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PREM 19/2086

PART 18

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SECRET

Confidential Filing

Domestic Monetary Policy

ECONOMIC POLICY

PART 1: MAY 1979

PART 18: JANUARY 1988

PREM 19/2086

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~9.1.88~~							
~~11.1.88~~							
~~11/2/88~~							
~~15/2/88~~							
~~1.3.88~~							
~~10.3/88~~							
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~~31.3.88~~							
~~2.6.88~~ (1A)							
~~13.6.88~~							
~~17.6.88~~ 1A							
24.6.88							
PT 18							
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PART 18 ends:-

Pa to HMT. 24.6.88

PART 19 begins:-

Pa to PM. 1.7.88.

SECRET AND PERSONAL

16 A-B
file DCA ALK
Subject CC MASTER

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

24 June 1988

Dear Alex,

MARKET MANAGEMENT

The Prime Minister and the Chancellor this morning discussed market management issues against the background of the balance of payments current account figures to be published on Monday.

I should be grateful if you could ensure that this record of the discussion is seen only by named individuals on a strict need to know basis.

The Prime Minister said she was concerned at the picture shown by the balance of payments figures. She invited the Chancellor to give his assessment and say how he thought it was best to handle the markets once the figures were published.

The Chancellor said that he had indicated at Treasury Questions last week that the current account deficit for 1988 was likely to be higher than the forecast of £4 billion included in the FSBR. The May figures were a further indicator that the growth of the economy was moving ahead faster than had been expected. There were however crumbs of comfort to be drawn from the current account figures in that the fastest rate of growth within imports was for capital goods, reflecting the current strong performance of business investment. He felt it was uncertain how the markets would react to the current account figures, but unless the markets took extreme fright he would want to adopt a reasoned rather than a crisis response. He therefore would prefer not to take any immediate action further to raise interest rates. If there was immediate downward pressure on the exchange rate, he would propose to allow the rate to fall a little, but also to intervene on a sufficient scale to break the fall. Once the markets had settled, he would favour an initial further ½% interest rate increase.

The Prime Minister wondered whether such an approach would convince the markets that the authorities were taking the situation sufficiently seriously. In particular to raise interest rates only by ½% might lead the markets to the immediate conclusion that a further rise was essential. It

might therefore be preferable to make a full 1% increase at the outset. She agreed that some intervention to break any fall in sterling would be appropriate, but this should not involve excessive amounts.

Responding, the Chancellor said he did not rule out making a full 1% increase if there was a markedly adverse market reaction to the current account figures. But, while this was a possibility, he did not think it was likely, and if circumstances allowed he would strongly prefer to continue to make interest rate adjustments in steps of ½%. He did however agree with the Prime Minister that it was appropriate to plan for a period of significant tightening of policy. He certainly thought it would be necessary to take interest rates up to 10%, and possibly higher.

In further discussion, the Prime Minister expressed concern that the United Kingdom could be moving into a sustained period of large current account deficit. Although the United States deficit now seemed to be falling substantially, the surpluses of Germany and Japan remained very high, and she feared the United Kingdom was poised to square the circle with an increased deficit. The Chancellor said that he was not unduly concerned by a temporary period of current account deficit following the large surpluses of recent years, and this could be viewed as a safety valve for the recent strong UK economic performance much preferable to the alternative of renewed upward pressure on inflation. He felt that the necessary process of adjusting the current account position would come about as the growth rate of the UK economy slowed down and growth rates in other economies possibly picked up. But the process was likely to be gradual and could not to completed quickly; a substantial deficit might persist for, say, two years. The Prime Minister said she would regard two years of substantial deficit as considerably too long, and she felt that the necessary policy adjustments should be made to complete the process more quickly.

There was also brief discussion of the implications for the 1988 public expenditure round. The Prime Minister and Chancellor agreed that the necessary overall tightening in policy must be reinforced by a tough public spending round. It was noted that they would be discussing the handling of public expenditure further next week.

(PAUL GRAY)

Alex Allan, Esq.,
HM Treasury.

PRIME MINISTER

RA

THE MARKETS AND INTEREST RATES

Sterling opened weaker this morning, mainly influenced by yesterday's set of economic statistics, although it has strengthened a little during the course of the day. | market report attached

I have discussed with the Treasury the Chancellor's latest thinking on interest rates. His views are:

(i) It was not appropriate to have a half per cent increase today. It is too soon to assess the market trend and would have looked rather panicky.

(ii) But if sterling remains weaker next week, he will want to make the further half per cent interest rate increase. In normal circumstances, this might best be done on either Monday or Tuesday. But he accepts that it would be unwelcome to make the change while you were both in Toronto. I made the point that you would not, for example, want your Press Conference on Tuesday diverted into discussion of the latest move by the United Kingdom authorities.

(iii) So, unless there is any particular market weakness on Monday or Tuesday, the Chancellor will aim to leave the increase until later in the week - either Wednesday (by which time he will be back but you will still be away) or Thursday.

(iv) The Chancellor's party will, however, be in touch with London first thing on Monday. If the Chancellor then reaches the view that action early in the week is appropriate, he will of course be able to discuss this with you in Toronto.

In reaching your view, you will want to consider the latest economic statistics. The figures published this week do, I think, clearly point to the need for some tightening of policy. Next week, ~~you~~ we will have on Monday the provisional

B

money supply figures for May (attached); these are not too bad, but again suggest that some tightening would be in order. Monday also sees publication of the latest CBI Monthly Trends Inquiry, but I have not yet seen that material. Other figures later in the week are of less significance, the most important being Tuesday's first quarter's GDP figures.

The next major figure to hit us will be the May Balance of Payments. That will be published on Monday 27 June. We will not know until well into next week the import side of the equation. The export figures have just arrived (also attached) and do not look too good, with a £0.3 million drop from April. So at this stage, it looks as though the current account figure will be far from healthy.

All in all, the conclusion I draw from this is that it would be right to take the opportunity to push interest rates up another half per cent. You will not welcome the impact this would have on mortgage rates. But two factors to bear in mind on that are:

(i) Any rise will merely offset the reductions seen earlier this Spring.

(ii) One of the most direct counter-inflation effects of rising interest rates is via the reduction in personal consumption as individuals' residual incomes are squeezed by the increase in mortgage repayments.

We shall have to consider whether it would be better to do so MT

PR CG

PAUL GRAY
17 June 1988

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CC BG

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

13 June 1988

The Rt Hon Lord Young of Graffham
Secretary of State for Trade and Industry
1-19 Victoria Street
London SW1

NBPM
PRCG
14/6

Dear David

REPORT ON THE STOCK MARKET FALL

Thank you for your letter of ~~26~~ May enclosing a report by your officials on the Stock Market Fall. I have also seen the Deputy Governor's letter of ~~7~~ June, and agree with all the points he makes.

There is clearly no reason why you should not send a copy of the report to the regulatory bodies, particularly since I understand they have seen the paper in draft already.

But I see no case for publication, either of this paper, or of an abridged version. There is little pressure for publication, and, frankly, the paper adds very little to the conclusions of earlier reports eg. by the Stock Exchange. If published, I fear it will be seen as a somewhat feeble and very belated response to October's events.

That said, it is for you to decide on publication. If you do decide to go ahead I trust it will be made clear that this is a report by your officials and not in any way a joint product with the Treasury.

I am copying this letter to the Prime Minister and the Governor.

Yours
Nigel

NIGEL LAWSON

ECON POL: Domestic Monetary Policy Pt 2.

RA

Not to be released before 11.30 a.m. CET
on Monday, 13th June 1988

BANK FOR INTERNATIONAL SETTLEMENTS

13th June 1988

PRESS COMMUNIQUÉ

The following are excerpts from the speech delivered by Dr. W.F. Duisenberg, Chairman of the Board of Directors and President of the Bank for International Settlements, to the fifty-eighth Annual General Meeting of the Bank held in Basle on 13th June 1988.

I now turn to economic and monetary developments in 1987 and the first few months of this year. That period has, in certain respects, been a very eventful one. In the industrial countries it has been marked by three main features: continuing economic growth with inflation remaining subdued, but inflationary expectations rather volatile; a reduction, both in real and, to a lesser extent, in nominal terms, of the major payments imbalances; and, owing mainly to the persistence of large nominal imbalances, episodes of major turbulence in the financial markets.

1987 was the fifth year of the economic upswing that had begun towards the end of 1982. The industrial countries' overall growth rate was 3%, slightly higher than in 1986; and growth appears to have continued steadily in the first quarter of this year, although perhaps not quite at the same pace as in the second half of 1987. Two features of the recent growth performance have been particularly encouraging: the resilience of economic activity in the face of the stock market crash, as demonstrated by the marked acceleration of growth in the second half of the year; and the vigorous, domestically oriented expansion of activity in Japan. A less favourable element in the situation is that the growth of real domestic demand in the United States, while lower than in most other large industrial countries, remains rather buoyant in relation both to the need for further external adjustment and to approaching capacity restraints in the economy.

On average, recorded inflation rates rose last year in the industrial world, after having declined in 1986 as the oil price fell. Consumer price inflation went up from 2 3/4% in 1986 to 3 3/4% by the end of 1987, at which level it was slightly lower than just before the oil price decline. Moreover, in the first quarter of this year the rise in prices slowed down a little. Wage trends were not a major problem in most countries last year. In particular, wages rose less than consumer prices in the United States despite the continuing decline in unemployment. In the United Kingdom, on the other hand, where the decline in unemployment was greater, wage increases accelerated somewhat from levels that were already higher than in most other major countries. While inflation itself remained subdued, inflationary expectations fluctuated markedly over the past year. After having been dampened by the stock market crash, they have recently resurfaced, particularly in the United States in connection with the combined strength of domestic and export demand. Given the imminence of bottlenecks both in the labour market and in industry, resources need to be set free if further progress is to be made in reducing the US external deficit.

Turning to the major payments imbalances, the most encouraging evidence of the workings of the adjustment process during the past year has been the strength of US exports. By the fourth quarter of 1987 their volume was over 18% above the level of a year earlier. Export gains have been broad-based both by commodities and by markets, and they point to a major and welcome recovery of competitiveness by US industry. On the import side, the evidence has been less clear. Excluding oil, US imports rose by almost 8% between the fourth quarters of 1986 and 1987.

In Japan there was evidence last year of adjustment on both sides of the trade balance. Between the fourth quarters of 1986 and 1987 the volume of non-oil imports went up by nearly 14% while that of exports was unchanged. In Germany, too, real non-oil imports increased over that period quite strongly, by 8 1/2%; in contrast to Japan, however, exports rose by 7 1/2%.

In addition to these signs of real external adjustment, the nominal current-account surpluses in both Japan and Germany declined in the second half of last year. In the United States, however, it was only in the early part of 1988 that the first clear signs of a reduction in the nominal current-account deficit appeared and it was the persistence until then of very large nominal trade deficits that was in all likelihood the most important cause of last year's financial turbulence.

Three features of that turbulence were notable. Firstly, its magnitude. That was most evident in the scale of last October's stock market crash. But in addition the volume of central bank exchange market intervention since the Louvre Accord of February 1987 has been exceptionally large, despite which the dollar had by early this month fallen by a further 18% against the yen and by 6% against the Deutsche Mark. Moreover, the yields on long-term US and Japanese government securities varied by as much as one-third and one-half respectively in the course of 1987, despite only modest changes in these countries' observed inflation rates.

The second notable feature of the past year's financial turbulence was the confirmation it provided of the extent to which

financial markets are now interconnected. Thus, in the spring of last year lack of confidence in the dollar affected not only the exchange markets, but also the bond markets, where rates rose in the US market and fell in those of the strong currencies. Moreover, the stock market crash was remarkable for the fact that, except in Japan, the decline of equity prices was rather uniform across countries, regardless of the extent of their earlier rise or of differences between countries' economic fundamentals. Subsequently, during most of the first quarter of 1988 we saw a phase of relative stability in all financial markets.

Despite the interconnections between different markets, however, there was no point last year at which all markets were in trouble at the same time. In particular, the stock market crash, while it led to further exchange market turbulence, triggered a strong recovery of prices in the bond market and did not create any systemic problems in the financial system. No doubt that reflected in part the actions taken by central banks to provide ample liquidity to their markets in the wake of the crash.

The third feature of last year's turbulence was that it was limited to the financial markets. There appears to have been no significant impact on economic activity. In that very important respect events since October 1987 have contrasted sharply with those that followed the 1929 stock market crash. To my mind, a more appropriate comparison is with the large, although much less rapid, fall of share prices on many stock markets in 1962. That fall occurred at a time of even more buoyant economic activity and it also was not followed by any weakening of real growth.

As regards the course of events in the developing countries, the first feature I should like to mention is the further increase that occurred last year, to over $30 billion, in the combined current-account surpluses of certain newly industrialised countries in Asia. These combined surpluses, of which Taiwan alone accounted for over $18 billion last year, are now the largest counterparts, outside Japan and Germany, to the current-account deficit of the United States, and by the end of 1987 Taiwan's foreign exchange reserves were the largest of any country in the world. This group of countries, and Taiwan in particular, can make a significant contribution to the reduction of the present global payments imbalances, mainly by the adoption of appropriate trade liberalisation and exchange rate policies.

As far as the international debt situation is concerned, the middle-income problem debtor countries reduced their aggregate current-account deficit last year, partly through increased export earnings. Together with lower interest rates, this contributed to a sharp decline in the share of their export earnings that was devoted to debt service. Moreover, various new initiatives were taken with a view to giving added flexibility to the handling of debt problems. Some of these were aimed at speeding up rescheduling and new money negotiations between the debtors and the banks and others at achieving voluntary reductions of outstanding debt. The latter included debt conversion and buy-back schemes based on the secondary market prices for countries' banking debt.

There is as yet, however, no sign that these countries are regaining spontaneous access to market finance. Indeed, last year's substantial debt provisioning by US and other banks and the greater awareness of secondary market discounts on these countries' debts may make

it more difficult for banks to put up new money for problem debtors. Nevertheless, it is hard to conceive of a solution to the debt problem without the banks, as the major creditors, contributing to it in one form or another. Debtor countries themselves should, of course, continue to pursue their adjustment efforts. All in all, and despite the progress that has been made since 1982, particularly in reinforcing the capital positions of international banks, the debt situation remains a major problem.

At the centre of the international scene at present, however, are concerns about problems in the industrial world. I should therefore like to conclude by spending a few minutes considering the outlook for conditions in financial markets and for the evolution of the major payments imbalances.

Last year's turbulence in the financial markets was, without doubt, an unpleasant surprise. What are the chances that we could see a repeat performance of those events? I believe that the risks of this happening have substantially diminished. Last year's stock market crash did not lead to any slowdown of economic growth and it was, except in Japan, followed by a stabilisation of stock market prices at much less vulnerable levels than before. In the exchange markets, the further fall of the dollar after the stock market crash should, coming on top of last year's dynamic growth of US exports and the recent clear improvement in the US foreign trade balance, contribute to greater exchange market stability in the future. Lastly, for most of the first quarter of 1988 we did in fact see a phase of relative calm in all financial markets.

More recently, however, there have been reminders from the markets of the uncertainties which still exist. US long-term interest rates have been moving up again because the buoyancy of demand is pushing the economy towards full use of capacity, and rates have risen in Germany and Japan too; and there have been occasional quite sharp falls in equity prices. Moreover, the disappointing US trade figures for February put immediate downward pressure on the dollar, while the much better ones for March triggered a fall in US bond prices. Those episodes showed that markets remain unsettled. Looking beyond recent events, all forecasters seem to be agreed that, barring a US recession, the rest of the world will have to finance sizable US current-account deficits for some time to come. The markets are very conscious of this - hence the close attention they pay to the monthly US trade data.

What, then, can be done to guard against the risk of a recurrence of financial market turbulence of the kind that we saw last year? Obviously, there are lessons to be drawn from the stock market crash and this process is already under way. Those who operate in the securities market need to look carefully, for instance, at the role of new financial techniques such as program trading. Securities market supervisors need to consider the implications of the close connections which exist between stock markets proper and markets in stock futures and options. Last year's turbulence also underlined the importance of financial institutions being adequately capitalised in relation to the risks inherent in today's deregulated and globalised markets. In that connection I welcome the proposals made at the end of last year for a convergence of capital adequacy standards for banks in the Group of Ten countries. Finally, I should like to stress the need to develop co-operation, both domestically and internationally, between banking and securities market supervisors.

In my view, however, given the prospect that nominal current-account imbalances in the United States, Japan and Germany will continue to be substantial for the foreseeable future, the decisive factor for the behaviour of financial markets will be the perceived efforts of governments and central banks to handle the situation by co-ordinated policy actions. What lessons can we draw from the events of the past year for international policy co-ordination efforts? There was certainly no lack of joint action in the exchange market. Indeed, intervention helped to produce, admittedly at considerable cost, substantial results on two occasions - the recovery of the dollar to its pre-Louvre levels in the summer of 1987 and the period of stable exchange rates during the first quarter of this year. But nobody thinks that intervention alone can stabilise the dollar.

Moreover, monetary policy has been used in support of official exchange market intervention, as can be seen from the persistent differentials between short-term rates in the United States, on the one hand, and in Germany and Japan, on the other. However, the policies which produce such interest rate differentials can, beyond a certain point, themselves create new risks: in Germany and Japan the risk that rapid monetary growth may reawaken inflationary expectations; and in the United States the risk that upward adjustments of short-term rates may come on top of, and add to, existing upward pressure on long rates.

What went wrong last year was that policy co-ordination relied too much on exchange market and monetary policies and too little on fiscal adjustment. In saying this, I do not forget last year's fiscal stimulus in Japan. That was a notable contribution to the international adjustment process; it was also a useful reminder that fiscal policy can, in a non-inflationary environment, be an effective tool of demand management policy. Germany's fiscal policy, too, has moved in the right direction for international adjustment, although not as far as some, both in Germany and elsewhere, would like. In the United States last year's reduction of the Federal budget deficit was substantial. However, its effect on total US domestic demand was offset by a further fall in private savings. More adjustment, including additional fiscal restraint, is therefore needed in the US domestic economy.

The goal of correcting, through international policy co-ordination, the payments imbalances that emerged in the first half of the 1980s may seem hard to attain. However, we must not forget the time that elapsed before it was agreed, in late 1985, that the imbalances constituted a problem and the size that they had by then reached. Nor should we overlook what has been achieved so far in dealing with the two main factors that produced them. The misalignment of exchange rates has been corrected, as the recent performance of US exports indicates. In addition, the most recent data show that the earlier difference in the growth of domestic demand between the United States and the two main surplus countries has been reversed. These are not negligible results and they show that we are on the right path. The task now is to build on them by maintaining the momentum of co-ordinated adjustment efforts.

With the Compliments of
Sir George Blunden

DEPUTY GOVERNOR
BANK OF ENGLAND

01-601 4472

CG BG

BANK OF ENGLAND
LONDON EC2R 8AH

THE DEPUTY GOVERNOR

7 June 1988

The Rt Hon Lord Young of Graffham
Secretary of State for Trade and Industry
Department of Trade and Industry
1-19 Victoria Street
London
SW1H 0ET

MRPM
Rec 6
8/6

Dear Lord Young

AC/Kg

REPORT ON THE STOCK MARKET FALL

In the absence of the Governor abroad on business, I am writing to thank you for sending us a copy of your letter of 26 May, addressed to the Chancellor, together with the accompanying report by your officials. This reply was seen in draft by the Governor before he left, and he fully supports all that is said in it.

You refer to concerns which Bank officials have expressed about publishing the report, and comment that the passages on collaboration between regulators amount to no more than bland statements of the obvious. We accept that this is a fair description of those particular passages, as they are now worded. Nevertheless the very act of making public the series of official conclusions set out in Chapter 6 would give an impression of a checklist of actions to be taken and arrangements to be brought into play in a crisis by the appropriate regulators which would give journalists and others a standing invitation continually to enquire about their nature or progress.

I will give two illustrations of what we have in mind. One is the passage calling for improvements in the arrangements between banks and their dealer customers, where we consider that such arrangements actually stood the test of October 1987 very well in London and where, although there were no doubt lessons learnt by individual banks and securities dealers, as well as by regulators, the conclusion that these need particular improvement gives a misleading and slightly alarmist impression of the reality. This would of course be less worrying in a report given limited circulation than in one given wide publication. Another example is in the drawing of attention to the fact that the Stock Exchange is considering a central margining system for equities. This is certainly an interesting and potentially important proposal which we would expect your officials to report to you. But it seems

premature for it to be highlighted in a published report, when it is at an early stage of internal consideration in the Stock Exchange and may in the event possibly not be pursued, if a comparison of its costs and benefits shows it to be inferior to other methods of reducing counterparty risk.

Hence our preference would still be that you should not publish the report. We do not sense any great pressure from the media for publication; and the likelihood of this arising is surely receding the further away we move from October 1987. It would be sufficient in our view for you to circulate the report to those bodies which your officials have consulted and who would anyway include the people principally interested in its conclusions. That course would also have the advantage that some, perhaps all, of the excisions from the report which would be necessary in a wider publication need not not be made; and to that extent the report could be less anodyne.

We recognise, of course, that it is for you to judge whether to publish a report which you commissioned from your officials. If you go ahead, we assume that it will be presented on that basis rather than as the joint product of your own Department and, among others, the Bank.

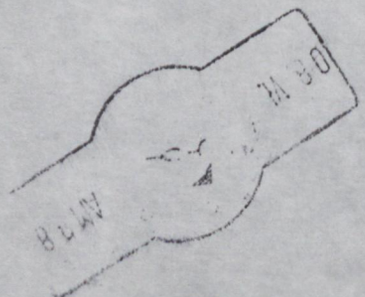
I am copying this letter to the Chancellor of the Exchequer and the Prime Minister.

Yours sincerely,

George Blunden

Exec Pol

Parole Marshall Policy Pt 18



SECRET 14

HMO
LOSANI

10 DOWNING STREET

LONDON SW1A 2AA

From the Principal Private Secretary

2 June 1988

INTEREST RATES

The Prime Minister and the Chancellor of the Exchequer had a short discussion this morning about interest rates.

The Chancellor explained that recent developments in the foreign exchange markets suggested that there was a strong case for an immediate increase of ½ per cent in interest rates. The Prime Minister said that she agreed with this judgement. The Chancellor said that it might be necessary to increase interest rates by a further ½ per cent before too long. The Prime Minister hoped that this would not be the case, because of the effect on mortgage rates. But she agreed that if higher interest rates were necessary, they should be increased.

N. L. WICKS

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

SECRET

From: THE PRIVATE SECRETARY

nbpm cc PBO

HOME OFFICE
QUEEN ANNE'S GATE
LONDON SWIH 9AT

1 June 1988

Dear Eleanor

"NATIONAL" LOTTERIES

I attach a copy of a letter dated 13 May from my Secretary of State to the Lord President on the above subject. I am sorry that this was not copied to your Minister, as it should have been.

I also attach copies of responses received so far and would be grateful if recipients of this letter could ensure that your Minister is included in any subsequent correspondence.

I am copying this to Private Secretaries to recipients of the Home Secretary's letter of 13 May. I should be most grateful if any comments could reach our office by Wednesday 8 June.

Yours
Catherine

MISS C J BANNISTER

Miss E Goodison

91G.SCB.4317.8

Prime Minister 2

CONFIDENTIAL

FROM: I POLIN
DATE: 1 June 1988

1. MISS O'MARA mon 1/6
2. CHANCELLOR OF THE EXCHEQUER

Distribution

PPS
PS/EST
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Version as amended by the Chancellor.

Ian Polin
2/6/88

THE RESERVES IN MAY 1988

The reserves announcement for May will be made on Thursday 2 June at 11.30 am. This month's announcement reports a rise in the reserves of $676 million and an underlying rise of $814 million.

Ian Polin.

I POLIN

Mr Gray - No 10
Mr Cassell - Washington (after publication)

Mr Foot)
Mr D J Reid) - B/E
Mr J Milne)
Miss J Plumbly)
Mrs Jupp)

CONFIDENTIAL

91G.SCB.4317.3

CONFIDENTIAL
until Thursday 2 June 1988
thereafter UNCLASSIFIED

DRAFT PRESS NOTICE

THE RESERVES IN MAY 1988

The UK official reserves rose by $676 million in May. Repayments of borrowing under the exchange cover scheme amounted to $105 million. There was no new borrowing under the exchange cover scheme this month. Repayments of HMG debt amounted to $33 million. After taking account of foreign currency borrowing and repayments, the underlying change in the reserves during May was a rise of $814 million. At the end of May, the reserves stood at $48,533 million (£26,374 million*) compared with $47,857 million (£25,467 million+) at the end of April.

Note to Editors

2. The underlying change 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).

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* When converted at the closing market rate on Tuesday 31 May £1=$1.8402

\+ When converted at the closing market rate on Friday 29 April £1=$1.8792

3. There was no new borrowing under the public sector exchange cover scheme this month but repayments of such borrowing were as follows:

North West Water Authority, $32 million; North of Scotland Hydro Electricity Board, $25 million; Electricity Council, $15 million; British Telecommunications PLC, $12 million; Welsh Water Authority, $4 million; Lancashire County Council, $2 million; Lothian Regional Council, $2 million; Northern Ireland Electricity Services, $2 million; Northumbrian Water Authority, $2 million; Severn Trent Water Authority, $2 million; Strathclyde Regional Council, $2 million; Yorkshire Water Authority, $2 million; British Nuclear Fuels PLC, $1 million; Others, $2 million.

4. The repayment of $33 million of HMG debt represents a further sinking fund instalment in respect of the $150 million issue of the United Kingdom $8^{7}/_{8}$ per cent Bonds due 1993. This issue was made in New York in 1978.

91G.SCB.4317.2

THE RESERVES IN MAY 1988 : PRESS BRIEFING

Factual : Main features of markets in May

	3 May (cob)*	Month's High	Month's Low	31 May (cob)*
£ ERI	78.1	79.2 (16th)	77.8 (5th)	77.9
$/£	1.8700	1.8947 (16th)	1.8385 (31st)	1.8402
DM/£	3.1382	3.1945 (16th)	3.1270 (5th)	3.1743
$ ERI	92.7	93.7 (31st)	92.5 (11th)	93.7
DM/$	1.6782	1.7282 (31st)	1.6755 (5th)	1.7250
Yen/$	124.87	126.25 (17th)	124.00 (24th)	125.05

*cob = close of business.

In spite of a further reduction in UK base rates and a rise in the visible trade deficit, sentiment towards sterling this month remained bullish. It began the month on a softer note, when oil prices fell below $16 a barrel. However, after it had touched lows of $1.8585, DM3.1270 and ERI 77.8 on 5/6 May, the release of a report by Goldman Sachs suggesting that sterling was undervalued against the mark, and that British industry would still be competitive at DM3.27, re-established a bullish tone. However, having touched $1.8947 and DM3.1945 on 16 May, it fell sharply (to 1.8735 and DM3.1625) the following day when UK base rates were reduced to 7½%. Sterling later fell against the dollar on release of US trade data and the Prime Minister's statement of the Government's exchange rate policy, but retained a firm undertone, edging up to $1.8722 (23 May) and DM3.1830 (24 May). Despite the rise in the visible UK trade deficit to £1.1bn, sterling continued to rise against the mark reaching DM3.1870 on 31 May before seeing a bout of professional selling causing it to ease below DM3.18 before the close that day.

The dollar was restricted to a narrow trading range for much of the month. It fell to a low of DM1.6755 on 5 May, but quickly recovered. A ½% increase in US prime rates (9%) on 11 May tended to be offset by a statement from Fed Governor Angell that assumptions about further tightening by the FRBNY "could well be mistaken". It took news of a significant reduction in the US trade deficit to lift the dollar out of its narrow range advancing strongly to DM1.7070 and Yen 126.25. Although subsequently surrendering some ground to the yen, the dollar consolidated its gains against most currencies and ended the month on a firm note trading around DM1.725 and Yen125 on 31 May, with rumours of a US discount rate hike likely in the immediate future.

Previous reserve changes

(i) At the beginning of January 1987, the reserves stood at $21,923 million; at the end of December 1987, they stood at $44,326 million, a rise of $22,403 million (including effect of 1987 revaluation).

(ii) The underlying rise in the reserves in 1987 totalled $20,475 million.

(iii) Reserve changes from the beginning of 1988 have been:

		$ million		
		Underlying change	Total change	Level of reserves at end period
1988	January	+ 38	- 1,233	43,093
	February	- 25	- 166	42,927
	March	+ 2,225	+ 1,713	47,519+
	April	+ 514	+ 338	47,857
	May	+ 814	+ 676	48,533

+after revaluation

(iv) October 1987 underlying change of $6,699 million was largest ever.

(v) Reserves now stand at highest ever level.

Level of official debt

Now stands at $18.2 billion at end January* (latest published figure, Bank of England Quarterly Bulletin, May 1988, Table 17.2). (In May 1979 was $22 billion.)

*at end January market rates.

POSITIVE

Reserves remain very strong after substantial underlying increase of $20 billion in 1987. Reserves stand at highest ever level of $48½ billion.

DEFENSIVE

(A) **POLICY**

1. **Exchange rate policy:** As Prime Minister told House on 17 May [OR Vol 133 No 152 Cols 794-798], "My right hon Friend and I entirely agree that we must maintain a firm monetary policy and a downward pull on inflation. I totally agree with all my right hon Friend's Budget Speech, every bit of it.....The right hon Gentleman asked about exchange rate policy. It is a part of total economic policy. As I indicated a moment ago, he will note that we have taken interest rates down three times in the last two months. That was clearly intended to affect the exchange rate. We use the available levers, both interest rates and intervention, as seems right in the circumstances.....it would be a great mistake for any speculator to think at any time that sterling was a one-way bet."

2. **Exchange rate stability runs counter to anti-inflation strategy?** Not alternative strategy. Most of time exchange rate stability reinforces anti-inflationary strategy. As Chancellor said in interview on 'This Week Next Week' BBC1 on 24 April "we are certainly .... interested in the maximum possible exchange rate stability within the context of sound anti-inflationary policy". Chancellor told Interim Committee of International Monetary Fund (IMF) on 14 April, if conflict between objectives for inflation and exchange rates emerges, priority must be given to inflation - but, in practice, this dilemma occurs only infrequently.

3. **No mention of exchange rate stability in Prime Minister's statement to House on 17 May?** Prime Minister explicitly endorsed all of Budget Speech [Chancellor said on 15 March "Exchange rates play a central role in domestic monetary decisions as well as in international policy co-operation. I believe that most businessmen have welcomed the greater exchange rate stability over the past year. It is important that they also accept the financial discipline inherent in this policy".]

4. **Continuing confusion over Government's exchange rate policy?** No. Remarks by Prime Minister in House on 17 May, in conjunction with Government actions ~~with ½ per cent cut in interest rates~~, clearly demonstrate agreed Government policy of seeking greater exchange rate stability within context of firm monetary policy designed to ensure steady downward pressure on inflation.

5. **Sterling shadowing deutschemark?** ['Wall Street Journal', 11 May, claimed to report Chancellor's support for close link between sterling and DM.]
Exchange rate against deutschemark important to industry given proportion of UK trade with EC (50%), so Government naturally pays attention to it.

6. **Tactics:** As Prime Minister reminded House on 17 May, all instruments - interest rates and intervention - will be used as seems right in circumstances ~~and when appropriate~~. But not sensible to reveal operational details or be more precise.

~~7. **Action to counter any further rise in sterling?** As Prime Minister told Leader of Opposition on 17 May (OR Vol 133 No 152 Col 795), "Anyone who is asking to know precisely what will happen is the friend of the speculator and aiding and abetting him."~~

8. ~~British industry suffering from exchange rate rise?~~ [At CBI Annual Dinner, 12 May, President Sir David Nickson called for exchange rate stability. He also said: very considerable achievement .. by Government to keep sterling stable against Mark ... helpful to business; number one priority must remain continued reduction in inflation; devaluation to accommodate inflationary wage settlements, must not be in ... vocabulary; international competitiveness must remain paramount.]

If firms accept financial discipline inherent in Government's strategy and contain their costs, no need for any loss of competitiveness. Greatest threat to output and employment would ~~come if Government relaxed its anti-inflationary stance.~~

9. High exchange rate destroys competitiveness? Maintaining competitive position largely in hands of industry. But, as Chancellor said (on 'This Week Next Week', 24 April), certainly do not want to see exchange rate appreciate further - that would be unsustainable, and as such, damaging for business and industry.

10. April current account deficit suggests exchange rate against deutschemark too high? ~~Current account figures for 1988 need~~ to be interpreted with even greater caution ~~than~~ usual because of changes in documentation and classification system. Prudent to await further ~~months'~~ data before deciding what extent pattern ~~of trade distorted.~~ Current account deficit forecast at time of Budget is readily financiable.

11. CBI May monthly trends survey [published 31 May] attributes weakening export order books to recent strength of sterling. ~~CBI May survey indicates export order books actually risen and reports continuing strong growth in output.~~ British exporters continue to do well in world markets, but have to contain their costs including wage costs.

12. Will Government be prepared to let sterling fall if recent pressures reversed? ~~Consistently made clear will not allow sterling to depreciate to accommodate excessive increases in domestic costs.~~ Never comment on market tactics. No wish to see unsustainable high exchange rate, but equally have consistently made clear will not accommodate excessive increases in domestic costs by sterling depreciations.

13. **Were dollar exchange rate targets and/or a budget for intervention set at Plaza/Louvre?** ["Managing the dollar: from the Plaza to the Louvre" by Yoichi Funabashi claimed narrow exchange rate targets were set at Plaza and revised at Louvre and a budget set for intervention at limits of agreed ranges.]
No comment.

(B) **INTERVENTION**

14. **Why cut interest rates on 17 May rather than intervene?** As Prime Minister said in House on 17 May, use available levers - interest rates and intervention - as seems right in circumstances.

15. **Value of intervention as instrument?** Has important role to play in preventing unsustainable fluctuations in exchange rates which do not reflect underlying fundamentals.

16. **Intervention inflationary?** Only poses inflationary threat if not funded. Government made clear intervention will be fully funded as in 1987-88 so that effect on liquidity sterilised ~~[Prime Minister has argued against excessive intervention.]~~

17. **Details of intervention?** Policy never to discuss.

18. **Have Bank been switching dollars into deutschemarks and yen?** ['Financial Times' article, 27 May 1988.]
Never discuss detailed reserves transactions.

19. **Treasury and Civil Service Select Committee (TCSC) report, published 25 April, recommended "intervention should not be used to maintain an exchange rate incompatible with underlying economic forces".** Agree exchange rates should reflect fundamentals, as G7 communique on 13 April made clear. Under Plaza Agreement and Louvre Accord, intervention aimed first at achieving this position, then maintaining it. Fluctuations in foreign exchange markets do not necessarily reflect fundamentals.

20. Is intervention profitable? Intervention undertaken to support exchange rate policy - not primarily to make profit. For intervention to be profitable, authorities would need to sell sterling when firm and buy it back when soft. This is, of course, what tends to happen over longer term. [N.B. See also BEQB, September 1983 pgs 384-391.]

(C) **INTEREST RATES/MONETARY POLICY**

21. **Monetary policy**: Object of monetary policy to maintain monetary conditions that keep downward pressure on money GDP and hence inflation. Inflation now down to levels of 20 years ago, despite strong and sustained upswing in real growth. Short term interest rates will continue to be held at levels necessary to keep monetary conditions on track. Will not take risks with inflation.

22. Interest rate policy; As Chancellor said in Budget speech: "Within continuous and comprehensive assessment of monetary conditions, I will continue to set interest rates at the level necessary to ensure downward pressure on inflation."

23. **May Bank of England Quarterly Bulletin (BEQB) said current combination of high exchange rates and low interest rates not ideal and different balance would be desirable. Position worsened by interest rate cut?**

BEQB referred to an ideal policy mix. But Government has to act in light of market conditions at time. Overall tightness of policy remains appropriate.

(D) **EUROPEAN MONETARY INTEGRATION**

24. **UK membership of exchange rate mechanism (ERM)?** [Sir Nicholas Goodison, Chairman of Stock Exchange, called on 27 May in speech to Royal Institute of International Affairs, for Government to join ERM immediately, as did National Institute Economic Review, May 1988.] As Prime Minister made clear in answering questions in House on 17 May, matter kept under continual review. Will join when Government considers time is right.

25. **Recent interest rate moves would not have been necessary if UK had been in ERM?** Joining ERM would not be soft option. Countries within ERM frequently change their interest rates.

26. **Sterling's recent rise would not have occurred if UK had been in ERM?** Countries within ERM not protected from realignments.

27. **Join ERM by 1992?** No fixed timetable. Will join when time is right.

28. **Proposals for Central Bank of Europe and common European currency?** [Chancellor said at Conservative Women's Conference, 24 May, difficult to see development of European Central Bank and European currency .... would mean end of independence in economic policy. UK wants to see more development on financial plane: development of common currency already in existence (ecu) and more cooperation in Europe. Not worth pursuing visionary ideas where even those advancing them are not sure of what they mean.] Most of those ~~Finance Ministers~~ who have put forward these proposals have recognised they are very much for longer term. Immediate priority is to achieve liberalisation of capital movements throughout Community. Making good ~~swift~~ progress, ~~under German Presidency.~~

TABLE 3 - TOTAL PUBLISHED RESERVES

$ billion

	Total reserve changes during month		Level at end of month
USA	- 0.4	(end April)	43
Japan	+ 1.9	(end April)	87
Germany	Negligible	(w/e 13 May)	60
France	- 1.0	(end April)	69
Italy	- 1.9	(end March)	61
Canada	+ 1.1	(end April)	14
United Kingdom	+ 0.7	(end May)	~~48½~~ 49

Notes

1. The figures for Germany, France and Italy were originally published in local currencies; they have been converted to dollars at appropriate exchange rates.

2. Figures not strictly comparable because of different valuation conventions for eg gold.

PRIME MINISTER

MARKETS

The pound has moved downward today, from an opening Index figure of 77.7 to closing of 77.3 (compared to the previous close of 77.9). The latest figure (1945) for the dollar rate is $1.8170 (against an opening of $1.8365) and for the Deutschmark a rate of DM 3.1390 (against an opening of DM 3.1652). Interest rates have already firmed with the 3 month inter-bank rate now standing at $8^{1}/_{16}$.

The Chancellor is holding a markets meeting at 1000 tomorrow and may well wish to come to see you thereafter to seek agreement to a ½ percentage point increase in interest rates. As you know, the Treasury believe that the slight looseness in monetary conditions has been compensated for by the higher exchange rate, and obviously with the rate lower that tightening is removed.

My own view is that, subject to any changes in the market tomorrow morning, the Chancellor has a good case for a ½% interest rate increase in view of our priority for the anti-inflationary objective. It is possible to debate the timing of the increase, on the lines that we should permit the rate to fall to say DM 3.10 before moving the rate. But we might then be faced with the need for a 1% increase; and that might give the impression of "emergency" action. So a ½% now looks right subject to tomorrow's markets.

If the Chancellor wished to come to see you tomorrow, it would probably be between 1030 and 1130. The diary is free.

N.L.W.

Agreed - will be ready

(N.L. WICKS)

1 June 1988

SECRET

file

PRIME MINISTER

MARKETS

It has been an active day in the markets today with strong upward pressure on sterling, as shown in the attached Market Report. In New York the pound was continuing to trade above $1.89 and DM3.18 this evening.

You will see that intervention has been very heavy. The Treasury have kept me in touch with developments. At one stage there was a plan to undertake a further heavy bout of co-ordinated intervention during the afternoon, if the Bank (whose idea it was) were confident this would have the effect of driving the rate down. I cautioned against. In the event, this operation did not proceed.

The reasons for sterling's strength seem to have been:

(i) reactions to yesterday's Bank of England Quarterly Bulletin - extract attached - in which the Bank made clear they would prefer to see interest rates higher and the exchange rate lower. The market has taken this as a clear indication that interest rates will not be reduced, and indeed could be raised, which has made operators more bullish about sterling;

(ii) the never-ending story of your alleged disagreements with the Chancellor continues, with emphasis being placed on your alleged antipathy towards intervention;

(iii) the continuing perceived politico-economic strength of the UK plc.

The Chancellor is having a major meeting with Bank and Treasury officials on Monday morning to consider next steps. He may then want to have an urgent word with you.

If the upward pressure continues, we face the familiar three options:

(i) do nothing and let the exchange rate find its own level;

(ii) take another half point off interest rates;

(iii) engage in further tactical intervention if market circumstances are thought favourable.

I understand that the Chancellor is resolutely opposed to letting the exchange rate go significantly higher. He may be becoming a prisoner of his own words in recent weeks about a higher exchange rate being unsustainable.

He is therefore likely to see the choice resting between more intervention and a half point off interest rates. I think it is an open question which of these he will opt for.

My view - and that of Brian Griffiths - is that it would not be right to make a further cut in interest rates. The whole "feel" at the moment is that the monetary position is too loose - the MO figures are high, credit is still growing fast and so on. Another half point off would trigger another cut in mortgage rates, so further boosting both the housing market and personal consumption.

So the question then becomes whether conditions are appropriate for further intervention. The arguments against intervention are well rehearsed. And the thing we must avoid above all is getting trapped in a position where we are seen to be defending figures of $1.90 and DM3.20 - which the markets probably see as their next "target". If I could borrow your phrase, it is no good trying to buck a strong market trend. So the only circumstances in which substantial intervention might be appropriate is if the markets became uncertain and there is a reasonable expectation that a heavy burst of intervention might actually take the

rate down.

This has to be a matter of tactical judgment at the time. As of now I think it unlikely that intervention will do the trick. But I don't think we should immediately rule out the possibility of, say, a concerted $500 million operation early next week if the market conditions are favourable. The ~~political~~ potential inflationary consequences of this - and indeed of several such operations - would in my view be much less serious than a further interest rate cut.

You may want to reflect on the options over the weekend. Depending on the conclusions he reaches on Monday morning, the Chancellor may want to have an early word with you. This should not pose too much of a problem in diary terms.

PRCG.

PAUL GRAY

13 May 1988

PMMAYS

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the department for Enterprise

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Your ref
Date 26 May 1988

Prime Minister

You may like to glance at the covering minute and executive summary (first 5 pages of attachment). But no need to go through the detailed report. This doesn't add much to the Stock Exchange's own earlier assessment of last autumn's events.

Dear Nigel,

REPORT ON THE STOCK MARKET FALL

As you may know, towards the end of last year I asked officials to review the major studies being carried out around the world of the implications of the Stock Market Fall of last October, and to draw out any implications for UK markets and market mechanisms. The aim was to produce a report identifying what responses might be appropriate by the various UK regulators and market authorities, and to enable us to satisfy ourselves that no inappropriate measures were likely to be taken.

The work has been carried out with participation by Treasury officials. The Bank have also been closely associated and the Securities and Investments Board, The Stock Exchange, LIFFE, the International Commodities Clearing House and a number of users have all been consulted. Of course many of the issues examined are the responsibility of the various regulatory and market authorities; the report is therefore understandably cast as noting what the authorities are doing in the light of the market fall and inviting them to consider the other recommended actions in their area.

The main conclusion is encouraging: that our systems stood up well in the circumstances of last October. The report is sceptical about many of the recommendations in the American reports, particularly those advocating wider use of circuit breakers or proposals to limit certain kinds of computer trading. It does, however, identify a number of areas where technical improvements could and probably should be made to improve dealing and settlement arrangements. What is said in

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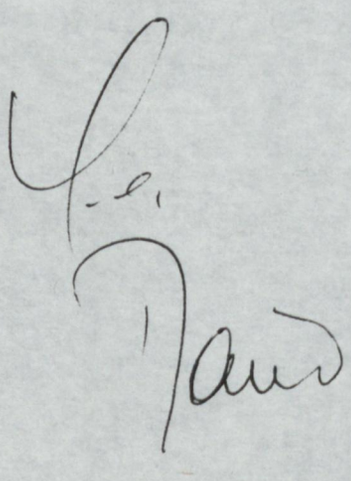
the report on these reflects discussions with the authorities concerned and should be broadly acceptable.

If you are content I propose to write to the organisations concerned, sending them the report in confidence, (omitting the sensitive passages) and inviting them to take note of any of the recommendations relevant to them.

I understand that officials, particularly in the Bank, have reservations about wider publication on the basis that parts of it, particularly Part V, might indicate a degree of contingency planning that could lead to moral hazard. I have to say I do not share this view: Part V seems to me a blandly-phrased statement of the obvious - that regulators should collaborate, particularly in difficult market conditions.

It is public knowledge that the Department is considering the implications of the market fall, in consultation with the relevant market authorities, and we are bound to be asked about our conclusions. It would in my judgement be better to present these conclusions at our own initiative, as part of a considered document, rather than risking the accusation that we have suppressed our findings. I will therefore ask my officials to discuss with yours the preparation of a suitably abridged version for publication.

I am copying this to the Prime Minister and to the Governor.



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OCTOBER STOCK MARKET FALL: IMPLICATIONS FOR MARKET MECHANISMS AND REGULATION

CONTENTS

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Part II Brief description of the fall

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Part VI Main conclusions of report

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A. Description of the economic background.

B. Summaries of Published Reports

EXECUTIVE SUMMARY

The October stock market break has been extensively analysed in respect both of underlying causes and of the actual events in the markets. This report is confined to reviewing events in the UK markets, the lessons to be drawn and the actions in hand by the appropriate UK authorities. In the USA, market mechanisms may have helped to aggravate the speed and extent of the fall, but there is no evidence to suggest that London mechanisms did so. In particular there is at present no reason to restrict the growth of the relatively small London markets for futures and options.

Market and regulatory mechanisms in London were able to cope so as to maintain the financial integrity of the markets and ensure that bargains once made were performed. No serious defaults occurred. Some investors experienced difficulty in dealing during the period of difficulty, and were not always able to deal on such good terms as in normal conditions, but the London markets did remain open throughout and handled a large volume of business.

We were not able to judge whether markets are more prone to sudden large price movements now than they were before the break. The Securities and Investments Board (SIB) is however reviewing its requirements for capital adequacy, which are based on historic volatilities. The Bank of

England and SIB are pursuing their discussions with overseas regulators to ensure that overseas firms operating in UK markets are effectively supervised. In the longer term it will be important for both regulators and Government to work towards international co-ordination and convergence of capital requirements for securities.

In the futures and options markets, each party to a bargain is required to pay "margin" to a clearing house so that if he defaults his counterparty is protected. UK margin systems worked effectively in October, although the clearing houses should consider whether to make more frequent and smaller changes to their margin requirements when prices are changing rapidly. There is no need to set margin requirements artificially high to discourage speculation or to constrain the growth of these markets.

Improvements have already been made to the arrangements for clearing and settling bargains on the London exchanges. The Stock Exchange is considering whether to introduce a centrally-operated margin system for equity bargains. The legal position of these various arrangements when a market member becomes insolvent needs to be clarified in the 1988/89 Companies Bill.

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Closer links between the various UK clearing systems would make it easier to handle during periods of difficulty.

That could be information exchange, or closer integration which could reduce the cost to participants.

The Stock Exchange is considering whether to change its Account System, under which equity bargains do not have to be settled for 6-16 trading days or even longer, perhaps to rolling settlement. Change would reduce exposure to the risk of counterparty default, as would further reductions in the settlement backlog.

Automatic halts to trading ("circuit breakers") have advantages and disadvantages, but on balance we are sceptical of their value. However, if more circuit breakers are introduced overseas the UK exchanges will need to assess the implication for their markets. If business were diverted to UK markets in times of crisis, it would be all the more important that they had sufficient capacity.

Computer assisted techniques such as portfolio insurance and index arbitrage are little used in the UK and we see no reason at present to try and restrict them, but the exchanges should keep the development of such techniques here under review for potentially destabilising effects.

It is essential that there should be clear lines of responsibility, efficient channels of communication and co-operation between regulators. When markets are

turbulent this becomes of critical importance. The Bank of England and SIB will keep existing arrangements under review, particularly in the light of the new regulatory system introduced by the Financial Services Act, to ensure their continued effectiveness.

INTRODUCTION

1.1 The purpose of this report to the Secretary of State for Trade and Industry is to review, in the light of the stock market break of October 1987, what action is contemplated by the various authorities in the UK, and what lessons might be drawn about the market mechanisms and the regulation of the UK financial markets.

1.2 In the exceptional circumstances of a sudden change in market levels the overriding requirement is that the market and regulatory mechanisms should maintain the overall financial integrity of the market and ensure that bargains once struck are performed.

1.3 It is also desirable that markets should as far as possible continue to be available, liquid, transparent, fair and cheap to use and that the mechanisms themselves should not artificially exaggerate the speed or extent of a movement in prices. Investors cannot however expect to be able to deal as easily or on such good terms during a crisis as they can in normal conditions.

1.4 The function of the financial markets is to bring together buyers and sellers at a price at which both are willing to deal, thereby facilitating the raising of capital, the deployment of savings, the transfer of risk, and changes in corporate ownership through mergers or acquisition.

Changing circumstances and fresh information will inevitably cause fluctuation in the price level. A rapid movement in price or continuing price volatility need not undermine the ability of the market to function. Indeed it can be argued that there is some advantage in a rapid movement to a new price level where supply and demand can balance. Nevertheless, excessive rapidity or volatility may bring the systems designed to ensure market integrity under strain or may deter users of the market from entering it. (Users may be deterred either by the higher risks or by higher costs of using the market as market makers widen their price spreads to cover their own risks).

1.5 The report seeks to investigate the way in which the market and regulatory mechanisms operated in October onwards, but does not seek to reach conclusions on the overall causes of the break.

1.6 At all times a balance need to be struck between safeguarding the financial integrity of the markets and avoiding unnecessary costs or restrictions which could unduly undermine their international competitiveness. This is a continuing dilemma. There is a close connection between the market mechanisms and the financial requirements to ensure market integrity. Tougher requirements are necessary in times of greater volatility than in calmer trading conditions. The continuing task of

the regulators is to assess market conditions and the risk to market integrity so as to strike the right balance between safety and competitiveness.

1.7 The report has drawn extensively on published studies undertaken by other organisations in the UK and abroad. These are listed and summarised in Annex B. The reports are far from unanimous in the recommendations they make. We have considered the relevance of their principal recommendations to the UK and have also looked at some other proposals which have been put forward by other bodies. We have consulted various UK regulators, market authorities and users.

1.8 Many of the reports by US regulators propose various changes to market practice. In translating these to the UK context it is important to make allowance for the significant differences between US and UK markets. In particular -

i) futures and options in the UK represent a small fraction of the underlying equity market, in marked contrast to the USA where volumes of futures transactions heavily outweigh those in the underlying market;

ii) computer driven trading techniques such as programme trading and arbitrage do not account for a significant proportion of dealing in the UK.

iii) the UK Stock Exchange, unlike the New York Stock Exchange (NYSE), has abandoned use of a trading floor;

iv) there are differences between market makers on The Stock Exchange and NYSE specialists in terms of capitalisation, competition and continuity in the obligation to quote prices;

v) regulatory responsibility in the UK differs structurally from that in the US.

1.9 We have grouped together the various areas for consideration under three main headings:

Part III

prudential regulation: capital adequacy and centrally operated margin systems;

Part IV

market mechanisms: dealing systems and market capacity, clearing and settlement systems, suspension or restriction of trading and computer trading;

Part V

planning and co-operation between regulators

1.10 We have examined these ideas on their own merits and also in case their adoption overseas might have implications for our markets. We have attempted to distinguish between arrangements appropriate for normal trading conditions and those which could or should be implemented rapidly during periods of rapid change in the markets.

1.11 Although some exchanges in the USA are already testing various new mechanisms designed to reduce volatility, overseas authorities, particularly in the USA, have yet to reach final decisions on whether to institute permanent changes in their markets later this year which could carry implications for our market mechanisms.

1.12 Many of the areas examined in this report do not need new initiatives but are already under examination by the Bank of England, The Securities and Investments Board (SIB), The Stock Exchange, The London International Financial Futures Exchange (LIFFE), The International Commodities Clearing House (ICCH), and others who have responsibility in this area. Discussion with overseas regulators will also be taking place.

II BRIEF DESCRIPTION OF THE FALL

2.1 Much has been written about the events surrounding the sudden fall in the stock market, including analyses of why the bull market lasted so long and why the market break was so sharp when it came. The economic background is described in Annex A. Although there is still considerable argument about the analysis, it is clear that since the beginning of 1987 share prices had moved further than economic realities justified and in particular had moved out of line with fixed interest securities. A growing number of people were beginning to become uneasy and concern in particular focused on certain features of the US economy. Considerable softening of the markets had been evident in the week before the market break. When it came, it is possible that features of the market mechanisms, such as the relationship between US markets for futures and stocks may also have contributed to the scale and rapidity of the fall.

2.2 In the US the action taken by regulators in response to the fall is well documented. On 20 October an announcement was made that "the Federal Reserve Board affirms its readiness to serve as a source of liquidity to support the economic and financial system".

2.3 This report is not concerned to weigh up all the possible causal factors of the break. Instead its concerns are

first to judge whether UK market mechanisms played a significant part in causing or aggravating it; and second whether the UK mechanisms coped adequately with the fall once it started.

2.4 Between its July peak and November trough, the FTSE Index fell by 36%. It is currently about a quarter below its peak level. So far, this is much less severe than the last major stock-market crash of 1973/74: prices in December 1974 were nearly 70% lower than two years earlier, and had more than halved in the course of the year. Falls of around 25% in stock prices from peak to trough in a few months are not unusual: 1969, 1976 and 1979 are examples. What was unusual about the 1987 fall was the sheer speed of adjustment, with the bulk of the fall concentrated into a few days.

2.5 The trading of financial futures, options and shares is so closely interrelated that the exchanges concerned cannot be considered in isolation: the underlying reality is a single market place. However, futures and options play a much less significant role in London than in the USA. The combined trading in FTSE traded options and FTSE futures is normally equivalent to about 10% of UK equity turnover, whereas trading in the CME S & P 500 futures contract is routinely four times the value of equity trading on the New York Stock Exchange. There is no evidence to suggest that the London futures and options markets caused or aggravated the fall.

2.6 All world markets fell simultaneously. This presumably reflects the extent to which investors hold overseas equities and market participants trade internationally, the dismantling of exchange controls and the speed of modern communications, as well as the international nature of the economic problems leading up to the market break.

2.7 London did not fall further (or indeed more rapidly) than most other exchanges. Tokyo has proved remarkably resilient, and indeed has now recovered to above its pre-break level. But comparing individual peaks to troughs, London fell by less than the other major European markets (which fell by around 40%) and markets such as Australia, Singapore and Hong Kong, which recorded falls of at least 50%. New York fell by about the same amount as London in local currency, but fell further when adjusted to common currency terms.

2.8 It is therefore difficult to blame mechanisms peculiar to the UK for causing or aggravating the fall.

2.9 There were some noteworthy features of the London market; its visibility and its accessibility. Trading hours were not curtailed; the SEAQ system remained in operation, although for certain, mainly short periods when "fast markets" were declared prices were only indicative. It has been alleged that these features (in that they also attracted business to the UK) could have caused the UK

market to fall more rapidly than otherwise, both because of the weight of selling pressure and because of defensive action by market makers, adjusting their prices down in anticipation of such pressure. Allegations of this nature are difficult to substantiate - or disprove. Such evidence as there is (set out in The Stock Exchange's Quality of Markets report and summarised in Annex B) suggests that artificial marking down did not occur to any significant degree and that the existence of a liquid, open and technically sophisticated market in London did not magnify the effects of the break on the UK market.

2.10 The complete closure of the Hong Kong markets for four days might have caused difficulty for some members of the London Stock Exchange but fortunately none had a very large exposure to Hong Kong stocks or futures. A rescue operation was mounted for the Hong Kong Futures Exchange, because when some participants defaulted the margin available in the clearing system was inadequate to support the guarantee to their counterparties. The NYSE decision to shorten its trading day helped confidence because it provided an opportunity to settle the large volume of NYSE bargains generated on 19 October and the next few days.

2.11 A particular feature affecting confidence in the UK and North American markets was the impending sale of BP shares. In the event the underwritten placing went ahead but the Chancellor of the Exchequer announced arrangements

by which the Bank of England would support the price of the new BP shares. This increased market confidence.

Volatility in the future

2.12 Are the markets now more prone to extreme shifts of volatility than in the past? In the immediate aftermath of the market break, there were six trading days when the index moved in excess of 50 points, a significant deviation by the standards of early 1987. Since then there have been a couple of occasions in the USA when the index has fallen by around 100 points but without sparking a chain reaction in other countries. But the Brady Commission's study of this question concluded that, whilst volatility in 1986 and 1987 was higher than in the immediately preceding years it was not unduly high by historical standards - for example before the Second World War.

2.13 There are several long term developments which may continue to affect price volatility. These include the growth in volume of securities transactions, internationalisation of markets, the greater use of futures, options and other sophisticated instruments, faster communications, technological advance in both dealing and control systems, and regulation and degregulation. There have also been changes in the mix of investors, for example institutional investors of various

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kinds have become more predominant, and Japanese investors represent a growing proportion of the total. Developments in the theory of investment also impinge on the attitudes of investors. Some of these factors may tend to increase volatility, others to reduce it.

2.14 Developments in the world economy also affect price volatility. In the short to medium term, the limited prospects for early substantial reduction in the US "twin deficits", uncertainty over Japanese willingness to finance them and the vulnerability of the dollar suggest that another marked fall might occur. On the other hand, the gap between equity and bond yields has narrowed, economic growth has held up and the G7 Louvre Agreement has survived: these factors suggest that markets may remain fairly stable.

2.15 Considerable research would be required to analyse all the factors which could affect the likelihood of sudden, large price movements. Thus it is not possible to reach a conclusive view on whether the markets are more prone to a sudden fall now than they have been in recent years.

Summary of Action taken by UK regulators

The Stock Exchange

2.16 The extent of the dramatic fall on Wall Street was not fully manifested until after London had closed on 19 October. The following morning The Stock Exchange Surveillance Department undertook a rapid check of the financial position of market makers and broker-dealers with large principal positions as revealed in their regular monitoring returns. These forty firms were subsequently required to make daily reports by 11 a.m. on the previous day's position. Some members initially found difficulty in supplying this information promptly, but they were eventually able to do so on a regular basis. Improvements to firms' internal control systems would help to avoid any such delay in future. The information obtained by The Stock Exchange was shared with the Bank of England in a joint working group, which made a daily assessment of the position.

2.17 By 21 October, a number of members had already received injections of additional capital, and others whose capital had been eroded were required by The Exchange to obtain fresh injections. The fact that many Stock Exchange firms are now parts of larger financial groups made this process much easier.

2.18 Other actions taken by Surveillance Department included:

- using its Database to monitor large individual client open positions and open under writing positions;

- requiring broker dealers with overseas principal trading business to provide information on any losses or bad book positions.

- making direct contact with firms' bankers where client defaults in options margin had already taken place;

- issuing closing-out recommendations on a regular basis;

2.19 Several members experienced difficulties with particular clients who were unable to meet their obligations as writers of traded options, especially FTSE options. A sole-trader in the options market had to close. The problems were contained without undermining the integrity of the market. The Stock Exchange's London Traded Options Market (LTOM) imposed an intra day additional 50% margin call. Member firms had little time to raise additional margin from their clients - an inevitable feature of a margin system. Member firms do need to have the power to close out their clients' positions if margin is not

forthcoming in the specified time and the new client agreement letters are designed to clarify the member's right to do this.

2.20 The Stock Exchange continued its close daily monitoring and contacts with the Bank of England and the banks throughout the crisis and helped members to deal with their problems. Account Day on 2 November passed without a default. Thereafter it was possible to put monitoring of the majority of members on to a weekly basis.

2.21 When price quotations on the screens cannot be updated fast enought to keep pace with the prices at which deals are being done, The Stock Exchange can declare a "fast market". The effect of this is to relieve market makers of the obligation to deal at the outdated and inaccurate screen prices, which become "indicative prices". Seven fast market declarations were made during the week of 19 October, covering an average of one hour each. The Stock Exchange concluded that during most of the critical period, bargains were struck very close to the screen prices, although there were a few short periods when a marked divergence occurred. (On 19 October there were six occasions when the gap measured by the FTSE index exceeded 1%, reaching 7% at one point, but for most of the day the gap was less than one quarter of 1%).

ICCH

2.22 The margin system operated by ICCH is designed to protect clearing members of LIFFE and other commodity markets against counterparty default. ICCH needs to hold sufficient margin at any given time to safeguard against an adverse price movement during a single day's trading. On 16 October the margin held for the FTSE futures contract represented 2.6% of the value of the contract. On 19 and 20 October ICCH made special intra-day margin calls which raised this percentage to 11.2%. These calls were met, and ICCH detected no reluctance on the part of the settlement banks to guarantee payment on behalf of the members, although the short time (one hour) during which settlement banks are required to respond to intra-day calls inevitably caused some administrative difficulty.

2.23 ICCH also had to raise the margin requirments for some other contracts on LIFFE and the London Metal Exchange (LME). Where price volatilities have fallen back since the crash, it has been possible to make some reduction in margin requirements.

2.24 ICCH has the discretion to impose additional margin requirements where an individual customer has built up a large position. ICCH consulted LIFFE before imposing its intra-day calls and also liaised with LTOM, the London Options Clearing House (LOCH) and overseas regulators.

LIFFE

2.25 LIFFE increased surveillance and analysis of the trading positions and volumes of individual members, with particular emphasis on the FTSE contract, liaised closely with the clearing house on margin and sought regular confirmation from members that no serious financial problems were arising.

2.26 LIFFE considers that the imposition of large intra-day margin calls ensured that members (and their clients) covered paper losses promptly. Any greater margin burden might have added further to the liquidity problems experienced elsewhere. All members met their margin calls promptly and this fact certainly gave confidence to the market. Some attempt was made at co-operation between markets prior to The Stock Exchange Settlement Day on 2 November. A meeting between LIFFE, LTOM, ICCH and LOCH was held to identify cross market positions of common members since no single regulator was in a position to see both sides. Uncertainty as to the possible outcome on that settlement day directly contributed to LIFFE/ICCH maintaining an exceptionally high level of initial margin for the FTSE contract during that period.

2.27 UK market mechanisms coped with the events of October by ensuring that the UK markets remained open and that investors were protected against default so that the bargains they had made were settled.

Conclusion

2.28 Although the performance was satisfactory it is difficult to judge how close the mechanisms came to breaking down under the unusual strains. If the slide in prices had continued, would market participants have been able to meet further margin calls and to raise further capital where necessary? Those participants with banking parents would presumably have continued to receive capital injections where necessary: a bank would wish to preserve confidence in its own integrity by maintaining its securities subsidiary if able to do so, and the actual losses of the subsidiaries could have been a great deal worse without causing serious difficulties for the banks concerned.

2.29 It is more difficult to assess whether a major UK - or US - participant without a banking parent might have run out of capital and been unable to find someone willing to rescue it. If that had happened, how great would the effect have been on market confidence and on other participants? It is impossible to answer these hypothetical questions - so much would depend on how much further prices might have fallen and on how serious the defaults might have been.

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PART III: PRUDENTIAL REGULATION

Capital adequacy

3.1 Most market and securities regulators require participants in markets to have a minimum level of capital reflecting the nature of the investments they make, their potential exposure and the normal volatility of the markets concerned. The most advanced systems, such as those developed by the SIB and The Securities Association (TSA) provide specifically for capital requirements to be calculated against both position risk (the change in asset value if the market moves) and counterparty risk (the loss of asset value if a counterparty defaults).

3.2 Several of the American reports recommend a review of US capital requirements and an increase in capitalisation of NYSE specialists. The UK has its own capital adequacy requirements - if we were to adopt and enforce higher requirements, that would reduce the risk of any given price movement threatening the integrity of the system. But applying them in normal trading conditions would add to the cost of doing business, reduce liquidity in the market and possibly drive business away from the UK. The key question is therefore what degree of 'normal' volatility should firms be capitalised to handle.

3.3 The minimum standard for capital adequacy has been set by SIB and self-regulating organisations (SROs) must at least match it. These requirements had not yet been applied in October and are to be introduced progressively under the Financial Services Act between now and January 1989. It would be undesirable to make frequent changes to capital requirements and it will be some time before it is possible to assess what the level of price volatility is likely to be when the after effects of the break have been absorbed by the markets. SIB is, however, reviewing its requirements (including those relating to underwriting commitments) in the light of these events, and has the statutory power to adjust them speedily and flexibly if this proves necessary.

3.4 It is important that the formulation and enforcement of capital adequacy requirements should permit flexible application in time of greater volatility so as not to aggravate the situation. An inflexible approach, requiring automatic suspension from trading or immediate liquidation of particular positions, could in an adverse market cause defaults which might have been avoided by swift corrective action (such as the injection of new capital).

3.5 Banks who do investment business are covered by the Financial Services Act, but, under arrangements agreed between the Bank of England and SIB, responsibility for

monitoring the capital adequacy of UK-owned banks falls to the Bank. A lead regulator system has been developed to facilitate sharing of information between UK regulators and to enable prompt and co-ordinated action to be taken with an individual conglomerate.

3.6 Particular problems arise in enabling supervisors to exercise their responsibilities in an effective and co-ordinated way with regard to transnational companies without unduly increasing bureaucracy and costs. The extent to which overseas regulators of foreign groups supervise securities operations through UK branches varies from country to country. The Bank of England and SIB are pursuing as a matter of urgency their discussions with overseas regulators to ensure that each overseas firm operating in the London markets has an agreed lead regulator and to establish clear arrangements for supervising it.

3.7 The global nature of the market fall has underlined the importance for both regulators and Government of working in the longer term towards the international co-ordination and convergence of capital adequacy requirements for securities business.

Firms' Internal Control Systems

3.8 Each active participant in the markets needs effective

internal control systems so as to keep position risk and the risk consequent upon a counterparty default to levels compatible with its capital base. This is particularly important in a crisis and there is some evidence to suggest that some firms' systems fell short of the ideal. The Financial Services Act regime introduces new requirements on internal controls and it would seem desirable for the relevant self-regulating organisations (SROs) to give priority to satisfying themselves that their members' control systems are adequate.

Role of lending banks

3.9 In the USA, the flow of information to banks about their customers was identified as important and some difficulties were experienced there. As a consequence the Commodities and Futures Trade Commission (CFTC) recommends that banks should have better access to data on their customers' markets obligations (and should receive prompt notification of margin calls made to their customers by clearing houses).

3.10 In the UK, communication difficulties did not arise to any major extent between regulators, market participants and the banks. This was partly because many of the key participants are owned by banking groups, and partly because ICCH operates a Protected Payments System whereby its margin calls are made direct to the clearing member's

settlement bank. This procedure does not extend to the London Traded Options Market which relies on town clearing cheques.

3.11 It is however important that lending banks should have speedy access to accurate and reliable information in a crisis, and be sufficiently familiar with the markets and market procedures, to be able rapidly to reach informed commercial decisions on whether to extend lines of credit. A bank's assessments may need to take account of a borrower's positions on more than one exchange and the extent to which these increase exposure or reduce exposure through hedging.

3.12 Last October, the banks coped well in general, but there was some indication during the crash that some smaller Stock Exchange members who had borrowed from provincial branches of the clearing banks were experiencing problems because these branch managers were less familiar with The Stock Exchange than the specialist City branches who handle most of this banking business.

3.13 <u>The SROs should consider, in conjunction with the Bank of England and the clearing banks, whether any further steps can be taken to improve the arrangements between market participants and their banks, so that banks can make well-informed judgements quickly in times of difficulty</u>.

Centrally operated margin systems

3.14 All members of the relevant financial markets are subject to capital adequacy requirements. Futures and options markets are also supported by centrally operated margin systems.

3.15 The primary purpose of market members making margin payments to a central clearing house is to protect each member involved in the bargain from default by the other. The margin enables the clearing house to quarantee performance to each counterparty. The initial margin requirement is calculated by reference to historical volatility and the margin is topped up daily by variation margin calls whenever the price moves against the firm (with a corresponding payout to the other party) . If prices move sharply the clearing house may call for more margin during the day. If prices remain volatile, margin requirements will remain high. (Thus the initial margin currently required for the FTSE option writer now safeguards against a movement of 160 index points, whereas before the fall the margin only covered a 60 point move).

3.16 In the USA the CFTC argues that the primary role of margin is to provide financial security. It recommends the routine use of intra-day margin calls to reduce pressure on the settlement banks and enhance the ability of the

system to run smoothly at times of volatility; and a review of margin levels to include a "cushion" against sharp price movements. On the other hand, the US President's Commission (Brady) accepts that futures margin requirements are adequate for the primary purpose of protecting financial integrity, but argues for higher margins for the secondary purpose of deterring "speculation".

3.17 Although the role of speculation remains controversial, we do not believe that the level of speculation in the UK is execessive or that the operations of the relatively small London futures and options markets exacerbated the crash. Indeed we take the view that speculation normally plays a useful role by increasing liquidity and reducing volatility, provided that the amount of speculation does not become excessive. There is therefore no reason at the present time to discourage the growth of these markets by imposing artificially high margin requirements on certain types of transaction.

3.18 The current approach to setting margin requirements should succeed in protecting market integrity if price volatility remains within the bounds allowed for in setting the margin. If volatility exceeds those bounds, the system will be able to cope provided first that the clearing house rapidly increases its margin requirements and second that the market members are immediately able to meet those

requirements. If an individual member is unable to meet the new requirement, and defaults, the clearing house will need to cover any shortfall in the margin from its own resources.

3.19 Thus the lower the margin requirement, the more resources the clearing house itself should have to ensure the financial integrity of the system in the event of an increase in price volatility. ICCH has recently made external arrangements with third parties to provide backing for its obligations to its members amounting to £100m. The Grain and Feed Trade Association (GAFTA) has also increased its external arrangements. These arrangements are adequate in relation to the current exposure of ICCH and GAFTA, but SIB should keep them under review in relation to the level of business in the future. The London Options Clearing House (LOCH), which clears the LTOM, is a subsidiary of The Stock Exchange, which is considering increasing the separate guarantee arrangements which exist specifically for LOCH.

3.20 A sudden increase in margin requirements may be destabilising if it forces market participants or investors to liquidate positions at whatever price they can get in order to meet the new requirement. This will depend upon the extent to which market participants can draw quickly on other sources, principally the banks, to meet margin calls. (See paragraph 3.13 above). If

difficulties are foreseen, clearing houses may feel constrained from raising margin requirements too sharply when volatility increases. This factor needs to be balanced against the requirement to protect the clearing house by adding to the margin it holds and it is not always easy to judge how much flexibility is appropriate. This dilemma would be less acute if margin requirements for normal trading conditions were set at higher levels than has been the policy in the past. But although that might improve the financial security of the market in a crisis, it would have serious implications for the normal operation of the market by reducing market liquidity, increasing the cost of doing business and hence affecting London's competitiveness.

3.21 There is no evidence to suggest that the London futures and options markets caused or aggravated the fall and it would not be appropriate to impose higher margin requirements merely to discourage the growth of these markets. Clearing houses should continue to base margin requirements on their assessment of price volatilities, using existing analytical techniques. They should however consider the case for more frequent changes to margin requirements for futures contracts as price volatilities vary, so as to reduce the risk of having to make sudden large margin calls.

Counterparty default procedures for the equity market

3.22 The equity market does not have comprehensive procedures to guarantee settlement in full of all transactions. When shares are delivered into the TALISMAN system, The Stock Exchange guarantees payment (in most circumstances) to the seller. But this leaves two significant gaps:

(a) the time between the transaction and the date when performance of the transaction is due, which under the account system will normally be one to three weeks;

(b) an additional period where delivery is delayed beyond the due date - the settlement backlog includes many bargains up to a year old.

During these periods each member runs the risk of his counterparty defaulting.

3.23 The new proposals for capital adequacy, based on SIB's rules, would require a TSA member to have additional capital in relation to this counterparty risk. The requirement would be adjusted daily as the counterparty risk varied. When fully implemented, in January 1989, this system will help to ensure that each member could survive the default of another.

3.24 The Stock Exchange is considering an alternative to this approach, namely a centrally operated margin system for equities, accompanied by a Stock Exchange guarantee of settlement. This would operate in a similar way to the ICCH.*

3.25 Neither a centrally operated margin system, nor the capital adequacy based approach would be proof against a sharp and substantial increase in price volatility.

