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PREM 19/2630

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PART 20

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SECRET

Confidential Filing

Domestic Monetary Policy.

[In attached folder
① Treasury Economic Forecast - June '89
② Barclays Economic Review - May '89]

ECONOMIC POLICY

Pt 1 May 1979

Pt 20 November 1988

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~7-11-88~~							
~~11-11-88~~							
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~~8-12-88~~							
~~17-1-89~~							
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~~12-6-89~~ TPM							
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5.9.89							
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PREM 19/2630

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PART 20. ends:-

PG to HMT 21.8.89

PART 21 begins:-

PG to PM 5.9.89

Published Papers

The following published paper(s) enclosed on this file have been removed and destroyed. Copies may be found elsewhere in The National Archives.

Barclays Economic Review, May 1989
(Published quarterly by Barclays Bank)

Signed *OMWayland* Date *13 October 2016*

PREM Records Team

SECRET

FILE PMZAUN 26

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

21 August 1989

SUBJECT CC MASTER

Dear Jonathan

As you know, the Chancellor came in to see the Prime Minister this morning to discuss the likely market reaction to the trade figures. The Chancellor noted that the figures were extremely difficult. Car imports in July ahead of the G registration (and the diversion of UK exports to meet home demand) were obviously a factor. The market had already discounted the dock strike and indeed had expected it to have a slightly favourable effect on the trade figures, so Wednesday's figures would come as a greater shock. The July seasonal adjustment was always a large one. That factor would disappear in next month's figures.

The Chancellor felt that the markets would react very badly. He had agreed the intervention strategy with the Bank, which the Prime Minister said she fully endorsed. The Chancellor agreed to contact the Prime Minister if there were significant exchange rate problems or if he felt that, contrary to both their hopes, a rise in interest rates was necessary. Both noted that, with the exception of this set of trade figures, all the other indicators in the economy pointed to it slowing down at the right rate and it would be a great pity to bring about too sharp an adjustment to the economy on the strength of one set of figures against all the other indicators.

Yours ever

Dominic

DOMINIC MORRIS

Jonathan Taylor, Esq.,
H.M. Treasury.

SECRET

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PRIME MINISTER

THE ECONOMY

The key figures to come out next week are the trade figures which come out on Wednesday. They are awful. At £2.1 billion the July deficit on current account is the second worst ever (the worst being this time last year). The Treasury is at something of a loss for why the figures should be so bad this month. They run counter to most of the other indicators we have been getting on the economy; of a gradual slow-down and of things coming right again. As the attached full assessment says, the dock strike effect is likely to have been small.

The Chancellor may well want to come in for a brief word on Monday morning on his way through town to discuss with you the likely market reaction to these figures. I will come back to you on this early on Monday morning.

The other figures to come out are:

Monday
GDP (output) for the second quarter which show a half per cent drop on the first quarter of 1989. The main part of the fall is accounted for by the energy sector (accidents in the North Sea, etc.).

Tuesday
The building society monthly figures come out. We do not yet have details for these, but they are likely to show commitment to loans slightly below what the market is expecting. Another indicator of a gently slowing economy.

Wednesday
The CSO pink book for the UK balance of payments comes out. The annual revisions are small. Also on Wednesday we have the construction new orders figures for June which we have not yet seen.

B

Thursday

The cyclical indicators for the UK economy in July also not yet out.

DM

18 AUGUST, 1989.

Central Statistical Office

Great George Street London SW1P 3AQ

Telephone 01-270 6040 Fax 01-270 5866

SECRET AND PERSONAL UNTIL RELEASE OF PRESS NOTICE AT 11.30 AM ON 23 AUGUST AND THEREAFTER UNCLASSIFIED

17 August 1989

TO: PS/CHANCELLOR OF THE EXCHEQUER

FROM: J E KIDGELL

OVERSEAS TRADE FIGURES FOR JULY 1989

THE CURRENT ACCOUNT

In July, the value of exports was £7.7 billion and imports £10.2 billion, so that visible trade, seasonally adjusted on a balance of payments basis, shows a deficit of £2.5 billion compared with the deficit of £1.9 billion in June.

The surplus on invisibles is projected to be £0.4 billion for months in the current quarter so that the current account in July is provisionally estimated to have been in deficit by £2.1 billion, compared with a provisional estimate of £1.5 billion in June.

[Invisibles and hence the current account for months and quarters of 1988 and 1989 will be subject to minor revisions before publication. Final figures will be included in the press notice sent to the Chancellor for approval tomorrow.]

TABLE 1: CURRENT BALANCE, VISIBLE TRADE AND INVISIBLES (TABLE 2 OF PRESS NOTICE)

Seasonally adjusted
Balance of Payments Basis
£ million

	Current Account	Visible Trade Balances			Invisibles Balance
		Total	Oil	Non-oil	
1987	- 3672	-10929	+4183	-15112	+7257
1988	-14618	-20826	+2787	-23612	+6208
1989 Q1	- 4838*	- 5980	+ 241	- 6220	+1142*
1989 Q2	- 4632a*	- 5832	+ 333	- 6164	+1200a*
1989 May	- 1340a*	- 1740	+ 43	- 1783	+ 400a*
1989 June	- 1517a*	- 1917	+ 156	- 2073	+ 400a*
1989 July	-2062a*	- 2462	+ 84	- 2545	+ 400a*

a - Projection or part projection
* Figures for the current account and invisibles balance are subject to revision

SECRET AND PERSONAL UNTIL RELEASE OF PRESS NOTICE AT 11.30 AM ON 23 AUGUST AND THEREAFTER UNCLASSIFIED

In the three months ended July there was a deficit on visible trade £6.1 billion - a surplus on trade in oil of £0.3 billion, offset by a deficit in non-oil trade of £6.4 billion. Between the three months ended April and the latest three months, the visible trade deficit was little changed (up by only £10 million); a small increase in the surplus on oil was offset by a small increase in the deficit on non-oil trade.

EXPORTS

The value of exports in July was £145 million (2 per cent) lower than in June. Exports of oil fell by £68 million and exports of the erratic items fell by £79 million between the two months. Excluding oil and the erratic items, exports hardly changed between June and July.

In the three months ended July, total export volume was 5 1/2 per cent higher than in the previous three months and 2 1/2 per cent higher than in the same period a year earlier. Excluding oil and the erratic items, export volume was 4 per cent higher than in the previous three months and 9 per cent up on the same period a year earlier. It appears that the underlying trend of non-oil export volume is continuing to rise.

TABLE 2: EXPORTS BY VALUE AND VOLUME (Tables 1, 4 and 7 of Press Notice)

Bop Basis, Seasonally Adjusted

	VALUE (£m)		VOLUME (1985 = 100)	
	Total	Total less Oil and Erratics	Total	Total less Oil and Erratics
1987	79421	64999	109.1	109.4
1988	80602	69140	110.7	113.9
1989 Q1	21656	18789	112.8	122.1
1989 Q2	22680	19344	115.1	122.6
1989 May	7623	6474	115.2	123.4
1989 June	7873	6674	118.7	125.3
1989 July	7728	6676	117.1	126.4

SECRET AND PERSONAL UNTIL RELEASE OF PRESS NOTICE AT 11.30 AM ON 23 AUGUST AND THEREAFTER UNCLASSIFIED

By value, exports of manufactures during the three months ended July were 8 1/2 per cent higher than in the previous three months.

Also by value, total exports rose by 8 1/2 per cent in the latest three months compared with the previous three months. The rise in exports to the developed countries was 10 per cent - within which exports to the rest of the European Community rose by 15 per cent while exports to North America rose by 4 1/2 per cent. Exports to the developed countries decreased by 2 1/2 per cent while exports to developing countries were little changed between the two three-month periods.

IMPORTS

The value of imports in July was £400 million (4 per cent) higher than in June. Imports of oil and imports of the erratic items were little changed between the two months. Excluding oil and the erratic items, imports rose by 4 1/2 per cent between June and July.

In the three months ended July, total import volume was 3 per cent higher than in the previous three months and 7 per cent higher than in the same period a year earlier. Excluding oil and the erratic items import volume was 3 per cent up on the previous three months and 8 per cent up on the same period a year ealier. It appears that the underlying level of non-oil import volume is continuing to rise.

TABLE 3: IMPORTS BY VALUE AND VOLUME (Tables 1, 4 and 7 of Press Notice)

Bop Basis, Seasonally Adjusted

	VALUE (£m)		VOLUME (1985 = 100)	
	Total	Total less Oil and Erratics	Total	Total less Oil and Erratics
1987	90350	82214	114.6	115.9
1988	101428	93809	129.5	132.2
1989 Q1	27636	25517	140.5	143.0
1989 Q2	28511	26096	140.2	143.2
1989 May	9363	8501	138.4	140.7
1989 June	9790	8960	142.1	145.0
1989 July	10190	9366	148.2	151.4

SECRET AND PERSONAL UNTIL RELEASE OF PRESS NOTICE AT 11.30 AM ON 23 AUGUST AND THEREAFTER UNCLASSIFIED

By value, imports rose by 6 1/2 per cent in the latest three months compared with the previous three months. Imports of manufactures during the latest three months were 5 1/2 per cent up on the previous three months.

Again in value terms, imports from the developed countries rose by 6 1/2 per cent over the latest three months, with arrivals from the European Community countries up by 6 per cent, from North America up by 10 per cent and from the other developed countries up by 5 per cent. Imports from the developing countries increased by 10 per cent between the two three-month periods.

TRADE IN MANUFACTURES

Figures showing trade in manufactures on a balance of payments basis will be published in the September edition of the Monthly Review of External Trade Statistics following the release of the press notice. On present estimates they show a deficit in the three months ended July of £4.2 billion compared with a deficit of £4.4 billion in the previous three months.

TABLE 4: TRADE IN MANUFACTURES, (SITC 5-8) (TABLE 16 OF PRESS NOTICE, QUARTERLY DATA ONLY)

£ million
Seasonally Adjusted
Balance of Payments Basis

	Exports	Imports	Balance
1987	60651	68480	- 7828
1988	64731	79627	- 14897
1989 Q1	17724	22017	- 4293
1989 Q2	18333	22370	- 4037
1989 May	6228	7307	- 1079
1989 June	6370	7720	- 1351
1989 July	6276	8052	- 1775

INDUSTRIAL ACTION AT NDLS PORTS

It is likely that trade recorded in the July month of account has to some extent been distorted by the recovery from unofficial action at National Dock Labour Scheme ports during 8-19 June, and the official action which started on 11 July. The effect of these two periods of action will to some extent have been offsetting, and their net effect is probably small, though at this stage impossible to quantify.

SECRET AND PERSONAL UNTIL RELEASE OF PRESS NOTICE AT 11.30 AM ON 23 AUGUST 1989 AND THEREAFTER UNCLASSIFIED

REVISIONS TO PUBLISHED FIGURES

Figures for the current account, visible trade and invisibles for 1987 and 1988 have been revised in line with the annual estimates to be published in the "Pink Book" on 23 August. The current account deficit for 1987 has been revised upwards from £2.9 billion to £3.7 billion. For 1988 the current account deficit is now in deficit by £14.7 billion compared with the previous estimate of £14.9 billion. The visible trade deficit has increased by £0.3, offset by an increase in the surplus on invisibles of £0.6 billion.

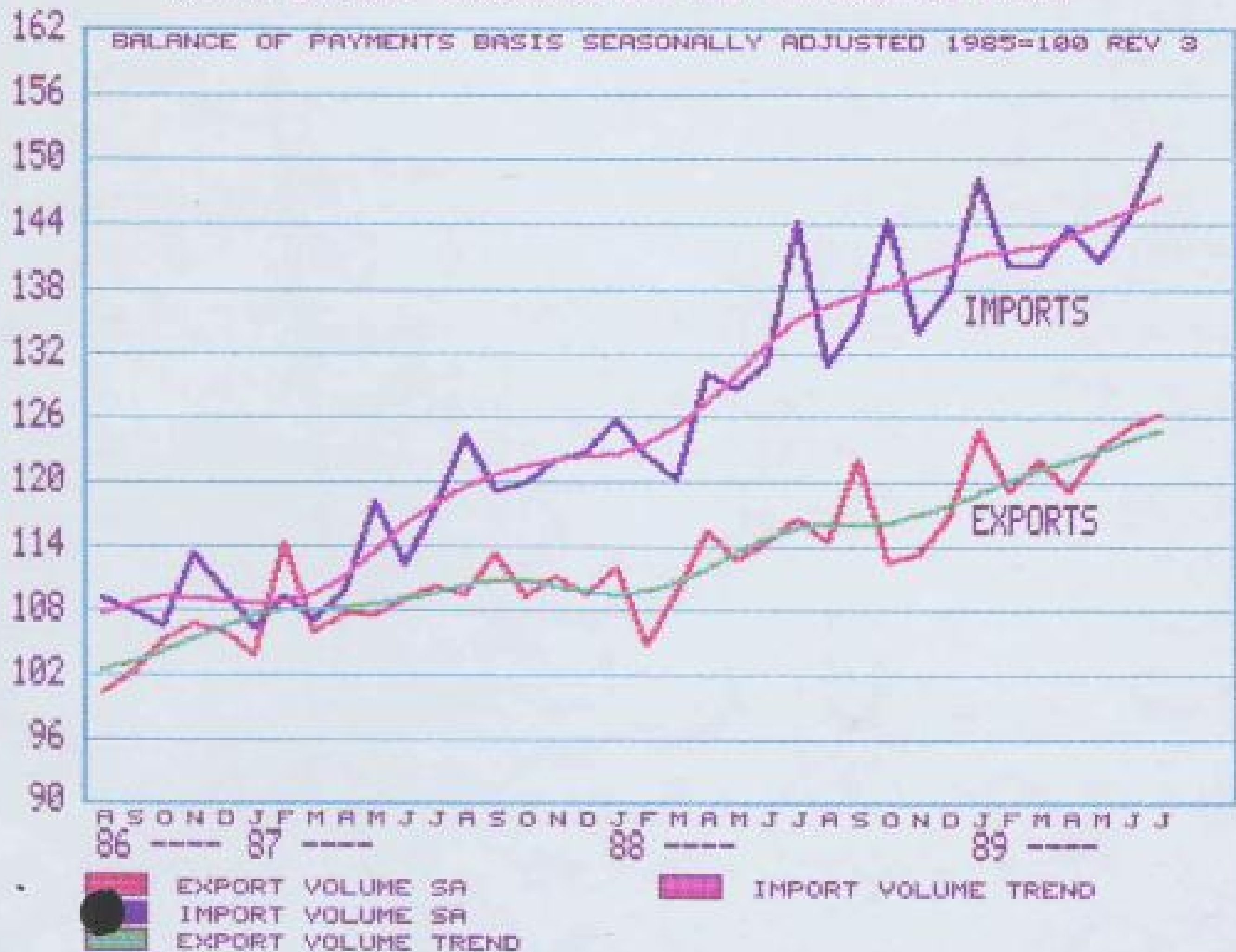
The change to the visible trade deficit in 1988 results from an upward revision to oil exports of £0.4 billion, and an upward revision to imports of £0.7 billion in respect of a revised method of estimating freight on imports. The latter revision gives rise to offsetting changes to the invisibles balance.

PUBLICATION

The press notice containing the July figures is scheduled for release on Wednesday 23 August 1989.

J.E.Kidgell.

J E KIDGELL
Head Directorate D


SECRET AND PERSONAL UNTIL THE RELEASE OF THE PRESS NOTICE ON 23.8.89
VOLUME INDICES EXCLUDING OIL AND THE ERRATIC ITEMS
BALANCE OF PAYMENTS BASIS SEASONALLY ADJUSTED 1985=100 REV 3
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IMPORTS
EXPORTS
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88 ----
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IMPORT VOLUME TREND

CIRCULATION LIST

Copy No:		
	1	Financial Secretary
	2	Prime Minister
	3	Chancellor of the Exchequer
	4	Minister for Trade
	5	Sir Robin Butler (Cabinet Office)
	6	Sir Peter Middleton (H M Treasury)
	7	Sir Terence Burns (H M Treasury)
	8	Sir Peter Gregson (DTI)
	9	Governor/Bank of England
	10	Chairman/HM Customs
	11	Mr J Hibbert (CSO)
	12	Mr M Pratt (HM Customs)
	13	Mr Lind (H M Treasury)
	14	Mr P Sedgwick (H M Treasury)
	15	Mr B Morgan (Dept Energy)
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	17	Mr J Kidgell (CSO)
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	26	File

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SECRET AND PERSONAL

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FROM: S BROOKS/R D KERLEY
DATE: 17 AUGUST 1989
EXT: 4605/4614

1. MR PERETZ
2. CHIEF SECRETARY

The line to take and briefing do not draw attention to the faster growth of M0 since the end of July, in the first three weeks of August — nor do they need to do so. But in general I suggest that I DT keep a low profile in commenting on these figures.

DCP 17/8

cc Chancellor
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Wicks
Mr Evans
Mr Odling Smee
Mr Scholar
Mr Sedgwick
Mr Grice
Mr O'Donnell
Miss O'Mara
Mr Ritchie
Miss Simspon
Ms Ryding
Mr Sheath
Mr Gray (No 10 Personal)
Sir A Walters (No 10 Personal)

PROVISIONAL MONEY FIGURES - JULY 1989

(All figures are unadjusted unless specified otherwise)

1. The provisional money supply figures for July will be published by the Bank at 11.30am on Thursday 20 August. These will be the first set of money figures published since the Abbey National converted from a building society to a bank, and the provisional press notice will not refer to M3 at all. We understand, however, that the final figures (published on 30 August) will permit M3 to be calculated easily, although even then it will not appear explicitly in the published figures.

SECRET AND PERSONAL

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2. As usual M4 and M5 broad money figures are subject to revision.

3. **Summary**

Monetary Aggregates for July (per cent)

			Annualised Rates		
Rate	Annual Growth Rate		Three Months	Six Months	Monthly Growth
M0	5.2				1.9
	5.3	sa*	9.5	4.7	0.3
M4	16.7				0.9
		sa	16.3	18.3	0.6
M5	16.3				1·0
		sa	16.7	18.2	0.6

* Seasonally adjusted

	Lending £ billion			Per cent Growth Rates	
					Previous Month
	This Month	Last Month	Average of Previous 6 months	Annual (Monthly) (unadjusted)	Annual (Monthly) (unadjusted)
Lending by Banks and Building Societies	7.5	9.4	7.0	21.5 (1.6)	22.5 (2.1)
Societies s.a.	6.9	7.2	7.0		

Table 2 attached gives the historical growth rates for M0, M4, M5, NIBM1, and bank and building society lending. Tables 3 and 4 show respectively the components and counterparts for broad money together with the average change over the previous twelve months.

M0

4. M0 increased by 5.3 per cent (seasonally adjusted) in the twelve months ending in July, lower than June's 5.9 per cent and the smallest 12 month increase since February last year. Notes and coin rose by 0.4 per cent (seasonally adjusted) in July, less than June's rise of 0.9 per cent. But, while the July figures show further progress towards the target range, weekly figures for notes and coin in the first three weeks of August show larger increases on average than in July.

Broad Money

5. The twelve month growth rate of M4 was 16.7 per cent in July, well below June's figure of 18.5 per cent. This represents the smallest 12 month increase since May last year. The monthly increase of 0.6 per cent (seasonally adjusted) was well below the average increase of the previous six months.

6. Within the M4 components, the increase in total retail deposits was £2.2 billion (seasonally adjusted), a little below June's figure (£2.4 billion) and the average of the previous six months (£2.6 billion). The twelve month growth rate of the retail deposit component of M4 (seasonally adjusted) fell ½ per cent to 14 per cent. Analysis of the composition of the inflow is complicated by the Abbey's conversion. But it looks as if the switch away from non interest bearing sight deposits to the new interest bearing bank current accounts continued. Building societies retail inflows in July were much higher in July than in May or June in spite of the removal of the Abbey from the figures. The underlying inflow for the remaining building societies was probably similar to that of the first four months of the year. This recovery may ease the immediate pressures on some societies, making mortgage rate rises less likely.

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7. The increase in wholesale deposits in July of £0.3 billion (seasonally adjusted) is very low by the standards of recent months, perhaps a reaction to June's very large increase of £6½ billion. The twelve month growth of wholesale deposits within M4 in July fell back to 27½ per cent (seasonally adjusted) from 32½ per cent in June. The July figure is close to those of the first five months of the year and June's figure now looks decidedly out of line with the others.

8. Within the M4 counterparts, the PSBR was overfunded by about £1 billion, in contrast to the underfunding of about £0.8 billion on average in the first three months of the financial year.

9. M4 lending was £6.9 billion on a seasonally adjusted basis, marginally lower than in June (£7.2 billion) and the average monthly increase in the first half of the year (£7.0 billion). Its twelve month growth rate fell by a full percentage point to 21.5 per cent, the seventh fall in a row. Last October's peak was 24.7 per cent. The six month growth rate of lending was 20 per cent in July, down from 21.3 per cent in June. The faster growth of M4 lending than of M4 in July is partly explained, arithmetically, by the increase in non-residents' sterling deposits which are not included in M4.

10. We have not yet seen the figures ourselves, but we understand from the Bank that CLSB banks' lending for consumption was low, about £40 million (of which credit cards £22 million). After applying their own unpublished seasonal adjustments, the Bank reckon that this implies an underlying increase of only around £100 million [NOT FOR USE], one of the lowest figures in the last two and a half years. The increase in lending for consumption has now fallen for four months in a row - but the series is erratic.

11. CLSB lending for house purchase was also low at £0.2 billion, both before and after the Bank's seasonal adjustment. This is less than half the average monthly increase (seasonally adjusted) in the second quarter [NOT FOR USE]. Lending by the building societies and the Abbey National was probably around £2 billion [NOT FOR USE], lower than in June (£2.3 billion) and a little below the second quarter monthly average (£2.1 billion). Overall the evidence is consistent with a continuing slowdown in mortgage lending as a whole, with the banks continuing to lose market share.

12. Lending to companies by CLSB banks was £1.8 billion, with the highest increases in the food drink and tobacco, property, and 'other services' sectors. But some sectors repaid debt, including hotels and catering, investment and unit trusts, and life assurance and pension funds.

Presentation

13. These figures should receive a mildly favourable reception from the markets. The average market expectation for M0 is broadly accurate this month, having been forecast more or less correctly from the Bank's weekly returns. M4 growth was very modest in July and well below market expectations. Both the six and twelve month growth rates fell back, the twelve month rate particularly sharply. As for bank and building society lending the rise was in line with the last three months but a little above the market expectation. However, the six and twelve month growth rates continued to decline steadily and the composition looks to be favourable, with the CLSB figures showing that lending for consumption was very low in July.

	Outturn June	"Average Market" Expectations
M0 - one month change: %	+1.9 (+0.3)	(+0.4)
M4 - one month change: %	+0.9 (+0.6)	(+1.4)
Bank and building society lending £ billion	+7.5 (+6.9)	(+6.4)

(figures in brackets seasonally adjusted)

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14. Against this background we recommend a line to take as follows:

> "12 month growth rates of M0, M4 and bank and building society lending all lower than in June, as high interest rates have their expected effect."

15. We would be grateful for approval of the line to take and comments on the attached more detail briefing as early as possible tomorrow morning.

S BROOKS/R D KERLEY

cc Bank of England

Mr George
Mr Thorp (Financial Statistics Division)

TABLE 2

S E C R E T (Until Publication)

£ million

GROWTH RATES OF MONETARY AGGREGATES AND BANK & BUILDING SOCIETY LENDING

			1988 Jul	Aug	Sep	Oct	Nov	Dec	1989 Jan	Feb	Mar	Apr	May	Jun	Jul
M0	Monthly change	sa	147	157	256	-11	43	159	-130	-103	80	24	211	123	56
	Monthly % change	nsa	2.2	0.8	0.4	-0.6	0.5	7.5	-6.5	-2.2	1.9	0.1	1.6	0.3	1.9
	Monthly % change	sa	0.9	1.0	1.5	-0.1	0.3	0.9	-0.8	-0.6	0.5	0.1	1.2	0.7	0.3
	3-month annualised % change	sa	11.2	12.2	14.5	10.1	7.1	4.6	1.7	-1.7	-3.5	0.0	7.7	8.7	9.5
	6-month annualised % change	sa	8.6	10.9	12.4	10.7	9.6	9.4	5.8	2.6	0.5	0.9	2.9	2.4	4.7
	Annual % change	sa	6.9	7.6	8.5	7.7	7.7	7.7	7.2	6.6	6.2	5.7	6.2	5.9	5.3
M4	Monthly change	nsa	8062	2562	7528	2585	2906	5221	2114	3095	10026	1935	5555	9060	3545
	Monthly % change	nsa	2.5	0.8	2.2	0.7	0.8	1.5	0.6	0.9	2.8	0.5	1.5	2.4	0.9
	Monthly % change	sa	2.2	1.2	2.2	0.9	0.5	2.0	0.7	1.9	1.8	0.9	0.9	2.3	0.6
	3-month annualised % change	sa	20.8	23.6	25.0	18.5	15.3	14.1	13.5	20.0	19.3	20.4	15.8	18.0	16.3
	6-month annualised % change	sa	20.1	19.3	20.1	19.6	19.4	19.4	15.9	17.6	16.7	16.9	17.9	18.7	18.3
	Annual % change	nsa	17.4	17.3	18.7	17.4	17.7	17.6	18.1	18.6	18.1	18.0	18.2	18.5	16.7
M5	Monthly change	nsa	8289	2582	7793	2518	2963	4586	2273	3023	10151	2610	5550	9360	3947
	Monthly % change	nsa	2.4	0.7	2.2	0.7	0.8	1.2	0.6	0.8	2.7	0.7	1.4	2.4	1.0
	Monthly % change	sa	2.1	1.1	2.2	0.8	0.5	1.7	0.8	1.8	1.7	1.0	1.0	2.3	0.6
	3-month annualised % change	sa	20.2	22.6	24.3	18.0	15.2	12.8	12.6	18.3	18.7	19.8	15.8	18.6	16.7
	6-month annualised % change	sa	19.2	18.6	19.1	19.1	18.9	18.4	15.2	16.8	15.7	16.1	17.1	18.6	18.2
	Annual % change	nsa	16.8	16.6	18.0	16.7	17.1	16.6	17.3	17.8	17.1	17.4	17.6	18.0	16.3
NIBM1	Monthly change	nsa	126	-284	1262	-353	141	1374	-3812	110	908	-1715	322	277	-596
	Monthly % change	nsa	0.3	-0.6	2.6	-0.7	0.3	2.8	-7.5	0.2	1.9	-3.6	0.7	0.6	-1.3
	Monthly % change	sa	0.9	-0.6	1.0	1.9	-1.6	3.5	-3.3	0.1	-0.1	-3.8	-1.0	-0.1	-1.1
	3-month annualised % change	sa	7.1	1.1	5.4	9.7	5.4	16.0	-5.8	0.9	-12.3	-14.2	-17.9	-18.0	-8.4
	6-month annualised % change	sa	11.1	6.7	4.9	8.4	3.2	10.6	1.6	3.1	0.8	-10.1	-9.0	-15.2	-11.3
	Annual % change	nsa	10.8	10.4	12.5	11.0	10.2	12.4	7.2	5.4	2.4	-1.3	-3.0	-3.4	-4.9
M4 LENDING	Monthly change	nsa	9075	4476	8864	6431	5321	7848	7407	4490	9830	4925	6077	9353	7453
	Monthly % change	nsa	2.4	1.2	2.3	1.6	1.3	1.9	1.8	1.1	2.3	1.1	1.4	2.1	1.6
	Monthly % change	sa	2.4	1.6	1.9	1.6	1.5	1.8	2.1	1.1	1.8	1.6	1.5	1.6	1.5
	3-month annualised % change	sa	27.2	26.8	26.4	22.7	22.0	21.4	23.7	22.0	22.1	19.9	21.7	20.6	20.1
	6-month annualised % change	sa	25.5	26.4	27.1	24.9	24.4	23.9	23.2	22.0	21.7	21.8	21.8	21.3	20.0
	Annual % change	nsa	23.5	24.1	24.2	24.7	24.5	24.6	24.4	24.3	24.2	23.4	23.2	22.5	21.5

SECRET AND PERSONAL

TABLE 3 : PROVISIONAL BROAD MONEY COMPONENTS

£ millions

	JULY	AVERAGE GROWTH IN PREVIOUS 12 MONTHS
Notes and coins in circulation (M4ps)	-189	75
Bank & building society deposits (M4ps)		
Retail		
non interest bearing	-382	-223
interest bearing	2689	2825
Wholesale	1427	2377
Change in M4	3545	5054
Money market instruments (M4ps)	400	63
National Savings Bank (M4ps)	2	25
Change in M5	3947	5141

M4ps = non-bank, non-building society private sector

SECRET AND PERSONAL

TABLE 4 : PROVISIONAL BROAD MONEY COUNTERPARTS

£ millions

JULY 1989

	M4	M5
1. PSBR	-1398	-1398
2. Debt sales to private sector (-)		
Gilts	543	543
Treasury Bills	-182	
National Savings	30	32
CTDs	-114	
Other CG debt	2	2
LA and PC debt	217	262
3. External finance of the public sector (-)	-116	-116
4. Public sector contribution (1+2+3)	-1018	-675
5. Sterling lending to private sector	7453	7512
6. Externals	-2857	-2857
7. NNDLs	-33	-33
8. Total change (4+5+6+7)	3545	3947
(Percentage change)	(0.9	1.0)

AVERAGE CHANGE IN PREVIOUS 12 MONTHS

	M4	M5
1. PSBR	-1075	-1075
2. Debt sales to private sector (-)	1047	1133
o/w Gilts	1029	1029
Other public sector debt	72	81
3. External finance of the public sector (-)	82	82
4. Public sector contribution (1+2+3)	53	140
5. Sterling lending to private sector	7008	7009
6. Externals	-765	-765
7. NNDLs	-1243	-1243
8. Total change (4+5+6+7)	5054	5142
(Percentage change)	(1.4	1.4)

j

MONEY SUPPLY IN JULY: PRESS BRIEFING

A. LINE TO TAKE

12 month growth rates of M0, M4 and bank and building society lending all lower than in June, as high interest rates have their expected effect.

B. THE FIGURES IN DETAIL

i. Changes in main monetary aggregates

		per cent	
	M0	M4	M5
12 month growth rate	+5.2 (+5.3)	+16.7 (+17.1)	+16.3 (+16.7)
Annualised six-month growth	(+4.7)	(+18.3)	(+18.2)
Annualised 3-month growth	(+9.5)	(+16.3)	(+16.7)
one month change	+1.9 (+0.3)	+0.9 (+0.6)	+1.0 (+0.6)

(Figures in brackets seasonally adjusted s.a.)

ii M0: growth rates (sa)

	3 month annualised	6 month annualised	12 month
December	4.6*	9.4	7.7
January	1.7	5.8	7.2
February	- 1.7	2.6	6.6
March	- 3.5	0.5*	6.2
April	0.0	0.9	5.7
May	7.7	2.9	6.2
June	8.7	2.4	5.9
July	9.5	4.7	5.3

* slightly distorted downwards by postal strike in 3 months to December and in 6 months to March

K

SECRET AND PERSONAL
UNTIL 11.30 AM ON FRIDAY 18 AUGUST

a. Annual growth rate (s.a) Fallen back again after pick up in May.

b. Annual growth rate (unadjusted): Seasonally adjusted rate better guide to underlying monetary conditions.

c. 3 month growth rate somewhat higher than in recent months, but very sensitive to uncertain seasonal factors due to timing of bank holidays.

d. 6 month growth rate Shows pick up from June but still well down on peak levels experienced in 1988. Confirms slowdown from end of last year.

e. One month growth (s.a) shows modest 0.3 per cent rise on June.

iii. Broad money

[Note - as announced on 29 June M3 (and M1 and M3C) no longer published following the large break in series caused by Abbey National's Conversion.]

M4: growth rates

	3 month+	6 month+	12 month*
May	15.2	15.5	16.0
June	15.4	15.5	16.8
July	20.8	20.1	17.4
August	23.6	19.3	17.3
September	25.0	20.1	18.7
October	18.5	19.6	17.4
November	15.3	19.4	17.7
December	14.1	19.4	17.6
January	13.5	15.9	18.1
February	20.0	17.6	18.6
March	19.3	16.7	18.1
April	20.4	16.9	18.0
May	15.8	17.9	18.2
June	18.0	18.7	18.5
July	16.3	18.3	16.7

+ sa and annualised

* unadjusted

a. One month growth (sa) shows very modest 0.6 per cent rise on June.

b. 3 month growth rate: Very erratic. Fell back sharply in July after pick up in June. Well below peak growth rates experienced in July-September 1988.

c. 6 month growth rate: Declined slightly and remains below peak figures seen in latter half of 1988.

d. 12 month growth rate: Unadjusted rate fell back sharply to lowest level since May 1988.

iv. Lending

(a) One month changes:

	Bank and building society lending			
	sa		nsa	
	£bn	%	£bn	%
December	+7.4	+1.8	+7.8	+1.9
January	+8.7	+2.1	+7.4	+1.8
February	+4.8	+1.1	+4.5	+1.1
March	+7.8	+1.8	+9.8	+2.3
April	+7.1	+1.6	+4.9	+1.1
May	+6.6	+1.5	+6.1	+1.4
June	+7.2	+1.6	+9.4	+2.1
July	+6.9	+1.5	+7.5	+1.6

(b) Bank and building society lending: growth rates

	3 month+ %	6 month+ %	12 month* %
July	27.2	25.5	23.5
August	26.8	26.4	24.1
September	26.4	27.1	24.2
October	22.7	24.9	24.7
November	22.0	24.4	24.5
December	21.4	23.9	24.6
January	23.7	23.2	24.4
February	22.0	22.0	24.3
March	22.1	21.7	24.2
April	19.9	21.8	23.4
May	21.7	21.8	23.2
June	20.6	21.3	22.5
July	20.1	20.0	21.5

\+ s.a and annualised

* unadjusted

(c) 12 month growth rate (unadjusted): Further confirmation of slowdown after period of broad stability.

(d) 6 month annualised growth rate (adjusted): Last few months shown considerable slowdown.

(e) 3 month annualised growth rate (adjusted): Erratic, but slight fall and at level well down on peak growth rates experienced in summer 1988.

v. CLSB lending

Lending for consumption - £40 million. Lending for house purchase - £200 million. Both low.

SECRET AND PERSONAL
UNTIL 11.30 AM ON FRIDAY 18 AUGUST

vi. Funding.

(a) Overfund (on M4 definition) in July of £1.0 billion; PSBR surplus in July of £1.4 billion.

(b) Cumulative over/underfunding:

Financial year 1989-90 to date: £1.4 billion underfund; (£2.2 billion overfund carried over from 1988-89 and earlier years.)
Last 12 months: cumulative overfund of £0.2 billion.

SECRET AND PERSONAL
UNTIL 11.30 AM ON FRIDAY 18 AUGUST

C. DEFENSIVE

i. M0 growth still not within target range? Annual growth rate slowed in July. [If pressed: Will re-enter target range soon.]

ii. Broad money still growing strongly? Very modest growth in July and 12 month growth rate now lowest since May 1988.

iii. Government should adopt Divisia Index as its target monetary aggregate. [A divisia index weights assets according to their liquidity - in fact weights vary inversely with interest rate on particular assets. Advocated in FT article on 16 August.]

No. M0 has proven track record. However, the components of such an index are monitored as part of Government's continuous and comprehensive assessment of monetary conditions, and as MTFS says (para 2.22) the interpretation of broad money, or liquidity, requires considerable judgement.

iv. Relatively buoyant lending figures indicate interest rate rises having no effect? No. 6 and 12 month growth rates continue to decelerate and currently well down on last year's levels. CLSB figures show lending for consumption at £40 million very low in July.

P

INTEREST RATES: BRIEFING ON GENERAL POLICY

i. Recent interest rate increases

(a) Future movements in interest rates? Interest rates will stay as high as is needed, for as long as is needed, to bring inflationary pressures under control. Chancellor said at Foreign Press Association on 11 July "Currently the rate is 14 per cent and I believe we will keep it at that level for some little while to come - if indeed we need to go higher we'll go higher, but certainly we need to keep it at 14 per cent for some time to come."

(b) Interest rates bearing excessive burden in adjustment process? Chancellor in Budget speech, 14 March: "Inflation is a disease of money; and monetary policy, is its cure.... Short term interest rates remain the essential instrument of monetary policy."

(c) Risk of 'hard landing'? Chancellor in Budget speech, 14 March: "But the question of just how soft or hard the so-called landing will be is not in the hands of the Government alone. The Government's task is to reduce inflation by acting, through monetary policy, to bring down the growth of national income in money terms. The task of business and industry is to control their pay and other costs. The more successfully they do so, the less costly in terms of output and employment the necessary adjustment will be."

ii. Interest rates and industry

(a) Interest rate increases damage industry? [Latest figures show manufacturing output virtually unchanged between 1989Q1 and Q2.]

- Only to be expected that output growth would slow in response to tightening of policy. But manufacturing output still over 5 per cent above level a year ago.

- Rises in interest rates affects households far more than companies

- Have important influence on housing market (especially in South East) where rise in prices has been important influence on consumption growth and on household sector which is now substantial net payer of interest

- Companies, by contrast, now in far stronger position than for very long time and hence less effected by interest rate rises than in past

- Most larger firms can borrow long term and long term rates have risen much less than short rates. Now Government no longer making demands on gilt market, excellent opportunities for other borrowers, particularly for long term fixed interest debt.

- But even for those smaller businesses dependent on bank borrowing and adversely affected in short term, resurgence of inflation more likely to damage investment than period of higher interest rates. 1 per cent increase in interest rates, even if sustained for whole year raises costs by far less than 1 per cent rise in pay settlements.

(b) Higher interest rates curb investment? [Latest CBI Quarterly Industrial Trends Survey showed fall in investment intentions.]

No. Latest CSO figures for manufacturing investment show rise of 13 per cent between 1989Q1 and Q2, although would expect investment growth to slowdown from exceptionally fast rates of last year. Even so, DTI Investment Intentions Survey (June) forecasts 15 per cent growth in manufacturing investment this year, and "further, though smaller" increase in 1990.

chex.jp/mwl/45

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

27 July 1989

Paul Gray Esq
10 Downing Street
LONDON
SW1A 2AA

Dear Paul,

CHANCELLOR'S END-OF-TERM LETTER

As you know, the Chancellor writes an end-of-term letter to Conservative MPs each July. The Prime Minister may like to have the attached copy.

Yours,

Moira.

MOIRA WALLACE

11 DOWNING STREET
WHITEHALL SW1A 2AB

26 July 1989

As the House rises for the Summer Recess, I thought it would be helpful if, as in previous years, I set out how I see the current economic situation and prospects.

The most welcome development over the past twelve months has been the continuing investment boom, particularly in manufacturing. Manufacturing investment grew by 14½ per cent in 1988, and total business investment by 15½ per cent. And the latest DTI Investment Intentions Survey in June projected a further 15 per cent rise in manufacturing investment in 1989.

As a share of national income, business investment is now higher than at any time since records began. Whereas we were near the bottom of the European investment growth league in the '60s and '70s, in the 1980s we have been at the top. When I announced the reform of business taxation in my 1984 Budget there were fears in some quarters that this might discourage investment. In the event, not only has investment surged ahead, but its quality has improved out of all recognition, as is shown by the dramatic improvement in the return on capital employed.

But, while the investment boom is wholly welcome, and bodes well for the future, total spending in the economy has been growing too fast, and that in turn has led to an increase in inflation. Bringing inflation down is and must remain our top priority. Hence the need for high interest rates.

Our experience over the past year has in fact broadly mirrored that of the rest of the industrial world. The world economy shrugged off the effects of the October 1987 stock market crash with far more resilience than anyone foresaw at the time. The crash led to widespread predictions of a return to the slump of the 1930s. But Governments acted swiftly to cut interest rates and preserve confidence, and in the event the world economy has

continued to forge ahead. This easing of monetary conditions in the aftermath of the crash may have contributed something to the subsequent worldwide pick-up in inflation, but the damage that would have been done if confidence had been lost would have been severe. More recently, other countries, too, have been responding to the pick-up in inflation by raising interest rates.

In the UK, the rise in inflation has been exaggerated by the inclusion, contrary to the general practice overseas, of mortgage interest payments in the Retail Price Index. The RPI excluding mortgage interest payments provides a better guide to the underlying position, and shows that the inflation rate in June was 5.9 per cent: still too high, but less than one per cent higher than it was last July - less than the comparable rise in other major countries over the same period. It is worth recalling too, that under Labour the average underlying rate of inflation was 15.6 per cent, and the lowest rate they ever achieved was 7.7 per cent.

Along with a rise in inflation, the rapid expansion of demand over the past two years has shifted the current account into substantial deficit. But it is important not to confuse our priorities: high inflation is the one real threat to our continued economic success, and the need to get inflation down is both urgent and paramount. By contrast, we have no difficulty financing a current account deficit of the present size, if need be for a considerable period, provided we maintain sound financial policies, as of course we shall. In time, as the economy slows down and as the new capacity which will follow the investment boom comes on stream, the current account deficit will decline. But in the shorter term, the investment boom has itself played a major part in the increase in the current account deficit: fully three quarters of the increase in manufactured imports in 1988 consisted not of consumer goods but of production and investment goods.

The sound financial policies we need encompass both a firm monetary policy and a tight fiscal policy. On the fiscal side, the public finances have been transformed beyond recognition, with decades of borrowing replaced by a substantial budget surplus. For the time being, it is essential that we keep it that way. The Budget surplus is not a pot of gold that we can dissipate at will. In present circumstances it is a necessary buttress against inflation. At the same time it enables us to repay debt, thus benefiting future generations.

We must maintain a firm monetary policy too. That means keeping interest rates as high as is necessary for as long as is necessary. I recognise the difficulties this causes for those with sizeable mortgages, and for many farmers and small businessmen; but the damage that would be done if we were to relax our anti-inflationary stance would be far worse. Given that mortgages account for some 85 per cent of total household borrowing, there is simply no way to curb the growth of credit and bring down inflation without increasing the cost of mortgages. And it is too often overlooked that higher interest rates benefit those with savings, particularly pensioners.

This is not the first time we have faced a rise in inflation and have had to raise interest rates firmly to counter it. In 1985,

too, base rates had to rise to 14 per cent, and this successfully brought inflation back down and laid the foundation for the subsequent four years of strong growth.

There is now clear evidence that high interest rates are again succeeding in damping down the inflationary pressures. Consumer spending has slowed considerably, and the somewhat feverish rise in household prices has been stopped in its tracks. As a result it now looks very much as if inflation may already have peaked. But we need to see a sustained fall, and it is clear that we must persist with tight financial policies until that is achieved.

At the same time, we must press ahead with the policies that have transformed the supply side of the economy - including tax reform, deregulation, privatisation and promoting a wider spread of ownership. Among the measures yet to come into effect are the reform of employees' national insurance contributions and the abolition of the pensioners' earning rule in October.

The policies that have transformed the British economy in the '80s will provide the foundation for further progress in the '90s. In the '80s we have seen Britain go from the bottom of the major European growth league to the top; we have seen manufacturing productivity grow faster than in any other major industrial country, including Japan; we have seen a record number of new businesses starting up; and, more recently, we have seen the benefits coming through in a sharp fall in unemployment to well below the European average. Living standards have risen markedly at all income levels. And the North has participated in this transformation just as much as the South.

So provided we persevere with sound financial policies, the prospects for the rest of this Parliament, and beyond that for the rest of the 1990s, look good. The tough measures we have taken over the past year are our passport to further success in the future.

NIGEL LAWSON

B cc B/UP

PRIME MINISTER 25 July 1989

PROSPECTS FOR MONETARY CONDITIONS:
August - September

While it is true that monetary shocks usually occur in the summer months (you will recall no doubt the U S floating in 1971 and the Mexican default in 1982), I cannot forsee any "surprise" in store in August or September!

1. 14 per cent or more?

It is very unlikely that there will appear circumstances under which we should increase interest rates (to 16 per cent, say). All the evidence is consistent with a slowing down of the inflation rate and an increasing squeeze on profits and, eventually, wage costs. A rise to 16 per cent (real interest rates of 10 per cent) would be likely to bring on a serious recession. True, it would also bring down the underlying inflation rate more quickly. But the undoubted rise in mortgage interest rates would first increase the RPI and secondly involve political obliquy which would be difficult to survive.

There is a considerable body of opinion in the Treasury (Burns and Middleton) which is doubtful that enough has been done to ensure that inflation is unequivocally arrested and reversed. The Bank, on the other hand, do believe that higher interest rates would cause such deleterious effects on the real economy that any further disinflation would be bought at an unacceptable price. Nevertheless, if there is a sharp fall in the exchange rate from 92.5 down below 90, there will be Treasury if not Bank pressure to put interest rates up to 16 per cent. In my view this should be firmly resisted. Any surge in rates in the money markets, because of expectations of a rate rise, can be countered by leaving the market sitting on its excess cash (as we did a

few weeks ago). We do not need to sell gilts and we need not sell bills, so the Bank can control the market rates. We should not be driven off our policy by the foreign exchange markets.

There are circumstances where an increase to 16 per cent may be justified - that is when M0 clearly jumps up to and stays above 8 per cent growth. But the possibility is so remote it can be ruled out.

2. **14 per cent or less?**

I cannot see a case now or how a case might plausibly develop for reducing interest rates. If, for example, the Fed gets worried about the imminence of a deep recession and cuts the Fed Funds rate from 9 per cent to less than 6 per cent, it would be tempting to follow with a 1 or 2 per cent cut in base rates to arrest the rise of sterling to "uncompetitive levels". Again, we should resist - unless the growth of M0 has actually become substantially negative.

In my view, however, Greenspan will never counternance such Fed incontinence, even under the most pressing political pressure. He wants to ease the tightness of monetary policy but only slightly. He still believes that there is a lot of inflationary pressure yet to be countered and eliminated.

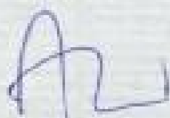
3. **Another Black Monday?**

Again a crash, although conceivable, is the most remote of possibilities. True stock markets have been creeping back towards their mid-1987 levels but they have not been driven there by a monetary expansion similar to those of 1985/7 (U S) and 1986/8 (U K). The continuing expansion in corporate profits is a more likely explanation of the modest rises in 1988/89. There is the expectation that the profit growth will shortly fade. So that may be accompanied by the modest fall in U S interest rates.

In short, this summer there is little or no chance of another stock market collapse and liquidity crisis comparable to that of October 1987.

4. **Sitting tight on 14 per cent?**

Yes: we should.



ALAN WALTERS

cc PA

PA

ANDREW TURNBULL 17 July 1989

INTERVENTION AND STERILISATION - 1987 - 1988

On your comments dated 16 July:

(i) As I said, there are many definitions of sterilisation. I was concerned to define it so that we knew the principles which lay behind it. The normal definition among economists (eg the IMF) is one that leaves the quantity of high-powered money constant. I would contend that, since we target M0, this is a sensible definition for the UK. The Treasury quantity definition, however, is one which, through funding levels, holds a much broader aggregate constant - so that the private sector acquires gilts equal in market value to the intervention. This is a relevant definition if you are targetting a broad aggregate, but, since we simultaneously contend that the broad aggregates are misleading, it is clearly inconsistent to hinge the definition of sterilisation on such a disavowed indicator of monetary conditions. The "funding" definition of sterilisation is a hangover from the old days of credit control and targetting.
We should, therefore, use M0 as our sterilisation standard and concentrate on the monetary, not the credit, conditions being held constant.

Alternatively, using the short interest rate criterion, instead of the M0 constant condition, we do have sterilisation in the sense that we sell bills to maintain the short interest rate. In fact, since short interest rates remain the same, Eddie George properly regards all intervention as immediately sterilised.

In my view, this interest rate definition is not as reliable or as useful as the M0-fixed definition. Many of the reasons for this view are obvious, but one is worth noting - we should be fixing the <u>real</u> rate of interest, not the nominal value.

(ii) Here you are implicitly postulating that there is always an infinitely elastic demand for gilts whatever the quantity in the portfolio of the private sector. You "suppose there is an increase in the demand for sterling" - but what you really mean is that there is an increased demand for highly transitory transactions sterling which is <u>immediately</u> sunk in buying <u>gilts at the constant interest rate</u> and exchange rates. The Goverment simply supplies the gilts and pockets the foreign exchange. You are then quite right. To simplify, if foreigners are willing to absorb <u>unlimited</u> quantities of gilts, the expansion of sterling is sterilised without affecting interest rates or exchange rates. This applies only if the additional (net) demand for sterling is a net movement in the demand curve for gilts. But is it not far more likely that the net demand increase would not be entirely for gilts? In which case, in order to sell gilts equal to the intervention, one would have to <u>increase the interest rates</u>.

But, cet par, that would attract a larger demand for sterling and so would drive up the exchange rate. This, in turn, would induce more intervention, more gilts sales to sterilise and higher interest rates, upward pressure on sterling, etc.

So far, this ignores the dynamics and expectations effect. I believe that these considerations will exacerbate the effects and render the system probably unstable. But that is a long story.

(iii) As I indicated on page 2, I do not think that the effect on the yield curve would be anything but very small. I doubt very much whether one would ever be able to discriminate between the Treasury (more gilts) result and the money market (more bills) result. The yield curve slope is determined primarily by expectations and is affected only to the extent that different policies on sterilisation generate different expectations.

(iv) I remain convinced that unsterilised intervention did contribute to monetary growth in 1987-88. In order to maintain the exchange rate, interest rates were reduced dramatically (on a first definition) and M0 grew faster (on a second definition) than it would have expanded without this intervention. ~~If it stood up to critical examination it would certainly be an important result.~~

(v) The ephemerality of sterilised intervention has been argued above. I would add, however, that all the studies I have ever seen confirm this empirically (using the M0 constant definition). If you know of a counter-example, I would very much like to review it. If it stood up to critical examination, it would certainly be an important result.

p.p. ALAN WALTERS

cc Paul Gray
Professor Brian Griffiths

cc Professor Walters, Mr Gray, Professor Griffiths:
How do you reconcile your view (para (i)) that there was some unsterilised intervention and that it added to growth of M0 with Treasury / Bank view that all intervention was sterilised? Either you are saying that they did not succeed in sterilising? Or, that sterilization was only in respect of gross funding / broad money but that at level of M0 sterilization was incomplete?

ANDREW TURNBULL 17 July 1989

AT 18/7

INTERVENTION AND STERILISATION - 1987 - 1988

On your comments dated 16 July:

(i) As I said, there are many definitions of sterilisation. I was concerned to define it so that we knew the principles which lay behind it. The normal definition among economists (eg the IMF) is one that leaves the quantity of high-powered money constant. I would contend that, since we target M0, this is a sensible definition for the UK. The Treasury quantity definition, however, is one which, through funding levels, holds a much broader aggregate constant - so that the private sector acquires gilts equal in market value to the intervention. This is a relevant definition if you are targetting a broad aggregate, but, since we simultaneously contend that the broad aggregates are misleading, it is clearly inconsistent to hinge the definition of sterilisation on such a disavowed indicator of monetary conditions. The "funding" definition of sterilisation is a hangover from the old days of credit control and targetting.
We should, therefore, use M0 as our sterilisation standard and concentrate on the monetary, not the credit, conditions being held constant.

Alternatively, using the short interest rate criterion, instead of the M0 constant condition, we do have sterilisation in the sense that we sell bills to maintain the short interest rate. In fact, since short interest rates remain the same, Eddie George properly regards all intervention as immediately sterilised.

PROFESSOR WALTERS

cc Paul Gray

INTERVENTION AND STERILISATION

Could I offer a few comments and questions on your minute to Mr Gray of 11 July.

