2	6.2
4	6.7	3 3.6	1.3	2.6	3.3	4.0	- 13.0	3.1	4.4
1987 1	7.0	4 3.9	4.1	3.4	3.4	4.0	- 5.6	1.1	5.0
2	8.1	1987 1 4.5	4.8	3.9	3.7	4.1	- 1.7	0.6	4.0
3	9.5*	2 4.1	5.2	4.2	3.6	4.5	4.6	1.2	4.6
4	8.2	3 4.5	6.1					1.5	
1988 1	8.1	4							
1987-88	8.5								
		1986 September	1.6	3.0	3.4	4.0	- 11.5	3.2**	
		October	3.8	3.0	3.4	4.0	- 7.4	2.7	
		November	4.3	3.5	3.3	3.8	- 4.9	1.8	
		December	4.3	3.7	3.5	4.0	- 4.4	1.6	
		1987 January	3.0	3.9	3.7	4.2	- 2.5	1.9	
		February	5.8	3.9	3.7	4.2	- 2.9	1.5	
		March	5.5	4.0	3.8	4.1	0.4	0.9	
		April	4.2	4.2	3.6	4.3	3.0	0.5	
		May	5.7	4.1	3.8	4.5	3.4	0.8	
		June	5.7	4.2	3.5	4.5	7.2	1.3	
		July	5.9	4.4	3.7	4.7	13.4	1.5	
		August	6.8	4.4	3.7	4.7	14.5	1.5	
		September	5.5	4.2	3.5	4.7	10.7	1.5	
		October		4.5	3.9	4.8	7.7	1.5	

* Autumn Statement forecast.

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

*** Excluding food, drink and tobacco.

TABLE 5: INDICATORS OF FISCAL STANCE

(a) Annual Data

	PSBR		PSBR excluding privatisation proceeds		PSFD	
	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	1½	0.8	1½	-0.2	-½
1971-72	1.0	1¾	1.0	1¾	0.7	1
1972-73	2.4	3½	2.4	3½	2.0	3
1973-74	4.3	5¾	4.3	5¾	3.5	4½
1974-75	8.0	9	8.0	9	6.0	6¾
1975-76	10.3	9¼	10.3	9¼	8.1	7¼
1976-77	8.3	6½	8.3	6½	7.5	5¾
1977-78	5.4	3½	5.9	4	6.6	4½
1978-79	9.2	5¼	9.2	5¼	8.3	4¾
1979-80	10.0	4¾	10.4	5	8.0	3¾
1980-81	12.7	5½	13.1	5½	11.7	5
1981-82	8.6	3¼	9.1	3½	5.2	2
1982-83	8.8	3¼	9.3	3¼	8.3	3
1983-84	9.7	3¼	10.9	3½	11.4	3¾
1984-85*	10.2	3	12.3	3¾	13.1	4
1985-86*	5.8	1½	8.5	2¼	8.3	2¼
1986-87	3.4	1	7.8	2	9.6	2½
1987-88 (October forecast)	-1.2	-¼	4.1	1	4.3	1

* If adjusted for coal strike, PSBR and PSFD ratios to GDP roughly 0.9 per cent lower in 1984-85 and 0.3 per cent lower in 1985-86.

(b) Quarterly Data

£ billion		PSBR		PSBR excluding privatisation		PSFD	
		s.a.*	u.a.	s.a.*	u.a.	s.a.+	u.a.
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	1.6	0.0
1987	Q1	0.5	-0.7	1.7	0.4	2.6	1.9
	Q2	0.2	1.1	2.5	3.4	1.6	3.3

* financial year - constrained
\+ calendar year - constrained

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Table 6: CGBR(O) April - October Comparison with Budget Profile
£ billion

Receipts	
Inland Revenue	+2.0
Customs and Excise	+ 0.4
Privatisation proceeds	- 1.1
Other receipts	+ 0.2
Expenditure	
Net debt interest payments	+ 0.3
Other departmental expenditure(1)	- 1.0
Net effect on CGBR(O)	- 2.3

(1) on a cash basis, net of certain receipts and on-lending

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)
1983	(3)	84.9	114.5	1.042	1.53	3.94	103.4	-0.3	30.9
	(4)	83.2	112.3	1.035	1.47	3.93	102.9	-0.5	29.6
1984	(1)	81.7	110.3	1.012	1.44	3.87	101.9	-0.9	29.7
	(2)	79.8	109.0	0.988	1.40	3.78	99.6	-2.1	29.7
	(3)	78.0	106.8	0.979	1.30	3.78	99.5	-0.6	28.5
	(4)	75.0	103.5	0.946	1.21	3.72	97.5	+0.3	28.6
1985	(1)	72.1	99.9	0.908	1.12	3.63	95.2	+4.1	27.7
	(2)	78.9	111.1	1.001	1.26	3.88	102.3	+4.4	27.0
	(3)	82.1	117.4	1.040	1.38	3.92	103.8	+3.6	27.4
	(4)	79.8	115.7	1.001	1.44	3.71	98.7	+3.5	28.3
1986	(1)	75.1	111.7	1.037	1.44	3.38	90.9	+4.5	17.8
	(2)	76.1	117.2	1.101	1.51	3.39	91.4	+3.2	12.8
	(3)	71.9	112.7	1.049	1.50	3.10	84.9	+3.8	12.4
	(4)	68.3	108.0	0.970	1.43	2.87	79.0	+5.1	14.8
1987	(1)	69.9	111.6	0.967	1.54	2.83	78.8	+4.3	17.9
	(2)	72.8	116.8	0.996	1.64	2.96	82.6	+2.1	18.6
	(3)	72.7	116.5	0.992	1.62	2.97	83.0	+2.8	19.0
1987	January	68.9	109.8	0.950	1.51	2.80	77.8	+4.9	18.4
	February	69.0	110.3	0.960	1.53	2.78	77.4	+4.4	17.2
	March	71.9	114.8	0.991	1.59	2.92	81.2	+3.4	18.0
	April	72.3	116.1	0.994	1.63	2.95	82.1	+2.9	18.2
	May	73.3	117.9	1.002	1.67	2.98	83.1	+1.6	18.8
	June	72.7	116.5	0.991	1.63	2.96	82.6	+2.1	18.9
	July	72.8	116.7	0.985	1.61	2.97	82.9	+2.6	19.8
	August	72.3	115.5	0.988	1.60	2.97	82.8	+3.2	18.9
	September	73.1	116.9	1.004	1.65	2.98	83.2	+2.6	18.3
	October	73.6	n/a	1.006	1.66	2.99	83.5	+1.7	18.8
	November 30th	76.4	n/a	1.055	1.83	3.00	84.3	+1.0	17.7

/ 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

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
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	3.9	6.0	3.1	4.2	4.0
	October	10.0	8.3	9.5	9.8	4.0	5.1	3.1	4.5	4.3
	November 30th	8.9	7.9	9.0	9.3	4.0	4.7	2.0	3.9	3.9

* 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	0.5	8.6	0.5	4035
1983	-1.1	9.5	-0.6	3338
1984	9.6	11.0	-1.9	1474
1985	6.8	4.2	1.8	2919
1986	2.4	5.7	-0.8	-980
1986 Q1	-2.5	3.2	3.0	744
2	0.0	2.4	1.9	146
3	2.9	7.5	-2.4	-910
4	9.3	9.9	-4.9	-960
1987 Q1	11.2	5.4	-1.5	672
Q2	6.4	10.2	+0.9	-195
Q3	9.1	12.0	+1.6	-1248
1986 Jan	-2.6	1.5	4.5	995
Feb	-2.7	2.6	3.3	204
Mar	-2.3	5.7	1.7	-466
Apr	-2.2	-1.8	2.3	283
May	-0.2	7.3	2.9	-113
Jun	2.6	1.7	1.6	-35
Jul	2.6	4.2	-1.9	-5
Aug	-0.4	9.7	-2.8	-734
Sep	6.4	8.4	-2.5	-179
Oct	7.7	5.1	-3.3	-155
Nov	11.3	10.6	-5.0	-462
Dec	9.0	15.0	-6.1	-313
1987 Jan	7.3	6.4	-2.7	85
Feb	18.2	8.5	-2.0	400
Mar	7.9	1.0	+0.3	186
April	10.4	10.6	+1.2	203
May	5.6	14.5	-0.1	-378
June	4.6	5.6	+1.5	-19
July	7.7	11.2	+0.4	-325
Aug	8.8	13.7	+1.2	-907
Sep	10.9	11.0	+3.3	-17
Oct	4.7	11.8	+2.0	-282

* excluding oil and erratics.

tables
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TABLE 10

Key Monetary Indicators

	1986-87			1987-88								
	Oct	Nov	Dec	Jan	Feb	Mar	April	May	June	July	Aug	Sept	Oct
MONETARY AGGREGATES 12 month % change (ua)													
MO	4.9	5.2	5.2	4.1	4.1	3.5	5.3	4.4	4.2	5.3	4.5	5.2	5.5
M3	18.5	18.6	18.0	17.6	19.0	19.0	20.4	18.9	19.1	20.9	22.1	19.5	22.2
M4	15.8	15.6	15.2	13.9	13.9	13.9	14.5	13.7	13.8	14.8	15.5	14.9	15.7
M5	15.1	15.1	14.4	13.2	13.3	13.4	14.0	13.4	13.5	14.3	14.8	14.3	15.1
STERLING LENDING 12 month % change (ua)													
Banks	19.4	20.8	21.8	22.5	21.7	20.7	21.4	21.7	21.5	22.2	21.5	23.5	22.8
Banks and building societies	19.0	19.6	20.2	20.4	19.8	19.1	19.4	19.4	19.2	19.4	18.8	20.0	19.2
OVER(-)/UNDER (+) FUNDING financial year to date: £mm	812	-3	-1,577	-3,931	-3,969	395	3,197	5,144	2,368	1,905	2,209	2,002	3,816
MONEY MARKET ASSISTANCE/ Level outstanding £mn	10,247	11,295	12,970	14,948	14,873	9,742	6,126	3,340	5,132	7,078	6,114	5,421	5,403
INTEREST RATES													
3 months*	11.1	11.3	11.3	11.0	10.8	9.9	9.8	8.8	9.0	9.3	10.2	10.1	9.97
20 yearϕ	10.6	10.9	10.6	10.0	9.8	9.1	9.2	8.8	8.9	9.3	10.0	10.0	9.84
EFFECTIVE EXCHANGE RATE	67.8	68.5	68.5	68.9	69.0	71.9	73.3	73.3	72.7	72.8	72.3	73.1	73.6

* Inter bank

ϕ par yield

/ banking months until August thereafter end calendar months

Table 11

MONETARY AGGREGATES 1987-88

		FEB	MAR	APR	MAY	JUNE	JULY	AUG	SEP	OCT
MO	Averaged weekly									
	Monthly change (£ million)	-228	+115	+325	+42	-93	+423	+13	+14	-32
	Monthly % change	-1.5	+0.8	+2.2	+0.3	-0.6	+2.8	+0.1	+0.1	-0.2
		(-0.8)	(+0.4)	(+0.5)	(+0.4)	(+0.2)	(+1.2)	(+0.3)	(+0.8)	(+0.6)
	12 Monthly % change	+4.1	+3.5	+5.3	+4.4	+4.2	+5.3	+4.5	+5.2	+5.5
M3	Monthly change (£ million)	+2,930	+6,797	+3,183	+3,245	+1,884	+4,212	+2,287	+1,576	+5,480
	Monthly % change	+1.9	+4.4	+2.0	+2.0	+1.1	+2.5	+1.3	+0.9	+3.1
		(+1.9)	(+2.8)	(+2.2)	(+1.4)	(+1.4)	(+2.2)	(+1.4)	(+1.4)	(+3.5)
	12 Monthly % change	+19.0	+19.0	+20.4	+18.9	+19.1	+20.9	+22.1	+19.5	+22.2
M4	Monthly change (£ million)	+2,456	+6,651	+3,535	+3,436	+4,019	5,289	+2,752	+2,888	+5,155
	Monthly % change	+0.9	+2.5	+1.3	+1.3	+1.4	+1.9	+1.0	+1.0	+1.8
		(+1.5)	(+1.7)	(+1.5)	(+0.9)	(+1.4)	(+1.5)	(+1.3)	(+1.1)	(+2.1)
	12 Monthly % change	+13.9	+13.9	+14.5	+13.7	+13.8	14.9	+15.5	+14.9	+15.7
M5	Monthly change (£ million)	+2,594	+6,945	+3,544	+4,108	+4,122	+5,350	+2,618	+2,985	+5,288
	Monthly % change	+0.9	+2.5	+1.2	+1.4	+1.4	+1.8	+0.9	+1.0	+1.7
		(+1.5)	(+1.5)	(+1.3)	(+1.2)	(+1.4)	(+1.4)	(+1.2)	(+1.1)	(+2.1)
	12 Monthly % change	+13.3	+13.4	+14.0	+13.4	+13.5	+14.3	+14.8	+14.3	+15.1
NIBMI	Monthly change (£ million)	+519	+1,058	+475	+1,168	+1,471	+99	-78	+398	+192
	Monthly % change	+1.3	+2.6	+1.2	+2.8	+3.4	+0.2	-0.2	+0.9	+0.4
		(+0.4)	(-0.9)	(-1.2)	(+2.2)	(+4.3)	(+0.3)	(+0.4)	(+0.7)	(+3.4)
	12 Monthly % change	+10.5	+10.3	+11.9	+12.1	+13.5	+12.4	+12.4	+6.1	+12.0
M1	Monthly change (£ million)	+392	+4,364	+705	+2,967	+2,102	+984	+1,163	+1,524	+2,679
	Monthly % change	+0.5	+5.8	+0.9	+3.7	+2.5	+1.2	+1.3	+1.7	+3.0
		(+0.1)	(+3.7)	(-0.3)	(+3.4)	(+2.8)	(+1.2)	(+1.7)	(+1.6)	(+4.6)
	12 Monthly % change	+21.2	22.5	+23.2	+23.7	+23.8	+22.5	+23.8	+20.3	+24.4
Net £ deposits from banks abroad		-845	-1,395	+724	+987	-946	+492	-954	-111	+1,271
Overseas non-bank £ deposits		+550	+742	-194	+765	-429	+490	+195	+37	+902
WIDER £ AGGREGATE										
	Monthly change (£ million)	+2,635	+6,144	+3,713	+4,997	+509	+5,194	+1,528	+1,685	+7,470
	Monthly % change	+1.5	+3.4	+2.0	+2.6	+0.3	+2.7	+0.8	+0.8	+3.7
		(+1.4)	(+2.0)	(+2.1)	(+2.2)	(+0.5)	(+2.4)	(+0.8)	(+1.2)	(+4.0)

NB Figures in brackets are seasonally adjusted.

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	9.7	9.2
12 MONTH % CHANGES (ua except M0)						
	SEPTEMBER	3.4	1.4	15.1	11.9	11.1
	OCTOBER	3.4	1.5	14.6	12.0	11.3
	NOVEMBER	3.3	1.9	14.8	11.9	11.4
	DECEMBER	3.7	1.6	13.8	11.1	10.3
1987	JANUARY	3.7	1.4	13.4	9.8	9.2
	FEBRUARY	3.7	0.4	14.8	9.8	9.3
	MARCH	3.8	0.3	14.6	9.7	9.2
	APRIL	3.6	1.2	16.2	10.5	10.0
	MAY	3.8	0.6	14.5	9.5	9.2
	JUNE	3.5	0.7	15.1	10.0	9.7
	JULY	3.7	1.6	16.6	10.8	10.2
	AUGUST	3.7	1.0	17.7	11.4	10.7
	SEPTEMBER	3.5	1.4	15.5	11.0	10.4
	OCTOBER	3.9	1.6	17.6	11.4	10.8

TABLE 13

MO, THE WIDE MONETARY BASE

Calendar months	Levels £ million (changes in brackets)							% change on previous Month		% change on year earlier			
	Notes and coin (nsa)	Notes and coin (sa)		Bankers' deposits	MO (nsa)	MO (s.a.)		Notes (sa) and coin	MO (sa)	Notes and Coin (nsa)	Notes and Coin (sa)	MO (nsa)	MO (sa)
1987													
June	14,946	15,075	(+91)	137	15,083	15,212	(+24)	+0.6	+0.2	+4.6	+4.6	+4.2	+4.2
July	15,271	15,166	(+91)	235	15,506	15,401	(+189)	+0.6	+1.2	+4.7	+4.8	+5.3	+5.5
August	15,337	15,258	(+92)	182	15,519	15,440	(+39)	+0.6	+0.3	+4.3	+4.6	+4.5	+4.7
September	15,349	15,376	(+118)	184	15,533	15,560	(+120)	+0.8	+0.8	+5.3	+5.1	+5.2	+5.0
October	15,299	15,457	(+81)	202	15,500	15,659	(+99)	+0.5	+0.6	+5.1	+5.1	+5.5	+5.6
November (4 of 4)	15,364	15,524	(+67)	183	15,547	15,707	(+48)	+0.4	+0.3	+4.8	+4.8	+4.9	+4.9

Weekly data	Notes (sa) and coin		Bankers' deposits	MO (sa)		% change on previous week MO (sa)
October						
7th	15,435	(+42)	190	15,625	(+111)	+0.7
14th	15,418	(-17)	192	15,610	(-15)	-0.1
21st	15,467	(+49)	223	15,690	(+80)	+0.5
28th	15,503	(+36)	202	15,705	(+15)	+0.1
November						
4th	15,510	(+7)	128	15,638	(-67)	-0.4
11th	15,511	(+1)	225	15,736	(+98)	+0.6
18th	15,522	(+11)	193	15,715	(-21)	-0.1
25th	15,553	(+31)	185	15,738	(+23)	+0.1

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 *	1459	1193	239 (18.0)	27	592	495	205	167
1986 *	1623	1589	17 (16.4)	17	553	498	523	49
1985 Q3*	1666	1157	479 (17.0)	30	590	384	153	539
Q4*	2172	1367	783 (18.0)	22	766	660	594	152
1986 Q1*	858	1271	-431 (17.5)	18	740	462	167	-511
Q2*	1591	1645	-74 (16.6)	20	478	522	321	270
Q3*	1783	1884	-112 (15.7)	11	56	402	1099	226
Q4*	2262	1556	686 (16.4)	20	938	649	403	272
1987 Q1*	1240	1120	105 (16.1)	15	484	594	279	-117
Q2*	1564	1240	309 (16.4)	15	612	457	182	313
Q3*	1487	1272	200 (16.1)	15	410	515	364	198
Sep	1043	1238	-210 (16.1)	15	193	630	594	-374
Forecast								
1987 Q4*	2158	1373	770 6 16.9)	15	970	610	262	316
Oct+	2122	1399	708 (16.4)	15	814	309	535	464
Nov	2046	1568	463 (16.4)	15	976	111	0	959
Dec	2306	1152	1139 (16.9)	15	1418	1411	250	-773
1988 Jan	1750	1217	518 (17.1)	15	1119	1298	250	-917

* Monthly averages
+ Estimated ; part data

TABLE 15

THE COMPONENTS OF M3

	NOTES AND COINS	BANK DEPOSITS			M3
		RETAIL		WHOLESALE	
		NIB	IB		
% 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)					
OCTOBER	5.8	15.3	18.6	22.8	18.5
NOVEMBER	4.0	13.3	17.1	25.6	18.6
DECEMBER	5.1	14.4	18.7	22.2	18.0
1987 JANUARY	3.7	14.7	16.2	23.0	17.6
FEBRUARY	3.2	14.5	17.2	25.7	19.0
MARCH	-2.1	16.9	17.4	25.4	19.0
APRIL	6.5	14.5	17.1	27.9	20.4
MAY	3.7	16.4	19.0	23.1	18.9
JUNE	4.1	18.0	15.4	25.1	19.1
JULY	6.4	15.3	12.1	32.3	20.9
AUGUST	4.4	16.4	15.1	32.8	22.1
SEPTEMBER	6.1	6.1	14.2	31.8	19.5
OCTOBER	4.9	15.4	12.4	34.6	22.2
Over 6 months (sa)					
1987 MAY	-0.3	13.2	12.9	36.2	21.9
JUNE	-1.9	25.4	12.1	37.0	24.0
JULY	2.2	14.4	12.3	46.5	26.3
AUGUST	4.0	13.2	14.5	41.5	25.1
SEPTEMBER	8.9	16.0	12.7	32.1	21.7
OCTOBER	7.1	33.2	11.7	33.3	25.0
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 MAY	-74	963	270	1178	2337
JUNE	-35	1814	491	43	2313
JULY	294	-178	660	2836	3612
AUGUST	10	150	533	1702	2395
SEPTEMBER	-2	310	434	1651	2393
OCTOBER	262	1238	170	4519	6189

[1]March on March

TABLE 16 SECRET

THE 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)							
NOVEMBER	18.6	15.6		24.0	15.6	5.4	15.1
DECEMBER	18.0	17.0		17.9	15.2	1.7	14.4
1987 JANUARY	17.6	15.6		43.0	13.9	2.4	13.2
FEBRUARY	19.0	16.1		62.8	13.9	2.8	13.3
MARCH	19.0	17.2		57.6	13.9	4.3	13.4
APRIL	20.4	16.1		55.7	14.5	4.2	14.0
MAY	18.9	17.9		60.0	13.7	8.5	13.4
JUNE	19.1	16.4		69.0	13.8	8.3	13.5
JULY	20.9	13.4		69.2	14.9	5.0	14.3
AUGUST	22.1	15.6		67.6	15.5	2.8	14.8
SEPTEMBER	19.5	10.8		62.0	14.9	4.0	14.3
OCTOBER	22.2	13.5		60.0	15.7	5.1	15.1
Over 6 months (sa)							
1987 MAY	21.9	10.4		82.9	13.1	8.0	12.8
JUNE	24.0	11.1		72.8	15.2	8.7	14.8
JULY	26.3	11.5		45.1	18.4	12.0	18.1
AUGUST	25.1	12.2		48.3	18.0	6.0	17.4
SEPTEMBER	21.7	10.1		25.3	16.8	9.8	16.5
OCTOBER	25.0	9.1		23.5	18.3	15.8	18.2
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 MAY	2337	908	100	-857	2488	914	3402
JUNE	2313	1269	-2	412	3992	236	4228
JULY	3612	936	249	-571	4237	-108	4129
AUGUST	2395	1363	39	12	3799	-167	3632
SEPTEMBER	2393	223	430	207	3270	110	3380
OCTOBER	6189	658	-2	-622	6227	68	6295

[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[1] SOCIETIES	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)				
NOVEMBER	15.6	12.2	8.1	12.8
DECEMBER	17.0	11.7	8.4	13.0
1987 JANUARY	15.6	11.4	9.1	12.3
FEBRUARY	16.1	11.0	10.1	12.4
MARCH	17.2	10.8	10.8	12.6
APRIL	16.1	10.6	11.0	12.1
MAY	17.9	10.5	10.8	12.6
JUNE	16.4	10.6	10.5	12.1
JULY	13.4	10.6	9.2	11.0
AUGUST	15.6	10.7	9.7	11.9
SEPTEMBER	10.8	11.7	9.3	10.8
OCTOBER	13.5	10.5	8.3	10.9
Over 6 months (sa)				
1987 MAY	13	10.4	10.5	11.7
JUNE	17.2	11.1	10.4	12.7
JULY	13.1	11.5	8.9	13.6
AUGUST	13.9	12.2	8.1	13
SEPTEMBER	14	10.1	6.9	11.5
OCTOBER	19.7	9.1	5.6	10.9
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 MAY	1233	908	185	2326
JUNE	2305	1269	269	3843
JULY	482	936	203	1621
AUGUST	683	1363	105	2151
SEPTEMBER	744	223	75	1042
OCTOBER	1408	658	-70	1996

NOTES

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

SECRET

TABLE 18

Breakdown of Bank Lending by instrument (banking months before 1986 October)

					unadjusted		
		Advances	**Commercial Bills**	**Investment[1]**	**Other[2]**	**Total**	**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
Contributions to annual bank lending growth[4]							
Monthly changes							
1986							
	November	2221	420	129	483	3253	3374
	December	2655	1369	221	-272	3973	3599
1987	January	905	562	104	-136	1435	1640
	February	2617	-426	70	345	2606	2750
	March	4644	-2026	336	420	3374	2470
	April	1727	-409	210	-398	1130	2202
	May	3626	-2125	290	497	2288	2502
	June	5154	751	-8	-1215	4682	3979
	July	2090	1679	-98	890	4643	4530
	August	2840	-1519	119	-288	1154	2653
	September	5456	+13	-15	66	5520	4330
	October	2545	-500	77	813	2935	2894

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
4. First four columns equal fifth column.

TABLE 19

S E C R E T

COUNTERPARTS TO BROAD MONEY

£ million

	M3	M4
LATEST MONTH : OCTOBER 1987		
PSBR	-984	-984
Debt sales (-): Other Public Sector	-45	-111
Central Government	57	-607
Public external & fc finance (-)	2786	2786
Over(-)/under(+)funding	1814	1084
£ lending to private sector	2935	4136
Bank/bank & b society externals (-)	628	514
Bank/bank & b society £NNDLs (-)	103	-579
TOTAL	5480	5155
FINANCIAL YEAR 1987/88 TO DATE		
PSBR	458	458
Debt sales (-): Other Public Sector	1697	813
Central Government	-1483	-1803
Public external & fc finance (-)	3144	3144
Over(-)/under(+)funding	3816	2612
£ lending to private sector	22352	31904
Bank/bank & b society externals (-)	-2028	-2666
Bank/bank & b society £NNDLs (-)	-2273	-4776
TOTAL	21867	27074
FINANCIAL YEAR 1986/87		
PSBR	3343	3343
Debt sales to private sector (-)	-1235	-5840
Public external & fc finance (-)	-1700	-1700
Over(-)/under(+)funding	408	-4197
£ lending to private sector	30299	47406
Bank/bank & b society externals (-)	-676	-1553
Bank/bank & b society £NNDLs (-)	-4601	-8689
TOTAL	25430	32967

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	Equities	Bonds	Euro-Sterling (*)	TOTAL	Sterling	Foreign Currency	TOTAL
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		471	209	350	1030	12328	2362	14690
Q2	5465	5083	10548		1369	344	325	2038	12586	1575	14161
Q3	5764	5592	11356		1431	290	231	1952	13308	3688	16996
Q4	10433	4667	15100	67	2338	-52	281	2634	17734	591	18325
1987											
Q1	7074	3464	10538	368	1553	-782	1231	2370	12908	7358	20266
Q2	8571	4240	12811	651	2259	352	655	3917	16728	4633	21361
Q3	11068	3889	14957	284	5950	732	570	7536	22493	-1129	21364
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	16.75	1402	198	297	1914	13989	2054	16043
1987 to q3	8904	3864	12769	434	3254	101	819	4608	17376	3621	20997
1987											
JANUARY	1390	1304	2694	150	500	-67	110	693	3387	1369	4756
FEBRUARY	2600	980	3580	104	870	20	315	1309	4889	2402	7291
MARCH	3084	1180	4264	114	183	-735	806	368	4632	3584	8216
APRIL	1288	1590	2878	192	828	110	355	1485	4363	1236	5599
MAY	2268	1295	3563	171	415	184	150	920	4483	2693	7176
JUNE	5015	1355	6370	288	1016	58	150	1512	7882	749	8631
JULY	4525	1302	5827	131	1840	182	210	2363	8190	-2214	5976
AUGUST	1055	1269	2324	9	2090	390	150	2639	4963	1020	5983
SEPTEMBER	5488	1318	6806	144	2020	160	210	2534	9340	11	9351
OCTOBER	2626	1510	4136	111	1385	190	45	1731	5867	3513	9380

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

	BANK BORROWING				OTHER BORROWING						ALL BORROWING
	Sterling		Foreign		Sterling			Euro-Sterling(*)			
	ICC's	BSOC's	Currency	TOTAL	Commercial Paper	Equities	Bonds	ICC's	BSOC's	TOTAL	TOTAL
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	-606	2786		924	170	235	0	1329	4115
Q2	747	248	47	1042		1092	327	230	0	1649	2691
Q3	229	161	1469	1859		873	274	130	600	1877	3736
Q4	874	351	1444	2669		525	89	200	475	1289	3958
1986											
Q1	3935	89	-879	3145		471	209	350	935	1965	5110
Q2	-172	178	-1120	-1114		1369	344	325	1075	3113	1999
Q3	1055	976	-1072	959		1431	290	231	1575	3527	4486
Q4	4604	187	-50	4741	67	2338	-52	281	0	2634	7375
1987											
Q1	1063	306	2085	3454	368	1553	-782	1231	290	2660	6114
Q2	984	-490	727	1221	651	2259	352	655	50	3967	5188
Q3	3390	-188	-141	3061	284	5950	732	570	100	7636	10697
Average per quarter											
1984	1749	200	68	2016	0	282	63	84	0	429	2445
1985	1309	192	589	2089	0	854	215	199	269	1536	3625
1986	2356	358	-780	1933	17	1402	198	297	896	2809.	4743
1987 to q3	1812	-124	890	2579	434	3254	101	819	147	4754	7333
1986:- AUGUST					12	698	126	100	650	1586	
SEPTEMBER					31	385	113	0	750	1279	
OCTOBER					76	898	-49	105	0	1030	
NOVEMBER					77	835	-3	0	0	909	
DECEMBER					-86	605	0	176	0	695	
1987:- JANUARY					150	500	-67	110	0	693	
FEBRUARY					104	870	20	315	140	1449	
MARCH					114	183	-735	806	150	518	
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					144	2020	160	210	100	2634	
OCTOBER					111	1385	190	45	0	1731	

* 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.

TABLE 22 SECRET

FUNDING AND MONEY MARKET ASSISTANCE - FINANCIAL YEAR 1987/88

£ million u/a

	APR-OCT 1987		
CGBR	3744		
Gilt sales to nbps and overseas (inc-)	-4816		
Other CG debt sales to nbps incl Treasury bills* (-)	-1607		
CG external and fc finance other than BGS(-)	7892		
Funding of the CGBR Over(-)/under(+)	5213		5213
		Other BGS sales (-)	547
OPS net of on lending	-3286		
		Other CG debt sales (-)	45
OPS debt sales to nbps(-)	1697		
		Notes and coins (-)	-1138
OPS currency finance(-)	192		
		Other incl exchequer (-)	-603
Funding of OPS Over(-)/under(+)	-1397		
		CG bank deposits (+)	79
Funding of PSBR Over(-)/under(+)	3816	Total influences* (surplus+,shortage-)	4143
		Change in bankers deposits (-)	196
		Change in level of assistance (+) #	-4339
		of which	
		Issue Department bills	-2784
		Banking Department bills	682
		Market advances	-1364
		Repos	-874
		Level of assistance	
		End March 1986	13317
		End March 1987	9742
		End October 1987	5403

* Treasury bills usually included below the line in the Money Market Assistance Table

Surplus on influences leads to a fall in assistance and vice versa

TABLE 23 SECRET

MONETARY AGGREGATES : FORECAST GROWTH RATES

percent

Not seasonally adjusted			M0	M3	M4
1 MONTH % CHANGE TO:					
1987 AUG			0.1	1.3	1.0
SEP			0.1	0.9	1.0
OCT			-0.2	3.1	1.8
NOV	)	*	0.3	1.4	1.1
DEC	)FORECAST		n/a	1.5	1.6
JAN	)		n/a	-0.9	0.0
12 MONTH % CHANGE TO:					
1987 AUG			4.5	22.1	15.5
SEP			5.2	19.5	14.9
OCT			5.2	22.2	15.7
NOV	)	*	4.9	22.1	15.8
DEC	) FORECAST		n/a	23.6	16.8
JAN	)		n/a	23.5	17.0
Seasonally adjusted					
1 MONTH % CHANGE TO:					
1987 AUG			0.3	1.4	1.3
SEP			0.8	1.4	1.1
OCT			0.6	3.5	2.1
NOV	)	*	0.3	0.8	0.9
DEC	) FORECAST		0.8	1.6	1.4
JAN	)		0.5	0.7	0.2
12 MONTH % CHANGE TO:					
1987 AUG			4.7	21.8	15.0
SEP			4.9	19.8	14.6
OCT			5.6	22.9	15.7
NOV	)	*	4.9	22.7	15.7
DEC	) FORECAST		4.3	23.9	16.7
JAN	)		5.4	23.3	16.8

* Provisional November outturn for M0

91/G.LD.4496.001

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TABLE 24: MO FORECAST

SEASONALLY ADJUSTED

	LEVELS £ MILLION			% CHANGE ON PREVIOUS MONTH		% CHANGE ON YEAR EARLIER	
	Notes and coin	Bankers' Deposits	MO	Notes and coin	MO	Notes and coin	MO
ACTUAL							
April	14,916	204	15,120	+0.7	+0.5	+4.6	+4.8
May	14,984	204	15,188	+0.5	+0.4	+4.5	+4.4
June	15,075	137	15,212	+0.6	+0.2	+4.6	+4.2
July	15,166	235	15,401	+0.6	+1.2	+4.7	+5.4
August	15,258	182	15,440	+0.6	+0.3	+4.6	+4.7
September	15,376	184	15,560	+0.8	+0.8	+5.0	+4.9
October	15,457	202	15,659	+0.5	+0.6	+5.2	+5.6
November	15,524	183	15,707	+0.4	+0.3	+4.9(4.9)	+4.9(5.0)
FORECAST							
December	15,650	190	15,840	+0.8	+0.8	4.7(4.6)	4.3(4.2)
January	15,730	190	15,920	+0.5	+0.5	5.3(5.0)	5.4(5.2)
February	15,780	190	15,970	+0.3	+0.3	6.5(6.5)	6.6(6.6)
March	15,830	190	16,020	+0.3	+0.3	6.9(6.9)	6.5(6.5)

* Last month's forecast in brackets.

TABLE 25: MONEY MARKET INFLUENCES

£ million
not seasonally adjusted

	Actual		Forecast	
	1987 OCT	NOV	DEC 1988 JAN	
A. Money market influences				
(i) CGBR (+)	-730	-250	800	-6200
(ii) Reserves etc (+)	3921	25	0	0
(iii) Notes and coin (-)	-537	300	-800	725
(iv) National Savings (-)	1	0	-50	-125
(v) CTDs (-)	-282	50	200	1100
(vi) Gilts (-)	-1474	-125	-775	-525
(vii) Other Exchequer items etc	-221	0	0	0
A. TOTAL MONEY MARKET INFLUENCES (Market surplus + / shortage -)	678	0	-625	-5025
B. Money market operations				
(i) Commercial bills (purchase +):				
Issue Department - outright	-1191			
- repo terms	1080			
Banking Department	-83			
(ii) LA bills (purchase +)				
Issue Department	-49			
Banking Department	-28			
(iii) Treasury bills (purchase +)	-400	-1800	500	1500
(iv) Market advances	56			
(v) Export Credit/Shipbuilding Repos	0			
(vi) Gilt Repos	0			
B. TOTAL MONEY MARKET OPERATIONS	-615	0	625	5025
C. Change in bankers balances = A + B	63			
D. TOTAL ASSISTANCE OUTSTANDING (excluding Treasury bills) = previous level + B - B(iii)	5403	7200	7325	10850
of which commercial bills	5808	5257	5375	8900

TABLE 26

SECRET

TIMING OF GOVERNMENT SHARE SALES

The timetable now stands as follows:

1987

BP(I)	(28 October (Offer closes) (30 October (dealings start)

An issue of BT bonus shares is planned in December/January based on a record date of 30 November, and that £250m of BT prefs are to be repaid in December.

1988

BGC(III)	19 April
BAA(II)	19 May
BP(II)	30 August

1989

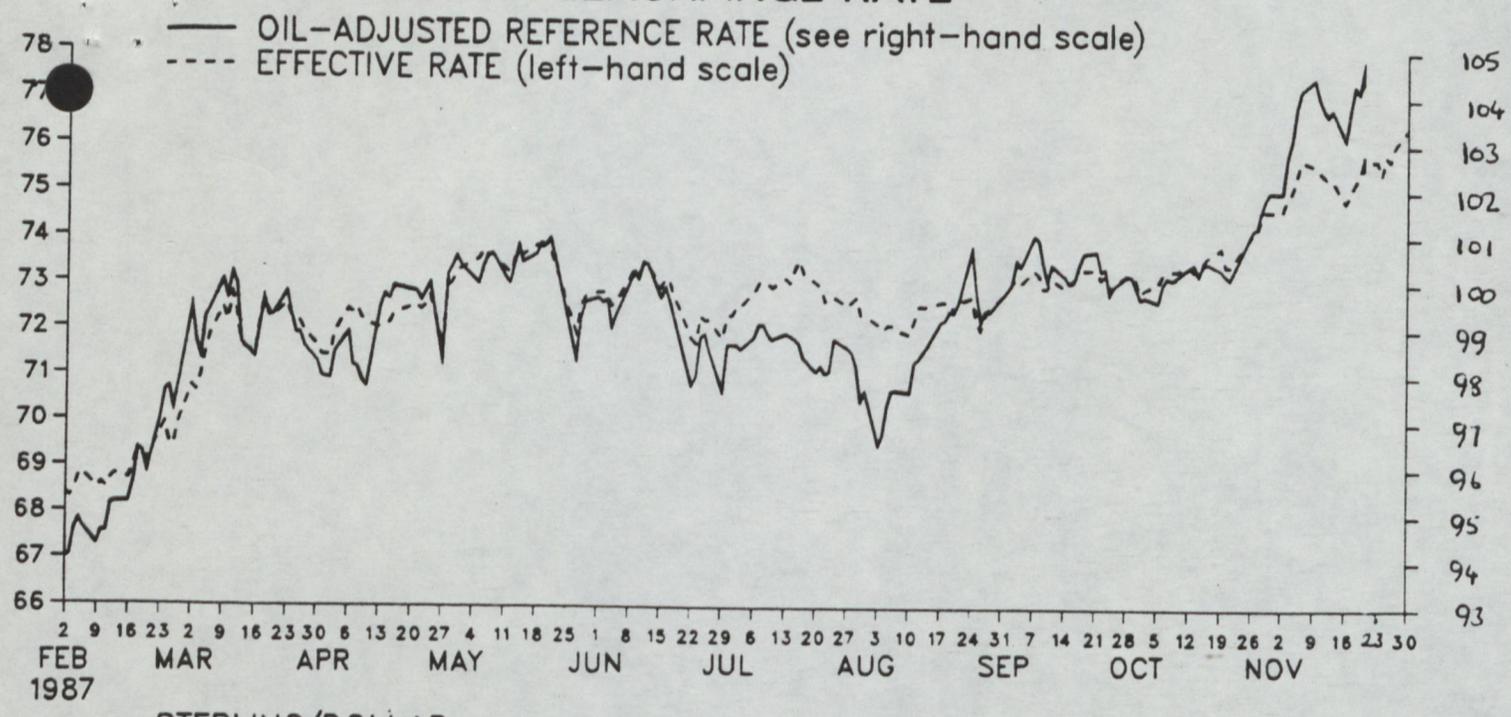
BP(III)	27 April

SECRET

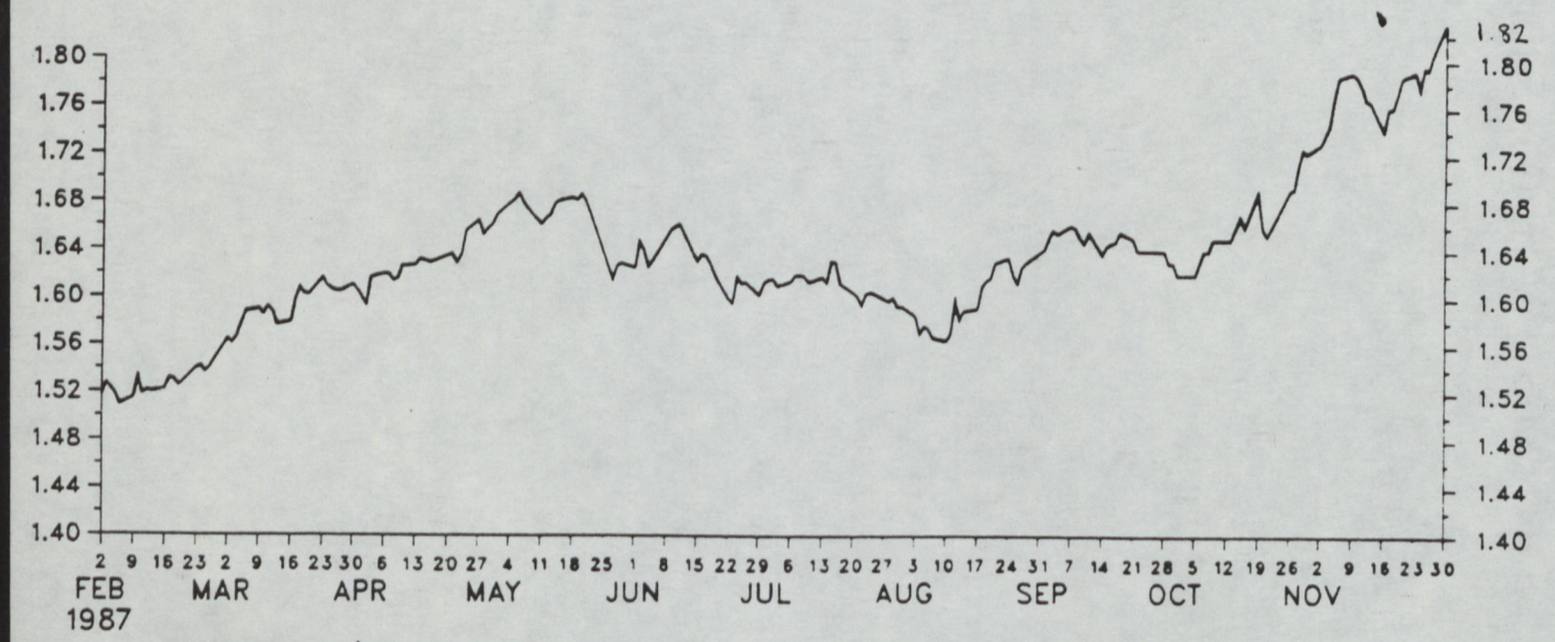
MONTHLY MONETARY REPORT : CHARTS

I	Exchange Rate Short Term
II	UK/US interest rate differential
III	Narrow money growth
IV	Broad money growth
V	Real M0 growth
VI	Real Broad money
VII	FSBR budget profile M0
VIII	FSBR budget profile M3
IX	M0 growth against target
X	Retail Deposits
XI	Bank and Building Society Lending
XII	£ Corporate bond issues
XIII	Bill Mountain
XIV	Nominal Interest Rates
XV	Yield Curve
XVI	Real Yields
XVII	House prices 1
XVIII	House prices 2
XIX	Capital Markets

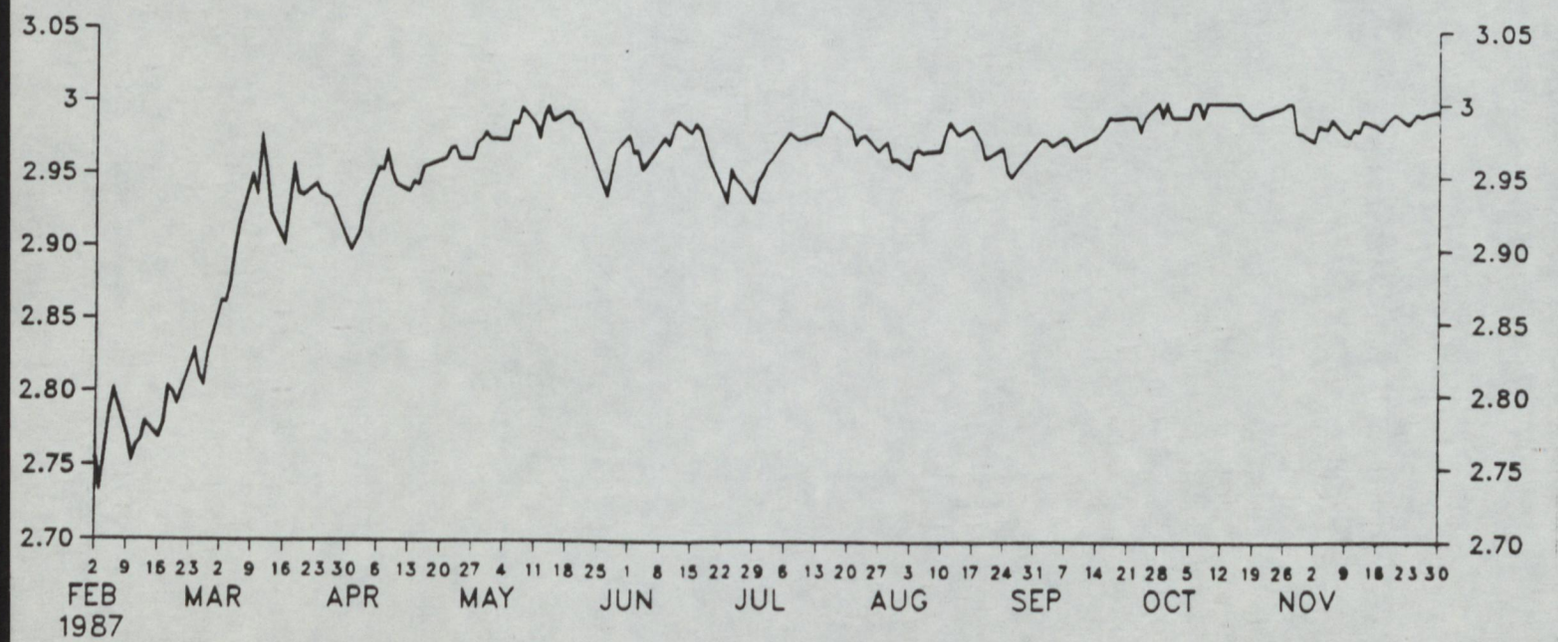
CHART I:EXCHANGE RATE



STERLING/DOLLAR



STERLING/DEUTSCHEMARK



UK/US INTEREST RATE DIFFERENTIAL

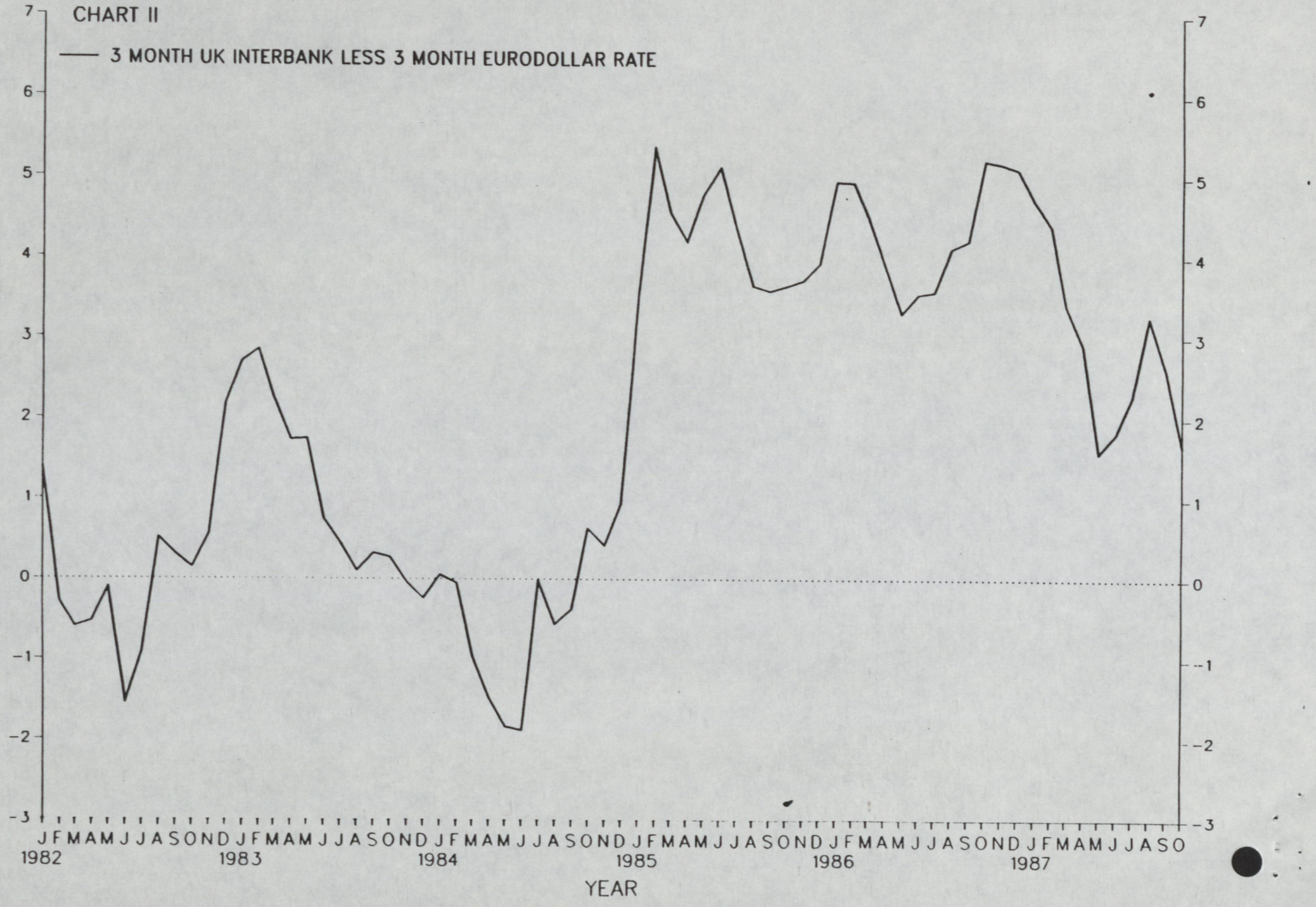


CHART III NARROW MONEY

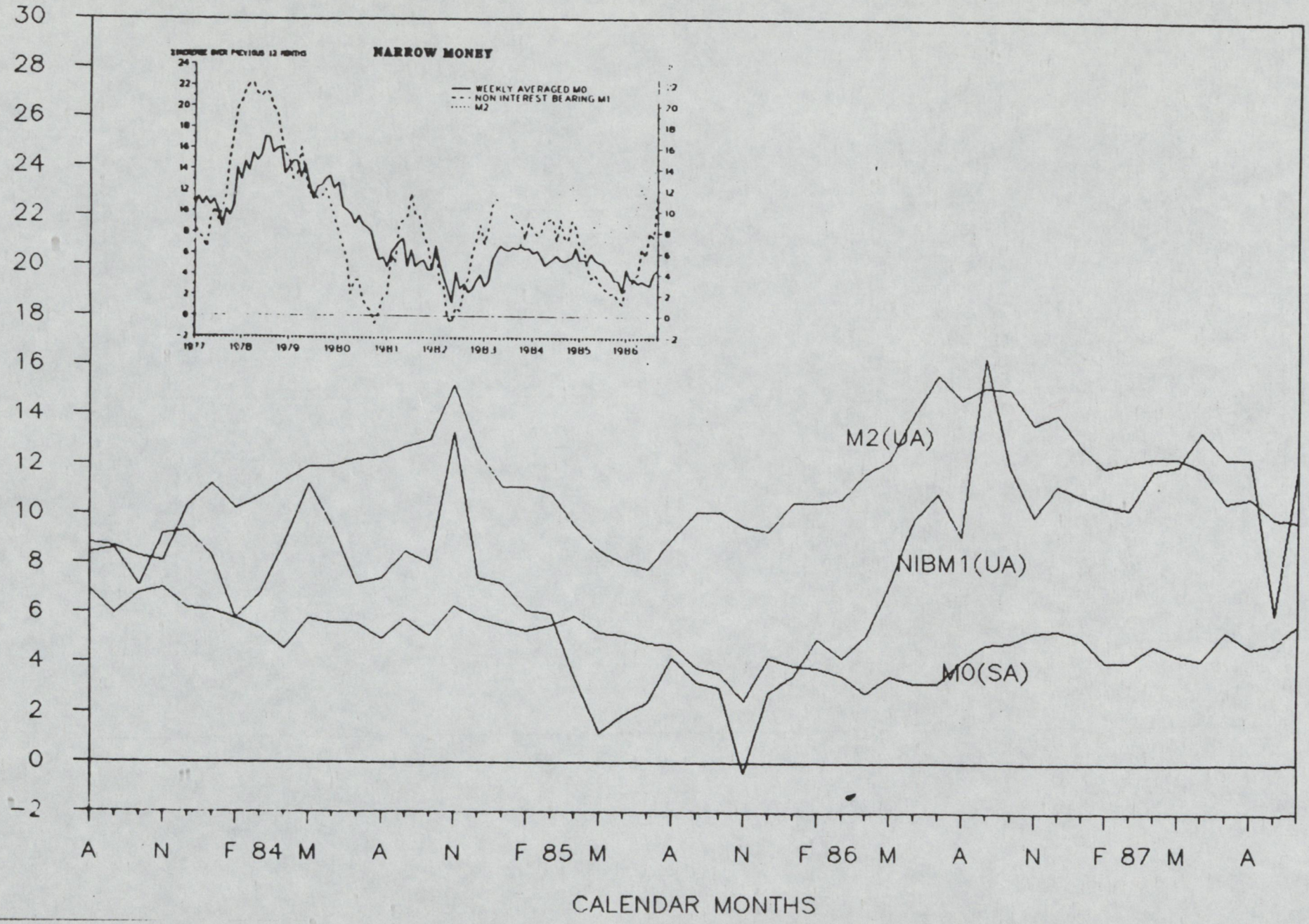


CHART IV BROAD MONEY

Annual percentage growth (ua)

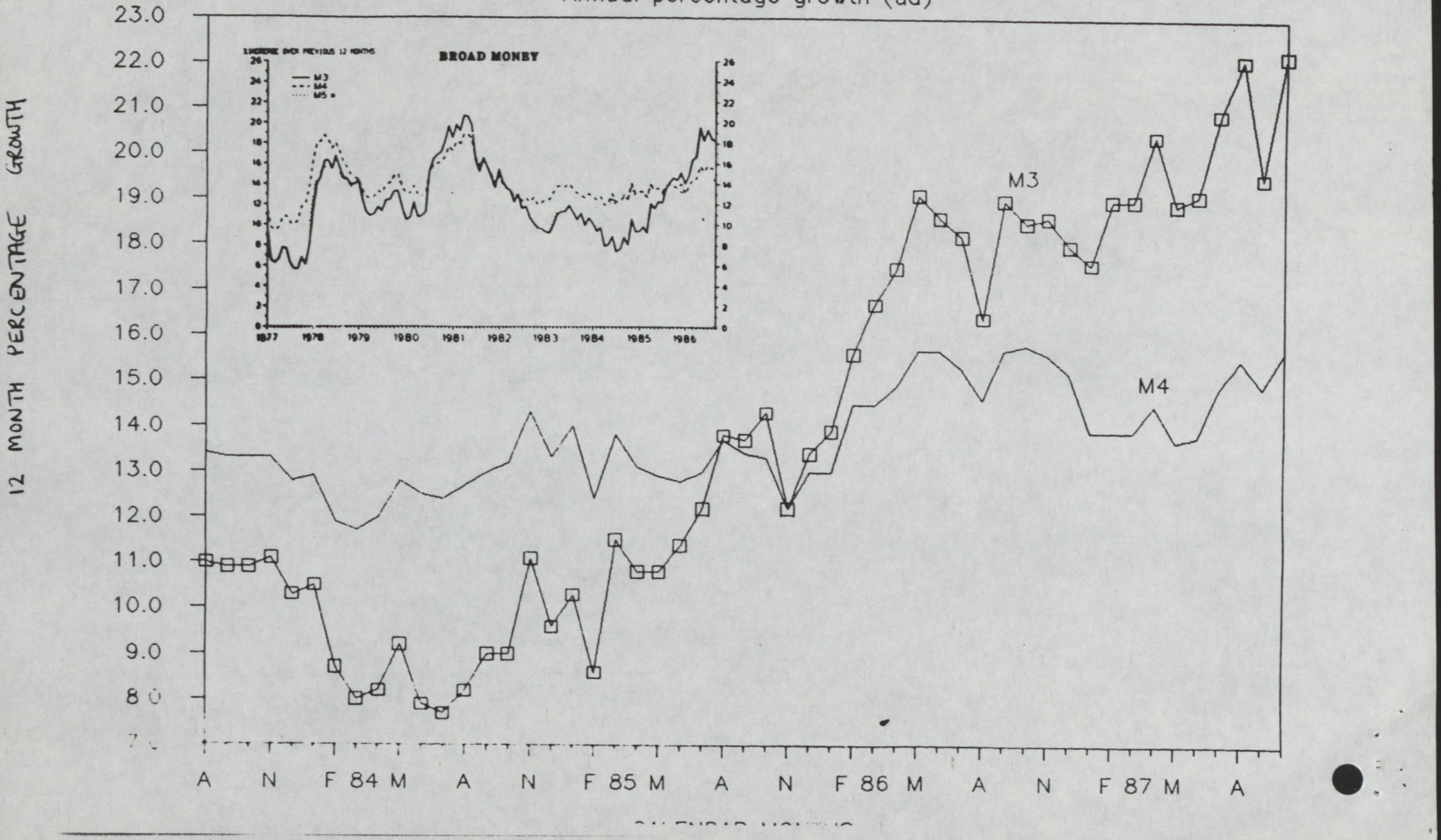


CHART V REAL M0

Annual percentage growth (sa)

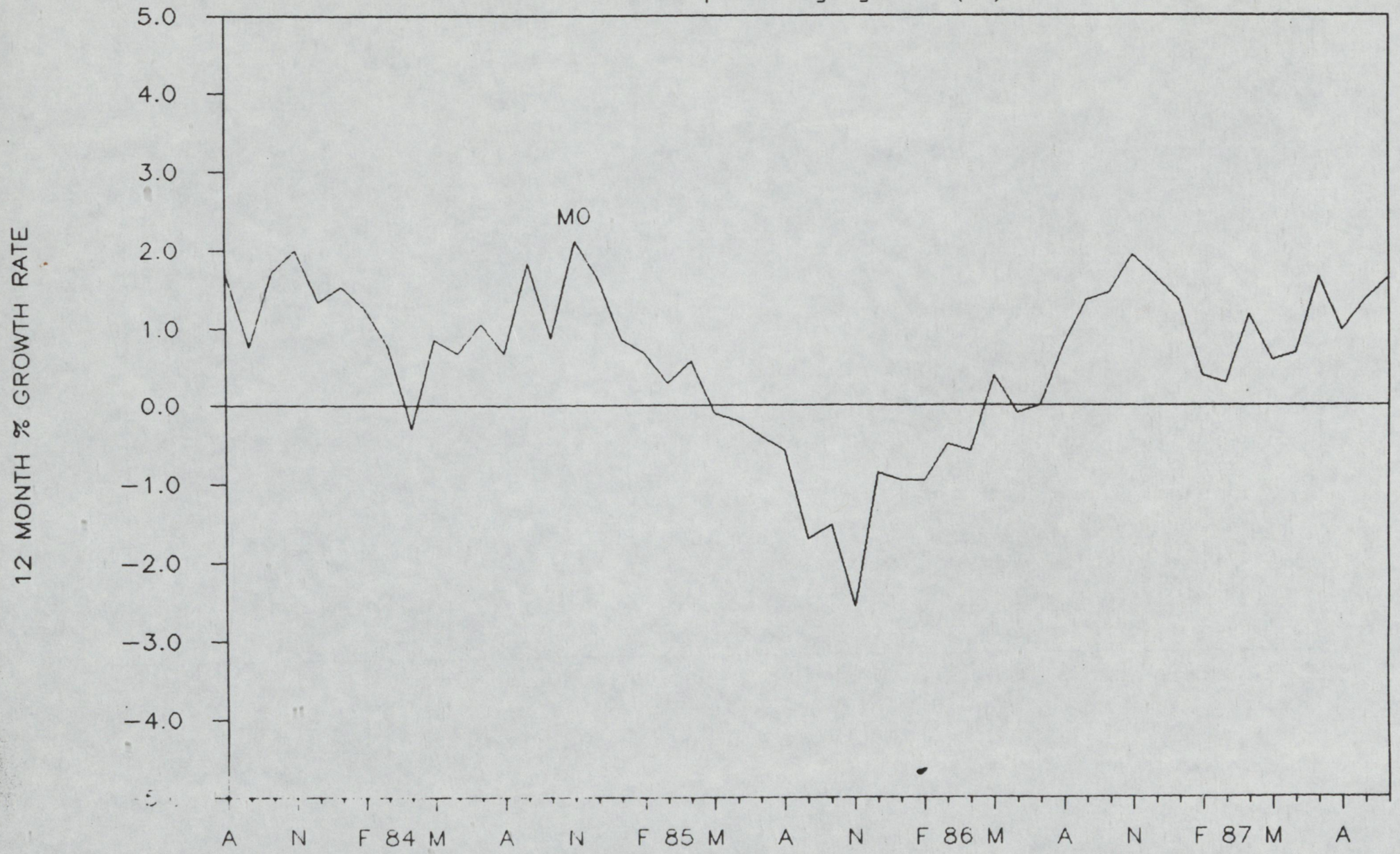


CHART VI REAL BROAD MONEY

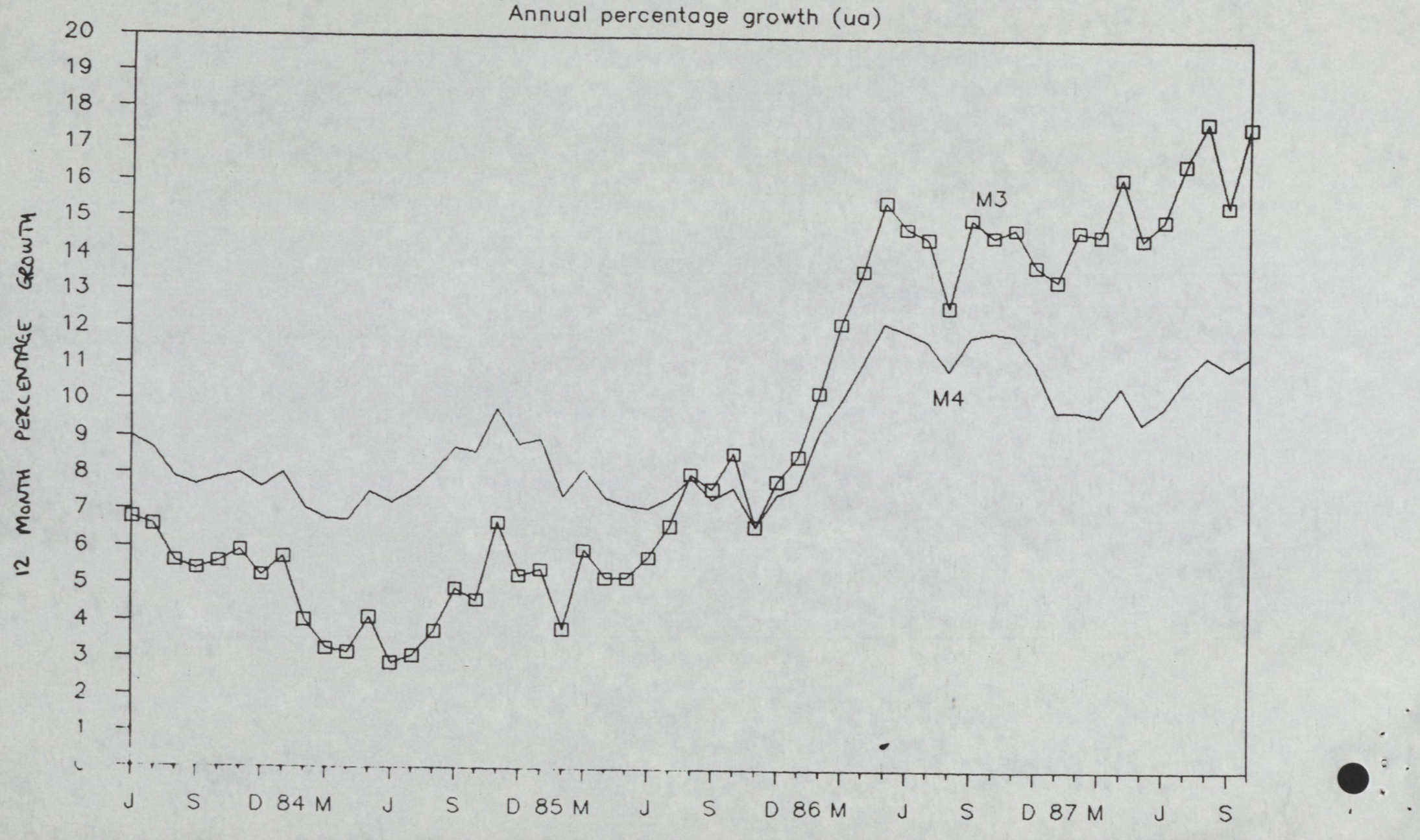


CHART VII

COMPARISON OF 1987 BUDGET FORECAST WITH OUT-TURN FOR M0

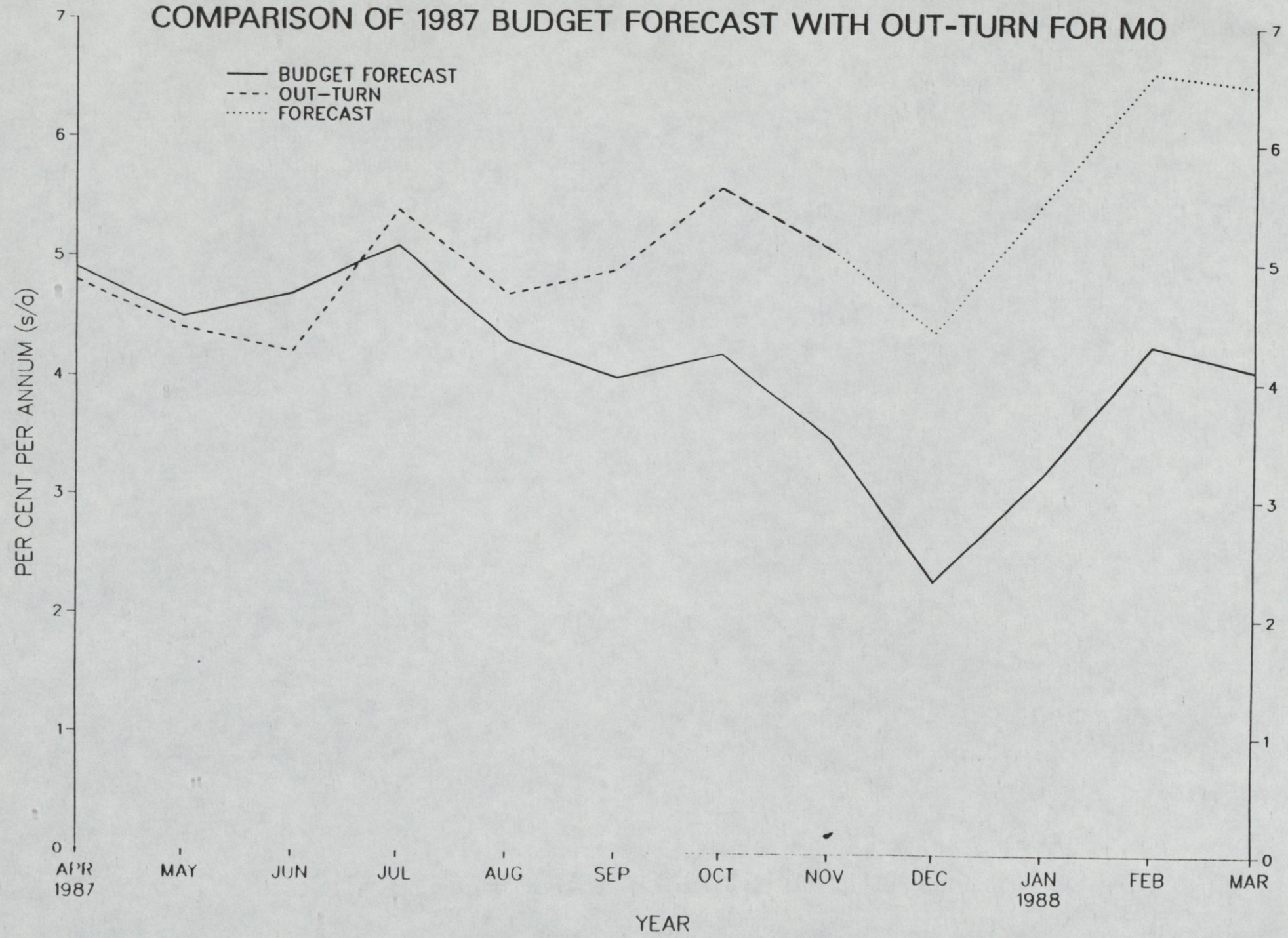


CHART VIII

COMPARISON OF 1987 BUDGET FORECAST WITH OUT-TURN FOR M3

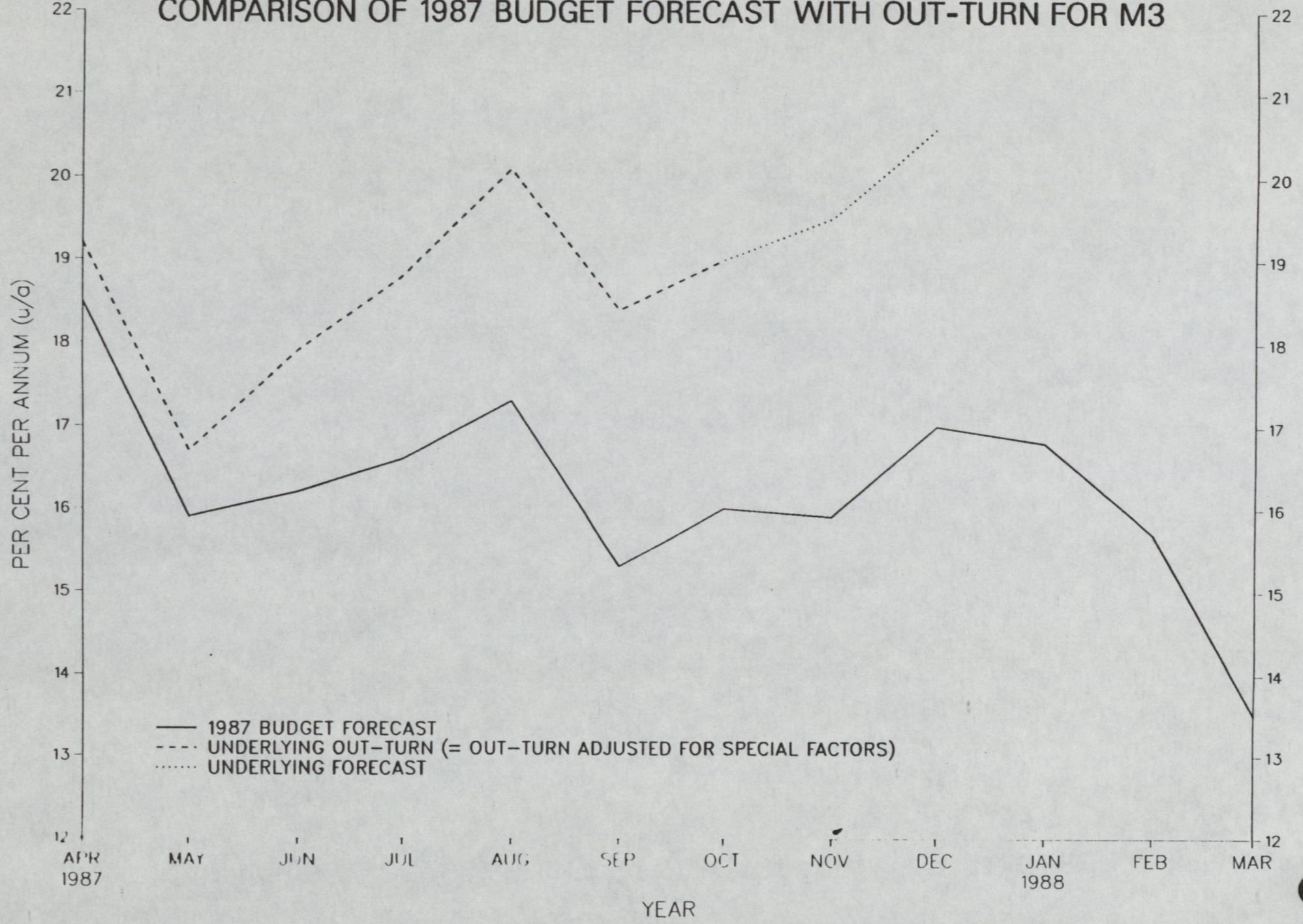


Chart IX

MO GROWTH (SA) COMPARED TO TARGET RANGE

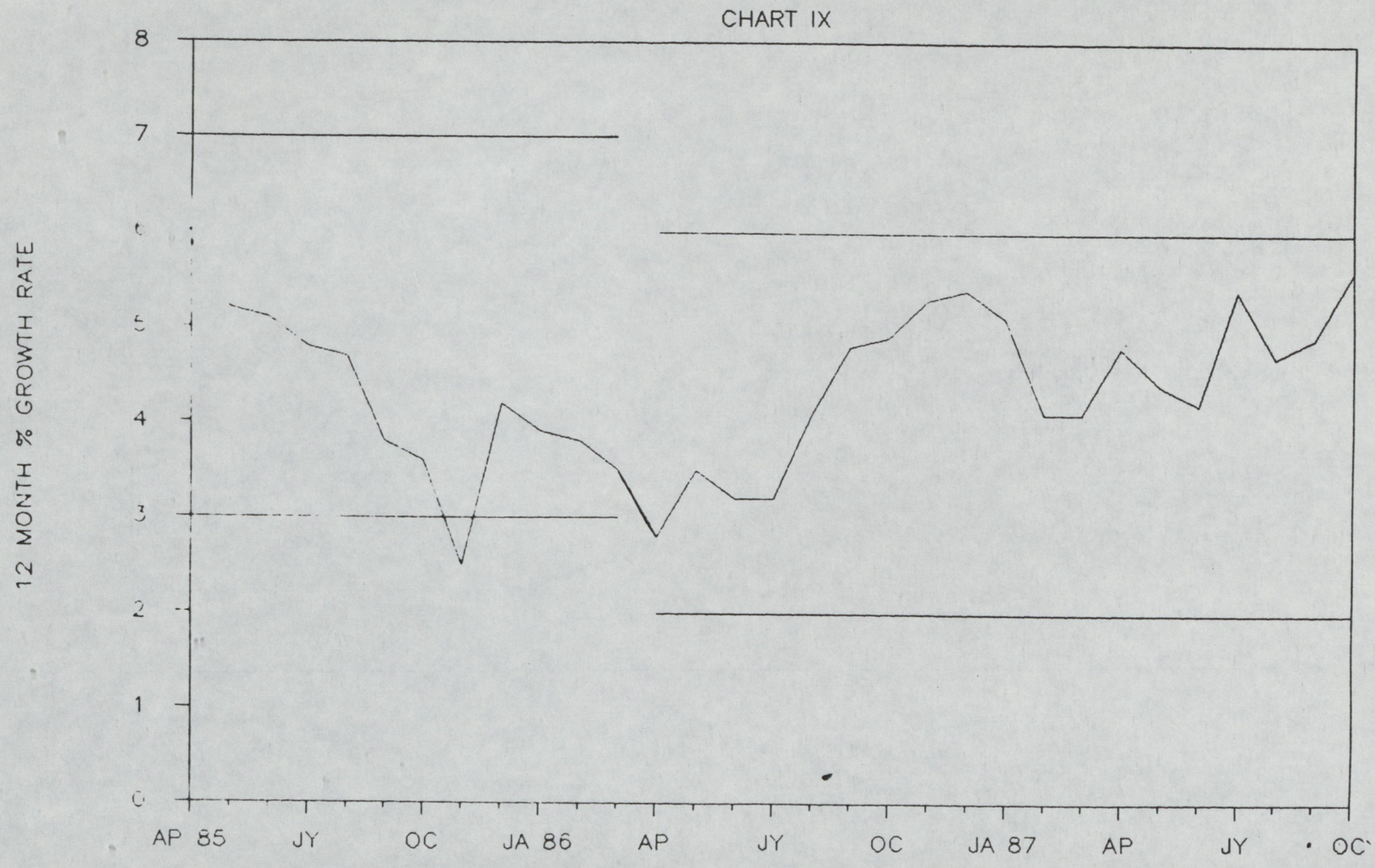


CHART X RETAIL DEPOSITS

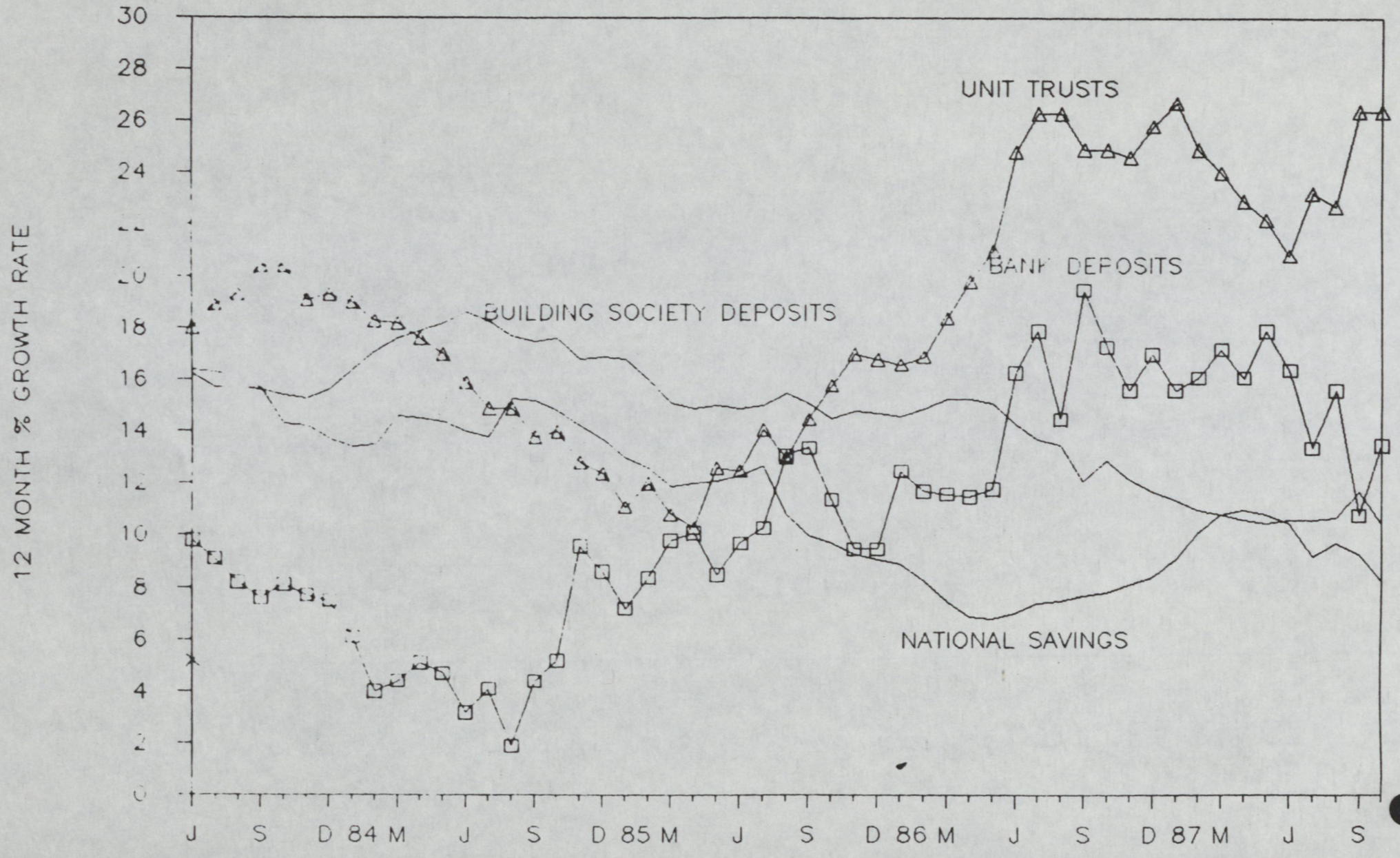


CHART XI

ANNUAL GROWTH OF THE STOCK OF LENDING TO THE NON BANK PRIVATE SECTOR

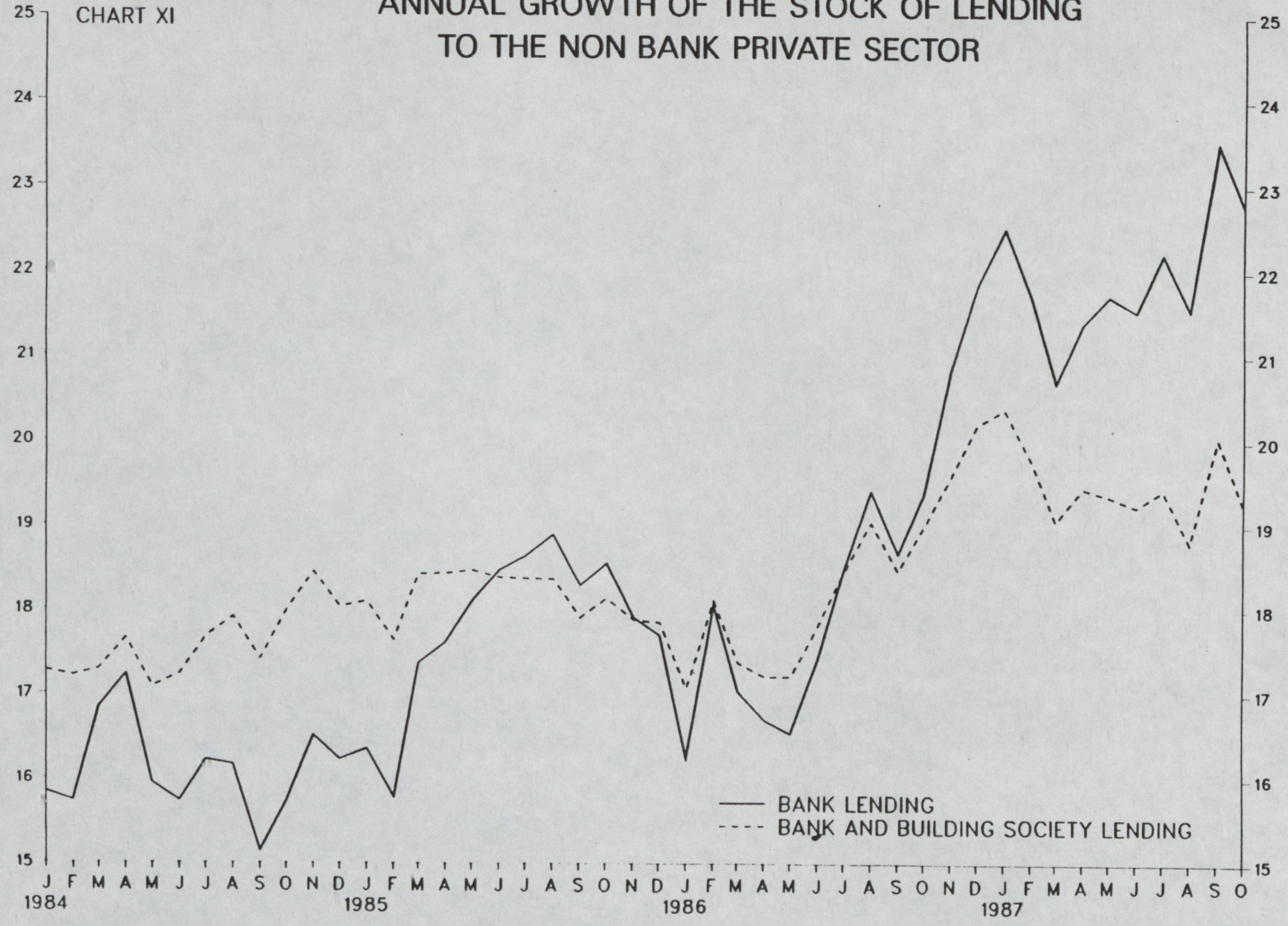
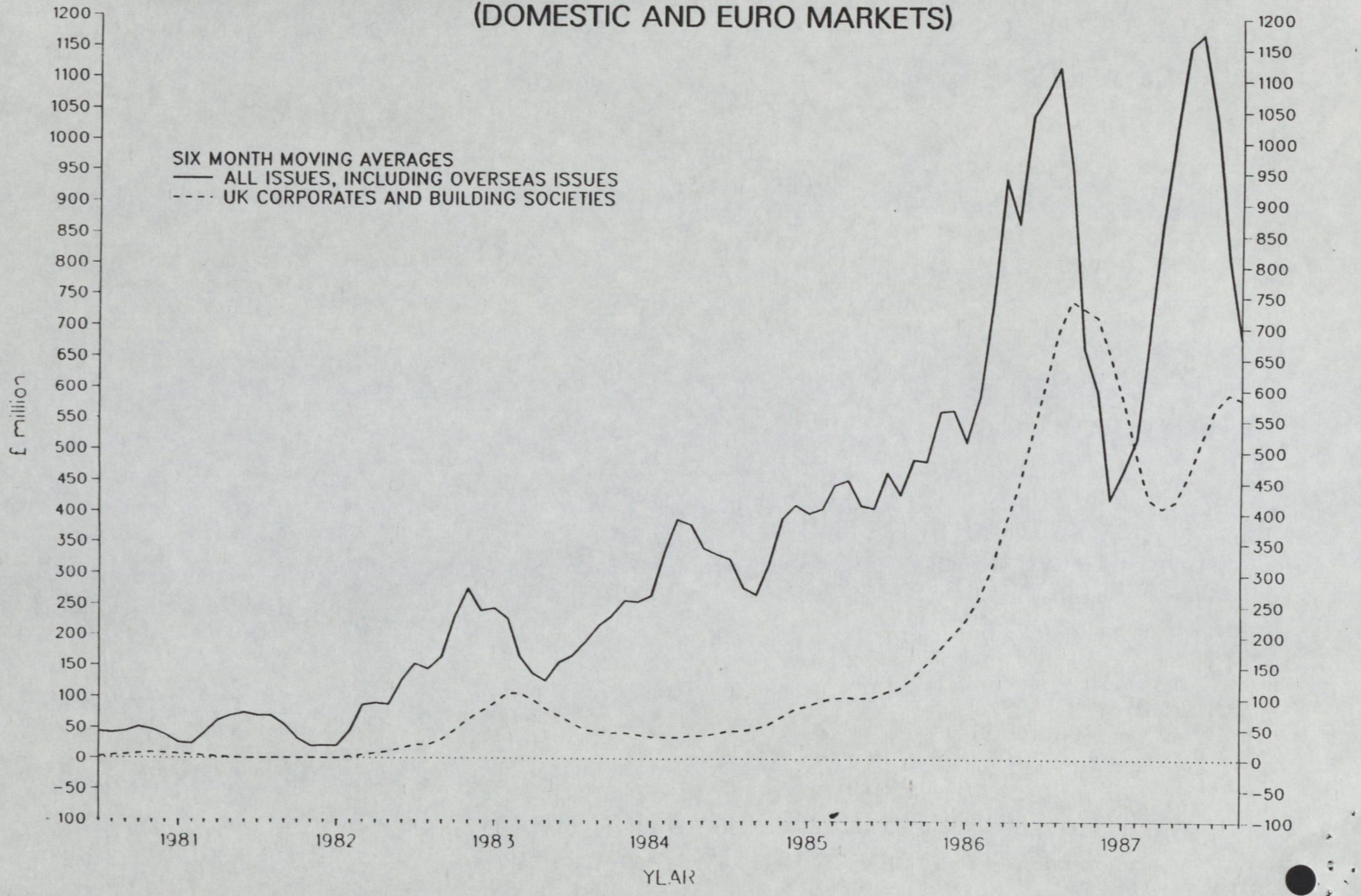


CHART XII

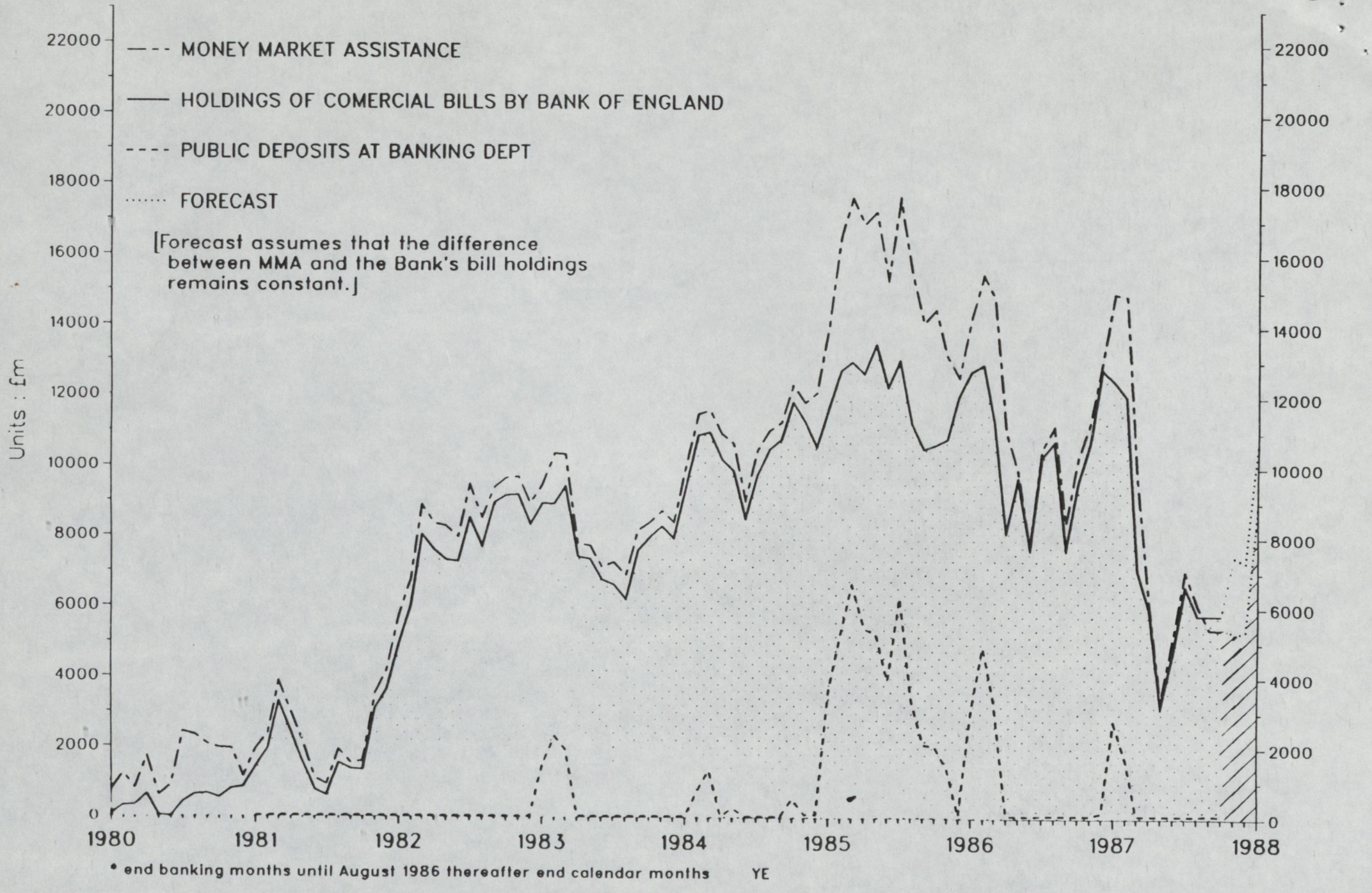
STERLING BOND ISSUES BY UK AND OVERSEAS INSTITUTIONS

(DOMESTIC AND EURO MARKETS)

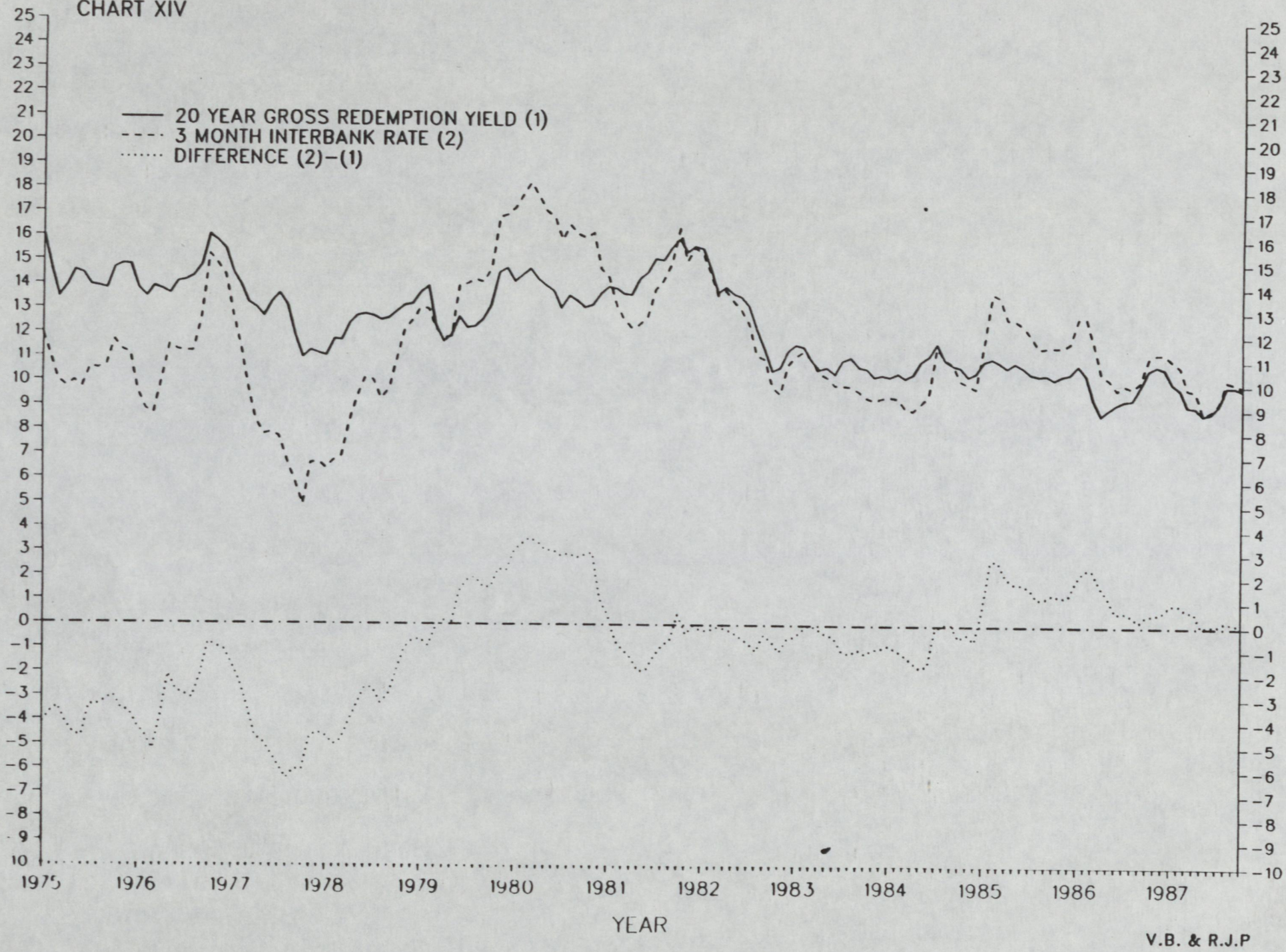


BILL MOUNTAIN RANGE

CHART XIII



NOMINAL INTEREST RATES



Time / Yield Curves of British Government Stocks

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.