3.26 A centrally operated margin system would, however, avoid the disadvantages of leaving a longer gap between the date of the bargain and the date at which the new capital is required, of relying on continuous monitoring of capital

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Footnote

* Each party to the bargain would deposit margin with a central clearing house, to reflect the price movement which might occur during one day's trading. If the market price changed, additional margin would be called from the party aginst whom the price had moved (the seller in a rising market, the buyer in a falling market). This additional margin would be paid out to the winning party. The result should be that if either party defaulted, the margin already obtained from him should be sufficient to cover the cost of buying (or selling) the stock in the market during the day of default, so as to settle the bargin

for the counterparty at the original price.

against the requirement, and of leaving the innocent member with depleted capital when his counterparty defaults. It would enable the clearing house to guarantee performance to the innocent member. It is not yet clear, however, whether such a margin system would impose higher costs on members and users of the market than capital requirements based on counterparty risk.

3.27 Another protective mechanism which has recently been adopted by The Stock Exchange is to provide for the automatic closing out and netting off of all the outstanding bargains of a member acting as principal who defaults. This is designed to limit the size of the impact of a member's default on other members. (Where the defaulting member was acting as agent, the two principals would be put in touch with each other to settle the bargain, in accordance with existing practice.)

3.28 Similar arrangements apply on the LTOM, which is also undertaking a review of its procedures in the event of default, in particular the responsibility which its clearing members assume for the clients whose trades are cleared through them.

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3.29 There is real concern, particularly at The Stock Exchange and ICCH, that these guarantee systems and default procedures might be successfully challenged in the courts as being incompatible with UK insolvency legislation. The DTI is therefore preparing primary legislation to remove this risk, with the aim of introduction in the 1988/89 Parliamentary Session. The Bank of England, SIB, The Stock Exchange, LIFFE and ICCH have all expressed their concern that Parliamentary time should be found in that Session.

PART IV: MARKET MECHANISMS

Dealing Systems and market capacity

4.1 A number of the US reports have focused on the need for more capacity to handle a larger volume of trading; for more competition in the NYSE "Specialist System" to provide greater capacity and keener prices; and for measures which establish an orderly adjustment process once capacity limits have been reached.

4.2 In the UK The Stock Exchange study considers the well-published complaint from several quarters that it was difficult to get access to market makers during the most hectic days of the market adjustment. The study accepts that there were access difficulties - particularly for investors wishing to trade in foreign equities, but it attributes these primarily to the upsurge in volume to nearly twice the normal level (which itself is 3 times up on a year ago). Exchange members did execute 100,000 bargains per day, compared to a normal level of 60,000 before the fall. It is also noticeable that a few market makers - in particular those who previously were jobbing firms - attracted an especially high proportion of business, thus adding to the pressures on their in-house resources. Because of the increased price volatility, it was not always possible for institutional investors to

deal in as large a size as they are acustomed to in normal trading conditions.

4.3 The Stock Exchange argues that it would be uneconomic for members to maintain sufficient capacity to deal with infrequent upsurges in trading volume, but accepts that there should be more capacity to execute and settle transactions. This will be important in preserving the long term confidence of investors in using the UK market.

4.4 The planned SEAQ Automated Execution Facility (SAEF) will help in due course with execution, but not during "fast market" conditions (see paragraph 2.21 above), and problems may still arise if investors are unable to make contact with Stock Exchange members. This suggests the emphasis will have to be on increasing capacity if resort to "fast market" conditions is to be minimised.

4.5 It is impossible to say to what extent access difficulties were aggravated by deliberate refusal to answer the telephone, and The Stock Exchange study reaches no conclusion on this point. The Exchange is however introducing an electronic surveillance system which will enable it to monitor how long members take to answer telephones on the Exchange's switchboard.

4.6 Problems arose for small investors wishing to deal in unit trusts, and unit trust managers had difficulty valuing

their units when market prices were changing rapidly or not available. Some managers suspended dealings (particularly in trusts with exposure to Hong Kong where the market had closed). Other unit trust managers shifted to forward pricing and wider spreads between bid and offer prices so that investors were generally able to deal.

Clearing and Settlement Systems

4.7 Most of the US reports recommend a more co-ordinated approach to clearing and settling bargains, either by establishing a single clearing system for all US markets or through rapid and automatic exchange of information between the existing systems.

4.8 In particular CFTC found that during the market break firms and settlement banks tended to delay payment beyond the deadline and it was difficult to check quickly who was doing so in more than one clearing system.

4.9 When intra-day margin calls are made, sums due to the clearing house must be paid the same day, but sums due from the clearing house are not paid until the following day. Members awaiting payments may experience credit difficulties if their banks are nervous about the creditworthiness of the clearing house. This problem would be less acute as Brady points out if common clearing arrangements allowed payments due to one clearing house to

be netted off against receipts due from another.

4.10 In the UK, clearing is done by: TALISMAN for equities, Central Gilts Office (CGO) for gilts, LOCH for most Stock Exchange options, ICCH for other Stock Exchange options for LIFFE and for other UK futures and options markets (except grain which is cleared by the GAFTA Clearing House). Clearing for Eurobonds is provided by Cedel and Euroclear, and various other systems operate for other instruments.

4.11 Some information is already exchanged between these clearing systems, but closer co-operation between them is highly desirable. This could take various forms, ranging from routine exchange of information to full integration of computer matching and clearing systems, assured payments systems and a common guarantor. Close links could permit netting off between margin requirements arising from different markets, thus reducing costs to the business. The closest links will be possible between markets with similar characteristics. LIFFE and the Stock Exchange options market are already studying this, but the exchanges should consider developing closer links between all the London clearing systems.

4.12 The UK benefits from the trend towards globalisation of securities markets. It is widely recognised that proposals to establish trading links with overseas

exchanges should cater for the control of risk and exchange of information between clearing systems so as to avoid creating problems for clearing and settlement systems.

Stock Exchange Account System

4.13 Three features of The Stock Exchange Account System for equities merit attention:

(a) the length of the trading period (normally 10 trading days), during which a position can be "closed" so that the original seller does not have to deliver stock;

(b) the gap (normally five trading days) between the end of the trading period and the day when settlement is due; and

(c) the fact that settlement does not take place automatically on the due date. Until recently there was a very large backlog of orders, many up to a year old.

4.14 These three features, while they may increase liquidity, increase the size of the risk which the member runs if his customer or his counterparty member defaults, because they add to the total of unsettled bargains at any given time.

That would cause less prudential concern if there were a centrally operated margin system or effectively monitored capital adequacy requirements based on counterparty risk. TSA is introducing a Counterparty Risk Requirement which will be fully implemented by January 1989, but where neither party has performed his obligations the requirement will not apply to bargains until 31 days after Settlement Day. The requirement will therefore not provide a safeguard during the first 6 to 8 weeks after the bargain is struck against default accompanied by adverse price movements.

4.15 Changes to one or more of the features of the Account System would tend to reduce the scale of the risk, while changes to capital adequacy requirements would protect firms against it. If a centrally operated margin system were adopted, however, there would be less need for changes to the Account period on prudential grounds.

4.16 Changing the length of the 10 day Trading Period would also reduce the scope for investors buying and selling within the account, but it is an open question whether the current level of "speculation" is excessive or whether introducing restrictions would remove useful liquidity. There might also be consequences for the levels of short-term funding and stock borrowing required by members. Changing the gap before settlement or requiring automatic settlement on the due date would not have these

effects, but would be impossible without implementing the TAURUS proposals for share transfer without share certificates. Building the TAURUS system will take some time but timely enactment of legislation is required if it is not to be delayed.

4.17 Institutional investors normally settle by paying cash against documents and any changes to settlement procedure should avoid exposing investors to greater counterparty risk than at present.

4.18 Introducing rolling settlement (as in New York) would smooth the fortnightly peaks in movement of short-term funds and would bring UK practice more into line with those overseas markets (such as NYSE) which settle more rapidly.

4.19 These prudential and other concerns need to be considered alongside the preferences which members of the market and investors may have. Changes may involve additional costs. On the other hand, changes which reduce exposure to counterparty risk may well reduce the cost of safeguarding against that risk (either through capital requirements or marginning). <u>The Stock Exchange is considering the possibility of making changes to the Account System</u>.

4.20 The Stock Exchange has made considerable progress in reducing the settlement backlog, thereby helping limit the counterparty risk. The Exchange should maintain its efforts to ensure that all member firms reduce their backlogs and keep them down to acceptable levels.

Suspension or Restriction of Trading

4.21 Considerable attention has been given in the US reports to the question of "circuit breakers". On some markets a decision to suspend trading, or to restrict the way in which trading is permitted, is left to the discretion of the market regulators, who can take it in the light of the prevailing circumstances. An alternative approach is to have in place devices which will automatically trigger a suspension or restriction on trading when specific events occur. Devices of this kind can take many forms but since the crash attention has focused on "price limits". When the price moves outside a predetermined range, trading of the contract is automatically suspended under one variety of price limit. Another variety, introduced by the NYSE in response to the events of last October, restricts the use of automated trading systems when price limits are reached.

4.22 The Brady report and CBOT recommend that devices of this kind be co-ordinated across the markets for stocks, stock index futures and options.

4.23 Price limits have operated for some time in Japan, but their effect must be judged against the particular characteristics of that market.

4.24 The advantages claimed for mechanisms to suspend trading ("circuit breakers") are that

(i) regulators may need a breathing space to calculate the market exposure of market participants and to call for new margin or new capital to be put up before trading resumes;

(ii) the suspension of trading may lead market participants to stop panicking, and perhaps reverse or moderate the previous sharp price movements when trading resumes;

(iii) in markets where order-matching is important, the pause could be used to share privately-held information about the size of unfulfilled buy or sell orders amongst all market participants.

4.25 The disadvantages are that

(i) investors are deprived of the opportunity to deal. Small investors are particularly likely to be locked in. Unit trust managers will experience difficulty in valuing units. Large investors may

try to deal off the exchange (weakening the price-setting mechanism) or through an exchange abroad;

(ii) if the price movement continues unabated when trading resumes, the market may effectively be suspended for some time until a price floor is found;

(iii) the threat of suspension may lead to greater price volatility as investors try to sell before suspension is imposed, or try to sell immediately trading resumes in case it is suspended again;

(iv) futures and options markets may be unable to function satisfactorily while trading is suspended in the underlying product; they may continue to trade at prices which anticipate further movement in the underlying product;

(v) artificial constraints on the market may encourage market manipulation (for example if investors place stop loss orders near to a price limit, traders may try to move the price so as to trigger the orders).

These disadvantages are likely to be greater if suspension is for a lengthy or unspecified period than if trading is

suspended for a short pre-announced period of (say) 15-30 minutes. Specific action taken during the suspension and the procedures for re-opening trading are also relevant.

4.26 A number of US reports favour circuit breakers but there is no agreement on what the effects are of using circuit breakers or on which varieties offer the best prospects of a beneficial effect. There is even a dispute over the relative mertis of automatic and discretionary devices.

4.27 The New York Stock Exchange (NYSE) now cuts off programme trading when the principal index falls more than 50 points in a trading day. This system was criticised when it was activated on 14 April. It is alleged that sell orders which computer programmes were recommending were still being carried out manually by dealers but the activity of index arbitrageurs whose influence would generally have been to stabilise prices was curtailed by the enforced absence of computer trading. Some have claimed that an extra 30 points fall occurred as a result, and others believe that the unco-ordinated imposition of circuit breakers by the various US exchanges has led to difficulties.

4.28 Complications could arise if circuit breakers operated in some countries' markets but not in others. The result could be a sudden switch of business to markets which were still operating freely without circuit breakers, which could be disruptive for them if their systems were unable to cope. Those regulators operating circuit breakers might still be able to achieve the primary objective of protecting their market systems from overload, although they might not be as effective in their secondary aim of imposing a pause for reflection on investors.

4.29 The Stock Exchange does not operate any circuit breakers which prevent willing buyers dealing with willing sellers. Instead it can declare a "fast market" (see paragraph 2.21 above) to relieve market makers of the obligation of dealing at screen prices. Market makers can also protect themselves at other times by reducing the size of bargain in which they are willing to deal at screen prices, and at all times by widening their spreads between the prices at which they buy and sell. The Stock Exchange considers that this approach is preferable to suspending trading, which it argues is not appropriate to a market based on competing market makers.

4.30 LIFFE used to operate price limits, but found them unsatisfactory and abandoned them some years ago (except for the Japanese bond contract). There is thus no

conflict between the approaches of The Stock Exchange and LIFFE.

4.31 It is important to ensure that the systems designed to protect market participants and users (margin, capital adequacy etc) can in practice react quickly enough to sharp price movements. Trading may need to be suspended if surveillance, dealing, clearing or settlement systems break down or are in danger of doing so. That decision can best be left to the discretion of the exchange authorities, after consulting other regulators. It is not obvious, however, that automatic circuit breakers carry any clear advantage if no specific action is to be taken during the trading halt.

4.32 Nevertheless The Stock Exchange and LIFFE will need to assess the implications for UK markets if more circuit breakers are permanently adopted in US or other overseas markets. If the UK does not follow suit, business may be diverted to UK markets when breakers are used elsewhere and it would then be all the more important that the capacity of our systems and capital base of our market makers were sufficiently robust to cope with that business.

Computer Trading

4.33 Computer trading can be used to permit the simultaneous purchase or sale of several stocks on a stock exchange and was common amongst large US traders prior to the crash. Computers can be programmed to indentify the stocks to be bought or sold and in some systems can execute the trade. Programmes can be written to identify when to change the balance of a portfolio, either by trading in securities, or by trading in the futures markets (which is cheaper and quicker). The main strategies based on these techniques are index arbitrage and portfolio insurance.

(a) Index Arbitrage

4.34 Index arbitrage is a means of profiting from a discrepancy between the price of an index future and the price of an equivalent amount of the underlying basket of stock. A simultaneous transaction, buying one element and selling the other allows profit to be locked in, virtually without risk.

4.35 The main effect of index arbitrage should be to keep futures prices and prices of the underlying product broadly in step. This is desirable, but it cannot work if one of the two markets suspends trading or is expected to do so. In these circumstances, disruptive effects may occur.

4.36 This lends support to the need for co-operation between regulators but does not suggest any action against index arbitrage as such.

4.37 Indeed The Stock Exchange and LIFFE argue that there was not enough index arbitrage in London - because delays in updating equity prices on the screens underminded confidence at the time in the calculated FTSE index. Although with hindsight The Stock Exchange consider that screen quotes and the prices at which deals were struck moved fairly closely except for a few short intervals this was not known at the time. At times FTSE futures traded at a very large discount to the FTSE index. The exchanges believe that bearish sentiment was aggravated by the existence of this large discount, which could have been irradicated if index arbitrage had been able to operate more effectively.

(b) Portfolio insurance

4.38 Portfolio insurance using computers is an alternative to straightforward hedging: instead of selling futures now to secure guaranteed protection against a market fall, the investor programmes his computer to do so as soon as a fall begins. This approach assumes that futures can be sold at close to current price levels when a fall occurs.

In October prices slid too fast for most portfolio insurers to be able to do this as the supply of buyers of the futures dried up.

4.39 When used successfully computer programes, operating through the futures market, represent a cheap and easy way of "insuring" a portfolio against loss. US institutions relying on this technique may have chased prices up further before the abrupt fall than they would have done if the technique had not been used. The problem for these institutions was that the technique failed to provide the expected insurance against loss. The problem for investors at large may have been that because the market was driven too high it fell further and faster than it might otherwise have done.

4.40 The US Federal Reserve Board estimates that the use of portfolio insurance in the US has declined since the crash. Little portfolio insurance is done in London: The Stock Exchange estimate insured funds are certainly less than £250 million.

4.41 Amongst the factors which tend to inhibit both portfolio insurance and index arbitrage in the UK are stamp duty on equity purchases, the tax treatment of trading in futures, the use of screen quotations rather than transaction prices as the basis for calculating the FTSE Index, the lack of an automated dealing facility on The Stock

Exchange, spreads on equities, expiry procedures on LIFFE, the relatively small size of the UK futures market and the conservative attitudes of some institutional investors.

4.42 Index arbitrage has the beneficial effect of keeping prices on different markets aligned and it should not be discouraged. The impact of portfolio insurance programmes is more questionable, but the technique is little used in the UK. It is arguable that the various forms of computer-assisted trading are part of the normal range of available techniques, but the Stock Exchange and LIFFE should monitor the extent to which portfolio insurance is used in the UK and keep other techniques under review for potentially destabilising effects.

PART V: CO-OPERATION BETWEEN REGULATORS

5.1 The American reports identify a need for closer co-ordination between US regulators and some favour changes to their responsibilities. The structure of regulation in the USA is not our concern. In particular there is no parallel here to the split of responsibility between the SEC and CFTC. SIB has overall responsibility for regulating securities, futures and options. It needs to work closely with the Bank of England which has overall responsibility for the Banking System.

5.2 There is a need to promote international co-operation between securities regulators. A period of turbulence can be handled more easily if close working relationships already exist between regulators. These need to be developed both bilaterally and multilaterally.

5.3 Flexibility is important in responding to particular market developments. Each situation is unique and extensive planning would be inappropriate. But it is necessary to be able to respond quickly and for regulators to collaborate smoothly. Problems could for example arise if one market closes or suspends trading without consultation, while related instruments continue to be traded on another. Special arrangements may be necessary for monitoring and handling a firm which trades on more than one exchange. Additional margin calls (see

paragraph 3.20) or rule changes on one market can have repercussions on other markets.

5.4 In times of uncertainty in the markets it is essential that there should be clear lines of responsibility, efficient channels of communication and co-operation between regulators. These arrangements should be developed and strengthened in normal times so that when the need arises regulators are able to cope with the issues that arise urgently. The Bank of England and SIB will be keeping the existing arrangements under review, particularly in the light of the new regulatory system introduced by the Financial Services Act, to ensure their continued effectiveness.

VI MAIN CONCLUSIONS OF THE REPORT

6.1 Features of the markets, such as the relationship between futures and shares, did not play the dominant role in causing the market break. There is no evidence to suggest that the London futures and options markets caused or aggravated the fall and therefore no reason to restrict the growth of those markets.

6.2 The market and regulatory mechanisms in London were able to cope so as to maintain the financial integrity of the market and ensure the performance of bargains. Although some investors experienced difficulty in dealing during the crisis, the London markets remained open throughout and handled a large volume of business.

Prudential Regulation

6.3 SIB is reviewing its requirements for capital adequacy, in the light of the events of October (paragraph 3.3).

6.4 The Bank of England and SIB are pursuing their discussions with overseas regulators to ensure that each overseas firm operating in London has effective supervision. It is important for both regulators and Government to work in

the longer term towards the international co-ordination and covergence of captial adequacy requirements for securities business (paragraphs 3.6 and 3.7).

6.5 The relevant SROs should give priority to satisfying themselves that their members' internal control systems are adequate (paragraph 3.8).

6.6 The SROs should consider in conjunction with the Bank of England and the clearing banks whether any further steps can be taken to improve arrangements between markets participants and their banks so that banks can make well-informed judgements quickly in times of difficulty (paragraph 3.13).

6.7 ICCH and GAFTA have made external arrangements with third parties to provide backing for their obligations to their members in the event of a default, and LTOM is considering increasing its arrangements. SIB should keep all these arrangements under review in relation to the level of business in the future. (paragraph 3.19).

6.8 Clearing houses should continue to base margin requirements on their assessment of price volatilities, but consider the case for more frequent changes to margin requirements when price volatilities vary (paragraph 3.21).

6.9 The Stock Exchange is considering whether to introduce a centrally operated margin system for equities; and has recently adopted procedures for automatic closing out of positions in the event of a default (paragraphs 3.24-27).

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6.10 All market authorities are concerned that the legal position on default procedures in the event of insolvency should be clarified in the 1988/89 Parliamentary Session (paragraph 3.29).

Market Mechanisms

6.11 The exchanges and clearing houses should consider developing closer links between all the London clearing systems. (paragraph 4.11).

6.12 UK Exchanges developing links with overseas exchanges should consider measures to control risk and to exchange information (paragraph 4.12)

6.13 The Stock Exchange is considering the possibility of making changes to the Account System. (paragraph 4.19).

6.14 The Stock Exchange should maintain its efforts to ensure that all member firms reduce their backlogs and keep them down to acceptable levels (paragraph 4.20).

6.15 Automatic halts to trading ("circuit breakers") offer no clear-cut advantages, but The Stock Exchange and LIFFE will need to assess the implications for UK markets if more circuit breakers are permanently adopted in US or other overseas markets (paragraphs 4.31-32).

6.16 It is arguable that the various forms of computer-assisted trading are part of the normal range of available techniques, but The Stock Exchange and LIFFE should monitor the extent to which portfolio insurance using computer programmes is used in the UK and keep other techniques under review for potentially destabilising effects. (paragraph 4.42).

Co-operation between regulators

6.17 In times of uncertainty in the markets it is essential that there should be clear lines of responsibility, efficient channels of communication and co-operation between regulators. These arrangements should be developed and strengthened in normal times so that when the need arises regulators are able to cope with the issues that arise urgently. The Bank of England and SIB will keep existing arrangements under review, particularly in the light of the new regulatory system introduced by the Financial Services Act, to ensure their continued effectiveness (paragraph 5.4).

ECONOMIC BACKGROUND

1 In retrospect the peak of the long bull market can be seen to have occurred in the summer of 1987. Most equity markets peaked in July or August and drifted slowly down over the rest of the summer. In London, there were some signs of increased volatility. On 6 August, the FTSE index fell by a then record of 56 points, on publication of poor trade figures. Turnover on all markets remained high. There was a short-lived recovery from the summer drift in September.

2 In October, there were several economic considerations which particularly affected market perception of the economic situation:

i) how the US trade deficit was to be financed, in the event that falls in the value of the dollar dissuaded foreign investors from purchasing US debt;

ii) the volatility of the dollar;

iii) a rising trend in interest rates

iv) a belief that the rapid rise in stock values during 1986 and 1987 had led to their becoming over-valued.

3 On 14 October, two events particularly focused US market concerns. The August US trade figures revealed a deficit of $15.7 billion, well above market expectations. This precipitated a fall in the dollar and a rise in the yield of US Treasury bonds which made equity investment look less attractive. Second, legislation was filed which would eliminate tax benefits associated with the financing of corporate take-overs. This initiative was particularly unwelcome to risk arbitrageurs whose selling activity particularly centred on take-over candidates.

4 The week before the break the Dow Jones index fell 95 points (a then record) on Wednesday 14 October, and a further 57 points on Thursday. In London, the FTSE index in response fell 50 points over the two days but on Friday 16 October, when the Dow fell 108 points, the London markets were closed by a freak storm.

5 Over the weekend, the US Treasury Secretary, James Baker, exhorted the German Central Bank to stimulate its economy, and was perceived to have been warning that otherwise US support for the dollar would not be forthcoming. This was taken to indicate that the future of the Louvre accord was in doubt. In addition, computer models operated by portfolio insurers recommended heavy selling in line with the heavy selling of futures which the insurers had already entered into during the preceding week.

6 This atmosphere led to the unprecedented trading conditions on 19 October, with heavy falls recorded on all world markets. In London, the FTSE index fell 250 points; in New York, the fall on the Dow was a record 508 points. On Tuesday 20, there was a further fall in London of 251 points, although New York, after a day in which the mechanisms of the financial markets came closest to breaking point, subsequently closed up over 100 points.

7 There is no clear economic rationale why markets rose so much only to fall so sharply in October. However, the factors identified above seem to have led the markets in October to believe that the dollar (which had declined by about 3% since August) was about to go into sharp decline. That could well have provoked a sharp rise in US interest rates, which were already edging up, and perhaps rises in other major industrial countries. The prospect of rising interest rates sending an already fragile US economy into a recession which could adversely affect world growth, apart from making equity holding itself less attractive, may well have reduced confidence in industrial prospects and forced a re-assessment of equity prices. In this sense, the October fall may have reflected fears about the lack of progress in reducing the current account imbalances, which pose a threat to world growth, and the ability of the G7 countries to continue to act together to overcome these problems.

8 If so, these fears may have proved the last straw to equity markets, which objectively were already showing signs of being over-valued. The economic rationale for existing stock market prices in late 1986, following a 5 year bull-market, might have appeared defensible: by August 1987, after an accelerating rise in prices over the year, that was less apparent. The Brady Report comments that by then, US stock valuation "challenged historical precendent and fundamental justification". By October Japanese price/earnings ratios had doubled since the start of the year, to average levels which would appear surreal in other countries. London, where prices had risen by nearly a half since the start of the year, had the highest price/earnings ratios since the slump of 1973/74. The widening gap between dividend yields on equities and redemption yields on gilts hardly suggested holding equity for long-term income flows. And there was very little in terms of economic performance which could explain why equity prices were rising so quickly.

9 London was very much at the forefront of the 1987 bull-market, rising as fast as Tokyo and New York, and considerably faster than Paris or Germany. Over the whole of 1987, London proved more buoyant than other markets except Tokyo.

a International Stock Exchange: Report by Quality of Markets Unit (to which the London International Financial Futures Exchange contributed) and letter from the Chairman to the Secretary of State for Trade and Industry

b Report of the Presidential Task Force on Market Mechanisms - the Brady report.

c US Federal Reserve Board: oral testimony to Senate Committee by Chairman Greenspan

d US General Accounting Office report

e Four reports by the US Commodity Futures Trading Commission

f Report by the US Securities Exchange Commission

g New York Stock Exchange: "An Overview of Program Trading and Its Impact on Current Market Practices" (The Katzenbach report)

h Report of the Chicago Mercantile Exchange

i Chicago Board of Trade comments on Brady Report

j Report of the US President's Working Group on Financial Markets

INTERNATIONAL STOCK EXCHANGE: QUALITY OF MARKETS REPORT

1. The Quality of Markets Committee of the International Stock Exchange has produced a survey of trading conditions during the market break in its Quarterly Bulletin. It provided the post Big Bang market with its first test of sustained selling pressure.

UK Equity Market

2. The FTSE 100 index fell 22% in the course of the period from 14 to 20 October, with further declines in the following two weeks followed by a period of stabilisation until the year-end. The period around mid-October also saw a substantial increase in volatility, with indexes moving a couple of hundred points in the course of a day's trading. Whilst this extreme volatility abated together with the marked fall in turnover, the market still seemed initially more volatile than before the crash. There were six trading days in November and December when movements in excess of 50 index points were recorded.

3. The extent and speed at which the London market fell may have been exacerbated by the high levels of equity held by UK institutions as a proportion of their total portfolio. They were also short of liquid funds because of underwriting calls. In addition, UK companies do not buy-back their own stock as in, for example, the USA, which can provide price support to a market.

4. Trading volumes were unprecendentaly high, at over 100,000 bargains on two days; trading in alpha stocks was especially high - not surprising given their greater liquidity and apparent desire of institutions to reduce their equity exposure swiftly; they accounted for 68% of turnover by value, compared with levels of 50% in normal trading conditions. Turnover in other stocks rose at the time of the fall but declined thereafter. Customer business accounted for the bulk of trading; intra-market turnover fell from 50% to 40% of total turnover a higher proportion of intra-market business is now carried out through inter-dealer brokers.

5. The Committee consider that the "fast market" indicator (which makes all prices quoted on SEAQ indicative) had worked well. It provides a safety valve at times of very heavy dealing pressure and high volatility to prevent market makers being 'hit' for large trades if their prices were momentarily out of line with the market. Without its use, market makers would have pulled out of the market, reduced quotation size or put quote prices below the current market bid quote, all of which would have been more damaging for the market than indicative price displays. The indicator was used sparingly and, save on 20 October, for periods of less than one hour at a time.

6. The survey finds that in the three weeks after the fall, a large number of small buy orders were matched with a lower number of high value "sell" orders. 80% (by number) of customer transactions were for purchases. The conclusion drawn is that individuals were net buyers in the period of the main fall on the market.

7. Market makers who were anyway long of stock at the beginning of October 19 not least because of the loss of the previous Friday's trading day had to absorb net customer sales on the day in excess of £250m. Subsequently, these positions were unwound at a rate which, in the report's opinion indicates a successful pricing strategy. Substantial buying occurred in early November. No market maker failed or withdrew from the market

8. The liquidity of the market deteriorated on the afternoon of Tuesday 20 October but not before. This was reflected in increased spreads * (which more than doubled in alpha stocks from 1.2% to 3%),an increased touch price * from 0.8% to 2%, a reduction in total market size * and the

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* The "spread" is the difference between the prices at which an individual market maker will buy and sell; the "touch" is the difference between the best buy and sell prices available in the market; and the "size" is the maximum number of shares for which the quoted price holds good.

emergence of significant size premia. The spread and touch in beta and gamma stocks also widened (from a higher base) so that, by October 30, the 'touch' in beta stocks was over 4%, up from 1.8%. The size of the market fell by two thirds (an indication of declining liquidity) and the maximum quote size for beta stocks is still well down. The touch for gamma stocks doubled.

9. The report's examination of movements in individual stocks concludes that those with high dollar exposure performed proportionately badly.

10. The report accepts that, with trading at such exceptional levels, there were delays in access to market makers. It concludes that, save for brief periods, transactions were being executed at quoted prices even when a fast market had been declared. These brief divergences could arise from technicalities in the collection of data. The Committee is encouraged by the relatively few divergences, as indicating a fair market.

11. The report also concludes that the visibility of the UK market did not add to its volatility; the difference in volatility between the (most visible) alpha stocks and other less visible stocks including beta stocks was negligible. This is seen as an indication that prices did not collapse like dominos but only in response to selling pressure; and the speedy dissemination of information in a

highly visible market leads to more efficient markets; market makers are not thought to have reduced prices in panic.

12. Evidence about whether foreign investors precipitated the UK market decline by selling their holdings in UK equities is unavailable; but ADR holders do not appear to have sold back into the UK. So there is no reason to assume heavy overseas selling.

13. Since October, spreads and touch prices, at least in alpha and beta stocks, have recovered but remain at around double pre-crash levels. The spread on gamma stocks has not improved, an indication of illiquidity in that area. The report recommends steps to increase the commitment of market makers in these stocks. Total market size and the maximum quote size in all categories of stock has improved, and the size premium has declined.

Foreign Equity Market

14. SEAQ International also had record volume levels in late October, some 50% higher than September's average at a value nearly 70% up. Selling pressure was heavy and at times indiscriminate especially on 19 and 20 October when prices were indicative but the market managed to transact over 40% more bargains for its customers; this suggests that delays in reaching market makers were caused more by

the constraints of firms' resources than by a refusal to answer the telephone. Spreads widened to up to three times the pre-break levels (and have since fallen); some market makers considered that new business was still attracted to London because of its greater liquidity.

15. The report notes considerable differences between individual countries. The level of trading in French equities rose sharply but fell in German stocks and was unchanged in US stocks. Trading in Japanese stocks was also high, at double the average bargain size. The market in Australian equities which is not exclusively professional seems to have attracted private investors or purchasers; with institutions selling stock.

16. The overall conclusion is that the market performed well, despite inevitable capacity constraints which led to delays in obtaining accurate price information.

Derivative Products. (Futures and options)

17. This part of the report was produced in consultation with LIFFE. It notes that the UK is different from the US in that UK trading volumes in derivative products are much less significant in relation to the underlying cash market, representing about 20%. The risk of "gridlock" on UK stock exchanges is correspondingly less. But there were price anomalies between cash and derivative markets

which can best be resolved by the facilitation of trading strategies which reinforce the connection between the markets.

18. At the time of the fall, many investors were exposed to price falls in the market because the writing of FTSE put options in the previous few months had been seen as a safe means to enhance investment yield. On October 19 with markets tumbling and the options becoming extremely unprofitable, these investors tried to close out their positions, spreads widened, prices were very volatile and there was a considerable excess of put options over call options until the afternoon. In the options on individual stocks, spreads widened sharply. The average size of trades reduced sharply, around 90% of trades being for 10 or less contracts. Intra-day margin calls were made twice on 20 October. The market suffered from some uncertainty over the quality of data being received from the cash market.

19. On LIFFE, FTSE futures (which only account for 3% of market activity) traded at record volumes of over three times the usual average , with exceptional price volatility of around 500 points in a day's trading. The futures were trading, on average, at a 5% discount to the quoted index level which may have caused alarm in equity dealing rooms for short periods. Spreads were raised, (up to 4% for a while on the morning of the 20 October) but

the average spread for the week was 0.5% or less. Intra-day margin calls were made on 19, 20 and 22 October (though they were not applicable to all contracts); and initial margin was increased on 21 October.

20. The report finds little evidence of arbitrage activity on the UK markets because of tax treatment, lack of automatic execution facilities and cash settlement procedures. At the time of the crash, arbitrageurs found their trading no longer risk free because of the pace of price changes and difficulties in executing orders.

21. The report concludes that the absence of strategies such as arbitrage ensured that the discrepancies between cash and derivative markets were not eliminated. The discount appears to have been caused by an expectation amongst sellers that they would not be able to deal in the cash market. They accordingly sold futures. Alternatively there may have been a suspicion that price data in the cash markets was unreliable.

22. The report believes that development of techniques such as index arbitrage would help to prevent divergence between cash and derivative markets to enable efficient risk transfers and more speedy execution services in the cash market are needed to improve the efficiency with which business is transacted. The SEAQ Automatic Execution Facility is one of the mechanisms by which this may be achieved.

Presidential Task Force on Market Mechanisms

The President of the USA set up the Task Force on Market Mechanisms, headed by Nicholas Brady. It concluded that the fall in the markets was triggered by bad US trade figures and proposals to alter US tax legislation which would make take-overs less attractive. Once prices began to fall, institutions using portfolio insurance programmes added to selling pressures, as did other investors who anticipated this portfolio insurance behaviour.

2. The selling momentum strained the capacity of the system as US markets handled record volumes. Market makers were not able to smooth the fall in prices. Problems were experienced in clearance and settlement systems.

3. The separate exchanges for stock and futures operate as a single marketplace, but prices did not move in line during the crash.

4. The report recommended greater consistency in the regulation of individual exchanges, and a review of the ability of the specialists on the New York Stock Exchange to cope with large order imbalances.

5. The report recommended that a single agency, such as the Federal Reserve Board, should co-ordinate regulation on

issues which affect all markets, that clearing systems for the markets should be unified, that margins should be set at consistent levels across the markets that circuit breakers should be implemented on a co-ordinated basis across the markets and that more information should be exchanged between markets.

US Federal Reserve Board

The Chairman of the US Fed testified before Congress. The Fed's actions during the break had been designed to reduce irrational demands for liquidity, and to meet unusual demands.

2. The historically very large and rapid decline in prices may have been attributable in the USA to the use of portfolio insurance, the technological ability to place large orders suddenly, fear that order execution, margin and clearing systems were breaking down and the disconnection between stock and futures prices.

3. The Fed Chairman emphasised that the stock and futures exchanges need to be seen as a single economic marketplace, and that the system had insufficient capacity to cope with the level of business. Circuit breakers to allow regulators to react might be the best solution when capacity proved inadequate, although they were inherently destabilising.

4. Either a single clearing organistion or greater co-ordination between clearing organistions was necessary, for example to avoid strains on liquidity because margin payments arising on different markets could not be netted off.

5. The level of margin required careful review and should be set by the markets, subject to Federal oversight.

6. The Federal Reserve Board should not have sole authority over the markets. Increasing the Fed's role might be interpreted as an indication that the Fed would support a wider range of financial institutions.

US General Accounting Office

The GAO report noted the problems experienced by the New York Stock Exchange in routeing orders and reporting bargains and recommended improvements in the automated operational systems. It also recommended contingency planning by self-regulatory organisations, to include information exchange and co-ordination of decision-making.

2. It recommended a role for the Federal Reserve Board in intermarket regulation.

3. It recommended greater co-operation between regulators in the longer term, to include review of margin requirements and the need for better capitalised market making.

Commodity Futures Trading Commission

The CFTC produced four reports. It found that the clearing and settlement systems were able to handle record flows of margin, that no investors experienced losses due to default and that no futures commission merchants failed.

2. The CFTC concluded that the margin system was adequate to protect market participants against the risk of counterparty default and saw no need to set margin at artificially high levels to discourage speculation.

3. The CFTC recommended that information about trading halts and delayed openings on the NYSE should be passed rapidly to the futures exchanges. It also recommended that exchanges should have co-ordinated plans for emergency closure of exchanges.

Securities and Exchange Commission

The SEC concludes that the US futures markets did not cause the break, but did aggravate the speed of the fall. Some investors sold in anticipation of portfolio insurance selling. NYSE specialists were unable to maintain orderly markets. Delays occurred in routeing orders between regional exchanges and the NYSE. Both stock and options markets suffered from volatility, order imbalances and trading halts.

2. Members of the SEC were divided on whether to seek the sole responsibility, currently shared with the CFTC, for regulating futures based on stock indices.

3. The SEC recommended higher capital requirements for NYSE specialists, increased capacity for the NYSE Designated Order Turnaround system and faster clearing procedures. It also recommends better monitoring of clearing members, and improved co-ordination of clearing and settlement systems.

4. The SEC recommends an express probition of "front-running" whereby a person trades on inside knowledge that a bargain in the same or a related instrument is imminent.

5. The SEC favours an increase in margin requirements for futures contracts to 20-25%

New York Stock Exchange

A study by Nicholas Katzenbach was commissioned by the NYSE. It found that the NYSE's Designated Order Turnaround system was unable to cope with the flow of orders during the break, and because quoted prices could not keep up with the prices at which investors wished to deal index arbitrage could not operate effectively. Portfolio insurance contributed to the speed of the price fall, but not necessarily to its size.

Chicago Mercantile Exchange

The CME found that because prices on the NYSE could not be relied upon, futures prices fell below stock prices. This uncertainty, together with the NYSE "uptick rule" (forbidding short sales when the last price movement was a fall) discouraged index arbitrage which would otherwise have kept prices in line.

2. The CME argues against a ban on either portfolio insurance or index arbitrage.

Chicago Board of Trade

The Chicago Board of Trade submitted a report to the Brady Commission. Its main findings included:

- the break was caused by worldwide uncertainty and fear about the US economy

- futures markets did not cause the decline and performed their hedging and risk-transfer functions admirably

- the CBOT markets remained open throughout, without trading halts

- the CBOT increased futures margins ten times during October reflecting increased volatility.

- all margin calls made by the clearing house were met and the CBOT markets maintained their financial integrity

2. The Board's recommendations include

- CFTC should retain jurisdiction over stock index futures

- futures margins should remain under the control of futures exchanges and not be raised to prohibitively high levels

- price limits should be established for all stock index futures

- daily exchange of information between futures exchanges (from the end of 1987) will improve financial assessment of clearing members, whereas consolidation of clearing houses would be a dangerous concentration of risk in one place

- more competition should be introduced into the NYSE specialist system

- markets should remain open, and the problem of trading halts and delayed openings on the NYSE should be examined

- if trading halts are imposed they should be instituted on a uniform basis under pre-set conditions and announced publicly when triggered

- capital requirements for the futures industry should be reassessed in relation to position risk.

US President's Working Group on Financial Markets

The US President set up a working group comprising representatives of the US Treasury, Federal Reserve Board, SEC and CFTC.

2. The group recommends that all relevant US markets should introduce a circuit breaker which would automatically halt trading for one hour if the Dow Jones Industrial Average declined 250 points from its previous day's closing level. 250 points is a wide gap and 19 October 1987 is the only occasion on which such a circuit breaker would have been triggered in the past. The group also proposes that a fall of 400 points would trigger a two hour halt.

3. The group proposes a series of studies of clearing and settlement procedures designed to improve liquidity.

4. The group proposesto remain in existence so as to improve co-operation between regulators, but makes no other recommendation on contingency planning.

5. The group does not recommend raising margin requirements for futures. Nor does it recommend restrictions on computer trading.

SECRET 1/B

Price Miracle 2

R915.

A useful background commentary. RRCG 10/5

MONTHLY MONETARY ASSESSMENT : APRIL 1988

Summary Assessment

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

Main Points

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

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

M0 grew by 6.2 per cent in the year to April, and the 12 month growth rate is expected to remain at about 6¼ per cent in May and June. Thereafter, the rate is projected to fall to below 5 per cent after August as consumer spending slows. (Paras 25, 26)

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

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

Annex: Company Finance Post-Crash.

MG2 Division
6 May 1988

SECRET

A. External Developments

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

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

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

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

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

Conditions in W Germany

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

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

B. Activity and Inflation

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

Recent indicators of activity

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

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

final figure shows no change. PLC6.

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

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

Inflation

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

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

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

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

Projections for money GDP

16. The Budget forecast showed a 9¼ per cent increase in **money GDP** in 1987-88, with deceleration to 7½ per cent in 1988-89. The forecast slowdown in money GDP growth is primarily associated with

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

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

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

C. Public Sector Finances and the Fiscal Stance

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

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

D. UK Exchange Rate and External Accounts

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

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

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

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

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

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

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

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

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

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

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

Narrow Money

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

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

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

Broad Money

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

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

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

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

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

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

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

Credit

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

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

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

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

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

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

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

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

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

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

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

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

Funding

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

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

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

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

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

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

Money Markets and Interest Rates

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

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

Gilts

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

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

Gives an interesting perspective on the market view of reduction in inflation trends.

RR66

Capital Markets and Corporate Finance

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

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

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

MG2 Division
6 May 1988

90/G.jfw.4555/22

SECRET

Monetary developments since last month's report

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

+ April outturn

* figures are for October, March and April.

ANNEX

COMPANY FINANCE POST-CRASH

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

Company finance, pre-crash

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

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

4. Several factors underlie this shift towards securitisation:

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

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

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

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

Company finance, post-crash

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

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

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

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

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

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

Conclusion

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

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

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

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

90/G.jfw.4569.009

TABLE 1: SOURCES OF NEW COMPANY FINANCE (external)

(a) £ billion

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

Notes

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

(2) foreign currency issues

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

* estimate

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

TABLE 1: SOURCES OF NEW COMPANY FINANCE (external)

(b) % of total finance

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

* estimate

TABLE 2: LIQUID ASSETS OF INDUSTRIAL AND COMMERCIAL COMPANIES

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

* estimate

Source: Financial Statistics, table 8.4

TABLE 3: EUROSTERLING ISSUES (Fixed and Floating Rate)

£ billion

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

* most

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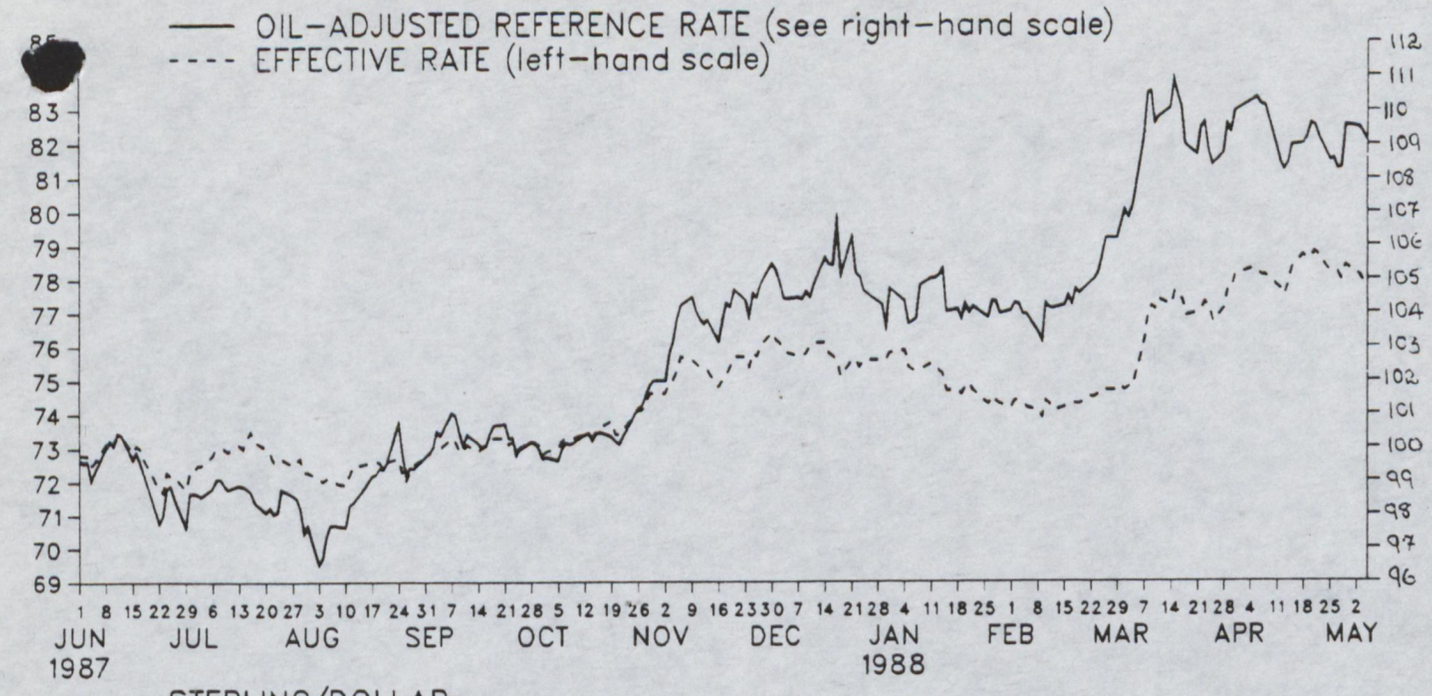
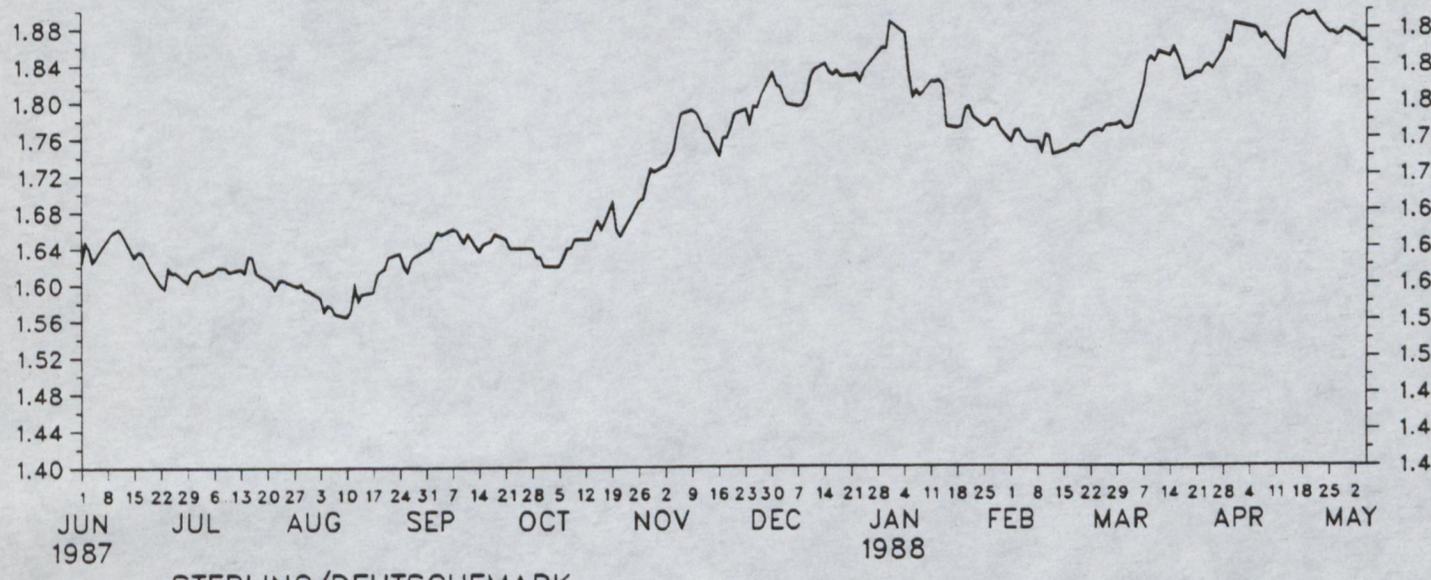
MONTHLY MONETARY REPORT : CHARTS

I	Exchange Rate Short Term
II	UK/US interest rate differential
III	Narrow money growth
IV	Broad money growth
V	Real M0 growth
VII	FSBR budget profile M0
IX	FSBR budget profile M4
X	Retail Deposits
XI	Bank and Building Society Lending
XII	£ Corporate bond issues
XIII	Money Market Assistance
XIV	Nominal Interest Rates
XV	Yield Curve
XVI	Real Yields
XVII	House prices 1
XVIII	House prices 2
XIX	Capital Markets

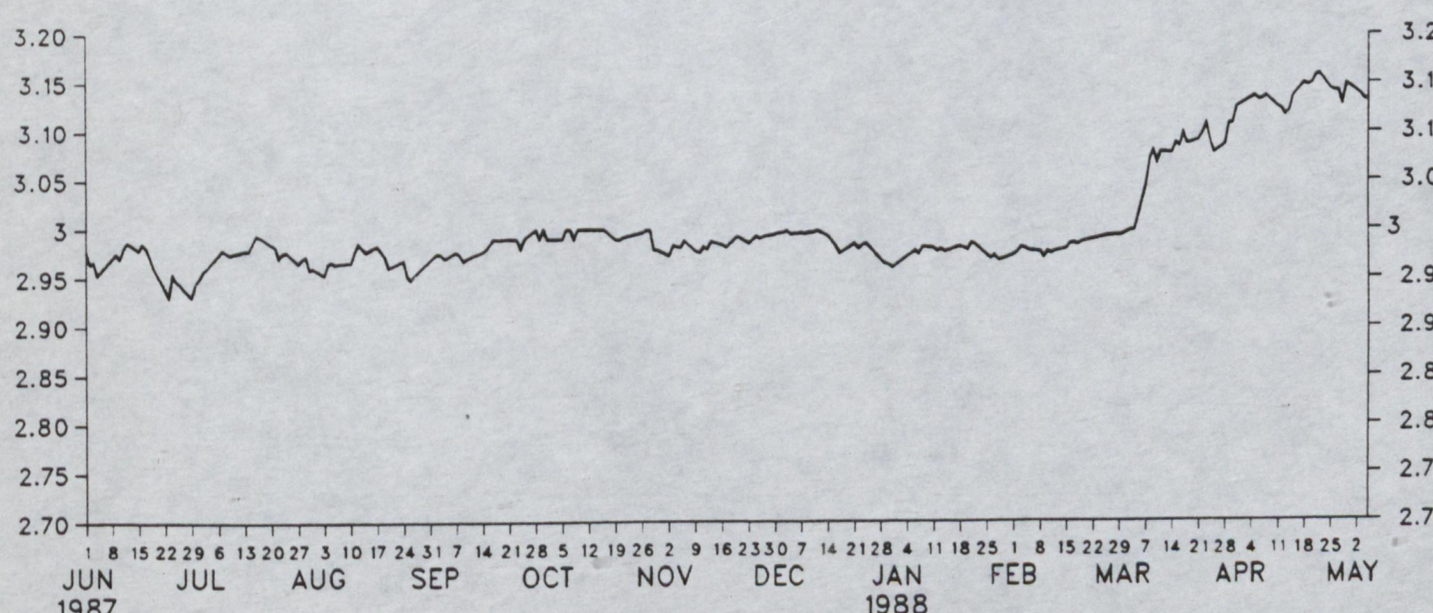
CHART I:EXCHANGE RATE



STERLING/DOLLAR



STERLING/DEUTSCHEMARK



UK/US INTEREST RATE DIFFERENTIAL

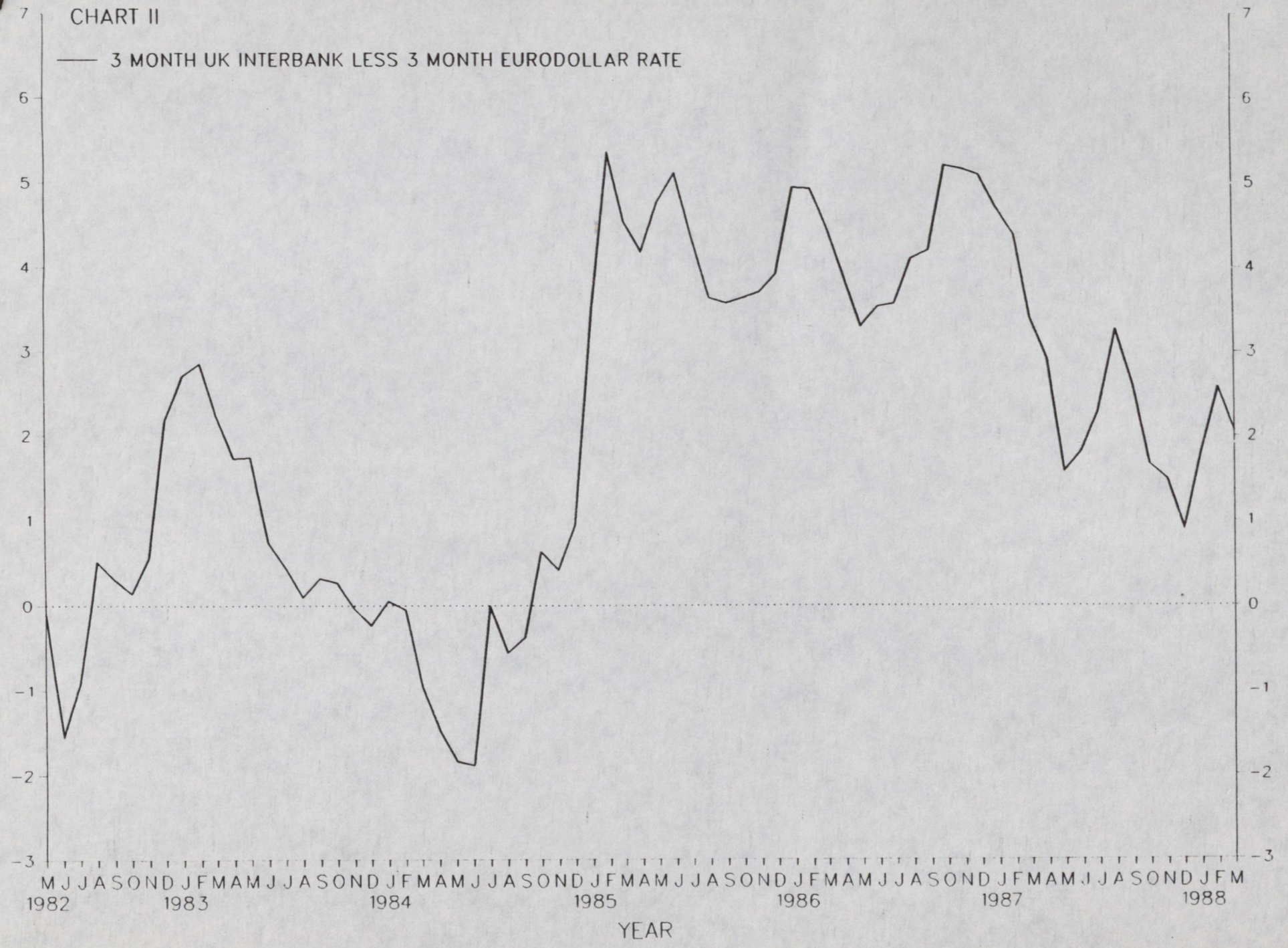


CHART III NARROW MONEY

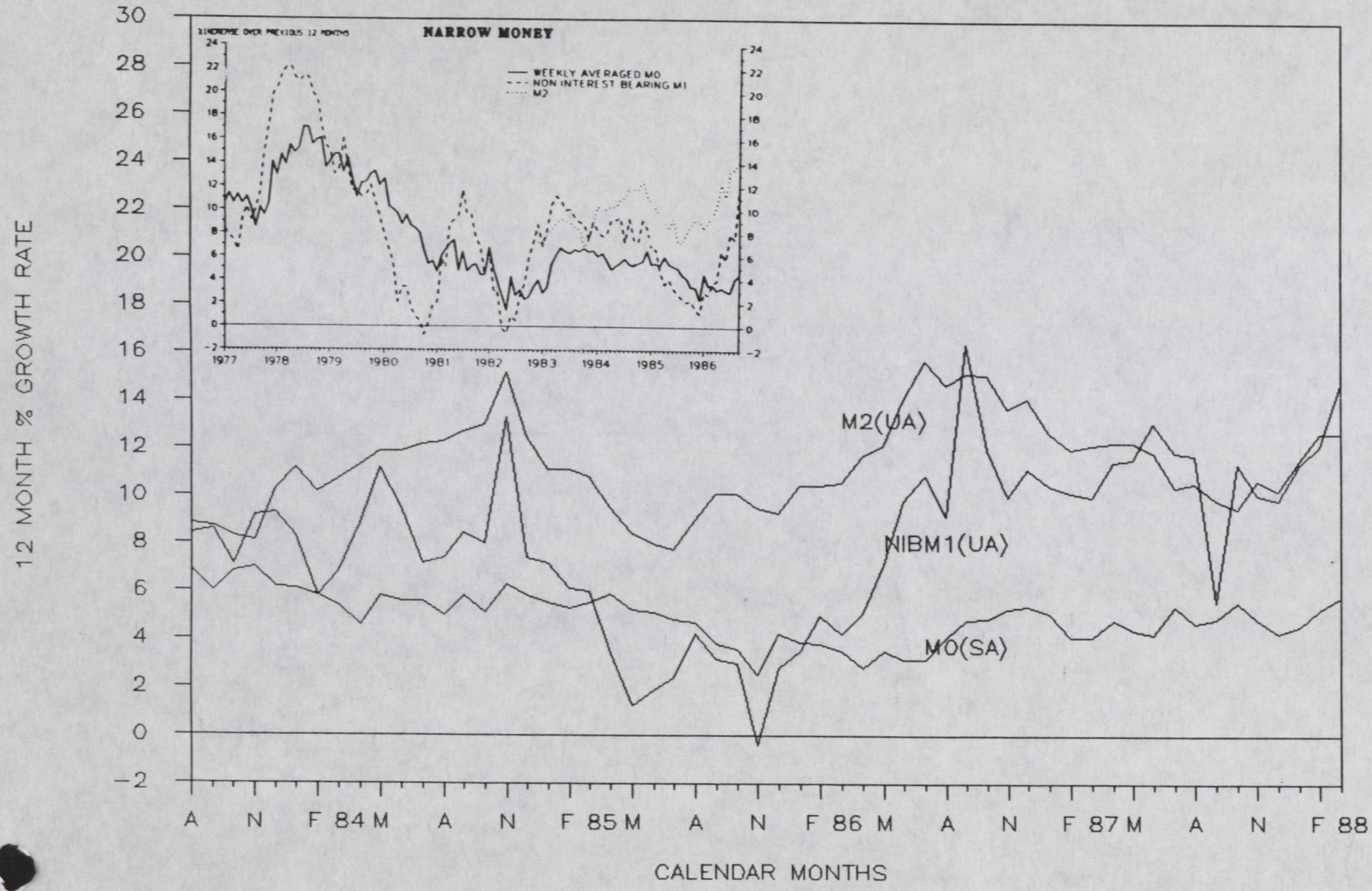


CHART IV BROAD MONEY

Annual percentage growth (ua)

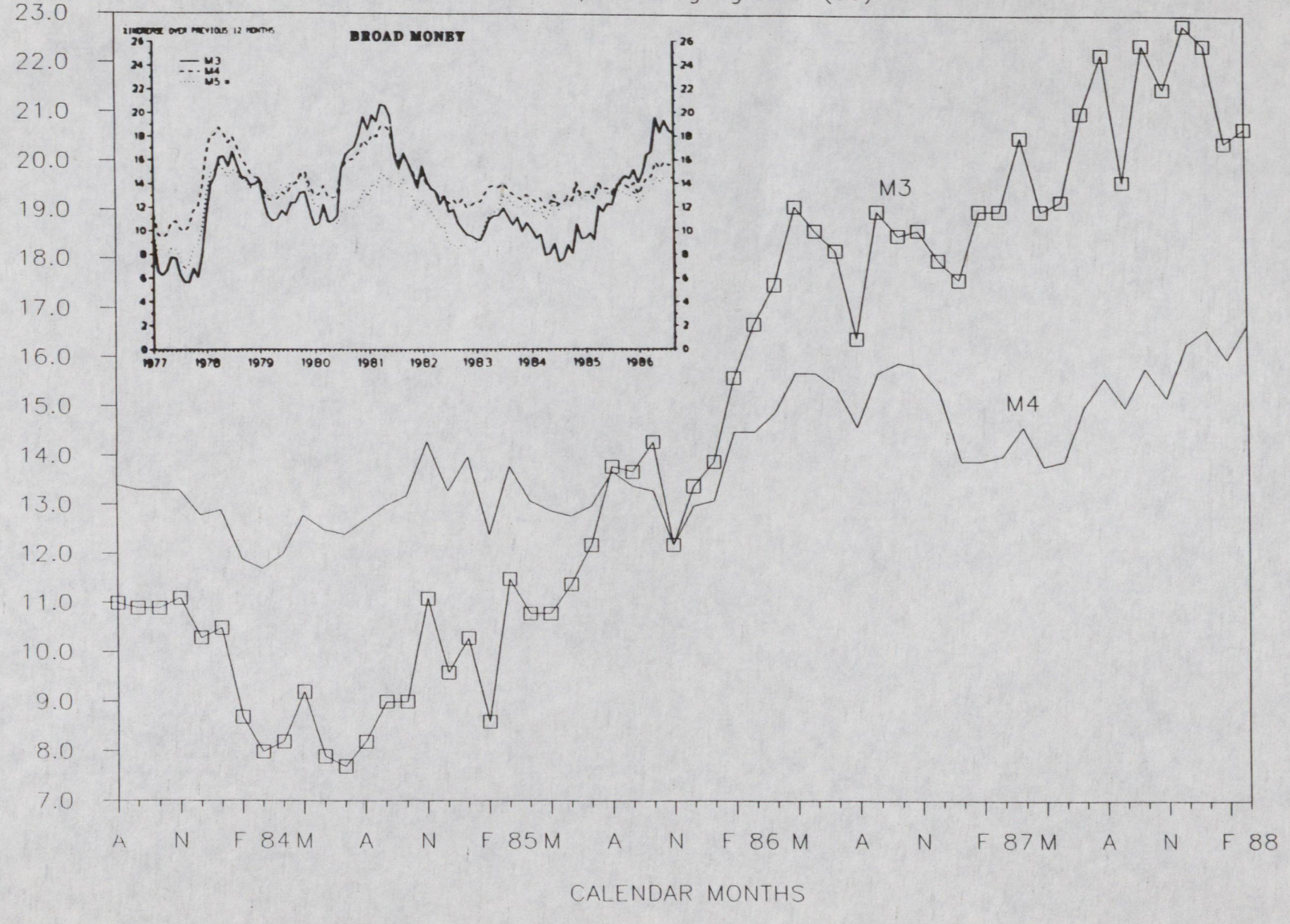


CHART V REAL M0

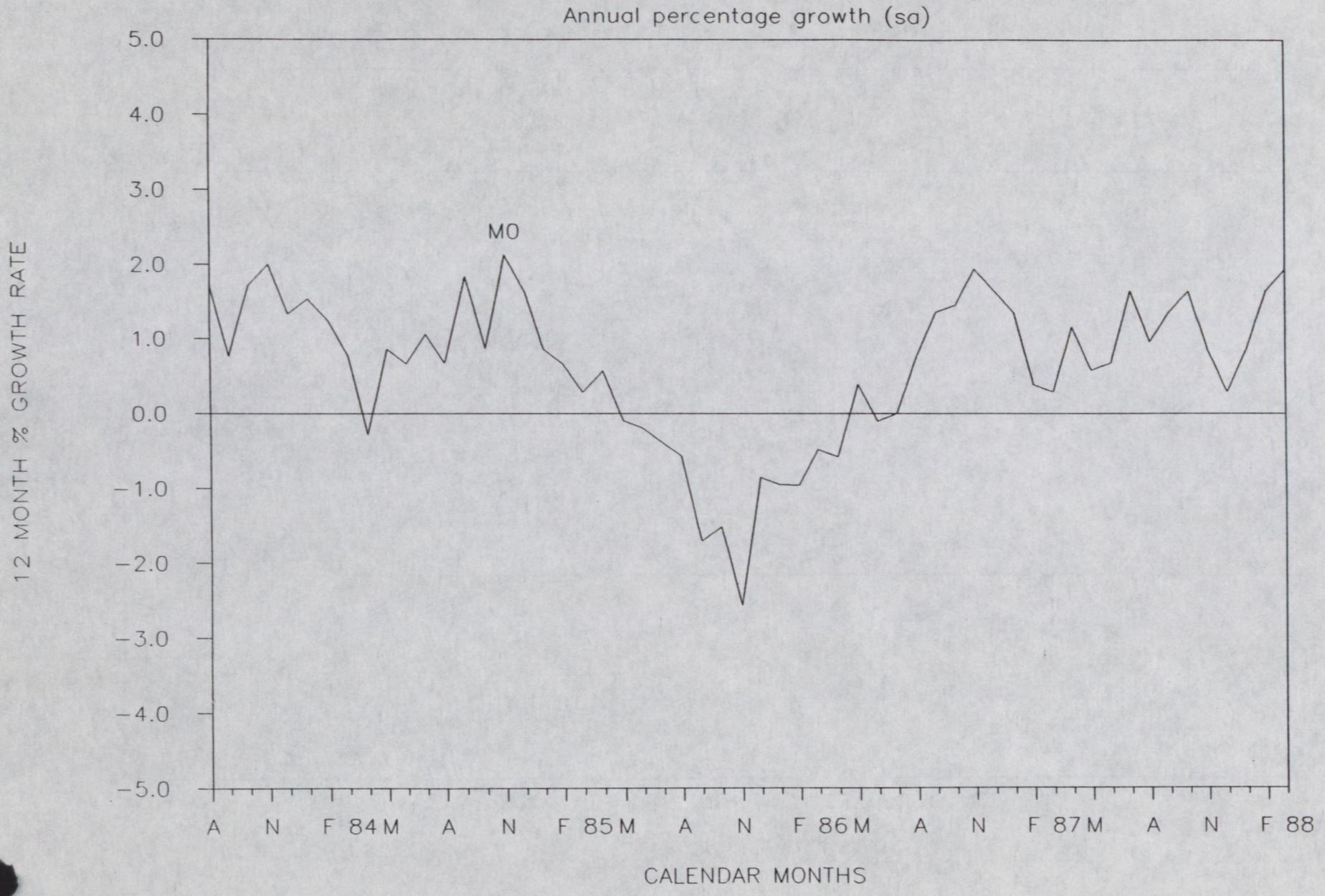


Chart VII MO : 1988 BUDGET FORECAST

COMPARED WITH OUTTURN & LATEST FORECAST

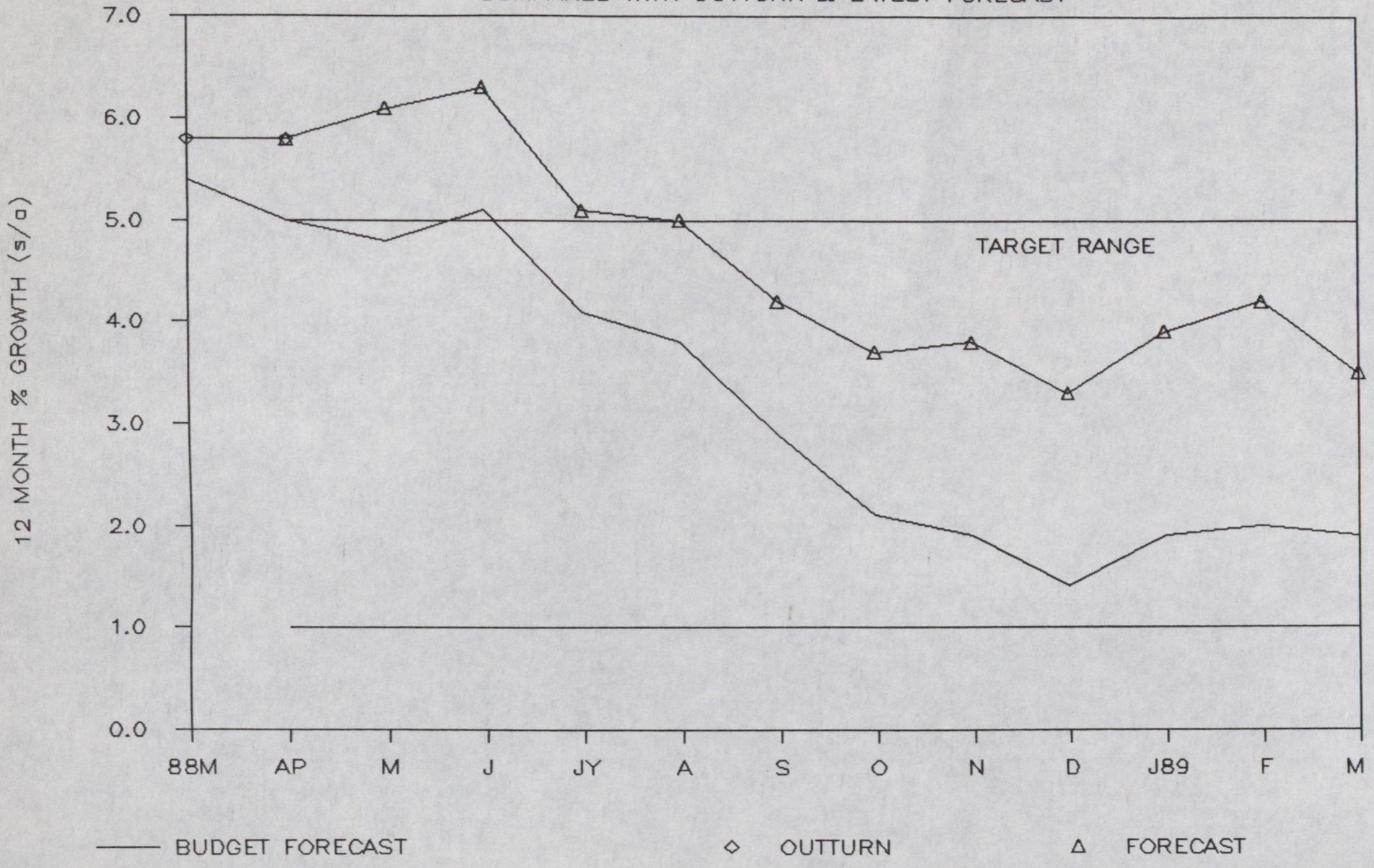


Chart IX M4 : 1988 BUDGET FORECAST

COMPARED WITH OUTTURN & LATEST FORECAST

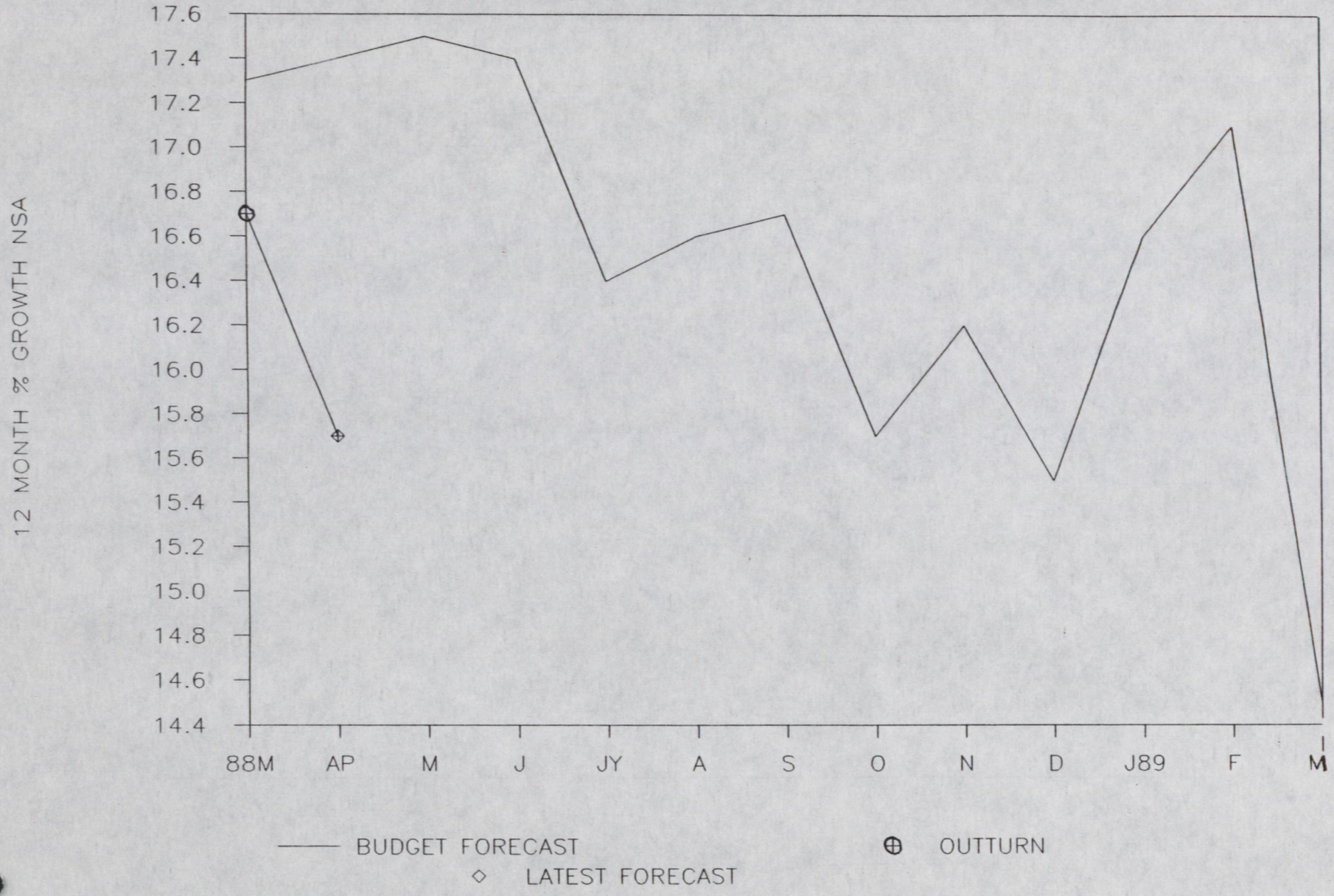


CHART X RETAIL DEPOSITS

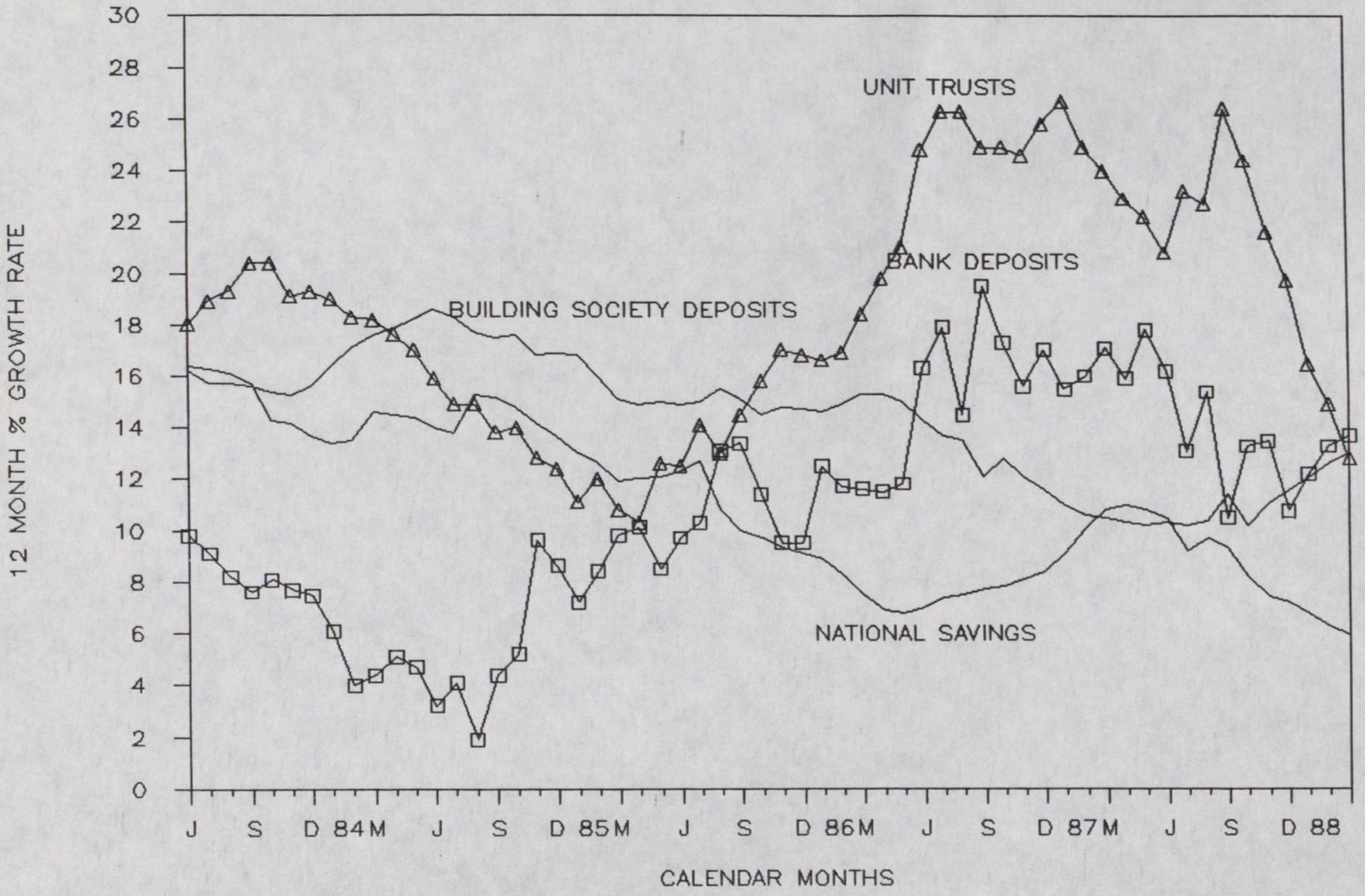


CHART XI

BANK AND BUILDING SOCIETY LENDING

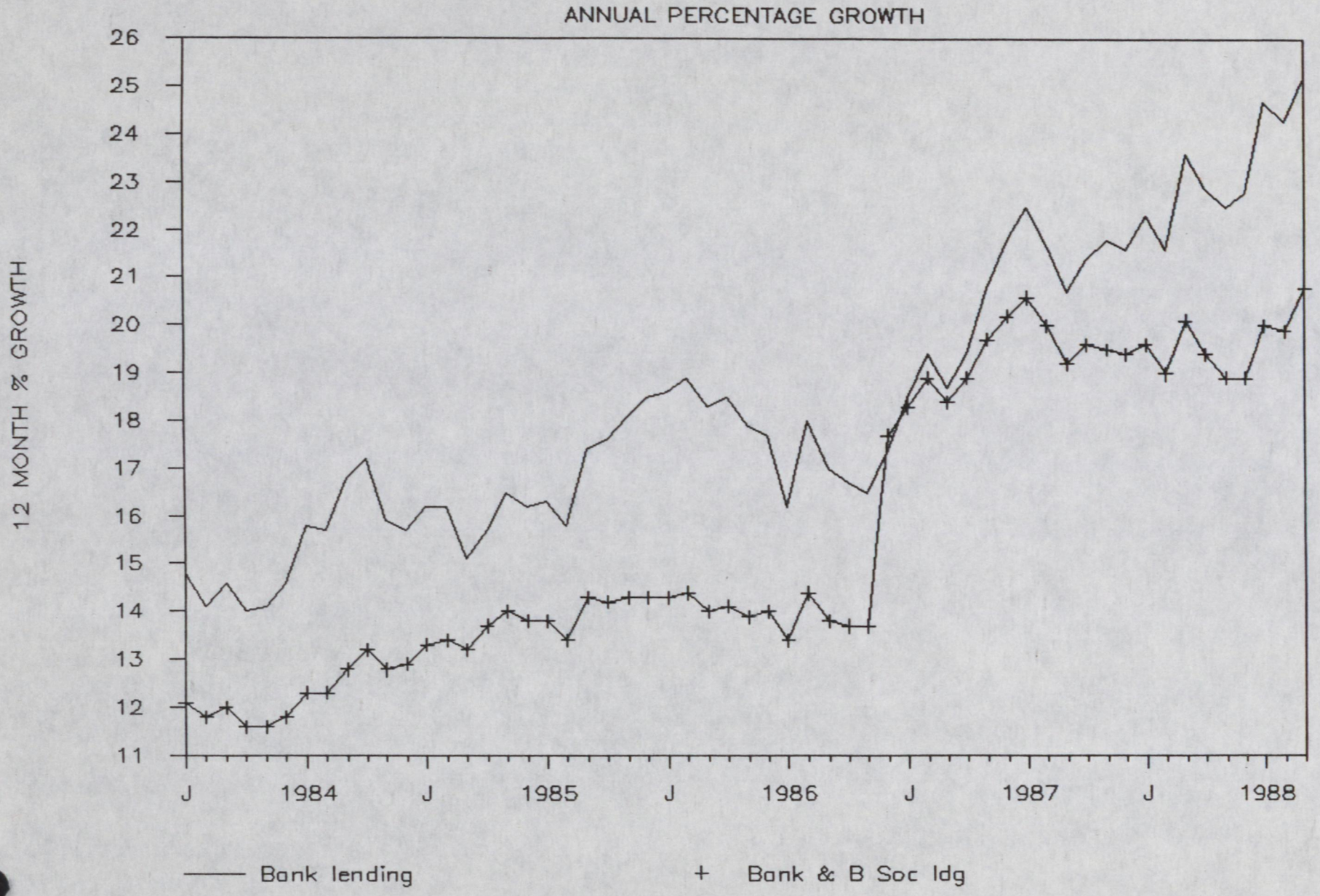


CHART XII

STERLING BOND ISSUES BY UK AND OVERSEAS INSTITUTIONS

(DOMESTIC AND EURO MARKETS)