I agree with your main conclusion that the dominant influence in 1987-88 (and in my view even before that) was that interest rates were too low, given the demand and inflation rate pressures, so any differences are second order ones.

i. The discussion in the first half of your note defines sterilisation in relation to the money markets, whereas the Treasury defines it in terms of funding, ie sales of gilts to the non-bank, non-building society private sector sufficient to cover the PSBR/PSDR plus any changes in foreign exchange holdings. Thus, in their framework, the counterpart to higher reserves held by the public sector is not lower holdings of bills but higher gilt-edged liabilities. In their system, intervention of £X million leaves the banks' assets and liabilities unchanged; the public sector's holdings of foreign exchange up by £X million and its debt up by £X million; and the private sector's holdings of gilts up by £X million and its holdings of foreign exchange down by £X million.

ii. In the first full paragraph on page 2, you say that sterilised intervention does not keep the exchange rate from rising. It is not clear why this should be so. Suppose we start from a position of equilibrium where the interest rates are keeping monetary growth close to the authorities' targets, and the exchange rate is showing no tendency to move one way or the other. Suppose there is then an increase in demand for sterling. The Government could attempt to hold the exchange rate by intervention, sterilising this by selling more gilts. The position is

then that the supply of sterling assets has been increased to match the increase in demand for sterling assets. The Government could short-circuit this process by selling gilts for foreign exchange. Why should this not prevent the exchange rate from rising? Why should it not be possible to sustain this indefinitely? I agree that it is difficult for the authorities to assess whether an increase in demand for sterling is transitory or permanent, but as a matter of theory I do not see why it should not be possible to hold the exchange rate indefinitely. This is of course possible only when sterling is rising as the opposite process comes to an end when reserves have been exhausted.

iii. At the bottom of page 2, you say that sterilised intervention is likely to increase the downward slope of the yield curve. In the Treasury's view of the world, it steepens the yield curve because the supply of gilts is being increased relative to short-term assets.

iv. At the top of page 3, you said that unsterilised intervention contributed to the monetary growth in 1987-88. The Treasury maintain that intervention was, other than over very short periods, sterilised throughout this period. How then was it contributing to monetary growth?

v. At the top of page 4, you state that if sterilised intervention has a positive effect it is only ephemeral. As indicated in ii above, I do not understand why this should be so.

ANDREW TURNBULL
16 July 1989

SECRET 24 CC SIR A WALTERS

PRIME MINISTER

INTERVENTION, STERILISATION AND FUNDING

At your recent meeting with the Chancellor, Peter Middleton and Terry Burns, there was some debate about whether the high level of intervention in 1987-88 had been genuinely sterilised and/or funded. In the light of that discussion, I asked Alan to prepare a note.

Alan's note is now attached. I think the key points are:

- he accepts that, in some sense at least, the intervention was automatically sterilised;

- but the real problem was that, in order to keep the exchange rate at DM3, interest rates had to be kept at too low a rate, and those lower interest rates generated the excessive monetary growth;

- on the funding side, it is right to stick to the policy of full funding and to avoid over-funding. This would not be a substitute for using the primary weapon of interest rates;

- he remains highly sceptical abut the 'psychology' argument for intervention.

PRG

Thank you very much
MT

PAUL GRAY
14 July 1989

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23a-e a

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PAUL GRAY 11 July 1989

INTERVENTION AND STERILISATION - 1987 - 1988

1. Definitions

Heavy intervention to prevent sterling rising, as with the $25bn in 1987-8, will, as a first stage, immediately:

(i) increase the sterling money supply, and

(ii) reduce market interest rates.

Sterilisation takes place when the effect on "monetary conditions" is contemporaneously neutralised. Depending on whether one interprets such "conditions" in terms of money supply or interest rates, this in turn implies that either:-

(a) the money supply, however defined, is not allowed to expand and is maintained at its original quantity, or

(b) market nominal short term interest rates, however defined, are maintained at their original levels.

The normal academic and IMF definition of sterilisation is in terms of the money supply [(a) above]. But since we use interest rates as the instrument and money growth as the target, the Bank would naturally think of sterilisation in terms of keeping short-term nominal interest rates unchanged [sense (b) above] rather than in terms of the target money growth.

2. Money Market Management as Sterilisation

The Bank would argue that as a rule all intervention is sterilised. Money market operations would, at the end of the day, remove any surplus cash at the prevailing intervention

SECRET

nominal interest rate. [sense (b) above]. The excess sterling due to intervention would be mopped up by the Bank selling bills or repos, so as to prevent a fall in short-term interest rates in the money market. In this interest-rate sense the intervention is automatically sterilised.

But since interest rates are unchanged, such sterilised intervention does not keep the exchange rate from rising. The only way to contain the exchange rate is to yield to market pressure and allow the nominal interest rate to fall. Then there is an associated expansion in the money supply through unsterilised intervention and residual money market management - to support this lower level of interest rates.

It is the persistence in pegging the exchange rate which is the proximate cause of the monetary expansion. The exchange rate peg (together with the rate of expected inflation) determines the nominal interest rate required which in turn determines the quantity of money needed to validate the fixed exchange rate. The circle is closed. As for unsterilised intervention, it is part of monetary policy and affects monetary growth and interest rates. If per contra it be sterilised, the monetary growth and exchange rates are not affected.

With sterilised intervention the private sector ends up with the same amount of money and with more bills (correspondingly the Bank's bill mountain melts down). In order to accommodate this increased supply of short-term liquid assets relative to long, there is likely to be some pressure to increase the downward slope of the yield curve by reductions in long rates. But this is likely to be a small effect and can be safely ignored.

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3. Intervention as a "Cause" of Monetary Growth in 1987-1988

In essence the proximate cause of the monetary growth of 1987-8 was the consequent need to validate the pegging of sterling to the 3.00 Dmark level when current market conditions required an exchange rate far higher at perhaps 3.30 to 3.35. Reductions of interest rates and associated monetary growth were required to hold the rate at 3.00. Unsterilised intervention contributed to the monetary growth, but that was a consquential required expansion and was determined by the 3.00 Dmark peg.

4. Funding

The full-fund rule is designed to ensure that the public sector financial balance has no effect on the money supply. What money is taken in tax receipts over and above public spending is put back into the private sector by purchases of gilts. The result - a level playing field.

In my view this is a good policy. It is easily understood by the market. Debt-management policies are therefore predictable with low levels of uncertainty.

It would be a mistake to use "over-funding", that is buying more gilts than needed for full-fund, with the objective of reducing monetary growth. First, it would cause needless consternation in the markets (as we saw some weeks ago when over-funding was, falsely, rumoured to be returning). Secondly, provided that we continue to control monetary growth through the instrument of interest rates, over-funding would then have to be offset by assistance to the money market. The conclusion is that if we judge that potential inflation requires an increase in the severity of the monetary squeeze, then we should pursue a clear policy of increasing short-term interest rates and not confuse this by arbitrary activity in the gilt market.

SECRET

5. Short-term effects and "psychology".

The evidence from every study I have seen is that sterilised intervention has only a positive effect which can be measured only in hours (in sophisticated markets) or a few days (in less sophisticated markets). Then it is gone. Nevertheless it is asserted that this fly-by-night effect is useful psychologically, particularly in falling markets, because it shows that the authorities "really care" and are not happy with these consequences of monetary policy.

I am not a psychologist (but nor are they who make such allegations!). Furthermore, I have seen no studies, by psychologists or laymen, of these psychological effects. I remain very doubtful if such alleged positive effects outweigh the portfolio losses which are incurred in such intervention.

The Treasury and Bank sometimes point out that the intervention is not sterilised immediately and so may have some effects on exchange rates. Because of the operation of our money market assistance, etc, and the interest rate definition of sterilisation, I do not see how that can be of any quantitative importance. Of course even with fixed nominal interest rates there will generally be some effect on the quantity of money (the relationship between money and nominal interest rates is not tight) and the Treasury or Bank may be anticipating, at fixed interest rates, some quantity-of-money effect on the exchange rate. But that must be both relatively small and unpredictable in magnitude on the exchanges.

6. The "Genius" Case for Intervention (unsterilised).

If we knew that a substantial increase in the demand for sterling was transitory and if we knew precisely the magnitude and duration, when it would subside and to what level, then

there is a case for intervention to prevent the exchange rate movement occuring - "ironing out the bumps". Broadly speaking this is the view that the Chancellor took in 1987-8, and it is a policy promoted by some academics (eg Ronald McKinnon of Stanford). The trouble is that no-one could ever have sufficient knowledge to pursue such a policy. We do not know, even after the event, how the demand for sterling moved, what part was transitory and what part permanent. How much more difficult it is, then, to forecast successfully such movements before they take place. The attempt to insulate the exchange rate from market oscillations usually gives rise only to distortions and sudden reversals.

7. **The Main Problem of 1987-8**

In response to your request for my view whether intervention or constraining interest rates was more damaging, the answer is clearly the interest rate. In our system, this determines monetary policy and the permissible extent of unsterilised intervention.

ALAN WALTERS

cc Professor Brian Griffiths
Andrew Turnbull
Charles Powell
Sir Peter Middleton
Michael Scholar

SECRET

SIR ALAN WALTERS

cc Mr Turnbull

22(a-e)

ECONOMIC PERFORMANCE AND PROSPECTS

You will want to see the attached record of the meeting the Prime Minister had with the Chancellor and Treasury officials on Wednesday.

There is one aspect on which I think it would be helpful if you could prepare an explanatory note for the Prime Minister. It relates to the issues raised in (vi) of my record. The Prime Minister said she found it hard to believe that the $25 billion intervention undertaken in 1987-88 had been genuinely sterilised and funded; the Treasury insisted that it had. At a later point in the discussion (not recorded) the Prime Minister made welcoming noises about the recent intervention in support of sterling, and urged the Treasury not to sterilise it; otherwise she said the beneficial tightening on monetary conditions would be lost. The Treasury response was that this would be inconsistent with the policy of level funding.

Could you therefore do a note which:

- sets out the facts as you see them on whether or not the 1987-88 intervention was sterilised and funded;

- relates to the process of sterilisation/funding to the concept of level funding;

- offers your view on whether the more damaging development in 1987-88 was the intervention or the constraining of interest rates to meet exchange rate objectives.

Perhaps you could let Andrew and me have a sight of your note before we put it in to the Prime Minister.

PAUL GRAY

6 July 1989

DASAWP

SECRET

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

5 July 1989

ECONOMIC PERFORMANCE AND PROSPECTS

The Prime Minister had a meeting this afternoon with the Chancellor, Sir Peter Middleton, Sir Terry Burns and Professor Brian Griffiths to discuss economic performance and prospects. The papers before the meeting were the recent Treasury note on the recent rise of inflation and the Treasury economic forecast for June 1989.

I should be grateful if you would ensure that this letter is copied only to those with a clear need to know.

The recent rise of inflation

Opening the discussion, the Prime Minister said she wished to consider whether there were any indicators or factors that should have been identified in recent years that would have pointed to the need to take action to tighten policy at an earlier stage. She was struck by the charts in the Treasury paper showing that UK inflation relative to that in other countries had risen significantly since around 1985. She wondered whether we had mistakenly disregarded signals which, although not completely accurate, had been telling us that some corrective action was needed. For example, was it right to have ignored the signals coming from the growth of broad money?

In discussion, the following main points were raised:

(i) as compared with the other major countries, the UK had had a tighter fiscal policy. We had also had higher interest rates in real terms. It had, however, been more difficult for this country to reap the benefit of lower oil prices because of the off-setting effect which had followed from sterling's depreciation;

(ii) unambiguous signals of the correct policy response were never available at the time decisions had to be taken. Looking back over the last three to four years, there had been good reasons for ignoring at the time the signals

coming from the continuing fast growth of broad money; there was no doubt that this indicator had given the wrong signals in the early 1980s. Even with the benefit of hindsight, there was no one indicator that had pointed to the conclusion that policy was too lax. However, it was now clear that the general stance of monetary policy over recent years should have been tighter.

(iii) one factor of major importance had been the impact of financial deregulation. Its effects had been more far-reaching than expected and this meant that a tighter stance of monetary policy was needed to achieve a given downward pressure on inflation. The effect had been exacerbated against the background of substantial exchange rate depreciation during the period from 1981-1986.

(iv) one of the difficulties with MO was that it tended to be a coincident indicator and was not a good predictor, although this view had been challenged in the recent work by Stephen Hannah. But it was also argued that, had MO been successfully kept within its target range during the last couple of years, the rate of inflation would have been kept lower.

(v) there was some evidence to suggest that monetary policy had been too lax from around 1985. But from 1987 onwards, there was a strong case for the view that renewed inflation was caused by attention having been taken away from domestic monetary conditions in favour of aiming to keep the exchange rate stable.

(vi) the period of shadowing the ERM had led to very heavy intervention to hold the sterling exchange rate down. It was questioned whether the process of adding to the Reserves had been fully sterilised and funded; and if it had, whether the process would have automatically rendered intervention ineffective. On the other hand, it was argued that sterilisation was not undertaken contemporaneously and could have an important short-term effect in the markets; it was also wrong to view the exchange markets in a mechanistic way and intervention could have important psychological effects.

(vii) whatever the precise position on intervention, it was clear with hindsight that interest rate policy had been wrongly constrained by exchange rate considerations.

Summing up this part of the discussion, the Prime Minister said that, although there were differences of emphasis on certain points, there was general agreement that

over recent years the stance of monetary policy had not been sufficiently tight.

Treasury economic forecast

The Chancellor said that the position set out in the forecast was not encouraging. The moral from the first part of the discussion was to err on the side of caution in ensuring that monetary policy was kept sufficiently tight.

In discussion, the following main points were raised:

(viii) domestic indicators were still worrying, with MO remaining above its target range and continued strong growth of broad money. To be confident of achieving a substantial reduction in inflation over the next two years it was necessary to consider a further tightening of monetary policy now. There was no way of squeezing out inflation without a degree of pain.

(ix) the exchange rate had depreciated significantly in recent weeks. Although there had been some recovery over the last couple of days, if there was a renewed threat of significant further depreciation it would be important to tighten conditions via an increase in interest rates. There was no need to act now, but this response should certainly not be ruled out for the future.

(x) it was extremely difficult to assess the present position of the economy. But despite the indicators now published showing continuing growth in May, there was strong impressionistic evidence that the economy was now on the turn. This was certainly true of the housing market, and substantial evidence was coming through also from the retail sector. Action now further to raise interest rates carried a major risk of pushing the economy into a substantial down-turn. On that view, the important point was to maintain the present level of interest rates for a sufficiently long period rather than to raise them further at this stage.

(xi) there were further major risks involved in a further interest rate increase now. It would have the effect of raising mortgage rates and add a further ratchet to the upward pressure of wages. The RPI consequences would have a very serious psychological impact, undermining confidence in the Government and in turn undermining confidence in the markets. The overall impact could be devastating. There was a major prize to be achieved in the psychological battle against inflation by holding present interest rates so that the expected significant

e

drop in the RPI could come through in August.

(xii) once the reduction in the RPI had been achieved, there was a strong case for taking a further look at the general coverage and methodology of the RPI; the existing Advisory Committee arrangements did not work well. One possibility would be to ask the OECD to prepare a recommended standard.

Summing up the discussion, the Prime Minister said that, although a further increase in interest rates could not be ruled out and the position would need to be kept under review in the normal way, she saw major difficulties with such a step in the near future.

PAUL GRAY

Alex Allan, Esq.,
H.M. Treasury

SUBJECT cc MASTER

SECRET AND PERSONAL

21(a-d) file PM2 ARS

Mtg Record

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

5 July 1989

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SECRET AND PERSONAL

D

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d

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Summing up the discussion, the Prime Minister said that, although a further increase in interest rates could not be ruled out and the position would need to be kept under review in the normal way, she saw major difficulties with such a step in the near future.

PAUL GRAY

Alex Allan, Esq.,
H.M. Treasury

10 DOWNING STREET

Prime Minister

TREASURY MEETING

You saw these ~~[illegible]~~ papers over the weekend, but you may want another glance this evening.

PRCB

4/7

20(a-c)

PRIME MINISTER

MEETING WITH CHANCELLOR AND TREASURY OFFICIALS: WEDNESDAY 5 JULY

As we discussed I have now fixed up a meeting with the Chancellor, Peter Middleton, Terry Burns and Brian Griffiths for next Wednesday afternoon. The Governor has not been invited. I have discussed further with Alan Walters the possibility of him coming back early from the United States to be present; unfortunately he has been unable to reschedule his commitments and sends his apologies.

There are a number of key issues you will want to cover in the discussion. But I think these fall under two broad headings:

- Where did we go wrong over the last 2-3 years on inflation?

- Where do we go from here on interest rate and exchange rate policy?

I have included various papers in the folder. You have already seen Flags A - D which are mainly relevant to the first item. These are:

Flag A - The Treasury paper on the recent rise of inflation

Flag B - The Alan Budd article

Flag C - The Tim Congdon article

Flag D - The Stephen Hannah article on M0.

The main new paper in the folder, relevant for the discussion of where we go from here, is the latest Treasury forecast; this is at Flag E.

What went wrong?

Points for discussion might include?

(i) Broad money - was it really such a bad indicator? Notwithstanding the distortions can we really afford to ignore it if it constantly grows at around 20 per cent per annum? Should it really be dismissed to the extent the Flag A paper suggests, or is such an attitude just as much in error as Tim Congdon's belief that broad money is all important?

(ii) Narrow money - was it a good indicator? Was the problem that it gave good signals but we failed to act upon them? Or did it behave, as some have argued, only as a concurrent indicator, giving no advance warning of inflationary pressures? What importance should we attach to the Hannah P-star analysis?

(iii) Intervention - What was the impact of sterilised intervention? Did the process of sterilisation fully neutralise its adverse effect on the money supply variables and in turn inflation, while simultaneously rendering the impact on the exchange rate ineffective?

(iv) Loosening of monentary conditions - When we say monetary conditions were too loose, what does this mean? Is this a comment on intervention policy? Or do we really mean that interest rates were too low? Is the main moral to be drawn from the 1985-88 experience that interest rates should have been kept substantially higher throughout - so implying a higher exchange rate, restraining growth, keeping inflation lower and avoiding the present need for sharp corrective action?

(v) RPI versus GDP deflator - The Chancellor continues to emphasise the RPI excluding mortgage interest as an indicator of underlying inflation. The latest forecast (Flag E) shows that the GDP deflator figures have been substantially higher and probably closer to the level of the measured RPI. Ought we not to pay more attention to the GDP deflator in our internal assessments?

(vi) The 4 for 1 rule - Was this a dangerous formula to adopt? It is argued with the exchange rate appreciating a "balancing" cut in the interest rates keeps monetary pressures overall unchanged. But for the personal sector may not the two things be reinforcing rather than neutralise each other - a cut in mortgage rates boosts the growth in real income from the appreciation of the exchange rate. The same is true when the exchange rate is falling - though when inflation is as high as it is maybe there should be a bias towards restrictiveness.

Looking ahead

You will want to have a careful look at the Treasury forecast (Flag E). Most of the key points are brought out in the Summary and Main Issue Section (Pages 1-9); but if you have time it will also be useful to skim through the other more detailed material. The main points that strike me are:

- As compared with the budget forecast, the economy is now expected to grow faster and inflation to come down more slowly (RPI still $6^{3}/4$ per cent at the end of this year and around 5 per cent still by 1991 (see page 51)).

- Even with the economy growing faster, the PSDR is projected to be smaller this year - £12 billion rather than £14 billion. Tax revenues do now seem to be slowing down.

- The current account deficit for this year is now put at £16 1/4 billion, notwithstanding an assumed very strong export performance, and still forecast to be £13½ billion in 1990.

You may want to address the following issues in discussion:

(vii) How confident are the Treasury about the forcast assessment? With the economy close to a turning point it is a particularly difficult point to reach a judgment.

(viii) Is there a case on domestic counter inflation grounds for a further interest rate increase?

(ix) What forms of words will now be used about the ERM? You may want to emphasise that the Chancellor should stick closely to your Madrid approach, and avoid public statements that a decision will be taken sooner rather than later.

(x) What should intervention policy be? Are you content for heavy intervention in an attempt to prevent the exchange rate depreciating?

(xi) What should Ministers say about exchange rate depreciation? A balance needs to be struck between hawkish words which may subsequently have to be eaten, and giving sufficient reassurance of firmness to the markets.

PRCG.

PAUL GRAY
30 June 1989
KAYAXA

pso.vh/Simon/Gray

COVERING SECRET

Parliament Street
London SW1P 3AG
Telephone 01 270

Sir Peter Middleton GCB
Permanent Secretary

29 June 1989

Paul Gray Esq
10 Downing Street
London SW1

Dear Paul, RA

TREASURY ECONOMIC FORECAST

— in attached folder

I enclose three copies of the forecast - one for the Prime Minister, one for Sir Alan Walters and one for Brian Griffiths.

As usual, these copies are provided on a personal basis for the Prime Minister, Sir Alan Walters, Brian Griffiths, Andrew Turnbull and yourself only.

Yours ever,

Simon

S D H SARGENT
Private Secretary

COVERTING SECRET

Switchboard 01 270 3000 Fax 01 270 5653 Telex 9413704

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TREASURY ECONOMIC FORECAST

JUNE 1989

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TREASURY ECONOMIC FORECAST

SUMMARY

The forecast covers the period to 1991 (1991-92 for public finances). Table 1.1 summarises the results.

- Activity in the world economy has remained high in 1989; **G7 GNP growth** is forecast at over 3 per cent, and **world trade in manufactures** at 8½ per cent. The forecast has a slowdown in world trade growth in 1990 and 1991. Tight monetary policy halts the rise in **G7 consumer price inflation**, and leads to a gradual fall during 1990.

- Growth in **UK GDP** slowed at the end of 1988, though **non-oil GDP** in 1989Q1 was still 4 per cent higher than a year earlier, only a little above the FSBR estimate. It is forecast to grow by 3 per cent in 1989 and a little less thereafter. Total GDP growth, which is affected by North Sea accidents, is forecast at just over 2 per cent in 1989 and around 2½ per cent in the two subsequent years. **Unemployment** changes little from the end of 1989.

- Tight monetary policy has curbed the growth of consumers' expenditure, and is likely to continue to restrain it. But investment is likely to grow more rapidly in 1989 than envisaged in the FSBR, though less than in 1988, keeping **domestic demand** growth up to 3 per cent. Private sector investment is expected to be flat in 1990, with a modest fall thereafter. But, even with real interest rates at record levels, the downturn in investment is less than in previous cycles. Total domestic demand is forecast to grow by 1½ to 2 per cent in 1990 and 1991, a little below growth of GDP.

- Inflation is higher than in the FSBR throughout the forecast period. **RPI inflation** is expected to decline slowly from its peak of just under 8½ per cent in the middle of 1989 to 6¾ per cent in 1989Q4 and 5¾ per cent in 1990Q4. Forecast growth of **money GDP** overshoots the 1989 MTFS path in all years (when adjusted for distortions caused by the introduction of the community charge), mainly as a result of higher inflation.

- The current account deficit for 1989 is forecast to be £16½ bn., a little more than in 1988, and to fall gradually in 1990 and 1991.

- The PSDR is forecast to be £12 bn. in 1989-90, below the FSBR forecast mainly because of less buoyant NIC receipts following high take up of personal pensions. Thereafter the forecast is for both public expenditure and revenues to be higher than in the FSBR in cash terms, but lower or little different as a share of GDP. After small assumed fiscal adjustments in 1990 and 1991 the forecast path for the PSDR declines at a similar rate as in the FSBR.

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TABLE 1.1 : SUMMARY OF FORECAST

		JANUARY† 1989 (internal)	FSBR 1989	JUNE 1989
A	THE WORLD ECONOMY			
1.	GNP (MAJOR 7 EXCLUDING UK) (per cent change on a year earlier)			
	1988	4.1	4.1	4.2
	1989	3.1	3.1	3.2
	1990	2.6	2.6	2.9
	1991	2.7	2.9	2.9
2.	DOMESTIC DEMAND (MAJOR 7 EXCLUDING UK) (per cent change on a year earlier)			
	1988	4.2	4.2	4.3
	1989	3.3	3.3	3.2
	1990	2.7	2.7	3.0
	1991	2.7	2.9	3.0
3.	WORLD TRADE IN MANUFACTURES (per cent change on a year earlier)			
	1988	10.1	10.0	10.5
	1989	7.9	7.9	8.5
	1990	6.0	6.0	6.6
	1991	5.5	5.5	5.5
B	UK ACTIVITY AND DEMAND			
4.	GDP VOLUME (per cent change on a year earlier)			
	1988	4.4	4.3	4.4
	1989	2.0	2.3	2.2
	1990	1.5	2.1	2.5
	1991	1.7	2.6	2.7
5.	NON-NORTH SEA GDP VOLUME (per cent change on a year earlier)			
	1988	5.1	5.1	5.2
	1989	2.7	2.8	3.1
	1990	1.4	1.9	2.3
	1991	1.8	2.7	2.7
6.	VOLUME OF DOMESTIC DEMAND (per cent change on a year earlier)			
	1988	7.1	6.5	6.5
	1989	2.6	2.5	3.0
	1990	1.1	1.3	1.6
	1991	1.2	1.8	2.2
7.	UNEMPLOYMENT (UK S.A. EXCLUDING SCHOOL LEAVERS million)			
	1988 Q4	2.11	2.10	2.10
	1989 Q4	2.00	1.92	1.81
	1990Q4	2.07	2.15	1.88
	1991Q4	2.27	2.15	1.86

†The January forecast used adjusted national and sectoral accounts.

	JANUARY 1989 (internal)	FSBR 1989	JUNE 1989
C INFLATION AND MONEY GDP			
8. MONEY GDP (MARKET PRICES) (per cent change on a year earlier)			
1988-89	11.1	11.0	11.1
1989-90	7.2	7.8	9.8*
1990-91	6.3	5.9	7.7
1991-92	5.5	5.9	7.3
9. RPI (per cent change on a year earlier)			
1988 Q4	6.6	6.6	6.6
1989 Q4	5.5	5.6	6.7
1990 Q4	4.1	3.3	5.1
1991 Q4	3.1	2.8	4.6
10. RPI excluding mortgage interest payments (per cent change on a year earlier)			
1988Q4	5.2	5.2	5.2
1989Q4	5.1	5.1	5.6
1990Q4	4.0	3.7	5.1
1991Q4	3.2	3.1	4.6
11. GDP market price deflator (per cent change on a year earlier)			
1988-89	7.0	7.2	7.3
1989-90	5.8	5.4	7.2*
1990-91	4.5	3.9	5.2
1991-92	3.8	3.0	4.6
D PUBLIC FINANCES			
12. PSBR - £ bn.			
1988-89	-12.9	-13.9	-14.4
1989-90	-11.2	-13.8	-12.1
1990-91	-9.5	-10.0	-9.3
1992-92	-6.6	-6.0	-6.2
13. PSBR - % OF GDP			
1988-89	-2¾	-3	-3
1989-90	-2¼	-2¾	-2½
1990-91	-1¾	-2	-1¾
1991-92	-1¼	-1	-1
14. ANNUAL FISCAL ADJUSTMENT - £ bn.			
1989-90	1.5	0.0	0.0
1990-91	0.0	1.0	1.0
1991-92	0.0	2.0	1.0

* adjusted to remove the effects of the community charge which reduces growth by ¼ per cent in 1989-90 and 2 per cent in 1990-91.

SECRET

E MONETARY CONDITIONS

	JANUARY 1989 (internal)	FSBR 1989	JUNE 1989
15. SHORT TERM INTEREST RATES (per cent))			
1988 Q4	12.5	12.5	12.5
1989 Q4	12.0	12.0	14.0
1990 Q4	11.0	10.0	13.5
1991 Q4	10.0	8.5	12.5
16. MO (per cent change on a year earlier)			
1988-89	7.3	7.2	7.1
1989-90	3.7	3.6	4.5
1990-91	3.5	2.7	3.2
1991-92	3.5	2.4	4.0
17. STERLING INDEX (1975=100)			
1988 Q4	96.7	96.7	96.7
Q4	96.0	95.3	90.0
1990 Q4	92.9	93.8	90.0
1991 Q4	89.7	92.9	90.0
18. £/DM EXCHANGE RATE			
1988 Q4	3.19	3.19	3.19
1989 Q4	3.09	3.16	3.04
1990 Q4	2.95	3.04	3.00
1991 Q4	2.82	2.97	2.97
19. RELATIVE UNIT LABOUR COSTS (1980=100)			
1988	93.9	96.5	97.2
1989	97.0	98.9	96.4
1990	96.2	98.5	94.8
1991	95.2	97.6	95.6

F TRADE AND CURRENT ACCOUNT

	JANUARY 1989 (internal)	FSBR 1989	JUNE 1989
20. VOLUME OF NON-OIL EXPORTS OF GOODS AND SERVICES (per cent change on a year earlier)			
1988	4.2	1.3	1.3
1989	6.1	6.1	8.0
1990	4.4	5.0	6.1
1991	4.3	6.5	4.4
21. VOLUME OF NON-OIL IMPORTS OF GOODS AND SERVICES (per cent change on a year earlier)			
1988	12.9	13.3	13.4
1989	6.2	3.9	7.2
1990	2.5	2.5	2.6
1991	1.9	2.5	2.4
22. CURRENT BALANCE £ bn.			
1988	-10.4	-14.7	-14.9
1989	-11.4	-14.5	-16.3
1990	-10.0	-12.1	-13.6
1991	-7.2	-8.6	-10.4

(1) MAIN ISSUES

The world economy

2. The forecast is for sustained growth of G7 GNP at about the rate of growth of productive potential. Inflation gradually declines as the effects of tighter monetary policy feed through. Real commodity prices are broadly constant over the next two and half years. Following the rise in the dollar in the first part of this year, the US and Japanese current balances are expected to fall somewhat, but to widen again in 1990 and 1991 (assuming unchanged real exchange rates).

3. Real interest rates in the G7 rise by just under 1 percentage point compared with 1988. If activity and inflationary pressure remain stronger than expected, particularly in Japan and Germany, it might be necessary for monetary policy in the affected countries to be tightened by more than the small further increases in short term interest rates that have been assumed. Stronger activity over the near future would put upward pressure on output and commodity prices, and might be followed by a period of lower growth.

Monetary conditions

4. The forecast deceleration in GDP and domestic demand occurs with very high short term interest rates, which stay at 14 per cent until mid-1990 and decline gradually thereafter. Real short term interest rates, which were on average already high by past standards during 1987 and 1988, are assumed to remain at even higher levels. The strong growth in the economy in recent years, together with supply side policies and liberalisation that contributed to it, appear to have produced much greater confidence among persons and companies. As a result they are saving less and planning to spend more than might have been expected. The forecast of continued buoyant expenditure contributes to further overshoots in money GDP growth with inflationary pressures abating slowly. If persons or companies adjust their spending by more than forecast, perhaps because of emerging financial constraints, there would be less need to keep interest rates high for so long. In these circumstances, however, a period of very low output growth in the short term - a hard landing - could occur, but inflation would probably fall more rapidly.

5. The forecast assumes that high short term interest rates will be necessary to keep the exchange rate close to its current level (90 for the sterling index). There are major uncertainties about the path for the

exchange rate with important implications for, inter alia, the path of inflation.

The national and sectoral accounts

6. There are still major inconsistencies for recent quarters in the latest national accounts (published on June 20). Sectoral balancing items remain very large. With more time to assess these data the forecast would have been based on adjusted national and sectoral accounts as in the January forecast (see Annex B). The inconsistencies make it more difficult to assess the precise extent to which the growth of output and domestic demand have fallen following the tightening of monetary policy. Nevertheless it is clear that growth of GDP and personal sector demand have fallen from the high rates in the first half of 1988. There are, however, major problems in assessing company sector spending. The poor state of the sectoral accounts makes it difficult to construct convincing interpretations of personal and company sector behaviour.

The personal sector

7. High short term interest rates have had a marked dampening effect on the growth of personal sector expenditure, particularly on housing. Nevertheless consumers' expenditure, while moderating, has continued to rise, and is likely to be 3½ per cent higher in 1989 than in 1988. But recent trends in retail sales and consumer intentions suggest that growth in the year to 1989Q4 could fall to 2 per cent, compared to 5½ per cent in the year to 1988Q4. While high short term interest rates have depressed the price of certain assets, especially house prices, they have not stopped persons increasing their gross borrowing more rapidly than their income. They now face very high levels of income gearing and debt service ratios.

8. Despite sustained high interest rates consumers' expenditure is expected to rise at 2 to 2½ per cent beyond 1989, though investment in new houses falls sharply. The personal sector savings ratio is likely to rise only slowly from its current low level. If high short term interest rates have a more powerful effect, the personal sector may adjust more than assumed in the forecast. In the forecast house prices stabilise from early 1990 and then grow very slowly: if they actually fell, there could be a sharper rise in personal sector savings.

The company sector

9. It is even more difficult to monitor recent behaviour of industrial and commercial companies than that of the personal sector. There are few signs that the company sector has yet been seriously affected by high short term interest rates; indeed the indications are that little change in spending behaviour or plans has occurred.

10. The recent and forecast strength of company sector spending is at first sight odd. Industrial and commercial companies (ICCs) are probably already in financial deficit on much the same scale as in 1974-75 and 1979-80, and their net liquidity is at a historically low level. (The balancing item in ICCs' accounts is consistent with an even larger deficit than recorded in recent years.) Both large deficits and falling liquidity persist throughout the forecast period, with investment at high levels.

11. Similar financial prospects have in the past been associated with recessions. They have led to sharp adjustment by companies to improve their financial position, which in turn has been a major factor behind low (or negative) GDP growth and rising unemployment. The difference between present conditions and earlier episodes is the very high profitability of companies. Despite the slowdown in the economy the return on investment remains very high relative to the 1970s and early 1980s. With profitability so high the financial and overseas sectors are assumed to be willing to finance the deficits implied by ICCs' high investment plans. The key issues are first whether the willingness to finance investment on this scale will persist if short term interest rates stay very high, and second how money GDP growth can be kept close to the MTFS path if companies carry on spending at a high rate.

Inflation and money GDP

12. Measures of "core" inflation - such as the RPI less MIPs or producer output prices - have risen gradually over the past two years to levels even further above the average for the G7. The forecast is that core inflation will stabilise at its mid-1989 level and then fall as slowly as it rose in recent years. In the second half of 1989 companies' profit margins should stop rising - they could fall a little - for the first time for 6 years, though the recent fall in the exchange rate will help companies. Pressure on margins will itself help to bring down inflation both directly and by strengthening companies' resolve to control the growth of earnings. Unless the company sector is under some financial pressure this disinflationary process cannot operate.

13. Some measures of inflation are likely to be higher than core inflation. The high assumed level of base and mortgage rates will keep up total RPI inflation in 1989 and early 1990. Further large increases in real nationalised industries prices, together with large increases in local authority rents and the forecast high initial level of the community charge - 17 per cent higher than domestic rates per head in 1989-90 - will also boost recorded RPI inflation until 1990.

14. Investment prices are likely to rise strongly in 1989 and 1990, particularly as construction industry output remains close to capacity. The pressure on construction capacity is likely to be maintained as public sector investment rises rapidly, just as the growth of private sector investment is forecast to slacken.

15. Earnings growth has risen gradually since the beginning of 1987, though less than might have been expected with such strong output growth. The forecast is for a gradual deceleration in private sector earnings from the end of 1989. Central government and local authority earnings are forecast to grow a little more than in the private sector.

16. In 1989-90 and 1990-91 the replacement of domestic rates by the community charge will produce a major discontinuity in the published numbers for money GDP at market prices (though not at factor cost) and the associated GDP deflator. Domestic rates are classified in the national accounts as a tax on expenditure, while the community charge will not be. For this reason the switch to the community charge reduces the growth of money GDP at market prices and the deflator of GDP at market prices by 0.2 per cent in 1989-90 and by 1.9 per cent in 1990-91.

TABLE 1.2 : THE EFFECT OF THE SWITCH TO THE COMMUNITY CHARGE ON MONEY GDP AT MARKET PRICES

	Money GDP at market prices		Distortion caused by introduction of the community charge	The deflator for GDP at market prices	
	Recorded basis	Adjusted		Recorded basis	Adjusted
1989-90	9.6	9.8	0.2	7.1	7.2
1990-91	5.8	7.7	1.9	3.3	5.2

17. Money GDP at market prices is used in the MTFS and to calculate the ratios of general government expenditure and taxes to GDP. In the rest of this report all these measures are adjusted to remove distortions.

18. Adjusting for distortions, growth in the GDP deflator and money GDP are above the paths in the 1989 MTFS in every year. Strong growth of investment prices and the price of general government consumption (mainly pay) are the main factors behind the high growth in money GDP: forecast real growth is only a little above the path underlying the 1989 MTFS.

Balance of payments

19. The forecast is for a slow fall in the current account deficit from the very high levels - over 4 per cent of GDP - at the end of 1988 and in early 1989. Exports are responding favourably to the combination of slowing domestic demand, which helps to ease capacity constraints, and to strong growth in world trade. Imports remain at high levels, although there are signs that the growth rate of import volumes is slowing down. The visible deficit is expected to peak in 1989 and 1990 at around £22 bn., but thereafter to decline gradually. It would require much lower growth of domestic demand than forecast, or a faster increase in capacity, for the deficit to fall more quickly. Only about half of the excess of GDP growth over productive potential in the last four years is reversed over the three years to 1991.

20. The oil surplus has been adversely affected by a spate of accidents in the North Sea. Output was reduced by 6 per cent in 1988 and probably will be 12 per cent below potential in 1989.

21. The invisibles balance is unlikely to improve in 1989, but in time the slower growth of domestic demand should reduce the demand for imports of services, particularly travel. There may also be an improvement in the financial services balance with the spread of financial liberalisation in the EC and as memories of the stock market crash begin to fade. There is also likely to be an improvement in net earnings from interest, profits, and dividends on the UK's net overseas asset holdings, due in part to the decline in sterling. But estimates of IPD flows are subject to wide margins of error as knowledge about the true level of net external assets is limited. The overseas sector balancing item has amounted to £40 bn. over the last three years, a large part of which probably reflects unidentified capital inflows. Given errors of this magnitude it is unwise to place much faith in precise estimates of IPD flows and the level of the UK's net overseas assets.

Public finances

22. The relentless improvement over the past two and a half years in the prospects for public finances may well have come to an end. The forecast

PSDR for 1989-90 is over £1½ bn. less than the FSBR forecast.

23. There are a number of obvious upward pressures on public expenditure that contribute to forecast growth of general government expenditure (excluding privatisation proceeds) of 2¾ per cent in 1990-91 and 3 per cent in 1991-92, following the more modest growth in recent years. Public sector pay is forecast to rise rapidly than in the private sector. Local authorities are forecast to increase their current expenditure at a rapid rate from 1990-91 and to set a high starting level for the community charge.

24. The prospect is for the volume of public sector investment to rise at a very rapid rate by historical standards. The forecast allows for the current level of provision for public sector investment and for some sizeable addition for roads, prisons, health, education, nationalised transport industries and water (this will score as private investment after privatisation). Apart from water, the additions are, however, well below departmental aspirations and make no allowance for mega-transport projects (most of which would not involve investment on a sizeable scale during the forecast period). Indeed the increase in the volume of projects, many of which will increase pressures on the construction industry, is so great that the forecast assumes that much of the volume growth - though not necessarily the cash expenditure - will slip into later years, as in previous public sector investment booms.

25. Fast growth of public expenditure on pay and investment is likely to be offset by lower than expected growth of more demand sensitive components, such as social security payments, which could continue to benefit from the high level of activity.

26. The forecast for receipts in 1989-90 has been reduced by over £2 bn. since the FSBR. Higher than assumed take-up of personal pensions has reduced national insurance contributions through higher rebates and incentive payments, more than offsetting the boost to receipts from faster growth of money GDP. In subsequent years higher money GDP produces more receipts than in the FSBR.

27. The non-oil tax burden is forecast to fall by ¼ to ½ percentage point in 1989-90, compared with no change in the FSBR, because of faster forecast growth of money GDP. Thereafter, it is forecast to fall marginally before fiscal adjustment, with the lagged effects of the 1988 and 1989 Budgets, and lower growth of corporation tax, more than offsetting real fiscal drag. The forecast assumes two small fiscal adjustments of £1 bn. in 1990-91 and 1991-92, that are by convention allocated to personal income tax.

28. Table 1.3 shows that the *ex post* fiscal stance in the UK is forecast to remain tighter than the average for the G7 - as given by the general government financial deficit, the only comparable measure for G7 economies. But the general government financial surplus in the UK falls over the forecast period as public sector investment accelerates.

TABLE 1.3 : GENERAL GOVERNMENT FISCAL DEFICITS
(per cent of GDP)

	1988	1989	1990	1991
UK*	-1	-¾	-½	0
G7 (less UK)	2	1½	1½	1½
(Japan)	-1¼	-1¾	-2	-2¼

*financial years

(2) THE WORLD ECONOMY

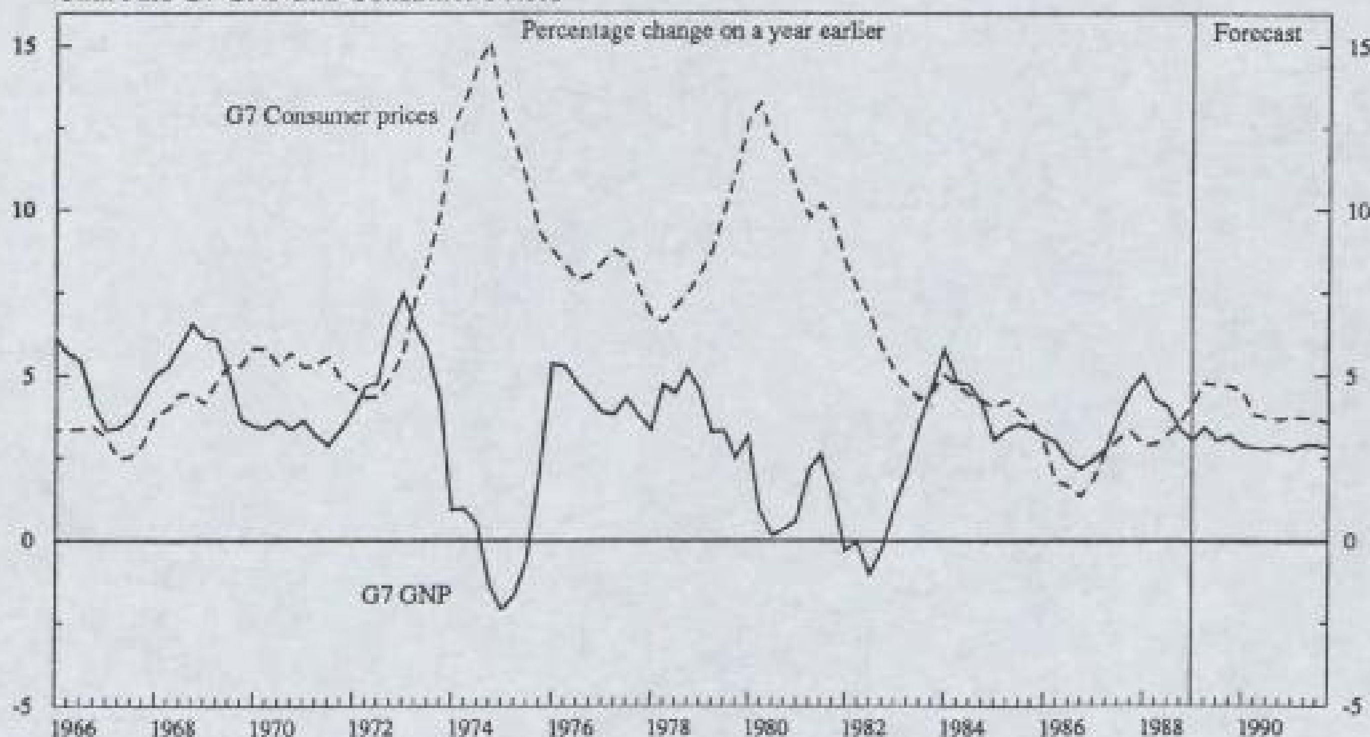
29. The available indicators suggest that activity in the G7 countries so far in 1989 has remained strong. In the US, Canada and the UK, there are significant signs that activity is slowing. Elsewhere there are some indications that by the beginning of this year growth had slowed compared with the very fast rates experienced at the start of last year. But data for industrial production and, where available, provisional first quarter national accounts, suggest that little further deceleration has taken place: growth in Japan and Germany seems particularly buoyant.

TABLE 2.1: G7 GROWTH AND INFLATION

	1988	1989	1990	1991
Real GNP	4.2	3.2	2.8	2.8
Domestic Demand	4.4	3.2	2.8	2.9
Industrial Production	6.0	4.3	2.8	2.9
Consumer Prices	3.1	4.5	3.9	3.7

30. The prospects for output growth, coupled with higher than expected inflation so far this year suggest that the peak in nominal interest rates may not yet have been reached. The forecast assumes that there will be further rises in interest rates in the second half of this year in Continental Europe and Japan, taking nominal short rates to the highest levels since 1985. However real interest rates in the G7 peak at a level only a little higher than the average of 1984 to 1988. Once it is apparent that inflation is no longer rising nominal interest rates outside the US are slowly reduced through 1990 and 1991. This easing back is similar to the pattern already observed in the US.

Chart 2.1 G7 GNP and Consumer Prices



31. The recent strength of the dollar is assumed to be only partly reversed: by the end of 1989 it is still above its end 1988 level. Thereafter constant real exchange rates are assumed.

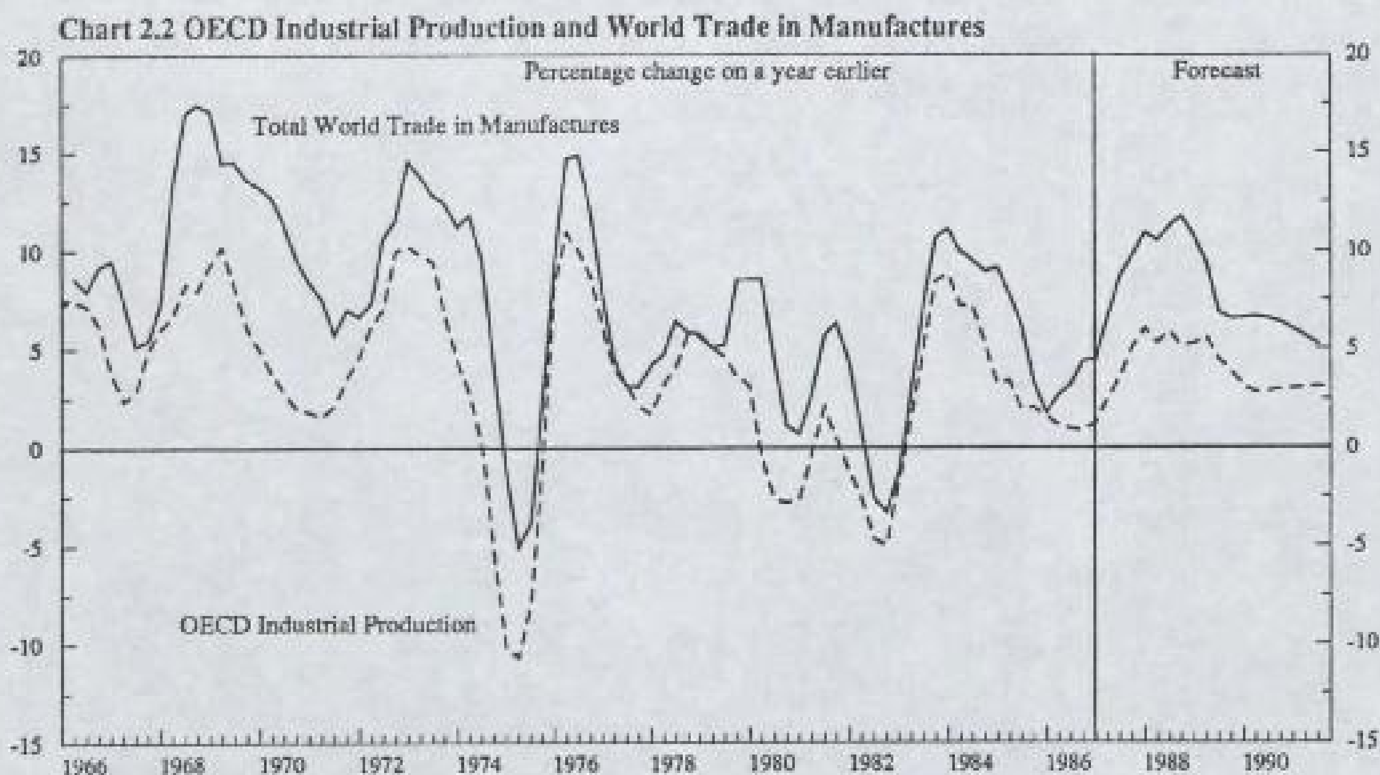
32. The forecast for **G7 GNP** for 1989 is of growth of 3¼ per cent, following 4¼ per cent in 1988. Growth in the US slows to about 2½ per cent: but in Japan and Germany it continues at or above 3 per cent. In 1990 and 1991, as the effects of the assumed monetary tightening outside the US come through, G7 GNP growth is forecast to fall below 3 per cent for the first time since 1986. G7 consumers expenditure is expected to grow steadily at about 2¾ per cent with little change in the savings ratio. Growth of business investment slows down to about 4 per cent from the exceptionally fast rate of 1988.

33. In 1989 the growth of **world trade in manufactures** continues to be quite rapid, 8½ per cent up on a year following 10½ per cent in 1988. In 1990 and 1991 the pace slows to 6½ and 5½ per cent respectively. If growth is as forecast, 1986 to 1991 would represent the strongest and most sustained period of growth since the 1960s.

TABLE 2.2 : WORLD TRADE

(Per cent change on previous year)

	average 1980-88	1988	1989	1990	1991
Total World Trade	4.2	9.6	7.4	5.4	4.9
World Trade in manufactures	5.6	10.5	8.5	6.6	5.5
G7 Imports	5.1	10	7.0	5.0	4.8



34. Non-oil commodity prices have fallen back slightly since the beginning of the year, repeating less sharply the pattern of last summer. The forecast is for real commodity prices to remain at current levels through the forecast at a level close to the average for 1988.

35. Oil prices have remained firm, with an average world price so far this year of $17pb, about $2½ pb below the April peak. The forecast assumes some weakening in 1989H2 and again at the beginning of 1990.

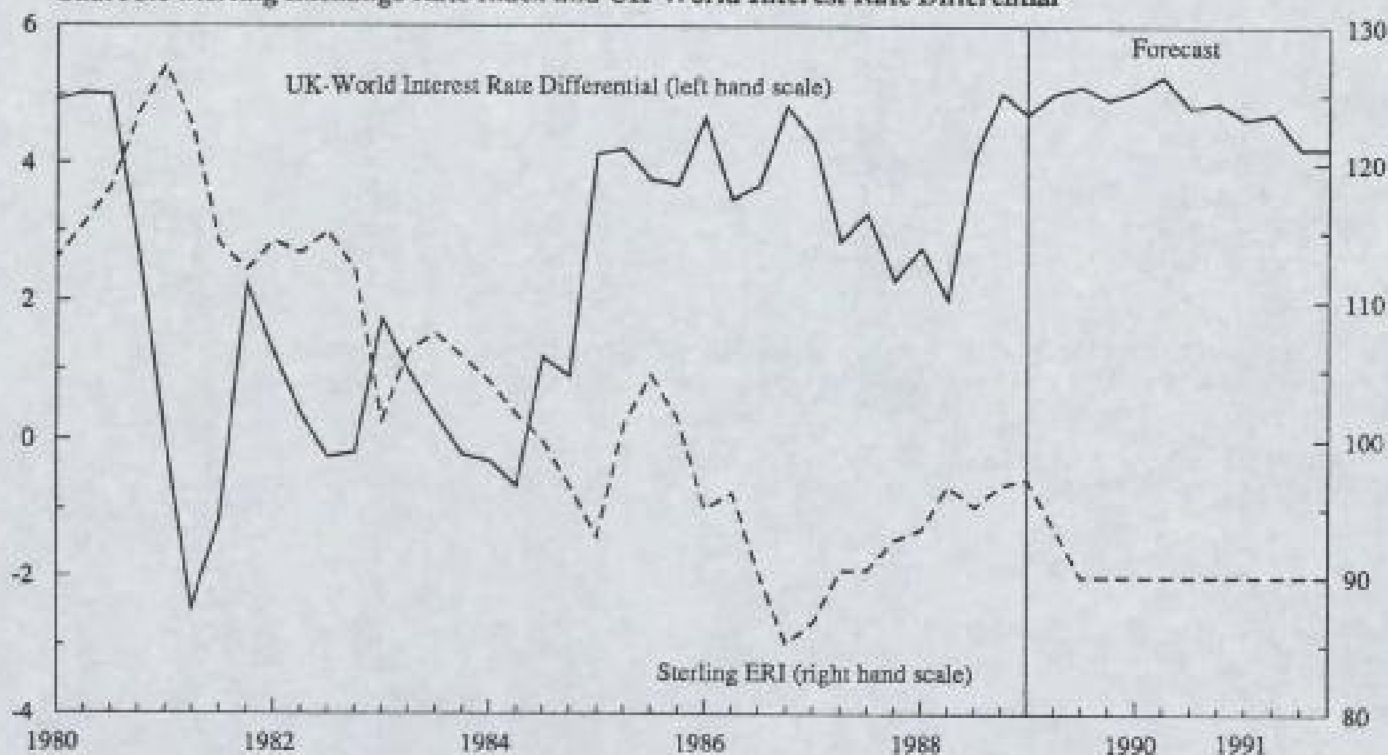
36. Consumer price inflation in G7 countries has risen since the beginning of the year by more than was earlier expected. Special factors - expenditure taxes in Japan and Germany, higher oil prices, and the effect of the strong dollar on import prices in Japan and Europe - have all contributed. Consumer price inflation is currently running at about 4½ per cent in G7 countries. The forecast is for this

to reach a peak of between 4½ and 4¾ per cent in the second half of the year with a gradual fall to about 3¾ per cent by the middle of 1990, and little change thereafter. The US inflation rate, currently above the G7 average, is expected to fall to about the average by the end of 1991, reflecting relatively weak growth.