23rd November 1987

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 4.46

CHART XV

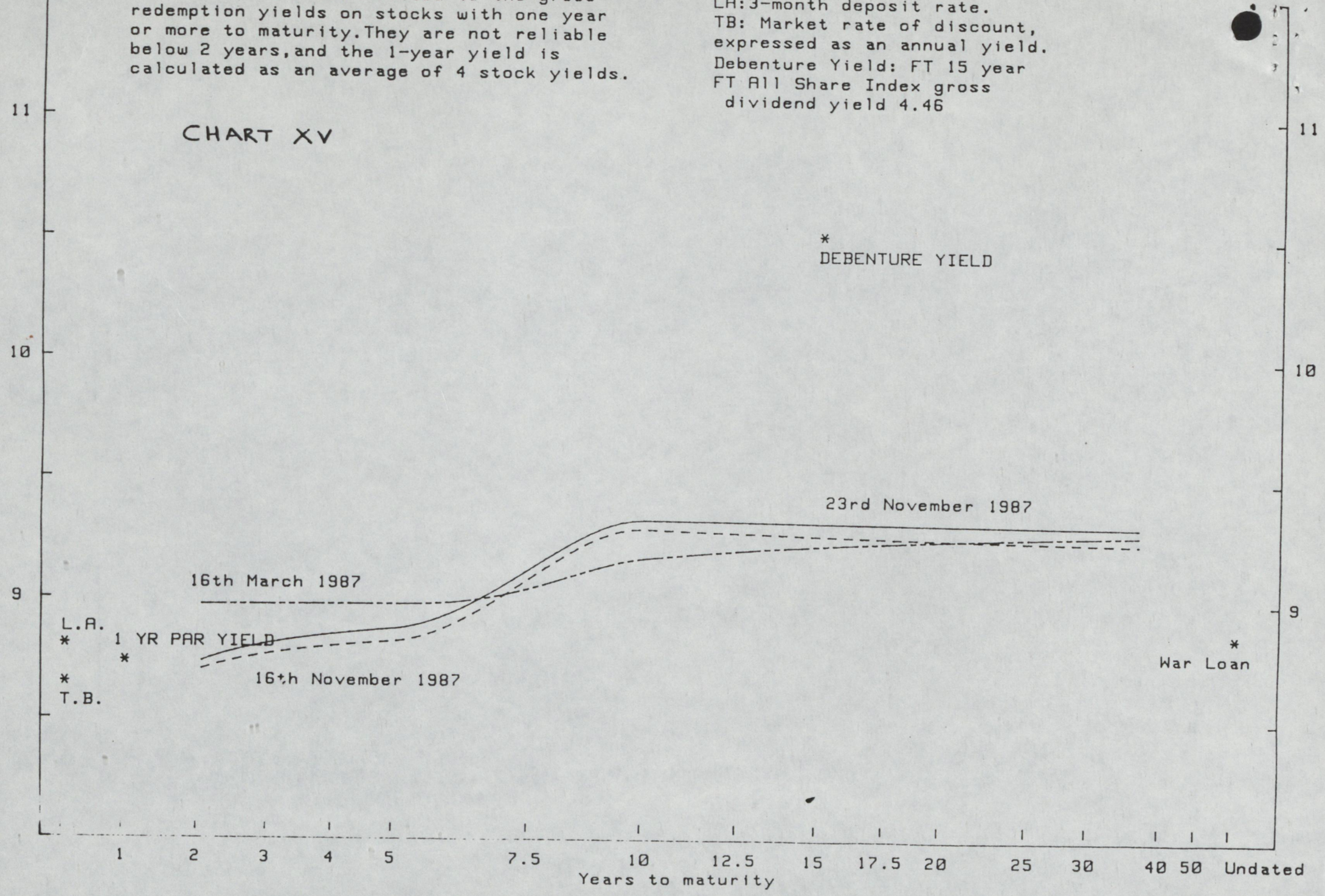
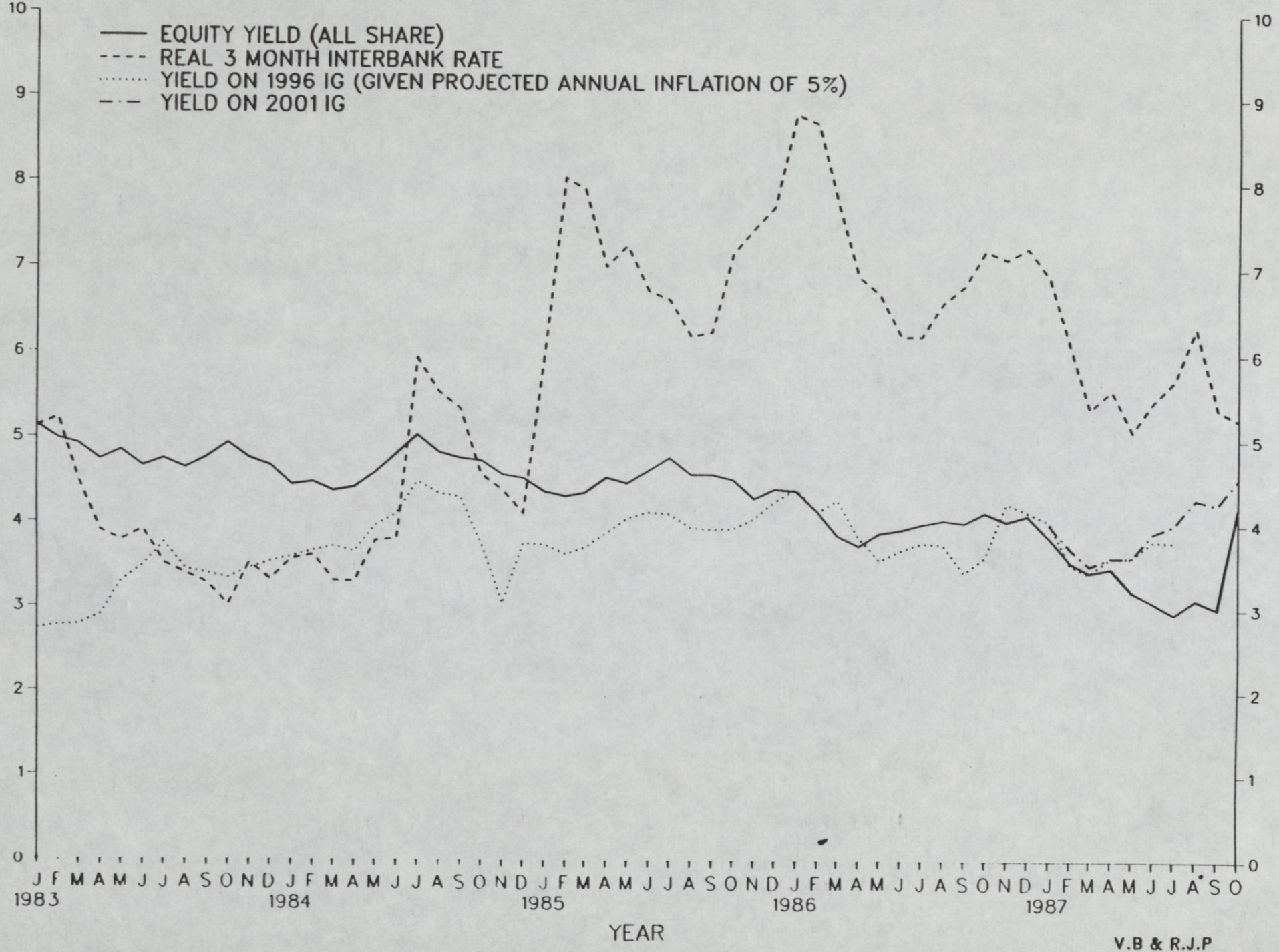


CHART XVI

REAL YIELDS



V.B & R.J.P

ANNUAL HOUSE PRICE INFLATION

CHART XVII

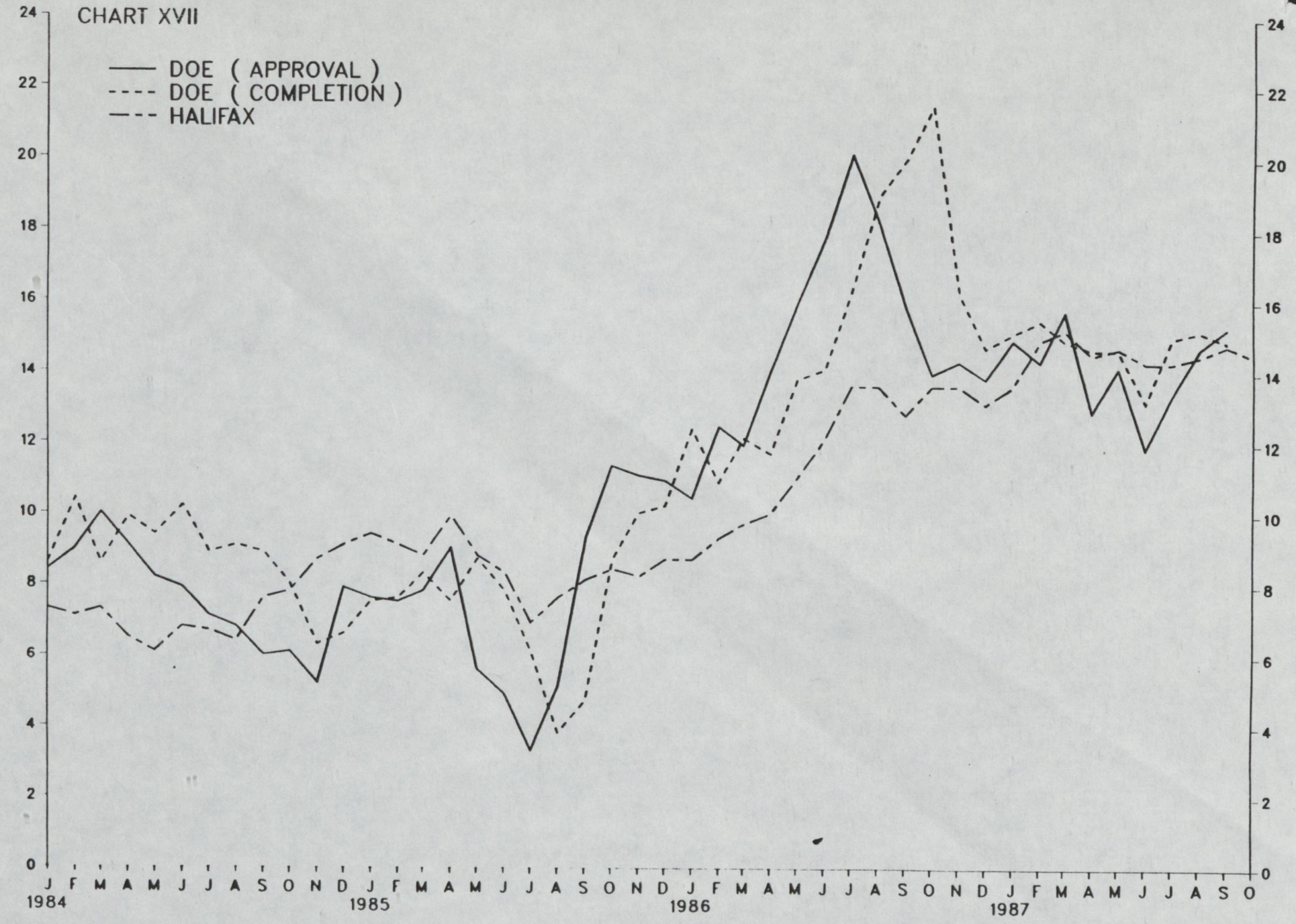
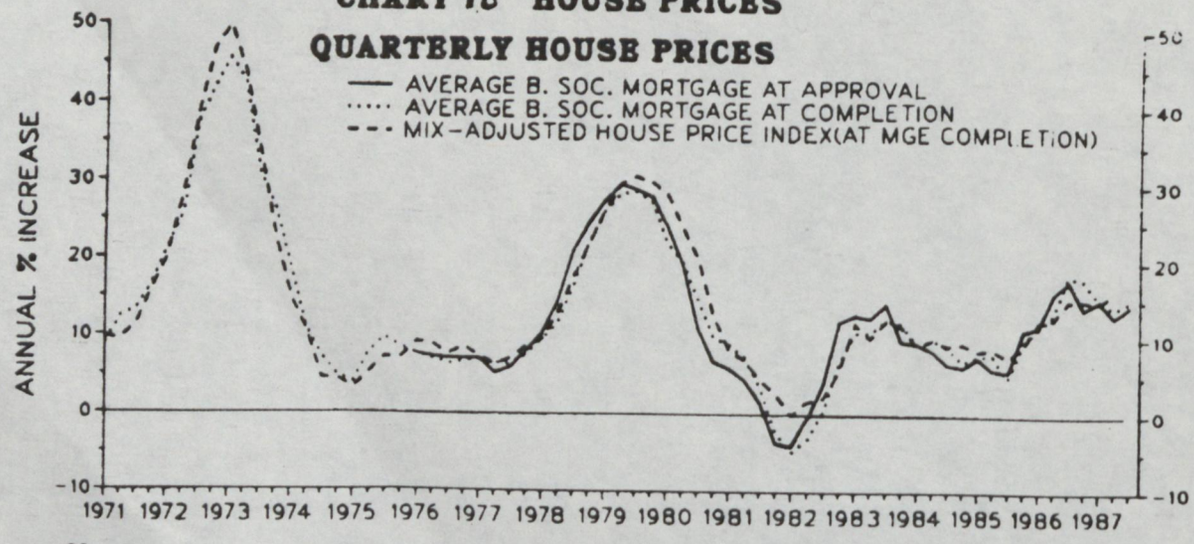
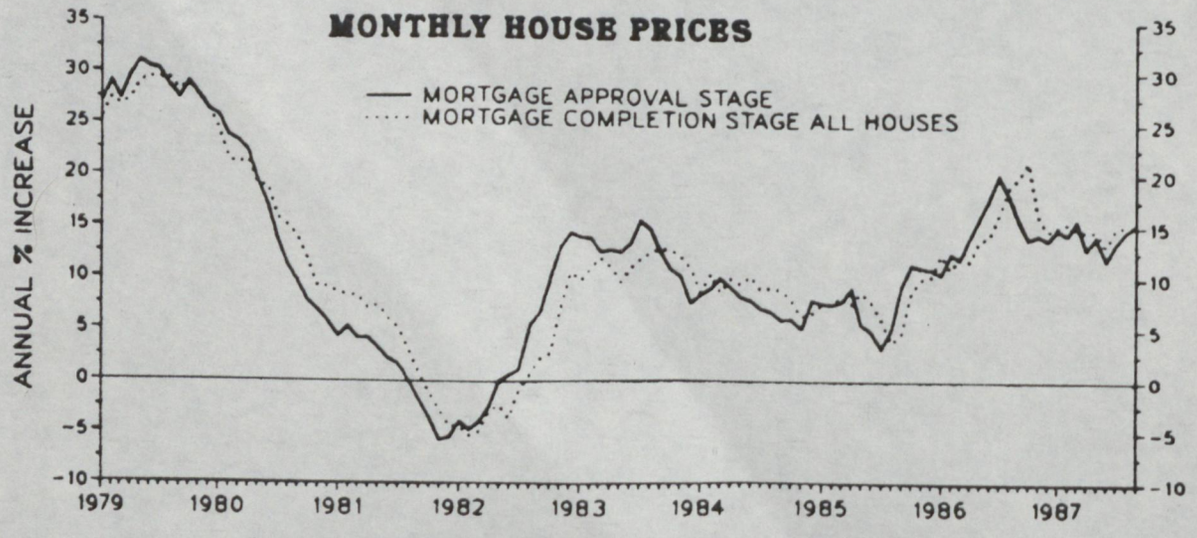
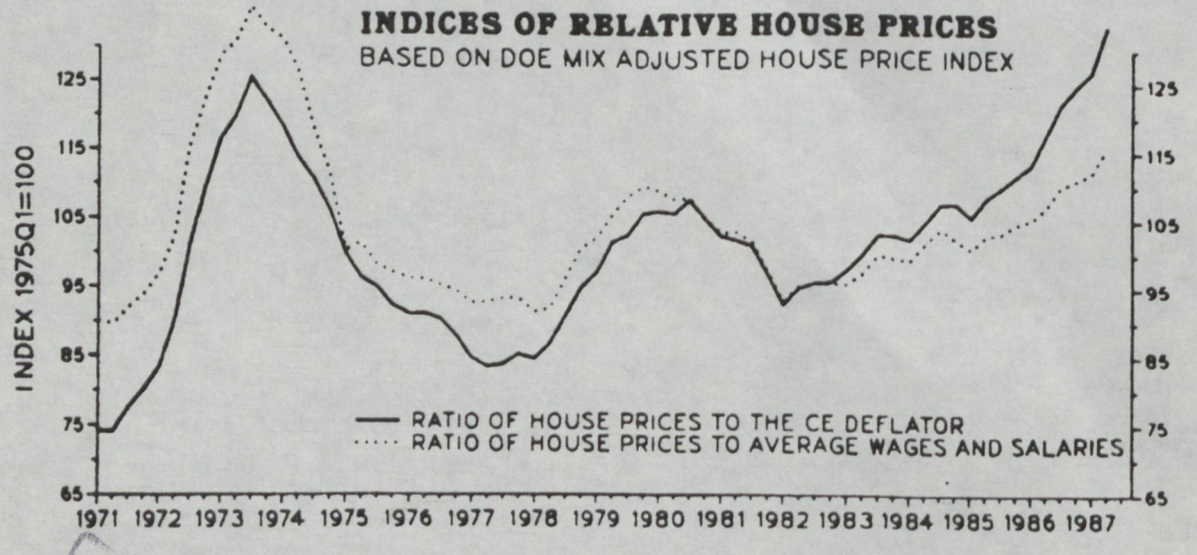


CHART 18 HOUSE PRICES







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PRIME MINISTER 27 November 1987

JKS
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Is a Recession Inevitable?

Of course the answer must be no.

Yet I find that the question is being asked constantly by the business community regarding the US economy - the implication being that if the US went into recession so would the UK.

A number of points need to be made to back up the argument.

Overvaluation of the Stock Market

Until October the US stock market had been rising since 1982. Other stock markets had been equally bullish. As a result price-earnings ratios were abnormally high - see Table 1. Price rises had gone well beyond the rise in consumer prices or profits. Appendix A shows stock market indices (mainly industrial) for each of the G-7 countries in nominal form and deflated by consumer prices.

What is interesting is that the size of the correction which has occurred is not unusual by past standards - but its speed is much more rapid.

Getting the consumer "right"

The key to the changed forecast for the US economy is the effect of the reduction in equity valuation on consumer

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TABLE 1

PRICE-EARNINGS RATIOS

	1976-80	1981-85	1986	End August 1987	22 Oct 1987*
US	8.9	10.4	22.8	22.4	16.0
JAPAN	29.7	30.9	60.4	72.6	69.1
GERMANY	10.0	11.9	15.1	16.2	13.7
FRANCE	13.7	10.8	17.4	16.7	14.0
UK	8.3	11.8	19.1	18.4	14.9
ITALY	n/a	8.0	17.0	17.0	17.2
CANADA	8.4	15.8	22.7	21.4	16.5

Source: Phillips and Drew World Investment Review (to end August)

* Extrapolated assuming constant earnings

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spending. On the basis of past behaviour the likely fall in consumer spending while substantial is by no means catastrophic. Two methods of rough calculation of the impact on consumption are as follows:

(a) the "wealth effect": a rule of thumb for the US is that 5% of the wealth changes in households net worth affect consumer spending in the 6 quarters. The key is that the bulk of personal wealth goes into saving; but that a small percentage (roughly 5) will lead to increased spending if wealth increases and decreased spending if wealth falls.

The calculation then is as follows: in June 1987 American households had an equity portfolio of roughly $2.7 trillion. A 30% fall in value would result in a wealth loss of $800 billion. A 5% negative wealth effect implies a decline in personal consumption of $40 billion by the end of 1988 (or $30 billion in 1982 dollars). Aggregate consumption in the US is currently $2.5 trillion - hence the stock market fall will lead to a reduction in consumption of just 1%. Although very small, the forecast growth in real consumption in 1988 before the crash was only 2%, so in terms of growth it is highly significant.

(b) personal saving behaviour following stock market declines :
a fall in stock market prices will prompt higher saving as people rebuild their base of future income. The behaviour of the savings ratio following five of the largest stock market crashes over the post war years are shown below.

As can be seen from Table 2, in four of the cases, a fall in the stock market led to an increase in the saving rate of roughly 1½%. Rough calculations suggest

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TABLE 2

SAVING RATE CHANGES FOLLOWING MAJOR STOCK MARKET DECLINES

Market Declines	Personal Saving Rate Low	High	Change in Percentage Points
February 1966 to October 1966	6.7%	8.7%	+2.0
December 1968 to March 1970	5.4	7.2	+1.8
March 1974 to October 1974	8.7	9.7	+1.0
September 1976 to February 1978	5.8	7.3	+1.5
Average	6.6%	8.2%	+1.6
Market Rises			
December 1961 to June 1962	Saving rate fell by 2.2%		

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that it takes a 1% cut in real consumer spending to boost the savings rate by 1 percentage point over one year. Hence the fall in consumption calculated in this way is just about the same as from the wealth effect above.

[the fall in the stock market in 1962 is not considered typical because the economy was in a very different phase of the business cycle. In 1962 the recovery was barely a year old and therefore not really as vulnerable to the strains which are typically found later in the cycle.]

Conclusion: the fall in consumer spending in the US following the stock market crash is significant, but not strong enough to throw the economy into recession.

Indicators since the Crash

Although these are early days, all the indicators which have been published since the crash do not reveal any panic or precipitate behaviour by US consumers. In fact all of the published indicators have contained good news.

In addition the fall in the dollar is having a remarkable effect on the profits of those companies in the export business. After five painful years (1980-85) in which the dollar rose and companies became leaner and fitter they are now experiencing what Americans call "fat city". This is hardly the background for a recession.

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1987 is not 1929

And that for four reasons. The stock market collapse of 1929 was transformed into the Great Depression due to a number of factors - none of which really hold now:

(a) fiscal rigidity - in the 30's there was a doctrinaire belief in balanced budgets and a refusal to increase deficit spending or cut taxes to replace an abrupt fall in private spending by an increase in public spending.

- this is not so at present: in fact the only fiscal rigidity is the US deficit and that is clearly falling: it is right for the US to reduce its planned deficit while at the same time recognising that if nominal demand were to fall abruptly it may be necessary to accommodate this with a larger temporary deficit.

(b) monetary mismanagement - this was at the heart of the Great Depression as the Fed allowed the money stock to contract by one-third between 1929-1933.

- at the time of the crash Alan Greenspan made it absolutely clear that he was prepared to pump in sufficient liquidity to prevent the equity price fall from having a knock-on effect on the solvency of financial institutions.

(c) conflict between the major countries - the 30's were an unhappy period as evidenced for example in competitive currency devaluations by countries against each other.

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- at present the G-5 and G-7 arrangements are working well: if anything there is too much co-operation (e.g. over exchange rates) not too little: certainly there is a marked contrast with the 30's.

(d) the deliberate imposition of protectionist measures.

- although there has been creeping protectionism since the inflation and recesion of the early 1970's the President is determined to veto a major new Congressional package of protectionist measures.

All of this suggests therefore that 1987 is very different from 1929 and that there is no reason to expect that the stock market crash will trigger a recession.

Conclusion

The main danger I see at present is the business community talking itself into a downturn. Every opportunity needs to be used to explain that the fundamentals at present are moving in the right direction.

BRIAN GRIFFITHS

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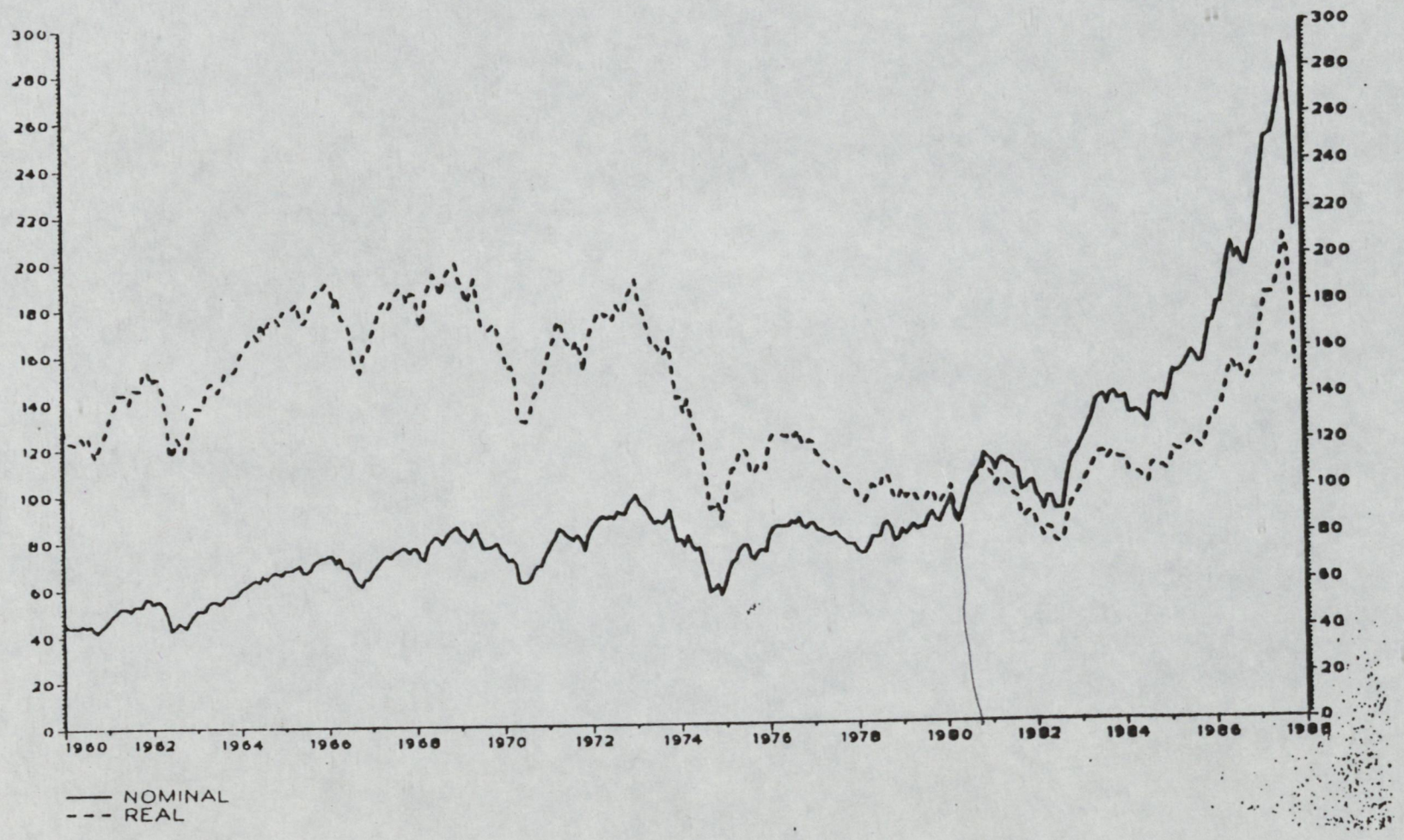
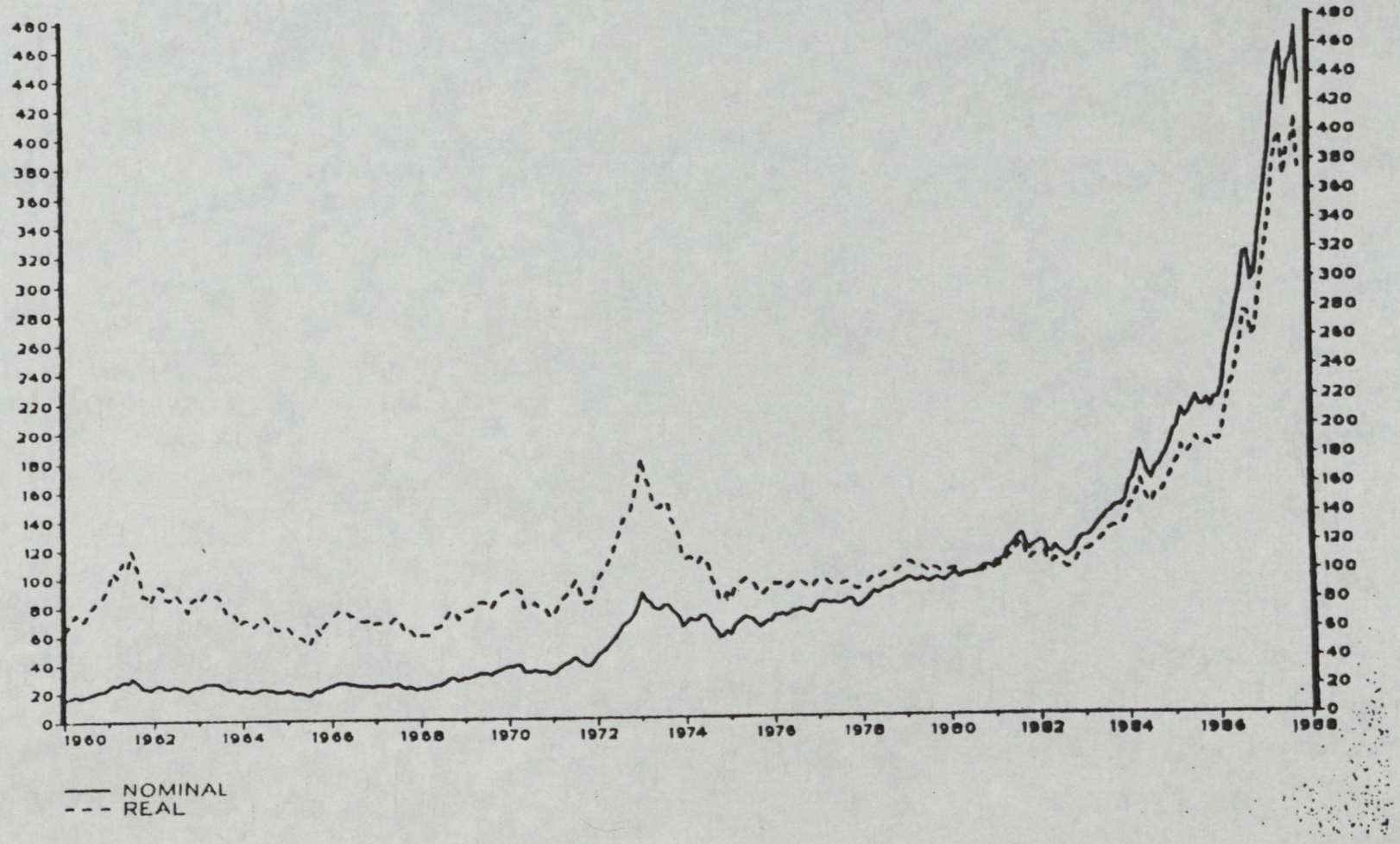
APPENDIX A

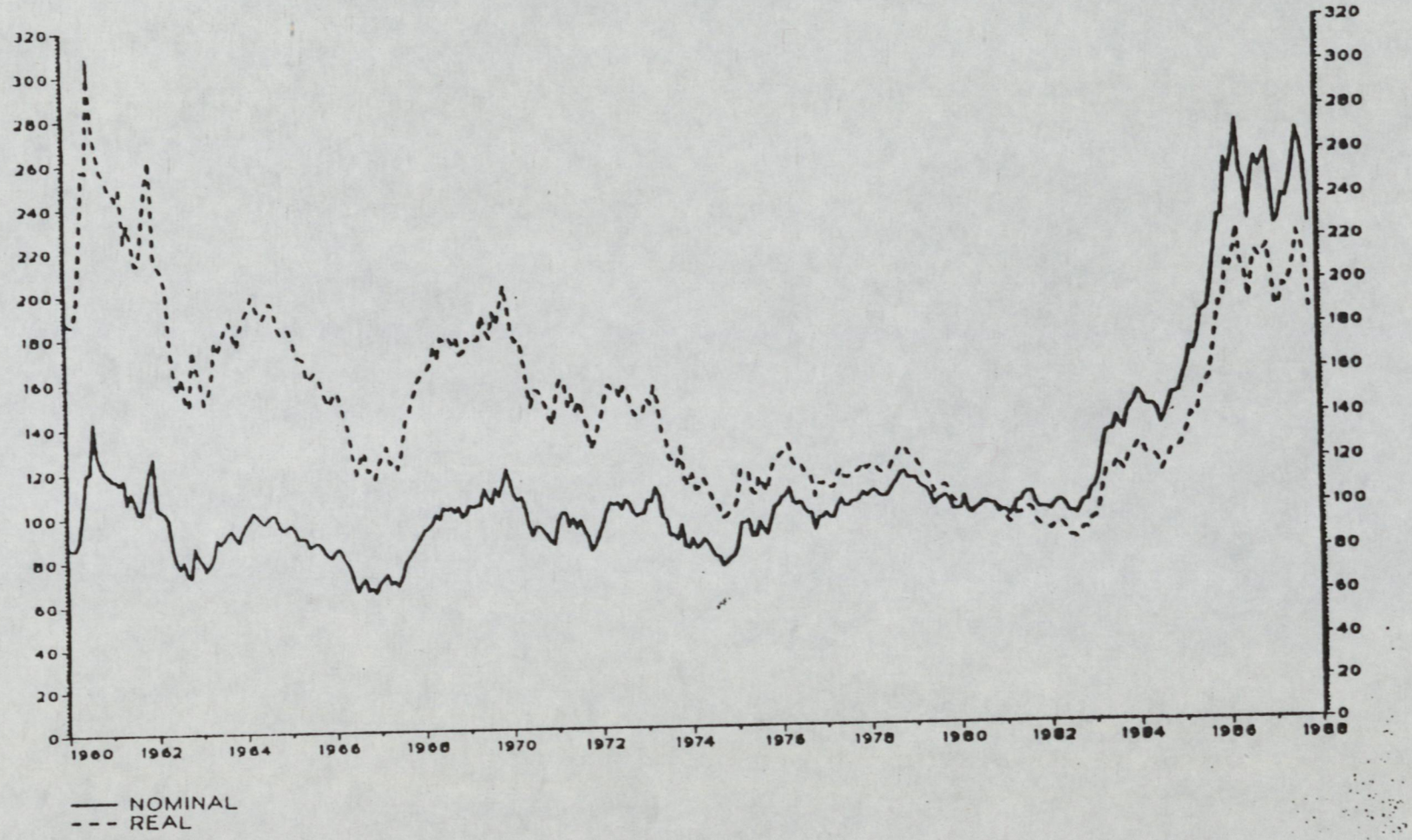
US SHARE PRICES



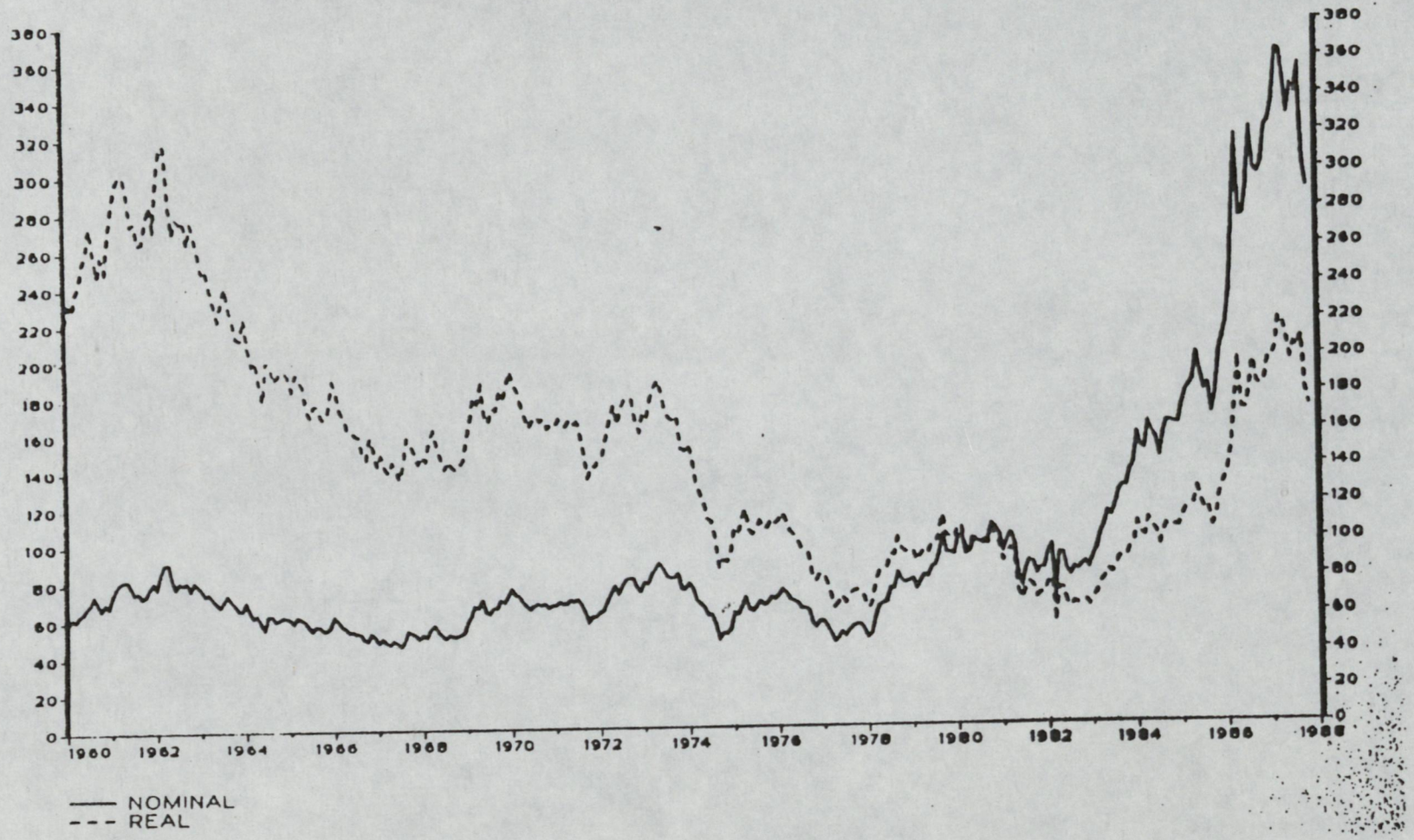
JAPANESE SHARE PRICES



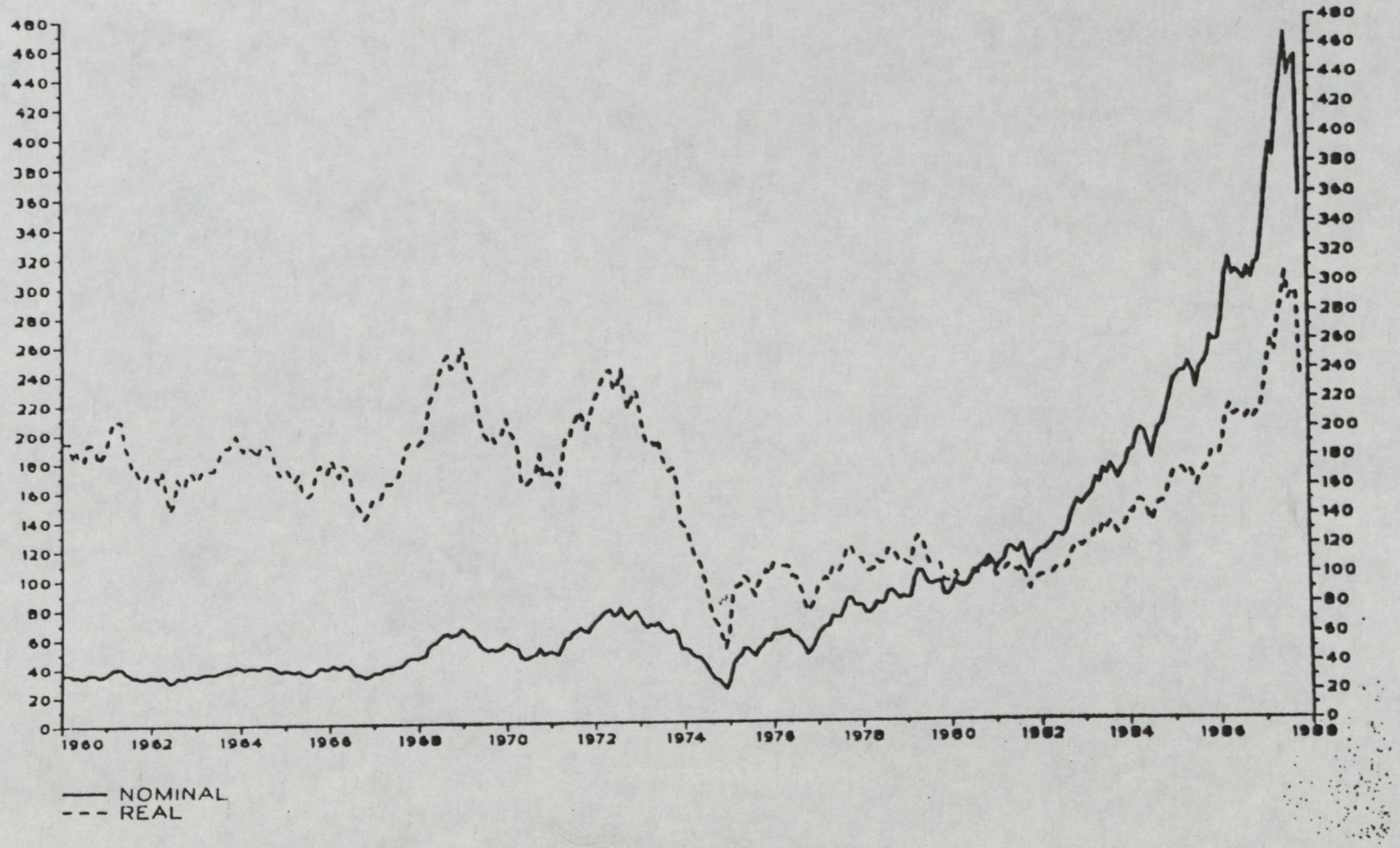
GERMAN SHARE PRICES



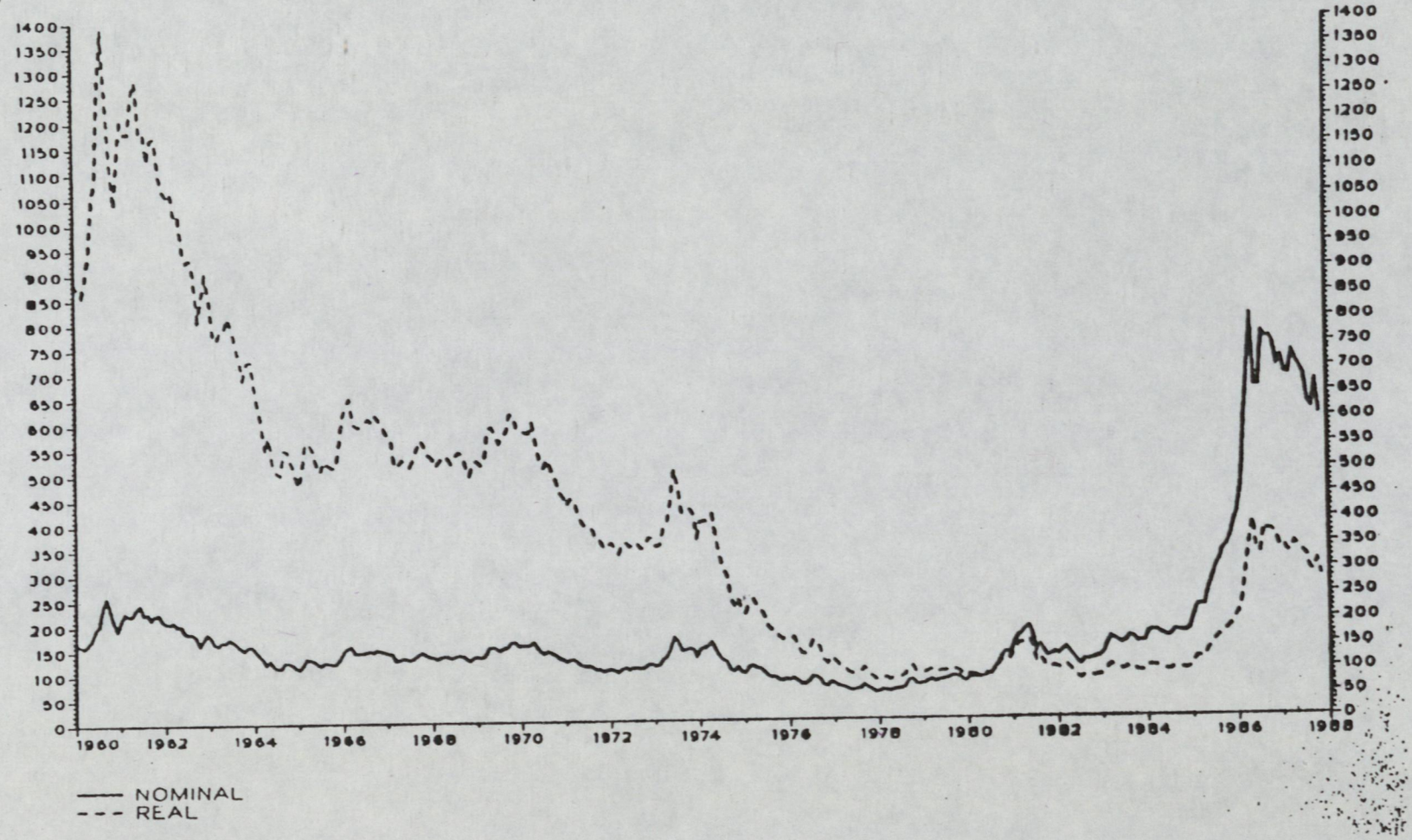
FRENCH SHARE PRICES



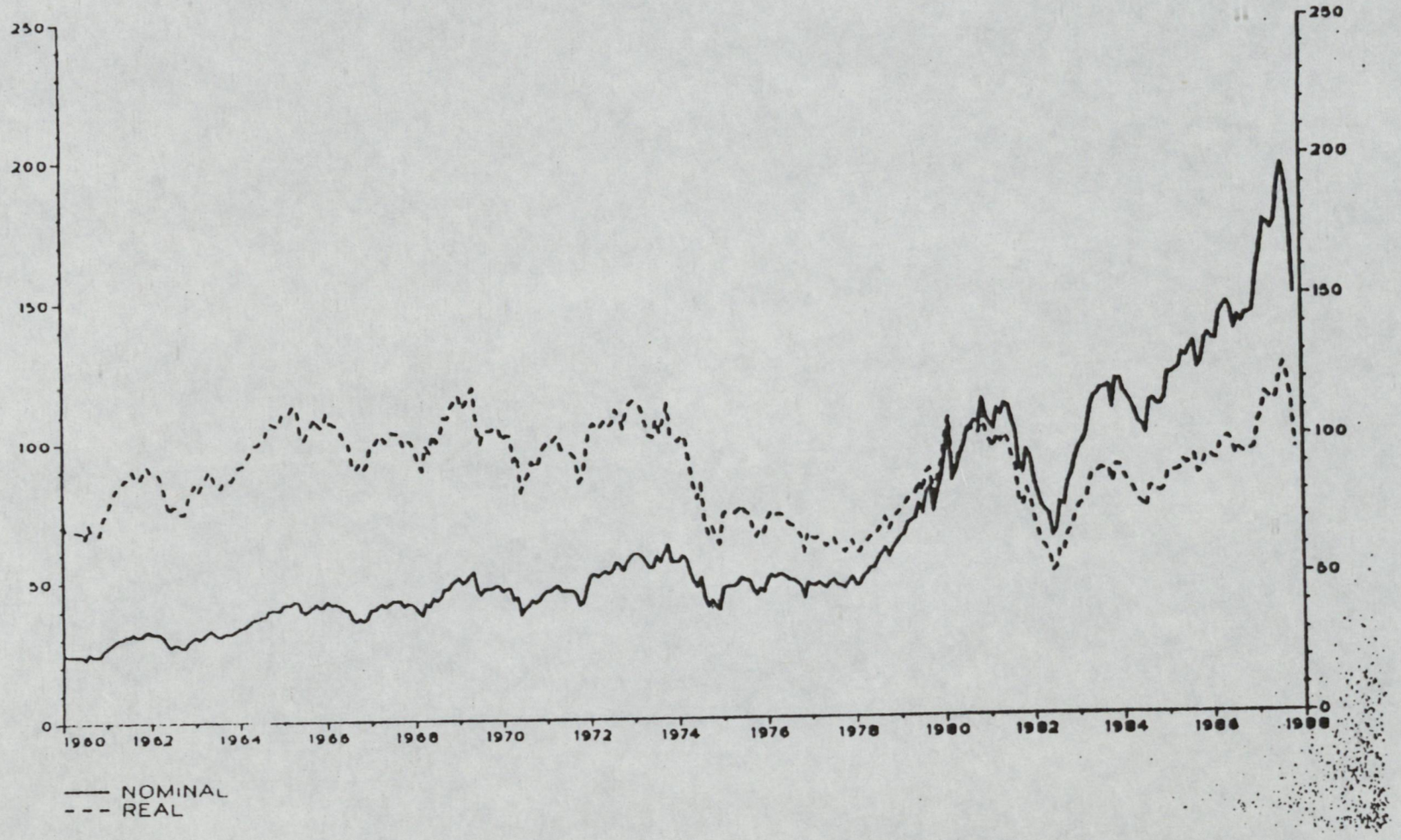
U.K. SHARE PRICES



ITALIAN SHARE PRICES



CANADIAN SHARE PRICES



World Financial Markets

Morgan Guaranty Trust Company of New York

September/October 1987

Global growth and adjustment at risk, 1

Stubborn external imbalances, 2

Approaches to adjustment, 4

Growth in Japan, 7

Growth in Europe, 9

U.S. growth and inflation, 10

Conclusions, 12

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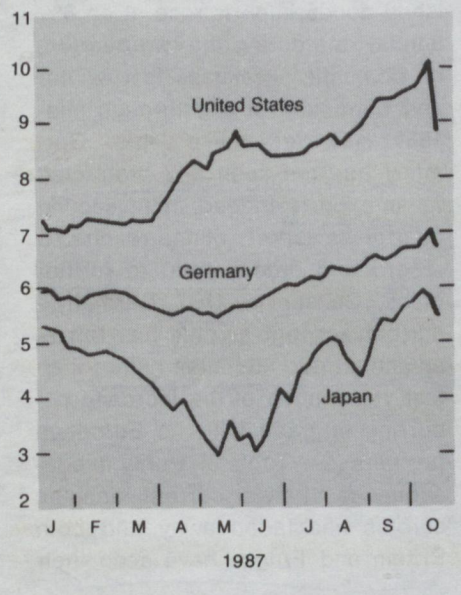
Chart 1

10-year government bond yields

percent per annum



Global growth and adjustment at risk

Scholars, politicians, and financial market participants doubtless will wrangle for years to come over the causes and consequences of this October's stock market crash. At a minimum, the crash represented belated, if abrupt, recognition of the steep rise in bond yields that initially occurred last April in the U.S. case and that gathered pace around the world following the early-September hike in the U.S. discount rate. Mid-October saw ten-year governments yielding as much as 300 basis points above the lows of last spring in both the United States and Japan, and 130 points in Germany (see Chart 1). Following the stock market crash, government yields have moved significantly lower.

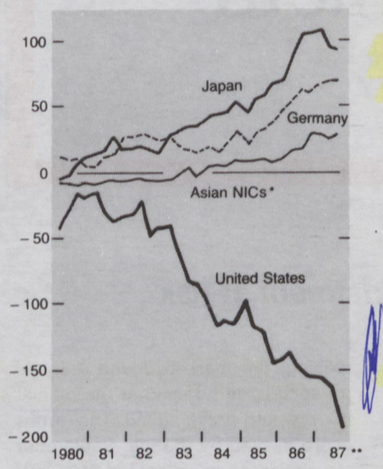
On a more basic level, the bond market developments were the logical outgrowth of last February's Louvre accord. This created the impression that satisfactory progress could and would be made in redressing the major global imbalances on the basis of existing exchange rates and policy fundamentals — those either already extant or coming shortly into place. During the spring and early summer, soothed by the Venice summit's endorsement of the Louvre judgment and encouraged by Japan's fiscal easing, the markets found a sense of security in hopes that the official view would prove sound. The hopes were dashed by the mid-September revelation of July's record $16.5 billion U.S. trade deficit and the news, one month later, of an August deficit scarcely lower. Not only was the U.S. deficit setting records, but Germany's surplus had widened since last winter, the narrowing of Japan's trade surplus had not gone far, and the surpluses of the increasingly prominent Asian NICs showed no convincing decline (see Chart 2).

Plainly, the fundamentals have failed to play by the Louvre script. The modified Gramm-Rudman-Hollings mechanism for U.S. fiscal deficit reduction has set an unambitious goal for the new fiscal year and hardly settles the budget issue. The fact that the yen and mark were not allowed to appreciate for a full eight months added needless substance to rising inflation expectations in Japan and Germany, which were compounded by central bank concerns over fast money growth. Attitudes hardened against expansionary policies in both countries, and instead inspired monetary tightening. Thus both the leading deficit country and the two principal surplus countries have shown little progress and polit-

Chart 2

Trade balances

billions of dollars, BOP basis, seasonally adjusted annual rates



*Hong Kong, Korea, Singapore, and Taiwan

**Latest plotting: Jul-Aug estimated average, except Japan, Jul-Sep

ical will to reorient their domestic policies in the interest of reducing external imbalances. Premature stabilization of the dollar has been as "counterproductive" for global growth and adjustment as the "hard landing" crash that stabilization efforts were supposed to preclude.

This article reviews the actual progress of trade adjustment among the major countries; considers the reasons and the means to press it further; assesses recent domestic performance and policies as they relate to international adjustment; and offers recommendations.

The markets have fired a warning shot across the bow of the good ship G-7. More conciliatory now, the U.S. Administration and Congress may go beyond the immediate Gramm-Rudman-Hollings mandate on fiscal restraint. Surplus countries then need to follow up with expansionary measures, opening the way to orderly realignment of exchange rates in due course. Otherwise, market instabilities will recur and global economic progress be in grave jeopardy.

Table 1

Japan: shipments of manufactured goods

percent change from previous period (not at annual rates)

	1980-1985*	1986	1987 Q1	1987 Q2
Total	16.5	0.1	0.9	—0.3
Export	55.9	—1.8	0.4	—3.0
Domestic	10.6	0.5	0.9	0.4
Sectors				
Fabricated metals				
Export	—34.9	—14.7	—1.2	—15.5
Domestic	0.0	0.2	4.9	—2.2
Transportation				
Export	28.6	—10.5	3.8	—11.7
Domestic	0.9	1.2	—1.6	—4.1
Electrical machinery				
Export	189.5	4.9	—0.1	—1.7
Domestic	82.3	8.0	3.6	1.4
Chemicals				
Export	24.6	17.2	3.1	—4.8
Domestic	16.0	—0.9	3.5	—0.7

*Cumulative percentage change.

Stubborn external imbalances

Progress in reducing imbalances has been patchy and limited. It has fallen short of predictions based on historical experience, leaving yawning trade gaps not only for the leading industrial economies but also for the Asian NICs.

On the positive side, the slowdown in Japan's exports has continued in 1987, especially for fabricated metals and transportation equipment (see Table 1). Overall export volume was off 2.4% for the first nine months of 1987 on a year-over-year comparison, while total imports rose 6%. Officials stress the much steeper rise in Japan's imports of manufactures which, excluding gold, jumped 19% in volume terms. Of course, the jump was from a very low base. Still, contrary to common assumption, at least some of Japan's imports respond to yen appreciation (in yen terms Japan's manufactures import prices averaged 24% lower this year to date than in all of 1985).

Having dropped 1.3% of GNP in 1986, Japan's real net exports may be down another 0.8% this year. Yet there is far to go in rectifying the external imbalance in dollar terms. The overall trade surplus has ebbed but the only significant bilateral declines have been with China, the Middle East, and some commodity-producing countries. Japan's reduced exports to China reflect Chinese spending cuts. Its rising imports from oil and other commodity producers mainly reflect price developments. Meanwhile, Japan's trade surpluses with North America and Europe continue stubbornly high (see Table 2). For 1987 as a whole, Japan's trade surplus may be down little and its current account surplus may brush last year's record. Further, machinery orders suggest that the falloff in exports is nearing its end.

Germany has experienced some limited volume adjustment in its external trade. Its real net exports fell 1.1% of GNP in 1986 and may dip a further 0.5% this year. Its finished goods imports rose at an 8% annual rate during the two quarters of domestic weakness last winter and continued strong through mid-1987. However, unlike Japan, Germany has not seen any protracted fall in exports. Indeed, in the second quarter its export volume reached a record and orders point to further gains. So far in 1987 Germany's current account surplus has run at an annual rate $8 billion higher than last year, much of the increase occurring in trade with its European partners (see Table 3). Partly in consequence, Italy's current account surplus has faded away and both Britain and France have seen their

Table 2

Japan: bilateral trade balances

CIF, billions of dollars at annual rates

	1986	3 months ended September 1987 Actual	Change from year earlier
United States	51.4	53.5	—1.6
Canada	0.6	—0.7	—1.1
Western Europe	19.4	22.3	—0.5
Southeast Asia	12.3	12.5	—4.4
China	4.2	—0.3	—5.5
Middle East	—8.6	—11.0	—4.7
Latin America	3.3	1.7	—1.2
Total	82.7	78.3	—20.2

Table 3

Germany: bilateral trade balances

CIF, billions of dollars at annual rates

	1986	3 months ended August 1987 Actual	Change from year earlier
United States	13.2	13.5	—0.8
EC	24.0	33.2	6.5
Non-oil developing countries	—0.7	—1.5	—1.5
OPEC	2.2	1.3	—2.1
Eastern Europe	2.3	1.4	—1.4
Total	52.1	60.7	1.0

current accounts slide into deficit — trends that are not sustainable.

The good news on U.S. trade adjustment lies in the slowing of import growth and, more especially, the strong, if belated, recovery of exports. From the third quarter of 1986 through the second quarter of this year, non-oil import volume rose at a mere 2.4% annual rate. By contrast, agricultural exports climbed 13% by volume and other merchandise exports only a little less. U.S. exporters have started to win back world market share: the 1987 volume increase in U.S. manufactures exports, for example, may reach 12% — at least triple foreign import growth. External trade should add 0.4% to U.S. growth this year. Already, in the final quarter of 1986 and the first of 1987, it contributed more than two-fifths of the gain in real GNP.

Unhappily, in the second quarter of 1987 and still more in the third, the trend of improving real net exports was interrupted. With the terms of trade moving adversely, the trade deficit in dollar terms actually widened. The red ink reached an annual rate of $171 billion on the CIF valuation in January-August, substantially greater than in the same months of 1986 and worse by a staggering $14 billion vis-à-vis Asian countries (see Table 4). With no repeat of the 1986 special gold shipments, U.S. exports to Japan *fell* 3%, while imports were virtually unchanged; and, although the United States exported 24% more to the four principal Asian NICs, its much larger imports from the four jumped 27%.

U.S. adjustment is impeded by demand restraint abroad, where investment spending is weak by historical standards, undermining demand for U.S. capital goods. Demand weakness has imposed remarkable pricing restraint on U.S. exporters generally. In the second quarter of 1987 U.S. export prices were up only 0.8% from a year earlier and remained below the average for 1985. Farm prices stayed depressed. Prices for capital goods were up just 1% over the two years and those for autos and consumer goods only 4%-6%. Some, but not all, of the explanation lies in the tendency of U.S. firms to set their export prices much in line with those for domestic sales. Consequently, in yen or European-currency terms, U.S. exporters have cut prices steeply since 1985 — "passing through" to foreign purchasers virtually 100% of the dollar's depreciation.

This contrasts with the minimum-pass-through, U.S.-market-sensitive pricing practiced by other industrial countries and the Asian NICs. The dearth of attractive alternatives has driven them to every effort to hang on to U.S. market share, taking advantage of the leeway afforded by the high profits earned at the dollar's peak, lower oil and raw material costs, and domestic conditions conducive to compressing labor costs. This has retarded increases in U.S. import prices. Of course oil prices have actually fallen. Among manufactures imports price gains were more marked — almost 17% for autos and about 14% for both capital and consumer goods — but paled beside the dollar's 22% depreciation in broad, real effective terms. Not surprisingly, import penetration of the U.S. market remains historically high.*

*To a large extent, the limited pass-through of the dollar's decline to U.S. import prices mirrors experience during the dollar's earlier appreciation: from 1981 through 1985, while the dollar rose 24% in broad, real effective terms on a calendar-year average comparison, the national accounts deflators for U.S. imports of capital goods, autos, and consumer goods declined 14%, 2%, and 4%, respectively, relative to final-sales deflators; these moderate falls help explain why the subsequent return of the dollar close to its 1981 real level has raised relative import prices for the same three product sectors just 11%, 11%, and 8%. Effective price adjustment likely runs higher, since changing credit and service terms are not captured in recorded import prices.

Table 4

United States: bilateral trade balances

FAS/CIF valuation; billions of dollars at annual rates; not seasonally adjusted

	Year-to-date ended August 1987		
	1986*	Actual	Change from year earlier*
Japan	—58.6	—59.4	—1.2
Canada**	—13.9	—10.7	3.5
Western Europe	—32.6	—30.6	4.7
Germany	—15.6	—16.5	0.4
France	—3.4	—3.3	0.5
United Kingdom	—4.6	—3.7	0.9
Italy	—6.5	—6.3	0.6
Netherlands	3.5	4.0	1.0
Latin America	—13.6	—15.6	—1.1
Brazil	—3.5	—4.2	—0.1
Mexico	—5.2	—6.1	—1.0
OPEC***	—4.6	—7.7	—3.1
Asia excluding Japan	—37.4	—49.1	—12.8
Hong Kong	—6.5	—6.4	—0.4
Korea	—7.1	—9.8	—2.9
Singapore	—1.5	—2.1	—0.8
Taiwan	—15.7	—19.7	—4.4
Other countries	0.4	2.0	1.6
Total revised statistical month	—166.3	—177.5	—14.4
Total Canada adjusted	—160.3	—171.1	—8.4

*1986 data were reported on a basis that the U.S. Department of Commerce discontinued in 1987. Thus, year-earlier comparisons are approximate.
**Beginning in 1987, monthly trade data include an adjustment for understated exports to Canada. Adjusted monthly estimates for 1986 were obtained by prorating the 1986 annual adjustment.
***Excluding Ecuador, Indonesia, and Venezuela.

Another obstacle to U.S. trade adjustment is the domestic oil demand-supply imbalance. This year's net imports have averaged 5.9 million bpd so far, 33% above the 1985 average. Valued at $19 per barrel, they now contribute over $40 billion to the trade deficit. Domestic oil consumption may rise 2% in 1987, while production may dip some 350,000 bpd, or 3.5%. These are smaller percentages than recorded in 1986, but bring net imports to 37% of 1987's consumption, up from 28% just two years ago.

Despite this year's disappointments, some alleviation of the major global imbalances should yet come to pass given the present U.S. and foreign demand outlook. If the dollar falls no lower, the 1988 U.S. trade deficit may narrow to perhaps $150 billion CIF, down $25 billion from the likely 1987 outcome. Since U.S. net investment income is sliding inexorably into the red, the current account deficit would shrink much less, perhaps by only $7 billion, to $159 billion. Beyond 1988, however, the combination of a dollar locked near present levels with an already adverse U.S. inflation differential would soon halt adjustment. The U.S. current account would swiftly deteriorate and net international liabilities could rocket from an estimated $414 billion at the end of this year to as much as $900 billion, or 18% of U.S. GNP, by end-1990 (see Chart 3).

If, as interest rate differentials suggest, the dollar winds up falling moderately, the 1988 U.S. current account outcome would improve slightly to around $150 billion (see Table 5). Other principal countries would see modest reductions in their current account surpluses, to perhaps $79 billion for Japan and $37 billion for Germany in 1988, down $7 billion and $3 billion, respectively, from the likely 1987 results. Thus, more than two years' effort to tackle global imbalances promises no quick resolution.

Approaches to adjustment

There is no unanimity on what, if anything, should be done to advance international adjustment. Some analysts judge the imbalances to be of little concern. It is said that impressive employment gains, respectable output growth, and improving productivity — all amid moderate inflation — show the U.S. economy to be thriving despite, or even thanks to, the trade deficit. Moreover, the U.S. deficit has underwritten world recovery from the recession of the early 1980s and other economies still are not ready to cope without U.S. stimulus. Besides, the deficit ultimately is financed by investors in the surplus countries who voluntarily place funds in the United States in expectation of superior returns, or by their governments who deem it in their interest to avert further depreciation of the dollar. A number of the surplus countries see themselves as members of an informal dollar area, within which payments imbalances need not be addressed. Others maintain that the dollar already stands at a proper level and that adjustment will take care of itself in due course.

There further is a tendency to exaggerate the role of non-OECD countries, neglecting the fact that trade with industrial countries accounts for three-quarters of the overall U.S. trade deficit and still more of the surpluses of Japan and Germany. Some U.S. politicians, arguing that LDC financial problems perpetuate the U.S. trade deficit, see the answer in debt relief. Yet while U.S. trade with Latin America showed an annual rate deficit of over $15 billion in January-August this year, versus a surplus of $5 billion in 1981, the swing represents less than one-sixth of the $130 billion overall U.S. trade balance deterioration. In any event, it is naive to suppose that the bilateral swing can be easily undone, given the urgent need to increase LDC exports — a key prerequisite for restoring the import capacity and economic growth of the debtor countries and returning them to creditworthiness.

current account and net foreign debt
billions of dollars

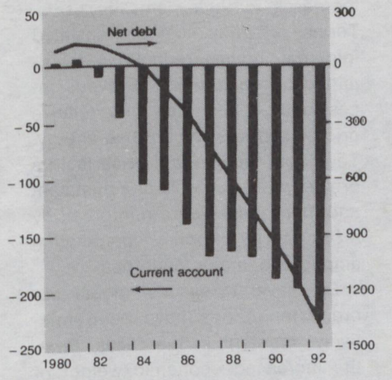


Table 5

Current account balances

billions of dollars

	1986	1987	1988
United States	—141	—167	—152
Japan	86	86	79
Germany	37	40	37
France	3	0	—1
Italy	5	1	—2
United Kingdom	—1	—3	—5
Canada	—7	—7	—7
Hong Kong	4	11	9
Korea	5	12	10
Singapore	1	0	0
Taiwan	16	26	24

Another obstacle to global adjustment is seen in the surpluses of Taiwan, Korea, and Hong Kong, which may aggregate $49 billion this year on current account. The transfer of technology, materials, and management skills to low-cost areas — most conspicuously the Asian NICs, but also Mexico and elsewhere in Latin America — increases global goods supply, swelling the trade deficits of the more open industrial countries, particularly the United States. Given time, it is said, the global demand-supply gap will close as the low-cost areas boost spending, certainly once Latin America's problems are sorted out. Until then, adjustment by industrial countries would be unlikely to blunt the fundamental competitiveness of the low-cost areas but could retard their exports and spending through world recession or impaired market access. Attempts to speed adjustment might be counterproductive.

Adjustment risks there surely are, but go-slow arguments are far too complacent about the costs, actual and potential, of failure to come to grips with the imbalances among the industrial countries themselves. The actual costs center on the consequences of the below-potential — and certainly suboptimal — growth that Japan and Continental Europe have settled for over the last several years. Their poor performance does no favors for their own peoples and unnecessarily burdens other countries besides. The global waste implicit in deficient demand in Japan and Europe today cannot be compensated by increased demand in the Asian NICs or others tomorrow.

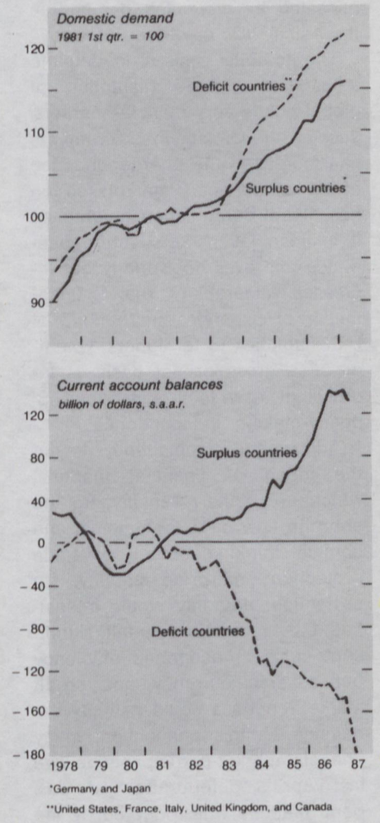
The potential costs of inadequate adjustment include disruption of global goods and financial markets. Just as the growth in U.S. imports has increased the interdependence of the world's goods markets, so too has global deregulation heightened it in financial markets. Interdependence improves opportunity but increases vulnerability, real or imagined. For example, the buildup of U.S. liabilities to foreigners, whether on a gross or net basis, is increasingly seen to circumscribe U.S. policy-making independence.

Adjustment complacency is not the mood of financial markets, which are acutely sensitive to the ebb and flow of U.S. economic and political thinking, notably on trade protection and price stability. On protection, not only would intensified U.S. restrictions entail significant costs in economic efficiency but adverse currency and credit market reactions could multiply the damage. In this connection, many financial market participants believe last April's deterioration of U.S. bond markets was triggered by the decision to impose punitive tariffs in the U.S.-Japan semiconductor dispute. Financial market reaction was similarly damaging more recently as the perception spread that the U.S. authorities were willing to accept higher inflation for the sake of short-term gains in activity and jobs. At the least, the attendant higher interest rates bloat the expense of servicing the U.S. external debt. More seriously, they now have devastated stock markets around the world and further may precipitate recession. That would make bitter reality of the long-playing prophecy of the world economy's inevitable "hard landing."

To help avert such calamity, more

Chart 4

Growth breeds deficits



*Germany and Japan

**United States, France, Italy, United Kingdom, and Canada

decisive adjustment is needed, and without delay. Yet the adjustment medicine appropriate for small countries may do more harm than good if unthinkingly urged upon the large. Whereas adjustment by a small country has no important global ramification, the same does not hold true for the large, least of all for the U.S. economy that generates 35% of industrial-country GNP. Even so, the United States will have to take the orthodox medicine, restraining domestic demand to free up resources and shifting relative prices to ensure that the resources go to work in export and import-competing production. To sustain global demand as this occurs — and, not incidentally, to complement and assist U.S. adjustment — countries in external surplus and with spare domestic capacity should *spend* their surpluses by expanding their domestic demand. Yet countries in surplus — in present circumstances, principally Japan, Germany, and some of the Asian NICs — are always reluctant to expand. They typically view surpluses as prudent and virtuous provision against future adversity. Further, being net external investors rather than borrowers, they are little influenced by outside pressure. This systemic failing helps explain the spreading perception that orthodox medicine is ineffective.

To the contrary, the medicine is highly effective when taken in the right dosage. More than one episode in recent history shows that adjustment occurs at a dramatic pace, once appropriate policies are in place. The outsize OPEC surpluses that followed the 1970s' price shocks speedily eroded, partly because all the oil exporters proved to be "high absorbers." They stepped up their imports unexpectedly fast; their vast terms of trade gains were passed on to their private sectors, which were willing to consume or invest, or spent by governments for social and infrastructure investment. At the same time, most oil importers passed on 100% or more of oil-price increases to their domestic users. Terms of trade losses translated into real income reductions — admittedly, precipitating grievous recessions — and also into relative price incentives to conserve energy. Thus both income and price factors proved powerful tools of adjustment and their effects were reinforced by a fair degree of policy coordination among the major countries.

For several reasons, global coordination efforts have been relatively impotent in the 1980s. First, the increased economic weight of other major industrial countries makes them less beholden to U.S. leadership. Second, global financial change and innovation render uncertain the quantitative effects of monetary policy, coordinated or not. Third, the proper coordination of fiscal policies now would require much larger adjustments of existing programs, relative to GNP, than in the mid-1970s. Fourth, the 1970s' experience of inflation calamity and public-sector excesses gave fiscal policy — and demand management generally — a bad name; only recently, and with much misgiving, has activist fiscal policy recovered some shred of acceptability, at least if dressed in supply-side garb.

Moreover, perversely, some of today's surplus countries have followed the rules written for *deficit* countries and have been reluctant and tardy in spending real income gains in the form of stepped-up domestic demand (see Chart 4). Tight-fisted fiscal policies have held down public spending or resisted tax cuts, thereby failing to counter the contractionary effects of currency appreciation. As a result, spending is discouraged by employment worries even where, as in Germany, workers have won sizable wage increases.

Table 6

*Terms of trade gains and losses**

percent of real GNP

	1986	1987
United States	0.3	—1.0
Japan	2.0	0.2
Germany	2.9	0.5
France	2.4	0.2
Italy	2.9	0.4
United Kingdom	—1.1	—0.1
Canada	—0.9	0.6

*The figures represent the amount by which real national income rises or falls as a result of changes in prices of exports relative to imports.
Source: OECD.

Table 7

Japan: sources of growth

percent change from previous period at seasonally adjusted annual rates

	1987 Year	Q1	Q2	1988
Domestic demand	4.2	3.2	4.8	4.1
Private consumption	3.2	7.6	2.6	2.8
Government consumption	0.0	—37.1	3.4	2.7
Business fixed investment	6.4	10.5	5.4	4.0
Residential investment	15.6	2.5	18.1	7.3
Government fixed investment	7.7	4.2	7.7	8.5
*Inventory investment**	0.4	0.2	0.3	0.7
*Net exports**	—0.8	2.1	—4.6	—0.7
Exports	—0.1	10.2	—6.3	—0.7
Imports	5.8	—2.5	26.0	4.3
GNP	3.2	5.3	0.0	3.2

*Change as percent of previous period's GNP; inventory investment estimated as a residual.

Spending in Japan is further deterred by competition from the Asian NICs, which has discouraged Japanese workers from pressing for higher wages. Moreover, in both Germany and Japan, there is too easy acceptance of the claim that wage increases are inflationary — an unreasonable contention if wage increases fall short, as they actually have, of the *sum* of productivity growth and terms of trade gains (see Table 6).

At the same time, whereas U.S. wage moderation, particularly in real terms, has been appropriate to the goal of external deficit adjustment, actual adjustment progress has been limited. The culprits have been unexpectedly robust domestic demand, thanks to the delay in tackling the fiscal deficit and the willingness of the private sector to borrow as necessary to sustain spending, and the "dollar pass-through" problem that, as discussed earlier, has prevented relative price changes sufficient for adjustment.

In sum, there have been shortcomings on the part of both surplus and deficit countries in implementing the orthodox income and price approach to external adjustment. The approach remains valid, but the shortcomings have to be addressed. The price aspect could be tackled by rendering existing pricing practices either untenable — through a sufficient further fall in the dollar — or unattractive, through U.S. demand restraint and stepped-up spending in other countries to reduce the *relative* appeal of the U.S. market for producers around the world. To some extent, price adjustment can substitute for income adjustment. The extent of further currency changes required to correct world imbalances is critically dependent on domestic demand trends in Japan, Europe, and the United States itself.

Growth in Japan

Because Japan's current account surplus is so large — about 3.5% of GNP this year — appropriate adjustment measures must be correspondingly large in scale and *sustained* over time. Japan's terms of trade gains, amounting to 2.2% of GNP in 1986-87, have to be passed through to economic sectors that will spend them, both on domestic and imported products. Public investment is an obvious candidate. So too must be private consumption, fortified by real wage increases in excess of productivity gains. With supportive policies, Japan should be capable of noninflationary growth distinctly above its approximately 4% annual potential for several years to come. Yet, Japan's actual performance falls short of potential and the future of its internal and external adjustment still is problematic.

At first glance, trends in 1987 make this assessment seem overly harsh. The economy is expected to grow by 3.2% this year and next, despite a 0.8 percentage point shrinkage of net exports in both years. Domestic demand growth accelerated to 4.8% annualized between the first and second quarters of 1987 (see Table 7), with private consumption growth averaging over 5% in those quarters — about two percentage points faster than in 1985-86. In the first eight months, housing starts soared 21% above the year-earlier pace. Moreover, Japan's fiscal policy has eased since last winter. Public investment could grow 8% in 1987 — almost double last year's rate. Taxes are being cut this fiscal year by a net 1.5 trillion yen, or 0.4% of GNP, with the maximum personal rate lowered from 70% to 60%. The tax cuts, plus waning fears of unemployment, should lessen the likely slowing of consumption in the second

half of this year.

Though Japan's fiscal easing should properly be a continuing endeavor, it may prove in fact a one-shot affair. Even in 1987, the fiscal posture is stimulative only if compared with the initial plan for the year; relative to the 1986 result, the posture for 1987 as a whole is slightly restrictive. Now, just a brief run of positive news on the economy's performance and adaptation to a 145-155 yen-dollar rate has resurrected earlier goals for long-run budgetary balance. Next year's newly enacted — and, in itself, desirable — termination of certain savings preferences, plus the indirect tax increase that the government may again propose, could largely undo the current year's net tax reduction and tighten fiscal policy anew.

Japan's monetary policy already is tilting toward restraint, with short-term interest rates edging higher and long-term rates up sharply since the spring. The Bank of Japan is anxious about inflationary pressures, and not only on Tokyo land prices, despite the prospect that consumer prices generally should not rise much above 1% this year or next. The monetary aggregates are rising more rapidly than in some previous years and the pace has picked up in recent months. To an extent this reflects the continuing effects of deflation and financial liberalization. But stepped-up monetary growth also results from efforts to hold down the yen. Were the yen to rise in line with fundamentals, overall inflationary pressure in Japan would be nugatory.