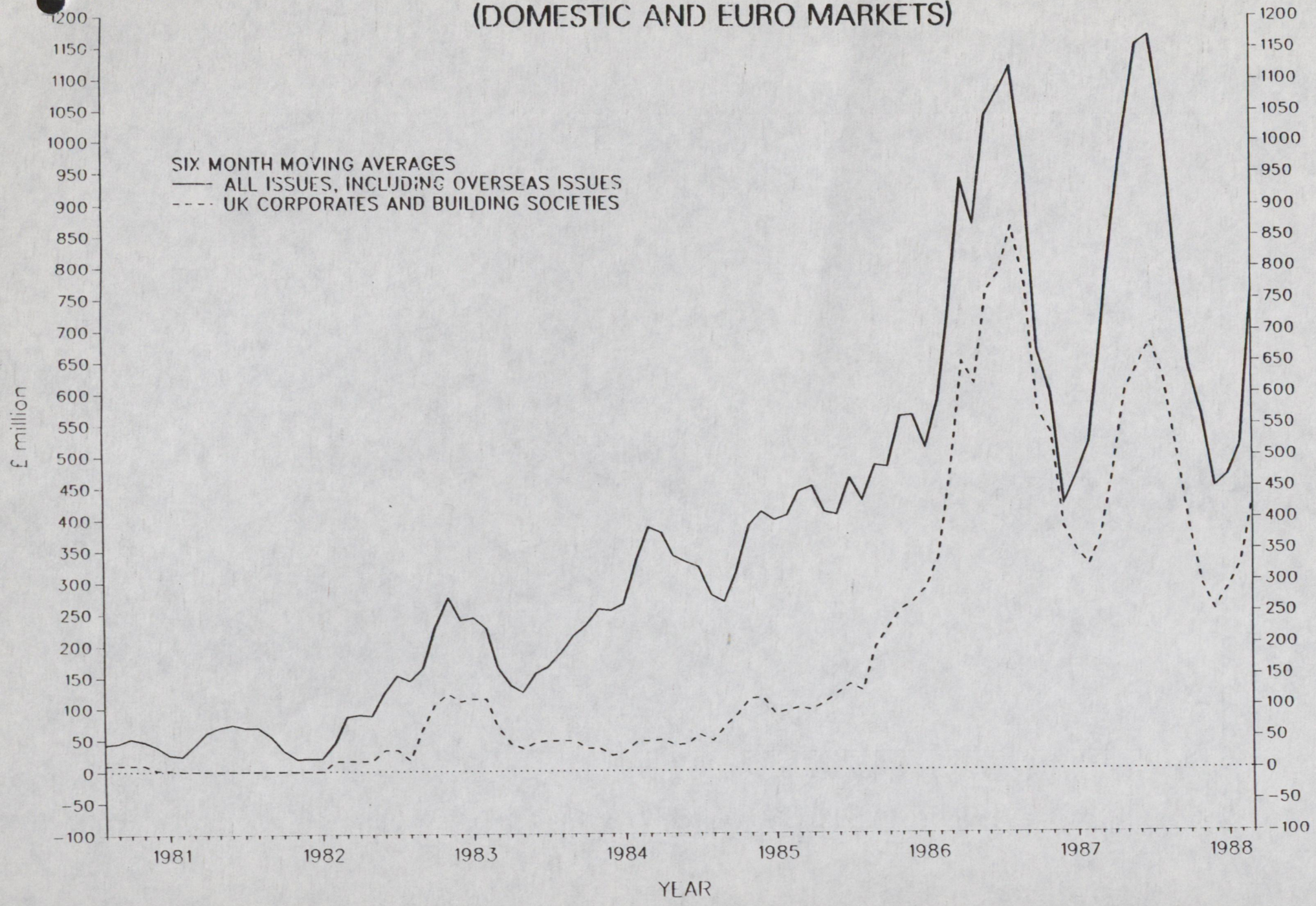
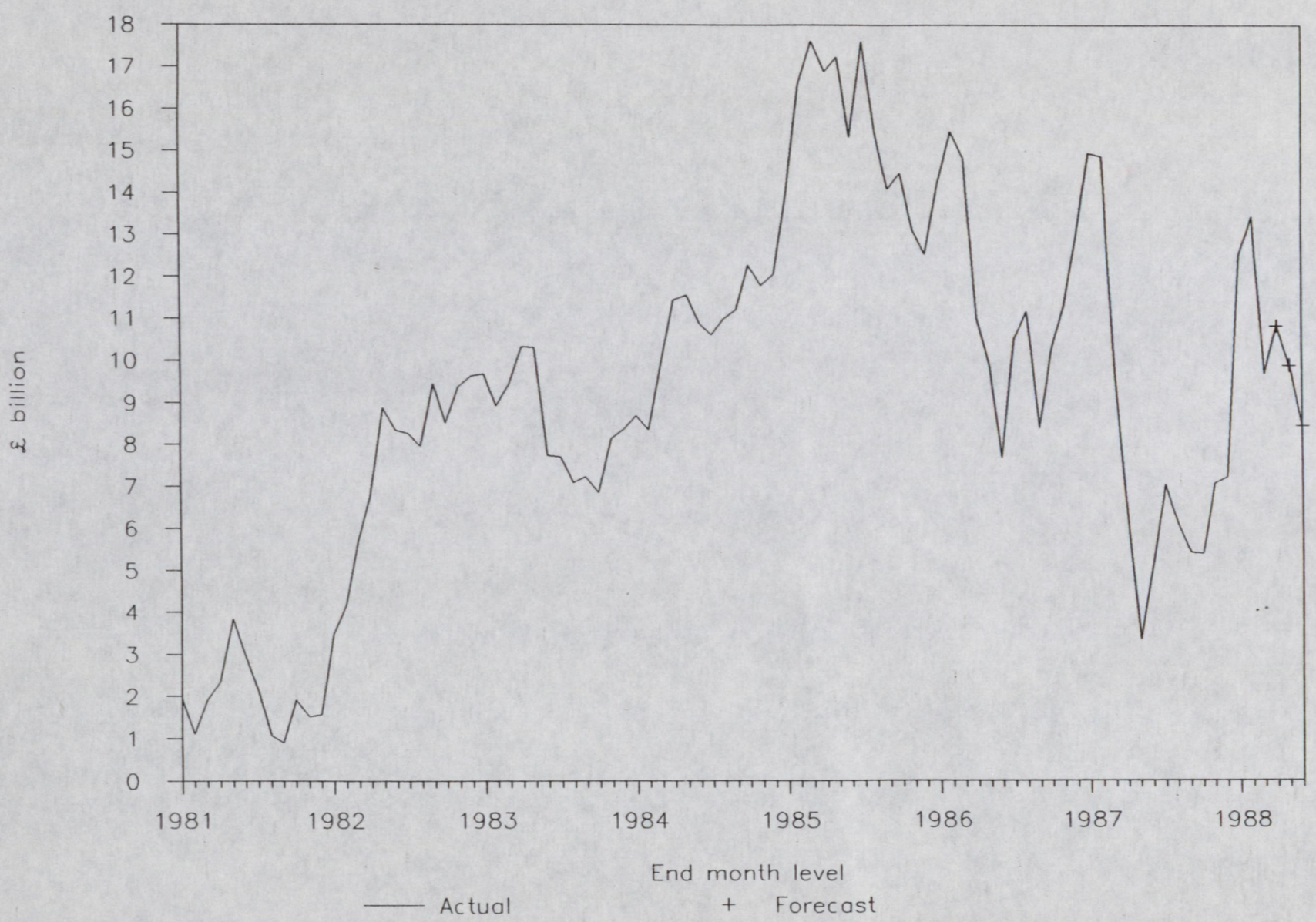


CHART XIII – MONEY MARKET ASSISTANCE



NOMINAL INTEREST RATES

CHART XIV

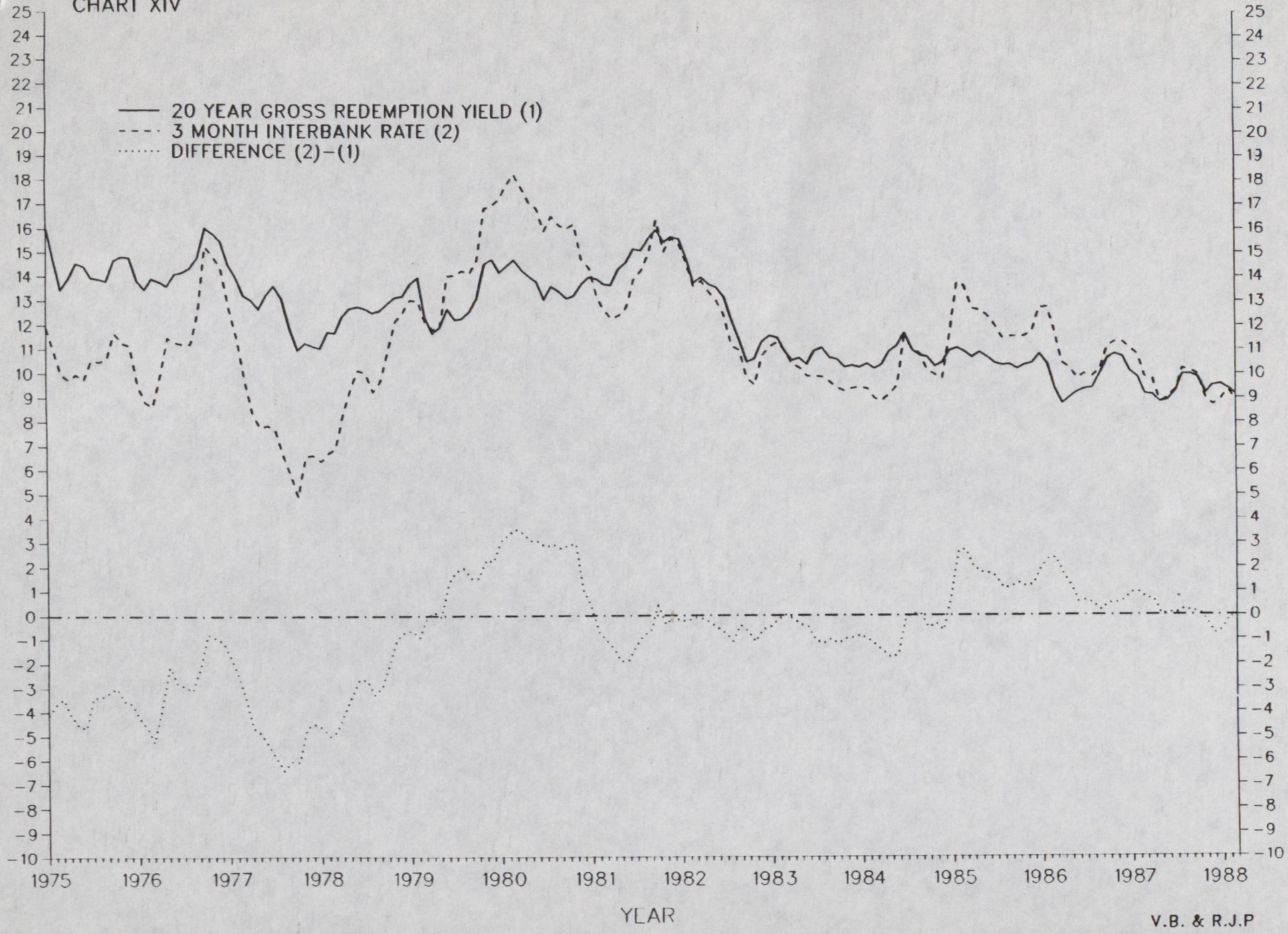


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CHART XV

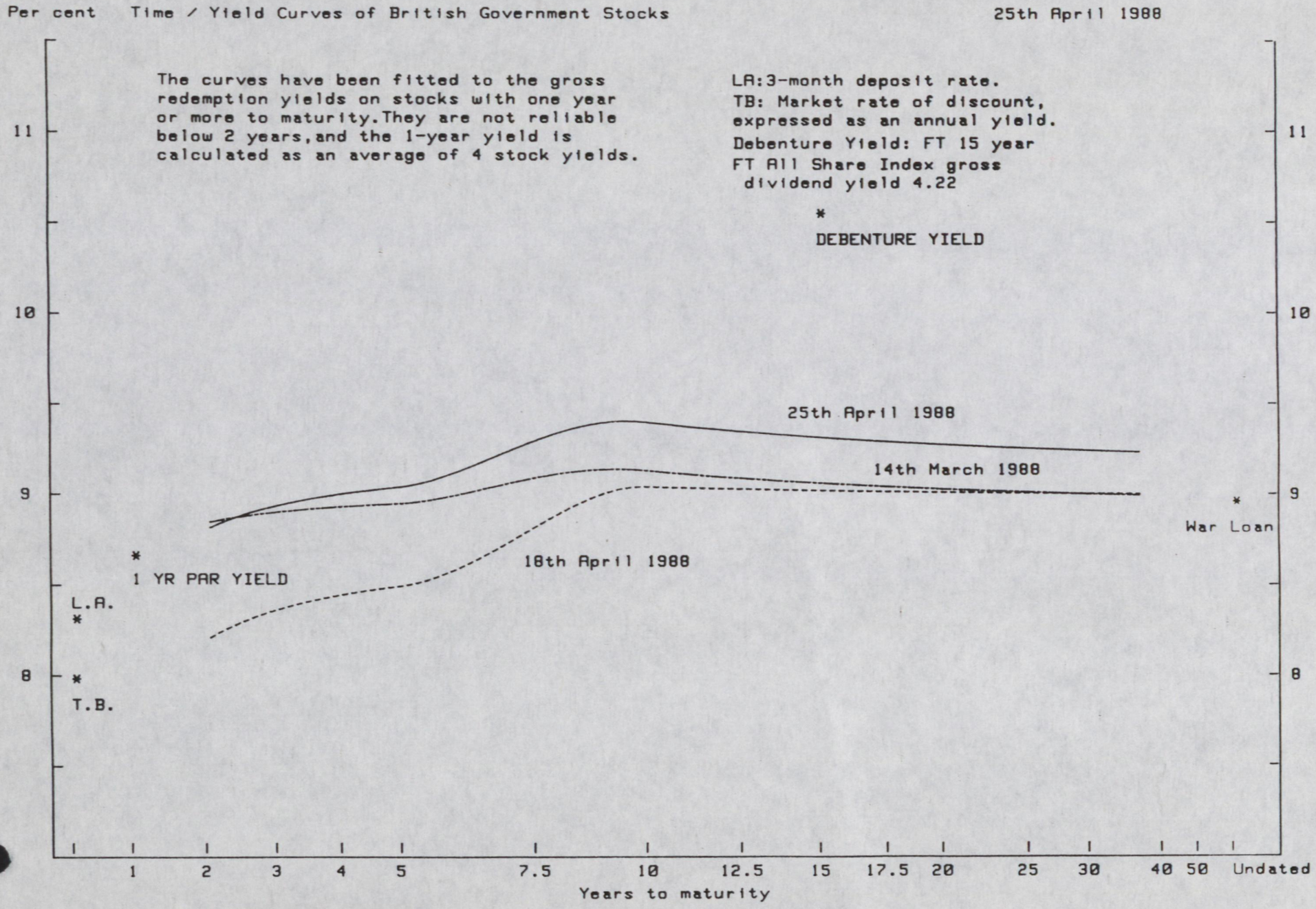
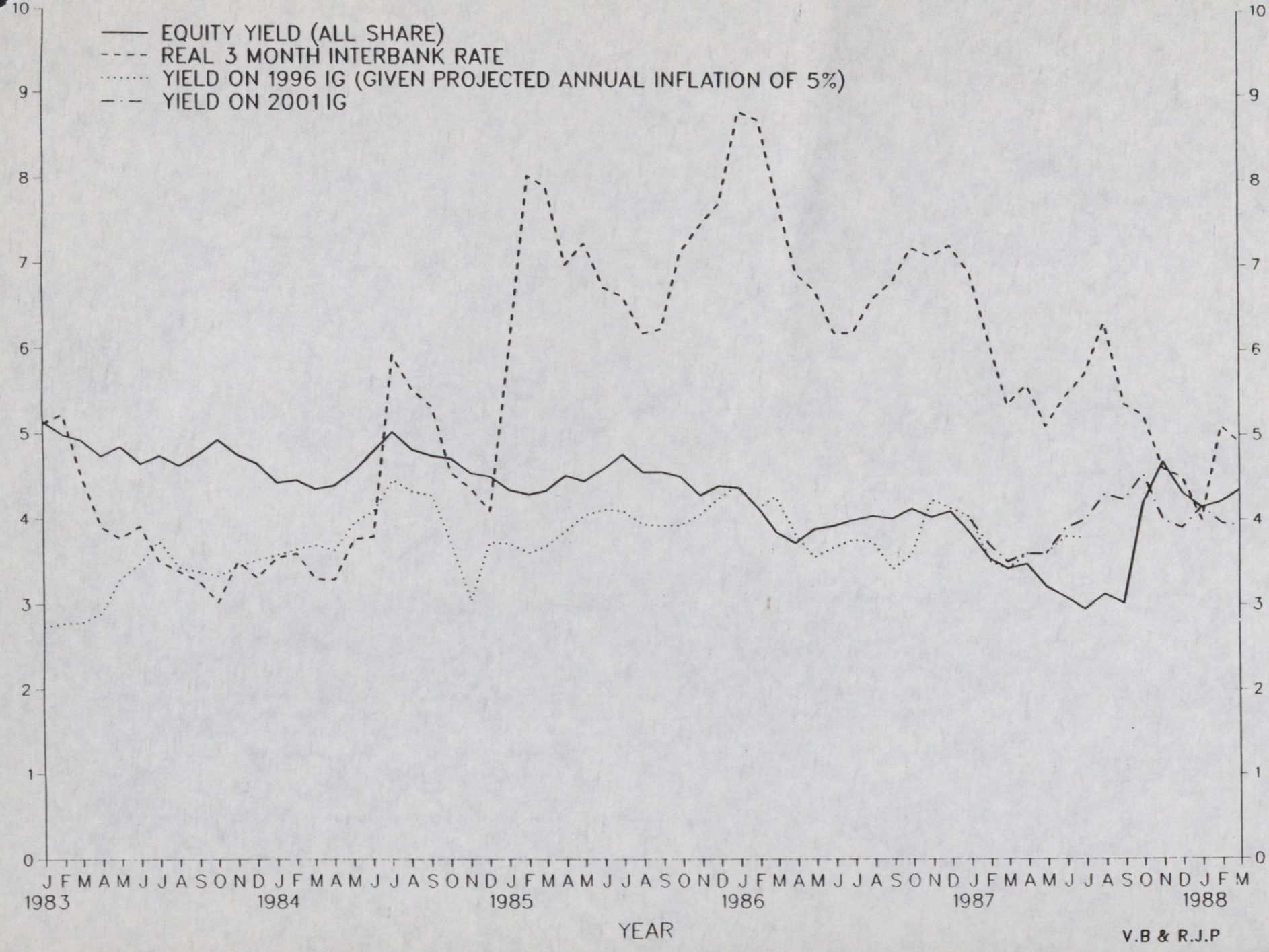

Per cent
Time / Yield Curves of British Government Stocks
25th April 1988
The curves have been fitted to the gross redemption yields on stocks with one year or more to maturity. They are not reliable below 2 years, and the 1-year yield is calculated as an average of 4 stock yields.
LA: 3-month deposit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

CHART XVI

REAL YIELDS



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ANNUAL HOUSE PRICE INFLATION : 1

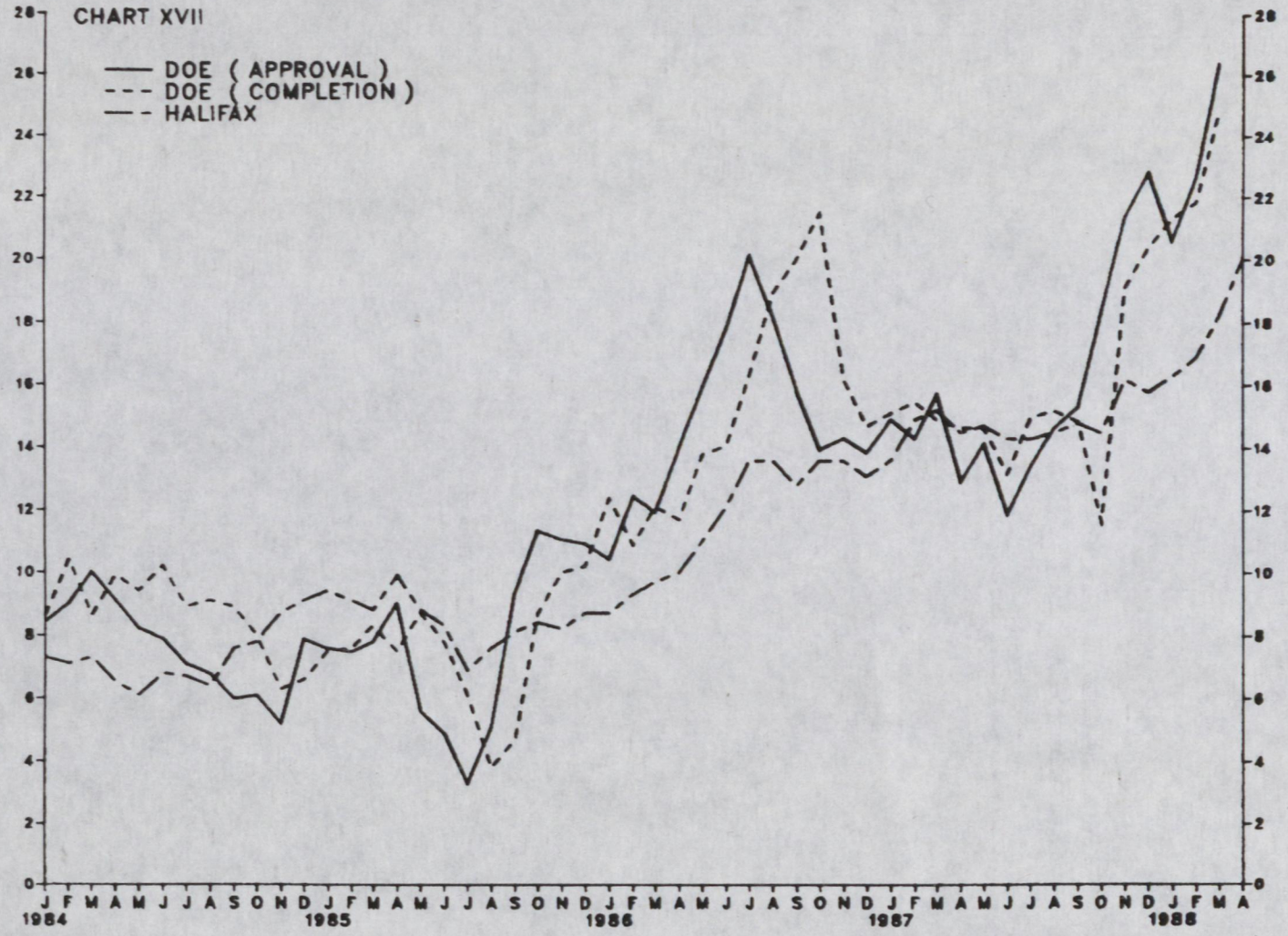
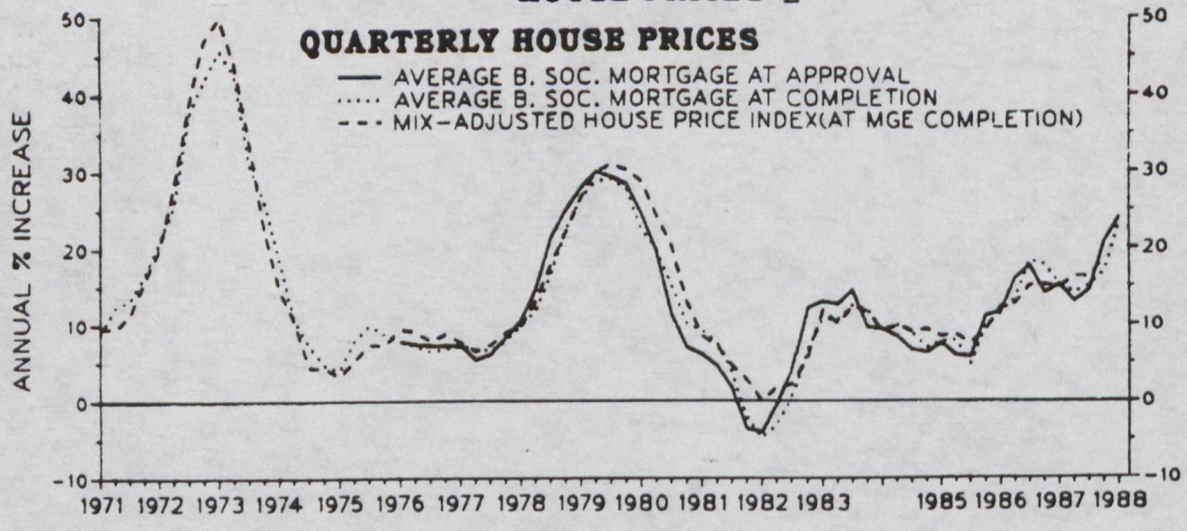
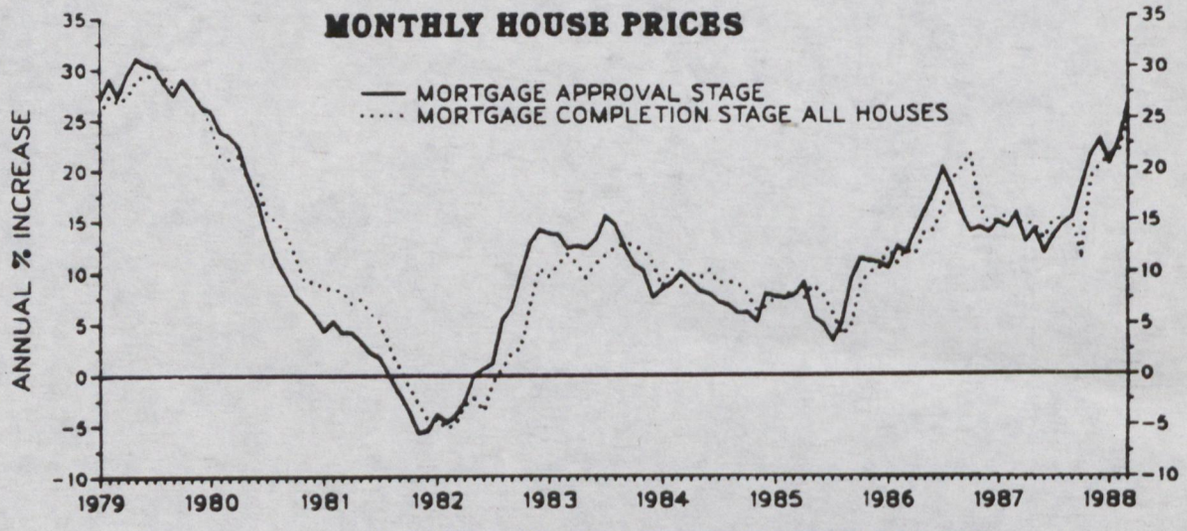


CHART XVIII

HOUSE PRICES 2





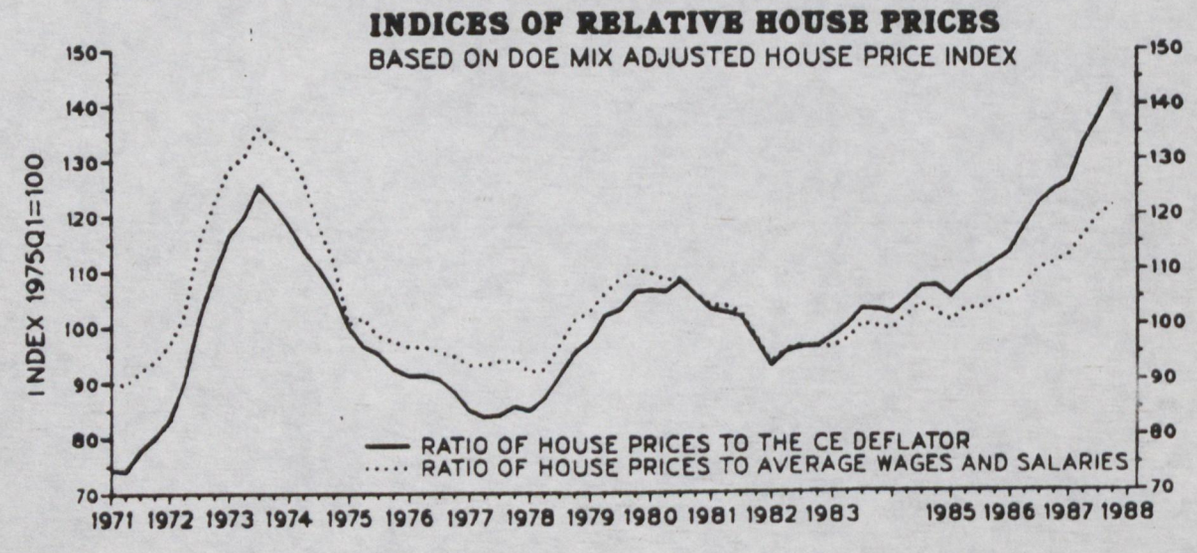
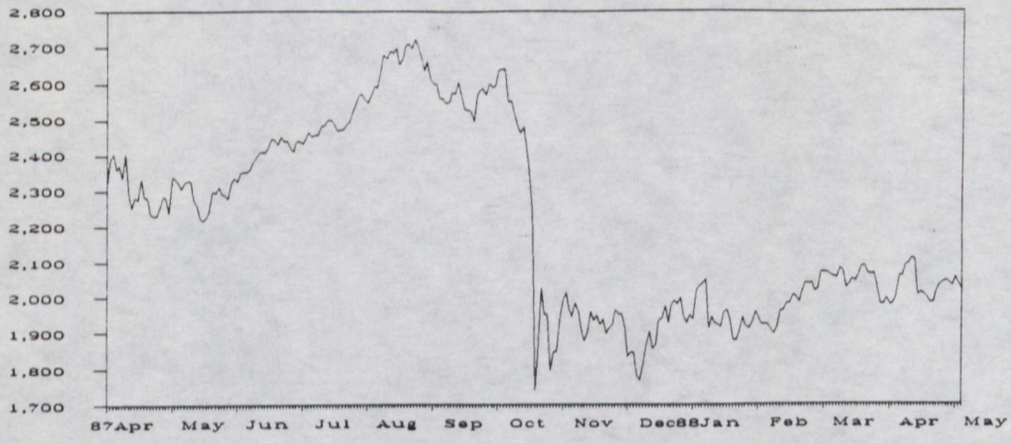
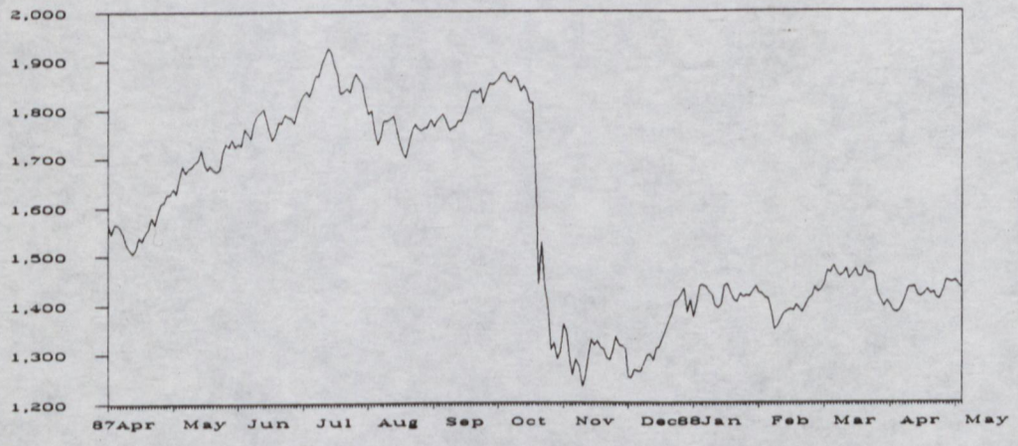


CHART XIX

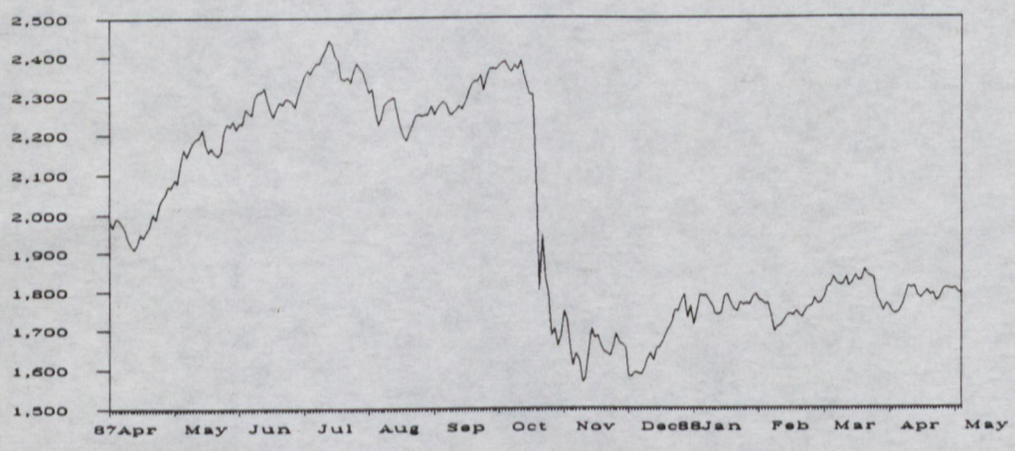
Dow Jones Industrial Average



FT Ordinary Index



FTSE 100



Gilt Index

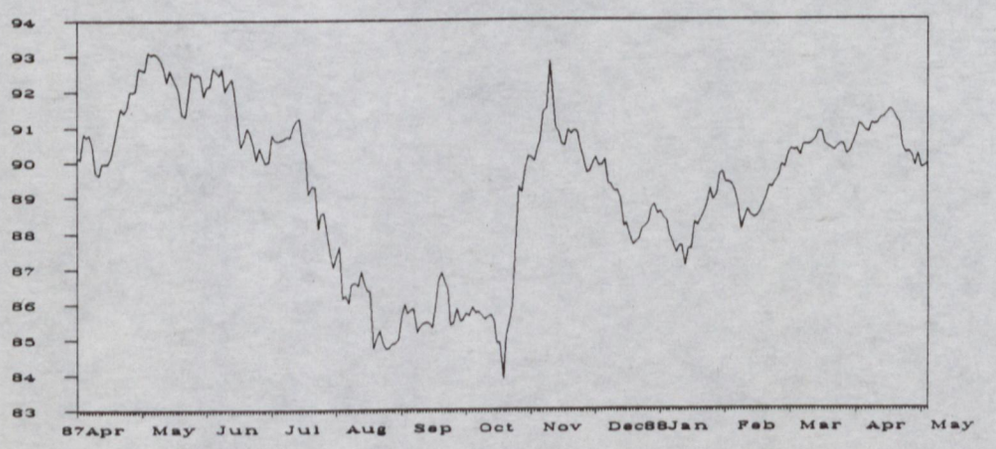


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Table 1: Developments in the G5 (including UK)*

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

* Percentage changes on a year before.

\+ Partly estimated.

Table 2

GERMANY: KEY FIGURES

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

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

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TABLE 3A

THREE MONTH INTEREST RATES IN THE G5 COUNTRIES*

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

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

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TABLE 3b

EFFECTIVE EXCHANGE RATE INDICES (1975 = 100)

	United States	Japan	Germany	France	UK	YEN/$	DM/$
1980	93.7	126.4	128.8	94.4	96.0	225.8	1.82
1981	105.6	142.9	119.2	84.3	94.8	219.5	2.25
1982	118.0	134.6	124.4	76.6	90.4	248.8	2.43
1983	124.8	148.4	127.1	70.0	83.2	237.4	2.55
1984	134.6	156.7	123.8	65.7	78.6	237.5	2.85
1985	140.7	160.5	123.6	66.3	78.2	238.4	2.94
1986	114.8	203.1	137.3	70.1	72.8	168.3	2.17
1987	101.2	219.6	147.6	71.8	72.7	144.7	1.80
1986 Q1	121.2	186.8	133.1	71.0	75.1	187.8	2.35
Q2	116.0	202.8	134.7	69.0	76.0	169.9	2.24
Q3	111.4	214.8	138.6	69.5	71.9	155.9	2.09
Q4	110.5	208.0	142.6	70.8	68.3	160.4	2.01
1987 Q1	104.2	210.1	147.7	71.9	70.2	155.2	1.84
Q2	101.1	222.9	146.9	71.6	72.7	142.6	1.81
Q3	102.5	218.0	146.4	71.4	72.7	147.0	1.84
Q4	97.0	227.4	149.4	72.3	75.2	134.0	1.71
1988 Q1	94.2	240.2	149.6	71.9	75.3	128.0	1.68
1987 Jan	105.5	209.4	147.5	71.8	68.9	154.6	1.86
Feb	103.9	209.3	148.4	72.3	69.0	153.4	1.82
Mar	103.3	211.7	147.1	71.8	71.9	157.5	1.84
Apr	101.0	222.7	146.6	71.6	72.3	142.9	1.81
May	100.4	225.3	147.2	71.7	73.3	140.6	1.79
June	101.8	220.8	146.8	71.5	72.6	144.4	1.82
July	103.3	213.7	146.6	71.[illegible]	72.8	150.[illegible]	1.85
Aug	103.3	218.2	146.0	71.1	72.3	147.6	1.86
Sept	100.8	222.1	146.7	71.[illegible]	73.0	143.1	1.81
Oct	100.6	221.4	147.1	71.5	73.6	143.3	1.80
Nov	96.5	228.4	150.9	72.3	75.4	135.3	1.66
Dec	93.9	232.4	150.2	73.1	76.6	123.4	1.65
1988 Jan	93.9	239.5	150.4	72.5	74.9	127.8	1.65
Feb	95.0	239.5	149.1	71.8	74.3	129.2	1.70
March	93.6	241.6	149.3	71.5	76.8	127.1	1.68
April	92.7	245.0	148.9	71.3	78.2	124.9	1.67
May 4	92.8	245.3	148.7	71.1	77.9	124.9	1.68
% Change since dollar peak (Feb 85)	- 41	+ 56	+ 27	+ 14½	+ 11	- 52	- 51
% Change since Plaza (Sept 85)	- 33½	+ 56½	+ 18½	+ 6	- 5	- 48	- 41
% Change since Louvre Accord (Feb 87)	- 11	+ 17½	+ ½	- 1½	+ 13	- 19	- 8
% Change since Stock market crash (16 Oct 1987)	- 7½	+ 10½	+ 1	- ½	+ 6	- 12½	- 6½

TABLE 3C

Economist Commodity Price Indices 1985=100

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

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

** Non-food agriculturals.

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TABLE 4A 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	1986	2.9	0.3	3.4	3.6	4.3	-10.8	4.7	5.4
1986-87	6.9	1987	4.8	5.5	4.1	3.7	4.5	5.3	n/a	n/a
1986 2	6.5	1986 1	2.2	- 1.7	4.9	4.6	5.0	-11.9	8.7	6.4
3	6.6	2	2.2	- 1.3	2.8	3.3	4.3	-12.4	6.9	6.8
4	7.0	3	3.5	0.8	2.6	3.3	4.0	-13.0	3.7	4.7
1987 1	7.3	4	3.9	3.8	3.4	3.4	4.0	- 5.6	1.4	5.1
2	8.9	1987 1	4.3	4.4	3.9	3.7	4.1	- 1.7	0.8	4.0
3	10.6	2	4.4	5.1	4.2	3.6	4.5	4.6	0.8	4.3
4	9.8	3	5.1	6.7	4.3	3.6	4.7	12.9	0.7	3.8
1988 1*	10.1	4	5.2	5.5	4.1	4.0	4.7	6.2	2.1	4.3
1987-88*	9.8	1988 1	-	-	3.4	3.7	4.9	4.6	-	-
1988-89*	7.6									
		1987 March		5.2	4.0	3.8	4.1	0.4	- 0.1**	
		April		4.4	4.2	3.6	4.3	3.0	- 0.4	
		May		5.8	4.1	3.8	4.5	3.4	0.0	
		June		5.1	4.2	3.5	4.5	7.2	0.8	
		July		5.8	4.4	3.7	4.7	13.4	1.2	
		August		8.4	4.4	3.7	4.7	14.5	1.0	
		September		6.2	4.2	3.5	4.7	10.8	0.7	
		October		5.6	4.5	3.9	4.7	7.6	0.8	
		November		5.3	4.1	4.0	4.8	4.8	1.8	
		December		5.5	3.7	4.0	4.9	5.0	2.1	
		1988 January		8.9[1]	3.3	3.7	4.8	4.6	1.1	
		February		2.7	3.3	3.6	4.9	5.2	2.0	
		March		-	3.5	3.8	5.0	4.0	-	

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

* 1988 FSBR forecast

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

*** Excluding food, drink and tobacco.

\- Not yet available.

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TABLE 4(b) UNDERLYING RETAIL PRICE INFLATION

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

TABLE 5 :INDICATORS OF FISCAL STANCE

(a) Annual data

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

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

(b) Quarterly Data

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

*financial year - constrained
+calendar year - constrained

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

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

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

\+ = higher receipts, higher borrowing and higher expenditure

\- = lower receipts, lower borrowing and lower expenditure

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TABLE 7

EXCHANGE RATES

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

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

* 1975=100

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

TABLE 8 : NOMINAL AND REAL INTEREST RATES

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

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

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

TABLE 9 CURRENT ACCOUNT

percentage change on previous year

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

* excluding oil and erratics.

tables
25CurAcc

TABLE 10

Key Monetary Indicators

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

* Inter bank

ϕ par yield

/ banking months until August thereafter end calendar months

TABLE 11

SECRET

£ million

GROWTH RATES OF MONETARY AGGREGATES

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

TABLE 12

REAL PERCENTAGE GROWTH RATES OF MONETARY AGGREGATES

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

TABLE 13

CONFIDENTIAL

M0 : THE WIDE MONETARY BASE

Monthly data	Level £ million (Change in brackets)					Percentage change on previous month		6 month % growth annualised		Percentage change on previous year			
	Notes and Coin (nsa)	Notes and Coin (sa)		Bankers' Deposits	M0 (nsa)	M0 (sa)		Notes(sa) and Coin	M0 (sa)	Notes & Coin (sa)	M0 (sa)	Notes and Coin (nsa)	Notes and Coin (sa)	M0 (nsa)	M0 (sa)
1987 September	15349	15376	(118)	185	15534	15561	(121)	0.8	0.8	7.8	7.0	5.3	5.0	5.2	4.9
October	15299	15456	(80)	203	15501	15659	(98)	0.5	0.6	7.4	7.3	5.1	5.2	5.5	5.6
November	15365	15525	(69)	183	15548	15707	(48)	0.4	0.3	7.4	7.0	4.8	4.8	4.9	4.9
December	16447	15661	(136)	186	16633	15846	(139)	0.9	0.9	7.9	8.5	4.7	4.8	4.2	4.3
1988 January	15458	15620	(-41)	181	15638	15801	(-45)	-0.3	-0.3	6.1	5.3	4.7	4.5	4.8	4.6
February	15353	15659	(39)	124	15477	15783	(-18)	0.2	-0.1	5.3	4.5	5.7	5.7	5.3	5.3
March	15588	15753	(94)	162	15750	15916	(133)	0.6	0.8	5.0	4.6	6.9	6.4	6.4	5.8
April	15797	15826	(73)	229	16026	16055	(139)	0.5	0.9	4.8	5.1	5.8	6.1	5.9	6.2
May (1/4) @	15947	15948	(122)	160	16107	16108	(53)	0.8	0.3	5.5	5.2	6.5	6.4	6.1	6.1
Latest 4 weeks @	15756	15855	(59)	203	15959	16058	(77)	0.4	0.5	5.0	5.1	4.7	5.9	4.5	5.7

Weekly data	Level £ million (Change in brackets)			Percentage change on previous week
	Notes(sa) and Coin	Bankers' Deposits	M0 (sa)	M0 (sa)
April				
6th	15832 (5)	263	16095 (87)	0.5
13th	15775 (-57)	97	15872 (-223)	-1.4
20th	15834 (59)	259	16093 (221)	1.4
27th	15862 (28)	297	16159 (66)	0.4
May				
4th	15948 (86)	160	16108 (-51)	-0.3

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

TABLE 14

SECRET

BUILDING SOCIETY BALANCE SHEET FLOWS

Unadjusted # million

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

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

TABLE 15

THE COMPONENTS OF M3

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

[1] March on March

TABLE 16

SECRET

T[redacted]OMPONENTS OF M4 AND M5

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

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

TABLE 17

RETAIL DEPOSITS

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

NOTES

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

SECRET

TABLE 18

Breakdown of Bank Lending by instrument

		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
Monthly changes							
1987	March	4643	-1969	339	420	3433	2529
	April	1726	-420	210	-398	1118	2190
	May	3622	-2068	295	497	2346	2560
	June	5144	771	3	-1206	4712	4009
	July	2139	1627	-57	890	599	4486
	August	2847	-1544	119	-288	1134	2633
	September	5460	12	-19	66	5519	4329
	October	2507	-489	139	804	2961	2920
	November	2309	819	235	-62	3301	3274
	December	3955	1544	120	-165	5454	4986
1988	January	2569	2485	-220	254	5088	5585
	February	2077	392	-32	63	2500	2595
	March	5627	-525	241	508	5894	4779

1. Investment by banks in private sector

2. Market loans, shipbuilding repos, CD's and time deposits of building societies, commercial paper, and transit items.

3. April on April

TABLE 19

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

£ million

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

Relationship between lines:

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

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

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

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

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

	BANK BORROWING				OTHER BORROWING						ALL BORROWING
	Sterling		Foreign	TOTAL	Sterling Commercial Paper	Ordinary Shares	Pref & Bonds	Euro-Sterling(*)		TOTAL	TOTAL
	ICC's	BSOC's	Currency					ICC's	BSOC's		
Change in Quarter											
1984											
Q1	2905	-86	-895	1924		163	44	25	0	232	2156
Q2	559	-56	-193	310		429	75	0	0	504	814
Q3	1219	533	-74	1678		288	59	100	0	447	2125
Q4	2312	408	1433	4153		249	73	210	0	532	4685
1985											
Q1	3386	6	-352	3040		924	170	235	0	1329	4369
Q2	747	248	207	1202		1092	327	230	0	1649	2851
Q3	229	161	1371	1761		873	274	130	600	1877	3638
Q4	874	343	1377	2594		525	89	200	475	1289	3883
1986											
Q1	3807	346	108	4261	0	471	209	350	935	1965	6226
Q2	-356	442	108	194	0	1369	344	325	1075	3113	3307
Q3	28	1800	1128	2956	69	1431	290	231	1575	3596	6552
Q4	5223	390	-21	5592	65	2338	-52	281	2632	5264	10856
1987											
Q1	1185	353	2008	2294	368	1553	-782	1231	290	2660	4954
Q2	710	-516	756	100	651	2259	352	655	50	3967	4067
Q3	3747	397	-94	4826	298	5950	732	570	100	7650	12476
Q4	4379	832	682	5211	-89	3735	423	105	0	4174	9385
1988											
Q1	7148	257	2169	7405	722	325	-115	915	625	2472	
Average per quarter											
1984	1749	200	68	2016	0	282	63	84	0	429	2445
1985	1309	190	651	2149	0	854	215	199	269	1536	3685
1986	2176	745	331	3251	34	1402	198	297	1554	3485	6735
1987	2505	267	838	3610	307	3374	181	640	147	4649	8259
1988	7148	257	2169	7405	722	325	-115	915	625	2472	9877
Change in Month											
1987	APRIL				192	828	110	355	0	1485	
	MAY				171	415	184	150	50	970	
	JUNE				288	1016	58	150	0	1512	
	JULY				131	1840	182	210	0	2363	
	AUGUST				9	2090	390	150	0	2639	
	SEPTEMBER				158	2020	160	210	100	2648	
	OCTOBER				165	2535	195	45	0	2940	
	NOVEMBER				-16	975	55	60	0	1074	
	DECEMBER				-238	225	173	0	0	160	
1988	JANUARY				212	48	41	450	50	801	
	FEBRUARY				339	219	123	355	150	1186	
	MARCH				171	58	-279	110	425	485	

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

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

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Table 23

M0 FORECAST, 1988-89

Seasonally adjusted

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

[1]average of 12 months

Table 24

Broad Money forcast

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

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

91/G.LCLD.4501.062

Table 25

Lending forecasts

		OUTTURN 1988 MARCH			FORECAST APRIL		
		Bank lending	B Soc lending	M4 Counterpart	Bank lending	B Soc lending	M4 Counterpart
(i)	Underlying increase (sa)	5209	1618	6631	3645	1550	5095
(ii)	Estimated Special factors	- 430	450	20	- 300	450	150
	Arbitrage: bills against deposits	-	-	-	- 500		- 500
	bills against foreign currencies	- 200	-	- 200	- 250		- 250
	PSBR offset	- 400	-	- 400	-	-	-
	Bill leak	- 530	-	- 530	-	-	-
	Bank borrowing to replace equity issues	750	-	750	500	-	500
	Bank/building society competition	- 150	150	-	- 150	150	-
	Buoyant housing market	100	300	400	100	300	400
(iii)	Lending increase (sa)	4779	2068	6651	3345	2000	5245
	Lending increase (nsa)	5894	2097	7795	1625	1975	3500
	Annual % change (nsa)	25.2	13.9	20.8	25.3	14.1	20.8
	Annual % change expected at Budget time	24.9	13.6	20.4	26.0	13.4	20.9

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

TABLE 26 : BROAD AGGREGATES COUNTERPARTS AND FORECAST £ million

OUTTURN: MARCH 1988	M3	M4
PSBR	3819	3819
LA and PC debt sales to NBPS (-)	-165	-64
CG debt sales to NBPS (-)	402	43
o/w Gilts	(634)	(427)
Treasury bills etc	(-57)	(-56)
National Savings	(-189)	(-188)
CTDs	(14)	(-140)
Public sector external & fc finance (-)	1524	1524
OVER(-)/UNDER(+)FUNDING	5580	5322
Sterling lending to NBPS	5894	7795
(seasonally adjusted)	(4779)	(6651)
Banks'/B socs' externals	-218	-193
Banks'/B socs' £NNDLs	-2197	-2855
TOTAL	9059	10069
Monthly % growth nsa	4.9	3.3
sa	3.2	2.3
Annual % growth nsa	20.9	16.8

FORECAST: APRIL 1988		
PSBR	-475	-475
LA and PC debt sales to NBPS (-)	0	-50
CG debt sales to NBPS (-)	-400	-400
o/w Gilts	(-250)	(-250)
Treasury bills etc	(0)	(0)
National Savings	(-200)	(-200)
CTDs	(50)	(50)
Public sector external & fc finance (-)	-125	-125
OVER(-)/UNDER(+)FUNDING	-1000	-1050
Sterling lending to NBPS	1625	3500
(seasonally adjusted)	(3345)	(5245)
Banks'/B socs' externals & £NNDLs	-125	-1200
TOTAL	500	1250
Monthly % growth nsa	0.3	0.4
sa	1.1	0.9
Annual % growth nsa	18.9	15.8
Annual % growth sa	19.6	15.7
BUILDING SOCIETIES: Retail inflows		1325
Interest credited		100
Wholesale inflows from NBPS		0
Holdings of M3 (-)		-675

SECRET

TABLE 27: MONEY MARKET ASSISTANCE £ million

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

91/G.LCLD.4515.015

TABLE 28

SECRET

GOVERNMENT SHARE SALES TIMING

1988/89

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

1989/90

BP III		27 April
BSC II	Undecided	

PA

PRIME MINISTER

You will recall Alan Walters suggested when he was here that he might ask Geoffrey Owen to include an article in the FT in response to Sam Brittan's. Alan rang me this evening to say that Owen had agreed to include a piece next week; apparently with a few purple passages deleted!

I hope it will not give renewed life ~~to the~~ current press claims. But I am sure Alan will have conveyed his comments to Sam Brittan!

PCC6.

(PAUL GRAY)
31 March 1988

SECRET

PA Price Markets 2 11A.

MONTHLY MONETARY ASSESSMENT : MARCH 1988

You may like to flick through this latest Treasury assessment, in particular the annex on the exchange rate. RRCG 3/3

Summary Assessment

The indicators continue to suggest a strong economy, though the effects of the rise in sterling during March remain to be seen. The reduction in base rates of 17 March has left interest rates about ½ per cent lower than assumed in the Budget Forecast; the effect on monetary conditions of a higher exchange rate and lower interest rates is examined in a special Annex.

Main Points

Sterling has risen by about 3 per cent since 7 March, both against the DM and in effective terms, following the decision by the authorities to refrain from further large-scale intervention - which totalled $2 billion in the first week of the month. A rise in the oil price has left the oil adjusted exchange rate 2 per cent higher. (Paras 21, 23).

The Budget Forecast showed money GDP growth for 1987-88 of 9¾ per cent. A deceleration is projected for 1988-89, with growth of 7½ per cent. If sustained, the combination of the rise in the exchange rate and lower interest rates in March might further reduce money GDP growth by about ¼ per cent in 1988-89. (Paras 16, 17 and Annex)

M0 grew by 5.3 per cent in the year to February, and the 12 month growth rate is expected to rise to 5¾ per cent in March. As consumer spending slows, the rate is projected to fall from 5¾ per cent in April to below 5 per cent in July. (Paras 26, 27)

February broad money and credit growth was relatively modest. This may owe something to the partial unwinding of earlier bill arbitrage, although most will probably unwind in March and April. M4 grew by 16 per cent in the year to February (16½ per cent in the previous month). Bank and building society lending grew by 20 per cent in the year to February, unchanged from the previous month. (Paras 29-37)

Building societies continued to benefit from the unpopularity of equities and unit trusts, allowing many societies to bid aggressively for lending, market share. (Paras 33, 36)

Annex: The Rise in the Exchange Rate

MG2 Division
30 March 1988

A. External Developments

1. Total **output** in the G5 rose by 3 per cent in 1987. Growth was much stronger in the second half of the year than the first (table 1). **Industrial production** picked up in all countries at the end of 1987. In January it was 6 per cent higher than a year earlier in the US. A continuing rise in **commodity prices**, particularly in industrial materials, is consistent with the picture of strenghtening industrial activity since last summer (table 3C).

2. **Short term interest rates** in the US have fallen by about ½ percentage point since the beginning of the year, most of the fall occuring in January. Rates in Germany and Japan drifted down slightly during January and have been broadly unchanged since then (table 3A).

3. The **dollar** effective exchange rate remained relatively stable from the middle of January to the middle of March, following sharp falls at the end of 1987 and a partial recovery in early January. Since then it has fallen by 1 percentage point and is now 9 per cent lower than immediately before the stock market crash.

4. **Share prices** have risen in all major markets since January. Prices on Wall Street have now recovered about half their earlier losses while those in Tokyo are virtually back to their levels immediately before the crash.

Conditions in West Germany

5. **Industrial production** was nearly 5 per cent higher in January than a year earlier, but this exaggerated the strength of activity as production in January 1987 was hit by bad weather. The trade surplus increased sharply in the last two months of 1987 in dollar terms, but this was mainly because of the fall in the dollar. In DM terms the surplus remained fairly constant during 1987.

6. **Inflation** remains a little below 1 per cent and, with unit labour costs hardly rising and import prices remaining low in DM terms, cost pressures remain weak. The new targeted aggregate (M3) continues to grow close to the upper end of its 3-6 per cent range.

B. Activity and Inflation

7. Table 4 summarises recent indicators of **activity and inflation.** Indicators released this month show continued strength of economic activity and little change in inflation. High levels of overtime working held the underlying increase in average earnings at 8½ per cent for the second successive month.

Recent indicators of activity

8. National accounts for the fourth quarter of 1987, published on 18 March, showed the average measure of **GDP** up just over ½ per cent from the third quarter. The output measure of GDP - a more reliable indicator of short term GDP trends - rose 1 per cent in the fourth quarter, somewhat less than the 1½-2 per cent increases in GDP(O) seen in the second and third quarters.

9. Output growth was broadly based in 1987Q4: manufacturing output rose 1¼ per cent; services ¾ per cent; and construction activity nearly 3½ per cent. Latest indicators suggest continued expansion into 1988: **manufacturing output** rose, provisionally, around ¼ per cent between December and January. The March CBI survey of manufacturers, which reflects responses collected since the rise in sterling but before the base rate cut, was published on 28 March. Output expectations remain high and the CBI expect continued rapid growth across the whole range of manufacturing. However, responses for total and export order books (adjusted for seasonal variation) have fallen relative to both January and February outturns, and may hint at some moderation in growth later in 1988. Private sector **housing starts** eased only slightly in January following a sharp increase to historically high levels in December.

10. Fourth quarter growth in the expenditure measure of GDP (1¼ per cent) was also broadly based: **consumers' expenditure** rose 1 per cent; exports of goods and services 1½ per cent, and fixed investment a strong 4 per cent after rather sluggish growth earlier in 1987. The fourth quarter saw a particularly notable rise in **industrial investment** spending (revised) primarily reflecting a

sharp increase in recorded investment by the financial and business services industry. While quarter to quarter movements in industrial investment are often erratic, growth of 9 per cent in 1987 is indicative of the underlying buoyancy of business investment .

11. Consumers' expenditure growth has apparently been maintained into 1988 with retail sales broadly unchanged between January and February but - for these two months - up by over 1 per cent relative to 1987Q4 levels. New car registrations fell only marginally in January following a high December outturn.

12. **Labour market indicators** are consistent with continued growth in activity. Overtime working in manufacturing rose sharply in January, to a level well above recent outturns. Unemployment fell further in February, though the 33,000 reduction was slightly below the average 50,000 monthly fall over the preceding 6 months. Unfilled vacancies at job centres fell for the third successive month in February, but remain high by recent standards.

Inflation

13. **Retail price inflation** remained unchanged at 3.3 per cent between January and February, while inflation measured by the RPI excluding mortgage interest payments edged down from 3.7 to 3.6 per cent (see Table 4b). The 12 month increase in the **producer price index** (excluding food, drink and tobacco) in February was 5.0 per cent, compared to 4.8 per cent in January. Despite this, the March CBI survey of manufacturers saw the second consecutive monthly fall in (seasonally adjusted) price expectations. The CBI remarked that the rate of price inflation is now slowing. The annual increase in producer input prices (also excluding FDT) was 5.6 per cent in February, up from 4.5 per cent in January. Input prices rose 1 per cent on a seasonally adjusted basis in February, following a period of downward movement totalling 1½ per cent over the six months to January.

14. Underlying growth in **average earnings** remained at 8½ per cent in January. Increases in the manufacturing sector edged up from

8¼ to 8½ per cent, while in services there was a fall from 8¾ to 8½ per cent.

15. Figures for **house prices** in February show that the rapid rates of increase seen over recent months are, if anything, rising further. The Halifax index reported in last month's report showed an increase from 16.3% in January to 16.9%, whilst the DoE indices on completions and approvals showed increases from 21.3% to 21.8% and from 20.5% to 22.7% respectively. More evidence is also coming in - largely from the Royal Institute of Chartered Surveyors - of considerable changes in the regional pattern of house price inflation, with the North, the South West and the East Midlands experiencing 'mushrooming' growth, with the market in London and the South East slowing. It is thought that the Budget measure on joint mortgages may provide a temporary lift to London prices, but will prove a depressing factor over the medium term.

Projections for money GDP

16. **Money GDP** is estimated to have increased 9¾ per cent in the year to the fourth quarter of 1987, the same as the average year-on-year increase for the last three quarters of the year (ie the first three quarters of financial year 1987-88). The Budget forecast showed a 9¾ per cent increase in money GDP for 1987-88 as a whole, with deceleration to 7½ per cent growth in 1988-89. For 1987-88 the difference between the Budget forecast and the figure of 10 per cent circulated at the time of the winter internal forecast represents a difference of rounding rather than a significant change of view about the prospects for activity or the GDP deflator in early 1988. The Budget forecast for 1988-89 (7½ per cent money GDP growth) is in line with the winter internal forecast, though the composition has changed marginally, with real activity showing ¼ per cent higher growth, and the GDP deflator ¼ per cent lower.

17. Following the recent appreciation of sterling, the effective exchange rate now stands around 3 per cent higher than assumed for the remainder of 1988 in the Budget forecast. Against this,

base rates are a half point lower (though the difference for market rates is marginally smaller). If sustained, this is likely to constitute a small net tightening of monetary conditions: money GDP growth may possibly be reduced by a little under ¼ per cent, with real GDP around 0.1 per cent lower, in 1988-89, see Annex. Lower interest rates and a stronger pound imply downward pressure on the RPI, together with some shift from external to domestic demand. Though the latter effects may be relatively small it will be important to monitor closely CBI survey outturns on export order books and retail sales figures over the coming months.

C. Public Sector Finances and the Fiscal Stance

18. Table 5 gives the main indicators of the **fiscal stance.** The PSBR in February was a surplus of £0.5 billion, with privatisation proceeds close to zero. The PSBR for the first eleven months of 1987-88 is a surplus of £7.4 billion, £7.5 billion greater than the 1987 Budget profile. Central government own account borrowing is £6.8 billion below profile - Table 6 gives details. Public corporations' borrowing is £0.7 billion below profile, but local authorities' borrowing is £0.2 billion above profile. Excluding privatisation proceeds, there was a surplus of £2.3 billion in April to February.

19. The published 1988 Budget forecast for the PSBR in 1987-88 was a surplus of £3.1 billion. This forecast was deliberately cautious - the corresponding central forecast was a surplus of £3.7 billion.

20. The latest central estimate for the PSBR in 1987-88 (£3.3 billion as of 24 March - estimate made for funding purposes) represents a predicted undershoot of about £7¼ billion on the 1987 Budget forecast (which was for a PSBR of £3.9 billion). Nearly £4 billion of this undershoot is now estimated to be attributable to higher than expected economic activity and higher oil prices (onshore GDP deflator growth being much as expected). Of the remainder almost £1 billion reflects higher receipts from Local Authority sales of land and existing buildings and mortgage

repayments, which have little impact on the economy. This leaves an estimate of about £2¼ billion - attributable to both higher revenue and lower expenditure - representing a tightening of ex-ante fiscal stance ie for given activity and prices. (Privatisation proceeds are likely to be much as expected in the 1987 Budget.) In other words, even excluding the automatic fiscal tightening connected with higher than expected activity, and after allowing for relevant compositional changes, fiscal stance in 1987-88 appears to have been appreciably tighter than envisaged in the 1987 Budget. On the basis of latest data the direct effect of fiscal policy therefore looks to have been in the direction of restraining money GDP growth, although to some extent this assessment may be symptomatic of errors in the latest GDP estimates.