(3) INTEREST RATES, THE EXCHANGE RATE, AND COMPETITIVENESS

37. The forecast has the sterling index remaining at 90. Short-term interest rates stay at 14 per cent until mid-1990, then gradually fall. The projected path for interest rates implies a sustained very high interest differential against overseas short rates in comparison with the rest of the 1980s. The consequences for sterling are very difficult to predict. It could be that the perceived tightness of the monetary stance and the very favourable yield on sterling assets results in periodic strong upward pressure on sterling. Alternatively, the forecast of persistent large current account deficits together with growth of money GDP and inflation above the MTFS profiles may give rise to further sterling weakness.

Chart 3.1 Sterling Exchange Rate Index and UK-World Interest Rate Differential*



* UK 3 month interbank rate less weighted average of G7 (excluding UK) 3 month interest rates

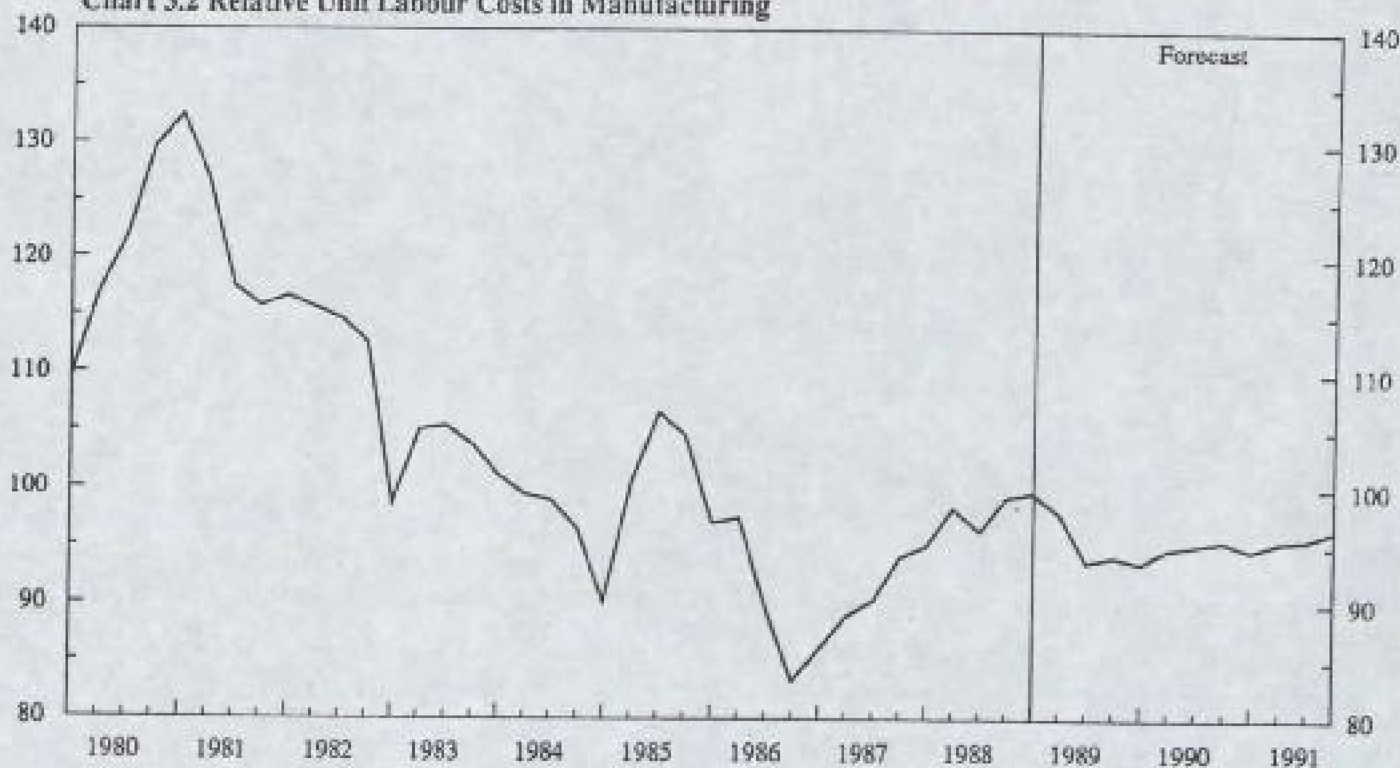
38. The path for the exchange rate, together with forecasts of unit labour costs at home and abroad, imply that the 8 per cent loss in competitiveness between 1987 and 1988 is not regained over the forecast period. Labour cost competitiveness is forecast to fall by a further 5½ per cent through 1989, but to recover slightly, so that by the end of 1990 it is slightly above its average level of 1988.

Table 3.1 : EXCHANGE RATES AND COMPETITIVENESS

	Base rates	Sterling Index (1985=100)	$/£	Dm/£	Labour cost competitiveness* (1985=100)
1985	12.3	100.0	1.30	3.78	100.0
1986	10.9	91.6	1.48	3.19	91.0
1987	9.7	90.1	1.65	2.94	89.4
1988	10.1	95.5	1.80	3.13	96.6
1988 Q1	8.8	93.5	1.81	3.01	94.5
Q2	8.2	96.6	1.86	3.14	97.7
Q3	11.1	95.2	1.71	3.16	95.8
Q4	12.4	96.7	1.81	3.19	98.7
1989 Q1	13.0	97.1	1.77	3.27	99.0
June 21	14.0	90.6	1.55	3.05	-
1989 Q2	13.4	93.6	1.64	3.18	97.3
Q3	14	90.0	1.60	3.05	93.1
Q4	14	90.0	1.62	3.04	93.6
1990 Q1	14	90.0	1.63	3.03	93.1
Q2	14	90.0	1.63	3.02	94.3
Q3	13.5	90.0	1.64	3.01	94.6
Q4	13.5	90.0	1.64	3.00	94.9
1991 Q1	13	90.0	1.65	2.99	94.2
Q2	13	90.0	1.65	2.98	94.9
Q3	12.5	90.0	1.66	2.97	95.1
Q4	12.5	90.0	1.66	2.97	95.8

* UK unit labour costs relative to those of trading partners. A fall implies an improvement in competitiveness.

Chart 3.2 Relative Unit Labour Costs in Manufacturing



39. The differential between UK short rates and eurodollar rates averaged about 3¼ points from 1985 to the end of 1988, while against world rates the

average differential over the same period was about 3¾ points. Differentials are currently 4½ and 5½ points, respectively, which is around their highest levels throughout the 1980s. They are forecast to remain fairly close to these levels as the gradual easing of UK rates is accompanied by an easing of rates abroad. These interest differentials should be sufficient to attract the inflows to finance the current account deficits expected over the next two years, without requiring a lower exchange rate. The forecast assumes no further intervention.

40. Table 3.2 summarises the financing of the current account deficit. The consistently large balancing item and known statistical discrepancies in the capital account increase uncertainty, but it is clear that substantial net capital inflows, especially into UK banks, will be required over the next two years.

TABLE 3.2 : FINANCING THE CURRENT ACCOUNT DEFICIT (£ bn.)

	1988	1989	1990
Current Account	-14.9	-16.3	-13.6
Balancing Item	13.9	13.5	13.0
Required Identified Capital Inflows	1.0	2.8	0.6
of which:			
Net direct investment	-7.3	-5.2	-4.5
Net non-bank non-govt portfolio	-5.1	-14.4	-11.8
Net Banks £	9.0	13.7	12.5
FC	3.9	4.6	3.2
Net general government*	0.5	4.1	1.2

* includes reserves

41. The forecast envisages net outflows on direct investment, at a slightly lower level than in 1988. Such net outflows - due in part to the retention of earnings by UK subsidiaries abroad - have been a feature of the UK economy for some years. Both inward and outward cross-border investment flows are expected to remain high in anticipation of more open EC markets in 1992, but the UK is not expected to benefit especially in terms of net inflows from the gradual removal of capital restrictions across the EC.

42. There are also large net outflows on non-bank portfolio investment, which in part reflects institutional requirements to place investment funds against the background of a contracting gilts market. Institutional investment abroad has already begun to recover sharply following their substantial disinvestment overseas after the stock market crash in October 1987. Overseas disposals of gilts will reduce the inward portfolio figure slightly.

(4) TRADE AND THE BALANCE OF PAYMENTS

Summary

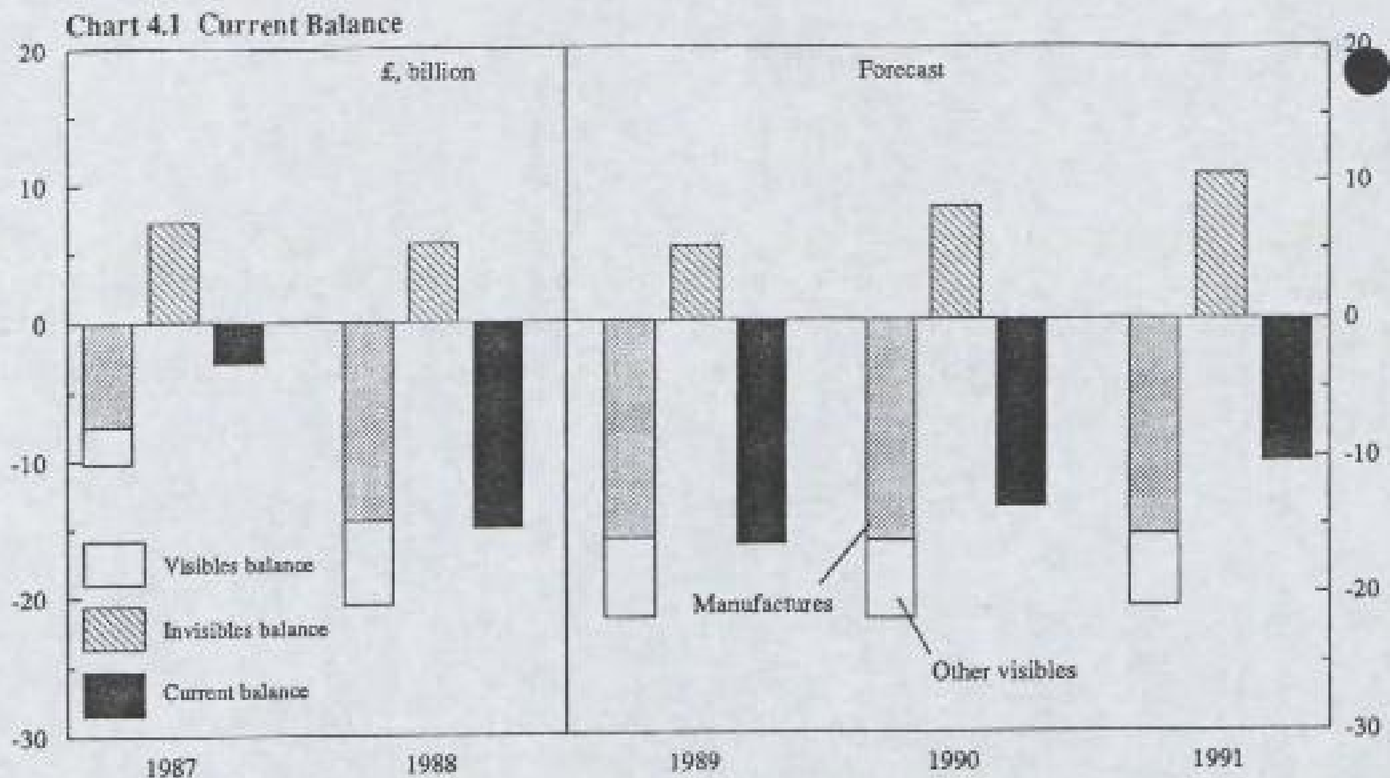
43. The forecast is for a current account deficit of £16¼ bn in 1989, £1½ bn higher than last year's deficit and £1¾ bn. higher than the FSBR forecast for this year. Given a cumulative deficit for the first four months of the year of £6½ bn., this implies an average monthly deficit for the rest of the year of £1¼ bn.

TABLE 4.1: CURRENT BALANCE (£ bn)

	Visible trade			Total	Invisibles	Current
	Manufactures	Oil	Other	visibles		balance
1987	-7.5	4.2	-6.8	-10.2	7.3	-2.9
1988	-14.4	2.3	-8.5	-20.6	5.6	-14.9
1988 Q1	-2.7	0.7	-2.0	-4.0	1.0	-3.0
Q2	-3.4	0.8	-2.0	-4.5	1.7	-2.9
Q3	-3.9	0.5	-2.2	-5.7	2.2	-3.5
Q4	-4.4	0.3	-2.2	-6.3	0.7	-5.6
1989 Q1	-4.2	0.2	-1.9	-5.9	1.0	-4.8
Forecast						
1989	-15.9	1.6	-7.4	-21.7	5.3	-16.3
1990	-16.1	1.7	-7.4	-21.8	8.2	-13.6
1991	-15.7	1.9	-7.1	-20.9	10.6	-10.4

44. Since reaching a peak in the fourth quarter of 1988, the deficit is estimated to have fallen somewhat in the first quarter, and this trend is expected to continue through the year. While the improvement through 1989 is not sufficient to prevent a deterioration in the current balance for the year as a whole, a steady reduction in the deficit is forecast in subsequent years.

Chart 4.1 Current Balance



45. The £1½ bn. deterioration in the current account forecast for 1989 is made up of a deterioration in the visibles deficit of just over £1 bn. and a deterioration in the invisibles surplus of slightly over £¼ bn. The worse outcome for visibles occurs despite favourable movements in domestic demand growth and competitiveness (although world trade growth is forecast to slow down a little), and reflects two factors.

(a) Mainly as a result of the recent spate of accidents in the North Sea, the oil balance is forecast to deteriorate by £¾ bn.

(b) The difference between the levels of non-oil imports and exports in 1988 implies that exports would need to grow by around 3½ percentage points faster than imports just to keep the non-oil deficit constant. The forecast differential of only a little under 3 percentage points in 1989 implies a deterioration of nearly £½ bn. in the non-oil trade balance.

<u>Non-oil visible trade</u>

46. After failing to keep pace with world trade in 1988, the volume of exports of manufactures is forecast to regain some of the losses in 1989. Despite a significant deterioration in competitiveness last year (whose lagged effects on export growth this year are expected to outweigh the effect of the more recent gains in competitiveness), the volume of exports of manufactures is forecast to grow by 9 per cent this year. More than half of this growth has already occurred in the first four months of the year;

over this period exports of manufactures were 5¾ per cent higher, on average, than in 1988.

Table 4.2: EXPORTS OF MANUFACTURES AND MAIN DETERMINANTS

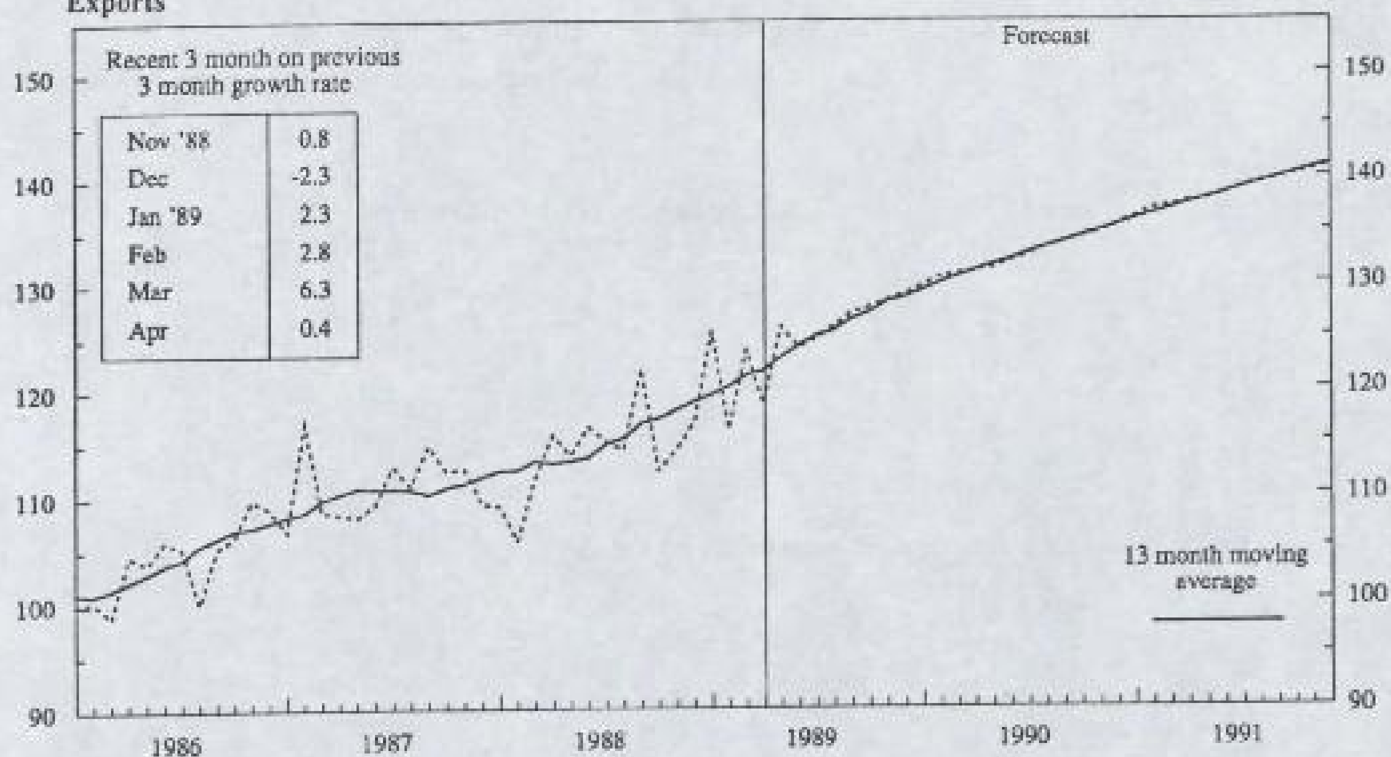
(per cent change on previous year)

	World trade	Relative unit labour costs*	Volume of exports of manufactures
1986	2.6	-8.9	3.3
1987	8.0	-1.9	7.7
1988	10.5	8.2	4.3
1989	8.5	-0.9	9.1
1990	6.6	-1.6	6.8
1991	5.5	0.8	4.9

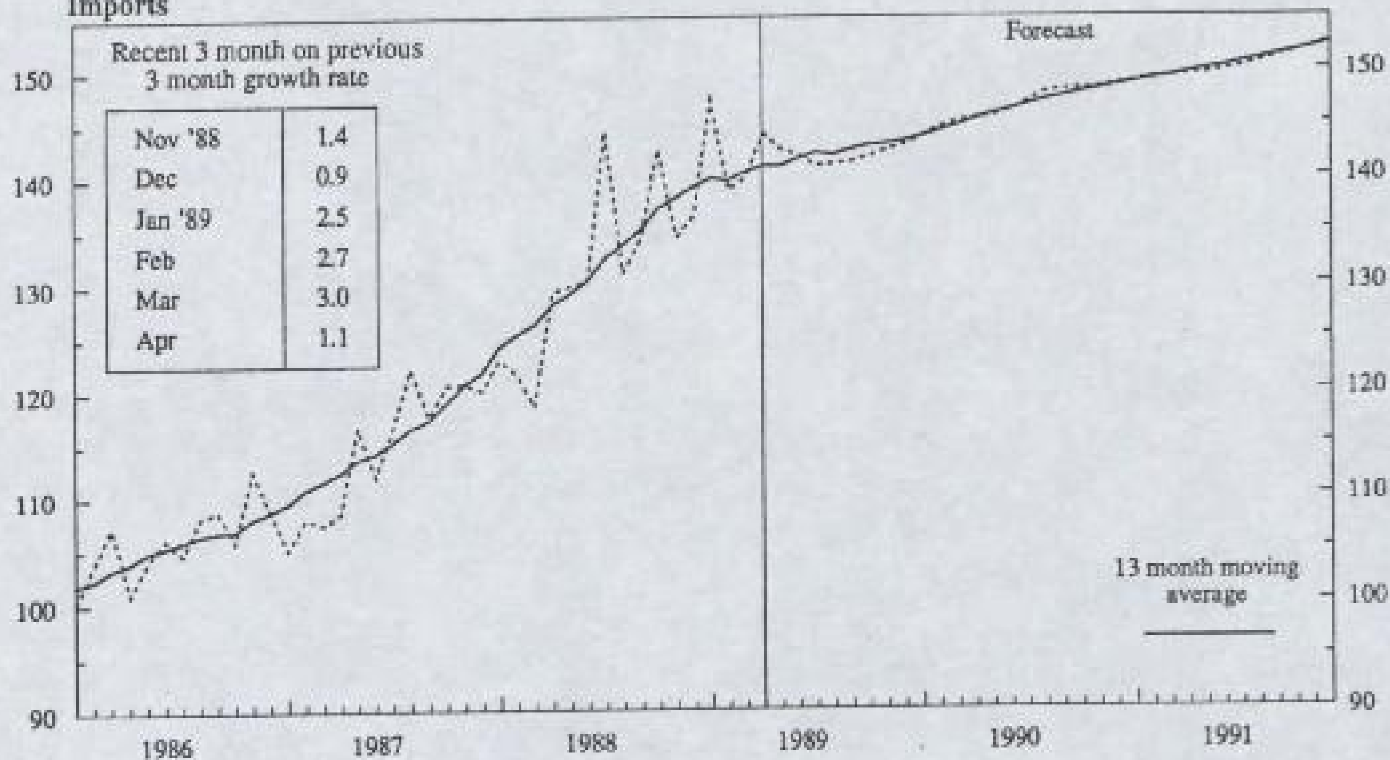
* fall implies improves competitiveness

Chart 4.2 Non-Oil trade volumes

Exports

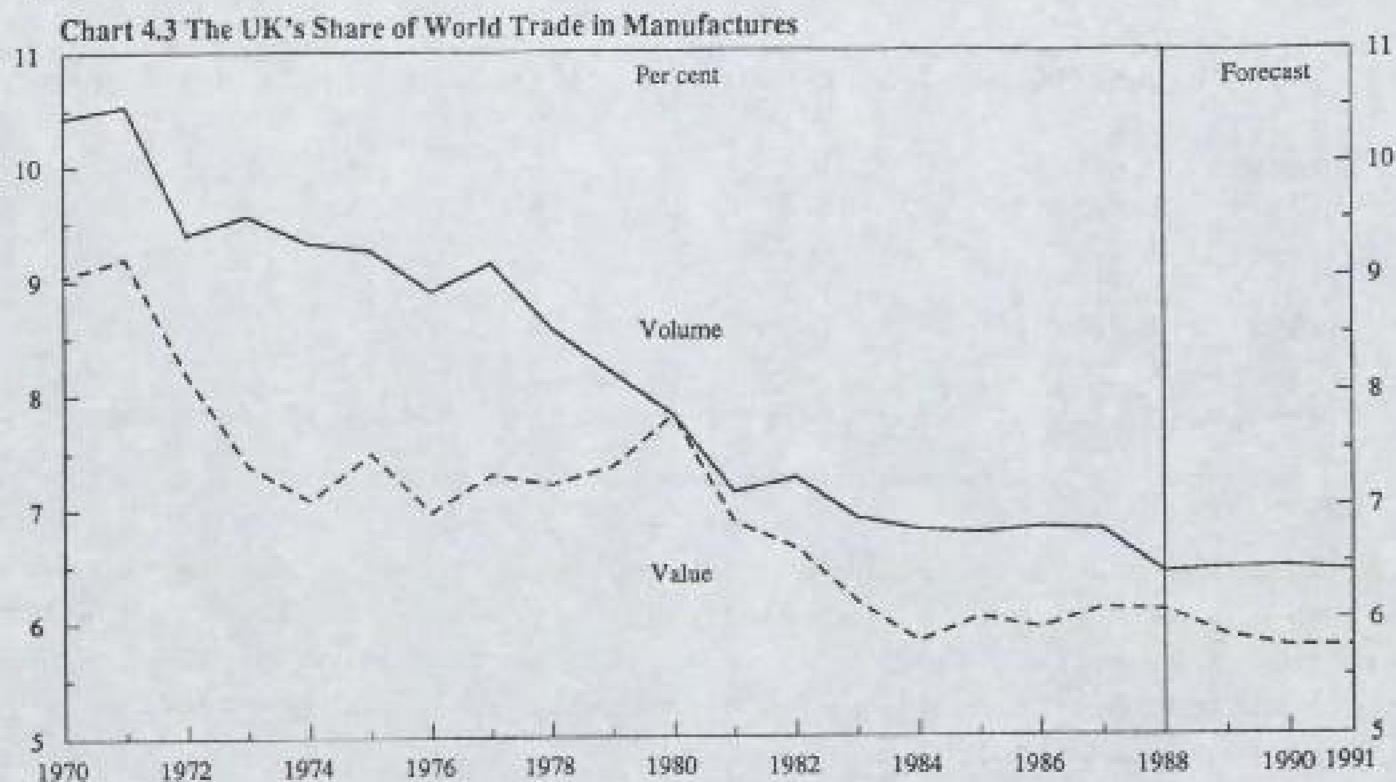


Imports



47. In subsequent years, exports of manufactures are forecast to grow broadly in line with world trade.

Chart 4.3 The UK's Share of World Trade in Manufactures



48. The volume of imports of manufactures is forecast to grow by just over 11 per cent in 1989. This implies that there will be little further growth on average this year beyond that which has already taken place in the first four months. This forecast flattening of imports of manufactures over the rest of the year is attributable to

(i) the slowdown in the demand (which is rather more marked for the manufacturing-intensive components of TFE than for TFE itself),

and (ii) the associated reduction in capacity utilisation whose effects only start to feed into import volumes in the second quarter.

The pattern of deficits in 1989 will probably be affected by the threatened dock strike. Imports and exports may have been boosted by similar percentages in the second quarter in anticipation of a strike and may be correspondingly reduced in the third quarter whether a strike occurs or not.

TABLE 4.3: IMPORTS OF MANUFACTURES AND MAIN DETERMINANTS

(per cent change on previous year)

	Total final expenditure	Relative unit labour costs*	Capacity utilisation**	Volume of imports of manufactures
1986	4.1(3.3)[1]	6.3	48	5.9
1987	5.0(6.0)	1.8	54	9.7
1988	4.8(9.4)	-8.2	68	17.1
1989	3.3(5.1)	-0.5	62	11.1
1990	2.7(3.5)	1.2	54	4.1
1991	2.5(2.6)	-1.3	51	3.0

* rise implies improved competitiveness

** percentage of firms (level) reporting operation at full capacity

[1]Figures in brackets show the demand for manufactures

49. A sharp slowdown in the growth of imports of manufactures is forecast in 1990 as the main effects of slower demand growth and lower capacity utilisation are felt. Also, the fall in competitiveness in 1988, whose effects on trade tend to be felt with a lag, will no longer be exerting any significant adverse effect by 1990.

50. The effects of changes in capacity utilisation have again played an important part in the forecast. Changes in capacity utilisation in 1989 and 1990 reduce imports of manufactures by around 2 per cent (nearly £2 bn.) in each year. A small allowance for capacity effects, worth about £½ bn. in both 1989 and 1990, is built into the forecast for exports.

51. Some support for the link between capacity utilisation and trade volumes is provided by commodity-level data which shows some correlation between improved trade performance and the extent to which capacity constraints have eased.

TABLE 4.4 : CAPACITY* AND TRADE BALANCE (£bn) BY COMMODITY GROUP

	Consumer goods		Capital goods		Intermediate goods	
	Trade balance	Capacity	Trade balance	Capacity	Trade balance	Capacity
1988 Q4	-4.3	74	-0.3	65	-2.9	68
1989 Q1	-3.7	69	-0.4	70	-2.9	68
1989 Q2**	-3.8	58	-0.6	66	-3.2	64

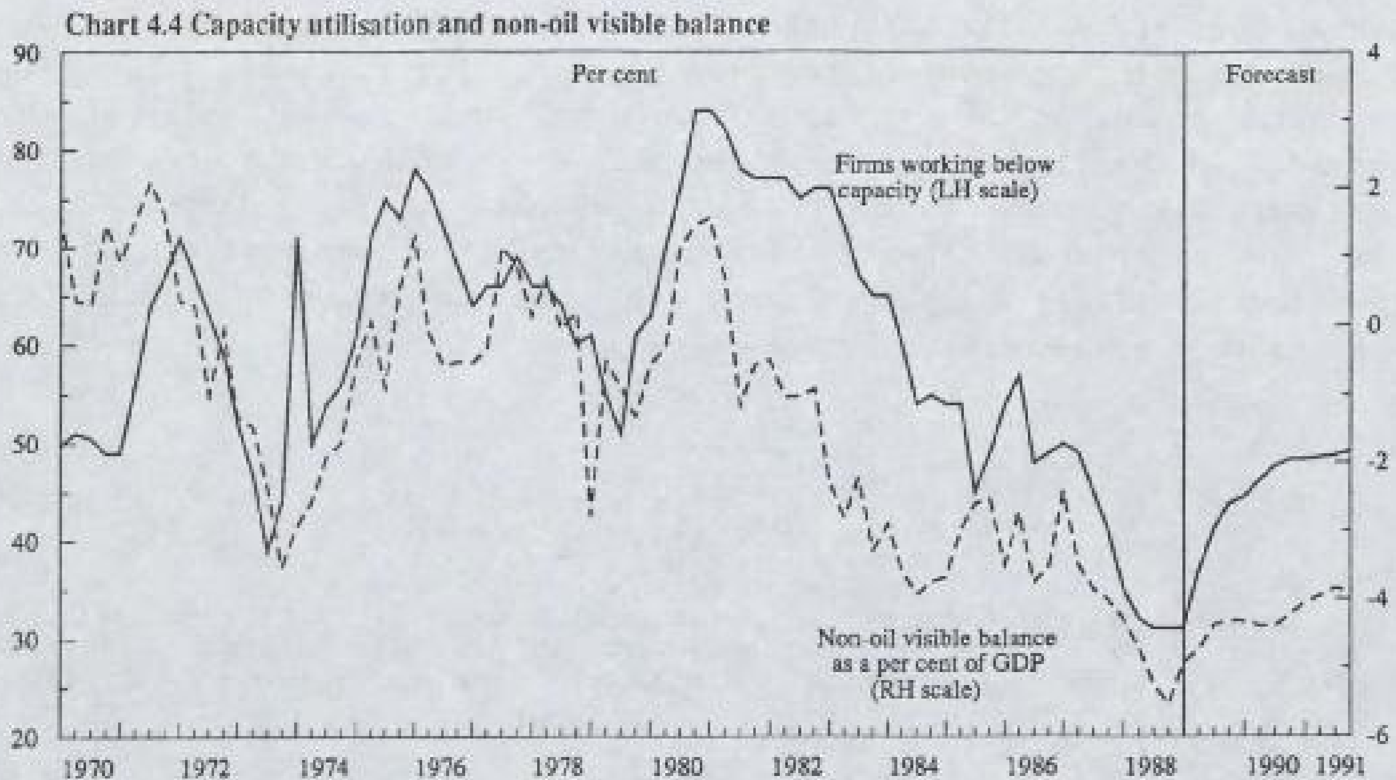
* CBI measures of percentage of firms operating at full capacity

** April figure at quarterly rate

52. The consumer goods industries have reported the most pronounced reduction in capacity shortages this year, and this has been accompanied by

a significant improvement in the trade balance. But in the capital goods industries - where capacity constraints have, if anything, worsened in 198[illegible] the trade balance has deteriorated. Chart 4.4 summarises the relationship at the aggregate level.

Chart 4.4 Capacity utilisation and non-oil visible balance



53. The recent upward movement in the terms of trade in manufactures has continued in the first quarter of 1989 with a 1 per cent rise on the previous quarter. However the fall in the exchange rate is expected to halt this upward movement. Nevertheless the terms of trade are still forecast to be higher in 1989 than in 1988. The forecast assumes no change in the terms of trade from the fourth quarter of 1989.

TABLE 4.5: TERMS OF TRADE IN MANUFACTURES
(per cent change on year earlier)

	Price of Imports (AVI)	Price of Exports (AVI)	Terms of trade
1987	3.4	3.5	0.1
1988	-0.8	2.3	3.0
1989	1.3	3.7	2.4
1990	5.0	4.0	-1.0
1991	4.3	4.3	0

54. While the forecast for trade in manufactures contributes £1½ bn. to the deterioration in the current balance in 1989, the balance on non-manufactures is forecast to improve by £1 bn. The relatively slow growth of imports of non-manufactures is not surprising since these goods tend to have a lower income-elasticity than manufactured goods. But the strength of exports of non-manufactures forecast for 1989 is rather surprising. Around two-thirds of the forecast 12 per cent growth in 1989 has already occurred in the first quarter and represents a combination of higher than normal exports of grain to the USSR as a result of poor harvests last year, and increased exports of eggs and dairy produce to the EC. With these factors likely to prove temporary, non-manufactured exports are expected to grow substantially more slowly over the rest of the forecast.

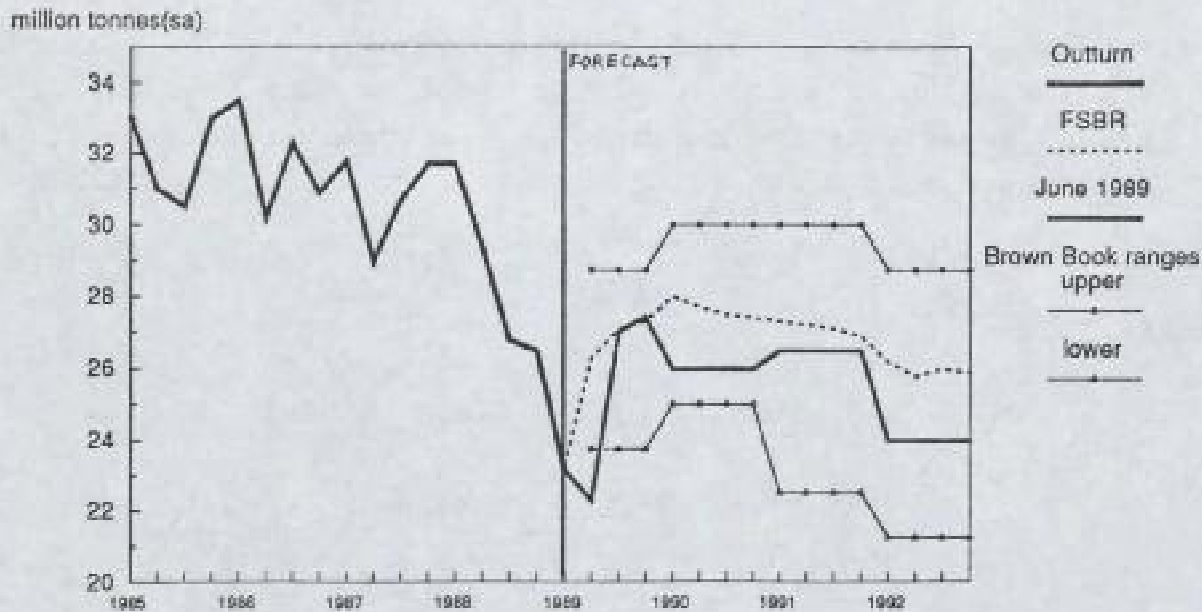
North Sea oil

TABLE 4.6 : NORTH SEA OIL FORECAST

	Average North Sea price $p.b	£p.b	Output (oil+ NGLs) (m.tonnes)	Estimated accidents loss (m.t)	Growth in UK demand (% p.a)	Oil Trade balance (£bn)	North Sea Revenue (£bn)
1987	18.0	10.9	123.2	-	-3.4	4.2	4.5
1988	15.1	8.4	114.4	7.0	6.0	2.3	3.6
1989	17.6	10.7	99.9	13.7	3.5	1.6	3.0
1990	16.4	10.0	104.0	7.9	2.0	1.7	2.6
1991	17.3	10.4	106.0	3.5	1.5	1.9	2.6

55. The underlying path of a gentle decline in North Sea production since its peak in 1985 has been severely disrupted by a series of accidents. Most of the implications of the accidents were incorporated in the FSBR forecast, but the subsequent Cormorant Alpha incident and revisions to expected restart dates in other fields have reduced the 1989 output forecast by a further 4 million tonnes (mt) to 100mt. The latest estimate is that output has been reduced by 7mt in 1988 and 13.7mt in 1989 on account of accidents - roughly 6 per cent and 12 per cent of potential.

Chart 4.5: Quarterly path of North Sea production
FSBR & June forecast



56. Over the forecast production recovers as fields come back on stream, but is lower than in the FSBR. Postponement of new field starts and downward revisions to some existing fields are partly responsible, but the main factor is a 5 per cent allowance for further accidents in the older fields which has been incorporated in this forecast. Set against this, the Piper reservoir is now expected to produce more than it otherwise would have done in years beyond 1993. Annual production is still expected to fall within the announced (Brown Book) ranges.

57. Oil prices turned out somewhat higher in Q1 than was assumed in the FSBR and the forecast has been revised upwards in the light of market developments. The premium which Brent oil attracts over higher sulphur Middle Eastern crudes has recently been as high as $2.50 with the shortage of supply, but is not expected to fall back further than $2 by the end of 1989 and through 1990 because of the shift in demand towards unleaded petrol which is more easily manufactured from light crudes. Prices have fallen recently following the OPEC agreement to increase supply.

58. The oil trade balance is now believed to be more adversely affected by the accidents than was anticipated in the FSBR. The effects are still concentrated in the first half of 1989 - net exports in 1989H1 are now likely to be only one third of the 1988H1 value. Overall, the loss to visible trade in 1989 due to North Sea accidents could be as much as £1 bn. at current and forecast prices and exchange rates. The oil trade surplus is

forecast to be around £1½ bn. in 1989 and then to rise gradually to just under £2 bn. in 1991.

59. On invisibles, however, the contribution of oil improves as North Sea production declines, with as a result lower profits due abroad, and UK companies invest relatively more abroad. Net credits from oil interest profit and dividends should reach £2 bn. in 1990, exceeding the surplus from oil trade.

Invisibles

TABLE 4.7 : SUMMARY OF INVISIBLES BALANCES

	Services	IPD	Transfers	Total Invisibles
1987	5.3	5.4	-3.5	7.3
1988	3.4	5.8	-3.6	5.6
1989	4.2	5.1	-4.0	5.3
1990	6.0	6.9	-4.7	8.2
1991	6.9	8.5	-4.8	10.6

60. The invisibles balance for 1988 is currently estimated at £5.6 bn., a sharp fall over the 1987 level. Data revisions are common in this area. Interest profit and dividends (IPD) improved marginally, but have essentially been flat for 3 years, and net outflows of transfers were unaltered in 1988. Earnings from trade in services fell back to their lowest level for five years.

Services

61. Two principal factors lie behind this fall in the surplus on services:

- The deficits on **travel** and on **civil aviation** have increased sharply as UK residents have been travelling and spending more outside Western Europe (particularly N America), reflecting favourable movements in the exchange rate during 1988 and strong growth in consumer demand. Foreign tourists spent 3 per cent less in the UK in the year to 1988, whereas UK residents spent 12 per cent more abroad over the same period.

- Earnings from exports of **financial services** grew dramatically in the early 1980s, but have now levelled off at a surplus of around £9 bn.

This is mainly attributable to a turnaround in Lloyds net premiums reflecting the decline in the dollar, a downturn in the insurance cycle after mid 1987, and a catch-up of claims with the higher premiums introduced to protect against high awards in the US courts.

62. Data on services for the first quarter of 1989 are encouraging on the exports side, but do not yet show a reversal of the trend in imports. The forecast for import volumes has been revised up from the FSBR. Nevertheless import volume growth is forecast to fall in 1989 and 1990 as domestic demand slackens. Travel debits in particular are expected to fall from recent high levels in response to the tightening of monetary policy. Export volume growth is a little higher than in the FSBR reflecting strong growth in world demand. In addition export prices are expected to rise faster than import prices in 1989, hence the services surplus is forecast to recover in 1989 and improve further in 1990 and 1991.

TABLE 4.8 : TRADE IN SERVICES

	Volumes (Percentage change over previous year)		Values (£ bn.)		
	Exports	Imports	Exports	Imports	Balance
1988	-2.3	8.6	27.5	24.1	3.4
1989	4.3	2.9	30.9	26.7	4.2
1990	5.3	0.4	33.9	28.0	6.0
1991	3.4	1.7	36.4	29.6	6.9

IPD

63. The IPD balance improved slightly in 1988, with the largest increase coming from the oil sector where declining production and accidents reduced payments abroad by North Sea companies. Portfolio earnings declined despite a gradual recovery in the share of portfolios allocated to overseas equities and bonds after the repatriation of assets following the October 1987 crash.

TABLE 4.9 : SUMMARY OF IPD BALANCES

£bn

	Banks' lending Foreign currency	Sterling	Direct Investment Non-oil	Oil	Portfolio	Other	Total	Change in net assets
1877	0.7	-0.9	4.3	0.2	1.9	-0.8	5.4	-11.0
1988	0.9	-1.2	4.3	1.1	1.4	-0.7	5.8	16.1
1989	0.8	-3.2	5.7	1.2	1.6	-1.0	5.1	35.3
1990	1.2	-4.9	6.6	2.1	3.0	-1.0	6.9	11.8
1991	1.3	-6.0	6.9	3.1	4.3	-1.1	8.5	15.8

64. The IPD surplus falls in 1989, but recovers in 1990 and 1991. The UK's net identified stock of net overseas assets should rise considerably in 1989 on account of the strength of the dollar, but this is not forecast to be sufficient to offset an increase in interest payments abroad on banks' sterling lending. This interest element of IPD is adversely affected by higher levels of UK interest rates, because the stocks of liabilities are so much higher than of assets in respect of banks' sterling lending. Net IPD credits improve beyond 1989 as the spreads between rates of return on debits and credits narrow back to long run levels.

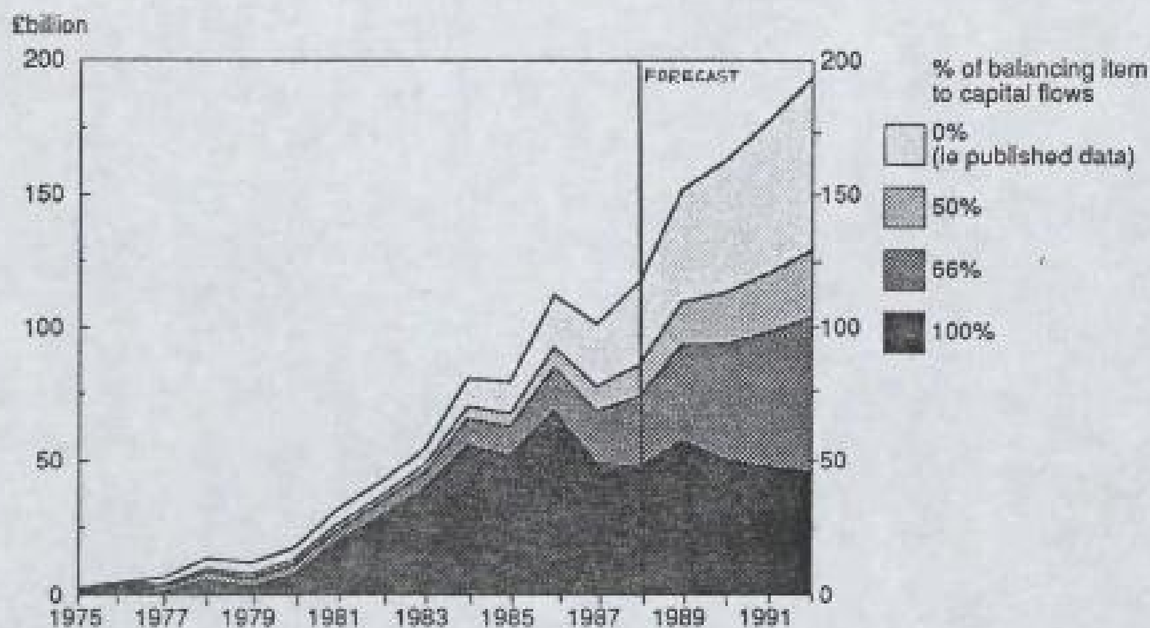
65. The invisibles surplus as a whole is expected to rise over the forecast - net debits on transfers increase, but the surpluses on services and IPD increase by more. The improvement in the balance after 1989 is not especially dramatic in relation to GDP - the invisibles surplus was 1.8 per cent of money GDP in 1987, and is forecast to fall to 1.1 per cent in 1989 and recover to 1.8 per cent by 1991.

The UK's net overseas assets

66. The continuation of large current account deficits might initially be expected to result in a reduction in the net overseas asset stock. But revaluations, caused by sterling's decline and the relatively slower growth of UK equity prices, raise the sterling value of the UK's net asset position. In addition the net capital inflow required to finance the deficit equals the current account deficit less the balancing item. Since large balancing items on the overseas sector are expected to continue, the identified stock of net external assets is not reduced very much by the large deficits. The combined effect of the revaluations and the assumption about the balancing items results in a projected increase in the net identified overseas asset stock to nearly

£180 bn. by the end of 1991. However this overstates the true level of the UK's net assets. Chart 4.6 shows the level of net overseas assets using various assumptions about the proportion of the balancing item that represents unidentified capital inflows.

Chart 4.6: STOCK OF NET OVERSEAS ASSETS, 1975-92



Top line is IDENTIFIED net stock overseas assets using CSO's methods

Other lines show net stock of overseas assets implied if various proportions of the balancing item are allocated to capital (in)flows

(5) PERSONAL SECTOR

Recent developments

67. Consumer spending has slowed sharply since the summer of last year. Retail sales have decelerated since July, though they have recently been subject to erratic monthly movements (Chart 5.1). For example there was a strong pick up in May, following a sharp fall in April. The pick up in May was briefly foreshadowed by a recovery in the EC/Gallup Survey of consumer confidence, which till then had been on steep downward trend from June of last year (Chart 5.2). The EC Consumer Confidence indicator fell back in June, following the increase in interest rates in late May. The attitude to major purchases from the same survey has been flat since late 1988 following a steep fall from mid-year (Chart 5.3). The CBI/FT survey also reported a recovery in retail sales in May. Despite the recovery in May, retail sales growth in the latest three months (March-May) on the same period a year earlier was 3.8 per cent, the lowest annual growth since early 1986. John Lewis sales figures for the first two weeks of June suggest slower growth than in May.