As it is, Japanese consumers face notoriously high prices in some sectors, partly through lack of effective openness to imports. They also are receiving slim wage increases. Nominal wages in the first half of 1987 were just 2.8% above their year-earlier level, below the 3% growth trend in economywide real productivity since 1980, let alone its 4% rise in the first half of this year. The shortfall is yet larger in manufacturing, where productivity runs above average but earnings have risen only 1.8%. The general softness of wages reflects subdued domestic demand and employment during the 1980s as a whole. In addition, Asian NIC competition is curbing Japanese wages in manufacturing and, by institutional extension, in the wider economy too. Japanese consumers therefore have received only a fraction of the nation's terms of trade gains.

A related drag on trade adjustment has been the 20% cut in Japan's manufactures export prices in yen terms during the past two years, made possible by sheltered profits at home, wage docility, productivity gains, and greatly reduced imported input costs. Quite small increases in dollar selling prices have turned out consistent with satisfactory overall business profits at the present yen exchange rate. Unhappily, this prolongs reliance on export markets.

How can price and income adjustments be brought about that will correct Japan's external imbalance and realize the economy's potential? Conceivably, a run-up in commodity prices could bloat Japan's import bill and curb its overall trade surplus. Such a "solution" — implausible though it is — might do little to redress Japan's surpluses with North America and Europe and certainly would not promote growth. Another scenario might see the Asian NICs losing competitiveness through currency appreciation or large-scale wage increases; Japanese firms then would have less reason to penny-pinch their own labor costs and could more readily accommodate domestic wage pressures should Japan's economy pick up steam. This scenario may be one possibility for the future, but is not today's actuality.

The hard truth is that Japan is unlikely to adjust externally if the authorities cling to the present yen exchange rate and yield to their inclinations to tighten domestic policies. Perniciously, that would increase Japan's reliance on external demand for growth, prematurely terminating the overdue shift toward reliance on domestic sources. Japan instead needs a policy framework accepting that the yen will rise further and targeting domestic demand for several years to come to contribute five percentage points annually to the economy's growth. Real GNP growth then would run close to Japan's 4% potential rate and the negative contribution of net external demand could serve to work the current account surplus down to $47 billion by 1990 — still sizable, but far more consistent with global adjustment than the $70 billion surplus that existing tendencies suggest. Multiyear fiscal expansion would have to be the principal instrument. Unfortunately, no such plan — rather, the reverse — is currently on Japan's agenda.

Table 8

Germany: sources of growth

percent change from previous period at seasonally adjusted annual rates

	1987 Year	1987 Q1	1987 Q2	1988
Domestic demand	2.1	—2.3	4.1	2.5
Private consumption	3.0	—3.6	12.8	3.5
Government consumption	1.0	2.0	1.0	2.0
Equipment investment	3.0	21.5	—7.6	1.5
Construction	—1.5	—45.3	52.3	1.0
*Inventory investment**	0.3	7.2	0.0	0.0
*Net exports**	—0.6	—0.8	0.1	—0.2
Exports	1.5	—8.0	10.3	2.0
Imports	4.5	—6.6	11.0	3.0
GNP	1.5	—3.0	4.1	2.2

*Change as percent of previous period's GNP; inventory investment estimated as a residual.

Growth in Europe

The terms of trade gains associated with currency appreciation and lower energy prices have flowed through more fully into consumer real incomes in Europe than in Japan. Yet, the resulting spur to Europe's economic activity has proven weak. With external demand shrinking and domestic demand falling short of original expectations, Europe's overall real GNP growth has not picked up this year. Although it has accelerated in Italy and the United Kingdom, growth has sagged in France and Germany.

Germany's disappointing performance is the core concern, deteriorating during 1986 as a small real export decline, largely reflecting OPEC and East European austerity, prompted firms to slow investment and consumers to step up saving. Domestic manufacturing orders fell from mid-1986 through the middle of this year, only reviving in August. However, private consumption perked up in the second quarter (see Table 8), soon after the new metalworkers' contract called for a 3.7% wage increase. Real wages should be up more than 2% economywide in 1987, shifting to workers some of the earlier terms of trade gains that initially had accrued largely to profits. Still, consumers are likely to receive very modest real wage increases in 1988 and 1989, while the shorter workweek prescribed by the wage agreement will raise employers' labor costs and depress employment.

Germany's industrial production has fallen and its unemployment has risen so far in 1987. Although both turned around in August, optimism would be premature. Real GNP growth may not exceed 1.5% for the year as a whole, compared with the 2.5% achieved in 1986, due to the slide in domestic demand growth from 3.5% last year to 2% for 1987. This domestic weakness is holding down Germany's imports, in turn depressing growth elsewhere, particularly within Europe.* France and Italy — neither with strong balance of payments positions — will again show real net export declines this year. Germany's real net exports may be down just 0.5% of GNP this year, much less than the 1.1% decline in 1986. Next year, despite expectations of slightly stronger domestic demand growth, real net exports may erode hardly at all unless the mark appreciates. In sum, though real GNP growth may edge a

*Being so highly integrated into the world economy, some of the smaller European countries — the Netherlands, for example — would rather reduce real wages and domestic growth than suffer export declines.

little above 2% in 1988, Germany's performance, as distinct from intention, may contribute little to constructive international adjustment.

On the face of it, Germany has eased both fiscal and monetary policies this year. The Bundesbank has acquiesced in considerable overrun on its money supply objective, with CBM (central bank money) rising at an annualized 7.8% during the first nine months of 1987 versus a target of 3%-6% for the year as a whole. The Bundesbank is concerned that chronic overruns could jeopardize its credibility. This year's overrun, however, is less stimulative or inflationary than appears, in part because international investors betting on an appreciating mark have helped swell the demand for German money. Still, CBM growth has slowed since last winter, if with some pickup in the last two months. Of course, rapid money growth does not automatically push up prices in an economy that is far from full employment. In Germany today, actual nonenergy, nonfood inflation remains very slight. Land and commodity prices, in mark terms, still are below their levels of two or three years ago. And prospective nominal wage growth is low. These facts leave little basis for the degree of inflation anxiety now subsumed in German long-term interest rates, nor for the Bundesbank's recent steps to tighten at the short end.

On the fiscal side, the first half of 1987 saw Germany's combined federal-state cash deficit run at an annual rate of DM13 billion, or 0.6% of GNP, above the corresponding 1986 figure. The bulk of the widening was cyclical as revenues were undermined by the economy's unexpected weakness. In 1988, the second tranche of a three-stage tax reduction and reform is due, cutting taxes by DM14 billion, or 0.7% of GNP. The third tranche would cut net taxes in 1990 by a further DM20 billion, or 1% of GNP, lowering gross taxes by DM39 billion b[illegible]ecoupling DM19 billion by scaling back subsidies and preferences.* Following protracted dispute, the coalition recently agreed on savings aggregating DM18 billion, of which DM4 billion is supposed to come from a 10% withholding tax on German interest income. For modest revenue gain, this new impost has demoralized the bond markets, while the package otherwise adds up to something less than a frontal assault on the subsidy and preference apparatus. Still, the net tax cut should bolster the medium-term outlook for German growth. Even better would be implementation of the 1990 tranche well ahead of schedule, giving domestic demand a swift and potent tonic.

Considering Germany's large current account surplus, its minimal rate of inflation, and its economic leadership of Europe, German fiscal policy should countenance budget deficits *consistently* sufficient to foster annual domestic demand growth of 4%. If the mark also is allowed to appreciate, the current account surplus could be worked down to $15 billion by 1990 and the negative contribution of external demand would hold Germany's real GNP growth to a noninflationary, yet unemployment-reducing, 3% annually. Unfortunately, steadfast implementation of this approach to adjustment runs afoul of domestic politics and the limited popular acceptance of activist fiscal policy.

U.S. growth and inflation

If the United States is to correct its trade and current account deficits,

*The reform adjusts marginal rates in the middle- to upper-income brackets, but the top rate is to fall only from 56% to 53% and corporate relief will be small. Thus the reform does not significantly restructure incentives for entrepreneurship and efficiency, as in the U.S. case. Rather, it amounts to a traditional Keynesian stimulus.

Table 9

U[illegible]d States: sources of growth

percent change from previous period at seasonally adjusted annual rates

	1987 Year	Q2	Q3	1988
Domestic demand	2.2	2.4	4.0	2.1
Private consumption	2.1	1.9	4.8	2.4
Government purchases	2.6	3.8	4.7	2.0
Business investment	0.3	11.7	23.7	4.0
Residential investment	—0.8	—2.8	—0.2	—7.0
*Inventory investment**	0.5	—0.9	—0.3	0.2
*Net exports**	0.4	0.1	—0.2	0.8
Exports	11.0	17.9	16.5	11.0
Imports	5.9	11.1	16.5	3.5
GNP	2.6	2.5	3.8	2.9

*Change as a percent of previous period's GNP.

it too must make appropriate income and price adjustments. Impressive job creation since 1982 has brought the economy to the verge of full employment, implying a need for domestic restraint to free resources for trade improvement. Estimates of the annual potential growth of U.S. real GNP cluster in a 2.5%-2.7% range. If one percentage point is to be taken up by net external demand — reversing by 1990 most of the deterioration the United States has sustained during the 1980s so far — domestic demand can grow hardly more than 1.5% annually without escalating inflation.

Recently, actual domestic demand growth has run distinctly higher — averaging over 3% in the first two quarters of 1987 (see Table 9) rising to 4% in the third. Restraint requires private and public spending discipline. The first is contingent on sustained wage moderation, the second on difficult budgetary decisions. Finally, relative prices must make the employment of resources profitable in export and import-competing production, in particular, requiring that U.S. import prices rise significantly relative to general domestic prices.

The need to free resources for trade improvement does not yet apply to U.S. plant and equipment capacity, despite the 4.5% increase in manufacturing production in the twelve months through September. Capacity utilization in U.S. manufacturing was only 81.5% that month. This was two percentage points above the year-earlier level but far below the 86.5% attained during the inflationary 1978-80 period.

U.S. labor resources are another story. The fall in the unemployment rate — to a September figure of 5.9%, down from 7% twelve months earlier — leaves it nudging even the more optimistic estimates of the U.S. economy's NAIRU (nonaccelerating inflation rate of unemployment). Scattered labor shortages and wage pressure are emerging in various skills and regional markets. Were more pervasive shortages to develop, the hard-won climate of wage "realism" — bred by deregulation, international competition and, not least, the last recession — could not be sustained. Already, legislative initiatives manifest dissatisfaction with the long-standing decline in real wages, in terms of hourly earnings per head. Nominal wage acceleration now may be at hand, although real wages may not turn upward for some time in view of contractual inertia and the slow revision of inflation expectations.

The fiscal posture remains a key obstacle to prudent management of overall U.S. domestic demand. True, public spending growth has been slowing in real terms since 1985, when measured by government purchases, while the federal deficit tumbled from FY1986's $221 billion to just $148 billion (3.3% of GNP) in the fiscal year just ended.* But, even complying with the revised Gramm-Rudman-Hollings provision, the deficit may back up to $165 billion or more in FY1988, a posture that would not manifest restraint.

How then may appropriate demand restraint be achieved? Whether or not help comes from the budget, monetary policy has the key discretionary role. September's rise in the discount rate was put through in a climate of concern about budgetary impasse and inflationary pressures despite the record of much-reduced growth in the monetary aggregates this year, the evidence that actual inflation has slowed in recent months at most

*A bonanza in capital gains tax collections, plus front-loading aspects of tax reform and miscellaneous one-shot actions, largely explain the improvement. These factors may contribute less, or work in reverse, during FY1988. However, it is worth remembering the gross inaccuracies that have long plagued forecasting of the budget outcome, culminating in the extreme underestimation of deficit reduction in FY1987.

Table 10

U.S. inflation

*selected indices; annual rate percent changes**

	Latest 12 months	Latest 6 months	Latest 3 months*
GNP deflator			
Implicit	4.1	5.5	4.9
Non-oil imports	5.5	8.2	14.8
Consumer prices	4.3	4.6	4.3
Excluding food and energy	4.2	4.5	3.8
Goods	4.4	4.6	3.6
Services	4.2	4.5	4.9
Producer prices			
Finished goods	3.2	3.3	1.9
Intermediate goods	4.2	5.4	7.3
September commodity prices**	19.9	20.4	18.2
Food	4.3	9.9	—2.0
Industrials	32.1	28.2	34.5

*Data are through September 1987, except for consumer prices (August) and the GNP deflators (1987 Q2).
**Commodity Research Bureau.

levels of the U.S. economy (see Table 10), and the likelihood that a combination of tight monetary policy with dollar stability will deter the rise in U.S. import prices essential to expenditure switching and trade adjustment.* October's stock market crash interrupted the tightening monetary trend, at least temporarily, as the Federal Reserve rightly moved to supply liquidity to safeguard the financial system. The stock market action leaves a legacy of uncertainty and impaired net worth that is likely to slow private consumption and investment. In turn, this could help avert overheating of the labor market, the central objective of counterinflation policy. Still, amid continuing market turmoil it is too soon for any confident assessment of the scale and timing of the economic fallout.

The crisis-compelled easing of monetary policy will not be sustainable without a prompt and successful undertaking to break the impasse over fiscal policy. Its urgency could hardly have been signaled more forcefully than by the stock market's plunge. Yet federal spending sequestration under the Gramm-Rudman-Hollings provision would amount less to a credible compromise than to a demonstration of continuing failure of the political process. The kind of compromise that would most help market confidence requires a combination of revenue increases and spending cuts that is substantive on both scores and that, without overkill, yields rather more than the mandated minimum of $23 billion (0.5% of GNP) in deficit-reducing measures for the current year — and substantially more as economic conditions warrant in subsequent years. This would restrain domestic demand and release resources that a lower dollar, abetted by easier monetary policy, could channel into external adjustment. Such an approach, pursued consistently year by year, would rely on both income and price adjustments to avoid recession while bringing the current account deficit below $100 billion by 1990.

*Higher import prices raise the general U.S. price level, yielding a transitory hump in the rate of inflation — but not a continuing increase if unit costs stay in check. Over the past eighteen months, manufacturing unit labor costs have shown an absolute fall, since labor productivity rose 4.1% annually during the past three years and in the second quarter of 1987 reached 4.9%. If the productivity trend can be maintained or bettered, unit cost inflation need not spiral unless wage growth picks up a real head of steam.

Conclusions

A root cause of this fall's maelstrom in international bond and stock markets lies in the persistence of major global imbalances. Last February's Louvre accord led the markets to believe the imbalances were on course to correction based on policy fundamentals officially judged broadly consistent with exchange rate stability. That judgment has proven wanting. If current exchange rates hold, the United States will be lucky to maintain decent economic growth and simultaneously narrow its trade deficit more than $25 billion in 1988 from the $175 billion, CIF basis, now in store for 1987. Chronic deficits on this scale — more than 3.5% of GNP — are simply not acceptable. Their inconsistency with fixed exchange rates, given the failure of both surplus countries and the United States to achieve appropriate domestic demand conditions, has contributed mightily to the run-up in interest rates. Altogether, the Louvre accord has become a formula for world recession.

The slowness of trade and current account adjustment should be neither surprise nor mystery. The principal hindrance lies in the fact that the basic demand management policies of the major industrial countries have been too slow to shift into a posture supportive of adjustment and still do not measure up to the needed scale of adjustment. Thus, U.S. domestic demand grew 4% in the third quarter of 1987 and net external demand deteriorated. Yet, though U.S. fiscal discipline commands virtually unanimous praise as a principle, sustained follow-through is quite another matter as twilight steals over the incumbent Administration. Elsewhere, the budget stance was supercautious in Japan during 1985-86 and, notwithstanding this year's shift in plans, cannot be rated expansionary for the long haul. Germany's three-stage tax reduction is decidedly gradualist, and its design pays scant heed to external considerations. In addition, some other countries in Europe, heavily reliant on exports, are loath to part with their external surpluses. Thus the surplus countries have done little to boost their spending and the number-one deficit nation has dawdled on spending restraint.

Table 11

Global economic adjustment

percent per annum, unless otherwise noted

	1986	1st half* 1987	1987	1988	Policy objective 1988-1990 avg.**
Domestic demand contribution					
United States	3.9	1.8	2.2	2.1	1.5
Japan	3.8	3.4	4.0	3.9	5.0
Germany	3.6	0.4	2.0	2.4	4.0
Exchange rates (average)					
Yen/$	168	148	144	125	115
DM/$	2.17	1.83	1.83	1.63	1.50
Net foreign contribution					
United States	—0.9	1.3	0.4	0.8	1.0
Japan	—1.3	0.0	—0.8	—0.7	—0.8
Germany	—1.1	—1.2	—0.5	—0.2	—1.0
Real GNP					
United States	2.9	3.1	2.6	2.9	2.5
Japan	2.5	3.4	3.2	3.2	4.2
Germany	2.5	—0.8	1.5	2.2	3.0
Trade balance, CIF**					
United States	—160	—164	—175	—143	—77
Japan	93	96	96	85	62
Germany	52	61	60	59	30
Current account balances***					
United States	—141	—156	—167	—152	—97
Japan	86	91	86	79	47
Germany	37	44	40	37	15

*Real GNP data, including components, are percent change from the preceding half year at seasonally adjusted annual rates.
**Trade and current account figures are for 1990, while other data are average for the period.
***$ billions.

At the same time, the adjustment potential of exchange rate changes has not come through in practice. Economic weakness abroad has limited the ability of U.S. exporters to sustain their foreign-currency selling prices — and thus boost their dollar earnings in line with the dollar's depreciation — and foreign suppliers have gone to extraordinary lengths to hold the line on their U.S. selling prices rather than pass through the dollar's depreciation to U.S. consumers. In short, both expenditure and price factors have tended to cripple adjustment so far, and under current policies are unlikely to yield significant progress in the future.

If policymakers are to reclaim influence over events, the Louvre accord requires a full and urgent rewrite. At United States behest, the G-7 has endorsed a profusion of indicators as bearing on the state of the world economy. These indicators now should be used in support of an explicit goal for correcting the principal global imbalance: specifically, to cut the U.S. trade deficit $100 billion, to the $70-$80 billion range or preferably lower, by 1990.

There are any number of ways by which this goal might be attained, but few that would do so while sustaining world economic growth. If both goals are to be reached, the number-one priority must be to get demand management policies in order. To make room for external improvement, the United States should

curb its domestic demand growth to the 1.5%-1.7% range — at least one-half percentage point less than the likely growth this year (see Table 11) — through fiscal restraint that exceeds the modest immediate goal of the Gramm-Rudman-Hollings edict. At the same time, Japan should shoot for domestic demand growth of at least 5% annually and Germany at least 4% — in both cases, growth rates markedly above what present policy intentions suggest; again, fiscal expansion is the preferred instrument.

Once demand policies are put right, it would be foolish to resist a further fall in the dollar as an aid to adjustment. However, it is an illusion to suppose that the U.S. trade deficit can be cured by driving down the dollar while procrastinating on the demand issue. If domestic demand growth is not reined back, currency depreciation in today's full-employment economy would breed little or no trade adjustment but build an inflation problem ultimately soluble only by recession. By contrast, if U.S. domestic demand is held in check, it becomes entirely sensible to let the dollar go lower. In that way, amplified by the increased exchange rate "pass-through" that renewed dollar decline should compel, price incentive would reinforce the income determinant of U.S. trade adjustment. The more that domestic demand paths can be tilted to favor external adjustment, in the surplus countries as importantly as in the United States, the less will adjustment need to rely on dollar depreciation.

In a world of integrated production and markets, the management of global imbalances and economic growth demands an international approach. Policymakers have responded by upgrading the G-7 forum, issuing pronouncements of impressive gravity, and sometimes adjusting policies at the margin, albeit largely as domestic considerations might warrant. But willingness to adjust domestic policies for global ends is rarely in evidence. Nationalism still rules. Its danger now is a rocky descent into protectionism, trade bilateralism (a factor in the otherwise commendable U.S. initiatives vis-à-vis Canada and Mexico), disintegration of global trade and financial markets, and impaired growth and living standards for the free world generally.

The markets have delivered the strongest possible message to the G-7. The Group's efforts at coordination for global growth and adjustment so far have been to little positive effect and lack credibility. For now, musings on gold, commodity prices, or nominal GNP targets are best left to academic research. Nor is pursuit of exchange rate stability for its own sake an appropriate endeavor. The real urgency lies in getting macroeconomic policy fundamentals right.

Statistical appendix

For key to data in tables see April 1987 issue.

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Information herein is from sources considered to be reliable but is furnished without responsibility on the part of Morgan Guaranty Trust Company.

Effective exchange rates — industrial countries

Index numbers, 1980-82 average=100.

	United States	Canada	Japan	Australia	France	Germany	Italy	United Kingdom	Austria	Belgium	Netherlands	Spain	Switzerland	Denmark	Norway	Sweden
Nominal against 15 other industrial-country currencies																
1982	109.8	99.4	98.5	100.0	93.1	102.8	92.7	98.0	101.7	92.2	102.7	94.0	106.3	95.6	101.7	92.7
1983	114.2	100.8	107.7	91.9	87.3	107.5	90.3	91.5	103.6	90.0	105.0	78.4	111.4	96.4	99.4	82.1
1984	122.3	97.3	112.8	94.2	84.4	107.3	86.7	88.0	103.6	88.9	103.9	77.3	110.4	93.9	97.8	84.2
1985	126.9	92.8	115.7	76.3	85.4	107.8	92.1	88.1	104.2	89.5	104.0	75.5	109.5	95.0	95.6	83.8
1986	105.9	87.6	150.0	61.3	87.4	116.1	82.8	80.6	107.8	92.9	110.3	73.4	118.0	99.7	89.2	81.5
1987																
January	98.5	88.1	156.1	57.2	87.4	122.2	84.0	74.8	110.4	95.9	114.9	71.9	121.7	103.9	83.8	79.9
February	96.9	89.7	156.4	57.2	87.9	122.7	83.9	74.8	110.7	96.4	115.0	71.3	121.4	104.6	84.4	80.0
March	96.0	90.5	157.9	58.3	87.3	121.7	83.3	78.1	110.3	95.7	114.1	71.1	121.4	103.7	84.8	80.6
April	94.0	90.2	165.9	59.1	87.2	121.4	82.9	78.8	110.0	95.5	114.1	71.1	123.0	103.2	85.3	80.6
May	93.5	88.4	168.2	58.7	87.1	121.7	82.1	79.8	110.1	95.6	114.3	71.4	123.8	103.6	85.8	80.4
June	94.8	88.8	164.7	59.9	87.1	121.6	81.8	79.1	110.2	95.6	114.3	71.9	122.7	103.4	86.5	80.5
July	96.0	90.0	159.1	60.0	87.2	121.4	81.6	79.2	110.2	95.4	114.2	72.5	122.2	102.4	87.2	80.4
August	95.7	90.0	162.7	59.8	86.8	121.3	81.5	78.9	110.1	95.2	114.1	73.6	122.6	101.3	87.3	80.2
September	93.9	90.3	165.4	60.5	86.9	121.5	81.7	79.6	110.1	95.3	114.1	74.6	122.7	100.6	87.4	79.9
September 4	93.4	90.2	167.3	60.0	86.8	121.7	81.7	79.4	110.1	95.4	114.4	74.4	123.2	101.1	87.3	79.8
11	93.5	89.9	166.4	60.3	86.9	121.8	81.7	79.5	110.2	95.3	114.6	74.5	123.0	100.9	87.3	79.8
18	93.9	90.3	164.8	60.8	87.0	121.5	81.8	79.6	110.0	95.3	114.4	74.5	122.6	101.0	87.3	79.8
25	94.0	90.3	165.0	60.9	87.0	121.4	81.8	79.7	110.0	95.3	114.3	74.6	122.4	101.2	87.5	79.2
October 2	94.7	91.0	163.2	60.1	87.0	121.2	81.7	79.6	109.9	95.2	114.2	74.9	121.9	101.0	87.4	79.9
9	94.3	91.1	163.3	60.2	86.2	121.5	81.9	79.9	110.1	95.3	114.4	75.1	121.9	101.1	87.4	80.0
16	93.3	91.1	165.7	60.0	86.9	121.4	81.8	80.0	110.0	95.0	114.3	75.7	122.6	101.3	87.4	79.8
Real against 15 other industrial-country currencies																
1981	100.8	99.5	104.6	102.6	100.0	96.9	98.9	102.3	99.4	101.4	97.1	99.6	98.7	98.9	101.3	101.8
1982	109.3	100.6	92.3	105.7	97.2	99.9	98.5	98.6	101.2	91.8	100.5	98.9	102.9	97.9	103.2	95.5
1983	112.7	102.6	96.7	101.8	94.7	101.0	101.1	93.0	102.0	88.5	100.7	88.8	105.0	100.4	102.0	90.7
1984	119.5	100.2	97.6	106.4	97.0	98.0	101.8	90.1	103.0	85.8	97.8	91.0	100.0	99.2	100.5	95.9
1985	122.3	96.4	96.5	89.4	100.4	96.7	100.2	92.7	103.3	85.2	96.6	92.5	97.9	101.2	99.4	96.8
1986	101.4	93.4	119.1	78.8	103.8	103.3	102.6	87.2	106.6	84.6	101.4	95.3	105.6	107.5	97.0	95.9
1987																
April	90.5	96.5	126.3	81.3	105.6	105.9	103.6	86.9	108.8	84.6	105.3	95.0	110.2	111.9	99.8	95.5
May	89.9	95.1	127.5	80.8	105.3	106.1	103.4	88.3	108.6	84.2	105.3	95.4	110.7	113.1	100.9	95.0
June	91.2	95.6	124.8	82.7	105.4	105.9	103.1	87.6	110.0	84.3	104.6	95.9	109.3	112.5	101.1	95.5
July	92.6	96.9	120.7	83.8	105.8	105.9	102.6	87.8	111.4	83.4	102.9	97.0	108.7	111.3	102.1	95.6
August	92.2	97.2	123.6	84.4	105.3	105.7	102.7	87.4	109.9	83.2	103.0	98.7	109.2	110.1	103.3	95.7
September	90.0	98.1	125.0	86.4	106.0	105.4	102.8	88.2	110.1	83.1	104.5	100.0	109.4	109.8	104.8	95.4
Real against 18 other industrial-country and 22 LDC currencies																
1981	99.8	99.4	104.6	102.5	99.5	96.1	98.2	101.8	98.9	100.8	96.6	98.8	98.0	98.7	101.2	101.5
1982	109.6	101.7	93.9	105.2	96.9	99.4	98.1	98.4	101.1	91.5	99.5	98.9	102.6	97.7	102.9	95.3
1983	114.9	104.6	100.3	102.0	94.4	100.5	100.8	93.0	102.1	88.1	99.5	89.2	105.1	100.3	101.9	90.9
1984	120.7	102.7	102.3	106.7	96.4	96.8	101.0	89.6	102.6	85.0	95.8	91.2	99.7	99.0	100.5	95.7
1985	123.8	99.2	101.5	90.0	100.0	95.8	99.8	92.2	102.9	84.5	94.8	93.2	97.7	101.2	99.8	96.8
1986	107.0	94.5	123.9	80.7	104.4	104.5	104.0	88.0	107.4	85.1	101.3	97.9	107.4	108.0	97.8	96.7
1987																
April	97.2	96.7	130.5	83.2	106.8	108.2	106.2	88.6	110.3	85.8	106.3	98.6	113.1	112.8	100.8	96.8
May	96.3	95.2	131.5	82.7	106.6	108.5	106.0	90.0	110.2	85.5	106.4	99.0	113.6	114.1	102.1	96.6
June	97.3	95.8	128.8	84.4	106.5	108.2	105.6	89.2	111.5	85.5	105.5	99.4	112.1	113.4	102.1	96.8
July	98.5	97.3	124.7	85.0	106.9	108.0	105.0	89.4	112.9	84.5	103.7	100.5	111.4	112.2	103.1	96.8
August	98.1	97.5	127.8	85.7	106.3	107.7	105.0	88.9	111.3	84.2	103.7	102.2	112.0	111.0	104.3	96.9
September	95.7	98.1	128.5	87.5	107.0	107.5	105.1	89.8	111.5	84.2	105.2	103.5	112.1	110.7	105.7	96.6

Real effective exchange rates — developing countries

Index numbers, 1980-82 average=100.

	Argentina	Brazil	Chile	Colombia	Mexico	Peru	Venezuela	Hong Kong	Indonesia	Korea	Malaysia	Philippines	Singapore	Taiwan	Israel	Turkey
1981	107.1	103.2	108.0	100.6	113.9	103.3	99.7	98.9	99.8	100.3	99.4	101.2	102.0	101.8	99.2	104.5
1982	76.6	112.8	97.0	105.9	82.2	104.5	110.2	101.6	111.7	101.9	105.6	106.7	100.8	96.6	108.6	95.8
1983	71.2	85.9	89.1	104.9	78.5	98.3	117.2	95.7	98.2	97.6	113.9	96.1	101.8	94.6	120.7	93.3
1984	79.8	85.6	89.9	99.6	91.3	105.7	85.9	100.2	95.9	96.5	119.6	107.8	102.4	97.1	119.4	91.0
1985	70.9	84.9	79.4	85.6	90.0	96.3	93.0	104.1	94.7	89.1	116.3	114.5	95.6	94.6	106.5	91.3
1986	60.7	74.3	68.4	67.7	64.7	93.7	85.7	94.9	71.6	75.7	94.5	90.2	80.2	88.7	100.7	71.0
1987																
January	56.2	75.9	65.6	65.5	60.8	107.7	49.9	91.0	56.0	74.1	89.5	87.6	76.4	88.4	94.5	63.7
February	55.5	71.7	66.1	65.7	61.2	110.9	53.5	90.4	56.0	73.7	89.9	84.9	74.7	88.7	93.2	63.3
March	53.3	71.2	66.6	64.9	62.0	112.8	56.9	91.5	55.1	73.7	90.1	84.5	74.2	89.2	94.4	64.1
April	53.1	75.4	65.9	63.9	62.1	115.4	57.6	90.6	53.6	73.5	90.0	83.8	73.1	89.6	94.9	63.4
May	53.1	75.7	66.0	63.2	63.0	118.2	55.9	90.7	53.8	74.1	89.5	84.0	73.3	92.0	94.8	62.9
June	53.6	75.5	65.6	63.1	65.1	121.7	57.9	92.3	54.7	75.4	89.8	86.4	73.8	94.8	96.7	63.0
July	53.5	73.1	65.8	63.6	68.4	131.5	58.6	91.5	56.1	76.6	91.0	88.8	74.5	95.9	97.4	62.8
August	54.7	71.4	67.3	63.6	67.7	140.8	58.7	91.5	55.9	76.4	90.9	86.5	74.4	98.0	98.3	62.4
September	53.3	80.1	65.8	63.3	68.3	146.9	58.6	92.5	57.4	76.0	89.9	86.9	73.4	96.4	98.2	60.0

International banking market size

at end of period, billions of dollars

	1982	1983	1984	1985	1986 Mar	1986 Jun	1986 Sep	1986 Dec	1987 Mar
Gross claims									
Eurocurrencies, on residents and nonresidents	**2 146**	**2 253**	**2 359**	**2 833**	**2 947**	**3 040**	**3 347**	**3 560**	**3 811**
On nonbanks	634	665	694	822	854	875	914	938	995
On banks	1 512	1 588	1 665	2 011	2 093	2 165	2 433	2 622	2 817
In dollars	1 694	1 797	1 894	2 101	2 138	2 166	2 381	2 534	2 602
In other currencies	452	456	465	732	809	874	966	1 025	1 209
Domestic currencies, on nonresidents	**398**	**402**	**402**	**506**	**535**	**578**	**633**	**672**	**721**
On nonbanks	132	140	142	187	186	201	211	209	229
On banks	266	262	260	319	349	377	422	463	492
In dollars	211	221	215	215	203	210	219	227	206
In other currencies	187	181	187	291	332	368	414	445	515
Total	**2 544**	**2 655**	**2 761**	**3 339**	**3 482**	**3 618**	**3 980**	**4 232**	**4 532**
On nonbanks	766	805	836	1 009	1 040	1 076	1 125	1 147	1 224
On banks	1 778	1 850	1 925	2 330	2 442	2 542	2 855	3 085	3 309
In dollars	1 905	2 018	2 109	2 316	2 341	2 376	2 600	2 761	2 808
In other currencies	639	637	652	1 023	1 141	1 242	1 380	1 470	1 724
Gross liabilities									
Eurocurrencies, to residents and nonresidents	**2 168**	**2 278**	**2 386**	**2 846**	**2 964**	**3 059**	**3 384**	**3 579**	**3 851**
To nonbanks	432	479	497	585	610	632	660	685	740
To official monetary institutions	91	88	96	112	106	109	110	109	125
To other banks	1 645	1 711	1 793	2 149	2 248	2 318	2 614	2 786	2 986
In dollars	1 741	1 846	1 950	2 147	2 166	2 204	2 425	2 553	2 648
In other currencies	427	432	436	699	798	855	959	1 026	1 203
Domestic currencies, to nonresidents	**250**	**260**	**280**	**377**	**394**	**418**	**464**	**494**	**556**
To nonbanks	70	73	80	114	121	121	121	116	134
To banks	180	187	200	263	273	297	343	377	422
In dollars	116	135	146	169	166	171	191	192	192
In other currencies	134	125	134	208	228	247	273	302	364
Total	**2 418**	**2 538**	**2 666**	**3 223**	**3 358**	**3 477**	**3 848**	**4 073**	**4 407**
To nonbanks	502	552	577	699	731	753	781	801	874
To banks and official institutions	1 916	1 986	2 089	2 524	2 627	2 724	3 067	3 272	3 533
In dollars	1 857	1 981	2 096	2 316	2 332	2 375	2 616	2 745	2 840
In other currencies	561	557	570	907	1 026	1 102	1 232	1 328	1 567
Net market size	**1 285**	**1 382**	**1 430**	**1 676**	**1 735**	**1 800**	**1 912**	**1 979**	**2 023**

International bond issues and bank credits

millions of dollars

	1984	1985	1986	1987			Jan-Aug	
				Jun	Jul	Aug	1987	1986
By country of borrower								
Industrial countries	**177 077**	**226 711**	**270 231**	**17 825**	**23 225**	**15 277**	**159 701**	**174 119**
Australia	5 816	14 407	20 106	1 157	2 150	305	8 491	10 609
Austria	2 254	2 435	3 581	305	212	418	2 909	2 499
Belgium	1 847	3 269	4 952	430	395	601	3 480	3 585
Canada	13 124	17 184	21 633	1 386	806	206	6 772	12 770
Denmark	4 825	3 589	9 633	246	142	78	3 969	4 603
Finland	1 713	1 846	3 445	151	110	244	2 472	2 024
France	11 298	18 773	19 701	604	784	438	9 069	12 394
Germany	2 165	3 452	11 927	737	1 213	1 183	9 050	7 958
Greece	1 551	1 587	1 317	166	—	158	834	902
Ireland	1 377	1 881	4 179	130	85	80	1 233	3 208
Italy	6 933	11 033	12 962	810	1 192	200	5 476	9 486
Japan	17 526	21 269	35 508	4 125	6 592	5 262	33 685	22 011
Netherlands	1 973	2 299	3 579	789	896	—	3 843	2 288
New Zealand	3 208	2 707	8 078	275	228	308	3 379	4 683
Norway	1 324	3 905	6 644	292	205	429	4 281	4 274
Portugal	1 796	2 382	2 433	336	589	—	1 891	2 130
South Africa	1 422	825	—	—	—	—	—	—
Spain	4 931	3 913	7 015	139	98	—	994	4 205
Sweden	11 256	9 890	8 020	765	405	137	4 196	6 248
United Kingdom	8 899	25 424	24 295	1 136	1 492	959	19 205	14 914
United States	65 054	69 193	56 774	3 287	4 432	3 087	29 275	40 385
*Other**	6 785	5 447	4 448	555	1 200	1 182	5 195	2 942
Developing countries	**39 725**	**32 139**	**24 317**	**1 549**	**2 445**	**2 598**	**21 810**	**16 336**
Latin American countries	**17 464**	**8 115**	**3 192**	**66**	**191**	**1 950**	**10 732**	**1 795**
Argentina	4 212	3 700	17	—	—	1 950	1 950	17
Brazil	6 649	—	219	—	—	—	—	—
Chile	784	1 085	—	—	—	—	—	—
Colombia	589	1 052	89	—	—	—	50	89
Mexico	3 918	109	313	—	—	—	7 700	50
Venezuela	—	48	—	—	30	—	30	—
*Other***	1 312	2 121	2 554	66	161	—	1 002	1 639
Asian countries	**15 893**	**18 410**	**15 291**	**1 000**	**2 054**	**648**	**8 968**	**10 460**
India	945	818	1 721	55	628	25	1 458	844
Indonesia	1 924	451	1 358	215	25	35	895	1 008
Korea	6 201	5 898	3 134	174	375	242	2 113	2 606
Malaysia	2 605	2 219	1 328	83	113	—	363	762
Philippines	925	925	—	—	—	—	—	—
Thailand	1 221	1 497	1 401	—	66	38	273	1 044
Other	2 072	6 602	6 350	473	847	308	3 866	4 196
Middle Eastern and African countries	**6 368**	**5 613**	**5 834**	**483**	**200**	**—**	**2 110**	**4 081**
Algeria	821	1 450	1 344	87	—	—	241	996
Nigeria	985	—	—	—	—	—	—	—
Turkey	741	1 203	2 637	370	200	—	1 423	1 522
Other	3 821	2 960	1 853	26	—	—	446	1 563
Eastern European countries	**3 244**	**5 236**	**4 091**	**100**	**652**	**—**	**2 409**	**3 308**
Hungary	1 386	1 577	1 315	—	400	—	1 114	1 149
Soviet Union	1 051	1 489	1 821	—	32	—	694	1 298
*Other****	807	2 169	955	100	220	—	600	860
International organizations****	**13 287**	**20 635**	**18 916**	**1 372**	**2 770**	**1 026**	**13 163**	**12 041**
By type of instrument and currency								
International bond issues	**107 411**	**167 756**	**226 393**	**14 137**	**20 260**	**14 376**	**136 208**	**148 732**
Eurobonds	79 458	136 731	187 952	12 176	16 449	10 925	113 649	125 370
U.S. dollar	63 593	97 782	118 220	5 104	9 303	7 887	48 995	77 449
German mark	4 604	9 491	16 870	834	1 214	520	11 378	12 650
British pound	3 997	5 766	10 510	1 272	1 236	648	11 314	8 462
Japanese yen	1 212	6 539	18 673	2 583	444	185	17 774	10 889
European composite units	3 032	7 038	6 965	693	335	389	5 985	5 074
Other	3 020	10 114	16 713	1 689	3 916	1 296	18 203	10 846
Foreign bonds	27 953	31 025	38 441	1 962	3 811	3 451	22 559	23 362
U.S. dollar	5 487	4 655	6 064	—	300	50	2 100	2 814
German mark	2 243	1 741	—	—	—	—	—	—
British pound	1 292	958	322	—	—	—	—	321
Swiss franc	12 626	14 954	23 401	1 512	3 157	2 707	16 166	14 636
Japanese yen	4 628	6 379	4 756	209	66	297	2 089	3 362
Other	1 677	2 339	3 898	241	288	397	2 204	2 227
International bank credits	**125 922**	**116 964**	**91 164**	**6 709**	**8 833**	**4 525**	**60 874**	**57 072**
Eurocurrency credits	112 605	110 317	82 755	5 830	7 078	3 608	54 161	51 909
Foreign credits	13 317	6 647	8 409	879	1 755	917	6 713	5 163
Total	**233 333**	**284 720**	**317 556**	**20 846**	**29 093**	**18 901**	**197 082**	**205 804**

*Includes multinational organizations. **Includes unallocated. ***Includes COMECON institutions. ****Includes regional development organizations.

Eurocurrency deposit rates

prime banks' bid rates, at or near end of month

	1984	1985	1986	1987						
	Dec	Dec	Dec	Mar	Apr	May	Jun	Jul	Aug	Sep
Eurodollar										
overnight	8.63	12.25	22 00	6.25	6.50	6.69	6.44	6.62	6.81	8.25
one month	8.38	8.00	6.50	6.44	6.69	7.12	6.94	6.75	7.12	7.75
three months	8.63	7.88	6.25	6.50	7.00	7.25	7.06	7.00	7.19	8.37
six months	9.13	7.88	6.12	6.56	7.25	7.44	7.25	7.25	7.44	8.50
twelve months	9.81	7.94	6.12	6.69	7.62	7.94	7.62	7.69	7.94	9.00
Euro-Canadian dollar										
one month	9.88	9.00	8.00	6.87	7.37	7.87	8.06	8.94	9.12	9.19
three months	10.81	9.00	8.12	6.87	8.25	8.12	8.19	9.12	9.25	9.69
six months	10.06	9.00	8.19	6.94	8.62	8.44	8.37	9.56	9.62	10.19
twelve months	10.44	9.00	8.31	7.06	8.87	8.87	8.69	9.87	10.00	10.69
Euro-French franc										
one month	10.69	12 50	10.12	8.19	8.12	8.00	8.06	7.81	7.81	7.81
three months	10.69	13.00	10.37	8.25	8.25	8.19	8.37	8.12	8.19	8.31
six months	11.00	13.13	9.75	8.31	8.31	8.37	8.56	8.56	8.81	8 69
twelve months	11.38	12.25	8.75	8.31	8.50	8.62	9.00	9.12	9.31	9.19
Euromark										
one month	5.50	4.75	5.12	3.87	3.81	3.75	3.62	3 87	4.00	4.12
three months	5.50	4.75	4.87	3 87	3.81	3.75	3.81	3.94	4.06	4.56
six months	5.56	4.75	4.81	3.87	3.87	3.75	3.81	4.12	4.31	4.75
twelve months	5.56	4.81	4.81	4.00	4.00	3.87	3.87	4.00	4.44	4.81
Euro-Dutch guilder										
one month	5.69	5.75	6 31	5.31	5.19	5.06	5.19	5.25	5.19	5.25
three months	5.75	5.75	6.00	5.31	5.19	5.06	5.19	5.31	5.31	5.56
six months	5.81	5.81	5.87	5.31	5.19	5.12	5.19	5.37	5.37	5.62
twelve months	5.94	5.88	5.81	5.31	5.19	5.12	5.19	5.44	5.50	5.75
Euro-Swiss franc										
one month	4.44	3 88	3 94	3.25	3.25	4.25	3.69	3 62	3 94	3,69
three months	4.56	4.00	3.94	3.69	3.69	3.87	3.81	3.81	3.75	4.37
six months	4.63	4.00	3 87	3.69	3.69	3.87	3.81	3.94	4 00	4.37
twelve months	4.69	4.06	3.87	3.75	3.81	3.87	3.87	4.00	4.06	4.37
Eurosterling										
one month	9.50	11.69	11.12	10.00	9.44	8.87	9.12	9.00	10.00	10.19
three months	9.88	11.81	11.12	9 81	9.25	8.81	9.19	9.44	10.50	10.37
six months	10.00	11.81	11 06	9 69	9.12	8.81	9.19	9 69	10,75	10.50
twelve months	10.19	11.69	11.06	9.62	9.12	9.06	9.31	10.06	11.00	10.69
Euroyen										
one month	6.19	7.13	4 56	3.94	3.94	4.00	3.81	3.62	4.00	4.37
three months	6.19	6.56	4 50	4 00	3.94	3.87	4.00	4.06	4.06	5.00
six months	6.13	6.50	4 37	4.00	3.87	3.87	4.00	4.12	4.19	5.19
twelve months	6.13	6.38	4.31	4.00	3.94	3.94	4.06	4.25	4.31	5.25
European currency unit										
one month	9.25	9.63	8 56	7.16	6 94	6.69	6.56	6.62	6.75	6,87
three months	9.38	9.63	8 44	7.16	6.94	6.87	6 75	6.19	7.00	7.37
six months	9.50	9.63	8.06	7 16	7.00	7.00	6.94	6.94	7.25	7.56
twelve months	9.63	9.63	7.31	7.19	7.19	7.12	7.12	7.12	7.37	7.68

International bond yields

average yield of several actively traded, high quality issues with a maturity of 7 to 12 years at or near end of month

	1985	1986	1987							
	Dec	Dec	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
United States companies										
Eurodollar	9 68	8.67	8.71	8.78	9.53	9.78	10.11	9 82	9.99	10.95
Euromark	6.73	6.62	6.60	6 56	6 59	6.57	6 65	7.04	6.82	6.87
Swiss franc	5.49	5.70	5.64	5.68	5.55	5.52	5.50	5.57	5.43	5.50
European governments										
Eurodollar	10.52	9.91	10.03	10 08	11.00	11.24	11.14	11 22	11.41	11.81
Euromark	7.03	6.77	6.70	6 50	6.33	6.35	6 36	6 55	6 65	6.76
Swiss franc	4.91	4.51	4 35	4.37	4.27	4.34	4.33	4.33	4.38	4.39
European currency unit	10.23	10.20	10.37	10.26	13.07	10.32	10.51	10.40	10.43	10.46

Central bank discount rates

at or near end of month

	1984	1985	1986	1987					Current	
	Dec	Dec	Dec	May	Jun	Jul	Aug	Sep	Oct 21 1987	effective since
United States	8.00	7.50	5.50	5.50	5.50	5.50	5.50	6.00	6.00	Aug 24, 87
Canada	10.09	9.49	8.47	8.44	8.54	9.22	9.24	9.57	9.83	Oct 15, 87
Austria	4.50	4.00	4.00	3.50	3.50	3.50	3.50	3.50	3.50	Jan 23, 87
Belgium	11.00	9.75	8.00	7.75	7.50	7.25	7.25	7.25	7.25	Jul 23, 87
Denmark	7.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00	Oct 27, 83
Finland	9.50	9.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00	May 19, 86
France	9.50	9.50	9.50	9.50	9.50	9.50	9.50	9.50	9.50	Aug 31, 77
Germany	4.50	4.00	3.50	3.00	3.00	3.00	3.00	3.00	3.00	Jan 23, 87
Ireland	14.00	10.25	13.25	11.75	11.25	10.25	10.25	9.75	9.75	Sep, 87
Italy	16.50	15.00	12.00	11.50	11.50	11.50	12.00	12.00	12.00	Aug 28, 87
Netherlands	5.00	5.00	4.50	4.50	4.50	4.50	4.50	4.50	4.50	Mar 7, 86
Portugal	25.00	19.00	16.00	15.00	15.00	15.00	15.00	15.00	15.00	Mar 23, 87
Spain	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00	Jul 26, 77
Sweden	9.50	10.50	7.50	7.50	7.50	7.50	7.50	7.50	7.50	Sep 19, 86
Switzerland	4.00	4.00	4.00	3.50	3.50	3.50	3.50	3.50	3.50	Jan 22, 87
United Kingdom	9.38	11.31	10.81	8.87	8.87	8.87	9.87	9.87	9.87	Aug 7, 87
Japan	5.00	5.00	3.00	2.50	2.50	2.50	2.50	2.50	2.50	Feb 23, 87
New Zealand	13.50	19.80	24.60	21.35	20.00	19.20	18.55	n.a.	n.a.	Aug, 87
South Africa	21.75	13.50	10.00	10.00	10.00	10.00	10.00	10.00	10.00	Dec 10, 86
Argentina*	18.19	5.00	11.19	9.00	10.50	12.80	15.20	15.70	n.a.	Sep, 87
Korea	5.00	5.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00	Jul 10, 86
Philippines	12.11	11.50	9.64	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	Feb, 87
Singapore	6.75	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	Jul, 85
Thailand	12.00	11.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00	Sep 1, 86
Venezuela	11.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	Mar, 85

*Percent per month.

Day-to-day money rates

monthly averages

	1984	1985	1986	1987							
	Dec	Dec	Dec	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
United States	8.38	8.27	6.71	6.10	6.13	6.35	6.85	6.72	6.58	6.82	7.21
Canada	10.50	9.23	8.28	7.22	7.16	7.10	7.41	8.35	8.53	8.72	8.80
Austria	7.63	7.25	7.62	4.25	4.12	4.25	3.80	3.95	4.10	4.10	4.12
Belgium	9.12	6.60	5.09	6.90	5.83	5.65	5.41	5.42	5.62	4.82	5.24
Finland	15.07	11.96	11.97	11.76	11.44	11.14	11.00	11.00	11.00	11.00	11.00
France	10.95	9.02	7.80	8.36	7.89	7.91	8.02	8.01	7.46	7.41	7.19
Germany	5.62	4.64	5.00	3.83	3.84	3.75	3.69	3.61	3.73	3.78	3.71
Ireland	14.50	9.62	13.00	13.94	13.75	13.25	12.00	11.00	9.00	8.25	8.75
Italy	17.25	14.75	11.42	11.81	11.22	10.56	10.25	10.78	10.95	11.09	11.70
Netherlands	5.60	5.75	6.19	5.31	5.56	5.19	5.20	5.19	5.19	4.84	4.75
Norway	12.50	12.50	14.00	14.00	14.00	14.00	14.00	14.00	n.a	n.a.	n.a.
Spain	12.18	9.92	11.76	12.47	14.43	17.32	20.18	18.12	18.09	17.68	17.45
Sweden	11.88	11.83	8.89	11.73	12.02	8.70	8.71	8.22	8.61	8.50	n.a.
Switzerland	1.50	2.00	1.12	1.00	1.00	1.75	1.37	2.25	2.00	1.50	1.37
United Kingdom	6.31	9.72	9.19	10.88	10.30	9.61	8.78	9.16	8.78	9.12	9.72
Australia	10.98	18.37	15.40	16.22	16.14	14.71	13.45	12.79	12.08	11.90	11.58
Japan	6.41	8.02	4.18	4.05	3.85	3.52	3.16	3.16	3.17	3.20	3.25
South Africa	21.13	12.50	8.50	8.50	8.37	8.31	8.37	8.00	8.56	n.a.	8.45
Argentina*	17.75	4.50	7.00	4.00	5.32	5.50	6.00	8.00	9.00	11.17	12.50
Brazil	272.02	352.23	83.05	412.00	408.00	853.00	n.a.	n.a.	n.a.	n.a.	n.a.
Hong Kong	6.80	6.10	3.90	1.97	3.76	4.11	4.20	6.45	5.33	5.54	3.67
Korea	10.00	8.80	9.00	8.60	8.80	8.40	8.50	8.90	8.90	n.a.	n.a.
Philippines	15.22	15.03	n.a.	6.44	13.79	13.29	n.a.	n.a.	n.a.	n.a.	n.a.
Singapore	6.01	4.53	3.51	3.22	2.24	3.31	4.39	2.57	3.33	2.91	2.52
Taiwan	8.07	4.50	3.00	3.25	3.10	3.50	3.50	3.50	5.50	n.a.	n.a.

*Percent per month.

Treasury bill rates

bond-equivalent yields, at or near end of month

	1984	1985	1986	1987							
	Dec	Dec	Dec	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
United States	7.99	7.25	5.73	5.48	5.76	5.61	5.82	5.90	6.11	6.41	6.82
Canada	9.84	9.24	8.22	7.28	6.80	8.08	8.19	8.29	8.97	8.99	9.32
Belgium	10.90	9.89	7.50	7.86	7.50	7.35	7.15	6.84	6.74	6.74	6.74
Ireland	15.10	11.15	13.60	13.67	13.51	11.29	10.86	10.46	9.56	9.93	8.93
Italy	14.69	13.10	10.00	9.74	9.66	9.60	9.60	9.60	10.53	10.92	n.a.
Netherlands	5.88	5.69	6.37	5.87	5.44	5.31	5.31	4.75	5.25	5.62	n.a.
Spain	12.27	9.52	8.37	7.67	n.t.	9.61	10.40	9.59	8.61	7.10	6.73
Sweden	11.83	12.49	9.20	10.80	10.31	9.25	9.16	8.60	9.11	9.25	n.a.
United Kingdom	9.33	11.49	10.79	10.46	9.54	9.39	8.68	8.96	9.14	10.12	10.02
Australia	12.27	19.40	14.91	16.32	15.47	14.00	13.01	12.23	12.04	11.91	11.09
Japan	4.91	4.91	2.89	2.89	2.38	2.38	2.38	2.38	2.38	2.38	2.38
New Zealand	13.50	17.62	19.69	25.38	24.70	25.29	19.48	18.40	n.t.	19.38	n.t.
South Africa	21.94	12.99	8.84	8.78	8.26	8.60	8.96	8.64	8.74	8.70	8.72
Brazil	273.03	379.77	149.00	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Mexico	48.67	72.98	104.03	104.83	100.66	99.01	98.60	98.40	96.86	n.a.	n.a.
Philippines	47.14	16.45	n.a.	7.71	11.76	11.80	n.a.	n.a.	n.a.	n.a.	n.a.
Singapore	2.91	2.94	2.10	1.67	1.93	2.12	2.61	2.63	2.97	3.01	3.26

Representative money market rates

bond-equivalent yields on major short-term (mostly 3-4 month) money market instruments other than Treasury bills, at or near end of month

	1984	1985	1986	1987							
	Dec	Dec	Dec	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
United States	8.34	8.01	8.04	6.24	6.70	6.98	7.12	7.10	6.98	7.10	7.94
Canada	10.00	9.40	8.35	7.40	6.90	8.15	8.30	8.45	9.20	9.15	9.25
Belgium	10.85	9.89	7.60	7.81	7.50	7.40	7.30	7.00	6.84	6.79	6.79
France	10.69	9.12	8.37	8.25	7.87	8.00	8.12	8.25	7.87	7.81	7.87
Germany	5.75	4.80	4.85	3.85	3.85	3.80	3.65	3.65	3.85	3.85	4.55
Ireland	15.13	12.00	14.06	14.25	13.37	10.87	11.19	10.50	9.87	9.94	9.94
Italy	16.88	15.13	11.37	11.12	10.12	10.00	10.50	11.00	11.12	12.37	12.37
Netherlands	5.75	5.75	6.19	5.50	5.55	5.31	5.25	5.25	5.37	5.25	5.38
Portugal	24.57	20.71	16.07	14.94	14.95	14.96	14.90	15.05	15.07	15.09	n.a.
Spain	12.21	10.51	11.79	12.60	14.60	17.09	19.80	18.29	17.56	16.83	16.86
Switzerland	5.00	4.75	4.50	4.00	3.87	3.75	3.87	3.81	3.94	3.75	4.25
United Kingdom	9.88	12.75	11.25	10.19	10.06	9.25	9.00	9.25	9.44	10.31	10.19
Australia	12.90	19.75	15.10	16.60	16.25	14.50	13.80	13.35	12.40	12.50	11.25
Japan	6.33	7.03	4.34	3.96	3.98	3.89	3.70	3.73	3.74	3.71	3.84
New Zealand	15.00	20.00	24.25	25.15	25.60	25.70	20.35	18.75	18.70	18.30	18.90
South Africa	22.78	13.35	8.55	9.05	8.40	9.10	9.00	8.80	8.80	8.85	8.90
Chile	20.68	22.42	19.56	25.34	23.87	22.42	28.32	14.03	18.16	25.34	26.82
Hong Kong	8.25	6.50	4.62	4.37	4.87	5.50	6.25	6.87	6.19	6.56	6.37
Indonesia	19.00	15.00	19.50	16.00	17.00	16.50	18.00	27.00	n.a.	20.50	18.75
Korea	8.00	8.00	8.00	8.00	8.00	8.00	7.50	7.50	7.50	7.50	n.a.
Malaysia	10.30	8.20	6.00	3.30	2.60	2.70	2.80	2.75	n.a.	n.a.	n.a.
Philippines	33.21	14.61	8.31	7.05	8.72	10.05	n.a.	n.a.	n.a.	n.a.	n.a.
Singapore	7.00	5.88	3.94	3.31	3.26	3.73	4.44	4.31	4.13	n.a.	n.a.
Taiwan	7.85	4.10	3.87	3.67	3.56	3.57	3.48	4.36	4.72	n.a.	n.a.
Thailand	12.00	15.50	7.75	7.75	7.75	7.75	7.75	7.75	n.a.	n.a.	n.a.

Commercial bank deposit rates

at or near end of month

	1984	1985	1986	1987							
	Dec	Dec	Dec	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
United States	8.35	7.75	6.30	6.13	6.30	6.80	7.05	6.90	6.77	6.95	8.05
Canada	10.05	9.40	8.15	7.40	7.00	8.25	8.45	8.50	9.25	9.20	9.60
Austria	7.50	6.50	5.50	4.75	4.50	4.37	4.15	4.15	4.25	4.30	4.60
Belgium	10.63	9.63	7.44	7.69	7.37	7.19	7.00	6.56	6.19	6.52	6.56
Denmark	6.00	7.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00
Finland	5.25	4.75	2.75	2.75	2.75	2.75	2.75	2.75	2.75	2.75	2.75
France	7.04	6.12	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50	n.a.
Germany	5.25	4.40	4.80	3.90	3.95	3.95	3.85	3.75	3.75	3.75	3.90
Ireland	14.63	11.87	13.75	14.00	13.25	10.75	11.00	10.25	9.62	9.87	9.00
Italy	11.64	13.21	10.69	10.08	9.88	9.75	10.53	n.a.	n.a.	n.a.	n.a.
Netherlands	5.69	5.81	6.06	5.37	5.37	5.25	5.12	5.12	5.25	5.25	5.50
Norway	12.75	12.00	15.00	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Portugal	28.00	20.00	n.a.	15.00	14.50	14.50	14.50	14.50	14.50	14.50	14.50
Spain	11.64	9.64	8.67	8.57	8.58	8.60	8.77	8.98	9.04	9.21	9.22
Sweden	11.45	12.18	9.93	11.00	10.75	9.75	10.00	9.00	9.25	9.70	n.a.
Switzerland	4.50	4.50	4.25	3.75	3.62	3.50	3.62	3.56	3.69	3.50	4.00
United Kingdom	9.88	11.75	11.19	10.59	9.84	9.25	8.81	9.25	9.31	10.12	10.00
Australia	12.75	18.80	15.56	16.62	16.19	15.21	14.42	13.85	13.41	12.67	12.14
Japan	6.38	7.04	4.55	4.17	4.20	4.11	3.88	3.99	4.09	4.10	4.45
New Zealand	15.25	19.98	23.50	23.70	23.30	23.85	20.00	18.40	18.35	18.40	18.75
South Africa	22.88	13.20	8.65	9.25	8.75	9.15	9.25	9.00	9.00	9.00	9.35
Argentina*	31.23	5.40	8.41	4.43	4.86	7.17	7.81	7.96	10.24	12.20	18.20
Brazil**	27.00	18.00	220.00	32.00	30.00	24.00	n.a.	n.a.	n.a.	n.a.	n.a.
Chile	20.68	23.60	20.98	27.42	24.31	25.93	18.00	17.00	17.74	25.05	26.83
Hong Kong	8.25	6.50	4.62	4.37	4.87	5.50	6.25	6.87	6.19	6.56	6.37
Korea	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00
Malaysia	9.58	7.00	6.33	4.66	2.33	2.43	2.35	2.42	n.a.	n.a.	n.a.
Mexico	47.45	72.90	94.30	94.30	94.30	94.30	94.30	94.30	94.30	n.a.	n.a.
Philippines	31.01	12.34	n.a.	6.68	6.13	7.96	n.a.	n.a.	n.a.	n.a.	n.a.
Singapore	6.13	5.26	3.63	3.32	3.32	3.63	4.88	4.38	4.25	n.a.	n.a.
Taiwan	6.50	5.25	4.00	4.00	4.00	4.00	4.00	4.00	4.00	n.a.	n.a.
Thailand	13.00	10.50	6.75	6.75	6.75	6.75	n.a.	n.a.	n.a.	n.a.	n.a.
Venezuela	12.50	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00	n.a.

*Percent per month.

Domestic government bond yields

long-term issues, at or near end of month

	1984	1985	1986	1987							
	Dec	Dec	Dec	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
United States	11.61	9.49	7.79	7.48	7.81	8.45	8.65	8.50	8.88	9.18	9.80
Canada	11.66	10.04	9.23	9.10	8.98	9.82	9.92	9.78	10.23	10.44	11.16
Austria	8.03	7.61	7.33	7.05	6.93	6.86	6.74	6.61	6.68	6.83	7.00
Belgium	11.56	9.60	7.70	7.57	7.64	7.66	7.76	7.82	7.64	7.93	8.25
Denmark	14.60	9.67	11.04	11.48	10.56	13.09	13.03	10.09	11.57	13.02	12.33
Finland	10.73	10.58	7.80	7.82	7.89	7.77	7.88	7.85	7.86	7.87	7.83
France	12.70	11.33	9.89	9.84	9.42	9.51	9.86	10.40	10.39	10.60	n.a.
Germany	7.17	6.57	6.25	6.26	6.12	5.98	5.99	6.31	6.39	6.59	6.86
Ireland	14.90	11.84	12.97	12.41	11.16	10.47	10.92	10.93	11.81	11.92	11.30
Italy	14.52	13.66	10.05	9.84	10.03	10.08	10.20	10.41	10.90	11.30	n.a.
Netherlands	7.72	6.96	6.40	6.15	6.22	6.12	6.07	6.26	6.43	6.66	6.81
Norway	12.00	13.00	13.24	13.03	13.20	12.96	13.08	13.11	13.00	13.00	n.a.
Portugal	22.23	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Spain	13.93	12.52	10.36	10.59	10.95	12.04	13.43	13.29	13.56	13.75	14.26
Sweden	12.04	12.11	10.66	11.23	10.70	11.07	11.77	11.37	11.79	11.92	n.a.
Switzerland	4.60	4.42	4.05	4.01	4.04	4.03	4.07	4.02	3.98	4.06	4.32
United Kingdom	10.25	10.35	10.17	9.51	9.15	8.87	8.79	9.15	9.69	9.93	9.85
Australia	13.50	14.85	13.40	14.00	13.45	13.05	13.00	12.80	12.95	12.95	12.50
Japan	6.47	5.92	4.61	3.96	3.72	3.42	3.38	3.91	4.44	4.43	5.72
New Zealand	16.90	17.00	16.00	16.80	16.30	15.95	15.65	15.45	15.80	15.65	15.45
South Africa	16.55	18.09	15.06	15.30	14.66	15.30	15.70	15.60	15.18	14.98	15.12
Philippines	18.54	n.t.	n.t.	n.t.	n.t.	n.t.	n.a.	n.a.	n.a.	n.a.	n.a.
Venezuela	14.00	12.00	12.00	12.00	12.00	12.00	12.00	12.00	12.00	12.00	n.a.

Commercial bank lending rates to prime borrowers

at or near end of month

	1984	1985	1986	1987							
	Dec	Dec	Dec	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
United States	10.75	9.50	7.50	7.50	7.50	7.75	8.25	8.25	8.25	8.25	8.75
Canada	11.25	10.00	9.75	9.25	8.75	9.25	9.50	9.50	9.50	10.00	10.00
Austria	9.25	9.00	9.00	8.75	8.75	8.75	8.75	8.50	8.50	8.50	8.50
Belgium	14.00	11.50	9.75	10.25	9.75	9.75	9.25	9.25	8.75	8.75	8.75
Denmark	10.50	8.50	8.00	10.00	10.00	10.00	10.00	9.50	9.50	9.50	9.50
Finland	10.68	10.37	8.81	8.80	8.84	8.86	8.89	8.91	8.93	8.94	n.a.
France	12.00	10.60	9.45	9.45	9.45	9.45	9.45	9.45	9.45	9.45	9.45
Germany	7.75	7.25	6.75	6.25	6.25	6.25	6.25	6.25	6.25	6.25	6.25
Ireland	15.75	12.50	15.75	15.75	15.75	15.25	14.25	13.75	12.75	12.75	12.00
Italy	18.00	15.88	13.00	13.00	12.50	12.50	12.50	12.50	12.50	13.00	13.00
Netherlands	6.25	6.25	7.12	5.75	5.87	5.75	5.62	5.62	5.62	5.62	5.62
Norway	13.00	12.40	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Portugal	29.00	22.50	17.50	17.50	19.50	19.50	19.50	19.50	19.50	19.50	19.50
Spain	15.84	14.75	14.22	14.24	14.57	15.23	16.21	16.51	16.62	16.61	16.69
Sweden	14.50	15.05	11.50	11.50	11.50	11.50	11.50	11.50	11.50	11.50	n.a.
Switzerland	6.00	6.00	5.75	5.25	5.25	5.00	5.00	5.00	5.00	5.00	5.00
United Kingdom	9.50	11.50	11.00	11.00	10.00	9.50	9.00	9.00	9.00	10.00	10.00
Australia	14.00	21.00	18.50	18.50	18.50	17.50	16.75	16.25	15.75	15.25	14.45
Japan	5.50	5.50	3.75	3.75	3.37	3.37	3.37	3.37	3.37	3.37	3.37
New Zealand	14.00	21.00	18.50	25.00	27.00	29.00	22.50	22.00	21.00	19.00	20.00
South Africa	24.00	16.50	12.00	12.50	12.50	12.50	12.50	12.50	12.50	12.50	12.50
Argentina*	32.05	7.30	11.30	5.45	5.71	9.20	8.50	9.65	13.20	15.90	20.00
Brazil**	31.00	19.00	250.00	45.00	40.00	37.00	n.a.	n.a.	n.a.	n.a.	n.a.
Chile	60.82	33.34	29.13	36.07	34.48	36.07	40.27	30.91	27.11	31.66	33.12
Hong Kong	11.00	7.00	6.50	5.00	6.00	6.50	6.50	7.50	7.50	7.50	7.50
Indonesia	23.50	18.75	19.75	19.50	19.50	19.25	19.75	26.00	26.00	23.00	22.00
Korea	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00
Malaysia	12.00	10.50	10.00	9.00	9.00	8.50	8.50	7.75	7.25	n.a.	n.a.
Mexico	47.54	65.66	95.33	96.20	96.25	95.79	94.79	93.76	92.91	n.a.	n.a.
Philippines	44.00	15.00	10.50	8.75	8.53	8.55	9.31	9.50	n.a.	n.a.	n.a.
Singapore	9.40	7.20	6.10	6.10	6.10	6.10	6.10	6.10	6.10	6.10	6.10
Taiwan	10.00	9.50	9.00	9.00	9.00	9.00	9.00	9.00	9.00	n.a.	n.a.
Thailand	16.50	15.50	12.00	12.00	12.00	12.00	n.a.	n.a.	n.a.	n.a.	n.a.
Venezuela	16.00	13.00	13.00	13.00	13.00	13.00	13.00	13.00	13.00	13.00	n.a.

*Percent per month. **Spread above monetary correction until Feb 86; nominal rate of interest until Jan 87; spread above LBC rate thereafter.

Domestic corporate bond yields

long-term issues, at or near end of month

	1984	1985	1986	1987							
	Dec	Dec	Dec	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
United States	12.25	10.15	8.88	8.55	8.65	9.60	9.55	9.55	9.90	10.15	10.75
Canada	12.42	10.74	10.18	9.90	9.79	10.44	10.44	10.46	11.05	11.74	11.74
France	12.94	11.76	10.18	10.06	9.79	9.82	10.05	10.38	10.37	10.77	n.a.
Germany	7.20	6.90	6.50	6.40	6.60	6.50	6.40	6.50	6.60	6.70	n.a.
Netherlands	7.51	n.t.	n.t.	n.t.	n.t.	n.t.	n.t.	n.t.	n.t.	n.t.	n.t.
Norway	12.75	14.00	14.94	n.a.	16.37	15.47	14.22	16.21	n.a.	n.a.	n.a.
Spain	18.32	14.92	13.40	14.13	14.82	15.52	15.76	16.39	16.94	17.52	17.39
Sweden	12.33	13.25	11.99	12.63	12.15	12.15	12.89	12.47	12.68	12.89	n.a.
Switzerland	5.09	4.93	4.72	4.56	4.58	4.57	4.56	4.56	4.53	4.55	4.72
United Kingdom	11.64	11.47	11.71	10.58	10.21	10.09	10.19	10.15	10.55	11.41	11.43
Japan	7.10	6.79	5.93	5.35	5.20	4.99	4.71	5.20	n.a.	6.00	n.a.
Korea	15.00	13.60	12.80	12.70	13.00	13.00	12.80	12.70	12.70	n.a.	n.a.
Venezuela	18.00	17.00	17.00	17.00	17.00	17.00	17.00	17.00	17.00	n.a.	n.a.

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SECRET AND PERSONAL

12

FROM: N I HOLGATE
DATE: 11 November 1987

1. MR KELLY cc
2. CHANCELLOR

cc: Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Peretz
Miss O'Mara
Mr Grice
Mr Pike
Mrs Ryding
Ms Bronk
Mr Norgrove - No 10

Prime Minister

DCN

11/11.

MONEY SUPPLY IN OCTOBER: "FIRST GUESS"

(All figures are unadjusted unless specified otherwise)

This note summarises the Bank's "first guess" at MO and M3 figures for October. As usual at this stage M3 figures are subject to significant revision.

Table 1: Monetary Aggregates (per cent)

	MO	M3**
Annual growth rate*	5.5 (5.6)	21.8-22.6
Change in month*	-0.2 (0.6)	2.7-3.5 (3.1-3.9)
Target range	2-6	-

* Figures in brackets seasonally adjusted

**The actual outturn has been within the range forecast on this basis in 10 of the last 12 months.

2. The increase in sterling bank lending in September is likely to be in the range £1.4-3.4 billion (also £1.4-3.4 billion seasonally adjusted). Lending in October will have been reduced by the repayment of the £0.5 billion takeover related loan (which had boosted the lending figures for September).

SECRET AND PERSONAL

3. Other main points of note in the "first guess" are that both the external and foreign currency finance of the public sector, and the residual are very expansionary. External and foreign currency finance increased by £2.9 billion, reflecting heavy intervention offset by overseas inflows of sterling bank deposits, gilts and Treasury bills. The residual is expansionary by £1.4 billion which suggests that bank lending or others of the figures may turn out to be somewhat higher than suggested by the "first guess" range. Special factors may include a build-up of liquidity by potential BP investors and UK underwriters who were due to pay £1.5 billion to the government early in November; and an increase in BP's holdings of sterling bank deposits due to their receipt of £1.5 billion proceeds on the last day of October. In the M3 counterparts £0.9 billion of the £1.5 billion is part of the expansionary effect of the rise in reserves, because foreign underwriters paid foreign currency to the EEA and the equivalent in sterling was then paid to BP.

M3 components and counterparts

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

Timetable

5. We expect to receive provisional October figures on Wednesday 18 November. They will be published on Thursday 19 November. Full money and banking figures for October will appear on Monday 30 November.

N. Holgate

N I HOLGATE

SECRET AND PERSONAL

TABLE 2: M3 COMPONENTS - OCTOBER 1987

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

£ millions

	First Guess	Average monthly change in year to September
Notes and coins in circulation	481	60
Non-interest bearing sight	-409	160
Interest bearing sight	2501	1030
Time deposits (including (CDs)	2289	1140
Change in £M3	4862	2390

SECRET AND PERSONAL

TABLE 3 : M3 COUNTERPARTS - OCTOBER 1987

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

£ millions

	First Guess		Average change in year to September	
CGBR (O) (ex bank deposits)		-513		-20
Other public sector:				
LABR)				
PCBR)		-274		140
OPS debt sales)				
		------		------
Modified PSBR*		-787		120
CG debt: Gilts	-107		10	
Treasury bills	78		-30	
National Savings	1		-250	
CTD's etc.	-166		110	
		------		------
Total CG debt sales (-)		-194		-160
External and fc finance of public sector (-)		2867		20
		------		------
Wide over(-)/under(+)funding		1886		-20
		------		------
Sterling lending to nbps (incl Issue Dept commercial bills)		1571 #		3090
Net private externals **)				
)		1405		-680
Residual (includes NNDLS **)				
and reporting differences))				
		------		------
Change in M3		4862		2390
		------		------
(Monthly percentage change)		(3.1%)		(1.5%)
(12 month percentage change)		(22.2%)		(19.3%)

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* Modified PSBR equals PSBR less OPS debt sales

** For the "first guess", Private Externals and NNDLs cannot be separately identified

\# £1532 million after seasonal adjustment.

File DG2CJF

Subject ccmaster

bc: BG

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

9 November 1987

MARKETS

Lord Stevens, Chairman of United Newspapers and MIM Britannia Limited, called to see the Prime Minister this morning. Some of the discussion concerned the markets, and Lord Stevens made a strong attack on the performance of the Stock Exchange over the past few weeks. The markets had been thin and it had often proved extremely difficult to deal. The market capitalisation of MIM had been moved on occasion by tens of millions of pounds on the basis of a selling order of a few tens of thousands of pounds. Market makers had widened their spreads and at one stage one major broker had tried for an agreement under which market makers would widen their spreads to 10 per cent. Lord Stevens also said that broker had sent MIM no statement since February this year. It was difficult to see how they could know what their profits were when they had not reconciled their dealings with customers. At one point he had told MIM's dealers to turn off their Stock Exchange screens. Wall Street in contrast had coped with record volumes.

I am sure the Prime Minister will want to return to this subject in the next few days, and she may well feel inclined to discuss it in her Guildhall speech on Monday. I should be grateful for your urgent comments. Among other things, it would be helpful to have an analysis of turnover in London and New York over the past few weeks in relation to movements in the stock indices, and how turnover has compared with more normal times. Lord Stevens also argued that UK institutional investors are short of liquidity, and it would be useful if this could also be covered.

I am copying this letter to Tim Walker (Department of Trade and Industry).

David Norgrove

Alex Allan, Esq.,
H.M. Treasury.

surely the IBA can fulfil their obligation "to be distinctive, to encourage experiment and to appeal to tastes and interests not generally catered for by ITV" without approving the broadcasting of foul language such as that to which Mrs Whitehouse has justifiably taken exception.

It is no answer to say her own cause by describing the poem as a "work of singular nastiness". *v* is a cry of moral indignation at the poverty of language and environment which young skinheads are forced to endure.

Yours sincerely,
BRIAN COX,
20 Park Gates Drive,
Cheadle Hulme, Cheshire.

Word of honour

From Richmond Herald

Sir, On September 1, 1939, I was mobilised to become assistant adjutant and attestation officer at No 15 Reception Unit, which took over the Oxford University OTC. An experienced warrant officer briefed me on the mechanism of attestation. I was issued, as I recollect, with an Authorised Version, a Douai Version, an Old Testament and a Koran.

Furthermore, I was given a single saucer, but strictly instructed to break it over my own knee after the oath.

I wonder what became of that saucer?

Yours faithfully,
MICHAEL MACLAGAN,
Richmond Herald of Arms,
College of Arms,
Queen Victoria Street, EC4.

Stock market slide

From Mr David W. Harding

Sir, In the hunt for a scapegoat that will inevitably ensue following "Wall Street's darkest hour" rational analysis is likely to be the first casualty. There is no doubt that a prime contender this time will be the "computer programs" that tripped wave upon wave of selling in the futures markets and, in an indirect sense, the speed of the fall is indeed attributable to them.

However, let us not forget that computers are programmed by people to do their bidding and if people are so collectively and extraordinarily foolish as to need reminding of the dangers of excessive speculation every 20 years or so, that is their problem.

The technique that lay at the heart of Monday's selling is (cleverly) named "portfolio insurance". Most people seem to have a hazy idea of what this is. In simple terms, all it involves is selling a predetermined percentage of a stock portfolio for each incremental fall in the market (and reversing the process as the market rises). In this way its proponents have purported to "prove" (from their strictly limited, and unfortunately inapplicable, experience) that losses in a falling market can be limited to a pre-set level.

It has long been possible to "insure" against market declines with the purchase of put options – a form of underwriting – but only in exchange for hefty and prohibitive up-front premiums. Such insurance would not accelerate declines in the way that portfolio insurance did, since the bearish "impulse" is transmitted immediately to the market through the payment of such premiums. Portfolio insurance differs in this respect in simply storing up "bearish potential".

Portfolio insurance has been "sold" to a ready market of gigantic institutional investors in America (and elsewhere) as a "free lunch". No premiums to pay, just sign here, Sir, and when the crash comes, on the basis of our theoretical model, we will unload vast quantities of stock on to a falling futures market for you!

In this way your portfolio is "insured" and you don't need to worry about falling stock prices ever again. In fact you can load up even more (than before) with vastly and obviously overvalued stocks.

For anyone with a grain of detachment it was evident that the reason that portfolio insurance sold so well was fear of the very circumstances under which it would patently fail to work. But don't blame the computers; blame the prevailing mentality of stupidity and greed.

And now? Portfolio insurance is dead, but like the investment trusts of the twenties it was a symptom rather than a cause of the malaise. So when recession strikes and stock prices are less than half their current level, please remember that the fault lies in ourselves, not in our computers.

Yours faithfully,
DAVID HARDING,
Adam, Harding & Lueck Limited,
135 Cannon Street, EC4.
October 22.

Shuffling papers

From Lady Stansgate

Sir, Your correspondent, Mr George Ditton (October 27), asks for better ideas on preserving *The Times* from his wife's disruptive handling than that of stapling it up the middle at danger to his thumb.

May I commend to him my custom at home? My husband always generously presented me with my own copy to read – and even to rumple if I so desired.

Yours truly,
MARGARET STANSGATE,
10 North Court,
Great Peter Street, SW1.
October 27.

"precise": my dictionary defines *habere* as "have", "hold", "wear", "carry", "contain", "rule over", "inhabit", "own", "keep"; and this is one example in hundreds.

Latin is no "clearer", thank heavens, than any other human language, and this imprecision is what makes Latin a human rather than a computer language. Moreover, to defend a language, as Mr Massie seems to do, on the grounds that it lacks nuances or has become fossilized, seems very odd – more like an apology for linguistic poverty.

Yours faithfully,
JOHN BUTT,
Department of Spanish and Spanish-American Studies,
University of London,
King's College,
Strand, WC2.
October 18.

Times Monday 2 Nov 87

For back up for meeting with the Chancellor.

DRW.

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FRG ECONOMY: REACTIONS TO DEVELOPMENTS ON THE FINANCIAL MARKETS

SUMMARY

1. SATISFACTION THAT GERMAN FINANCIAL CENTRES HAVE THUS FAR ESCAPED THE MORE VIOLENT FLUCTATIONS OF THE STOCK MARKETS. SOME DIVISIONS APPEARING OVER DOMESTIC ECONOMIC MANAGEMENT WHICH MAY IMPINGE UNHELPFULLY ON THE INTERNATIONAL SITUATION. A RISK THAT THE GERMANS, UNIMPRESSED BY THE DEBATE WITHIN THE US ON THE BUDGET DEFICIT, WILL NOT FEEL INCLINED TO MAKE A SIGNIFICANT REDUCTION IN INTEREST RATES IN THE FORESEEABLE FUTURE.

DETAIL

2. THE GYRATIONS IN THE WORLD'S FINANCIAL CENTRES HAVE BEEN FOLLOWED WITH INTEREST IN GERMANY, BUT WITH LESS INTENSITY THAN HAS BEEN SHOWN BY BRITISH PRESS AND RADIO. THE STOCK MARKET IS NOT PERCEIVED HERE AS AN ESPECIALLY IMPORTANT INDICATOR OF ECONOMIC HEALTH. THE GERMAN FINANCIAL COMMUNITY HAS SUPPORTED THE CONTENTION OF THE BUNDESBANK AND THE GOVERNMENT THAT THE FALL IN SHARE PRICES WAS PRECIPITATED BY INTEMPERATE CRITICISM BY THE US TREASURY SECRETARY OF RISING GERMAN INTEREST RATES. SUPPORT HAS ALSO BEEN GIVEN TO SUGGESTION THAT IN INCREASING ITS REPURCHASE INTEREST RATES TO 3.85 PERCENT, THE BUNDESBANK WAS REACTING SOLELY TO MARKET FORCES WHICH STEMMED FROM INCREASING US INTEREST RATES. THE PRESS AND FINANCIAL ANALYSTS HAVE ACCEPTED THE VIEW THAT THE INHERENT STRENGTHS OF THE GERMAN ECONOMY HAVE BEEN SUFFICIENT TO PROTECT GERMAN FINANCIAL CENTRES FROM THE WORST FLUCTUATIONS OF THE INTERNATIONAL MARKETS. THE COMMERZBANK INDEX, FOR EXAMPLE, HAS FALLEN BY ONLY 16.4 PER CENT SINCE 16 OCTOBER. THE UNDERLYING FEELING IS ONE OF CONFIDENCE THAT GERMAN MARKETS WILL SURVIVE THE STORM BETTER THAN OTHERS AND THAT WHEN THE RECOVERY EVENTUALLY COMES GERMAN EXCHANGES WILL START FROM A SOLID BASE. COMMENTATORS HAVE BEEN QUICK TO EMPHASISE THE ROLE PLAYED BY PROGRAMME TRADING IN THE DECLINE IN OTHER MARKETS WITH SOME SATISFACTION THAT THERE IS NO SUCH TRADING IN FRANKFURT OR DUESSELDORF.

3. DESPITE THIS COMFORTABLE AND SOMEWHAT SELF RIGHTEOUS ANALYSIS, THERE ARE SIGNS OF ANXIETY ABOUT THE FUTURE AND DISAGREEMENT OVER ECONOMIC MANAGEMENT. THE DIFFICULTY IS TWOFOLD: INSTITUTIONAL AND POLICY. THE BUNDESBANK HAS A RIGHT, THROUGH ITS MEMBERSHIP OF THE WORKING PARTY ON TAX REVENUE ESTIMATES TO BE INVOLVED IN THE DRAWING UP OF THE GOVERNMENTS FIVE YEAR FINANCIAL PLAN WHICH WAS PUBLISHED IN SEPTEMBER. THIS RIGHT WAS OBSERVED, BUT THE BUNDESBANK HAS SINCE BEEN CUT OUT OF THE DEBATE WITHIN THE GOVERNMENT ABOUT HOW THE TAX REDUCTIONS WOULD BE FINANCED. MOREOVER, WHEN THE DECISION WAS MADE, THE SINGLE LARGEST ELEMENT OF THE FINANCING WAS TO BE BORNE BY THE PROPOSED WITHOLDING TAX ON CERTAIN SAVINGS AND INVESTMENTS. ALL THIS, COMBINED WITH THE GENERAL IMPRESSION THAT THE COALITION GIVES OF NOT BEING MASTER OF EVENTS, HAS BROUGHT ABOUT A DECLINE IN CONFIDENCE IN THE CENTRAL BANK ABOUT THE ABILITY OF THE GOVERNMENT TO IDENTIFY THE RIGHT COURSE OF ACTION OR PURSUE IT.

4. SECONDLY POLICY. THE BUNDESBANK FEELS THAT THE COALITION SEES LITTLE BEYOND THE NEED TO SATISFY ITS VOTERS. THE BANK FEELS LONELY AS A RESULT. ITS UNEASE IS INCREASED BY THE FACT THAT OPINION WITHIN IT IS DIVIDED ON THE WAY FORWARD BETWEEN THOSE, LED BY DEPUTY PRESIDENT, SCHLESINGER WHOSE OVERIDING CONCERN IS TO PREVENT DOMESTIC INFLATION AND WHO IS THEREFORE PREPARED TO ALLOW INTEREST RATES TO RISE TO THE LEVEL NECESSARY TO REDUCE LIQUIDITY AND THOSE LED BY THE PRESIDENT, POEHL WHO SEE HIGH INTEREST RATES AS ENDANGERING DOMESTIC GROWTH AND RISKING CONFRONTATION WITH THE UNITED STATES. ONE THEREFORE HAS THE SPECTACLE OF THE SPD PRESIDENT OF THE BUNDESBANK IN ALLIANCE WITH THE CDU FINANCE MINISTER AND FDP ECONOMICS MINISTER, BOTH OF WHOM HAVE THE INTERESTS OF GERMAN BUSINESS, ESPECIALLY SMALL AND MEDIUM SIZED BUSINESS, UPPERMOST IN THEIR MINDS, AND WHO DO NOT WANT TO BE ACCUSED OF STIFLING ECONOMIC ACTIVITY. ONE MIGHT HAVE THOUGHT THAT THIS COMBINATION WOULD HAVE BEEN POWERFUL ENOUGH TO ALLOW A MORE EXPANSIONARY ECONOMIC POLICY TO BE PURSUED. BUT, WITHIN THE BUNDESBANK, THE SCHLESINGER FACTION IS STRONG (AND IS RUMOURED TO BE INCREASING IN STRENGTH). SINCE IT WOULD BE A NOTABLE DEPARTURE FROM NORMAL PRACTICE FOR THE BUNDESBANK TO CHANGE COURSE WITHOUT INTERNAL AGREEMENT, THERE IS A STALEMATE.

5. INABILITY TO MOVE IS REINFORCED BY SCEPTICISM ABOUT WHETHER THE US ADMINISTRATION WILL ACTUALLY HONOUR THE COMMITMENTS UNDERTAKEN AT THE TIME OF THE LOUVRE ACCORD TO REDUCE THE BUDGET DEFICIT. PROVIDED THE DOLLAR DOES NOT FALL SIGNIFICANTLY FURTHER, THE GERMAN AUTHORITIES ARE UNLIKELY TO FEEL UNDER GREATER PRESSURE THAN THEY HAVE ALREADY WITHSTOOD TO LOWER DOMESTIC INTEREST RATES. AND EVEN IF

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THE DOLLAR FALLS FURTHER, THE MOST LIKELY INITIAL GERMAN REACTION WILL BE TO INTERVENE TO SUPPORT IT OR AT LEAST MANAGE ITS DECLINE. THIS ACTION WOULD IN TURN BE LIKELY TO STRENGTHEN SCHLESINGER'S HAND BECAUSE OF THE FEAR THAT INTERVENTION WOULD INCREASE THE PROBLEM OF ADHERING TO DOMESTIC MONETARY TARGETS. IT IS NOT CLEAR AT THE MOMENT WHAT, IF ANYTHING, WILL CAUSE THE GERMANS TO BREAK OUT OF THIS CLOSED CIRCLE.

6. THERE IS NO TIDY END TO THIS STORY.

BULLARD

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WASHINGTON TELNO 2301: JAPANESE REACTION TO THE FALL IN WORLD STOCK MARKETS

SUMMARY

1. FALL IN TOKYO LESS SEVERE THAN ELSEWHERE, DUE PARTLY TO CONFIDENCE IN STRENGTH OF THE JAPANESE ECONOMY AND PARTLY TO OFFICIAL GUIDANCE AND INSTITUTIONAL CHARACTERISTICS OF THE JAPANESE MARKET. WITHDRAWAL BY FOREIGN INVESTORS A MAJOR CONTRIBUTOR TO FALL. POLICY MEASURES TO MAINTAIN PUBLIC CONFIDNECE, STABILISE MARKETS AND SUPPORT THE U S DOLLAR. MARKET AND GOVERNMENT LOOKING FOR SIGNS OF US ACTION TO CUT DEFICITS. FEAR OF CONSEQUENCES OF LOSS OF CONFIDENCE IN DOLLAR, BUT JAPANESE INSTITUTIONS WEIGHING CAUTIOUSLY THE RISKS OF PURCHASING MORE US TREASURY BONDS.