D. UK Exchange Rate and External Accounts

21. Foreign exchange markets in the first half of March were dominated by the decision of the UK authorities to allow **sterling** to rise above DM 3. Sterling began the month firmly above DM 2.99, despite poor trade figures for January. Easier oil prices did not have any effect, and heavy intervention was necessary to hold the DM 3 rate. After the cap was lifted, sterling rose rapidly despite further intervention. The announcement of larger than expected fiscal surpluses caused sterling to move above DM 3.09 and a rise above DM 3.10 on 17 March was followed by a decision to cut the Bank's dealing rates by ½ per cent. Sterling subsequently fell back to under DM 3.09 on worse than expected trade figures for February. In effective terms sterling has risen from 74.7 to 77.1 (up to 28 March), a 3¼ per cent rise over this period, and from $1.77 to $1.85, a rise of 4½ per cent.

22. The **UK 3 month interest rate**, which stood at 9.3 at the beginning of the month, eased back to 8·8 on 28 March. The decline was fairly steady over the first half of the month, though re-inforced after the uncapping of sterling and the subsequent base rate cut on 17 March. Rates in other major countries have been stable over the period, so the interest rate differentials against them have narrowed by half a point since the beginning

of the month, more than reversing February's rise.

23. The rise in sterling took place despite a further fall in the Brent **oil price**, from $14¾ a barrel at the end of February to just over $14 a barrel in mid March. As a result the **oil adjusted ERI** rose sharply, by nearly 4½ per cent, over this period. Subsequently, OPEC developments have brought the oil price back to $15½, but the adjusted exchange rate is still 2 per cent higher than at the beginning of March.

24. Since the beginning of March official **intervention** has amounted to $2.8 billion, of which $0.8 billion has taken place since sterling rose above 3 DM on 7 March.

25. The February **trade figures**, published an 25 March, showed a current account deficit of £720 million compared with a revised deficit of £844 million in January. This was rather worse than City expectations, reflecting a 2 per cent fall in exports volumes recorded, a 2½ per cent fall in import volumes and a ½ per cent improvement in the terms of trade. The February figures - like those for January - should be interpreted with some caution. We are statisfied that all documents received by Customs have been correctly processed and validated and there is no evidence of shipments being delayed by documentation problems. It is possible that some traders may have been late in submitting documents, but this is unlikely to explain the sharp fall in January and February. The Ferry operators' strike in early February is likely to have affected exports more than imports, although most shipments from Dover were apparently re-routed to neighbouring parts. The Ford strike is estimated to have had only minimal effects. We will have to wait for some months before we can be sure whether the pattern of trade in January and February has been distorted.

E. Domestic Monetary and Financial Market Developments

(see Tables 10 to 27)

Narrow Money

26. **M0** growth was below expectations in February, reflecting erratic falls in bankers' balances and the Northern Irish note issue. The seasonally adjusted 12 month growth rate rose to 5.3 per cent, from 4.6 per cent in January, reflecting developments a year ago. The 12 month growth rate of notes and coin rose to 5¾ per cent, from 4½ per cent in January. In contrast, annualised six month growth of notes and coin has been falling recently, from 8 per cent in December to 5¼ per cent in February, although this may reflect in part faulty seasonal factors in the months around Christmas when seasonal influences are particularly strong.

27. Based on the weekly figures to date, the **forecast** has the 12 month growth rate of M0 rising to about 5¾ per cent in March, with the growth rate still being depressed (by about ¼ per cent) by a series of low figures for bankers' balances. The 12 month growth rate of M0 is projected to remain at abut 5¾ per cent in April, but to fall under 5 per cent from July, mainly reflecting an expected slowdown in the growth of consumer spending.

28. **NIB M1** rose by £0.6 billion in February and the annual growth rate rose to 12 per cent, from 11¾ per cent in January. The annual growth rate of NIB M1 has been relatively stable, at between 10 and 12 per cent, since the end of 1986, in contrast to earlier periods when NIB M1 growth was extremely volatile. Interest-bearing sight deposits fell by £1.0 billion in February which, together with the increase in NIB M1, gives a £0.4 billion fall in M1 in February and the annual growth rate of M1 fell to 20½ per cent, from 21¾ per cent in January. The growth of IB sight deposits has slowed down since the stock market crash, averaging a fall of £0.3 billion per month since October compared to an average increase of £1.4 billion per month in the six months to October. To what extent this might reflect a slowdown in the growth of corporate liquidity

post-crash - as companies increasingly finance their takeover activity from their stocks of liquidity - is unclear prior to the Q1 sectoral breakdown available next month. However, the growth of wholesale bank deposits - which consist primarily of company deposits - has slowed rapidly in 1988 so far (see table 15).

Broad Money

29. Twelve month growth rates of broad money fell back in February, reflecting the low growth of bank deposits. This may owe something to the partial unwinding of bill arbitrage in December and January, although it is likely that much of the bill arbitrage has still to unwind, since interest differentials were apparently greatest for 3 month bills which will mature in March and April. Building society retail deposits continued to grow strongly, so that while the 12 month growth rate of M3 fell back by 2 percentage points in February the 12 month growth rate of M4 fell by just over ½ percentage point, to 16 per cent. Within the broad money counterparts, the rise in bank and building society lending was at more normal levels in February, after two very high months.

30. **M4** grew by £1.2 billion (0.4 per cent) in February and at an annual rate of 16 per cent, compared to 16½ per cent in January. **M3** rose by £0.5 billion (0.3 per cent) in February and the annual rate fell to 20½ per cent, from 22½ per cent in January.

31. With respect to the **M4 components**, holdings of M3 by the private sector excluding building societies rose by £0.1 billion. Private sector retail deposits with the building societies (including interest credited) were £1.2 billion in February, which continues the trend of a substantially higher level of inflows compared to pre-crash. Wholesale funding of the building societies by the private sector was negligible.

32. Of the **M3 components**, retail bank deposits increased by £1.3 billion in February - almost double the average increase of the previous 12 months - while wholesale deposits fell by £0.5 billion, compared to an average increase of £2 billion per month

over the previous 12 months. The low figure for wholesale deposits suggests there may have been some unwinding of December's and January's bill arbitrage this month, although the fall in wholesale deposits was exclusively in sight deposits whereas the unwinding of arbitrage would be expected to show up primarily in a fall in time deposits.

33. **Building societies' retail inflows**, at just over £1 billion (excluding interest credited), were very strong in February, despite a slight narrowing of their competitive advantage over the banks which raised some retail rates following the ½% base rate rise on 2 February. The continued weakness both of unit trust inflows and new equity issues is one explanation. Another, which may become increasingly important, is the provision of current account services, notably the launch by the Abbey National at the beginning of March of its "Current Account", following the success of the Nationwide Anglia's "Flex Account". Wholesale funding in February was, at £100 million, surprisingly low. So far this year societies have announced over £2½ billion of issues and facilities in bond markets, CD and Commercial Paper, and syndicated credit. Not all will be taken up, but there will be a significant inflow of wholesale funds over the next few months, which point to a planned expansion of lending activity. Meanwhile their liquidity ratio, at 16.6% (not seasonally adjusted including building society CDs), continues at a relatively high level.

Credit

34. **Bank and building society lending** rose by £4.0 billion (1.2 per cent) in February and the 12 month growth rate was virtually unchanged at around 20 per cent. While there was probably a partial unwinding of previous months' bill arbitrage in February, the 12 month growth rate of sterling lending is probably still being inflated by this.

35. **Sterling bank lending** grew by 1.2 per cent in February and at an annual rate of 24¼ per cent, compared to 24¾ per cent in January. Of the £2.5 billion increase in sterling bank lending,

advances increased by £2.3 billion, lending via commercial bills increased by £0.4 billion and lending to GEMM's fell by £0.3 billion. The £0.4 billion increase in acceptances provides further evidence that there was not a substantial amount of unwinding of previous months' bill arbitrage in February, although the increase in acceptances is more than fully explained by the Bank's net purchases of £1 billion of bills during the month. The CLSB banks covered £0.8 billion (about 40 per cent) of total bank advances. Of these, lending to persons was £0.5 billion, all of which was for house purchase. This compares with an average level of lending for house purchase of £¾ billion per month in the previous four non-interest charging months. Although CLSB bank lending to persons for consumption was flat in February, seasonal factors are likely to have had a depressing influence.

36. **Building societies' mortgage lending** in February was £1.4 billion, slightly lower than January's exceptionally high level, but still one of the highest figures over the past year. In combination with the lower level of bank mortgage lending in recent months, this suggests that building societies are gaining market share, although some increase in total mortgage demand would tie in with the acceleration of house prices. Also, recent mortgage commitment figures have been very high, and the Budget changes may stimulate additional demand from unmarried co-habiters trying to beat the 1 August 1988 deadline for obtaining separate mortgage interest tax relief for each borrower. It is not yet clear whether other societies will follow the half point cut in mortgage rates announced by the Halifax on March 30. Half point cuts are unusual, and the Halifax were somewhat uncompetitive previously. On the other hand societies with excess funds will be reluctant to be upstaged. Should a further half point cut be made, societies would be likely to reduce their rates by around a full point, and possibly even by slightly more. In the absence of any further cut, some societies may alternatively choose peripheral mortgage rate moves by starting to offer fixed rate mortgages or move towards LIBOR linked mortgages. The forecast is for building society mortgage lending to recover in March to the January level of £1.7 billion (seasonally adjusted) and to increase slightly thereafter.

37. The provisional analysis of sterling bank lending by industry in the quarter to February suggests a continuation of the pattern in the previous two quarters. Lending remained very high to property companies, "other financial" (including mortgage finance companies), "other services" (mainly small businesses) and distribution companies, while securities dealers, brokers and jobbers continued to repay debt. New developments included some moderation in lending to the personal sector, both for house purchase and for consumption, though this is partly seasonal and also reflects higher mortgage lending by building societies. There was a surge in lending to manufacturing and construction companies, as in the same quarter last year, but lending to leasing companies fell back sharply.

Other Broad Money Counterparts

38. A PSBR surplus of £0.5 billion and gilt sales of £0.8 billion to the private sector were largely responsible for the **overfund** of £1.6 billion in February, giving a cumulative overfund of £5.7 billion in 1987-88 so far and a forecast underfund of about £½ billion in 1987-88 as a whole. On the basis of the funding rule for 1988-89 (which is based on funding with respect to the M4 private sector) overfunding was £1.5 billion in February, giving a cumulative M4 overfund in the financial year so far of £6.7 billion. The forecast is for a cumulative M4 overfund of £¼ billion in 1987-88 as a whole. The **residual counterparts** to M4 were minus £1.2 billion in February, reflecting bank and building society external transactions of minus £0.5 billion and £NNDL's of minus £0.7 billion.

39. The **external counterparts** to M4 were minus £0.9 billion in February. The main influence behind the public externals of minus £0.4 billion was continued gilt sales to the overseas sector, although at a much lower level than before the crash. Banks' and building societies' external transactions were minus £0.5 billion, reflecting the net reduction in banks' foreign currency assets. Banks' foreign currency lending to the private sector fell by £1.0 billion in February. Most of this is accounted for by the repayment of borrowing by non-monetary sector bank branches in the Channel Islands, so that the source of the reduction in currency

lending may be the overseas sector.

40. The **broad money forecast** for March shows very large one-month rises in both M3 and M4, reflecting expected underfunding of about £6 billion. This compares, however, with underfunding in March last year of £4¼ billion (and £3¾ billion on the M4 basis), so that the annual rate of M3 is virtually unchanged at 20½ per cent. M4 annual growth rises to 16¾ per cent, from 16 per cent in February. Other influences in March are broadly offsetting (see Table 24) with a continuing boost to retail infows - reflecting low unit trust inflows - offset by a continued rundown of liquidity by companies in substitution for equity issues, and some further unwinding of bill arbitrage. The growth of bank and building society lending in March is forecast to be similar to February's - that is, quite moderate monthly growth by recent standards but annual growth remaining at almost 20 per cent for bank and building society lending and 24 per cent for bank lending. The factors causing relatively modest growth in March are shown in Table 25: some further unwinding of arbitrage and reduced borrowing caused by the PSBR surplus, partly offset by continued extra borrowing to replace equity issues. Building societies are expected to continue to recover market share from banks in the mortgage market.

Money Markets and Interest Rates

41. **Money market rates** began March ranging from 9.0 per cent at one month to 9.7 per cent at 12 months. The uncapping of sterling followed by the cut in base rates to 8½ per cent has led to a steady fall in rates, which currently range from 8.6 per cent at one month to 9.2 per cent at 12 months.

42. The stock of **money market assistance** is expected to fall sharply, from £13½ billion at the end of February to about £8¾ billion by the end of March, reflecting March's £6 billion underfund (see Table 27). It is expected to rise modestly in April and return to about £9 billion in May.

Gilts

43. **Gilts** began March with the index at 90.5 and 5,10 and 20 year

par yields at 8.9, 9.3 and 9.1 respectively. The market rose slightly during the first half of the month, with the index reaching 90.8, and the 5 year par yield dropping briefly below 9%. However the market fell back after the Budget, and the cut in interest rates had little impact. The index currently stands at 90.2, with par yields at 8.9, 9.3 and 9.2 respectively.

44. Real yields on **index-linked stock** began March at around 3.9 (3.6 at the very long end). During the early part of the month yields rose to 4.0 (3.7 at the very long end) before falling again to levels comparable to the beginning of the month. Break-even inflation rates for index-linked Treasury 1990 and 2006 are currently 4.0 and 5.3 respectively compared with 3.6 and 5.3 at the end of February. The **equity dividend yield** (based on the all share index) stands at 4.4, up from 4.2 at the start of March.

Capital Markets and Corporate Finance

45. **Equity prices** rose slightly in the first half of March but were little affected by the Budget and the base rate cut, and subsequently fell sharply, reflecting both currency fears and worries of the strength of the US economy. The index currently stands at 899, 15 per cent above its post-crash trough in November and 27 per cent down on its July peak. New issues remain depressed but the **eurobond market** has continued to strengthen, with issues by UK companies rising from £0.7 billion in January to £0.9 billion in February and £1.2 billion in March so far. The majority of these issues have been by financial companies and building societies, with maturities of 5 years, compared to a typical maturity of 15 years pre-crash.

46. There were net inflows into **unit trusts** of £162 million in February, which continues the depressed level of inflows post-crash. (Before the crash, inflows were averaging £660 million per month during 1987.)

47. **Sterling commercial paper** outstanding recovered further in February to £2¾ billion, from £2½ billion in January and £2 billion

in December. The recovery is likely to reflect seasonal influences, and also possibly the closure of the window during February between bill rates and interbank rates - making commercial paper issues more attractive. Monetary sector holdings rose by £90 million in February, to £0.7 billion.

MG2 Division
30 March 1988

90/G.jfw.4555/22

SECRET

Monetary developments since last month's report

	Latest outturns available at time of: Sept Report	Feb Report	Mar Report
Monetary aggregates (12 month % growth)	(Aug)	(Jan)	(Feb)
M0 (sa)	4.7	4.6	5.3
M3	22.1	22.4	20.4
M4	15.6	16.6	16.0
M5	14.9	16.3	15.5
Bank lending	21.6	24.6	24.3
Bank & building society lending	18.8	20.0	19.9
Interest rates (%)	1 Oct	1 Mar	28 Mar
3 month interbank	10.3	9.3	8.8
20 year gilt-edged (par yield)	10.0	9.1	9.2
Yield gap	0.3	0.2	-0.4
UK real 3 month interbank	6.1	5.0	4.4
Equity dividend yield (all-share)	3.0	4.2	4.4
IG yield (2001) assuming 5% inflation	4.4	3.9	3.9
3 month UK interest differential with:			
Germany	5.8	6.0	5.4
US	2.1	2.6	1.9
World basket	3.4	3.2	2.5
Exchange rate			
DM/£	2.99	2.99	3.09
ERI	72.8	74.8	77.1
Oil adjusted ERI*	99.7	106.9	108.7
(Oil-adjusted reference index)	(73.0)	(70.0)	(70.9)
Asset prices			
FT-A Index (% pa)	56.4	-8.0	-10.5
FT-A Level (July peak: 1239)	1215	914	899
Halifax house index (% pa)**	14.8		16.9

* 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 September and February.

ANNEX

THE RISE IN THE EXCHANGE RATE

This annex considers the 3 per cent appreciation of sterling - both against the DM and in effective terms - during March:

i. It puts the rise in context of sterling's behaviour over the last few years; and

ii. It considers the possible impact on monetary conditions, taken together with the ½ per cent cut in base rates during March.

Exchange Rate Developments since 1985

2. Chart 1 shows the behaviour of sterling since early 1985. The chart shows that over this period, despite its recent rise, sterling has fallen by around 20 per cent against the DM. In contrast, a weakening dollar has resulted in nearly a 50 per cent appreciation of the $/£ exchange rate. Sterling's effective rate is unchanged over the period.

3. Chart 2 shows comparable sterling exchange rates in real terms (using relative producer prices as the deflator). Since early 1985, sterling's 20 per cent depreciation against the DM has been more than sufficient to offset higher domestic producer price inflation of about 15 per cent, so that the real DM/£ exchange rate has fallen by about 5 per cent. But the combination of a stable effective rate over the period and lower world inflation than in the UK has resulted in a 10 per cent rise in the real sterling effective rate. Interestingly, the real DM/£, $/£ and sterling effective rates are all currently around their average levels of 1980.

Impact on Monetary Conditions

4. Table 1 below gives details of the 1988-89 Budget Forecast, as it relates to monetary conditions. The Forecast was made on the assumption of unchanged interest rates (at 9 per cent) and DM/£ exchange rate (at 3DM).

Table 1 The Budget Forecast, 1988-89

	per cent per annum					
	Money GDP o/w	Output	GDP deflator	Current balance £ billion	Exchange Rate ERI	$/£
1987 Q1	7.3	4.3	3.0	0.8	69.9	1.54
Q2	8.8	4.4	4.2	-0.3	72.8	1.64
Q3	10.6	5.1	5.2	-0.9	72.7	1.62
Q4	9.8	5.2	4.4	-1.3	74.9	1.75
1988 Q1	10.1	4.1	5.8	-1.0	74.8	1.78
Q2	9.5	4.3	5.0	-0.6	74.8	1.79
Q3	6.7	2.2	4.4	-1.0	75.2	1.81
Q4	7.1	2.2	4.8	-1.3	75.5	1.82
1989 Q1	7.1	3.1	3.9	-0.8	75.9	1.84
1987-88	9.8	4.7	4.9	-3.4	73.8	1.70
1988-89	7.6	3.0	4.5	-3.8	75.4	1.82

The table shows that money GDP growth is projected to fall back during 1988-89, with the year on year growth rate falling from 9.8 per cent in 1987-88 to 7.6 per cent in 1988-89, mostly reflecting lower growth of output, but also some easing of inflation. The exchange rate is projected to rise slightly over this period, primarily reflecting a weaker dollar.

5. Since the Budget Forecast was made sterling has risen to an effective rate of about 77 and DM3.09 (28 March) as the authorities refrained from further large-scale intervention, while a ½ point reduction in base rates on 17 March has left short rates at just over 8½ per cent. The effect on monetary conditions of these changes will depend on circumstances - for example, whether the new configuration of interest and exchange rates is broadly sustained throughout 1988. (The worse than expected trade figures for February, announced on 25 March, led to an immediate ½ per cent fall in sterling's effective rate, to 76.7, and a fall against the deutschemark to DM3.07, although these losses were largely recovered on 28 March.)

6. Depending amongst other things on whether the rise in the exchange rate reflected a permanent change in sentiment in favour of sterling, and hence whether interest and exchange rates stay around

current levels, money GDP growth could be reduced by about ¼ percentage point in 1988-89, reflecting a 0.1 percentage point fall both in the rate of inflation and output growth. The balance of expenditure is also likely to be affected, with a lower contribution to money GDP growth from the trade balance and a greater contribution from consumption. For example, the growth of exports might be reduced, and the growth of imports increased, by about ½ percentage point in 1988-89, implying a deterioration of the current balance of perhaps around £¼ billion.

7. Assuming interest rates stay at around 8½ per cent, these calculations suggest that an effective exchange rate of about 76¼ and a deutschemark rate of a little below DM3.04 in 1988-89 would be consistent with the Budget Forecast projections of money GDP growth and inflation. But this combination of interest and exchange rates would probably lead to some shift in the pattern of demand, for example the current balance might still deteriorate by around £¼ billion relative to the Budget Forecast.

Conclusion

8. The jump in the exchange rate during March should be judged in comparison to levels of sterling over recent years. Put in this context, the higher level of the exchange rate in March -particularly the DM/£ rate - is by no means exceptional. Monetary conditions could be marginally tighter, with both inflation and output growth lower by 0.1 per cent in 1988-89.

CHART A1

STERLING EXCHANGE RATES

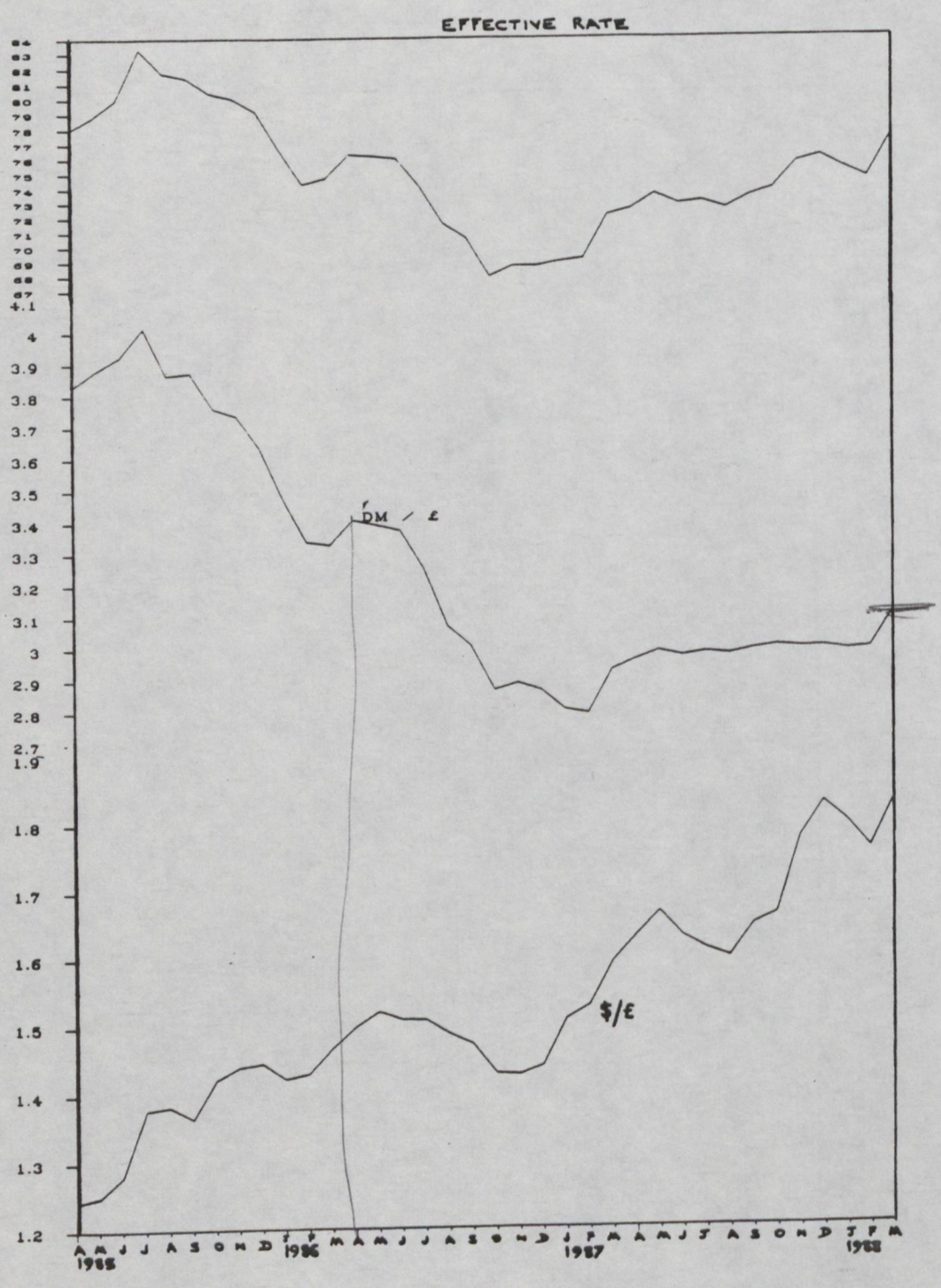
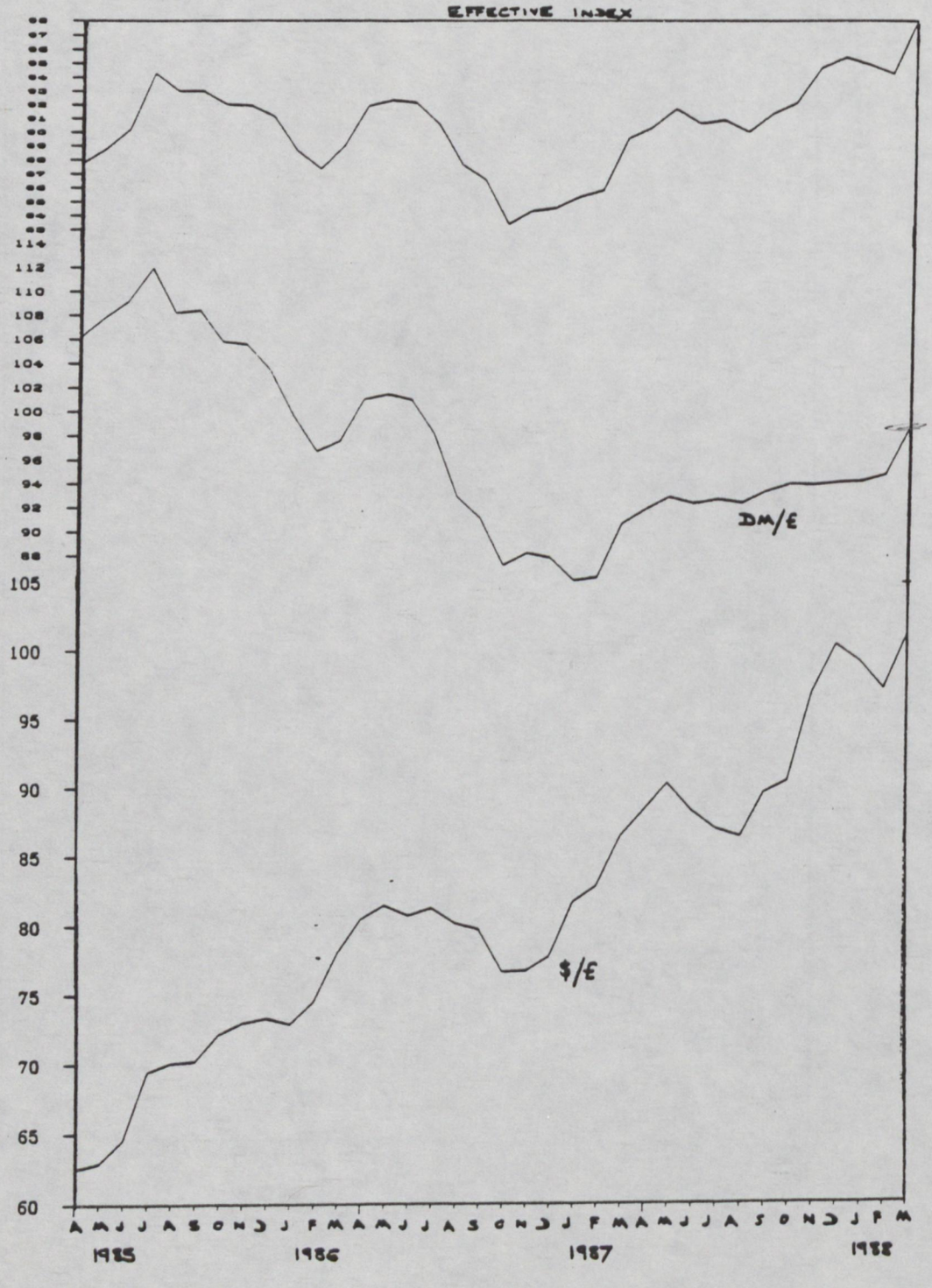


CHART A2

REAL STERLING EXCHANGE RATES
(1980 = 100)



NOTE

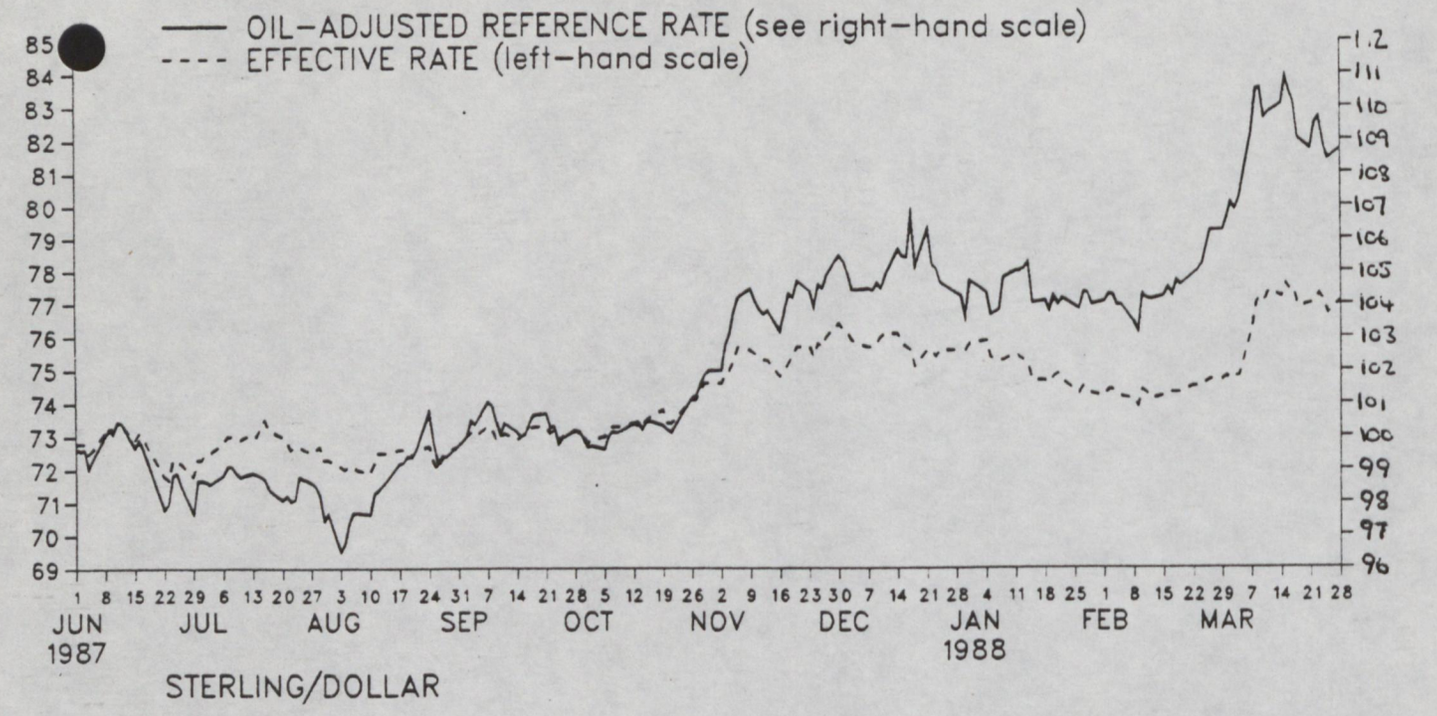
Figures for March 1988 are estimates

SECRET

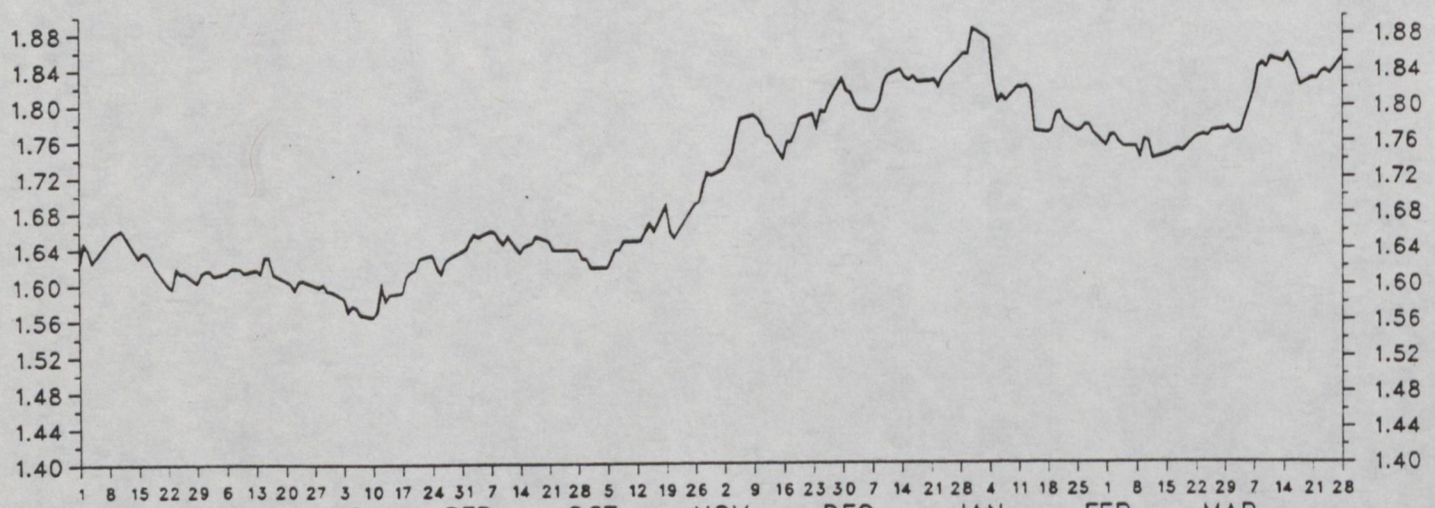
MONTHLY MONETARY REPORT : CHARTS

I	Exchange Rate Short Term
II	UK/US interest rate differential
III	Narrow money growth
IV	Broad money growth
V	Real M0 growth
VII	FSBR budget profile M0
IX	FSBR budget profile M4
X	Retail Deposits
XI	Bank and Building Society Lending
XII	£ Corporate bond issues
XIII	Money Market Assistance
XIV	Nominal Interest Rates
XV	Yield Curve
XVI	Real Yields
XVII	House prices 1
XVIII	House prices 2
XIX	Capital Markets

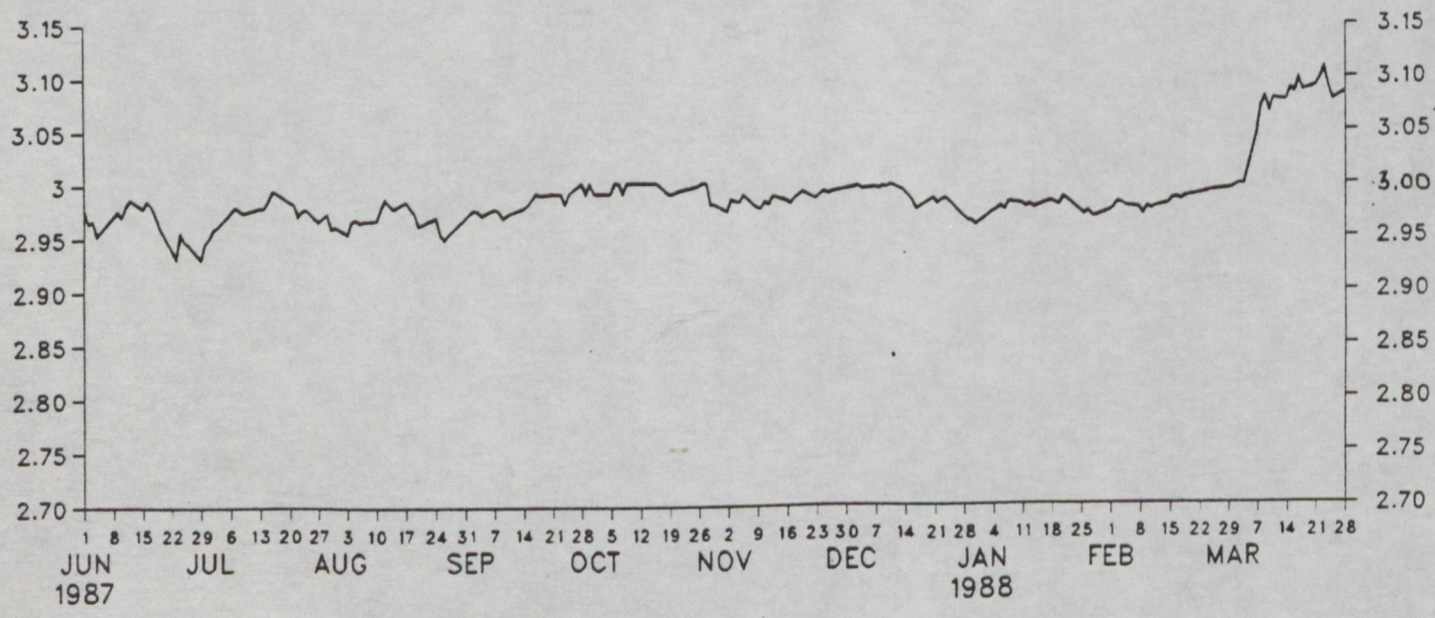
CHART I:EXCHANGE RATE



STERLING/DOLLAR



STERLING/DEUTSCHEMARK



UK/US INTEREST RATE DIFFERENTIAL

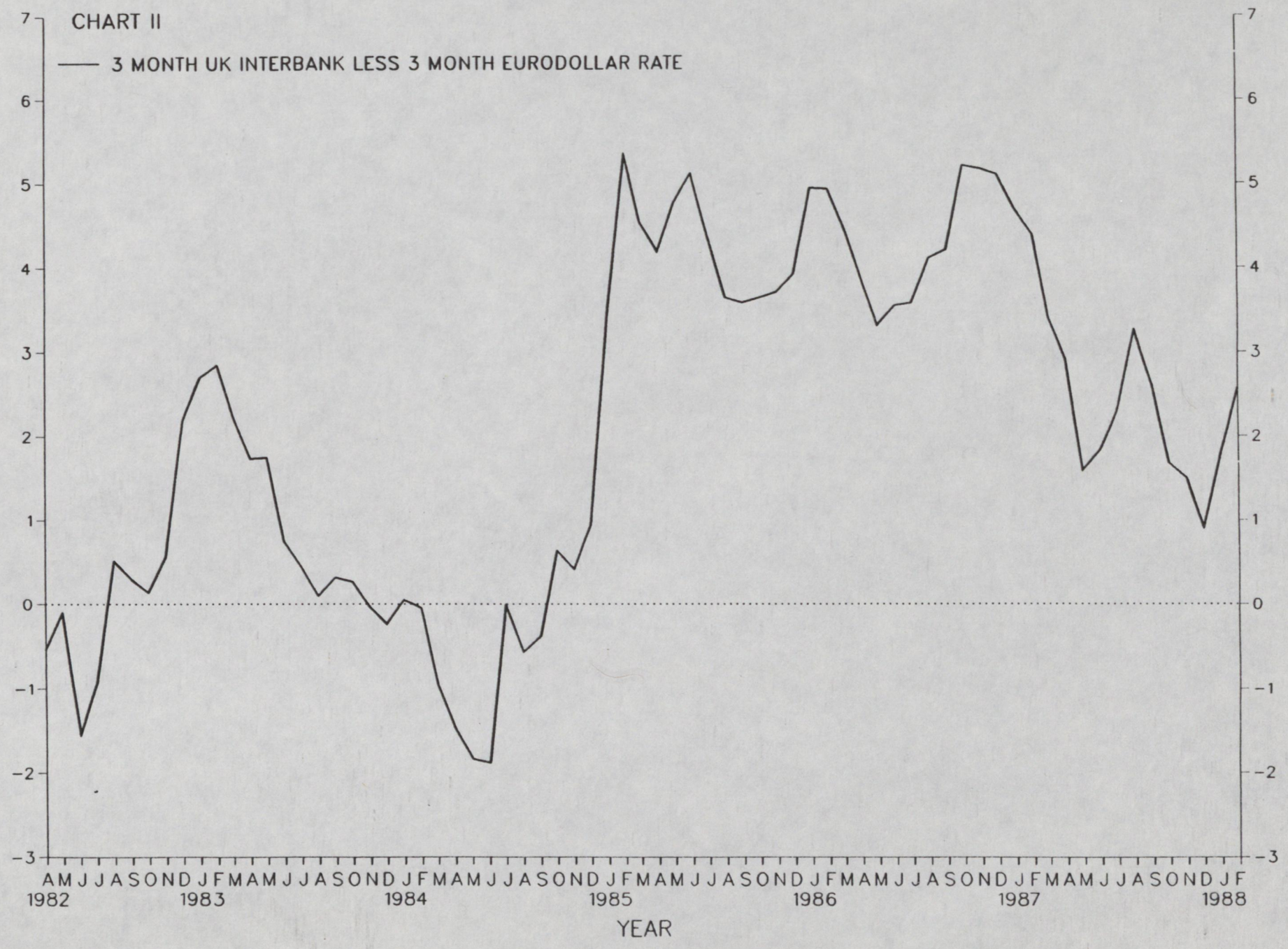


CHART III NARROW MONEY

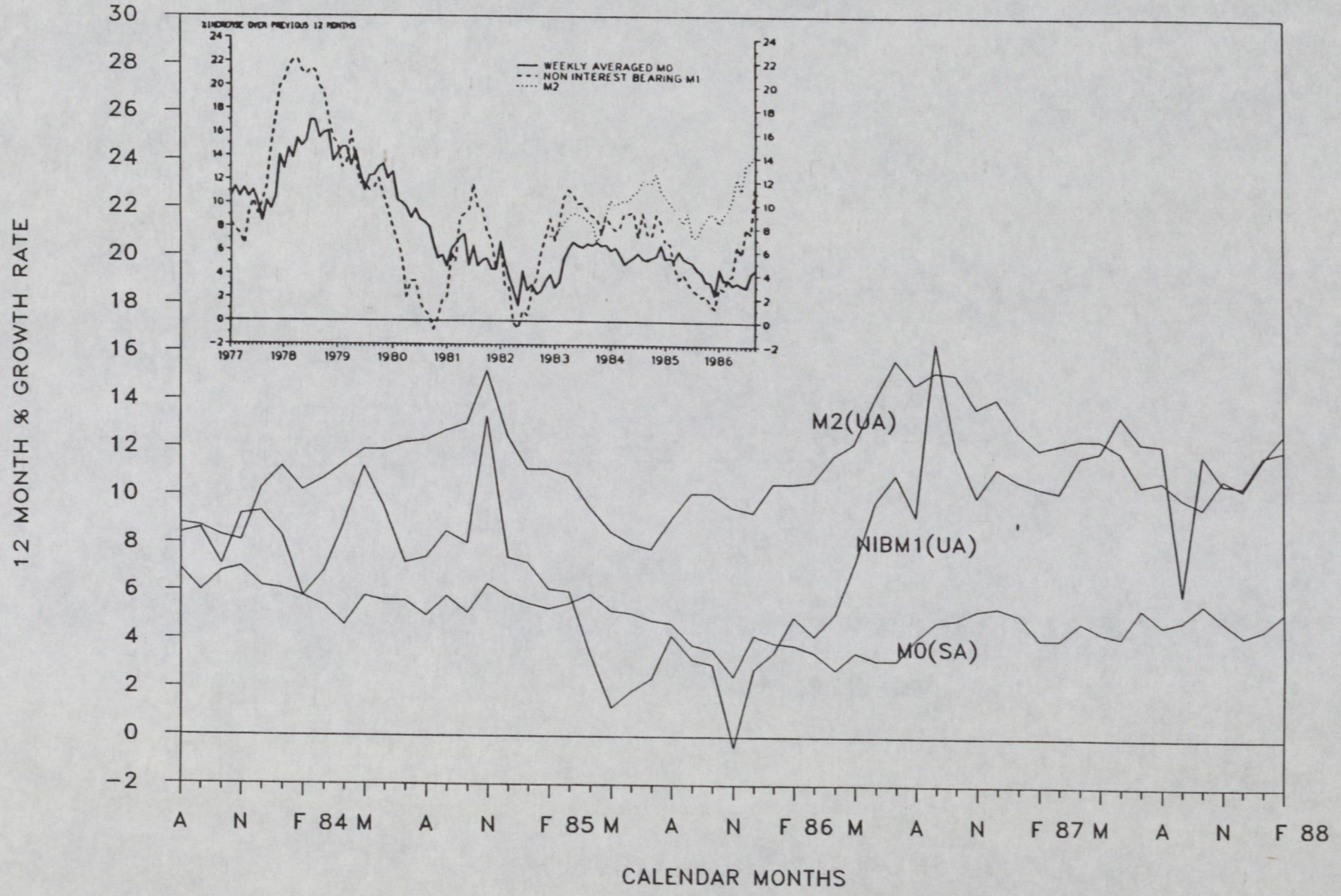


CHART IV BROAD MONEY

Annual percentage growth (ua)

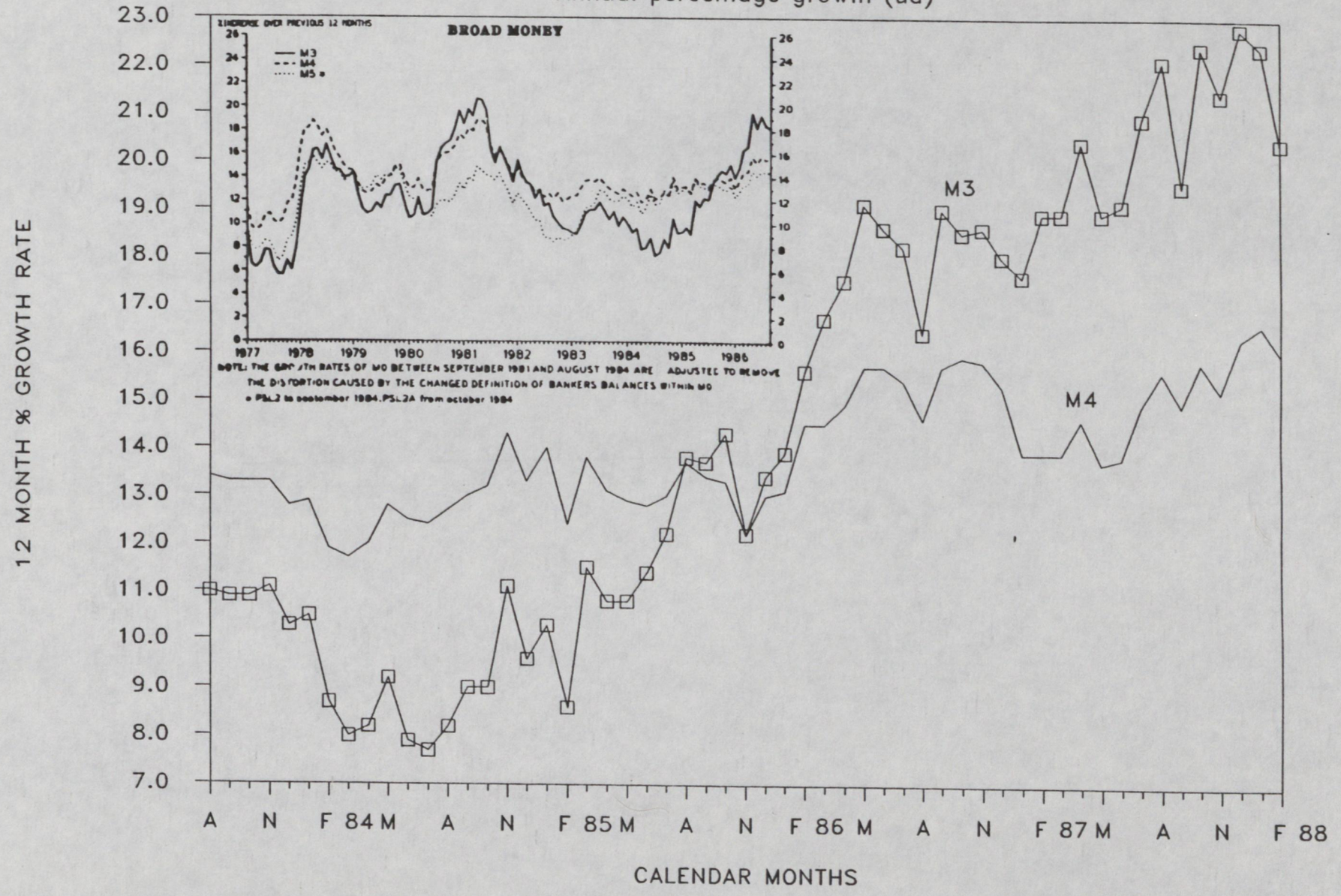


CHART V REAL M0

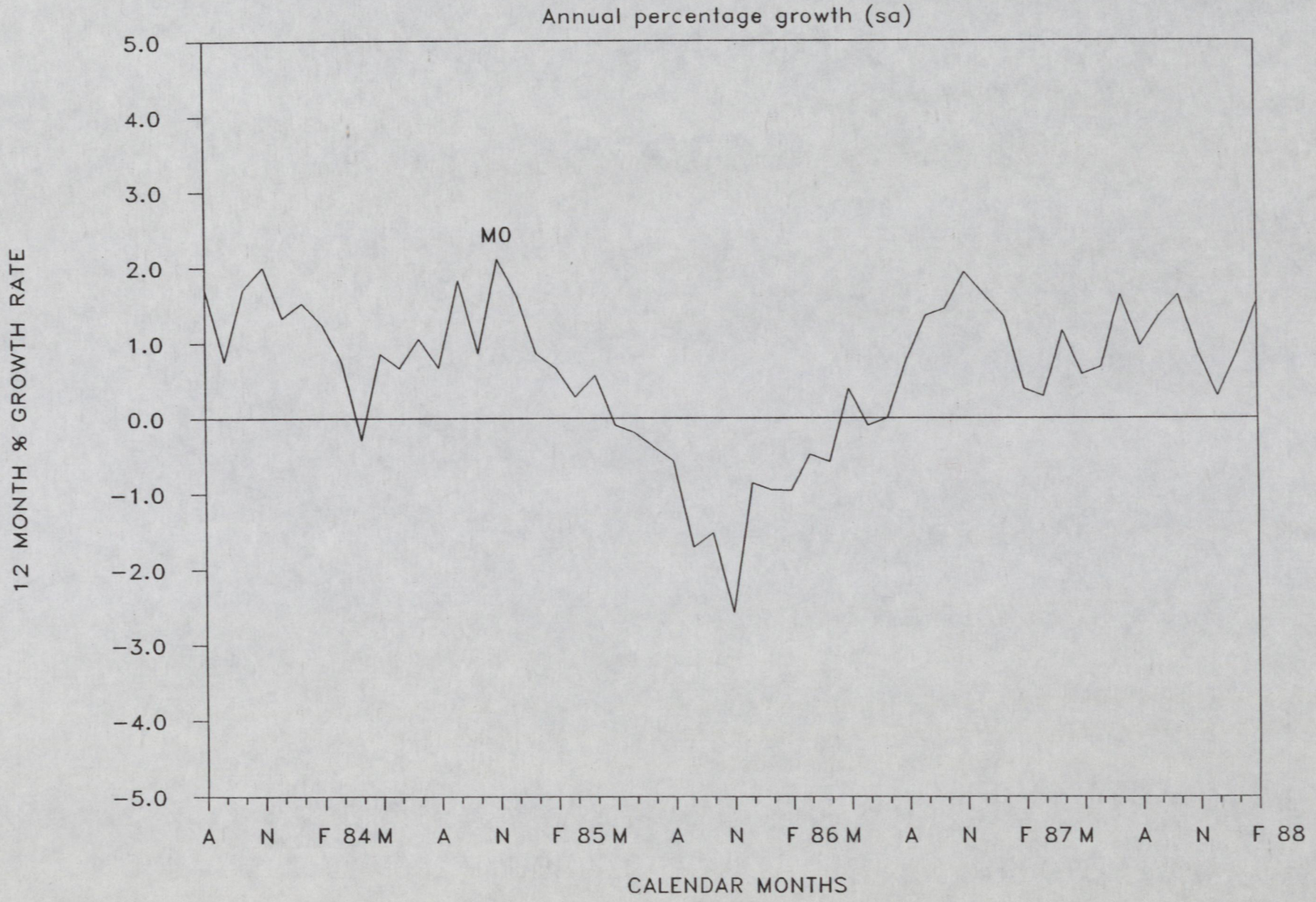


CHART VII

COMPARISON OF 1987 BUDGET FORECAST WITH OUT-TURN FOR M0

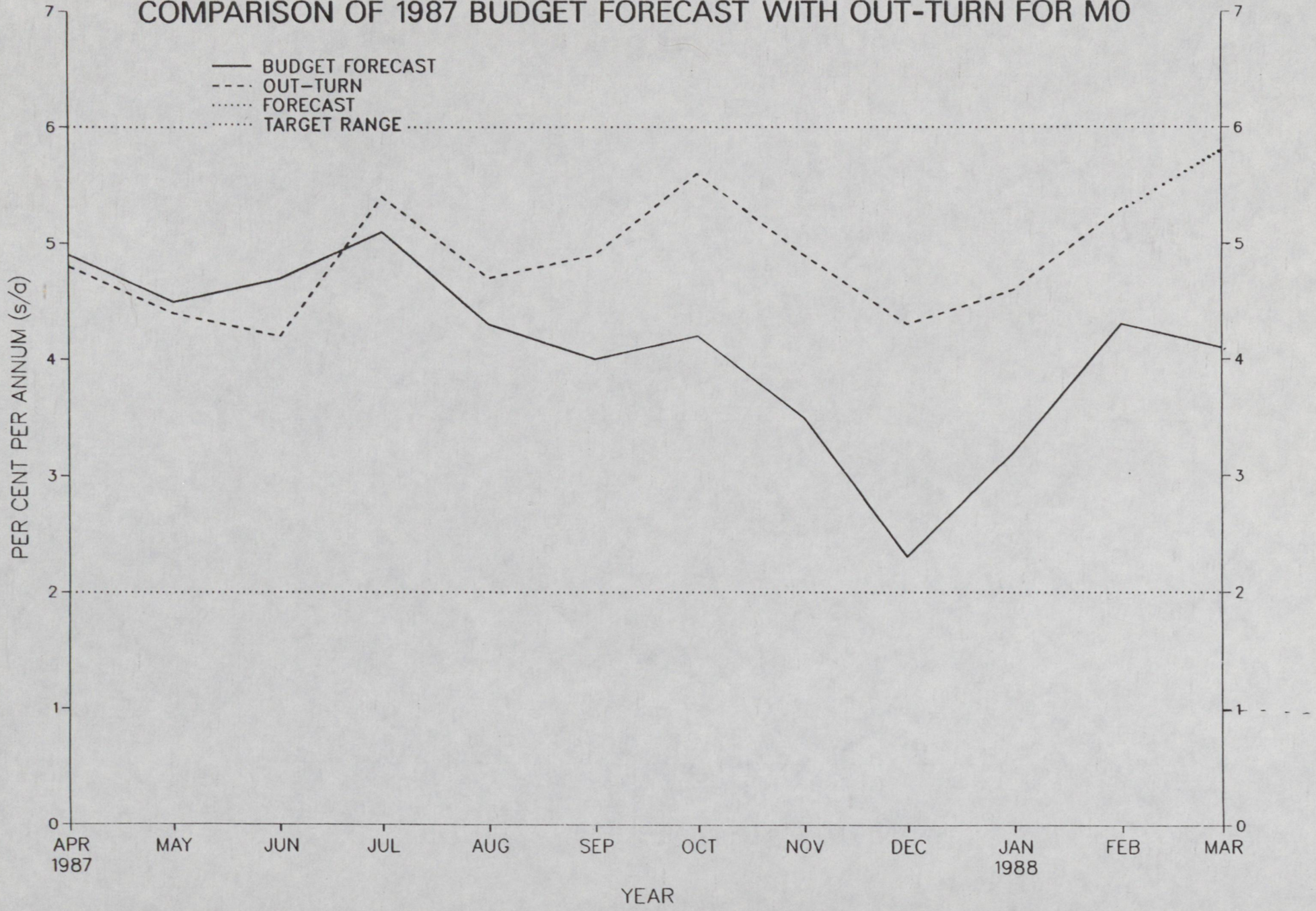


CHART IX

COMPARISON OF 1987 BUDGET FORECAST WITH OUTTURN FOR M4

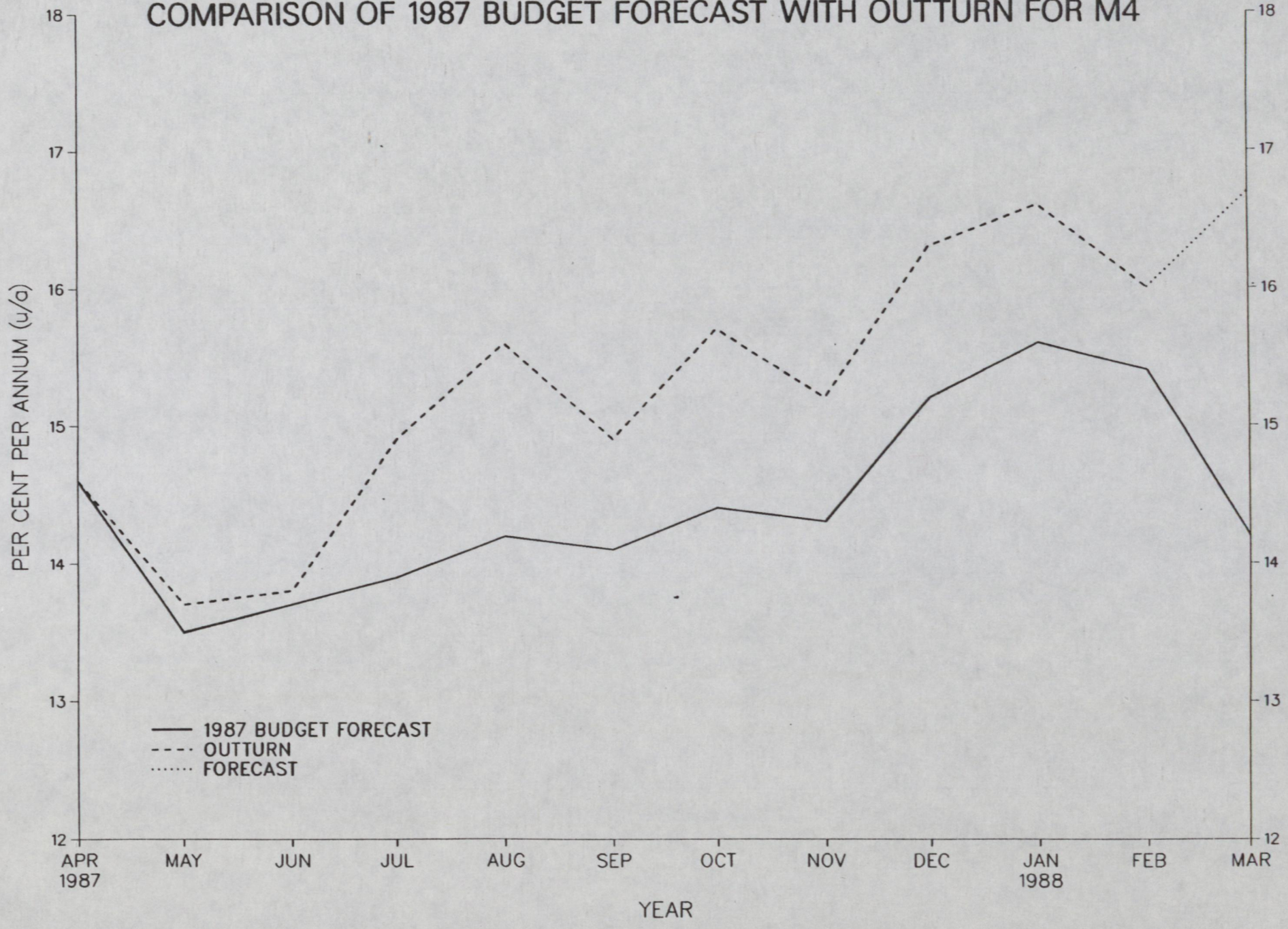


CHART X RETAIL DEPOSITS

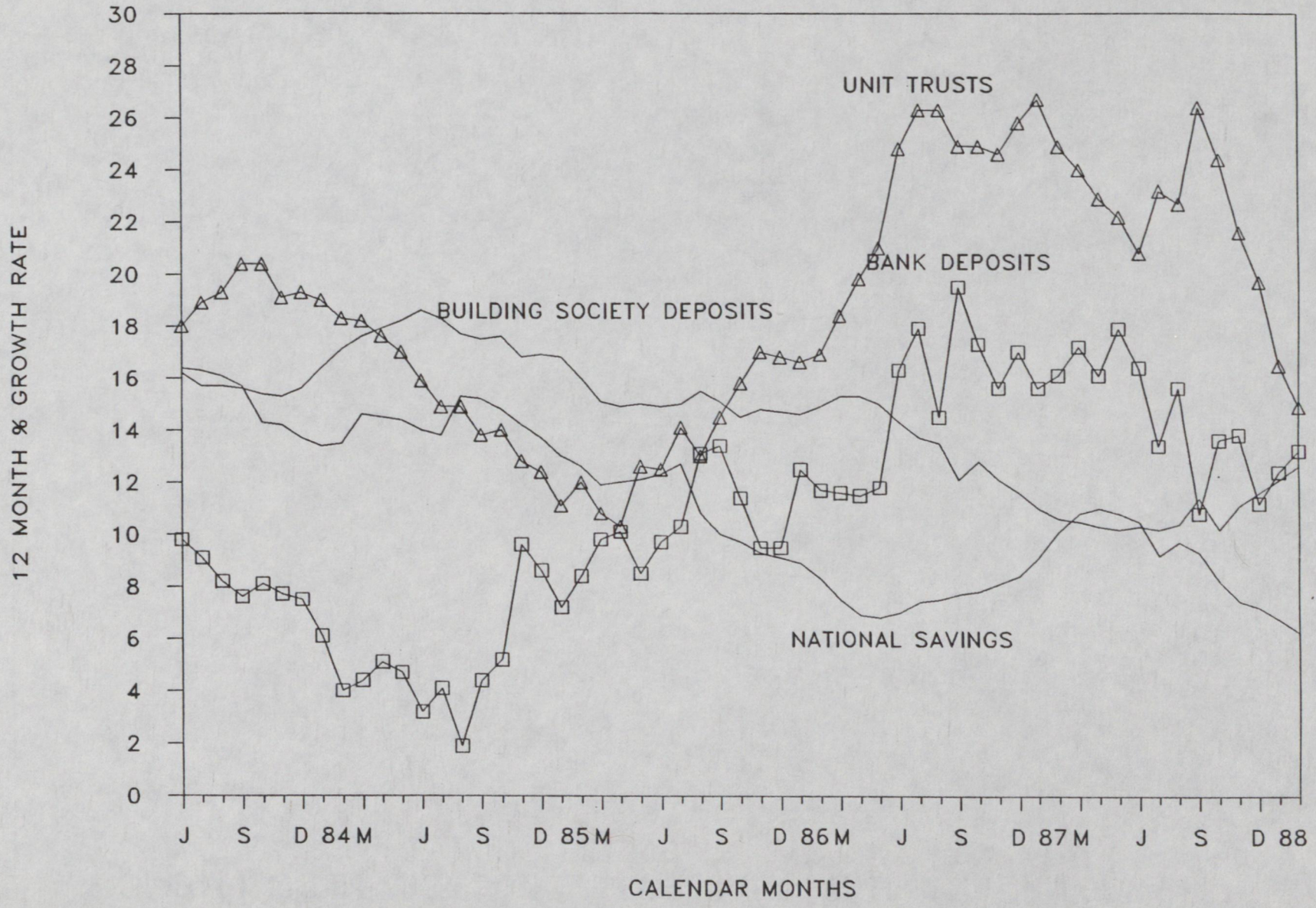


CHART XI

BANK AND BUILDING SOCIETY LENDING

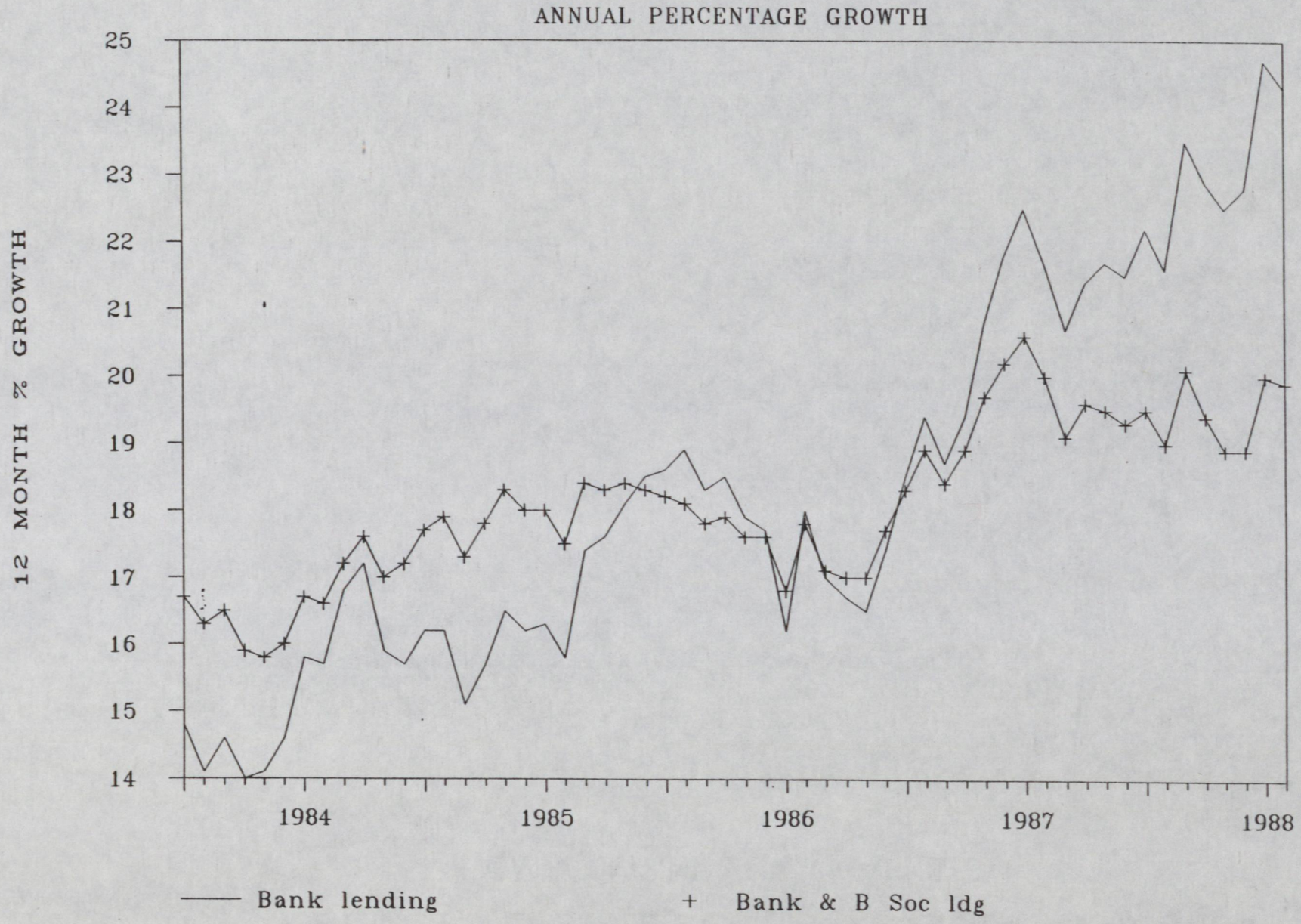


CHART XII

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

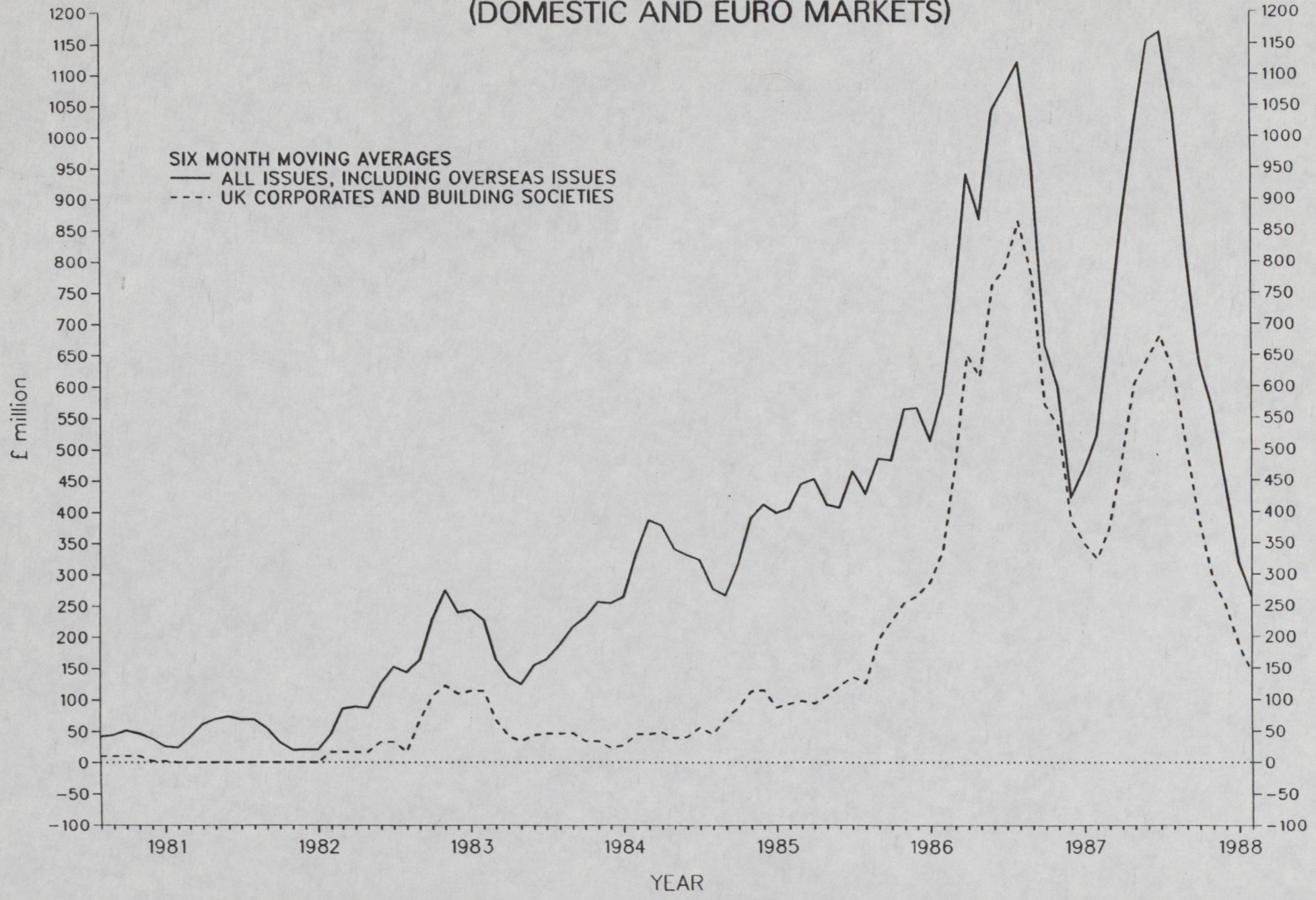
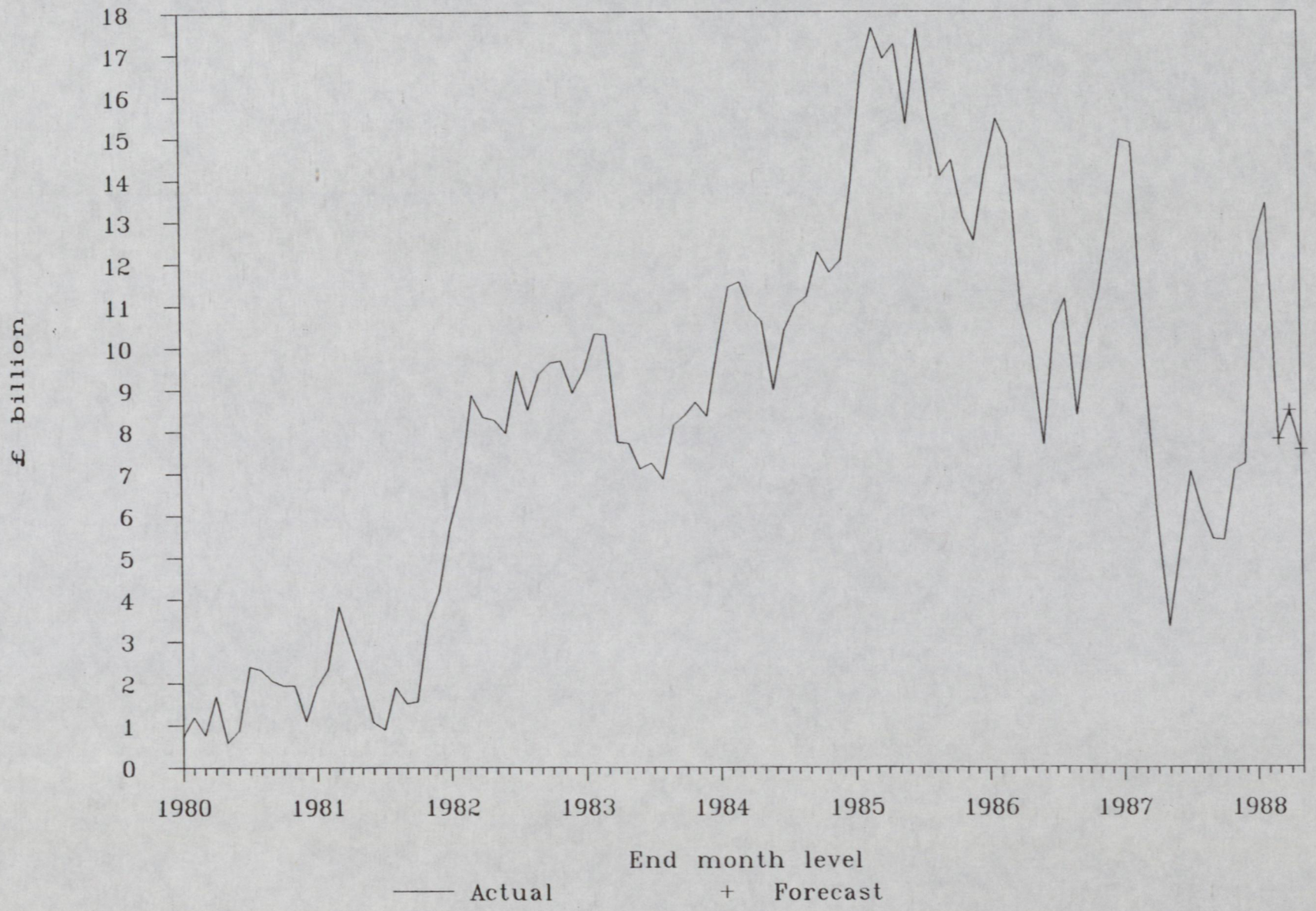