Chart 5.1 Retail sales

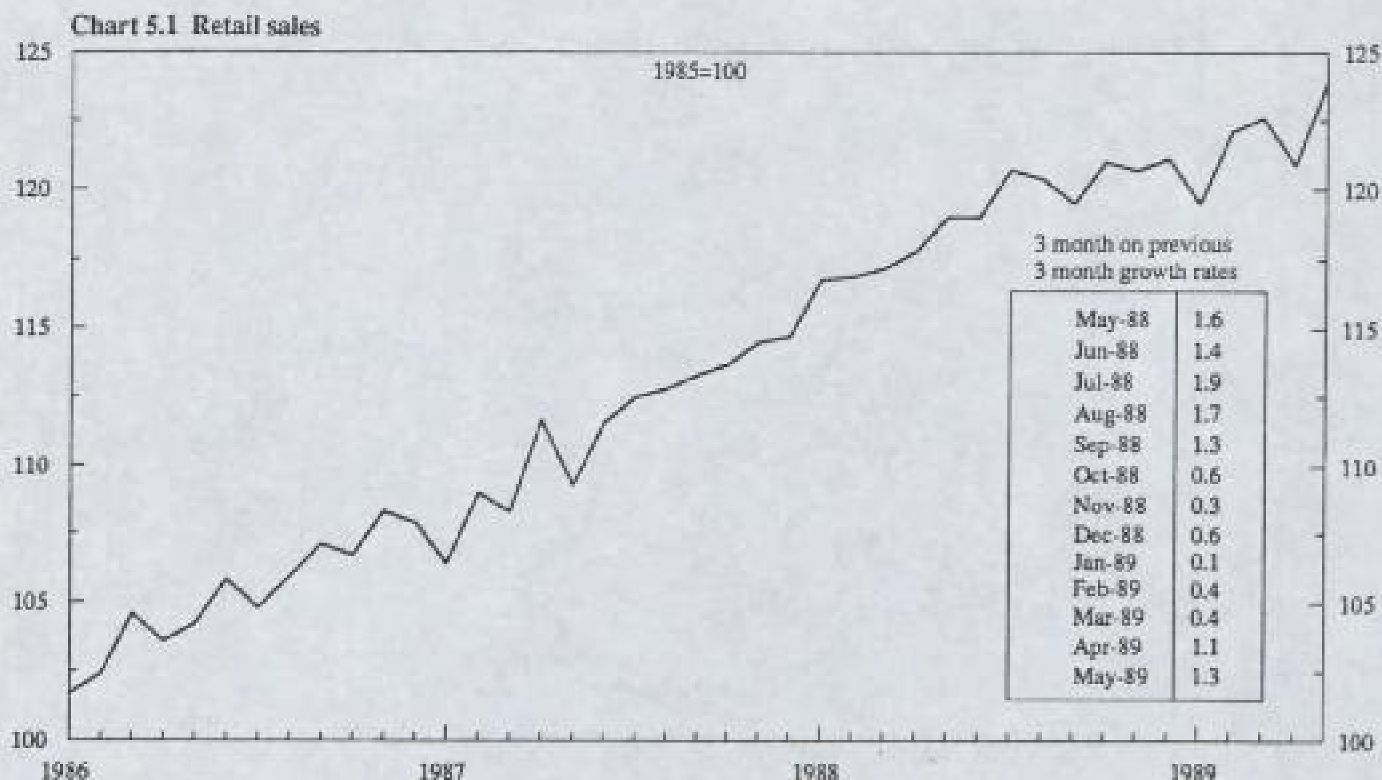


Chart 5.2 Consumer confidence and total consumer spending

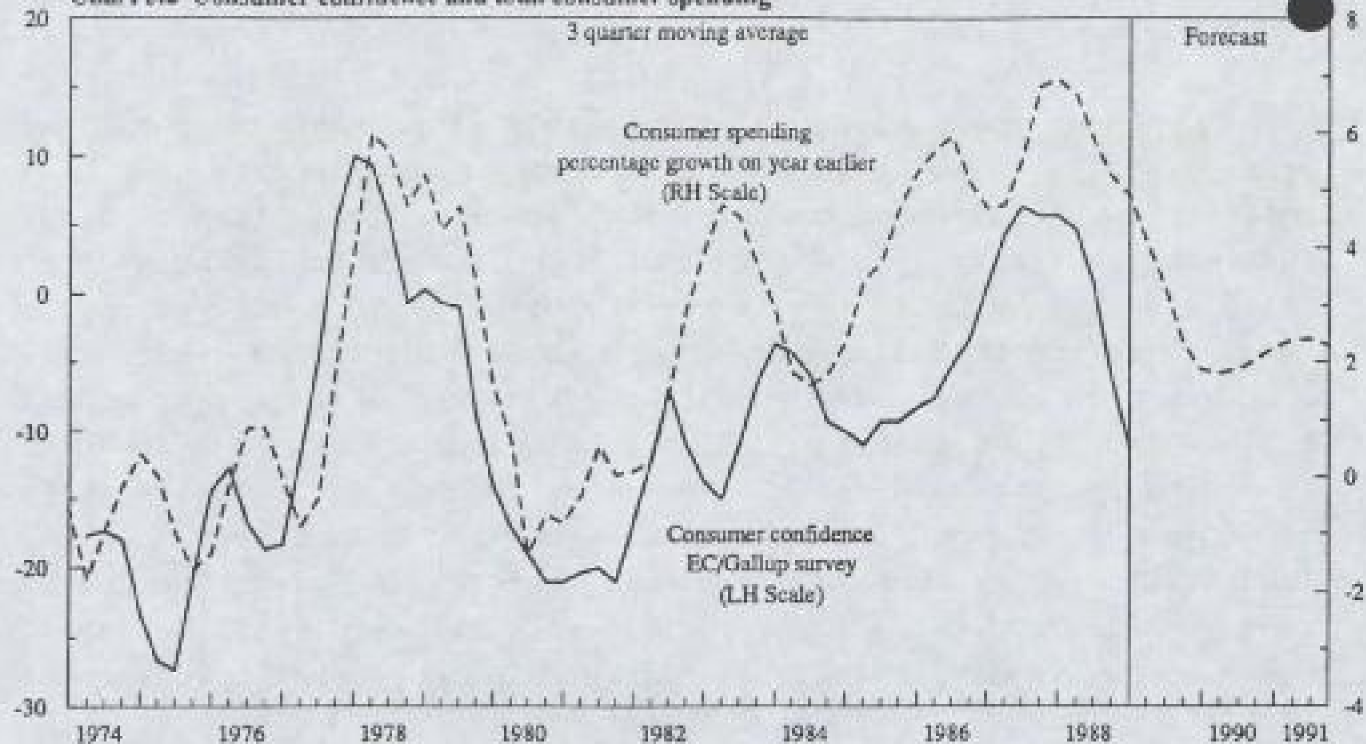


Chart 5.3 Attitude to major purchases and durables spending

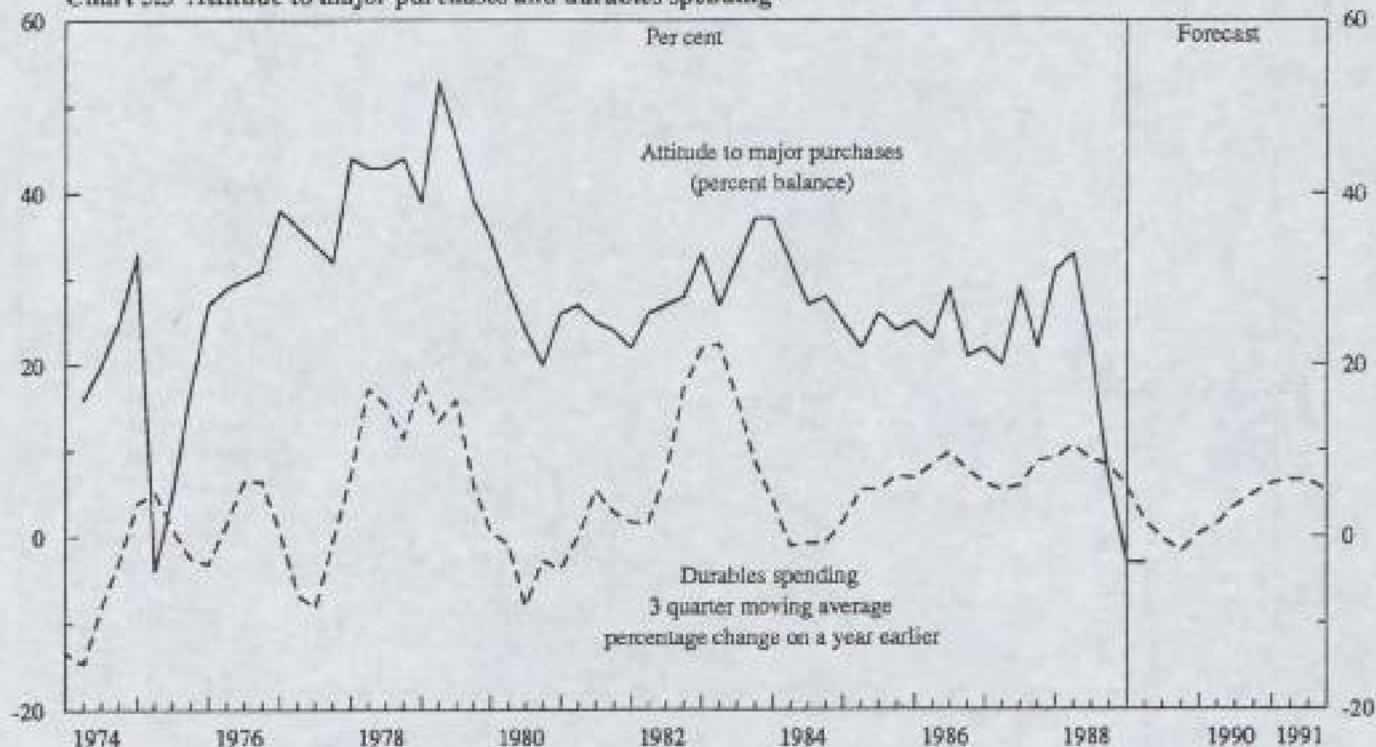


Chart 5.4 New car registrations by persons and companies

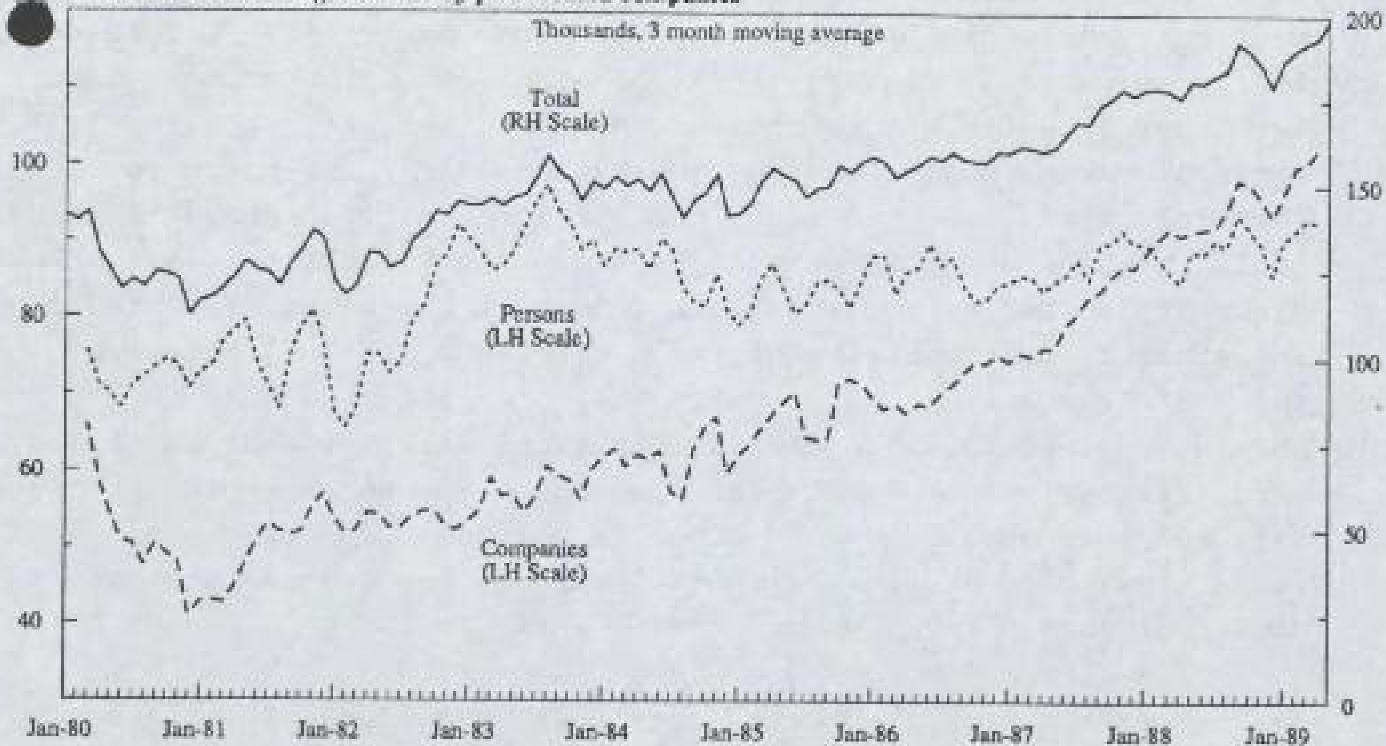
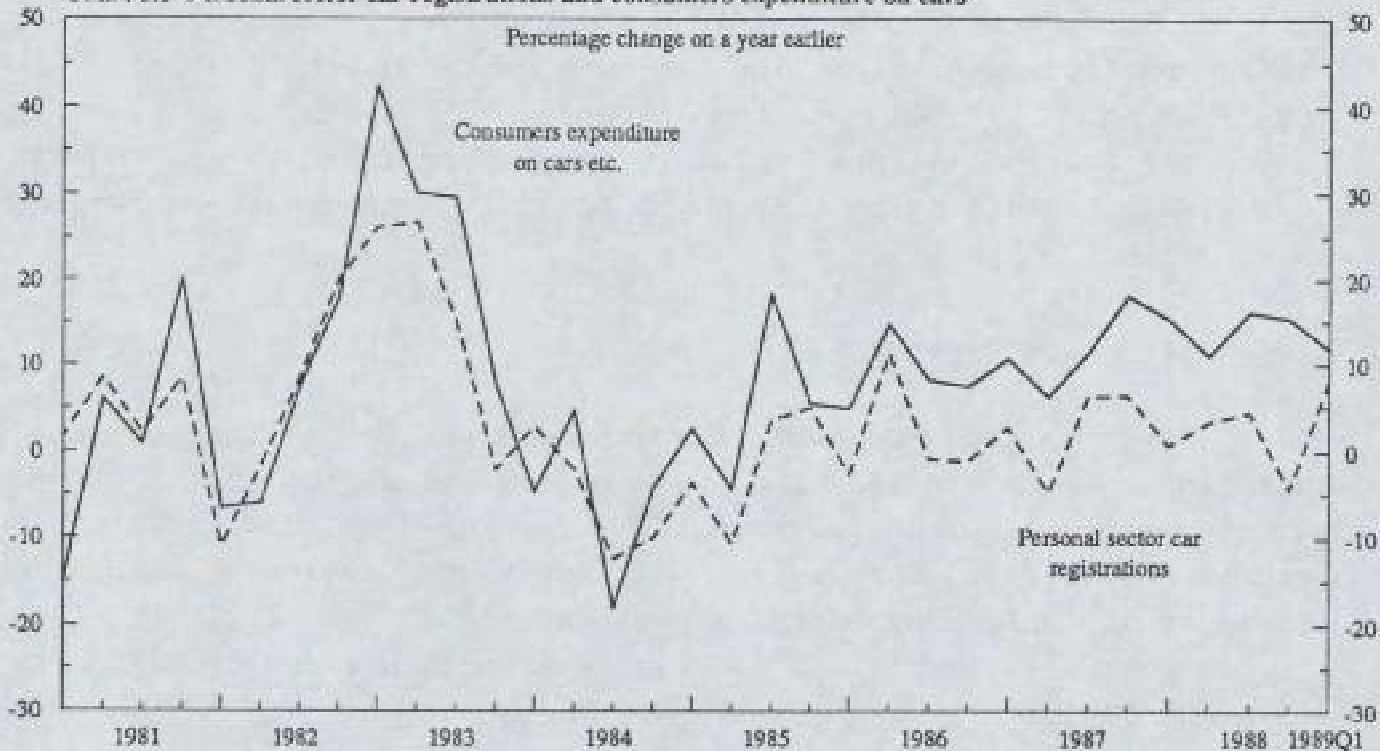


Chart 5.5 Personal sector car registrations and consumers expenditure on cars



68. **New car registrations** continue to grow quite strongly But most of the sharp pick-up in growth since early 1987 is accounted for by company car registrations. The number of personal sector new car registrations has been rising slowly **(Chart 5.4). Personal sector real spending on vehicles** (including motor cycles, caravans etc), on the other hand, has risen at an annual rate of 10-15 per cent over the past eighteen months **(Chart 5.5).** The disparity between registrations and real expenditure is probably explained by the inclusion of car purchases by the self-employed in personal sector spending, while they are likely to be recorded as company registrations in the registrations data. The disparity may also reflect second-hand car purchases in the consumer spending data and, perhaps, a move to bigger or higher quality cars. But even growth in consumer spending on cars has come down since the middle of 1988.

69. **Consumer credit growth** continues significantly below the average in the first eight months of last year. Though **building society mortgage lending and commitments** picked up in April, the levels remain lower than in the first half of 1988. In any case, the recovery seems to be mainly accounted for by increased market share by building societies in the first quarter (expected to continue into 1989Q2) at the expense of banks. By itself, therefore, it does not point to renewed pressure in the housing market or to a significant increase in equity withdrawal to finance consumption.

Income and expenditure: the outlook

70. The forecast projects a sharp deceleration in **real personal disposable income** in 1989 and 1990, mainly because of much slower growth of employment relative to 1988 (caused by the slow-down in output growth), and increasing net interest payments. RPDI is forecast to rise by only 2 per cent in 1989 and 1990; it rises 2¼ per cent in 1991. It is boosted by a small assumed tax cuts in 1990 and 1991.

71. The slowdown in real disposable income and house price inflation projected for 1989, along with an already high level of debt servicing and recent low levels of confidence, all point to a deceleration in consumer spending in 1989. It is likely to rise by 2 per cent in the year to 1989Q4, after growth of 5½ per cent in the year to 1988Q4. Consumer spending is likely to remain sluggish, rising by 2 to 2¼ per cent through both 1990 and 1991.

Spending on durables is expected to fall slightly during 1989. The saving ratio is projected to fall further through 1989 and to recover slowly in 1990 and 1991.

Table 5.1: CONSUMER SPENDING, RPDI AND THE SAVING RATIO
(percent changes on a year earlier)

	Consumer spending			RPDI	Saving Ratio (%)
	Total	Durables	Non-durables		
1988	6.4	10.0	6.0	4.8	4.6
1989	3.5	1.1	3.8	2.1	3.3
1990	1.8	2.5	1.8	2.0	3.4
1991	2.4	6.6	1.9	2.7	3.7
1988Q4	5.6	8.1	5.3	5.6	5.0
1989Q4	2.0	-0.6	2.3	-0.2	2.9
1990Q4	2.0	5.7	1.6	2.4	3.3

72. The forecast slow-down in consumers' expenditure relative to income is similar to the last lull in personal spending between 1983Q3 and 1984Q4. The main difference is that it endures longer. However, it comes after the most sustained burst of strong consumer spending for the last twenty-five years (averaging almost 6 per cent a year between 1985 and 1988). Some retrenchment may, therefore, be expected, especially given a tightening personal sector financial position over the forecast period.

73. Nonetheless, there is still a major uncertainty. Persons may continue to borrow to finance rising consumption and interest payments. Their total wealth: income ratios, while falling over the forecast period, still remain at historically fairly high levels. So there may be considerable scope for further borrowing. In that event, consumer spending growth may be faster than predicted in 1989 at least and perhaps into 1990. But that would be storing up trouble for later years, when retrenchment would have to be correspondingly more severe.

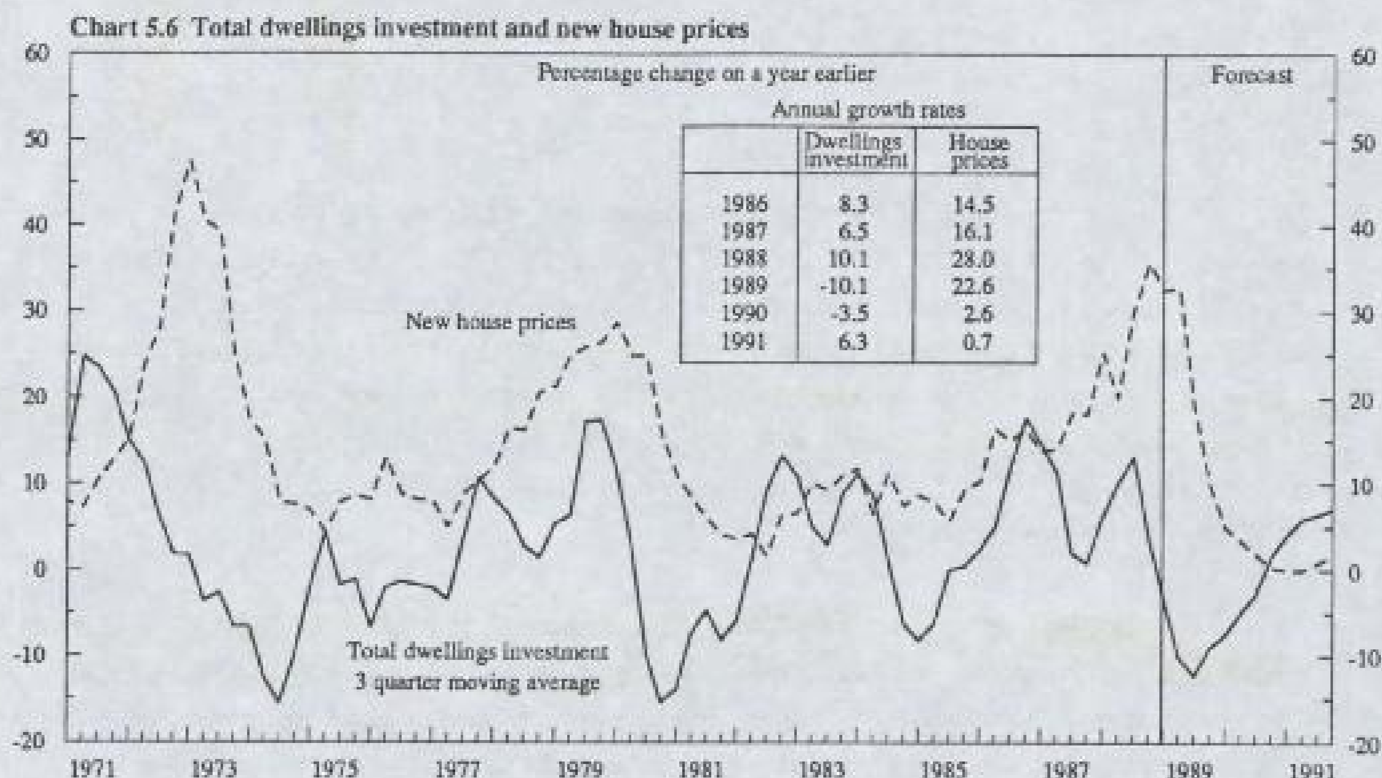
The housing market

74. The housing market has eased substantially in recent months in response to high interest rates. House prices are decelerating, mortgage activity is sluggish, and new housing starts and completions have both fallen from their levels in early 1988. House price inflation is expected to abate to 10 per cent by the end of 1989. House prices

are forecast to be flat from 1990Q1 till the middle of 1991. A sharp fall in house price inflation is consistent with behaviour in the aftermath of past housing booms (Chart 5.6). What is unusual in the current forecast is a sustained period of stable house prices from the beginning of 1990. But real interest rates are maintained at an unprecedentedly high level for an unprecedentedly long time, at least in post war experience. It is possible that average UK new house prices may actually fall for a while against such a background.

75. Total housing investment (new housing and improvements) is expected to fall by 10 per cent in 1989 (investment in new houses actually falls 25 per cent, while investment in improvements rises hardly at all) and to fall further in 1990. It starts to recover thereafter (Chart 5.6).

Chart 5.6 Total dwellings investment and new house prices



Annual growth rates

	Dwellings investment	House prices
1986	8.3	14.5
1987	6.5	16.1
1988	10.1	28.0
1989	-10.1	22.6
1990	-3.5	2.6
1991	6.3	0.7

76. In these circumstances, turnover in the housing market is expected to decline substantially, with a fall in the annual rate of growth of mortgage borrowing from current levels of over 20 per cent to around 14 per cent by end-1990. The scope for mortgage equity withdrawal declines markedly. This is another factor likely to depress consumers' expenditure.

TABLE 5.2: HOUSING FINANCE
(Percent changes on a year earlier unless otherwise stated)

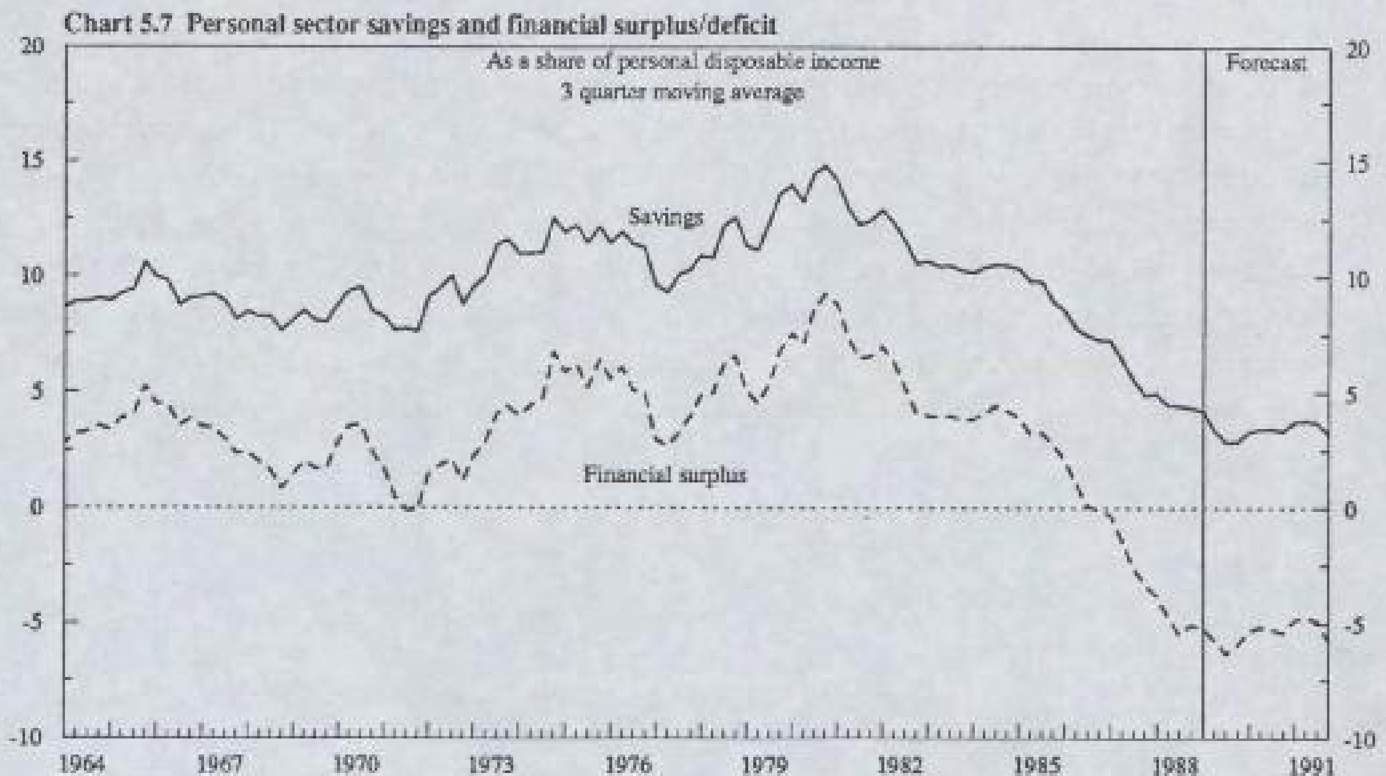
	New House Prices	Mortgage Borrowing from all sources			Estimated Mortgage Equity Withdrawal		Mortgage Rate Average over year
		%	£bn		%(1)	£bn	%
1985Q4	9.2	17.9	19.0	1985	6.3	7.4	13.2
1986Q4	16.4	21.6	27.0	1986	9.6	13.5	11.8
1987Q4	18.2	18.9	28.7	1987	7.5	12.7	11.5
1988Q4	35.7	22.2	40.2	1988	9.4	19.3	11.0
1989Q4	10.0	13.8	33.5	1989	3.7	8.8	13.5
1990Q4	0.4	14.0	37.7	1990	4.8	13.2	13.5
1991Q4	1.8	13.7	41.6	1991	5.2	16.1	13.3

(1) As a percent of outstanding stock of mortgage borrowing.

Personal sector financial position

77. Charts 5.7-5.11 summarise the personal sector's financial position. The personal sector went into financial deficit in 1987 and is forecast to remain in deficit over the next three years. The last time the personal sector ran a sustained (or even a single year) deficit was in the late 1940s and early 1950s, in the post-war recovery. Most measures of the personal sector's wealth-income ratios rose sharply through the 1980s. The forecast reveals a mixed picture.

78. The slight rise in the savings ratio and the fall in dwellings investment lead to a small reduction in the personal sector's financial deficit during 1990 (Chart 5.7).



79. **The net financial wealth: income ratio** (including life assurance and pension funds (LAPFs)) falls steadily over the forecast period, but remains historically high **(Chart 5.8)**. Excluding LAPFs, however, the forecast projects a continued deterioration in the net financial wealth: income ratio to historically low levels. Arguably it is the latter which features most prominently in individuals' assessment of their financial position. A more sanguine picture emerges from total **wealth: income ratios** which include housing wealth **(Chart 5.9)**. On this measure, the personal sector's position deteriorates over the next two years, but remains very strong by historic standards if LAPFs are included. Excluding LAPFs, the position is still comparatively comfortable.

80. **Income gearing** (the ratio of gross debt interest payments to personal income) reached record levels in 1988 and early 1989, and is expected to go on rising steeply **(Chart 5.10)**. Total gross interest payments could account for about 13 to 15 per cent of disposable income throughout the forecast period. Any given level of gross interest payments now has a greater impact on net income because income tax rates have been reduced substantially and the proportion of mortgage payments that qualify for tax relief has been steadily declining.

81. Finally, the UK household sector's **gross debt: income ratio**, which until recently was at similar levels to other G7 countries, is projected to rise well above average levels elsewhere - even the US **(Chart 5.11)**.

82. In summary, total wealth (including housing and LAPFs) of the personal sector remains fairly healthy. This could be exploited to secure further borrowing to sustain faster spending growth than forecast for 1989 and into 1990, though perhaps at the expense of a sharper slow-down thereafter. Another possibility is that individuals will maintain their consumption by running down their gross wealth holdings. Most other financial indicators, however, suggest that the personal sector needs to concentrate on moderating its spending.

Chart 5.8 Ratio of personal sector net financial wealth to income

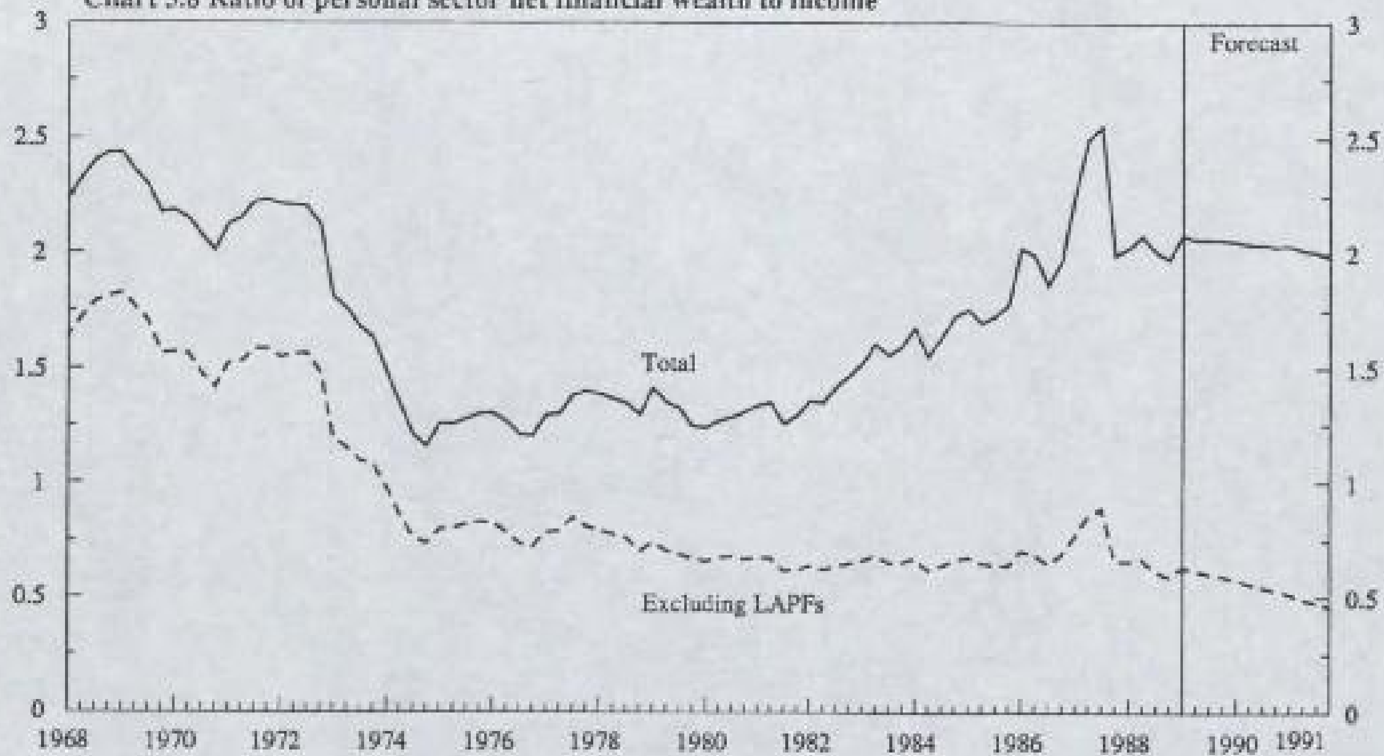


Chart 5.9 Ratio of personal sector total net wealth (including housing) to income

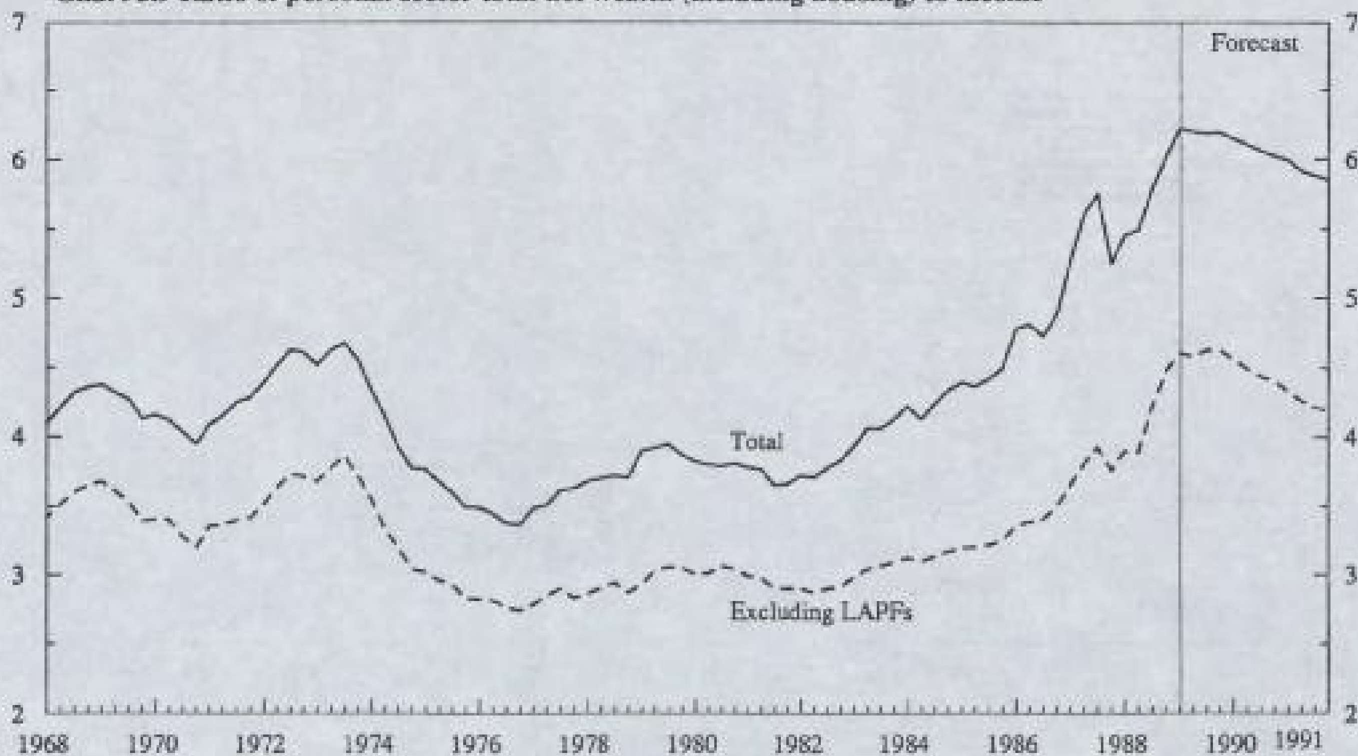


Chart 5.10 Personal Sector Income Gearing

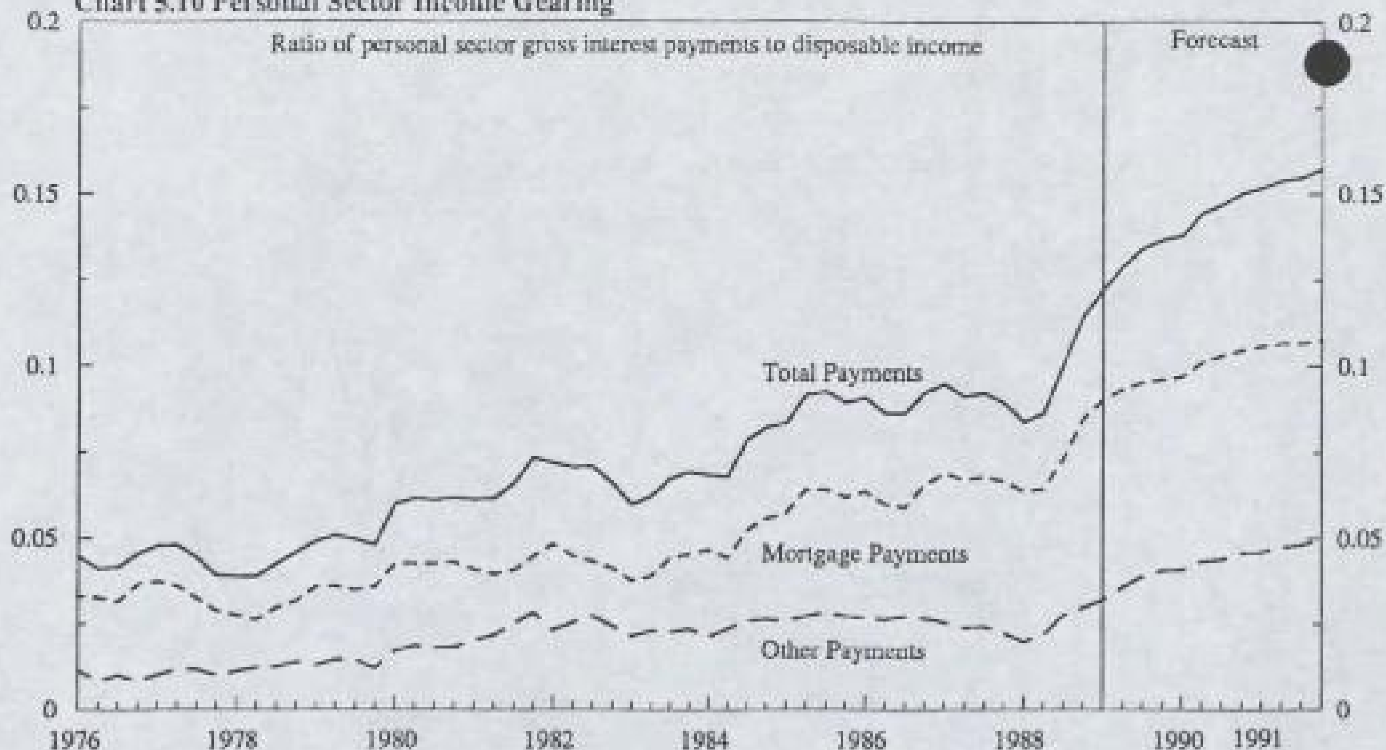
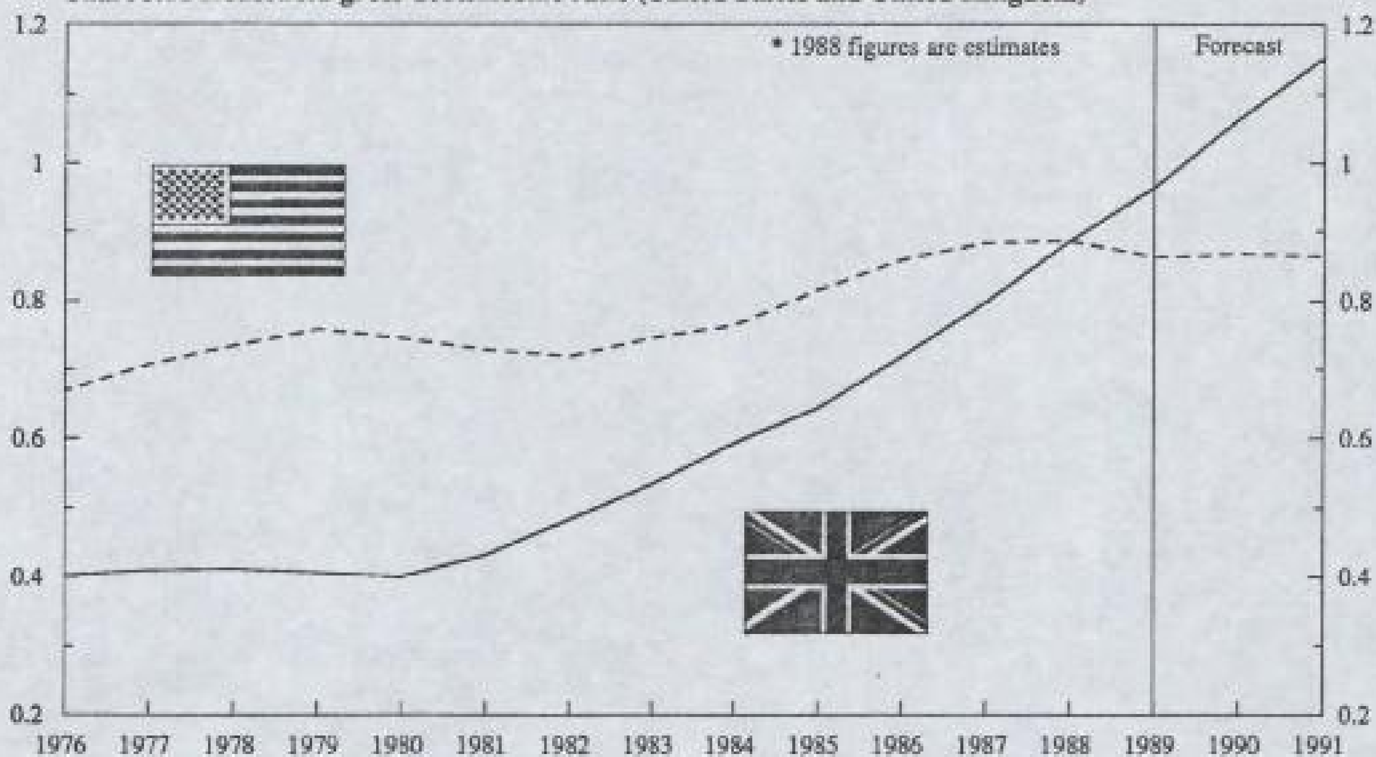


Chart 5.11 Household gross debt:income ratio (United States and United Kingdom)



(6) COMPANY SECTOR

Recent developments

83. **Business investment data are in a mess**, with BSO and CSO publishing inconsistent estimates in two separate press notices in June. The data used in this report for 1988 and 1989Q1 are based mainly on CSO's analysis of supply of investment goods, ie domestic production plus net imports. The forecast has an ad hoc sectoral allocation of the CSO aggregate figures. Nonetheless, there seems little doubt that **investment by the manufacturing and non-manufacturing industries** rose very strongly in 1988, perhaps by 16 and 20 per cent respectively. This follows 6 per cent growth by manufacturing industries in 1987, and 22 per cent by non-manufacturing.

84. **Total company stockbuilding** is estimated to have been £1½ billion (at 1985 prices) in 1988Q4. Further stockbuilding of £½ billion is estimated for 1989Q1.

85. **Non-North Sea industrial and commercial company profits** (net of stock appreciation) rose by over 20 per cent in 1988, after average increases of 23 per cent in the preceding three years. Despite the strength of investment last year, ICCs net real rate of return probably rose slightly from its high 1987 level. **(Chart 6.1)**. ICCs went into financial deficit in 1988 as a result of rapid investment growth and higher stockbuilding **(Chart 6.6)**.

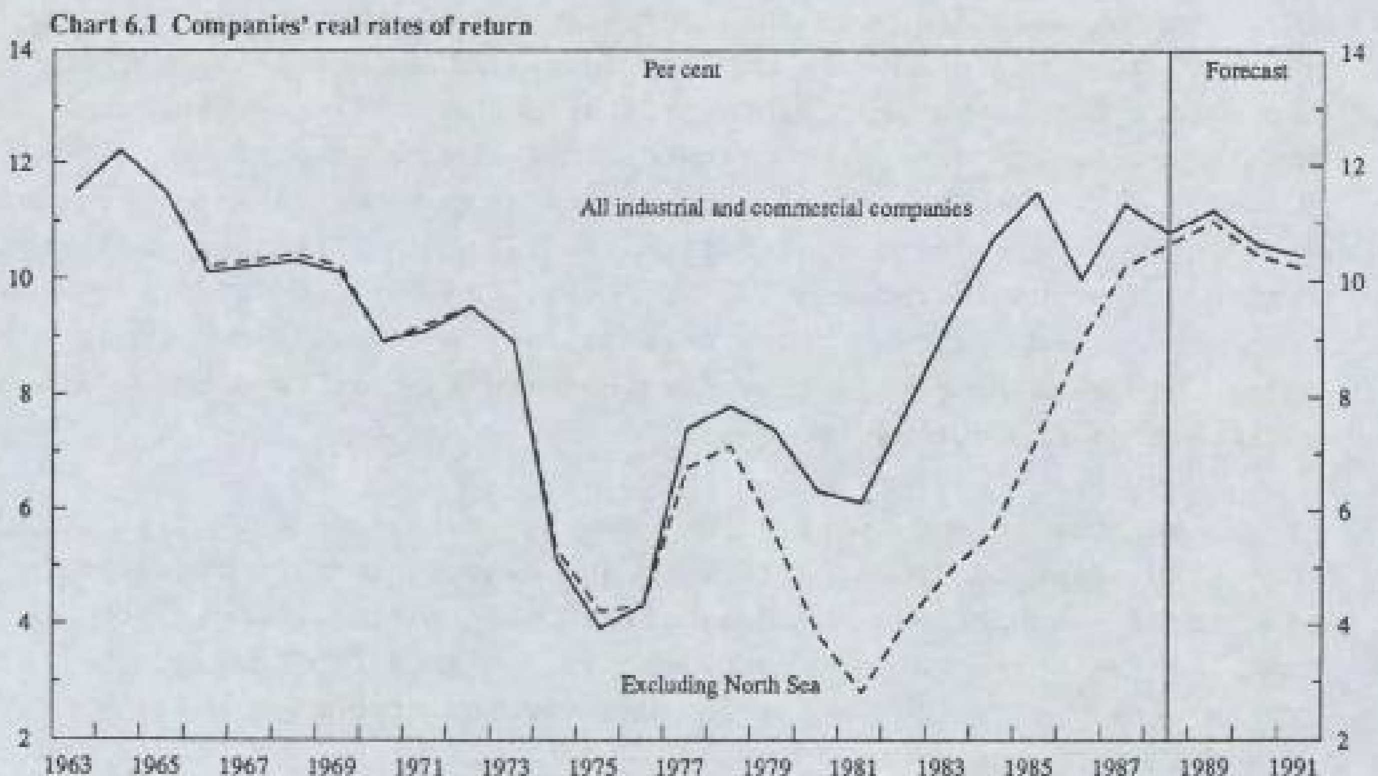


Chart 6.1 Companies' real rates of return

Company expenditure and income: the forecast

86. The **June DTI Investment Intentions Survey** published on 12 June revealed a yet more buoyant outlook for 1989 than the already bullish December 1988 Survey. In fact, the raw intentions data suggested a still more (even unbelievably) buoyant outlook than the final published figures. BSO statisticians discounted the raw data on the basis of past biases in the Intentions Surveys. BSO did not publish intentions for 1990, but further growth is indicated by the survey both for manufacturing (9 per cent) and distribution, construction and financial service industries (8 per cent). (The raw survey data indicated a fall in both sectors in 1990. But over the recent past, the record shows that investment intentions at this time of year have been too pessimistic.)

87. Responses to **expected investment authorisation** questions in the CBI Industrial Trends Survey, on the other hand, reveal some slackening of intentions since mid-1988, though the balances are still at historically high levels. The CBI data suggest a fairly buoyant outlook for manufacturing investment in 1989 as a whole, but with a noticeable slackening in the second half of 1989 and early 1990. The CBI's own assessment of the Trends Enquiry (reported in their April Economic Situation Report) is that manufacturing investment is likely to grow by 8 per cent in 1989, considerably slower than the DTI Intentions Survey.

88. A key issue for the forecast was whether the very bullish DTI survey data could be taken at face value. For 1989, the forecast projects a slow down in profits growth, a standstill in the growth of profit margins, and a continued worsening of the financial deficit **(Chart 6.6)**. (The balancing item in the company sector is consistent with an even worse financial balance in 1987 and 1988 than suggested by income and expenditure data.) Moreover, the DTI and CBI Surveys were both conducted before the increase in interest rates in late May. Other things being equal, these factors might point to a more sluggish outlook than the surveys suggest.

89. On the other hand, the survey data undoubtedly indicate something about business confidence and expectations. Industrial and commercial companies' (ICCs) financial deficits may not be as constraining a factor for investment as in previous periods. Profits growth (net of stock appreciation) remains strong (averaging between 10 and 15 per cent over 1989-91). And the net real rate of return, though declining slowly after 1989, is still high by historic

standards, especially relative to past cyclical slowdowns. Moreover, the financial deficit of the ICCs' sector has a counterpart in a healthy financial surplus for the financial company sector. There should, therefore, be plenty of scope for financing investment plans if financial companies believe that high rates of return will persist: it may even be possible to cut the cost of investment by more leasing than is assumed in the forecast.

90. On balance, the outlook given by DTI Intentions for 1989 has been shaded down slightly, giving some weight to the forecast of activity, to company sector financial prospects, and to the CBI survey. Even so, manufacturing investment is forecast to rise by 12½ per cent in 1989 and non-manufacturing by 10½ per cent. For 1990 and 1991, however, the forecasts give much greater weight to the prospect of weaker output and the sustained financial deficit. A fall is projected in manufacturing investment through 1990 and in 1991, consistent with past strong cycles in investment (Chart 6.2). Non-manufacturing investment continues to grow, but only slowly (Chart 6.3).