DETAIL

2. THE NIKKEI'S AVERAGE, AT THE CLOSE ON 28 OCTOBER, OF 22,577 REPRESENTS A 15% FALL FROM ITS PEAK ON 14 OCTOBER, BUT IS STILL 20% ABOVE ITS LEVEL AT THE BEGINNING OF THE YEAR. THE MAIN SELLING HAS COME FROM FOREIGN INVESTORS, INCLUDING MANY LONDON AND NEW YORK BASED FUND OPERATORS NEEDING TO RAISE CASH, WHO HAVE SOLD AN ESTIMATED DOLLARS 10 BILLION, OR 9% OF NON-RESIDENT HOLDINGS OF JAPANESE EQUITY. ALTHOUGH SOME JAPANESE PRIVATE INVESTORS SOLD HEAVILY LAST WEEK AS FOREIGN MARKETS FELL, THEIR WEIGHT IS RELATIVELY SMALL, AND SOME ARE REPORTEDLY BUYING AGAIN. JAPANESE INSTITUTIONAL INVESTORS WITH OFFICIAL ENCOURAGEMENT HAVE REFRAINED FROM SELLING. JAPANESE BROKERS HAVE BEEN BUYING SOME LEADING STOCKS ON THEIR OWN ACCOUNT TO TRY TO STABILISE THE MARKET AND IMPROVE THE CLIMATE FOR GOVERNMENT FLOTATIONS. SO FAR THERE HAVE BEEN NO REPORTS OF LIQUIDITY PROBLEMS EITHER AMONG BROKING COMPANIES OR CORPORATIONS. JAPANESE INVESTORS IN DOLLAR ASSETS SEEM TO BE SITTING TIGHT FOR THE MOMENT, THOUGH WATCHING THE DOLLAR CAREFULLY.

3. THE JAPANESE AUTHORITIES SEE THE FALL IN TOKYO AS THE RESULT OF THE CRISIS IN KS MARKETS, OCCASIONED BY LACK OF CONFIDENCE IN U S FISCAL POLICY AND EXACERBATED BY PANIC SELLING OF STOCKS BY PRIVATE INVESTORS. THEY BELIEVE THAT, WHILE U S STOCK PRICES HAD RISEN SERIOUSLY OUT OF LINE WITH DEVELOPMENTS IN THE REAL ECONOMY, THE SAME IS NOT TRUE IN JAPAN, WHERE A SOUNDLY BASED RECOVERY FROM LAST YEAR'S RELATIVE RECESSION IS WELL UNDER WAY, WITH CONSUMPTION, AND TURNOVER AND PROFITS IN LEADING DOMESTIC-DEMAND RELATED INDUSTRIES SHOWING VERY HEALTHY GROWTH. THESE POINTS WERE HEAVILY EMPHASISED IN ANNOUNCMENTS ON 27 OCTOBER BY THE ECONOMIC PLANNING AGENCY AND BANK OF JAPAN. ALTHOUGH CONSUMPTION MAY FALL A LITTLE THEREFORE, OVERALL THE FALL ON THE TOKYO MARKET SO FAR IS THOUGHT LIKELY TO HAVE A RELATIVELY SMALL EFFECT UPON ECONOMIC ACTIVITY HERE. BUT WHILE PUBLICLY OPTIMISTIC, THE AUTHORITIES ARE STILL CONCERNED THAT THE MORE SEVERE EFFECTS OF THE CRISIS UPON BUSINESS IN THE US MAY CAUSE A LOSS OF CONFIDENCE AND RAPID FALL IN THE DOLLAR, AND THAT THIS WOULD IN TURN HAVE SEVERE CONSEQUENCIES FOR JAPAN.

4. EFFORTS OVER THE LAST FEW DAYS HAVE THEREFORE BEEN AIMED AT STABLIZING THE TOKYO STOCK MARKET AND DIRECTLY AND INDIRECTLY SUPPORTING THE DOLLAR EXCHANGE RATE. THE MINISTRY OF FINANCE HAVE CALLED IN THE BROKER, INSURANCE COMPANIES, TRUST BANKS ETC IN TURN AND, UNDER THE GUISE OF HEARINGS ON THE CURRENT SITUATION, ENCOURAGED THEM TO REFRAIN FROM SELLING OF STOCKS. REPORTS HAVE ALSO SURFACED ON FURTHER EMERGENCY MEASURES WHICH COULD BE TAKEN IN FUTURE TO PEG THE SALES OF SHARES. MOF HAVE ALSO PEGGED THE LONG-TERM PRIME RATE AT 5.7% AND DECIDED NOT TO PROCEED WITH A PLANNED GOVERNMENT BOND ISSUE IN NOVEMBER, WHICH WOULD HAVE RAISED INTEREST RATES. IN THE INTEREST OF PREVENTING A FURTHER FALL IN THE MARKETS, THE BANK OF JAPAN HAS PUBLICLY SOFTENED ITS RECENT SHIFT IN POLICY IN FAVOUR OF TIGHTER MONETARY CONDITIONS TO FORESTALL DOMESTIC INFLATION. SHORT AND LONG-TERM COMMERCIAL INTEREST RATES HAVE FALLEN SLIGHTLY IN RESPONSE. THE GOVERNMENT IS ALSO PLANNING TO GO AHEAD WITH ITS MAJOR FLOATATION OF GOVERNMENT HELD NTT SHARES ON 10-12 NOVEMBER AND OF JAL SHARES IN DECEMBER. LDP SOURCES HAVE ALSO INDICATED AN INTENTION TO CONTINUE THE MILDLY REFLATIONARY LINE OF THE LAST SUPPLEMENTARY BUDGET IN NEXT YEAR'S MAIN XUDGET.

5. THE BANK OF JAPAN HAS BEEN INVOLVED IN CONCERTED INTERVENTIONS

TO SUPPORT THE DOLLAR, WHOSE RATE AGAINST THE YEN TODAY FELL TO BELOW YEN 141. THE BANK SEE IT AS AN AMERICAN PREREQUISITE TO DEFEND THE DOLLAR EXCHANGE RATE IN CURRENT CIRCUMSTANCES. FROM THE POINT OF VIEW OF THE JAPANESE ECONMY THEY REGARD A GRADUAL UPWARD MOVEMENT OF THE YEN AS BOTH TOLERABLE AND LIKELY IN DUE COURSE.

6. THE ATTITUDE OF JAPANESE INSTITUTIONS TOWARDS THE NEXT ISSUE OF U S TREASURTY BONDS EXPECTED IN EARLY NOVEMBER, IS ALSO OF GREAT CONCERN TO THE JAPANESE AUTHORITIES. THE MINISTRY OF FINANCE DENY ANY INFLUENCE OR GUIDANCE, BUT THERE IS AN EXPECTATION IN THE MARKET THAT THE MOF ARE HOPING THAT JAPANESE INVESTORS WILL CONTINUE TO MAKE QUOTE A POSITIVE CONTRIBUTION UNQUOTE. HOWEVER, SECURITY COMPANY SOURCES TELL US THAT DESPITE THE OBVIOUS RISK OF A SHARP FALL IN THE DOLLAR IF THEY FAIL TO BUY, THEIR ATTITUDE IS EXTREMELY CAUTIOUS, BECAUSE OF LOW EXPECTATION OF RETURNS, AND BECAUSE THEY FEEL THAT JAPANESE INSTITUTIONS PURCHASED TOO EXPENSIVELY IN PREVIOUS ROUNDS.

7. WHILE CONFIDENCE STILL REMAINS IN THE DOMESTIC ECONOMY, PRESS AND POLICY MAKERS ALIKE POINT TO THE STRUCTUAL IMBALANCES IN THE WORLD ECONOMY AS THE FUNDAMENTAL CAUSE OF THE CURRENT CRISIS. WHILE THE NIKKEI HELPFULLY CONCLUDES THAT JAPAN CANNOT BE EXEMPTED FROM FURTHER EFFORTS TO OPEN ITS MARKETS AND BOOST DEMAND TO COMPENSATE FOR A FALL IN U S ACTIVITY, PRESIDENT REAGAN'S RESOLVE IN REDUCING THE DEFICIT, PARTICULARLY NOW IN ACCEPTING TAX INCREASES, IS SEEN, NOT ONLY BY THE PRESS, BUT BY THE FINANCIAL SECTOR AS WELL, AS THE KEY TO RESTORING CONFIDNCE AND CALM TO THE MARKETS.

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US ECONOMY: REACTIONS TO DEVELOPMENTS ON WALL STREET

SUMMARY

1. UNPRECEDENTED VOLATILITY BLAMED ON TWIN DEFICITS AND PROGRAMME TRADING. CONSUMPTION AND INVESTMENT LIKELY TO BE DELAYED, LOWERING GROWTH NEXT YEAR. MANY SMALL AND POSSIBLY A FEW LARGE FINANCIAL BANKRUPTCIES EXPECTED. BANKING DEREGULATION LIKELY TO GO ON BACK BURNER. SILVER LININGS ARE PRESIDENT'S AGREEMENT TO DISCUSS BUDGET DEFICIT REDUCTION (BUT THIS MAY HAVE BEEN OVERSOLD), LIKELY INCREASE IN DOMESTIC SAVINGS AND LOWER INTEREST RATES. MARKET VOLATILITY LIKELY TO CONTINUE.

DETAIL

2. OVER THE LAST TEN DAYS THE STOCK MARKET HAS FALLEN BY 22 PER CENT ON THE DOW JONES INDEX. EQUITIES ARE NOW 26 PER CENT BELOW THE PEAK LEVEL REACHED ON 25 AUGUST BUT ARE STILL 142 PER CENT ABOVE THE TROUGH ATTAINED ON AUGUST 12, 1982 (COMMONLY REGARDED AS THE START OF THE BULL MARKET). THE DECLINE CONTINUED ON 26 OCTOBER (ANOTHER 157 POINTS). VOLATILITY HAS BEEN AT UNPRECEDENTED LEVELS AND TRADING VOLUME HAS BEEN FOUR TIMES HIGHER THAN USUAL.

3. THE DOMINANT VIEW HERE IS THAT THE FUNDAMENTAL CAUSES OF THE SLIDE ARE THE TWIN DEFICITS AND, TO A LESSER EXTENT, FEARS THAT THE FED WOULD HAVE TO RAISE INTEREST RATES TO COMBAT RISING INFLATIONARY EXPECTATIONS. KAUFMAN HAS ARGUED THAT THE BULL PHASE OF THE MARKET WAS ARTIFICIALLY PROLONGED BY COMPANIES BUYING THEIR OWN STOCK, THEREBY REDUCING THE SUPPLY OF SUCH SHARES AND PUSHING UP THEIR PRICE IN AN ATTEMPT TO WARD OFF HOSTILE TAKEOVERS. PROGRAMME TRADING IS BEING WIDELY BLAMED FOR INCREASING THE VOLATILITY OF, BUT NOT THE DECLINE IN, THE MARKET.

4. A NUMBER OF CONSEQUENCES AND CONCERNS ARISING FROM LAST WEEK'S EVENTS HAVE ALREADY EMERGED, THE MOST SIGNIFICANT BEING: (I) A LASTING IMPRESSION OF THE TRUE RISKINESS OF EQUITIES WHICH WILL PROBABLY REDUCE THE SCALE OF DIRECT EQUITY INVESTMENT BY INDIVIDUALS FOR SOME TIME:

(II) THE REALISATION THAT FUTURES MARKETS AND, IN PARTICULAR, STOCK INDEX OPTIONS DO NOT OFFER MUCH HEDGING PROTECTION BUT APPEAR TO INCREASE VOLATILITY SIGNIFICANTLY. (IN THE YEAR TO DATE TRADING IN STOCK FUTURES HAS EXCEEDED TRADING IN ORDINARY STOCKS BY 50 PER CENT.) TRADING IN STOCK INDEX OPTIONS WAS BANNED AT TIMES LAST WEEK AND SOME COMMENTATORS ARE ARGUING THAT THEY SHOULD BE PERMANENTLY OUTLAWED:
(III) GROWING WORRIES ABOUT THE CONSEQUENCES OF FINANCIAL DEREGULATION. IT IS NOW MUCH LESS LIKELY THAT CONGRESS WILL TAKE RADICAL STEPS TO REFORM THE GLASS-STEAGALL ACT'S DIVISION BETWEEN BANKING AND SECURITIES DEALING. INDEED THERE ARE ALREADY MOVES TO CONSIDER IMPROVING THE REGULATION OF FINANCIAL MARKETS, IN PARTICULAR, THE FUTURES MARKETS:
(IV) INCREASING CONCERN ABOUT ATHE CAPITALISATION OF SECURITIES HOUSES. IN NEW YORK RUMOURS THAT MANY SMALL, AND SOME LARGE, HOUSES ARE IN TROUBLE ARE WIDESPREAD. E F HUTTON HAS BEEN MENTIONED AS A POSSIBLE LARGE CASUALTY, BUT MOST PEOPLE BELIEVE THE FED MAY ORGANISE TAKEOVERS RATHER THAN ALLOWING FIRMS TO FAIL:
(V) RISING OPTIMISM OVER THE PROSPECTS FOR BUDGET DEFICITS IN THE LIGHT OF THE PRESIDENT'S AGREEMENT TO DISCUSS A DEFICIT REDUCTION PACKAGE WITH CONGRESS (BUT SEE PARA 7 BELOW):
(VI) LOWER EXPECTATIONS OF ECONOMIC GROWTH NEXT YEAR. MOST ANALYSTS AGREE THAT INVESTMENT PLANS AND EXPENDITURE ON CONSUMER DURABLES AND HOUSES COULD WELL BE DELAYED FOR SOME TIME. THE FED'S MODEL SUGGESTS THAT A 20 PER CENT DROP IN EQUITY PRICES WOULD REDUCE REAL GNP GROWTH BY 0.75 PER CENT IN THE FOLLOWING YEAR, ALTHOUGH THE FED STAFF REGARD THIS ESTIMATE AS SOMEWHAT ON THE HIGH SIDE. PRIVATE SECTOR MODELS PRODUCE MUCH SMALLER EFFECTS. THE ADVERSE EFFECTS ON CONSUMPTION, INVESTMENT AND THE HOUSING SECTORS MAY BE OFFSET SOMEWHAT BY THE LARGE FALL IN INTEREST RATES. BUT THE INCREASED VOLATILITY OF INTEREST RATES WILL TEND TO OFFSET THE ADVANTAGES OF A REDUCTION IN THEIR LEVEL. THE ONE POSSIBLE SILVER LINING IS THAT DOMESTIC SAVINGS MAY RISE AS CONSUMPTION IS POSTPONED AND INCOMES REMAIN AT LEAST INITIALLY UNAFFECTED:
(VII) FEARS THAT 1987 COULD BE A REPEAT OF 1929. FEW BELIEVE THAT THE FED WILL MAKE THE MISTAKE OF TIGHTENING POLICY AS THEY DID IN 1929 AND GREENSPAN IS WIDELY PRAISED FOR INJECTING LIQUIDITY INTO THE SYSTEM IN A TIMELY FASHION. MANY COMMENTATORS HAVE USEFULLY POINTED OUT THAT 1929 WAS FOLLOWED BY SMOOT-HAWLEY WHICH WAS A MAJOR CAUSE OF THE GREAT DEPRESSION. THIS MAY SERVE TO STRENGTHEN THE ANTI-PROTECTIONISTS IN THEIR EFFORTS TO IMPROVE THE ATATADE BILL:

(VIII) WORRIES THAT THE DOLLAR MAY ALSO COME UNDER PRESSURE IN THE NEAR FUTURE. FOREIGN EXCHANGE ANALYSTS IN NEW YORK ARE ARGUING THAT THE FED DARE NOT RAISE INTEREST RATES TO DEFEND THE DOLLAR BECAUSE OF THE FRAGILITY OF ATE FINANCIAL SYSTEM. IF FOREIGNERS DECIDE TO TAKE THEIR INVESTMENTS OUT OF DOLLARS IT MAY THEREFORE NOT BE POSSIBLE FOR THE G7 COUNTRIES TO PREVENT A DECLINE IN THE DOLLAR UNLESS THERE IS CONCERTED INTERVENTION ON A MASSIVE SCALE, OR INTEREST RATES OVERSEAS ARE REDUCED. (ANALYSTS WILL REGARD THE EXTENT OF JAPANESE PARTICIPATION IN THE TREASURY'S QUARTERLY AUCTION, SCHEDULED FOR 3-5 NOVEMBER, AS A GOOD INDICATOR OF FOREIGN INTEREST IN DOLLAR SECURITIES.)

COMMENT

5. WALL STREET'S PROBLEMS SEEM FAR FROM OVER. THE MARKETS HAVE YET TO DIGEST FULLY THE POOR TRADE FIGURES CONTAINED IN THE PRELIMINARY THIRD QUARTER GNP REPORT RELEASED ON 23 OCTOBER. BOTH EXPORTS AND IMPORTS ARE ESTIMATED TO HAVE INCREASED IN VOLUME TERMS BY 16.5 PER CENT (ANNUAL RATE) IN THE THIRD QUARTER. SINCE IMPORTS ARE MUCH LARGER THAN EXPORTS, THE TRADE BALANCE DETERIORATED. THIS IS A BLOW TO ONE OF THE ADMINISTRATION'S MAIN ARGUMENTS ABOUT THE SLOWNESS OF THE J-CURVE EFFECT TO SHOW UP, NAMELY THAT EVEN IF IN DOLLAR TERMS THE GAP HAD NOT YET NARROWED, IN VOLUME TERMS THE SITUATION WAS IMPROVING. THE RESILIENCE OF IMPORT VOLUMES DESPITE THE PRICE INCREASE OF 8.3 PER CENT (ANNUAL RATE) WILL PROVIDE AMMUNITION TO THOSE IN FAVOUR OF A TOUGHER TRADE BILL (THOUGH SEE ALSO PARA 4(VII) ABOVE). THE FALL IN THE STOCK MARKET IS EXPECTED TO WEAKEN CONSUMPTION AND INVESTMENT WHICH MAY HELP TO REDUCE IMPORTS. HOWEVER THE DECLINES IN OVERSEAS STOCK MARKETS MAY HAVE A SIMILAR DAMPENING EFFECT ON DEMAND FOR US EXPORTS.

6. THE PROSPECTS FOR AGREEMENT BETWEEN CONGRESS AND THE ADMINISTRATION ON A DEFICIT REDUCTION PACKAGE HAVE IMPROVED AS A RESULT OF THE UPHEAVALS IN THE STOCK MARKET. ON THE CONGRESSIONAL SIDE, THERE HAVE BEEN INCREASING SIGNS IN THE LAST FEW DAYS OF A MORE BIPARTISAN APPROACH. AND DESPITE DOUBTS ABOUT THE ABILITY OF A WEAKENED PRESIDENT TO PROVIDE THE NECESSARY LEADERSHIP TO CALM THE MARKETS, THE PRESIDENT'S NEW WILLINGNESS TO START NEGOTIATIONS WITH CONGRESS HAS HAD A POSITIVE PSYCHOLOGICAL EFFECT. SPRINKEL (CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS) SUGGESTED ON TV AT THE WEEKEND THAT THE PRESIDENT MIGHT ACCEPT MEASURES TO CLOSE LOOPHOLES AND REDUCE DEDUCTIONS AS PART OF A PACKAGE THAT INCLUDED SPENDING CUTS. THE RECONCILIATION BILLS PASSED BY THE HOUSE WAYS AND MEANS AND THE SENATE FINANCE COMMITTEES CONTAIN MEASURES OF THIS KIND WHICH WOULD RAISE AROUND DOLLARS 12 BILLION IN REVENUE. IT MAY

THEREFORE BE POSSIBLE TO AGREE A PACKAGE WHICH RAISES SUFFICIATNT REVENUE WITHOUT INCREASING TAX RATES (SOMETHING THE PRESIDENT STILL EVIDENTLY REFUSES TO ACCEPT). SPRINKEL SUGGESTED THAT A FREEZE OF CERTAIN SPENDING PROGRAMMES COULD BE A USEFUL PART OF AN OVERALL DEFICIT REDUCTION PACKAGE.

7. THE HOUSE RECONCILIATION BILL IS LIKELY TO BE VOTED ON (AND PROBABLY PASSED) LATER THIS WEEK. IT IS LIKELY THAT ANY MEASURES AGREED WITH THE PRESIDENT COULD BE INCLUDED IN ATE SENATE BILL, WHICH HAS NOT YET REACHED THE FLOOR. A CONFERENCE WILL BE NEEDED TO AGREE A COMPROMISE BILL, SO IT IS UNLIKELY THAT A DEFICIT REDUCTION PACKAGE WILL BE SIGNED INTO LAW MUCH BEFORE THE 20 NOVEMBER DEADLINE IMPOSED BY THE REVISED GRAMM-RUDMAN LEGISLATION. IF THERE IS NO AGREEMENT BY THEN, THE DOLLARS 23 BILLION SEQUESTRATION WILL BE IMPLEMENTED. TREASURY SECRETARY BAKER AND HOUSE WAYS AND MEANS COMMITTEE CHAIRMAN ROSTENKOWSKI HAVE EXPRESSED SCEPTICISM ABOUT THE POSSIBILITY OF AGREEING A PACKAGE INCLUDING LARGER CUTS THAT HAS THE SUPPORT OF SENATORS DOLE, BENTSEN AND CHILES. BUT IT IS LIKELY THAT THE OUTCOME OF THE TALKS BETWEEN CONGRESS AND THE ADMINISTRATION WILL MAINLY DETERMINE THE FORM OF DEFICIT REDUCTION, NOT THE AMOUNT. NEVERTHELESS THE MARKETS SEEM TO ATTACH IMPORTANCE TO THE WHITE HOUSE REACHING AGREEMENT WITH CONGRESS AND MAY REACT BADLY IF THE TALKS BREAK DOWN OR FAIL TO PRODUCE ANYTHING SIGNIFICANT. IT IS WORTH EMPHASISING THAT, EVEN WITH A DOLLARS 23 BILLION CUT, NEXT YEAR'S DEFICIT IS LIKELY TO BE CONSIDERABLY ABOVE THE FY 87 LEVEL, AS THE LATTER WAS REDUCED BY A NUMBER OF ONE-OFF FACTORS. THE CONGRESSIONAL BUDGET OFFICE HAVE ESTIMATED THAT THE DEFICIT WILL BE DOLLARS 156 BILLION IN FY 88 IF CUTS OF DOLLARS 23 BILLION ARE IMPLEMENTED (AS OPPOSED TO AN ESTIMATED DOLLARS 148 BILLION FOR FY 87).

8. FCO PLEASE ADVANCE TO PS/CHANCELLOR, SIR P MIDDLETON, SIR T BURNS, PERETZ, EVANS AND LOMAX (TREASURY),PS/GOVERNOR, GEORGE, WALKER AND GREEN (BANK), HILTON (DTI), AND RICHARDSON (ERD).

ACLAND

YYYY

PRIME MINISTER

cc Mr Norgrove

FINANCIAL DEVELOPMENTS

Sir James Goldsmith has telephoned me from New York and asked me to pass on the following thoughts.

It is perfectly evident that politicians are losing their heads completely in the present situation and will do all the wrong things unless given a strong lead. The Americans are the worst. They are "panicking and dead". They will go unerringly for the soft option. The only person who can give a lead is you.

The Americans are set to do after the event what they should have done before, i.e. cut the deficit. Six months ago that would have been preventative medicine which might have worked. Now it will only aggravate the situation. Reducing expenditure and raising taxes in the situation we now face will precipitate a deflationary slump.

The level of savings in the United States in recent years has been low. This is because people do not save a fixed proportion of their earnings, they build up a specific nest-egg. With high stock market values, they have stopped saving and switched to spending on discretionary items. Now that the value of their nest-eggs has been halved, they are going to start saving ferociously. The deficit will therefore increase even further because revenue will fall.

What is needed is an Economic Summit with you in the lead. At this there would be agreement: to lop $60 billion off the US deficit (half by increasing revenue, half by ~~increasing taxes~~ reducing expenditure); Japan and Germany to boost their economies to the tune of $30 billion each; and Japan to make a loan to the developing countries to bail them out.

At the same time the EMS must be broken open. At the moment the whole of Europe is in thrall to Germany's deflationary

policies. The French are actively considering this. You were wise enough not to get dragged into the snake in the first place.

Without these steps, we shall have a deflationary crisis exactly on the lines of 1929. What we have is a political problem which has precipitated an economic crisis not visa versa. Governments are just about to do exactly the wrong thing.

On the BP share issue, his advice is that you should stick to it. But he has an alternative solution. Hanson Trust have $5 billion in cash to spare at present and they could be allowed to sweep the market.

I said that I would pass all this on. It is somewhat lacking in internal consistency.

C.D.P.

CHARLES POWELL
26 October 1987

EL3CFW

Dom Mon Pol.

PRIME MINISTER

HONG KONG

It now looks as though they have succeeded in putting together a MK II rescue plan for the Hong Kong Futures Exchange. This consists of another 2 billion Hong Kong dollars. Half will come from the Hong Kong exchange fund. The other half will be divided equally between Hong Kong & Shanghai Bank, Standard & Chartered and the Bank of China. The last-named have been pretty difficult and have still not finally confirmed their participation. The fund should be enough to support the Futures market through tomorrow if there is no further drastic fall in the index. But if the index declines steeply again it certainly will not suffice.

Amanda Ross

pp (C.D. POWELL)

26 October 1987

MI

10 DOWNING STREET

Prime Minister

Brian drew my attention to this. See the charts on page 3, which suggest a monetary squeeze in the US. This can't I think be the whole story (if monetary policy has been tight, why has the $ been falling?) but it's interesting.

DLV
26/10

Midland Montagu Research

MONETARY BULLETIN

Editor : *Gordon Pepper*

23rd October 1987

Bulls in China Shops

The main purpose of this note is to explain why markets have been behaving as they have. Investors who understand the true reasons for the current behaviour of a market will have a competitive advantage over those who do not.

The sharp fall in the world's equity markets is the result of a financial bubble bursting. It did not start because the prospects for dividends, earnings and profits have deteriorated. Stock markets react to imbalances between buyers and sellers, and these can easily be the result of a financial disequilibrium rather than a change in the real outlook. This time financial factors were dominant.

The mechanics for the formation of the financial bubble in the UK were described in our September Monetary Bulletin. A parallel was drawn between the current situation and what occurred between 1972 and 1974, when Mr. Heath was Prime Minister. In 1972-4 there was an explosion in bank lending primarily to finance expenditure on goods and services. The additional bank deposits created by these loans were also spent mainly on goods and services. The result was a large rise in the price of goods and services, i.e. in conventional inflation.

This time the explosion in bank lending was primarily to finance the acquisition of assets. Until quite recently, the additional bank deposits were also being spent mainly on assets. The result was an increase in the price of those assets and the rise in the equity market was one of the main examples. This is quite a different form of inflation.

A financial bubble also existed in the US, for very similar reasons, following the record explosion in money and credit starting in 1982. The US bubble was more dangerous than that in the UK because the underlying economy is much less sound, particularly the

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budget and balance of trade deficits. The Japanese equity market was even more overvalued. The explanation was again financial; it was the result of a chronic surplus of savings rather than surplus money and credit. The Japanese markets had to become substantially overvalued compared with rest of the world in order to induce surplus savings to flow out of the country into international markets. Although the Japanese market was more overvalued than either New York or London, the financial cause was more enduring - chronic surplus savings are likely to persist longer than buoyant monetary growth.

So much for the background to the current situaiton. Why did the break come in the US and why did it occur now? The answer is that there has been a very substantial tightening of monetary policy in the US. The decline in the growth of the money supply in real terms, on all definitions, is illustrated in the charts. So far this tightening has received little publicity. It is nevertheless most important. **Given the dangerous financial bubble which existed, the Fed tightened monetary policy too suddenly and too sharply.** This turned a chronic situation into one which was acutely dangerous.

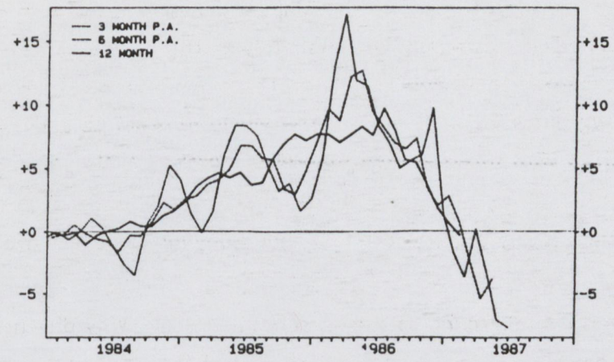
Other important factors were the large falls which had occurred in the German and Japanese bond markets. The German bond market, in particular, was scared of a replay of the events in the late 1970's and early 1980's, which followed the last massive intervention in currency markets by the Bundesbank to resist a rise in the DM. The 1977/78 intervention led to an explosion in German monetary growth. In due course inflation accelerated, in accordance with monetarists' predictions, to over 7%, which was horrifying by German standards. The same happened in Switzerland.

The foreign currency intervention by the Bundesbank this time was even greater. The result was, again, very buoyant monetary growth. Domestic inflation had not had time to respond, but global commodity prices started to rise more or less on cue. The result was a sharp rise in inflationary expectations and a fall in bond prices.

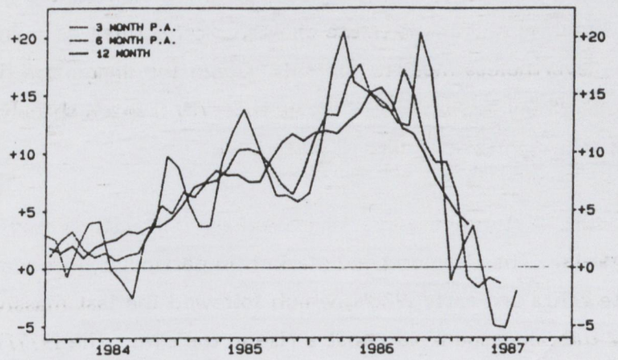
In effect, the German bond market was itself exerting financial discipline on its central bank and government. The message was for the Bundesbank to stop intervening because intervention was too inflationary; and so the the Bundesbank paid greater attention to the tangible message from its domestic financial markets than to the mere talk of US politicians, and German money rates started to rise.

All this had implications for the dollar; it was bound to fall. The US authorities can ignore a fall in the dollar if commodity prices are also falling, because the latter offsets the inflationary effect of the former. They cannot ignore the combination of a falling dollar and rising commodity prices; and the US bond market certainly won't.

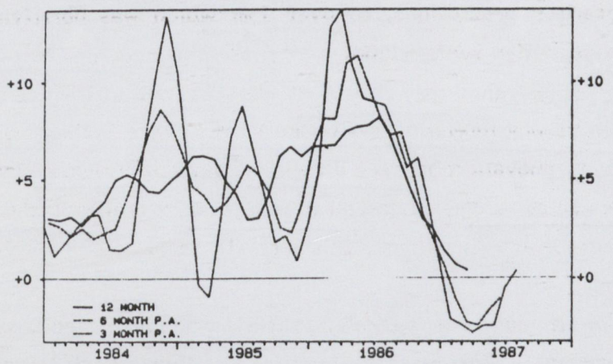
GROWTH RATES OF REAL U.S. NON-INTEREST BEARING M1 %



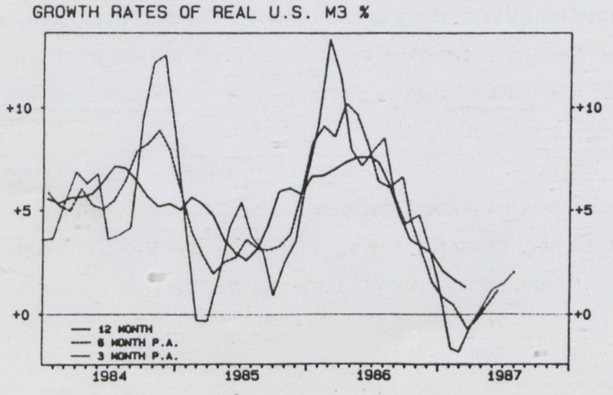
GROWTH RATES OF REAL U.S. M1 %



GROWTH RATES OF REAL U.S. M2 %



GROWTH RATES OF REAL U.S. M3 %



Where do we go from here? Although a deterioration in the outlook for dividends, earnings and profits was not the cause of the fall in the equity markets, the sharp fall in share prices will have a subsequent contractionary impact on economic activity and, therefore, the outlook for the real factors affecting ordinary share prices has now deteriorated. The danger facing world economies has changed from inflation back to recession. This is bad for ordinary shares and good for bonds.

The greatest danger is in the US. No less a person than Mr. Paul Volcker has drawn attention to the very worrying way in which the expansion of debt has far outpaced the growth of incomes in the US. One of the reasons why there have so far been few adverse consequences is that the ratio of wealth to debt was increasing as a result of the rise in asset values in general and equities in particular. With the fall in the equity market, the ratio of wealth to debt has now reduced. This suggests that the adverse consequences of the explosion of debt may now start to come through. Bankruptcies will be another factor depressing the US economy.

The monetary squeeze in real terms in the US will have to be reversed if economic activity is to be prevented from decelerating. Indeed, the Fed has already acted. The snag is that this will have dangerous consequences for the dollar.

It is difficult to envisage how the US trade deficit can be financed in the coming months. Japanese investors are likely to be shell-shocked as a result of the losses on their holdings of US securities. They are unlikely to increase their current rate of investment of new money in the US; indeed, they may reduce it. The reversal of the US monetary squeeze will also mean that net flows of banking money into the US are unlikely to increase. The conclusion must be that continuing massive intervention by central banks and reductions in interest rates in other countries will be absolutely necessary to prevent another sharp fall in the dollar.

Investors in ordinary shares throughout the world would be wise to monitor two other criteria. The first is German bond prices. Providing they remain strong the Bundesbank will be able to intervene to reduce the fall in the dollar and continue with the Louvre agreement. The same applies to Japan. The second criterion to watch is commodity prices. If they fall, a modest decline in the dollar will not cause a sharp rise in inflationary expectations and a fall in the US bond market.

If the outcomes to the factors identified above are not favourable, the outlook for equity markets is grim.

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MS

10 DOWNING STREET

Prime Minister

Hong Kong.

The Hong Kong market had a very bad day, ending 33% ↓.

The operation to support the Futures Market was rapidly exhausted. Negotiations to obtain more funds before the market opens tomorrow are in progress but as of now – 2 a.m. in Hong Kong – have not

reached any conclusion.
If there is no result,
& the market opens
without any safety net,
the consequences could be
very serious.

I will keep you
informed of any developments
during the evening.

CDD
26/x

10 DOWNING STREET

Prime Minister

You may like to see this now, in advance of any comments.

Note the scope for tax reductions in the next Budget, assuming the PSBR as in the last MTFS, of £13.6 bn.

It will be dangerous either to speech is taken on this basis at present. The uncertainty has become too great

DRN 23/10

CCDNQ.
11

H M Treasury
Parliament Street London SW1P 3AG
Switchboard 01-270 3000
Direct Dialling 01-270 5158

Sir Peter Middleton KCB
Permanent Secretary

Covering SECRET

Professor Brian Griffiths
10 Downing Street
LONDON
SW1

23 October 1987

Dear Brian

I attach a copy of the autumn forecast. It needs to be treated with particular care because it does not allow for the effects of the last few days. We shall of course be publishing in the Autumn Statement a version which has been adjusted to take some account of this and other points which have arisen in discussion.

As promised, I will arrange a time for you to discuss it with Terry Burns and myself.

Copy to David Norgrove.

Yours sincerely

Peter Middleton

pp P E MIDDLETON

SECRET

Copy No12

TREASURY ECONOMIC FORECASTING EXERCISE

OCTOBER 1987 REPORT

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TREASURY ECONOMIC FORECASTING EXERCISE

REPORT BY EA AND PSF

(1) SUMMARY

The forecast covers the period to the end of 1989 (1989-90 for public finances). Table 1 summarises the results and compares them with earlier exercises and with the current average of outside forecasts.

(i) Main results

(a) Following the latest CSO upward revisions, in the Blue Book and subsequently, the growth of **money GDP** in 1986-87 is, at 6½ per cent, very close to that envisaged in the 1986 MTFS. With only limited data available on the early quarters of 1987-88 the prospect is for money GDP growth of 9 per cent, over a point above the figure in the 1987 MTFS. This overshoot could be greater if, following past practice, the CSO revises up the GDP data for the early part of the financial year. The forecast is for overshoots of the MTFS growth rates for money GDP that average almost 2 percentage points in 1988-89 and 1989-90. Both higher real growth and higher inflation than assumed in the MTFS contribute to these overshoots.

(b) Both real **GDP** and **domestic demand** appear to be growing at higher rates in the UK than in the rest of the G7. The forecast is for growth of consumers' expenditure of 4¾ per cent in 1987 and 4½ per cent in 1988, lower than the very high rate of 5¾ per cent recorded for 1986. This deceleration of consumers' expenditure is, however, offset by a strong rise in investment. Total domestic demand grows at 4 per cent in 1987 and 1988, before dropping to 3 per cent in 1989. UK domestic demand growth in 1987 and 1988 is on average 1 per cent higher than the average for the rest of the G7.

The latest forecast is for GDP growth of 4 per cent in 1987 - in line with the June forecast, but above the FSBR forecast of 3 per cent. With nearly all indicators suggesting that activity continues to be strong in the second half of 1987, forecast GDP growth in 1988 is 3 per cent (half a percent higher than in the FSBR and the June forecast) and 2½ per cent in 1989. Growth of **manufacturing output** could be over 5 per cent in 1987, though somewhat lower thereafter. **Unemployment** should continue to fall at a rapid rate in the near future, though as output growth moderates the rate of decline is likely to be less.

(c) **RPI** inflation in 1987(4) is likely to be very close to the FSBR forecast of 4 per cent, though above the 1986 Autumn Statement forecast of 3¾ per cent. The forecast is for a pick up to 5¼ per cent by

1988(4). This owes something to the rise in short term interest rates - and therefore the mortgage rate - that is judged necessary to keep the sterling index constant while the UK economy is relatively so buoyant. However, most of the rise in RPI inflation between the fourth quarters of 1987 and 1988 is the result of

the assumed **revalorisation of specific duties** in the 1988 budget after the standstill this year,

a large rise in **LA rates** in 1988-89, given the forecast of their current expenditure and the recent RSG settlement,

and some substantial increases in certain **nationalised industry prices** (plus BGC), following a period in which nominal prices have hardly risen and real prices have fallen substantially.

These factors, together with a gradual increase in unit labour costs, will have an increasing influence on the RPI from the second quarter of 1988.

With the exception of the assumed rise in the mortgage rate nearly all the factors that are forecast to cause a rise in RPI inflation between 1987(4) and 1988(4) will cause the inflation rate of the **GDP deflator** (at market prices) to rise between 1987-88 and 1988-89. The GDP deflator is also likely to be boosted by rising costs and margins in the construction industry, where the recent boom in output seems likely, on the strength of a recent further surge in orders, to continue for some while. The forecast is for construction prices to accelerate a little later than suggested in the June forecast, from early 1988 onwards.

The forecast has the relatively satisfactory recent performance of **unit labour costs in manufacturing** continuing, although growth in the range of 2½-4 per cent throughout the period is slightly above average growth in the UK's principal competitors. Strong productivity growth and the continued fall in employers' pension contributions keep growth of unit labour costs in manufacturing some 5 percentage points below growth in average earnings. Indeed these factors probably reduce the incentive for employers to press for more moderate growth in earnings.

(d) **GNP growth of the major 7** (less the UK) is likely to remain close to the 2¾ per cent recorded for 1986. There has, however, been an upturn in the growth of industrial production and world trade in manufactures which should continue in 1988. Short term interest rates are forecast

to rise further in the US - with rates in Japan and Germany remaining unchanged - to moderate the likely fall in the dollar exchange rate.

(e) It is extremely difficult to analyse the recent behaviour of the **current account**, a difficulty compounded by frequent and large revisions to the 'recorded' data for invisibles and doubts about the seasonal adjustment of visible trade. The visible balance was surprisingly favourable in the early months of the year. Since then there has been a sharp deterioration.

Internal forecasts for 1987 made during much of 1986 and the early part of 1987 showed relatively small current account deficits (as a proportion of GDP) on the basis of rather less domestic demand and output in the UK economy than has in the event occurred. At the same time the world economy has been less buoyant than forecast. For given activity at home and abroad the current account has so far been better than expected. As with the June exercise, the present forecast attempts to take account of this record.

In both 1988 and 1989 North Sea production is forecast to fall by about 5 per cent. With a constant (indexed) oil price at $18 this will produce falls in the **balance of trade on oil** of just under £1b. in each year. Over the forecast period UK labour costs rise slightly more than those in competing economies (in domestic currencies), so that, with short term interest rates set to keep the sterling index at 72.5, there is a small deterioration in measured competitiveness over the period. This, together with higher growth of domestic demand and output in the UK than in the rest of the G7, produces a £2½b. deterioration in **the non-oil current account** between 1986 and 1988, producing overall current account deficits of £2½b. and £4½b. in 1987 and 1988 respectively. While the growth of domestic demand falls in 1989 it remains above growth in the rest of the G7, contributing to a further deterioration in the current account.

(f) The emergence of a growing current deficit coupled with continued outward investment flows implies a need for substantial offsetting **capital account** inflows. The forecast is that UK companies and banks are able to attract these at the projected interest rates, and that confidence in sterling is sufficient to keep the sterling index constant. (With the dollar assumed to fall gradually, the assumption of a flat sterling index implies a very small fall in the £/DM rate over the period.) A weakening of sentiment would make it more difficult to finance the projected current deficit, and put upward pressure on interest rates.

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TABLE 1 : SUMMARY OF FORECAST

		FSBR 1987	SUMMER 1987	OCTOBER 1987	AVERAGE OUTSIDE FORECAST SEPTEMBER 1987
A	**THE WORLD ECONOMY**				
1.	GNP (MAJOR 7 EXCLUDING UK)				
	(per cent change on a year earlier)				
	1986	2.6	2.5	**2.7**	
	1987	2.6	2.3	**2.5**	
	1988	3.0	2.8	**2.6**	
	1989	3.0	2.8	**2.4**	
2.	DOMESTIC DEMAND (MAJOR 7 EXCLUDING UK)				
	(per cent change on a year earlier)				
	1986	3.8	3.7	**3.8**	
	1987	3.0	2.6	**2.6**	
	1988	3.2	2.8	**2.6**	
	1989	3.0	2.8	**2.5**	
3.	WORLD TRADE IN MANUFACTURES				
	(weighted by UK market shares: per cent change on a year earlier)				
	1986	2.4	2.1	**1.3**	
	1987	3.4	2.6	**2.6**	
	1988	4.1	3.2	**3.4**	
	1989	5.0	4.3	**3.8**	
B	**UK ACTIVITY AND DEMAND**				
4.	GDP VOLUME (non-North Sea GDP in brackets)				
	(per cent change on a year earlier)				
	1986	2.6(2.7)	2.8(2.9)	**3.1(3.2)**	
	1987	3.0(3.1)	3.9(4.1)	**4.1(4.5)**	3.2
	1988	2.4(2.9)	2.3(2.8)	**3.0(3.5)**	2.4
	1989	2.4(2.8)	1.7(2.1)	**2.4(2.8)**	
5.	VOLUME OF DOMESTIC DEMAND				
	(per cent change on a year earlier)				
	1986	3.2	3.5	**3.8**	
	1987	3.5	3.6	**3.9**	
	1988	2.4	3.3	**4.1**	
	1989	2.2	2.0	**2.9**	
6.	UNEMPLOYMENT (UK S.A. EXCLUDING SCHOOL LEAVERS million)				
	1986 Q4	3.14	3.14	**3.14**	
	1987 Q4	2.88	2.73	**2.74**	2.84
	1988 Q4	3.01	2.58	**2.52**	2.82
	1989 Q4	2.94	2.61	**2.54**	
C	**INFLATION AND MONEY GDP**				
7.	MONEY GDP (MARKET PRICES)				
	(per cent change on a year earlier)				
	1986-87	6.1	6.3	**6.6**	
	1987-88	7.5	8.8	**8.9**	
	1988-89	6.4	7.9	**8.5**	
	1989-90	6.1	7.1	**7.8**	

	FSBR 1987	SUMMER 1987	OCTOBER 1987	AVERAGE OUTSIDE FORECAST SEPTEMBER 1987
8. RPI (excluding mortgage interest payments in brackets) (per cent change on a year earlier)				
1986 Q4	3.4(3.4)	3.4(3.4)	**3.4(3.4)**	
1987 Q4	3.9(3.4)	3.8(3.6)	**3.9(3.7)**	4.0
1988 Q4	3.3(3.0)	5.1(4.4)	**5.3(4.6)**	4.6
1989 Q4	3.3(3.2)	4.2(3.9)	**4.3(3.9)**	
9. GDP market price deflator (per cent change on a year earlier)				
1986-87	3.2	3.0	3.0	
1987-88	4.5	5.0	4.6	
1988-89	4.0	5.7	5.4	
1989-90	3.6	5.1	5.2	
D PUBLIC FINANCES				
10. PSBR - £ billion				
1986-87	4.1	3.3	**3.5**	
1987-88	3.9	1.0	**-1.2**	3.4
1988-89	4.4	0.8	**-5.0**	
1989-90	4.9	0.8	**-5.4**	
11. PSBR - % OF GDP				
1986-87	1.1	0.9	**0.9**	
1987-88	1.0	0.2	**-0.3**	
1988-89	1.0	0.2	**-1.1**	
1989-90	1.0	0.2	**-1.1**	
12. ANNUAL FISCAL ADJUSTMENT - £ billion				
1988-89	3.2*	7.4*	**13.6***	
1989-90	1.7*	1.1*	**2.8***	
allocated to				
(a) reducing personal taxes				
1988-89	3.2	3.7	**4.1****	1.8
1989-90	1.7	0.5	**2.0**	
(b) reducing PSBR				
1988-89	0.0	3.7	**9.5**	
1989-90	0.0	0.6	**0.8**	

*Assuming PSBR ratio of 1 per cent as in 1987 MTFS.

**This is one third of the fiscal adjustment remaining after the higher than previouslyassumed level of privatisation receionts has been used to reduce the PSBR.

E MONETARY CONDITIONS				
13. SHORT TERM INTEREST RATES (per cent))				
1986 Q4	11.2	11.2	**11.2**	
1987 Q4	10.3	9.5	**10.5**	9.5
1988 Q4	10.1	10.5	**11.0**	8.9
1989 Q4	9.7	10.5	**11.0**	

	FSBR 1987	SUMMER 1987	OCTOBER 1987	AVERAGE OUTSIDE FORECAST SEPTEMBER 1987
14. MO				
(per cent change on a year earlier)				
1986-87	4.3	4.3	**4.3**	
1987-88	4.0	4.3	**5.1**	
1988-89	3.4	4.0	**4.4**	
1989-90	3.0	3.4	**3.4**	
15. STERLING INDEX (1975=100)				
1986	72.8	72.8	**72.8**	
1987	70.3	71.7	**72.0**	71.8(Q4)
1988	69.3	72.0	**72.5**	70.5(Q4)
1989	67.3	72.0	**72.5**	
16. £/DM EXCHANGE RATE				
1986	3.19	3.19	**3.19**	
1987	2.78	2.93	**2.95**	
1988	2.67	2.86	**2.94**	
1989	2.52	2.77	**2.87**	
17. RELATIVE UNIT LABOUR COSTS (1980=100)				
1986	77.6	77.7	**77.3**	
1987	74.0	75.2	**74.8**	
1988	73.5	77.1	**76.7**	
1989	70.1	78.6	**76.9**	
F TRADE AND CURRENT ACCOUNT				
18. VOLUME OF NON-OIL EXPORTS OF GOODS AND SERVICES (EXCL. ERRATICS)				
(per cent change on a year earlier)				
1986	1.9	1.9	**2.0**	
1987	5.8	4.4	**6.1**	
1988	4.0	3.6	**2.6**	
1989	5.1	4.5	**3.0**	
19. VOLUME OF NON-OIL IMPORTS OF GOODS AND SERVICES (EXCL. ERRATICS)				
(per cent change on a year earlier)				
1986	5.5	5.4	**5.7**	
1987	6.9	3.9	**7.2**	
1988	1.9	4.7	**4.8**	
1989	2.7	3.5	**2.9**	
20. CURRENT BALANCE				
£ billion				
1986	-1.1	-0.1	**-1.0**	
1987	-2.7	-0.5	**-2.4**	-1.1
1988	-1.7	-0.9	**-4.3**	-2.3
1989	-0.4	-2.3	**-5.6**	

(g) The prospects for **public finances** are again better than in earlier forecasts. The cumulative PSBR in the first six months of 1987-88 is about £3½b. below the budget profile. The major part of this shortfall is on the CGBR(O), with higher tax receipts the main explanation, but with central government expenditure below profile. Local authority borrowing has also been below profile. For 1987-88 the forecast is for a negative PSBR of £1b.

The forecasters attempt to predict the level of **public expenditure** that will occur. The forecast therefore implicitly includes judgements both on the results of the current round of Ministerial discussions (and for 1989-90 the results of the autumn 1988 discussions) and on the influence of the forecast evolution of the economy on demand led public expenditure. (Annex I summarises the assumptions on public expenditure.) The forecast has the outturn for the **planning total** (less privatisation receipts) in 1988-89 and 1989-90 respectively £5b. and £10b. above the previously announced plans (including the reserve). The emerging outcome for 1987-88 and the forecast for public expenditure in the later years implies that the ratio of general government expenditure (excluding privatisation receipts) to GDP starts off 1¼ percentage points below the value in the last PEWP and continues to fall further in 1988-89 and 1989-90.

Even with their current spending likely to exceed provision at much the same rate as in recent years and with the proportion of expenditure financed by central government grant falling, **local authorities' borrowing** should be close to its 1986-87 level during the forecast period as a result of a large increase in rates and buoyant capital receipts. **Public corporations' finances** benefit from the buoyant level of activity over the forecast. Nevertheless rising real levels of investment lead to an increased requirement for external finance, despite positive real price increases.

With the forecast levels of nominal and real demand and output higher than in earlier forecasts, forecast **tax receipts** (pre-fiscal adjustment) are higher. More real fiscal drag has contributed to slight upward revisions since June to the effective tax rates for PAYE and onshore CT. The share of pre-fiscal adjustment non-North Sea taxes in non-North Sea money GDP rises over the forecast period.

With the shares of public expenditure and pre-fiscal adjustment government revenues in GDP behaving so differently there are large fiscal adjustments. The forecast makes the stylised assumption that - after adjusting the PSBR for the higher than previously assumed

level of privatisation receipts - for 1988-89 one third of the available fiscal adjustment is allocated to cuts in personal taxes and the other two thirds to reduce further the PSBR below the level in the 1987 FSBR. In 1989-90 the PSBR ratio is maintained at the assumed level for the previous year and the additional fiscal adjustment that is available is allocated to cuts in personal taxes. This produces cuts in personal taxes of £4¼b. and £2b. in 1988 and 1989 budgets. Even with these assumed cuts the share of post fiscal adjustment government revenues in money GDP does not change over the forecast period. The PSBR adjusted for privatisation receipts and the PSFD are - as proportions of money GDP - lower in 1988-89 and 1989-90 than at any time since the war except in the late 1940s and early 1950s and in 1969-70 and 1970-71. (See Annex II.)

(h) The forecast for public finances in the UK implies a markedly greater ex post tightening of fiscal policy than in the rest of the G7 taken together, as shown by the **general government deficit** - the only comparable measure of fiscal stance available for all G7 countries.

TABLE 2 : GENERAL GOVERNMENT FISCAL DEFICITS AS A SHARE OF GDP (%)

	1979-85	1986	1987	1988	1989
UK	3.1	2.6	1.8	1.1	0.6
G7 (less UK)	3.1	3.1	2.8	2.7	2.7

(ii) Main issues and risks

2. It is invidious to label individual judgements as particularly important or vulnerable. Nevertheless in the current exercise there has inter alia been detailed discussion of

- **the likely extent of the fall in the private sector surplus,**
- **the prospects for pay,**
- **the short term prospects for the current account,**

and - **the robustness of the projections for public sector finances.**

(a) The forecast implies a decline in the **financial surplus of the private sector** from its current high level. (Annex II sets out the data for sectoral surpluses and deficits over a long historical period.) Some fall in the company sector surplus seems very likely given the good prospects for capital investment revealed in intentions surveys. Indeed there must be a significant risk that, following the recent buoyancy of the economy, investment will be stronger than in the forecast.

The prospect for the personal sector is particularly uncertain. The personal sector accounts include companies' pension funds which, following the strong rise in equity markets at home and abroad, have found themselves with assets well in excess of their liabilities. The principal reaction of companies has been to attempt to rein back their surpluses by cutting employers' contributions. This reduces measured personal sector (though not household sector) saving. This process is likely to continue, particularly as companies will be taking steps to meet the requirement, introduced in the 1986 budget, that pension funds' surpluses, measured on the Government Actuary's assumptions, should not exceed 5 per cent of liabilities. To allow for this the forecast has the personal saving ratio declining slightly, even though there is a rise in the savings ratio if employers' contributions are ignored. (See Chart C on page 15.)

In normal circumstances the personal sector saving ratio would rise significiantly at a time of strong growth in disposable income. This does not appear to have happened either in 1986 or - on the basis of available data - in 1987. But despite this it is possible that, contrary to what is forecast some rise could occur in 1988, producing lower growth of domestic demand and a more favourable current account than now forecast.

While such a development is possible there is a greater risk that personal saving, adjusted for the fall in employers' contributions, will not rise as much as envisaged in the forecast. The drop in the growth of consumers' expenditure from the 5¾ per cent recorded for 1986 to the forecasts of 4¾ and 4½ per cent in 1987 and 1988 depends critically on the judgement that the saving ratio, when adjusted for the fall in employers' contributions, will rise to a level over 1½ percentage points above the recorded 1986 level. Some rise in saving by households would be expected as both inflation and interest rates rise next year, but the extent of the forecast rise does mark a major break with behaviour so far in the 1980s. A faster than forecast growth of consumers' expenditure or company spending in 1987 and 1988 would have adverse consequences for the current account and domestic inflationary pressures.

(b) While there are already signs that private sector **pay settlements** and **average earnings** have begun to accelerate, the record on **labour costs** has been satisfactory. With the economy growing rapidly and RPI inflation rising there is a risk that the acceleration of earnings could be greater than the very slight upturn envisaged in the forecast.

(c) The very strong productivity growth in recent years does suggest that the UK's industrial performance has improved relatively to the rest of the G7 and that as a result a significant trend deterioration in trade performance is less likely. The evidence on this is, however, far from conclusive. A stronger than forecast surge in imports in response to strong domestic demand growth in the second half of 1987 and 1988 could be evidence that the forecast is too optimistic about industrial performance. This would mean both weaker GDP growth (with net exports lower) and a worse current account than forecast.

(d) The continuous improvement in recorded and forecast public finances since mid 1986-87 almost strains credulity. The prospect for onshore corporation tax is particularly important with increases on a year earlier of £3-3½b. forecast for both 1987-88 and 1988-89. By 1989-90 forecast CT receipts are approximately three times the 1984-85 level. If public expenditure were to over run the last published plans by less than the forecast assumes the improvement in public finances would be even more marked and the scope for fiscal adjustment correspondingly greater.

Most of the improvement since the June forecast in the overall prospect for public finances in 1988-89 and 1989-90 is the result of a higher forecast level of activity. The share of pre-fiscal adjustment of non-oil taxes in money GDP is about ½ a percentage point higher in both 1988-89 and 1989-90, whereas the level of real GDP is 2 per cent higher in 1989. If growth were less than forecast the ex post fiscal position would obviously be a good deal less favourable. Nevertheless, with a total fiscal adjustment in 1988-89 of £13½b. there would still be scope for some combination of further reductions in borrowing and tax cuts, even if taxes were markedly less buoyant than in the forecast.

(2) THE WORLD ECONOMY

3. There was a slowdown in the first half of 1987 in domestic demand growth in the United States, Germany and France that was not offset elsewhere among the major industrial countries. Exports of the group as a whole are, however, picking up and their import growth is slowing, so that the gap between domestic demand growth and real GNP growth in 1987 should be much lower than in 1986. Stockbuilding was particularly strong in the major countries in the first half of 1987 and, to the extent that this was involuntary, subsequent destocking could depress growth. This could be offset by the effects of the Japanese Government's fiscal package and, in 1988, tax cuts in Germany. The WEP sees real domestic demand in the other

major countries as a whole growing by 2.6 per cent in 1987, and real GNP growing by 2.5 per cent, with similar growth rates over the next two years. This is broadly in line with our latest estimates of growth in productive potential.

4. The forecast for the world economy incorporates the judgement that downward pressure on the dollar exchange rate will be fairly mild. This would enable the Federal Reserve to keep interest rate rises to the minimum necessary to control domestic inflationary pressures. With only a modest reduction in the Federal budget deficit in prospect (despite the new Gramm-Rudman deficit reduction programme), the resulting forecast shows the US current account deficit declining only gradually. There is a significant risk that such a slow turnaround would lead to a serious weakening of confidence in the dollar and a sharp drop in its exchange rate, causing the Fed to raise US interest rates substantially. In Japan and Germany the monetary authorities remain very reluctant to lower interest rates, and they may want to raise them for domestic reasons. Nevertheless strong upward pressure on their exchange rates might force them into further modest cuts. The forecast has German and Japanese short rates at their current levels, which with the assumed rise in US rates, involves a small rise in average world short rates.

5. Prospects for **oil prices** are clouded by developments in the Gulf and doubts about OPEC's ability to restrict production. The forecast is that the oil price (North Sea average) will be around $18 per barrel in the period to end-1988, and that the real price will be constant thereafter. **Non-oil commodity prices** have been rising in real terms during 1987. The forecast is for a further gradual rise in real non-food commodity prices until the end of 1988 as world industrial production strengthens, but food prices are expected to remain weak.

TABLE 3 : G7 (excluding UK) GROWTH AND INFLATION
(IMF World Economic Outlook in brackets)

Percentage changes on a year earlier	1986	1987	1988	1989
Real GNP	2.7	2.5(2.5)	2.6(2.7)	2.4
Domestic Demand	3.8	2.6(2.6)	2.6(2.7)	2.5
Industrial Production	0.9	2.8	4.4	4.3
Consumer prices	1.8	2.6(2.9)	3.0(3.4)	2.8

Note: IMF figures include UK

6. Total imports grew by almost 5 per cent in 1986 when oil trade was very buoyant following the fall in the price. Imports of manufactures are estimated to have grown by only 2 per cent. In 1987 the forecast is for

lower total world import growth, of about 3½ per cent, but a pick up in the growth of imports of manufactures to around 4 per cent. In later years world trade is expected to pick up as NODCs, and to a much lesser extent OPEC, increase their imports.

7. Total world trade in manufactures continues to grow more quickly than developed countries exports of manufactures throughout the forecast period because it is assumed that developing countries, and the Asian NICs in particular, will continue to increase their market share. Weighting developed countries exports by UK market share also reduces their growth, because OPEC is a relatively important UK market. Of the difference in 1987-88 and 1988-89 between growth in total world trade in manufactures and the UK market weighted version of developed countries trade in manufactures roughly two thirds results from the difference of coverage (ie the developed countries' loss of share to the NICs) and one third from the weighting.

TABLE 4 : THE VOLUME OF WORLD VISIBLE TRADE

(IMF World Economic Outlook in brackets)

percentage change on year earlier	1986	1987	1988	1989
Total world imports	4.7(4.9)	3.5(3.6)	4.2(4.5)	4.0
of which:-				
- Major seven	9.1	4.9	3.9	3.3
- OPEC	-20.5	-10.1	0	2.5
- Non-OPEC developing countries	1.2	3.3	5.5	6.0
Total world imports of manufactures	1.9	3.8	4.9	4.8
Main developed countries' exports of manufactures weighted by UK market share	1.3	2.6	3.4	3.8

(3) TRADE AND THE BALANCE OF PAYMENTS

8. The current balance, which recorded a surplus in the first four months of the year, returned to deficit in May and has shown average monthly deficits since then averaging £400 million, although individual monthly figures have been erratic. A return to deficit in the latter half of the year had always seemed likely. The scale of the deterioration, however, has been greater than expected at the time of the June forecast, although the current account for the year as a whole could still be close to the £2½ billion deficit forecast in the FSBR.

TABLE 5 : UK CURRENT ACCOUNT (£bn)

	Visible trade balances			Net invisibles			Current balance
	Manufactures	Oil	Other	Services	IPD	Transfers	
1986	-5.5	4.1	-7.0	5.0	4.7	-2.2	-1.0
1987	-7.9	4.3	-6.4	5.6	5.5	-3.4	-2.4
1988	-10.2	3.3	-6.3	5.5	6.8	-3.4	-4.4
1989	-11.6	2.4	-6.2	5.7	7.6	-3.5	-5.8

9. The forecast current deficit of £2½ billion for 1987 compares with a revised estimated deficit of £1 billion in 1986. The widening in the deficit is more than accounted for by a larger deficit on trade in manufactures, which is offset only in part by a higher surplus on oil trade, a smaller deficit on trade in other goods, and a modest improvement in invisibles. In 1988 the forecast is for the current account deficit to increase to around £4½ billion followed by a further widening to £5¾ billion in 1989, with an increasing deficit on manufactured trade and a worsening in the oil balance more than offsetting a rise in the invisibles surplus.

Non-oil visible trade

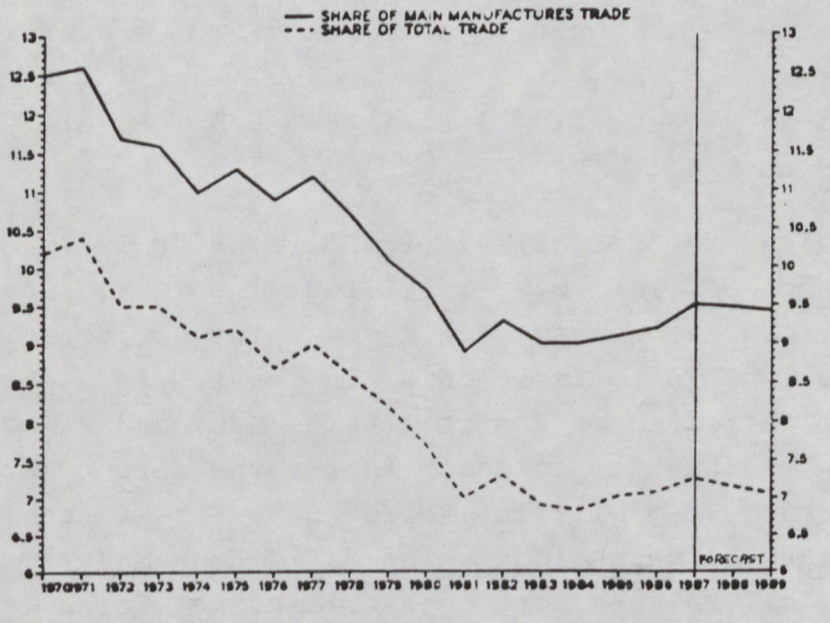
10. The rising deficit on trade in manufactures in 1987 and 1988 mainly reflects faster domestic growth in the UK compared to overseas. While labour cost competitiveness has deteriorated since the end of 1986, it is still significantly better than the average for 1984 and 1985. Over the forecast period there is a slight deterioration. (See Table 26.)

11. The volume of manufactured exports, which remained flat in the first half of 1987 after the surge towards the end of last year, appears to have begun rising again in recent months. Recorded growth, which may benefit from residual seasonal factors in the rest of this year, seems likely to continue at a modest rate to the end of next year, reflecting the slow rise in the world trade and the effects of the competitiveness loss during 1987. Growth may quicken thereafter as world trade rises more rapidly.

12. The UK's share of developed countries' exports of manufactures, which rose during 1986, may be slipping slightly during 1987, with further small falls forecast for 1988 and 1989. The forecast is for a slight fall also in the UK's share of the wider measure of world manufactured trade which includes NICs' exports. (See Chart A.). This projected share performance reflects mainly an assumption that the loss of competitiveness early this year has tended to restrain export growth fairly quickly, despite the fact that the forecast gives weight to the UK's improved export supply performance since 1981.

SECRET

CHART A : UK VOLUME SHARES OF TRADE IN MANUFACTURES



13. The volume of manufactured imports which fell sharply in the first quarter of 1987, has risen rapidly again since April. Some of this volatility may reflect residual seasonal factors, but a strong rise in domestic demand for manufactures, rising capacity utilisation, and some loss of recorded competitiveness since the end of 1986 have probably been important factors. The erratic nature of the monthly figures makes difficult the assessment of the underlying trend. The forecast has a further rise in imports during the rest of this year followed by a more gradual rise during 1988 and 1989 as domestic growth falls.

14. Non-manufactured exports and imports have fallen back recently, following the exceptionally rapid growth of trade in wheat and olive oil towards the end of 1986 and in early 1987. (This rapid growth of imports and exports, largely the result of the peculiarities of the CAP, had little effect on the current balance.) Exports are projected to resume growth in 1988 and 1989 as world demand rises, but imports may be rather sluggish as the recent surge in basic material imports ends and imports of food, drink and tobacco return to their modest trend growth.

15. The non-oil terms of trade rose sharply in the first half of this year from the trough at the end of 1986 reflecting partly sterling's appreciation and partly the weakness of world food prices. The forecast is for little change in 1988 and 1989.

Oil trade

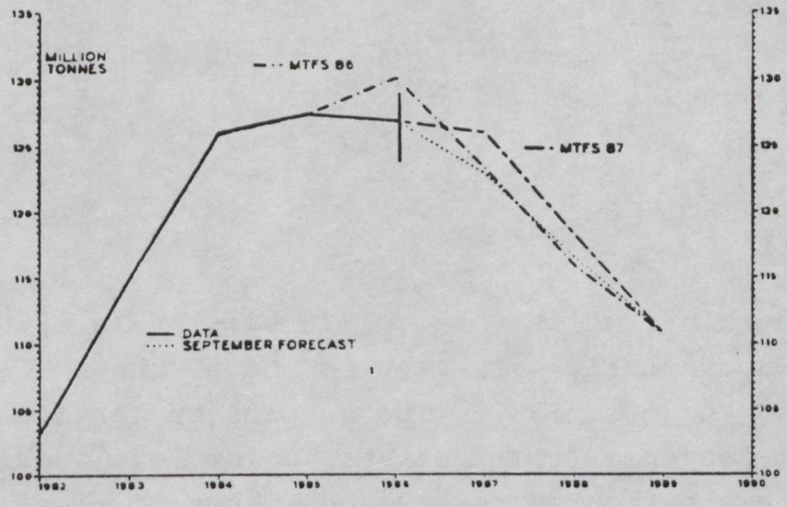
16. The strengthening in world prices during the first half of 1987 has helped to offset a lower than expected volume of North Sea output. On the assumption that oil prices remain close to their present level for the rest of the year and that some - but not all - of the production shortfall is made good, the oil trade balance should be a little higher than last year's £4 billion surplus.

TABLE 6: NORTH SEA OIL

	Average N.Sea oil price $/barrel	Average N.Sea oil price £/barrel	N.Sea output mn.tonnes	Oil trade balance £ bn	N.Sea* taxes £ bn
1986	14.2	9.7	126.9	4.1	4.8
1987	17.7	11.0	122.9	4.3	4.6
1988	18.0	10.7	116.5	3.3	4.5
1989	18.7	10.8	110.8	2.4	4.5

* financial year totals

CHART B : FORECASTS FOR NORTH SEA OIL PRODUCTION



17. The forecast that the average North Sea oil price will remain at $18 a barrel until the end of 1988 and then rise in line with world inflation implies a small fall in North Sea sterling prices next year as the dollar weakens and little change in 1989. North Sea output falls by 5 per cent a year in 1988 and 1989. The fall will largely be reflected in lower exports. The oil trade surplus is forecast to fall by about £1 billion in 1988 and a further £0.9 billion in 1989.

18. Table 7 summarises the forecast for trade volumes. Changes in aggregate exports and imports of goods and services mask divergent movements in components. The projected 3½ per cent a year growth in the volume of manufactured exports excluding erratics in 1988 and 1989 is offset partly by lower arms shipments to Saudi Arabia, a fall in oil exports and a reduction in the recent exceptionally high level of gold exports, together with a more modest growth in services credits, so that total exports only rise by 1½ per cent a year. Total imports are forecast to rise less rapidly than manufactured imports excluding erratics. This reflects mainly a decline in non-manufactured imports partly as a result of the ending of exceptional trade in olive oil and a fall in gold imports (offsetting the fall in exports).

TABLE 7 : EXPORTS AND IMPORT VOLUMES
(per cent changes on previous year)

	Manufactures excl. erratics	Erratics	Oil	Other goods	Total goods	Services	Total goods and services
Exports							
1986	1.1	28.0	2.0	5.5	3.7	1.0	3.1
1987	6.6	2.4	-0.6	6.9	5.2	4.5	5.0
1988	3.5	1.9	-4.0	0.7	1.5	1.9	1.6
1989	3.5	1.6	-6.5	2.2	1.6	1.8	1.6
Imports							
1986	5.6	-0.1	13.8	8.5	6.5	4.9	6.2
1987	9.6	+4.0	0.2	1.6	7.2	3.3	6.5
1988	7.5	-1.4	11.2	-3.0	5.3	3.6	5.0
1989	4.0	0.1	6.7	-0.7	3.2	2.6	3.1

10. Invisibles

19. The invisibles surplus, which rose to £7½ billion in 1986' compared to £5 billion in 1985, is currently estimated to have shown little further growth in the first half of 1987. The surplus on services has risen as travel earnings have recovered from last year's low level and earnings from financial services are estimated to have continued to rise. Net earnings from interests, profits and dividends (IPD), however, have fallen from the high level of late-1986 as the pound's appreciation has reduced the sterling value of overseas earnings, and margins on banks' overseas business have been squeezed.

TABLE 8 : THE BALANCE OF INVISIBLES (£ billion)

	Services	N.Sea IPD	Other IPD	EC transfers	Other transfers	Total invisibles
1986	5.0	-1.6	6.3	-0.7	-1.5	7.5
1987	5.6	-1.7	7.2	-1.7	-1.7	7.6
1988	5.5	-1.2	7.8	-1.6	-1.8	8.7
1989	5.7	-0.2	8.2	-1.7	-1.9	9.6

20. The invisibles surplus is forecast to rise from about £7½ billion this year to £8¾ billion in 1988 and £9½ billion in 1989. The services surplus is unlikely to rise in 1988 as UK growth remains buoyant compared to overseas, but may improve in 1989 as the growth gap narrows. The main increase in the invisibles surplus seems likely to reflect falling payments abroad, North Sea oil companies - as oil output declines - and a rise in other net IPD earnings as portfolio yields rise abroad and banks' margins return to more normal levels. Net transfers to the European Community are projected to show little change in 1988 and 1989 from this year's level. The precise profile of payments and receipts will of course depend on a number of factors on which decisions have not yet been taken.

(4) DOMESTIC DEMAND AND ACTIVITY

(a) Personal income and expenditure

21. Published figures for the first half of 1987 and retail sales for the year to August show consumer spending relatively sluggish at the start of the year, but picking up strongly since the spring. However, discrepancies in the national accounts for the first half of 1987 indicate a significant underrecording of one or more components of expenditure, so that growth of consumer spending growth may well not have fallen to 4 per cent as the recorded figures currently suggest. The figures for retail sales show growth as high as in 1986. Consumer spending seems to have been very strong in the third quarter of the year, and car registrations in August were 6 per cent higher than in August 1986.

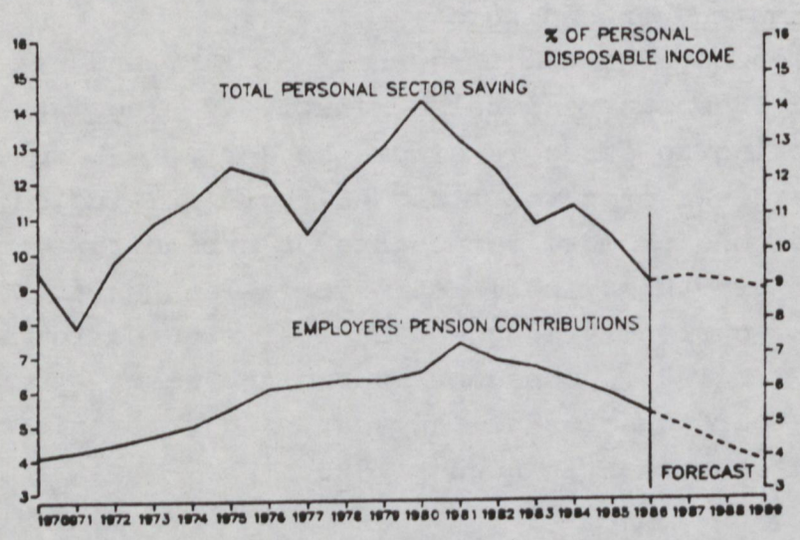
TABLE 9: RETAIL SALES AND CONSUMERS EXPENDITURE

	Retail Sales			Consumers' expenditure	
		Percentage change on			(percentage
	(1980=100)	previous period	year earlier	(£ billion 1980)	change on year earlier)
1986 Q1	119.3	1.7	4.3	39.5	5.1
Q2	121.3	1.7	4.7	40.1	6.6
Q3	123.7	2.0	5.5	40.7	5.8
Q4	126.5	2.3	7.3	40.9	5.6
1987 Q1	125.4	- 0.9	5.1	41.1	4.1
Q2	128.2	2.3	5.8	41.8	4.2
Q3*	131.9	3.2	7.0		
Jan	123.6	- 2.4	4.6		
Feb	127.0	2.8	7.1		
Mar	125.5	- 1.2	3.8		
Apr	130.0	3.6	7.7		
May	125.4	- 3.5	4.8		
June	129.4	3.2	5.0		
July	131.2	1.4	7.0		
Aug	132.5	1.0	6.9		

* Average of July and August

22. Between 1980 and 1986 the personal saving ratio has fallen by about a third, and it is currently close to the levels recorded in the latter part of the 1960s and in the early 1970s, before the dramatic rise in inflation. Part of the recent fall in the saving ratio (and part of its rise in the second half of the 1970s) is probably attributable to the behaviour of employers' contributions to pension funds. (See Chart C). Employers' pension contributions are recorded as part of personal income, but short-term fluctuations in them are unlikely to affect personal expenditure to anything like the extent that changes in after tax wages and salaries do. Instead they are likely to show up in fluctuations in the personal saving ratio.

CHART C. EMPLOYERS' PENSION CONTRIBUTIONS AND THE PERSONAL SAVING RATIO

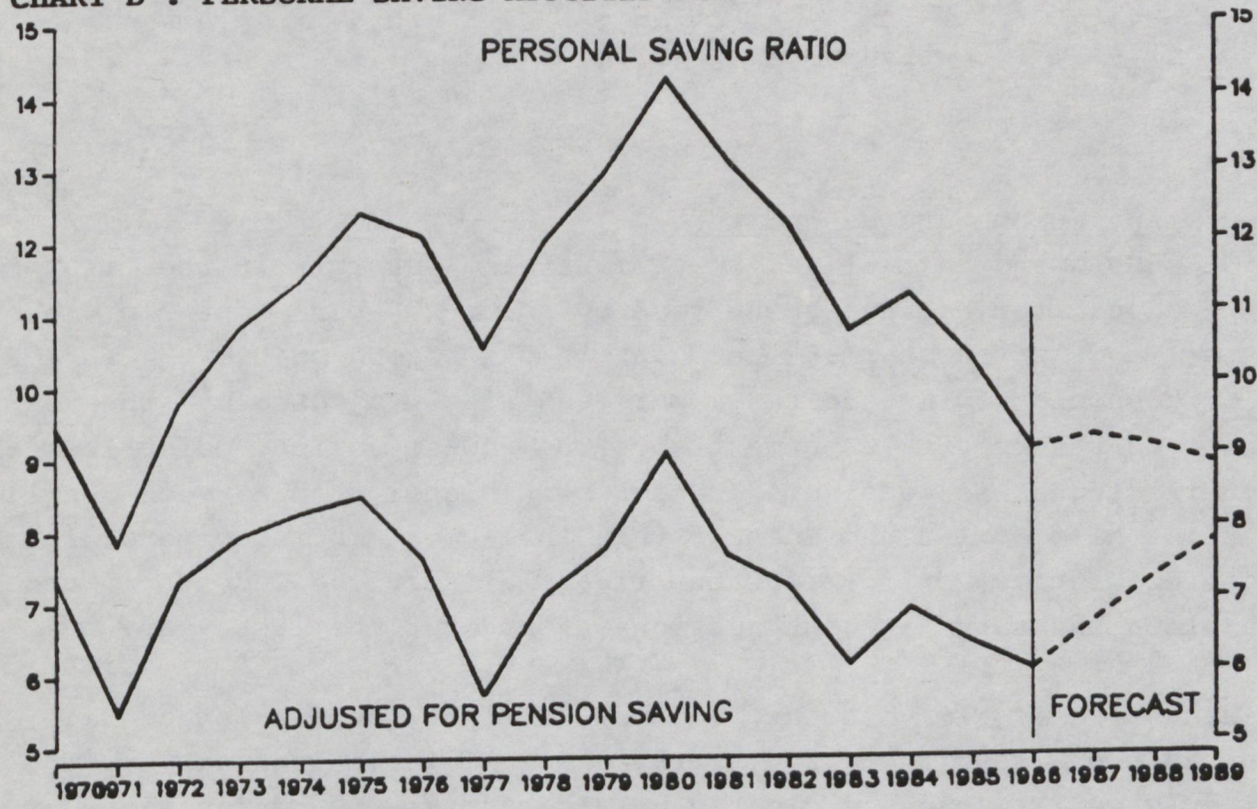


23. The rise to 1981 in pension fund contributions as a proportion of personal disposable income reflected expanding coverage of schemes and topping up payments made to cover actuarial deficits caused by the rise in inflation and the plunge in the stock market in the mid 1970s. In 1980 and 1981 there was also a rise in redundancy payments and an effect from the composition of employment. The fall in employment in this period particularly affected manual workers who would be less likely to be covered by private pension schemes.

24. The subsequent fall in pension contributions relative to wages and salaries must reflect in large part the impact on pension funds of the recovery in profitability and stock markets and the fall in inflation experienced since 1981. This has led to large actuarial surpluses, and an increasing number of firms have temporarily stopped making pension contributions. The 1986 Budget, which required reductions in actuarial surpluses where these exceeded liabilities by more than 5 per cent, and the

continuing rise in profitability and dividends are likely to ensure a further fall in pension contributions relative to pay. This in turn is likely to mean that the personal saving ratio is likely to fall a little further between 1987 and 1989, even though higher inflation and interest rates may be tending to restrain spending (see chart D). (The apparent rise in the recorded personal saving ratio so far in 1987 may be an illusion, reflecting under-recording of consumer spending.)

CHART D : PERSONAL SAVING ADJUSTED FOR PENSION FUND CONTRIBUTIONS



25. The published figures show real personal investment in dwellings weak in the first half of 1987, falling some 4 per cent from the second half of 1986. Spending on both improvements and investment in new dwellings was apparently lower than a year earlier in the second quarter of 1987, a development that is hard to understand given the general buoyancy of personal spending and in particular given the rise in the rate of house completions over the last year.

26. Nevertheless it does look as though housing starts, which were rising through 1986 and into the first quarter of 1987, have now flattened out. Even so for 1987 as a whole housing starts may be at least 5 per cent higher than last year. Completions should go on rising into 1988. In spite of the surprising investment figures for the first half of 1987, the forecast is for a 10 per cent rise in investment in dwellings in the year as a whole, followed by a 6 per cent rise in 1988. By 1989 investment in new dwellings may have stopped rising, although expenditure on improvements should continue to grow quite strongly.

27. Fast growth in both house prices and real personal investment combined with a falling saving ratio mean that the personal sector's financial surplus, which has already declined from about 6 per cent of GDP in 1980 to just over 1 per cent in 1986, is likely to fall further.

TABLE 10: REAL PERSONAL INCOME AND EXPENDITURE

	Real personal disposable income	Real consumers' expenditure	Real investment in dwellings	Persons' net acquisition of financial assets	Personal saving ratio	Saving ratio excluding pension saving
	(Percent changes on previous year)			(£ bn)	(per cent)	(per cent)
1985	2.7	3.7	-3.9	9.0	10.4	6.4
1986	4.3	5.8	11.8	4.7	9.1	6.0
1987	4.9	4.7	9.4	3.6	9.2	6.7
1988	4.4	4.6	6.1	2.6	9.1	7.3
1989	3.1	3.4	3.9	1.4	8.8	7.8

(b) Company income and expenditure

28. Company spending on fixed investment rose sharply in the first half of 1987. Manufacturing investment rose by about 7 per cent in the first quarter and a further 6½ per cent in the second quarter. In 1987 as a whole it should now exceed the 4 per cent rise projected by the June DTI intentions survey. Investment by the construction, distribution and financial industries was some 12½ per cent higher than a year earlier in the first half of 1987. Much of this investment is in commercial building (shopping centres, offices for the financial services industry) and helps to explain the surge in construction output over the last year.

29. Manufacturing investment is also likely to show a larger rise in 1988 than the 6 per cent suggested by the June DTI intentions survey. The latest quarterly CBI survey indicated a substantial upward revision during the summer to intended expenditure on both buildings and plant and machinery. Other private sector business investment may also rise quite strongly again next year, and the build up of work on the Channel Tunnel will contribute to a further rise in construction work. Table 11 summarises the forecast for investment. Nationalised industry investment is much less buoyant than private sector investment, and reduces the growth of "other business" investment shown in table 11.

TABLE 11: GROSS FIXED CAPITAL FORMATION

(percentage changes on previous year)

	1986	1987	1988	1989
Business	- 3	6½	5½	3½
of which				
North Sea	- 14½	- 20	4	- 4½
Manufacturing	- 5	7	10½	8
Other business	- 1	8½	4	2½
Private dwellings	7½	7	5½	3
General government	5½	- 2½	- 3	0
Total	½	5	4½	3

30. Manufacturers reduced their stocks during the first half of 1987. Some of this destocking may have been unintended: by the summer manufacturers were telling the CBI for the first time this decade that on balance they no longer held excessive stocks. This year has also seen a decline in the balance of firms expecting stocks to fall. Distributors' stocks rose during the first half of 1987, though not enough to prevent a fall in the ratio of stocks to sales. The rise in consumer goods imports in the third quarter may indicate a stronger rebuilding of stocks. The forecast is for some further gradual fall in the stock output ratio, but at a slower pace than recorded in recent years. (The main reaction to the tax changes in the 1984 which raised the cost of stockholding should now have taken place.) This implies an increased rate of stockbuilding over the forecast period, though stockbuilding remains on a modest scale compared with many years of the 1960s and 1970s.

31. Non-North Sea industrial and commercial companies' profits net of stock appreciation rose by 13 per cent between the first halves of 1986 and 1987. Part of this rise is accounted for by reallocation of newly privatised companies (especially BGC) to the private sector. Excluding the profits of such companies the growth of profits was probably 10-11 per cent over this period - a slower rate of growth than recorded in recent years but still above the growth of money GDP. For 1987 as a whole the underlying growth of non-North Sea ICCs' profits is forecast to be similar to that experienced in the first half of the year. Profit growth may slow further in 1988, as output growth slows down and the rate of increase in costs rises slightly. This outlook for profits, at a time when company expenditure is likely to be rising strongly, implies a fall in companies' financial surplus - not, however, to an extent that should pose any general financial problems for companies.

TABLE 12: THE FINANCIAL POSITION OF INDUSTRIAL INDUSTRIAL AND COMMERCIAL COMPANIES

	Profits as a share of money GDP (per cent) Total	Non-oil	Rate of return on assets, non-oil ICCs' (per cent)	Net acquisition of financial assets (£ bn) (all ICCs)	Borrowing requirement (£ bn) (all ICCs)
1973-85 average	12.0	8.9	5.5	2.2	3.6
1986	15.0	12.5	8.9	6.4	6.1
1987	15.9	13.2	9.6	9.3	14.0
1988	15.2	13.0	9.2	4.2	11.0
1989	15.2	13.2	9.3	4.5	10.0

32. Table 13 shows the forecast for industrial and commercial companies' gross trading profits. The table also shows companies' net income - which is net of interest payments and receipts and corresponds roughly to the base for corporation tax. The slowing of net income growth in 1988 partly reflects the rise in interest rates forecast for the start of the year.

TABLE 13: PROFITS OF INDUSTRIAL AND FINANCIAL COMPANIES

(percentage changes on previous year)

	Non-North Sea Industrial and Commercial Companies*		Financial Companies
	Gross Trading Profits	Net Income	Net Income
1986	19 (16)	26	21
1987	16 (13)	18½	19
1988	7½	3½	16½
1989	7½	6	6½

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

(c) Aggregate demand and output

33. The average estimate of GDP grew by 3¾ per cent between the first halves of 1986 and 1987, while the output estimate grew by around 4¼ per cent (4¾ per cent non-North Sea). Output growth was particularly strong in the construction sector (up by 7½ per cent), and manufacturing output also recorded a rise of 5 per cent. The full extent of the rise in output is not explicable in terms of recorded expenditure. The expenditure estimate of GDP shows less than a 2½ per cent rise over the same period.

34. For 1987 as a whole the output measure of GDP seems likely to record a rise of 4 per cent or a little more. It is likely that the

average estimate of GDP will eventually show a similar increase. But there is some risk that, if the problems with the expenditure measure persist into the second half of the year, recorded growth could be a little under 4 per cent on the average estimate when the first figures for calendar 1987 are published by the CSO at around the time of the Budget. Given the record of upward revisions to GDP at the times of fast output growth it is quite likely that recorded growth for the average measure of GDP in 1987 will eventually settle down at a figure above 4 per cent.

35. Growth is expected to fall back to around 3 per cent in 1988 (3½ per cent non-North Sea). This slowing down is caused by a worse trade performance and by some deceleration in personal spending. After two years of above trend growth in 1987 and 1988, 1989 could see somewhat slower growth if the investment cycle has started to turn down by then.

TABLE 14: EXPENDITURE AND OUTPUT

(percentage changes on previous year)

	1986	1987	1988	1989
Domestic demand	3.8	3.9	4.1	2.9
Exports of goods and services	3.1	5.0	1.6	1.6
Imports of goods and services	6.2	6.5	5.0	3.1
Compromise adjustment	0.4	0.8	0	0
GDP(A)	3.1	4.1	3.0	2.4
Non-oil GDP(O)	3.1	4.5	3.5	2.8
Manufacturing output	1.1	5.2	2.9	3.2

(5) INFLATION

36. RPI inflation is likely to average close to 4 per cent in the fourth quarter of 1987, in line with the forecast published in the FSBR. Producer output prices, on the other hand, seem likely to rise some ½ per cent more on average this year than forecast at Budget time, principally as a result of higher input prices. In the third quarter of 1987 materials and fuel input prices were some 7 per cent higher than forecast at Budget time. Inflation as measured by the main national accounts deflators, however, was actually lower in the second quarter than expected at Budget time. There is currently an unusually large difference between inflation as measured by the RPI and inflation as measured by the national accounts consumption deflator. The national accounts deflators are subject to revision, and revisions tend to be upward.