CHART XIII - MONEY MARKET ASSISTANCE



NOMINAL INTEREST RATES

CHART XIV

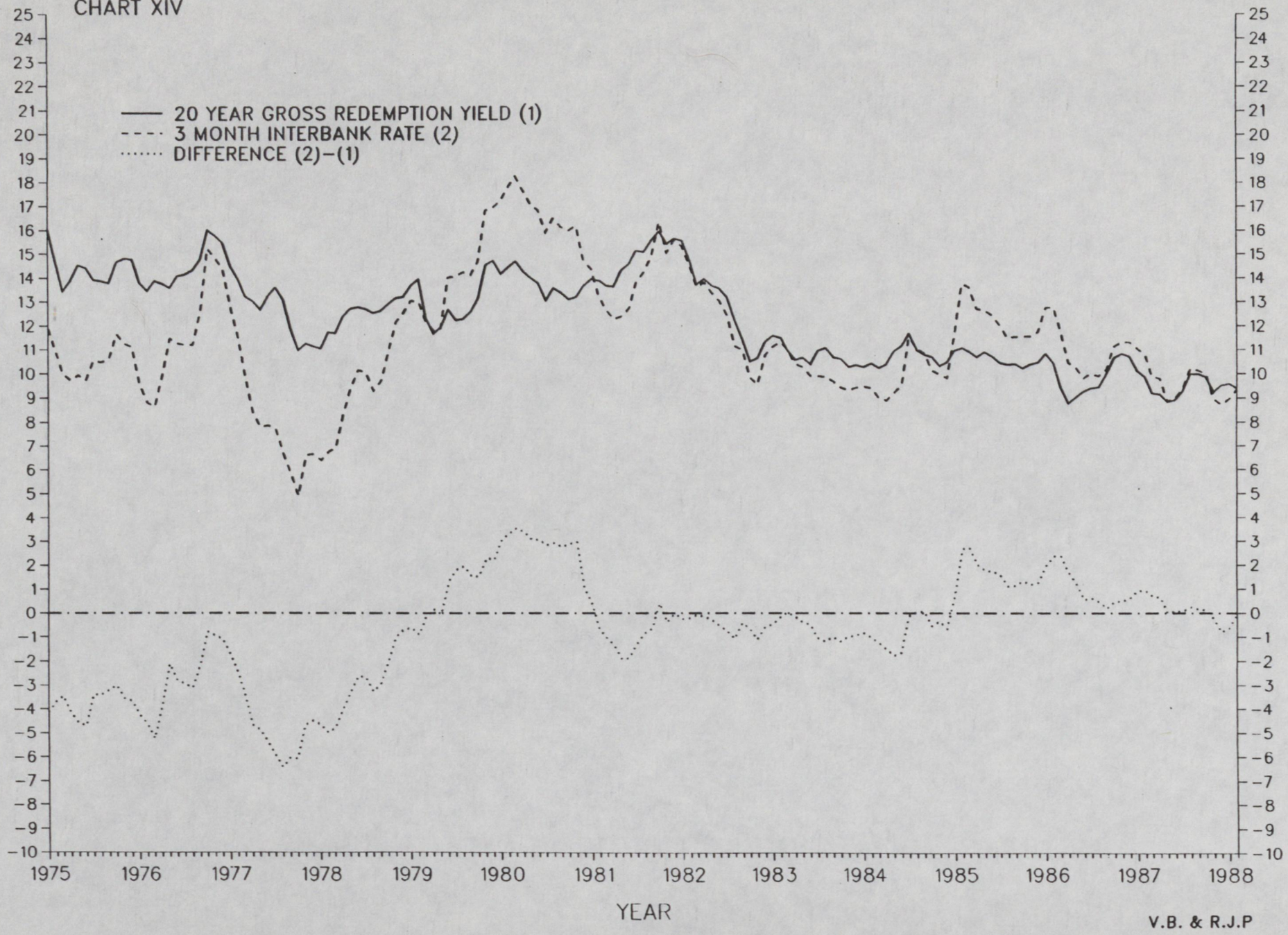


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CHART XV

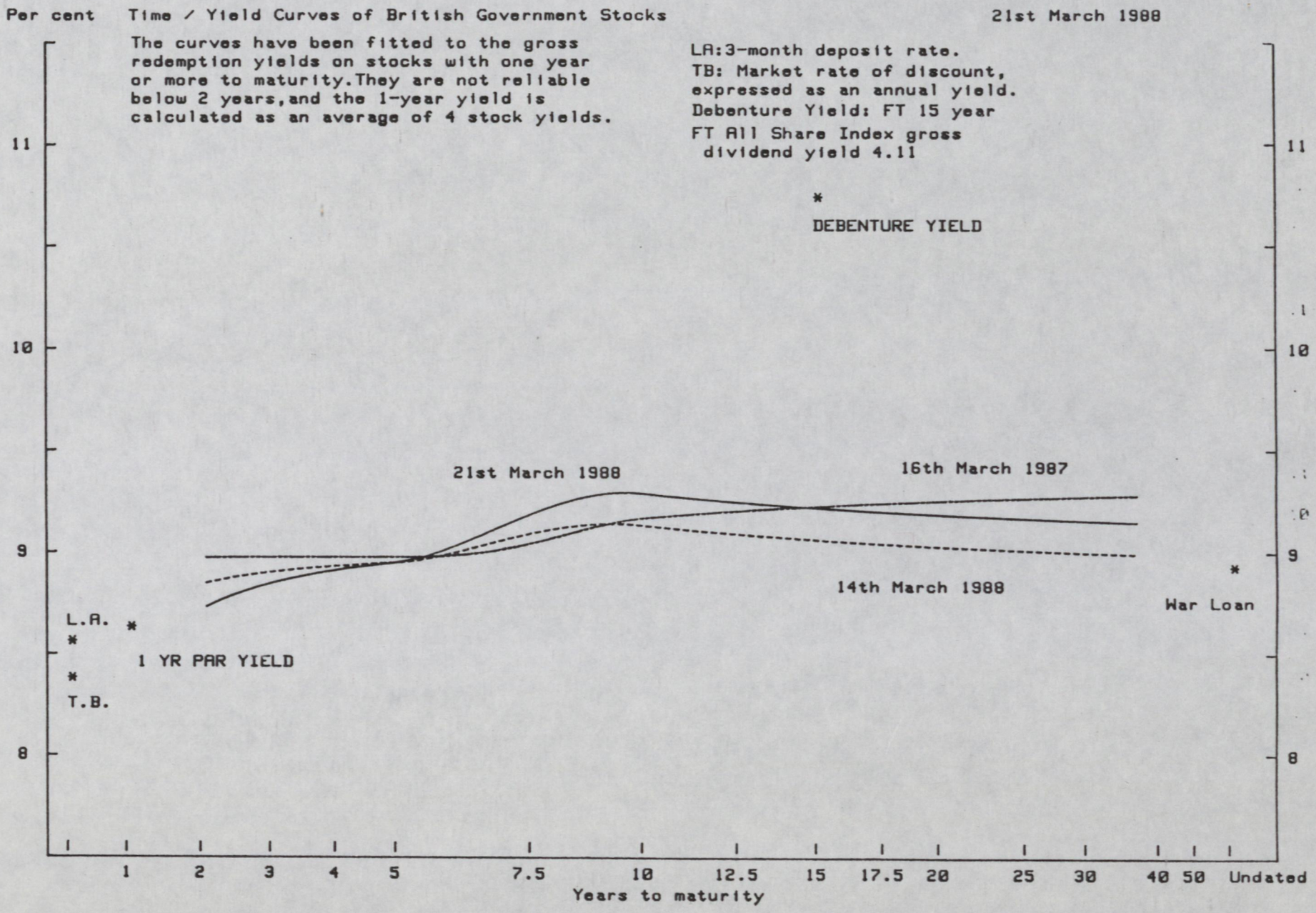
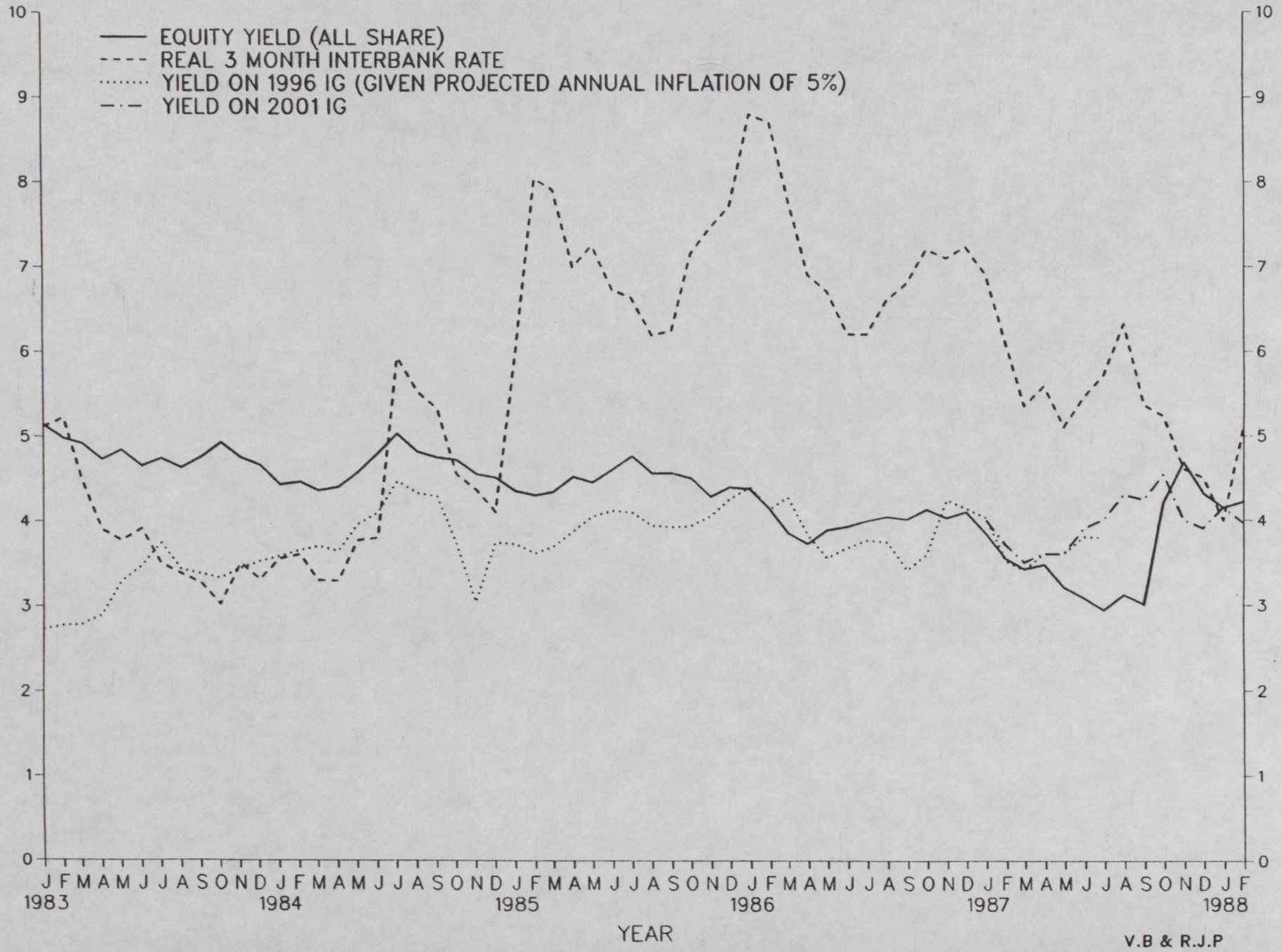

Per cent
Time / Yield Curves of British Government Stocks
21st March 1988
The curves have been fitted to the gross redemption yields on stocks with one year or more to maturity. They are not reliable below 2 years, and the 1-year yield is calculated as an average of 4 stock yields.
LA: 3-month deposit rate.
TB: Market rate of discount, expressed as an annual yield.
Debenture Yield: FT 15 year
FT All Share Index gross dividend yield 4.11
DEBENTURE YIELD
11
10
9
8
21st March 1988
16th March 1987
14th March 1988
War Loan
L.A.
1 YR PAR YIELD
T.B.
1
2
3
4
5
7.5
10
12.5
15
17.5
20
25
30
40
50
Undated
Years to maturity

CHART XVI

REAL YIELDS



V.B & R.J.P

CHART XVII

ANNUAL HOUSE PRICE INFLATION : I

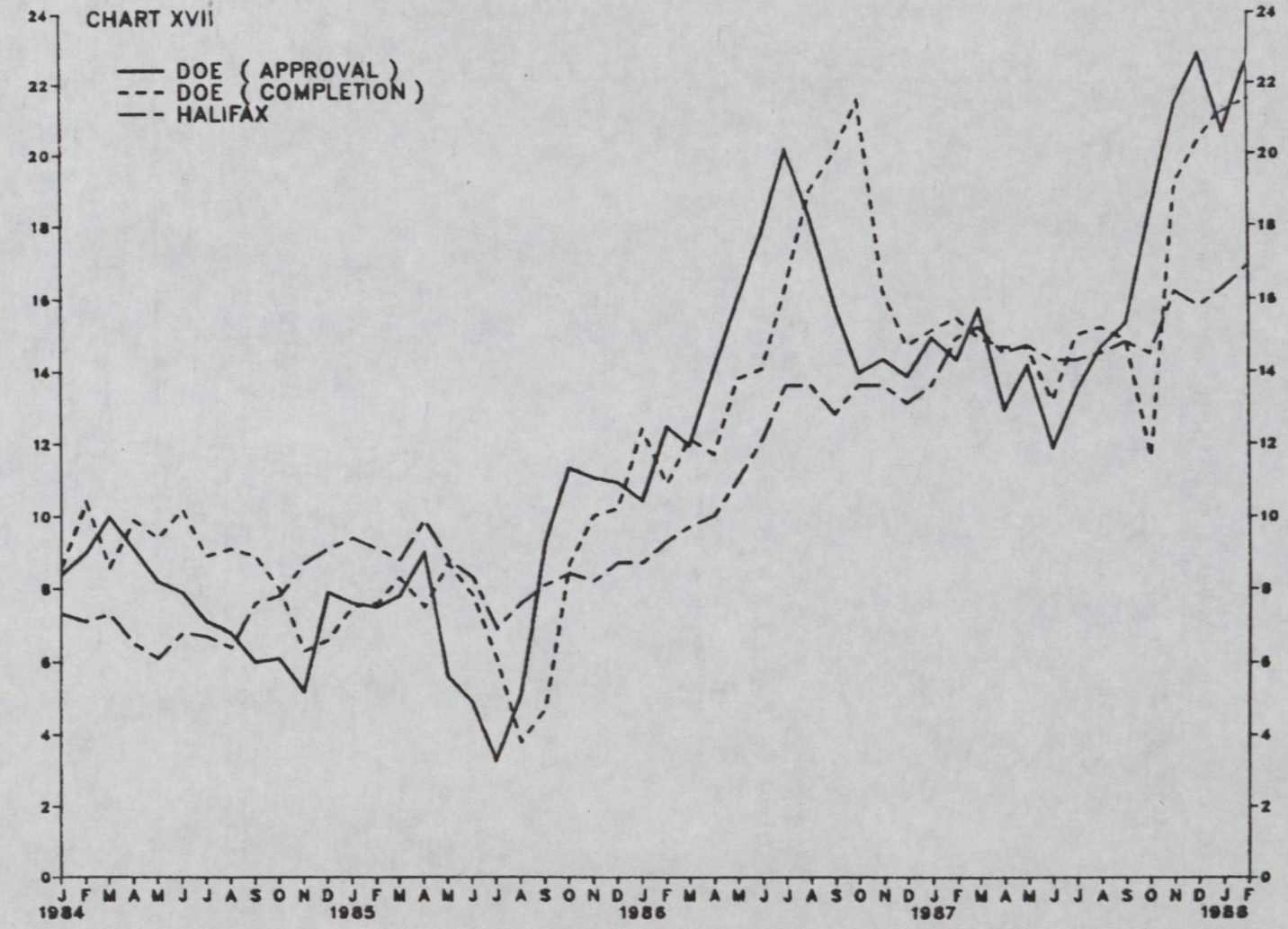
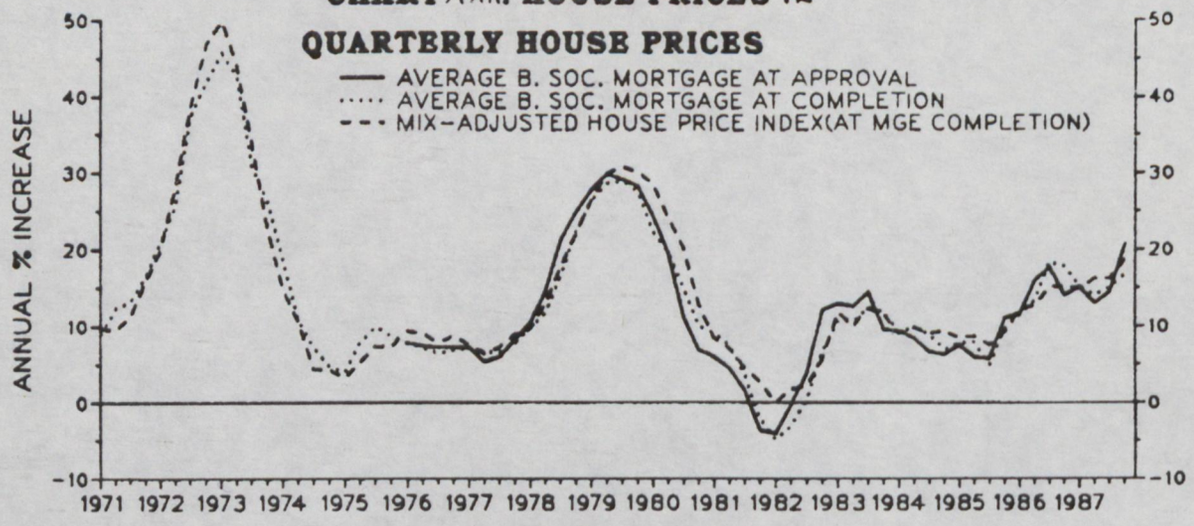
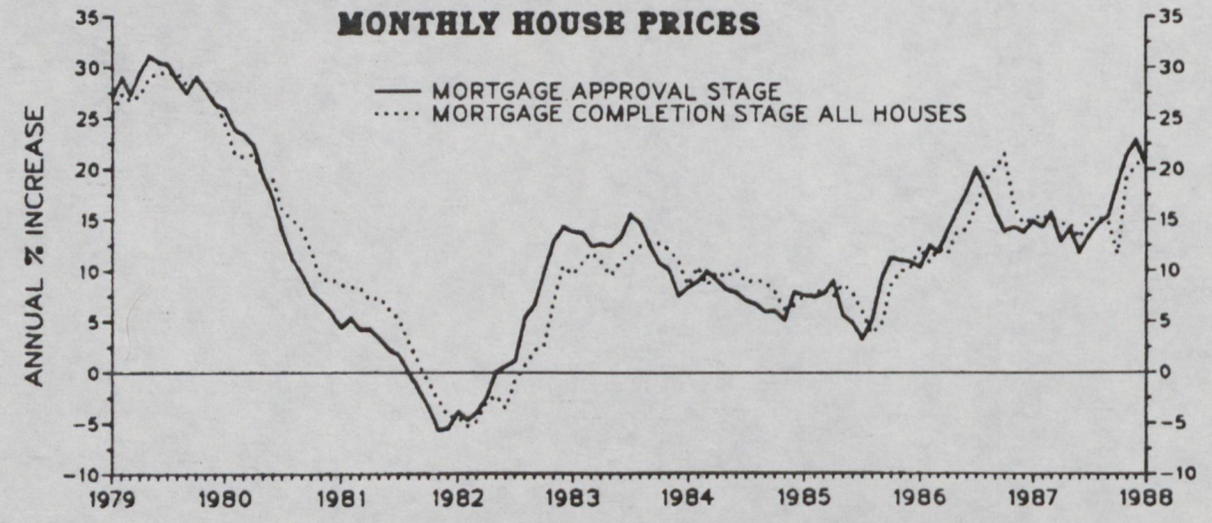
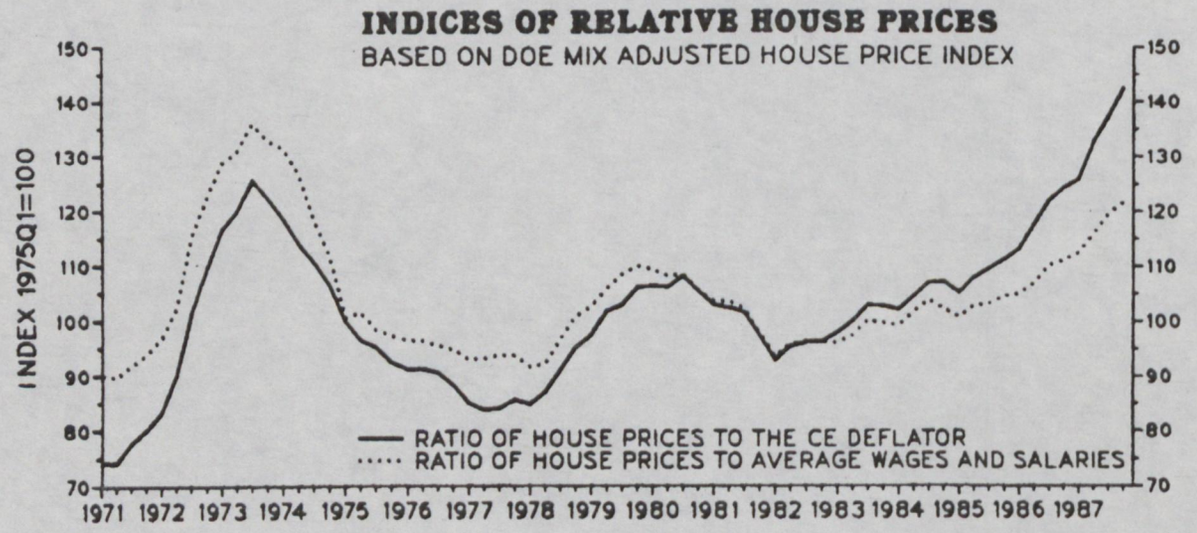


CHART XVIII: HOUSE PRICES :2



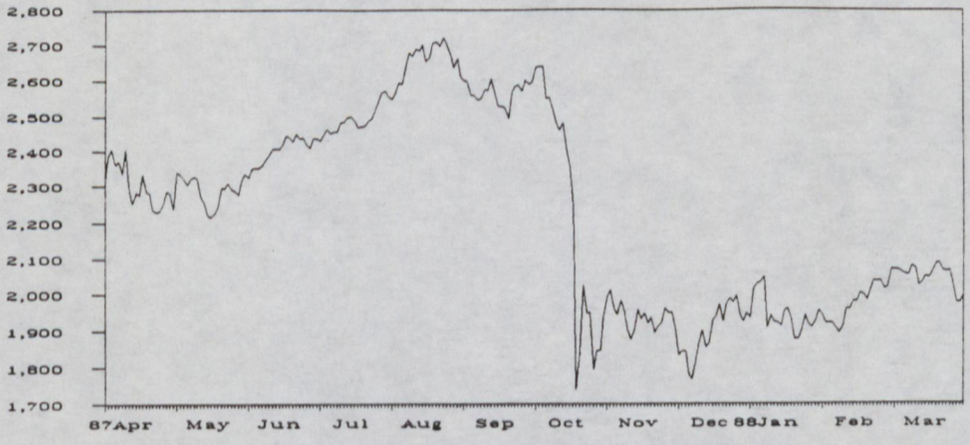




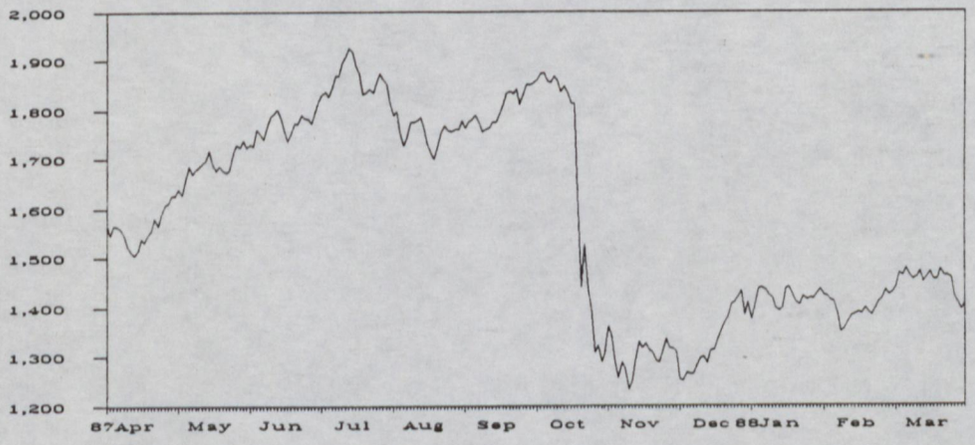
CAPITAL MARKETS

CHART XIX

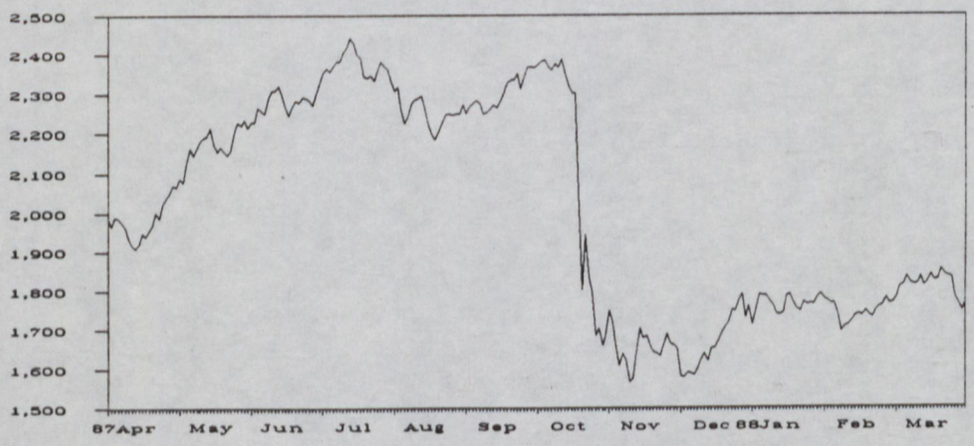
Dow Jones Industrial Average



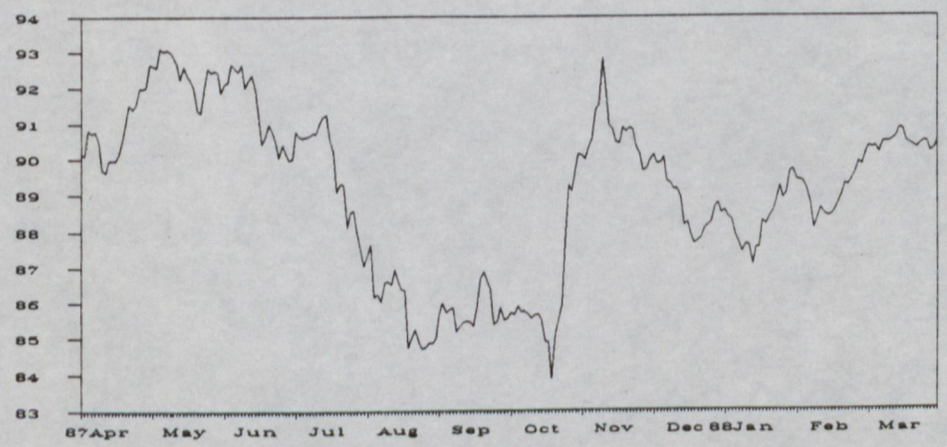
FT Ordinary Index



FTSE 100



Gilt Index



SECRET

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

	Activity			Money supply		Costs and prices		
	Nominal GNP	Real GNP	Industrial production	M1	M2/M3	Unit labour costs	Consumer prices	GNP deflator
1984	8.6	4.9	8.1	6.6	8.6	-0.8	4.1	3.6
1985	6.6	3.2	3.0	8.2	8.4	0.5	3.5	3.3
1986	5.6	2.7	1.0	11.5	8.1	1.0	1.5	2.9
1987	5.4	2.9	3.0	11.1+	8.7+	-	2.5	2.4
1987 Q1	5.0	2.5	0.9	13.7	8.9	0.1	1.5	2.4
Q2	4.7	2.3	2.0	12.5	9.0	-0.6	2.5	2.5
Q3	5.6	3.2	3.7	10.1	8.4	-1.7	2.9	2.2
Q4	6.3	3.7	5.4	8.1+	8.5+	-	3.0	2.5
1987 Jul			2.9	10.6	8.5		2.6	
Aug			4.2	10.4	8.5		3.0	
Sep			4.0	9.4	8.2		2.9	
Oct			5.1	10.0	8.8		3.1	
Nov			5.6	8.2	8.5		3.0	
Dec			5.6	6.2+	8.3+		3.0	
1988 Jan			-	6.8+	8.4+		2.7	

* Percentage changes on a year before.

\+ Partly estimated.

91/G.ECED.4900.054

Table 2

GERMANY: KEY FIGURES

Percentage changes on a year earlier unless otherwise stated

	INDUSTRIAL PRODUCTION index (1980=100)	CONSUMER PRICES	TRADE SURPLUS* $bn	MONEY SUPPLY (M3)
1984	3.4	100	2.4	1.7	3.3
1985	5.4	105	2.2	2.2	3.8
1986	2.1	107	- 0.2	4.5	4.2
1987	0.2	107	0.3	5.5	6.7
1987J	-1.9	104	- 0.8	4.8 (4.5)	6.7
F	0.0	106	- 0.5	6.1 (4.7)	7.1
M	-0.9	106	- 0.2	4.8 (4.9)	6.6
A	-0.9	107	0.1	5.3 (5.0)	7.9
M	2.9	108	0.2	6.0 (5.2)	8.5
J	-0.9	107	0.2	4.6 (5.1)	7.4
J	-2.8	106	0.7	5.6 (5.1)	6.7
A	2.8	110	0.8	4.9 (5.1)	6.5
S	0.9	108	0.4	5.8 (5.2)	5.8
O	0.9	108	0.9	4.8 (5.2)	5.8
N	0.9	108	1.0	6.1 (5.3)	5.5
D	3.4	109	1.0	6.8 (5.5)	5.8
1988J	4.9	109	0.7	-	5.8
F	-	-	0.9	-	6.1

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

TABLE 3A

THREE MONTH INTEREST RATES IN THE G5 COUNTRIES*

	United States	Japan	Germany	France	UK
1983	91	6.5	5.8	12.5	10.1
1984	10.1	6.3	6.0	11.7	9.9
1985	8.1	6.5	5.5	10.0	12.2
1986	6.5	5.0	4.6	7.8	11.0
1987	6.9	3.9	4.0	8.2	9.7
1987 Jan	5.8	4.3	4.6	8.4	11.0
Feb	6.1	4.0	4.0	8.5	11.0
Mar	6.2	4.0	4.0	8.0	10.0
Apr	6.5	3.9	3.9	8.0	9.8
May	7.0	3.8	3.8	8.2	8.8
June	7.0	3.7	3.7	8.2	9.0
July	6.7	3.7	3.9	7.9	9.2
Aug	6.8	3.7	4.0	7.9	10.1
Sept	7.4	3.8	4.0	7.9	10.1
Oct	8.2	3.9	4.8	8.2	9.9
Nov	7.4	3.9	3.9	8.6	9.0
Dec	7.8	3.9	3.6	8.7	8.7
1988 Jan	7.0	3.9	3.4	8.3	8.9
Feb	6.6	3.8	3.4	7.6	9.2
March 28	6.6	3.8	3.4	8.3	8.9

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

TABLE 38

EFFECTIVE EXCHANGE RATE INDICES (1975 = 100)

	United States	Japan	Germany	France	UK	YEN/$	DM/$
1980	93.7	126.4	128.8	94.4	96.0	225.8	1.82
1981	105.6	142.9	119.2	84.3	94.8	219.5	2.25
1982	118.0	134.6	124.4	76.6	90.4	248.8	2.43
1983	124.8	148.4	127.1	70.0	83.2	237.4	2.55
1984	134.6	156.7	123.8	65.7	78.6	237.5	2.85
1985	140.7	160.5	123.6	66.3	78.2	238.4	2.94
1986	114.8	203.1	137.3	70.1	72.8	168.3	2.17
1987	101.2	219.6	147.6	71.8	72.7	144.7	1.80
1986 Q1	121.2	186.8	133.1	71.0	75.1	187.8	2.35
Q2	116.0	202.8	134.7	69.0	76.0	169.9	2.24
Q3	111.4	214.8	138.6	69.5	71.9	155.9	2.09
Q4	110.5	208.0	142.6	70.8	68.3	160.4	2.01
1987 Q1	104.2	210.1	147.7	71.9	70.2	155.2	1.84
Q2	101.1	222.9	146.9	71.6	72.7	142.6	1.81
Q3	102.5	218.0	146.4	71.4	72.7	147.0	1.84
Q4	97.0	227.4	149.4	72.3	75.2	134.0	1.71
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	96.5	228.4	150.9	72.3	75.4	135.3	1.68
Dec	93.9	232.4	150.2	73.1	76.6	123.4	1.65
1988 Jan	93.9	239.5	150.4	72.5	74.9	127.8	1.65
Feb	95.0	239.5	149.1	71.8	74.3	129.2	1.70
March 29	92.5	245.5	149.2	71.6	77.7	124.5	1.66
% Change since dollar peak (Feb 85)	- 41	+ 56	+ 27½	+ 15½	+ 10½	- 52	- 51½
% Change since Plaza (Sept 85)	- 33½	+ 57	+ 19	+ 6½	- 5	- 48	- 41½
% Change since Louvre Accord (Feb 87)	- 11	+ 17½	+ ½	- 1	+ 12½	- 19	- 9
% Change since Stock market crash (16 Oct 1987)	- 7½	+ 11½	+ 1½	0	+ 5½	- 13	- 8

TABLE 3C

Economist Commodity Price Indices

1980=100

	All items indices				SDR indices		
Annual	SDR	Dollar	Sterling	Real*	Food	Nfa**	Metals
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
1987	88.8	88.4	125.2	73.7	84.4	98.8	82.1
Quarterly							
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	73.9	82.6	107.1	87.5
Q4	95.3	98.2	130.4	78.2	87.0	99.0	96.8
Monthly							
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	93.6	97.0	127.6		86.5	97.1	93.8
December	97.4	103.4	131.4		87.9	97.9	102.2
January	99.4	105.2	135.8		90.2	98.6	104.4
February (prov)	100.0	104.2	137.7		90.9	101.7	103.4
Weekly							
December 8	96.0	100.4	129.8		88.1	98.3	97.7
15	96.2	102.5	130.1		87.0	97.0	100.5
22	98.3	104.8	133.1		87.6	98.0	105.1
29	99.8	108.0	134.9		87.3	97.1	110.6
January 5	98.9	106.2	134.9		88.5	98.6	105.4
12	99.0	105.2	134.3		89.0	98.0	105.4
19	100.3	104.9	137.1		91.6	99.3	104.8
26	99.4	104.4	136.8		91.7	98.5	102.2
February 2	97.8	102.2	134.1		90.0	101.4	98.5
9	99.1	103.1	137.2		90.5	101.4	101.6
16	101.6	105.8	140.7		91.2	101.8	107.7
23(prov)	101.4	105.5	138.8		91.9	102.3	105.9

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

** Non-food agriculturals.

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TABLE 4a 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	1986	2.9	0.3	3.4	3.6	4.3	-10.8	4.7	5.4
1986-87	6.9	1987	4.8	5.5	4.1	3.7	4.5	5.3	n/a	n/a
1986 2	6.5	1986 1	2.2	- 1.7	4.9	4.6	5.0	-11.9	8.2	6.0
3	6.6	2	2.2	- 1.3	2.8	3.3	4.3	-12.4	6.2	6.2
4	7.0	3	3.5	0.8	2.6	3.3	4.0	-13.0	3.3	4.4
1987 1	7.3	4	3.9	3.8	3.4	3.4	4.0	- 5.6	1.2	5.0
2	8.9	1987 1	4.3	4.4	3.9	3.7	4.1	- 1.7	0.1	3.5
3	10.6	2	4.4	5.1	4.2	3.6	4.5	4.6	0.8	4.1
4	9.8	3	5.1	6.7	4.3	3.6	4.7	12.9	1.0	3.3
1988 1	10.1 *	4	5.2	5.5	4.1	4.0	4.7	6.2	1.3	
1987-88	9.8									
1988-89	7.6									
		1987 March		5.3	4.0	3.8	4.1	0.4	- 0.1**	
		April		4.4	4.2	3.6	4.3	3.0	- 0.4	
		May		5.8	4.1	3.8	4.5	3.4	0.0	
		June		5.1	4.2	3.5	4.5	7.2	0.8	
		July		5.8	4.4	3.7	4.7	13.4	1.2	
		August		8.3	4.4	3.7	4.7	14.5	1.0	
		September		6.3	4.2	3.5	4.7	10.8	0.8	
		October		5.6	4.5	3.9	4.7	7.6	0.6	
		November		5.4	4.1	4.0	4.8	4.8	1.4	
		December		5.6	3.7	4.0	4.9	5.0	2.0	
		1988 January		8.5[1]	3.3	3.7	4.8	4.5		
		February			3.3	3.6	5.0	5.6		

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

* 1988 FSBR forecast

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

*** Excluding food, drink and tobacco.

SA20.040.SS.98A/1

TABLE 4(b) UNDERLYING RETAIL PRICE INFLATION

% change on a year earlier

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

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	1.5	0.8	1.5	-0.2	-0.4
1971-72	1.0	1.6	1.0	1.6	0.7	1.1
1972-73	2.4	3.6	2.4	3.6	2.0	3.0
1973-74	4.3	5.8	4.3	5.8	3.5	4.6
1974-75	8.0	9.0	8.0	9.0	6.0	6.7
1975-76	10.3	9.3	10.3	9.3	8.1	7.3
1976-77	8.3	6.4	8.3	6.4	7.5	5.7
1977-78	5.4	3.6	5.9	3.9	6.6	4.4
1978-79	9.2	5.3	9.2	5.3	8.3	4.8
1979-80	10.0	4.8	10.4	5.0	8.0	3.9
1980-81	12.7	5.4	13.1	5.5	11.7	5.0
1981-82	8.6	3.3	9.1	3.5	5.2	2.0
1982-83	8.8	3.1	9.3	3.3	8.3	2.9
1983-84	9.7	3.2	10.9	3.5	11.5	3.7
1984-85*	10.2	3.1	12.3	3.7	13.1	4.0
1985-86*	5.8	1.6	8.5	2.3	8.2	2.3
1986-87	3.4	0.9	7.8	2.0	9.2	2.4
1987-88	-3.1	-3/4	1.9	1/2	2.8	3/4
Budget forecast 1988-89	-3.1	-3/4	1.8	1/2	1.4	1/4

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

(b) Quarterly Data

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

*financial year - constrained
+calendar year - constrained

90/G/jfw/4555/55

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

	£ billion
Receipts	
Inland Revenue	+ 2.8
Customs and Excise	+ 0.7
National Insurance contributions	+ 0.4
Privatisation proceeds	+ 0.1
Interest and dividends	+ 0.2
Other receipts	+ 0.4
Total receipts	+ 4.7
Expenditure	
Interest payments	- 0.3
Departmental expenditure (1)	- 1.9
Total expenditure	- 2.1
Net effect on CGBR(O)	- 6.8

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

\+ = higher receipts, higher borrowing and higher expenditure

\- = lower receipts, lower borrowing and lower expenditure

TABLE 7

EXCHANGE RATES

		Exchange Rate Index*	Real Exchange Rate @	ERI/(Oil Price Adjusted ERI)/	Dollar: Sterling exchange rate	D-Mark: Sterling exchange rate	Index against EMS currencies*	US-UK Interest rate differential	Brent spot price ($/bl)
1985	(1)	72.1	80.1	0.908	1.12	3.63	95.2	+4.1	27.7
	(2)	78.9	88.9	1.001	1.26	3.88	102.3	+4.4	27.0
	(3)	82.1	93.3	1.040	1.38	3.92	103.8	+3.6	27.4
	(4)	79.8	91.6	1.001	1.44	3.71	98.7	+3.5	28.3
1986	(1)	75.1	88.3	1.037	1.44	3.38	90.9	+4.5	17.8
	(2)	76.1	92.1	1.101	1.51	3.39	91.4	+3.2	12.8
	(3)	71.9	88.2	1.049	1.50	3.10	84.9	+3.8	12.4
	(4)	68.3	84.0	0.970	1.43	2.87	79.0	+5.1	14.8
1987	(1)	69.9	86.9	0.967	1.54	2.83	78.8	+4.3	17.9
	(2)	72.8	90.9	0.996	1.64	2.96	82.6	+2.1	18.6
	(3)	72.7	90.7	0.992	1.62	2.97	83.0	+2.8	19.0
	(4)	74.9	94.0	1.030	1.76	2.99	83.8	+1.2	18.1
1987	February	69.0	85.7	0.960	1.53	2.78	77.4	+4.4	17.2
	March	71.9	89.4	0.991	1.59	2.92	81.2	+3.4	18.0
	April	72.3	90.3	0.994	1.63	2.95	82.1	+2.9	18.2
	May	73.3	91.7	1.002	1.67	2.98	83.1	+1.6	18.8
	June	72.7	89.8	0.991	1.63	2.96	82.6	+2.1	18.9
	July	72.8	90.7	0.985	1.61	2.97	82.9	+2.6	19.8
	August	72.3	90.0	0.988	1.60	2.97	82.8	+3.2	18.9
	September	73.1	91.2	1.004	1.65	2.98	83.2	+2.6	18.3
	October	73.6	92.0	1.006	1.66	2.99	83.5	+1.7	18.8
	November	75.4	94.6	1.040	1.78	2.99	83.9	+1.0	17.8
	December	75.7	95.2	1.045	1.83	2.98	84.0	+0.9	17.7
1988	January	74.8	94.7	1.038	1.78	2.98	83.5	+1.8	16.7
	February	74.3	94.1	1.047	1.75	2.98	83.7	+2.6	15.6
	March 28	77.1	na	1.087	1.85	3.09	87.4	+2.0	15.6

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

* 1975=100

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

TABLE 8 : NOMINAL AND REAL INTEREST RATES

		NOMINAL RATES				REAL RATES			
		Three month interbank	Three month Eurodollar	Base Rate	Long Rate (20 year Gilts)	Expected inflation over 12 months*	Real 3-month interbank rate	Yield on Index-linked Gilts** 1990	2001	2011
1985	(1)	13.0	8.9	12.9	10.9	5.7	6.9	4.4	3.5	3.2
	(2)	12.6	8.2	12.6	10.8	5.6	6.6	4.3	3.8	3.4
	(3)	11.7	8.1	11.7	10.4	5.3	6.1	4.3	3.8	3.5
	(4)	11.6	8.1	11.5	10.3	4.2	7.1	4.1	3.9	3.6
1986	(1)	12.4	7.9	12.3	10.2	3.9	8.2	4.3	4.2	3.8
	(2)	10.2	7.0	10.4	9.0	3.6	6.5	3.6	3.6	3.4
	(3)	10.0	6.2	10.0	9.7	3.4	6.5	3.7	3.9	3.5
	(4)	11.2	6.1	11.0	10.7	4.1	6.8	3.7	4.1	3.8
1987	(1)	10.6	6.3	10.8	9.6	4.3	6.0	3.0	3.7	3.5
	(2)	9.2	7.1	9.4	9.0	3.8	5.2	2.4	3.8	3.6
	(3)	9.9	7.1	9.7	9.8	3.7	6.0	2.6	4.2	3.9
	(4)	9.2	7.8	9.0	9.5	4.0	4.7	2.4	4.1	3.8
1987	January	11.0	6.1	11.0	10.0	4.1	6.6	3.5	4.0	3.7
	February	10.8	6.4	11.0	9.8	4.3	6.2	3.0	3.7	3.5
	March	9.9	6.5	10.4	9.1	4.5	5.2	2.5	3.5	3.4
	April	9.8	6.9	10.0	9.2	4.2	5.4	2.6	3.6	3.4
	May	8.8	7.2	9.1	8.8	3.7	4.9	2.1	3.6	3.6
	June	9.0	7.1	9.0	8.9	3.5	5.3	2.3	3.9	3.7
	July	9.3	6.9	9.0	9.3	3.4	5.7	2.2	4.0	3.8
	August	10.2	7.0	10.0	10.0	3.9	6.1	2.6	4.3	4.0
	September	10.1	7.5	10.0	10.0	4.0	5.9	3.1	4.2	4.0
	October	10.0	8.3	9.5	9.8	4.2	5.6	3.1	4.5	4.3
	November	8.9	7.4	9.0	9.2	3.8	4.9	1.9	4.0	3.3
	December	8.7	7.8	8.5	9.5	3.9	4.6	2.3	3.9	3.9
1988	January	8.9	7.1	8.5	9.6	4.1	4.6	2.3	4.2	4.1
	February	9.3	6.7	9.0	9.4	4.2	4.9	2.2	4.0	3.9
	March 28th	8.8	6.8	8.5	9.2	na	na	2.1	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		0.7	8.9	0.6	4027
1983		-0.6	10.1	-0.7	3308
1984		9.5	11.0	-2.0	1461
1985		6.8	4.1	1.8	2877
1986		2.3	5.8	-0.7	-944
1987		7.3	8.8	+1.1	-2493
1986	Q3	2.9	7.5	-2.4	-874
	Q4	8.6	8.6	-4.9	-818
1987	Q1	10.0	3.8	-1.3	496
	Q2	6.0	9.2	+1.9	-594
	Q3	8.9	11.5	+1.2	-1207
	Q4	4.7	9.7	+3.0	-1188
1987	Jan	6.5	4.5	-2.7	-28
	Feb	16.3	6.0	-2.0	329
	Mar	7.1	0.7	+0.6	195
	April	9.8	9.6	+1.7	110
	May	5.3	1[illegible].8	-0.1	-485
	June	4.3	5.1	+2.0	-219
	July	7.6	10.6	+0.2	-357
	Aug	8.7	13.4	+0.6	-790
	Sep	10.8	10.5	+3.2	-61
	Oct	4.0	10.7	+1.8	-322
	Nov	3.6	7.4	+3.5	-456
	Dec	6.4	11.1	+3.8	-410
1988	Jan	3.3	19.0	+5.2	-844
	Feb	-8.0	11.0	+3.9	-720

* excluding oil and erratics.

tables
25CurAcc

TABLE 10

Key Monetary Indicators

	1986-87						1987-88						
	Feb	Mar	April	May	June	July	Aug	Sept	Oct	Nov	Dec	Jan	Feb
MONETARY AGGREGATES													
12 month % change (ua)													
MO	4.1	3.5	5.3	4.4	4.2	5.3	4.5	5.2	5.5	4.9	4.2	4.8	5.3
M3	18.9	20.4	20.4	18.9	19.1	20.9	22.1	19.5	22.4	21.4	22.8	22.4	20.4
M4	13.9	13.9	14.6	13.7	13.8	14.9	15.6	14.9	15.7	15.2	16.3	16.6	16.0
M5	13.3	13.5	14.1	13.4	13.5	14.4	14.9	14.4	15.2	14.7	15.8	16.3	15.5
STERLING LENDING													
12 month % change (ua)													
Banks	21.7	20.7	21.4	21.7	21.5	22.2	21.6	23.5	22.9	22.5	22.8	24.7	24.3
Banks and building societies	19.8	19.1	19.5	19.4	19.3	19.5	18.8	20.0	19.3	19.0	18.8	20.0	19.9
OVER(-)/UNDER (+) FUNDING													
financial year to date:£mm	-3,969	395	3,216	5,162	2,373	1,916	2,221	2,021	3,796	1,187	2,422	-4131	-5693
MONEY MARKET ASSISTANCE/													
Level outstanding £mn	14,873	9,742	6,126	3,340	5,132	7,078	6,114	5,421	5,403	7,073	7,221	12507	13425
INTEREST RATES													
3 months*	10.8	9.9	9.8	8.8	9.0	9.3	10.2	10.1	10.0	8.9	8.7	8.9	9.3
20 yearϕ	9.8	9.1	9.2	8.8	8.9	9.3	10.0	10.0	9.8	9.2	9.5	9.6	9.4
EFFECTIVE EXCHANGE RATE	69.0	71.9	72.3	73.3	72.7	72.8	72.3	73.1	73.6	75.4	75.7	74.8	74.3

* Inter bank

ϕ par yield

/ banking months until August thereafter end calendar months

TABLE 11

£ million

GROWTH RATES OF MONETARY AGGREGATES

			1987 MAY	JUNE	JULY	AUG	SEP	OCT	NOV	DEC	1988 JAN	FEB
M0 -	Monthly change	sa	68	24	189	39	120	99	49	139	-46	-18
	Monthly % change	nsa	0.3	-0.6	2.8	0.1	0.1	-0.2	0.3	7.0	-6.0	-1.0
	Monthly % change	sa	0.4	0.2	1.2	0.3	0.8	0.6	0.3	0.9	-0.3	-0.1
	6-month annualised % change	sa	2.9	0.2	4	6.2	7	7.3	7	8.5	5.3	4.5
	Annual % change	sa	4.4	4.2	5.4	4.7	4.9	5.6	4.9	4.3	4.6	5.3
M3 -	Monthly change	sa	2331	2304	3116	2323	2479	6468	- 50	2532	915	717
	Monthly % change	nsa	2.0	1.1	2.6	1.3	1.0	3.3	0.7	1.4	-1.2	0.3
	Monthly % change	sa	1.4	1.4	2.2	1.4	1.4	3.7	0.0	1.4	0.5	0.4
	6-month annualised % change	sa	21.8	24	26.4	25.1	21.9	25.5	22	22	17.9	15.6
	Annual % change	sa	18.6	18.9	20.9	21.8	19.9	23.1	21.9	23.0	22.1	20.3
M4 -	Monthly change	sa	2550	4050	4419	3792	3458	6570	879	3830	791	2882
	Monthly % change	nsa	1.3	1.4	1.9	0.9	1.0	1.9	0.5	1.6	0.1	0.4
	Monthly % change	sa	0.9	1.5	1.6	1.3	1.2	2.2	0.3	1.3	0.3	0.9
	6-month annualised % change	sa	13.6	15.7	18.8	18.4	17.2	18.9	17.4	17	14	13.1
	Annual % change	sa	13.7	13.8	14.9	15.6	14.9	15.8	15.2	16.3	16.6	16.0
M5 -	Monthly change	sa	3464	4286	4331	3847	3535	6565	911	4080	1002	2682
	Monthly % change	nsa	1.4	1.4	1.9	0.9	1.0	1.8	0.5	1.7	0.0	0.3
	Monthly % change	sa	1.2	1.5	1.5	1.3	1.2	2.1	0.3	1.3	0.3	0.8
	6-month annualised % change	sa	13.2	15.2	18.5	17.9	17	18.8	16.7	16.3	13.7	12.7
	Annual % change	sa	13.4	13.5	14.4	14.9	14.4	15.2	14.7	15.8	16.3	15.5
NIBM1 -	Monthly change	sa	881	1770	119	163	312	1498	-987	-73	1480	417
	Monthly % change	nsa	2.8	3.4	0.2	-0.2	0.9	0.4	1.1	0.9	-3.3	1.4
	Monthly % change	sa	2.2	4.2	0.3	0.4	0.7	3.4	-2.2	-0.2	3.3	0.9
	6-month annualised % change	sa	8.5	16	10.3	10.2	13.7	24.5	14.2	4.8	11.3	12.5
	Annual % change	sa	13.4	13.4	12.3	12.2	6.0	11.8	10.6	10.5	11.8	12.0
M1 -	Monthly change	sa	2950	2092	1087	1099	1571	2861	524	-250	-1107	-424
	Monthly % change	nsa	3.7	2.5	1.3	1.3	1.8	3.2	0.6	-0.3	-1.2	-0.5
	Monthly % change	sa	3.4	2.8	1.3	1.6	1.6	4.8	-1.0	-1.0	2.2	-0.6
	6-month annualised % change	sa	20	30.4	24.4	28.2	23	35.9	24.7	15.6	17.5	12.5
	Annual % change	sa	23.5	23.6	22.6	23.7	20.3	24.7	21.7	22.7	21.7	20.5
WIDER £	Monthly change	sa	4992	500	5295	1467	1778	7758	23	3520	485	170
AGGREGATE	Monthly % change	nsa	2.6	0.3	2.7	0.7	0.9	3.8	0.0	1.7	0.2	0.1
	Monthly % change	sa	2.2	0.5	2.4	0.8	1.3	4.2	-0.6	1.6	1.7	0.2
	6-month annualised % change	sa	23.3	22.1	23.4	21.8	20.2	25.0	18.3	21.1	19.3	17.8
	Annual % change	sa					18.5	22.3	20.4	21.5	21.6	19.9

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	14.5	9.7	9.3
12 MONTH % CHANGES (ua except M0)					
1987 FEBRUARY	3.7	0.4	14.7	9.8	9.3
MARCH	3.8	0.3	14.5	9.7	9.3
APRIL	3.6	1.2	16.2	10.6	10.1
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	10.3
AUGUST	3.7	1.0	17.7	11.5	10.8
SEPTEMBER	3.5	1.4	15.5	11.0	10.5
OCTOBER	3.9	1.6	17.8	11.5	10.9
NOVEMBER	4.0	0.9	16.7	10.8	10.3
DECEMBER	4.0	0.3	18.1	11.8	11.3
1988 JANUARY	3.7	0.9	18.0	12.4	12.2
FEBRUARY	3.6	1.6	16.2	12.0	11.5

TABLE 13

CONFIDENTIAL

M0 : THE WIDE MONETARY BASE

Monthly data	Level £ million (Change in brackets)						Percentage change previous month		Percentage change on previous year				6 month % growth annualised	
	Notes and Coin (nsa)	Notes and Coin (sa)		Bankers' Deposits	M0 (nsa)	M0 (sa)		Notes(sa) and Coin	M0 (sa)	Notes and Coin (nsa)	Notes and Coin (sa)	M0 (nsa)	M0 (sa)	Notes & Coin (sa)	M0 (sa)
1987 July	15271	15166	(91)	235	15506	15401	(190)	0.6	1.2	4.7	4.7	5.3	5.4	3.0	4.0
August	15337	15258	(92)	182	15519	15440	(39)	0.6	0.3	4.3	4.6	4.5	4.7	6.0	6.2
September	15349	15376	(118)	185	15534	15561	(121)	0.8	0.8	5.3	5.0	5.2	4.9	7.8	7.0
October	15299	15456	(80)	203	15501	15659	(98)	0.5	0.6	5.1	5.2	5.5	5.6	7.4	7.3
November	15365	15525	(69)	183	15548	15707	(48)	0.4	0.3	4.8	4.8	4.9	4.9	7.4	7.0
December	16447	15661	(136)	186	16633	15846	(139)	0.9	0.9	4.7	4.8	4.2	4.3	7.9	8.5
1988 January	15458	15620	(-41)	181	15638	15801	(-45)	-0.3	-0.3	4.7	4.5	4.8	4.6	6.1	5.3
February	15352	15658	(38)	122	15474	15780	(-21)	0.2	-0.1	5.7	5.7	5.3	5.3	5.3	4.5
March (4/5)	15475	15730	(72)	156	15631	15886	(106)	0.5	0.7	6.2	6.2	5.6	5.6	4.7	4.2

	Level £ million (Change in brackets)			Percentage change on previous week
	Notes(sa) and Coin	Bankers' Deposits	M0 (sa)	M0 (sa)
February				
3rd	15629 (-11)	45	15674 (-109)	-0.7
10th	15661 (32)	174	15835 (161)	1.0
17th	15676 (15)	142	15818 (-17)	-0.1
24th	15667 (-9)	126	15793 (-25)	-0.2
March				
2nd	15677 (10)	96	15773 (-20)	-0.1
9th	15726 (49)	237	15963 (190)	1.2
16th	15733 (7)	131	15864 (-99)	-0.6
23rd	15783 (50)	159	15942 (78)	0.5

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

TABLE 14

SECRET

BUILDING SOCIETY BALANCE SHEET FLOWS

Unadjusted £ million

	Total Flow	ASSETS			LIABILITIES			
		Net Mortgage Advances & Unsecured Lending	Liquid Assets	Fixed Assets	Retail principal	Interest credited	Wholesale funds	Other (eg reserves)
1985 *	1497	1226	244 (18.0)	27	621	497	205	174
1986 *	1593	1589	-19 (16.4)	23	553	508	498	34
1987 *	1626	1235	343 (16.9)	48	634	570	281	141
1986 Q1*	953	1271	-341 (17.5)	23	740	461	167	-415
Q2*	1518	1645	-150 (16.6)	23	478	521	321	198
Q3*	1740	1884	-165 (15.7)	21	56	402	1099	183
Q4*	2160	1556	581 (16.4)	23	938	647	403	172
1987 Q1*	1324	1120	126 (16.1)	78	484	523	279	38
Q2*	1573	1240	313 (16.2)	20	612	457	182	322
Q3*	1516	1272	200 (16.1)	44	410	515	364	227
Q4*	2090	1306	734 (16.9)	50	1028	785	299	-22
1988 Jan	1152	1526	-424 (16.5)	50	890	927	68	-733
Feb	1743	1297	396 (16.6)	50	1094	94	102	453
Forecast								
1988 Q1*	1488	1518	-80 (16.6)	50	846	470	223	-51
Mar	1570	1732	-212 (16.3)	50	555	388	500	127

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

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)					
1987 MARCH	-2.4	16.9	17.4	25.4	18.9
APRIL	6.2	14.5	17.1	27.9	20.4
MAY	3.3	16.4	19.0	23.1	18.9
JUNE	3.6	18.0	15.4	25.1	19.1
JULY	6.0	15.3	12.1	32.4	20.9
AUGUST	4.0	16.4	15.1	32.8	22.1
SEPTEMBER	5.7	6.1	14.2	32.0	19.5
OCTOBER	4.5	15.4	12.4	35.2	22.4
NOVEMBER	1.3	15.1	13.0	33.5	21.4
DECEMBER	5.8	12.8	10.1	38.5	22.8
1988 JANUARY	5.1	15.2	10.7	35.9	22.4
FEBRUARY	2.5	16.6	11.1	30.9	20.4
Over 6 months (sa)					
1987 SEPTEMBER	8.7	16.0	12.7	32.5	21.9
OCTOBER	6.8	33.3	11.7	34.5	25.5
NOVEMBER	7.0	17.6	13.2	31.5	22.0
DECEMBER	11.3	2.1	7.9	40.9	22.0
1988 JANUARY	7.6	12.9	9.0	26.8	17.9
FEBRUARY	6.4	15.1	8.0	21.8	15.6
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 SEPTEMBER	1	311	434	1753	2499
OCTOBER	253	1245	170	4800	6468
NOVEMBER	-71	-916	600	337	-50
DECEMBER	217	-290	-630	3235	2532
1988 JANUARY	83	1397	927	-1492	915
FEBRUARY	-69	486	343	-43	717

[1] March on March

TABLE 16 SECRET

THE COMPONENTS OF M4 AND M5

		BUILDING SOCIETIES					
	M3	RETAIL[1]	WHOLESALE	HOLDINGS OF M3	M4	MONEY MARKET INSTRUMENTS	M5
% CHANGES							
Financial years (ua)							
1984-85[3]	11.5	15.1				13.8	13.8
1985-86[3]	16.7	15.3	52.6	94	-0.1	13.5	14.5
1986-87[3]	19.1	10.8	11.4	50	-15.6	13.5	12.9
Over 12 months (ua)							
1987 MARCH	18.9	17.2		52.2	13.9	5.3	13.5
APRIL	20.4	16.1		50.3	14.6	5.0	14.1
MAY	18.9	17.9		54.7	13.7	8.9	13.4
JUNE	19.1	16.4		63.7	13.8	8.4	13.5
JULY	20.9	13.4		64.2	14.9	5.3	14.4
AUGUST	22.1	15.6		63.2	15.6	4.5	14.9
SEPTEMBER	19.5	10.8		58.1	14.9	5.5	14.4
OCTOBER	22.4	13.6		58.3	15.8	5.8	15.2
NOVEMBER	21.4	13.8		66.0	15.2	5.3	14.7
DECEMBER	22.8	11.2		63.2	16.3	8.1	15.8
1988 JANUARY	22.4	12.4		57.0	16.6	10.8	16.3
FEBRUARY	20.4	13.2		47.8	16.0	7.5	15.5
Over 6 months (sa)							
1987 SEPTEMBER	21.9	10.8		25.2	17.2	13.0	17.0
OCTOBER	25.5	9.7		23.4	18.9	17.9	18.8
NOVEMBER	22.0	11.6		21.0	17.4	4.2	16.7
DECEMBER	22.0	11.2		31.3	17.0	4.3	16.3
1988 JANUARY	17.9	11.3		39.5	14.0	8.5	13.7
FEBRUARY	15.6	11.4		31.9	13.1	4.9	12.7
£ MILLION CHANGES							
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 SEPTEMBER	2499	295	457	207	3458	77	3535
OCTOBER	6468	720	0	-618	6570	-5	6565
NOVEMBER	-50	2080	-355	-796	879	32	911
DECEMBER	2532	1221	325	-248	3830	250	4080
1988 JANUARY	915	1124	50	-1298	791	211	1002
FEBRUARY	717	1557	12	596	2882	-200	2682

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

TABLE 17

RETAIL DEPOSITS

	BANKS	BUILDING SOCIETIES[1]	NATIONAL SAVINGS[2]	TOTAL
% CHANGES				
Financial years (ua)				
1984-85[3]	7.1	15.1	11.9	12.0
1985-86[3]	11.6	15.3	7.5	12.9
1986-87[3]	17.2	10.8	10.8	12.7
Over 12 months (ua)				
1987 MARCH	17.2	10.5	10.8	12.6
APRIL	16.1	10.3	11.0	12.2
MAY	17.9	10.2	10.8	12.6
JUNE	16.4	10.3	10.5	12.2
JULY	13.4	10.2	9.2	11.1
AUGUST	15.6	10.4	9.7	11.9
SEPTEMBER	10.8	11.4	9.3	10.7
OCTOBER	13.6	10.2	8.2	10.9
NOVEMBER	13.8	11.1	7.4	11.3
DECEMBER	11.2	11.6	7.2	10.5
1988 JANUARY	12.4	12.1	6.7	10.9
FEBRUARY	13.2	12.6	6.2	11.2
Over 6 months (sa)				
1987 SEPTEMBER	14	10.8	6.8	11.3
OCTOBER	19.8	9.7	5.3	10.7
NOVEMBER	14.9	11.6	4.4	10.8
DECEMBER	5.6	11.2	4	8.3
1988 JANUARY	10.5	11.3	4.5	8.2
FEBRUARY	10.8	11.4	4.3	9.3
£ 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 SEPTEMBER	745	295	83	1123
OCTOBER	1415	720	-62	2073
NOVEMBER	-316	2080	69	1833
DECEMBER	-920	1221	262	563
1988 JANUARY	2324	1124	296	3744
FEBRUARY	829	1557	207	2593

NOTES

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

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							
1987	February	2618	-426	69	345	2606	2705
	March	4643	-2026	339	420	3376	2472
	April	1726	-409	210	-398	1129	2201
	May	3622	-2125	295	497	2289	2503
	June	5144	751	3	-1206	4692	3989
	July	2133	1680	-59	890	4644	4531
	August	2841	-1518	117	-288	1152	2651
	September	5456	12	-20	66	5514	4324
	October	2512	-417	141	823	3059	3018
	November	2316	819	237	-56	3316	3289
	December	3944	1544	121	-155	5454	4986
1988	January	2537	2485	-220	250	5052	5549
	February	2107	393	-32	58	2526	2621

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

SECRET

FUNDING : FINANCIAL YEAR POSITION 1987/88 30/3/88

£ million

	FORECAST	OUTTURN	RESIDUAL	
	Financial Year 87/88	April 87 - Feb 88	March 88	
PSBR AND FUNDING TARGET				
1 PSBR excl asset sales	1770	-2321	4091	
2 Asset sales (sales-)	-5070	-5078	8	
3 PSBR	-3300	-7399	4099	
FINANCED BY:				
4 OPS debt sales to nbps (sales-)	819	1294	-475	
5 National Savings (sales-)	-2000	-1837	-163	* -163
6 CTDs (sales-)	66	41	25	
7 Treasury bills etc (sales-)	-73	-73	0	
8 Intervention (reserves inc+)	11405	10030	1375	
9 Public sector externals excl intervention and gilts (inc-)	464	464	0	
10 NET GILT SALES TO NBPS & OVERSEAS NEEDED FOR FULL FUND (sales+)	7381	2520		
11 Adjustment for 1986/87 underfund	318			
12 OVER(-)/UNDER(+)FUNDING	-318	-5693	5375	
GILT SALES:				
13 Net purchases by nbps and overseas (purchases+)	7699	8213	-514	
14 Net purchases by monetary and other public sector (purchases+)	-432	-532	100	
15 Maturities	6800	5460	1340	
16 GROSS OFFICIAL SALES	14067	13141	926	
MARCH GROSS GILT SALES TO DATE			307	
EXPECTED UNDERFUND 1987/88			619	
17 Monthly average gross gilt sales	1172	1195		

* average per month

Relationship between lines:

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

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	0	471	209	350	1030	12328	2362	14690
Q2	5465	5083	10548	0	1369	344	325	2038	12586	1575	14161
Q3	5764	5592	11356	69	1431	290	231	2021	13377	3688	17065
Q4	10433	4667	15100	65	2338	-52	281	2632	17732	591	18323
1987											
Q1	7062	3619	10681	368	1553	-782	1231	2370	13051	7158	20209
Q2	8626	4240	12866	651	2259	352	655	3917	16783	4679	21462
Q3	10913	3889	14802	298	5950	732	570	7550	22352	-1196	21156
Q4	10925	3746	14671	-89	3730	343	105	4089	18760	-126	18634
Average per quarter											
1984	3936	3643	7579	0	282	63	84	429	8007	1226	9234
1985	5051	3682	8733	0	854	215	199	1267	10000	1185	11185
1986	7273	4802	12076	34	1402	198	297	1930	14006	2054	16060
1987	9382	3874	13255	307	3373	161	640	4482	17737	2629	20365
1987											
JANUARY	1392	1459	2851	150	500	-67	110	693	3544	1375	4919
FEBRUARY	2604	980	3584	104	870	20	315	1309	4893	2402	7295
MARCH	3066	1180	4246	114	183	-735	806	368	4614	3381	7995
APRIL	1269	1590	2859	192	828	110	355	1485	4344	1238	5582
MAY	2259	1295	3554	171	415	184	150	920	4474	2686	7160
JUNE	5098	1355	6453	288	1016	58	150	1512	7965	755	8720
JULY	4448	1302	5750	131	1840	182	210	2363	8113	-2233	5880
AUGUST	1041	1269	2310	9	2090	390	150	2639	4949	1019	5968
SEPTEMBER	5424	1318	6742	158	2020	160	210	2548	9290	18	9308
OCTOBER	2574	1510	4084	165	2535	195	45	2940	7024	3459	10483
NOVEMBER	3236	1266	4502	-16	975	55	60	1074	5576	-1528	4048
DECEMBER	5115	970	6085	-238	225	173	0	160	6245	-2057	4188
1988											
JANUARY	4890	1466	6356	212	48	41	450	751	7107	794	7901
FEBRUARY	2573	1385	3958	339	150	100	355	944	4902	-973	3929

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

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

	BANK BORROWING				OTHER BORROWING						ALL BORROWING
	Sterling		Foreign		Sterling			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	-352	3040		924	170	235	0	1329	4369
Q2	747	248	207	1202		1092	327	230	0	1649	2851
Q3	229	161	1371	1761		873	274	130	600	1877	3638
Q4	874	343	1377	2594		525	89	200	475	1289	3883
1986											
Q1	3807	346	108	4261	0	471	209	350	935	1965	6226
Q2	-356	442	108	194	0	1369	344	325	1075	3113	3307
Q3	28	1800	1128	2956	69	1431	290	231	1575	3596	6552
Q4	5275	390	-59	5606	65	2338	-52	281	2632	5264	10870
1987											
Q1	1047	353	2102	3502	368	1553	-782	1231	290	2660	6162
Q2	662	-508	739	893	651	2259	352	655	50	3967	4860
Q3	3513	364	-90	3787	284	5950	732	570	100	7636	11423
Q4	5305	769	718	6792	-168	3735	423	105	0	4095	10887
Average per quarter											
1984	1749	200	68	2016	0	282	63	84	0	429	2445
1985	1309	190	651	2149	0	854	215	199	269	1536	3685
1986	2189	745	321	3254	34	1402	198	297	1554	3485	6739
1987	2632	245	867	3744	284	3374	181	640	147	4626	8370
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					158	2020	160	210	100	2634	
OCTOBER					165	2535	195	45	0	2897	
NOVEMBER					-16	975	55	60	0	1047	
DECEMBER					-238	225	173	0	0	151	
1988:- JANUARY					212	48	41	450	50	801	
FEBRUARY					339	150	100	355	150	1094	

* 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' figure

91.G.LCLD.4515.006

TAB 23

CONFIDENTIAL

M0 FORECAST, 1988-89

Seasonally adjusted

	Levels (£ million)		12 month growth rate (%)		6 month growth rate (annualised)	
	Notes and Coin	M0	Notes and Coin	M0	Notes and Coin	M0
Actual						
1988 January	15 620	15 801	4.5	4.6	6.1	5.3
February	15 659	15 783	5.7	5.3	5.3	4.5
Forecast						
March	15 760	15 920	6.4	5.8	5.1	4.7
April	15 800	15 990	5.9	5.8	4.5	4.3
May	15 830	16 020	5.6	5.5	4.0	4.0
June	15 850	16 040	5.1	5.4	2.4	2.5
July	15 870	16 060	4.6	4.3	3.2	3.3
August	15 890	16 080	4.1	4.1	3.0	3.8
September	15 910	16 100	3.5	3.5	1.9	2.3
October	15 930	16 120	3.1	2.9	1.7	1.6
November	15 960	16 150	2.8	2.8	1.6	1.6
December	16 000	16 190	2.2	2.2	1.9	1.9
1989 January	16 000	16 190	2.4	2.5	1.6	1.6
February	16 030	16 220	2.4	2.8	1.8	1.7
March	16 060	16 250	1.9	2.1	1.9	1.9

Table 24

Broad Money forcast

		OUTTURN 1988 FEBRUARY		FORECAST MARCH	
		M3	M4	M3	M4
(i)	Underlying increase	2320	2732	2850	3600
(ii)	Estimated Special Factors	- 1800	- 1500	5625	6000
	Arbitrage: bills against deposits	- 250	- 250	- 350	- 350
	Over(-)/Under(+)funding	- 1550	- 1500	5975	6100
	Liquidity rundown to replace equity issues	- 250	- 250	- 250	- 250
	Low unit trust inflows	250	500	250	500
(iii)	Total Increase	520	1232	8475	9600
	Monthly % change	0.3	0.4	4.6	3.1
	Annual % change	20.4	16.0	20.6	16.7
	Annual % change expected at Budget time	15.7	15.4	13.5	14.2

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

91/G.LCLD.4501.062

Table 25

Lending forecasts

		OUTTURN 1988 FEBRUARY			FORECAST MARCH		
		Bank lending	B Soc lending	M4 Counterpart	Bank lending	B Soc lending	M4 Counterpar
(i)	Underlying increase (sa)	2921	1420	4388	3475	1550	4775
(ii)	Estimated Special factors	- 300	150	- 150	- 1150	150	- 1000
	Arbitrage: bills against deposits	- 250	-	- 250	- 350		- 350
	bills against foreign currencies	- 250	-	- 250	- 350		- 350
	PSBR offset	-	-	-	- 350	-	- 350
	Bill leak	100	-	100	- 200	-	- 200
	Bank borrowing to replace equity issues	250	-	250	250	-	250
	Bank/building society competition	- 150	150	-	- 150	150	-
(iii)	Lending increase (sa)	2621	1570	4238	2325	1700	3775
	Lending increase (nsa)	2526	1385	3958	3450	1725	4925
	Annual % change (nsa)	24.3	13.3	19.9	23.9	13.6	19.8
	Annual % change expected at Budget time	18.5	16.3	17.0	18.4	16.6	17.3

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

TABLE 26 : BROAD AGGREGATES COUNTERPARTS AND FORECAST £ million

OUTTURN: FEBRUARY 1988	M3	M4
PSBR	-483	-483
LA and PC debt sales to NBPS (-)	111	253
CG debt sales to NBPS (-)	-833	-911
o/w Gilts	(-779)	(-925)
Treasury bills etc	(-21)	(-26)
National Savings	(-200)	(-200)
CTDs	(167)	(240)
Public sector external & fc finance (-)	-357	-357
OVER(-)/UNDER(+)FUNDING	-1562	-1498
Sterling lending to private sector	2526	3958
(seasonally adjusted)	(2621)	(4238)
Banks'/B socs' externals	-489	-536
Banks'/B socs' £NNDLs	45	-692
TOTAL	520	1232
Monthly % growth nsa	0.3	0.4
sa	0.4	0.9
Annual % growth nsa	20.4	16.0

FORECAST: MARCH 1988	M3	M4
PSBR	4100	4100
LA and PC debt sales to NBPS (-)	-475	-300
CG debt sales to NBPS (-)	775	725
o/w Gilts	(925)	(925)
Treasury bills etc	(0)	(0)
National Savings	(-175)	(-175)
CTDs	(25)	(-25)
Public sector external & fc finance (-)	1575	1575
OVER(-)/UNDER(+)FUNDING	5975	6100
Sterling lending to private sector	3450	4925
(seasonally adjusted)	(2325)	(3775)
Banks'/B socs' externals & £NNDLs	-950	-1425
TOTAL	8475	9600
Monthly % growth nsa	4.6	3.1
sa	2.9	2.2
Annual % growth nsa	20.6	16.7
Memo: building societies'		
Retail inflows		550
Interest credited		250
Wholesale inflows from NBPS		200
Holdings of M3 (-)		100

TABLE 27: MONEY MARKET ASSISTANCE £ million

	Outturn 1988 FEB	Forecast MAR	APR	MAY
A. Money market influences				
(i) CGBR excl bank deposits (+)	169	3575	-875	525
(ii) Reserves etc (+)	-106	1100	-100	-100
(iii) Notes and coin (-)	272	-925	250	50
(iv) National Savings (-)	-280	-175	-200	-200
(v) CTDs (-)	164	25	50	50
(vi) Gilts (-)	-1031	1025	-50	300
(vii) Other Exchequer items etc	187			
A. TOTAL MONEY MARKET INFLUENCES (Market surplus + / shortage -	-643	4625	-925	625
B. Money market operations				
(i) Commercial bills (purchase +):				
Issue Department - outrig	953			
- repo t	0			
Banking Department	35			
(ii) LA bills (purchase +)				
Issue Department	41			
Banking Department	6			
(iii) Treasury bills (purchase +)	-156			
(iv) Market advances	-117			
(v) Treasury bill Repos	0			
(vi) Export Credit/Shipbuilding	0			
(vii) Gilt Repos	0			
B. TOTAL MONEY MARKET OPERATIONS	762	-4625	925	-625
C. Change in bankers balances = A + B	120			
D. TOTAL ASSISTANCE OUTSTANDING	13425	8800	9725	9100
of which commercial bills	11720			

TABLE 28

SECRET

GOVERNMENT SHARE SALES TIMING

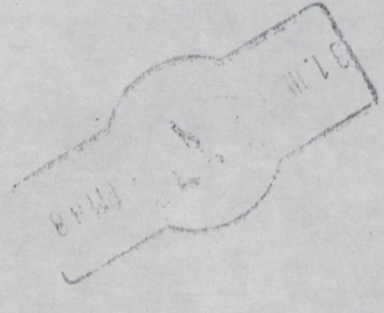
1988

Gas debt	11 April
BGC III	19 April
BT Prefs	10 May
BAA II	19 May
BP II	30 August

1989

BP III	27 April

In addition, the timing of the British Steel privatisation remains to be decided. We are currently looking at the choice between target dates in the period October 1988 - January 1989. We expect payment in two instalments, with the second instalment being in 1989-90.