TABLE 6.1: GROSS DOMESTIC FIXED CAPITAL FORMATION

(percentage changes on previous year)

	1987	1988	1989	1990	1991
Business*	10½	15½	11	4½	-1
of which:					
North Sea	-22½	-9	39	24	-1½
Manufacturing	5½	16	12½	2	-8
Non-manufacturing	22	20	10½	6½	5
Private dwellings	6½	10	-10	-3½	6½
General government	-½	1	19	3½	1½
Total Investment	8	12½	6½	3	1

* Includes public corporations

Chart 6.2 Manufacturing investment

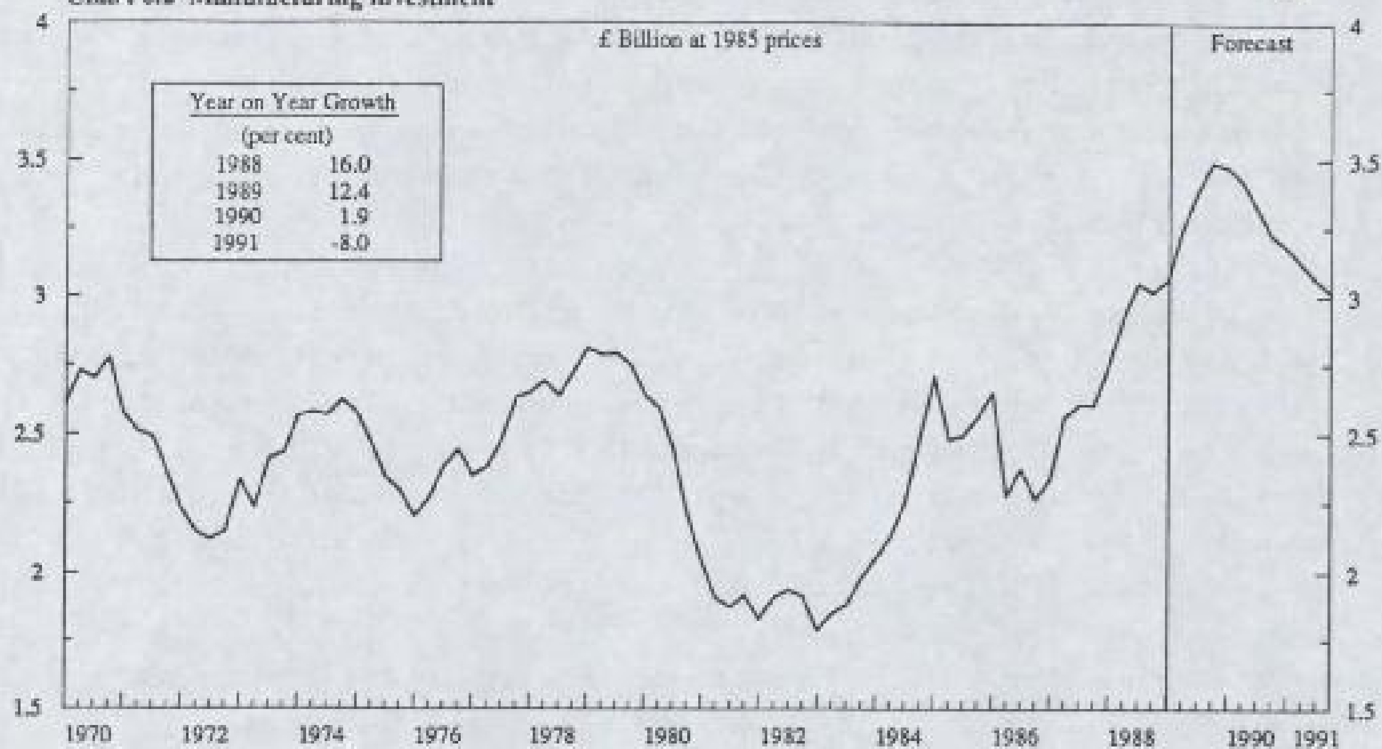
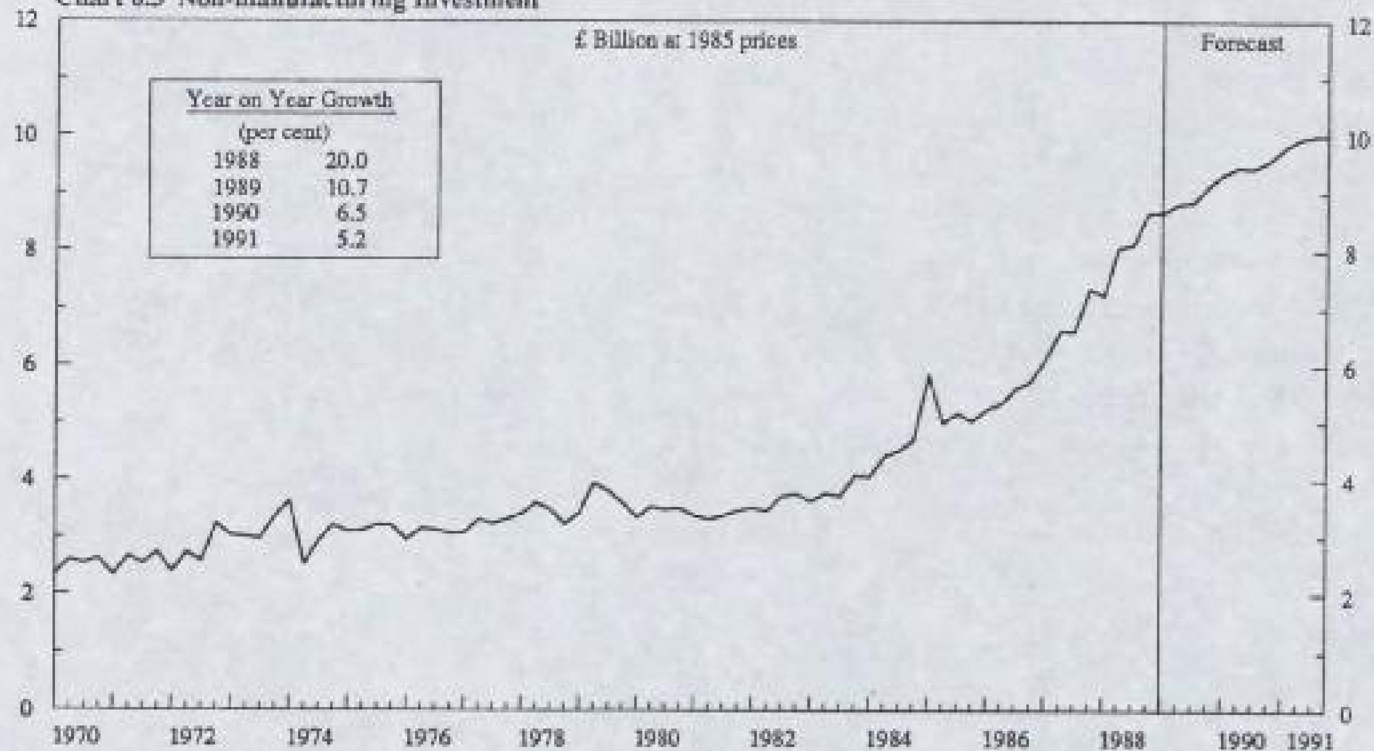
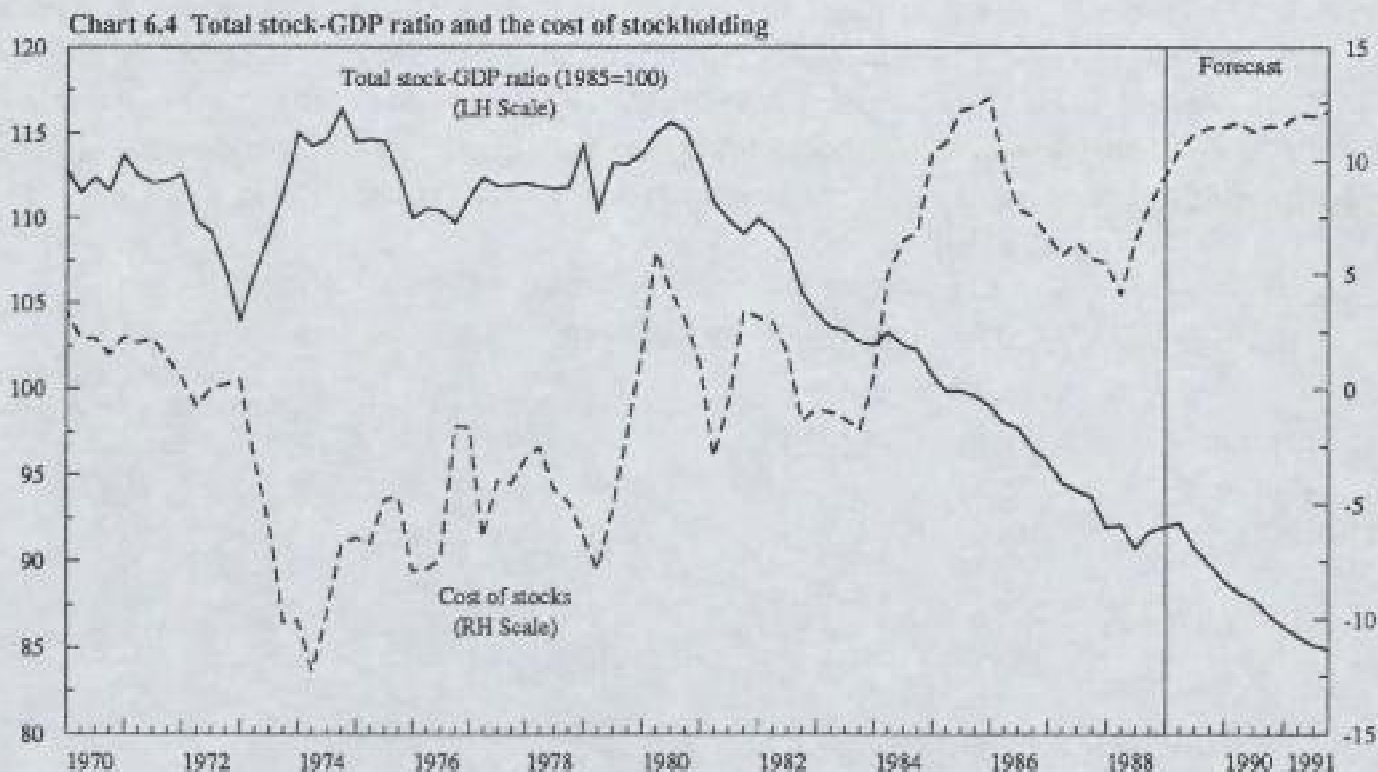


Chart 6.3 Non-manufacturing Investment



91. The increased stockbuilding in late 1988 and early 1989 is likely to have been largely involuntary. The April CBI Economic Situation report made that point explicitly, and pointed to destocking in the immediate period ahead. With weaker financial prospects and the rising cost of holding stocks (associated with high interest rates) the forecast is for some destocking through 1989H2 and 1990. The total stock: GDP ratio continues its long run downward trend throughout the forecast period, (Chart 6.4).



Company sector financial position

92. **Non-North Sea ICCs profits** (net of stock appreciation) are expected to rise by 15 per cent in 1989 and by 11 per cent in 1990. This is slower than the average 23 per cent growth over 1985-88 and reflects the deceleration in domestic demand and an associated gradual halt in margins growth. **Net real rates of return** are projected to decline in 1990 and beyond from the high levels of 1988 and 1989, but will still be high by the standards of the 1970s and early 1980s. Nonetheless, **non-North Sea ICCs saving** falls in real terms in 1989 **(Chart 6.5)**. Along with the strong projected growth in investment this implies a further **financial deficit** in this year **(Chart 6.6)**. Despite much slower investment growth in 1990 and some destocking, the deficit stays much about the same next year. The high level of borrowing associated with company spending reduces net liquidity to historically low levels **(Chart 6.7)**.

Table 6.2: COMPANIES' INCOME AND RATES OF RETURN

(a) Profit shares and rates of return

(per cent)	Total	Non-oil	Non-oil (excl-privatised) companies	Rate of return on assets, non-oil ICCs***
1986	14.5	12.3	11.2	8.9
1987	16.3	14.0	12.3	10.2
1988	16.8	15.3	13.4	10.6
1989	17.4	16.0	13.9	11.0
1990	17.9	16.6	13.7	10.4
1991	18.4	17.1	13.6	10.2

(b) Growth of profits and net income (percent changes on a year earlier)

	Non-North Sea Industrial and Commercial Companies*			Financial Companies
	Gross Trading Profits**		Net Income	Net Income
1986	15.2	(15.2)	18.1	28.0
1987	18.8	(14.5)	29.7	12.5
1988	20.6	(20.5)	18.2	33.1
1989	14.9	(13.8)	0.2	42.0
1990	11.5	(6.2)	5.9	19.6
1991	10.5	(6.2)	9.7	16.5

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

** Net of stock appreciation.

*** excluding companies to be privatised and British Steel.

Chart 6.5 Company saving and spending in real terms

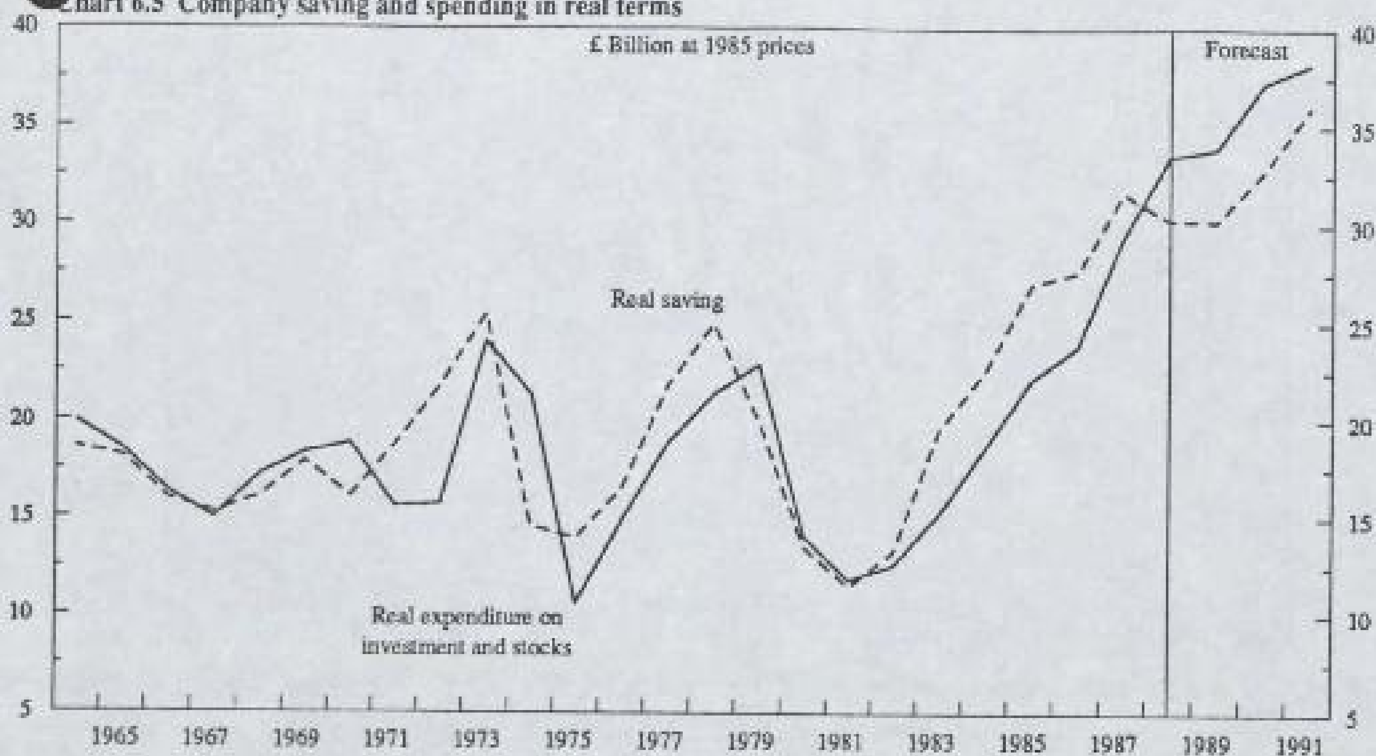


Chart 6.6 All ICCs' NAFA and borrowing requirement (share of TFE)

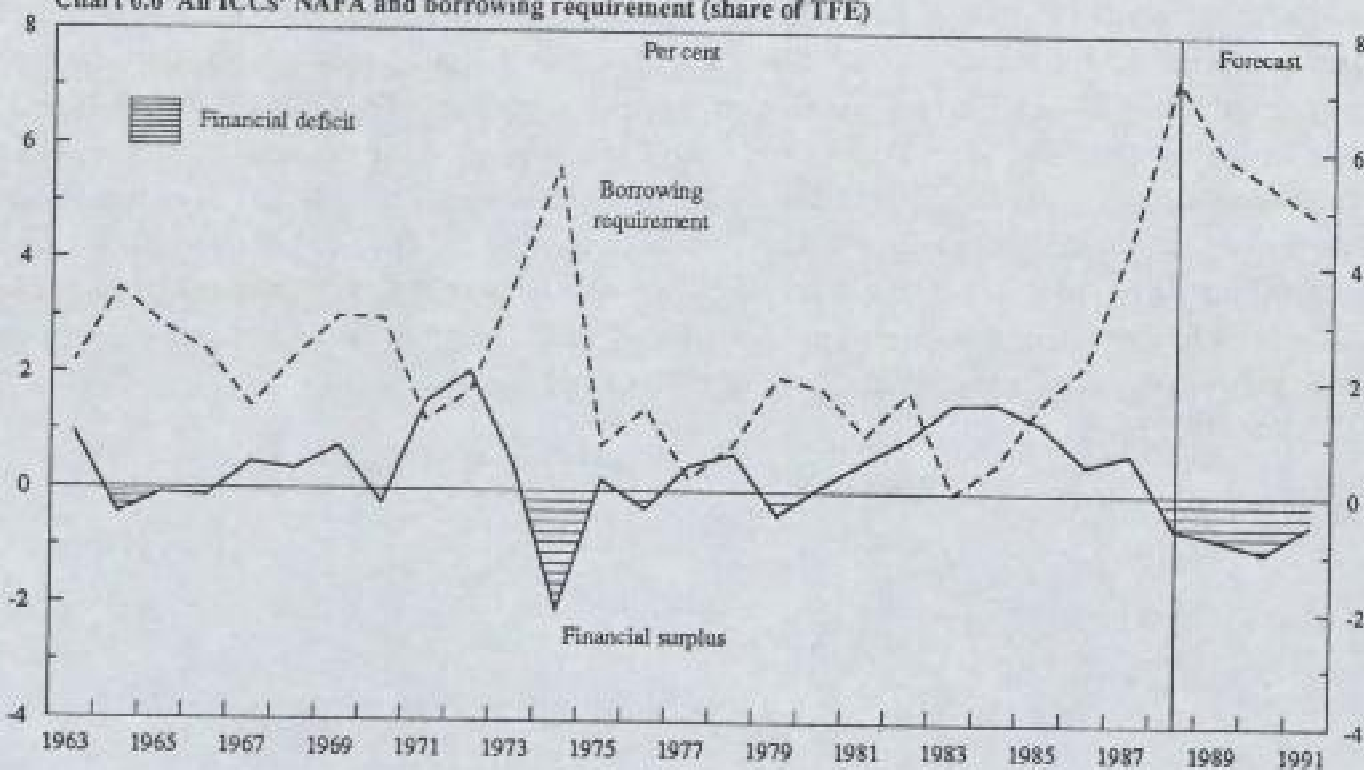
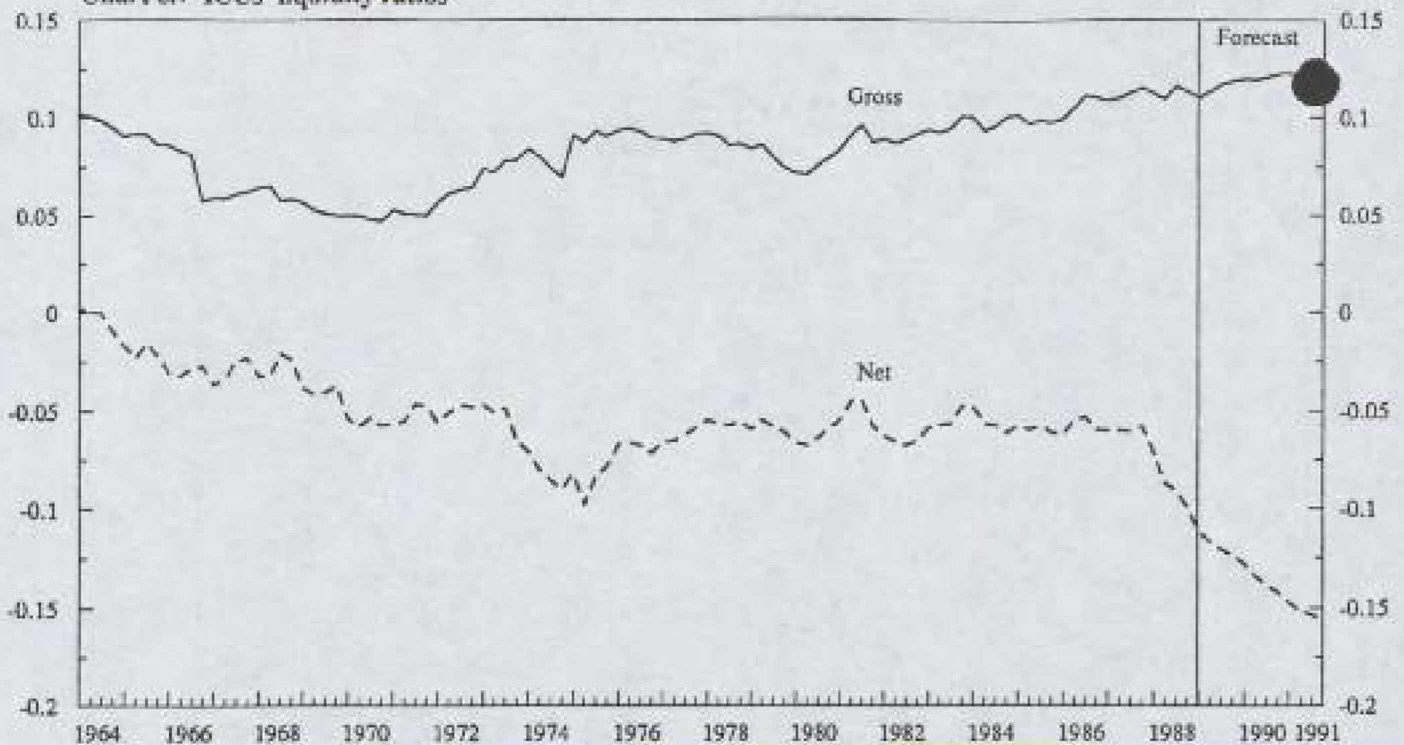


Chart 6.7 ICCs' liquidity ratios



93. This outlook raises the question, rehearsed in the winter forecast report, of whether companies will adjust more strenuously to this financial prospect than has been allowed for in the forecast. It would certainly be unusual for the company sector to run deficits over a run of years. In periods of more extreme recession than are forecast here, companies have always responded very quickly to avoid larger or persistent deficits. On the other hand business confidence and expectations may now be much more robust following the strong performance of the economy over the last seven years and supply side improvements. With continued high real rates of return in prospect, they may be more willing to run deficits to finance continued real spending growth than in earlier periods. But it is inevitably a risk on the threshold of a turning point in the economy that the company sector may react more than projected here.

(7) DOMESTIC DEMAND AND ACTIVITY

94. Domestic demand is expected to grow by 3 per cent between 1988 and 1989. It slows very sharply through the year; between 1988Q4 and 1989Q4 it grows by only ¼ per cent. Slow growth of personal consumption and investment, but especially destocking by companies, account for this sluggish prospect. Domestic demand growth picks up through 1990, though only to about 2 per cent, well below estimated productive potential. GDP is expected to rise 2¼ per cent in 1989 and 2½ per cent in 1990.

Table 7.1 DOMESTIC DEMAND FORECAST: SUMMARY

	1988	1989	1990	1991	1988Q4	1989Q4	1990Q4	1990Q4
Consumers' expenditure	6.4	3.5	1.8	2.4	5.6	2.0	2.0	2.3
Public authorities consumption	0.5	0.1	0.5	1.3	0.1	-1.0	2.3	1.3
Fixed investment	12.2	6.5	3.1	0.9	10.3	6.3	0.2	1.8
Stockbuilding*	0.3	-0.5	-0.3	0.3	2.2	-2.3	0.5	0.2
Total domestic demand	**6.5**	**3.0**	**1.6**	**2.2**	**7.2**	**0.3**	**2.1**	**2.2**
Exports of goods and services	-1.0	4.5	6.6	4.1	-3.0	10.5	4.2	3.8
Imports of goods and services	12.0	6.8	2.9	2.3	12.1	1.6	4.2	2.3
GDP compromise measure	**4.4**	**2.2**	**2.5**	**2.7**	**4.3**	**2.2**	**2.3**	**2.6**
Non-oil GDP	5.2	3.1	2.3	2.7	5.4	2.2	2.6	2.6
Manufacturing output	7.1	4.3	2.5	3.2	7.1	2.6	2.2	3.2

* Change in stockbuilding as a percentage of GDP in the previous year.

(8) PRICES AND EARNINGS

Recent inflation trends

95. Inflation indicators have picked up sharply over the past year. The **all items RPI** inflation rate has risen from 4¼ per cent in mid-1988 to just over 8¼ per cent by May 1989. Most of this rise is accounted for by increased mortgage interest rates since last summer. But **underlying** RPI inflation (excluding MIPs) also picked up over the same period, from around 5 per cent to 6 per cent. Increases since March have been exacerbated by rises in petrol prices, the result of an increase in world oil prices and attempts by major UK producers' to rebuild profit margins.

96. **Producer output price** inflation (excluding food, drink and tobacco) rose slowly through 1988 ending up at 5 per cent in the year to the fourth quarter. It rose to 5.4 per cent by the end of the first quarter of 1989, but fell back very slightly to 5.2 per cent in May. Continued strong growth of profit margins associated with buoyant domestic demand has largely accounted for the rise over the past year.

TABLE 8.1: INFLATION INDICATORS
(per cent change on year earlier)

		Manufacturers output prices*	RPI		GDP (Market price) Deflator	
			All items	Less MIPS		
1987	Q3	4.5	4.3	3.6	5.4	
	Q4	4.8	4.1	4.0	5.8	
1988	Jan	4.8	3.3	3.7	5.4	(1988Q1)
	Feb	4.7	3.3	3.6		
	March	4.7	3.5	3.8		
	April	4.6	3.9	4.2	6.7	(1988Q2)
	May	4.7	4.2	4.4		
	June	4.7	4.6	4.7		
	July	4.8	4.8	5.0	7.4	(1988Q3)
	August	4.8	5.7	5.0		
	Sept	4.9	5.9	5.2		
	Oct	5.0	6.4	5.1	7.1	(1988Q4)
	Nov	5.0	6.4	5.1		
	Dec	4.9	6.8	5.1		
1989	Jan	5.3	7.5	5.5	7.9	(1989Q1)
	Feb	5.3	7.8	5.7		
	March	5.4	7.9	5.7		
	April	5.3	8.0	5.9		
	May	5.2	8.3	6.0		

* excl food, drink and tobacco.

Producer Prices

97. Producer price inflation is expected to moderate slowly to 5 per cent by the end of 1989. This is despite the fact that firms will be facing increased cost pressure. Sustained growth in pay together with some fall off in productivity growth will result in faster rising unit labour costs, and import costs will rise given the recent depreciation of sterling, which is assumed to be sustained over the next three years. But profit margins fall from recent very high levels and this keeps price inflation stable over 1989 despite cost pressures. Cost inflation abates thereafter and, with profit margins staying broadly flat, producer price inflation falls through 1990 and 1991.

TABLE 8.2 : COSTS AND PRICES IN MANUFACTURING
(percentage changes on previous year)

	Unit labour costs	Costs of materials and fuels	Estimated total costs	Domestic producer output prices*
1987 Q4	3.1	5.1	2.3	4.8
1998 Q4	1.8	5.1	2.4	5.0
1989 Q4	4.9	4.2	5.4	4.9
1990 Q4	4.3	5.4	3.8	4.3
1991 Q4	2.9	7.6	3.5	3.7

* Excluding food, drink and tobacco.

Retail prices

98. Retail price inflation, boosted by a succession of mortgage interest rate increases in the second half of last year, is likely to peak below 8½ per cent in the next couple of months. But the underlying rate (ie excluding MIPs) is still high at around 6 per cent. This partly reflects large nationalised industries' price increases in 1989-90, and a significant increase in local authority domestic rates (and the community charge in Scotland) of 10 per cent. Over the forecast period RPI inflation moderates from July as recent petrol price cuts take effect, and more significantly from August as last year's mortgage interest rate increases begin to drop out of the inflation rate calculation. The forecast is for some squeeze on retailers margins in the face of sluggish consumer spending.

99. Retail price inflation should fall to under 7 per cent by end-1989 and to a little under 6 per cent by end-1990. Underlying retail price inflation (excluding MIPs) should moderate to 5½ per cent by end-1989 and 5 per cent by end-1990 (Table 8.3).

TABLE 8.3: COMPONENTS OF THE RETAIL PRICE INDEX

	1986Q4	1987Q4	1988Q4	1989Q4	1990Q4	1991Q4
Mainly retailed items	4.0	4.3	4.9	4.9	3.7	3.9
Food prices	3.2	3.4	4.0	4.9	3.7	3.6
NI prices	2.9	2.1	7.4	7.5	8.0	5.8
Housing costs	7.1	7.0	16.5	14.7	13.9	7.3
Petrol	-12.6	1.3	- 0.1	6.0	3.8	4.6
Total RPI	3.4	4.1	6.6	6.7	5.7	4.7
RPI excluding Mortgage Interest payments	3.4	4.0	5.2	5.6	5.1	4.6

100. **Table 8.4** sets out monthly RPI inflation until mid-1990, together with the path consistent with the FSBR forecast. Annex A has further details on the forecast for RPI inflation. The slight pick up in inflation from April 1990 reflects the conventional assumption on indexation of excise duties.

TABLE 8.4: MONTHLY PATH OF RPI INFLATION

(percent changes on a year earlier)

		All items RPI		RPI excluding mortgage interest payments	
		FSBR	Summer	FSBR	Summer
1989	Jan	7.5	7.5	5.5	5.5
	Feb	7.9	7.8	5.7	5.7
	Mar	7.9	7.9	5.7	5.7
	April	7.6	8.0	5.7	5.9
	May	7.7	8.3	5.5	6.0
	June	7.8	8.3	5.5	6.0
	July	7.6	8.2	5.2	5.8
	August	6.2	7.4	5.2	5.7
	Sept	6.3	7.3	5.2	5.6
	Oct	5.6	6.8	5.1	5.6
	Nov	5.6	6.7	5.1	5.6
	Dec	5.6	6.6	5.1	5.5
1990	Jan		6.3		5.3
	Feb		6.2		5.3
	March		6.1		5.2
	April		6.4		5.6
	May		6.3		5.4
	June		6.1		5.2

The GDP deflator

101. The market price GDP deflator rose 7.3 per cent in 1988-89, compared with 3.2 per cent in 1986-87 and 5.2 per cent in 1987-88. (The low figure for 1986-87 was mainly accounted for by the collapse in oil prices during 1986.) Although inflation in many of the individual component deflators increases from 1988-89 to 1989-90 (for example the consumers' expenditure deflator rises from 5.4 to 6.1 per cent, and the investment deflator rises from 4.6 to 7.7 per cent), the overall GDP deflator falls slightly to 7.1 per cent. This reflects the effect of the changing composition of expenditure within GDP (particularly the de-stocking which occurs through the year). A fixed weighted GDP deflator, on the other hand, would show a figure of 7 per cent in 1989-90 compared to 6½ in 1988-89.

102. The sharp fall in GDP deflator inflation in 1990-91 is largely a statistical illusion. It reflects the national accounts treatment of the abolition of domestic rates and the introduction of the community charge. The effect of this change is to take about 2 per cent of the growth of the GDP deflator (and money GDP) at market prices in 1990-91. Table 8.5 shows the figures on a standard basis, and adjusted for the community charge effect.

TABLE 8.5: GDP DEFLATOR AT MARKET PRICES
(percentage change on previous year)

	1987-88	1988-89	1989-90	1990-91	1991-92
FSBR					
Total	5.0	7.2	5.4	3.9	3.0
non-oil	4.5	7.2	5.4	4.0	2.9
June forecast					
Total	5.2	7.3	7.1(7.2)[1]	3.3(5.2)	4.6
non-oil	4.7	7.2	6.7(6.8)	3.4(5.3)	4.6

[1]figures in brackets are adjusted to remove the 'Community Charge effect'

103. Table 8.6 sets out the separate components of the GDP deflator and their contribution to overall movements. The investment deflator rises particularly sharply in 1989-90 both because construction prices continue to rise faster than other prices in the face of sustained high demand and because of the extension of VAT to new construction.

TABLE 8.6: COMPONENTS OF GDP DEFLATOR

(a) Component deflators (Percentage increases on previous year)

	Consumers' expenditure	Investment & Stocks	Central government current expenditure on goods & services	Export	Imports	Total
1987-88	3.8	6.6	5.7	3.4	2.0	5.2
1988-89	5.4	4.8	7.4	3.6	0.2	7.3
1989-90	6.1(6.3)[1]	7.5	8.8	6.5	5.1	7.1(7.2)
1990-91	2.3(5.3)	3.6	7.4	3.6	4.3	3.3(5.2)
1991-92	4.3	3.1	6.8	4.1	3.6	4.6

[1]figures in brackets are adjusted to remove the 'Community Charge effect'

(b) Contribution of components to total percentage increase in deflator

	Consumers' expenditure	Investment & Stocks	Central government current expenditure on goods & services	Export	Imports	Total
1987-88	3.6	2.2	0.7	0.6	-1.8	5.2
1988-89	5.7	3.0	1.2	0.4	-3.0	7.3
1989-90	4.0	1.3	1.0	2.3	-1.5	7.1
1990-91	1.3	0.6	1.2	1.7	-1.5	3.3
1991-92	2.6	0.6	1.1	1.3	-1.0	4.6

Settlements and Earnings

104. **Private sector settlements** have picked up noticeably since August 1988, though they are still less than might be expected given the buoyant labour market and high company profits. They averaged 7½ per cent in May, about a point and a half higher than a year ago. The average settlement figure for the period August 1988 to May 1989 is 7¼ per cent. According to the CBI data bank the main factor underlying growth in **manufacturing settlements** is the cost of living. For the **service sector** it is both the cost of living and the need to recruit and retain labour. Compared to the 1987-88 pay round it is generally true that downward pressures on settlements have weakened, though inability to increase prices is emerging as a possible constraint. But, against the background of continued high company profits, this is unlikely to inhibit settlements over the rest of this round.

105. **Private sector underlying earnings growth** has also picked up significantly in recent months. In April it stood at 9¼ per cent for the private sector and 9 per cent for manufacturing. However, drift in both

the manufacturing and private sector as a whole seems to have peaked around mid-1988 and has since been trending downwards.

106. Given labour market pressures and likely RPI inflation over the next few months, **private sector settlements** over the rest of the current pay round are expected to average closer to 8 per cent. This implies about 7½ per cent for the round as a whole. The 8 per cent rate at the close of the current round will probably set the tone for the opening months of the next pay round. But with the economy slowing down over the year; a likely squeeze on margins; moderation of inflation and an end to falling unemployment downward pressures in settlements can be expected to increase.

107. For the 1989-90 round as a whole settlements may average 7½ per cent again. With overtime also falling, earnings drift is likely to continue edging down and **private sector underlying earnings** growth is likely to moderate to 9 per cent.

TABLE 8.7: PRIVATE SECTOR SETTLEMENTS AND EARNINGS

(Contributions to changes on a year earlier)

	1987Q3	1988Q3	1989Q3	1990Q3	1991Q3
Settlements	5¼	6	8	7	6¼
Drift	2¾	2¾	1¼	1½	1½
Increase in average earnings	8	8¾	9¼	8½	7¾

108. With growing pressures for higher pay in both central and local government the forecast is for earnings in these sectors to grow by one per cent more than the private sector average in the next two pay rounds. This produces only a modest rise in the ratio of general government to private sector earnings from the current very low level.

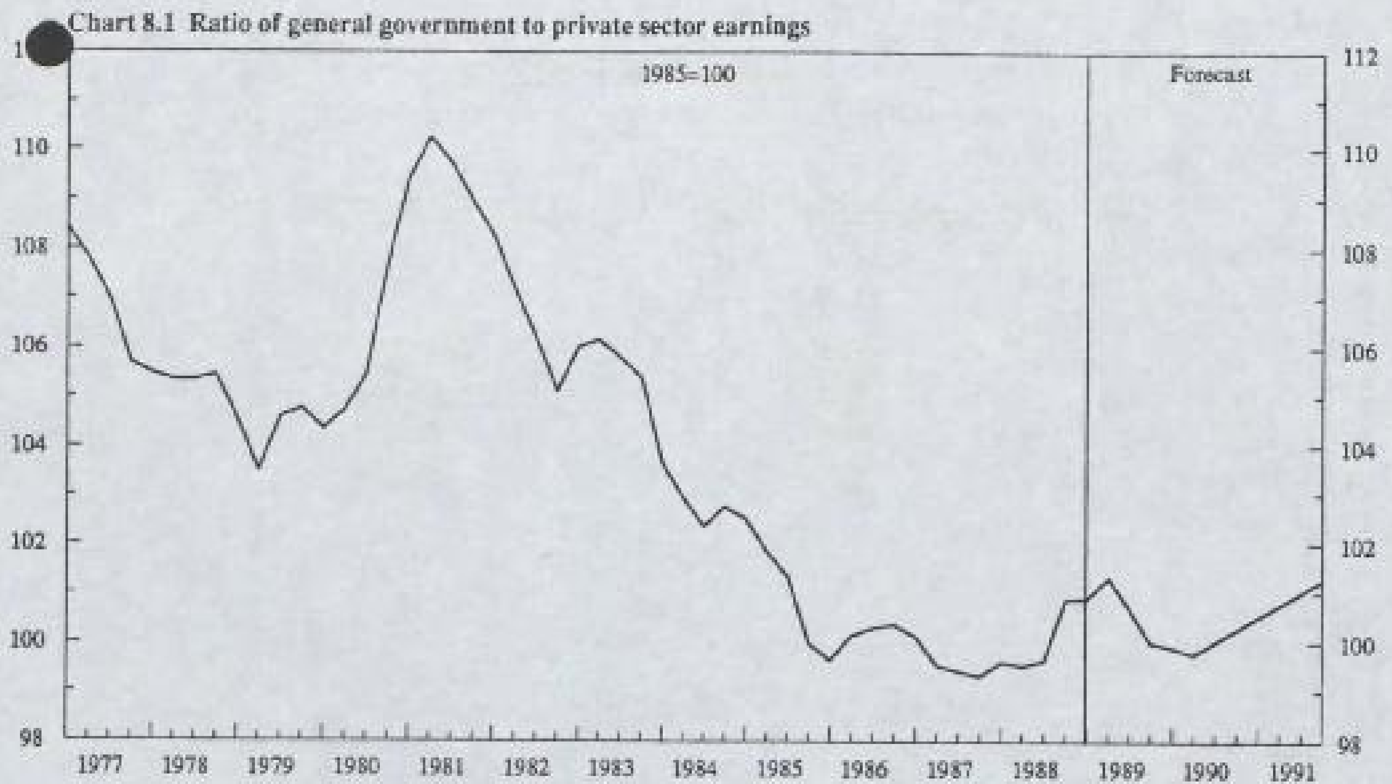


TABLE 8.8: PUBLIC AND PRIVATE SECTOR UNDERLYING AVERAGE EARNINGS

(Percentage changes over a year earlier)

	Central Government	Local authorities	Private sector
1987-88	7.8	7.7	8.2
1988-89	11.1	9.6	8.8
1989-90	8.7	8.3	9.6
1990-91	8.8	9.2	8.4
1991-92	8.7	8.7	7.6

Labour costs

109. Manufacturing unit labour cost growth picked up to over 2 per cent in 1988. With continued pressure on earnings and an expectation that the slow-down in output growth will reduce productivity gains, unit labour costs are forecast to rise faster in 1989. A similar pattern occurs in the economy as a whole, where labour costs are increasing at a higher rate because of lower measured productivity improvements.

TABLE 8.9: LABOUR COSTS

(Percentage increases on previous year)

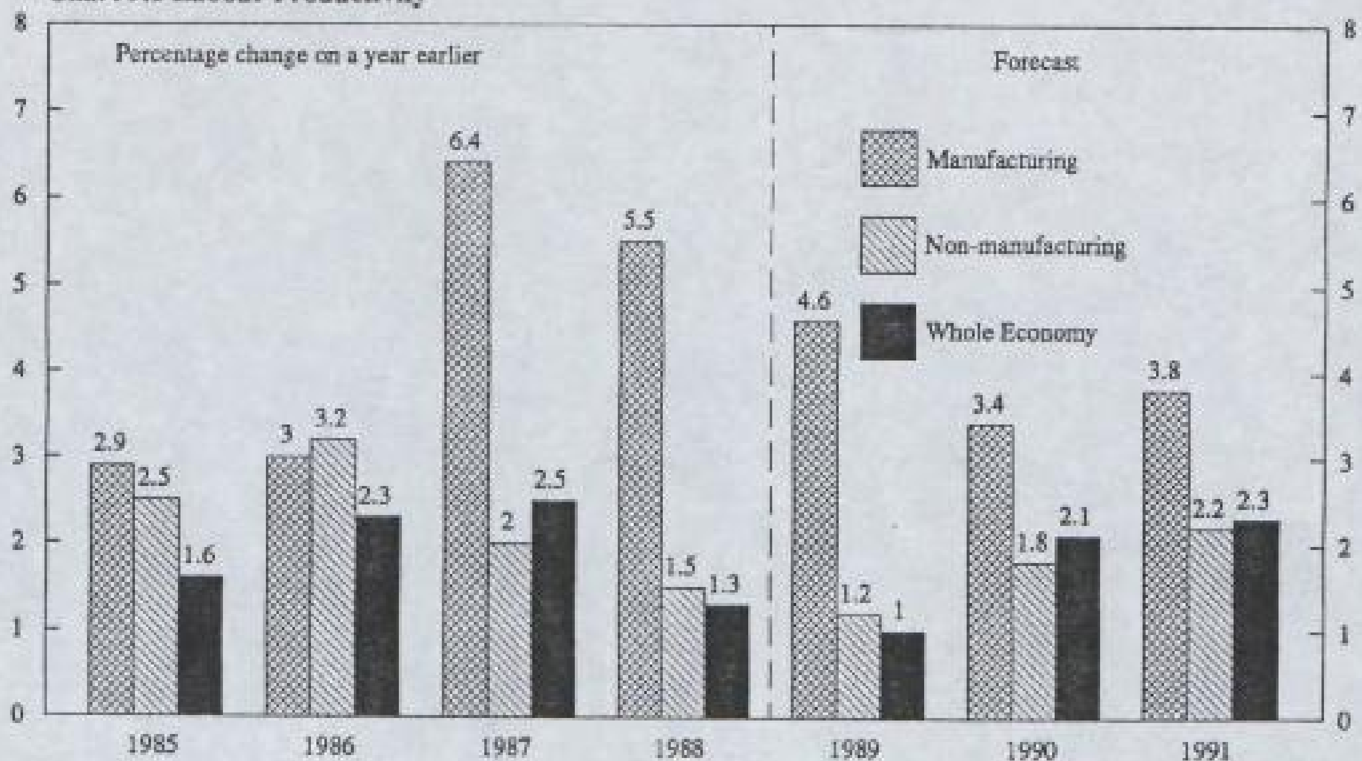
	Manufacturing	Whole Economy
1986	3.9	5.5
1987	1.0	4.4
1988	2.2	7.4
1989	4.1	8.4
1990	4.3	6.5
1991	3.2	5.5

(9) LABOUR MARKET

110. The large upward revisions to employment statistics published just before the Budget lowered estimates of productivity growth in the year to March 1988, by about 2 per cent and 1.5 per cent in the manufacturing and non-manufacturing sector respectively. Nonetheless, recent productivity growth in the non-oil economy has remained strong, particularly in the manufacturing sector. Productivity growth is likely to slow down sharply in 1989 as output growth itself moderates. However, employers are expected to maintain pressure for better productivity performance. They are assumed to shed labour in manufacturing and curtail recruitment in the non-manufacturing sectors more quickly, relative to output, than in previous slowdowns in the 1960s and 1970s.

111. Against this background and with output growth moderating, total employment is expected to rise at a much slower rate from now on than over the past two years. The outlook for employees in employment is weaker, but is partly offset by continued growth in self-employment. Manufacturing employment is projected to decline over the next three years, after rising since 1987Q2. Unemployment continues to fall (but at a much slower rate than recently) till end 1989, but starts rising slowly thereafter. The rise would have been faster but for expected slow labour supply growth, reflecting demographic effects, in 1988-1992.

Chart 9.1 Labour Productivity



(10) FINANCIAL CONDITIONS

Yield curve and funding

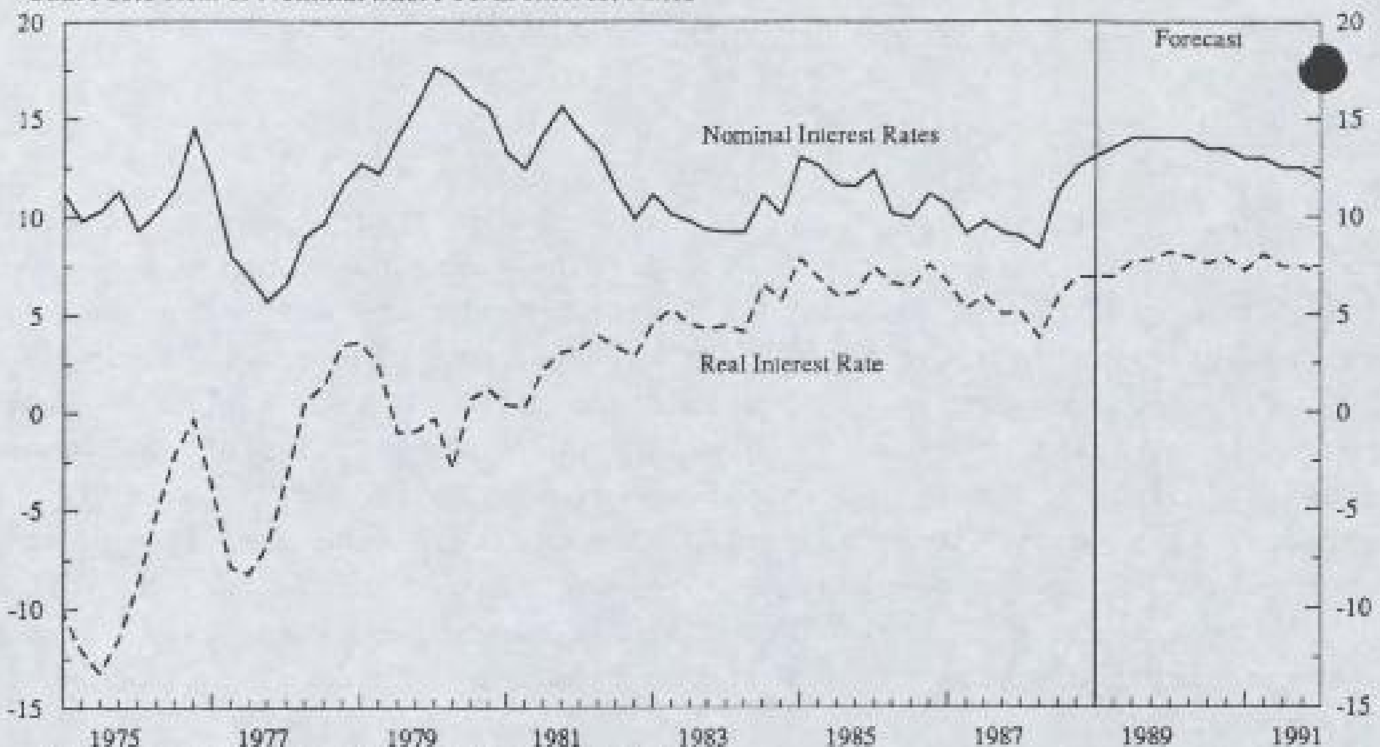
112. Over the past year short term interest rates have nearly doubled, yet long rates have hardly changed. The current, strongly inverted, yield curve is expected to remain a feature of the whole forecast period. The relatively high levels of inflation and money GDP growth during the forecast period require short term interest rates to be maintained well above the inflation rate. Over the period 1989Q1-1991Q1 real short rates as defined in Table 10.1 are projected to be around 7½ per cent on average. The only previous period of comparable high real short rates was from 1985Q1 to 1987Q1 when they averaged 6½ per cent. On the other hand, real short rates were high - averaging just over 5½ per cent - during the period of very strong growth and rising inflation in 1987 and 1988.

TABLE 10.1 : UK SHORT AND LONG INTEREST RATES
(per cent)

	3 month interbank (1)	20 year gilts (2)	Yield gap (2)-(1)	Real short rates (3)*
1986	11.0	9.9	-1.1	7.1
1987	9.7	9.5	-0.2	5.8
1988	10.3	9.4	-0.9	5.4
1989	13.7	9.7	-4.0	7.4
(June 21)	(14.0)	(9.9)	(-4.1)	(7.5)
1990	13.8	9.9	-3.9	7.9
1991	12.8	9.4	-3.4	7.5

* 3 month interbank rate deflated by RPI inflation excluding mortgage interest payments.

Chart 10.1 Real & Nominal Short Term Interest Rates



Note: The real interest rate is the 3 month interbank rate deflated by the RPI inflation rate excluding mortgage interest payments (MIPs). Figures for RPI inflation excluding MIPs are not available before 1975

113. The large reverse yield gap partly reflects the shortage of long gilts, which is forecast to become more pronounced over the next two years. This follows from the current funding rule combined with large predicted PSDRs. The private sector is to a large extent filling this gap left by gilts. Total net issues of fixed rate sterling debt by ICCs and OFIs together amounted to over £7 bn. in 1988, with almost a further £5 bn. in 1989 so far. Both figures exceed the value of equities issued by ICCs over the same period. Other financial institutions (OFIs) are forecast to continue filling the gap in their portfolios resulting from the declining stock of gilts by increasing their holdings of ICCs' debt and overseas assets.

114. A new feature of this forecast is the growth in personal pensions. This will result in increased inflows to LAPFs and, in theory, should marginally raise equity prices as a result of the transfer from unfunded to funded pension schemes.

PSBR and funding

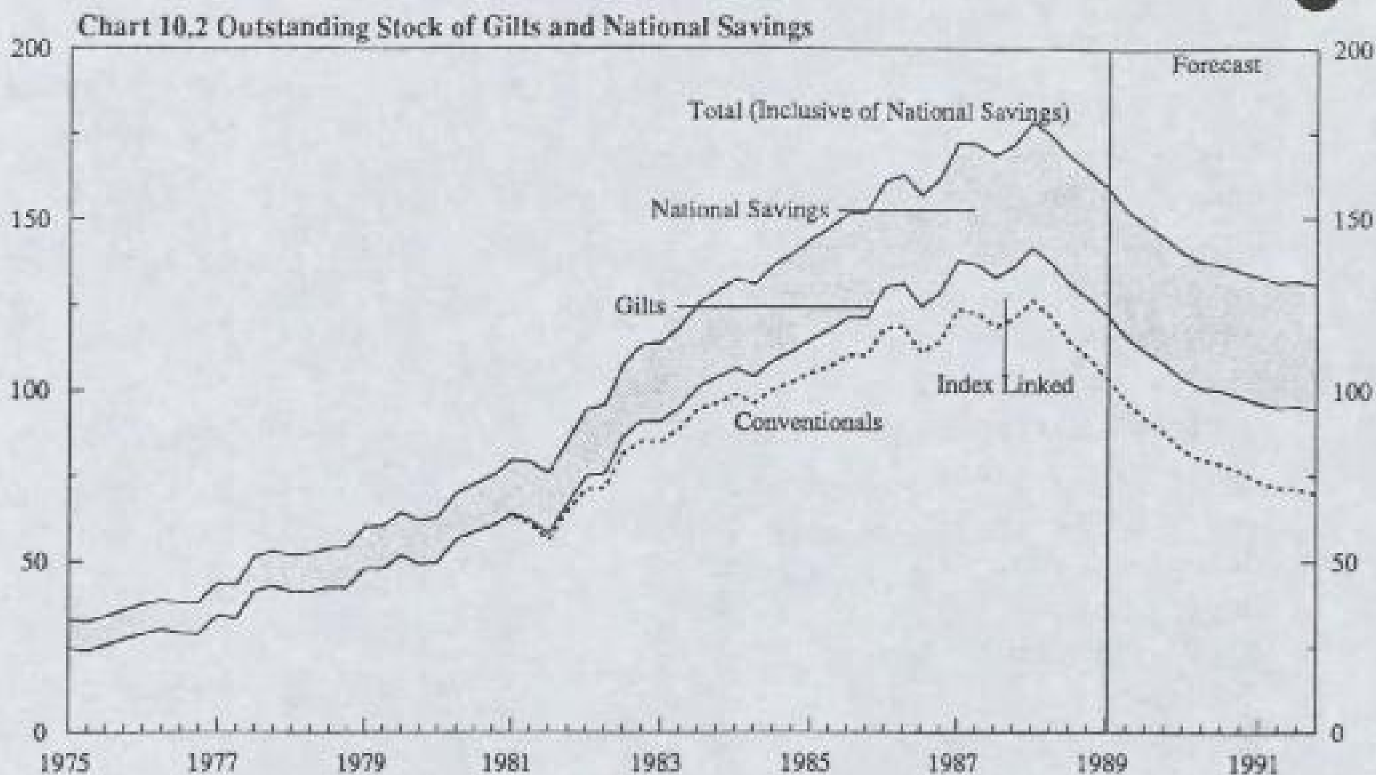
115. Table 10.2 shows the financing of the PSBR. National Savings are expected to make a negative contribution of £½ bn. per year to funding as sales fall short of redemptions.