Producer prices

37. Productivity growth of around 7 per cent has left manufacturers' unit labour costs virtually unchanged over the last year. In spite of the rise in materials costs over the last year, manufacturers' total unit costs are still no higher than they were at the start of 1985. Over the forecast period there is likely to be a modest rise in unit labour costs, as productivity growth reverts to its estimated underlying rate of increase, and real commodity prices may continue a gradual recovery from their exceptionally depressed levels of 1986. However, with a stable exchange rate for sterling, manufacturers will find it difficult to raise profit margins to anything like the extent they have done over the last three years. A slight reduction in inflation is expected during 1988, and inflation may fall further in 1989 if the economy slows down as forecast and competitive pressures intensify.

TABLE 15: MANUFACTURING COSTS AND PRICES

(percentage changes on previous year)

	Unit labour costs	Cost of materials and fuels	Estimated total costs	Domestic producer output prices*
1986 Q4	0.2	- 5.6	- 0.4	3.9
1987 Q4	0.9	7.7	2.2	4.8
1988 Q4	3.0	2.2	2.9	4.4
1989 Q4	2.8	3.1	2.4	3.2

* excluding food, drink and tobacco

Retail prices

38. Although retail price inflation in the fourth quarter of 1987 may turn out marginally below the Budget forecast, inflation is likely to rise during the first half of 1988 to around 5¼ per cent by the end of the year. This rise in inflation reflects in particular substantial electricity and gas price increases, a large rise in local authority rates, the loss of the benefits of the non-revalorisation of specific duties in the 1987 Budget, and a forecast rise in mortgage rates, as well as the effect of faster growth of unit labour costs.

39. Table 16 sets out changes in **nationalised industry** prices charged to domestic consumers over the year to 1987 Q4 and 1988 Q4, and gives real price increases over a run of financial years.

TABLE 16 : NATIONALISED INDUSTRY PRICES

(a) Nominal price increases for consumers

	Year to 1987 Q4	Year to 1988 Q4
Post	2.6	4.5
Rail	5.7	5.0
Electricity	- 0.3	8.0
Coal and coke	- 0.1	2.2
Bus	4.9	4.3
Water	5.6	6.4

(b) real price increases (weighted average for consumers and industry)

	1983-4	1984-5	1985-6	1986-7	1987-8	1988-9	1989-90
British Coal	2.3	0.0	- 1.9	- 3.1	- 4.5	- 2.9	- 2.4
Electricity	- 3.8	- 2.0	- 2.2	- 1.9	- 3.9	2.9	0.0
BSC	- 8.1	1.1	- 4.6	- 1.8	- 1.6	- 2.3	- 1.7
Post Office	- 2.0	- 1.5	- 4.2	- 2.0	- 0.8	- 0.4	- 1.0
Water	1.5	1.0	4.7	4.4	1.7	1.4	2.0
LTR	-15.7	- 3.2	1.5	2.2	2.1	4.4	4.1
British Rail	- 4.5	0.4	0.0	2.8	1.2	- 0.2	- 0.9

* Nominal changes deflated by the RPI

40. The larger increases in nationalised industry prices charged to consumers in 1988 will raise RPI inflation in 1988(4) by about ¼ per cent compared with inflation in 1987(4). Other factors that contribute to the rise in RPI inflation between 1987(4) and 1988(4) are as follows:

(i) The formula relating **gas prices** to oil prices and the RPI should give almost a 4 per cent rise in domestic prices next year, following a 4½ per cent fall this year (the difference is worth about 0.2 per cent on inflation).

(ii) The rate support grant settlement is assessed as implying an 12 per cent rise in average **local authority rate** poundages next year, compared with 7¾ per cent this year (the difference is worth 0.18 per cent on inflation).

(iii) A 1 point rise in **mortgage rates** compared with their end September level means that the path of mortgage interest payments adds about 0.4 per cent more to RPI inflation next year than this.

(iv) The assumed **indexation of specific duties** in the 1988 Budget will add a little over 0.3 per cent to RPI inflation in the latter part of 1988 compared with the latter part of 1987.

(v) **Food** prices are also likely to rise a little faster over the next year. Although world food prices are expected to remain relatively weak, a partial recovery in tropical beverage prices means that the prices of the foods the UK buys on world markets will rise a little more in 1988 than in 1987, and the faster rise in UK labour costs will also tend to put up food retail prices inflation.

(vi) **Petrol** prices have been unexpectedly low during the summer - the normal seasonal rise did not occur - in spite of the strength of crude oil prices. Over the next year there may be little change in petrol prices, other than that resulting from the assumed indexation of petrol duties in the 1988 Budget.

(vii) **Other private sector prices** have risen by 3½ per cent over the last year. (They would have risen by about 4 per cent but for the non-indexation of duties in the 1987 Budget.) Making a small allowance for the possibility that some of the acceleration of producer output prices in recent months has still to feed through into these prices and for the effect of the recent rise in pay settlements, these prices could rise by around 4¼ per cent over the next year.

41. The forecast for the RPI is summarised in table 17.

TABLE 17: COMPONENTS OF THE RETAIL PRICE INDEX

(Percentage changes on previous year)

	1986 Q4	1987 Q4	1988 Q4	1989 Q4
Food prices	3.2	3.4	3.9	3.5
NI prices	3.7	2.3	6.3	4.3
Housing prices	7.1	7.5	11.4	8.1
Other prices	2.6	3.4	4.1	3.5
- of which petrol	3.4	-12.6	1.8	3.4
- other items	3.8	3.4	4.2	3.4
All items RPI	3.4	3.9	5.3	4.3
RPI excluding mortgage interest payments	3.4	3.7	4.6	3.9

42. The annual rate of increase in the RPI should fall below 4 per cent in November when the mortgage rate increase that occurred in November 1986 drops out of the twelve month comparison. The inflation rate will rise again early next year on the assumption that the mortgage rate rises at the beginning of the year. Inflation is likely to rise quite sharply after March as post Budget increases in specific duties and rates and electricity price increases show up in the index. The forecast monthly path of retail price inflation up to the end of 1988 is shown below.

TABLE 18: MONTHLY PATH OF RPI INFLATION

		All items RPI	RPI excluding mortgage interest payments			All items RPI	RPI excluding mortgage interest payments
1987	August	4.4	3.7	1988	April	4.5	4.2
	September	4.2	3.5		May	4.9	4.3
	October	4.3	3.6		June	5.1	4.4
	November	3.8	3.7		July	5.2	4.5
	December	3.7	3.7		August	5.3	4.6
					September	5.5	4.7
1988	January	3.9	3.6		October	5.4	4.6
	February	3.9	3.6		November	5.3	4.5
	March	4.1	3.7		December	5.3	4.5

(c) The GDP deflator

43. The national accounts deflators published for 1987Q2 are surprisingly low. The CSO are currently looking at some aspects of the figure for the deflator for consumers expenditure, and have indicated that it is quite likely that the figure will be revised up. The latest published figure for the GDP deflator (showing a 4.1 rise in the GDP deflator at market prices over the year to 1987Q2) does not suggest any overrun of the Budget forecast for the current financial year which was for a 4½ per cent rise in the GDP deflator.

44. For 1988-89 most of the factors tending to push up the RPI (other than the path of mortgage rates) will also affect the GDP deflator. The GDP deflator will also be affected to the extent that the current boom in construction output feeds into construction prices and the forecast has a modest allowance for this effect in 1988-89.

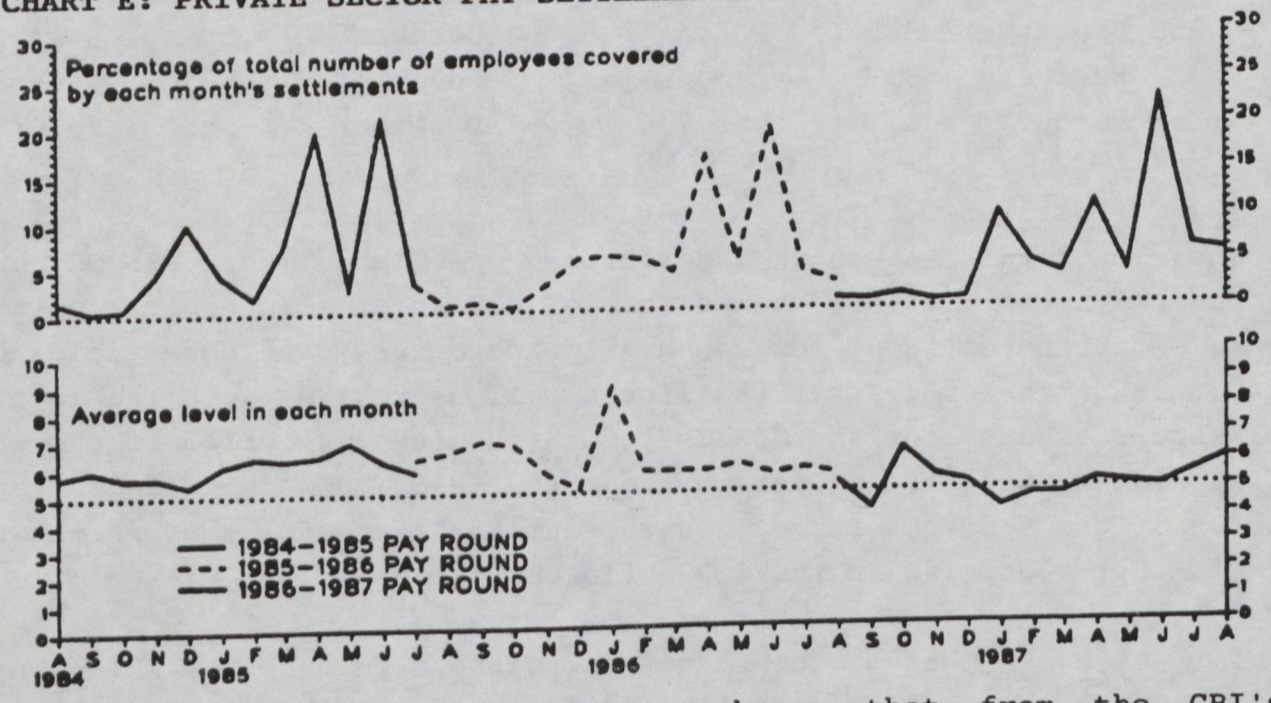
TABLE 19: FORECASTS FOR THE DEFLATOR FOR GDP AT MARKET PRICES

	1986-87	1987-88	1988-89	1989-90
MTFS				
Total	3	4½	4	3½
non-oil	6	4¼	3¾	3¼
Autumn forecast				
Total	3	4½	5½	5¼
non-oil	5¾	4	5½	5

(d) Earnings

45. Over the twelve months to August 1987, private sector pay settlements monitored by Department of Employment averaged 5 per cent, about ¾ per cent less than during the previous twelve month period. Settlements fell during the second half of last year, but appear to have bottomed out at around the beginning of 1987, and in the most recent month settlements averaged 6 per cent (see Chart E).

CHART E: PRIVATE SECTOR PAY SETTLEMENTS



46. Other evidence on settlements, such as that from the CBI's pay databank, tells a similar story. Although a relatively small number of employees are covered by the most recent settlements, the upward trend seems well established and it is not likely that as major settlements are concluded over the autumn they will generally be at rates below 6 per cent. This forecast assumes 6 per cent settlements on average over the next twelve months. Settlement rates may thereafter rise further (reflecting inflation at around 5½ per cent in mid 1988), but fall back in the second half of 1989 as the economy slows further and price inflation falls.

47. Overtime has been very high in recent months - at around record levels in relation to the number of operatives - and is currently estimated to be responsible for around ½ percentage point of the 8 per cent growth of private sector earnings over the last year. Over the next two years cyclical effects will tend to reduce earnings growth, and will offset the effect of rising pay settlements.

TABLE 20: PRIVATE SECTOR SETTLEMENTS AND EARNINGS
(Contributions to changes between third quarters of successive years)

	1986-87	1987-88	1988-89
Settlements	5¼	6	6½
Drift	2¾	2	1½
Increase in average earnings	8	8	8

48. Over the twelve months to August growth in local authority earnings has been roughly in line with private sector, while central government earnings has been a little lower. Over the following twelve months, local authority pay seems likely to rise somewhat faster than private sector pay. The teachers are already due for 8.2 per cent from October and a further 1 per cent next April. The forecast assumes that they receive only 4½ per cent "new money" on top of this in the light of Cabinet's decision not to pay more than the increase in the RPI. Local authority manuals have already agreed an increase of 10½ per cent. Local authority construction workers may also do well, particularly given the pressures from construction workers' pay in the private sector (up over 10 per cent in the year to June). It seems likely that some important groups of local authority workers will continue to do better than the private sector. While others (eg further education teachers) may do worse, local authority pay on average looks likely to rise a little faster than private sector pay.

49. On the other hand, central government earnings are likely once again to rise more slowly than private sector earnings over the next year. If there is a relatively high settlement for health service employees, it could well be staged, while a settlement for civil servants below the private sector average is expected. In later years central government pay is expected to rise more closely in line with private sector pay.

TABLE 21 : PUBLIC AND PRIVATE SECTOR UNDERLYING AVERAGE EARNINGS
(percentage changes over years to August)

	Central Government	Local authorities	Private sector**
1986-87	7	8 (7)*	7½
1987-88	7	9½(9¼)*	8
1988-89	8	9 (8¾)*	8½

* figures in brackets excluding settlements for primary and secondary teachers
** adjusted for changes in overtime hours.

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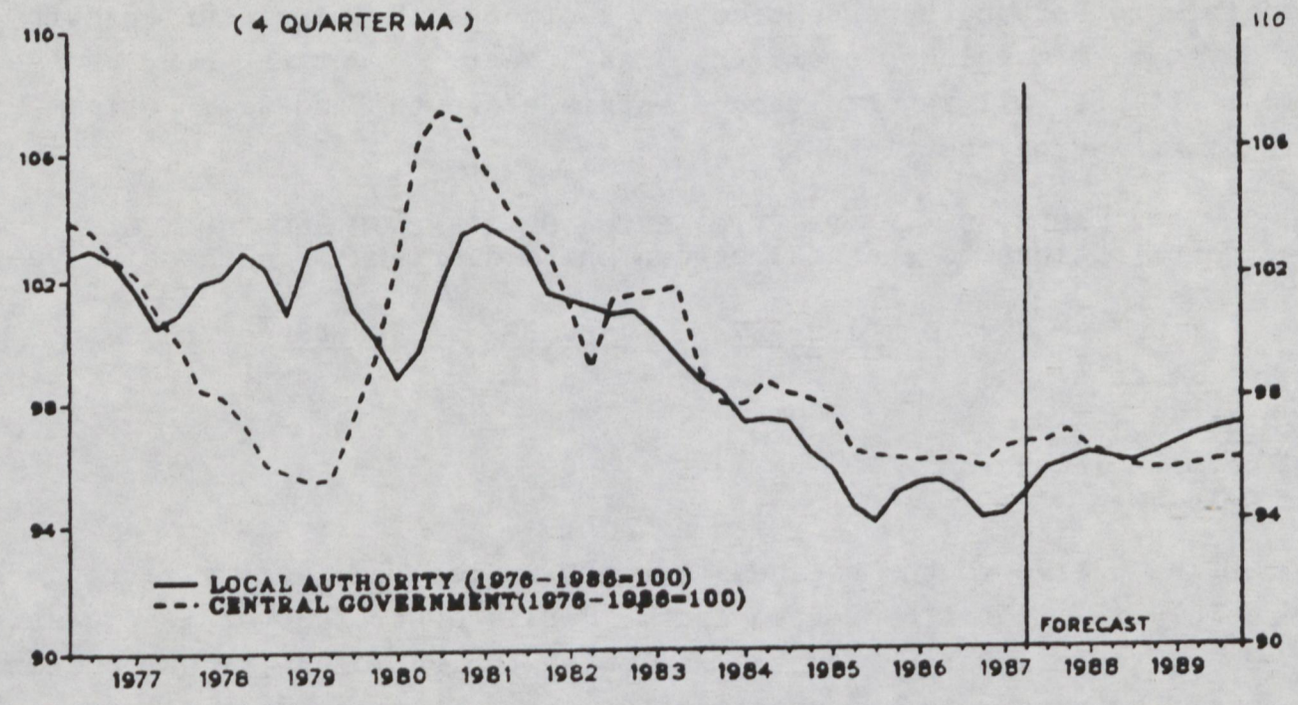
CHART F : RATIO OF LOCAL AUTHORITY AND CENTRAL GOVERNMENT EARNINGS TO PRIVATE SECTOR AVERAGE



(e) Labour costs

50. The forecast for private sector earnings combined with the forecast for productivity (discussed in section 6 below) produces forecast increases in labour costs in manufacturing that are modest by past standards, and close to those forecast for competitor countries.

TABLE 22 : LABOUR COST INCREASES IN MANUFACTURING

(percentage increases on previous year)

	UK	Major 7 (less UK)
1986	3.4	2.3
1987	0.0	1.3
1988	3.3	1.6
1989	2.6	2.3

(6) PRODUCTIVITY, EMPLOYMENT AND UNEMPLOYMENT

51. The latest upward revisions to manufacturing output mean that manufacturing productivity is now estimated to have risen by around 7 per cent in the first seven months of this year compared with a year earlier. While much of the recent rise in productivity is the result of a cyclical increase in the intensity of use of labour (as indicated by the rise in overtime hours), it seems that underlying productivity growth may have been a little higher recently than has been previously assumed. For this forecast the projection of underlying productivity

growth has been raised from 4 to 4¼ per cent a year.

52. Employment outside manufacturing rose by over 130,000 during the first quarter of 1987. Current indications are that the second quarter showed an increase of around 120,000. Growth in output per man outside manufacturing was unusually strong during 1986 - reflecting, among other things, redundancies in the coal industry and good productivity gains in other public corporations -, but as far as can be discerned has been much slower this year. Underlying growth in private sector non-manufacturing productivity is projected at around 1¾ per cent a year (about 2½ per cent a year in terms of full time equivalents).

TABLE 23: RECORDED AND FORECAST GROWTH OF OUTPUT PER HEAD

Annual averages, percentage changes

	1964-73	1973-79	1979-86	1986-89
Manufacturing	5¾	¾	3¾	5
Non-manufacturing*	3	½	1¼	1½
Total non-oil economy	2¾	½	1¾	2¼
Whole economy	2¾	1	2	1¾

* Includes private sector and nationalised industries other than in manufacturing and oil.

53. Labour supply is forecast to grow by about 680 thousand over the three years to 1989, about 200 thousand less than in the previous three years. This projection is somewhat higher than growth shown in the projections published in the Employment Gazette because the UK's relatively strong economic performance is likely to lead to both higher net inward migration and higher participation ratios than allowed for in the Department of Employment's projections.

TABLE 24: PRODUCTIVE POTENTIAL

(Annual averages; percent changes)

	Trend non-North Sea productivity growth	Labour supply	Non-North Sea productive potential	Contribution of North Sea	Whole economy productivity potential
1973-79	1	½	1½	½	2¼
1979-86	1½	½	2	¼	2¼
1986-89	2	¾	2¾	- ½	2½

54. Growth in the "working population" - the sum of employment and unemployment - has been very low over the past year: around 40,000 between mid 1986 and mid 1987, below the projected growth in labour supply, and down from increases of over 500,000 a year between mid 1983 and mid 1985. This is the phenomenon publicised by Layard and Clarke. The employment programmes which have been expanding recently and other measures such as Restart have tended to reduce the working population. (This is not the case with the Community Programme, whose participants are generally counted as employees and so remain in the working population).

55. But government programmes and Restart are not the only factors responsible for the recent slow growth of the working population. One important factor has been that the composition of employment growth has changed somewhat in favour of areas where most of the jobs are filled by men. Construction employment has started to rise, manufacturing employment has flattened out, and the programme of redundancies in the coal industry has - at least for a while - come to an end. Thus a higher proportion of new jobs have been going to claimants, and a smaller proportion to non-claimants. Moreover, the growth of the "working population" between 1983 and 1985 was quite exceptional relative to growth in the population of working age. It was never likely to be sustained and does not provide a reasonable benchmark against which to assess the impact of Restart and other recent measures. Between mid 1986 and mid 1987 the shortfall of growth in the working population relative to the projected increase in population of working age was some 130,000 - much less than the fall in unemployment over this period (roughly 290,000 including school-leavers). As shown in table 25, on our estimates of the effects of the various measures, about two thirds of the improvement in the adult unemployment trend as between the year to mid 1986 and the year to mid 1987 is attributable to underlying economic factors rather than to the effect of measures.

56. Unemployment is likely to fall more slowly during the forecast period. This is primarily because the 5 per cent growth in manufacturing output and 7 per cent rise in construction output forecast for this year are not forecast to be repeated over the next two years and so male employment growth will slow down. Nevertheless, helped by the removal from the count in September 1988 of everyone under 18, unemployment could go on falling into 1989.

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TABLE 25 CHANGES IN ADULT UNEMPLOYMENT

(seasonally adjusted 000s)

	Unemployment	Effects of employment and training measures, restart and availability testing	Underlying unemployment
1985(2)-1986(2)	+ 88	- 64	152
1986(2)-1987(2)	- 238	- 173	- 65
1987(2)-1988(2)	- 322	- 117	- 205
1988(2)-1989(2)	- 135	- 64	- 71

(7) FINANCIAL CONDITIONS

57. WEP has a rise in US interest rates during 1988, which is judged sufficient to limit the fall in the dollar exchange rate to modest proportions. With interest rates in the other major economies flat the average world interest rate rises. Because this rise in the average world interest rate is the consequence of likely downward pressure on the dollar exchange rate there could be some upward pressure on sterling against the dollar. However, the prospect that the UK current account deficit will widen in 1988 and 1989 could raise expectations of some decline in the sterling exchange rate with a need for an increase in interest rates in order to achieve a constant sterling index.

CHART G : STERLING AND THE CURRENT BALANCE

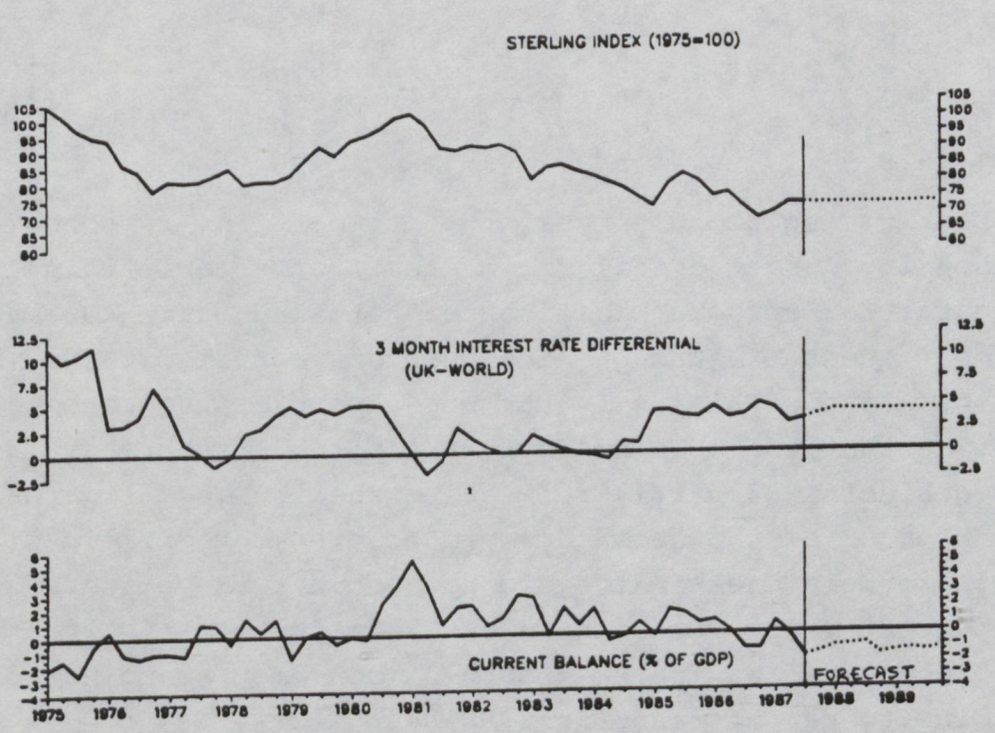

TABLE 26: EXCHANGE RATES AND COMPETITIVENESS
(average yearly rates)

	US dollar index (1975=1000)	Sterling index (1975=100)	$/£	DM/£	Relative unit labour costs (1980=100)
1984	134.6	78.6	1.34	3.79	82.9
1985	140.7	78.2	1.30	3.78	84.5
1986	114.8	72.8	1.47	3.19	77.3
7 Oct	101.5	73.3	1.64	2.998	75.4
1987	102.4	72.0	1.61	2.94	74.8
1988	98.1	72.5	1.68	2.94	76.7
1989	94.6	72.5	1.73	2.87	76.9

58. Domestic factors also point to upward pressure on interest rates. MO will be very close to the top of its target range in the near future, reflecting strong growth in consumers' expenditure. Money GDP growth is expected to overshoot the objectives set in the 1987 FSBR in every year in the forecast period. Continued strong credit demand from the private sector - both companies and persons - tends to offset the decline in the needs of the public sector. The forecast has short-term interest rates rising over the next few months to reach 11 per cent by the middle of 1988Q1. This rise, however, is not sufficient to bring the growth of money GDP back to its MTFS path.

TABLE 27: INTEREST RATES

	3-month US interest rates	3-month world rates	3-month sterling LIBOR	Mortgage rate
7 October	7.9	6.9	10.2	11.3
1986-87	6.2	6.3	10.5	11.7
1987-88	7.3	6.6	10.1	11.5
1988-89	8.4	6.9	11.0	12.3
1989-90	8.5	6.9	11.0	12.3

59. M0 has been rising rapidly over the summer in response to buoyant consumer spending and the fall in interest rates earlier in the year. In the three months to September holdings of notes and coin rose at an annual rate of 8 per cent, although the year on year figures for M0 have been closer to 5 per cent. This is in the upper part of the target range, and the forecast is that the year-on-year rate for M0 may breach its ceiling in the early months of 1988 partly reflecting the low M0 figures in early-1987. (A breach of the ceiling would be even more likely if the assumed rise in short term interest rates did not occur.) The effects of the recent rise in interest rates together with the further rise projected in the forecast and the slowdown in the growth of consumer spending should bring M0 back within its target range in 1988-89.

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TABLE 28: MONETARY AGGREGATES AND CREDIT

(per cent change on a year earlier)

	M0		M3	M4	Lending by banks and building societies
	MTFS range	Actual forecast			
August 1987	-	4.7	22.1	15.6	18.8
1986-87	2-6	4.3	19.0	14.9	18.5
1987-88	2-6	5.1	20.4	14.9	18.9
1988-89	1-5	4.4	16.2	13.8	17.2
1989-90	1-5	3.4	13.0	12.7	14.8

60. Broad money has continued to grow rapidly, with M3 increasing by 22 per cent in the year to August reflecting a continued strong rise in deposits by persons, ICCs, and building societies with some slowdown in deposits by other financial institutions after the surge early in the year. The forecast is that M3 growth may slow next year. Persons' deposits may continue to rise rapidly reflecting rising personal incomes and the relative attractiveness of high-interest bank accounts. Companies' deposits, however, may increase less rapidly than in the recent past as their investment in real asset rises. Deposits by financial institutions may grow markedly less quickly than recently as a result of lower inflows to pension funds and a slower rise in their total portfolio. The growth of M4 which contains a greater proportion of personal sector deposits, continues to rise less rapidly than M3 initially, but the gap closes later in the forecast period.

61. Lending by banks and building societies which rose by 19 per cent in the year to August, is forecast to rise by a further 17 per cent in 1988-89 before slowing in 1989-90. Lending to companies is projected to rise as less buoyant securities markets limit at least to some extent companies' scope to rely on equity issues. Lending to persons is also projected to rise steadily for both housing and other purposes. Competitive pressures on building societies and the limit on their access to wholesale funds continues to erode their share of new mortgage advances.

62. The PSBR is assumed to be funded fully outside the banking system, but the move to a negative borrowing requirement leads to net gilt repayments of £7 billion in 1988-89 and £6½ billion in 1989-90 - even on the assumption that receipts from National Savings are reduced to £1 billion a year. Gross gilt sales fall from £9½ billion in the current financial year to £3½ billion in 1988-89 and £1½ billion in 1989-90.

63. The emergence of a growing current account deficit coupled with continued net direct investment outflows and further portfolio investment abroad by financial institutions implies the need for substantial

offsetting capital inflows. The precise form of these is difficult to judge. The forecast assumes that corporate security issues on both the euro currency and US commercial paper market will play a significant role. Banks are also assumed to increase both their foreign currency and sterling borrowing from abroad for on-lending to residents. Net overseas sales of gilts are projected at zero. The forecast assumes that £1 billion of the intervention so far in 1987-88 is unwound before the end of the financial year with a further £1 billion in 1988-89.

TABLE 29: NET EXTERNAL CAPITAL FLOWS

	Direct invest-ment††	Non bank port-folio*	Banks' foreign currency†	Banks' ster-ling	Other	Official reserves	Balan-cing item	Current balance
1986	-6.0	-7.1	2.9	-0.4	2.8	-2.9	11.7	-1.0
1987	-10.0	7.1	6.2	3.8	2.8	-5.7	-1.8	-2.4
1988	-5.3	0.8	2.2	2.2	2.1	1.3	1.0	-4.3
1989	-5.5	0.9	4.2	2.2	2.5	0.3	1.0	-5.6

* includes gilts
† includes securities
†† includes oil

(8) PUBLIC FINANCES

64. Table 30 summarises the forecast and compares it with the numbers in the FSBR, and with the internal June forecast. The projections in the FSBR were on the basis of certain conventional assumptions and not a central forecast.

TABLE 30 : PUBLIC SECTOR EXPENDITURE, REVENUE, AND BORROWING
(£ billion)

	1986-87 Outturn	1987-88			1988-89			1989-90		
		FSBR	June Fore-cast	Oct. Fore-cast	FSBR	June Fore-cast	Oct. Fore-cast	FSBR	June Fore-cast	Oct Fore-cast
General Government Expenditure	165	174	173	172½	180	185	184	188	198	197
General Government receipts	160	169	172	173	178	187	192	187	201	206
Assumed cuts in personal taxes (cumulative)					3	3	4	5	5	6
GGBR	5	5	2	-½	5	2	-3	6	2	-4
Public corporations' overseas and market borrowing	-1½	-1	-1	-½	-1	-1	-2	-1	-1	-2
PSBR	3½	4	1	-1	4	1	-5	5	1	-5
(per cent of GDP) brackets)	(1)	(1)	(¼)	(-¾)	(1)	(¼)	(-1)	(1)	(¼)	(-1)

(a) 1987-88

65. The PSBR for 1987-88 is now forecast to be a surplus of £1b. The

margins of error attached to PSBR forecasts made at this time of the year, whilst lower than those for the Budget forecast, are still very high. The average absolute error is around 0.8 per cent of GDP (£3b.).

66. The latest forecast represents an undershoot on the FSBR forecast of £5b., and a reduction of £2b. from the June forecast. Table 31 shows the main components of the £5b. reduction in the PSBR forecast since the Budget. Over three-quarters of the predicted undershoot of the FSBR forecast is accounted for by lower central government own account borrowing, with most of the remainder due to lower local authorities' borrowing. The forecast of public corporations' market and overseas borrowing is little changed. Looked at another way three-quarters of the downward revision to the forecast has been on general government receipts, and one-third to general government expenditure.

TABLE 31 : CONTRIBUTION TO THE CHANGE IN THE 1987 PSBR FORECAST SINCE JUNE AND THE FSBR

	£ billion Changes since	
	FSBR	June
- higher North Sea revenues from a higher North Sea oil price;	-¾	-
- higher non-North Sea corporation tax reflecting upward revisions to 1986 profits data and higher dividend payments (generating ACT) in 1987;	-1	-½
- higher income tax, in line with experience to date and mainly reflecting higher money incomes;	-¾	-¾
- higher national insurance contributions, reflecting higher money incomes;	-½	-
- higher VAT, in line with outturn to date, and reflecting buoyant expenditure and - we think - a larger than expected reduction in arrears as a result of the Keith reforms;	-½	-½
- higher stamp duty as a result of the buoyant housing and stock markets;	-½	-
- higher privatisation proceeds;	-¼	-¼
- a lower public expenditure planning total (excluding privatisation proceeds);	-1	-1¼
- offsetting increases, mainly lower 'other' receipts and higher national accounts adjustments	+¼	+1¼
TOTAL CHANGE IN PSBR FORECAST	-5	-2

67. Lower expenditure and higher receipts have contributed roughly equally to the £2b. reduction in the PSBR since June. The main upward revisions on the receipts side have been to income tax, non-North Sea corporation tax and VAT. On the expenditure side the main reduction is lower local authority net capital spending, reflecting higher capital receipts, but the forecasts of social security spending and nationalised industries' EFLs have also been reduced.

(b) Fiscal adjustment and PSBR in 1988-89 and 1989-90

68. The MTFS assumption of PSBRs of one per cent of GDP would, on present projections, imply a massive fiscal adjustment in 1988-89 of around £13½b., with a further annual fiscal adjustment of £3b. in 1989-90. The forecast makes the stylised assumption that higher than previously planned privatisation proceeds are used to reduce the PSBR and that one third of the remaining available fiscal adjustment for 1988-89, calculated on this basis, reduces personal taxes, with the remaining two thirds reducing the PSBR to a surplus equivalent to about 1 per cent of GDP. The assumed cut in taxes is a little larger than in the June forecast. In 1989-90 the PSBR is maintained at the arbitrary surplus of 1 per cent of GDP, and there is scope for a further cut in personal taxes of £2b.

(c) Public expenditure

69. The forecast of the planning total excluding privatisation proceeds in 1987-88 has been revised down since June, and instead of a small overspend of the 1987 PEWP plans, a £1b. undershoot is now forecast. Substantial overspends of the PEWP totals are forecast for 1988-89 and 1989-90, only a little less than those forecast in June. The forecast for these years takes account both of the differences between the economic assumptions used in the PEWP and of the economic prospects in the forecast, together with other pressures on programmes which past experience suggests are likely. The forecast is in effect attempting to anticipate not only the final outcome of the current survey (and in the case of 1989-90 the next survey as well), but also any eventual over or underspend on the finally agreed planning totals. The forecast incorporates some modest additions to expenditure in 1989-90 following the buoyant performance of the economy in general and public finances in particular in 1987 and 1988. Privatisation proceeds of £5¾b. are assumed for 1987-88, in line with PE's latest assessment. Proceeds of £6b. a year are assumed for 1988-89 and 1989-90.

70. Table 32 sets out forecast increases in actual programme spending compared with the 1987 PEWP in terms of economic rather than departmental categories. About half the projected excess above current programme plans is accounted for by social security and local authority current expenditure. These are areas over which the Government has limited direct control.

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TABLE 32 : FORECAST ADDITIONS TO PROGRAMME BASELINES

£ billion

	1987-88		1988-89		1989-90	
	PEWP 1987	Forecast Claims on Reserve	PES 1987 Base-line	Forecast additions to baseline	PES 1987 Base-line	Forecast additions to baseline
Allocated to programmes						
1. Social Security (including HB)	44.7	0.5	46.1	2.2	48.0	4.1
2. LA current (excluding HB)	32.5	1.1	33.7	2.9	34.6	5.2
3. CG pay	24.8	0.5	25.8	1.5	26.6	2.9
4. CG procurement	24.6	0.1	25.0	1.4	25.9	2.3
5. LA capital	4.3	-0.7	4.0	-0.2	4.1	0.0
6. EC	0.9	0.4	0.4	0.9	1.1	0.6
7. Nationalised industries	0.7	-0.1	0.3	0.3	-0.1	0.7
8. Other	17.8	0.6	18.3	0.9	18.8	1.5
9. Total programmes	150.1	2.5	153.7	9.9	9.0	17.3
10. Expenditure met from existing reserve						
(i) allocated to programme baseline	0.0	2.5	0.0	5.5	0.0	7.5
(ii) unallocated	3.5	0.0	5.5	0.0	7.5	0.0
11. Underspend (-) Addition to Reserve(+)	0.0	-1.0	0.0	4.4	0.0	9.8
12. PLANNING TOTAL excluding privatisation proceeds	153.6	-1.0	159.2	4.4	166.5	9.8

71. The forecast of social security spending assumes that the underlying growth in spending - ie the growth after allowing for the effects of changes in unemployment, upratings, policy changes, demographic factors etc - which is projected to have risen rapidly in 1987-88, falls back somewhat in 1988-89 and 1989-90. The forecast of local authority current spending, most of which is pay, assumes that numbers employed will rise at much the same average rate as in the last 2-3 years and that earnings increases will be somewhat above the private sector average (see para 48). This, together with the RSG settlements announced in July, implies average rates increases of about 11 per cent in 1988-89.

72. The forecast of central government pay assumes little change in numbers and earnings increases averaging below the private sector in 1988-89 and much the same as the private sector in 1989-90 (see para 49). The forecast of central government procurement assumes that non-defence spending will rise in real terms at much the same rate as over the past 5 years, and that defence spending will rise at ½ per cent a year in real terms. Local authority capital receipts and gross capital spending are assumed to be higher than in the 1987 PEWP, but by roughly equal amounts in 1988-89 and 1989-90. The forecast has partially smoothed out the projected dip in net EC contributions in 1988-89 and the rebound in 1989-90.

73. The large upward revision to the planning total forecasts for 1988-89 and 1989-90 since the Budget are largely matched by a higher inflation forecast. Consequently the increase in the planning total in real terms is less than the cash increase. In real terms the planning total and GGE (see table 33) are much the same as earlier internal forecasts. The forecast of GGE in real terms is almost identical to that made a year ago for 1988-89 and less than 1 per cent higher for 1989-90.

TABLE 33 PAST AND CURRENT FORECASTS OF GGE EXCLUDING PRIVATISATION PROCEEDS

£ billion

Forecast	1986-87		1987-88		1988-89		1989-90	
	Current prices	Real Terms*	Current Prices	Real Terms*	Current Prices	Real Terms*	Current Prices	Real Terms*
Jan 1986	169	169	176	169	186	169	-	-
June 1986	169	169	177	170	186	171	-	-
Oct 1986	170	170	178	171	188	172	200	173
Jan 1987	170	170	179	171	190	173	202	175
FSBR 1987	169	170	179	171	185	171	193	172
June 1987	169	169	179	170	190	171	203	174
Oct 1987	170	170	178	170	190	172	203	175

* in 1986-87 prices

74. The ratio of GGE (excluding privatisation proceeds) to money GDP is forecast to show a sharp fall in 1987-88 and more modest falls in 1988-89 and 1989-90. It is below the PEWP/MTFS paths in all three years.

TABLE 34 : RATIO OF GGE EXCLUDING PRIVATISATION PROCEEDS TO MONEY GDP

per cent

	1985-86	1986-87	1987-88	1988-89	1989-90
1987 PEWP	44¾	44½	44	42¾	42½
1987 FSBR	44¾	44¼	43½	42½	41¾
Oct forecast	44¾	44	42¼	41¾	41¼

(d) General Government Receipts

75. The recent history of forecasts of general government receipts has been a series of successive upward revisions. The current forecast continues this pattern, with substantial upward revisions to 1988-89 and 1989-90

compared the with June forecast. The upward revision since June to the forecast for 1987-88 has been smaller (about £1b.), though this still leaves the 1987-88 forecast of revenues £4b. higher than that in the FSBR.

76. Part of the upward revision to 1987-88 receipts since the FSBR can be attributed to higher economic activity, including stronger than expected stock and housing markets, which have boosted stamp duty receipts. Higher non-North Sea corporation tax for the most part reflects stronger than previously estimated activity and profits in 1986. Higher non-North Sea corporation tax is the most important single factor behind the higher total receipts now forecast for 1988-89 and 1989-90, accounting for around half of the revision since June to 1988-89 and one-third of the revision to 1989-90. The revision to the forecasts partly reflects higher profits growth for 1987 (and thus higher tax receipts for 1988-89). The remainder of the upward revision since June to the receipts forecasts for 1988-89 and 1989-90 are for the most part attributable to higher income and expenditure (income tax, VAT and NICs account for between one-third and half of the total upward revision in each year), but the forecast of local authorities rates has been raised by between £¾ to £1b. in each year.

TABLE 35: COMPARISON OF FORECASTS OF GENERAL GOVERNMENT RECEIPTS (PRE-FISCAL ADJUSTMENT FOR 1988-89 AND 1989-90)*

£ billion

Forecast:	1986-87		1987-88		1988-89		1989-90	
	Cash	Real Terms	Cash	Real Terms	Cash	Real Terms	Cash	Real Terms
January 1986	157	153	166	159	178	162	188	164
June 1986	156	156	164	158	179	164	188	166
October 1986	156	156	165	159	181	165	196	169
January 1987	158	158	169	162	184	168	197	171
FSBR 1987	159	159	169	162	178	164	187	167
June 1987	159	160	172	164	187	168	201	172
October 1987	160	160	173	165	192	174	206	178

* Forecasts made before this and last year's Budgets have been adjusted to be consistent with current tax rates and allowances. Real terms figures are at 1986-87 prices.

77. Table 36 shows non-oil taxes and national insurance contributions (NICs) as a percentage of non-oil GDP. The changes to the tax forecast since the FSBR mean that the forecast now shows a substantial rise in the pre-fiscal adjustment tax burden for 1988-89, but this is offset by the assumed cut in taxes. The projected rise for 1989-90 is smaller, and is

again offset by the assumed tax cut. Thus with the stylised assumption used here on the allocation of the fiscal adjustment, the tax burden for 1989-90 is the same as the level for 1987-88. With oil revenues as a percentage of GDP expected to be broadly flat at the projected 1987-88 level, the ratio of total taxes to money GDP is forecast to follow a similar pattern to the non-oil ratio.

TABLE 36: NON-OIL TAXES AND NICs AS A PERCENTAGE OF NON-OIL GDP

	1985-86	1986-87	1987-88	1988-89	1989-90
FSBR					
(a) pre-fiscal adjustment	37.2	37.3	37.8	37.9	37.7
(b) post fiscal adjustment	37.2	37.3	37.8	37.1	36.6
June Forecast					
(a) pre-fiscal adjustment	37.3	37.7	38.0	38.4	38.8
(b) post fiscal adjustment	37.3	37.7	38.0	37.5	37.9
October Forecast					
(a) pre-fiscal adjustment	37.0	37.5	38.0	39.1	39.4
(b) post-fiscal adjustment	37.0	37.5	38.0	38.0	38.0

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ANNEX I: PUBLIC EXPENDITURE ASSUMPTIONS

The forecast of public expenditure in 1987-88 takes account of the latest monthly data on expenditure, the expected evolution of the economy over the rest of the year (which affects such programmes as social security) and Treasury expenditure divisions' assessments of the likely final outturn. For 1988-89 and 1989-90 the forecasters attempt to predict the level of public expenditure that will occur (as opposed to the programme plans which will eventually be agreed). The forecast therefore implicitly includes judgements both on the results of the current round of Ministerial discussions (and for 1989-90 the results of the autumn 1988 discussions) and on the influence of the forecast evolution of the economy on demand led public expenditure.

2. In constructing the forecast it is necessary to make detailed assumptions in certain areas. The main ones were as follows:

(i) The outturn percentage for local authorities' Aggregate Exchequer Grant, which on the basis of the forecasters' view of relevant expenditure, is forecast to fall from 45¾ per cent (GB, accruals) in 1987-88 to 45 per cent in 1988-89, is assumed to fall a further ½ percentage point in 1989-90.

(ii) The forecast assumes an increase in the VAT ceiling for EC own resources contributions from 1.4 to 1.6 per cent with effect from 1 January 1988 and that a Community Budget is agreed before 31 March 1988.

(iii) Privatisation proceeds are assumed to be £6 billion per annum in 1988-89 and 1989-90. For 1987-88 PE's latest best estimate of £5¼ billion is used.

(iv) The Treasury Supplement to the National Insurance Fund is assumed to be reduced by 2 per cent in 1988-89 and a further 2 per cent in 1989-90, to a level of 3 per cent.

3. The table below compares the forecast with the main economic assumptions used in the 1987 PEWP, the 1987 MTFS, and with assumptions which have either already been agreed, or proposed (Mr Davies' minute of 2 October to the Chancellor) for use in the forthcoming Autumn Statement and PEWP.

	1986-87	1987-88	1988-89	1989-90	1990-91
GDP Deflator (%)					
1987 PEWP	3	3¾	3½	3	
1987 MTFS	3¼	4½	4	3½	
October Forecast	3	4½	5½	5¼	
Proposed New Assumption	3	4½	5	3½	3
Money GDP (%)					
1987 PEWP	5½	7	6	5½	
1987 MTFS	6	7½	6½	6	
October Forecast	6½	9	8½	7¾	
Money GDP (£b)					
1987 PEWP	380.2	407.0	431.4	455.2	
1987 MTFS	382.4	411.0	437.2	463.8	
October Forecast	385.3	419.5	455.1	490.4	
Unemployment (Adult, GB millions)					
1987 PEWP	3.1	3.05	3.05	3.05	
October Forecast	3.0	2.7	2.5	2.5	
Agreed New Assumption	3.0	2.7	2.6	2.6	
RPI* (%)					
1987 PEWP			3¾	3½	
October Forecast			4.2	5¼	
Proposed New Assumption			4.2	5	3¼
Average Earnings (%)					
March Assumptions		6½	6	5½	5
October Forecast	8	8¼	8	8	
Agreed New Assumption		7½	6½	5½	5
UK 3 month LIBOR					
March Assumptions		9¾	9½	9½	9
October Forecast		10	11	11	
Proposed New Assumption		10	10	9½	9
UK 20 year gilt rate					
March Assumptions		9	9	9	9
October Forecast		10	11	11	11
Proposed New Assumption		10	10	9	9
6 month dollar LIBOR					
March Assumptions		7	8½	9	9½
October Forecast		7¾	8¾	9	
Proposed New Assumption		7½	8½	9	9

* increases in year to previous September

ANNEX II : SECTORAL SURPLUSES AND DEFICITS

Table IIA compares sectoral net acquisition of financial assets by sector (sectoral surpluses and deficits) as proportions of money GDP since 1948. The overseas sector surplus is the current account deficit with the sign changed. Similarly the public sector's surplus is the PSFD with the sign changed.

The large forecast residual error reflects and continues discrepancies between the measures of GDP in the first half of 1987. Normally the residual error comes down as the CSO reduces measurement of errors for a particular period.

For 1988-89 and 1989-90

(i) The **total private sector surplus** is lower than in any year since 1974-75. It is not particularly low compared with earlier experience.

(ii) The **personal sector surplus** is low in comparison with experience in the years from 1960. It is not low in comparison with the earlier period.

Table IIB shows the PSBR, the PSBR adjusted for privatisation receipts, and the PSFD (public sector financial deficit) as proportions of money GDP.

For 1988-89 and 1989-90

(i) The **PSBR** ratio, at -1 per cent, is lower than in every year since 1952 except 1969-70.

(ii) The **PSFD** ratio is lower than in every year except 1968-69, 1969-70, and the three years to 1950.

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TABLE IIA: NET ACQUISITION OF FINANCIAL ASSETS BY SECTOR (AS PER CENTAGE OF GDP)

	Personal (1)	ICC (2)	Financial (3)	Total Private Sector (4)	Public (5)	Overseas (6)	Residual Error (7)
Calendar Years							
1948	- 2.8	1.8	0.3	- 0.7	2.2	- 1.4	- 0.2
1949	- 2.6	2.1	0.3	- 0.1	2.4	- 1.2	- 1.1
1950	- 2.1	3.1	0.3	1.3	2.6	- 3.3	- 0.6
1951	- 3.2	2.5	0.3	- 0.4	- 1.6	2.2	- 0.2
1952	0.1	4.0	0.5	4.6	- 3.4	- 1.0	- 0.1
1952	- 0.4	3.7	0.3	3.7	- 4.1	- 0.8	1.2
1954	- 1.6	3.6	0.4	2.3	- 2.4	- 0.6	0.7
1955	- 1.4	2.1	0.4	1.1	- 2.0	+ 0.8	0.1
1956	0.2	2.0	0.3	2.6	- 2.6	- 1.0	1.0
1957	0.0	1.5	0.4	1.9	- 2.4	- 1.0	1.5
1958	- 0.6	2.1	0.3	1.8	- 1.9	- 1.6	1.7
1959	- 0.3	1.8	0.2	1.6	- 2.2	- 0.7	- 1.3
1960	1.1	0.9	0.2	2.3	- 2.7	+ 0.9	- 0.4
1961	2.3	- 0.2	0.2	2.4	- 2.6	- 0.2	0.5
1962	2.0	0.0	0.2	2.1	- 1.8	- 0.5	0.2
1963	1.9	1.4	- 0.2	3.0	- 2.6	- 0.4	0.0
Financial Years							
1963/64	1.9	1.8	- 0.3	3.4	- 3.3	0.0	- 0.1
1964/65	2.6	- 0.6	- 0.5	1.5	- 2.4	1.0	- 0.1
1965/66	3.6	- 1.0	- 0.5	2.1	- 1.7	0.2	- 0.6
1966/67	2.5	0.8	- 0.7	2.6	- 2.6	- 0.4	0.4
1967/68	2.0	1.6	- 0.8	2.8	- 4.2	1.1	0.2
1968/69	1.2	0.5	- 1.1	0.6	- 0.8	0.3	- 0.1
1969/70	1.5	0.7	- 1.6	0.6	1.7	- 1.5	- 0.8
1970/71	2.1	0.8	- 1.2	1.7	0.4	- 1.1	- 1.0
1971/72	0.1	2.4	- 0.7	1.8	- 1.1	- 1.7	1.1
1972/73	1.4	2.5	- 0.5	3.3	- 3.0	0.4	- 0.7
1973/74	3.4	0.0	- 0.7	2.7	- 4.6	2.0	- 0.1
1974/75	4.3	- 1.7	- 0.7	2.0	- 6.7	3.6	1.2
1975/76	4.1	0.9	- 0.7	4.3	- 7.3	1.0	2.0
1976/77	3.4	- 0.5	0.2	3.1	- 5.7	1.1	1.5
1977/78	2.6	1.1	0.3	4.0	- 4.4	0.0	0.4
1978/79	4.5	0.3	0.2	5.0	- 4.8	- 0.3	0.1
1979/80	4.4	- 0.3	0.2	4.2	- 3.9	0.1	- 0.4
1980/81	6.6	0.3	- 0.3	6.6	- 5.0	- 2.5	0.8
1981/82	4.9	0.3	- 0.2	5.0	- 2.0	- 1.8	- 1.2
1982/83	3.5	2.0	0.1	5.6	- 2.9	- 1.6	- 1.0
1983/84	2.9	2.4	0.4	5.7	- 3.7	- 0.9	- 1.1
1984/85	3.2	2.2	0.0	5.4	- 4.0	0.0	- 1.4
1985/86	2.3	1.9	0.3	4.6	- 2.3	- 1.1	- 1.2
1986/87	1.3	1.7	1.4	4.5	- 2.5	0.2	- 2.2
Forecast							
1987/88	0.5	1.9	0.9	3.2	- 1.0	1.0	- 3.1
1988/89	0.5	0.8	1.1	2.4	- 0.5	1.0	- 3.0
1989/90	0.2	1.0	0.9	2.1	- 0.3	1.2	- 3.0

NB: Columns 1 + 2 + 3 = 4
Columns 4 + 5 + 6 + 7 = 0

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Table IIB: PUBLIC SECTOR BORROWING as a percentage of GDP

	PSBR	PSBR less Privatisation proceeds	PSFD
1948			-2.2
1949			-2.4
1950			-2.6
1951			1.6
1952	5.0		3.5
1953	3.4		4.1
1954	2.0		2.4
1955	2.4		2.0
1956	2.7		2.6
1957	2.2		2.4
1958	2.1		1.9
1959	2.3		2.2
1960	2.7		2.7
1961	2.5		2.6
1962	1.9		1.8
1963	2.7		2.6
1963-64	3.3		3.4
1964-65	2.7		2.4
1965-66	2.6		1.7
1966-67	2.9		2.6
1967-68	4.9		4.2
1968-69	0.8		0.8
1969-70	-1.2		-1.7
1970-71	1.5		-0.4
1971-72	1.6		1.1
1972-73	3.6		3.0
1973-74	5.8		4.6
1974-75	9.0		6.7
1975-76	9.3		7.3
1976-77	6.4		5.7
1977-78	3.6	3.9	4.4
1978-79	5.3	5.3	4.8
1979-80	4.8	5.0	3.9
1980-81	5.4	5.5	5.0
1981-82	3.3	3.5	2.0
1982-83	3.1	3.3	2.9
1983-84	3.2	3.5	3.7
1984-85	3.1	3.7	4.0
1985-86	1.6	2.3	2.3
1986-87	0.9	2.0	2.5
		Forecast	
1987-88	-0.3	1.0	1.0
1988-89	-1.1	0.2	0.5
1989-90	-1.1	0.1	0.3

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PRIME MINISTER

RECENT STATISTICS

You may find it helpful to have an aide memoire on recent statistics.

Unemployment: seasonally adjusted unemployment fell in September by 54,000; the headline total rose by 4,000.

Output: output in the production industries is estimated to have risen by 1 per cent in the 3 months to August 1987 and is 3 per cent higher than a year earlier. Within this, manufacturing output in the latest 3 months rose by 2 per cent and is 6 per cent higher than a year earlier.

PSBR: the PSBR in September is provisionally put at £35 million. In the financial year so far, the PSBR was £1.4 billion compared with £5.8 billion in the corresponding period in 1986/87.

Money: in September MO grew by 0.1 per cent, with a 3 month annualised increase of 12.5 per cent; the increase in M3 is put at 1 per cent, though this is probably artificially low. Seasonally adjusted bank lending rose by £4.4 billion.

Current Account: the current account deficit in September is put at £55 million, making £0.8 billion for the year so far. Exports rose sharply and imports fell in September. (This will be published on Thursday.)

DASCOA

pp DAVID NORGROVE

20 October 1987

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BANK OF ENGLAND
LONDON EC2R 8AH

A. L. Coleby
Chief Monetary Adviser
to the Governor
01-601 4220

29 September 1987

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

Dear Peter,

I enclose our regular monthly note on interest rates over the next few weeks for our meeting on Thursday afternoon.

Yours ever,

Tony

PERM. SEC'S. OFFICE
RECEIVED
29 SEP 1987

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Mr Richardson
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Mr Mr Kelly
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£ millions

INTEREST RATES OVER THE NEXT FEW WEEKS

1 The unpublished band for interest rates on bills with up to 14 days to maturity stands at 9-11%. Within the band, we have been buying bills in all maturity bands at a common discount rate of 9 7/8%.

Market conditions

2 Since the last meeting the US discount rate has been raised by 1/2% to 6% and US money market rates have moved up in line with it; moreover the recent trend in bond yields has been upwards, not only in the US but also in Japan and Germany. Oil prices have not reacted very markedly to the continuing tension in The Gulf: they are apparently being held down by above-quota production by some OPEC members.

3 In the foreign exchange markets there has been a modest recovery in the dollar since the last meeting. Sterling strengthened in response to encouraging indicators on industrial production, the PSBR, and money and bank lending, but remained below the DM 3.00 level without the need for heavy intervention on our part. It fell back on the trade figures, though only modestly; and has since recovered the ground it lost. Recent changes are shown in the table below.

	£ERI	£/$	£/DM	$/DM
10 September	72.9	1.6450	2.9725	1.8045
28 September	73.1	1.6387	2.9906	1.8250

4 In the money market, the August money figures caused market concerns about a possible rise in interest rates, which had already been lessening, to diminish further, and the three month interbank rate fell back to around 10%. The August trade figures caused some tightening in rates, though they did not give rise to

any market expectation of an increase in the general level of interest rates in the near future. The one, three and twelve month interbank rates currently stand at 10%, 10 3/16% and 10 1/2% respectively.

5 Sentiment in the gilt-edged market improved with the publication of the industrial production, PSBR and money/bank lending figures; and we were able to sell our residual holdings of the 1991 tap stock, as well as substantial amounts of the 1992 low coupon stock, before the long gilt auction. The August trade figures, coming the day after the auction, set the market back quite sharply, taking the yield on the auction stock to around 9 3/4%, compared with the average yield at the auction of 9.57%.

Monetary conditions

6 Monetary growth in August was as shown below:

	1986		1987				
	Q4	Q4	Q1	Q2	July	August	12 months to August
M0*	1.6	2.4	-1.0	1.1	1.2	0.3	4.7
M3	4.4	1.6	6.8	5.1	2.3	1.5	22.2
nib M1	8.8	-4.6	2.1	7.1	-0.4	0.6	13.4
M1	7.7	-0.3	7.7	7.1	0.9	1.7	24.5
M2	4.3	1.9	1.3	4.0	0.8	0.6	11.0
M4	2.8	2.0	4.1	4.1	1.8	1.3	15.5
M5	2.9	1.9	3.9	4.2	1.7	1.3	14.9

7 The increase of 0.3% in M0 in August included a reversal of July's erratic rise in average bankers' balances. Although the 12-month growth rate of notes and coin remains at around 4 1/2%, the annualised growth rate over the latest three months was some 7%.

8 The broad aggregates all grew by around 1 1/2% in August - in each case more slowly than in July, though their 12-month growth rates nevertheless went up. On the M3 basis (ie not counting

debt sales to banks in the funding total), the PSBR was underfunded by 2,720 (1.6% of M3) over the 12 months to August. In contrast, on the M4 basis (ie not counting debt sales either to banks or to building societies), it was overfunded by 760 (0.3% of M4) over that period.

9 The public sector had a small surplus in August, which was overfunded (on the M3 basis) by 350 thanks to a fall in the reserves and overseas purchases of gilts, and despite a substantial further run-off in the private sector's holding of other public sector debt.

10 The main counterpart to the slowdown in broad money growth was in bank and building society sterling lending, which (including private sector holdings of bills) went up by no more than 3,120 in August, compared to an average of 5,540 in June and July and 4,020 in the two months before that. The indications are that the slowdown in credit growth was mainly accounted for by lending to the corporate sector - the rate of personal lending seems to have been broadly unchanged. Foreign currency lending, however, went up by 1,040; so that the total of sterling and foreign currency lending went up by more in August than in July, though still by less than on average over the year to end-June.

11 The three-month forecast is for some acceleration in M0, taking its 12-month growth rate up to 5% by the end of November. Broad money is expected to grow at a relatively moderate pace, with M3 continuing faster than M4 and M5. The 12-month growth rates of M3, M4 and M5 are forecast to fall back to 20.8%, 15.0% and 14.3% respectively by the end of November. The end-October figures for the aggregates other than M0 are likely to be distorted by the BP share sale, for which lists close on 28 October.

12 The latest GDP figures show strong output growth of around 3 3/4% in the year to the second quarter on the average estimate, and the July industrial production figures suggest that this has persisted into the third quarter. However, even though the August external trade figures were probably erratically bad, the trend in the trade figures since the beginning of the year makes

it clear that, at least over that period, domestic spending for consumption and investment purposes has grown faster even than output.

13 The retail price index rose by 0.3% in August, but its 12-month increase remained at 4.4% (3.7% if mortgage interest is excluded). Manufacturers' input prices rose by a further 1.1% in August to a level 9% higher than a year earlier (though there are signs that commodity price increases have begun to moderate), but manufacturers' output prices (which rose by 0.3% in August) were no more than 3 1/2% higher than in August 1986. The underlying increase in average earnings in the economy as a whole remained at 7 3/4% in the year to July.

Conclusion

14 The evidence that has accumulated since the last meeting on the monetary and economic situation is mixed. On the demand side, broad money and credit growth moderated in August, and the PSBR has been running at a lower rate than expected. On the other hand, rapid growth in retail sales has continued, perhaps associated with the upturn in M0 growth. On the supply side, output has been growing faster than was earlier thought, and unemployment has continued to fall. But although the exchange rate has been firm, it is clear from the trade figures that domestic demand has been growing faster than output.

15 Against this background we continue to think that the risks on inflation are asymmetrical, with a significant rise more likely than a significant fall, and that the case for a move up in interest rates is stronger than that for a move down.

Bank of England
29 September 1987

MR 1/79 ph

1. Mr Norgrove 2. Prime Minister 2

CONFIDENTIAL

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

18 September 1987

Nigel Wicks
No.10 Downing Street

Dear Nigel,

MO: BANKERS' BALANCES

... I attach a note on banker's balances held at the Bank of England, as the Prime Minister requested when she and the Chancellor discussed interest rates on 6 August.

Yours
Alex

A C S ALLAN
Principal Private Secretary

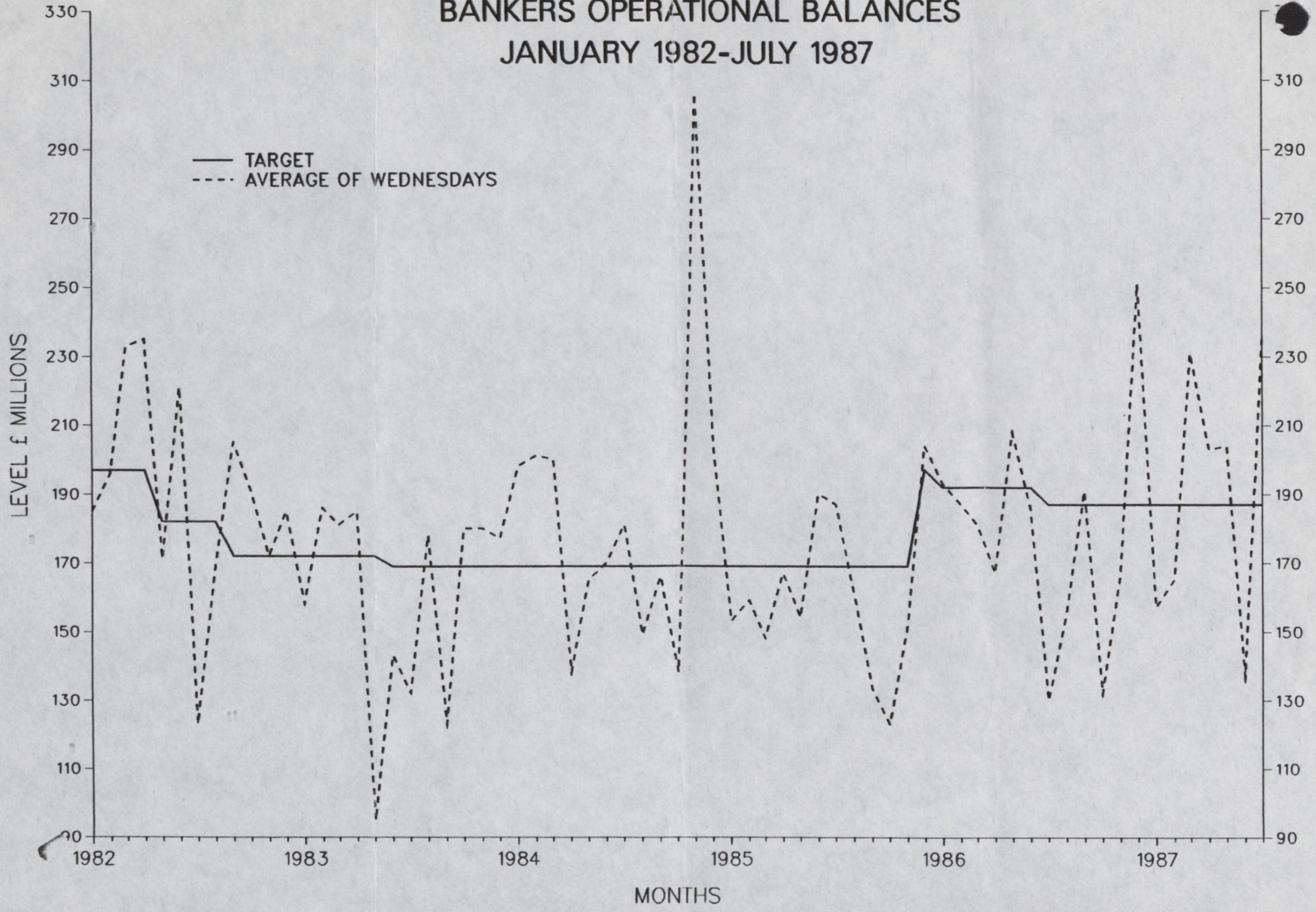
MO: BANKERS' BALANCES AT THE BANK OF ENGLAND

At the end of each day, the clearing banks settle up with each other and with the Bank of England through their clearing accounts held at the Bank. These "bankers' balances", which are non-interest bearing, are a component of MO. The banks individually conduct their day-to-day money market operations with the objective of reaching a target credit balance on these accounts. This target is set so as to provide the banks with a cushion against unexpected outflows and to protect them from going into overdraft (which both they and the Bank would regard as contrary to the understandings on money market operations reached in 1981).

2. The average level of bankers' balances and the fluctuations around this depend on the accuracy with which individual banks and the Bank of England can forecast their net positions at the end of each day. These fluctuations can be considerable, a factor underlying the decision to measure MO (uniquely among the monetary aggregates) as the average of Wednesday levels during each month.

3. The present target level, which has changed little since 1981, is £187 million. Since this represents only a little more than one per cent of the stock of MO, which is just under £16 billion, bankers' balances can in any case have very little medium-term effect on the aggregate. However the monthly change in MO, from which one and twelve month growth rates are calculated, is typically less than £100 million. The volatility of bankers' balances therefore means that an erratic swing in their level (such as the increase of £98 million in July) can impact heavily on the growth rate of MO in any particular month.

BANKERS OPERATIONAL BALANCES
JANUARY 1982-JULY 1987



10 DOWNING STREET

Note for the record

PM + Ch/Ex discussed the Italian request at Chequers today, 14/9. The Prime Minister agreed to the proposal, noting that we had little choice but to do so.

DLS
14/9.

20/4561

SECRET

DRN

9

MONTHLY MONETARY ASSESSMENT: AUGUST 1987

Summary Assessment

Most but not all of the main indicators continue to suggest monetary conditions looser than would be required to meet the Government's objectives for money GDP. Of the monetary aggregates, it is perhaps MO which is giving the clearest signal for concern, though the rise in growth of broad money and credit has attracted more attention in the markets. But the effect of the rise in base rates will not yet have come through, except on the exchange rate, which has been firm despite falling oil prices.

Main Points

MO has grown by 4.7 per cent in the 12 months to August. Though this is below the 5.4 per cent in the year to July, MO has now been growing at an annualised rate above 6 per cent for several months, and the twelve month rate is projected to reach 5½ per cent at the end of October (paras 19-22).

M4 grew by 14.9 per cent in the 12 months to July, 1 per cent more than in the year to June. M3 showed a similar acceleration: from 19.2 per cent to 20.9 per cent in the corresponding periods (para 25).

Bank lending. Sterling lending, at £4.6 billion in July, was some £2 billion higher than the average in the first half of the year. But this owes a good deal to a switch out of foreign currency borrowing by residents - the boost to sterling borrowing being offset within the external counterparts - and to banks improving their share of the mortgage market. Bank and building society lending together in July was not much above the average of recent months (paras 31-33).

The exchange rate has risen slightly since the end of July despite falling oil prices, but against the background of a weak dollar (paras 16,35).

Activity looks set to remain well above levels expected at Budget time but this has not yet manifested itself in higher than expected RPI inflation. The twelve month rate of growth in house prices remains around 14½ per cent, little changed in August and below the March peak (paras 3-11).

MG2 Division
11 September 1987

A. External Developments

1. Main developments in the G7 countries other than the UK are set out in tables 1-3. In particular:

- **GNP** grew more slowly in the US in the second quarter than in Q1. It picked up in France and Germany after a bad first quarter.

- After rising sharply earlier in the year, **consumer price inflation** in G7 has remained around 3 per cent since April.

- Non-oil commodity prices are currently about 15 per cent higher (in SDR terms) than a year ago; in particular, metal and non-food agricultural prices are both around 40 per cent higher. Oil spot prices are currently 20 per cent higher (in dollar terms) than a year ago but have weakened over the last month.

- **Short term interest rates** in the US have risen over the last four weeks, and the discount rate in Italy rose by ½ per cent on 3 September. Short rates in Germany and Japan are little changed.

- The **dollar** has weakened since the beginning of August, falling by 6 per cent against the yen (to 142 Y/$ on 10 September) and 3½ per cent against the deutschemark (to 1.81 DM/$). Since the Louvre Accord the dollar has fallen by 7 per cent against the yen and by 1 per cent against the DM.

B. Activity and Inflation

2. Table 4 summarises recent indicators of **activity and inflation.** The latest employment, unemployment, and overtime figures were all very strong, confirming the buoyancy of the economy in the first half of 1987, and as far as one can tell from the figures, manufacturing production remains on a strong upward trend. Retail sales are rising fast again. The latest RPI inflation figures have been broadly as anticipated.

Recent indicators of activity

3. Provisional figures for production industry output in June show a ½ per cent rise in **manufacturing output** from May, to a level almost 5½ per cent higher than a year earlier. The August CBI survey, published on 1 September, reported continued buoyancy in manufacturers' order books and output expectations.

4. Retail sales rose 1.4 per cent in July. Though the recent profile has been quite erratic the last two months figures suggest that the underlying trend is firmly upwards. The CSO's latest estimate of consumers' expenditure in the second quarter shows it to be up 4¼ per cent on a year earlier (the previous published estimate was a 3½ per cent rise).

5. Provisional estimates of second quarter industrial spending on **stocks** and **fixed investments** were published on 20 August. Manufacturers are estimated to have increased stocks marginally, while stocks held by retailers rose more strongly. Industrial investment rose sharply in the second quarter - up 3½ per cent on first quarter levels - with spending by manufacturers up by over 11½ per cent. Private **housing starts** in July are provisionally estimated to have risen 8 per cent from June, but remain below the high level of starts seen in the first quarter.

6. **Unemployment** fell by 48,000 in July. The rate of decline has increased recently, even though special measures are contributing less than they were a few months ago. **Overtime working** rose in June: overtime per operative is now higher than at any other time in the 1980's. **Vacancies** rose a further 2,000 in July, following a similar increase in June. Further evidence of buoyant activity is provided by the latest figures for manufacturing employment which show an estimated increase of 10,000 in the second quarter, the largest quarterly rise since 1978.

Inflation

7. The outturn for **retail prices** in August was 4.4 per cent, unchanged from July. Although this was marginally higher than anticipated, underlying RPI inflation still seems little different from projections made at Budget time and, more recently, in June.

8. The twelve month increase in the **producer output price** index (excluding food, drink, and tobacco) in July was 4.6 per cent, compared with a (revised) estimate of 4.4 per cent for June. **CBI survey** responses relating to manufacturers' price expectations, having edged upwards over the first half of 1987, showed little change in August.

9. **Producer input prices** (also excluding FDT) rose by 12.8 per cent in the year to July, up from 7.2 per cent in the year to June. This acceleration reflects the diminishing influence of the large fall in input prices during the first half of 1986, together with a pick up in prices during the most recent month - most notably for metals and non food agricultural products. (See section A).

10. Underlying growth in **average earnings** in June remained unchanged at 7¾ per cent, despite the high overtime figure for June. Private sector settlements concluded during the 1986-87 pay round just ended averaged about ¾ per cent lower than the outturn for the previous round. Manufacturing settlements were down 1 per cent on the same comparison, but the latest CBI settlement data points to a small upward drift in manufacturing pay settlements since the end of 1986.

11. The annual rate of **house price inflation** (measured by the Halifax index) was 14.5 per cent in August, little changed from July and compared to a peak of 15.2 per cent in March. Figures for the DoE index show a rise of 15 per cent at completion stage and 13½ per cent at approval in July, compared to 13¼ and 12 per cent respectively in June.

Projections for Money GDP

12. June forecast projections for **money GDP** in 1987-88 show an overshoot of over 1 per cent relative to the Budget forecast for 7½ per cent growth. Real activity has been stronger than expected. The GDP deflator is also likely to be higher than in the Budget forecast, but mainly because of higher projected oil prices. It is too early to assess whether this implied improvement in supply performance can be expected to continue through 1987-88. Although demand is clearly buoyant there are, as yet, no convincing signs

of overheating: recent RPI inflation outturns have been broadly as anticipated. UK net trade performance proved better than expected in the first quarter of 1987, but worse in the second quarter.

C. Public Sector Finances and the Fiscal Stance

13. Table 5 gives the main indicators of the fiscal stance. The PSBR for 1987 Q2 has been revised up by £0.4 billion, largely reflecting a higher PCBR.

14. The **PSBR** in July was a surplus of £0.4 billion, compared with last month's forecast of zero borrowing. Excluding privatisation proceeds the PSBR in the first four months of 1987-88 was £3.7 billion, about £½ billion above the same period in 1986-87, but £1¼ billion below the Budget profile. Most of the difference from profile is accounted for by central government own account borrowing; table 6 analyses this difference. The June forecast was for a PSBR in 1987-88 of £1 billion, nearly £3 billion below the Budget forecast. The latest outturns and revisions do not significantly alter the prospects for the year as a whole.

15. This assessment implies no change since last month in the interpretation of the **fiscal stance**; the June forecast of the PSBR for the year as a whole points to a tighter fiscal stance than envisaged at Budget time even after taking account of the automatic tightening associated with higher output and higher oil prices.

D. Exchange Rates and External Accounts

16. The **sterling index** has firmed a little as the dollar has declined over the past month, following a period in late July when poor trade figures, declining short term interest rates and rising rates abroad were tending to depress the pound despite the strength of world oil prices. The pound remained nervous in the first part of August and appreciable support was given on 3 days before the June trade figures were announced. But the sharp rise in UK interest rates on 6 August, together with the announcement of better than anticipated trade figures for June on 11 August , helped sterling to recover to around 72½ despite oil prices falling back and a continuing slight rise in overseas interest rates. The **interest**

rate differential now stands at about 3½ per cent against the world basket and 2½ per cent against the dollar, compared to 3 per cent and 2¼ per cent at the end of July.

17. The fall in oil prices of over $2 since the end of July reflects recent OPEC overproduction, and has occurred despite increased tension in the Gulf, which might otherwise be expected to push up oil prices and hence strengthen sterling. As a result, the oil-adjusted reference ratio has risen by about 1½ per cent since the end of July. In August spot and forward market intervention totalled minus $0.5 billion - most of this occurring on a few days before the June trade figures - which has been partly unwound (by $0.2 billion) in September so far. The cumulative build-up of reserves this year still stands at about $10 billion.

18. The July **trade figures**, published on 1 September, showed a visible deficit of £910 million and a projected current account deficit of £310 million, rather worse than markets expected. Although smaller than the large May deficit the July deficit was £170 million larger than in June, reflecting a sharp rise in the volume of non oil imports which more than offset a recovery in export volumes. The current account is now estimated to have been in deficit by £400 million in the first seven months of 1987.

E. Domestic Monetary and Financial Market Developments

(see Tables 10 to 26)

Narrow Money

19. MO has begun to exhibit disturbing signs. Since June, annualised three month growth has been consistently around 6-8 per cent. Although the 12 month growth rate has been significantly lower, it is above what was expected at Budget time. Both higher activity and lower than projected interest rates have contributed to this faster growth. After the interest rate rises in August, these are now closer to what was assumed in the Budget projections. But activity looks set to remain more buoyant. Thus as Chart 7 shows, the 12 month growth rate is now projected to start rising

up to October, compared to some decline forecast at Budget time. Although the annual growth rate is projected to fall back until December, thereafter it is projected to rise to the top of its target range during Q1 1988.

20. **M0** (seasonally adjusted) rose by 0.3 per cent in August while the annual growth rate fell back to 4.7 per cent, from 5.4 per cent in July. The lower annual growth rate of M0 in August mainly reflects erratic movements in bankers' balances - both between July and August 1987 and between the corresponding months a year ago. The annual growth rate of notes and coin was, at 4.6 per cent, little changed in August and has been consistently around 4¾ per cent since April. But this mainly reflects the brisk growth of notes and coin during 1986 - annualised growth of notes and coin in the three months to August rose to 7¾ per cent, from 7 per cent in the three months to July.

21. The upward trend of three month annualised notes and coin growth has continued in the first two weeks of September, with the annualised rate rising to 8½ per cent. The **forecast** assumes that annualised three month growth continues at this rate during the rest of September and October, reflecting both the expected buoyancy of consumers' expenditure and the expectation that the August base rate increase will not have any immediate dampening effect on M0 growth. Thereafter, annualised M0 growth is expected to fall back steadily - partly reflecting the influence of the base rate increase - to around 3½ per cent by the end of the financial year.

22. In terms of twelve month growth rates, M0 growth is forecast to rise to about 5½ per cent in October (the figure being distorted upwards by abnormally low bankers' balances in October 1986). Thereafter, the annual growth rate is expected to fall back to about 4 per cent in December - reflecting the brisk growth of M0 towards the end of 1986 - before rising again to around 6 per cent at the end of the financial year as the lower levels of M0 in Q1 1987 drop out of the twelve month comparisons. The effect of the base rate increase in August is assumed to reduce the twelve month growth

rate by 1/3 percentage point in December, rising to about 2/3 percentage point by March 1988.

23. **NIB M1** increased by £0.1 billion in July and its annual growth rate fell back to 12.5 per cent, from 13.5 per cent in June, as the effects of recent share issues may have begun to unwind. The underlying annual growth rate of NIB M1 seems to have risen during 1987-88.

Broad Money

24. Broad money continued to grow rapidly in July. Twelve month growth rates of all the broad aggregates rose. The very high sterling bank lending figure attracted much comment but needs to be considered with caution. Total bank and building society lending was not out of the ordinary and its twelve month growth rate is marginally below the average of the last few months. On the other hand, part of the explanation for the high sterling lending is that residents switched their borrowing from foreign currency to sterling. This suggests that residents are not wholly confident about the prospects for sterling though the absence of major pressure on the exchange rate implies that non-residents - who switched into sterling over the month - remain relatively optimistic.

25. **M4** rose by £5.3 billion (1.9 per cent) in July and its annual rate increased to 15 per cent, from 14 per cent in June. **M3** rose by £4.2 billion (2.5 per cent) and its annual rate increased to 21 per cent, from 19 ¼ per cent in June. The differential between the annual growth of M3 and M4 widened in July, to 6 percentage points. This may in part reflect the current buoyancy of equity issues by UK companies, the proceeds being held temporarily as bank deposits prior to deployment, which boosts M3 growth relative to M4 since M3 is a narrower aggregate. Individuals may also have partly financed their equity purchases (in particular of BAA) by running down their building society deposits. (See paras 28 and 42).

26. The **forecast** shows M4 annual growth rising to 15½ per cent in August and M3 growth rising to 22 per cent, as lending (especially by banks) is expected to remain buoyant, although the twelve month

growth rates are distorted upwards by low growth in August 1986. The differential between the annual growth of M3 and M4 is expected to widen further, to about 6½ percentage points, as building societies renew the build-up of their bank deposits. (See annex for further details of the forecast.)

27. With respect to the **M4 components**, holdings of M3 by the private sector (excluding building societies) rose by £4.0 billion (3 per cent) and private sector retail deposits with building societies rose by £1.1 billion (1 per cent). Within M3 holdings, NIB M1 increased by £0.1 billion, IB retail deposits increased by £0.4 billion and wholesale deposits increased by over £3.6 billion. Wholesale deposits grew by 24 per cent in the twelve months to July, reflecting both the current liquidity of UK companies and OFIs, and a competitive rate of return.

28. Building society retail inflows in July may have been reduced by the BAA privatisation although they were above the monthly average for 1987 so far. Hence the overall picture remains one of strong underlying inflows, reflecting the considerable competitive advantage enjoyed by societies in the retail market over banks and national savings. Building society wholesale funding is estimated at nearly £0.5 billion in July, one of the highest figures of the year, of which the private sector contributed an unusually high £0.3 billion to M4.

29. Societies increased their bank deposits by £250 million in July, following a large (£750 million) run down in bank deposits in June. Societies also bought £179 million of gilts in July, having bought £410 million in June. Some societies have indicated that they have now fully realigned their portfolios following the requirements on capital adequacy introduced earlier this year. Hence their behaviour in the gilts market in future is more likely to be governed by the growth of their portfolios and expected returns relative to competing assets.

30. Bank deposits of the private sector (excluding building societies) increased by a little over £7½ billion (5½ per cent) in the second quarter. After allowing for distortions arising

from oversubscribed share sales at end June, ICC's accounted for about £3 billion of this (an increase of 8 per cent); the personal sector £3½ billion (5 per cent); and OFI's, excluding building societies, about £1 billion (3 per cent). Bank deposits of ICC's are likely to have been boosted by the proceeds of equity issues (see para 25). In recent years OFI's holdings of bank deposits have been growing more rapidly than those of other sectors - by an average of 26 per cent per annum since end 1984 - probably reflecting the rapid expansion of their total portfolios. (Comparable figures for ICC's and the personal sector are 21 and 12 per cent respectively.) Personal holdings of building society deposits have been growing in line with their bank deposits, rising by an average of 12½ per cent per annum since end 1984.

Credit

31. **Bank and building society lending** rose by 1.9 per cent in July, compared with an average of 1.5 per cent over the previous twelve months. The annual growth rate of lending to the private sector in July was at 19½ per cent, little changed compared to June.

32. **Bank lending** grew by 2.5 per cent (2.6 per cent seasonally adjusted) in July following a 2.6 per cent increase in June and compared to an average of 1.6 per cent over the previous twelve months. Within bank lending, advances increased by £2.8 billion and lending via commercial bills increased by £1.7 billion. Other lending increased by £0.1 billion. Returns from the London and Scottish retail banks show that advances for house purchase were £0.8 billion, below the very high June figure but still well above the average of the previous six months. This may reflect seasonal factors as well as the widened differential between building society and bank lending rates in recent months. The annual growth rate rose to 22¼ per cent in July, from 21½ per cent in June. Compared to the monthly average of about £2½ billion in the first half of 1987, July's increase was some £2.1 billion higher. Annex 1 considers possible explanations for the current surge in bank lending. The main factors are described below.

(i) industrial company borrowing rose substantially. The available figures suggest an increase of about £1½-£2 billion in July against a monthly average of only £0.3 billion in the second quarter;

(ii) UK residents appear to have switched out of foreign currency borrowing into sterling borrowing. Foreign currency borrowing fell by some £2¼ billion in July after rising by £12 billion in the first half of the year. Much of this will have been converted to sterling and may account for some of the high figure for companies noted in (i) above;

(iii) the banks continued to increase their share of the mortgage market though the absolute amount advanced by the CLSB banks at £0.8 billion was below the £1.0 billion advanced in June.

(iv) there is weak evidence of round-tripping between bills and deposits on a few days. But the figures suggest that neither this nor Stock Exchange problems affected the bank lending figures to a significant extent.

33. **Building society mortgage lending** continued to be relatively subdued rising by 1.5 per cent in July and by 17.3 per cent over the past twelve months. Despite cuts in mortgage rates for new borrowers by the Halifax and the Abbey National, societies as a whole remained uncompetitive with respect to banks and miscellaneous financial institutions (MFI's).

Other Broad Money Counterparts

34. A surplus PSBR of £0.4 billion was **overfunded** by £0.5 billion, reflecting public sector debt repayments of £0.7 billion to the non-bank private sector and sales of £1.1 billion overseas, together with a £0.3 billion increase in the reserves. (So far in 1987-88, with the £4.8 billion increase in reserves, there has been cumulative underfunding of £1.9 billion.) Since the building societies made small purchases of gilts in July the **public sector contribution** to M4 is slightly less contractionary, at minus

£0.4 billion. Bank and building society **externals** were contractionary by £1.6 billion and **£NNDLs** were expansionary by £1.4 billion.

35. Public and private sector **external transactions** were contractionary by £2.4 billion in July, although the underlying externals were somewhat less contractionary (minus £1.4 billion) due to a bank switching its provision against its loans to Brazil from sterling to foreign currency, causing an offsetting reduction in £NNDL's. The negative externals are the result of the private sector reducing its foreign currency borrowing - which may reflect an unwinding of speculative positions built up over the previous six months (see para 32 ii) - the other side of the transactions being a take-up of gilts by non-residents and an increase in non-residents' sterling bank deposits. This suggests an asymmetry between domestic and overseas residents in their expected returns on sterling assets, with external outflows of the domestic private sector being matched by inflows from overseas residents (in contrast to previous months when the counterparty to external inflows was the EEA).

M5

36. M5 grew by £5.6 billion (1.9 per cent) in July and at an annual rate of 14½ per cent, compared to 13½ per cent in June. Among the **M5 components**, aside from the £5.3 billion increase in M4, there was a £0.3 billion increase in private sector holdings of bank bills and a modest rise in holdings of Treasury bills and national savings instruments, offset by a fall in CTDs.

Money Markets and Interest Rates

37. **Money market rates** realigned after the one percentage point rise in base rates on 6 August, as the one month interbank rate increased by over 100 basis points to 9.8 per cent whereas the twelve month rate increased by under 40 basis points to 10.3 per cent, leaving the yield curve much flatter than before. Rates increased again after the release of the money figures and currently range from 9.7 per cent at one month to 10.7 per cent at twelve months, so that the markets are if anything expecting the next move in base rates to be up rather than down.

38. The stock of **money market assistance** rose by £1.9 billion in July to £7.0 billion, the shortage reflecting both the overfunding and a £0.7 billion increase in notes and coin. (See Table 26). The Bank of England's purchase of bills will have put downward pressure on bill rates in July, making bill finance relatively attractive to UK corporates. (See para 3[illegible].) The stock of assistance fell by £0.9 billion, in August.

39. Gilts began the month with the index at 87½, and with 5, 10, and 20 year par yields at 9.6, 9.9 and 9.7 per cent respectively. The market suffered two falls of nearly 3 points at the longer end - following the 6 August base rate increase and the 20 August provisional money figures. The gilts index now stands at around 85½ (a fall of some 6½ per cent since mid July), and par yields range from 10.3 at 5 years to 10.1 at 20. Breakeven inflation rates of Treasury 1990 and 2006 **indexed gilts** against comparison stocks are currently 3.5 per cent and 6.0 per cent respectively, compared to 3.5 per cent and 5.5 per cent at the end of July. The **equity dividend yield** (based on the all-share index) fell to 2.9 per cent in mid-July but has since risen slightly, to 3.1 per cent.