SECRET

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

17 March 1988

SUBJECT cc MASTER

INTEREST RATES

It may be helpful if I record that, when they met at 0900 this morning, the Prime Minister agreed to the Chancellor's proposal that the Bank should signal a half per cent interest rate reduction at 0945 am.

Paul Gray

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

SECRET

90/G/jfw/4561/024

10

SECRET AND PERSONAL

Prime Minister
Welcome signs of some moderation in growth.
RAB 10/3

FROM: MS V F BRONK
DATE: 10 March 1988

1. MR GRICE

2. CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Peretz
Miss O'Mara
Mr Pike
Mrs Ryding
Mr Holgate
Mr Gray No 10

MS

There seems little doubt that the unwinding of arbitrage and round-tripping from December and January is partly responsible for the much lower broad money and bank lending growth. Even so, they are both well below what we expected. JWG 10.3.88

MONEY SUPPLY IN FEBRUARY: "FIRST GUESS" FOR M3 AND OUTTURN FOR M0

(All figures are unadjusted unless specified otherwise)

Table 1 summarises the Bank's "first guess" at the M3 figures for February, which are still subject to significant revision, and shows the confirmed outturn figures for M0 that were circulated on 25 February.

Table 1: Growth of Monetary Aggregates in February

per cent

	M0	M3**
Annual growth rate*	5.3 (5.3)	19.3 to 20.3
Change in month*	-1.0 (-0.1)	-0.6 to 0.2 (-0.5 to 0.3)
Target range	2-6	-

* Figures in brackets are seasonally adjusted

** The actual outturn has been within the range forecast on this basis in 14 of the last 16 months.

2. The low outturn for M3 suggested by these figures probably reflects unwinding of arbitrage undertaken in December and January.

3. The increase in sterling bank lending in February is likely to be in the range £1.3-3.3 billion (£1.4-3.4 billion seasonally

adjusted). This shows some slackening from recent rates and probably also reflects unwinding of arbitrage and round-tripping in December and January.

M3 components and counterparts

3. Table 2 (attached) compares the changes in M3 components 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

4. We expect to receive provisional February figures on Thursday 17 March. They will be published on Friday 18 March. Full money and banking figures for February will appear on Tuesday 29 March.

Vyvien Bronk

V F BRONK

90/G/jfw/4561/025

SECRET AND PERSONAL

TABLE 2: M3 COMPONENTS - FEBRUARY 1987

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

£ millions

	First Guess	**Average monthly change in year to January**
Notes and coins in circulation	- 271	60
Non-interest bearing sight	822	330
Interest bearing sight	-1079	960
Time deposits (including (CDs)	207	1450
Change in M3	- 321	2800

SECRET AND PERSONAL

TABLE 3 : M3 COUNTERPARTS - FEBRUARY 1988

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

£ millions

	First Guess		Average change in year to January	
CGBR (O) (ex bank deposits)		-256		-310
Other public sector:				
LABR)				
PCBR)		12		110
OPS debt sales)				
		------		------
Modified PSBR*		-244		-200
CG debt: Gilts	-685		-80	
Treasury bills	10		-20	
National Savings	-284		-190	
CTD's etc.	168		20	
		------		------
Total CG debt sales (-)		-791		-270
External and fc finance of public sector (-)		-365		480
		------		------
Wide over(-)/under(+)funding		-1400		10
		------		------
Sterling lending to nbps (incl Issue Dept commercial bills)		1406 #		3510
Net private externals **)				
)		-327		-720
Residual (includes NNDLS **)				
and reporting differences))				
		------		------
Change in M3		-321		2800
		------		------
(Monthly percentage change)		(-0.2%)		(1.7%)
(12 month percentage change)		(19.8%)		(20.6%)

---

* Modified PSBR equals PSBR less OPS debt sales

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

£1501 million after seasonal adjustment.

SUBJECT cc MASTER

SECRET AND PERSONAL

file LOSAKP

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

4 March 1988

MARKET MANAGEMENT

It may be helpful if I record the outcome of the two discussions the Prime Minister and the Chancellor had this afternoon.

When they met at 1400 the Prime Minister expressed her deep concern about the continuing heavy level of exchange market intervention, which had now totalled some $1.8 billion in the last 48 hours. She was concerned that this was adding to the inflationary pressures in the economy and she felt that the market perception that the authorities were seeking to hold the rate at DM3 was acting as a magnet and encouraging further pressure on it. In response, the Chancellor said that there would be no difficulty in sterilising the addition to liquidity through funding policy, and he was most reluctant to give up the benefits obtained from the recent period of exchange rate stability, particularly in the immediate run-up to the Budget. But he accepted that intervention at the rate of the last 48 hours could not be allowed to continue indefinitely.

At the end of this first meeting it was agreed that the Chancellor would consider the position further, in consultation with the Bank of England, and would report back to the Prime Minister later in the day on whether the DM3 "cap" should be removed and, if so, when.

When they met again at 1630 the Chancellor said that, in the light of developments over the last couple of days, it might no longer be possible to hold the exchange rate below DM3 until the Budget as he had originally hoped. After consulting the Bank of England he had concluded that further intervention should be undertaken today, if necessary, in the London and New York markets to hold the rate below DM3; it would be unwise for the "cap" to be seen to have been removed immediately before the weekend. However, if on Monday morning there was still strong demand for sterling he accepted that the rate should be allowed to go above DM3. The Prime Minister said she was content to proceed on this basis.

SECRET AND PERSONAL

In further discussion, the Chancellor said he thought it essential to be prepared to undertake some further intervention to break the speed with which the exchange rate might rise. The Prime Minister expressed concern about this, and said her strong preference would be to allow time for the rate to find its own level without any intervention. Following further exchanges, it was agreed that some limited intervention (the Prime Minister mentioned a figure of up to $50 million) to smooth market movements should not be ruled out. But the position would need to be very closely monitored on Monday with regular contacts at least every half hour between this office and your office. Depending on developments, it might be necessary to arrange a further meeting to review the position at short notice.

PAUL GRAY

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

SECRET

PRIME MINISTER

OVERNIGHT MARKET REPORT

I gather there was a further intervention of about $300 million overnight in New York, all in DM. This brings total intervention in the last two days to about $1 billion.

At the opening in London this morning sterling is still close to DM3, although at the moment (0840) there is marginal headroom.*

I gather from the Chancellor's Office that he feels strongly he cannot make an exchange rate policy change so near to the Budget. He is of course in a trap entirely of his own making, but it is true that if sterling was allowed to rise above DM3 it would be interpreted as a substantial policy shift.

The case for your talking to the Chancellor today is perhaps finely balanced. I gather he plans to be around until about 2pm. Do you want us to arrange a talk for around lunchtime when you have the NATO statement out of the way?

* now disappeared!

Yes pse.

Paul Gray
4 March 1988

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SECRET

RA

SECRET

Prime Minister

3 March 1988

Intervention and the Markets

I believe the time is now right to uncap the DM/£ exchange rate.

The argument is as follows:

1. The scale of current intervention (£1bn in two days) shows that the authorities are under enormous pressure.

2. The current strength of sterling is a reflection of two factors: a government fiscal position which is enviable, and interest rate yields which are very high.

3. Nothing that is likely to happen between now and the Budget will ease these pressures. Indeed the Budget itself will only intensify them. Cumulatively therefore, the intervention could lead to large numbers.

4. The domestic perception is different from the external perception: domestic investors are worried about inflation - which is reflected in the upward slope of the yield curve. Foreign investors recognise inflation may rise, but not for some time; however as other currency relationships have stabilised, they wish to take capital gains in sterling.

SECRET

5. We already know, and it is certainly the view of the Bank, that monetary policy is if anything on the loose side. Continued intervention is emasculating monetary policy - and effectively telling business that we are protecting their comptitiveness. We are therefore creating an extremely unattractive climate for wage negotiations (earnings have increased by 8-8½% in the last three months).

6. The key question therefore is how long does intervention carry on if the markets continue to be under pressure?

   As there are no factors in sight which look like changing the markets' current expectations - indeed quite the reverse - we should let the exchange rate rise and welcome its contribution to our anti-inflation policy.

   If the exchange rate is allowed to rise now we will avoid the pressure for higher interest rates which will almost certainly follow the Budget.

BRIAN GRIFFITHS

PRIME MINISTER

THE MARKETS

I attach today's evening report.

It reveals that there has been significant further intervention this afternoon, some of it in London. The total covering last night and today is put in the report at $646m. But I gather intervention has been continuing, to the tune of at least another $50m. It remains to be seen how much more is done in New York before the markets close there.

So the total of intervention is now building up significantly from the figure we discussed earlier this afternoon. I will let you know in the morning the latest position, and you will want to consider then whether to arrange a chat with the Chancellor at lunch-time, or whether to leave it until after the weekend.

Meantime you might like to have a summary of the options as I see them.

i) Do nothing. The Chancellor will I am sure continue to authorise intervention without limit. If the market quietens down all well and good. But if anything like the last 24 hours experiences are repeated we could soon be into really big money.

ii) Reduce interest rates. Timing considerations vis-à-vis the Budget apart, this is surely the wrong response. It might well help with the exchange rate problem, but is the wrong signal for the general stance of monetary policy.

iii) Consider tightening the planned stance of the Budget. This does nothing for the immediate problem, and at this stage would present major logistical

difficulties. But you might want to hold this possibility in reserve for when you discuss the Budget with the Chancellor next week. It would make it easier to reduce interest rates after the Budget.

iv) Let the rate go through DM3. The Chancellor would, as we discussed earlier, fiercely resist this (although I think there are others in the Treasury who would be content). Aside from the Chancellor's attachment to stability for its own sake, the main counter argument is that a higher exchange rate is the wrong direction given the emerging balance of payments position. But the key question is how far the rate would go once the market realised that the "cap" had been removed. My hunch is that it would not rise very far, and could well be reversed quite soon. One possibility might be to urge on the Chancellor letting the rate go but agreeing that the position should be reconsidered if, say, it went as high as DM3.05. Brian Griffiths agrees with this approach.

RRCG.

Paul Gray

3 March 1988

SECRET

file 88

9

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

15 February 1988

VALUATION OF THE RESERVES

The Prime Minister was most grateful for the material provided with your letters of 9 February concerning the revaluation of the EMCF swap, and 10 February concerning the valuation of dollar reserves in the UK and Germany.

PAUL GRAY

Alex Allan, Esq.,
H M Treasury

SECRET

mjd 1/60A

COVERING SECRET

8

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

15 February 1988

Trevor Woolley Esq
PS/Sir Robin Butler
Cabinet Office
Whitehall
London SW1A 2AS

1. Mr Wicks (to see cleared with PM as he wished)
2. PA + BF Wednesday a.m.

RRCG
15/2

Dear Trevor,

CABINET 18 FEBRUARY: CHANCELLOR'S PAPER ON ECONOMIC STRATEGY

I attach the text of the Chancellor's paper on Economic Strategy for Cabinet on Thursday. You told me you would, as usual, be retyping this to Cabinet format. I also attach 90 copies of the 3 annexes.

The paper should be classified 'SECRET - CMO UNTIL 16 MARCH 1988'.

I am copying this to Paul Gray (No.10 Downing Street).

Yours sincerely,

Moira Wallace

pp A C S ALLAN
Principal Private Secretary

mjd 1/58A

SECRET

CABINET

ECONOMIC STRATEGY

Memorandum by the Chancellor of the Exchequer

Eight years of steady and cautious financial policies have put the British economy in the strongest position we have enjoyed for many years. Provided that we stick to those policies, we shall be well placed to withstand any shocks which may lie ahead, particularly overseas, and should continue to enjoy a healthy growth rate with low inflation.

2. All in all, 1987 was a successful year for the British economy. The growth rate could well turn out to be a shade over 4 per cent, compared with the Budget forecast of 3 per cent. Unemployment fell by over half a million. Manufacturing productivity grew by over 6½ per cent. And, unlike in earlier periods of rapid growth, there was no resurgence of inflation.

3. Looked at in a longer term perspective, the performance of the economy also shows up well. It is not simply a matter of doing better than in the 1970s: it would have been appalling if we had not. But output in recent years has on average grown faster than in the 1950s and the 1960s together; we have brought inflation back to its average level in the 1950s and 1960s; and manufacturing productivity has grown at over 4½ per cent a year, compared with less than 3½ per cent in the 1950s and 1960s.

4. These achievements reflect the steady transformation which is taking place in the efficiency, enterprise and adaptability of all sectors of the economy. Our financial policies have given the private sector the room and the confidence to expand. And our supply-side policies have reduced the barriers which held British

industry in check for far too long. It is clearly vital that we stick to the policies that have brought about this success.

Economic Prospects

5. This is especially true against a world background that remains uncertain. Very large trade imbalances persist, especially between the US, Germany and Japan. And while we have recently seen somewhat more stable conditions in financial markets around the world, the dollar remains volatile and confidence in equity markets is fragile.

6. World growth in 1987 was close to what I forecast in the Budget last year. The GNP of the major seven industrial countries probably rose by 3 per cent. And industrial production in the G7 accelerated during the year as net exports to the rest of the world improved. World trade in manufactures appears to have risen by 5 per cent, somewhat above the rate in the previous two years.

7. The latest indicators suggest that world activity remains fairly buoyant, particularly in Japan, the UK and (for the most part) the US. But the stock market collapse is likely to dampen demand in the US, and growth in Germany remains sluggish. We are likely to see GNP growth in the G7 slow down to perhaps 2½ per cent in 1988, although it could be less than that, particularly if there is further instability in world equity and foreign exchange markets.

8. Nevertheless, we should see continued healthy growth in UK exports in 1988, though probably not as high as in 1987, when our non-oil exports grew by 7 per cent.

9. So far as UK domestic demand is concerned, we should see a further strong rise in investment growth; this is confirmed by the various surveys of business confidence and intentions carried out since the Stock Market collapse in October, which continue to

indicate buoyant investment plans. Consumers' expenditure should grow a little less strongly in 1988, as the savings ratio picks up from its historically very low level in 1987.

10. With a steady growth of domestic demand and further strong growth in exports, I now expect 3 per cent growth in 1988for the economy as a whole. As North sea production will be falling, this implies non-oil GDP growth of around 3½ per cent. This should be sufficient to ensure a further fall in unemployment, though probably not at the rapid rate of the last 12 months. The prospects for a further fall in unemployment would clearly be better if pay settlements were more modest.

11. The deficit on the current account of the balance of payments in 1987 is now estimated at £2.7 billion - broadly in line with the £2½ billion deficit I forecast at the time of last year's Budget. With UK growth in 1988 once again exceeding that of the other major economies, and our surplus on oil trade falling as North Sea oil output falls, a higher current account deficit is likely in 1988. It will be very much lower than the trade imbalances elsewhere, and we should have no difficulty in financing it. But it is a factor pointing in the direction of a cautious policy stance.

12. Inflation as measured by the Retail Price Index (RPI) crept up to just under 4½ per cent in the third quarter of last year, but has since fallen back to under 3½ per cent. These fluctuations largely mirror fluctuations in the mortgage rate, and the prospect is that the inflation rate should stay at around 4 per cent during 1988.

13. Our recent record of sustained low inflation is impressive when compared with the UK's earlier experience at times of rapid growth. But many of our major competitors have still lower inflation rates, and we must continue to give the highest priority to getting our inflation rate down further during the course of this Parliament.

Fiscal Prospects

14. Last year I introduced a cautious Budget which, despite a cut of 2p in the basic rate of income tax, was expected to produce a PSBR inclusive of privatisation proceeds of just under £4 billion (1 per cent of GDP), somewhat less than had been previously envisaged. In the event, the public finances in the current financial year are turning out to be considerably stronger than I expected. It now seems likely that the PSBR will be negative - ie there will be a Budget surplus - for the first time since 1969-70.

15. The major reason for the improvement in public finances has been a faster growth in tax revenues than we had foreseen. This has meant that, despite the tax reductions in the Budget, the share of non-North Sea taxes in GDP has increased. In fact, the tax burden has now risen in each of the last 2 years, and is probably nearly 4 percentage points higher than it was in 1978-79.

16. I am convinced that we must continue to follow a cautious fiscal policy. With the uncertainties ahead -and with UK demand remaining buoyant at a time when growth elsewhere is sluggish - this means that we should aim for a PSBR well below the level envisaged in the MTFS: indeed, I believe I should budget for a modest surplus.

17. But even on this basis there should be some scope to lower tax rates again this year. Indeed, unless we do so, fiscal drag will ensure that the non-North Sea tax burden rises yet again next year. But there are clearly limits to how much can be done while still maintaining the sound financial policies which have been the cornerstone of our success.

Summary and Conclusions

18. Output growth last year was well above the 3 per cent average we have enjoyed since 1981, but is likely to be closer to that average this year. This will still be well above the growth rate in most other major countries. Unemployment is likely to continue to fall, although more slowly than in 1987. Inflation should remain steady at about 4 per cent.

19. But there are considerable risks and uncertainties, especially on the international front. We must therefore once again play safe, to ensure that in the coming year, as in the past, we are buttressed by sound and strong public finances. That means that tax reductions must be limited to a scale that enables us to secure a further year of Budget surplus.

20. As in previous years, I would welcome colleagues' views on the Budget against the background of the fiscal and economic prospect I have outlined.

SECRET

ANNEX A.

	1980	1981	1982	1983	1984	1985	1986	1987	1988(1)
World GNP,(2) in major 7 economies (per cent change)	1	1½	-½	3	5	3	2½	3	2½
UK GDP,(2) (per cent change)	-2½	-1	1½	3½	2½	3½	3	4¼	3
Domestic demand,(2) (per cent change)	-3	-1½	2	4½	3	3	4	4	4
Retail prices Q4 (per cent change) on a year earlier	15½	12	6	5	5	5½	3½	4	4
Interest rates (average 3-month interbank)	16½	14	12½	10	10	12	11	9½	9½(3)
Unemployment (UK, per cent of working population excluding school leavers)	5½	8½	10	11	11	11½	11½	10½	9
Sterling Index	96	95	90½	83	78½	78	73	72½	74(3)

(1) Provisional pre-Budget figures.

(2) At constant prices.

(3) February 12.

CONFIDENTIAL

ANNEX 2: DIRECT EFFECTS OF TAX CHANGES

A. Direct Taxes: Indexation

The RPI increased in the year to December 1987 by 3.7 per cent. With indexation by this amount and statutory rounding, the figures for the main allowances and other thresholds would be:

Personal allowances	1987-88	1988-89
Single and wife's earned income allowance	2,425	2,515
Married allowance	3,795	3,945
Bands, eg:		
29% rate	0-17,900	0-18,600
60% rate	over 41,200	over 42,800

The total revenue costs of indexation of income tax (included in the forecast) are £840 million in 1988-89 and £1,370 million in 1989-90.

B. Indirect Taxes: Indexation

The effects of 3.7 per cent revalorisation of the excise duties (including VAT effects) are as follows:

VAT inclusive price change		Yield in 1987-88 £m	RPI impact % points
Beer	0.8p/pint	60	0.04
Wine	3.1p/75cl light wine	20	0.02
Spirits	20.1p/bottle	25	0.03
Tobacco	3.4p/20 king size	100	0.09
Petrol	3.7p/gallon	195	0.07
Derv	3.2p/gallon	50	neg.
VED	£3.7/car	100	0.03
Overall effect, including minor duties (included in forecast)		550	0.28

C. Ready Reckoners: Illustrative Tax Changes

	£ million 1988-89	1989-90
INCOME TAX		
Allowances and Thresholds		
1% above indexation on all statutory allowances	185	240
1% above indexation on all statutory allowances and thresholds	215	295
Rates		
Change in basic rate of 1p	1,250	1,600
Change all higher rates by 1p	85	165
CORPORATION TAX		
Change in main rate of 1 percentage point	360	560
Change in small companies' rate of 1 percentage point	25	45
VALUE ADDED TAX		
Change in VAT rate of 1 percentage point[(1)]	940	1,310

[(1)] A 1% change in the VAT rate would change the RPI by 0.5%

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ANNEX 3: PUBLIC FINANCES AND THE TAX BURDEN

Taxation, Expenditure and Borrowing

Since the Government first took office, total taxes and NICs have risen by over 4 percentage points of GDP, though the ratio has fallen from its peak in 1981-82. This has enabled us to secure a substantial reduction in public borrowing.

Table 1

Overall Taxation, Expenditure and Borrowing

(percentage of GDP at market prices)

	Non-North Sea Taxes plus NICs (as per cent of non-North Sea GDP)	Total Taxes plus NICs	General Government Expenditure (excluding privatisation proceeds)	PSBR
1978-79	34.1	33.8	43.2	5.3
1979-80	35.2	35.1	43.4	4.8
1980-81	36.1	36.3	46.0	5.4
1981-82	38.7	39.4	46.5	3.3
1982-83	38.2	38.9	46.8	3.1
1983-84	37.8	38.5	45.9	3.2
1984-85	37.8	39.1	46.2	3.1
1985-86	37.0	38.5	44.5	1.6
1986-87	37.4	37.9	43.9	0.9

Personal Taxation

2. Despite reductions in income tax, total personal taxes (direct and indirect, including employees' NICs and domestic rates) in 1987-88 are about £24 billion higher in real terms (ie 1987-88 prices) than they were in 1978-79. For income tax and national insurance contributions the following table shows how the proportion of gross pay they represent rose up to 1981-82, particularly for the low paid:

Table 2

Income Tax and NICs as a % of Gross Earnings*

	½ average earnings	average earnings	2 average earnings
1978-79	16.0	27.8	31.4
1981-82	20.8	29.3	32.2
1982-83	20.8	29.8	32.3
1983-84	20.1	29.6	31.7
1984-85	19.3	29.2	31.5
1985-86	18.9	29.0	31.5
1986-87	18.9	28.5	30.9
1987-88 (estimate)	18.9	27.4	29.7
1988-89 (indexation)	19.3	27.6	30.0

*Adult male earnings (all occupations). Married couple, wife not working: the couple are assumed to have no children, to avoid distortion of the figures from the abolition of child tax allowances.

3. These figures reflect the rise in the standard employees' NIC rate from 6½% to 9%. The lower rates introduced in the 1985 Finance Act do not affect the cases shown. So far as income tax is concerned, personal allowances have increased by about 22% in real terms since 1978-79, slightly less than earnings. The basic rate has been reduced from 33p to 27p, but the 25p reduced rate band has been abolished.

4. As the table shows, indexation of allowances in the Budget would lead to a slight rise in the proportion of incomes taken in tax and NICs. This is because earnings are assumed to rise by more than the increase in tax thresholds, which is indexed to changes in prices.

Business Taxation

5. Following the sharp rise in corporation tax receipts over the past two years, total taxes paid by businesses (outside the North Sea) are now higher as a percentage of GDP than in 1978-79. Within this total, the major change has been a fall in employers' NICs and NIS as a percentage of GDP, offset by increases in corporation tax, business rates and 'other' taxes as the following table shows:

Table 3

Taxes paid by Businesses £bn in 1987 88 prices

(figures in brackets are % of GDP)

	Corporation Tax[1]	Taxes on self employment incomes	Employers' NICs and NIS	Rates	Other[2]	Total
1978-79	7.7	2.6	12.6	5.1	4.0	32.1
	(2.2)	(0.7)	(3.6)	(1.4)	(1.1)	(9.1)
1987-88 (estimate)	15.2	3.3	11.3	7.2	5.9	43.0
	(3.6)	(0.8)	(2.7)	(1.7)	(1.4)	(10.1)

[1]Excludes North Sea, but includes ACT

[2]VED, car tax, road fuel duty, duty on rebated oils, capital taxes

7

PRIME MINISTER

VALUATION OF THE RESERVES

I attach two notes the Treasury have prepared in response to your earlier queries.

First, at Flag A, a note on the book loss during 1987 on the UK's dollar holdings. This stemmed from the discussion you had with Alan Walters on 9 January. The figure is in fact surprisingly small at £0.4 billion reflecting the fact that our net dollar assets are currently only $12 billion. This is because we still have significant dollar liabilities ($14 billion) and ~~the~~ reasonable progress has been made in diversifying the reserves into other currencies (the non-dollar proportion of our net foreign currency reserves is up to 48 percent). None of this means of course that you should take any more relaxed attitude towards acquiring more dollars should we face renewed upward pressure on sterling.

Second, at Flag B, an explanation of the valuation affect of the EMCF swap, which led to a $660 million fall in the January reserves. This is all rather complex but the essential points are in Alex Allan's covering letter. There is nothing here to worry about - it simply reflects different valuation conventions between the EMCF and EEA.

PRCG.

(PAUL GRAY)
12 February 1988

ph52

SECRET

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

FM.

12 February 1988

Paul Gray
No.10 Downing Street

Note
Passed to PM's comments
to Alex Allan.
RRCG
15/2

Dear Paul,

PAPER FOR ECONOMIC CABINET

... I attach the latest draft of the Chancellor's paper for Cabinet next Thursday. The Chancellor himself will be working on the draft over the weekend, before it is circulated on Monday. He would be grateful for any comments the Prime Minister may have.

Yours
Alex.
A C S ALLAN

Prime Minister

I have asked mine comments on paras. 7 and 11. Otherwise this seems OK to me.

Content?

RRCG
12/2

mjd 1/58A

SECRET

PAPER FOR ECONOMIC CABINET

Eight years of steady and cautious financial policies have put the British economy in the strongest position we have enjoyed for many years. Provided that we stick to those policies, we shall be well placed to withstand any shocks which may lie ahead, particularly overseas, and should continue to enjoy a healthy growth rate with low inflation.

2. All in all, 1987 was a successful year for the British economy. The growth rate was probably a shade over 4 per cent, compared with the Budget forecast of 3 per cent. Unemployment fell by over half a million. Manufacturing productivity grew by about [6 per cent]. And, unlike in earlier periods of rapid growth, there was no resurgence of inflation.

3. Looked at in a longer term perspective, the performance of the economy also shows up well. It is not simply a matter of doing better than in the 1970s: it would have been appalling if we had not. But output in recent years has on average grown faster than in the 1950s and the 1960s; we have brought inflation back to its average level in the 1950s and 1960s; and

manufacturing productivity has grown at over 4½ per cent a year, compared with less than 3½ per cent in the 1950s and 1960s.

4. These achievements reflect the steady transformation which is taking place in the efficiency, enterprise and adaptability of all sectors of the economy. Our financial policies have given the private sector the room and the confidence to expand. And our supply-side policies have reduced the barriers which held British industry in check for far too long. It is clearly vital that we stick to the policies that have brought about this success.

Economic Prospects

5. This is especially true against world background that remains uncertain. Very large trade imbalances persist, especially between the US, Germany and Japan. And while we have recently seen somewhat more stable conditions in financial markets around the world, the dollar remains volatile and confidence in equity markets is fragile.

6. World growth in 1987 was close to what I forecast in the Budget last year. The GNP of the major seven industrial countries rose by 3 per cent. And industrial production in the G7 accelerated during the

year as net exports to the rest of the world improved. World trade in manufactures appears to have risen by 5 per cent, somewhat above the rate in the previous two years.

7. The latest indicators suggest that world activity remains fairly buoyant, particularly in Japan, the UK and (for the most part) the US. But the stock market collapse is likely to dampen demand in the US, and growth in Germany remains sluggish. We are likely to see GNP growth in the G7 slow down to perhaps 2½ per cent in 1988. But there are risks that it could be less than that, particularly if there is further instability in world equity and foreign exchange markets.

The risks are not all one-way. PRCG.

8. Nevertheless, we should see continued healthy growth in UK exports in 1988, though probably not as high as in 1987, when our non-oil exports grew by 7½ per cent.

9. So far as UK domestic demand is concerned, we should see a further strong rise in investment growth; this is confirmed by the various surveys of business confidence and intentions carried out since the Stock Market collapse in October, which continue to indicate buoyant investment plans. Consumers' expenditure should grow a little less strongly in 1988, as the savings ratio picks up from its historically very low level in 1987.

If it does

10. With a steady growth of domestic demand and further strong growth in exports, I now expect 3 per cent growth in 1988for the economy as a whole. As North sea production will be falling, this implies non-oil GDP growth of around 3½ per cent. This should be sufficient to ensure a further fall in unemployment, though probably not at the rapid rate of the last 12 months. The prospects for a further fall in unemployment would clearly be better if pay settlements were more modest.

11. The deficit on the current account of the balance of payments in 1987 is now estimated at £2.7 billion - broadly in line with the £2½ billion deficit I forecast at the time of last year's Budget. With UK growth in 1988 once again exceeding that of the other major economies, and our surplus on all trade falling as North Sea oil output falls, a higher current account deficit is likely in 1988. But at less than 1 per cent of GDP it will be very much lower than the trade imbalances elsewhere, and we should have no difficulty in financing it.

12. Inflation as measured by the Retail Price Index (RPI) crept up to just under 4½ per cent in the third quarter of last year, but has since fallen back to under 3½ per cent. These fluctuations largely mirror fluctuations in the mortgage rate, and the prospect is that the inflation rate should stay at around 4 per cent during 1988.

13. Our recent record of sustained low inflation is impressive when compared with the UK's earlier experience at times of rapid growth. But many of our major competitors have still lower inflation rates, and we must continue to give the highest priority to getting our inflation rate down further during the course of this Parliament.

Fiscal Prospects

14. Last year I introduced a cautious Budget which, despite a cut of 2p in the basic rate of income tax, was expected to produce a PSBR inclusive of privatisation proceeds of just under £4 billion (1 per cent of GDP), somewhat less than had been previously envisaged. In the event, the public finances in the current financial year are turning out to be considerably stronger than I expected. It now seems likely that the PSBR will be negative - ie there will be a Budget surplus - for the first time since 1969-70.

15. The major reason for the improvement in public finances has been a faster growth in tax revenues than we had foreseen. This has meant that, despite the tax reductions in the Budget, the share of non-North Sea taxes in GDP has increased. In fact, the tax burden has now risen in each of the last 2 years, and is nearly 4 percentage points higher than it was in 1978-79.

16. I am convinced that we must continue to follow a cautious fiscal policy. With the uncertainties ahead - and with UK demand remaining buoyant at a time when growth elsewhere is sluggish - this means that we should aim for a PSBR well below the level envisaged in the MTFS MSTF: indeed, I believe I should budget for a modest surplus.

17. But even on this basis there should be some scope to lower tax rates again this year. Indeed, unless we do so, fiscal drag will ensure that the non-North Sea tax burden rises yet again next year. But there are clearly limits to how much can be done while still maintaining the sound financial policies which have been the cornerstone of our success.

Summary and Conclusions

18. Output growth last year was well above the 3 per cent average we have enjoyed since 1981, but is likely to be closer to that average this year. This will still be well above the growth rate in most other major countries. Unemployment is likely to continue to fall, although more slowly than in 1987. Inflation should remain steady at about 4 per cent.

19. But there are considerable risks and uncertainties, especially on the international front. We must therefore

once again play safe, to ensure that in the coming year, as in the past, we are buttressed by sound and strong public finances. That means that tax reductions must be limited to a scale that enables us to secure a further year of Budget surplus.

20. I would welcome colleagues' views on the Budget against the background of the fiscal and economic prospect I have outlined.

I fear that some may respond to this invitation by demanding increased expenditure.

ANNEX 1

	1980	1981	1982	1983	1984	1985	1986	1987	1988(1)
World GNP,(2) in major 7 economies (per cent change)	1	1½	-½	3	5	3	2½	3	2½
UK GDP,(2) (per cent change)	-2½	-1	1½	3½	2½	3½	3	4¼	3
Domestic demand,(2) (per cent change)	-3	-1½	2	4½	3	3	4	4	4½
Retail prices Q4 (per cent change) on a year earlier	15½	12	6	5	5	5½	3½	4	4
Interest rates (average 3-month interbank)	16½	14	12½	10	10	12	11	9½	9 (3)
Unemployment (UK, per cent of working population excluding school leavers)	5½	8½	10	11	11	11½	11½	10½	9
Sterling Index	96	95	90½	83	78½	78	73	72½	74½ (3)

(1) Provisional pre-Budget figures.

(2) At constant prices.

(3) February 2.

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ANNEX 2: DIRECT EFFECTS OF TAX CHANGES

A. Direct Taxes: Indexation

The RPI increased in the year to December 1987 by 3.7 per cent. With indexation by this amount and statutory rounding, the figures for the main allowances and other thresholds would be:

Personal allowances	1987-88	1988-89
Single and wife's earned income allowance	2,425	2,515
Married allowance	3,795	3,945
Bands, eg:		
29% rate	0-17,900	0-18,600
60% rate	over 41,200	over 42,800

The total revenue costs of indexation of income tax (included in the forecast) are £840 million in 1988-89 and £1,370 million in 1989-90.

B. Indirect Taxes: Indexation

The effects of 3.7 per cent revalorisation of the excise duties (including VAT effects) are as follows:

VAT inclusive price change		Yield in 1987-88 £m	RPI impact % points
Beer	0.8p/pint	60	0.04
Wine	3.1p/75cl light wine	20	0.02
Spirits	20.1p/bottle	25	0.03
Tobacco	3.4p/20 king size	100	0.09
Petrol	3.7p/gallon	195	0.07
Derv	3.2p/gallon	50	neg.
VED	£3.7/car	100	0.03
Overall effect, including minor duties (included in forecast)		550	0.28

C. Ready Reckoners: Illustrative Tax Changes

	1988-89	£ million 1989-90
INCOME TAX		
Allowances and Thresholds		
1% above indexation on all statutory allowances	185	240
1% above indexation on all statutory allowances and thresholds	215	295
Rates		
Change in basic rate of 1p	1,250	1,600
CORPORATION TAX		
Change in main rate of 1 percentage point	360	560
Change in small companies' rate of 1 percentage point	25	45
VALUE ADDED TAX		
Change in VAT rate of 1 percentage point[(1)]	940	1,310

[(1)] A 1% change in the VAT rate would change the RPI by 0.5%

ANNEX 3: PUBLIC FINANCES AND THE TAX BURDEN

Taxation, Expenditure and Borrowing

Since the Government came to power total taxes and NICs have risen by over 4 percentage points of GDP, though the ratio has fallen from its peak in 1981-82. General government expenditure has fallen by more since then, permitting a significant reduction in borrowing.

Table 1

Overall Taxation, Expenditure and Borrowing

(percentage of GDP at market prices)

	Non-North Sea Taxes plus NICs (as per cent of non-North Sea GDP)	Total Taxes plus NICs	General Government Expenditure (excluding privatisation proceeds)	PSBR
1978-79	34.1	33.8	43.2	5.3
1979-80	35.2	35.1	43.4	4.8
1980-81	36.1	36.3	46.0	5.4
1981-82	38.7	39.4	46.5	3.3
1982-83	38.2	38.9	46.8	3.1
1983-84	37.8	38.5	45.9	3.2
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[1]Excludes North Sea, but includes ACT

[2]VED, car tax, road fuel duty, duty on rebated oils, capital taxes

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

12 February 1988

C Powell Esq
10 Downing Street
LONDON SW1

Dear Charles

INTERNATIONAL FINANCIAL SCENE

I attach the first regular report of 1988 on developments in the international debt scene.

The economic outlook for 1988, as it affects the evolution of the debt problem, remains essentially unchanged since our last report. Industrial countries' growth is expected to be just under 3 per cent, although slowing towards the end of 1988 and in 1989; with sustained growth in world trade. US dollar interest rates have remained broadly unchanged over the past few weeks, kept down for the moment by fear of recession in an election year; and real commodity prices excluding oil are now higher than they were some months ago. This should benefit debtor countries. However, there are some risks, in particular the implications for trade and growth if there were to be renewed downward pressure on the dollar.

Over the next few weeks there will be important discussions of the debt problem in the run-up to the April meetings in Washington. These will take account of current developments, in particular the tendency for the commercial banks to become more fragmented in their approach, their reluctance to participate in new money packages, and the emergence of market based ideas such as the Mexican buy-back scheme. We will be looking to these new ideas to develop the existing strategy rather than overturn it. Thus, we will continue to emphasise the need for appropriate policies and strong adjustment on the part of the debtors, and the need for the banks to continue to have the prime responsibility for the working out of their debt problems. The April Meetings - and the Summit if the Canadians have their way - will focus more on the middle income debtors than on the poorest. The impact of debt problems on the world economy will be on the agenda for the OECD Ministerial meeting in May.

Turning to individual countries, the most recent developments in Brazil look more encouraging. The Brazilian Government appears to have re-evaluated the costs of the confrontational approach and is now seeking normalisation of its relations with the international financial community. As a first step the Brazilians have made an unconditional payment to the commercial banks of some 1988 interest due in order to get negotiations on a medium-term package moving ahead. The Government has also said that it will negotiate a programme with the IMF and a deal with Paris Club creditors. Among G7 Governments there is agreement that such an IMF programme must precede any Paris Club rescheduling or a resumption of export credit cover. But the real test will be whether the Government of Brazil is prepared to adopt realistic measures to strengthen its economy.

For Mexico, the main focus is on the outcome of the debt buy-back scheme. This involves bank creditors swapping rescheduled debt for higher yielding 20 year bonds whose principal (but not interest) is backed by US Treasury securities. The likely outcome of the operation is difficult to judge at this stage. It seems unlikely that the US majors will bid, although the US regional banks may well treat the offer as an exit bond. US banks seem unlikely to make more than token bids. Once we can evaluate the success of the Mexican operation, we will need to consider whether it - or versions of it - would provide a useful addition to the strategy. Other debtors may well come forward with similar proposals. Only Chile so far has asked its commercial bank creditors for changes in existing agreements to give it the flexibility to contemplate a similar arrangement in the future.

The outlook for several other major debtors is poor. Argentina appears to be fast running out of money. The Argentines are being asked by the Fund to adopt additional measures to prevent the existing Fund programme from collapsing. In the meantime bridging finance is likely to be needed and the Argentines have looked to the US for help. If Brazil really does re-establish relations with its creditors, the US authorities may be more inclined to lean on the Argentines to implement a stronger programme.

The Yugoslav liquidity position is also becoming acute. They may turn to the BIS for a bridging loan in the near future. The Paris Club has emphasised the need for a strong IMF programme as a pre-requisite for any rescheduling of official funds. However a recent Fund mission made no progress. Despite their anxiety to conclude an early Standby Arrangement, the Yugoslavs seem unwilling and unable to engage in serious discussion.

Egypt too continues to pose problems. It was clear from President Mubarak's recent talks with UK Ministers that the Egyptian authorities are unlikely to agree to the necessary measures to enable the current IMF programme to continue. He seems to have taken the same line in his talks in Washington and Bonn

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where he was also urged to reach early agreement with the Fund. We shall want to keep up pressure on the Fund to ensure adequate conditionality in the Egyptian (and other) programmes. We will be keeping in close touch with Fund staff on this and with the Executive Directors of other G7 countries.

I am copying this letter and enclosure to Robert Culshaw (FCO), Jeremy Godfrey (DTI) and John Footman (Bank).

Yours sincerely

J M G TAYLOR
Private Secretary

C14/32

A

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SECRET

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

10 February 1988

Paul Gray Esq
10 Downing Street
London SW1

Dear Paul,

ACCOUNTING FOR THE RESERVES IN THE UK AND GERMANY

... You wrote to me on 9 January, enclosing the attached article from the Financial Times on the profitability of German intervention. You asked what the results of a similar calculation for the UK reserves would show. I am sorry we have not been able to let you have a reply before now, but we have found it difficult to establish exactly what method the Germans use.

The short answer is that, on a comparable 'net dollar assets' basis, we think the Bundesbank probably scored a book loss equivalent to about £3 billion in 1987 and our Exchange Equalisation Account (EEA) a book loss of £0.4 billion.

There are, of course, several important differences between the position in Germany and in the UK, as the Prime Minister recognised

First, the German reserves are owned by the Bundesbank, whereas the British reserves are a Treasury account. This difference in ownership is reflected in a difference of treatment of the reserves in relation to the borrowing requirement.

The Bundesbank's profit transfer (generally heavily influenced by changes in the deutschemark valuation of their foreign exchange reserves) is scored along with tax receipts as an item reducing the German Government's Borrowing Requirement.

In the UK, the EEA's purchases and sales of foreign currency do not affect the size of the PSBR but, like other changes in the mix of the Government's assets and liabilities, are treated as financing it. Valuation changes to the UK reserves affect the financing of the PSBR only when the gain or loss is realised and is reflected in a flow of sterling into or out of the reserves. Receipts of interest on the UK's foreign currency reserve assets do reduce the PSBR as they are treated as central government current income. Similarly, payments of interest on foreign currency borrowing form part of gross debt interest and so increase the PSBR. (In both these cases, the sterling sums involved will, of course, be affected by exchange rate movements.)

Second, the Germans have very much larger net dollar assets than we do. Theirs total about $43 billion. Ours are currently $12 billion, since our dollar assets of about $26 billion are offset by dollar loans of about $14 billion.

Finally, the UK has actively shifted substantial amounts of dollars into other currencies and we have on occasions bought deutschemarks against sterling in intervention operations on a considerable scale. As a result, the non-dollar proportion of our net foreign currency reserves has increased from 35 per cent in mid-year to 48 per cent at the end of 1987.

It is by no means straightforward to assess the effect of the dollar's fall on the Bundesbank's profit transfer and hence on the German Government's borrowing requirement. The Bundesbank's accounting principles are complex and contain a large element of discretion. Currency gains and losses are generally treated as contributing to profit, but there is considerable use of provisions to smooth the payment made to central government.

For example, the Bundesbank absorbed the losses on its substantial stocks of foreign exchange during the long period of deutschemark appreciation from 1968 to 1979 and in fact made a small overall profit transfer, taking into account its domestic operations. When the dollar started to appreciate in the 1980s, much of the profit was initially 'used' to offset earlier losses, but from 1982 there were annual transfers of profits of DM 10 - 13 billion (transfers relate to results a year earlier). At the same time, a substantial reserve (peaking at DM 7 billion at end 1984) was created.

The present phase of dollar weakness started in 1985. Even so, the Bundesbank managed to declare sizeable - though diminishing - overall profits in 1985 and 1986, despite dollar holdings averaging around $22 billion.

This will have been possible principally because of the use of profits carried over from earlier years (but also because interest earnings on the reserves are credited to profit, whereas there is no interest charge for the corresponding deutschemarks used to acquire the reserves). The transfer to central government was sharply reduced to DM7 billion in 1987 (reflecting 1986's lower overall profits, but after a transfer from the "provisions" reserve). Nevertheless, this was still enough to reduce the borrowing requirement by 20 per cent below the level it would otherwise have been.

The prospects for transfers in 1988 and 1989 are hard to judge, given the Bundesbank's discretion over how declared profit is struck and the existence of a further DM2.7 billion of "provisions" reserve. But with net dollar holdings of about $29 billion at end-1986 and $43 billion at end-1987, the Bundesbank must have suffered substantial deutschemark valuation losses, not fully offset by interest income. The Bank of England guess their losses, as calculated on their standard basis but before allowing for transfers from reserves, might have totalled some DM 9 billion (£3 billion) for calendar 1987. The press therefore seems correct in judging that any profit transfer in 1988 is likely to be small.

By contrast, the UK reserves have been much less exposed to dollar depreciation. Our dollar liabilities substantially exceeded our dollar assets for most of the recent period of dollar weakness, leading to substantial book profits as the dollar fell against sterling since the January 1985 peak. Only in April 1987 did we move into a position where dollar assets exceeded liabilities. Using the same method as the Bundesbank, the Bank of England calculate there would have been a book loss on the EEA's net dollar position in 1987 of about £0.4 billion, before allowing for any transfer from reserves. On the other main currencies held by the EEA, we probably made a small book profit in 1987 on our yen holdings in sterling terms, but a small loss on our deutschemark holdings, with no significant profit or loss on Canadian dollars.

These calculations are inevitably dependent on the assumptions used and not too much weight should be put on the precise figures. It is also important to remember that the £0.4 billion figure for the EEA represents only a book loss: whether a loss or a profit is eventually realised depends on the exchange rate if and when intervention during 1987 comes to be reversed.

Yours Alex

ALEX ALLAN

W Germany to raise taxes and cut spending

BY DAVID MARSH IN BONN AND ANDREW FISHER IN FRANKFURT

THE WEST GERMAN coalition yesterday decided to cut federal government borrowing by at least DM10bn (£3.36bn) next year through a mixture of increases in consumer taxes and cuts in budget spending

The move comes in reaction to a much sharper than planned increase in the federal deficit this year It is now expected to be DM40bn compared with DM29 5bn set down in the 1988 budget approved by parliament at the end of last year

The tightening of fiscal policy now planned for 1989 runs completely counter to persistent calls from home and abroad for West Germany to cut taxes next year in order to bolster sluggish economic growth.

Mr Gerhard Stoltenberg, the Finance Minister, told the press after yesterday's cabinet meeting: "There is no room for further tax cuts (in 1989)"

At the same time the Bundesbank in Frankfurt announced action to reduce banking liquidity through a DM6bn cut in banks' rediscount quotas, effective February 1 The move, which will cut the amounts banks can borrow from the central bank at the 2.5 per cent discount rate, came in response to big increases in liquidity through currency inflows

The Bundesbank said the decision did not imply any change in its basic monetary stance However, it underlines how the central bank is reacting cautiously to ward off possible inflationary dangers from currency inflows – DM25bn since October – accompanying the latest rise of the D-Mark

Yesterday's cabinet decision on the deficit underlines how West German fiscal policies have been severely blown off course by the fall of the dollar and the weakening economy

The admission by Mr Stoltenberg that the 1988 deficit will be much larger than expected is likely to expose him to a fresh wave of criticism at home from both Left and Right over the consequences of rising public borrowing

It casts a considerable question mark over whether the Government will be able to proceed with promised net tax cuts of DM20bn in 1990, conceived as a fundamental part of its economic strategy

The immediate causes of the jump in the 1988 deficit are higher West German contributions to the European Community and the near-disappearance of 1987 profits from the Bundesbank, due to be paid over to Bonn this year The Bundesbank profit will fall to "near zero" from the DM6bn which had been written into the 1988 budget, the Finance Minister said

This is because the central bank will have to write off between DM6.5bn and DM7bn on the D-Mark value of its foreign exchange reserves This is

Continued on Back Page
Details, Page 2

West Germany to raise taxes Continued from Page 1

because of the sharp fall in the dollar to DM1.5815 at the end of last year, the value the Bundesbank will use for its 1987 accounts

This year's federal deficit is also being driven up by DM14bn of tax cuts which came into effect at the beginning of the year Additionally, tax revenues have fallen well below earlier, projected levels because of economic growth of only 1.5 per cent last year

Mr Stoltenberg said a supplementary budget would be introduced before the summer to take account of the extra 1988 deficit. Additionally, around May or June, detailed decisions would be taken on finding the budgetary savings of at least DM10bn planned for 1989, Mr Stoltenberg said

Mr Stoltenberg said the Government faced no substantial risks on the spending side for 1988, although this year's deficit could plainly be driven higher if the economic downturn eats further into tax revenues and drives up subsidies

At present, Mr Stoltenberg is projecting a growth of between 1.5 and 2 per cent in gross national product this year although some more gloomy private sector forecasters are predicting only around 1 per cent.

Econ Pol: Domestic Monetary Pol's Pt. 8

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B 4

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

9 February 1988

Paul Gray Esq
10 Downing Street
LONDON SW1

Dear Paul.

EMCF SWAP

The Prime Minister asked why the revaluation of the European Monetary Co-operation Fund (EMCF) swap had contributed $660 million to the fall in the reserves last month.

I enclose a note which sets out the details of the transaction. Briefly, the reserves fall reflects the different valuation practices of the Exchange Equalisation Account (EEA) and the EMCF and relates almost entirely to the EMCF's higher valuation for gold for the October-January swap. The transaction is a purely notional one. The EEA actually retains the 20 per cent of its gold and dollar holdings which forms the basis of the swap and the dollar income which accrues from it. Moreover, while the spot reserves were reduced by $660 million on this account in January, there was a corresponding increase in the forward book of exactly the same amount.

Yours

A C S ALLAN
Principal Private Secretary

T06/G/GBR/151749

EMCF SWAP

The European Monetary Co-operation Fund (EMCF) provides short-term credit facilities for intervention for EMS members. The UK has participated since joining the EMS in 1979. Each member of the EMS swaps 20 per cent of its gold and dollar reserves with the EMCF in return for ecus. The swaps are for three months and revolve, so that after three months, EMS members receive back the same quantities of gold and dollars they previously swapped but provide as a new swap whatever quantities of gold and dollars then comprise 20 per cent of their total holdings.

The EEA accounts for the swap as follows. The UK surrenders 20 per cent of its gold and dollar reserves to the EMCF and so the spot reserves fall by that amount in the month the transaction takes place. Since the EMCF is committed to unwind the swap after three months, the forward book rises by the same amount. The EEA simultaneously receives ecus from the EMCF for the gold and dollars it has surrendered, so the spot reserves rise by that ecu amount and the forward book falls by the same ecu sum, reflecting the subsequent unwinding of the swap.

In principle, these transactions should cancel out completely, with no effect on either the spot or the forward book. However, this does not happen in practice because of the different way in which the EEA and the EMCF value their holdings. The operation can be broken down into three stages.

(i) When the EEA surrenders gold and dollars, the spot reserves fall and the forward book rises by the UK's valuation of its holding.

(ii) The ecus the EMCF gives the EEA in exchange reflect the EMCF's ecu valuation of gold and dollars.

(iii) Those ecus enter the UK's spot reserves, and are deducted from the forward book, at the UK's valuation of ecus.

This is, of course, only half the transaction. On each occasion the swap is unwound, the EEA enters a new swap with the EMCF, under which 20 per cent of the gold and dollar reserves held on that date are exchanged for ecus. It is the net valuation effect of both halves of the transaction which is separately identified as a reserve change in the reserves Press Notice.

In January, the bulk of the valuation effect was seen in the unwinding of the swap entered into in October. In that swap the EMCF had valued the EEA's gold at a much higher price than the UK does, although the EMCF and EEA had used similar valuations for the $/ecu rate. As a result, the EMCF had credited the EEA with a much greater value of ecu than the EEA had given up (at its valuation) in gold and dollars. But this gain had to be surrendered when the swap was unwound in January. In the new swap, the EMCF had cut its gold price, thus reducing the overvaluation effect, but it also cut its $/ecu rate so that

it now undervalues the EEA's dollars. These two effects broadly cancelled, so there is little net valuation change in the January swap. The valuation change shown in the January reserves is, therefore, almost entirely the unwinding of the overvaluation of gold in the October swap. The Annex sets out the effect of the January transaction on the EEA's accounts in detail.

Valuation changes relating to the EMCF swap can be in either direction. In April 1987, the spot reserves fell by a net $99 million as a result of the swap but in July they rose by $57 million and in October rose again by $129 million.

Not only is any valuation change in the spot reserves resulting from the swap offset by an exactly equivalent valuation change in the forward book but the whole swap transaction is in any case notional. The UK does not actually surrender gold and dollars for ecus; it continues to hold the underlying gold and dollar assets and manage them as part of the UK's reserves. It makes no loss on the swap as a result of the differing valuation practices and the dollar assets which form the basis for the swap continue to earn dollar income.

ANNEX

The EMCF difference reported in the reserves announcement reflects the combined effect of the valuation differences in unwinding one swap and entering the next. The table below shows how the difference of $660 million referred to in the January reserves announcement arises:

1. Unwinding swap	$million	mecu
EMCF values gold at		1893
EMCF values dollars at		3002
		4895
EEA surrenders 4895 mecu which UK values at	5504	
EEA receives gold which UK values at	1448	
EEA receives dollars	3385	
	4833	
Effect on spot reserves	-671	
2. Entering new swap		
EEA surrenders gold which UK values at	1448	
EEA surrenders dollars	4525	
	5973	
EMCF values gold at		1786
EMCF values dollars at		3536
		5322
EEA receives 5322 mecu which UK values at	5984	
Effect on spot reserves	+ 11	
Overall effect of EMCF swap rollover on spot reserves	-660	

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MONTHLY MONETARY ASSESSMENT : JANUARY 1988*

Summary Assessment

Although the economic indicators have been more mixed over the last month, this probably reflects reeaction from exceptionally strong indicators previously rather than pointing to any downturn. Money GDP in 1987-88 is now projected to grow by nearly 10 per cent compared to 8½ per cent growth projected in the Autumn Statement. The policy stance may also have eased over the last month; the oil adjusted exchange rate has fallen by ¾ point, mainly reflecting recovery in the dollar.

Main Points

M0 provisionally grew by 4.6 per cent in the year to January. The 12 month growth rate is projected to rise to around the top of the 2-6 per cent range in February and March (paras 26-28).

Broad money growth in December was moderate, despite some likely distortion from round-tripping. M4 grew by 1¾ per cent in December and the 12 month growth rate rose to 16¼ per cent from 15¼ per cent in November (paras 30-33).

Bank lending grew by 2.6 per cent in December. This was boosted by round-tripping and by arbitrage opportunities against dollar borrowing. But the underlying factor was probably companies' borrowing from banks to replace funds obtained from equity issues prior to the Stock Market fall. The same factor may have restrained monetary growth as firms drew on their liquidity (paras 30, 38-40, 52-53).

Sterling was broadly stable against the mark but fell against the dollar. The effective rate index fell by about 1½ per cent and the oil adjusted index by about ¾ per cent (para 21).

World economic growth quickened in the second half of 1987. Commodity prices resumed their rise in December after pausing in the previous two months (paras 1-2).

House price indicators give contradictory evidence. But the overall picture is of rapid inflation, concentrated in the region around London (para 15).

MG2 Division
5 February 1988

* This assessment was made before the ½ per cent base rate increase on 1 February.

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A. External Developments

1. Overall in the major countries, economic growth quickened in the second half of 1987 (see table 1). Industrial production in November was over 10 per cent higher than a year earlier in Japan, while US GDP grew by 3.7 per cent over the year to the fourth quarter of 1987. There are few signs so far that the fall in share prices has weakened activity - although survey evidence points to a weakening of consumer confidence in the US. Growth is expected to remain strong in the first part of 1988, but weaken somewhat, in North America particularly, later in the year.

2. Inflation in the G5 countries has remained at about 3 per cent since August, following the rise earlier last year. Domestic cost pressures remain weak, with unit labour costs falling in most of the major countries last year (table 1). The rise in commodity prices was interrupted in late October and early November, following the share price falls, but has since been resumed. Oil prices fell in early December, but have since recovered.

3. Following concerted intervention, the dollar has risen since the beginning of the year, but is still lower, in effective terms, than at the time of the Louvre Accord (table 3b).

Conditions in West Germany

4. The differential between German and British consumer price inflation rates narrowed from almost 5 per cent to 3 per cent during 1987, as prices in Germany have gradually started to rise again. But German inflation is not expected to rise much beyond the current rate of 1 per cent; both unit labour costs and import prices (measured in DM) are barely rising. Economic activity remains sluggish, with real GDP rising by 1.7 per cent in 1987, and is expected to remain so in 1988.

5. Concern that fast growth in monetary aggregates might cause the Bundesbank to raise interest rates may have receded somewhat with the substitution of M3 for CBM as the targeted aggregate.

M3 growth has been close to the upper end of the 3-6 per cent target range, while CBM - which is more interest-elastic because of its large currency component - has been growing over 2 per cent above the range.

6. The Federal **borrowing requirement** in 1987 turned out at DM 27.5 billion - a DM 5 billion overshoot. For 1988, there is expected to be a DM 10 billion overshoot to DM 40 billion. This is due to the effects of a lower dollar on the DM value of Foreign exchange reserves, higher EC contributions and lower tax revenues due to sluggish growth. This estimate takes account of the tax cuts and public expenditure announcements made before Christmas. However, Stoltenberg has stated his intention to hold the deficit to DM 30 billion in 1989 despite his commitment "not to offset budget revenue losses arising from recent developments" in 1988 (G7 communique, 23 December). Further tax reductions are not scheduled until 1990.

B. Activity and Inflation

7. Table 4 summarises recent indicators of **activity and inflation.** This month's indicators of activity have been more mixed than last month's buoyant figures; this may reflect some moderation in economic activity following exceptionally strong growth through 1987. Inflation indicators showed little underlying change between November and December, much as anticipated.

Recent indicators of activity

8. Monthly figures for production industry output show a ½ per cent fall in **manufacturing output** in November. The first quarter CBI survey of manufacturers, published on 26 January, showed total and export order books still strong and buoyant output expectations. But a sharp reduction in business optimism is also reported, perhaps reflecting increased uncertainty following the share price fall.

9. **Consumer spending** appears to have been particularly strong in November, both retail sales and new car registrations proved

very buoyant. Provisional figures for retail sales in December show a fall-back of around 1 per cent, to a level 5 per cent up on a year earlier. The first preliminary estimate of fourth quarter consumers' expenditure shows spending virtually unchanged from the third quarter, but 5¼ per cent up on a year earlier.

10. **Private housing starts** recovered somewhat in November after a low outturn in October. As yet, there are no signs of a significant downturn in housing construction activity.

11. **Labour market indicators** released this month remain strong, but may hint at a slight easing in labour market conditions relative to recent months. Figures for overtime in November showed no change from record October levels. But the 35,000 fall in unemployment in December, though possibly affected by seasonal variation in Special Employment Measures, represents the smallest reduction for six months. The 12,000 fall in vacancies in the same month, though coming after sharp increases in the preceding three months, represents the first fall since February 1987.

Inflation

12. **Retail price inflation** fell to 3.7 per cent in December compared with 4.1 per cent in November. This fall was in line with expectations, and primarily reflected the initial effect on the index of the latest reduction in mortgage interest rates. Excluding the mortgage interest component, the index shows little change in underlying inflation in December relative to recent months.

13. The 12 month increase in the **producer price index** (excluding food, drink and tobacco) in December was 4.7 per cent, down 0.1 per cent from November. CBI Survey responses relating to manufacturers' price expectations - adjusted for seasonal variation - picked up slightly in January. The annual rate of increase in producer input prices (also excluding FDT) was 5.6 per cent in December, up marginally from the (revised) 5.1 per cent November outturn.

14. Underlying growth in **average earnings** rose to 8¼ per cent in November, following outturns of 8 per cent in October and 7¾ per

cent in the preceding 6 months. Most of the increase in the underlying growth rate in October and November can be accounted for by the effects of the recent settlement of Local Authority Manual workers and the second stage of the teachers' award.

15. The latest indicators of house price inflation tell contrasting stories, but the overall picture remains one of rapid growth in house prices led more by the areas around London (East Anglia, the South East and the Midlands) than by London itself. The Halifax index shows annual growth in house prices of 16.3% in January - up from 15.8% in December and the highest 12 month growth rate since the index began in 1983 - and 15.5% in the year to Q4, significantly higher than the 14.6% in Q3. DoE figures also show a rising inflation rate to 16.7% in Q4 from 15.0% in Q3 for completions (20.7% from 14.4% for approvals). In contrast, the Nationwide index for Q4 shows annual growth of 16%, down from 19% in the year to Q3. Recent forecasts for 1988 also differ markedly, from below 10% (Nationwide and Woolwich building societies) to 15% (Halifax), although all forecasters expect a slowdown in the growth of house prices towards the end of 1988. The Royal Institute of Chartered Surveyors monthly report confirms demand recovering strongly in the South East and continuing buoyant elsewhere, but concludes that the outlook for 1988 is still uncertain.

Projections for money GDP

16. The Autumn Statement forecast for 8½ per cent growth in money GDP in 1987-88 is now likely to prove too low both because of upward revision to past data for the GDP deflator and faster than anticipated real activity through 1987. The average increase in money GDP in the years to the second and third quarters of 1987 is currently estimated at 9½ per cent; the winter forecast shows growth for 1987-88 as a whole at just under 10 per cent. The uplift relative to the Autumn Statement comprises similar increases to the forecasts for activity and the GDP deflator. The winter internal forecast projects slower money GDP growth through 1988-89 - to average around 7½ per cent for the financial year as a whole. The deceleration relative to 1987-88 primarily reflects slower growth in real activity, though the GDP deflator also rises slightly more slowly.

17. The latest set of indicators are likely to shift external comment from the risks of overheating to the possibility that we are now seeing the first sign of a slowdown after the share price fall. This would, however, be reading too much into one month's figures. Activity in October and November seems to have been exceptionally high and some deceleration was to be expected.

C. Public Sector Finances and the Fiscal Stance

18. Table 5 gives the main indicators of the fiscal stance. The PSBR in December was £0.2 billion, the buyback offer for BP shares, which closed on 6 January, having had a negligible impact. The April to November outturn for the PSBR has been revised up by £0.4 billion giving a PSBR surplus of £0.4 billion, for the first 9 months of 1987-88 - £5.6 billion below the Budget profile. If privatisation proceeds are excluded, borrowing in April to December has been £2.8 billion lower than for the same period in 1986-87.

19. Central government own account borrowing is £5.5 billion below profile - Table 6 gives details - and public corporations' borrowing £0.5 billion below profile, but local authorities' borrowing is £0.4 billion above profile.

20. The latest (Winter internal) forecast for the PSBR in 1987-88 is a surplus of about £2¾ billion. This is appreciably further into surplus than expected in the Autumn (eg. the internal Autumn forecast pre-stock market fall was for a surplus of about £1¼ billion). It is also over £6½ billion lower than the FSBR forecast (which was for a PSBR of about £4 billion). On the basis of the internal Autumn forecast the assessment was made that, even after allowing for a higher level of activity, fiscal stance was turning out considerably tighter than envisaged at Budget time. In qualitative terms there would not seem to be anything in the latest forecast to alter this conclusion: the forecasts of activity and inflation in 1987-88 have been revised upwards since the Autumn, but the PSBR forecast shows a higher surplus. Thus fiscal policy would not appear to be contributing directly to the higher than expected growth of output.

D. UK Exchange Rate and External Accounts

21. In January sterling stabilised against the DM at around 2.97 to 2.98, despite continued weakness in the oil market, but it has firmed a little following the half point rise in UK base rates in early February. As the dollar has recovered since early January the $/£ rate has fallen back sharply, from 1.88 to around 1.77 now, and this largely accounts for the recent easing of the sterling index to around 74½.

22. UK three month interest rates, which fell by ¼ percentage point to 8¾ per cent during January, rose to 9 per cent following the base rate rise on 1 February. US rates have fallen by ½ point since early January, while German rates have edged down by about ¼ point. As a result the interest rate differential against German rates, which had fallen back to 5¼ per cent in the second half of January, has risen to 5¾ per cent.

23. The Brent oil price, which weakened sharply in mid-December following the failure of the OPEC meeting to agree on how to constrain production, rallied briefly around the turn of the year (because one large trader had managed to corner the market in January Brent cargoes) but has steadily fallen back in January to just over $16 a barrel. But the fall in the exchange rate index since the beginning of January has reduced the oil adjusted ERI by around ¾ per cent.

24. In the absence of upward pressure on the DM/£ rate over the past month there has been little further official intervention.

25. The December trade figures, published on 28 January, showed a current account deficit of £582 million, broadly unchanged from November but at the pessimistic end of the range of City expectations. Total export volumes rose slightly more than import volumes in December but this was offset by a small deterioration in the terms of trade. In 1987 as a whole non-oil export volumes were 7½ per cent higher than in 1986 compared with a 9½ per cent

rise in non-oil import volumes. The current account deficit for 1987 is now estimated at £2.7 billion, close to the FSBR and Autumn Statement forecasts of £2½ billion.

E. Domestic Monetary and Financial Market Developments
(see Tables 10 to 26)

Narrow Money

26. M0 growth has been below expectations since the last assessment, with the level of M0 falling back slightly in the month to January. On the assumption that this fall was erratic - possibly reflecting suspect seasonal factors - and that M0 growth resumes in February at recent levels, the 12 month growth rate of M0 is forecast to rise from 4½ per cent in January to around the top of its target range of 6 per cent in February and March, as the fall in M0 in February 1987 drops out of the annual comparison.

27. **M0** (seasonally adjusted) provisionally fell by 0.3 per cent in January but the 12 month growth rate rose to 4.6 per cent, from 4.3 per cent in December, reflecting the sharp fall in the level of M0 in January 1987. The erratic falls in the level of M0 in both January 1987 and 1988 suggest suspect seasonal factors at this time of the year.

28. Assuming a resumption of the steady growth of M0 from its lower level in January, the forecast has the 12 month growth rate of M0 rising sharply in February and March, to around 5¾ and 6 per cent respectively, before dropping back to under 6 per cent from July. The sharp increase in the annual rate forecast in February mainly reflects a fall in the level of M0 in February 1987. But the 12 month growth rate is unlikely to breach its 6 per cent target in February, as an abnormally low level of bankers' deposits in the first week of the month will depress the annual rate by about ¼ percentage point.

29. **NIB M1** rose by £0.4 billion (a fall of £0.1 billion seasonally adjusted) in December and the annual growth rate was little changed

at about 10½ per cent. Interest-bearing sight deposits fell by £0.7 billion in December, partly reflecting the unwinding of an equity issue in September, the proceeds of which (£0.3 billion) were initially placed on retail deposit prior to investment during December. Together with the increase in NIB M1, this gives a £0.3 billion fall in M1. But the 12 month growth rate of M1 rose to 22¾ per cent in December, from 21¾ per cent in November, reflecting the effects of the British Gas sale on M1 a year ago.