TABLE 10.2 : PSBR AND FUNDING
(£ bn)

	1988-89	1989-90	1990-91	1991-92
1. PSBR	-14.4	-12.1	-9.3	-6.2
2. Change in Reserves	1.6	-1.2	0	0
3. Redemptions(a)	8.5	9.8	6.2	7.3
4. Total to be financed (= columns 1+2+3)	-4.3	-3.5	-3.1	1.1
5. National savings	0.6	-0.5	-0.5	-0.5
6. Other debt sales to nbnbsps(b)	-0.8	-0.3	-0.1	0
7. Other external	-0.8	0.8	0.2	0.2
8. Overfunding	2.5	-2.2	0	0
9. Debt sales to bbs(c)	-2.6	-1.2	-1.2	-1.2
10.Buying in of gilts (= columns 4-5-6-7+8+9)	3.4	6.9	3.9	-0.2
11.Reduction in outstanding stock of gilts (= columns 3+10)	11.9	16.7	10.1	7.1

(a) redemptions of market-held gilts;
(b) non-bank non-building society private sector
(c) banks and building societies

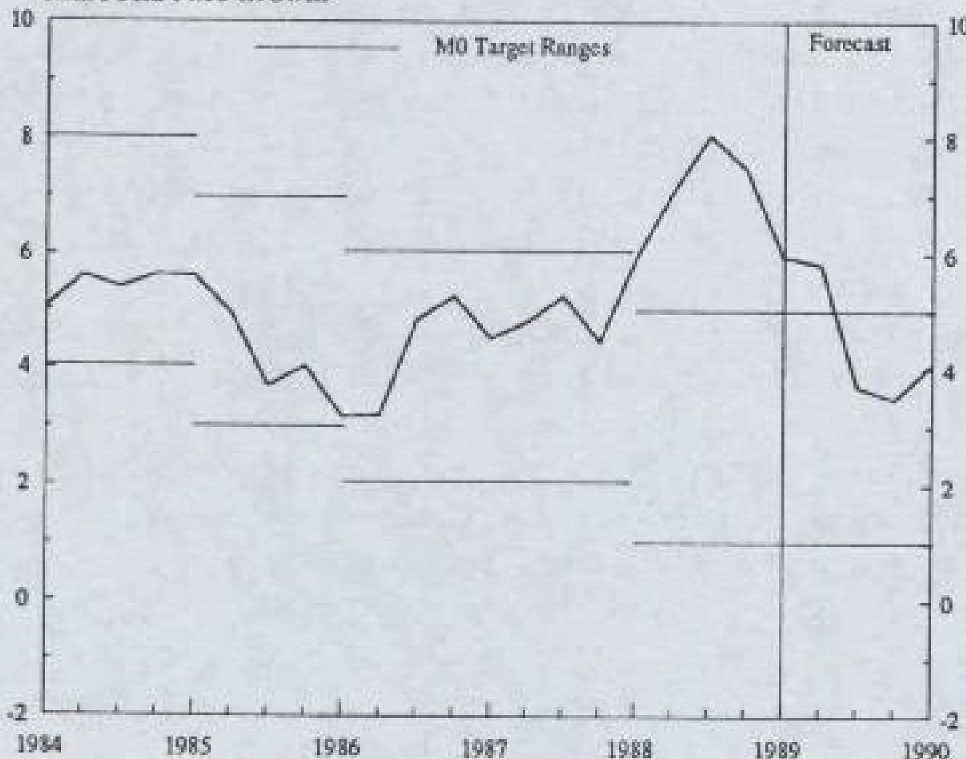
116. The £2.2 bn. forecast underfund in 1989-90 is required to offset the £2.5 bn. overfund in 1988-89, and the cumulated underfund of £0.3 bn. in the period up to the end of 1987-88. Another large PSDR in 1989-90 suggests that the stock of outstanding gilts may fall by around £17 bn., compared to £12 bn. in 1988-89. This increase partly reflects changes in the assumed level of intervention, which has added over £1 bn. to the required level of buying in so far this year, having reduced buying in by about £1½ bn. last year. It is assumed that net intervention will be zero from now on.



117. The outstanding stock of money market assistance had fallen to £3 bn. by the end of May and it is forecast to continue shrinking over the rest of this year, partly reflecting rising levels of bank deposits by local authorities and public corporations and further sales of gilts by the banks and building societies. These factors are expected to increase banks' liquidity in 1989-90 by around £1 bn. and £1¼ bn. respectively. Banks' liquidity also rises as local authorities are expected to repay market debt to the banks, financed by about £3 bn. extra borrowing from the PWLB this financial year. Overall money market influences are forecast to add to banks' liquidity by around £8 bn. this year. One way of maintaining control over short-term interest rates in these circumstances is to expand the issue of Treasury bills. It is assumed that this policy will be followed and hence the outstanding stock of Treasury bills is forecast to rise by about £5½ bn. during 1989-90 and by a further £3½ bn. next year. The stock of assistance is assumed to be run down to a little under £2 bn. at the end of this financial year.

Monetary aggregates and credit

118. MO growth has slowed rapidly since the end of 1988 and is forecast to return within its target range before the end of this year, and to remain at around 3½ per cent over the rest of 1989. The erratically low figure for MO in the first quarter of 1989 may result in MO growth rising temporarily to around 4 per cent at the end of the financial year, but it is then expected to fall immediately to well under the upper band of the 1990-91 target, currently set at 4 per cent. For the current financial year as a whole, MO growth is forecast to be around 4½ per cent, compared to 7 per cent last year. The slowdown to date seems to have reflected mostly the lower growth of consumers' expenditure, but the hike in interest rates since last summer has increased the opportunity cost of holding cash, and this should further slow MO growth through the current financial year. Next year, MO growth is forecast to fall further, to around 3 per cent, as growth of consumers' expenditure continues to be weak. The lower target band next year of 0-4 per cent means that MO growth is still expected to be in the top half of its range.



12 month growth rates in 1988/89

1988	Apr	6.1
	May	6.4
	June	7.3
	July	6.9
	Aug	7.6
	Sept	8.5*
	Oct	7.7
	Nov	7.7
	Dec	7.7
1989	Jan	7.2
	Feb	6.6
	Mar	6.2
	(May)	(6.2)

* affected by Postal Strike

119. The growth of liquidity and credit is likewise expected to fall back over the forecast period. The former largely reflects a growing squeeze on the financial position of the personal sector, while the

slower growth of credit is the result of the high level of real lending rates to persons and ICCs and the much slower turnover in the housing market. M4 growth is forecast to fall from 18 per cent at the end of 1988-89 to 15 per cent at the end of this financial year while the growth of bank and building society lending to the private sector falls from 24 per cent to 18½ per cent over the same period.

Sectoral balances

120. The stagnation of the housing market, together with high real rates of interest on borrowed funds, results in slower growth of personal sector borrowing and lower levels of mortgage equity withdrawal. But the personal sector gross debt-income ratio continues to rise strongly as individuals run down their net financial wealth to maintain desired consumption levels. While the level of real short rates encourages a switch into liquid assets by net savers, the net debtors within the personal sector may resort to running down their holdings of liquidity to finance consumption, so that overall the personal sector's net liquidity ratio continues to decline over the forecast period.

121. ICCs are forecast to move further into financial deficit in 1989, as investment is expected to remain strong, which gives rise to another large net borrowing requirement this year. Despite their financial deficit, companies are expected to continue building up their gross liquidity. This combination of increased holdings of assets and liabilities in part reflects the observed narrowing of spreads between borrowing and deposit rates during the 1980s. However, companies' net liquidity is forecast to decline with their persistent financial deficits. The reverse yield gap makes debt finance relatively attractive to companies compared to bank borrowing, and the growth of bank lending to ICCs is forecast to slow down sharply compared to the very high levels of 1988. Equity issues are expected to recover compared to last year, but not to reach pre-crash levels.

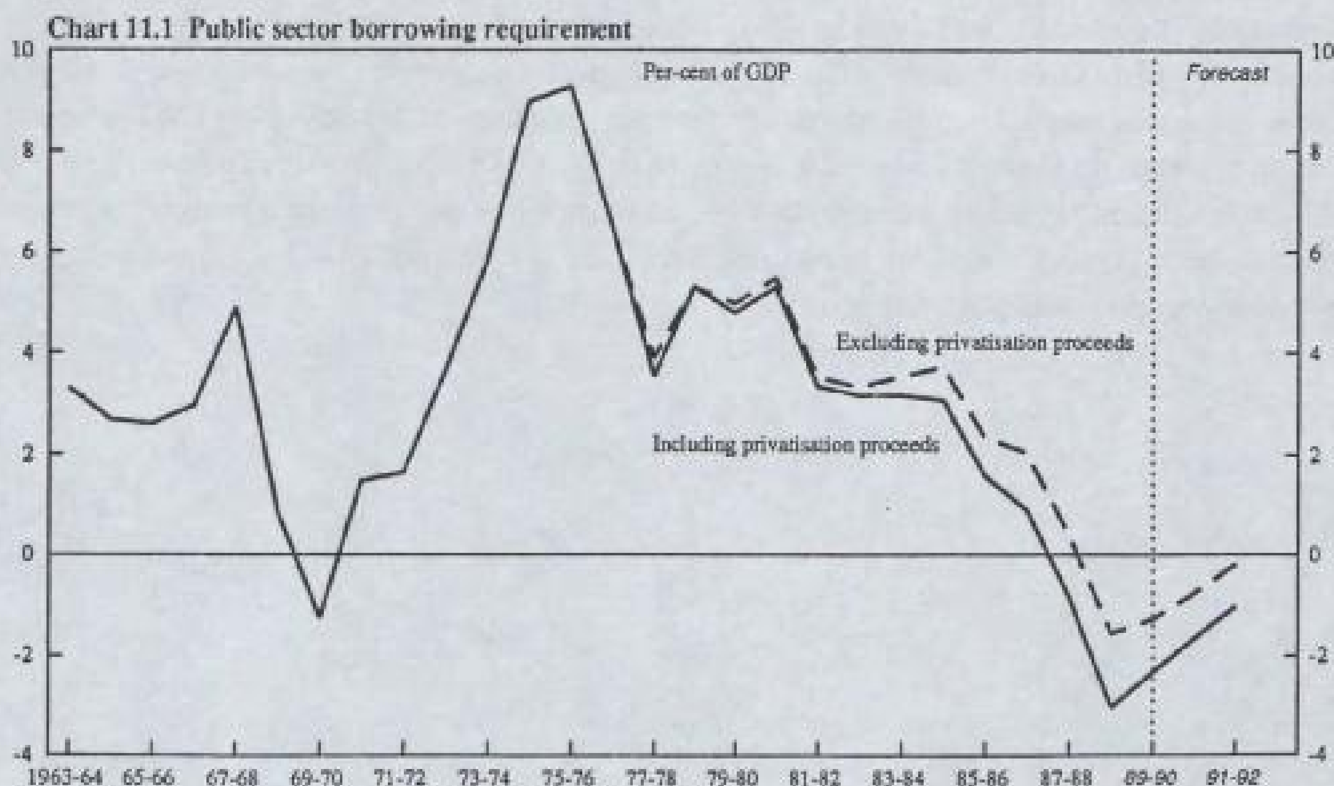
(11) PUBLIC FINANCES

122. The outturn for 1988-89 was a PSDR of £14.4 bn., 3 per cent of GDP. The forecast is for a PSDR of £12 bn. in 1989-90 over £1½ bn. below the FSBR forecast.

TABLE 11.1 : THE PSDR
(£bn)

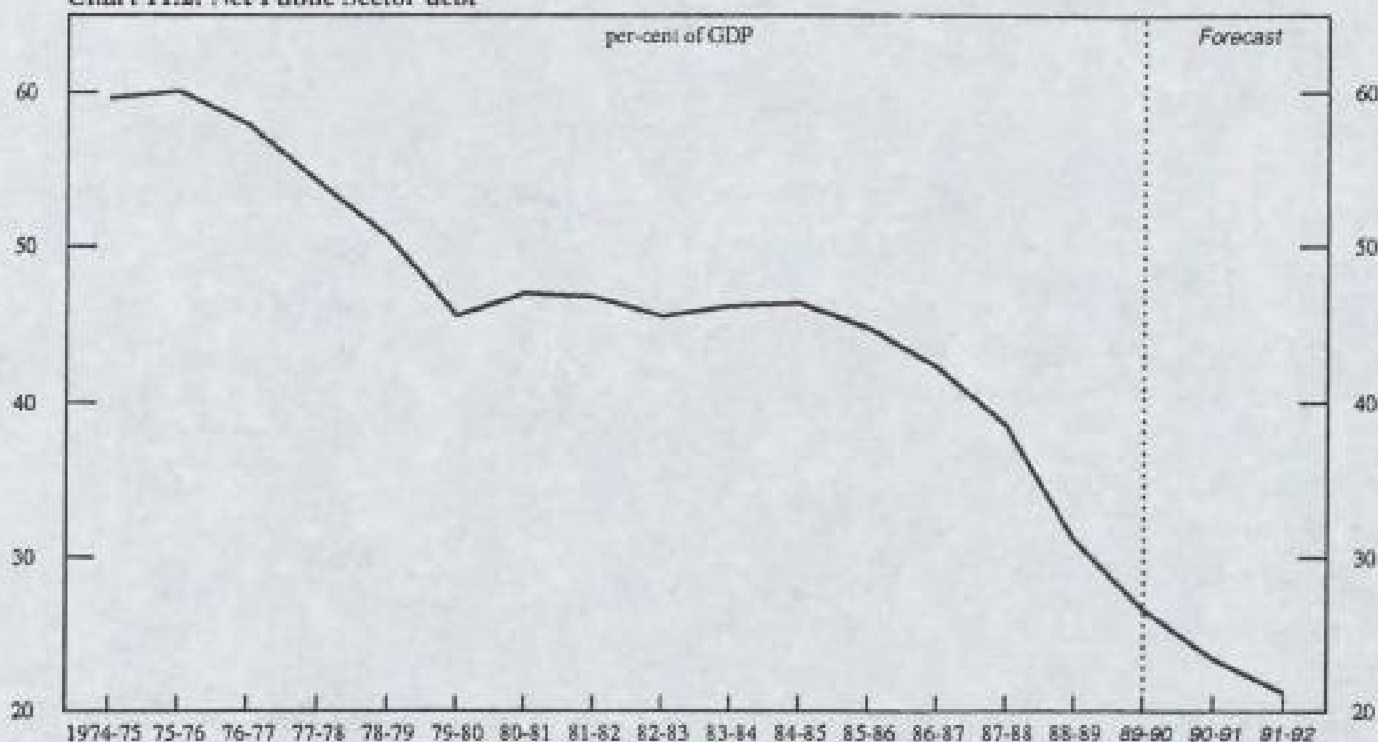
	1988-89	1989-90	1990-91	1991-92
(a) PSDR	14½	12	9½	6
Privatisation proceeds	7	5½	5	5
Other asset sales	6	6	5½	5
PSDR less all asset sales	1½	½	-1	-3½
(b) Components of the PSDR				
CGDR(O)*	13	9(10)	½(7½)	5½
LADR*	-½	1(0)	8½(1½)	1
PCDR	2	2½	½	-½

* Figures in brackets exclude the effect of grants to local authorities for the capitalisation of housing loans.



123. The stock of net public sector debt has fallen from 50 per cent of money GDP at the end of 1978-79 to an estimated 31 per cent of money GDP at end 1988-89. It is forecast to fall further over the forecast period.

Chart 11.2: Net Public Sector debt



124. Table 11.2 summarises the forecast for receipts, expenditure, and the fiscal adjustment. General Government expenditure in 1989-90 is similar to the FSBR. The planning total is £1 bn. lower due to higher privatisation proceeds, lower social security expenditure and an assumption that the Electricity Council will not pay tax in 1989-90 (there is an offsetting reduction in receipts), but debt interest and other adjustments are higher. Receipts are also down, despite faster growth of money GDP, because the take-up of personal pensions has been larger than expected, increasing the level of national insurance rebates and incentive payments. Net national insurance contributions are forecast in 1989-90 to be £1¼ bn. lower in cash terms than in the Budget forecast.

TABLE 11.2: PUBLIC SECTOR EXPENDITURE, REVENUE, AND BORROWING

(£ bn)

	1989-90		1990-91		1991-92	
	FSBR	June Fore-cast	FSBR	June Fore-cast	FSBR	June Fore-cast
General Government Expenditure	194½	194½	205	210	216	226½
General Government receipts	206½	204	214½	219	224½	235
Assumed cuts in taxes (cumulative)	-	-	1	1	3	2
GGDR	12	9½	8½	8½	6	6½
PCs' overseas and market debt repayment	1½	2½	1½	1	0	-½
PSDR	14	12	10	9½	6	6
(per cent of GDP)	(2¾)	(2¼)	(1¾)	(1¾)	(1)	(1)
PSDR excluding priv. proceeds	9	6½	5	4½	1	1
(per cent)	(1¾)	(1¼)	(1)	(¾)	(¼)	(¼)

125. Table 11.3 summarises the main changes since the FSBR to the forecast for 1989-90.

TABLE 11.3: MAIN CHANGES TO THE PSDR FORECAST FOR 1989-90 SINCE THE FSBR

	£ bn
Lower General Government Receipts	
- higher income tax from higher wages and salaries;	0.2
- lower NICs from higher incentive payments and rebates, partly offset by effect of higher wages and salaries	- 1.8
- higher ACT from faster dividend growth	0.4
- lower mainstream corporation tax from revised view of electricity industry's tax liability	- 0.3
- lower road fuel duty reflecting a higher share of unleaded petrol	- 0.2
- lower stamp duty from more depressed housing and equity markets	- 0.2
- lower other receipts, including removal of presentational adjustments	- 0.5
TOTAL RECEIPTS	- 2.3
Little change in General Government Expenditure overall	
- lower programme spending, from lower social security and lower electricity EFR, partly offset by higher local authority expenditure;	- 0.6
- higher privatisation proceeds	- 0.5
- higher interest payments largely from removal of FSBR presentational adjustments	0.4
- changes to other adjustments, mainly because a lower EFR increases PCs' debt repayment to market	0.8
TOTAL GGE	0.1
Higher public corporations' market debt repayment largely from non-payment of tax by electricity	0.8
TOTAL CHANGE IN PSDR FORECAST	- 1.7

Public Expenditure

126. The forecast for GGE in 1989-90 is the same as the FSBR. But the forecasts for 1990-91 and 1991-92 are well above PEWP/FSBR levels. This partly reflects higher inflation and partly the pressure for some catch up in real spending. In real terms however the forecast level for GGE is somewhat lower than earlier internal forecasts.

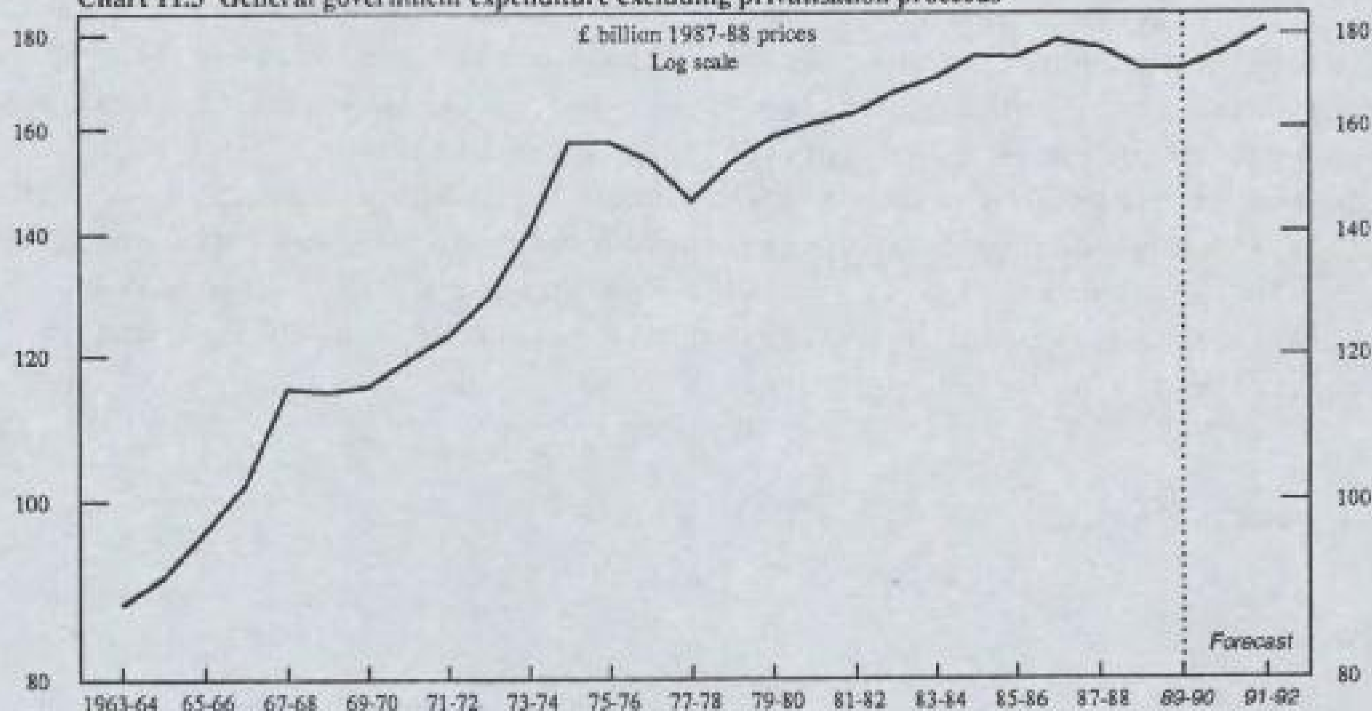
TABLE 11.4: PAST AND CURRENT FORECASTS OF GGE EXCLUDING PRIVATISATION PROCEEDS (£ bn.)

Forecast	1988-89		1989-90		1990-91		1991-92	
	Current Prices	Real Terms*	Current Prices	Real Terms*	Current Prices	Real Terms*	Current Prices	Real Terms*
PEWP 1986	179	174	-	-				
June 1986	186	177	-	-				
PEWP 1987	185	178	193	181				
June 1987	190	181	203	183				
PEWP 1988	188	180	198	183				
Jan 1988	188	180	200	182				
FSBR 1988	188	180	198	182	207	184		
June 1988	187	177	200	179	210	182		
Oct 1988	187	175	199	176	211	178		
Jan 1989	186	174	198	175	211	179		
PEWP 1989	187	176	199	178	210	182	221	186
June 1989	187	172	200	172	215	176	232	181

* 1987-88 prices, adjusted to remove the effect on the measured GDP deflator of the introduction of the community charge ie. figures here adopt same approach as FSBR, treating CC as if it were rates.

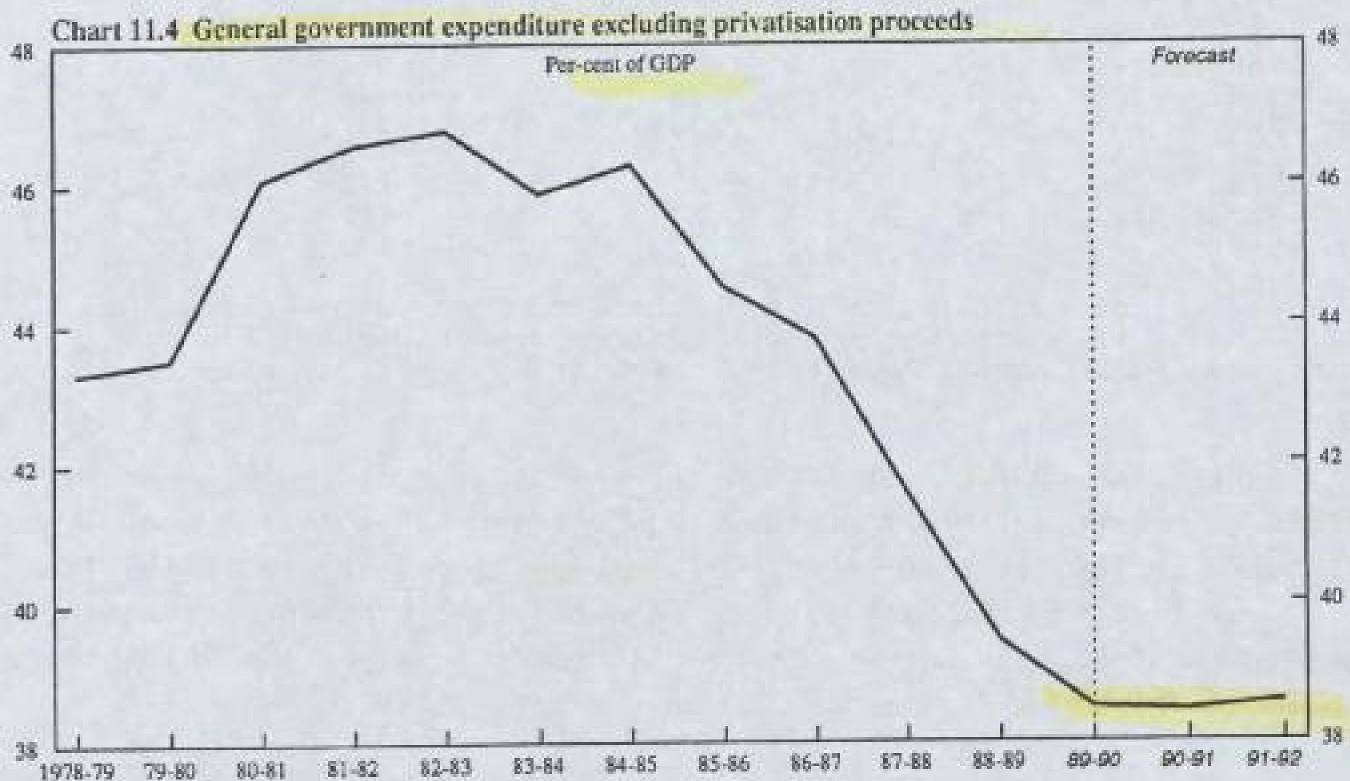
127. Public expenditure has fallen in real terms over recent years. GGE excluding privatisation proceeds is forecast to be 3½ per cent lower in real terms in 1989-90 than in 1986-87. It is forecast to rise in real terms in 1990-91 and 1991-92 by an average 2½ per cent (excluding debt interest the forecast increase is over 3½ per cent a year). This is more than in the PEWP but from a much lower starting point.

Chart 11.3 General government expenditure excluding privatisation proceeds



128. The projected fall in 1989-90 in the ratio of GGE excluding privatisation proceeds is larger than in the FSBR because money GDP is higher. The figures for measured money GDP will be reduced by about [illegible] per cent in 1990-91 by the introduction of the community charge. Other things being equal this would increase the GGE ratio by ¼ percentage point. Adjusting for this distortion the ratio is forecast to show no further falls in 1990-91 and 1991-92.

Chart 11.4 General government expenditure excluding privatisation proceeds



129. The forecast calculates both the old and new planning totals from individual components of expenditure. The forecast for 1989-90 is that the old planning total outturn will be £1 bn. below the level in the 1989 PEWP, partly due to an extra £½ bn. privatisation proceeds but also due to a projected further shortfall on social security. The forecasts for 1990-91 and 1991-92 however are for levels considerably in excess of the PEWP. Much of the excess is on central government's own expenditure and nationalised industries. Not surprisingly therefore a similar pattern is forecast for the new planning total.

TABLE 11.5: FORECASTS OF THE PLANNING TOTAL

£ bn.

	1989-90	1990-91	1991-92
Old Planning Total			
1989 PEWP	167.1	179.4	191.6
Forecast Outturn	166.0	184.4	202.5
Forecast less PEWP	- 1.1	+ 5.0	+ 10.9
New Planning Total			
Survey Baseline*		175.5	187.6
Forecast Outturn		178.5	195.2
Forecast less baseline		+ 3.0	+ 7.6

* including notional Reserves set at £7 bn. and £11 bn. in 1990-91 and 1991-92 respectively in order to keep consistency with published GGE figures

130. The upward pressure on **central government's own expenditure** arises particularly on **pay** and **investment**. The forecast has central government earnings rising 1 per cent a year more than the private sector average from 1990-91. Central government investment is forecast to rise in the three years to 1991-92 by an average of 26 per cent a year in cash terms and 11 per cent a year in volume terms. Such rates of increase are high by past standards. Even so the level of investment forecast for 1990-91 and 1991-92 is well below departments' aspirations. The forecast takes the view that departments will in practice have great difficulty in increasing the volume of investment as rapidly as wished. The capital projects could well be undertaken, but the work will take longer than departmental bids envisage. Nevertheless price increases for such projects could well be above the overall inflation rate. Any slippage on volume is likely to be greater than on cash expenditure.

131. The forecast of **social security expenditure** assumes that "underlying growth" of expenditure in 1989-90 will be less than assumed in the PEWP, following the very low growth in 1988-89. This, together with lower unemployment than assumed by PEWP, produces an underspend of £¾ bn. in 1989-90. Thereafter underlying growth is similar to that assumed in the PEWP. But with higher upratings in 1990-91 and 1991-92, and some policy increases, cash expenditure is above the PEWP.

132. On the assumption that **local authorities' expenditure** is close to their budgets in 1989-90, their current expenditure is expected to have risen in the three years to 1989-90 by an average 1½ per cent a year in real terms. Authorities in England and Wales are likely to take the opportunity of the introduction of the community charge in 1990-91 to raise

their spending by a relatively large amount. The extent to which they do this could be limited by a tough grant settlement. The forecast assumes that grants within AEF/AEG rise by 6½ per cent in cash terms, 1½ per cent in real terms. Expenditure is forecast to rise by 3 per cent in real terms. Taking into account the projected buoyancy of the NNDR and an assumption of little change in LAs' balances, a 17 per cent rise in the community charge (over average domestic rates per head in 1989-90) is forecast. The average level for the community charge in 1990-91 is £319.

133. 1989-90 could be the peak year for **local authority capital receipts**. The new capital control regime due to start in 1990-91 reduces the incentive to sell assets and the depressed state of the housing market could reduce personal sector demand to buy council houses. The forecast assumes therefore that the level of capital receipts falls in cash terms from a peak in 1989-90, but still remains above the level in the 1989 PEWP.

134. The outlook for the **Local Authority Borrowing Requirement** (LABR) is dominated by capital grants from central government for the capitalisation of housing debt. These amount to £1 bn. in 1989-90 and an assumed £7 bn. in 1990-91. The effect of these grants, which do not score in the new planning total, is to reduce the LABR and increase the CGBR(O), with no net effect on the PSDR. (See Table 11.1.) The size of these grants is such that net debt repayments, ie. LADRs, are forecast. But even if these grants are excluded, LAs are forecast to be close to balance in 1989-90 and to make small net repayments in 1990-91 and 1991-92.

135. Much of the pressure for extra public investment in future arises in the **nationalised industry** sector. The forecast assumes that investment by those industries remaining in the public sector throughout the forecast period rises in 1990-91 and 1991-92 by an average 14 per cent a year in cash terms, 10 per cent a year in volume terms. These are higher levels of investment than in existing plans, but well below departmental aspirations. The investment will inevitably lead to higher external finance. Public corporations as a whole are substantial net repayers of debt at present. The prospective rise in investment and the privatisation of the electricity industry which has a negative EFR are likely to mean a return to net borrowing by public corporations. The forecast also allows for substantial increases in investment - 20 per cent a year in volume terms - by the water industry after privatisation.

136. The forecast level of general government interest payments is a little higher - less than £½ bn. - than in the FSBR, but follows a similar falling profile.

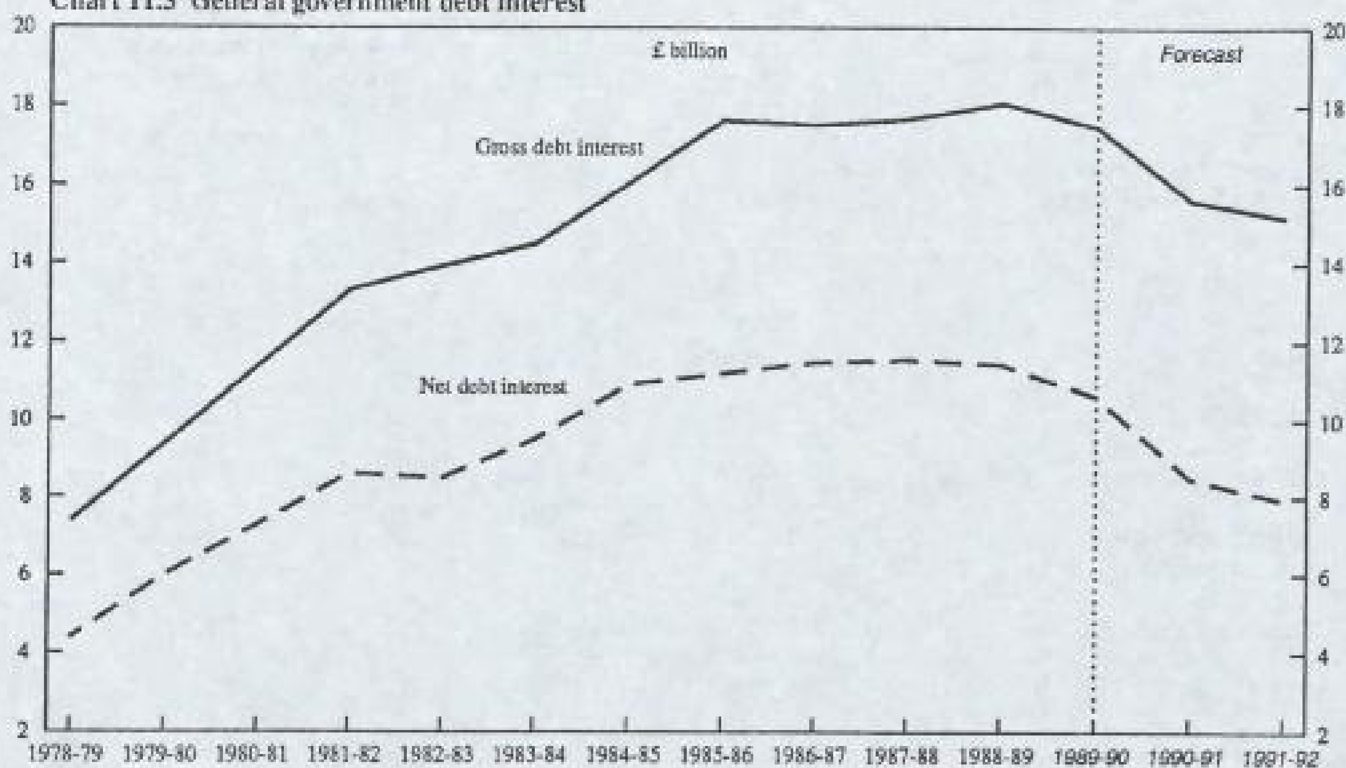


Chart 11.5 General government debt interest
£ billion
Forecast
Gross debt interest
Net debt interest
20
18
16
14
12
10
8
6
4
2
1978-79
1979-80
1980-81
1981-82
1982-83
1983-84
1984-85
1985-86
1986-87
1987-88
1988-89
1989-90
1990-91
1991-92

TABLE 11.6: FORECAST ADDITIONS TO EXPENDITURE PLANS*

£ bn.

	1990-91		1991-92	
	Survey Base-line	Forecast Claims on Reserve	Survey Base-line	Forecast Claims on Reserve
Allocated to programmes				
1. Social Security	49.9	0.7	53.0	2.1
2. CG pay	31.7	2.1	33.1	3.7
3. Other CG current	29.6	1.4	30.8	2.6
4. Net EC	2.0	0.5	1.6	0.6
5. CG investment	5.4	0.7	5.3	2.1
6. Other CG own expenditure	15.0	1.3	15.4	2.2
7. Grants to LAs	24.5	0.8	25.2	2.2
8. NNDR	11.5	0.9	11.8	1.5
9. LA credit approvals	3.4	0.7	3.5	0.8
10. Public corporations	0.5	1.1	2.0	0.8
11. Total programmes	173.5	10.1	181.6	18.6
12. Privatisation proceeds	-5.0	0.0	-5.0	0.0
13. Expenditure met from notional Reserve				
(i) allocated to programme baseline	0.0	7.1	0.0	10.9
(ii) unallocated	7.1	0.0	10.9	0.0
14. Underspend (-) Required Addition to Reserve (+)	0.0	3.0	0.0	7.6
15. LA self-financed expenditure, debt interest etc.	29.4	1.8	28.3	3.3
16. GGE	205.0	4.8	215.8	10.9

* On a new planning total basis

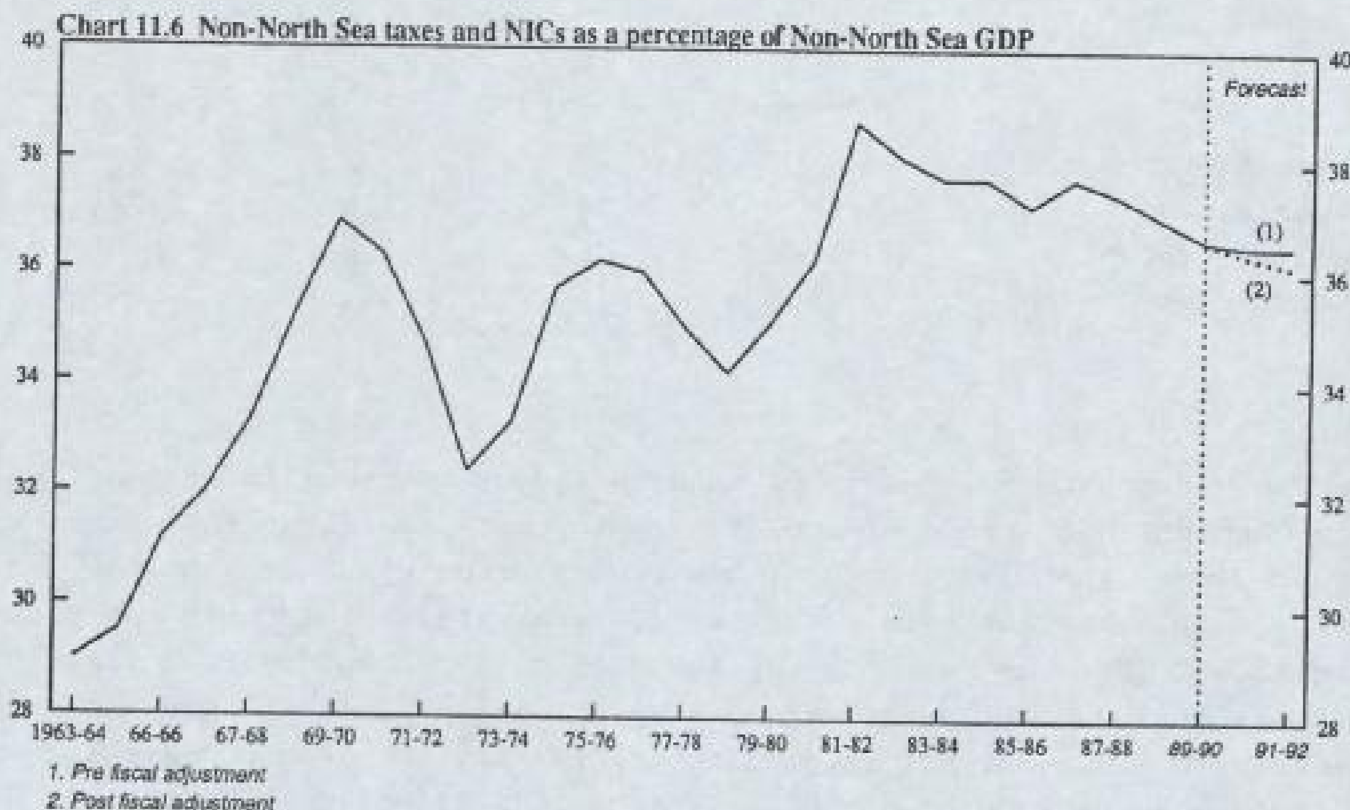
(c) Receipts

137. Latest data suggests that the non-oil tax burden may have fallen by ¼ to ½ per cent in 1988-89, a little more than estimated in the FSBR. A similar fall is forecast for 1989-90 compared with no change in the FSBR. This downward revision is mainly due to faster money GDP growth, but also reflects the assumption that the Electricity Council will not pay tax in 1989-90. The non-oil tax burden is forecast to fall slightly in 1990-91 before fiscal adjustment mainly because of the lagged effects of the 1988 and 1989 Budgets (independent taxation and NICs reform respectively).

TABLE 11.7 : NON-OIL TAXES AND NICs AS A PERCENTAGE OF NON-OIL GDP*

	1986-87	1987-88	1988-89	1989-90	1990-91	1991-92
FSBR						
(a) pre-fiscal adjustment					36.9	36.7
(b) post-fiscal adjustment	37.7	37.7	37.4	37.4	36.7	36.1
June Forecast						
(a) pre-fiscal adjustment					36.5	36.5
(b) post-fiscal adjustment	37.7	37.4	37.0	36.6	36.3	36.2

* adjusted to remove effect of community charge - see footnote to table 11.4



138. The main features of the outlook for taxes are:-

- the sharp deceleration in the growth of corporation tax in 1990-91, a feature of both the Budget and internal winter forecasts;

- the slow growth of national insurance contributions in both 1989-90 and 1990-91; while this was a feature of the Budget forecast, it is now more pronounced.

139. **Corporation tax** receipts in total are forecast to rise over 20 per cent in 1989-90, the same as the average increase in the four previous years. But they are forecast to rise only 5½ per cent in 1990-91 and 2½ per cent in 1991-92. The main reasons for this are much slower growth of ICC profits, both absolutely and relative to the growth of investment, and the build-up of writing down allowances as a result of the 1984 reforms. The effect is that the average rate of tax paid by ICCs is forecast to fall sharply, probably to levels not experienced since the introduction of the reforms. Financial companies' profits however, helped by high interest rates, are forecast to rise sharply, pushing up their average tax rate. But financial companies' tax bill is small relative to ICCs. For the company sector as a whole therefore the average tax rate is projected to fall.

TABLE 11.8 : EFFECTIVE CORPORATION TAX RATE

	1988-89	1989-90	1990-91	1991-92
Industrial & commercial companies	16	16½	12½	10½
Financial companies	12	15	18½	18½
All companies	15	16	14½	14

140. The forecast for **national insurance contributions** in 1989-90, which takes account of the reforms to employees' contributions that were announced in the 1989 Budget, has been revised up to reflect the faster growth in the wage and salary bill. However this has been completely overshadowed by the effects of the much higher than expected take-up of personal pensions. At Budget time, only ¾ million personal pensions were projected for 1988-89, but in practice by 17 May, the closing date for such pensions to be back-dated to 1987-88, some 3¼ million applications had been received. The resulting cost in cash terms in 1989-90 is estimated to be

more than £2 bn. in excess of the Budget forecast. In later years, the removal of this year's incentives means that growth in the number of new personal pensions is likely to be slower.

ANNEX A: THE COMPOSITION OF RPI INFLATION

This annex examines recorded and forecast RPI inflation in more detail than in the main report. Main features to note are:

- **Mortgage interest payments (MIPs)** underlay much of the pick up in **all-items RPI inflation** over the past year, and contribute significantly (though at a declining rate) to the inflation prospect in 1989 and 1990. Even with a stable mortgage rate this component rises faster than the all-items RPI because of the very strong growth in average mortgage debt over the past three years.

- Apart from MIPs, **housing costs** generally have risen much faster than the RPI itself. **Rates** have risen significantly over the past four years, including the increases from April 1989. There is a particularly large forecast increase in 1990 due both to the high initial level of the **community charge** in April 1990 and to the **"index household effect"** of the community charge. The "index household effect" arises because index households (ie those whose expenditure is covered by the RPI) exclude pensioners and the wealthiest 5 per cent (who normally pay much higher domestic rates than index households). Index households will thus have to pay a greater proportion of the community charge than the proportion they paid of domestic rates. It is worth 3½ per cent on the rates/community charge component of the RPI and up to 0.2 per cent on the all-items RPI.

- **Nationalised industry prices** rose slowly in 1986 and 1987, falling quite markedly in real terms. They picked up sharply in 1988, and are assumed to rise faster than general RPI inflation over the forecast period; very big increases in **water charges** contribute most to this outlook. Increases in water charges will be effective from 1 April each year and the increase will be determined by the annual RPI inflation rate in the previous November <u>plus</u> 6 per cent. This will accentuate the <u>real</u> rise in water charges (ie relative to the RPI)

when general RPI inflation is coming down, as it is in the forecast. For example, the rise in water charges in the year to 1990Q4 is forecast to be 12.7 per cent, while the all-items inflation rate is only 5 per cent. This differential reflects the fact that the 12.7 per cent for water charges is 6 per cent plus the annual inflation rate in November 1989 (inflation in 1989Q4 is projected at 6.7 per cent). (After privatisation water charges will, with a short lag, no longer be part of the nationalised industry component, though they will still be part of the all-items RPI index.)

- **"Retailed" price** inflation (broadly goods and services traded across the counter) also picked up through 1987 and 1988, though much less than housing costs or, in 1988, nationalised industries' prices. **Petrol prices** have been volatile, while there has been a slowly rising trend in **food price inflation. Other retailed price** inflation has also picked up (though fairly slowly), reflecting strongly rising personal consumption. **"Retailed" price** inflation comes down fairly quickly during 1990 (petrol prices are likely to fall in the July 1989 retail price figures), with the projected slow-down in personal demand growth.

- **Housing costs** abate only slowly next year, with strong increases in the community charge largely offsetting lower growth in MIPs. And **nationalised industry prices** continue to rise in real terms, especially water charges. It is mainly the influence of "retailed" prices that accounts for the decline in **the all-items RPI inflation** rate during 1990.

- The one point rise in **underlying RPI inflation** (ie excluding MIPs) between end-1987 and end-1988 was mainly due to nationalised industry prices, local authority rents and rates and other housing costs (insurance, DIY materials etc). The increase through 1989, however, is largely accounted for by "retailed" prices. The fall in underlying inflation through 1990 is primarily due to the deceleration in retailed prices.

Memorandum item - Output prices

- **Producer output prices** also give a good indication of "core" or underlying inflation They picked up in 1987 as oil prices recovered from their low levels in 1986. Output price inflation hovered at 4¾ per cent between 1987Q4 and 1988Q3 (faster than RPI inflation); and picked up to 5 per cent at the end of the year and to 5.4 per cent in the first quarter of 1989. Sustained growth in profit margins contributed notably to these developments.

- But producer output price inflation has slipped back slightly to 5.2 per cent in May. It is likely to go on falling slowly to 4.9 per cent by end-1989 (with a small fall in margins) and to edge down by ½ per cent a year thereafter.

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TABLE A1: **EVOLUTION AND PROSPECTS FOR RPI INFLATION**

(percent changes on year earlier)

	Weight*	1986Q4	1987Q4	1988Q4	1989Q4	1990Q4	1991Q4
RETAIL PRICES							
HOUSING	%						
MIPs	6.0	4.2	6.4	36.4	25.4	14.6	5.5
Rent	3.2	6.1	6.2	8.3	9.5	10.8	9.0
Rates/Community Charge	4.2	13.6	7.7	8.4	9.6	20.8[3]	9.4
Other	3.4	5.1	5.4	9.3	7.8	6.8	6.5
Total[1]	**16.8**	**7.1**	**7.0**	**16.5**	**14.7**	**13.9**	**7.3**
NATIONALISED INDUSTRIES							
Electricity	2.6	0.7	- 0.6	8.6	6.5	7.2	3.8
Water	0.7	8.2	6.9	8.1	13.7	12.7	11.7
Other	1.3	3.3	3.3	5.4	4.8	6.7	6.2
Total[2]	**4.6**	**2.9**	**2.1**	**7.4**	**7.5**	**7.9**	**5.8**
MEMO ITEM:							
Gas	2.2	1.3	- 4.5	6.0	3.5	2.8	3.9
"RETAILED" PRICES							
Food	15.4	3.2	3.4	3.9	4.9	3.7	3.5
Petrol	3.4	-12.6	1.3	- 0.1	6.0	3.8	4.6
Other	57.6	4.0	4.3	4.8	4.9	3.7	3.9
Total	**76.4**	**2.9**	**4.0**	**4.4**	**5.0**	**3.7**	**3.8**
TOTAL RPI INFLATION	**100**	**3.4**	**4.1**	**6.5**	**6.7**	**5.7**	**4.7**
TOTAL RPI INFLATION excl MIPs	**94**	**3.4**	**4.0**	5.1	5.6	5.0	4.7
OUTPUT PRICES							
Producer output prices (excluding food, drink, and tobacco)		3.7	4.8	5.0	4.9	4.3	3.7

1 excluding water
2 excluding gas from 1987Q1, buses from 1989Q1
3 includes 3.5 per cent for 'index household effect', worth about 0.15 per on the all-items RPI.

* Weights at Jan 1989

ANNEX B: NATIONAL AND SECTORAL ACCOUNTS

The inconsistencies in the national and sectoral accounts in recent quarters remain large, though they are smaller than at the time of the Winter forecast, when adjusted accounts were used. Substantial upward revisions to expenditure data, particularly investment, just before the Budget largely eliminated the differences between the GDP measures in 1986 and 1987, and reduced them in 1988. Nevertheless, growth of the expenditure measure in 1988 remained well below the other two measures, and there was no improvement in the discrepancies in the sectoral accounts.

2. The CSO press notice for GDP in the first quarter of 1989 (published June 20) included only small revisions to the expenditure and income measures in 1988, while growth of the output measure was revised up by ¼ per cent to 4½ per cent. GDP(E) is still estimated to have grown by under 2¾ per cent, more than 1½ points less than the other two measures (Table B.1).

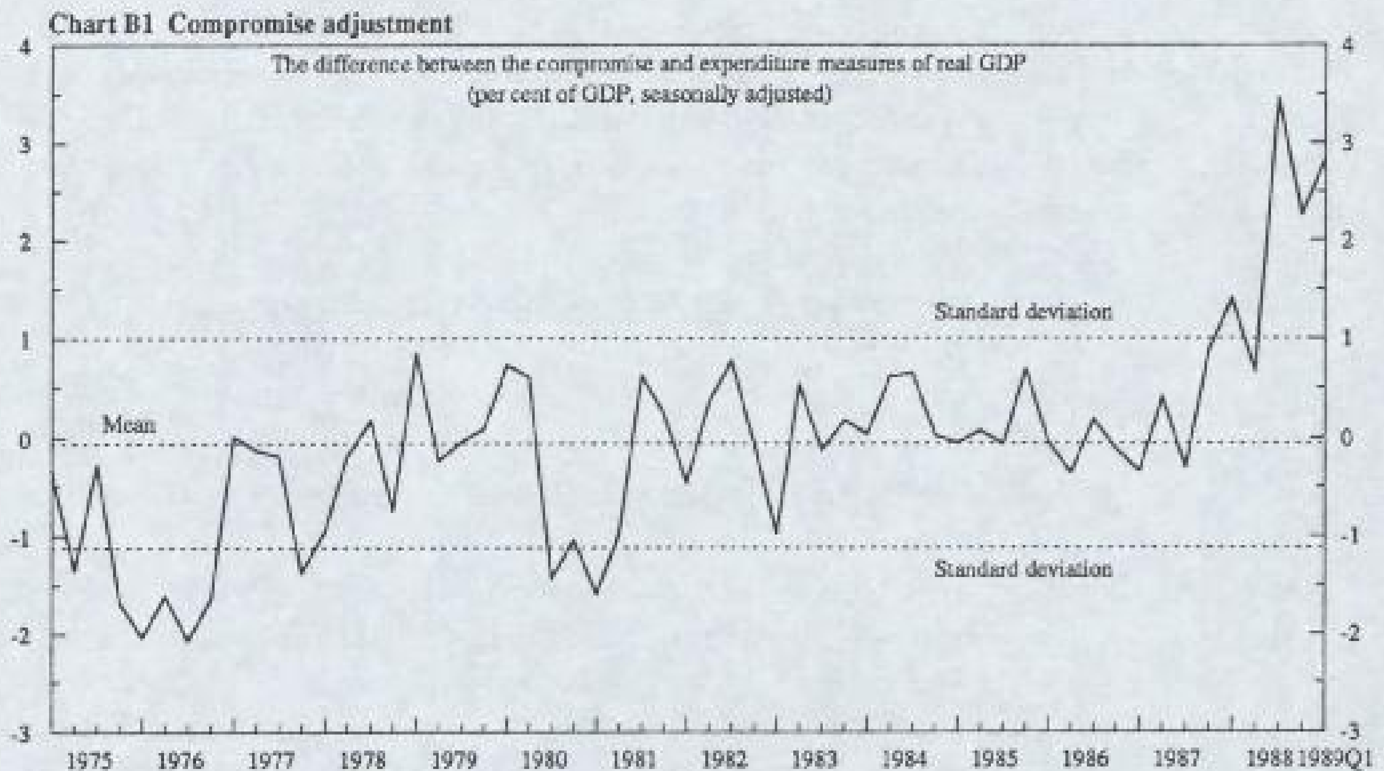
Table B.1: Measures of GDP at constant factor cost

1985 = 100

	Expenditure	Output	Income	CSO (Unweighted) average	HMT compromise measure
1987	107.5	107.8	107.2	107.5	107.5
1988	110.3	112.6	111.7	111.5	112.3
1988 Q1	109.7	111.4	112.1	111.1	111.0
Q2	111.0	111.9	111.2	111.4	111.6
Q3	109.2	113.3	111.9	111.4	112.9
Q4	111.2	113.9	111.8	112.3	113.5
1989 Q1	110.7	114.1	113.2	112.7	113.7
Growth rates (percent changes on a year earlier)					
1987	4.1	4.8	4.2	4.3	4.3
1988	2.6	4.5	4.2	3.7	4.5
1989Q1	1.0	2.4	1.0	1.4	2.4

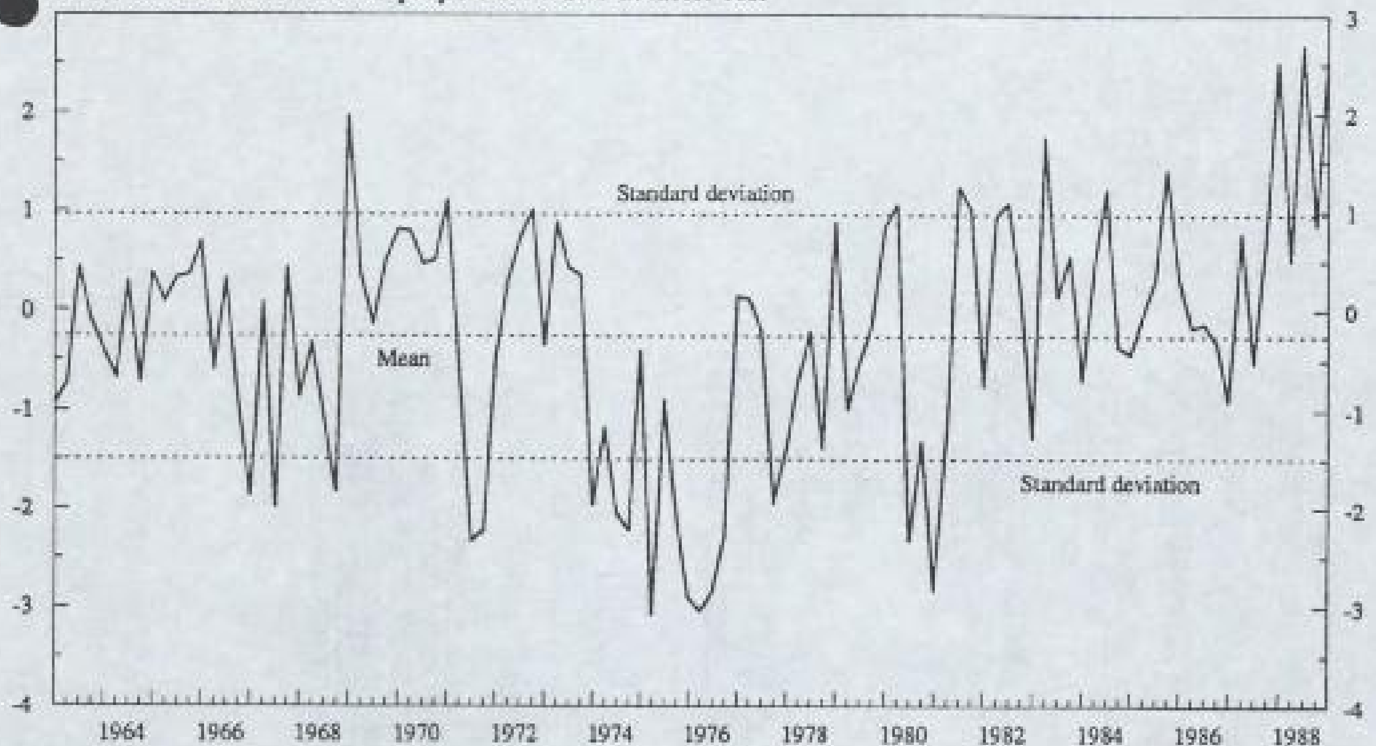
3. The output measure of GDP probably gives the best measure of recent movements and of changes over short periods. This forecast uses a compromise measure of GDP which is the unweighted average of the three measures while they are reasonably consistent - to the end of 1987 - and moves in line with GDP(O) thereafter. This was the procedure used in the FSBR.