40. The Halifax and Abbey National have reversed their mortgage rate cuts for new borrowers and joined the other societies with mortgage rates of 11.25 per cent. Share rates, which were not lowered by any societies, remain unchanged. Since the banks' deposit rates (and mortgage rates in the case of Natwest and Lloyds) have gone up in line with the rise in base rates, building societies have now lost their exceptional competitiveness on the deposit side, with the spread of top tier rates above those of the banks ranging from about 1.7 per cent net to a more normal 1 per cent. On the other hand, building societies as a whole will have regained competitiveness in the mortgage market, since with an increase in the cost of wholesale funding, the MFI's, like some of the banks, are raising interest rates.

Capital Markets and Corporate Finance

(see tables 20-21)

41. **Equity prices** (measured by the FT All Share Index) fell back after the base rate rise and remained weak thereafter, especially on the release of the money figures. Prices may also have been

affected by the volume of new issues and announcements during July and August. However, there has been some recovery in equities following a reassessment of the money figures and hence a less pessimistic outlook for interest rates. The index is currently 7 per cent below its mid-July record level.

42. UK commercial companies and building societies raised a total of £2.0 billion net sterling finance in July from the domestic capital and eurosterling markets, compared to a monthly average of £1.3 billion in the second quarter. Most new issues in July were on the stock market (£1.7 billion) as the sharp rise in share prices between May and July has made equity dividend yields increasingly attractive to corporate borrowers. This has continued in August, with net equity issues of £2.0 billion by UK companies. Announcements of future equity issues were over £1½ billion in August, well below the £2½ billion announced both in June and July but still slightly above the monthly average during 1987 so far. The volume of recent issues and announcements may have contributed to the current weakness in equity prices. In contrast, higher interest rates since the second half of June has depressed announcements of new issues in the fixed rate euromarkets, which have been very light between June and August. Building societies made no announcements in the euromarkets in August and have been largely absent from the market this year, having been very active in 1986.

43. The stock of **sterling commercial paper** (SCP) outstanding rose by £50 million in July, to £1¼ billion (comparable figures for net issues by UK commercial companies are £70 million and £1.1 billion respectively). Monetary sector holdings of SCP rose by £70 million to £½ billion. Although gross and net issues of SCP in July are down on the previous month, this may reflect the relative attractiveness of bill finance during July.

44. Net sales of **unit trusts** were a record £1.1 billion in July, compared to an average of £0.5 billion per month in the first half of 1987, which is consistent with the buoyancy of domestic equity prices at least in the first half of the month and hence the flood of corporate announcements of new equity issues during July.

45. The £3.6 billion raised by UK concerns in the second quarter compares with an increase in their bank borrowing of £0.8 billion, whereas comparable figures for the quarterly average of 1984 were £0.4 billion and £2.0 billion respectively. Table 20 shows that the trend towards securitisation since 1984 has been mainly via the UK equity and eurosterling markets, although the SCP market is also now making a significant contribution to corporate finance.

MG2 Division
11 September 1987

SECRET

Monetary developments since last month's report

	Latest outturns available at time of: Feb Report	July Report	August Report
Monetary aggregates (12 month % growth)	**(Jan)**	**(June)**	**(July)**
M0 (sa)	5.1	4.2	5.4(4.7)+
M3	17.6	19.2	20.9
M4	13.9	13.9	14.9
M5	13.3	13.6	14.6
Bank lending	22.5	21.5	22.2
Bank & building society lending	20.9	19.5	19.6
Interest rates (%)	**27 Feb**	**28 July**	**10 Sept**
3 month interbank	10.8	9.3	10.2
20 year gilt-edged (par yield)	9.7	9.5	10.1
Yield gap	1.1	-0.2	0.1
3 month overseas basket	6.3	6.4	6.8
3 month interbank/euro dollar differential	4.4	2.4	2.7
Real 3 month interbank	6.7	5.7	6.1
Equity dividend yield (all-share)	3.4	3.0	3.1
IG yields (1996) assuming 5% inflation	3.6	3.7	3.9
Exchange rate			
ERI	69.9	72.6	72.9
Oil adjusted reference index*	71.3	73.8	72.9
ERI/reference rate ratio	98.0	98.4	100.0
Asset prices			
FT-A Index (% pa)	30.8	55.9	41.7
FT-A Level (July peak: 1239)	985	1199	1152
Halifax house index (% pa)**	13.6	14.3	14.3(14.5)+

\+ August Outturn

* indicates what ERI would be if exchange rate simply responded to oil prices in the ratio 1:4. In determining the reference rate the base taken is the Jan '83 - Nov '85 average for the ERI and oil price.

** figures are for January, June and July.

ANNEX 1

BANK LENDING

Bank lending in sterling increased by £4.6 billion (2.5 per cent) in July, having risen by £4.7 billion in June. Over the latest three months, sterling bank lending increased at an annualised rate of 28 per cent. Below we examine the possible reasons.

2. There are a number of possible explanations for the current surge in sterling bank lending:

(i) shifts in market share of total lending in favour of banks against other lenders;

(ii) switches in currency composition of borrowing by residents - out of foreign currency into sterling;

(iii) round-tripping - companies borrowing at rates below interbank rates and re-depositing the proceeds profitably - and arbitrage between domestic bills and US commercial paper;

(iv) heavy corporate demand for capital expenditure purposes;

(v) increased bank lending to security dealers, associated with the Stock Exchange settlement problem.

These are considered in turn.

Shifts in Banks' Market Share

3. The rapid growth of bank lending partially reflects the greater competitiveness of banks in the mortgage lending market (see para 3o of main report). Banks' mortgage lending increased by a record £0.8 billion per month in the second quarter, while building societies' new lending fell to £1.2 billion per month - the third successive decline (all figures seasonally adjusted). The banks' share of the mortgage lending market has risen to 36 per cent in Q2, from 19 per cent in Q2 1986, while the building societies' share has fallen to 51 per cent, from 77 per cent a year ago.

4. The shift in market share seems to have continued in July. CLSB banks' lending for house purchase was again strong (£0.8 billion, compared to an average of £0.7 billion per month in Q2) while building society lending remained subdued (£1.3 billion). The annual growth rate of total mortgage lending has been about 20 per cent throughout the past year, however, which does not indicate a recent surge in total personal sector borrowing for house purchase. Moreover, lending to persons for consumption seems to have been modest in July: the CLSB returns show lending for consumption of £0.2 billion, although the average monthly figure in the second quarter was, at £0.5 billion, relatively high.

Shifts in Currency Composition of Lending

5. The sterling lending figures also seem to have been affected by the private sector's switching between sterling and foreign currency borrowing. Prior to the Election, the private sector was building up its foreign currency borrowing, which increased by £12 billion in the first half of 1987 (see table 2o). Much of this may have been in connection with planned foreign acquisitions by UK corporates, which would result in an increase in their physical foreign currency assets and a corresponding increase in financial foreign money liabilities without any major implications for monetary conditions. But some of the high foreign currency borrowing may have been speculative, in the anticipation of sterling appreciation after the Election, which would reduce the sterling value of foreign currency liabilities. In July, foreign currency borrowing fell by £2¼ billion, suggesting weakening of domestic sentiment on sterling matched by a switch into sterling borrowing. The overseas sector, by contrast, appeared willing to increase its net sterling assets in July, increasing gilts holdings by £1.2 billion and net sterling bank deposits by £0.3 billion. The Exchange Equalisation Account sold sterling over the month but only in relatively modest amounts - less than £0.7 billion.

Round Tripping

6. The Bank of England was buying bills throughout the whole of July to meet market shortages, the average daily purchase being £500 million. This will have put downward pressure on bill rates, perhaps at times pushing them below deposit rates. While we have no direct evidence of round tripping induced by this, chart A1 shows that a window may have opened up between three month bill and interbank rates, after allowing for dealing costs, at sometime during the mornings of 1, 9, 16 and 17 July (however, at the times for which we have data, there were no occasions when round-tripping was profitable). Moreover, wholesale bank deposits rose by over £3 billion in July, compared to an average of less than £1 billion in the previous twelve months, and this would also be consistent with the existence of round tripping activity (although part of the rise in wholesale deposits is probably due to high capital issues by ICCs). Anecdotal evidence from a merchant bank further suggests there were opportunities for bill arbitrage throughout the first week of July though this seems to be an isolated source of such anecdotes.

7. It is also possible that the downward pressure on bill rates induced companies to switch from borrowing via the US commercial paper (CP) market to borrowing via bills, which would be consistent with the reduction in foreign currency borrowing in July (see above). Chart A3 suggests that there may have been arbitrage opportunities in favour of domestic bill finance relative to US CP (with forward cover) for one month maturities in the first half of July.

Corporate Borrowing

8. Provisional estimates of manufacturing investment show an increase of £0.2 billion (11½ per cent) in the second quarter, while the level of stocks held by manufacturers, wholesalers and retailers increased by over £0.3 billion (both figures seasonally adjusted). There is no data yet available for July but business confidence appears to have remained strong and it seems reasonable that, with the clarification of political prospects after the General

Election, companies will have proceeded with capital expenditure programmes waiting on the outcome. Certainly, industrial and commercial companies' appetite for non-bank finance was substantial; they raised £2.1 billion net in domestic capital markets in July (mainly from equity issues), compared with a monthly average of £1.3 billion in the second quarter.

9. Banks lent nearly £1.7 billion to companies in July by way of commercial bills and it seems likely that little if any of this was used to repay advances. A sectoral breakdown of total bank lending is not available for July but the returns for the CLSB banks show virtually no change in advances to companies. So if total bank lending to companies was of the order of £1½-2 billion, this will have represented a sharp increase from the monthly average of only £0.3 billion in the second quarter.

Stock Exchange Settlement Problems

10. Press reports have suggested that bank lending was boosted in both June and July by settlement problems on the Stock Exchange (SE). Since June, the settlement backlog has increased by up to £1 billion, to about £3½ billion, and the Bank of England now requires brokers to have higher collateral against loans of stock. Both factors might be expected to increase bank lending, but there is no evidence of this in the latest banking statistics. For example, while lending to OFI's (excluding building societies) increased by over £3 billion in the second quarter, their bank deposits rose by only £0.2 billion: if SE firms had been borrowing to provide collateral against stock loans then deposits would be expected to have risen correspondingly. In addition, there was a small fall in lending by the clearing banks to securities dealers in June and a larger (£225 million) reduction in July. Nor have the Bank of England's normal statistical enquiries with the banks produced any evidence of large loans to SE firms.

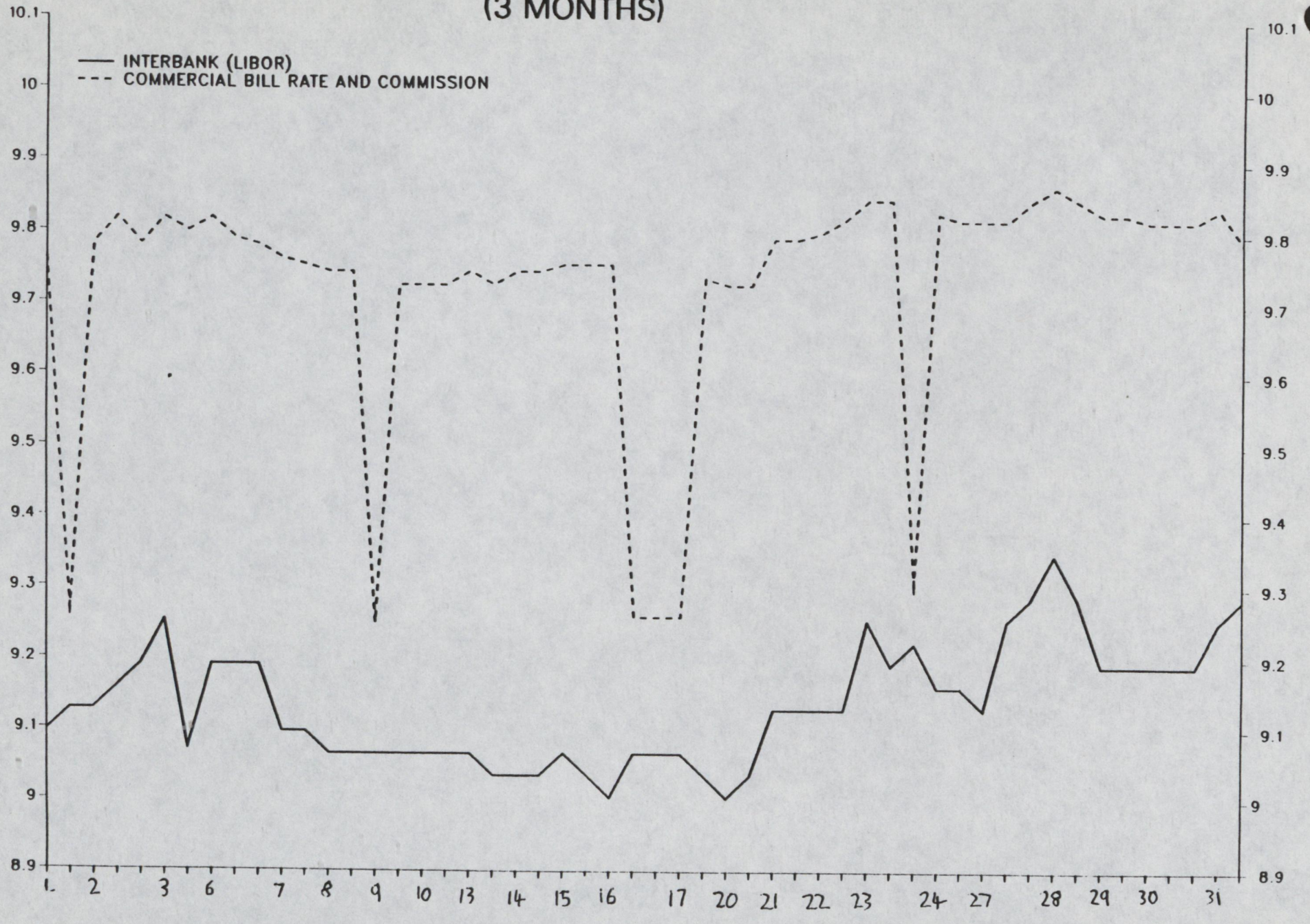
Conclusion

11. There is no shortage of explanations for the high bank lending figure in July. The two most important factors quantitatively seem to have been (i) the switch out of foreign currency borrowing into sterling borrowing by residents and (ii) the surge in corporate borrowing from banks, despite their continued heavy demands on the capital markets as well. In addition, banks continued to increase their share of mortgage lending at the expense of the building societies. Conditions may also have existed to allow round-tripping but the fact that this has not been widely reported suggests that in fact it has not been on a significant scale. Finally, whilst the Stock Exchange settlement problems might have been expected to add to bank lending, the figures themselves do not lend much support to this thesis.

ANNEX I

CHART AI

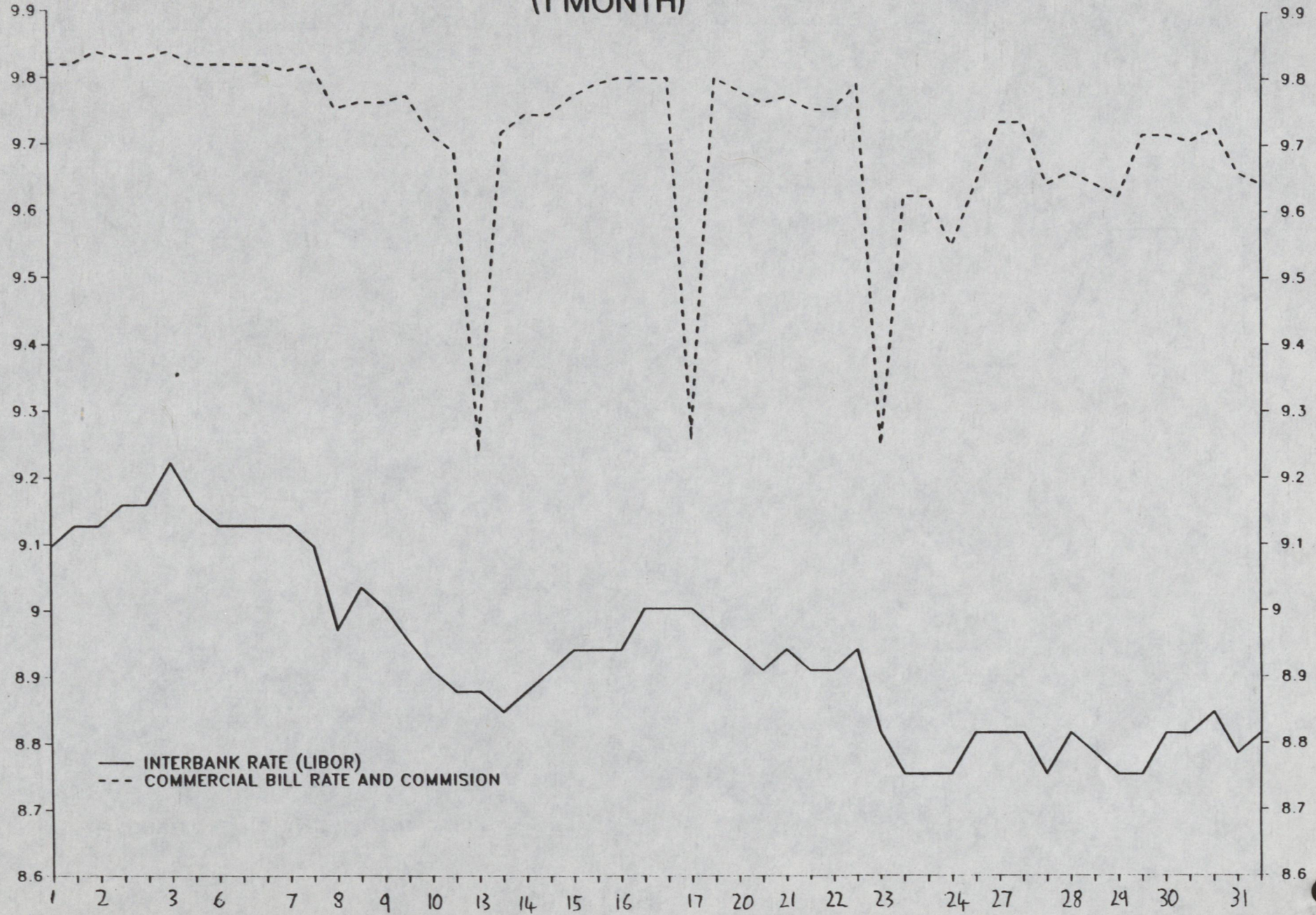
COMMERCIAL BILL AND INTERBANK RATES (3 MONTHS)



ANNEX 1

CHART A2

COMMERCIAL BILL AND INTERBANK RATES
(1 MONTH)

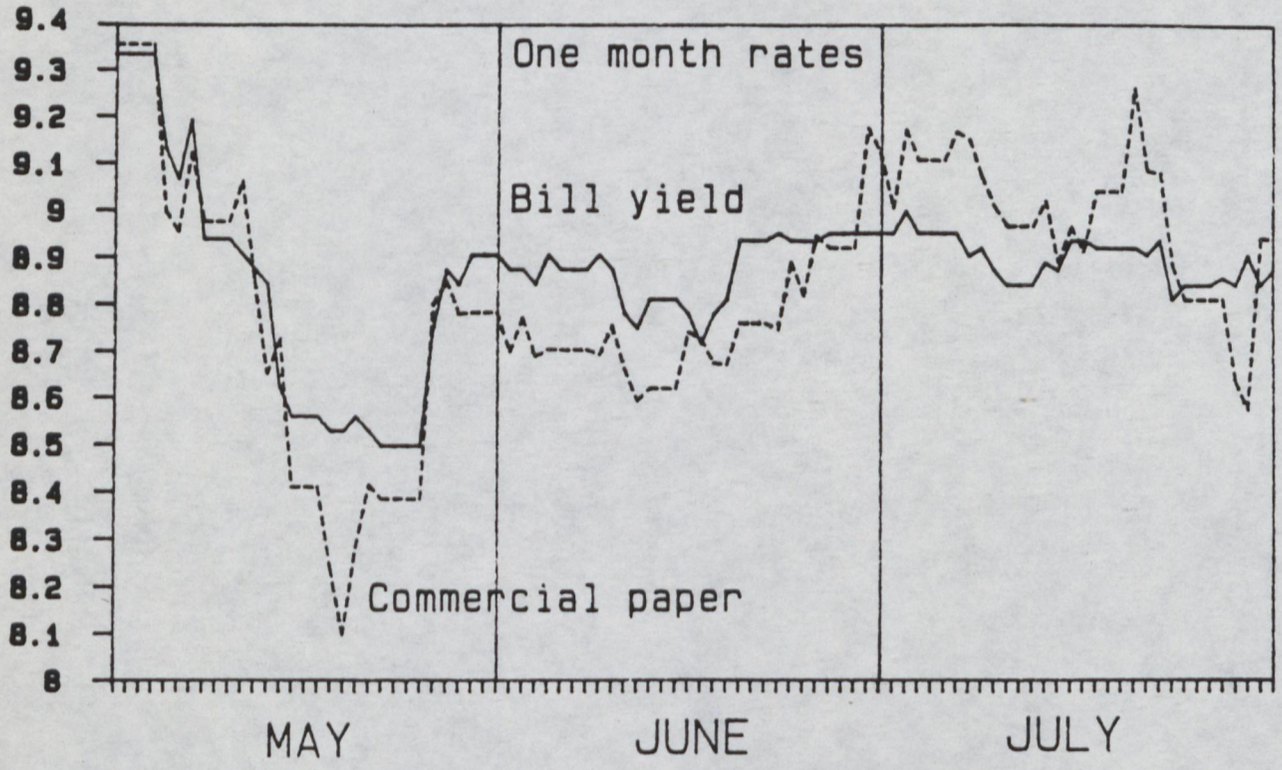


ANNEX I

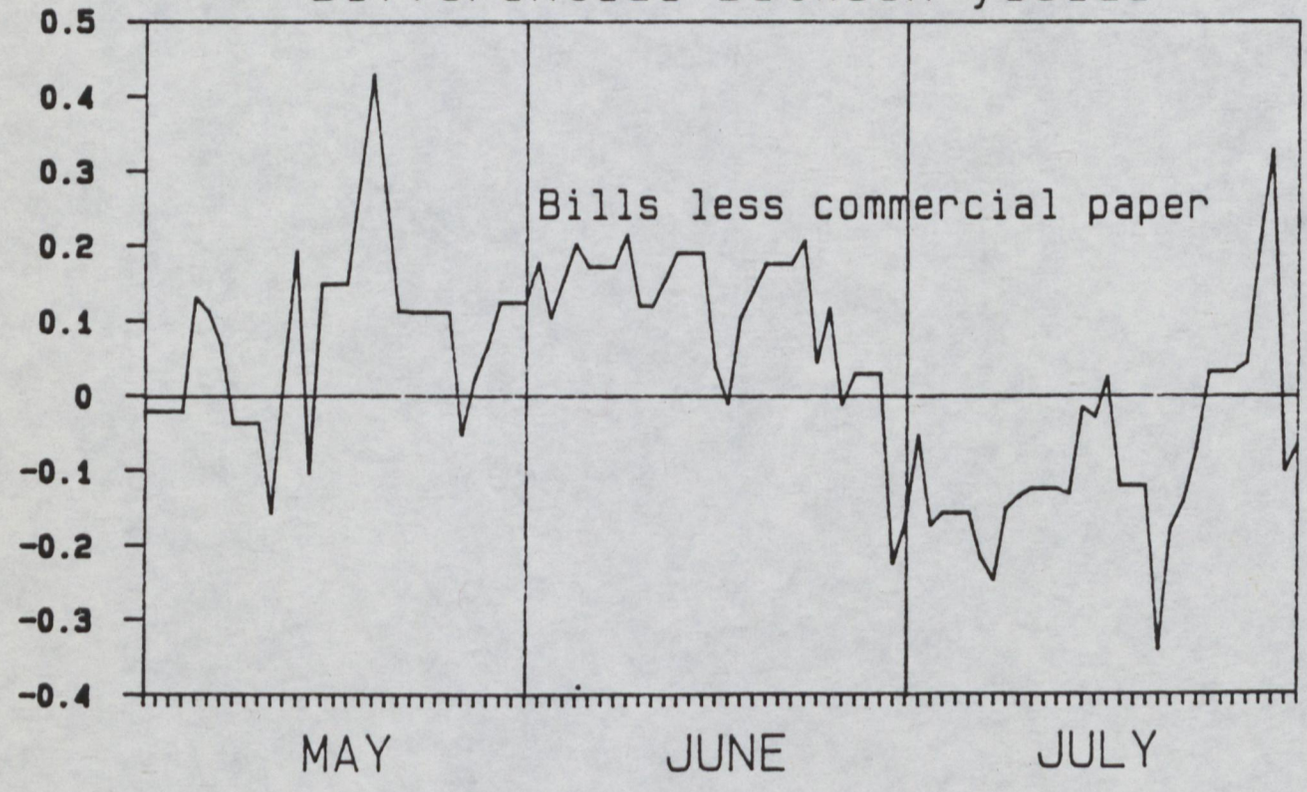
CHART A3

Yield on bank bills and US commercial paper

(adjusted for forward rates)



Differential between yields



ANNEX 2

BROAD MONEY FORECAST

1A. The forecast shows broad money growing in August at close to the average monthly rate during the past year - about 1¼ per cent a month for M4 and about 1½ per cent for M3 - and growing more slowly in September and October. The annual rates are, however, affected by the pattern of growth a year ago, namely exceptionally low growth in August 1986 and very high growth in September 1986 associated with the TSB share sale. This causes the forecast twelve month growth rates to rise in August, with M4, at 15½%, over 15% for the first time since November 1986 and M3 growth, at 22%, more than one per cent higher than July's high figure. The annual rates fall back in September and October to about 14½ per cent for M4 and about 19¾ per cent for M3, a little lower than July's rates but still some ¾ per cent above the rates in the first six months of 1987.

2A. Special factors affecting the forecast are set out in Table 1. They have little effect on broad money growth in August and October, and are contractionary in September by £600 million, largely due to the Midland Bank rights issue. In October, proceeds of £0.7 billion from the BP sale contribute to an overfund of £1.8 billion, but the sale also has offsetting expansionary effects of £0.2 billion on lending and £0.2 billion on the externals. Midland Bank's sale of subsidiaries to an Australian bank is contractionary by £350 million via NNDL's in October.

3A. The lending forecast assumes that underlying seasonally adjusted bank lending grows by 1.6 per cent (about £3 billion), and building society lending by 1.0 per cent (about £1¼ billion), per month. These underlying flows incorporate the effect of increased bank mortgage lending at the expense of building societies. Special factors superimposed on the underlying forecast as set out in Table 2: they increase lending by 100 in August, have no net effect in September and increase bank lending by 500 (and total lending by 300) in October. Lending is boosted by 100 in August due to exceptionally large capital issues by ICCs and also by 200 by a known bridging transaction which will unwind in September. Privatisations increase bank lending by 200 in September (Rolls Royce and TSB Second calls) and by 200 in October (BP).

4A. With the building societies' loss of competitiveness in the retail deposit market (albeit from an exceptionally strong base) following the rise in base rates, societies' underlying retail inflows are estimated to fall over the next three months by approximately £50m per month. The monthly profile is affected by privatisations with increased inflows in August (BAA return funds) and decreased inflows in September (Rolls Royce and TSB), and October (BP). With mortgage lending increasing due to improved competitiveness, societies are forecast to increase wholesale funding and, where this is impracticable, to run down liquidity ratios. Despite a heavy tax call in September, balance sheet expansion means that total liquid assets in the form of bank deposits and gilts are forecast to rise. The forecast does not make any allowance for possible tax rebates (up to £500m) related to the societies' dispute with the inland revenue.

5A. The stock of money market assistance is forecast to fall by about £1 billion in each of the next two months, to about £6 billion in August and £5 billion in September, before rising again in October to about the present level of £7 billion. The main features of the forecast (shown in Table 24) are the return in August of £750 million oversubscribed for BAA shares (reducing the need for assistance); in September fairly low net gilt sales of £375 million, in spite of the auction, because of buying in of £625 million; and in October a large market surplus mainly due to overfunding. It is assumed that the weekly Treasury bill tender, which has been 400 since the end of May, will fall to 300 in August, 200 in September, and 100 in October: this will reduce the need for commercial bill purchases by about £350 million per month.

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SECRET

ANNEX TABLE 1

Broad Money Forecasts

£ million not seasonally adjusted

		AUGUST		SEPTEMBER		OCTOBER	
		M4	M3	M4	M3	M4	M3
(i)	Underlying Increase*	2550	2300	2975	2075	2325	2175
	Special Factors:						
	Privatisations	- 50	- 50	-200	-200	200	200
	Bank/Building Society Lending	150	150	200	200	100	100
	Midland issue and sale of banks	-	-	-600	-600	-350	-350
	Intervention	-200	-200	-	-	-	-
(ii)	Total	-100	-100	-600	-600	- 50	- 50
(iii)	Projected Increase	2450	2200	2375	1475	2275	2125
	% Change of Previous month	0.9	1.3	0.8	0.8	0.8	1.2
	% Change on previous year	15.5	22.1	14.6	19.4	14.3	19.8
	Memo						
	Underlying % Change on previous year	15.5	20.1	14.9	17.8	14.6	18.3
	% Change expected at Budget time	14.2	17.3	14.1	15.3	14.4	16.0

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

* Based on the following assumptions:

(a) Underlying bank lending rises by £3.0 billion per month and building society lending rises by £1.2 billion per month, both seasonally adjusted.

(b) The public sector contribution to M4 and M3 is as follows:

	August	September	October
M4	750	600	-1675
M3	700	500	-1775

SECRET

ANNEX TABLE 2

Lending Forecasts

£ million

		AUGUST			SEPTEMBER			OCTOBER		
		Bank Lending	Building Society Lending	Lending Counter-Part To M4*	Bank Lending	Building Society Lending	Lending Counter-Part To M4*	Bank Lending	Building Society Lending	lending Counter-Part To M4*
(i)	Underlying Increase	2900	1200	3950	2950	1200	4000	3000	1200	4100
	Special Factors:									
	PSBR offset	-50	-	-50	-	-	-	100	-	100
	Bill leak	-100	-	-100	-100	-	-100	200	-	200
	Privatisations	-50	-	-50	200	-	200	200	-	-
	Capital issues	300	-	300	-100	-	-100	-	-	-
(ii)	Total	100	-	100	-	-	-	500	-	300
(iii)	Projected Increase (seasonally adjusted)	3000	1200	4050	2950	1200	4000	3500	1200	4400
	Projected Increase (nsa)	2050	1275	3175	3950	1050	4850	3350	1300	4350
% change on previous		22.1	16.8	19.2	23.0	16.2	19.6	22.6	16.2	12.9
Memo										
Underlying % Change on previous year		20.9	16.2	19.2	21.8	15.7	19.6	21.1	15.3	18.9
% Change expected at Budget time		20.4	16.8	18.4	21.3	16.3	18.9	20.3	15.9	18.1

*Excludes bank lending to building societies (which is included under Bank Lending)

SECRET

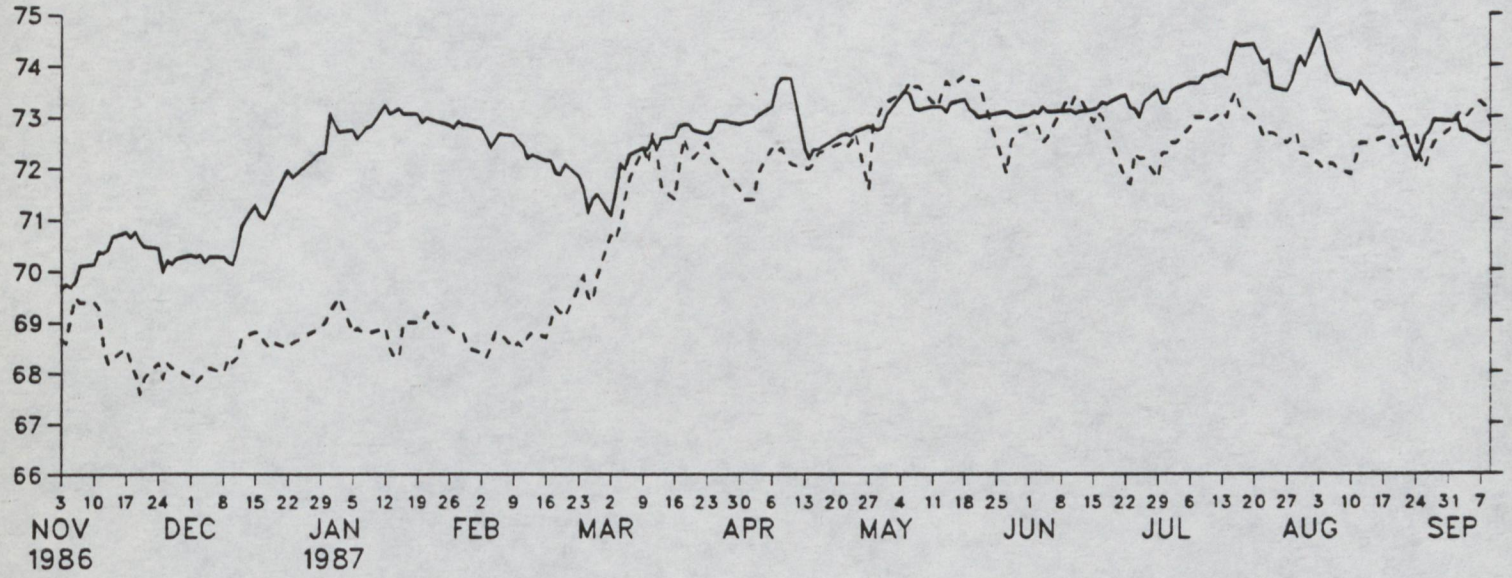
SECRET

MONTHLY MONETARY REPORT : CHARTS

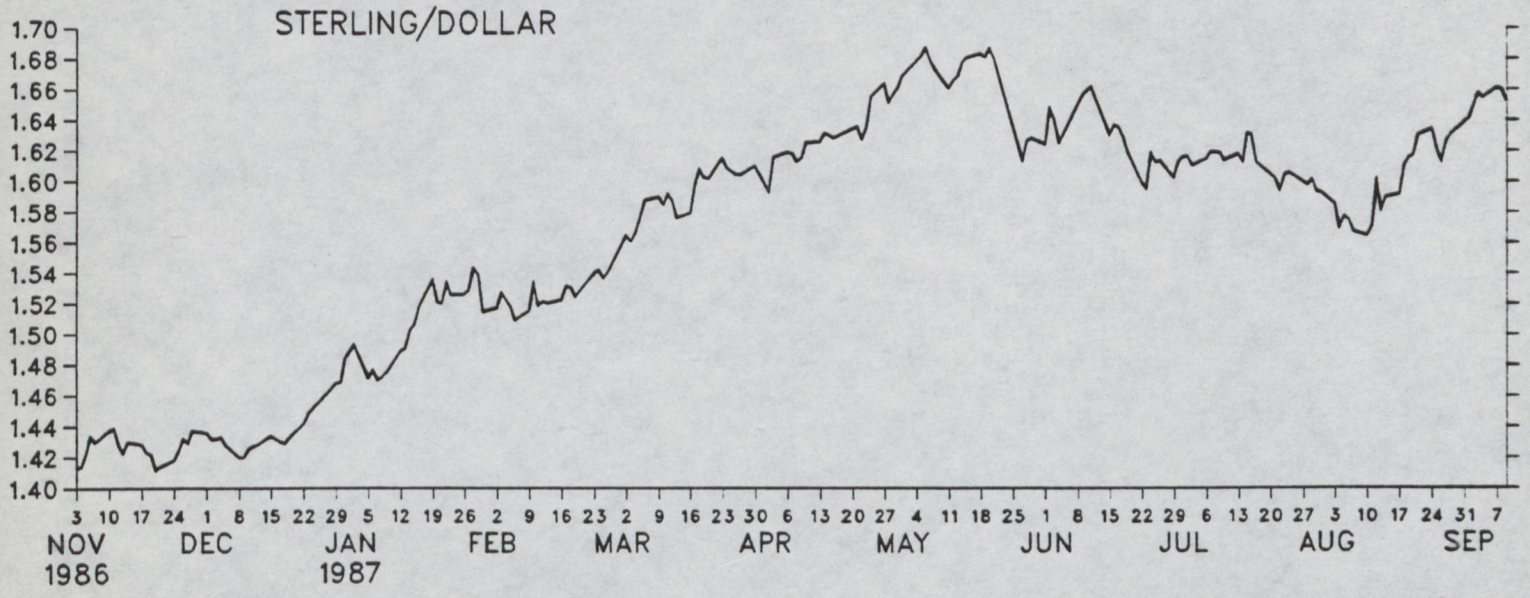
I	Exchange Rate Short Term
II	UK/US interest rate differential
III	Narrow money growth
IV	Broad money growth
V	Real M0 growth
VI	Real Broad money
VII	FSBR budget profile M0
VIII	FSBR budget profile M3
IX	M0 growth against target
X	Retail Deposits
XI	Bank and Building Society Lending
XII	£ Corporate bond issues
XIII	Bill Mountain
XIV	Nominal Interest Rates
XV	Yield Curve
XVI	Real Yields
XVII	House prices 1
XVIII	House prices 2
XIX	Capital Markets

CHART I:EXCHANGE RATE

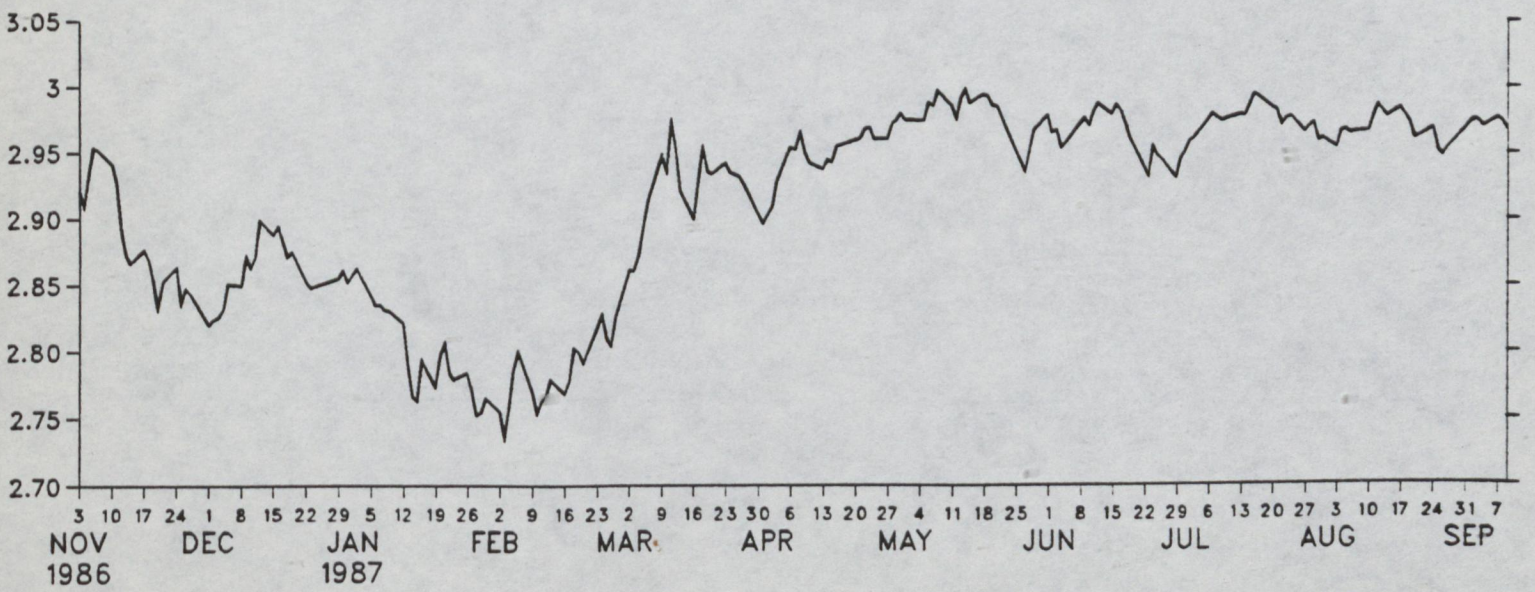
—— OIL–ADJUSTED REFERENCE RATE
---- EFFECTIVE RATE



STERLING/DOLLAR



STERLING/DEUTSCHEMARK



UK/US INTEREST RATE DIFFERENTIAL

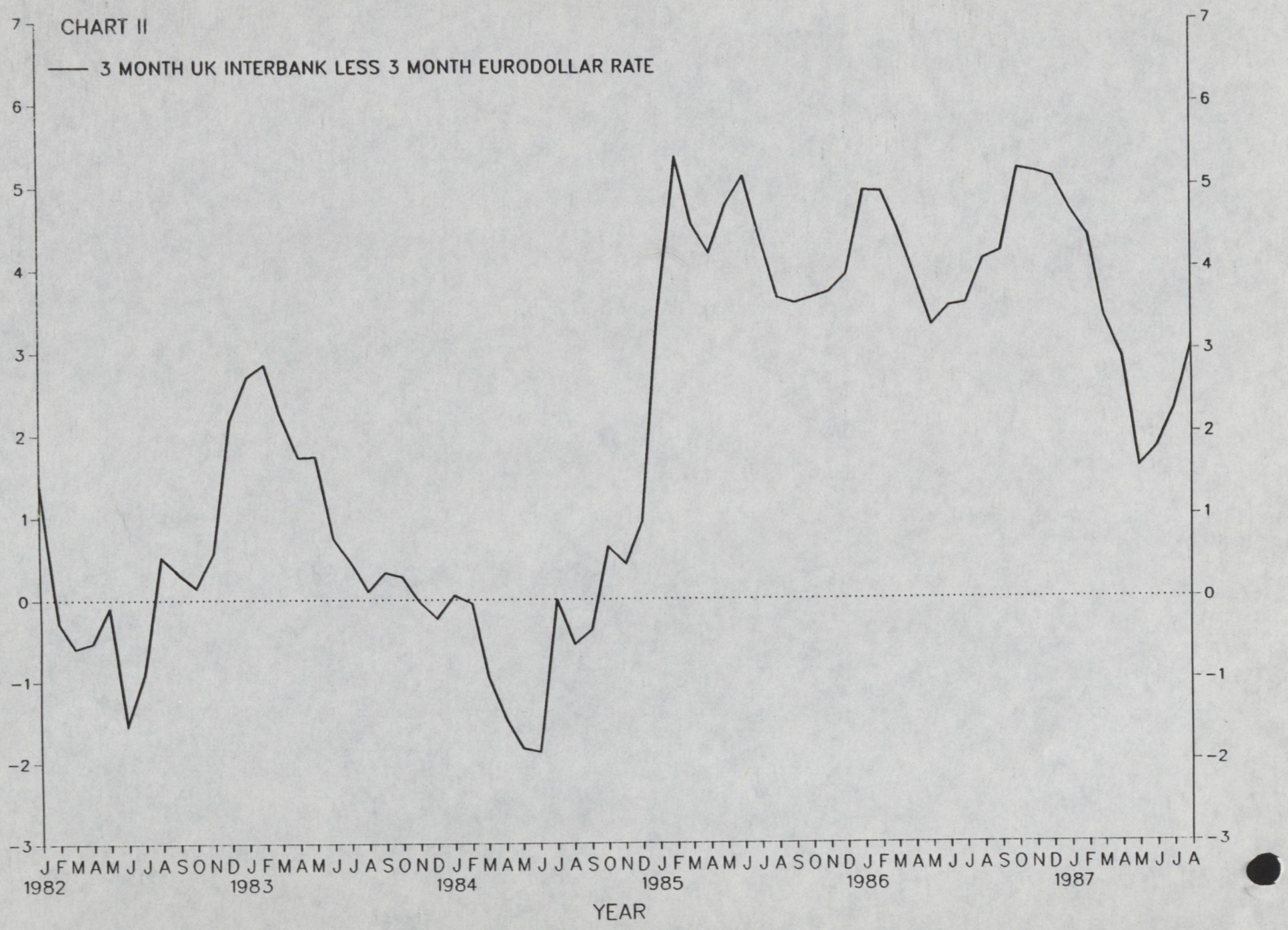


CHART III NARROW MONEY

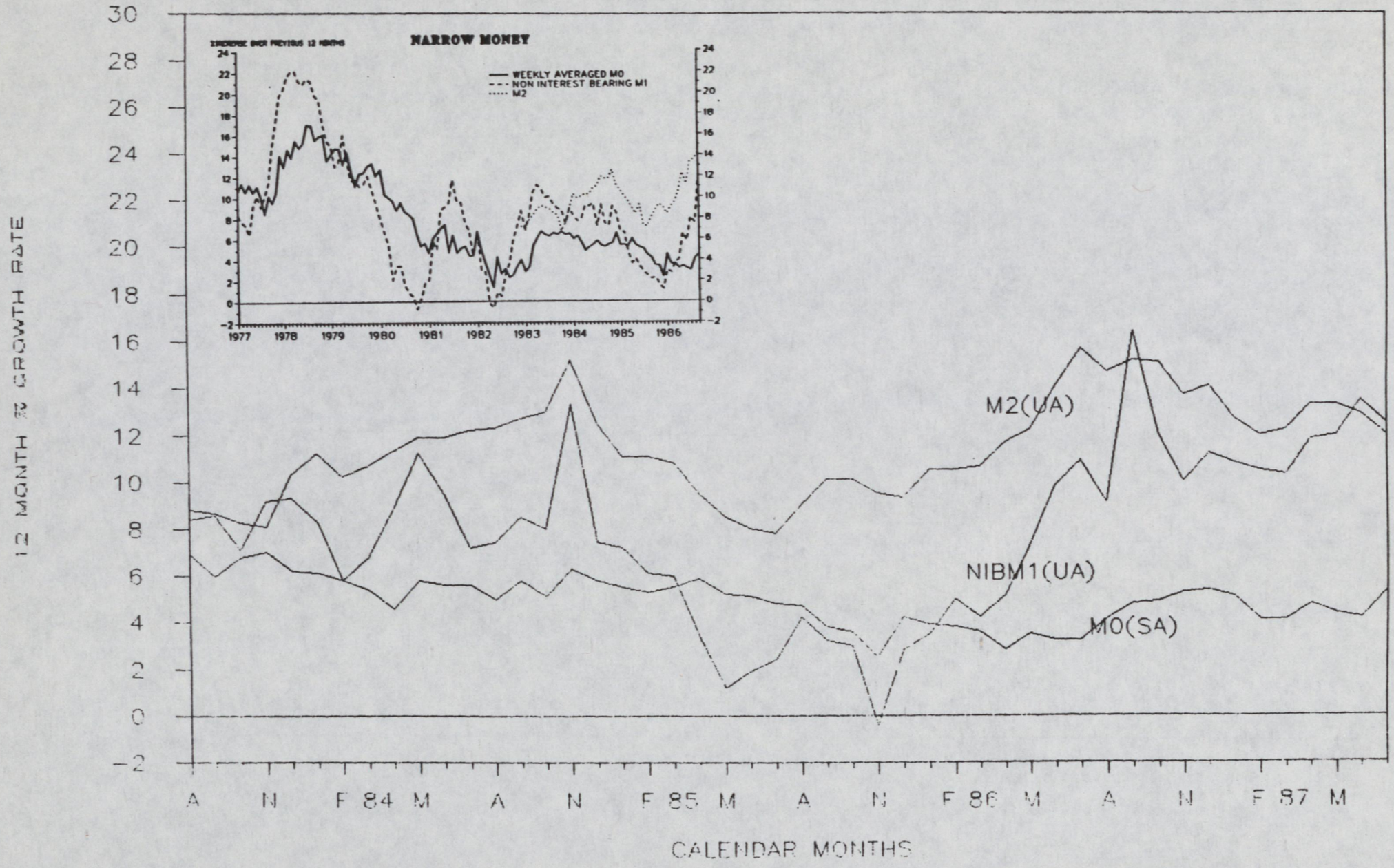


CHART IV BROAD MONEY

Annual percentage growth (sa)

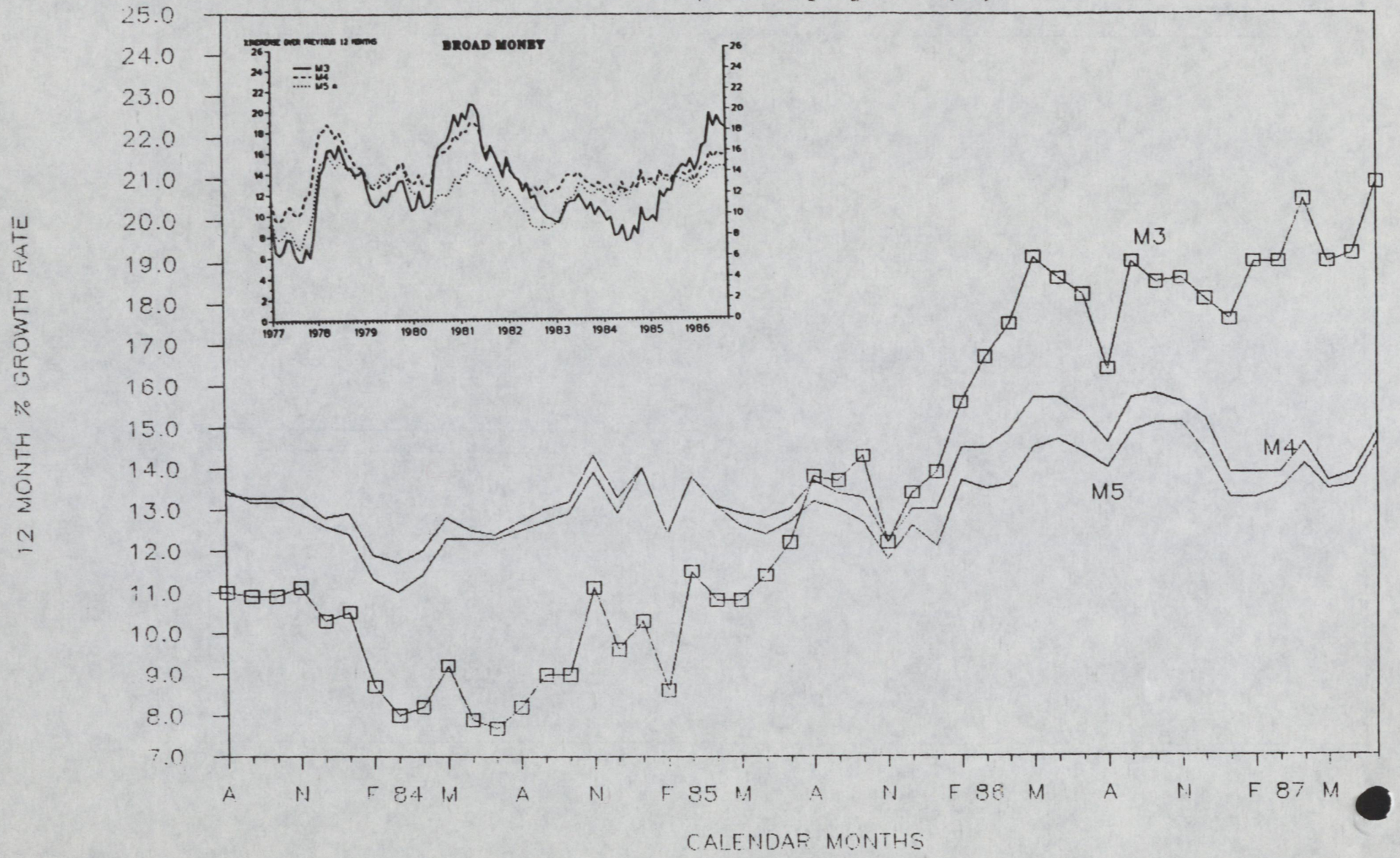


CHART V REAL MO

Annual percentage growth (sa)

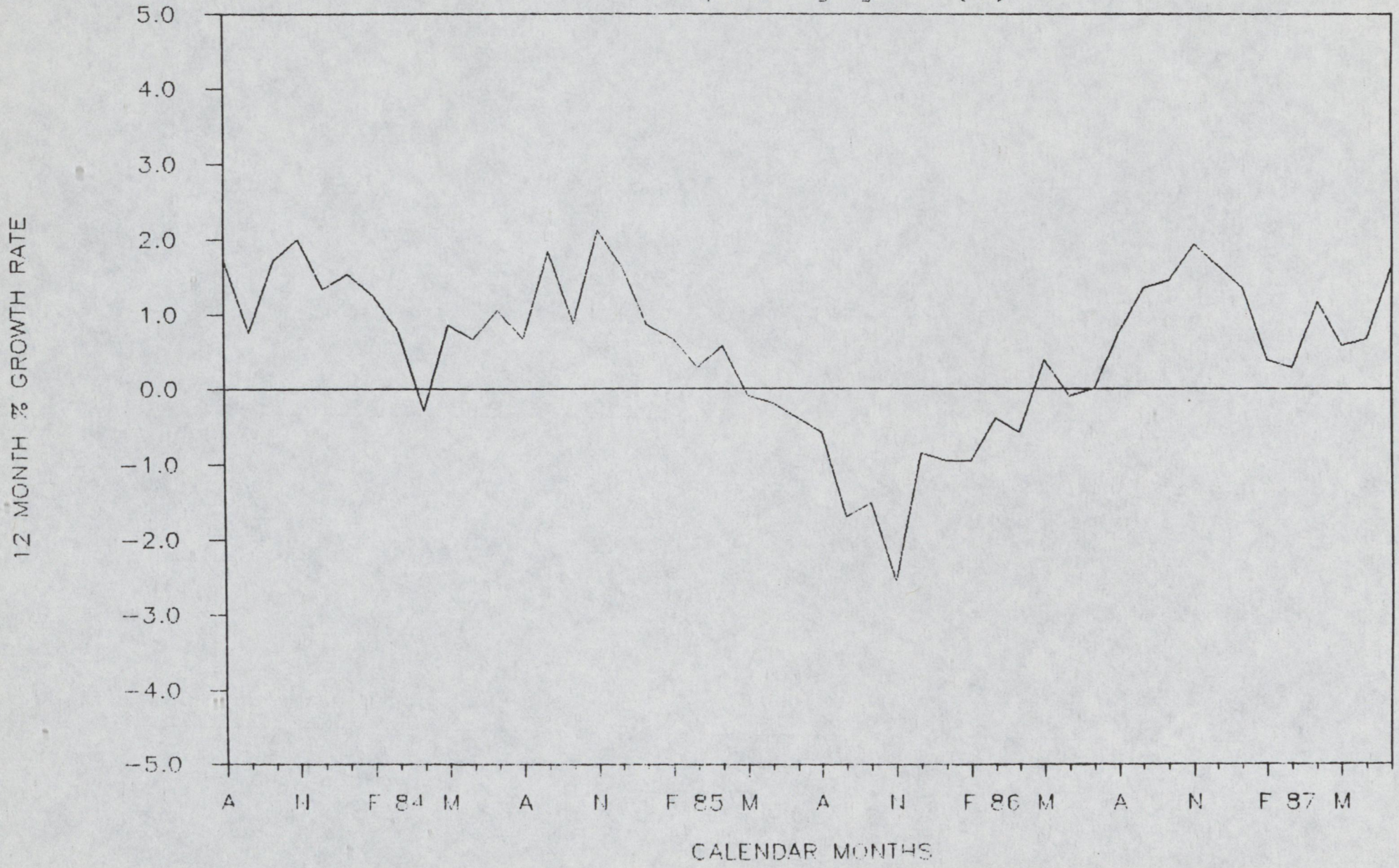


CHART VI REAL BROAD MONEY

Annual percentage growth (ua)

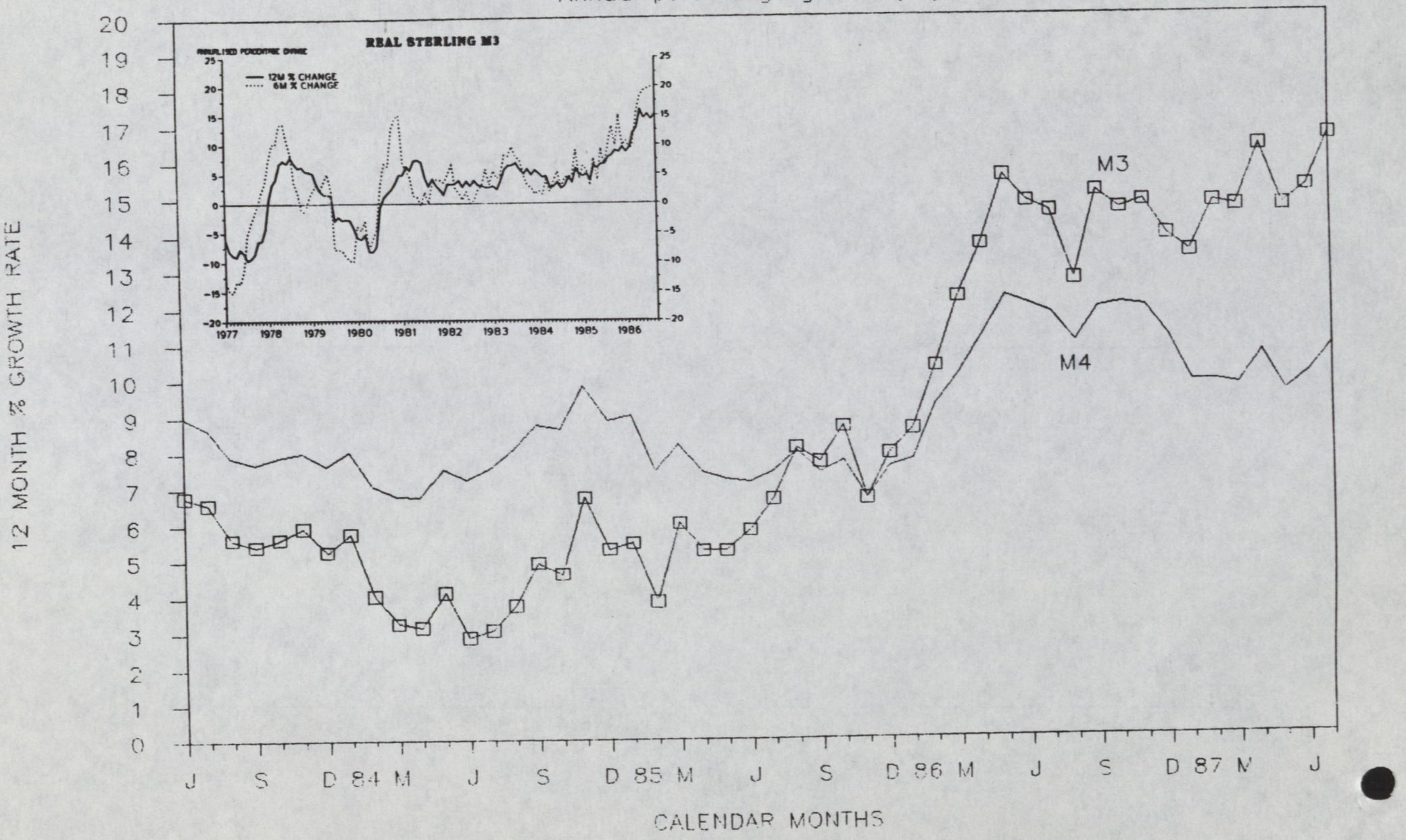


CHART VII

COMPARISON OF 1987 BUDGET FORECAST WITH OUT-TURN FOR M0

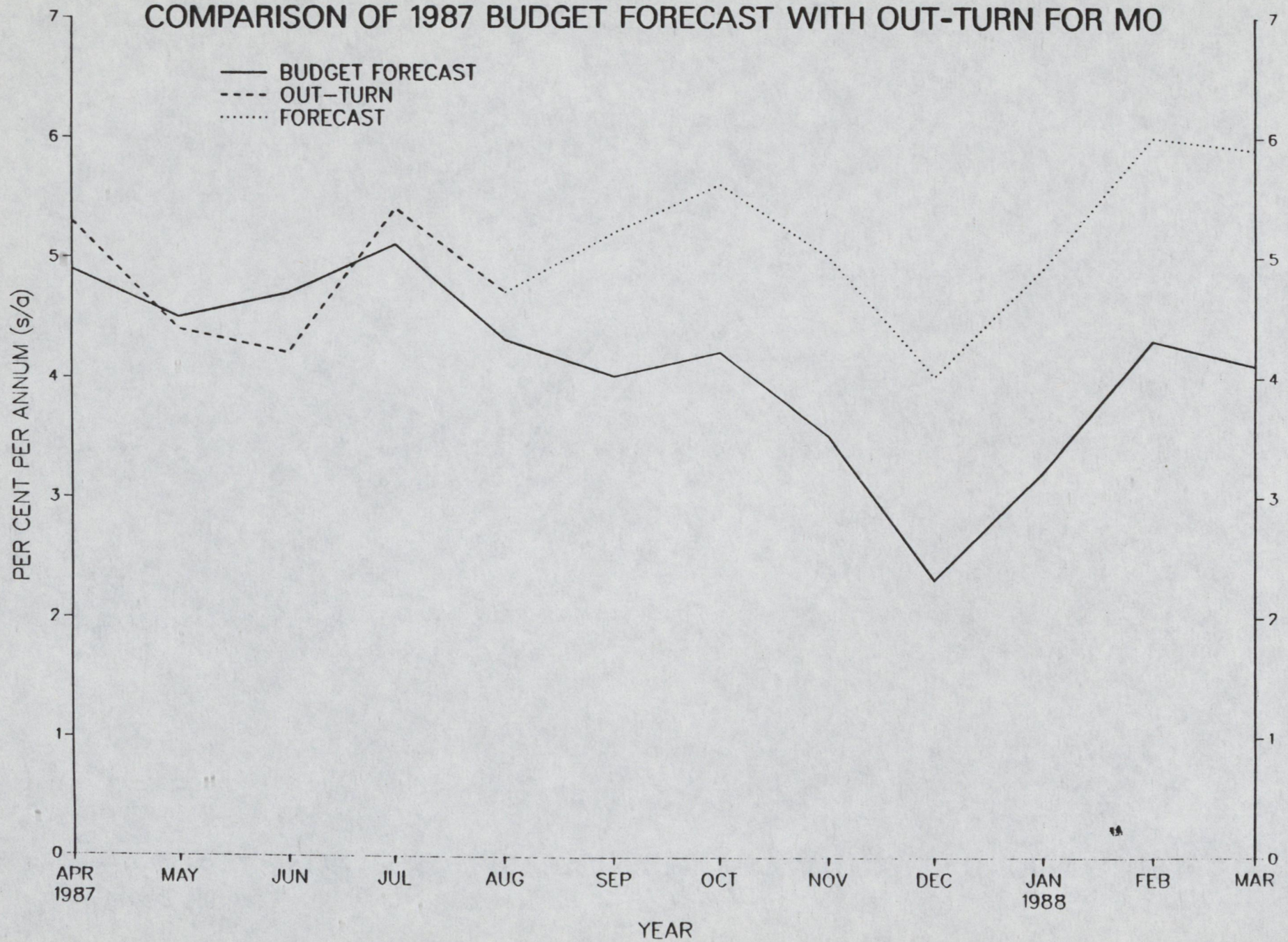
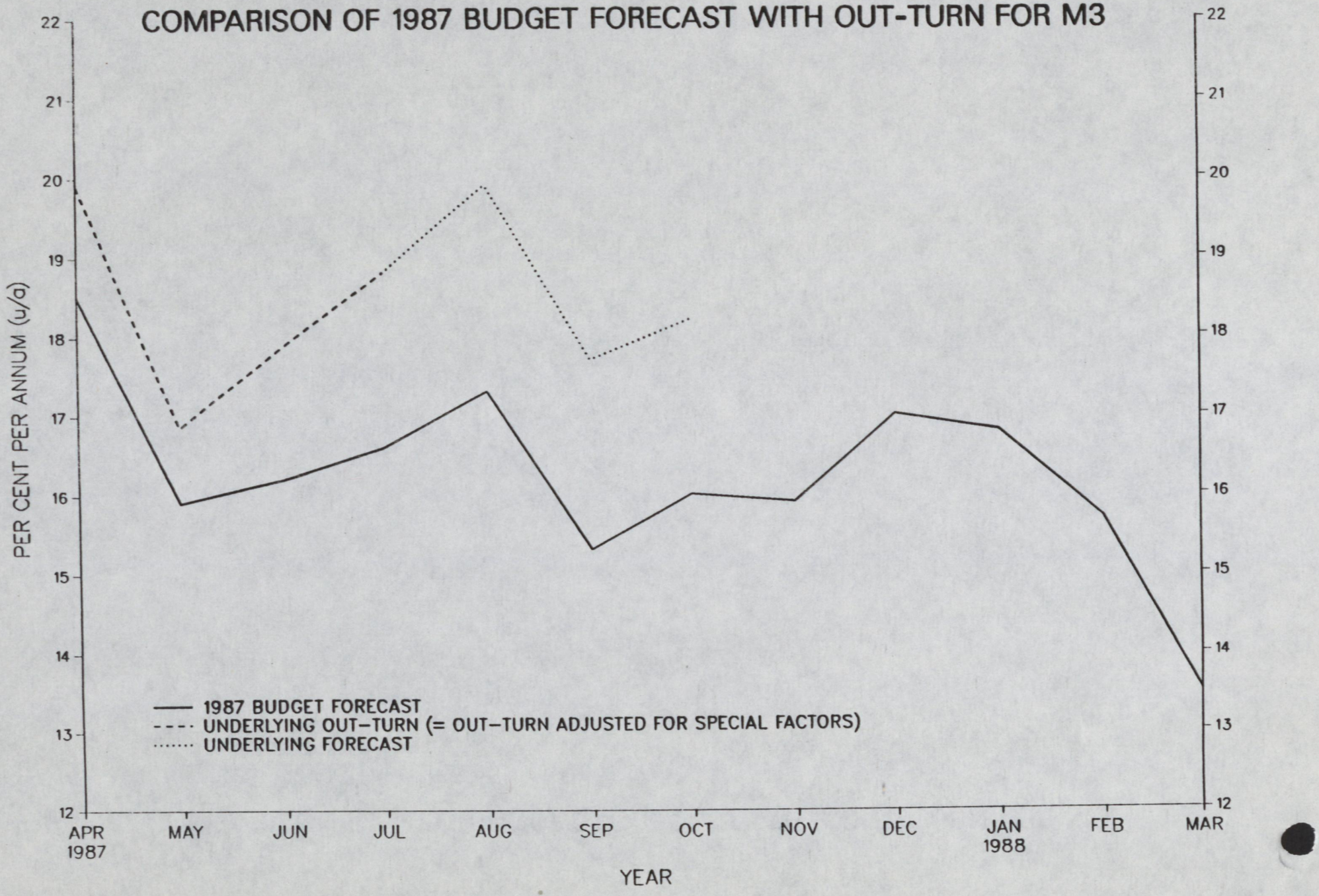


CHART VIII

COMPARISON OF 1987 BUDGET FORECAST WITH OUT-TURN FOR M3



MO GROWTH (SA) COMPARED TO TARGET RANGE

CHART IX

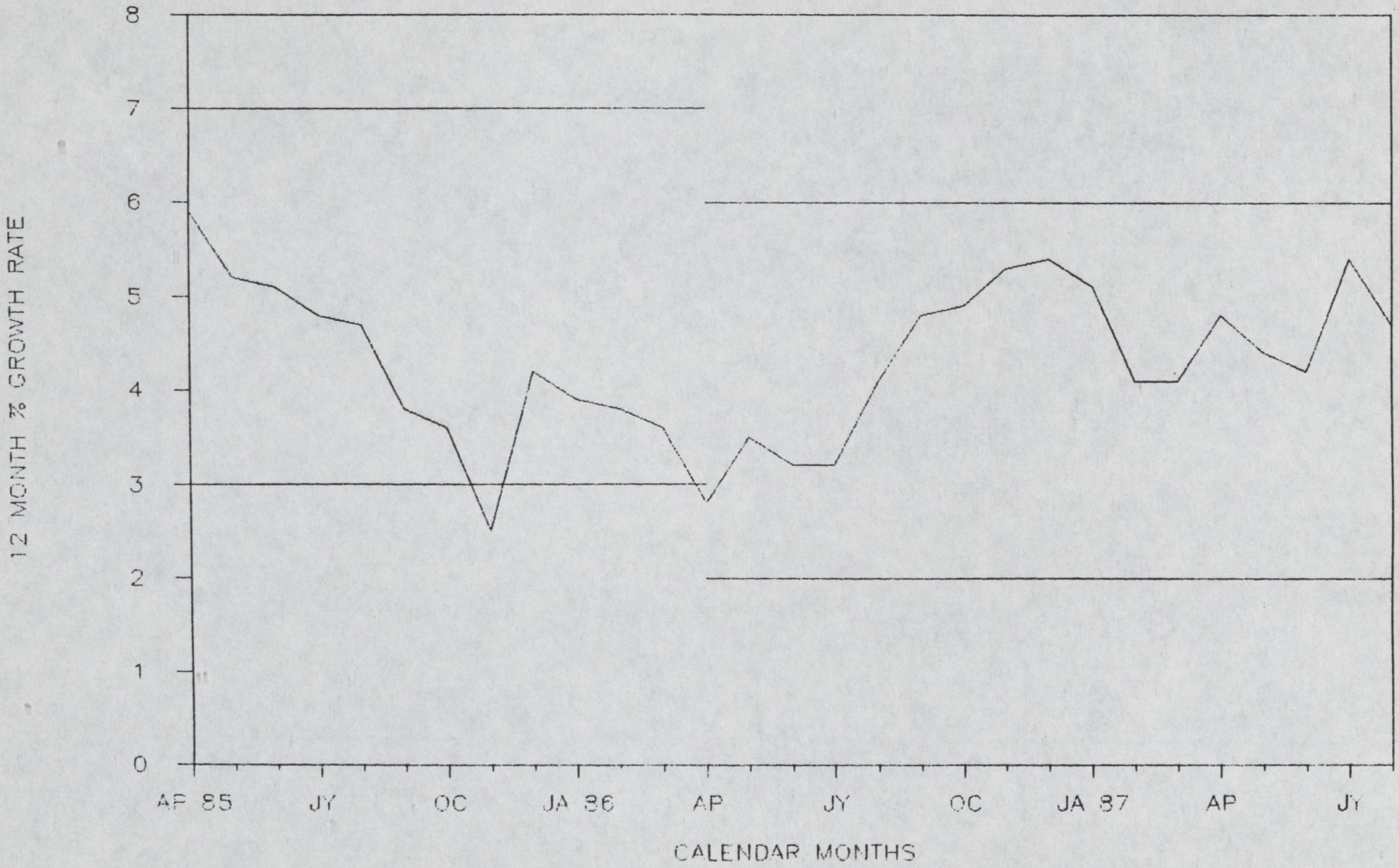


CHART X RETAIL DEPOSITS

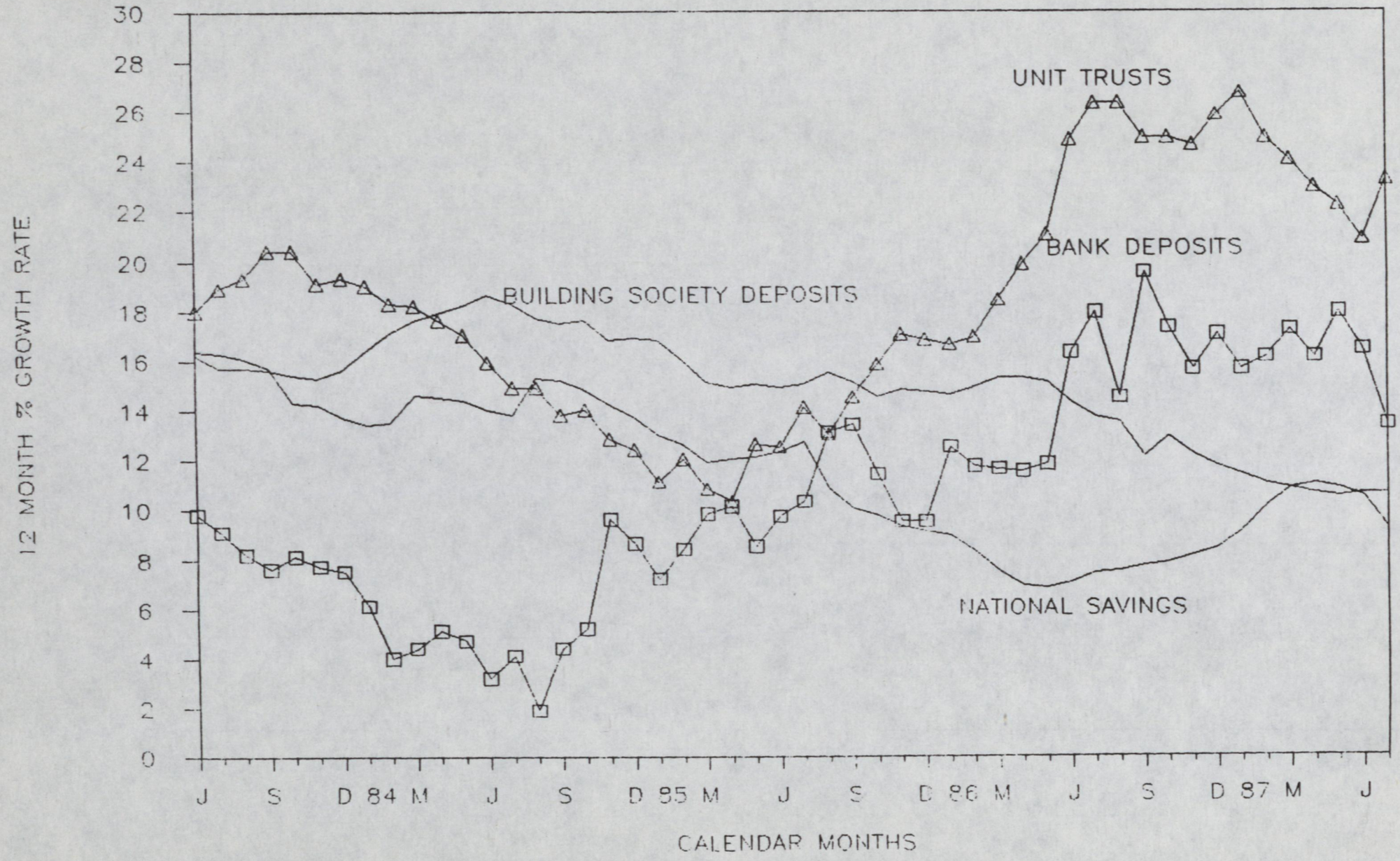
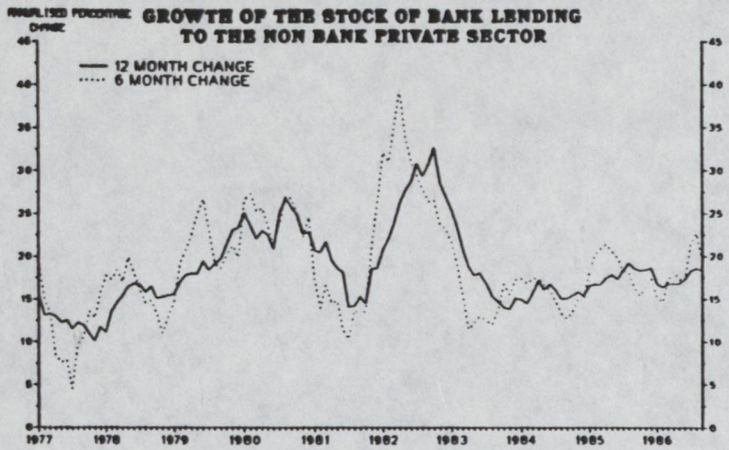


CHART XI

ANNUAL GROWTH OF THE STOCK OF LENDING TO THE NON BANK PRIVATE SECTOR



BANK LENDING

BANK AND BUILDING SOCIETY LENDING

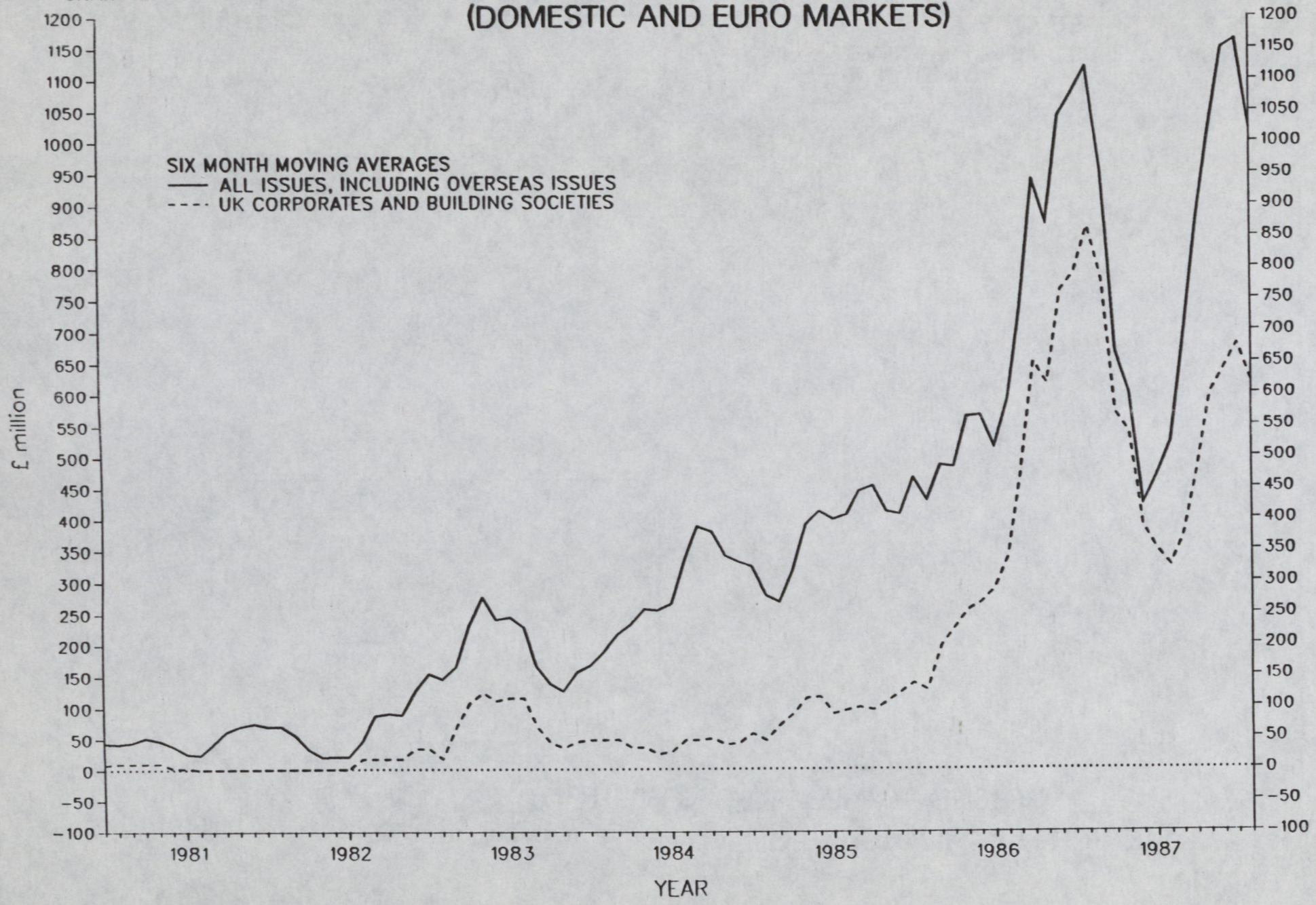
25 24 23 22 21 20 19 18 17 16 15

J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J

1984 1985 1986 1987

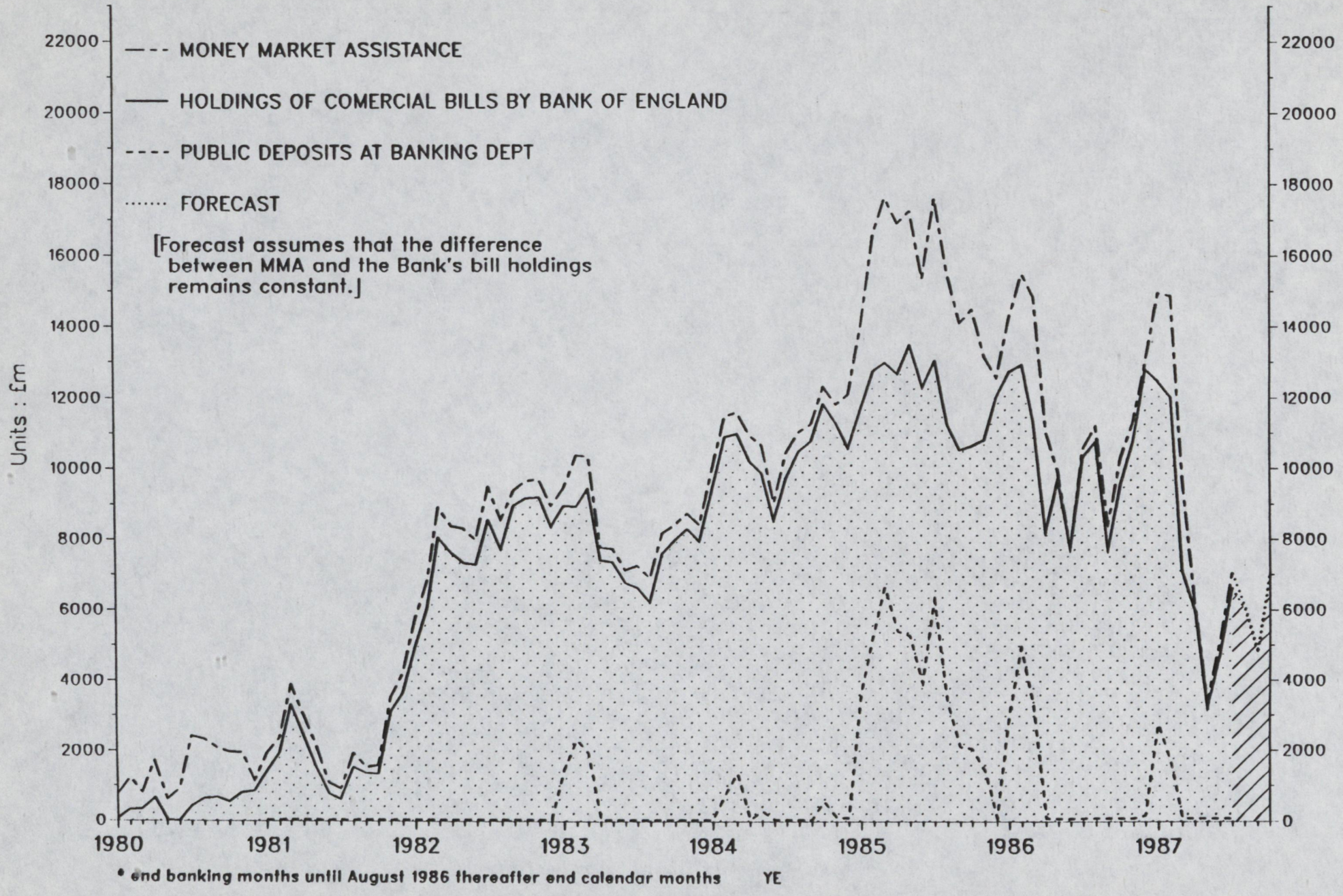
STERLING BOND ISSUES BY UK AND OVERSEAS INSTITUTIONS
(DOMESTIC AND EURO MARKETS)