Broad Money

30. The main features of the December money figures were moderate broad money growth - below the average increase over the past year - coupled with very high bank lending, over £5 billion. The private external counterpart was heavily negative, slightly outweighing the effects of heavy intervention, so that the externals were contractionary. A number of factors many help to explain this pattern (see especially para 38 below). But the underlying feature may be the predicament of companies after the stock market fall (see para 52 below). The evidence is broadly consistent with their turning both to bank borrowing and to accumulated liquidity to replace the finance formerly but no longer available from equity issues.

31. **M4** grew by £5.0 billion (1.7 per cent) in December and at an annual rate of 16¼ per cent, compared to 15¼ per cent in November. Seasonally adjusted M4 growth in the month to December was around its average level of recent months, the higher 12 month rate mainly reflecting the high growth of broad money in November 1986 before the British Gas sale, which depressed the 12 month comparison in November. **M3** rose by £2.7 billion (1.4 per cent) in December, slightly below the average of recent months, and the 12 month rate increased to 22¾ per cent, from 21½ per cent in November.

32. With respect to the **M4 components**, holdings of M3 by the private sector excluding building societies rose by £1.7 billion, compared to an average of £2.2 billion over the previous 12 months. Private sector retail deposits with the building societies were £3.0 billion

in December, of which £1.9 billion was interest credited. Wholesale funding of the building societies by the private sector was £0.3 billion.

33. With respect to the **M3 components**, apart from the £0.4 billion increase in NIB M1, interest-bearing retail deposits fell by £1.0 billion - the first fall since August 1986 - and wholesale deposits including CD's rose by £3.3 billion, of which nearly £1.0 billion is accounted for by building societies. The large fall in retail deposits in December is largely unexplained, although a contributory factor may have been the higher than expected tax payments in December, including some Corporation tax paid early. Wholesale deposits may have been inflated - perhaps by up to £½ billion - by round-tripping (see paragraph 38), and by companies building up liquidity prior to their large Corporation tax payments in early January.

34. **Building societies' retail position** continued to benefit from the effect of the stock market crash on unit trust and equity investment, with a seasonally adjusted inflow of £¾ billion in December. This was considerably lower than the November figure, but that was distorted by inflows related to the BP privatisation and also reflected a competitive advantage, no longer present in December, over bank accounts. But societies also borrowed heavily (£¾ billion) on the wholesale markets. Some of this borrowing was probably related to the announcement of the raising of the limit on wholesale funding, which has also led to three societies setting up euro CD facilities for a total $1.25 billion recently, but over £300 million consisted of increases in time deposits and was probably involuntary.

35. As a result of these retail and wholesale inflows, **societies' liquid assets** rose by over £1 billion, the largest increase of 1987 - this despite tax payments of £310 million. Within liquid assets, bank deposits (including CD's) rose by £1 billion; gilts rose by £0.2 billion, possibly as a delayed response to societies' large disposals in October; and holdings of bank bills fell by £0.2 billion.

36. The **broad money forecast** for January is dominated by the funding position: M3 and M4 are forecast to fall in January by £2¾ billion (1½ per cent) and £1 billion (¼ per cent), respectively, because of the expected Central Government surplus of £5½ billion and consequent overfunding, in excess of that last year. 12 month growth rates of M3 and M4 are forecast to fall by about 1 per cent and ¼ per cent, respectively, to 22 per cent and 16 per cent in January.

Credit

37. **Bank and building society lending** rose by £5.9 billion (1.8 per cent) in December and at an annual rate of 18¾ per cent, slightly below the 19 to 20 per cent range typical of 1987.

38. **Sterling bank lending** grew by 2.6 per cent in December and at an annual rate of 22¾ per cent, the 12 month rate being in line with recent months. Several factors may have contributed to the high growth in December:

(i) Takeover activity has been increasing lately and the slump in equity issues may have led to some substitution of bank borrowing to finance this, including the use of syndicated loans. The CLSB returns also suggest a high level of corporate borrowing, particularly amongst property companies (see paragraph 42);

(ii) Both anecdotal and statistical evidence suggest widespread round-tripping throughout the second half of December, as the Bank's money market operations put downward pressure on 3 month bill rates relative to interbank rates. Monetary sector holdings of bills rose by £1½ billion in December, with most purchases occurring throughout the second half of the month. Outside commentators have estimated that round-tripping may have been of the order of £½ billion in December;

(iii) A significant differential opened up in the second half of December between 3 month bill rates and US commercial

paper rates (adjusted for forward cover), making it profitable for companies to switch their borrowing out of US paper into domestic bills, swapping the proceeds into dollars. Anecdotal evidence suggests this occurred on a significant scale in December;

(iv) December is an interest charging month, accounting for about £1¼ billion (0.6 percentage points) of the rise in bank lending, which is offset within NNDL's in the broad money counterparts.

39. Foreign currency lending fell by £1.9 billion in December after having fallen by £1.6 billion in November. It is possible that at least some of this further reduction in foreign currency borrowing by the private sector represents the unwinding of October's hedging activity, when the private sector increased its currency bank borrowing by £3½ billion. With the fall in stock markets - and hence a fall in the value of portfolios - institutions may still have been overhedged, giving rise to the repayment of some of their currency borrowing. Foreign currency deposits of the private sector fell by under £0.4 billion in December, so that if repayments of currency borrowing were largely financed by running down sterling deposits, this would have contributed to the below average growth of broad money in December.

40. Overall the private sector reduced its net foreign currency liabilities with the monetary sector by £1.5 billion, and increased its net sterling liabilities by £2.4 billion, in December. But it was probably not the same individuals engaging in these transactions. The quarterly industrial analysis to November and CLSB returns for December (see paragraph 42) confirm that investment and unit trusts have been the only group in which sterling and currency borrowing were usually inversely related during 1987.

41. Building societies' mortgage lending strengthened slightly in December to a seasonally adjusted £1.3 billion. This figure probably reflects the competitive position before the equity price crash and gives little indication of the effect of the crash on

mortgage demand. But commitments figures for the 15 largest building societies, with 86% of all societies' assets, show little evidence of downturn in mortgage demand.

42. Several analyses of recent bank lending figures - namely the CLSB banks' breakdown by industry for December, all banks' breakdown by industry in the quarter to November, and the sectoral breakdown in Q4 1987 - all point to a continuation of the pattern of lending seen in the previous quarter. Sterling borrowing by persons remained very buoyant, both for house purchase and consumption; sterling lending to industrial and commercial companies accelerated, with growth particularly concentrated in lending to property companies and lending to small businesses; and sterling lending to the financial sector moderated, driven in particular by continuing repayments of borrowing by securities dealers and gilt-edged jobbers and by building societies. There is, however, evidence of distress lending (of £0.3 billion) by the banks to their non-bank financial subsidiaries during Q4, following the stock market crash. (This lending was capitalised during December, with no net effect on total bank lending in December.) Repayments of foreign currency borrowing were again concentrated in the financial sector, with large repayments by unit trusts unwinding their hedging of overseas assets built up earlier in the year.

Other Broad Money Counterparts

43. A PSBR of £0.2 billion and an increase in the reserves of £1.9 billion were underfunded in December by £1.3 billion, with negligible debt sales to the overseas sector and debt sales to the private sector of £1.2 billion. Cumulative underfunding in 1987-88 to date is £2.4 billion. Assuming a full fund over the financial year with no further intervention (see Annex for details), there is expected to be overfunding of £6.2 billion in January and £0.7 billion in February, followed by underfunding of £4.1 billion in March. This implies gross gilt sales, excluding calls, of £1.6 billion over the remainder of the financial year. The building societies purchased £0.4 billion of public sector debt in December, giving a slightly more expansionary public sector

contribution to M4 of £1.7 billion, which is also the cumulative public sector contribution to M4 in 1987-88 so far. The residual counterparts to M4 were contractionary by £2.6 billion, nearly all of which was within the banks' external transactions.

44. External influences on money were mildly contractionary in December. This was against a background of a rising exchange rate in the first half of December - requiring spot market intervention of £2.6 billion to cap the DM/£ rate - but a weakening exchange rate thereafter (except against a weak dollar). The counterparties to the intervention seem to have been mainly banks and overseas residents: the banks switched into sterling by £1.8 billion and overseas residents increased their net sterling deposits by £0.5 billion. Hence it appears that the intervention has not fed through into money. Banks' £NNDL's in December were contractionary by £1.6 billion; banks' capital was boosted by the combined effects of interest charging and capital issues.

Money Markets and Interest Rates

45. Money market rates started January at a premium to base rates, ranging from 8.7 per cent at one month to 9.5 per cent at 12 months. The ½ per cent increase in base rates to 9 per cent, announced on 1 February had little effect on rates, which currently range from 8.8 per cent at one month to 9.4 per cent at 12 months. 3 month yields on eligible bills - which were typically over ¼ percentage point below interbank rates in the second half of December - remained at a similar discount to interbank rates in the first half of January, with the gilt repo on 13 January having little effect. But the interest differential narrowed during the second half of the month and has now disappeared. Anecdotal evidence suggests that round-tripping occurred on a significant scale in the first half of January, which will have inflated the money figures.

46. The stock of money market assistance rose to a seasonal peak of £12½ billion at the end of January from £7¼ billion at end December. Some £1½ billion of Treasury bills sold in October and November matured in January, reducing the need for commercial bill

purchases accordingly. The need for bill purchases was further reduced by a £1¼ billion gilt repo, although this was undertaken primarily in an attempt to influence money market rates (see para 45). The stock of assistance is expected to remain at about £12½ billion until the end of February, and to fall back in March, due to the seasonal CG deficit, to about £9½ billion.

Gilts

47. Gilts began January with the index at 88.4 and 5, 10 and 20 year par yields at 9.1, 9.6 and 9.5 per cent respectively. The rise in bank base rates at the beginning of February had some impact on gilt prices which fell immediately on the news, having risen slightly during January. These losses have since been recovered somewhat, and the gilt index currently stands at 89.3, with par yields at 9.2, 9.4 and 9.3, indicating a flattening of the yield curve since the beginning of January.

48. The third and final experimental gilt-edged auction was conducted on 13 January. The stock offered was a medium, 8¾% Treasury Stock 1987 "C". The auction was covered 1.07 times, and the stock was sold at a weighted average yield of 9.99%. The lowest price which stock was allocated was £91.50, implying a yield to redemption of 10.15%.

49. Real yields on index-linked stock began January at around 2.8 per cent at the short end, rising to 4.0 at the longer end, although very long issues were around 3.8 per cent. They subsequently moved up by around 0.1 per cent at all but the shortest maturities, before falling back to end January much as they began it. The base rate rise had little effect. Breakeven inflation rates for index-linked Treasury 1990 and 2006 are currently 4.5 and 5.4 per cent respectively, compared with 4.6 and 5.6 per cent at the end of December . Together with the easing of long gilt yields, this would be consistent with some reduction in inflation expectations over the past month, possibly related to the release of less buoyant statistics on the real economy recently which has

reduced fears of overheating (see paragraph 17). The **equity dividend yield** (based on the all-share index) stands at 4.2 per cent, unchanged from the end of December.

Capital Markets and Corporate Finance
(see tables 20-21)

50. **Equity prices** (measured by the FT All Share Index) strengthened a little further during January, having risen by 9 per cent during December, but the market remains nervous. This is reflected in the scarcity of equity issues, see paragraph 52. The index currently stands at 906, 1 per cent down on a year ago and 27 per cent down on its July peak.

51. There were net inflows into **unit trusts** of £150 million in December, compared to a small net outflow in November. Gross sales of unit trusts have continued to fall, however, from £1.7 billion in October to £0.7 billion in December. The net inflow of £150 million in December compares to a monthly average of £1.00 billion in Q3 1987 and £0.5 billion in 1987 as a whole.

52. The short-term effects of the stock market crash on the pattern of **corporate finance**, and thus on the money figures, are beginning to emerge. With their equity issues having fallen from an average of £2¼ billion per month in the third quarter of 1987 to just £¼ billion per month in December and January, UK industrial and commercial companies will have to turn to other sources of finance. While there have been signs of some resurgence in the eurobond market, issues by UK companies only picked-up during January and the rise in base rates has since depressed the market. Issues of sterling commercial paper were also depressed in December (see below). Hence the main counterparty to corporate financing is likely to have been the monetary sector.

53. Corporate bank borrowing may have been as high as £3½ billion in December, of which £1½ billion was bill finance - which may have been inflated by round-tripping. There also have been

announcements of considerable quantities of syndicated credit and multiple option facilities over the last month - some being takeover related. It seems probable that some of these facilities will be exercised, boosting bank lending.

54. Unpublished early estimates of **life assurance companies' investments** in the fourth quarter of 1987, which in the past have given a reasonable guide to the direction of flows, suggest that **life companies sold overseas company securities heavily and acquired** UK company securities, as well as accumulating liquid assets. The proportion of their assets held overseas may have fallen back sharply to mid-1983 levels, while the proportion invested in UK company securities fell only to the level in early 1987 and the gilts proportion recovered to the early 1987 level. Their liquidity proportion may have risen from about 2½ per cent to about 3¾ per cent.

55. The stock of **sterling commercial paper** (SCP) outstanding fell by £270 million in December, to £2.1 billion, with net redemptions by UK companies of £250 million reducing the stock to £1.2 billion. Monetary sector holdings of SCP fell by £200 million, to £0.5 billion. The fall in stocks in December mainly reflects lower issues, which in part could be seasonal - for example, retailers would curtail their SCP issues because of high seasonal revenues - and may also reflect the relative attractiveness of bill finance during December. But issues also fell in November and stocks of SCP outstanding are now back to their levels over the summer.

MG2 Division
5 February 1988

90/G.jfw.4555/22

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Monetary developments since last month's report

	Latest outturns available at time of: July Report	Dec Report	Jan Report
Monetary aggregates (12 month % growth)	(June)	(Nov)	(Dec)
M0 (sa)	4.2	4.9	4.3(4.6+)
M3	19.1	21.4	22.8
M4	13.8	15.2	16.3
M5	13.5	14.6	15.7
Bank lending	21.5	22.5	22.7
Bank & building society lending (est)	19.3	19.0	18.8
Interest rates (%)	**28 July**	**22 Dec**	**3 Feb**
3 month interbank	9.3	8.9	9.0
20 year gilt-edged (par yield)	9.5	9.6	9.3
Yield gap	-0.2	-0.7	-0.3
UK real 3 month interbank	5.6	4.7	4.8
Equity dividend yield (all-share)	3.0	4.3	4.2
IG yield (2001) assuming 5% inflation	4.1	4.0	4.0
3 month UK interest differential with:			
Germany	5.4	5.2	5.7
US	2.4	1.0	2.2
World basket	3.0	2.2	2.9
Exchange rate			
DM/£	2.97	2.98	2.98
ERI	72.6	75.6	74.4
Oil adjusted ERI	98.4	105.1	104.3
(Oil-adjusted reference index)	(73.8)	(71.9)	(71.3)
Asset prices			
FT-A Index (% pa)	55.9	7.5	-0.7
FT-A Level (July peak: 1239)	1199	885	906
Halifax house index (% pa)**	14.3	15.8	16.3

+ January outturn (provisional)

* 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 July, December and January.

ANNEX

BROAD MONEY FORECAST

1A. The broad money forecast for January is dominated by an expected Central Government surplus of £5½ billion, resulting in large overfunding and a fall in the level of broad money: M3 is forecast to fall by £2¾ billion (1½ per cent) and M4 by £1 billion (¼ per cent). The CG surplus is, of course, seasonal, with falls in both M3 and M4 also occurring in January 1987. The fall in 1987 is, however, less than is forecast for 1988 so that annual growth rates of M3 and M4 are expected to fall by about 1 per cent and ¼ per cent, respectively, to 22 per cent and 16 per cent. The seasonal adjustments should, in theory, smooth the CG surplus and its effect on money growth over the financial year. In practice, however, the adjustments are based on much lower forecasts of the CG surplus, so that even in seasonally adjusted terms money growth is expected to be low in January - a rise of only 0.1 per cent in M3 and a fall of 0.2 per cent in M4.

2A. The unadjusted annual growth rate of M3 is forecast to fall further to 21½ per cent in February and 20¼ per cent in March, while annual growth of M4 is expected to remain at about 16 per cent.

3A. There are few other special factors affecting the money and bank lending forecasts (see tables 1 and 2). It is assumed that there will be no intervention during the forecast period, and that the PSBR and the reserves increase will be fully funded over the financial year (including an extra £0.4 billion of funding to compensate for the 1986-87 underfund). The impact of January's overfund on money is partly offset by an assumed boost of £¾ billion to bank lending - £¼ billion of it due to a fall in the bill leak associated with Bank of England purchases of commercial bills. In addition it is likely that bank lending may be boosted in the forecast period by increased use by companies of syndicated bank credits to replace equity issues. The magnititude of the switch is uncertain, since although a number of large credits are known to have been arranged recently, the draw-down dates for the facilities are not known and many of the loans are in foreign currencies. The forecast assumes a boost to sterling lending of £100 million per month.

4A. Building societies' retail inflows are forecast to remain extremely buoyant over the next few months at a level only slightly lower than that of December. But large tax payments will mean little growth in liquid assets and societies may therefore borrow small sums on the wholesale markets; at least one society is known to have issued eurobonds in January and the large recently arranged euro-CD facilities also point towards significant wholesale borrowing requirements in the near future. Within liquid assets, societies are likely to run down CTD holdings as tax payments fall due.

5A. The reasonably strong performance of mortgage commitments over the post-crash period points to moderate growth in societies advances over the next three months, although anecdotal reports of withdrawals from offers on houses, if true, may lower the number of completions relative to approvals. Whether the steady performance of building society commitments is a result of overall housing market conditions or reflects a growth in market share by societies is less easy to judge, but we do expect societies to gain share over the medium term at least.

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ANNEX TABLE 1

Broad Money Forecasts

£ million not seasonally adjusted

	1987 DECEMBER		1988 JANUARY		FEBRUARY		MARCH	
	M4	M3	M4	M3	M4	M3	M4	M3
(i) Underlying Increase*	4424	2106	-1875	3700	3275	2925	7125	6175
Special Factors:-								
Bank lending	550	550	900	900	100	100	-50	-50
(ii) Total Special Factors	550	550	900	900	100	100	-50	-50
(iii) Total Increase	4974	2656	-975	-2800	3375	3025	7075	6125
% Change on previous month	1.7	1.4	-0.3	-1.5	1.1	1.7	2.3	3.3
% Change on previous year	16.3	22.8	16.1	21.9	16.3	21.6	16.0	20.3
Memo								
Underlying % Change on previous year	14.9	20.3	14.3	18.8	14.5	18.5	14.3	17.4
% Change expected at Budget time	15.2	17.0	15.6	16.8	15.4	15.7	14.2	13.5

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

*Based on the following assumptions:

(a) Underlying bank lending rises by £3.6 billion per month and building society lending rises by £1.4 billion per month, both seasonally adjusted

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

	December	January	February	March
M4	1640	-6275	-775	3950
M3	1262	-6175	-675	4050

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ANNEX TABLE 2

Lending Forecasts

£ million

		1987 DECEMBER			1988 JANUARY			FEBRUARY			MARCH		
		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	4354	1068	5084	3600	1350	4900	3600	1400	4900	3650	1450	4900
	Special Factors												
	PSBR offset	500	-	500	-500	-	500	0	-	0	-150	-	-150
	Bill leak	-50	-	-50	300	-	300	-	-	-	-	-	-
	Take-overs	100	-	100	100	-	100	100	-	100	100	-	100
(ii)	Total Special Factors	550	-	550	900	-	900	100	-	100	-50	-	-50
(iii)	Total Increase (seasonally adjusted)	4904	1068	5634	4500	1350	5800	3700	1400	5000	3600	1450	4950
	Total Increase	5372	907	5941	4000	1150	5100	3600	1225	4725	2475	1475	3850
% Change on previous year		22.7	13.2	18.8	24.0	12.8	19.5	24.2	12.9	19.7	23.3	13.0	19.2
Memo													
Underlying % Change on previous year		22.4	13.2	18.6	23.2	12.8	19.0	23.3	12.9	19.0	22.5	13.0	18.7
% Change expected at Budget time		18.5	15.8	16.9	18.9	16.0	17.1	18.5	16.3	17.0	18.4	16.6	17.3

*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 DEC	FORECAST 1988 JAN	FEB	MAR
1. CG (OA) (SURPLUS-)	-536	-5725	375	3050
2. LABR	638	-300	-100	900
3. PCBR	94	-125	-300	-125
4. PSBR(1+2+3)	196	-6150	-25	3825
5. NET DEBT SALES TO NBPS (-)				
GILTS	-701	-625	-500	200
TREASURY BILLS etc	9	325	0	0
NATIONAL SAVINGS	-165	-225	-175	-200
CTDs	-18	400	75	25
OPS DEBT	-264	100	100	300
TOTAL	-1139	-25	-500	325
6. EXTERNAL FINANCE OF PUBLIC SECTOR (INC-)	2205	0	-150	-100
7. OVER (-)/UNDER (+) FUNDING (4+5+6)	1262	-6175	-675	4050
8. STERLING LENDING TO NON-BANK PRIVATE SECTOR	5372	4000	3600	2475
(seasonally adjusted)	(4904)	(4500)	(3700)	(3750)
9. PRIVATE NET EXTERNALS AND NET NON-DEPOSIT LIABILITES	-3978	-625	100	-400
10.M3 (7+8+9)	2656	-2800	3025	6125
BUILDING SOCIETIES:				
11. RETAIL DEPOSITS	2980	2325	800	825
12. WHOLESALE DEPOSITS NBPS	324	25	50	150
13. HOLDINGS OF M3 (-)	-986	-525	-500	-75
14.M4 (10+11+12+13)	4974	-975	3375	7025

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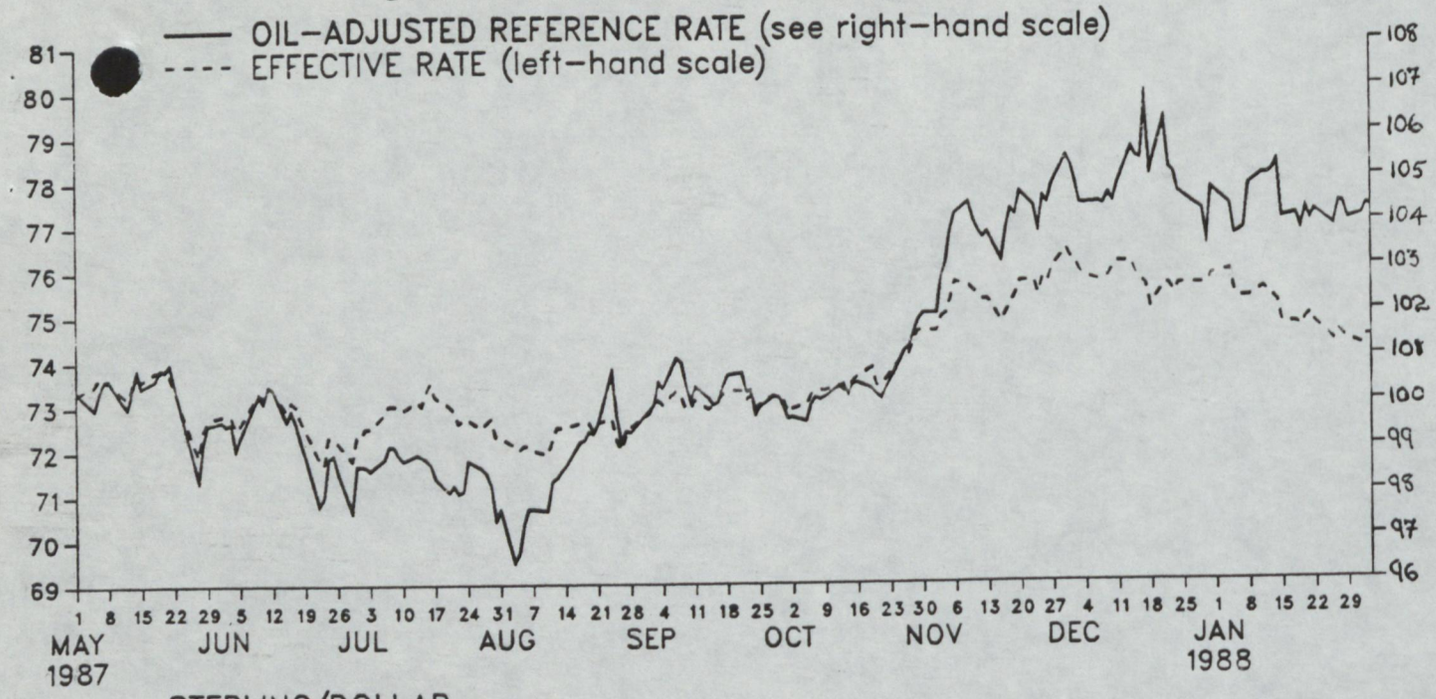
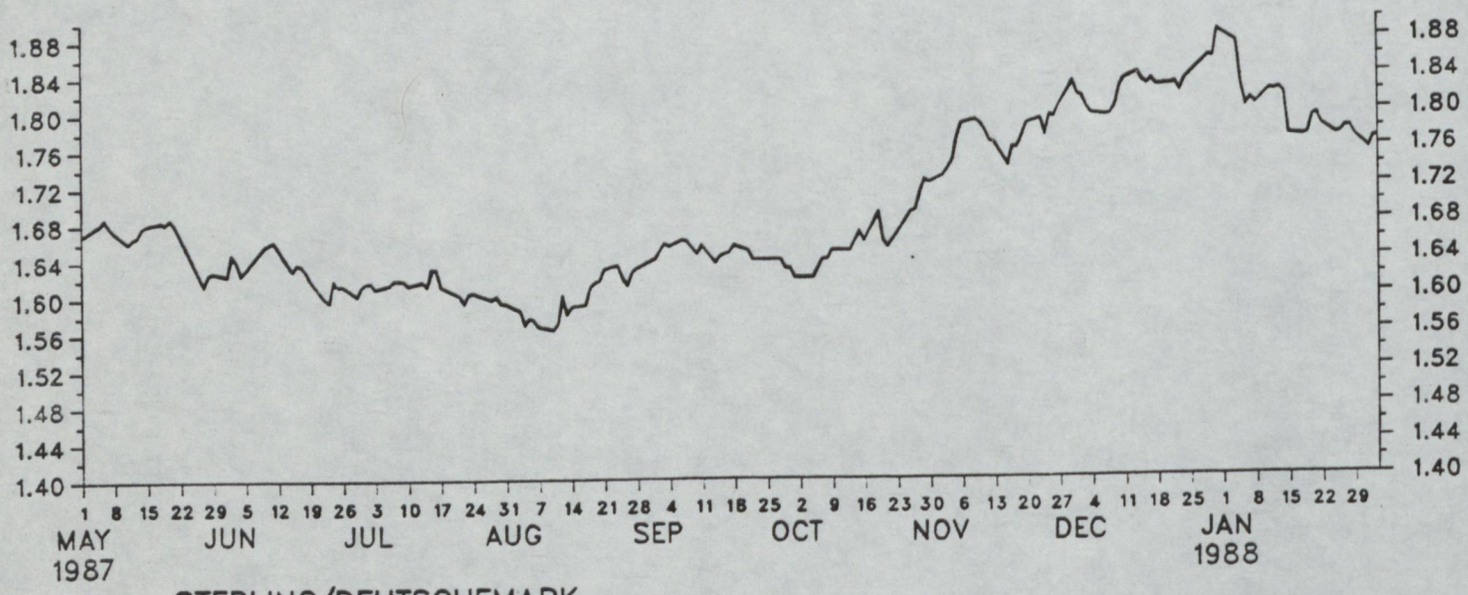
MONTHLY MONETARY REPORT : CHARTS

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

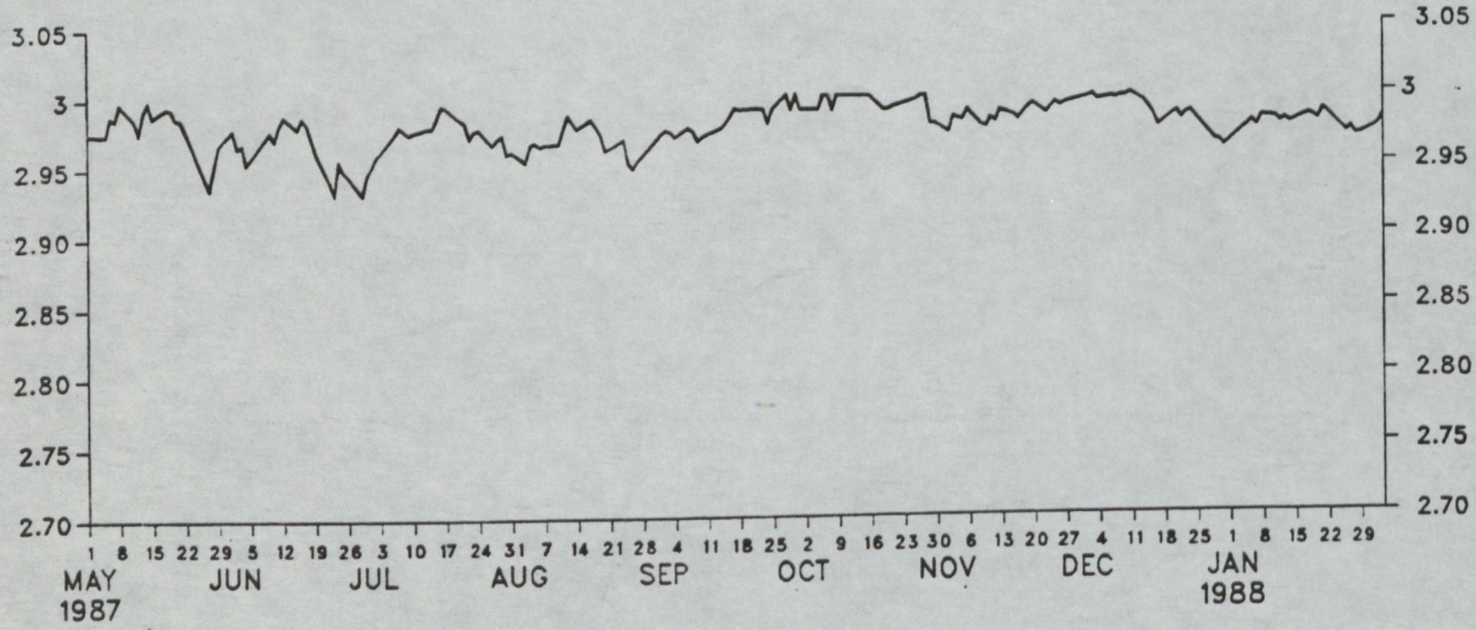
CHART I:EXCHANGE RATE



STERLING/DOLLAR



STERLING/DEUTSCHEMARK



UK/US INTEREST RATE DIFFERENTIAL

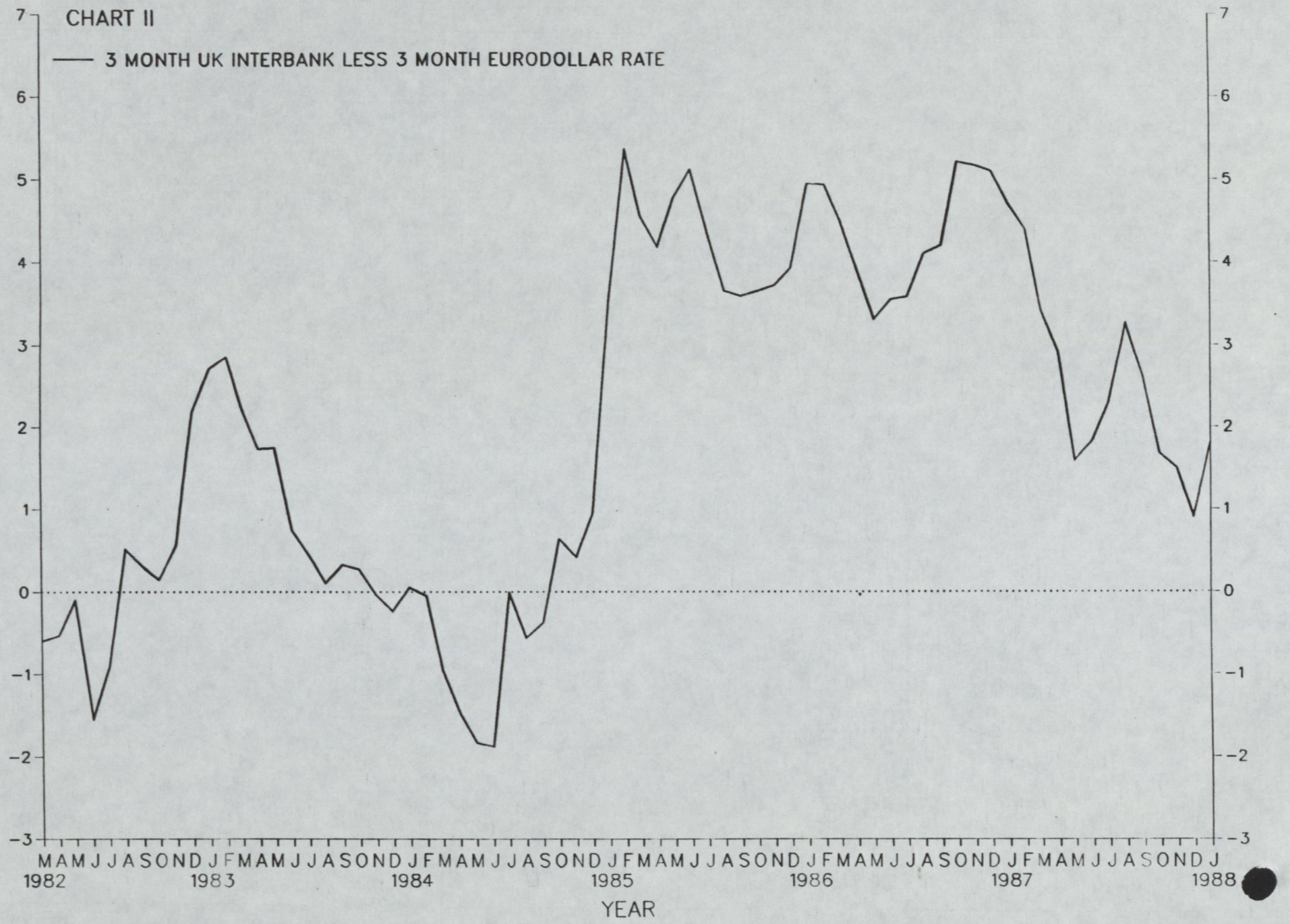


CHART III NARROW MONEY

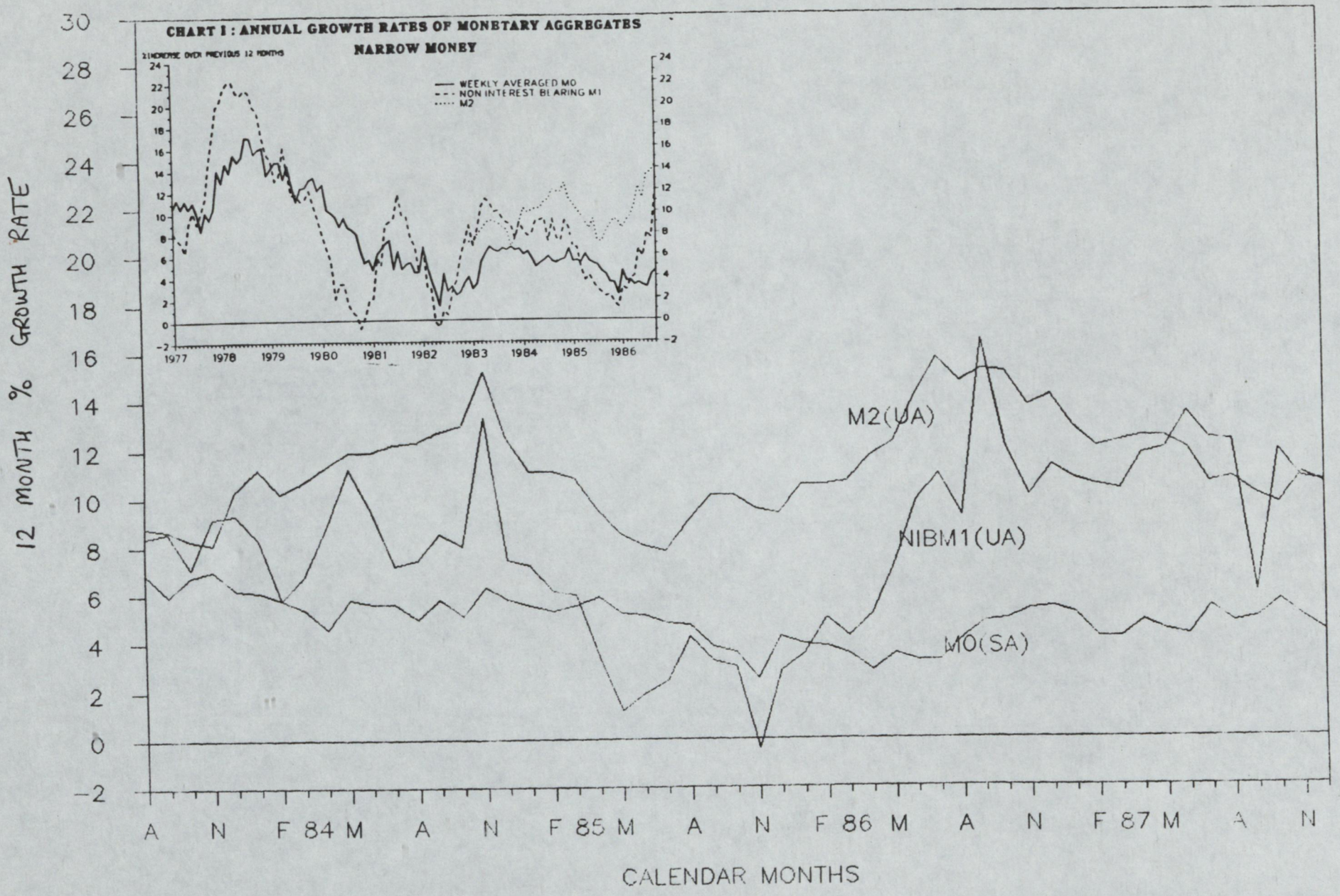


CHART IV BROAD MONEY

Annual percentage growth (ua)

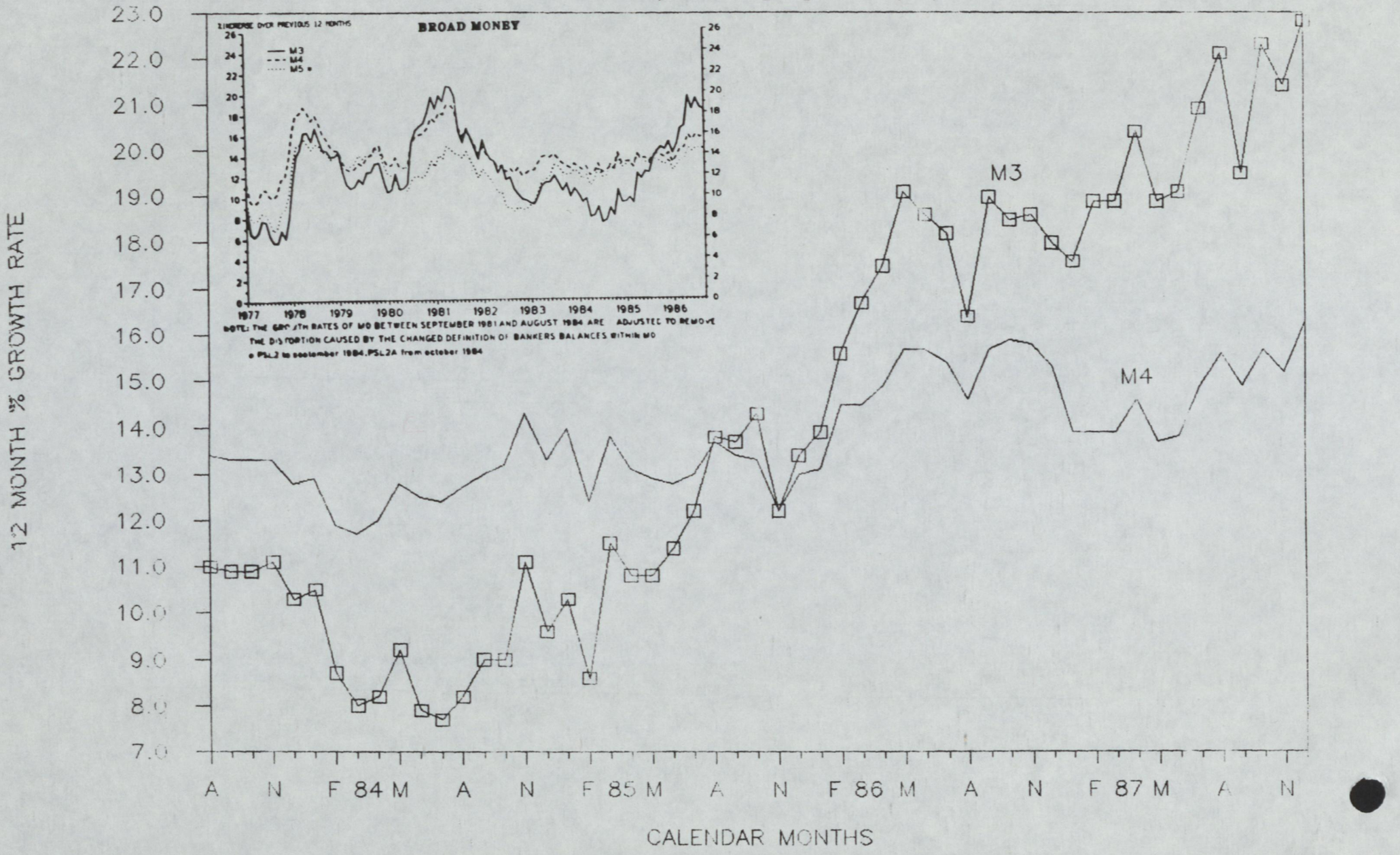


CHART V REAL M0

Annual percentage growth (sa)

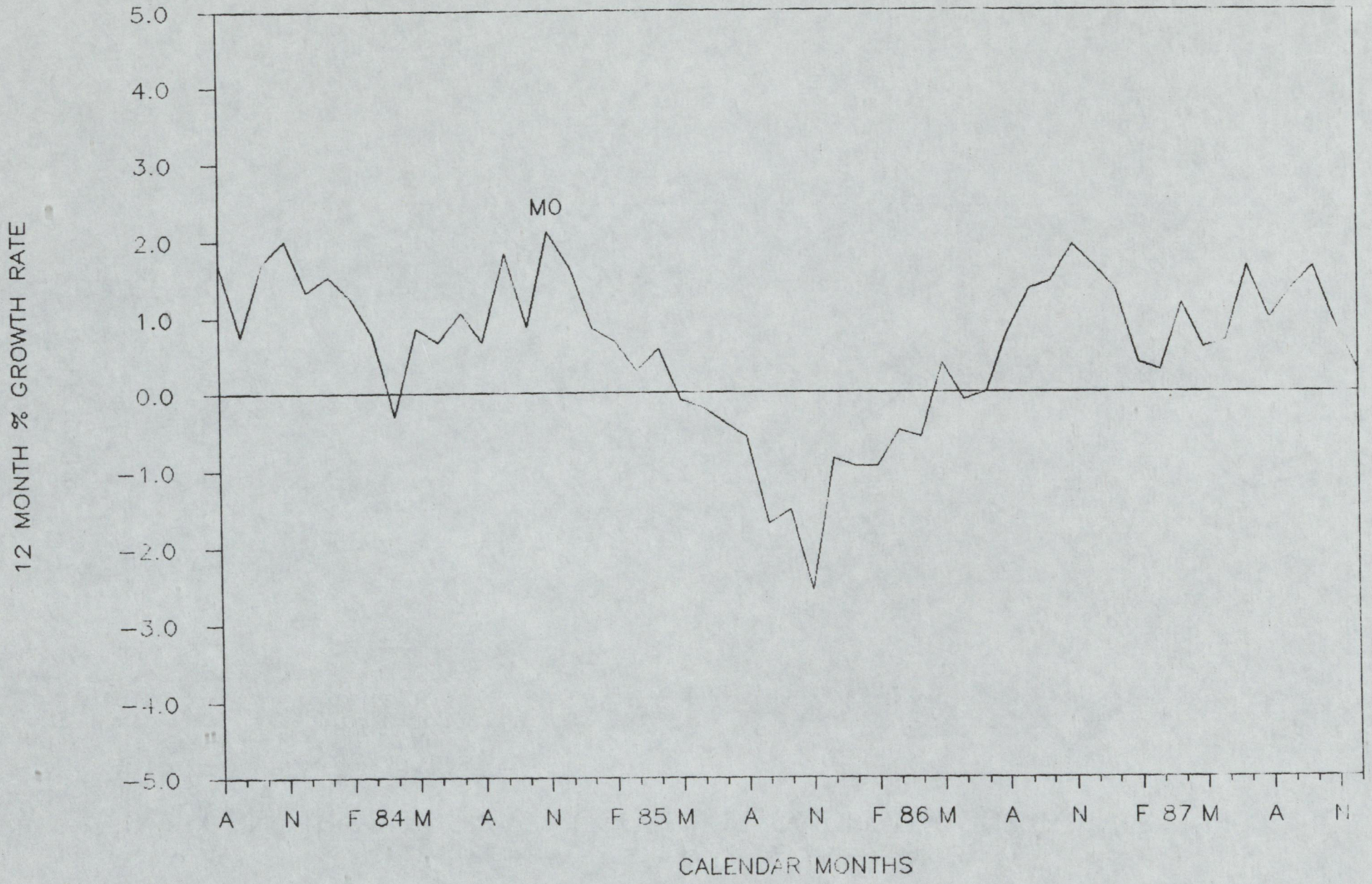


CHART VII

COMPARISON OF 1987 BUDGET FORECAST WITH OUT-TURN FOR M0

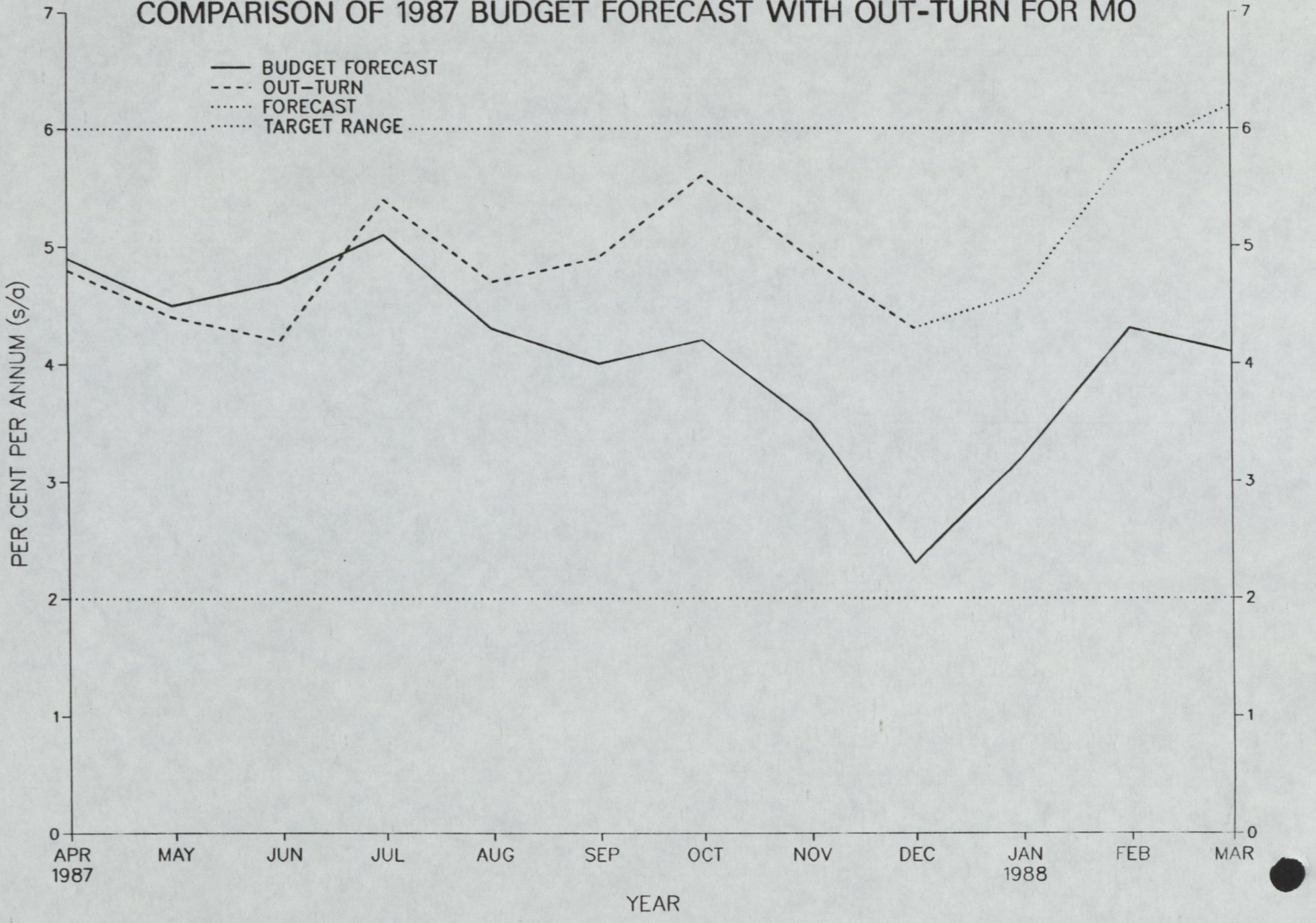


CHART VIII

COMPARISON OF 1987 BUDGET FORECAST WITH OUT-TURN FOR M3

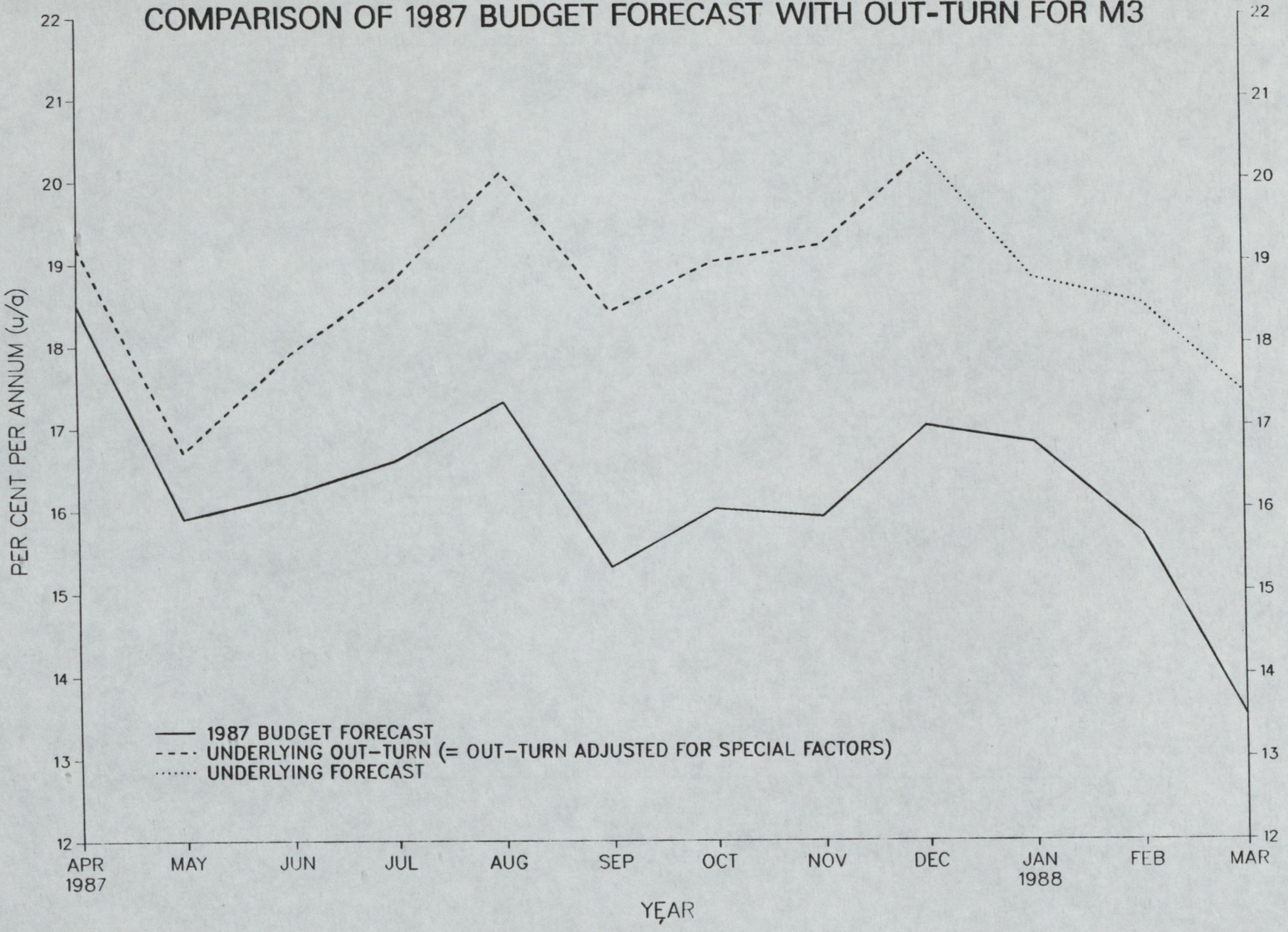


CHART X RETAIL DEPOSITS

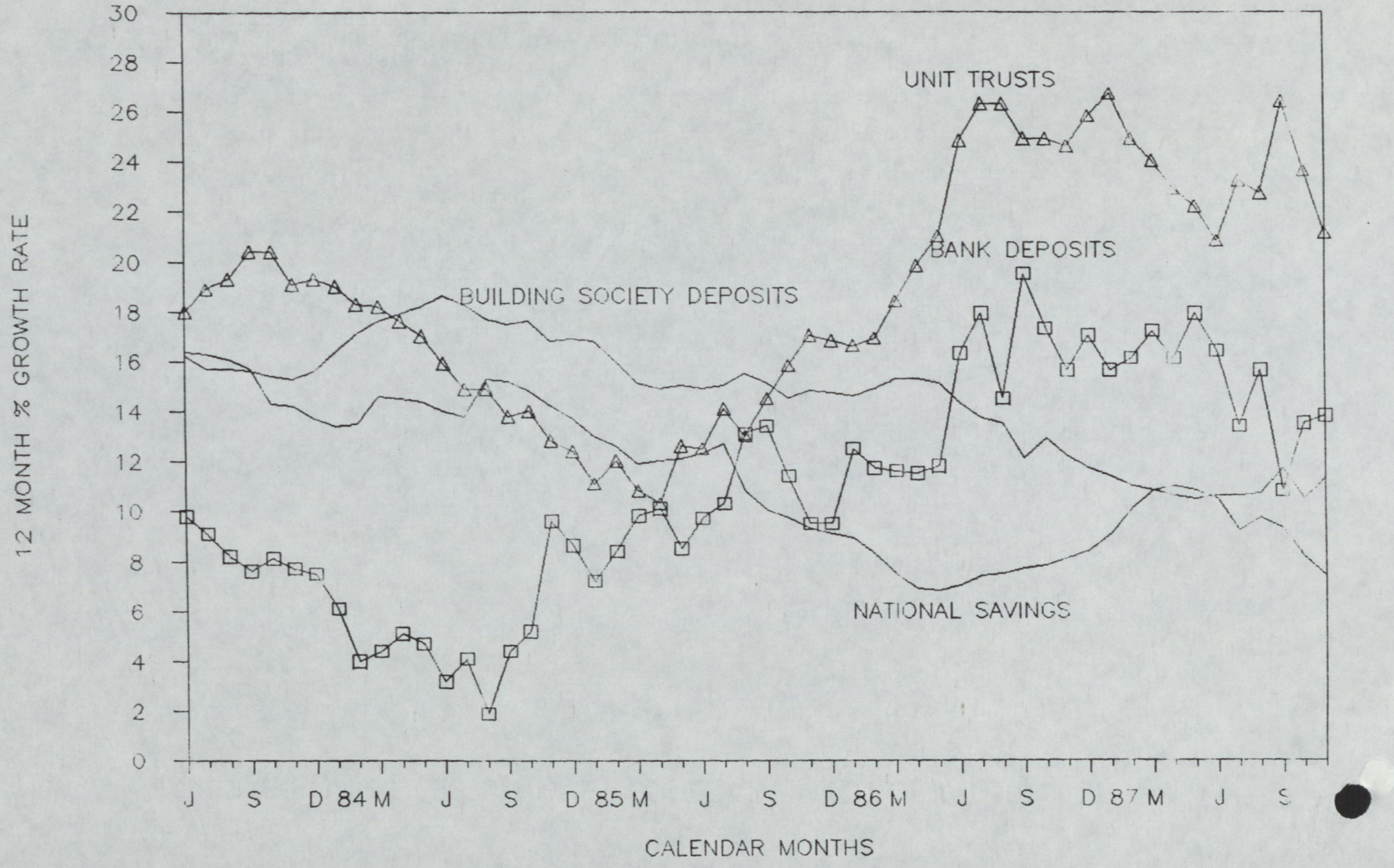
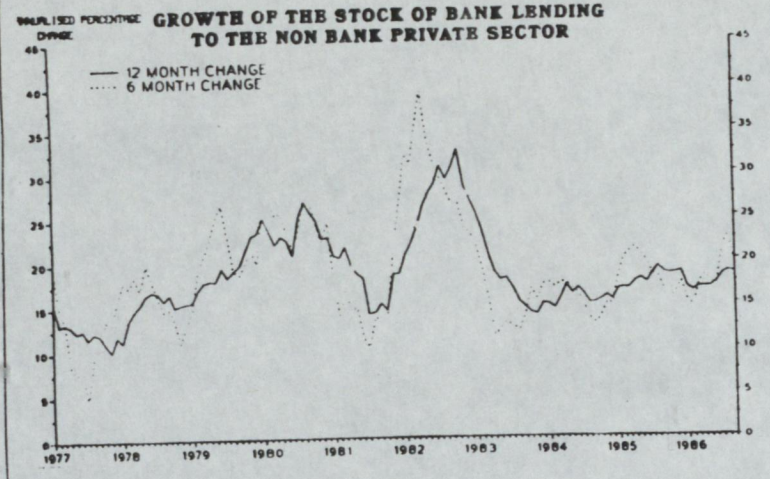


CHART XI

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



BANK LENDING

BANK AND BUILDING SOCIETY LENDING

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 A S O N D

1984 1985 1986 1987

CHART XII

STERLING BOND ISSUES BY UK AND OVERSEAS INSTITUTIONS

(DOMESTIC AND EURO MARKETS)

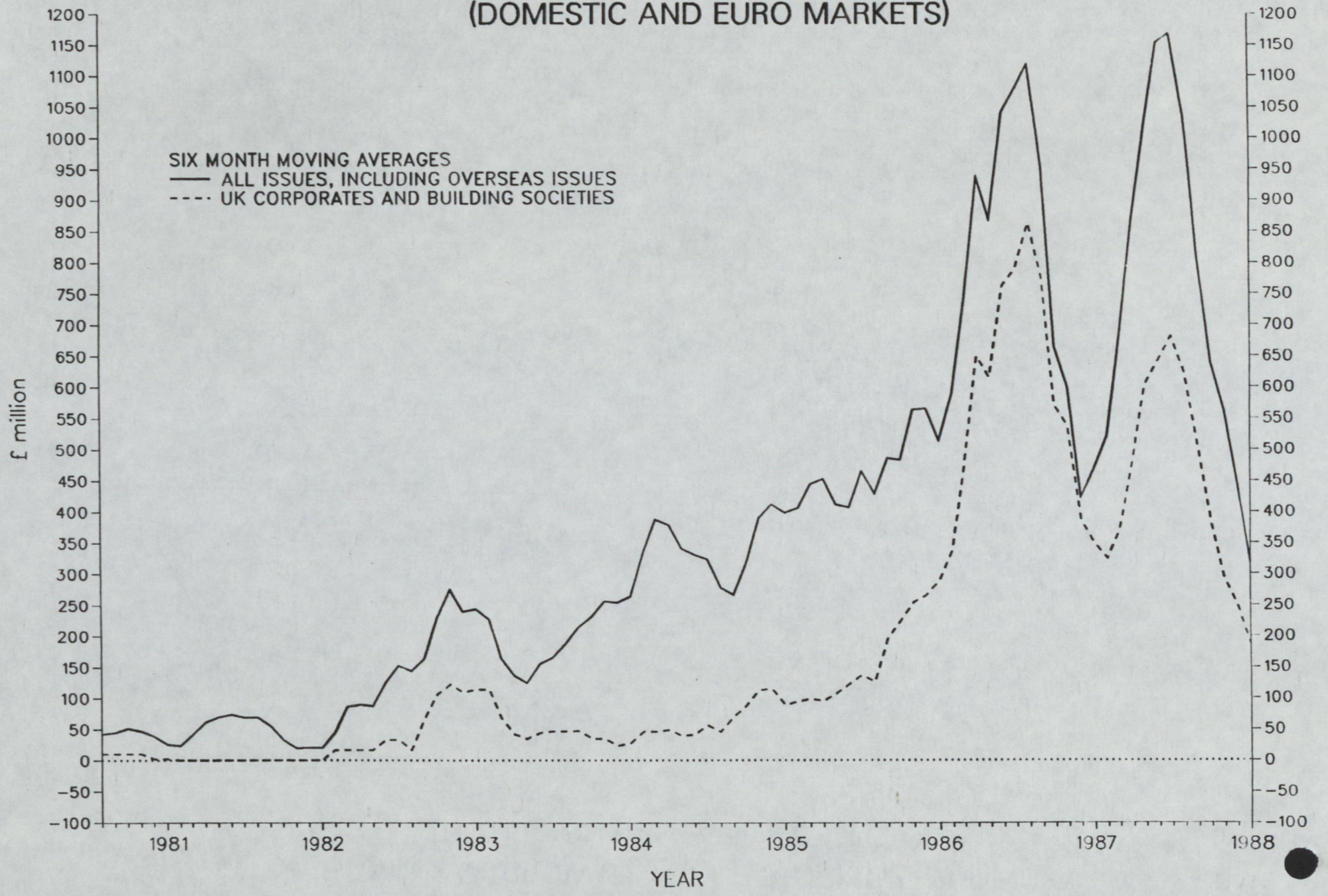
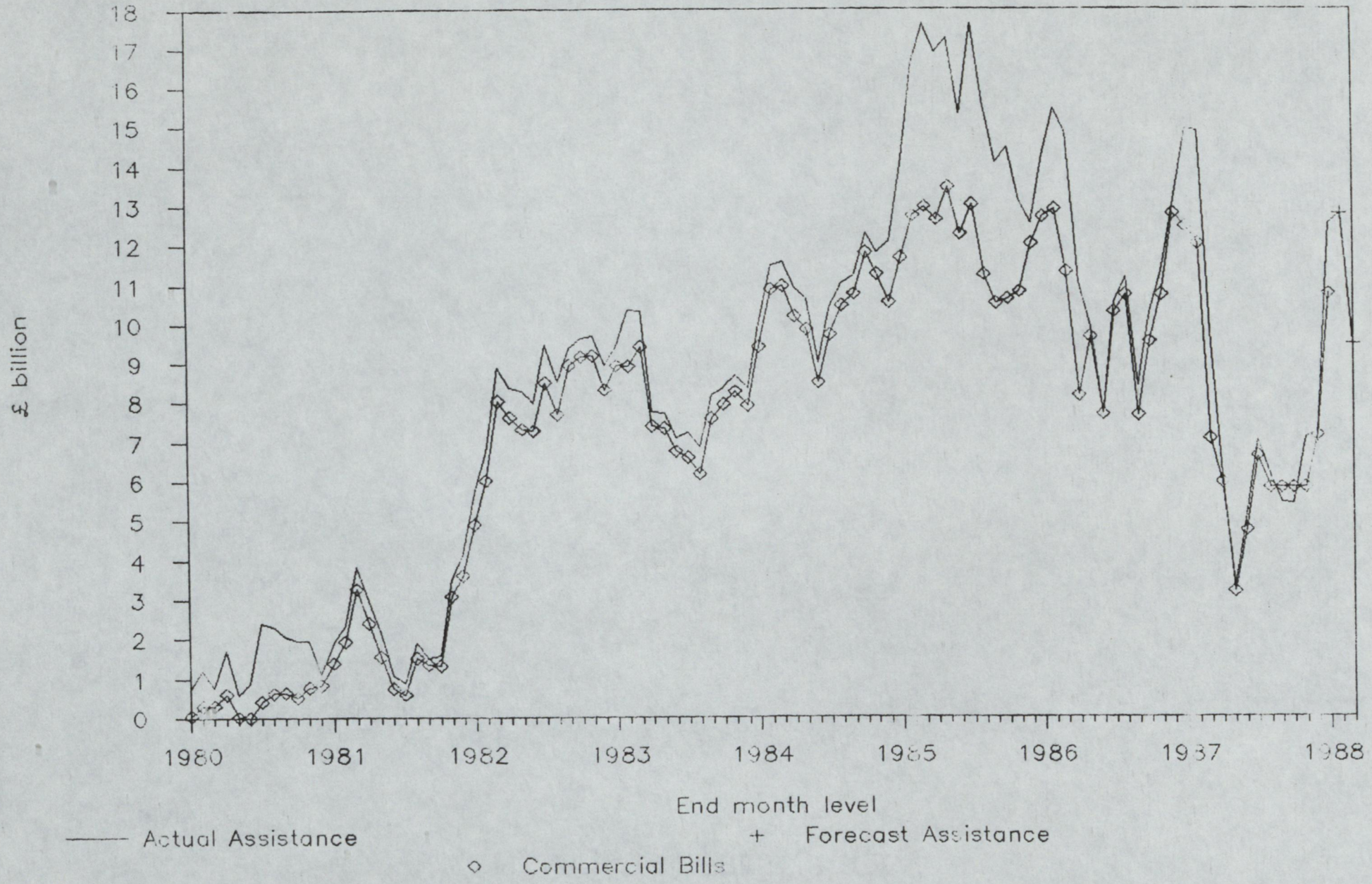
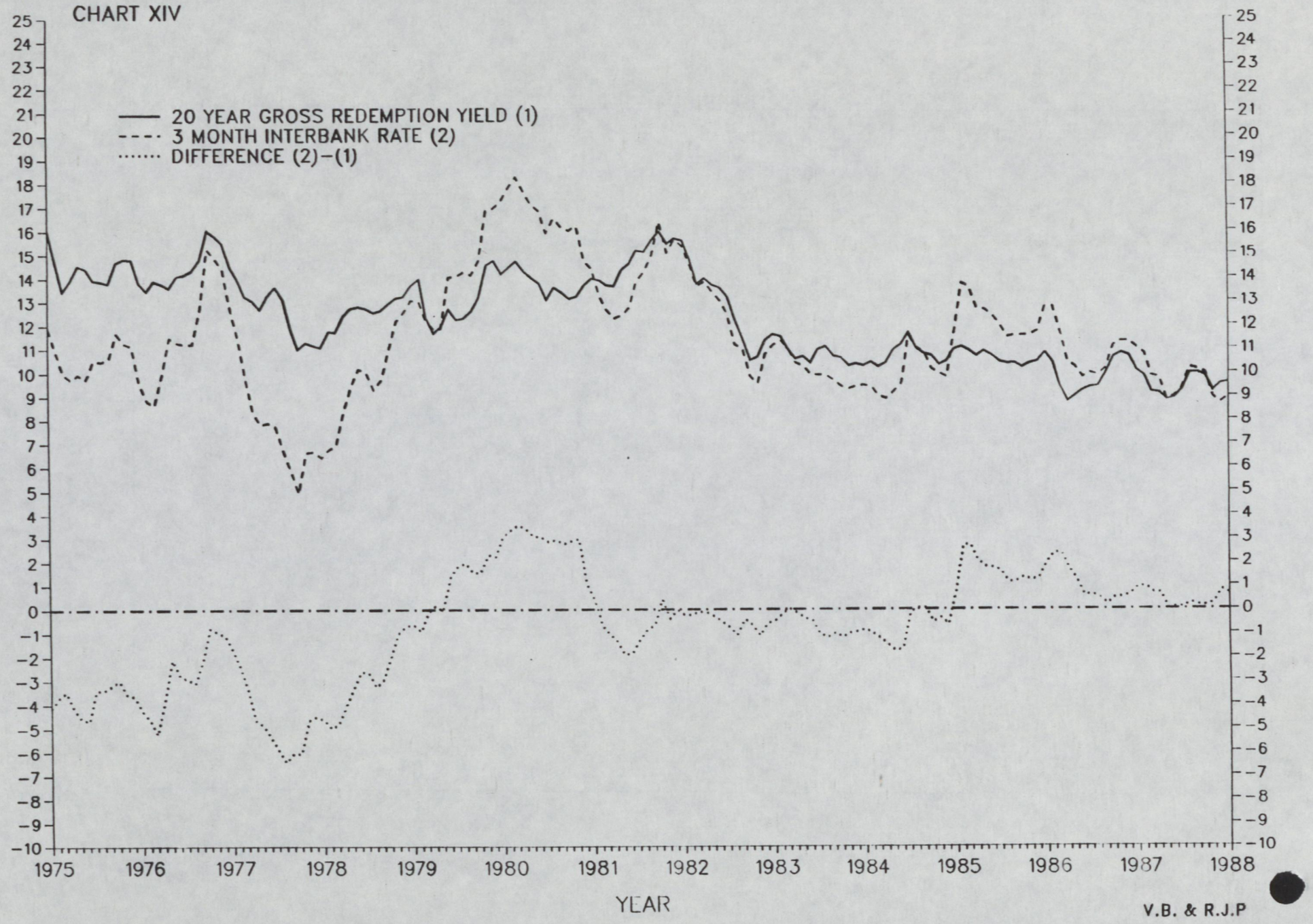


CHART XIII – MONEY MARKET ASSISTANCE



NOMINAL INTEREST RATES



Per cent Time / Yield Curves of British Government Stocks 1st February 1988

CHART XV

The curves have been fitted to the gross redemption yields on stocks with one year or more to maturity. They are not reliable below 2 years, and the 1-year yield is calculated as an average of 4 stock yields.