4. Between the fourth quarter of 1988 and the first quarter of 1989 the output measure rose slightly. However, the expenditure measure fell ½ per cent while the income measure rose by 1½ per cent. As a result the **compromise adjustment** - the difference between compromise GDP and the expenditure measure of GDP - widened from 2 per cent of GDP in 1988 to 3 per cent in the first quarter of 1989 (Chart B.1).



5. Similarly the **residual error** - the difference between the current price income and expenditure measures - rose from 1½ per cent of GDP in 1988 to 2½ per cent in the first quarter. These are very large discrepancies, though less than the 4 per cent of GDP at the time of the publication of the 1988Q3 GDP figures last December.

Chart B2 Residual error as a proportion of GDP at factor cost

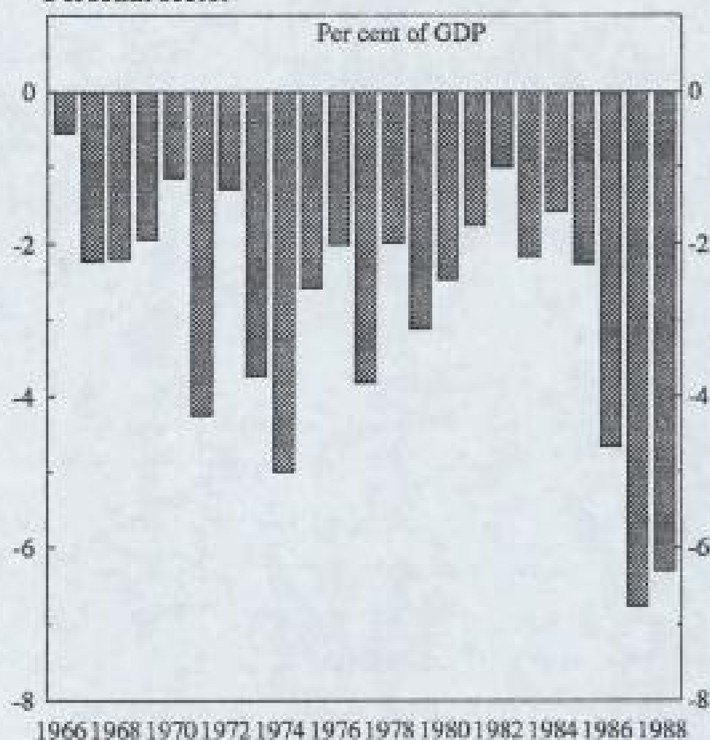


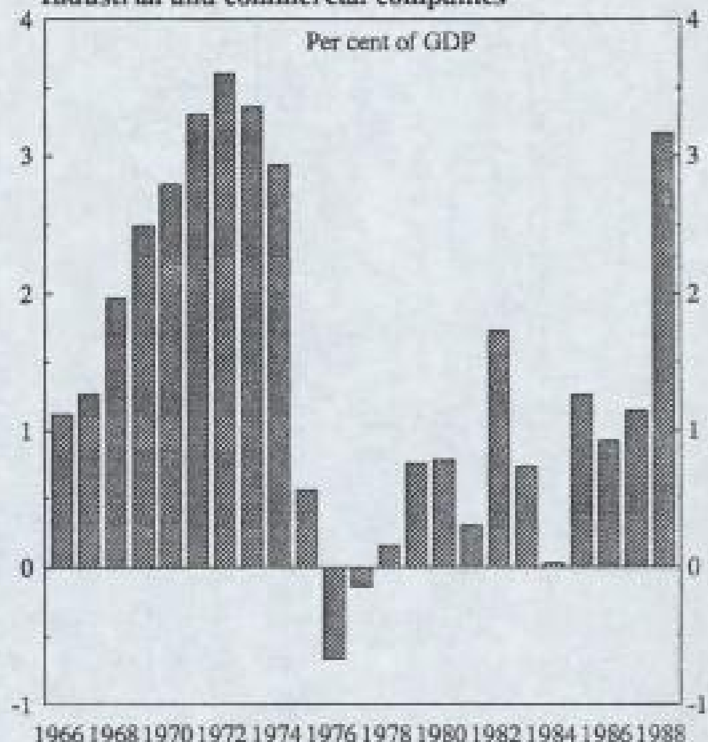
6. At one stage it looked as if the latest estimates of the measures of GDP would be closer than they have turned out. Had we known in time that the discrepancies would be as large as have been published, we would have adjusted the data, as we did in the Winter forecast, by allocating the compromise adjustment and the residual error to components of income and expenditure. The main changes would have been upward adjustments to the expenditure components. The CSO have already made very substantial upward revisions to investment since we last adjusted the accounts. If we had adjusted the data for this forecast we would, therefore, probably have allocated less of the remaining discrepancy to investment and more to other components - stockbuilding, net trade and consumption.

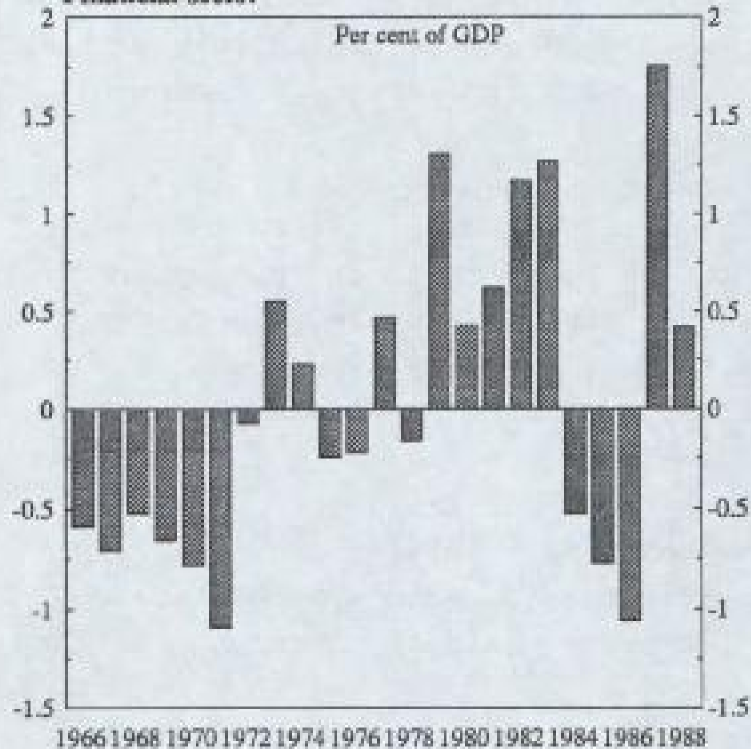
7. On the basis of the compromise measure, growth in 1988 is estimated at 4½ per cent but slows to 2½ per cent in the year to 1989Q1. Accidents in the North Sea have depressed whole economy output recently - non-oil GDP is estimated to have grown by 4 per cent in the year to 1989Q1, and at an annual rate of 3 per cent since the third quarter of 1988.

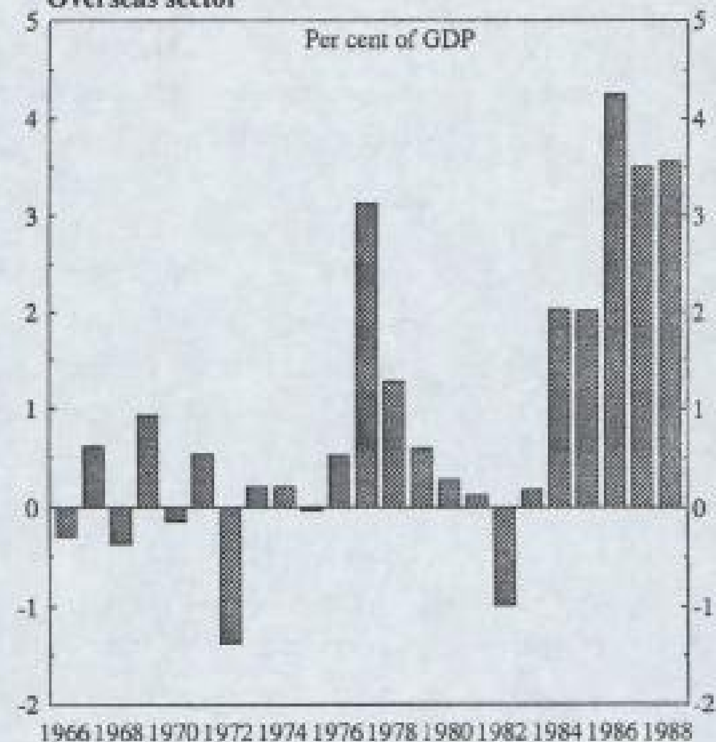
8. Complete sectoral accounts data for 1989Q1 are not yet available; nor have the latest revisions to expenditure, income or financial accounts data for 1988 yet been carried through to the

Chart B3 Sector balancing items









sectoral financial surpluses/deficits or balancing items. However, on the basis of the sectoral data consistent with the national accounts published at Budget time, there is no sign of any improvement in the coherence of the accounts (Chart B.3). The **personal sector** and **overseas balancing items** remained very large in 1988 - 6½ and 3½ per cent of GDP respectively - and the **ICCs balancing** item rose sharply. The latter suggests that, despite substantial upward adjustments to investment made by the CSO (largely on the basis of their supply estimate), company sector expenditure (including stockbuilding) may still be under-recorded. The overseas balancing item is consistent with some under-recording of net current account credits and more substantial under-recording of net inward capital flows to the UK.

MR. GRAY

cc Professor Griffiths

You are trying to set up a meeting with the Chancellor and the Treasury Knights to discuss their paper on the reduction in inflation. When I spoke to Peter Middleton recently he was anxious that this meeting should not only reach agreed conclusions on the past but should attempt to formulate agreed descriptions of policy for the future.

On the history, I suggest the following issues:

(i) Broad money - was it quite such a bad indicator? Could one really afford to ignore it once its growth got over 20 per cent p.a? Is there any inclination in the Treasury to rehabilitate it, even if not to the extent Tim Congdon advocates?

(ii) Narrow money - was it a good indicator? Was the problem that it gave good signals but we failed to act upon them? Or did it behave, as many have feared, only as a concurrent indicator, giving no advance warning of inflationary pressures?

(iii) Intervention - what was the impact of sterilised intervention?

(iv) RPI versus GDP deflator - when the Prime Minister queried the Chancellor's use of the RPI excluding mortgage interest as an indicator of underlying inflation, he argued that the growth of the GDP deflator was closer to the adjusted RPI than the actual RPI. I am sceptical of this but we should be able to find the answer from the Treasury forecast.

(v) The 4 for 1 rule - was this a dangerous formula to adopt? When the exchange rate is showing a tendency to appreciate a 'balancing' cut in interest rates may be deemed to sustain a given monetary pressures overall. But for the personal sector the two things reinforce rather than neutralise each other. The cut in mortgage interest rates boosts the growth in real income from the appreciation of the exchange rate. The same is true in the downward direction though it could be argued that with inflation as high as it is there should be a bias towards restrictiveness.

(vi) Shadowing EMS - the Prime Minister's interpretation of the results of the shadowing initiative assumes that we would have expressed the same output pressures had we been inside the ERM. Is it not more plausible to assume that once an upward realignment had taken place, eg. from a DM 3.00 to DM 3.12, that that would have been the end of the matter as far as the markets are concerned?

For the future, we need to coalesce around the Prime Minister's latest formulation on ERM. This still leaves a great deal of latitude on the timing of entry. We do not want the Chancellor and Foreign Secretary making public statements implying a decision will be taken sooner rather than later and the Prime Minister the opposite.

So long as we are outside the ERM we need to reach an agreed understanding on the priority to be given to exchange rate stability. There is a balance to be struck between hawkish words which may subsequently have to be eaten, and giving sufficient reassurance of firmness to the markets. Is it possible to devise a statement with which both the Chancellor and the Prime Minister feel comfortable.

AT

ANDREW TURNBULL

28 June 1989

SLHBHM

JD3AIC SECRET 19

PRIME MINISTER

MARKETS

I attach today's Evening Report.

Sterling started to come under serious pressure in the second half of the afternoon. That is continuing this evening. The latest intervention figure I have is some $300 million. At one stage sterling had dropped below DM3.03, but it is currently (at 1915) at DM 3.032. Having been around $1.56 for most of the day, it is now only just over $1.54. The current effective rate is probably around 90.

No particuular factor seems to be responsible. But sterling is now looking vulnerable.

The Chancellor has convened an urgent Markets meeting with Treasury and Bank officials first thing tomorrow morning. He will be considering the full range of options, including another move on interest rates. If he decided he wanted to move rates, he would obviously need to have an urgent word with you. I have therefore told his office he should be in a position to come to see you at 0915, before Mr. de Klerk arrives at 0930. Amanda or I will let you know in the morning if he does want to come.

You will obviously want to judge the position as it looks tomorrow morning. Alan is now back in the United States for a period, but I know he would strongly oppose another interest rate move and any mechanical notion that a weakening of monetary conditions via the exchange rate requires a tightening through interest rates. On the other hand, you have been concerned hitherto not to let the exchange rate run out of control, with all that could mean in the short term for the RPI.

I don't think another rise in interest rates would help at all. As the Building Society reports reveal a sharp reduction in ~~[illegible]~~ deposits in the last month, the increase in mortgages another 1% could trigger would be the [illegible] [illegible]

PRG

PG

22 June, 1989.

SECRET

SECRET

SRWCAX

→ PA

Prime Minister[2] 18

Your queries below:

(1) Yes.

(2) Chancellor did not know about this before he came to your 1700 meeting.

RRCB 21/6

PRIME MINISTER

TODAY'S MARKET REPORT

I attach today's report.

Before it arrived the Treasury had rung me to warn of the intervention entry. You will see that, bizarrely, we seem to have carried out significant intervention to hold the pound down. This was as much a shock to the Treasury as it will be to you. It was apparently undertaken by the Bank without reference to the Treasury. They rationalised it on the basis that the market conditions were sufficiently strong to carry out the usual funding of BAOR operations on ~~available~~ attractive terms.

That does not seem to me - or the Treasury - in the least convincing. Given the size of our Reserves there is no need at all to go out and buy fresh foreign currency for this purpose. As it happens, having been quite strong this morning, sterling did slip by this afternoon at more or less when the intervention was carried out which makes it all the more unfortunate.

On a lighter note, you will also see that the Spanish have again been quite active - $244 million though not on yesterday's scale.

Lawson

(1) Has the Treasury taken the requisite action with the Bank?

(2) I wonder why this was not mentioned to me by the Chancellor last evening? MT

pp. Diana Smith
Duty Clerk

(PAUL GRAY)
20 June 1989

SECRET

NatWest Capital Markets

P-STAR AS A MONETARY INDICATOR FOR THE UK

- UK inflation has soared and base rates have risen sharply. This has prompted active debate about the proper conduct of monetary policy.
- The mainstream alternatives to the current pragmatism are full EMS membership and a return to overfunding. However, both strategies have been discredited and the authorities claim that neither are on the policy agenda at present.
- This paper proposes a different approach - based on narrow money (M0) and the P-star methodology developed recently by the US Federal Reserve. In fact, the approach finds its roots in classical monetary theory and the Quantity Equation analysis developed by Irving Fisher in the 1920s.
- We find that the P-star approach accurately predicts long-run inflationary trends in the UK. The main theme running through our work is the robustness of M0 as a predictive tool.
- Contrary to conventional wisdom, M0 gave a clear warning about the inflation take-off in the mid-'70s. More recently, our P-star approach identified that inflation pressures were brewing as early as 1986.
- On the face of it, the sharp deceleration in M0 in recent months is encouraging. However, our P-star measure is still signalling inflation problems ahead - the monetary excesses of the past have not yet been sufficiently unwound. Moreover, there is evidence that the recent fall in M0 growth has been exaggerated by faulty seasonals. A further tightening of monetary policy may therefore be required.
- The P-star approach is reportedly playing an important role in Fed thinking on the direction of US interest rates. Mr Greenspan, in particular, is backing the Fed's experimental work on the measure. Our analysis shows that the methodology can also be successfully applied to the UK and we conclude that P-star should be given a prominent position in the authorities' analysis of monetary conditions.

Stephen Hannah - Head of Research
Adrian James - Economic Assistant

16th June 1989

A member of the National Westminster Bank Group

Time for a monetary rethink

UK inflation has turned out far worse than expected, severely undermining the authorities' credibility. Policy is widely perceived to be in disarray - pulling the rug from under sterling and forcing the Chancellor to raise base rates. After a pre-election "go" in 1986-87 the economy now faces an almighty "stop". For a government that has prided itself on the absence of "stop-go" policies and a supply-side revolution, the spectacle of a "boombust" economy will be deeply disappointing - it could also prove to be an electoral disaster. Little wonder, therefore, that there has been active discussion about alternative policy approaches.

Mr Lawson's favoured alternative to the current pragmatism is the EMS exchange rate mechanism. However, the experiment with DM targetting in 1987-88 dismally failed and, as the Prime Minister has indicated, was a reason for the inflation surge in 1988-89. Far from being a device to stabilise prices, the experiment with nominal exchange rate targetting actually diverted the Chancellor from worrying domestic monetary signals and so allowed dangerous inflationary pressures to build up. It now seems highly unlikely that the Prime Minister will alter her attitude to ERM membership ahead of the next general election. Indeed, recent events may well have hardened her opposition to exchange rate fixing regimes. On the international stage, too, there is increasing disillusion with the concept of fixing nominal exchange rates (see the latest BIS annual report). Arguably the ERM itself might enter an unfashionable phase - particularly when exchange controls are lifted next year and volatile pressures build up.

One alternative to fixed exchange rates - and the subject of heated debate recently - is a return to overfunding and broad money targetting. However, the effectiveness of overfunding in controlling broad money growth is questionable. The money market shortages created by "excess" gilt supply in the pre-1985 regime generated substantial central bank demand for bills, which in turn created hard arbitrage opportunities (ie round-tripping). The broad money benefits of overfunding were therefore offset (to an unknown extent) by arbitrage-related bank lending. By the mid-1980s overfunding became a discredited policy and we doubt there is much appetite for its re-introduction. Mr Lawson has already flatly denied plans for a change in the funding rule. Moreover, the return to old (and failed) remedies would undermine the "political economy" of monetary policy.

At a more technical level, broad money targetting remains hampered by the uncertainty surrounding velocity trends and the possibly perverse response to changes in interest rates (a tightening of monetary policy increasing the asset demand for interest-bearing balances). Attempts have been made to weight various components of broad money according to their "moneyness" ie giving higher weights to non-interest bearing transactions balances. However, the difficulty here is that the introduction of high interest cheque accounts has undermined the validity of the calculations, making the interpretation of synthetic broad money measures just as problematic as the more familiar, plain vanilla, originals.

In our view, narrow money provides the best anchor for monitoring inflationary conditions and guiding interest rate decisions. As we argued a year ago (UK Financial Bulletin - June 1988) the monetary base has played an impressive role in warning of inflationary pressures ahead. This paper builds on our earlier analysis - with a longer database going back to the early 1960s - and argues that, as a monetary indicator, M0 should command a prime position.

This particular piece of research was inspired by recent work at the Fed which developed an M2 based measure of equilibrium prices known as P-star†. This indicator was developed at the suggestion of the Fed Chairman, Alan Greenspan, and is still experimental. However the measure is thought to have influenced the Fed's recent decision to "desnug" its monetary stance. The first public mention of the P-star indicator came in February, at Mr Greenspan's monetary policy testimony.

The Fed's analysis showed that P-star had a useful role in signalling long-run inflationary pressures but said little or nothing about the direction of inflation in the short-term. As such - and attractive to monetary purists - the authorities could not use the P-star indicator to justify economic fine tuning. Moreover, another important aspect of the P-star work (consistent with its "long-termism") is its emphasis on equilibrium levels rather than growth rates. Thus, relatively slow monetary growth may not be enough to provide reassurance about inflationary trends. If monetary growth has been excessive in the past then it may be that, despite a deceleration, the existing stock is excessive in relation to underlying transactions and could therefore still present an inflation threat.

† *M2 per Unit of Potential GNP as an Anchor for the Price Level, J.J. Hallman, R.D. Porter and D.H. Small, Federal Reserve Board of Governors, April 1989.*

Fisher identity and P-star

There is nothing new about the theory underlying P-star. The idea goes back to Irving Fisher's 1920 analysis of the purchasing power of money. At the centre of this analysis is the famous Quantity Equation

$$MV = PY$$

Where the money stock (M) times velocity (V) equals the value of transactions - real GDP(Y) times its deflator (P).

Indeed this is an identity, rather than an equation, used to define velocity. Nevertheless, on the basis of some simplifying assumptions, the Fisher approach can provide an insight into long-run inflationary forces.

The main assumptions made in modelling P-star are

- Velocity is not necessarily constant (although the Fed work found that this was the case as far as US M2 was concerned) but changes at a steady, predictable rate in line with "habits" and technological change.
- Output has a steady, long-run equilibrium growth path determined by real, non-monetary forces.
- Monetary growth is exogenous and controllable.

P-star is then determined by taking the current money stock and long-run trend values of velocity and output. In other words:

$$P\text{-}star = P^* = M.V^* / Y^*$$

This equation identifies a clear, long-run relation between monetary growth and inflation. The equation is specified in equilibrium terms for P,V, and Y in acknowledgement that short-run inflation is likely to be dominated by dynamics and noise rather than monetary growth.

Out of steady states, the P-star approach argues that inflation will be driven by the deviation between actual and equilibrium prices (product market prices are thus assumed to be sticky). When the equilibrium price is above its actual level (because, say, of an expansionary monetary shock) then inflation accelerates until $P^* = P$. When the equilibrium price is below its actual level then inflation decelerates until equality (equilibrium) is restored.

Economic theory cannot be specific about the speed of adjustment and thus the actual inflation rate. To give the model empirical value, therefore, a speed of adjustment equation has to be added to the P-star model. For example, we might specify that:

$$INF_t^* = \beta\,(p^* - p) + INF_{t-1}$$

Where * denotes an equilibrium/expected value and the lower case p denotes the log of P. The β value represents the speed of adjustment coefficient.

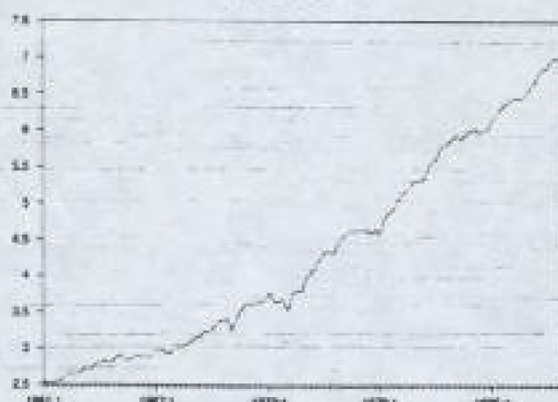
The above equation has the property that when actual inflation is in line with expectations then P converges with P-star. The steady state is also characterised by an inflation rate which equals monetary growth plus trend velocity growth less underlying output growth. If the system is then "shocked", the period of time taken to restore equilibrium will be determined by the lags specified and the relevant speed of adjustment coefficients.

In modelling P-star for the UK we have focussed on the monetary base (M0) as the appropriate money supply measure. Unlike the broad money measures, the velocity trend is relatively stable with its variability explained, to a significant extent, by cyclical variations in interest rates. As our research last summer indicated, the M0 measure has relatively attractive attributes as a monetary indicator: timeliness, a relatively stable velocity trend, a well determined interest rate response, and accurate measurement.

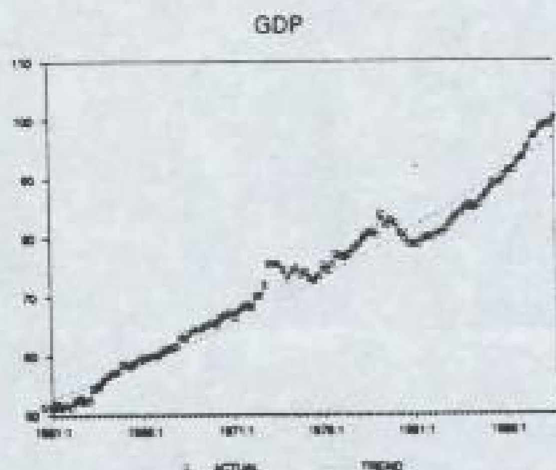
Our data set covers the period 1961-1988 (the final section of this paper covers more recent events) and detailed definitions and sources are provided below. The M0 data were adjusted for major breaks, in particular the 1981 change in the bankers' balances regime.

Our analysis of velocity (see chart) showed that the trend was broadly stable over the period. However, there was evidence of a statistically significant break after 1974 so a split time trend was incorporated into the preferred velocity equation. The estimations showed velocity trend growth of just over 3% in 1961-73 and around 4¼% thereafter. These growth rates were used in the P-star calculations.

M0 VELOCITY



The estimation of underlying output growth is more contentious. However, we have adopted a simple approach, taking the average growth rate seen since 1960 (around 2¼% per annum). Some have argued that Britain's underlying growth rate has increased over the past decade. If so, then our P-star measure for the recent period would be too high and inflationary pressures exaggerated. However, the output data do not suggest an upward break in the growth trend over the past decade (in fact, the reverse) and, as our analysis of UK inflation history shows, the P-star approach (based on a 2¼% trend) tells a perfectly consistent story about the most recent take-off in prices. More detailed analysis, such as a recent National Institute study of productivity using the new employment data (May 1989 Review), also questions whether there has been a sustainable shift in trend growth since the 1950s and 1960s.



On the basis of the assumptions outlined above the level of P-star in relation to P was calculated for the full period 1961-88. The following sections analyse the results and discuss how well the P-star methodology explains the UK's inflation history. Before moving on, it is worth dwelling on what our trend values imply for the relation between equilibrium inflation and M0 growth. Focussing on the post-'74 period, the equilibrium inflation rate is given by

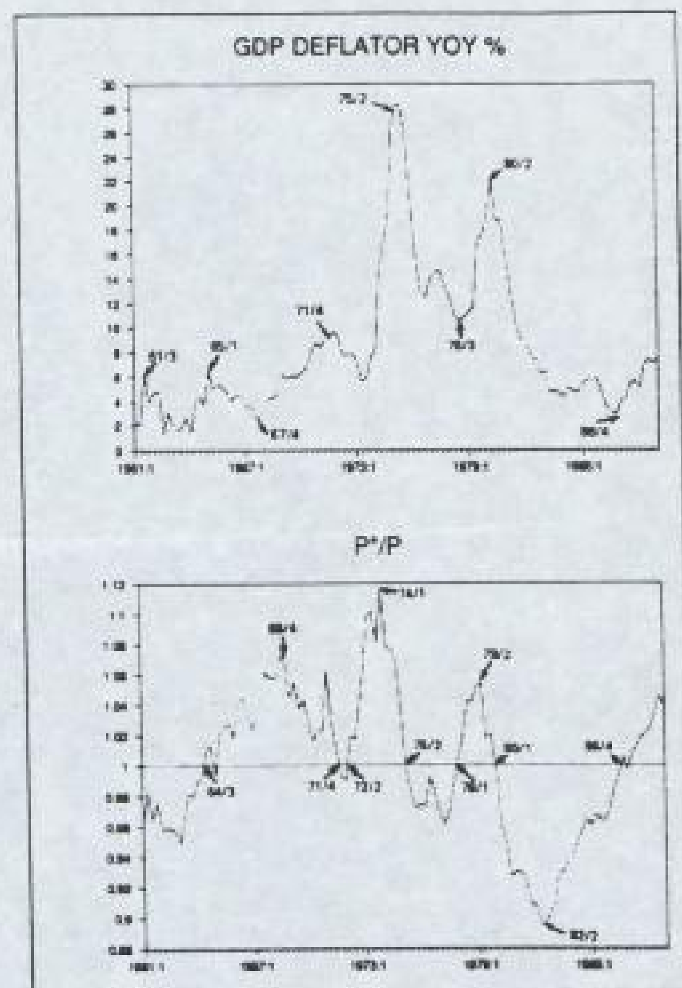
$$\dot{p}^* = \dot{m} + \dot{v}^* - \dot{y}^* = \dot{m} + 2$$

where lower cases represent logs of P*, M, V* and Y* respectively. The dot denotes a one-period change.

In other words, if a government is seeking a steady inflation rate of, say, 5% then not only should the P*/P ratio be unity but also M0 growth should be around 3% (the middle of the current target range). As we show in the next section, although some variation of M0 growth around 3% is acceptable in the short-run (temporary velocity cycles, etc) any sustained period of M0 growth above 3% should, on the basis of historical evidence and the assumed 5% inflation objective, give cause for concern.

The P*/P ratio and inflation, 1961-1988

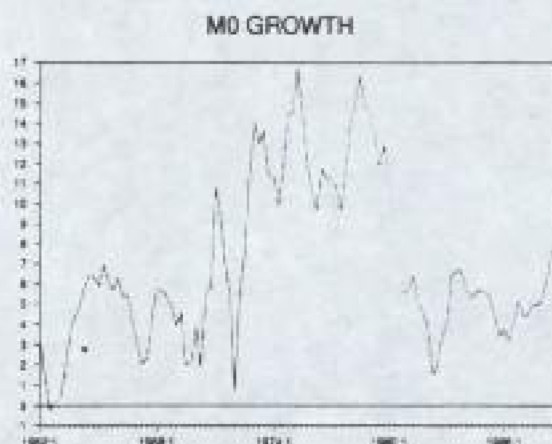
The history of inflation (as measured by the GDP deflator) and the degree to which its movements are foreshadowed by the P*/P ratio are depicted in the charts below. By construction the mean value of the ratio is unity over the period analysed. In other words the analysis assumes that, over the long run, prices converge to their equilibrium level (if we did not assume this then the whole P-star methodology becomes suspect).



Before analysing the charts it is worth recalling the correct interpretation of a unit value for P*/P. In particular, a unit value does not imply price stability, it simply means that P* and P are growing at the same rate (actual = expected inflation). To determine the equilibrium rate we need to look at monetary growth. If M0 growth is high then so will the equilibrium rate of inflation. The policy implication is that the authorities can in no way regard a unit value of P*/P as a sufficient condition for inflation success. As well as seeking stability in the sense of a steady rate of inflation, the authorities also have to get monetary growth right in order to avoid inflation settling at too high a level.

In order to describe the UK's inflation history over the past 25 years - and the ability of the P-star approach to spot problems ahead of time - it is convenient to split the period into various phases:

MO GROWTH



Phase I : 1964-1971

- The period began with a reflationary budget and M0 growth picking up sharply (reaching 7% by mid-'65 having been relatively flat in 1962). The P*/P ratio moved above unity in 1964Q3 and remained there for much of the period. Since M0 growth was already running at around 6% at this stage, the authorities had a clear warning signal of inflationary pressures ahead.

- However, this pressure was not at all evident in the inflation numbers themselves for some time. Indeed, between 1965Q1 and 1967Q4 the inflation rate fell from 6.4% to 2.4%. Does this mean the P-star model failed? The answer is no.

- Pressures **were** evident in 1965-67 but were prevented from being translated into actual inflation because of price controls. A prices and incomes freeze was in operation between July 1966 and January 1967 followed by a six month period of "severe restraint". It was the growing balance of payments deficits which reflected excess demand pressures and eventually led to the 1967 devaluation. Following this and the lifting of strict price and wage controls then inflationary pressures were let out of the bottle and inflation reached almost 10% by the end of the period.

Phase II : 1972-1978

- The P-star measure was signalling through 1971 that inflationary pressures might soon stabilise and indeed there was some respite between 1971Q4 and 1973Q2 (when inflation fell from 9.6% to 5.6%). Again, however, this deflation (as opposed to the stability implied by P*/P) was created by artificial forces, notably the 90 day statutory freeze on prices and incomes imposed in November 1972. Through 1972 monetary (M0) growth picked up very sharply and this continued for some time (this coincided with the floating of the sterling exchange rate).

- Note that the P-star measure was very clearly signalling problems as early as 1972 - disputing the conventional wisdom that M0 failed to warn about the inflation take-off in the mid-'70s. Even though the 1973 oil price hike exaggerated the impact of monetary excesses, it is clear that there was still a policy induced inflation problem during this period. As inflation took off in 1974-75 so P*/P began to fall sharply (real M0 growth tailing off). Between 1975Q2 and 1978Q1 the P-star measure suggested inflation would ease back - as it did - although with M0 growth still at double digit levels the implied equilibrium inflation rate was still very high by the standards of the 1950's and 1960's.

Phase III : 1978-1986

- The P*/P "undershoot" in 1975-78 had been relatively modest and this, coupled with the still high growth of the monetary base, suggested that inflation would remain problematic. Indeed between 1978Q1 and 1979Q2 the P*/P measure rose sharply - shortly followed by another take-off in inflation (again exaggerated by an oil price hike). In 1978-79 M0 growth was running at around 15%.

- From 1979Q2 to 1982Q2, the P*/P measure dipped sharply, substantially undershooting the unit level. This heralded the major deflation that took place between 1980Q2 and 1986Q4 when inflation fell from 22% to 3% - an impressive achievement, albeit at a substantial output and employment cost.

- Through 1986 M0 growth was picking up modestly and the P*/P measure rose towards unity (actual prices being depressed by the collapse in commodity prices). In the early part of 1986, with M0 growth running at around 3¾% and the P*/P measure suggesting that an inflation equilibrium was close to hand, it seemed that the inflation tiger had been tamed. Unfortunately, as the post-1986 experience shows, this was not to be the case.

Phase IV : 1986 to date

- In the latter part of 1986, the P*/P measure moved above unity and this, coupled with M0 growth above 5% should have rung alarm bells. As we argued earlier, velocity and output trends suggest that monetary base growth of more than 3% risks inflation equilibrating at 5% or above. However, by mid-'88, monetary base growth had virtually doubled yet interest rates were pushed as low as 7½%.

- The P*/P measure rose sharply from 1987Q1 onwards, signalling inflationary problems ahead. However, the authorities failed to respond adequately to the situation. Part of the reason was the Chancellor's adoption of an informal DM/£ target which was giving a completely opposite (and, in the event, wrong) signal. The October 1987 "market break" also gave good reason to ignore, temporarily, the conventional indicators in assessing the correct monetary stance. However, by early 1988, it was clear that the equity crash had had little discernible impact on activity. M0 growth continued to rise, and with it the P*/P ratio. Yet interest rates continued to be cut until mid-'88 by which time a substantial amount of inflationary pressure had been accommodated.
- Although M0 growth has recently begun to decelerate, following the sharp rise in interest rates, the current P*/P ratio still remains well above unity. **An important conclusion from our analysis - and one that is rather concerning for the current situation - is that there has not been a substantial fall in inflation without the P*/P ratio falling below unity for a prolonged period. As explained earlier, the periods of falling inflation in 1965-67 and 1972-73 (when P*/P was still greater than one) were because of price freezes whose deflationary impact was not sustainable. This suggests that the inflation peak in the current cycle is still some way off.** We discuss this in greater detail in the concluding section.

P-star forecasts and simulations

Formal analysis was undertaken of the P-star approach to inflation forecasting with the key statistical results reported below. The equations estimated performed well according to conventional econometric criteria and the simulation properties of the preferred equation compared favourably with that estimated by the Fed on US data.

The model tested took the form:

$$DINF = \sum_{i=1}^{4} \alpha_i \, DINF_{t-i} + \beta_1 (p^*_{t-1} - p_{t-1}) + \beta_2 (INF^*_{t-1} - INF_{t-1})$$

Where:

p	=	log of GDP deflator
INF	=	one-quarter change in p
p^*	=	log of P-star
INF^*	=	one-quarter change in p^*
$DINF$	=	one-quarter change in INF

(see box on data sources and definitions for further details)

KEY ASSUMPTIONS IN CALCULATING P-STAR

Productive potential (Y*)	Real GDP is assumed to grow at an underlying 2¼% per annum. This is the average growth rate seen since 1960. We remain sceptical about whether there has been a significant step up in underlying output growth since 1979 (see also National Institute Economic Review, May 1989).
Velocity trend (V*)	Equations estimated over period 1976Q1-1988Q4 suggested a break in trend in 1974. Estimated velocity trend for 1961Q1-1973Q4 = 3.1% pa; for 1974Q1-1988Q4 = 4.3%pa.

DATA SET AND DEFINITIONS

Monetary Base (M0)	The data were adjusted for breaks in August 1981 and April 1983 (see Bank of England discussion paper No23, Feb 1989). Source: Bank of England
Real GDP (Y)	GDP (A) at 1985 market prices. Source: Central Statistical Office
Prices (P)	GDP (A) deflator calculated by dividing money GDP by real GDP. Source: Central Statistical Office
Velocity (V)	Derived from the identity M0.V=P.Y
P-star (P*)	Derived from the identity M0.V* = P*.Y*

This equation has the property that in a steady state (DINF = O) P* = P and INF* = INF. In other words, where inflation is steady then the actual price level and the inflation rate are in line with their long-run equilibrium values. This is important for equilibrium and simulation analysis.

The equation was estimated from 1963Q1 to 1986Q4, with eight observations (1987Q1-1988Q4) retained for parameter stability tests. The sample was also split at 1974 as a further test of parameter stability. The results are reported in the table below (the 3rd and 4th lags of DINF were insignificant and therefore excluded from the preferred equation):

Dependent Variable: $DINF_t$

1963Q1 - 1986Q4

Independent Variable	Coefficient	T-Value
$DINF_{t-1}$	-0.499	4.8
$DINF_{t-2}$	-0.199	2.1
$(p^*_{t-1} - p_{t-1})$	0.043	2.4
$(INF^*_{t-1} - INF_{t-1})$	0.209	2.8

$\bar{R}$-Squared = 0.35
Standard Error = 1.1%

Autocorrelation Tests (Lagrange Multiplier)
CHISQ (1) = -0.02, not significant
CHISQ (4) = 1.59, not significant

Parameter Stability (after 1986Q4)
CHISQ (8) = 3.60, not significant

Chow Test (test for structural break after 1973Q4)
F(4,88) = 2.20, not significant

As the results show, the equation has a reasonable "fit" (bearing in mind the dependent variable is defined in changes format), there are no obvious problems with specification, the forecasting properties in the post estimation period are acceptable and there is no clear evidence of a structural break within the estimation period.

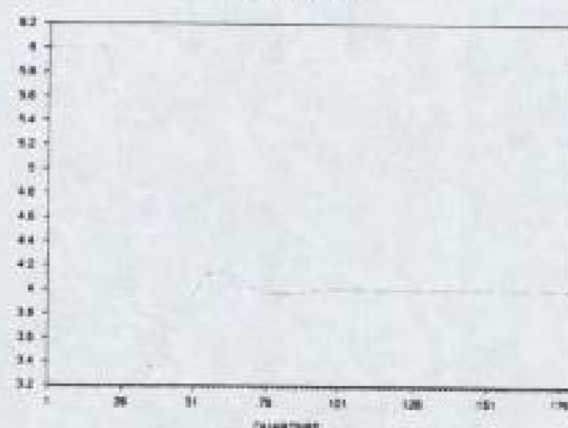
The remarkable property of the equation estimated - a finding which concurs with that of the Fed - is how well it performs considering the parsimonious nature of the specification. The equation is effectively just relating the price level to the monetary base. There are no oil price dummies, no fiscal effects, and no prices and incomes policy dummies. Yet, as the reported hypothesis tests show, the equation provides a perfectly adequate representation of inflation history.

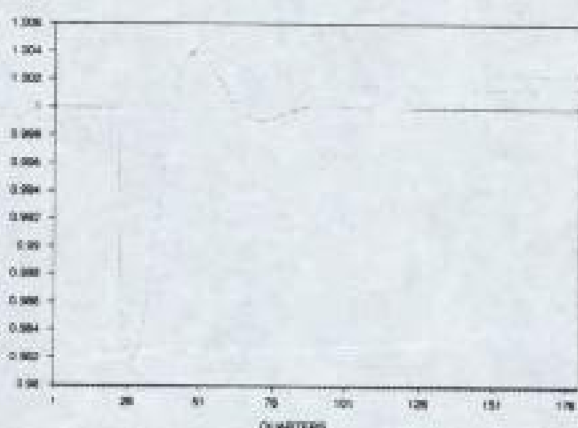
The above equation was then examined to test the dynamic response of inflation to a monetary shock. Specifically we set up a steady state in which inflation was 6% and P* = P. We then "shocked" M0 growth downwards by 2% (thus reducing the equilibrium inflation rate to 4%). The purpose of this simulation exercise was to

- check the dynamic stability of our estimated equation
- examine the implied lags in the system between changes in the monetary base and inflation

The results of our simulation exercise are given in the charts below. Clearly the equation is dynamically stable and exhibits cyclical convergence to the new equilibrium path (this "overshooting" characteristic is fairly typical of the model-type we have estimated). Following the shock to monetary growth (which is large in proportionate terms) it takes around 5 years for the system to settle down (within ½% of the new equilibrium inflation rate). As would be expected the P*/P ratio dips sharply after the monetary contraction before returning (on a heavily damped cycle) to its unit value.

P-STAR SIMULATION





Assessing the current monetary stance

The P-star approach developed above is admittedly simplistic. Certainly there is room for further analysis, sensitivity checks and the like. But the purpose of this paper has been to demonstrate, in a reasonably accessible form, the power of monetary effects in the long-run inflationary process.

P-star, we stress, is not foolproof. Its calculation is sensitive to the assumptions made and is of assistance more in judging long-run forces rather than providing short-run insights. Nevertheless our view, based on the above analysis, is that P-star is a worthy addition to the indicators monitored by the authorities.

CF → PA

PRIME MINISTER

CHANCELLOR'S "ON THE RECORD" INTERVIEW AND APPEARANCE BEFORE THE TCSC

You may find it helpful to glance this evening through the attached transcript of the Chancellor's "On The Record" interview yesterday. I think it demonstrates that there was substance in the various reports in today's newspapers. But the overall context of the interview was perhaps rather more rounded.

You will also want to be aware of the coverage of the Chancellor's comments to the Treasury and Civil Service Select Committee this afternoon. I sat in on this session, which lasted about one and a half hours. The majority of that time focused on the issue of ERM membership. It is difficult to judge how the press will write it up. There were some useful points the Chancellor made, which you yourself might want to pick up, but my guess is that the press coverage will focus on alleged differences of view with Alan Walters and, in turn, with you.

The session started with some general questioning from Terence Higgins about Economic and Monetary Union (EMU). The Chancellor responded on his well established Chatham House lines, and this material should cause no difficulty. When asked why the Government had signed up to the objective of EMU via the Single European Act, the Chancellor said that we had always interpreted this as meaning closer co-operation, not the kind of thing the Delors Report Stage 3 laid down. He laid stress on the objections to the transfer of sovereignty, and said he could not foresee us ever agreeing to a Treaty amendment designed to facilitate EMU. But he saw no difficulties with the quasi-transfer implied by systems such as the Gold Standard.

Another point that came up in the opening questioning was his attitude towards a current account deficit. The Chancellor said this was not the most important measure; the key variables were inflation and overall economic performance. In any event, exchange rate changes were unlikely to help reduce trade imbalances.

ERM

Most of the rest of the discussion was on the ERM.

The Chancellor said that the United Kingdom was already embarked on most of the Delors Stage One measures; the main thing we had not yet done was to join the ERM. But we would when the time was right. When pressed as to when that would be, he responded "wait and see".

Giles Radice then asked how well the Chancellor thought the ERM had worked in its first ten years; he quoted some of Alan Walters' comments on it. The Chancellor responded that it was difficult to escape the conclusion that the ERM had been successful, both in reducing exchange rate fluctuations within Europe and in helping EC countries to get inflation rates down. The EMS as such was not a substitute for proper monetary policy; but it was clear the EMS had not got in the way of achieving lower inflation. Alan's comments were difficult to reconcile with the facts.

Radice then asked what was the case for the United Kingdom joining the ERM. The Chancellor said this was the same as for other countries, ie it could help reduce exchange rate fluctuations and assist in the conduct of an anti-inflationary monetary policy. But the position on sterling was different from all the other non-DM currencies in the system; it was much more widely held and traded, and the practical problems of membership for us were therefore correspondingly greater. As to when the time would be right, the Government would of course find any advice from the Committee helpful!

Radice then asked whether the Chancellor agreed with the Governor that our joining the ERM would help us in other aspects of bargaining in Europe. The Chancellor said he thought there was potential help here either when the time was right and we had joined, or when it was clear that we would be joining within a given period; but this consideration could not be decisive in our taking a view on when we should join.

Terence Higgins then asked whether, if we joined now with high inflation and high interest rates and that led to large inflows, what action would we take? The Chancellor said he did not want to join now. He wanted to see inflation coming down first. The Committee needed to have patience; the time would come but not yet. As to the specific problem of dealing with inflows, there was a role for sterilised intervention as a first response; but if necessary, we would then need to revalue.

John Watts then took over the questioning. He was much more sceptical than some others about the merits of joining the system. He reiterated the Chancellor's own point about other non-DM currencies not being heavily traded; the Chancellor agreed but said the Government did not believe this factor alone made membership impossible. Watts then asked whether membership would have made it easier to resist the recent devaluation of the Pound. The Chancellor said he would not comment on current conditions. But in general he agreed with the Governor's earlier evidence that membership of the ERM would condition the market's expectations on the extent of fluctuations. Membership provided no new instruments of policy; we already had the power to intervene and set the right level of interest rates. But the issue was the context in which they were used. He accepted that market perceptions could be changed by the psychology of membership and the resultant scale of concerted intervention operations.

Watts then asked in what ways full membership would improve on the conditions we operated under in 1987-88 when we shadowed the ERM. The Chancellor said it would give greater

credibility within a helpful framework. As a result, currency pressures in the markets would tend to be less. And once in the system we could make exchange rate realignments with much greater market credibility, and thereby remove the present tendency of the markets to overshoot.

Watts then asked whether the process of pegging exchange rates was a cure for inflation or only helpful in keeping it low once that state had been achieved. The Chancellor said that ERM membership was not a substitute for correct policy decisions. Monetary policy was the way to get inflation down, but ERM membership was about how to use a framework to buttress monetary policy; he said there were some similarities between the Gold Standard and ERM. He believed that periods of free and floating exchange rates had been rare in the past and would remain rare.

Watts then turned to the potential conflict of interest policy between internal conditions and external commitments if we were members of the ERM. The Chancellor stressed the flexibility in the ERM, both via the bands and the possibility of realignment. We must be prepared to make use of <u>both</u> dimensions. If there was a conflict, counter-inflation must come first. But history showed that periods of conflict are few; generally there is compatibility between exchange rate stability and getting inflation down.

Finally, there was some questioning from Lewis Moonie. He again asked when the time would be right. The Chancellor said he was going to give no hint at all. But he then went on to say that he thought a relevant consideration would be whether the ERM system could survive the removal of exchange controls by the main existing members; it was reasonable to wait for that and see how the EMS worked out; but he could not give a date. The second factor to consider would be when our inflation rate was again coming down; which he said he expected to happen "later this year". Moonie pressed as to whether there were any other factors to be taken into account; the Chancellor said "these are the two main things". Giles

Radice then intervened to argue "therefore you are saying watch 1990". The Chancellor responded that he should not expect the Government to enter then, but that it would be sensible to wait until at least that date. He did not rule out joining before then, but he thought it reasonable to wait and see how things went with the removal of exchange controls, and then to form a view. Radice retorted by again mentioning 1990, and saying that by then your last remaining argument against ERM membership would have been removed.

PAUL GRAY
12 June 1989

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

12 June 1989

P R C Gray Esq
Private Secretary to
Prime Minister
10 Downing Street
LONDON
SW1

Dear Paul

THE RECENT RISE IN INFLATION

As you requested in your letter of 24 May, I attach a note on the recent rise in inflation. I also attach some points for Prime Minister's Questions tomorrow.

Yours
Alex

A C S ALLAN
Principal Private Secretary

PONTS FOR PRIME MINISTER'S QUESTIONS

Shadowing DM led to current inflation?

Economic policy is the policy of the Government as a whole. Inflation has risen, and to an unacceptable level, and that means that monetary policy has been too loose at times in the past, as my rhf has stated. One such period was in the aftermath of the stock market crash, when there were very real fears about industrial confidence.

More complex than that?

Of course the causes of inflation are complex, but then we all know that the rhg doesn't understand the first thing about them. [Won't take lectures on inflation etc... (including point that underlying rate - ie excluding MIPs - is lower than lowest achieved under last Labour Government)]

Agree with Walters 'EMS half-baked etc'?