CHART XII



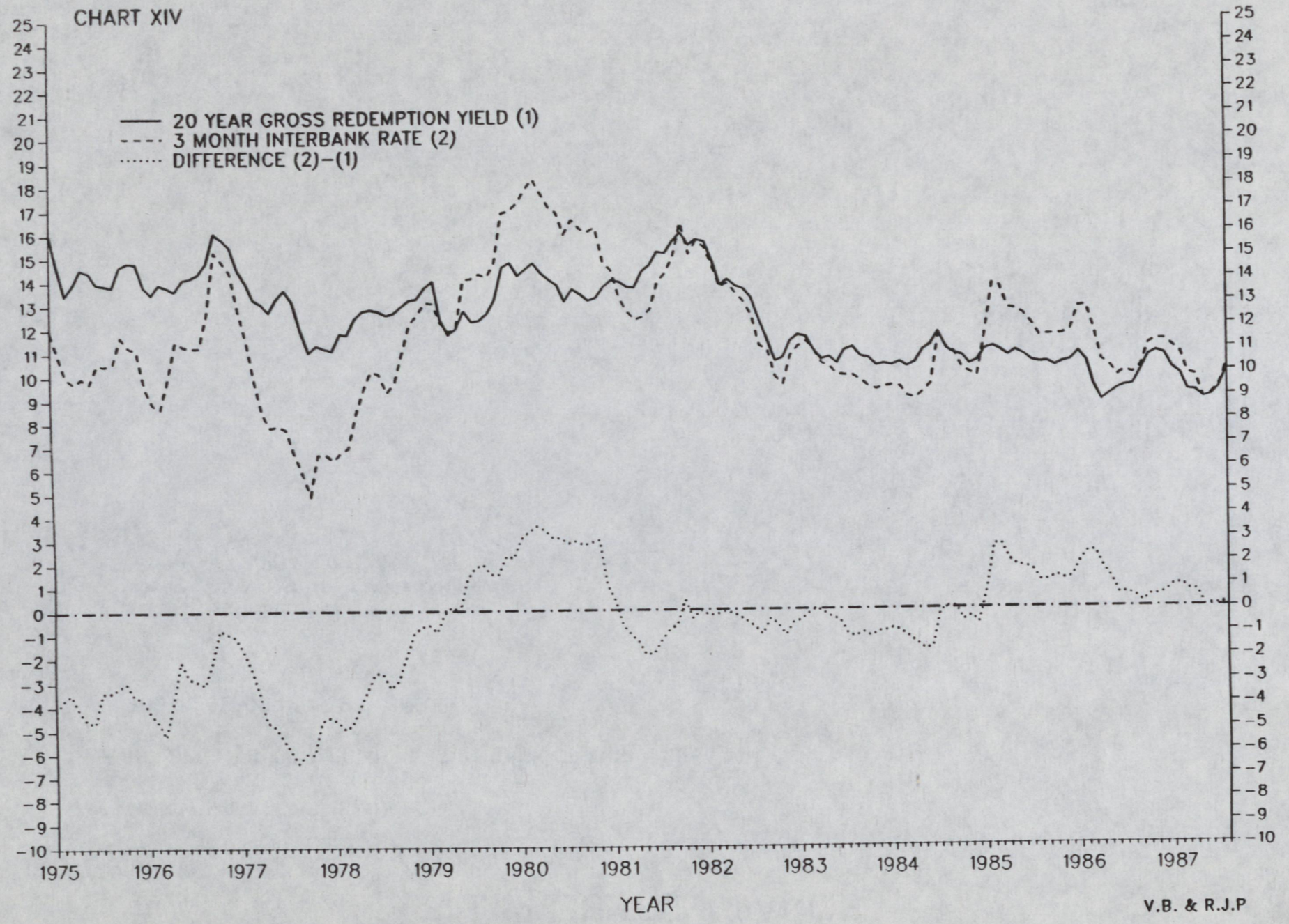
BILL MOUNTAIN RANGE

CHART XIII



• end banking months until August 1986 thereafter end calendar months YE

NOMINAL INTEREST RATES



Per cent

Time / Yield Curves of British Government Stocks

CHART XV

7th September 1987

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 3.06

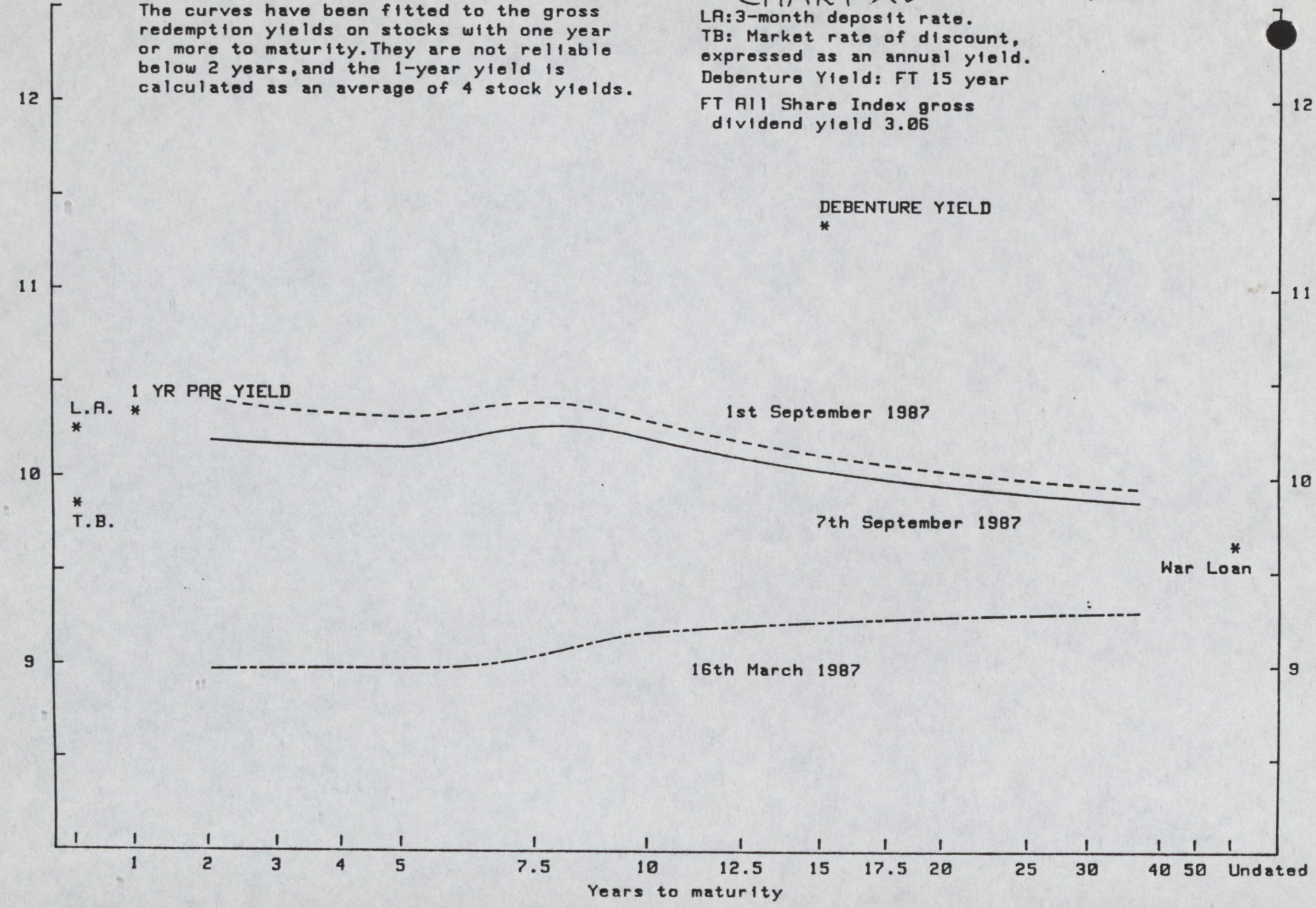
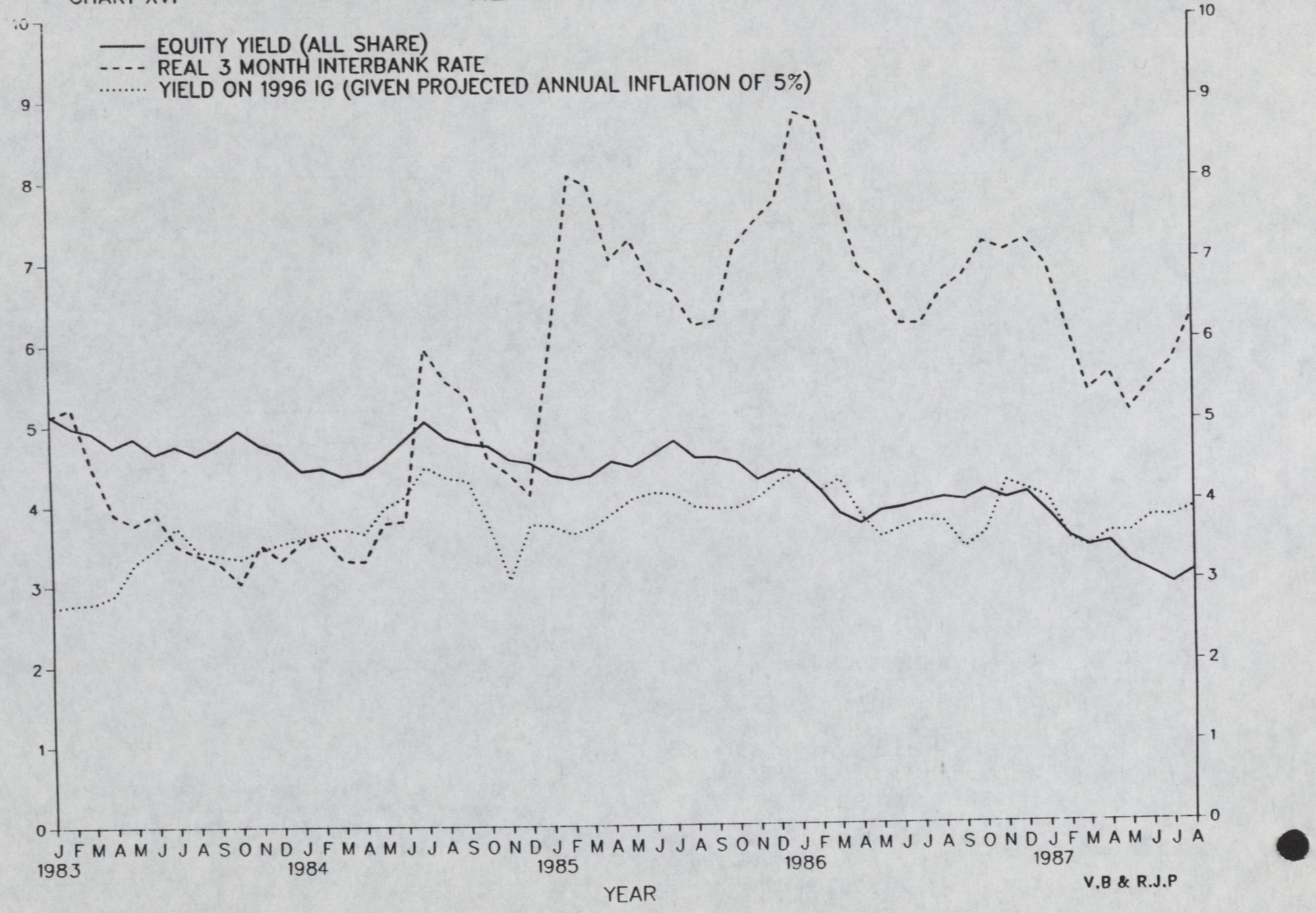


CHART XVI

REAL YIELDS



ANNUAL HOUSE PRICE INFLATION

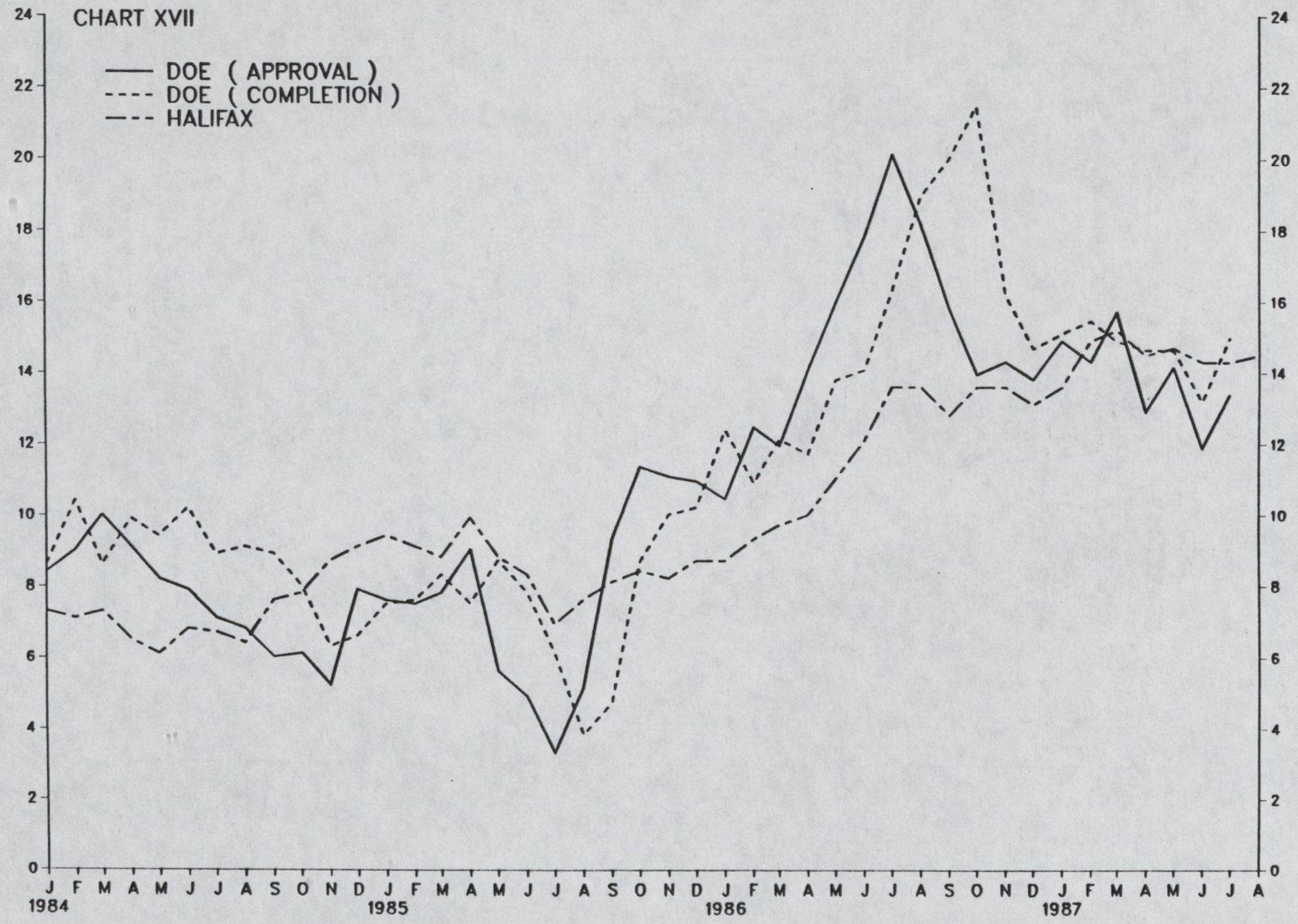
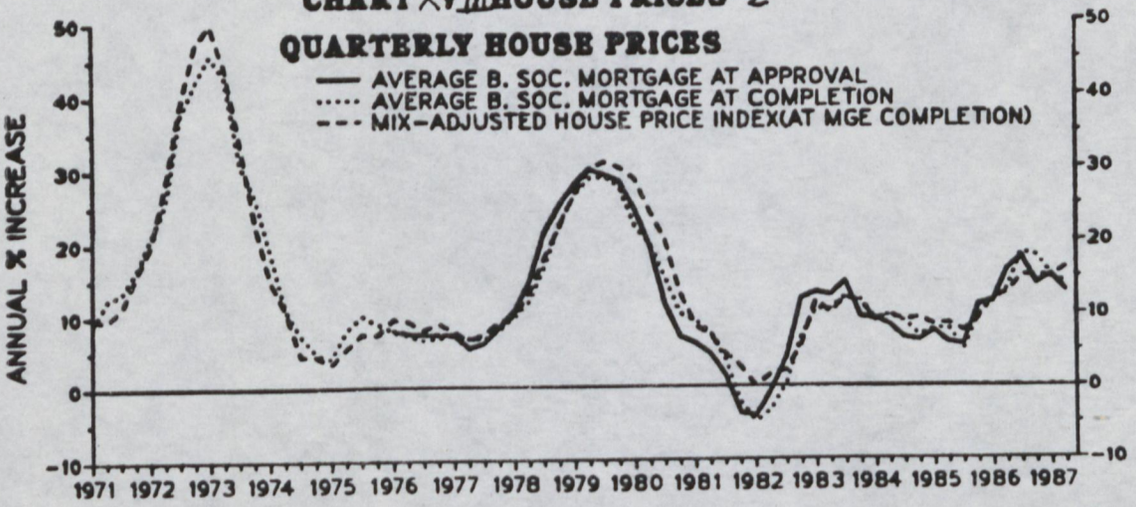
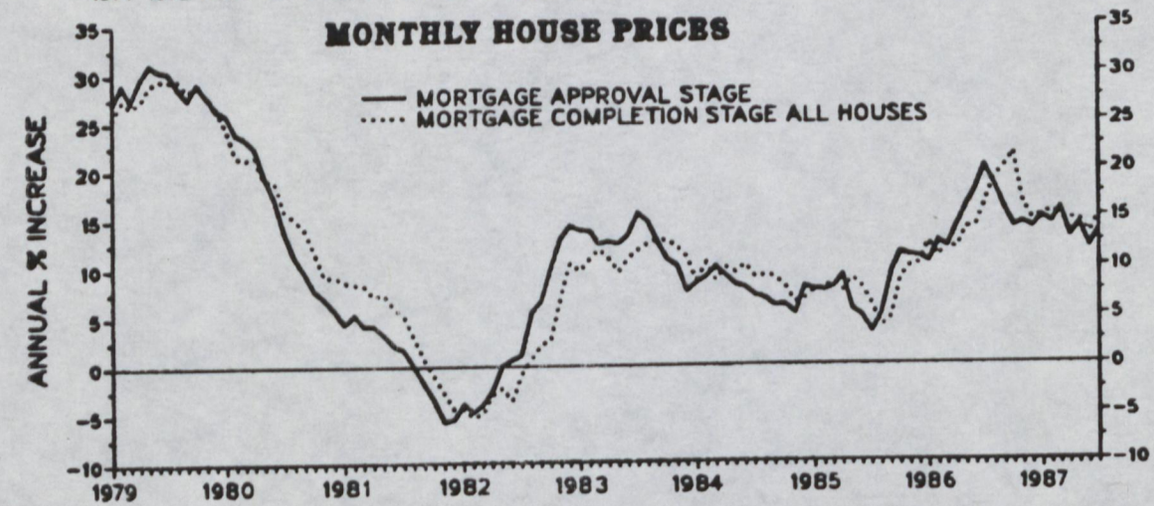


CHART XVIII HOUSE PRICES 2

QUARTERLY HOUSE PRICES

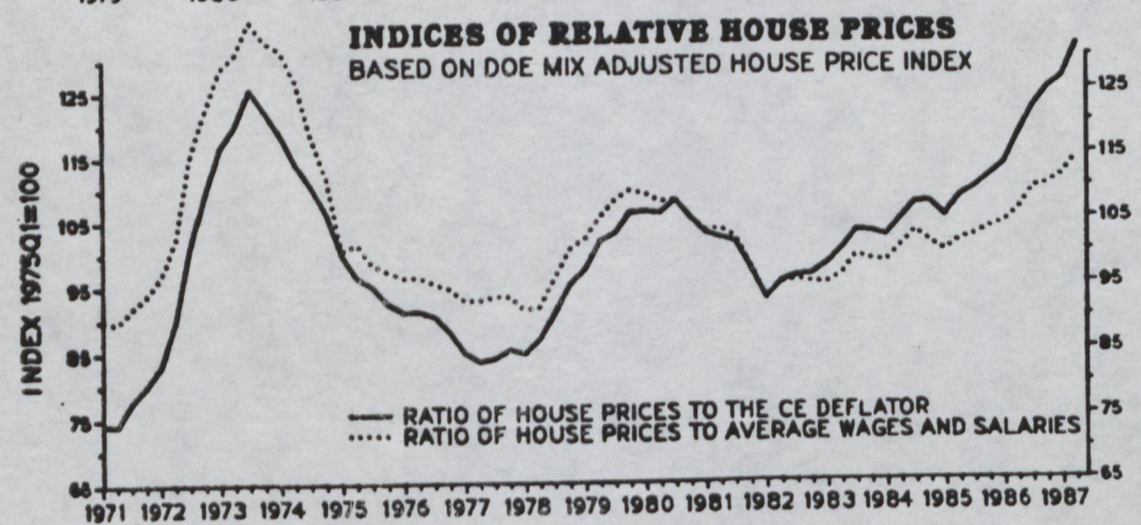


MONTHLY HOUSE PRICES



INDICES OF RELATIVE HOUSE PRICES

BASED ON DOE MIX ADJUSTED HOUSE PRICE INDEX



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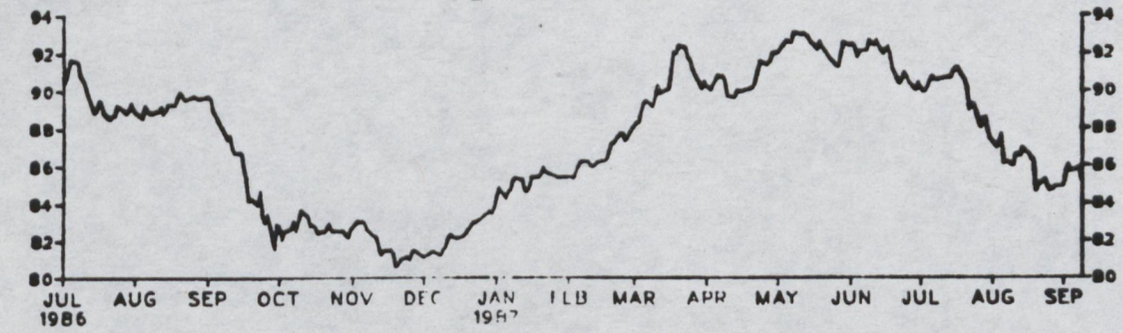
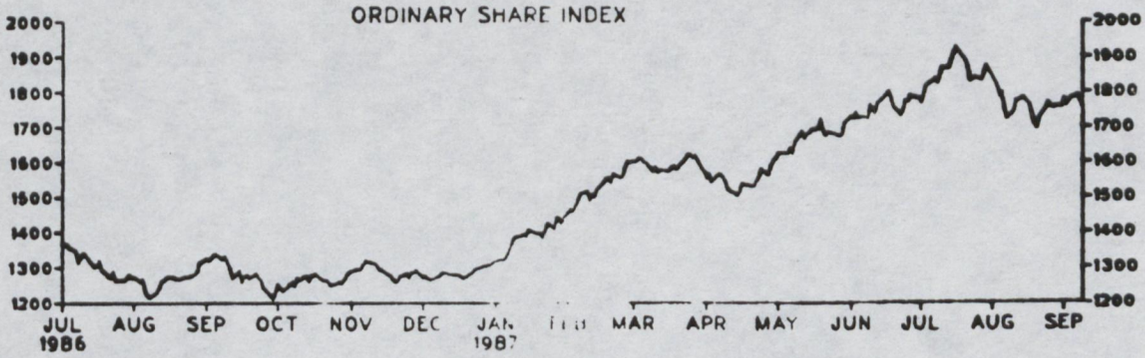
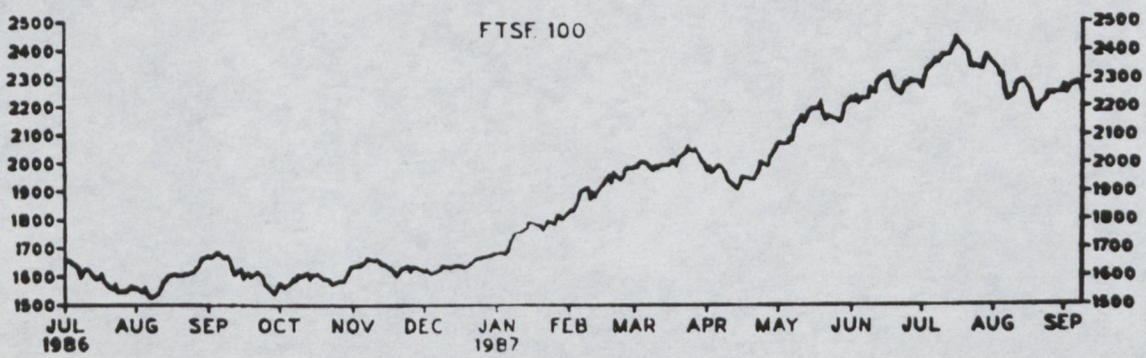


ORDINARY SHARE INDEX



FTSE 100



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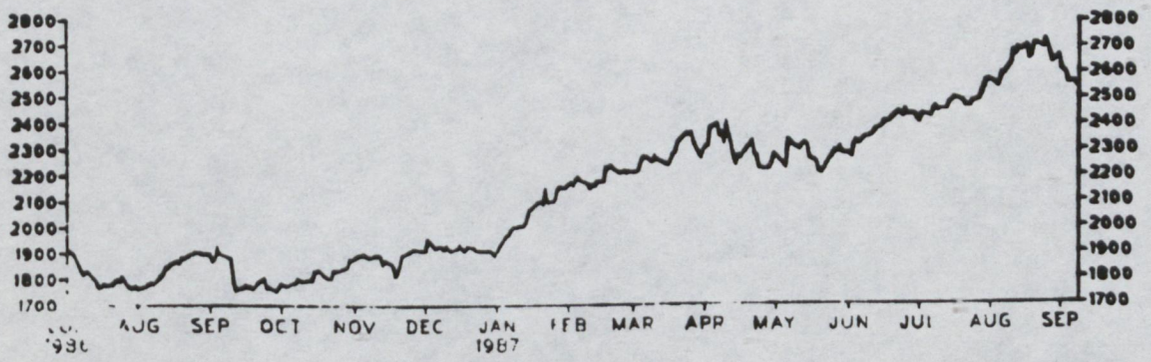

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TABLE 1: DEVELOPMENTS IN THE MAJOR 6 (EXCLUDING THE UK) COUNTRIES
(per cent change on same period a year earlier)

		OUTPUT		TRADE VOLUMES*		PRICES		MONEY	
	Nominal GNP	Real GNP	Industrial production	Exports	Imports	GNP Deflator	Consumer prices	Narrow money	Broad money
1982	6.2	-0.6	-4.1	-2.6	-1.3	6.9	7.0	6.7	9.9
1983	7.4	2.8	3.3	0.1	3.6	4.5	4.6	9.7	8.5
1984	9.5	5.1	8.4	10.0	15.8	4.2	4.5	6.3	8.5
1985	6.8	3.1	2.8	2.5	3.6	3.8	3.7	7.8	8.3
1986	6.2	2.7	1.0	0.4	7.6	3.4	1.8	10.2	7.2
1986Q1	6.6	3.0	1.8	-0.9	5.1	3.5	2.9	8.6	6.8
Q2	6.7	3.1	1.0	-0.1	8.0	3.5	1.7	10.2	6.7
Q3	6.1	2.6	0.6	1.7	10.4	3.4	1.5	10.6	7.4
Q4	5.2	2.2	0.5	0.9	6.9	2.9	1.1	11.4	7.8
1987 Q1	5.4	2.4	1.0	3.3	7.2	2.9	1.5	12.3	7.9
Q2			2.1				2.6	11.4	8.2
1987 Jan			-0.2				1.1	13.0	8.1
Feb			1.0				1.5	12.8	8.0
Mar			2.1				2.0	11.2	7.7
Apr			0.8				2.6	12.1	8.2
May			2.8				2.6	11.7+	8.3+
June			2.7				2.6	10.4+	8.2+

* On national accounts basis

\+ Estimate.

TABLE 2: THREE MONTH INTEREST RATES IN THE G5 COUNTRIES*

	United States	Japan	Germany	France	UK
1982	12.2	6.9	8.9	14.7	12.3
1983	9.1	6.5	5.8	12.5	10.1
1984	10.4	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
1986 Q1	7.6	6.0	4.6	8.7	12.4
Q2	6.7	4.7	4.6	7.4	10.2
Q3	6.0	4.7	4.6	7.2	10.0
Q4	5.8	4.5	4.7	7.7	11.2
1987 Q1	6.0	4.1	4.2	8.3	10.7
Q2	6.8	3.8	3.8	8.1	9.2
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	7.2	3.7	4.0	7.9	10.2

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

TABLE : EFFECTIVE EXCHANGE RATE INDICES (1975 = 100)

	United States	Japan	Germany	France	UK
1980	93.7	126.4	128.8	94.4	96.0
1981	105.6	142.9	119.2	84.3	94.8
1982	118.0	134.6	124.4	76.6	90.4
1983	124.8	148.4	127.1	70.0	83.2
1984	134.6	156.7	123.8	65.7	78.6
1985	140.7	160.5	123.6	66.3	78.2
1986	114.8	203.1	137.3	70.1	72.8
1985 Q1	149.7	154.3	119.3	63.4	72.1
Q2	145.8	155.2	121.6	65.2	78.9
Q3	138.4	157.6	125.0	67.2	82.1
Q4	128.8	174.9	128.5	69.3	79.8
1986 Q1	121.2	186.8	133.1	71.0	75.1
Q2	116.0	202.8	134.7	69.0	76.0
Q3	111.4	214.8	138.6	69.5	71.9
Q4	110.5	208.0	142.6	70.8	68.3
1987 Q1	104.2	210.1	147.7	71.9	70.2
Q2	101.1	222.9	146.9	71.6	72.7
1987 Jan	105.5	209.4	147.5	71.8	68.9
Feb	103.9	209.3	148.4	72.3	69.0
Mar	103.3	211.7	147.1	71.8	71.9
Apr	101.0	222.7	146.6	71.6	72.3
May	100.4	225.3	147.2	71.7	73.3
June	101.8	220.8	146.8	71.5	72.6
July	103.3	213.7	146.6	71.6	72.8
Aug	103.3	218.2	146.0	71.1	72.3
Sept 9	100.4	223.9	147.2	71.4	72.9
% Change since dollar peak (Feb 85)	-36	+42½	+25½	+15	+4
% Change since Plaza (Sept 85)	-28	+43	+17½	+6	-11
% change since Louvre Accord (Feb 87)	-3½	+7	-½	-1	+5½

TABLE 4: RECENT INDICATORS OF ACTIVITY AND INFLATION

per cent changes on year earlier

	MONEY		OUTPUT		PRICES AND UNIT LABOUR COSTS					
				Manufacturing		RPI excluding	Producer Prices***		Unit Wage Costs	
	GDP		GDP(O))	Output	RPI	mortgage payments	Output	Input	Manufacturing	Whole economy
1985-86	9.7	1985	3.7	3.0	6.1	5.2	6.3	4.4	5.6	5.3
1986-87	6.2	1986	2.8	0.9	3.4	3.6	4.3	-10.7	4.6	5.3
1986 2	6.2	1986 1	2.2	- 0.6	4.9	4.6	5.0	- 11.9	7.3	6.0
3	6.5	2	2.0	- 0.6	2.8	3.3	4.3	- 12.4	6.2	6.2
4	5.9	3	3.5	1.3	2.6	3.3	4.0	- 13.0	3.2	4.2
1987 1	6.4	4	3.6	3.6	3.4	3.4	4.0	- 5.6	1.6	4.9
2	8.9*	1987 1	4.2	4.3	3.9	3.7	4.1	- 1.7	0.9	4.1
3	8.6	2	3.8	4.7	4.2	3.6	4.5	4.6	1.3	
4	8.8	3								
1988 1	8.8	4								
1987-88	8.8									
		1986 June		- 1.1	2.5	3.3	4.3	- 12.4	6.2**	
		July		1.4	2.4	3.2	4.0	- 14.3	5.2	
		August		0.8	2.5	3.3	4.0	- 13.3	4.6	
		September		1.5	3.0	3.4	4.0	- 11.5	3.2	
		October		3.4	3.0	3.4	4.0	- 7.4	2.7	
		November		3.7	3.5	3.3	3.8	- 4.9	1.8	
		December		3.6	3.7	3.5	4.0	- 4.4	1.6	
		1987 January		2.6	3.9	3.7	4.2	- 2.5	1.9	
		February		5.3	3.9	3.7	4.2	- 2.9	1.5	
		March		5.0	4.0	3.8	4.1	0.4	0.9	
		April		3.5	4.2	3.6	4.3	3.0	0.5	
		May		5.2	4.1	3.8	4.5	3.4	0.8	
		June		5.4	4.2	3.5	4.4	7.2	1.3	
		July			4.4	3.7	4.6	12.8		
		August			4.4	3.7				

* June forecast.

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

*** Excluding food, drink and tobacco.

TABLE 5: INDICATORS OF FISCAL STANCE

(a) Annual Data

	PSBR		PSBR excluding privatisation proceeds		PSFD	
	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	1½	0.8	1½	-0.2	-½
1971-72	1.0	1¾	1.0	1¾	0.7	1
1972-73	2.4	3½	2.4	3½	2.0	3
1973-74	4.3	5¾	4.3	5¾	3.5	4¾
1974-75	8.0	9	8.0	9	6.0	6¾
1975-76	10.3	9¼	10.3	9¼	8.1	7¼
1976-77	8.3	6½	8.3	6½	7.4	5¾
1977-78	5.4	3½	5.9	4	6.6	4½
1978-79	9.2	5¼	9.2	5¼	8.5	5
1979-80	10.0	4¾	10.4	5	8.2	4
1980-81	12.7	5½	13.1	5½	11.9	5
1981-82	8.6	3¼	9.1	3½	5.7	2¼
1982-83	8.9	3¼	9.3	3¼	8.4	3
1983-84	9.8	3¼	10.9	3½	12.2	4
1984-85*	10.2	3	12.3	3¾	13.9	4¼
1985-86*	5.8	1½	8.5	2¼	8.4	2¼
1986-87	3.3	¾	7.7	2	9.7	2½
1987-88 (June forecast)	1.0	¼	6.3	1½	7.3	1¾

* If adjusted for coal strike, PSBR and PSFD ratios to GDP roughly 0.9 per cent lower in 1984-85 and 0.3 per cent lower in 1985-86.

(b) Quarterly Data

£ billion		PSBR		PSBR excluding privatisation		PSFD	
		s.a.*	u.a.	s.a.*	u.a.	s.a.+	u.a.
1985	Q2	1.4	2.6	2.8	4.0	2.6	4.0
	Q3	1.9	3.0	2.3	3.4	1.7	2.3
	Q4	1.2	2.1	1.7	2.6	2.0	0.4
1986	Q1	1.3	-1.9	1.8	-1.4	2.3	1.6
	Q2	2.2	2.3	3.3	3.4	2.7	3.5
	Q3	2.5	3.6	2.5	3.6	2.6	4.5
	Q4	-2.5	-1.6	-0.3	0.5	2.0	0.0
1987	Q1	1.4	-0.7	2.5	0.4	2.5	-1.7
	Q2	0.7	1.1	3.0	3.4		

* financial year - constrained
\+ calendar year - constrained

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Table 6: CGBR(O) April - July: Comparison with Budget Profile

£ billion (-indicates lower borrowing)

Receipts	
Inland Revenue	- 0.4
Customs and Excise	- 0.3
National insurance contributions	- 0.1
Privatisation proceeds	- 0.2
Other receipts	+ 0.1
Expenditure	
Net debt interest payments	+ 0.2
Net payments to EC	-
NIF benefit funding	+ 0.1
Other departmental expenditure(1)	- 1.0
Net effect on CGBR(O)	- 1.6

(1) on a cash basis, net of certain receipts and on-lending

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)
1983	(3)	84.9	114.7	1.042	1.53	3.94	103.4	-0.3	30.9
	(4)	83.2	112.5	1.035	1.47	3.93	102.9	-0.5	29.6
1984	(1)	81.7	110.5	1.012	1.44	3.87	101.9	-0.9	29.7
	(2)	79.8	109.2	0.988	1.40	3.78	99.6	-2.1	29.7
	(3)	78.0	106.9	0.979	1.30	3.78	99.5	-0.6	28.5
	(4)	75.0	103.7	0.946	1.21	3.72	97.5	+0.3	28.6
1985	(1)	72.1	100.2	0.908	1.12	3.63	95.2	+4.4	27.7
	(2)	78.9	111.4	1.001	1.26	3.88	102.3	+4.4	27.0
	(3)	82.1	117.7	1.040	1.38	3.92	103.8	+3.6	27.4
	(4)	79.8	116.2	1.001	1.44	3.71	98.7	+3.5	28.3
1986	(1)	75.1	112.5	1.037	1.44	3.38	90.9	+4.5	17.8
	(2)	76.1	118.3	1.101	1.51	3.39	91.4	+3.3	12.8
	(3)	71.9	113.6	1.049	1.5	3.1	84.9	+3.7	12.4
	(4)	68.3	107.8	0.97	1.43	2.87	79.0	5.1	14.8
19987	(1)	69.9	114.2	0.967	1.54	2.83	78.8	4.3	17.9
	(2)	72.8	116.7	0.996	1.64	2.96	82.6	2.1	18.6
1987	January	68.9	112.6	0.950	1.51	2.80	77.8	+4.9	18.4
	February	69.0	113.7	0.960	1.53	2.78	77.4	+4.5	17.2
	March	71.9	116.4	0.991	1.59	2.92	81.2	+3.6	18.0
	April	72.3	115.8	0.994	1.63	2.95	82.1	+3.0	18.2
	May	73.3	117.6	1.002	1.67	2.98	83.1	+1.6	18.8
	June	72.7	116.7	0.991	1.63	2.96	82.6	+1.8	18.9
	July	72.8	116.9	0.985	1.61	2.97	82.9	+2.7	19.8
	August	72.3	115.7	0.988	1.60	2.97	82.8	+3.0	18.9
	September 10th	72.9	n/a	n/a	1.65	2.97	83.0	+2.8	18.4

/ 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

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
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	6.3	2.6	4.3	4.0
	September 10	10.2	7.5	10.0	10.1	3.9	6.3	3.2	4.3	4.1

* 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	0.5	8.6	0.5	4035
1983	-1.1	9.5	-0.6	3338
1984	9.6	11.0	-1.9	1474
1985	6.8	4.2	1.8	2919
1986	2.4	5.7	-0.8	-980
1986 Q1	-2.5	3.2	3.0	733
2	0.0	2.4	1.9	135
3	2.9	7.5	-2.4	-918
4	9.3	9.9	-4.9	-930
1987 Q1	11.2	5.4	-1.0	471
Q2	6.3	10.1	+1.1	-561
Jan	-2.6	1.5	4.5	995
Feb	-2.7	2.6	3.3	204
Mar	-2.3	5.7	1.7	-466
Apr	-2.2	-1.8	2.3	283
May	-0.2	7.3	2.9	-113
Jun	2.6	1.7	1.6	-35
Jul	2.6	4.2	-1.9	-5
Aug	-0.4	9.7	-2.8	-734
Sep	6.4	8.4	-2.5	-179
Oct	7.7	5.1	-3.3	-155
Nov	11.3	10.6	-5.0	-462
Dec	9.0	15.0	-6.1	-313
1987 Jan	7.3	6.4	-2.7	18
Feb	18.2	8.5	-1.5	333
Mar	7.9	1.0	+0.8	119
April	8.9	10.7	+1.1	74
May	5.4	14.0	+0.3	-496
June	4.7	5.5	+1.6	-140
July	8.5	10.8	-0.4	-310

* excluding oil and erratics.

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TABLE 10

Key Monetary Indicators

	1985-86											1986-87
	Aug	Sept	Oct	Nov	Dec	Jan	Feb	Mar	April	May	June	July
MONETARY AGGREGATES 12 month % change (ua)												
MO	4.1	4.8	4.9	5.2	5.2	4.1	4.1	3.5	5.3	4.4	4.2	5.3
M3	16.4	19.0	18.5	18.6	18.1	17.6	19.0	19.0	20.5	19.0	19.2	20.9
M4	14.6	15.7	15.8	15.6	15.2	13.9	13.9	13.9	14.6	13.7	13.9	14.9
M5	14.0	14.9	15.1	15.1	14.4	13.3	13.3	13.5	14.1	13.5	13.6	14.6
STERLING LENDING 12 month % change (ua)												
Banks	19.4	18.6	19.4	20.8	21.9	22.5	21.7	20.7	21.4	21.7	21.5	22.9
Banks and building societies	19.4	18.9	19.4	20.1	20.7	20.9	20.2	19.5	19.9	19.7	19.5	19.6
OVER(-)/UNDER (+) FUNDING financial year to date:£mn	-75	2,654	812	-3	-1,577	-3,931	-3,969	393	3215	5178	2420	1928
MONEY MARKET ASSISTANCE/ Level outstanding £mn	11,168	8,390	10,247	11,295	12,970	14,948	14,873	9,742	6126	3340	5132	7038
INTEREST RATES												
3 months*	9.9	10.2	11.1	11.3	11.3	11.0	10.8	9.9	9.8	8.8	9.0	9.3
20 yearϕ	9.4	10.3	10.6	10.9	10.6	10.0	9.8	9.1	9.2	8.8	8.9	9.3
EFFECTIVE EXCHANGE RATE	71.4	70.4	67.8	68.5	68.5	68.9	69.0	71.9	73.3	73.3	72.6	72.8

* Inter bank
ϕ par yield
/ banking months until August thereafter end calendar months

Table 11

MONETARY AGGREGATES 1986-87

		NOV	DEC	JAN	FEB	MAR	APR	MAY	JUNE	JULY
MO	Averaged weekly									
	Monthly change (£ million)	+134	+1,129	-1,034	-228	+115	+325	+42	-93	+423
	Monthly % change	+0.9	+7.6	-6.5	-1.5	+0.8	+2.2	+0.3	-0.6	+2.8
		(+1.0)	(+1.4)	(-0.6)	(-0.8)	(+0.4)	(+0.4)	(+0.5)	(+0.2)	(+1.2)
	12 Monthly % change	+5.2	+5.2	+4.1	+4.1	+3.5	+5.3	+4.4	+4.2	+5.3
M3	(Exc Public sector deposit)									
	Monthly change (£ million)	+2,225	+267	-1,225	+2,945	+6,813	+3,203	+3,263	+1,904	+4,199
	Monthly % change	+1.5	+0.2	-0.8	+2.0	+4.4	+2.0	+2.0	+1.1	+2.5
		(+1.3)	(+0.2)	(+1.1)	(+2.3)	(+3.3)	(+1.9)	(+2.1)	(+1.0)	(+2.3)
	12 Monthly % change	+18.6	+18.1	+17.6	+19.0	+19.0	+20.5	+19.0	+19.2	+20.9
M4	Monthly change (£ million)	+2,583	+1,691	-325	+2,470	+6,668	+3,555	+3,454	+4,044	5,301
	Monthly % change	+1.0	+0.7	-0.1	+0.9	+2.5	+1.3	+1.3	+1.5	+1.9
		(+1.1)	(+0.2)	(+0.6)	(+1.4)	(+2.1)	(+1.4)	(+1.4)	(+1.3)	(+1.8)
	12 Monthly % change	+15.6	+15.2	+13.9	+13.9	+13.9	+14.6	+13.7	+13.9	14.9
M5	Monthly change (£ million)	+2,573	+1,529	-666	+2,616	+6,976	+3,575	+4,121	+4,159	+5,653
	Monthly % change	+1.0	+0.6	-0.2	+0.9	+2.5	+1.3	+1.4	+1.4	+1.9
		(+1.2)	(+0.1)	(+0.6)	(+1.3)	(+1.9)	(+1.2)	(+1.6)	(+1.3)	(+1.8)
	12 Monthly % change	+15.1	+14.4	+13.3	+13.3	+13.5	+14.1	+13.5	+13.6	+14.6
NIBMI	Monthly change (£ million)	+926	+410	-1,842	+516	+1,055	+474	+1,167	+1,469	+122
	Monthly % change	+2.3	+1.0	-4.4	+1.3	+2.6	+1.2	+2.8	+3.4	+0.3
		(+1.1)	(+0.8)	(+1.0)	(+1.7)	(-0.6)	(-0.2)	(+3.5)	(+3.8)	(-0.3)
	12 Monthly % change	+10.0	+11.2	+10.8	+10.5	+10.3	+11.8	+12.0	+13.5	+12.5
M1	Monthly change (£ million)	+2,197	-871	-237	+409	+4,381	+725	+2,983	+2,120	+1,008
	Monthly % change	+3.0	-1.2	-0.3	+0.5	+5.8	+0.9	+3.7	+2.5	+1.2
		(+2.4)	(-1.4)	(+2.8)	(+0.8)	(+4.0)	(+0.2)	(+4.1)	(+2.6)	(+0.9)
	12 Monthly % change	+23.5	+21.2	+23.2	+21.2	22.6	+23.3	+23.8	+23.9	+22.7
Net £ deposits from banks abroad		+803	+719	+1,004	-845	-1,395	+719	+992	-940	+408
Overseas non-bank £ deposits		-255	+180	+475	+550	+742	-190	+760	-432	+561
WIDER £ AGGREGATE										
	Monthly change (£ million)	+2,773	+1,166	+254	+2,650	+6,160	+3,732	+5,015	+532	+5,168
	Monthly % change	+1.6	+0.7	+0.1	+1.5	+3.4	+2.0	+2.6	+0.3	+2.6
		(+1.5)	(+0.7)	(+1.7)	(+1.8)	(+2.5)	(+1.9)	(+2.8)	(+0.2)	(+2.5)

NB Figures in brackets are seasonally adjusted.

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	-0.4	12.2	10.1	9.1
1986-87	3.8	0.3	14.6	9.7	9.3
12 MONTH % CHANGES (ua except M0)					
JUNE	3.3	-0.1	14.8	12.0	11.0
JULY	3.2	0.0	14.5	11.7	10.9
AUGUST	3.3	0.8	12.7	10.9	10.4
SEPTEMBER	3.4	1.4	15.1	11.9	11.1
OCTOBER	3.4	1.5	14.6	12.0	11.3
NOVEMBER	3.3	1.9	14.8	11.9	11.4
DECEMBER	3.7	1.6	13.9	11.1	10.3
1987 JANUARY	3.7	1.4	13.4	9.8	9.3
FEBRUARY	3.7	0.4	14.8	9.8	9.3
MARCH	3.8	0.3	14.6	9.7	9.3
APRIL	3.6	1.2	16.3	10.6	10.1
MAY	3.8	0.6	14.6	9.5	9.3
JUNE	3.5	0.7	15.2	10.0	9.8
JULY	3.7	1.6	16.6	10.8	10.5

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TABLE 13

MO, THE WIDE MONETARY BASE

Calendar months	Levels £ million (changes in brackets) Notes and coin (nsa)	Notes and coin (sa)		Bankers' deposits	MO (nsa)	MO (s.a.)		% change on previous Month Notes (sa) and coin	MO (sa)	% change on year earlier Notes and Coin (nsa)	Notes and Coin (sa)	MO (nsa)	MO (sa)
1987													
Mar	14,577	14,808	(-3)	232	14,809	15,040	(+64)	-0.0	+0.4	+3.2	+3.8	+3.5	+4.1
Apr	14,931	14,903	(+95)	203	15,134	15,106	(+66)	+0.6	+0.4	+5.1	+4.6	+5.3	+4.8
May	14,973	14,976	(+73)	203	15,176	15,179	(+73)	+0.5	+0.5	+4.5	+4.5	+4.4	+4.4
June	14,947	15,071	(+95)	136	15,083	15,207	(+28)	+0.6	+0.2	+4.6	+4.6	+4.2	+4.2
July	15,272	15,154	(+83)	234	15,506	15,388	(+181)	+0.5	+1.2	+4.7	+4.7	+5.3	+5.4
August	15,338	15,259	(+105)	182	15,520	15,441	(+53)	+0.7	+0.3	+4.3	+4.6	+4.5	+4.7
Sept† (2 of 5)	15,427	15,362	(+103)	269	15,696	15,631	(+190)	+0.7	+1.2	+5.8	+5.0	+6.3	+5.4
Latest 4 weeks†	15,389	15,328	(+139)	200	15,589	15,527	(+98)	+0.9	+0.6	+4.8	+4.9	+5.0	+5.0

Weekly data	Notes (sa) and coin		Bankers' deposits	MO (sa)		% change on previous week MO (sa)
August						
5th	15,202	(+43)	260	15,462	(-8)	-0.1
12th	15,245	(+43)	209	15,454	(-8)	-0.1
19th	15,270	(+25)	59	15,328	(-126)	-0.8
26th	15,317	(+47)	202	15,518	(+190)	+1.2
September†						
2nd	15,379	(+62)	325	15,703	(+185)	+1.2
9th	15,346	(-33)	214	15,560	(-143)	-0.9

† Most recent data include estimates only for coin and unbacked note issues. The percentage changes for September so far use as their base the average for the full relevant month; for the latest 4 week period changes as based on the previous 4 week period and a comparable period a year ago.

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TABLE 14 BUILDING SOCIETY BALANCE SHEET FLOWS

(Unadjusted, £m)

		Assets				Liabilities			
	Total Flow	Net Mortgage Advances & Unsecured Lending	Liquid Assets	Fixed assets	Retail principal	Interest credited	Wholesale funds	Other (eg reserves)
1985 *	1459	1193	239 (18.0)	27	592	495	205	167
1986 *	1623	1589	17 (16.4)	17	553	498	523	49
1985 Q2*	1490	1219	241 (16.5)	30	508	583	113	286
Q3*	1666	1157	479 (17.0)	30	590	384	153	539
Q4*	2172	1367	783 (18.0)	22	766	660	594	152
1986 Q1*	858	1271	-431 (17.5)	18	740	462	167	-511
Q2*	1591	1645	-74 (16.6)	20	478	522	321	270
Q3*	1783	1884	-112 (15.7)	11	56	402	1099	226
Q4*	2262	1556	686 (16.4)	20	938	649	403	272
1987 Q1*	1240	1120	105 (16.1)	15	484	594	279	-117
Q2*	1602	1284	303 (16.2)	15	595	523	182	302
June	965	1354	-404 (16.2)	15	556	1067	8	-666
Forecast								
Q3*	1509	1210	284 (16.3)	15	481	430	392	206
July +	1536	1308	213 (16.2)	15	281	745	475	35
August	1886	1273	598 (16.4)	15	404	93	400	989
Sept	1103	1048	40 (16.3)	15	697	451	300	-345
Oct	2312	1295	1002 (16.7)	15	1038	313	300	661

* Monthly Averages
Figures in ( ) liquidity ratio, unadjusted end period

+ Estimated ; part data

TABLE 15

COMPONENTS OF M3

	NOTES AND COINS	BANK DEPOSITS			M3
		RETAIL		WHOLESALE	
		NIB	IB		
% 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)					
JULY	5.3	13.9	20.6	21.8	18.2
AUGUST	4.1	11.9	16.2	21.7	16.4
SEPTEMBER	2.7	23.4	16.8	22.1	19.0
OCTOBER	5.8	15.3	18.6	22.8	18.5
NOVEMBER	4.0	13.3	17.1	25.6	18.6
DECEMBER	5.1	14.4	18.7	22.3	18.1
1987 JANUARY	3.7	14.7	16.2	23.0	17.6
FEBRUARY	3.2	14.5	17.2	25.7	19.0
MARCH	-2.2	16.9	17.4	25.5	19.0
APRIL	6.4	14.5	17.1	28.0	20.5
MAY	3.6	16.4	19.0	23.1	19.0
JUNE	4.0	18.1	15.4	25.3	19.2
JULY	6.3	15.4	12.0	32.5	20.9
Over 6 months (sa)					
1987 FEBRUARY	0.0	19.6	15.7	21.1	17.3
MARCH	2.9	-8.4	16.2	35.5	17.8
APRIL	2.3	10.5	12.2	37.8	22.0
MAY	-2.3	21.0	10.4	40.3	24.0
JUNE	9.0	24.5	11.3	40.0	26.0
JULY	3.5	22.9	12.5	48.8	29.2
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 FEBRUARY	-135	808	30	2743	3446
MARCH	-215	-15	702	4694	5166
APRIL	264	-357	488	2603	2998
MAY	156	1278	295	1748	3477
JUNE	-111	1705	557	-426	1725
JULY	267	-409	564	3527	3949

[1]March on March

TABLE 16 SECRET

THE COMPONENTS OF M4 AND M5

	M3	BUILDING SOCIETIES RETAIL[1]	BUILDING SOCIETIES WHOLESALE	HOLDINGS OF M3 (inc -)	M4	MONEY MARKET INSTRUMENTS	M5
% CHANGES							
Financial years (ua)							
1984-85[3]	11.5	15.1		1.5	13.8	12.2	13.8
1985-86[3]	16.7	15.3	52.6	93.7	13.5	-0.1	14.5
1986-87[3]	19.0	10.8	11.4	57.7	13.9	5.3	13.5
Over 12 months (ua)							
JULY	18.2	13.7		46.6	15.3	1.0	14.4
AUGUST	16.4	13.5		34.5	14.6	5.1	14.0
SEPTEMBER	19.0	12.1		24.1	15.7	2.8	14.9
OCTOBER	18.5	12.9		28.7	15.8	4.1	15.1
NOVEMBER	18.6	12.2		24.0	15.6	5.4	15.1
DECEMBER	18.1	11.7		17.9	15.2	1.7	14.4
1987 JANUARY	17.6	11.4		43.0	13.9	3.3	13.3
FEBRUARY	19.0	11.0		62.9	13.9	3.7	13.3
MARCH	19.0	10.8		57.7	13.9	5.3	13.5
APRIL	20.5	10.6		55.7	14.6	5.3	14.1
MAY	19.0	10.5		60.0	13.7	9.5	13.5
JUNE	19.2	10.6		69.0	13.9	9.4	13.6
JULY	20.9	10.6		69.2	14.9	8.0	14.6
Over 6 months (sa)							
1987 FEBRUARY	17.3	8.5		65.5	11.0	-0.5	10.3
MARCH	17.8	12.2		61.3	12.9	-1.9	12.1
APRIL	22.0	10.6		56.0	14.5	-4.9	13.5
MAY	24.0	11.0		68.2	15.1	1.5	14.4
JUNE	26.0	11.8		51.7	17.5	10.8	17.1
JULY	29.2	11.9		43.8	20.3	11.8	19.8
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 FEBRUARY	3446	877	-62	-625	3636	-48	3588
MARCH	5166	1499	-136	-848	5681	-309	5372
APRIL	2998	1297	41	-665	3671	-321	3350
MAY	3477	918	100	-720	3775	820	4595
JUNE	1785	1395	3	525	3558	255	3913
JULY	0	901	294	-180	4964	334	5298

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

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TABLE 17

RETAIL DEPOSITS

	BANKS	BUILDING[1] SOCIETIES	NATIONAL SAVINGS	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)				
JULY	17.9	13.7	7.4	14.0
AUGUST	14.5	13.5	7.5	12.8
SEPTEMBER	19.5	12.1	7.7	13.7
OCTOBER	17.3	12.9	7.8	13.4
NOVEMBER	15.6	12.2	8.1	12.6
DECEMBER	17.0	11.7	8.4	12.8
1987 JANUARY	15.6	11.4	9.1	12.3
FEBRUARY	16.1	11.0	10.1	12.4
MARCH	17.2	10.8	10.8	12.8
APRIL	16.1	10.6	11.0	12.5
MAY	17.9	10.5	10.8	12.9
JUNE	16.4	10.6	10.5	12.9
JULY	13.4	10.6	9.2	
Over 6 months (sa)				
1987 FEBRUARY	17.2	8.5	9.9	11.4
MARCH	5.6	12.2	11.5	9.9
APRIL	11.6	10.6	11.5	11.3
MAY	14.4	11.0	11.3	12.1
JUNE	16.4	11.8	11.5	12.1
JULY	16.5	11.9	10.8	
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 FEBRUARY	838	877	342	2057
MARCH	687	1499	281	2467
APRIL	131	1297	244	1672
MAY	1573	918	230	2721
JUNE	2262	1305	298	3865
JULY	155	901	248	1304

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 (banking months before 1986 October)

		unadjusted					
		Advances	**Commercial Bills**	**Investment[1]**	**Other[2]**	**Total**	**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
Contributions to annual bank lending growth[4]							
1986	April	15.6	-0.7	1.7	0.2	16.9	
	May	16.0	-0.7	1.8	-0.1	17.0	
	June	15.4	-1.2	1.9	1.3	17.4	
	July	15.4	0.5	2.1	0.2	18.2	
	August	15.5	0.5	1.9	0.6	18.4	
	September	16.2	0.4	1.9	1.2	18.6	
Monthly changes							
Banking months							
1986	July	2100	1956	421	282	4759	3164
	August	1524	-404	-10	432	1542	2502
	September	1757	-459	-21	-605	673	888
Calendar months							
1986	October	858	1154	323	980	3315	3486
	November	2221	420	129	482	3252	3837
	December	2655	1369	288	-271	4041	3193
1987	January	905	562	34	-136	1365	1701
	February	2617	-426	71	345	2607	2881
	March	4644	-2026	337	420	3375	2083
	April	1746	-409	211	-402	1146	1989
	May	3607	-2126	293	497	2271	2734
	June	5152	752	-8	-1210	4686	3931
	July	2122	1677	-102	868	4565	4861

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

4 First four columns equal fifth column.

TABLE 19 S E C R E T

COUNTERPARTS TO M3 M4 M5

£ million

LATEST MONTH : JULY 1987	M3	M4	M5
PSBR	-420	-420	-420
Debt sales (-): Other Public Sector	192	105	105
Central Government	524	703	713
Public external & fc finance (-)	-788	-788	-788
Over(-)/under(+)funding	-492	-400	-390
£ lending to private sector	4566	5942	6275
Bank/bank & b society externals (-)	-1481	-1612	-1612
Bank/bank & b society £NNDLs (-)	1606	1380	1380
TOTAL	4199	5310	5653

FINANCIAL YEAR 1987/88 TO DATE			
PSBR	664	664	664
Debt sales (-): Other Public Sector	1388	556	606
Central Government	-1738	-1341	-786
Public external & fc finance (-)	1614	1614	1614
Over(-)/under(+)funding	1928	1493	2098
£ lending to private sector	12669	18775	19315
Bank/bank & b society externals (-)	-2068	-2411	-2411
Bank/bank & b society £NNDLs (-)	40	-1494	-1494
TOTAL	12569	16363	17508

FINANCIAL YEAR 1986/87			
PSBR	3343	3343	3343
Debt sales to private sector (-)	-1235	-5840	-6082
Public external & fc finance (-)	-1700	-1700	-1700
Over(-)/under(+)funding	408	-4197	-4439
£ lending to private sector	30299	47406	48393
Bank/bank & b society externals (-)	-676	-1553	-1553
Bank/bank & b society £NNDLs (-)	-4601	-8689	-8689
TOTAL	25430	32967	33712

Table 20:- NET FINANCE OF U.K. INDUSTRIAL AND COMMERCIAL COMPANIES AND BUILDING SOCIETIES (£ million)

	BANK BORROWING				OTHER BORROWING						ALL BORROWING
	Sterling		Foreign		Sterling		Euro-Sterling(*)				
	ICC's	BSOC's	Currency	TOTAL	Commercial Paper	Equities	Bonds	ICC's	BSOC's	TOTAL	TOTAL
1984											
Q1	2905	-85	-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	-606	2786		924	170	235	0	1329	4115
Q2	747	248	47	1042		1092	327	230	0	1649	2691
Q3	229	161	1469	1859		873	274	130	600	1877	3736
Q4	874	351	1444	2669		525	89	200	475	1289	3958
1986											
Q1	3935	89	-879	3145		471	209	350	935	1965	5110
Q2	-172	178	-1120	-1114		1369	344	325	1075	3113	1999
Q3	355	976	-1072	259		1431	290	231	1575	3527	3786
Q4	5319	187	-50	5456	65	2339	-52	281	0	2633	8089
1987											
Q1	1051	306	2093	3450	312	1558	-781	1231	290	2610	6060
Q2	566	-490	759	835	588	2221	346	740	50	3955	4790
Average per quarter											
1984	1749	200	68	2016	0	282	63	84	0	429	2445
1985	1309	192	589	2089	0	854	215	199	269	1536	3625
1986	2359	358	-780	1937	16	1403	198	297	896	2809	4746
1987											
H1	809	-92	1426	2143	450	1895	-218	986	170	3283	5425
1986:- AUGUST					12	698	126	100	650	1586	
SEPTEMBER					31	385	113	0	750	1279	
OCTOBER					76	898	-49	105	0	1030	
NOVEMBER					77	835	-3	0	0	909	
DECEMBER					-66	605	0	176	0	715	
1987:- JANUARY					150	500	-67	110	0	693	
FEBRUARY					85	870	20	315	140	1430	
MARCH					77	183	-735	806	150	481	
APRIL					193	828	110	440	0	1571	
MAY					79	414	184	150	50	877	
JUNE					289	1007	58	150	0	1504	
JULY					24	1734	68	150	0	1976	
AUGUST						1972	386	150	0		

* 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.

Table 21:- 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	Equities	Bonds	Euro-Sterling (*)	TOTAL	Sterling	Foreign Currency	TOTAL
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		471	209	350	1030	12328	2362	14690
Q2	5465	5083	10548		1369	344	325	2038	12586	1575	14161
Q3	5764	5592	11356		1431	290	231	1952	13308	3688	16996
Q4	10433	4667	15100	65	2339	-52	281	2633	17733	591	18324
1987											
Q1	7037	3464	10501	312	1558	-781	1231	2320	12821	7358	20179
Q2	8585	4240	12825	588	2231	346	740	3905	16730	4633	21363
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	16	1403	198	297	1913	13989	2054	16043
1987											
H1	7811	3852	11663	450	1895	-218	986	3113	14776	5996	20771
1987											
JANUARY	1316	1304	2620	150	500	-67	110	693	3313	1368	4681
FEBRUARY	2594	980	3574	85	870	20	315	1290	4864	2404	7268
MARCH	3127	1180	4307	77	183	-735	806	331	4638	3586	8224
APRIL	1333	1590	2923	193	828	110	440	1571	4494	1242	5736
MAY	2222	1295	3517	79	414	184	150	827	4344	2635	6979
JUNE	5032	1355	6387	289	1007	58	150	1504	7891	756	8647
JULY	4639	1302	5941	24	1734	68	150	1976	7917	-2239	5678
AUGUST					1972	386	150				

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

TABLE 22 SECRET

FUNDING AND MONEY MARKET ASSISTANCE - FINANCIAL YEAR 1987/88

	APR-JUL 1987	£ million u/a	
CGBR	3755		
Gilt sales to nbps and overseas (inc-)	-3357		
Other CG debt sales to nbps incl Treasury bills* (-)	-1228		
CG external and fc finance other than BGS(-)	4434		
Funding of the CGBR Over(-)/under(+)	**3604**		**3604**
		Other BGS sales (-)	1548
OPS net of on lending	-3091	Other CG debt sales (-)	-780
OPS debt sales to nbps(-)	1388	Notes and coins (-)	-1020
OPS currency finance(-)	27	Other incl exchequer (-)	-559
Funding of OPS Over(-)/under(+)	-1676	CG bank deposits (+)	-188
Funding of PSBR Over(-)/under(+)	**1928**	**Total influences* (surplus+,shortage-)**	**2605**
		Change in bankers deposits (-)	100
		Change in level of assistance (+) #	**-2705**
		of which	
		Issue Department bills	331
		Banking Department bills	1436
		Market advances	-1341
		Repos	-3131
		Level of assistance	
		End March 1986	**13317**
		End March 1987	**9742**
		End July 1987	**7038**

* Treasury bills usually included below the line in the Money Market Assistance Table

\# Surplus on influences leads to a fall in assistance and vice versa

TABLE 23 SECRET

MONETARY AGGREGATES : FORECAST GROWTH RATES

percent

Not seasonally adjusted			M0	M3	M4	M5
1 MONTH % CHANGE TO:						
1987 MAY			0.3	2.0	1.3	1.4
JUNE			-0.6	1.1	1.5	1.4
JULY			2.8	2.5	1.9	1.9
AUG	)	*	0.1	1.3	0.9	0.9
SEP	) FORECAST		N/A	0.8	0.8	0.8
OCT	)		N/A	1.2	0.8	0.6
12 MONTH % CHANGE TO:						
1987 MAY			4.4	19.0	13.7	13.5
JUNE			4.2	19.2	13.9	13.6
JULY			5.3	20.9	14.9	14.6
AUG	)	*	4.5	22.1	15.5	15.0
SEP	) FORECAST		N/A	19.4	14.6	14.2
OCT	)		N/A	19.8	14.3	13.8
Seasonally adjusted						
1 MONTH % CHANGE TO:						
1987 MAY			0.5	2.1	1.4	1.6
JUNE			0.2	1.0	1.3	1.3
JULY			1.2	2.3	1.8	1.8
AUG	)	*	0.3	1.5	1.3	1.3
SEP	) FORECAST		1.0	0.7	0.4	0.4
OCT	)		0.4	0.9	0.6	0.5
12 MONTH % CHANGE TO:						
1987 MAY			4.4	18.9	13.5	13.4
JUNE			4.2	19.1	13.7	13.5
JULY			5.4	20.8	14.8	14.4
AUG	)	*	4.7	22.2	15.4	15.0
SEP	) FORECAST		5.2	19.3	14.5	14.1
OCT	)		5.6	20.3	14.4	14.0

* August out-turn for M0

SECRET

TABLE 24: MO FORECAST

SEASONALLY ADJUSTED

	LEVELS £ MILLION			% CHANGE ON PREVIOUS MONTH		% CHANGE ON YEAR EARLIER	
	Notes and coin	Bankers' Deposits	MO	Notes and coin	MO	Notes and coin	MO
ACTUAL							
Jan	14,947	157	15,104	+0.1	-0.5	+5.5	+5.1
Feb	14,811	165	14,976	-0.9	-0.8	+4.3	+4.1
Mar	14,808	232	15,040	-0.0	+0.4	+3.8	+4.1
April	14,902	204	15,106	+0.6	+0.4	+4.6	+4.8
May	14,975	204	15,179	+0.5	+0.5	+4.5	+4.4
June	15,070	137	15,207	+0.6	+0.2	+4.6	+4.2
July	15,154	234	15,388	+0.5	+1.2	+4.7(4.8)	+5.4(5.1
August	15,259	182	15,441	+0.7	+0.3	+4.6(4.5)	+4.7(4.7
FORECAST							
September	15,380	220	15,600	+0.8	+1.0	5.1(4.9)	5.2(4.8
October	15,465	190	15,655	+0.6	+0.4	5.2	5.6
November	15,530	190	15,720	+0.4	+0.4	4.9	5.0
December	15,600	190	15,790	+0.5	+0.4	4.4	4.0
January	15,650	190	15,840	+0.3	+0.3	4.7	4.9
February	15,690	190	15,880	+0.3	+0.3	5.9	6.0
March	15,730	190	15,920	+0.3	+0.3	6.2	5.9

* last month's forecast in brackets.

SECRET

TABLE 25 BROAD AGGREGATES FORECAST

£ mn u/a

	OUTTURN 1987 JULY	FORECAST AUG	SEP	OCT
1. CG (OA) (SURPLUS-)	-345	1200	375	-1200
2. LABR	186	250	-175	-300
3. PCBR	-261	-50	125	150
4. PSBR(1+2+3)	-420	1400	325	-1350
5. NET DEBT SALES TO NBPS (-)				
GILTS	631	-100	-225	-725
TREASURY BILLS etc	-17	50	50	50
NATIONAL SAVINGS	-178	-250	-150	-75
CTDs	88	0	250	150
OPS DEBT	192	50	100	150
TOTAL	716	-250	25	-450
6. EXTERNAL FINANCE OF PUBLIC SECTOR (INC-)	-788	-450	150	25
7. OVER (-)/UNDER (+) FUNDING (4+5+6)	-492	700	500	-1775
8. STERLING LENDING TO NON-BANK PRIVATE SECTOR	4566	2050	3950	3350
(seasonally adjusted)	(4862)	(3000)	(2950)	(3500)
9. PRIVATE NET EXTERNALS AND NET NON-DEPOSIT LIABILITES	125	-550	-2975	550
10.M3 (7+8+9)	4199	2200	1475	2125
BUILDING SOCIETIES:				
11. RETAIL DEPOSITS	1052	675	975	600
12. WHOLESALE DEPOSITS NBPS	294	150	100	100
13. HOLDINGS OF M3 (-)	-235	-575	-175	-550
14.M4 (10+11+12+13)	5310	2450	2375	2275
15.MONEY MARKET INSTRUMENTS	279	0	-25	-350
16.NATIONAL SAVINGS BANK	64	75	75	75
17.M5 (14+15+16)	5653	2525	2425	2000

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TABLE 26: MONEY MARKET INFLUENCES

£ million
not seasonally adjusted

	Actual		Forecast	
1987	JULY	AUG	SEP	OCT
A. Money market influences				
(i) CGBR (+)	-431	808	575	-1150
(ii) Reserves etc (+)	337	-325	-25	-125
(iii) Notes and coin (-)	-732	-102	475	-375
(iv) National Savings (-)	-169	-233	-150	-100
(v) CTDs (-)	90	16	250	150
(vi) Gilts (-)	-453	-267	-375	-900
(vii) Other Exchequer items etc	-473	334	0	0
A. TOTAL MONEY MARKET INFLUENCES (Market surplus + / shortage -)	-1831	231	750	-2500
B. Money market operations				
(i) Commercial bills (purchase +):				
Issue Department - outright	1373	-349		
- repo terms	0			
Banking Department	515	-463		
(ii) LA bills (purchase +)				
Issue Department	54	17		
Banking Department	54	-57		
(iii) Treasury bills (purchase +)	-46	690	500	300
(iv) Market advances	-90	-72		
(v) Export Credit/Shipbuilding Repos	0			
(vi) Gilt Repos	0			
B. TOTAL MONEY MARKET OPERATIONS	1860	-234	-750	2500
C. Change in bankers balances = A + B	29	-3		
D. TOTAL ASSISTANCE OUTSTANDING (excluding Treasury bills) = previous level + B - B(iii)	7038	6114	4864	7064
of which commercial bills	6620	6017	4767	6967

TABLE 27

SECRET

GOVERNMENT SHARE SALES: TIMETABLE

1987

23 September		Rolls-Royce II
15 October	(lists 16 October)	BP I

1988

19 April	BGC III
19 May	BAA II

10 DOWNING STREET

Prime Minister

The Italians have requested $800m through the EEC swap arrangements.

You will want to discuss with the Chancellor on Monday. (A decision is needed then.)

The letter below (DATED 13.1.77) sets out the background, from an earlier request by the Belgians which was not carried through.

DCW

11/9.

RC2.51 COVERING CONFIDENTIAL

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

7 September 1987

David Norgrove Esq
10 Downing Street
LONDON
SW1

Dear David,

FINANCIAL MARKETS

You asked for a note on developments in the financial markets since the Chancellor and the Prime Minister last met (ie. just before the 6 August base rate rise). This is attached.

Yours Cathy

CATHY RYDING
Assistant Private Secretary

FINANCIAL MARKETS SINCE 5 AUGUST

The attached table and graphs show the main developments in domestic and foreign exchange markets since before the 1 per cent base rate rise on 6 August. Domestic markets, in particular the equity market, have been jumpy at times, with market makers, depleted by absences on holiday, unwilling to take positions and moving prices sharply without any great volume of business. They now appear to have settled down, with share prices some 7 per cent below their all-time high in mid-July. In the foreign exchange market the main factor has been the strength of the dollar in early August, partly reflecting Gulf tensions, reaching a peak of over DM 1.89 (with the $/£ rate under 1.56); and its subsequent decline following the disappointing US trade figures on 14 August, to below DM 1.80 (with this $/£ rate above 1.65).

5-7 August

2. Although unexpected, the 1 per cent rise in interest rates announced on 6 August had little impact in the foreign exchange market: the DM/£ rate remained steady at DM 2.96½. Much of the initial comment welcomed the move as a sensible tightening of policy made, as the Chancellor explained, on an assessment of a range of evidence. Nevertheless both gilts and equities fell sharply, with market participants fearing the interest rate rise meant the authorities knew of bad news on the way.

10-14 August

3. There was a particular worry that the June trade figures published on 11 August would be bad. When in the event the June current account deficit turned out to be much less than the £½ billion May deficit the market began to settle down, with both the gilt and equity markets gradually recovering though not to their 5 August levels. By Friday 14 August the three month interbank rate had settled back to 10 per cent.

17-21 August

4. The next event was publication of the July money figures, on 20 August. Again it was the gilt market, and to some extent the equity market, which fell sharply - with commentators focussing particularly on the high bank lending figure. Long gilt yields rose well above 10 per cent, reaching the highest level since January. There was little impact on the exchange rate, with the ERI on Friday 21 August standing at much the same level as a week earlier, despite a falling oil price.

24 August - 4 September

5. The pre-Bank Holiday week was relatively quiet in all markets, with domestic markets beginning to look ahead to the July trade figures published on 1 September. The current account deficit (over £300m) was at the top end of the range of market expectations, and all markets - including the exchange rate - initially fell a little. But they subsequently recovered on second thoughts about the closer analysis of the trade figures. On the following day the announcement of a larger than expected fall in the reserves in August had no effect; and the Chancellor's remarks on the radio at midday helped take both gilts and the exchange rate ahead (with the Bank taking the opportunity to intervene to steady sterling's rise, and recoup some of the dollars spent defending sterling against the dollar at the beginning of August).

6. The main focus of attention in recent days has been the weakness of the dollar. There has been concerted intervention by central banks (including the Fed) to support the dollar on most days since 28 August, and the Fed raised its discount rate on 4 September by ½ per cent, to 6 per cent, the first change in the discount rate since it was lowered to 5½ per cent in August 1986 and the first increase since 1984. (This move had little immediate impact on the dollar, which remained below DM 1.80).

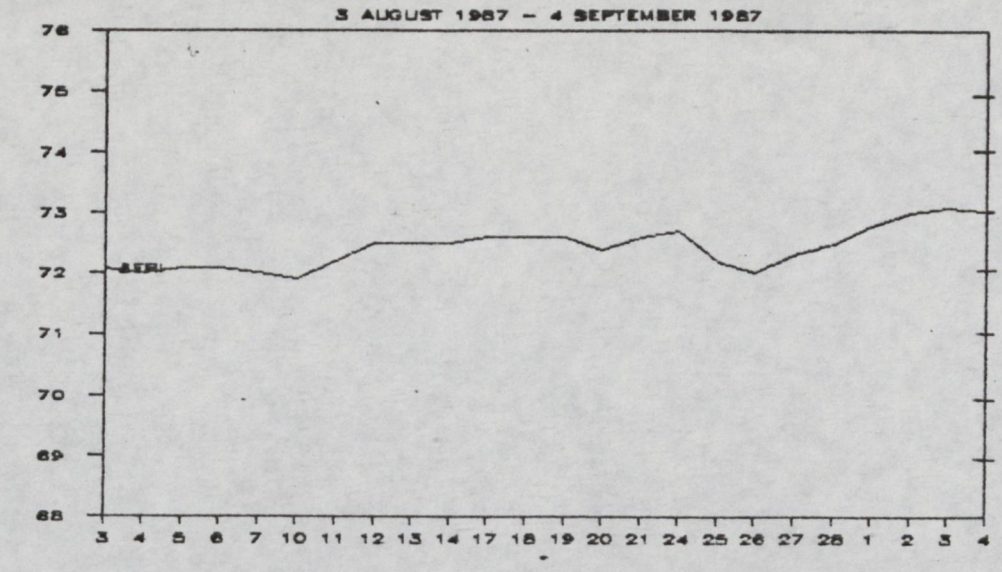
4 September 1987

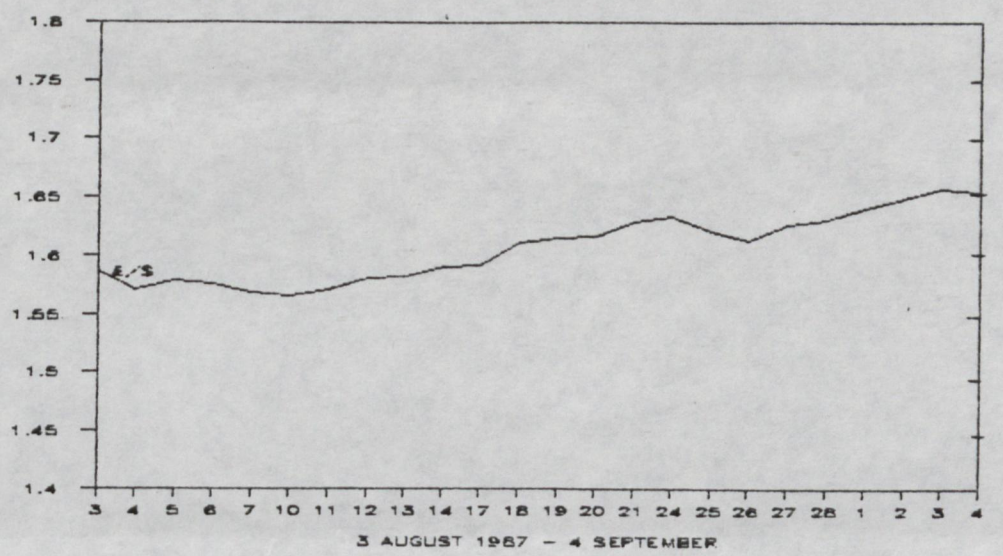
MARKET MOVEMENTS SINCE 5 AUGUST (CLOSING RATES)

	£(ERI)	3 month interbank	gilt index	Equities (FTSE 100 index	Oil Price spot Brent $ per barrel
August					
Wed 5	72.1	$9^{5}/_{16}$	87.63	2317	20.05
Fri 7	72.0	$10^{7}/_{32}$	86.24	2226	19.55
Tues 11	72.2	$10^{1}/_{8}$	86.57	2276	19.20
Fri 14	72.5	10	86.93	2295	19.25
Wed 19	72.6	$10^{3}/_{16}$	86.36	2198	18.60
Thurs 20	72.4	$10^{5}/_{16}$	84.74	2185	18.35
Fri 21	72.6	$10^{3}/_{16}$	85.02	2206	18.40
Fri 28	72.5	$10^{7}/_{16}$	84.87	2250	18.47
September					
Tues 1	72.8	$10^{7}/_{16}$	85.19	2273	18.42
Fri 4	73.0	10¼	85.71	2275	18.20

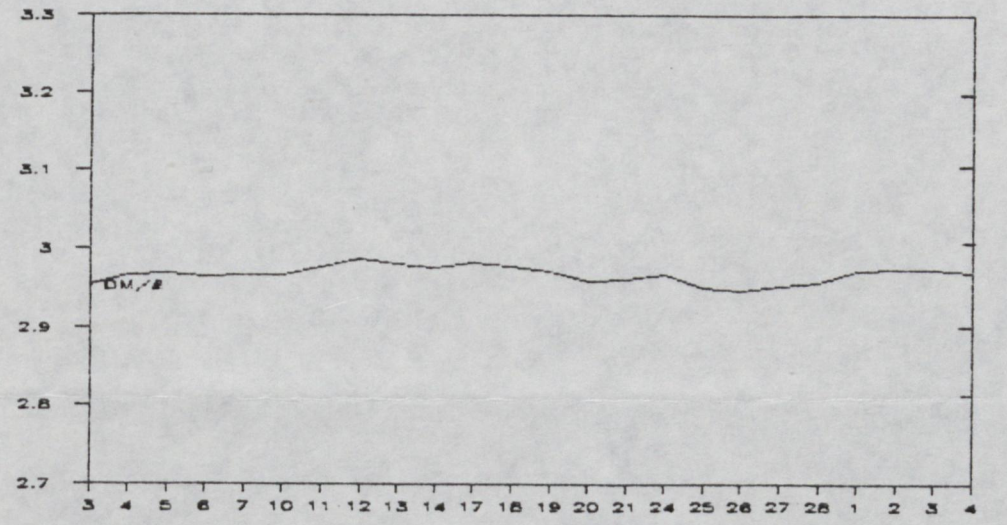
MOVEMENTS IN STERLING

3 AUGUST 1987 – 4 SEPTEMBER 1987





3 AUGUST 1987 – 4 SEPTEMBER



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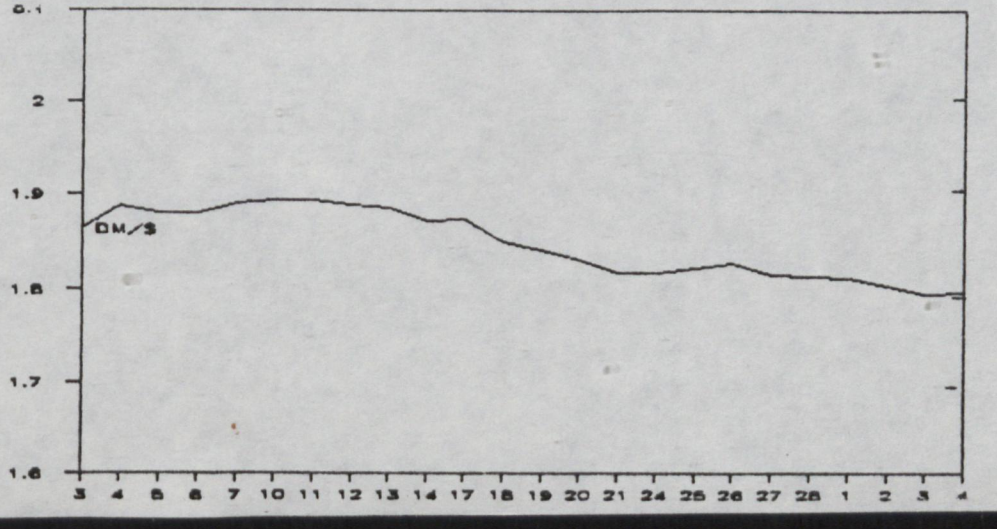

SECRET AND PERSONAL

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10 DOWNING STREET

LONDON SW1A 2AA

From the Principal Private Secretary

6 August 1987

Dear Alex.

INTEREST RATES

The Prime Minister discussed with the Chancellor of the Exchequer this morning his proposal for a one per cent increase in interest rates.

The Chancellor of the Exchequer said that the market's reaction to the forthcoming trade figures would depend on its underlying tone. Information on the forthcoming money figures was based on a first guess and partial information, but it looked as if they would be a source of concern to the market. A particularly worrying feature was the indication of the underlying growth in MO, which was a good indicator of monetary conditions. Since he had last spoken to the Prime Minister there had been a slight deterioration in the tone of the markets, and sterling had drifted down despite some support. He remained of the view that it would be prudent to increase interest rates now. Monetary conditions were loose and we would regret it in the Autumn if there was not an increase now. Monetary policy was no longer bearing down on inflation. We could not afford to continue with a relaxed monetary stance or risk a gradually depreciating exchange rate. Without an increase in interest rates the chances of reducing inflation in the medium term would be reduced. He did not expect that one per cent increase in interest rates would reduce growth in any significant way. Of course inflation in the short term would be higher, for example, because the building societies would not proceed with the mortgage rate cuts envisaged for next month (which would add some 0.1 per cent to the RPI). But in the medium term an increase in rates now would reduce the level of inflation below what it would otherwise have been.

The Prime Minister said that she was most unconvinced about the need for any increase in interest rates. Sterling had maintained its position better than other currencies in the face of recent dollar strengthening. An increase in interest rates would be associated with tensions in the Gulf and could lead to damaging financial repercussions throughout world financial markets. A one per cent increase in rates would look as if the Chancellor was defending a particular exchange rate prior to entry into the EMS. She feared that it

DTS

would increase unemployment and inflation damaging those sections of society whom the Government wished to help most. It would make it harder for exports at the very time when the current account needed strengthening. Nor should it be overlooked that the total borrowing (public and private) was down, and that the fiscal stance was tighter than had been expected. She feared too that the increase in interest rates would come just at the wrong moment when the economy was beginning to slow down on its own accord.

After further discussion, the Prime Minister said that she would not wish to stand in the Chancellor of the Exchequer's way if he was intent upon the increase in interest rates. He should make himself responsible for the public presentation of the increase by giving many TV and radio interviews over the next few days. The arguments of Labour Party spokesmen like Mr. Gould and Mr. Hattersley, had to be countered right from the beginning.

Finally, the Prime Minister said that she would welcome a note on bankers' balances held at the Bank of England, indicating the factors which determined their level and the significance, if any, that they had for monetary policy. She also asked the Chancellor to consider whether it would be worthwhile to make arrangements so that the authorities had earlier information about the direction of bank lending.

Nigel Wicks

(N. L. WICKS)

Alex Allan, Esq.,
HM Treasury.

4317.8

CONFIDENTIAL

Prime Minister (2)
The figures were released Friday. MEA 4/8

ERMP C/8

FROM: I POLIN
DATE: 3 August 1987

1. MR KELLY
2. ECONOMIC SECRETARY

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Mr Grice
Mr Culpin
Ms Goodman
Mr Pickford
Mr Cropper

THE RESERVES IN JULY 1987

The reserves announcement for July will be made on Tuesday 4 August at 11.30 am. This month's announcement reports a rise in the reserves of $551 million and an underlying rise of $499 million.

I POLIN

Mr Norgrove - No 10
Mr Lankester - Washington (after publication)

Mr Gill)
Mr D J Reid)
Mr J Milne) - B/E
Miss J Plumbly)
Mrs Jupp)

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thereafter UNCLASSIFIED

DRAFT PRESS NOTICE

THE RESERVES IN JULY 1987

The UK official reserves rose by $551 million in July. Accruals of borrowing under the exchange cover scheme amounted to $150 million; repayments of such borrowing amounted to $141 million. Capital repayments on assignments to HMG of other public sector debt taken out under the exchange cover scheme amounted to $14 million. The valuation change arising out of the quarterly rollover of the EMCF swap amounted to a rise of $57 million. At the end of July, the reserves stood at $34,915 million (£21,915 million*) compared with $34,364 million (£21,311 million+) at the end of June.

Note to Editors

2. After taking account of foreign currency borrowing and repayments, the underlying rise in the reserves during July was $499 million. The underlying change in the reserves is the result of a variety of transactions, both debits and credits, including, for example, transactions for Government departments and with other central banks, and interest receipts and payments. The underlying change should not therefore be taken as an indication of market intervention during the month. The above figures can also be obtained from the Reuters Monitor (Code TREA).

3. New borrowing under the public sector exchange cover scheme was as follows:

British Coal, $68 million; South of Scotland Electricity Board, $50 million; Yorkshire Water Authority, $32 million.

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* When converted at the closing market rate on Friday 31 July £1=$1.5932

\+ When converted at the closing market rate on Tuesday 30 June £1=1.6125

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Repayments of such borrowing were:

British Coal, $89 million; Electricity Council, $27 million; Northumbrian Water Authority, $13 million; British Telecommunications PLC, $4 million; South West Water Authority, $3 million; North of Scotland Hydro Electricity Board, $1 million; Shetland Islands Council, $1 million; Yorkshire Water Authority, $1 million; Others, $2 million.

4. The quarterly rollover of the EMCF swap, ie 20 per cent of the UK's gold and US dollar reserves, entailed a valuation increase of $57 million. This largely reflects the rise in the ECU value of gold, as valued by the EMCF. For the purposes of the swap, the EMCF values gold and dollars in terms of ecus at the end of each quarter, whereas the UK values gold and ecus held in the reserves on an annual basis.

THE RESERVES IN JULY 1987 : PRESS BRIEFING

Factual : main features of markets in July

	£ ERI	$/£	DM/£	$ ERI	DM/$	Yen/$
1 July	72.3	1.61½	2.95	102.2	1.82½	146½
6 July	72.8	1.61½	2.97½	103.1	1.84	149½
13 July	73.1	1.62	2.98	103.2	1.84	151
22 July	72.6	1.59½	2.97	104.0	1.86½	152½
27 July	72.5	1.60	2.96½	103.7	1.85½	150
31 July	72.3	1.59½	2.96	103.7	1.86	150

Sterling traded mainly on the sidelines in the first half of the month but rose from 72 to 73 in effective terms as the oil price rose above $20 a barrel for the first time in nineteen months. After publication of disappointing US trade data on 15 July, sterling rose against the dollar and the deutschemark to touch highs for the mcnth of $1.64 and DM2.99¾. The publication of worse than expected May UK trade figures and bank lending figures pushed sterling below $1.60, but it ended the month ~~around~~ at 72.3 in effective terms.

The dollar opened the month trading steadily around DM1.82½ and Yen 146½. It rose on comments from Nakasone that the yen decline was in accordance with G7 wishes and publication of a reduced Japanese trade surplus. But upward movement was limited by fear of central bank intervention. Following publication of worse than expected US trade data on 15 July the dollar fell sharply to around DM1.83 and Yen 148¼, but advanced later on good economic figures, including a 2.6% rise in US Q2 GNP. It closed the month on a quiet note around DM1.86 and Yen 150.

Previous reserve changes

(i) Reserve changes in recent months have been:

$ million

		Underlying Change	Total Change
1986	September	- 372	+ 3502
	October	- 668	- 434
	November	+ 35	+ 14
	December	+ 96	- 83
1987	January	+ 72	+ 29
	February	+ 287	+ 305
	March	+ 1785	+ 1892
	April	+ 2912	+ 2768
	May	+ 4760	+ 4872
	June	- 230	- 315
	July	+ 499	+ 551

Bank Base Rates

Base rate changes in recent months have been:

		Base Rate	Change
1987	10 March	10½	Down ½%
	19 March	10	Down ½%
	29 April	9½	Down ½%
	11 May	9	Down ½%

POSITIVE

1. Reserves ~~very~~ strong after ~~recent months of~~ substantial underlying increases in first half of the year.

2. Sterling has remained broadly stable, in line with February agreement at the Louvre, which is holding well.

DEFENSIVE

1. **Exchange rate policy.** Chancellor made clear that period of stability for sterling and other currencies highly desirable. Actions in recent months bear this out.