LA: 3-month deposit rate.
TB: Market rate of discount, expressed as an annual yield.
Debenture Yield: FT 15 year
FT All Share Index gross dividend yield 4.15

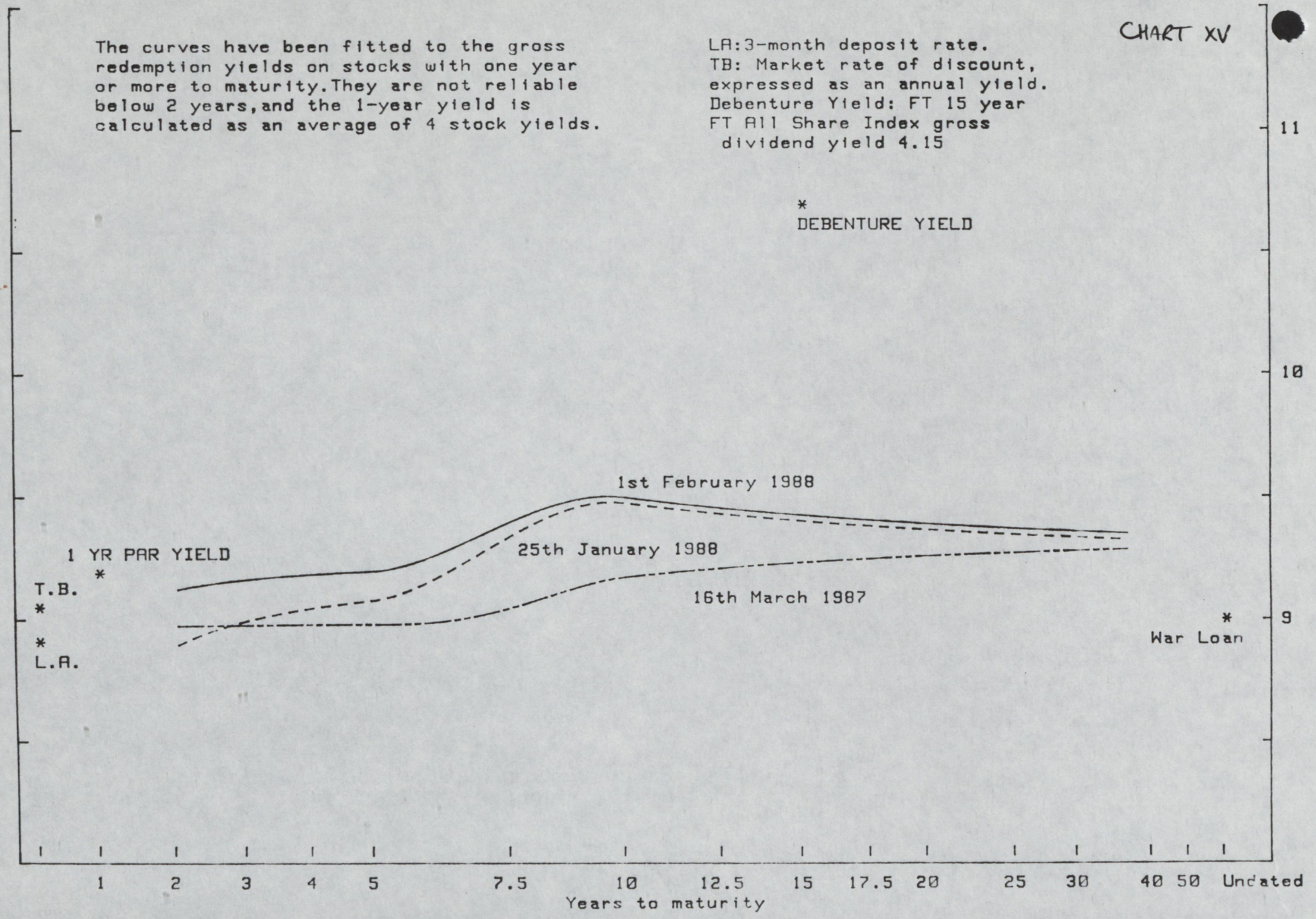
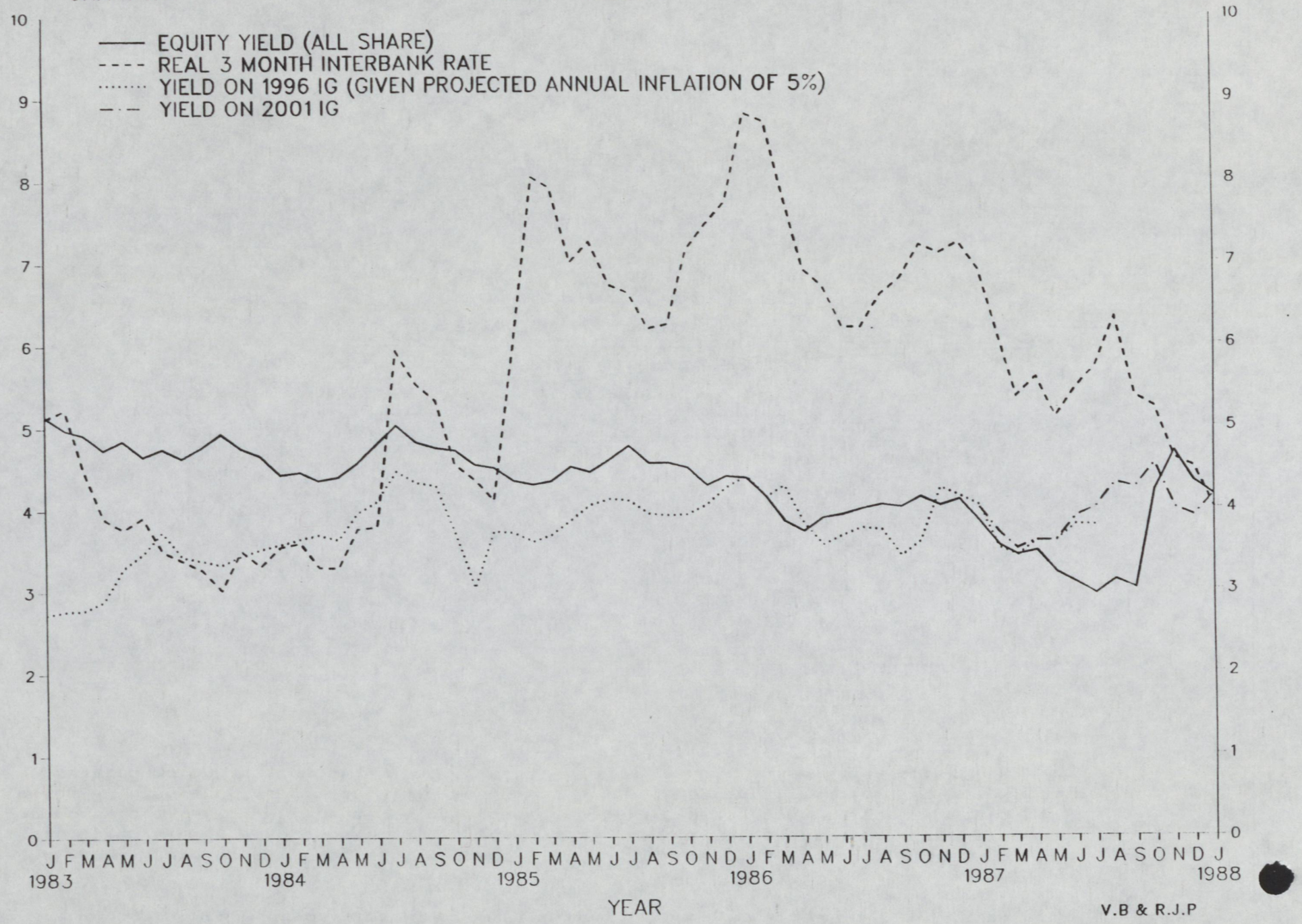


CHART XVI

REAL YIELDS



V.B & R.J.P

ANNUAL HOUSE PRICE INFLATION

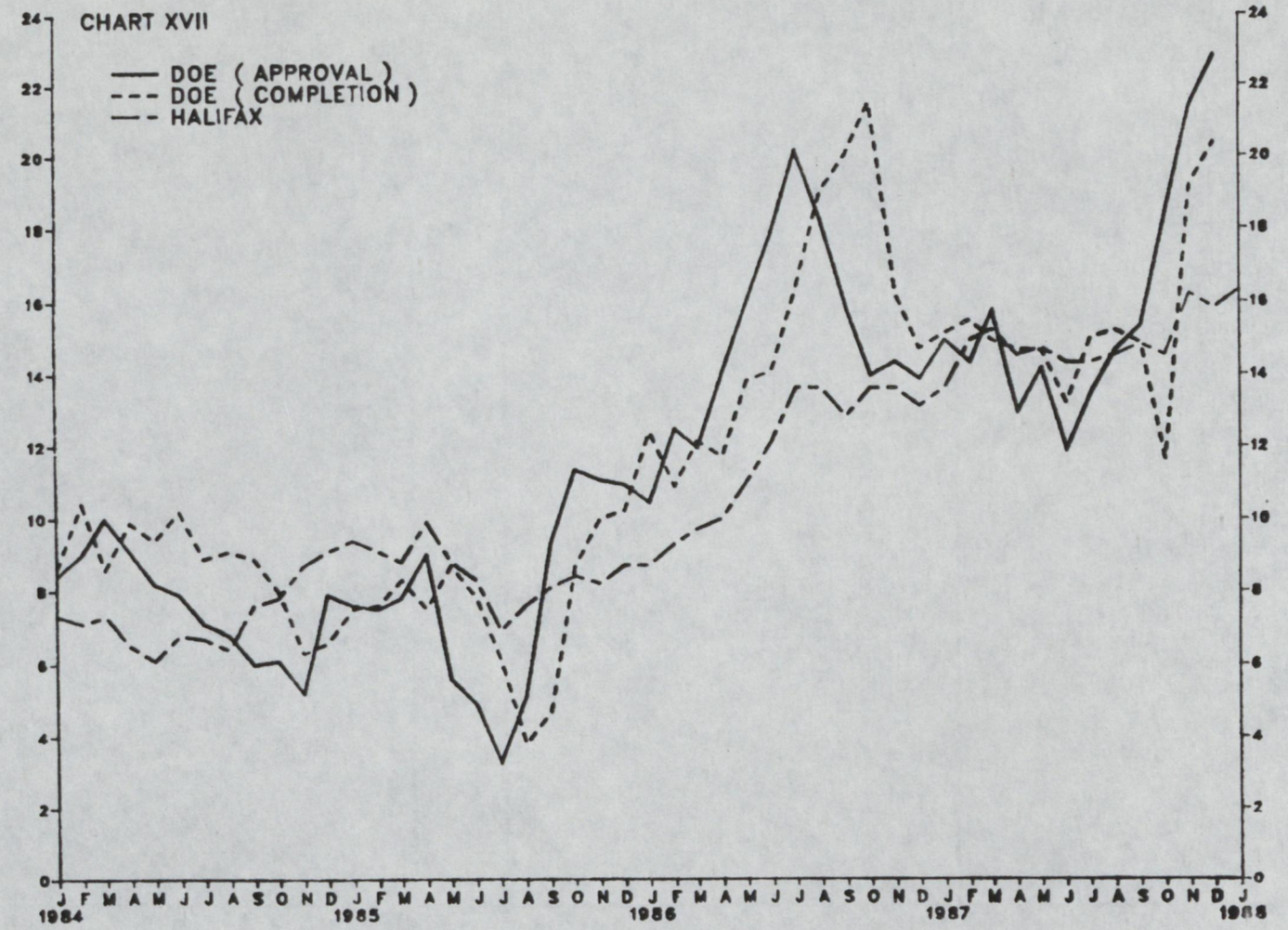
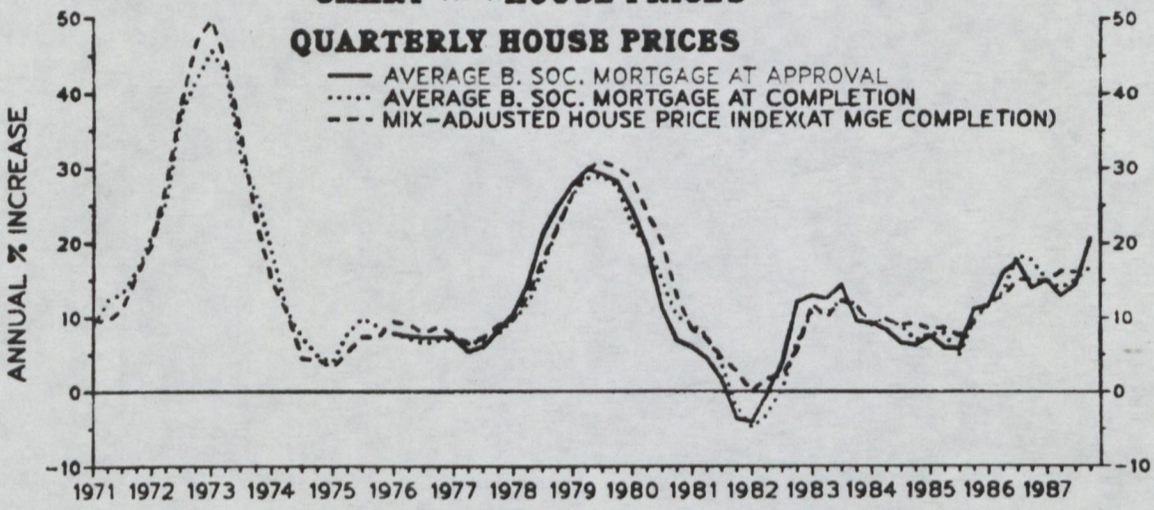
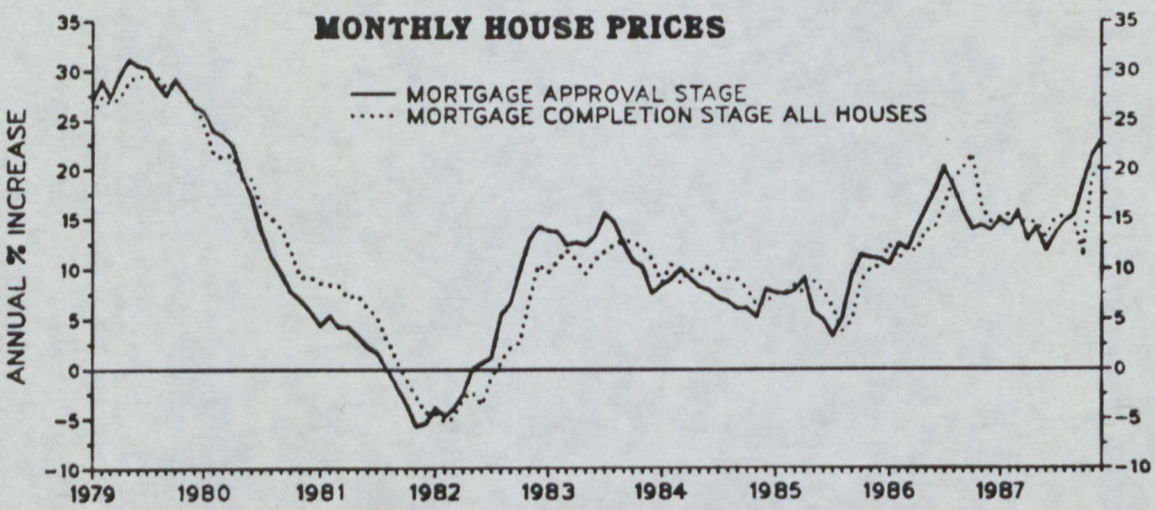


CHART XVIII HOUSE PRICES

QUARTERLY HOUSE PRICES

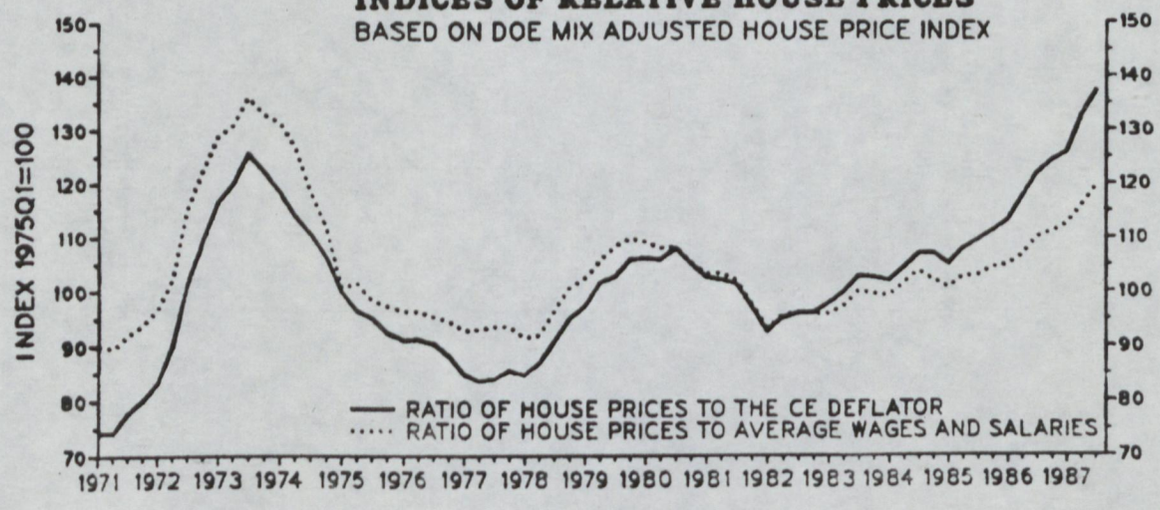


MONTHLY HOUSE PRICES



INDICES OF RELATIVE HOUSE PRICES

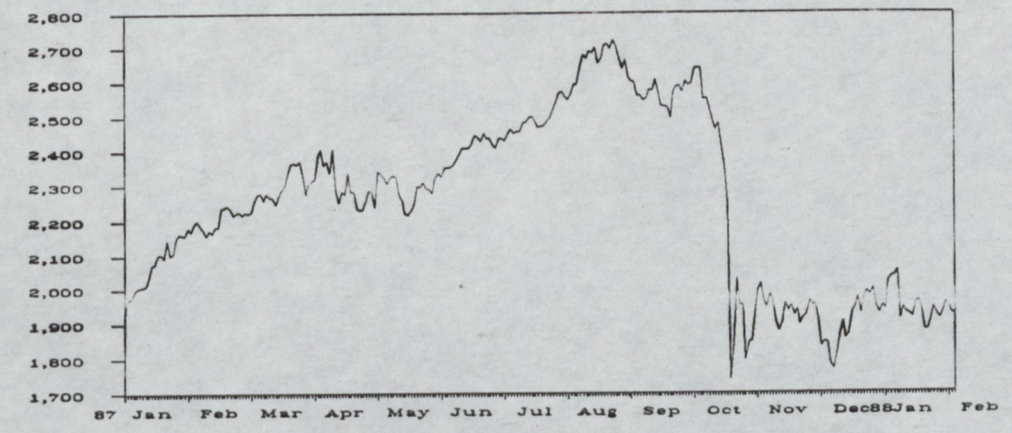
BASED ON DOE MIX ADJUSTED HOUSE PRICE INDEX



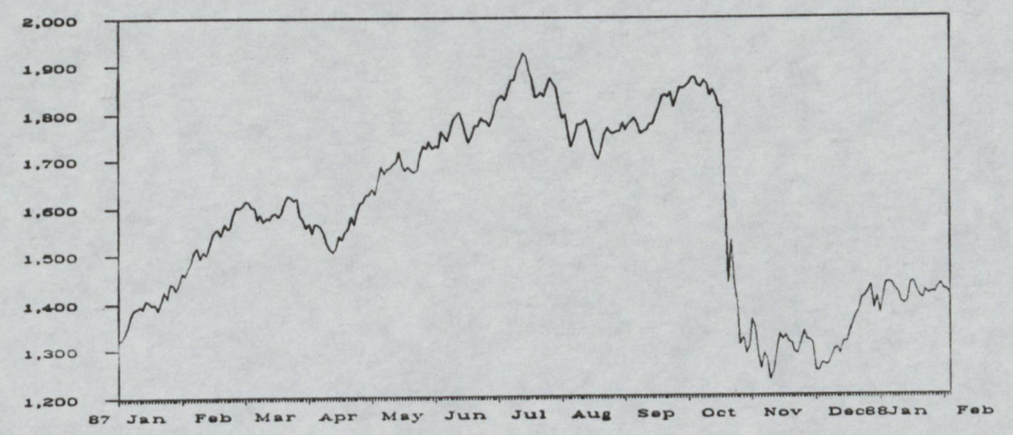
CAPITAL MARKETS

CHART XIX

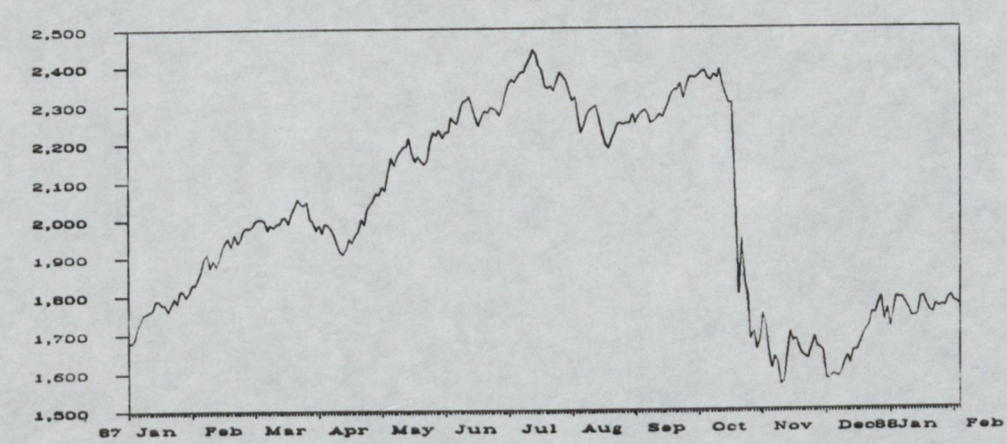
Dow Jones Industrial Average



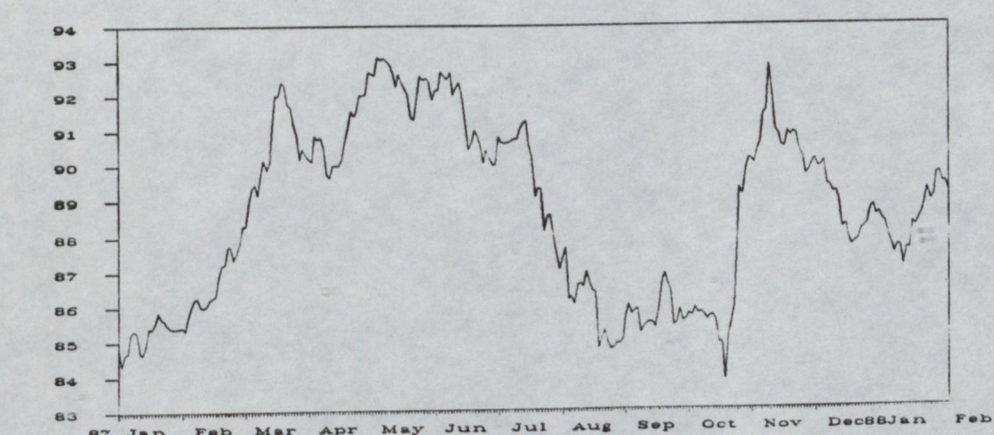
FT Ordinary Index



FTSE 100



Gilt Index



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MONTHLY MONETARY REPORT : TABLES

EXTERNAL

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

	Activity			Money supply		Costs and prices		
	Nominal GNP	Real GNP	Industrial production	M1	M2/M3	Unit labour costs	Consumer prices	GNP deflator
1984	8.6	4.9	8.0	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	0.9	13.5	8.8	0.5	1.5	2.4
Q2	4.7	2.2	2.0	12.4	8.9	-0.8	2.5	2.5
Q3	5.5	3.2	3.6	10.2	8.5		2.9	2.2
1978 Jan			-0.2	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			2.5	12.8	9.0		2.5	
Jun			2.8	11.4	8.7		2.7	
Jul			3.0	10.6	8.5		2.6	
Aug			3.9	10.4	8.6		3.1	
Sep			4.0	9.5	8.3		3.0	
Oct			4.4	9.7+	8.8+		3.1	
Nov			5.4	8.1+	8.6+		3.1	

* Percentage changes on a year before.

\+ Partly estimated.

91/G.LD.4508.034

TABLE 2

GERMANY: KEY FIGURES

	INDUSTRIAL PRODUCTION %pa	CONSUMER PRICES %pa	TRADE SURPLUS* $bn	MONEY SUPPLY (M3) %pa
1984	3.4	2.4	1.7	3.3
1985	5.4	2.2	2.2	4.1
1986	2.1	- 0.2	4.5	4.0
1987 J	- 1.9	- 0.8	4.8 (4.5)	6.8
F	0.0	- 0.5	6.1 (4.7)	6.8
M	- 0.9	- 0.2	4.8 (4.9)	6.7
A	- 0.9	0.1	5.3 (5.0)	7.7
M	2.9	0.2	6.0 (5.2)	8.5
J	- 0.9	0.2	4.6 (5.1)	7.0
J	- 2.8	0.7	5.6 (5.1)	6.6
A	1.6	0.8	4.9 (5.1)	6.7
S	0.7	0.4	5.8 (5.2)	5.8
O	0.7	0.9	4.8 (5.2)	6.3
N	1.5	1.0	6.1 (5.3)	5.9

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

35/3 3580/13/TR

TABLE 3a

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	6.9	3.9	4.0	8.2	9.7
1987 Jan	5.8	4.3	4.6	8.4	11.0
Feb	6.1	4.0	4.0	8.5	11.0
Mar	6.2	4.0	4.0	8.0	10.0
Apr	6.5	3.9	3.9	8.0	9.8
May	7.0	3.8	3.8	8.2	8.8
June	7.0	3.7	3.7	8.2	9.0
July	6.7	3.7	3.9	7.9	9.2
Aug	6.8	3.7	4.0	7.9	10.1
Sept	7.4	3.8	4.0	7.9	10.1
Oct	8.2	3.9	4.8	8.2	9.9
Nov	7.4	3.9	3.9	8.6	9.0
Dec	7.8	3.9	3.6	8.7	8.7
Jan	7.0	3.9	3.4	8.3	8.9
Feb 2nd	6.7	3.9	3.3	7.6	9.0

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

TABLE 3b

EFFECTIVE EXCHANGE RATE INDICES (1975 = 100)

	United States	Japan	Germany	France	UK	YEN/$	DM/$
1980	93.7	126.4	128.8	94.4	96.0	225.8	1.82
1981	105.6	142.9	119.2	84.3	94.8	219.5	2.25
1982	118.0	134.6	124.4	76.6	90.4	248.8	2.43
1983	124.9	119.1	127.1	70.0	83.9	237.1	2.55
1984	**134.6**	**156.7**	**123.8**	**65.7**	**78.6**	**237.5**	**2.85**
1985	140.7	160.5	123.6	66.3	78.2	238.4	2.94
1986	114.8	203.1	137.3	70.1	72.8	168.3	2.17
1987	101.2	219.6	147.6	71.8	72.7	144.7	1.80
1986 Q1	121.2	186.8	133.1	71.0	75.1	187.8	2.35
Q2	116.0	202.8	134.7	69.0	76.0	169.9	2.24
Q3	**111.4**	**214.8**	**138.6**	**69.5**	**71.9**	**155.9**	**2.09**
Q4	110.5	208.0	142.6	70.8	68.3	160.4	2.01
1987 Q1	104.2	210.1	147.7	71.9	70.2	155.2	1.94
Q2	101.1	222.9	146.9	71.6	72.7	142.6	1.81
Q3	102.5	218.0	146.4	71.4	72.7	147.0	1.84
Q4	97.0	227.4	149.4	72.3	75.2	134.0	1.71
1987 Jan	105.5	209.4	147.5	71.8	68.9	154.6	1.84
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	96.5	228.4	150.9	72.3	75.4	135.3	1.68
Dec	93.9	232.4	150.2	73.1	76.6	123.4	1.65
1988 Jan	93.9	239.5	150.4	72.5	74.9	127.8	1.65
Feb 2nd	94.6	240.4	149.4	72.0	74.4	128.1	1.68
% Change since dollar peak (Feb 85)	- 40	+ 53	+ 27½	+ 16	+ 6	- 51	- 51
% Change since Plaza (Sept 85)	- 32	+ 53½	+ 19	+ 7	- 9½	- 46½	- 41
% Change since Louvre Accord (Feb 87)	- 9	+ 15	+ 1	- ½	+ 7½	- 16½	- 8
% Change since Stock market crash (16 Oct 1987)	- 5½	+ 6½	+ 1.7	+ ½	+ 1	- 10½	- 6½

ECONOMIST COMMODITY PRICE INDICES

1980=100

Table 3C

	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
1987	88.8	88.4	125.2	73.7	84.4	98.8	82.1
Quarterly							
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	73.9	82.6	107.1	87.5
Q4	95.3	98.2	130.4	78.2	87.0	99.0	96.8
Monthly							
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	93.6	97.0	127.6		86.5	97.1	93.8
December	97.4	103.4	131.4		87.9	97.9	102.2
Weekly							
October 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	96.4	100.0	131.1		89.2	98.0	97.7
December 1	96.5	101.2	129.2		89.4	98.9	96.9
8	96.0	100.4	129.8		88.1	98.3	97.7
15	96.2	102.5	130.1		87.0	97.0	100.5
22	98.3	104.8	133.1		87.6	98.0	105.1
29	99.8	108.0	134.9		87.3	97.1	110.6
January 5	99.9	106.2	134.9		88.5	99.6	105.4
12 (prov)	99.0	105.2	134.2		89.0	97.8	105.4

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

** Non-food agriculturals

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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	9.6	1986	3.1	0.8	3.4	3.6	4.3	-10.8	4.7	5.4
1986-87	6.7	1987	n/a	n/a	4.1	3.7	4.5	5.3	n/a	n/a
1986 2	6.3	1986 1	2.2	- 1.5	4.9	4.6	5.0	-11.9	8.2	6.0
3	6.5	2	2.3	- 0.6	2.8	3.3	4.3	-12.4	6.2	6.2
4	6.8	3	3.7	1.2	2.6	3.3	4.0	-13.0	3.3	4.4
1987 1	7.3	4	4.0	4.1	3.4	3.4	4.0	- 5.6	1.2	5.0
2	8.7	1987 1	4.6	5.3	3.9	3.7	4.1	- 1.7	0.1	4.0
3	10.3	2	4.3	5.2	4.2	3.6	4.5	4.6	0.8	4.6
4	10.2*	3	5.2	6.6	4.3	3.6	4.7	12.9	0.9	
1988 1	10.3	4			4.1	4.0	4.7	6.2		
1987-88	9.5									
		1987 January		4.1	3.9	3.7	4.2	- 2.5	1.2**	
		February		4.6	3.9	3.7	4.2	- 2.9	0.8	
		March		3.2	4.0	3.8	4.1	0.4	- 0.1	
		April		4.3	4.2	3.6	4.3	3.0	- 0.4	
		May		6.3	4.1	3.8	4.5	3.4	0.0	
		June		5.2	4.2	3.5	4.5	7.2	0.8	
		July		6.3	4.4	3.7	4.7	13.4	1.2	
		August		5.8	4.4	3.7	4.7	14.5	0.9	
		September		5.5	4.2	3.5	4.7	10.8	0.9	
		October		5.9	4.5	3.9	4.7	7.8	1.1	
		November		5.0	4.1	4.0	4.8	5.1		
		December			3.7	4.0	4.7	5.6		

* Winter internal 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	1.5	0.8	1.5	-0.2	-0.4
1971-72	1.0	1.6	1.0	1.6	0.7	1.1
1972-73	2.4	3.6	2.4	3.6	2.0	3.0
1973-74	4.3	5.8	4.3	5.8	3.5	4.6
1974-75	8.0	9.0	8.0	9.0	6.0	6.7
1975-76	10.3	9.3	10.3	9.3	8.1	7.3
1976-77	8.3	6.4	8.3	6.4	7.5	5.7
1977-78	5.4	3.6	5.9	3.9	6.6	4.4
1978-79	9.2	5.3	9.2	5.3	8.3	4.8
1979-80	10.0	4.8	10.4	5.0	8.0	3.9
1980-81	12.7	5.4	13.1	5.5	11.7	5.0
1981-82	8.6	3.3	9.1	3.5	5.2	2.0
1982-83	8.8	3.1	9.3	3.3	8.3	2.9
1983-84	9.7	3.2	10.9	3.5	11.5	3.7
1984-85*	10.2	3.1	12.3	3.7	13.1	4.0
1985-86*	5.8	1.6	8.5	2.3	8.2	2.3
1986-87	3.4	0.9	7.8	2.0	9.2	2.4
January forecast 1987-88	-2.8	-3/4	2.2	1/2	3.0	3/4

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

(b) Quarterly Data

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

*financial year - constrained
+calendar year - constrained

90/G/jfw/4555/55

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

	£ billion
Receipts	
Inland Revenue	+ 2.9
Customs and Excise	+ 0.4
National Insurance contributions	+ 0.2
Privatisation proceeds	+ 0.6
Interest and dividends	- 0.2
Other receipts	+ 0.5
Total receipts	+ 4.3
Expenditure	
Interest payments	- 0.2
Departmental expenditure (1)	- 1.0
Total expenditure	- 1.2
Net effect on CGBR(O)	- 5.5

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

\+ = higher receipts, higher borrowing and higher expenditure

\- = lower receipts, lower borrowing and lower expenditure

TABLE 7

EXCHANGE RATES

		Exchange Rate Index*	Real Exchange Rate @	ERI/(Oil Price Adjusted ERI)≠	Dollar: Sterling exchange rate	D-Mark: Sterling exchange rate	Index against EMS currencies*	US-UK Interest rate differential	Brent spot price ($/bl)
1985	(1)	72.1	80.1	0.908	1.12	3.63	95.2	+4.1	27.7
	(2)	78.9	88.9	1.001	1.26	3.88	102.3	+4.4	27.0
	(3)	82.1	93.3	1.040	1.38	3.92	103.8	+3.6	27.4
	(4)	79.8	91.6	1.001	1.44	3.71	98.7	+3.5	28.3
1986	(1)	75.1	88.3	1.037	1.44	3.38	90.9	+4.5	17.8
	(2)	76.1	92.1	1.101	1.51	3.39	91.4	+3.2	12.8
	(3)	71.9	88.2	1.049	1.50	3.10	84.9	+3.8	12.4
	(4)	68.3	84.0	0.970	1.43	2.87	79.0	+5.1	14.8
1987	(1)	69.9	86.9	0.967	1.54	2.83	78.8	+4.3	17.9
	(2)	72.8	90.9	0.996	1.64	2.96	82.6	+2.1	18.6
	(3)	72.7	90.7	0.992	1.62	2.97	83.0	+2.8	19.0
	(4)	74.9	94.0	1.030	1.76	2.99	83.8	+1.2	18.1
1987	January	68.9	85.3	0.950	1.51	2.80	77.8	+4.9	18.4
	February	69.0	85.9	0.960	1.53	2.78	77.4	+4.4	17.2
	March	71.9	89.4	0.991	1.59	2.92	81.2	+3.4	18.0
	April	72.3	90.3	0.994	1.63	2.95	82.1	+2.9	18.2
	May	73.3	91.7	1.002	1.67	2.98	83.1	+1.6	18.8
	June	72.7	90.8	0.991	1.63	2.96	82.6	+2.1	18.9
	July	72.8	90.8	0.985	1.61	2.97	82.9	+2.6	19.8
	August	72.3	90.0	0.988	1.60	2.97	82.8	+3.2	18.9
	September	73.1	91.3	1.004	1.65	2.98	83.2	+2.6	18.3
	October	73.6	92.1	1.006	1.66	2.99	83.5	+1.7	18.8
	November	75.4	94.6	1.040	1.78	2.99	83.9	+1.0	17.8
	December	75.7	95.3	1.045	1.83	2.98	84.0	+0.9	17.7
1988	January	74.8	94.5	1.038	1.78	2.98	83.5	+1.8	16.7
	February 3rd	74.4	n/a	1.043	1.77	2.98	83.7	+2.3	16.2

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

* 1975=100

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

TABLE 8 : NOMINAL AND REAL INTEREST RATES

		NOMINAL RATES				REAL RATES				
		Three month interbank	Three month Eurodollar	Base Rate	Long Rate (20 year Gilts)	Expected inflation over 12 months*	Real 3-month interbank rate	Yield on Index-linked Gilts** 1990	2001	2011
1985	(1)	13.0	8.9	12.9	10.9	5.7	6.9	4.4	3.5	3.2
	(2)	12.6	8.2	12.6	10.8	5.6	6.6	4.3	3.8	3.4
	(3)	11.7	8.1	11.7	10.4	5.3	6.1	4.3	3.8	3.5
	(4)	11.6	8.1	11.5	10.3	4.2	7.1	4.1	3.9	3.6
1986	(1)	12.4	7.9	12.3	10.2	3.9	8.2	4.3	4.2	3.8
	(2)	10.2	7.0	10.4	9.0	3.6	6.5	3.6	3.6	3.4
	(3)	10.0	6.2	10.0	9.7	3.4	6.5	3.7	3.9	3.5
	(4)	11.2	6.1	11.0	10.7	4.1	6.8	3.7	4.1	3.8
1987	(1)	10.6	6.3	10.8	9.6	4.3	6.0	3.0	3.7	3.5
	(2)	9.2	7.1	9.4	9.0	3.8	5.2	2.4	3.8	3.6
	(3)	9.9	7.1	9.7	9.8	3.7	6.0	2.6	4.2	3.9
	(4)	9.2	7.8	9.0	9.5	4.0	4.7	2.4	4.1	3.8
1987	January	11.0	6.1	11.0	10.0	4.1	6.6	3.5	4.0	3.7
	February	10.8	6.4	11.0	9.8	4.3	6.2	3.0	3.7	3.5
	March	9.9	6.5	10.4	9.1	4.5	5.2	2.5	3.5	3.4
	April	9.8	6.9	10.0	9.2	4.2	5.4	2.6	3.6	3.4
	May	8.8	7.2	9.1	8.8	3.7	4.9	2.1	3.6	3.6
	June	9.0	7.1	9.0	8.9	3.5	5.3	2.3	3.9	3.7
	July	9.3	6.9	9.0	9.3	3.4	5.7	2.2	4.0	3.8
	August	10.2	7.0	10.0	10.0	3.9	6.1	2.6	4.3	4.0
	September	10.1	7.5	10.0	10.0	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	8.9	7.4	9.0	9.2	4.1	4.6	1.9	4.0	3.3
	December	8.7	7.8	8.5	9.5	4.0	4.5	2.3	3.9	3.9
1988	January	8.9	7.1	8.5	9.6	4.0	4.7	2.3	4.2	4.1
	February 3rd	9.0	6.8	9.0	9.3	n/a	n/a	2.0	4.0	4.0

* 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	2888
1986	2.4	5.7	-0.8	-944
1987	7.7	9.6	+1.0	-2692
1986 Q3	2.9	7.5	-2.4	-856
Q4	9.3	9.9	-4.9	-989
1987 Q1	11.2	5.4	-1.5	572
Q2	6.4	10.2	+0.9	-659
Q3	9.1	12.0	+1.6	-1146
Q4	4.6	10.7	+2.4	-1459
1987 Jan	7.3	6.4	-2.7	54
Feb	18.2	8.5	-2.0	366
Mar	7.9	1.0	+0.3	152
April	10.4	10.6	+1.2	48
May	5.6	14.5	-0.1	-532
June	4.6	5.6	+1.5	-174
July	7.7	11.2	+0.4	-291
Aug	8.8	13.7	+1.2	-873
Sep	10.9	11.0	+3.3	+17
Oct	4.7	11.8	+2.0	-282
Nov	3.5	8.2	+3.8	-595
Dec	5.8	12.1	+3.9	-582

* excluding oil and erratics.

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TABLE 10

Key Monetary Indicators

	1986-87			1987-88								
	Dec	Jan	Feb	Mar	April	May	June	July	Aug	Sept	Oct	Nov	Dec
MONETARY AGGREGATES 12 month % change (ua)													
MO	5.2	4.1	4.1	3.5	5.3	4.4	4.2	5.3	4.5	5.2	5.5	4.9	4.2
M3	18.0	17.6	18.9	20.4	20.4	18.9	19.1	20.9	22.1	19.5	22.3	21.4	22.8
M4	15.3	13.9	13.9	13.9	14.6	13.7	13.8	14.9	15.6	14.9	15.7	15.2	16.3
M5	14.6	13.3	13.3	13.5	14.1	13.4	13.5	14.4	14.9	14.3	15.1	14.6	15.7
STERLING LENDING 12 month % change (ua)													
Banks	21.8	22.5	21.7	20.7	21.4	21.7	21.5	22.2	21.6	23.5	22.8	22.5	22.7
Banks and building societies	19.6	20.4	19.8	19.1	19.5	19.4	19.3	19.5	18.8	20.0	19.3	19.0	18.8
OVER(-)/UNDER (+) FUNDING financial year to date: £mn	-1,577	-3,931	-3,969	395	3,216	5,144	2,345	1,883	2,188	1,988	3,771	1,153	2,415
MONEY MARKET ASSISTANCE/ Level outstanding £mn	12,970	14,948	14,873	9,742	6,126	3,340	5,132	7,078	6,114	5,421	5,403	7,073	7,221
INTEREST RATES													
3 months*	11.3	11.0	10.8	9.9	9.8	8.8	9.0	9.3	10.2	10.1	10.0	8.9	8.7
20 yearϕ	10.6	10.0	9.8	9.1	9.2	8.8	8.9	9.3	10.0	10.0	9.8	9.2	9.5
EFFECTIVE EXCHANGE RATE	68.5	68.9	69.0	71.9	72.3	73.3	72.7	72.8	72.3	73.1	73.6	75.4	75.7

* Inter bank

ϕ par yield

/ banking months until August thereafter end calendar months

Table 11

MONETARY AGGREGATES 1987-88

		APR	MAY	JUNE	JULY	AUG	SEP	OCT	NOV	DEC
MO	Averaged weekly									
	Monthly change (£ million)	+325	+42	-93	+423	+13	+14	-32	+47	+1,085
	Monthly % change	+2.2	+0.3	-0.6	+2.8	+0.1	+0.1	-0.2	+0.3	+7.0
	12 Monthly % change	+5.3	+4.4	+4.2	+5.3	+4.5	+5.2	+5.5	+4.9	+4.2
M3	Monthly change (£ million)	+3,176	+3,239	+1,876	+4,314	+2,214	+1,629	+5,604	+1,378	+2,656
	Monthly % change	+2.0	+2.0	+1.1	+2.6	+1.3	+0.9	+3.2	+0.8	+1.4
	12 Monthly % change	+20.4	+18.9	+19.1	+20.9	+22.1	+19.5	+22.3	+21.4	+22.8
M4	Monthly change (£ million)	+3,528	+3,430	+4,011	+5,399	+2,673	+2,951	+5,280	+1,698	+4,974
	Monthly % change	+1.3	+1.3	+1.4	+1.9	+0.9	+1.0	+1.8	+0.6	+1.7
	12 Monthly % change	+14.6	+13.7	+13.8	+14.9	+15.6	+14.9	+15.7	+15.2	+16.3
M5	Monthly change (£ million)	+3,537	+4,102	+4,115	+5,459	+2,532	+3,046	+5,434	+1,580	+5,275
	Monthly % change	+1.2	+1.4	+1.4	+1.8	+0.8	+1.0	+1.8	+0.5	+1.7
	12 Monthly % change	+14.1	+13.4	+13.5	+14.4	+14.9	+14.3	+15.1	+14.6	+15.7
NIBMI	Monthly change (£ million)	+467	+1,160	+1,463	+102	-76	+401	+187	+514	+409
	Monthly % change	+1.1	+2.8	+3.4	+0.2	-0.2	+0.9	+0.4	+1.1	+0.9
	12 Monthly % change	+11.7	+11.9	+13.4	+12.3	+12.2	+6.0	+11.8	+10.6	+10.5
M1	Monthly change (£ million)	+672	+2,950	+2,093	+1,088	+1,100	+1,570	+2,858	+522	-276
	Monthly % change	+0.8	+3.7	+2.5	+1.3	+1.3	+1.8	+3.2	+0.6	-0.3
	12 Monthly % change	+23.1	+23.5	+23.6	+22.6	+23.7	+20.3	+24.6	+21.7	+15.7
Net £ deposits from banks abroad										
Overseas non-bank £ deposits										
WIDER £ AGGREGATE										
	Monthly change (£ million)	+3,967	+4,084	+930	+4,694	+1,575	+2,542	+8,325	-1,204	+3,388
	Monthly % change	+2.1	+2.2	+0.5	+2.4	+0.8	+1.3	+4.1	+0.6	+1.6
	12 Monthly % change						+18.5	+22.2	+20.3	+21.4

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	14.5	9.7	9.3
12 MONTH % CHANGES (ua except M0)					
DECEMBER	3.7	1.6	13.8	11.0	10.5
1987 JANUARY	3.7	1.4	13.4	9.8	9.6
FEBRUARY	3.7	0.4	14.7	9.8	9.3
MARCH	3.8	0.3	14.5	9.7	9.3
APRIL	3.6	1.2	16.2	10.6	10.1
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	10.3
AUGUST	3.7	1.0	17.7	11.5	10.8
SEPTEMBER	3.5	1.4	15.5	11.0	10.4
OCTOBER	3.9	1.6	17.7	11.4	10.8
NOVEMBER	4.0	0.9	16.7	10.8	10.2
DECEMBER	4.0	0.3	18.1	11.8	11.3

TABLE 13

CONFIDENTIAL

M0 : THE WIDE MONETARY BASE

Monthly data	Level £ million (Change in brackets)						Percentage change on previous month		Percentage change on previous year			
	Notes and Coin (nsa)	Notes and Coin (sa)		Bankers' Deposits	M0 (nsa)	M0 (sa)		Notes(sa) and Coin	M0 (sa)	Notes and Coin (nsa)	Notes and Coin (sa)	M0 (nsa)	M0 (sa)
1987 July	15271	15166	(91)	235	15506	15401	(190)	0.6	1.2	4.7	4.7	5.3	5.4
August	15337	15258	(92)	182	15519	15440	(39)	0.6	0.3	4.3	4.6	4.5	4.7
September	15349	15376	(118)	185	15534	15561	(121)	0.8	0.8	5.3	5.0	5.2	4.9
October	15299	15456	(80)	203	15501	15659	(98)	0.5	0.6	5.1	5.2	5.5	5.6
November	15365	15525	(69)	183	15548	15707	(48)	0.4	0.3	4.8	4.8	4.9	4.9
December	16447	15661	(136)	186	16633	15846	(139)	0.9	0.9	4.7	4.8	4.2	4.3
January	15458	15620	(-41)	178	15636	15799	(-47)	-0.3	-0.3	4.7	4.5	4.8	4.6
1988 February (1 of 4) @	15363	15655	(35)	43	15406	15698	(-101)	0.2	-0.6	5.7	5.7	4.8	4.8
Latest 4 weeks @	15351	15640	(-34)	127	15478	15767	(-120)	-0.2	-0.8	4.7	4.7	4.6	4.5

Weekly data	Level £ million (Change in brackets)			Percentage change on previous week
	Notes(sa) and Coin	Bankers' Deposits	M0 (sa)	M0 (sa)
1988 January				
6th	15578 (-296)	248	15826 (-217)	-1.4
13th	15616 (38)	178	15794 (-32)	-0.2
20th	15647 (31)	146	15793 (-1)	0.0
27th	15640 (-7)	141	15781 (-12)	-0.1
February				
3rd	15655 (15)	43	15698 (-83)	-0.5

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

TABLE 14

SECRET

BUILDING SOCIETY BALANCE SHEET FLOWS

Unadjusted £ million

		ASSETS			LIABILITIES			
	Total Flow	Net Mortgage Advances & Unsecured Lending	Liquid Assets	Fixed Assets	Retail principal	Interest credited	Wholesale funds	Other (eg reserves)
1985 *	1497	1226	244 (18.0)	27	621	497	205	174
1986 *	1536	1589	-76 (16.4)	23	553	505	523	-45
1985 Q3*	1679	1188	460 (17.0)	31	618	385	153	523
Q4*	2183	1405	756 (18.0)	22	805	663	594	121
1986 Q1*	953	1271	-341 (17.5)	23	740	458	167	-412
Q2*	1518	1645	-150 (16.6)	23	478	519	321	200
Q3*	1740	1884	-165 (15.7)	21	56	401	1099	184
Q4*	2160	1556	581 (16.4)	23	938	643	403	176
1987 Q1*	1324	1120	126 (16.1)	78	484	670	279	-109
Q2*	1573	1240	313 (16.2)	20	612	457	182	322
Q3*	1516	1272	200 (16.1)	44	410	515	364	227
Oct	2168	1388	730 (16.4)	50	825	320	510	513
Nov	2076	1388	638 (16.6)	50	1130	113	-346	1179
Forecast								
1987 Q4*	2091	1306	735 (16.9)	50	1028	619	340	104
1988 Q1*	1512	1285	177 (16.7)	50	735	611	150	16
Dec	2028	1141	837 (16.9)	50	1130	1423	857	-1382
Jan	1415	1162	203 (16.9)	50	919	1361	100	-965
1988 Feb	1644	1215	379 (16.4)	50	781	97	150	616
Mar	1479	1479	-50 (16.7)	50	505	376	200	398

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

SECRET

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)					
1987 JANUARY	3.6	14.7	16.2	23.0	17.6
FEBRUARY	3.0	14.5	17.2	25.7	18.9
MARCH	-2.4	16.9	17.4	25.4	18.9
APRIL	6.2	14.5	17.1	27.9	20.4
MAY	3.3	16.4	19.0	23.1	18.9
JUNE	3.6	18.0	15.4	25.1	19.1
JULY	6.0	15.3	12.1	32.4	20.9
AUGUST	4.0	16.4	15.1	32.8	22.1
SEPTEMBER	5.7	6.1	14.2	31.9	19.5
OCTOBER	4.6	15.4	12.4	34.9	22.3
NOVEMBER	1.4	15.1	13.0	33.3	21.4
DECEMBER	5.9	12.7	10.1	38.4	22.8
Over 6 months (sa)					
1987 JULY	1.7	14.4	12.3	46.9	26.4
AUGUST	3.7	13.2	14.5	41.6	25.1
SEPTEMBER	8.7	16.0	12.7	32.3	21.8
OCTOBER	6.9	33.2	11.7	33.9	25.3
NOVEMBER	7.2	17.4	13.2	31.2	21.8
DECEMBER	11.6	2.0	7.9	40.8	21.9
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 JULY	297	-178	660	2935	3714
AUGUST	13	150	533	1626	2322
SEPTEMBER	1	310	434	1701	2446
OCTOBER	258	1237	170	4648	6313
NOVEMBER	-65	-924	600	442	53
DECEMBER	222	-296	-630	3301	2595

[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[2]	M5
% CHANGES							
Financial years (ua)							
1984-85[3]	**11.5**	**15.1**				**13.8**	**13.8**
1985-86[3]	**16.7**	**15.3**	**52.6**	**94**	**-0.1**	**13.5**	**14.5**
1986-87[3]	**19.1**	**10.8**	**11.4**	**50**	**-15.6**	**13.5**	**12.9**
Over 12 months (ua)							
1987 JANUARY	17.6	15.6		38.5	13.9	3.2	13.3
FEBRUARY	18.9	16.1		59.7	13.9	3.8	13.3
MARCH	18.9	17.2		52.2	13.9	5.3	13.5
APRIL	20.4	16.1		50.3	14.6	5.0	14.1
MAY	18.9	17.9		54.7	13.7	8.9	13.4
JUNE	19.1	16.4		63.7	13.8	8.4	13.5
JULY	20.9	18.4		64.2	14.9	5.1	14.4
AUGUST	22.1	15.6		63.2	15.6	2.8	14.9
SEPTEMBER	19.5	10.8		58.1	14.9	4.0	14.3
OCTOBER	22.3	13.5		58.3	15.7	4.9	15.1
NOVEMBER	21.4	13.8		66.0	15.2	3.9	14.6
DECEMBER	22.8	11.1		63.2	16.3	6.7	15.7
Over 6 months (sa)							
JULY	26.4	12.3		45.1	18.8	12.0	18.4
AUGUST	25.1	12.9		48.3	18.4	5.9	17.7
SEPTEMBER	21.8	10.8		25.3	17.2	9.7	16.8
OCTOBER	25.3	9.7		23.4	18.7	16.0	18.6
NOVEMBER	21.8	11.6		21.0	17.3	1.5	16.5
DECEMBER	21.9	11.2		31.3	16.9	1.5	16.1
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 JULY	3714	1006	268	-571	4417	-109	4308
AUGUST	2322	1434	23	12	3791	-174	3617
SEPTEMBER	2446	295	457	207	3405	108	3513
OCTOBER	6313	720	-1	-618	6414	89	6503
NOVEMBER	53	2080	-356	-796	981	-39	942
DECEMBER	2595	1221	324	-248	3892	240	4132

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

SECRET

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)				
1987 JANUARY	15.6	11.0	9.1	12.3
FEBRUARY	16.1	10.6	10.1	12.4
MARCH	17.2	10.5	10.8	12.6
APRIL	16.1	10.3	11.0	12.2
MAY	17.9	10.2	10.8	12.6
JUNE	16.4	10.3	10.5	12.2
JULY	13.4	10.2	9.2	11.1
AUGUST	15.6	10.4	9.7	11.9
SEPTEMBER	10.8	11.4	9.3	10.7
OCTOBER	13.5	10.2	8.2	10.9
NOVEMBER	13.8	11.1	7.4	11.3
DECEMBER	11.1	11.6	7.2	10.5
Over 6 months (sa)				
1987 JULY	13.1	12.3	8.6	13.6
AUGUST	13.9	12.9	7.8	13
SEPTEMBER	14	10.8	6.8	11.3
OCTOBER	19.7	9.7	5.3	10.7
NOVEMBER	14.8	11.6	4.3	10.8
DECEMBER	5.5	11.2	3.9	8.3
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 JULY	482	1006	202	1690
AUGUST	683	1434	90	2207
SEPTEMBER	744	295	83	1122
OCTOBER	1407	720	-64	2063
NOVEMBER	-324	2080	63	1819
DECEMBER	-928	1221	256	549

NOTES

1 Total retail funds, including terms shares and SAYE.

2 Total inflows.

3 March on March.

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							
1987	January	905	562	104	-136	1435	1640
	February	2618	-426	69	345	2606	2705
	March	4642	-2026	339	420	3375	2471
	April	1726	-409	210	-398	1129	2201
	May	3622	-2125	295	497	2289	2503
	June	5144	751	-7	-1206	4682	3979
	July	2132	1679	-41	890	4660	4547
	August	2840	-1519	117	-288	1150	2649
	September	5456	13	-41	66	5494	4304
	October	2556	-499	152	823	3032	2991
	November	2321	845	237	-56	3347	3320
	December	3703	1524	299	-124	5372	4904

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 : DECEMBER 1987		
PSBR	196	196
Debt sales (-): Other Public Sector	-264	-115
Central Government	-875	-646
Public external & fc finance (-)	2205	2205
Over(-)/under(+)funding	1262	1640
£ lending to private sector	5372	5941
Bank/bank & b society externals (-)	-2354	-2423
Bank/bank & b society £NNDLs (-)	-1624	-184
TOTAL	2656	4974
FINANCIAL YEAR 1987/88 TO DATE		
PSBR	-473	-473
Debt sales (-): Other Public Sector	1283	614
Central Government	-3792	-3846
Public external & fc finance (-)	5397	5397
Over(-)/under(+)funding	2415	1692
£ lending to private sector	31155	42342
Bank/bank & b society externals (-)	-4214	-5007
Bank/bank & b society £NNDLs (-)	-3270	-5083
TOTAL	26086	33944
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	0	471	209	350	1030	12328	2362	14690
Q2	5485	5083	10548	0	1369	344	325	2038	12586	1575	14161
Q3	5764	5592	11356	69	1431	290	231	2021	13377	3688	17065
Q4	10433	4667	15100	65	2338	-52	281	2632	17732	591	18323
1987											
Q1	7063	3619	10682	368	1553	-782	1231	2370	13052	7355	20407
Q2	8608	4240	12848	651	2259	352	655	3917	16765	4678	21443
Q3	10940	3889	14829	284	5950	732	570	7536	22365	-1198	21167
Q4	10982	3683	14665	-255	3730	343	105	3923	18588	-85	18503
Average per quarter											
1984	3938	3643	7579	0	292	63	84	429	8007	1226	9234
1985	5051	3682	8733	0	854	215	199	1267	10000	1185	11185
1986	7273	4802	12076	34	1402	198	297	1930	14006	2054	16060
1987	9398	3858	13256	262	3373	161	640	4437	17693	2688	20380
1987											
JANUARY	1391	1459	2850	150	500	-67	110	693	3543	1369	4912
FEBRUARY	2603	980	3583	104	870	20	315	1309	4892	2402	7294
MARCH	3069	1180	4249	114	183	-735	806	368	4617	3584	8201
APRIL	1272	1590	2862	192	828	110	355	1485	4347	1236	5583
MAY	2258	1295	3553	171	415	184	150	920	4473	2693	7166
JUNE	5079	1355	6433	288	1016	58	150	1512	7945	740	8684
JULY	4472	1302	5774	131	1840	182	210	2363	8137	-2215	5922
AUGUST	1055	1269	2324	9	2090	390	150	2639	4963	1019	5982
SEPTEMBER	5413	1318	6731	144	2020	160	210	2534	9265	-2	9263
OCTOBER	2596	1510	4106	31	2535	195	45	2806	6912	3461	10373
NOVEMBER	3352	1266	4618	-40	975	55	60	1050	5668	-1646	4022
DECEMBER	5034	907	5941	-246	885	173	0	153	6093	-1900	4193
1988											
JANUARY					43	41	450				

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	-352	3040		924	170	235	0	1329	4369
Q2	747	248	207	1202		1092	327	230	0	1649	2851
Q3	229	161	1371	1761		873	274	130	600	1877	3638
Q4	874	343	1377	2594		525	89	200	475	1289	3883
1986											
Q1	3807	346	108	4261	0	471	209	350	935	1965	6226
Q2	-356	442	108	194	0	1369	344	325	1075	3113	3307
Q3	28	1800	1128	2956	69	1431	290	231	1575	3596	6552
Q4	5275	390	-59	5606	65	2338	-53	281	2633	5884	11490
1987											
Q1	1047	353	2102	3502	368	1553	-782	1231	290	2660	6162
Q2	662	-508	739	893	651	2259	352	655	50	3967	4860
Q3	3513	364	-90	3787	284	5950	732	570	100	7636	11423
Q4	5305	769	718	6792	-255	3735	423	105	0	4008	10800
Average per quarter											
1984	1749	200	68	2016	0	282	63	84	0	429	2445
1985	1309	190	651	2149	0	854	215	199	269	1536	3685
1986	2189	745	321	3254	34	1402	198	297	1554	3485	6739
1987	2632	245	867	3744	262	3374	181	640	147	4604	8348
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					31	2535	195	45	0	2806	
NOVEMBER					-40	975	55	60	0	1050	
DECEMBER					-246	225	173	0	0	152	
1988:- JANUARY						43	41	450	50		

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

NOTE: Bank borrowing figures include monetary sector holdings of [illegible] counting in the 'All Borrowing' figures.

TABLE 22 SECRET

FUNDING AND MONEY MARKET ASSISTANCE - FINANCIAL YEAR 1987/88

£ million u/a

	APR-DEC 1987		
CGBR	**2804**		
Gilt sales to nbps and overseas (inc-)	-6470		
Other CG debt sales to nbps incl Treasury bills* (-)	-2035		
CG external and fc finance other than BGS(-)	9605		
Funding of the CGBR Over(-)/under(+)	**3904**		**3904**
		Other BGS sales (-)	1169
OPS net of on lending	-3277	Other CG debt sales (-)	-520
OPS debt sales to nbps(-)	1283	Notes and coins (-)	-1999
OPS currency finance(-)	505	Other incl exchequer (-)	-395
Funding of OPS Over(-)/under(+)	-1489	CG bank deposits (+)	166
	------		------
Funding of PSBR Over(-)/under(+)	**2415** ------	**Total influences* (surplus+,shortage-)**	**2325** ------
		Change in bankers deposits (-)	197
		Change in level of assistance (+) #	-2522
		of which	
		Issue Department bills	-552
		Banking Department bills	1083
		Market advances	-1449
		Repos	-1604
		Level of assistance	
		End March 1986	13317
		End March 1987	9742
		End December 1987	7221

* 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 OCT		-0.2	3.2	1.8
NOV		0.3	0.8	0.6
DEC		7.0	1.4	1.7
JAN	) *	-6.0	-1.5	-0.3
FEB	)FORECAST	n/a	1.7	1.1
MAR	)	n/a	3.3	2.3
12 MONTH % CHANGE TO:				
1987 OCT		5.5	22.3	15.7
NOV		4.9	21.4	15.2
DEC		4.2	22.8	16.3
JAN	) *	4.8	21.9	16.1
FEB	)FORECAST	n/a	21.6	16.3
MAR	)	n/a	20.9	16.0
Seasonally adjusted				
1 MONTH % CHANGE TO:				
1987 OCT		0.6	3.6	2.2
NOV		0.3	0.0	0.3
DEC		0.9	1.4	1.3
JAN	) *	-0.3	0.1	-0.2
FEB	)FORECAST	0.3	1.7	1.7
MAR	)	0.8	2.4	1.8
12 MONTH % CHANGE TO:				
1987 OCT		5.6	23.0	16.1
NOV		4.9	21.9	15.5
DEC		4.3	22.9	16.3
JAN	) *	4.6	21.6	15.8
FEB	)FORECAST	5.8	21.4	16.0
MAR	)	6.2	21.1	15.2

* Provisional January outturn for M0

91/G.LD.4496.001

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							
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	15,525	183	15,708	+0.4	+0.3	+4.9	+4.9
December	15,661	186	15,847	+0.9	+0.9	+4.8	+4.3
1988 January	15,620	178	15,798	-0.3	-0.3	+4.5(5.3)	+4.6(5.4)
FORECAST							
February	15,700	150	15,850	+0.5	+0.3	6.0(6.5)	5.8(6.6)
March	15,790	190	15,980	+0.6	+0.8	6.6(6.9)	6.2(6.5)
April	15,850	190	16,040	+0.4	+0.4	6.3	6.1
May	15,910	190	16,100	+0.4	+0.4	6.2	6.0
June	15,970	190	16,160	+0.4	+0.4	5.9	6.2
July	16,020	190	16,210	+0.3	+0.3	5.6	5.3
August	16,070	190	16,260	+0.3	+0.3	5.3	5.3
September	16,120	190	16,310	+0.3	+0.3	4.8	4.8
October	16,170	190	16,360	+0.3	+0.3	4.6	4.5
November	16,220	190	16,410	+0.3	+0.3	4.5	4.5
December	16,290	190	16,480	+0.4	+0.4	4.0	4.0

* Last month's forecast in brackets.

SECRET

TABLE 25: MONEY MARKET INFLUENCES

£ million

	Actual		Forecast	
	1987 DEC	1988 JAN	FEB	MAR
A. Money market influences				
(i) CGBR excl bank deposits (+)	-205	-6136	375	4750
(ii) Reserves etc (+)	1936	-256	-150	-225
(iii) Notes and coin (-)	-1146	970	425	-950
(iv) National Savings (-)	-185	-292	-175	-200
(v) CTDs (-)	-16	363	75	25
(vi) Gilts (-)	-931	-1360	-800	150
(vii) Other Exchequer items etc	-727	-15	0	0
A. TOTAL MONEY MARKET INFLUENCES (Market surplus + / shortage -)	-1274	-6726	-250	3550
B. Money market operations				
(i) Commercial bills (purchase +):				
Issue Department - outright	1396	5243		
- repo terms	-534	-1512		
Banking Department	452	-129		
(ii) LA bills (purchase +)				
Issue Department	-79	60		
Banking Department	-5	80		
(iii) Treasury bills (purchase +)	1201	1396	0	-250
(iv) Market advances	-414	233		
(v) Treasury bill Repos	-668	0		
(vi) Export Credit/Shipbuilding Repos	0	979		
(vii) Gilt Repos	0	332		
B. TOTAL MONEY MARKET OPERATIONS	1349	6682	250	-3550
C. Change in bankers balances = A + B	75	-44		
D. TOTAL ASSISTANCE OUTSTANDING (excluding Treasury bills) = previous level + B - B(iii)	7221	12507	12750	9450
of which commercial bills	7133			

TABLE 26

SECRET

TIMING OF GOVERNMENT SHARE SALES

1988	
BGC(III)	19 April
BAA(II)	19 May
BP(II)	30 August
1989	
BP(III)	27 April

EL3 CL2

2

SECRET

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

1 February 1988

Dear Alex,

INTEREST RATES

The Chancellor discussed with the Prime Minister this morning the position in the markets and proposed that the Bank of England should signal a half per cent increase at noon. Given that sterling had fallen during the morning against the dollar and deutschmark he did not expect a half per cent increase to lead to sterling pushing up against DM3. He also did not expect this to lead to any increase in building society rates.

The Prime Minister said she was content for some tightening of the monetary stance. However, if in the event higher interest rates did lead to sterling pushing up against DM3, she would be strongly opposed to any intervention and hence to a boost to domestic liquidity offsetting the impact of the interest rate rise. It was only on this basis that she was prepared to agree to the half per cent interest rate rise.

The Prime Minister also noted that the end January Reserves figure had been reduced by an EMCF revaluation of $600 million. The Chancellor agreed to provide a note setting out the background to this adjustment.

Yours,

Paul.

(PAUL GRAY)

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

SECRET

PRIME MINISTER

MARKET REPORT: 11 JANUARY

You will see from the attached evening report that there was some co-ordinated Central Bank intervention today, to which the Bank of England contributed $25 million. This was a switch transaction acquiring Dollars for Deutschmarks.

I have tackled the Treasury about this. They stressed that this was a switch, not a net addition to the Reserves; and that it was necessary in order to fulfil the commitments entered into with the other countries last year. Within that context, the Chancellor had apparently authorised a switch of up to $25 million. I have told his office that, since the Bank have now used up the existing authority he had issued, I was sure you would want him to consult you before authorising any further transactions of this sort. You might want to touch on this at your bilateral with the Chancellor on 13 January.

Acquiring more dollars?!

Regs.

Paul Gray

11 January 1988

DG2AMR

SECRET

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

9 January 1988

The Prime Minister was interested to see the attached report in Friday's Financial Times concerning the near disappearance of 1987 profits from the Bundesbank and the implications for the budget. She recognises that such calculations depend heavily on the precise dates used and that there are differences between the UK and German systems. But she would be interested to know the results of a similar calculation comparing the valuation of the UK's reserve at the end of 1987 with the rates at which foreign currencies were acquired during the period since 1 April 1987.

(PAUL GRAY)

Alex Allan Esq
HM Treasury

SECRET

W Germany to raise taxes and cut spending

BY DAVID MARSH IN BONN AND ANDREW FISHER IN FRANKFURT

THE WEST GERMAN coalition yesterday decided to cut federal government borrowing by at least DM10bn (£3.36bn) next year through a mixture of increases in consumer taxes and cuts in budget spending.

The move comes in reaction to a much sharper than planned increase in the federal deficit this year. It is now expected to be DM40bn compared with DM29.5bn set down in the 1988 budget approved by parliament at the end of last year.

The tightening of fiscal policy now planned for 1989 runs completely counter to persistent calls from home and abroad for West Germany to cut taxes next year in order to bolster sluggish economic growth.

Mr Gerhard Stoltenberg, the Finance Minister, told the press after yesterday's cabinet meeting: "There is no room for further tax cuts (in 1989)."

At the same time the Bundesbank in Frankfurt announced action to reduce banking liquidity through a DM6bn cut in banks' rediscount quotas, effective February 1. The move, which will cut the amounts banks can borrow from the central bank at the 2.5 per cent discount rate, came in response to big increases in liquidity through currency inflows.

The Bundesbank said the decision did not imply any change in its basic monetary stance. However, it underlines how the central bank is reacting cautiously to ward off possible inflationary dangers from currency inflows – DM25bn since October – accompanying the latest rise of the D-Mark.

Yesterday's cabinet decision on the deficit underlines how West German fiscal policies have been severely blown off course by the fall of the dollar and the weakening economy.

The admission by Mr Stoltenberg that the 1988 deficit will be much larger than expected is likely to expose him to a fresh wave of criticism at home from both Left and Right over the consequences of rising public borrowing.

It casts a considerable question mark over whether the Government will be able to proceed with promised net tax cuts of DM20bn in 1990, conceived as a fundamental part of its economic strategy.

The immediate causes of the jump in the 1988 deficit are higher West German contributions to the European Community and the near-disappearance of 1987 profits from the Bundesbank, due to be paid over to Bonn this year. The Bundesbank profit will fall to "near zero" from the DM6bn which had been written into the 1988 budget, the Finance Minister said.

This is because the central bank will have to write off between DM6.5bn and DM7bn on the D-Mark value of its foreign exchange reserves. This is

Continued on Back Page
Details, Page 2

West Germany to raise taxes Continued from Page 1

because of the sharp fall in the dollar to DM1.5815 at the end of last year, the value the Bundesbank will use for its 1987 accounts.

This year's federal deficit is also being driven up by DM14bn of tax cuts which came into effect at the beginning of the year. Additionally, tax revenues have fallen well below earlier projected levels because of economic growth of only 1.5 per cent last year.

Mr Stoltenberg said a supplementary budget would be introduced before the summer to take account of the extra 1988 deficit. Additionally, around May or June, detailed decisions would be taken on finding the budgetary savings of at least DM10bn planned for 1989, Mr Stoltenberg said.

Mr Stoltenberg said the Government faced no substantial risks on the spending side for 1988, although this year's deficit could plainly be driven higher if the economic downturn eats further into tax revenues and drives up subsidies.

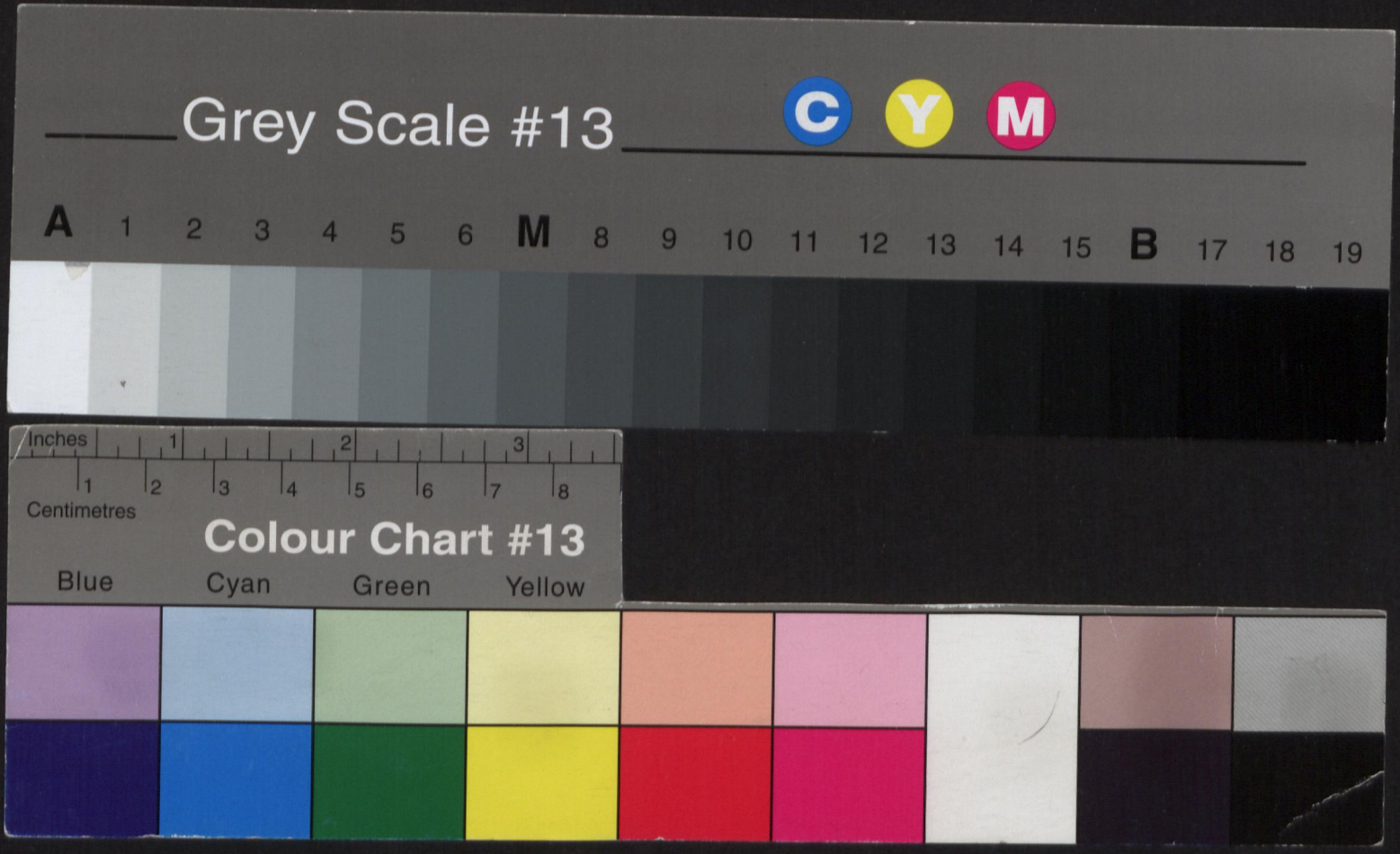
At present, Mr Stoltenberg is projecting a growth of between 1.5 and 2 per cent in gross national product this year, although some more gloomy private sector forecasters are predicting only around 1 per cent.

PART 17 ends:-

NLW to PM 28.12.87

PART 18 begins:-

PG to HMT 9.1.88.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C
Y
M
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Inches
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Colour Chart #13
Blue
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Green
Yellow