[Chancellor said in speech to CBI annual dinner on 19 May:

> "I allowed, last year, a proper adjustment in the exchange rate as we lost, in short order, half the value of our oil. I made clear in the autumn that the adjustment had gone far enough. I have made equally clear this Spring that I do not want to see it reversed. And I have shown, as plainly as possible, that I share the overwhelming view of British industry that a period of exchange rate stability is now highly desirable".]

2. **Louvre accord?** Reaffirmed at Venice Summit. Has now successfully produced six months of exchange rate stability. Recorded intervention of G7 countries shows commitment translated into action.

3. **May trade deficit ~~shows~~ fall in exchange rate needed to maintain competitiveness?** ~~Non-oil visible trade responding to 1986 exchange rate adjustment. Chancellor already said period of stability desirable. Vital that pay settlements are kept under control if existing gains in competitiveness are to be maintained.~~ Current account deficit only to be expected at a time when UK growth well above slow world growth. In any case, should ~~not~~ never read too much into one month's figures.

4. **Details of intervention?** Policy never to discuss.

5. **Implications for funding?** Policy is full fund of PSBR over financial year as a whole. Other things being equal increases in reserves require additional sales of debt to achieve a given quantity of funding. Funding programme well on course.

6. **UK membership of ERM.** No change in Government position. Matter kept under continual review. Will join when satisfied that balance clearly favours doing so.

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TABLE 3 - G7 TOTAL PUBLISHED RESERVES

$ billion

	Total Reserve changes during month	Level at end of month
USA	- 2.2	47
Japan	+ 0.5	70
Germany	- 0.7	51
France	+ 0.4	66
Italy	- 1.4	51
Canada	+ 0.6	6
United Kingdom	+ 0.~~5~~6	35

Source: Reuters.

Notes

1. Figures converted to dollars at end June exchange rates.

2. Figures not strictly comparable because of different valuation conventions for eg gold. They relate to end-June except for USA figures, which are for end-April and UK and Japan, which are for end-July.

6

PRIME MINISTER 2

INTEREST RATES

The Chancellor's ardour for an increase in base rates may be cooled by the fact that he would have to come back from his constituency to talk to you. But if he does, I guess he is likely to come to see you on Friday next week or Monday the following week. The first guess for the money numbers would not in the usual way be known until Tuesday 11 August (the day the July balance of payments figures are due to be published), but the Bank of England may have an indication a day or two before that.

If the figures are bad, particularly those for bank lending, the pressure for an increase in base rates is likely to be difficult to resist, and it would probably be wrong to do so. If they are bad enough the markets will anyway take interest rates up and the question will become one of market tactics - whether it is better for the Government to act in advance or not.

If the figures provide no clear signal for an increase, points you will wish to bear in mind include the following:

- the faster rate of growth in MO in the first half of the year was foreseen at the time of the Budget, and the latest monetary forecast shows a figure of 5.1 per cent in July, declining to 4.7 per cent in August and 4.8 per cent in September; the growth of MO in the second half of 1987 is however forecast to be higher than expected at the time of the Budget;

- the PSBR seems to be turning out much lower than expected at the time of the Budget, and the June forecast suggested an outturn for the year of around £1 billion as against nearly £4 billion at the time of the Budget, ie. the fiscal stance is tighter than expected;

- the growth of house prices seems to have slackened a little, down to an annual rate of 14.3 per cent in June compared to a peak of 15.2 per cent in March;

- the CBI survey showed an encouraging lack of concern about capacity constraints except perhaps in the area of skilled labour;

- it is not surprising that inflation is at present running rather high, given our present rate of growth of 4 per cent or more; that rate of growth is unlikely to be sustained and as it eases so too should concerns about inflationary pressures;

- the current account so far this year is still in surplus; we are a long way short of the £2½ billion forecast at the time of the Budget and the June forecast showed a deficit of only £½ billion for the whole year;

- total borrowing has fallen since 1979 from 13 per cent of GDP to 11 per cent and personal financial assets have grown faster than liabilities.

The Chancellor may emphasise the risks to the exchange rate. This goes with his wish to become a full member of the EMS. But there is no need to tie yourself to that particular hook: the exchange rate commitment is his, not yours. The most worrying combination would be a falling exchange rate with poor current account and money numbers.

DAVID NORGROVE
31 July 1987

SLHAME

SECRET

ALH.DLV
S file

SUBJECT cc MASTER

10 DOWNING STREET

LONDON SW1A 2AA

28 July 1987

From the Private Secretary

Dear Alex,

INTEREST RATES

The Prime Minister this afternoon held a meeting to discuss interest rates. There were present the Chancellor of the Exchequer, the Governor of the Bank of England and Sir Peter Middleton.

The Chancellor recalled that in an earlier discussion he had said that if there were an opportunity to raise base rates by half a per cent, that would be desirable. The economy appeared now to have a lot of steam behind it, and credit was growing particularly fast. There were widespread concerns - though in some cases greatly exaggerated - that the economy was growing too fast for comfort, and the markets were edgy. The position would be eased if the Government gave a clear signal that it remained firm in its intention to keep financial conditions adequately tight. This would reduce the risk of difficulties in the autumn and possibly the need for an increase greater than half a per cent. It would be undesirable for the Government to be pushed by events.

The Prime Minister was not convinced that an increase in base rates was needed now. Total borrowing had fallen as a proportion of GDP since 1979 from 13 per cent to 11 per cent, so it was difficult to argue that there was excessive growth of credit. The disturbing scale of the settlement backlog at the Stock Exchange might also be a factor. The tone of the markets had improved today, and there was little evidence of edginess. Moreover, personal assets had increased by more than liabilities and of the deterioration in the current account in May, only a quarter was attributable to imports of consumer goods. It would in any case be wrong to take action on the basis of one month's figures. The June forecast had shown a substantially better prospect for the current account than the Budget forecast. An increase in base rates now would damage confidence and might well simply create a higher base for another increase in interest rates. Indeed the markets might well react badly to an increase, believing that the Government was aware of bad news not known to them.

In further discussion the Governor argued that the markets expected the next move in interest rates to be upwards, and the only question was one of timing. The yield

curve now sloped upwards. The Chancellor agreed with the Prime Minister that many of the fears now being expressed were exaggerated. Nevertheless, his judgement was that conditions now warranted a small tightening. Figures for the past several months, including those for MO, supported this view. The confidence of the markets was of the first importance. Sir Peter Middleton noted that the growth of money GDP was uncomfortably high, and that there were at present poor prospects for a further reduction in the underlying rate of inflation.

Concluding the discussion, the Prime Minister said that the figures for monetary growth in July and the balance of payments in May had been known last week. An increase in base rates now would lead to accusations that the Government had simply delayed taking action until the Parliamentary recess. The June balance of payments figures would be known a few days before 11 August and there might also by then be indications of monetary growth in July. The need for an increase in base rates could be reconsidered if these figures suggested a case for action.

I am copying this letter to John Footman (Governor of the Bank of England's office).

Yours,

David.

DAVID NORGROVE

Alex Allan, Esq.,
H. M. Treasury

SECRET AND PERSONAL

4

SUBJECT cc MASTER

ECL

EL3CDP.

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

27 July 1987

INTEREST RATES

The Prime Minister and Chancellor this morning discussed policy towards interest rates.

The Chancellor noted that the CBI survey to be published tomorrow showed good results. However there was concern about the high rate of growth of the economy and there were signs of some looseness in financial conditions. Action now to raise rates by a half per cent would avoid the Government giving an appearance of reluctance, and might forestall a possible larger increase later.

The Prime Minister was very doubtful about the wisdom of an increase now. It could have an effect on mortgage rates, pushing up the RPI ahead of the September figure on which social security upratings were based. It would also harm exporters and this would be particularly damaging at a time when exports seemed to be turning down. An increase now would simply raise the starting level for any further increases.

The Chancellor noted that he might need to return to the Prime Minister on this within the next week or so.

DAVID NORGROVE

Alex Allan, Esq.,
H.M. Treasury.

SECRET AND PERSONAL

3

2

PRIME MINISTER

JUNE ECONOMIC FORECAST

The general picture painted by this forecast is of an economy growing very strongly in 1987, perhaps too strongly, growing at a rate more in line with productive potential in 1988, and with somewhat lower growth in 1989. The forecast beyond the next 18 months is however very unreliable. There is no further progress on inflation, and, indeed, inflation is expected to rise to over 5 per cent in 1988, after a temporary dip below 4 per cent towards the end of this year and in the first few months of next. The forecast assumes that next year, unlike this year, specific duties will be indexed.

In more detail, output this year, excluding North Sea Oil, is expected to grow by 4.1 per cent, a full one per cent higher than expected at the time of the Budget. This results, in part, from a better performance on trade, with the current account deficit this year put at only £0.5 billion. Consumers' expenditure is expected to rise by 3.7 per cent. Of particular interest is the forecast strong increase in investment, of 4 per cent in manufacturing and of 9 per cent elsewhere (excluding oil). Manufacturing output is expected to grow by just under 5 per cent.

Unemployment is expected to come down to about 2.75 million at the end of this year and to about 2.6 million at the end of 1988.

Strong growth is expected to have an effect on prices and costs. Total costs in manufacturing may rise by 3 to 4 per cent a year, and there are signs of an upturn in earnings growth, in the private sector, and particularly in local authorities, where average earnings "could easily rise by almost 9 per cent next year".

The forecasters expect out-turns for the public expenditure planning total in 1988/89 and 1989/90 that are respectively £5 billion and £11 billion above the current plans. About half of the over-spend is accounted for by social security and local authority current spending. But because inflation is expected to be higher, the level of expenditure in real terms is forecast to be a little below the level currently implied by the plans in 1988/89 and much the same in 1989/90. Revenues are extremely buoyant and the forecast is for a £7.4 billion fiscal adjustment in 1988/89. This is assumed to go half to reducing personal taxes and half to reducing the PSBR, giving a PSBR in 1988/98 of £0.8 billion following a forecast out-turn for this year of £1 billion.

Other points which are of interest include:

(i) the forecasters draw attention to a much improved trade performance since the early 1980s, with a faster response to better competitiveness and, at worst, stability in our share of world markets;

(ii) house building is responding strongly to higher house prices, with private housing starts up by about 20 per cent between the first quarters of 1986 and 1987; in London private house starts rose by almost 20 per cent in 1986 and by almost 80 per cent over the year to the first quarter of 1987;

(iii) higher electricity and gas prices are expected in the second half of next year;

(iv) the Treasury expect labour supply growth of around 660,000 in the three years to mid-1989 (put higher than a Department of Employment forecast because of the effects of strong growth) compared with 840,000 over the three years to 1986;

(v) exceptionally large direct investment overseas is forecast this year, dominated by BP's acquisition of Sohio.

Inflation and cost growth must be a central cause of concern in this forecast. This puts me in mind of your discussion with Sir Alan Walters about how core inflation in this country can be further reduced. But this is not, at present, a question to raise with the Chancellor.

DLW

D.R.N.
17 July 1987

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2 Q 284

H M Treasury

Parliament Street London SW1P 3AG

Switchboard 01-270 3000

Direct Dialling 01-270 4360

Sir Peter Middleton KCB
Permanent Secretary

13 July 1987

D R Norgrove Esq
10 Downing Street
London SW1

Dear David

TREASURY ECONOMIC FORECAST

I enclose two copies of this year's Summer Forecast, one for the Prime Minister and one for Brian Griffiths. As usual, these copies are on a personal basis for the Prime Minister, Brian Griffiths, Nigel Wicks and yourself only.

Yours

R B SAUNDERS

SECRET

Copy No 12

TREASURY ECONOMIC FORECASTING EXERCISE

JUNE 1987 REPORT

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TREASURY ECONOMIC FORECASTING EXERCISE

REPORT BY EA AND PSF

(1) INTRODUCTION AND SUMMARY OF MAIN RESULTS

The forecast covers the period to the end of 1990 (financial year 1990-91 for public finances). Table 1 summarises the results.

(a) Assumptions

(i) **Short term interest rates** are set in order to keep the sterling index at 72 from now on, close to the present level and slightly above that at the time of the Louvre agreement. This involves short term interest rates rising gradually through the period. It yields a path for money GDP above that envisaged in the 1987 MTFS.

(ii) The forecasters attempt to predict the level of **public expenditure** that will occur. The forecast therefore implicitly includes judgements both on the results of the annual rounds of Ministerial discussions and on how the evolution of the economy will influence demand led public expenditure. (The annex to this paper summarises the assumptions on particular categories of public expenditure.)

(iii) For the current financial year (1987-88) there is a forecast for the **PSBR** on the basis of existing tax rates and the best available assessment of the outcome for public expenditure. For the latter years - 1988-89 and 1989-90 - the forecast shows a very large cumulative fiscal adjustment if the PSBR ratios are set at 1 per cent and privatisation proceeds are assumed to be £5b. The forecast adopts the procedure used in the January forecast and assumes that half of the fiscal adjustment goes to reduce the PSBR (below the 1987 MTFS ratios) and half to reduce personal taxes.

(b) Main results

(i) Both **GDP** and **domestic demand** in the UK are likely to grow more rapidly in 1987 than previously envisaged by the majority of forecasters, despite weaker growth in the other G7 economies. Growth of manufacturing output in the UK could be almost 5 per cent in 1987. Growth in 1987, clearly above the recent trend is

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TABLE 1 : SUMMARY OF FORECAST

		JANUARY 1987	FSBR 1987	SUMMER 1987	AVERAGE OUTSIDE FORECAST JUNE 1987
A	**THE WORLD ECONOMY**				
1.	GNP (MAJOR 7 EXCLUDING UK)				
	(per cent change on a year earlier)				
	1986	2.6	2.6	**2.5**	
	1987	2.9	2.6	**2.3**	
	1988	3.0	3.0	**2.8**	
	1989	2.9	3.0	**2.8**	
2.	DOMESTIC DEMAND (MAJOR 7 EXCLUDING UK)				
	(per cent change on a year earlier)				
	1986	3.8	3.8	**3.7**	
	1987	3.3	3.0	**2.6**	
	1988	3.1	3.2	**2.8**	
	1989	2.8	3.0	**2.8**	
3.	WORLD TRADE IN MANUFACTURES				
	(weighted by UK market shares)				
	(per cent change on a year earlier)				
	1986	1.7	2.4	**2.1**	
	1987	3.6	3.4	**2.6**	3.8
	1988	4.1	4.1	**3.2**	4.2
	1989	4.8	5.0	**4.3**	
B	**UK ACTIVITY AND DEMAND**				
4.	GDP VOLUME (non-North Sea GDP in brackets)				
	(per cent change on a year earlier)				
	1986	3.0(2.9)	2.6(2.7)	**2.8(2.9)**	
	1987	3.1(3.4)	3.0(3.1)	**3.9(4.1)**	3.0
	1988	2.5(3.2)	2.4(2.9)	**2.3(2.8)**	2.5
	1989	2.4(3.0)	2.4(2.8)	**1.7(2.1)**	
5.	VOLUME OF DOMESTIC DEMAND				
	(per cent change on a year earlier)				
	1986	3.3	3.2	**3.5**	
	1987	3.4	3.5	**3.6**	
	1988	2.6	2.4	**3.3**	
	1989	2.4	2.2	**2.0**	
6.	UNEMPLOYMENT (UK S.A. EXCLUDING SCHOOL LEAVERS MILLION)				
	1986 Q4	3.14	3.14	**3.14**	
	1987 Q4	2.85	2.88	**2.73**	2.95
	1988 Q4	2.82	3.01	**2.58**	2.94
	1989 Q4	2.73	2.94	**2.61**	
C	**INFLATION AND MONEY GDP**				
7.	MONEY GDP (MARKET PRICES)				
	(per cent change on a year earlier)				
	1986-87	6.6	6.1	**6.3**	
	1987-88	7.3	7.5	**8.8**	
	1988-89	7.8	6.4	**7.9**	
	1989-90	7.8	6.1	**7.1**	

1(a)

	JANUARY 1987	FSBR 1987	SUMMER 1987	AVERAGE OUTSIDE FORECAST JUNE 1987
8. RPI (excluding mortgage interest payments in brackets) (per cent change on a year earlier)				
1986 Q4	3.4(3.4)	3.4(3.4)	**3.4(3.4)**	
1987 Q4	4.4(3.9)	3.9(3.4)	**3.8(3.6)**	3.9
1988 Q4	4.9(4.6)	3.3(3.0)	**5.1(4.4)**	4.6
1989 Q4	4.9(4.7)	3.3(3.2)	**4.2(3.9)**	
D PUBLIC FINANCES				
9. PSBR - £ BILLION				
1986-87	5.2	4.1	**3.3**	
1987-88	4.3	3.9	**1.0**	4.8
1988-89	2.2	4.4	**0.8**	4.9
1989-90	1.7	4.9	**0.8**	
10. PSBR - % OF GDP				
1986-87	1.3	1.1	**0.9**	
1987-88	1.0	1.0	**0.2**	1.2
1988-89	0.5	1.0	**0.2**	1.1
1989-90	0.4	1.0	**0.2**	
11. ANNUAL FISCAL ADJUSTMENT - £ BILLION				
1988-89	4.1*	3.2*	7.4*	
1989-90	1.9*	1.7*	1.1*	
allocated to				
(a) reducing personal taxes				
1988-89	1.9	3.2	**3.7**	2.3
1989-90	0.8	1.7	**0.5**	
(b) reducing PSBR				
1988-89	2.2	0.0	**3.7**	
1989-90	1.1	0.0	**0.6**	

*Assuming PSBR/money GDP ratio of 1 per cent as in 1987 MTFS.

E MONETARY CONDITIONS				
12. INTEREST RATES (SHORT-TERM (PER CENT))				
1986 Q4	11.2	11.2	**11.2**	
1987 Q4	11.0	10.3	**9.5**	8.9
1988 Q4	11.0	10.1	**10.5**	8.7
1989 Q4	11.0	9.7	**10.5**	
13. M0 (per cent change on a year earlier)				
1986-87	4.6	4.3	**4.3**	
1987-88	5.6	4.0	**4.3**	
1988-89	4.1	3.4	**4.0**	
1989-90	3.6	3.0	**3.4**	
14. EFFECTIVE EXCHANGE RATE (1975=100)				
1986	72.8	72.8	**72.8**	
1987	68.7	70.3	**71.7**	70.6 (Q4)
1988	67.3	69.3	**72.0**	69.0 (Q4)
1989	65.3	67.3	**72.0**	

	JANUARY 1987	FSBR 1987	SUMMER 1987	AVERAGE OUTSIDE FORECAST JUNE 1987
F TRADE AND CURRENT ACCOUNT				
15. VOLUME OF NON-OIL EXPORTS OF GOODS AND SERVICES (EXCL. ERRATICS) (per cent change on a year earlier)				
1986	1.5	1.9	**1.9**	
1987	6.1	5.8	**4.4**	
1988	4.4	4.0	**3.6**	
1989	5.3	5.1	**4.5**	
16. VOLUME OF NON-OIL IMPORTS OF GOODS AND SERVICES (EXCL. ERRATICS) (per cent change on a year earlier)				
1986	4.8	5.5	**5.4**	
1987	8.5	6.9	**3.9**	
1988	2.4	1.9	**4.7**	
1989	2.9	2.7	**3.5**	
17. CURRENT BALANCE £ BILLION				
1986	-0.1	-1.1	**-0.1**	
1987	-3.1	-2.7	**-0.5**	-1.7
1988	-3.3	-1.7	**-0.9**	-2.6
1989	-2.8	-0.4	**-2.3**	

likely to be followed by a period of slightly lower growth, but the forecast level of real GDP in 1989 is still a little higher than set out in the MTFS.

(ii) **RPI** inflation is expected to be close to the FSBR forecast of 4 per cent in 1987(4), but to edge up during 1988, although the rise is less if mortgage interest costs are excluded. Some prices which are very demand sensitive, eg for construction, are likely to accelerate during 1987. The GDP deflator is forecast to rise by 5 per cent in 1987-88, rather more than envisaged in the MTFS. Both higher real growth and inflation contribute throughout the forecast period to faster growth of **money GDP** than set out in the MTFS.

(iii) Since the fall in the oil price in the first quarter of 1986 the **current account** has been in approximate balance, even though domestic demand and output in the UK have risen rapidly and the growth of world trade in manufactures has been relatively modest. The evidence of recent years suggests the possibility both that the effects of improvements in competitiveness may be larger and quicker acting than previously expected by us, and that previous estimates of trend loss of market share may be too pessimistic. The forecast has small current account deficits in the three years from 1987. Over these three years domestic demand in the UK slows down and world trade accelerates. Both of these developments benefit the current account. They are offset by the diminishing effects of last year's competitiveness gain and the initial effects of the gradual loss of competitiveness. Over the forecast period domestic labour costs rise a little faster than in the main competing economies.

(iv) The prospects for **public finances** are yet again better than in earlier forecasts because of higher tax receipts. The forecast envisages outturns for the public expenditure planning total in 1988-89 and 1989-90 that are respectively £5b. and £11b. above the current plans. About half of this forecast overspend is accounted for by social security and local authority current spending, areas over which central government has limited direct control. Although public expenditure in cash terms is forecast to be significantly higher than in the current plans both prices and activity are forecast to be higher than assumed in the PEWP/

MTFS. In real terms the level of public expenditure (GGE) is forecast to be a little below the level currently implied by plans (and the assumption on which they are based) in 1988-89 and much the same in 1989-90. The ratio of non-oil government revenues to GDP is higher than in previous forecasts, and North Sea revenues benefit from the higher oil price. Finally the forecast embodies better prospects for borrowing by local authorities following the recent low outturns and our review of their behaviour. Taken together these judgements on the prospects for public finances imply that if the PSBR were held to one per cent of GDP as set out in the 1987 MTFS the cumulative fiscal adjustment in 1988-89 and 1989-90 would be £8½b., as against the estimate of £5b. published in the MTFS.

(v) The forecasts and policy assumptions for the UK and world economies imply a greater ex post tightening of fiscal policy in the UK than the rest of the Major 7 as shown by the general government financial deficit, the only reasonably comparable measure of stance available for all the developed economies.

TABLE 2 : GENERAL GOVERNMENT DEFICITS AS A SHARE OF GDP (%)

	1986	1987	1988	1989
UK*	2.9	2.0	1.9	1.7
Major 7 (less UK)	3.1	3.0	2.8	2.5

*financial years

(c) Risks

(i) The economy, which is currently very buoyant, could turn out to be **more cyclical** than it has been since the recovery began in 1981 or than currently forecast. If growth in the near future turns out to be even greater than forecast there is a greater risk of reduced growth later on. In addition the more buoyant the economy in the immediate future the greater is the chance that inflation in the short run will be higher than forecast.

(ii) **Trade performance** in the last few years has been considerably better than experienced in the previous ten to fifteen years. The forecast has attempted to take account of this, but the judgements are very uncertain. More buoyant domestic growth could help bring about a marked worsening in the current account, particularly if large-scale stockbuilding occurs.

(iii) Past forecasts for public expenditure have been surprisingly accurate given the enormous uncertainties. (See tables 30 and 33.) On average the forecasters have underestimated government revenues more than expenditure. Nevertheless the favourable prospect for **public finances** and the fiscal adjustment depends crucially on the forecast for public expenditure in real terms not turning our to be an underestimate. The margins of error around the forecasts for public finances are very large.

(2) THE WORLD ECONOMY

3. Following the oil price fall domestic demand in the Major 7 grew slightly faster in 1986 than in the UK. Major 7 GNP growth was, at 2½ per cent, over a percentage point lower than the growth of domestic demand because while import volumes grew strongly, at 9½ per cent, exports grew by only 1½ per cent. This poor net export performance in part reflected cutbacks in imports by OPEC and LDCs with financing difficulties. In addition, however, there was a large rise in the Major 7's real exchange rate. This resulted in a loss of world market share, with South Eastern Asian NICs being the principal beneficiaries. To a lesser extent than the NICs the UK appears to have improved its market shares at the expense of the rest of Major 7.

TABLE 3 : MAJOR 7 (less UK) GROWTH AND INFLATION

(latest OECD* forecast in brackets)

Percentage changes on a year earlier	1986	1987	1988	1989
Real GNP	2.5	2.3(2¼)	2.7(2½)	2.8
Domestic Demand	3.7	2.6(2¼)	2.8(2¼)	2.8
Industrial Production	0.9	1.9(2)	3.6(3¼)	3.4
Consumer prices	2.0	2.7(3)	3.0(3½)	3.3

* OECD figures for all the Major 7

4. In 1987 the WEP envisages, along with other recent forecasts, a drop in the growth of Major 7 (less UK) domestic demand to a little over 2½ per cent. With a somewhat better outlook for Major 7 net

exports GNP growth in 1987 is, however, not likely to drop much below the hardly spectacular rate of 2½ per cent recorded for 1986. The prospect is for a slight edging up of GNP growth in 1988 and 1989.

5. Recent movements in demand and output in the Major 7 have not been highly correlated with those in the various measures of world trade. In 1986 the effect of buoyant Major 7 imports on world trade was in large part offset by estimated further falls in OPEC imports and by very slow growth of imports by total developing countries. (As currently defined this group includes some important and prosperous countries, such as Taiwan.) For 1987 the forecast is for slightly lower growth for total world trade, but nevertheless at the same time for a slight pick up in growth of world trade in manufactures. This pick up in world trade growth continues in 1988 and 1989 as OPEC and NODC imports recover. For this forecast we have constructed a measure of total world trade in manufactures that includes estimates of exports by Newly Industrialised Countries (NIC's). (This measure has not been available in the past because of data deficiences, not all of which have been overcome, and is still liable to significant measurement error.) Total world trade in manufactures continues to grow more quickly through the forecast period than developed countries exports of manufactures, reflecting the lagged effects of the Major 7 real appreciation.

TABLE 4 : THE VOLUME OF WORLD VISIBLE TRADE

(percentage change on previous year)

	1986	1987	1988	1989
Total world imports	5	3	4	4½
of which:-				
- G7	9	4	4	4½
- OPEC	-21	-15	2	4
- Non-OPEC developing countries(NODC's)	2	4	5	6
Total world exports of manufactures (including NIC's)	3	4	4½	5½
Developed countries exports of manufactures weighted by UK market share (the conventional measure of UK weighted world trade in manufactures)	2	2½	3¼	4¼

6. World commodity prices have been rising so far during 1987 from the historically low real levels recorded in the second half of 1986. The

forecast is for a further gradual rise in real non-oil industrial material prices. (Food prices will remain weak.) This together with the rise in the oil price that has already occurred will - for a given exchange rate - exert a modest upward pressure on UK inflation. Within the Major 7 the average rates of consumer price and wage cost inflation are likely to remain low, though a little above the rates recorded in 1986.

(3) TRADE AND THE BALANCE OF PAYMENTS

7. The current account moved into deficit following the oil price fall at the beginning of 1986. The surplus in the first four months of this year - with exports remaining high and imports lower than in the second half of last year - produced a £½b. deficit in the current account in the year following the oil price fall. This was a much better outcome than the majority of forecasters expected.

TABLE 5 : UK CURRENT ACCOUNT (£BN)

	Visible trade balances			Net invisibles			Current balance
	Manufactures	Oil	Other	Services	IPD	Transfers	
1986	-5.4	4.2	-7.0	5.4	5.1	-2.3	-0.1
1987	-6.4	4.5	-6.4	5.7	5.5	-3.3	-0.5
1988	-8.2	3.4	-6.0	6.0	6.8	-2.8	-0.9
1989	-8.4	2.6	-6.2	6.5	7.1	-4.0	-2.4

8. The forecast judgement is that the improved trade performance since the early 1980s will continue. The implication of this is that at unchanged competitiveness and with demand growth at sustainable rates both at home and abroad the non-oil trade balance shows no tendency to worsen. In the past the presumption has been that the UK would over time lose share in developed countries' exports and experience faster rising import propensities than on average in other developed countries.

9. In 1987, the effect on the current account of the UK's relatively rapid growth of domestic demand and output is offset largely by the benefits of the 1986 competitiveness gain. In 1988 and 1989 UK growth gradually falls relative to overseas and this helps to offset the effects of the steady loss of competitiveness as domestic costs rise faster than those in other developed economies. (See Table 21.)

10. The structure of the current account continues to change over the forecast period. The balance of visible trade moves into greater

deficit, while the services surplus rises slowly, as do net earnings from interest profits and dividends. These forecast changes in the components of the current account continue the trends of recent years. The forecast deficit on transfers fluctuates in line with the assumed timing of net EC contributions.

(a) Non-oil visible trade

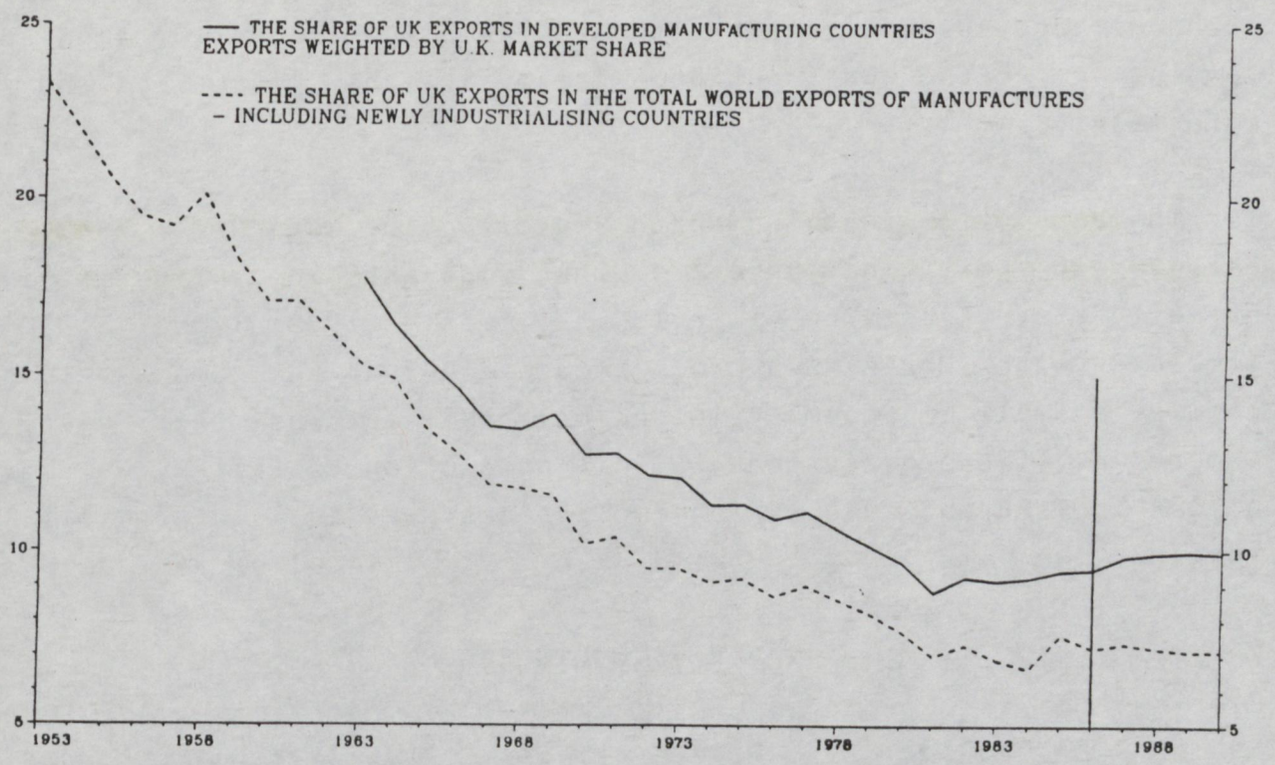
11. The volume of manufactured exports, which fell back slightly in the first four months of this year from the high level at the end of 1986, is forecast to resume growing in the rest of this year. Growth is forecast to be rather faster than the relatively modest projected rise in developed countries' exports of manufactures (the conventional measure of UK weighted world trade) as a result of the UK's strong competitive position, which is reflected in the relatively buoyant order books revealed by the CBI survey. The UK is forecast to continue to gain market share on this measure in 1988 and 1989 - albeit less rapidly than in the recent past. (See Chart A.) The UK's share in total world exports of manufactures has risen less, because NICs' exports of manufactures (not included in the conventional measure) have clearly been rising fast in recent years. Nevertheless even on this wider measure of export market share there has clearly been a change in UK trade performance in the 1980s which the forecast assumes to be maintained. The forecast is for a very slight fall in the UK's share of the wider measure of world trade in manufactures that covers NIC's. (See Chart A.)

TABLE 6 : VISIBLE TRADE VOLUMES (PER CENT CHANGES)

	Manufactures				Non-manufactures		Terms of trade
	Developed countries exports	UK exports	Domestic demand	UK imports	Exports	Imports	for nominal visible trade
1986	2.1	2.7	1.8	5.2	9.1	7.4	-0.4
1987	2.6	6.5	6.4	6.8	-0.5	-1.3	-0.5
1988	3.2	4.3	2.9	6.9	0.1	-2.3	0.8
1989	4.3	4.8	1.5	4.3	2.4	2.0	-0.2

CHART A

SHARES OF UK EXPORTS IN THE VOLUME OF WORLD MANUFACTURING TRADE



12. The volume of manufactured imports fell sharply in the first four months of this year after the rapid rise in the latter half of 1986. The fall, however, may in part reflect residual seasonal influences (imports have fallen in the first quarter of the last four years) and a temporary slowdown in consumer spending. For the rest of the year the forecast has a relatively strong rise in imports as domestic demand and output grow strongly. The prospect for 1988 and 1989 is for imports to continue to grow relatively quickly, with the gradually worsening competitiveness offsetting the effects of declining growth of domestic demand for manufactures.

13. Non-manufactured exports and imports both grew relatively rapidly in 1986 partly as a result of exceptional trade in wheat and olive oil boosting both, and therefore leaving the current account virtually unaffected). These effects are currently unwinding, and both exports and imports are expected to be lower in 1987 than in 1986. In the rest of the forecast period, non-manufactured exports may rise gradually. Imports of food, drink and tobacco may also rise, but basic material imports may ease later as the growth of manufacturing output and stockbuilding slacken.

14. The non-oil terms of trade which worsened during 1986 as sterling depreciated, appear to be slightly firmer now as the pound's recent appreciation has more than offset some strengthening in commodity

prices. Little change is expected in the forecast period with the exchange rate assumed constant and a weakening in world food prices tending to offset a continued rise in the price of industrial materials.

15. The assumption that the North Sea oil price stays at $18½ until early next year and then remains constant in real terms yields a steadily rising sterling oil price from early 1988. The $18½ price combined with North Sea production in 1987 at the same level as 1986 implies a small improvement in the oil trade surplus this year. The Department of Energy forecast NS oil production to fall by 6-7 per cent a year in 1988 and 1989, which implies a steady fall in the oil trade surplus.

TABLE 7: NORTH SEA OIL

	World oil price $/barrel	N.Sea price £/barrel	N.Sea output mn.tonnes	Oil trade balance £ bn	N.Sea* taxes £ bn
1986	14.3	9.7	126.9	4.2	7.5
1987	17.4	11.0	126.9	4.5	4.4
1988	18.2	10.7	117.2	3.4	4.7
1989	19.7	10.9	110.4	2.6	4.5

* financial year totals

(b) Invisibles

16. The invisibles surplus, which is now estimated to have risen to £8.1b. in 1986, may fall slightly this year (more than accounted for by a larger net transfer to the EC), before recovering in 1988 and 1989. The surplus on services, which was depressed last year by a combination of fewer US visitors to the UK and increased spending abroad by UK tourists, may rise again this year as the benefits of improved competitiveness are felt. The improvements in the services balance in 1988 and 1989 would be even greater without the gradual worsening of competitiveness.

TABLE 8 : THE BALANCE OF INVISIBLES (£ billion)

	Services	N.Sea IPD	Other IPD	EC transfers	Other transfers	Total invisibles
1986	5.4	-1.4	6.5	-0.7	-1.6	8.1
1987	5.7	-1.8	7.3	-1.5	-1.8	7.9
1988	6.0	-1.1	7.9	-0.8	-2.0	10.0
1989	6.5	-0.7	7.8	-2.0	-2.0	9.6

17. The net surplus on interest, profits and dividends which rose particularly sharply last year as sterling depreciated may show a small further rise this year, although higher North Sea debits will limit the improvement. North Sea payments abroad should decline in 1988 and 1989 as output falls. The pattern of transfer payments abroad is heavily influenced by net EC contributions, which are forecast to rise this year from the abnormally low level of 1986 before falling again sharply next year as large abatements are paid.

(4) DOMESTIC DEMAND AND ACTIVITY

(a) Personal income and expenditure

18. The consumer boom has flattened out since the late summer of last year even though personal incomes have continued to grow rapidly. The latest published estimates show a rise in the personal saving ratio from around 10 per cent in the third quarter of 1986 to around 12 per cent in the first quarter of 1987. Bad weather has undoubtedly depressed spending at times and more recently electoral uncertainties (and consequent uncertainties about future disposable income and tax rates) may have had some effect. Surveys, however, suggest consumer confidence remains high, and it seems likely that spending will rise relatively quickly over the remainder of 1987. The assumed allocation of half of the fiscal adjustment to cuts in personal taxes and the consequently fast growth in real personal disposable income keeps the growth of consumer spending high in 1988. The absence of a large cut in personal taxes in 1989 explains the fall from the high growth of the previous year.

19. Real personal investment in dwellings rose by 14 per cent in 1986 and is forecast to rise by almost 10 per cent this year. There has been a very strong supply response to the acceleration in house prices. Private housing starts rose by 10 per cent in 1986 and were about 20 per cent up between the first quarters of 1986 and 1987; in London private housing starts rose by almost 20 per cent in 1986 and by almost 80 per cent over the year to the first quarter of 1987.

20. The strong rise in both real housing investment and house prices means that the personal investment is rising fast in money terms at present. Personal saving is unlikely to rise to the same extent: indeed that part of personal saving that is accounted for by contributions into pension funds is likely to be depressed as funds continue to take measures to reduce existing surpluses. Thus the net

acquisition of financial assets by the personal sector, which virtually halved as a share of GDP between 1982 and 1986, is likely to fall further over the forecast period.

TABLE 9 : REAL PERSONAL INCOME AND EXPENDITURE

	Real Personal Disposable Income (RPDI)	Real Consumers' expenditure	Real Investment in dwellings	Personal saving ratio (per cent)	Persons' net acquisition of financial assets (£bn)
	(Per cent change on previous year)				
1986	4.7	5.1	14.2	11.0	9.1
1987	3.7	3.7	10.9	11.0	7.9
1988	3.8	4.2	6.3	10.7	6.5
1989	2.8	2.7	4.3	10.8	6.8

(b) Company income and expenditure

21. Non-oil industrial and commercial companies' profits (net of stock appreciation) are estimated to have risen by around 20 per cent in 1986; but recorded expenditure by companies has remained very sluggish into the first quarter of 1987. Given the strength of the recent rise in output, a major upturn in spending is likely to occur soon and there is clear evidence from surveys that such an upturn is imminent.

TABLE 10 : PRIVATE SECTOR INVESTMENT INTENTIONS AND FORECAST

	(percentage change on previous year) 1986	1987	1988	1989
Manufacturing*				
June DTI survey	-4½	4	6	
HMT June forecast	- 4½	4	5	2
Private non-oil, non-manufacturing*				
June DTI survey	0	10	7	
HMT June forecast	0	9	5½	-1

* Manufacturing includes leased assets; non-manufacturing excludes assets leased to manufacturers and is adjusted for the estimated effect of privatisation.

22. The latest DTI investment intentions survey points to a rise of about 8 per cent in non-oil industrial investment this year and a further similar rise in 1988. The rise in investment this year is expected to be particularly marked in commercial building work; and a big rise in this area seems to have been picked up in the construction output figures for the first quarter, even though it has not yet shown up in the figures for investment spending. Table 11 summarises the forecast for total investment.

TABLE 11: GROSS FIXED DOMESTIC CAPITAL FORMATION

(per cent changes on year earlier)

	1986	1987	1988	1989
Business	-2½	4½	4½	1
of which				
North Sea	-14½	-18½	0	1½
Manufacturing	-4½	4	5	2
Other business	-½	6½	5	½
Domestic dwellings	9½	8	4	3½
General government	7	-2	-2	1½
Total	1	4	3½	1½

23. There are also indications from the CBI monthly trends enquiry of a prospective upturn in stockbuilding in manufacturing industry following six successive years of falling stock output ratios. The balance of respondents quoting their stocks of finished goods as more than adequate has been falling steadily over the last year, and in the June enquiry there was a balance of one per cent of respondents reporting stocks as less than adequate. This is likely to imply somewhat higher stockbuilding over the next year or so than seen recently; though with the continuing implementation of methods of reducing inventory requirements the forecast does not have a massive stockbuilding boom on the scale seen in previous decades.

24. The forecast recovery in companies' expenditure means that the financial surplus of companies is likely to fall a little from the large figures recorded in recent years, while industrial companies' borrowing requirement will rise sharply this year partly because of an unusually high level of investment overseas.

TABLE 12 : THE FINANCIAL POSITION OF INDUSTRIAL AND COMMERCIAL COMPANIES

	Profits as a share of total income (per cent)		Rate of return on assets, non-oil ICCs (per cent)	Net acquisition of financial assets (£bn) (all ICCs)	Borrowing requirements (£bn) (all ICCs)
	Oil	Non-oil			
1973-85 average	2.1	10.6	5.5	1.8	3.3
1986	2.5	14.7	8	5.3	4.9
1987	2.8	15.0	9	4.7	10.7
1988	2.2	15.5	9½	5.0	7.0
1989	2.0	15.4	9	5.1	7.0

(c) Aggregate demand and output

25. Over the year to the first quarter of 1987 the average measure of GDP grew by about 3¼ per cent, while the output estimate of GDP grew by 4¼ per cent growth (4½ per cent non-oil). Within this growth of the output measure construction output grew by an exceptional 11½ per cent: a figure which may be subject to substantial revision. It is not possible to explain fully the recent strength of activity in terms of components of expenditure because of a large discrepancy between the expenditure estimate and the other estimates of GDP. An increase in the share of UK producers in domestic and foreign markets has made an important contribution to growth recently, and it is likely that as yet unrecorded rise in investment in the recent past may be partly responsible for the apparent buoyancy of domestic activity as consumption growth has appeared to moderate.

26. An important feature of the economy over the next two years is the forecast strength of company spending. During the upswing that has lasted since 1981 total company spending has so far remained relatively depressed, and the growth of demand has been weighted towards personal spending. With personal spending forecast to continue rising, the cyclical upswing in company spending in 1987 combined with a relatively favourable trade performance should mean overall GDP growth this year will be nearly 4 per cent. (This would be the highest GDP growth rate for a particular year since 1973.) Growth of manufacturing output could be even greater at just under 5 per cent. Investment should rise further in 1988, but because trade performance will not benefit to the same extent as this year from improved competitiveness. GDP growth will be lower than in 1987, though still close to 3 per cent. By 1989 there may be some cyclical down turn in company spending and GDP growth may be rather below figures recorded in the recent past, although the underlying growth of GDP would be similar to that recorded during the later part of 1985 and early 1986 (see Chart B). North Sea output is expected to decline quite sharply after 1987.

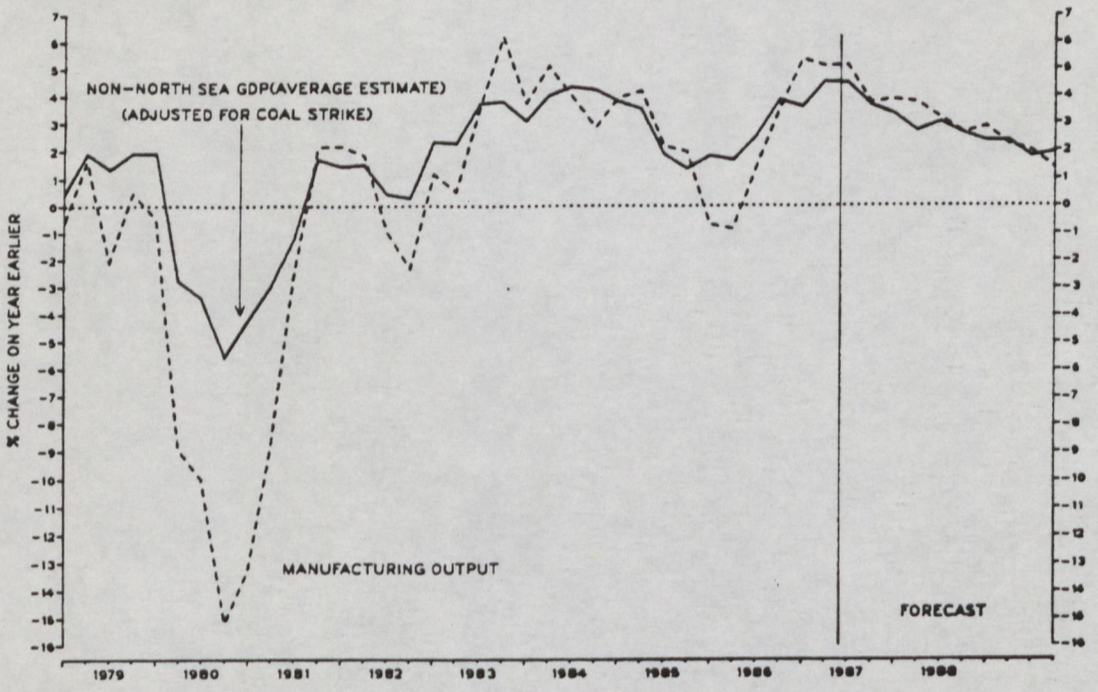
TABLE 13 : EXPENDITURE AND OUTPUT

(percent changes on a year earlier)

	1986	1987(1)	1987	1988	1989
Domestic demand	3.5	(1.7)	3.6	3.3	2.0
Exports of goods and services	3.0	(9.1)	3.9	1.5	2.5
Imports of goods and services	5.8	(4.8)	3.3	4.8	3.4
Compromise adjustment*	0.3	(0.8)	0.1	0	0
GDP(A)	2.8	(3.4)**	3.9	2.3	1.7
Non-oil GDP(O)	3.0	(4.5)**	4.1	3.0	2.1
Manufacturing output	0.8	(5.4)**	4.8	3.3	2.1

* Contribution to growth: ** Includes forecasters' adjustment to published figures for manufacturing output.

CHART B **ANNUAL GROWTH IN GDP & MANUFACTURING OUTPUT**



(5) INFLATION

27. There has been little change to immediate prospects for RPI inflation since the Budget, although inflation in the fourth quarter of this year could even turn out just below the FSBR forecast of 4 per cent. It is hard to be at all confident about the effect of declining unemployment and rising capacity utilisation on inflation during the rest of the forecast period. The relative weakness of the world economic background - and therefore the modest recovery in commodity prices from their very depressed levels - should help to keep inflationary pressures in check, provided the sterling index remains firm.

(a) Producer prices

28. Even though manufacturers' costs are probably no higher now than they were at the end of 1985, manufacturing output price inflation has been edging up in recent months, and now stands at 4½ per cent. The balance of CBI respondents reporting expected prices increases has changed little over the last few months and is consistent with inflation staying at around its current level over the immediate future. The forecast has productivity growth returning to a more sustainable (though high by past standards) rate over the next year, and import prices will rise gradually, so that total costs in manufacturing may rise by 3 to 4 per cent a year from now on. Profit

margins may rise further over the next year, but then stabilise or fall back a little as growth in manufacturing output slows. This could mean inflation remaining in the 4-5 per cent range this year and next, and falling below 4 per cent in 1989.

TABLE 14 : MANUFACTURING COSTS AND PRICES
percentage change on a year earlier

	Unit labour costs	Costs of materials and fuels	Estimated total costs	Domestic producer output prices
1986 Q4	1.3	- 5.6	0.2	3.9
1987 Q4	2.3	7.7	3.1	4.8
1988 Q4	4.6	1.1	3.2	4.3
1989 Q4	3.6	3.3	3.7	3.1

(b) RPI

29. As forecast at Budget time, RPI inflation is likely to peak in the summer months of this year and then fall back during the autumn. Inflation is likely to rise again after next year's Budget, assuming indexation of specific duties, and will rise further as this May's fall in mortgage rates drops out of the 12-month comparison. Retail price inflation may rise to around 5 per cent in the second half of 1988.

TABLE 15: MONTHLY PATH OF RPI

	Total RPI	RPI excluding mortgage interest payments
1987 May	4.1	3.8
June	4.5	3.8
July	4.6	3.9
August	4.5	4.0
September	4.2	3.7
October	4.3	3.6
November	3.6	3.5
December	3.5	3.4
1988 January	3.7	3.4
February	3.7	3.4
March	3.8	3.4
April	4.2	4.1
May	4.4	4.0
June	4.4	3.9

30. The contribution of **domestic fuel prices** to RPI inflation reaches its lowest point over the next few months as the recently announced fall in domestic gas prices is recorded in the RPI. By the second half of next year both electricity and gas prices will be recording increases.

TABLE 16 : ASSUMED CHANGES IN DOMESTIC ENERGY PRICES

	Electricity	Gas	Coal
1987		July 1987 - 4. 5 per cent	November 1987 + 2.8 per cent
1988	April 1988 + 5 per cent	July 1988 + 7.7 per cent	November 1988 - 0.7 per cent

31. **Food** prices have recently been a little higher than expected at Budget time, with seasonal food prices almost 8 per cent higher than a year ago. Given reasonable crops and harvests, MAFF expect food price inflation to fall to around 2 per cent during the second half of this year, but it is likely to rise a little faster than this over the remainder of the forecast period. Nevertheless food price inflation should stay below the rate of increase of most non-food prices.

32. The **housing** component of the RPI will continue to rise at a fast rate. Although the current high rate of increase of house prices has a negligible effect on RPI inflation in the short run, the lagged effect of past house prices increases, forecast increases in mortgage rates, and an increase of 7-8 per cent in Local Authority rates means that this component of the RPI may rise by almost 10 per cent over the year to the fourth quarter of 1988.

33. **Petrol** prices have yet to show signs of their normal summer rise. The forecast allows for an 9p rise in petrol prices in the near future: half in July and half in August. The price should then fall back again near the end of this year.

34. **'Other' private sector prices** have risen about 3¼ per cent over the last year. (They would have risen some ½ per cent more but for the non-indexation of duties in the 1987 Budget.) They have risen by 1 per cent in the last two months, following a short period in which they rose by a little less than expected. The forecast has not given much weight to the most recent increases, and is for little change in the underlying rate of increase in prices over the next eighteen months

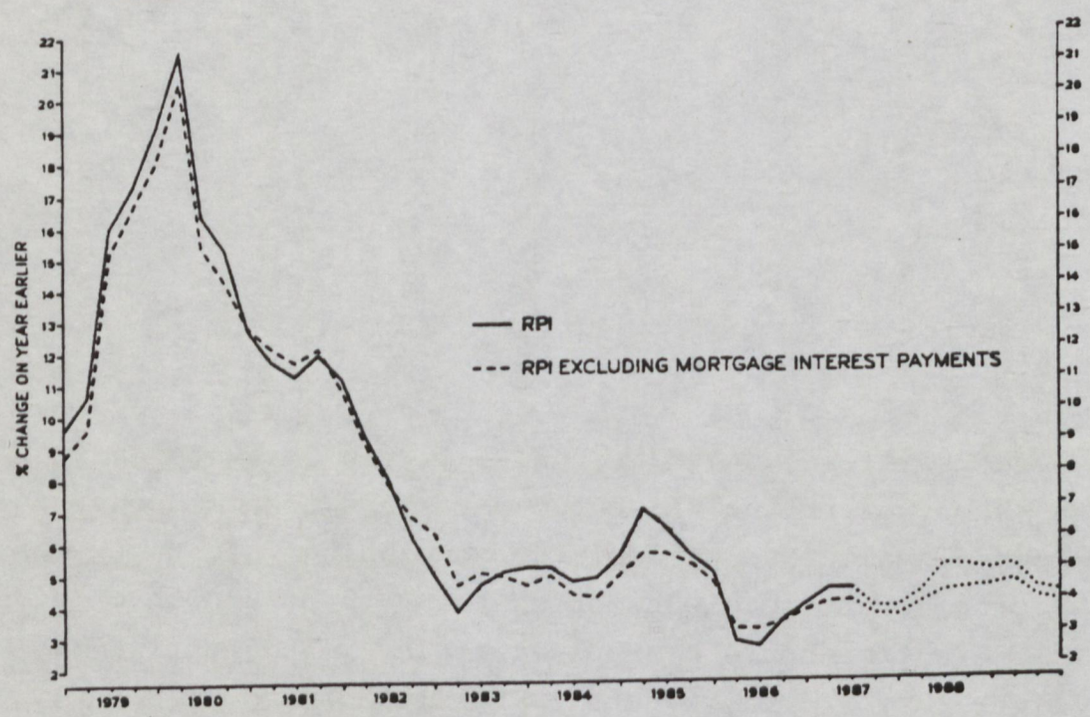
compared with the last year. As the economy slows down in 1989 the rate of increase of these prices is expected to fall.

35. The forecast for the RPI is summarised in table 17 and chart C below.

TABLE 17 : COMPONENTS OF THE RETAIL PRICES INDEX
Percentage changes on a year earlier

	1986 Q4	1987 Q4	1988 Q4	1989 Q4
Food prices	3.2	2.0	2.8	3.2
NI prices	3.6	1.8	5.6	3.5
Housing prices	7.1	7.2	9.2	6.9
Other prices	2.6	3.6	4.6	3.9
- of which petrol	-12.6	4.9	2.7	3.7
- other items	3.9	3.5	4.8	3.9
All items RPI	3.4	3.8	5.1	4.2
RPI excluding mortgage interest payments	3.4	3.5	4.4	3.8

CHART C **RPI INFLATION**



(c) The GDP deflator

36. While the new RPI forecast for this year is marginally lower than the Budget forecast, the new forecast for the GDP deflator in 1987-88 is about ½ a percentage point higher than the Budget forecast. This increase to the GDP deflator reflects:

- slightly better terms of trade (a rise in export prices for given import prices raises the GDP deflator, other things being equal);

- higher forecast construction prices;

- a forecast small pick up in pay settlements in the latter part of this year.

Over the two following years the GDP deflator is forecast to rise even faster than projected in the MTFS, and significantly faster than consumer prices. The assumption of a constant exchange rate forecast contributes to this differential, because sluggish import prices do not directly benefit the GDP deflator.

TABLE 18 : FORECASTS FOR THE DEFLATOR FOR GDP AT MARKET PRICES

	1986-87	1987-88	1988-89	1989-90
MTFS				
total	3	4½	4	3½
non-oil	6	4¼	3¾	3¼
June forecast:				
total	3	5	5½	5
non-oil	5¾	4½	5½	5

(d) Earnings

37. There are some signs that the fall in private sector pay settlements seen over the last two years has bottomed out, and that there has been a small rise since the beginning of the year. In addition rising overtime is boosting the rate of growth of earnings: the number of overtime hours per operative in manufacturing in April was the highest for many years. The Treasury model's equation for earnings points to quite strong upward pressure on earnings growth over the next two years, reflecting primarily strong company profits and the higher rates of retail and producer price inflation. Falling unemployment also has some influence, although this effect is quite weak. We have given some weight to the equation in the forecast.

38. The forecast has less of an acceleration in earnings than the model equation suggests, but allows for a small rise in settlements over the next year. Pay settlements are forecast to rise by about ½ a point on

average in the next pay round. While overtime in manufacturing may stay at a high level over the next year it is unlikely to rise much further: thus drift should be lower than it has been over the past year. The net effect may be that the rate of growth of private sector earnings will change little over the next pay round. By 1989 overtime will be falling and for that reason at least earnings growth should decline.

TABLE 19 : PRIVATE SECTOR SETTLEMENTS AND EARNINGS

	Payrounds		
	1986-87	1987-88	1988-89
Settlements	5	5½	5½
Effect of changes in overtime hours	+½	0	- ¼
Other drift	2	2	2
Increase in earnings	7½	7½	7¼

39. The rate of growth of earnings in public services over the last year is coming out close to that for the private sector. Settlements have been higher than in the private sector - an estimated 7.5 per cent - for local authorities' employees, including teachers, in the current pay round and 6.5 per cent for central government employees; but drift has as usual been much lower than in the private sector: only about ½ per cent. (Chart D shows outturns and forecasts for the ratio of public service to private sector average earnings.)

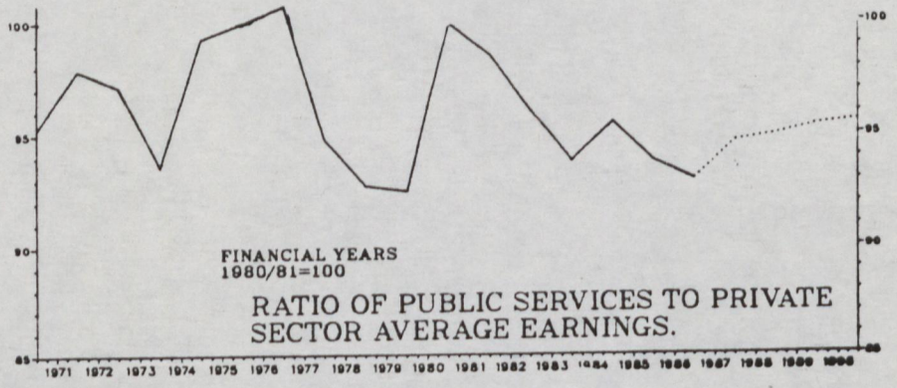
40. It seems likely that local authority pay will rise significantly faster than private sector pay over the 1987-88 pay round. (Section 8 discusses the relative absence of effective constraints on LA's ability to finance higher current expenditure.) Local authority manual workers have already been offered (though not yet accepted) a deal believed to be worth about 10½ per cent. Groups such as the police are unlikely to fare badly, and there is the continuing effect of the teachers' settlement boosting earnings. Local Authority average earnings could easily rise by almost 9 per cent next year. The forecast assumes, however, that central government pay rises will again be held to 7 per cent on average - similar to this year's expected outturn.

TABLE 20 : PUBLIC AND PRIVATE SECTOR UNDERLYING AVERAGE EARNINGS
percentage changes over pay rounds

Payrounds	Central government	Local authorities	Private sector
1986-87	7	8 (7)*	7½
1987-88	7	8¾(7¾)*	7½
1988-89	7½	7¾(7½)*	7¼

*excluding settlements for primary and secondary teachers.

CHART D



(e) Labour costs

41. The forecast for private sector earnings combined with the forecast for productivity (discussed in section 6 below) produces forecast increases in labour costs in manufacturing that, while modest by past standards, are above those forecast for competitor economies.

TABLE 21 : LABOUR COST INCREASES IN MANUFACTURING
(per cent increases on previous year)

	UK	Major 7 (less UK)
1986	4.3	2.1
1987	0.6	0.6
1988	3.6	0.5
1989	4.1	1.5

(6) PRODUCTIVITY, EMPLOYMENT AND UNEMPLOYMENT

42. Output per head in manufacturing is currently estimated to have risen by a little over 6½ per cent over the last year. If, as the past record suggests, the published manufacturing output figures for the

recent past are too low the true rate of growth of productivity has been faster than this, probably in the range 7 to 8 per cent. Allowing for a large temporary cyclical contribution to productivity growth, the recent figures seem consistent with an underlying rate of growth of manufacturing productivity of around 4 per cent. (This figure was assumed in the MTFS calculations.) It is likely, as the cyclical contribution to productivity growth declines, that there will be a more moderate rate of recorded growth of productivity in manufacturing over the next year.

43. There is currently no information on what has been happening to employment outside manufacturing since the beginning of 1987. The large recent fall in unemployment may indicate strong employment growth, however, and relatively modest gains in productivity.

TABLE 22: RECORDED GROWTH OF OUTPUT PER HEAD

Annual averages, percentage changes

	1964-73	1973-79	1979-86	1986-89
Manufacturing	3¾	¾	3¾	4¼
Non-manufacturing*	3	½	1¼	1¼
Non-oil economy	2¾	½	1¾	1¾
Whole economy	2¾	1	2	1½

* Includes private sector and nationalised industries other than in manufacturing and oil.

44. New labour supply projections published in the May 1987 Employment Gazette show GB labour supply growing by around 440,000 in total over the three years to 1989, compared with 840,000 over the three years to 1986. The strength of economic activity in the forecast probably implies somewhat higher participation rates than Department of Employment have allowed for, and it is also quite likely that net inward migration will be higher than assumed in the population projection used by Department of Employment (both because of the relatively buoyant UK economy and because of developments in South Africa). The forecast allows for UK labour supply growth of around 660,000 in the three years to mid 1989.

45. The labour supply and productivity forecasts together imply non-oil productive potential growing by about 2¾ per cent a year over the three

years to 1989. For the whole economy, after taking account of the forecast decline in North Sea output, productive potential may grow by around 2¾ per cent in 1987, and by around 2¼ per cent over the following two years.

TABLE 23: PRODUCTIVE POTENTIAL

(Annual averages; percent changes)

	Trend non-North Sea productivity growth	Labour supply	Non-North Sea productive potential	Contribution of North Sea	Whole economy productive potential
1973-79	1	½	1½	½	2
1979-86	1¾	½	2¼	¼	2½
1986-89	2	¾	2¾	- ½	2½

46. The composition of output growth in 1987, with manufacturing output up by almost 5 per cent and quite possibly a still larger rise in construction output, holds out very favourable prospects for a further substantial decline in unemployment. The forecast has a fall in unemployment of around 350,000 over the next year, of which less than a half will reflect the effect of measures of various sorts. "Perpetual Restart" is not expected to have a large effect on the unemployment count (although it is impossible to be at all confident about its effects). The Job Training Scheme is assumed to build up as planned, but with a delay of one quarter as a result of lack of co-operation from Trade Unions. The forecast of slower growth and no new employment measures means little further fall in unemployment after the second quarter of 1988, in spite of the deceleration of labour supply.

TABLE 24: CHANGES IN ADULT UNEMPLOYMENT

(seasonally adjusted 000s)

	Unemployment	Effects of employment and training measures, restart and availability testing	Underlying unemployment
1985(2)-1986(2)	+ 88	- 65	153
1986(2)-1987(2)	- 238	- 174	- 64
1987(2)-1988(2)	- 344	- 152	- 192
1988(2)-1989(2)	- 6	+ 20	- 26

(7) FINANCIAL CONDITIONS

47. The WEP has a further decline in the effective exchange rate for the US dollar. This forecast fall is coupled with rising US interest rates, broadly offset by falls elsewhere. Other things being equal, this set of circumstances might be expected to lead to some upward pressure on sterling accompanied by downward pressure on UK interest rates. The prospect, however, is that UK inflation will tend to remain slightly above that of competitors and that the forecast loss of competitiveness will raise expectations of a deterioration in the current balance. Chart E summarises the forecast for the effective exchange rate and competitivess as measured by relative unit labour costs.

CHART E **Factors Affecting Competitiveness**

(1980=100)

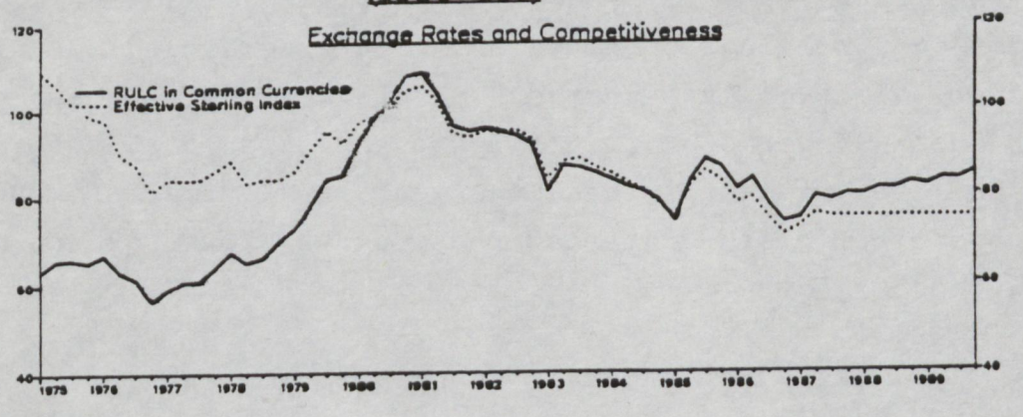


TABLE 25: EXCHANGE RATES AND COMPETITIVENESS
(average rates for calendar years)

	US dollar index (1975=100)	Sterling index (1975=100)	$/£	DM/£	Relative unit labour costs (1980=100)
1984	134.7	78.6	1.34	3.79	82.7
1985	140.7	78.2	1.30	3.78	84.4
1986	114.9	72.8	1.47	3.19	77.7
25 June	102.0	72.2	1.61	2.95	76.4
1987	101.1	71.7	1.62	2.91	75.2
1988	92.3	72.0	1.76	2.82	77.1
1989	86.9	72.0	1.86	2.73	78.6

48. The policy assumptions of maintaining a stable sterling effective rate of 72, implies a small rise in UK interest rates. The forecast

has short-term interest rates beginning to rise from the present 9 per cent level in 1987Q4, reaching 10½ per cent by the latter half of 1988. This rise in interest rates is not sufficient to bring the growth of money GDP back to the 1987 MTFS path.

TABLE 26: INTEREST RATES

	3-month US interest rates	3-month world rates	3-month domestic LIBOR	Mortgage rate
26 June	7.2	6.3	9.1	12.3
1986-87	6.2	6.3	10.5	11.7
1987-88	7.2	6.2	9.5	11.4
1988-89	8.2	6.2	10.4	12.2
1989-90	9.2	6.5	10.5	12.3

49. MO which fell slightly in the first quarter of 1987 as a result of the temporary slowdown in consumer spending and some special influences around the turn of the year, is now rising steadily. In the three months to June, holdings of notes and coin rose at an annual rate of 7 per cent although the year-on-year figures for M0 have been rather lower at about 4½ per cent. This is in the upper part of the target range and the forecast is that the year-on-year rate for M0 will stay around this until rising interest rates and a slower growth of consumer spending reduce growth.

TABLE 27: MONETARY AGGREGATES AND CREDIT

(per cent change on a year earlier)

	MO		M3	M4	Lending by banks and building societies
	MTFS range	Actual/ forecast			
May 1987	-	4.4	18.9	13.6	19.6
1986-87	2-6	4.3	18.7	14.9	19.0
1987-88	2-6	4.3	18.9	14.4	18.1
1988-89	1-5	4.0	13.9	13.1	16.5
1989-90	1-5	3.4	13.5	12.9	15.8

50. Broad money has continued to grow rapidly with M3 increasing by 19 per cent in the year to May, reflecting a strong rise in deposits held by industrial companies, building societies, and other financial institutions. Deposits held by persons have risen less rapidly than these although the increase has still been fast by recent standards as personal sector incomes and gross financial wealth have risen. The

forecast is that M3 will continue to grow at a similar rate through the rest of this financial year, but will grow more slowly in 1988-89 and 1989-90 as incomes and wealth rise less rapidly, and as the growth of companies' liquidity slows. The growth of M4 which contains a greater proportion of personal sector deposits, rises less rapidly than M3.

51. Lending by banks and building societies which had risen by almost 20 per cent in the year to May, is forecast to rise by a similar amount for 1987-88 as a whole with a continued strong rise in lending to persons for both housing and other purposes as well as further advances to financial institutions, including security dealers. Lending may rise less rapidly in the rest of the forecast period as growth falls somewhat, interest rates rise and companies turn increasingly to securities markets.

52. The PSBR is assumed to be funded fully, but its low level - coupled with the assumption of £2b. a year receipts from National Savings - implies net gilt repayments of £1½b. a year on average in 1988-89 and 1989-90. There would still be considerable gross sales - averaging £8½b. in 1988-89 and 1989-90 as there are large maturities in these years. The need to finance a small emerging current deficit coupled with continued net capital outflows implies a forecast increase in non-residents' sterling bank deposits.

TABLE 28: NET EXTERNAL CAPITAL FLOWS

(£ billion)

	Direct invest-	Non-bank port-folio*	Banks foreign currency†	Banks sterling	Other	Official reserves	Balancing item	Current balance
1986	-5.6	-5.8	4.0	-0.4	1.5	-2.9	9.3	-0.1
1987	-9.3	2.3	4.1	6.0	5.1	-4.7	-3.1	-0.5
1988	-3.1	-1.5	0.7	1.4	1.4	0.8	1.0	-0.9
1989	-3.3	-2.0	1.0	3.8	1.9	0.0	1.0	-2.5

* includes gilts
† includes securities

53. In the absence of any large changes in the current balance the external capital account is likely to be dominated by the need to finance a steady outflow of direct and portfolio investment. Net direct investment outflows which were abnormally high in 1986 as a result of mergers in the US, are boosted this year by BP's acquisition of Sohio, (largely financed by overseas borrowing, identified in the

'Other' column in table 28). They are forecast to return to more normal levels in 1988 and 1989. Non-banks' net portfolio outflows which were exceptionally high in 1986 ahead of Big Bang, are projected to fall back to a level sufficient to maintain the share of foreign assets in institutions' portfolios. These outflows are forecast to be offset partly by non-residents' purchases of UK company securities. UK banks are forecast to maintain their share of total BIS banks' cross-border claims but to match this and their continued purchases of overseas securities by attracting foreign currency deposits from overseas. The remaining non-bank net capital outflows are assumed to be financed by banks attracting non-residents' sterling deposits, given forecast interest rates.

(8) PUBLIC FINANCES

54. Table 29 summarises the forecast and compares it with the FSBR numbers.

TABLE 29: PUBLIC SECTOR EXPENDITURE, REVENUE AND BORROWING
(£ billion)

	1986-87 Outturn	1987-88 FSBR	1987-88 June Forecast	1987-88 Jan Forecast	1988-89 FSBR	1988-89 June Forecast	1989-90 Jan Forecast	1989-90 FSBR	1989-90 June Forecast
General Government Expenditure	165	174	173	185	180	185	197	188	198
General Government receipts	160	169	172	184	178	187	197	187	201
Fiscal adjustment (assumed cuts in personal taxes)				2	3	4*	3	2	1*
GGBR	5	5	2	3	5	2	3	6	2
Public corporations' overseas and market borrowing	-1½	-1	-1	-1	-1	-1	-1	-1	-1
PSBR (per cent of GDP in brackets)	3½ (¼)	4 (1)	1 (¼)	2 (½)	4 (1)	1 (¼)	2 (½)	5 (1)	1 (¼)

* The June Forecast also allocates £4bn and £1bn in 1988-89 and 1989-90 to reducing the PSBR below the 1 per cent ratio to GDP assumed in the FSBR.

(a) 1987-88

55. The forecast is that the PSBR in 1987-88 will again significantly undershoot the Budget forecast, by about £3b. About two thirds of the predicted undershoot is accounted for by central government own account

borrowing, with the rest due to lower local authority borrowing. The error margins attached to PSBR forecasts made in the summer for the current year remain very large, only a little smaller than for the Budget forecast.

56. The main components of the £3b. reduction in the PSBR forecast for 1987-88, nearly all on the receipts side, are:

Contribution to the change in the 1987-88 PSBR forecast	**£ billion**
- higher North Sea revenues with the North Sea oil price averaging $18 a barrel in 1987 and the £/$ exchange rate remaining close to its current level;	-¾
- higher non-North Sea corporation tax reflecting upward revisions to profits data for 1986 and higherdividend payments in 1987 (the latter generate higher ACT effectively bringing forward corporate tax payments);	-½
- higher stamp duty as a result of the buoyant housing and stock markets;	-¼
- higher national insurance contributions reflecting higher money incomes and a new detailed assessment by the Government Actuary;	-½
- lower local authority borrowing in line with the low level of borrowing in 1986-87 and first two months of 1987-88;	-1
- improved ECGD trading position reflecting more refinancing of debt;	-¼
- higher central government contribution to the planning total (excluding privatisation proceeds)	+¼
- lower central government dividend receipts partially offset by lower net debt interest payments	+¼
- higher privatisation proceeds in line with PE's latest assessment.	-¼
TOTAL CHANGE IN PSBR FORECAST	-3

(b) Fiscal adjustment and PSBR in 1988-89 and 1989-90

57. With the MTFS assumption of PSBRs of one per cent of money GDP in 1988-89 and 1989-90 the forecast would have annual fiscal adjustments of over £7b. and £1b. respectively. For both these years the totals of expenditure and (pre-fiscal adjustment) receipts have been revised up from the stylised levels published in the 1987 FSBR. The forecast levels for public expenditure are close to those in previous internal forecasts. The forecast levels of revenue are higher (see tables 31 and 33). Part of the explanation for the better prospect for finances overall in these years is the higher level of economic activity and prices now, which helps to keep expenditure down and increase revenues. A slight downturn in growth in 1989 contributes to the lower scope for further fiscal adjustment in that year.

(c) Public Expenditure

58. The forecast of the planning total excluding privatisation proceeds in 1987-88 is nearly £½b. above the PEWP, a smaller projected overspend than in 1986-87. For 1988-89 and 1989-90 the forecast takes account of both the differences between the economic assumptions used in the PEWP and the economic prospects in the forecast, and other pressures on programmes which past experience suggests are likely. The forecast is in effect attempting to anticipate not only the outcome of the current survey (and in the case of 1989-90 the next survey as well), but also any eventual over or underspend on the finally agreed planning totals. Privatisation proceeds of £5b. per annum have been assumed in both future years.

59. Table 31 sets out increases in programmes compared with the 1987 PEWP in terms of economic (rather than departmental) categories. In 1988-89 and 1989-90 about half the projected excess of the cash planning totals above the current plans is accounted for by social security and local authority current expenditure. These are areas over which the Government has limited direct control. Much social security expenditure is controlled to a great extent by the behaviour of the economy.

60. The forecast of local authority current spending, most of which is pay, assumes that numbers employed will rise at much the same average rate as in the last 2-3 years and that earnings will rise

faster than those in the private sector in the 1987-88 pay round but in line with the private sector thereafter, plus an adjustment for this year's teachers settlement (see paragraph 39). To finance the forecast level of current expenditure LA rates increase over the next two years at about the same rate as in 1987-88. This forecast for local authorities takes account of the available evidence that suggests that the bulk of them will not face undue difficulties in financing levels of cash expenditure some way above current plans. The projected increases in local authority spending and income appear to be consistent with the local authority borrowing requirement remaining at or only a little above its low 1986-87 level.

61. The forecast overspend on public corporations EFLs is expected to be consistent with continued repayment of borrowing, ie with a negative PCBR.

TABLE 30: FORECAST CLAIMS ON THE RESERVE (tb1)

	1987-88	1988-89	1989-90
Central government pay	0.6	1.5	2.8
Other central government current expenditure*	0.1	1.2	2.1
Net EC contributions	0.1	0.3	0.5
Social Security (including housing benefit)	0.7	2.0	3.9
Other central government	1.1	1.3	1.9
Local authority current	1.1	3.1	5.2
Local authority capital	0.2	0.3	0.4
Public corporations' EFLs	0.1	1.0	1.5
Privatisation proceeds	-0.3	-	-
1987 PEWP Reserves	-3.5	-5.5	-7.5
Overspending on PEWP planning totals	0.2	5.2	10.8

* includes MOD procurement

62. The large upward revision to the planning total forecast in 1988-89 since the Budget is largely matched by a higher inflation forecast. Consequently the increase in the planning total in real terms is much

less than the cash increase. In real terms the planning total and GGE (see table 31) are much the same as, or lower than, earlier forecasts.

TABLE 31: PAST AND CURRENT FORECASTS OF GGE INCLUDING PRIVATISATION PROCEEDS (£ bn.)

Forecast:	1986-87		1987-88		1988-89		1989-90	
	Current Prices	Real Terms*	Current Prices	Real Terms*	Current Prices	Real Terms*	Current prices	Real Terms*
Jan 1986	164	157	171	157	181	158	-	-
June 1986	164	158	172	160	181	160	-	-
Oct 1986	165	161	173	162	183	163	195	164
Jan 1987	165	160	174	162	185	164	197	166
FSBR 1987	165	160	174	161	181	161	189	162
June 1987	165	160	173	160	185	162	198	165

*1985-86 prices, using the GDP deflator

63. The ratio of GGE (excluding privatisation proceeds) in money GDP is forecast to fall in 1987-88 and 1988-89, but not in 1989-90. It is below or equal to the PEWP/MTFS paths, except in 1989-90 when it is above the MTFS, though not the PEWP, level.

TABLE 32: RATIO OF GGE EXCLUDING PRIVATISATION PROCEEDS TO MONEY GDP (%)

	1985-86	1986-87	1987-88	1988-89	1989-90
1987 PEWP	44¾	44½	44	42¾	42¼
1987 FSBR	44¾	44¼	43½	42½	41¾
June forecast	44¾	44¼	43	42¼	42¼

General government receipts

64. In the past year there have been consistent upward revisions to forecasts of non-oil receipts. In this forecast there is also a large upward revision to the forecast of oil revenues as a result of higher dollar oil prices.

65. Some of the upward revisions to non-oil receipts over the past year have been due to upward revisions to forecasts of money incomes and expenditure, but much the greater part has been due to higher receipts

for given incomes and expenditure - ie to higher effective tax rates. This time higher incomes and expenditure largely explain the higher non-oil receipts. Profits estimates for 1986 have been increased, producing more corporation tax in 1987-88 and the stock market has been stronger than expected so far this year leading to a higher forecast of stamp duty receipts. In addition the level of money GDP is forecast to be higher than in the FSBR and internal January forecasts throughout the forecast period. As table 33 shows the upward revisions to forecast receipts in 1988-89 and 1989-90 since January are in real terms slightly less than the upward revision to 1987-88.

TABLE 33: COMPARISON OF FORECASTS OF GENERAL GOVERNMENT RECEIPTS (PRE-FISCAL ADJUSTMENT FOR 1988-89 AND 1989-90)* (£b.)

Forecast:	1986-87		1987-88		1988-89		1989-90	
	Cash	Real Terms	Cash	Real Terms	Cash	Real Terms	Cash	Real Terms
January 1986	157	151	167	153	178	156	-	-
June 1986	156	151	164	154	179	160	-	-
October 1986	156	152	165	154	181	161	196	165
January 1987	158	154	169	157	184	163	197	166
FSBR 1987	159	155	169	157	178	159	187	162
June 1987	160	155	172	159	188	164	201	167

* Forecasts made before this and last year's Budgets have been adjusted to be consistent with current tax rates and allowances. Real terms figures are at 1985-86 prices.

66. Table 34 gives non-oil taxes and national insurance contributions (NICs) as a percentage of GDP. The non-oil tax burden is forecast to rise steadily at unchanged tax rates and allowances, ie before fiscal adjustment. The forecast fiscal adjustment is sufficient to reduce the tax burden in 1988-89 but it rises in 1989-90.

TABLE 34: NON-OIL TAXES AND NICs AS A PERCENTAGE OF NON-OIL GDP

	1985-86	1986-87	1987-88	1988-89	1989-90
FSBR					
(a) pre-fiscal adjustment	37.2	37.3	37.8	37.9	37.7
(b) post fiscal adjustment	37.2	37.3	37.8	37.1	36.6
June Forecast					
(a) pre-fiscal adjustment	37.3	37.7	38.0	38.4	38.8
(b) post fiscal adjustment	37.3	37.7	38.0	37.5	37.9

ANNEX A:

PUBLIC EXPENDITURE ASSUMPTIONS

The forecast of public expenditure for 1987-88 takes account of the latest information available, including GEP's monthly assessments. For 1988-89 onwards, the forecast reflects the extent to which the plans in the 1987 Public Expenditure White Paper are likely to be achieved given the forecast's assessment of economic developments and other pressures on expenditure. At the time the forecast was made no information on departmental bids for extra expenditure was available.

2. Detailed assumptions made were as follows:-

(i) The ratio of Aggregate Exchequer Grant for local authorities to expenditure outturn in Great Britain in 1988-89 and 1989-90 will be a little below the forecast outturn for 1987-88, which preliminary indications suggest will be 47¼ per cent compared with 47¾ in 1986-87.

(ii) An increase in the VAT ceiling for EC own resources contributions from 1.4 to 1.6 per cent with effect from 1 January 1988.

(iii) Privatisation proceeds of £5 billion per annum in 1988-89 and 1989-90. For 1987-88 PE's latest best guess of £5¼ billion is used.

3. The table below compares the main economic assumptions used in the 1987 PEWP with the forecast.

		1986-87	1987-88	1988-89	1989-90
GDP deflator %					
PEWP		3	3¾	3½	3
Forecast		3	5	5¾	5
Money GDP					
PEWP	£ billion	380.2	407.0	431.4	455.2
	% increase	5½	7	6	5½
Forecast	£ billion	382.6	416.2	449.1	480.8
	% increase	6¼	8¾	8	7
Unemployment (GB, narrow) million					
PEWP		3.1	3.05	3.05	3.05
Forecast		3.03	2.7	2.5	2.5

	Year to Sept 87	Year to Sept 88
RPI %		
PEWP	3¾	3½
Forecast	4¼	5

Short Term interest rates %				
PEWP	10¼	10¼	8½	8
Forecast	10½	9½	10½	10½

RC2.5

SECRET

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

6 July 1987

David Norgrove Esq
10 Downing Street
LONDON
SW1

Prime Minister

Dear David,

OFFICIAL RESERVES

You asked for an update of the breakdown of the official reserves assets and liabilities under the exchange cover scheme provided in my letter of 18 May. The figures, on the same basis as before, are:

Spot: (the total, but not the breakdown, published monthly)

	end April	$ billion end June
- US Dollars	14.0	17.8
- Other currencies (mainly DM and Yen)	4.7	5.6
- Gold	7.2	7.2
- SDR	3.4	3.3
Total	29.4	33.9
Forward (never publicly known)		
- US Dollars	3.3	3.5
- Other	1.5	0.9
Total	4.8	4.4

Intervention added $7.5 billion to the total in May, of which $4.9 billion was added to the spot book. The remainder went temporarily to the forward book in anticipation of the forward sale of about £3 billion equivalent to the MOD which took place early last month.

SECRET

Intervention in June was limited, falling short by about $300 million of the amount required to keep the spot book flat after taking account of outflows resulting principally from the requirements of government departments.

There is no change on the liabilities side:

	$ billion	
	end-April	end-June
- Long-term North American loans	2.4	2.4
- Other HMG debt	7.0	7.0
- Exchange Cover Scheme Debt	10.0	10.0
Total	19.4	19.4

Of this total $16 billion is denominated in dollars.

Yours,
Cathy

CATHY RYDING
Assistant Private Secretary

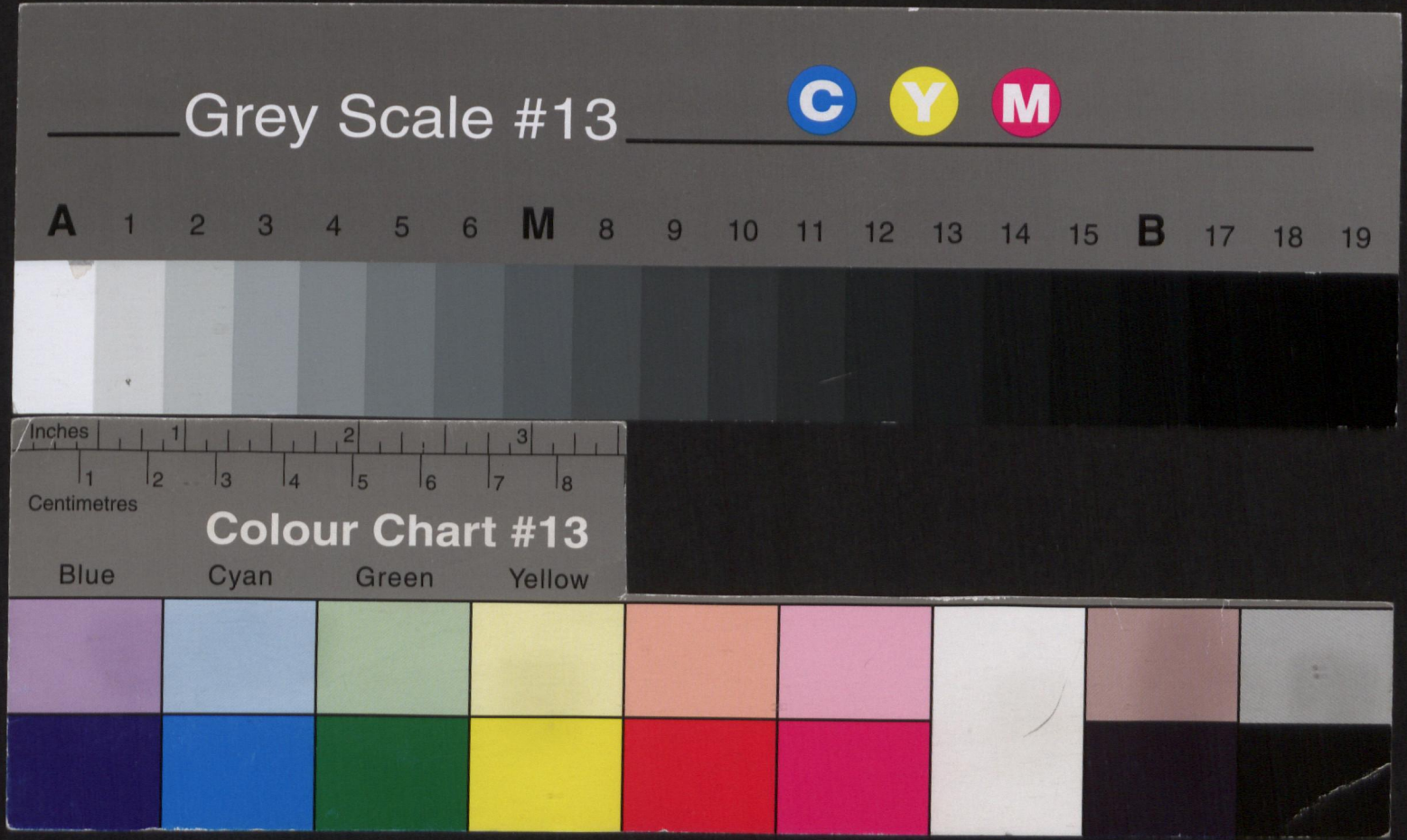
Econ Aor
DM Policy
P776

PART 16 ends:-

DRN TO PM 23.6.V7

PART 17 begins:-

HMT TO DRN 6.7.V7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