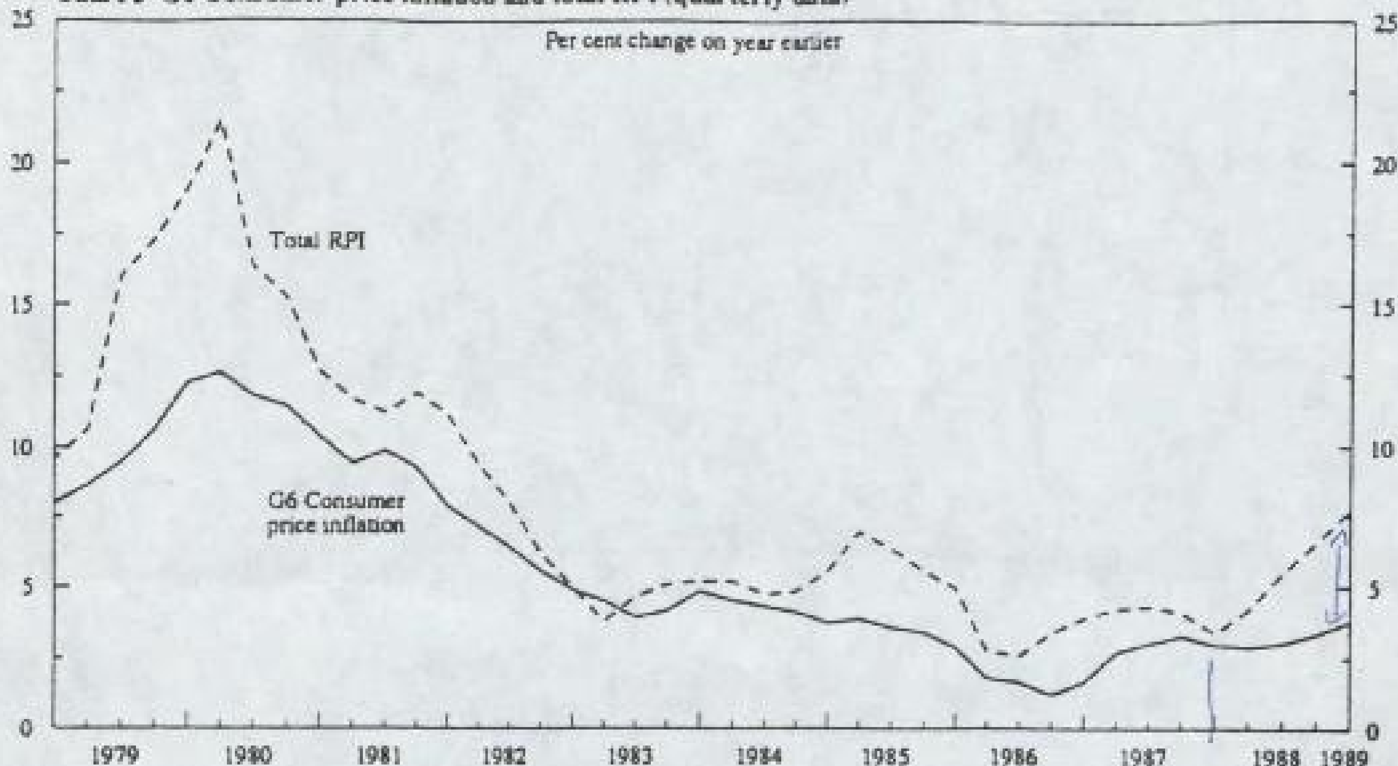
Government's policy is to join when the time is right. As my rhf has said, time is not right now. For example, will want to see how EMS copes with abolition of exchange controls in major countries.

TREASURY PAPER SUBMITTED ON 12/6/89

THE RECENT RISE OF INFLATION

The broad pattern of inflation through the 1980s has been similar in the UK and the rest of the G7. Inflation fell sharply between 1980 and 1983. The trend was distorted by the collapse of oil prices in 1986. Inflation has been rising since the beginning of 1987.

Chart 3 G6 Consumer price inflation and total RPI (quarterly data)



Inflation in the G7

2. The rise in inflation worldwide mainly reflects the unexpected buoyancy of the world economy. Demand has been much stronger than anyone expected, with rapid growth of consumer spending and fixed investment. Both are connected with a strengthening in the supply performance of the G7, helped by widespread deregulation. Pressure upon capacity has increased.

3. In the event, the stance of monetary policy at the G7 level turned out to be insufficiently tight to deal with the strength of demand pressures. There are a number of possible explanations:

- the conduct of monetary policy was made much more difficult by changes in the behaviour of the monetary indicators, partly reflecting financial deregulation;

- inflation rose as the once-and-for-all effects of lower oil prices worked their way through but also because the lagged effects of lower oil prices boosted growth more than expected;

- the world economy was surprisingly subdued in late 1986 and early 1987 which encouraged some further easing of the policy stance;

- interest rates had begun to rise during the course of 1987 but this tightening of policy was aborted by the stock market crash in October 1987. There was widespread concern about the dangers that could ensue from a further collapse of prices and the threat to the international financial system. To prevent this potential collapse of confidence, monetary policy was eased throughout the G7 countries;

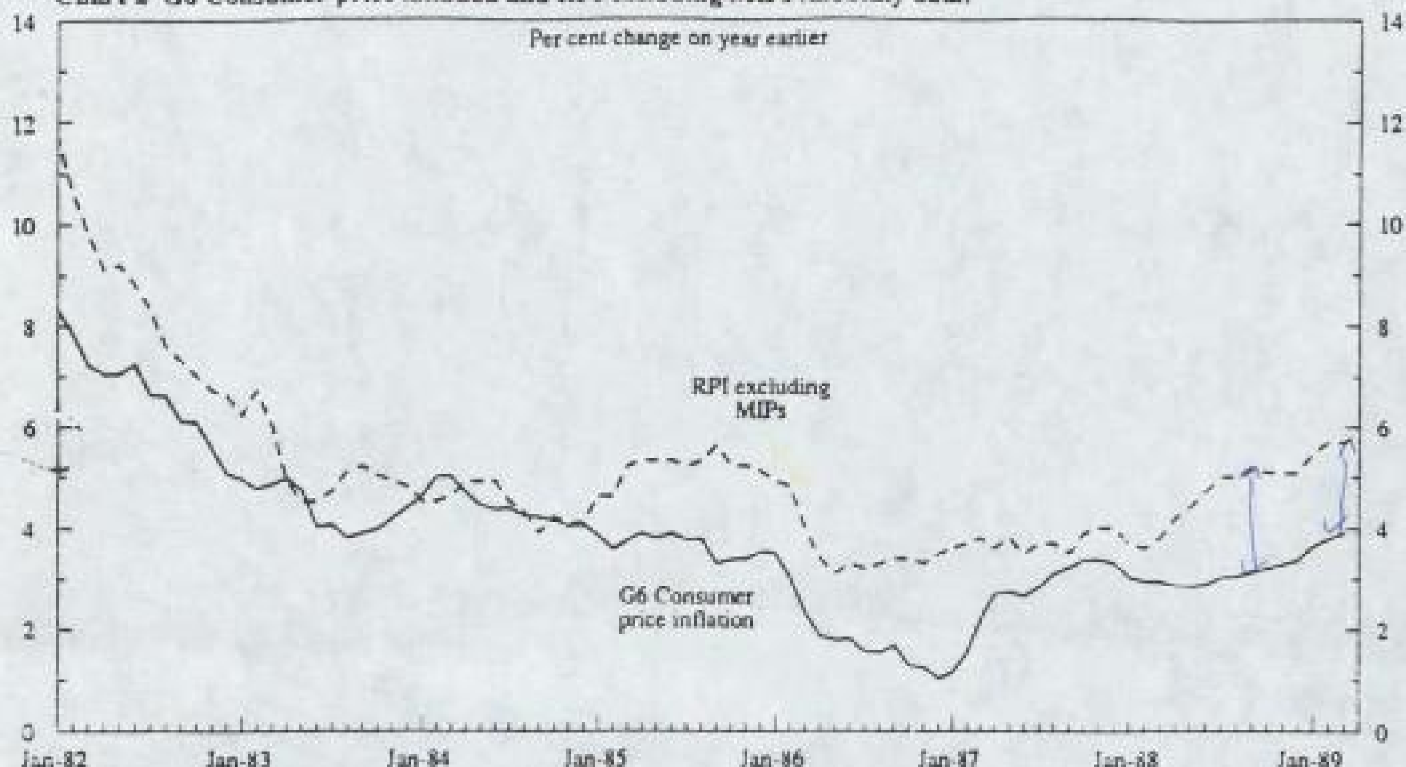
4. Since the rising pressure of inflation became evident in the Spring of 1988, monetary policy has been tightened noticeably. Interest rates in Germany and the US have risen by more than 3 per cent and substantial increases have taken place elsewhere.

Inflation in the UK

5. The true picture in the UK is obscured by mortgage rate changes - which distort international comparisons. Excluding mortgage interest payments, the similarity with developments in the rest of the G7 is even greater. But at each stage the pattern is more acute in the UK; inflation fell faster in the early

1980s; it shows a more pronounced flattening between 1984 and 1987; and recently has increased more sharply.

Chart 2 G6 Consumer price inflation and RPI excluding MIPs (monthly data)



6. The unexpected strength of demand has been particularly striking in the UK. Some of the reasons are:

- the earlier fall in inflation was greater;

- the supply side improvement with rising productivity, profitability and investment, went further;

- the reduction in oil prices produced less benefit in the UK; oil's contribution to the balance of payments was diminished and the expected decline in sterling offset some of the gains to the general price level;

- deregulation in the financial markets was more complete;

- developments in the housing market played a unique role.

7. It remains surprising that consumers have adjusted their savings levels to the extent they have. Credit liberalisation has had a major effect upon behaviour. In contrast to the United States, where people have now become accustomed to a deregulated credit regime, consumers in the UK have found the ready availability of credit a heady experience. This unfamiliarity has produced overshooting, and the ratio of personal sector debt to income now exceeds that in the US. In time, consumers will adjust to the realities of debt service but in the meantime it has meant a stimulus to demand.

8. The housing market has played a special role. Mortgage borrowing has been the main source of credit expansion. The easing of monetary policy following the stock market crash was evident in the growth of house prices and expansion of mortgage demand from the beginning of 1988. This was compounded by the announcement of the ending of double mortgage relief which did not become effective until the beginning of August. What was a curbing of the tax relief on credit was seen by the public as a sort of 'special offer': it sparked off an intense period of house purchase by potential sharers, who were then joined by other buyers who sensed prices might run away from them.

The money supply

9. Bearing in mind the lags in monetary policy, it is clear in retrospect that monetary policy should have been tighter on average throughout the last three or four years. But it is difficult even now to say by how much.

10. Over the period, MO has been the best monetary indicator. But it is a contemporaneous rather than a leading indicator of money GDP. So even if policy had been exclusively based upon MO, the strength of the forces in operation - the falling personal saving ratio and the investment boom - make it unlikely that

changes to interest rates made in response to MO developments would have been in time to prevent excess demand pressure.

11. It has been said that broad money growth was a useful leading indicator between 1985 and 1988 and showed the need to tighten monetary policy earlier. But that has to be set alongside all those occasions, since we started our policy of financial deregulation, when giving increased weight to broad money would have led to the wrong response. We could not and still cannot base policy on broad money. But can we ignore it?

12. It is, moreover, impossible to believe that the policy of not overfunding was at the heart of the monetary expansion. This is wrong on two counts. First, the ending of overfunding does not explain the acceleration of broad money growth and, second, it has not been established that the growth of broad money causes faster growth of nominal GDP.

13. It seems inescapable that we should continue to rely on MO as the best measure of the money supply. We have to recognise that we are without a reliable and reasonably long leading indicator of money GDP. So it is not possible to prevent fluctuations in inflation generated by surprises to domestic or external demand or capital flows. The job of monetary policy is to make sure that these surprises do not generate sustained higher inflation. This ? is what has been done. Monetary policy has been tightened sharply ? and the inflation surge will subside.

Exchange rate

14. Monetary policy has taken the exchange rate into account as an essential ingredient in monetary conditions for many years - both because of its direct effects and because of the unreliability of the monetary aggregates at a time of structural change.

15. There is no reason to doubt this long established policy. A higher exchange rate tightens monetary conditions and puts downward pressure on interest rates and vice versa. There is a

direct effect on import prices; and exchange rate changes affect the profitability of UK manufacturers by constraining their ability to raise prices. There are second-round effects through their impact on inflationary expectations and wage negotiations. Other countries adopt this approach for the same reasons.

16. Following the Louvre Agreement in February 1987, there seemed a strong case for using the framework that provided, for espousing exchange rate stability and arresting the steady decline in the exchange rate that had been occurring up to that point. In the event, the pressures soon proved to be the other way, but in the run up to the Election we held the rate below 3DM, and this continued after the Election as the current account moved into deficit.

No

17. There were obvious reasons for trying to maintain greater exchange rate stability at this time. Industrial performance and investment would have been damaged by a sharp and unsustainable appreciation of sterling - and this of course became particularly important in the aftermath of the Stock Exchange crash when business confidence was particularly fragile; other G7 countries were trying to achieve greater stability within the framework of the Louvre Agreement; and through a commitment to restrain the rise of sterling it was hoped to increase confidence in the equal commitment to resist any subsequent pressure for depreciation.

18. Containing the strength of sterling involved heavy intervention. But it is doubtful if the intervention that took place through 1987 and 1988 had any direct inflationary effect. Intervention increases liquidity in the economy if it is not funded and in some circumstances large-scale intervention can make monetary management more difficult. But during 1987-88, with the public sector moving into surplus, there was no financing problem. The intervention was fully sterilised on any basis. The operation of the Exchange Equalisation Account ensured that there was no addition to the monetary base, and the successful full funding of the intervention ensured that there was no addition to liquidity. The growth of broad money was due to the growth of private sector lending. There was no contribution from the public sector and,

therefore, there was no monetary stimulus - either to broad or narrow money - independent of any effect arising from keeping down interest rates and the exchange rate.

19. So far as interest rates are concerned, base rates were raised to 11 per cent as sterling weakened in Autumn 1986. As sterling appreciated following the Louvre Agreement, interest rates came down gradually to 9 per cent in May 1987. They were raised to 10 per cent as policy was tightened in the Summer. They were reduced, in line with other countries, following Black Monday - ½ per cent cuts in October, November and December. By February 1988 they were back to 9 per cent. Over the whole period interest rates came down only 2 per cent, of which 1½ per cent followed Black Monday.

20. In retrospect, it is no doubt true that we needed a tighter policy in the sense of higher interest rates, or a higher exchange rate or some combination of the two, in both 1986 and 1987 and in the early part of 1988 too. The 3DM policy played some part in this. But it is important not to exaggerate the part it played in a misjudgment of monetary conditions which we shared to a considerable extent with the rest of the world and which had many other causes.

Conclusions

21. This analysis points to the following conclusions:

(a) inflation has risen everywhere;

(b) international comparisons are distorted by the inclusion of mortgage interest payments in the RPI;

(c) excluding the effects of mortgage interest, the rise in inflation stems primarily from the same causes as in the rest of the world;

(d) monetary policy in the UK has had to cope with two linked factors which produced great strength in demand:

(i) the extent of financial deregulation - a once-for-all phenomenon

(ii) the rise in property prices;

(e) together with booming investment, these have put monetary policy under strain. But interest rates have been raised to bring inflation back down;

(f) MO remains the best monetary indicator, but no indicator is fully reliable at a time of structural change;

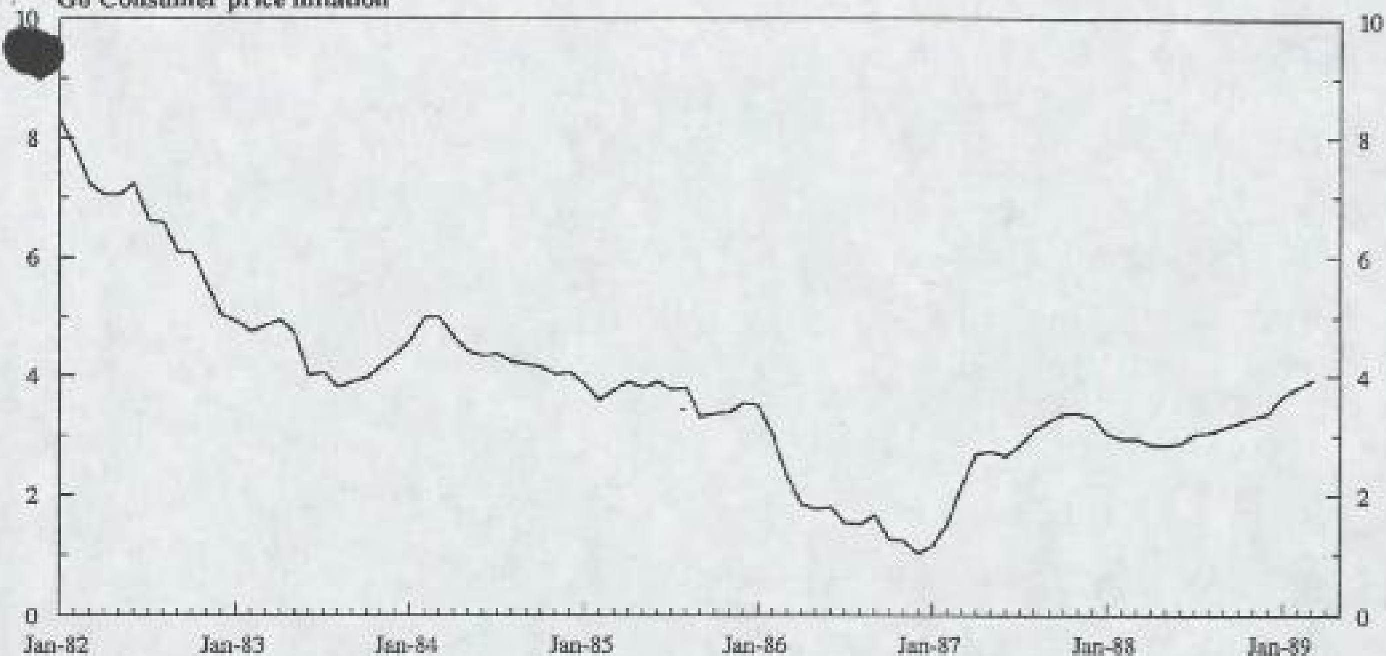
(g) taking the exchange rate into account and avoiding excess depreciation of the pound remains an essential ingredient in monetary policy.

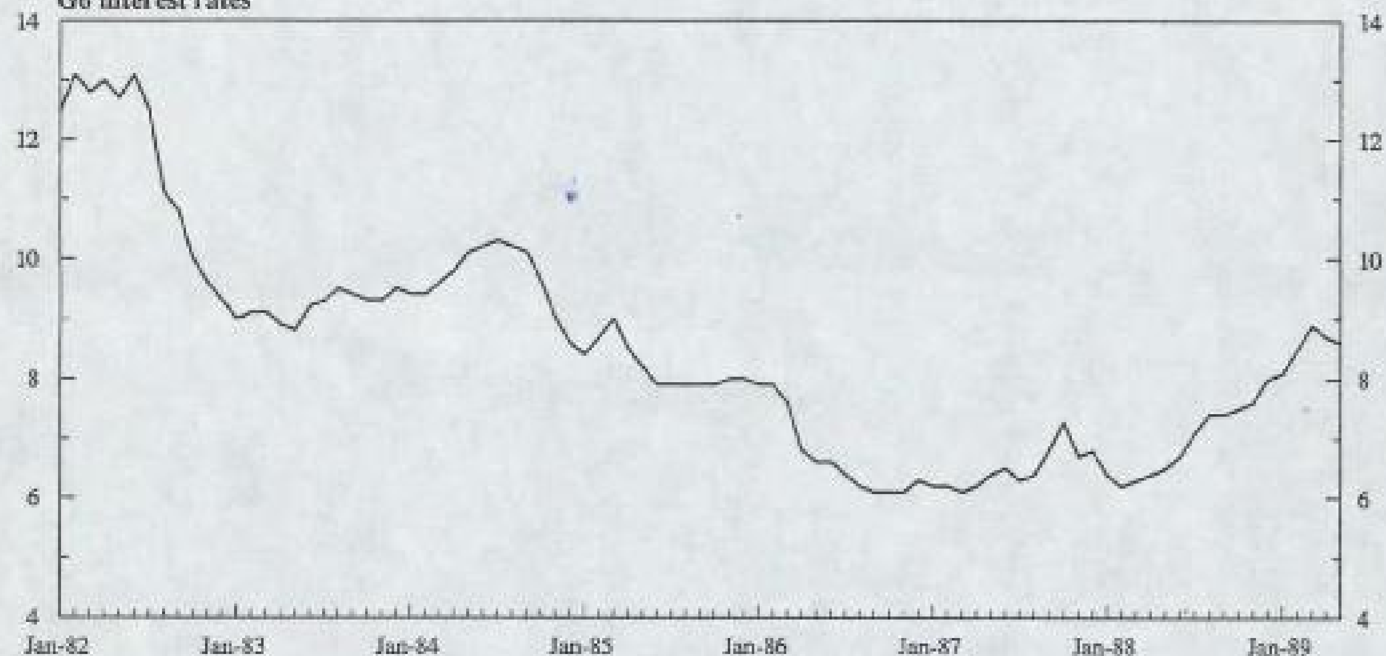
(h) there is no case for giving broad money a more significant role or for returning to overfunding;

(i) intervention has been fully sterilised and had no effect on either broad or the narrow measures of money;

(j) the 3DM policy may have been one factor among many contributing to what, in retrospect, were too loose monetary conditions over the past three years;

(k) with hindsight, the loosening of monetary conditions in response to the Stock Market crash proved particularly ill-judged, but it is difficult to say what would have happened if we had not done that.


G6 Consumer price inflation
10
8
6
4
2
0
Jan-82
Jan-83
Jan-84
Jan-85
Jan-86
Jan-87
Jan-88
Jan-89


G6 interest rates
14
12
10
8
6
4
Jan-82
Jan-83
Jan-84
Jan-85
Jan-86
Jan-87
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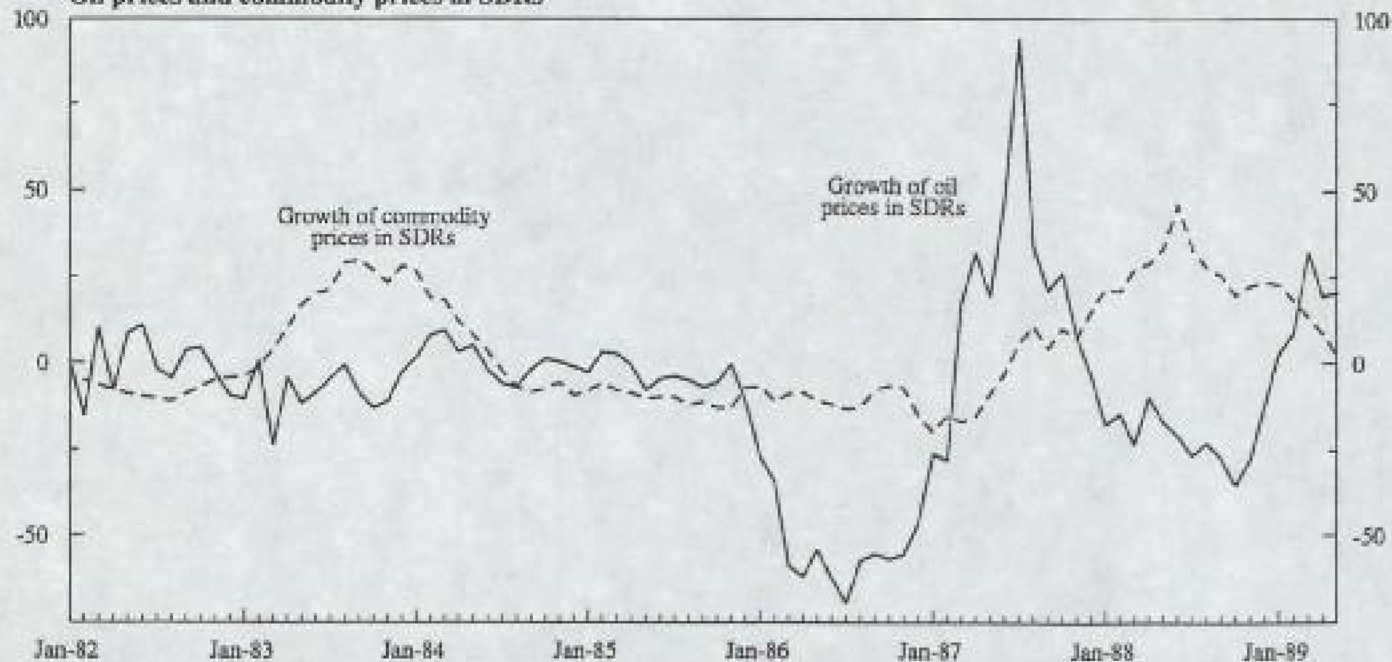
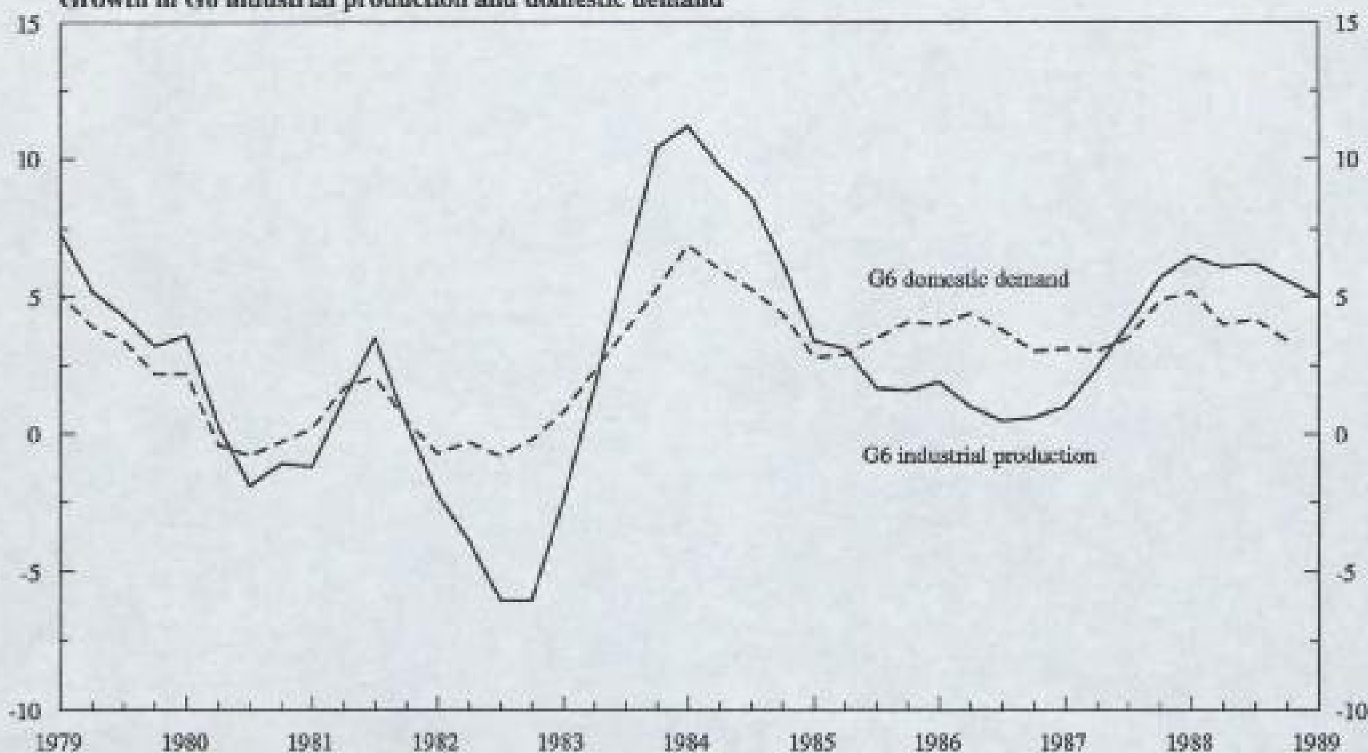
Jan-89


Oil prices and commodity prices in SDRs
100
50
0
-50
Growth of commodity prices in SDRs
Growth of oil prices in SDRs
Jan-82
Jan-83
Jan-84
Jan-85
Jan-86
Jan-87
Jan-88
Jan-89


Growth in G6 industrial production and domestic demand
G6 domestic demand
G6 industrial production
15
10
5
0
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-10
1979
1980
1981
1982
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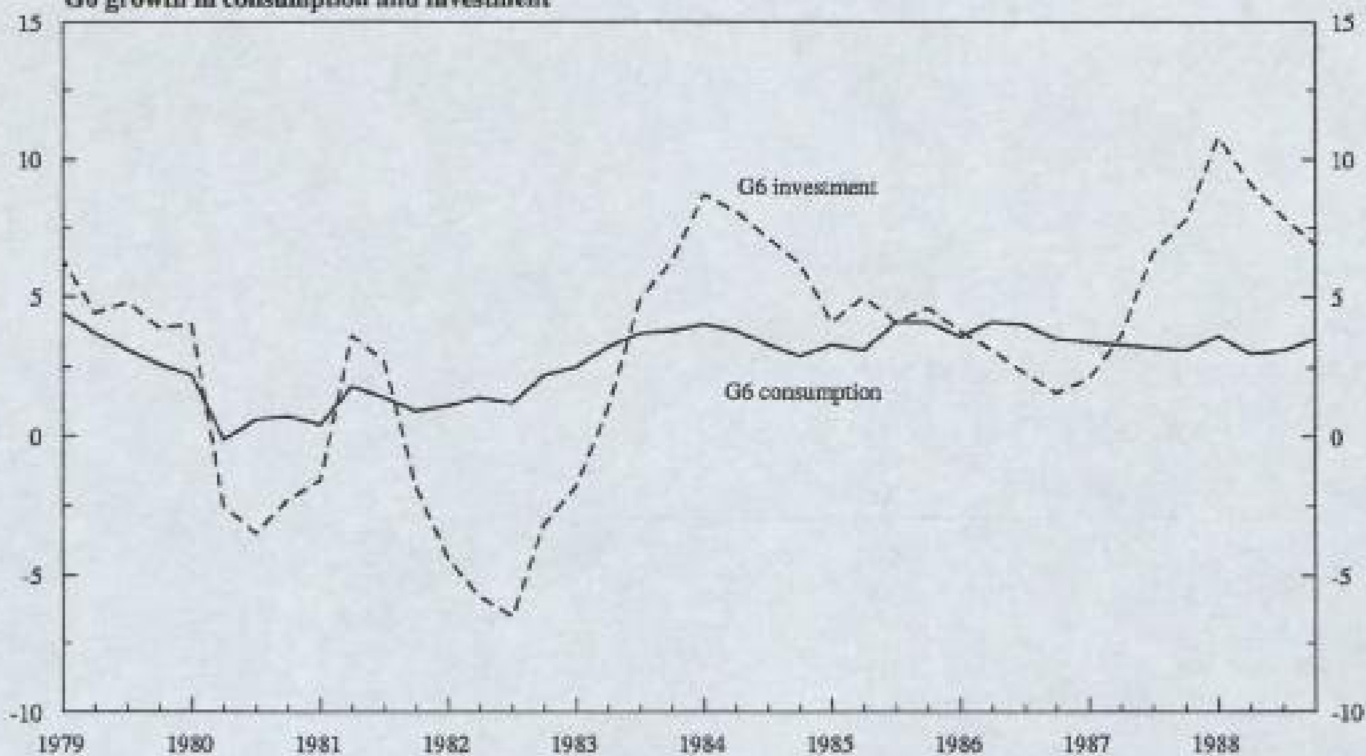
1984
1985
1986
1987
1988
1989


G6 growth in consumption and investment
G6 investment
G6 consumption
15
10
5
0
-5
-10
1979
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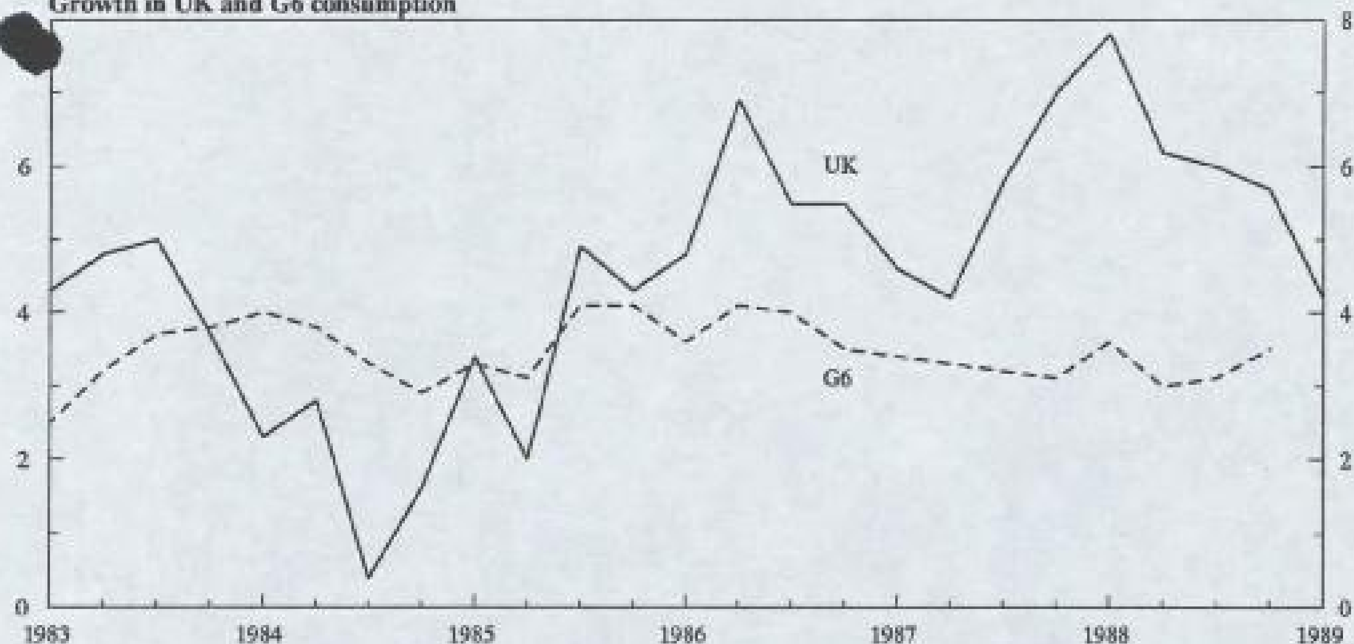
1986
1987
1988


Growth in UK and G6 consumption
UK
G6
8
6
4
2
0
1983
1984
1985
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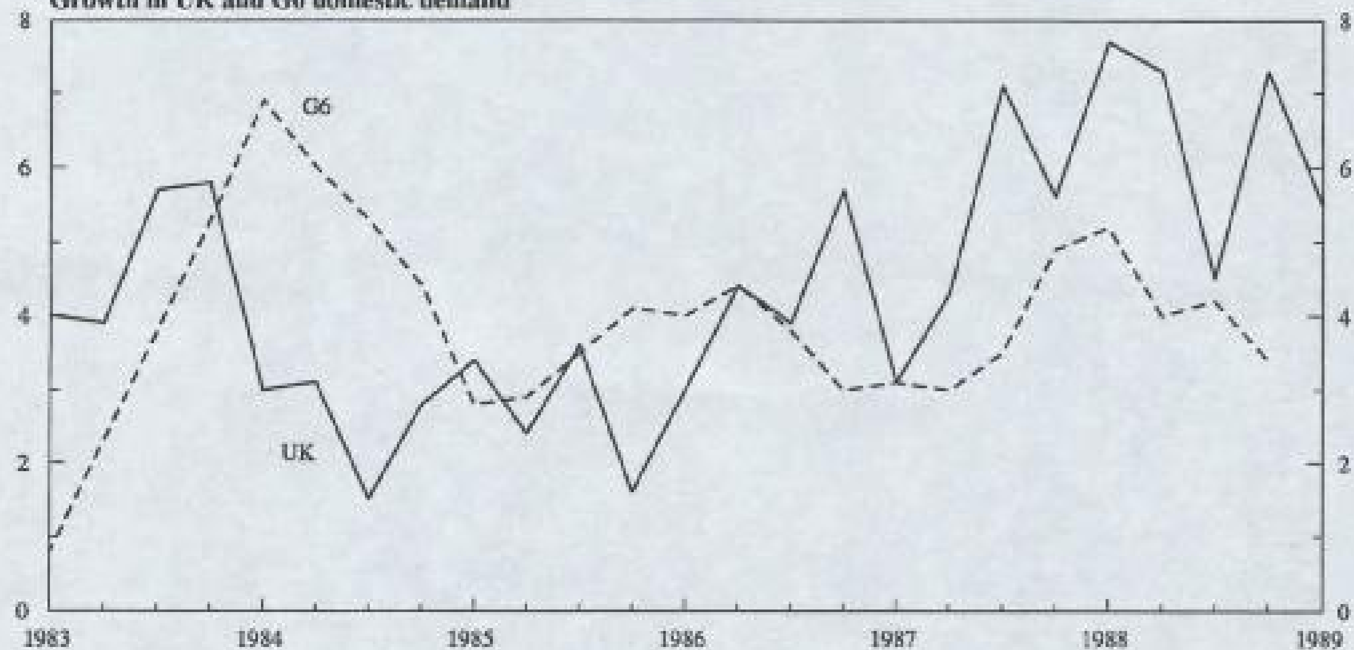
1987
1988
1989


Growth in UK and G6 domestic demand
G6
UK
8
6
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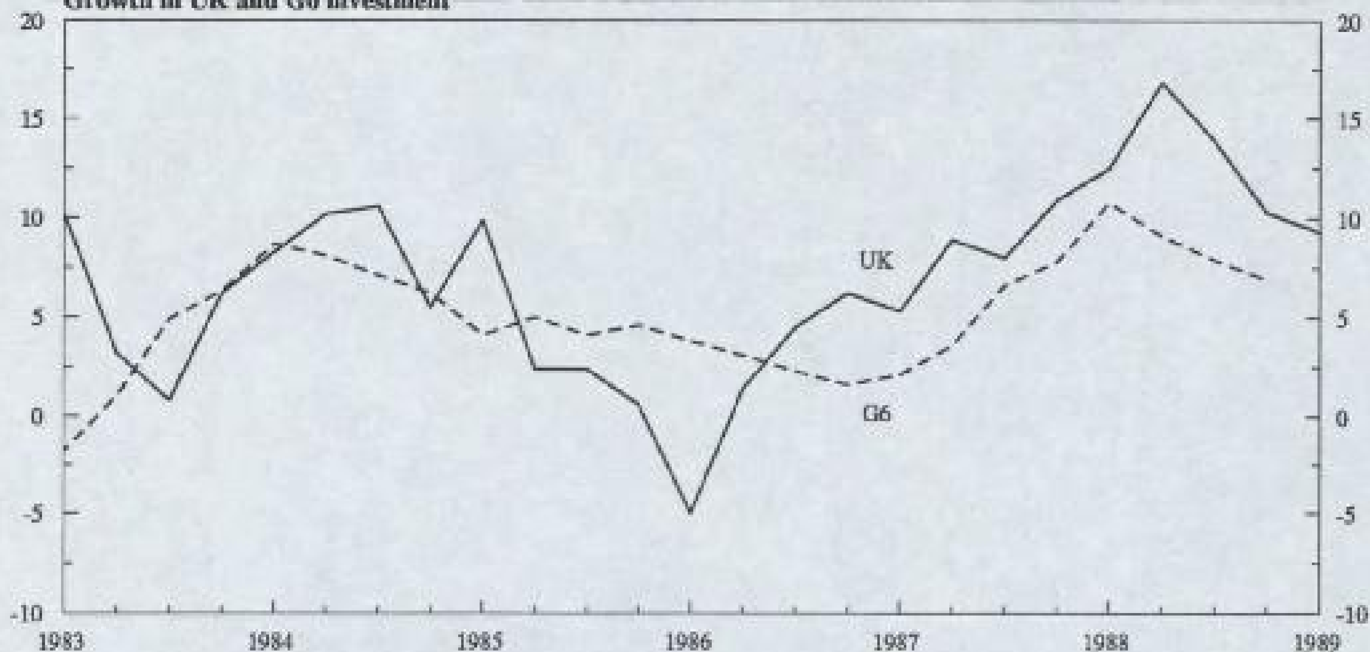
Growth in UK and G6 investment
UK
G6
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1984
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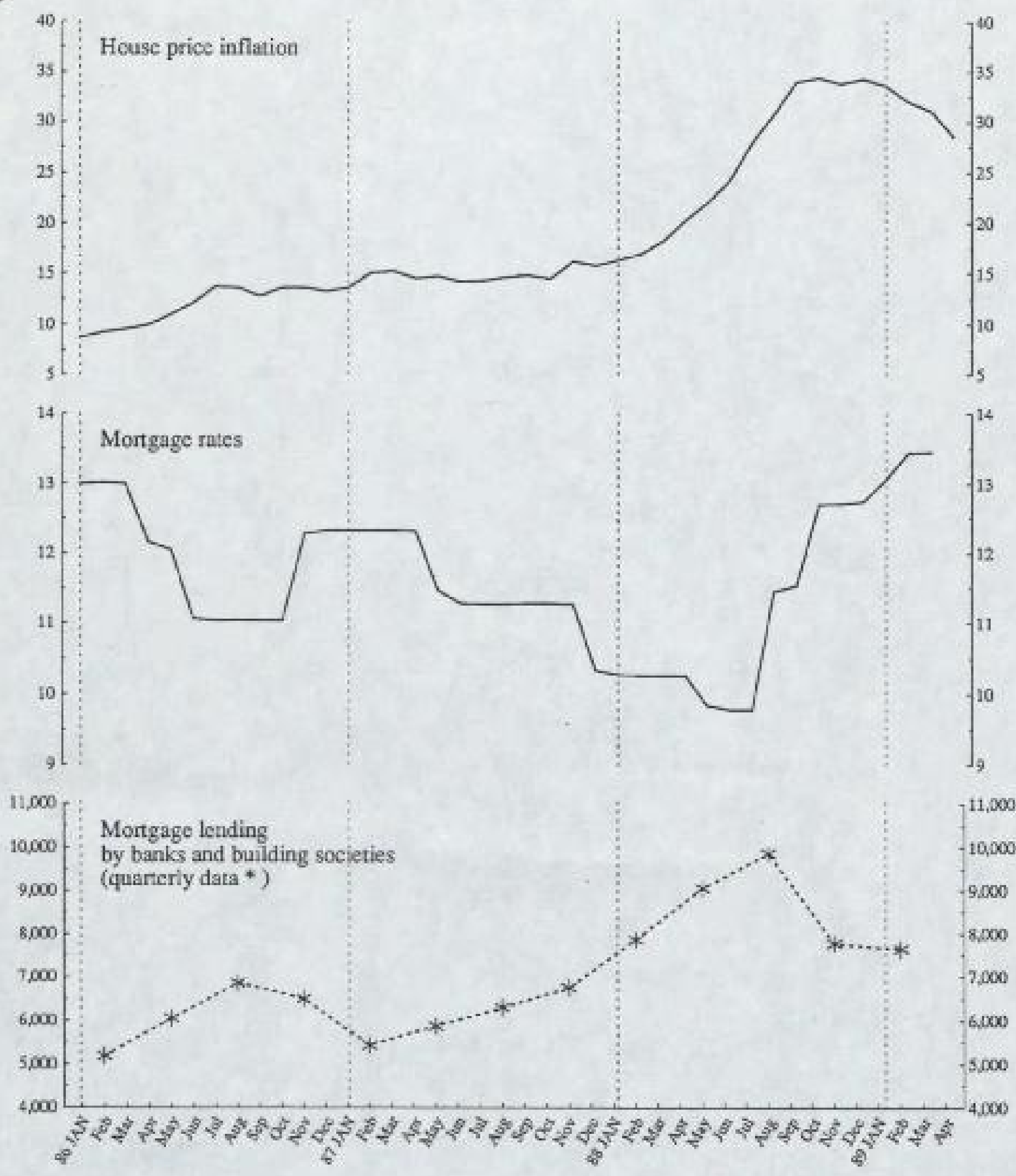
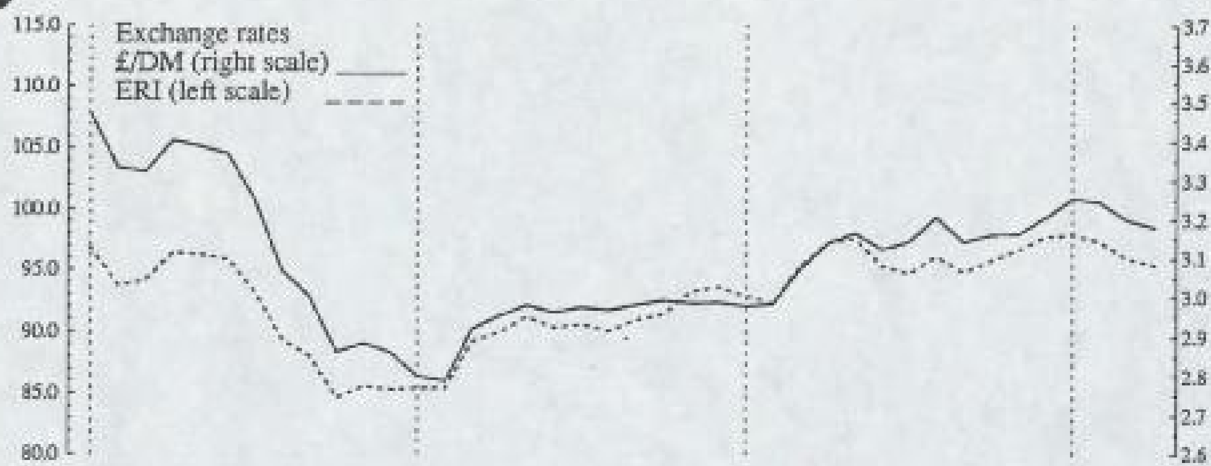
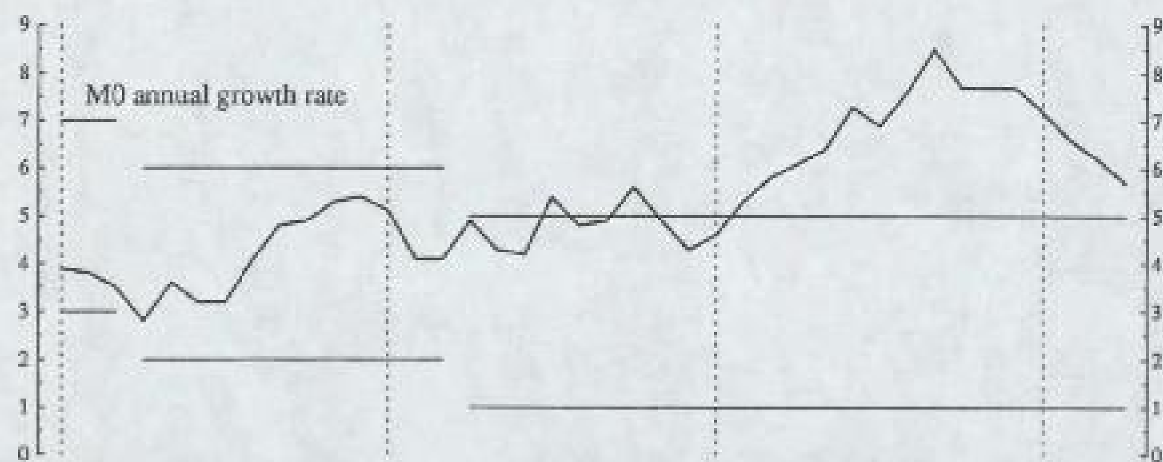
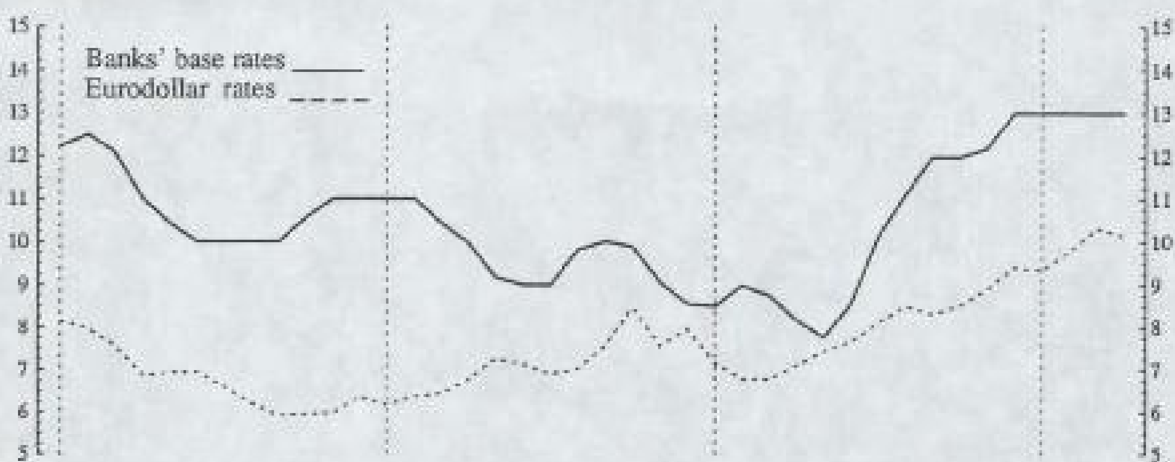

House price inflation
Mortgage rates
Mortgage lending
by banks and building societies
(quarterly data *)
86 JAN
Feb
Mar
Apr
May
Jun
Jul
Aug
Sep
Oct
Nov
Dec
87 JAN
88 JAN
89 JAN



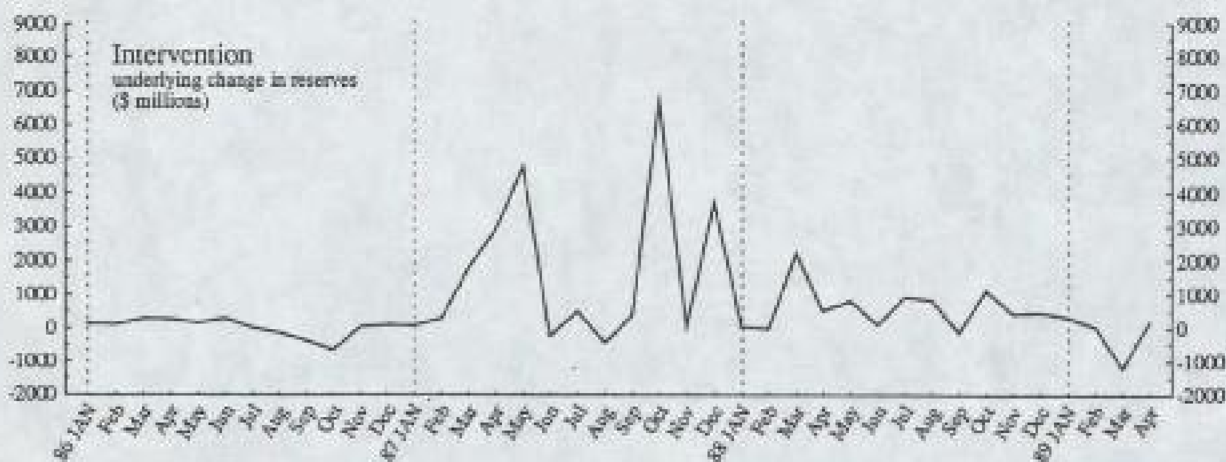
Exchange rates
£/DM (right scale)
ERI (left scale)
115.0
110.0
105.0
100.0
95.0
90.0
85.0
80.0
3.7
3.6
3.5
3.4
3.3
3.2
3.1
3.0
2.9
2.8
2.7
2.6



M0 annual growth rate
9
8
7
6
5
4
3
2
1
0



Banks' base rates
Eurodollar rates
15
14
13
12
11
10
9
8
7
6
5



Intervention
underlying change in reserves
($ millions)
9000
8000
7000
6000
5000
4000
3000
2000
1000
0
-1000
-2000
86 JAN
Feb
Mar
Apr
May
Jun
Jul
Aug
Sep
Oct
Nov
Dec
87 JAN
88 JAN
89 JAN

SECRET

PA

16a

PRIME MINISTER

TREASURY PAPER ON THE CAUSES OF THE PRESENT INFLATION

You asked me this morning to press the Treasury to speed up the timetable for this paper, and to let you have something today in advance of tomorrow's Questions. Their immediate response was to offer some kind of summary note, but after some pressing they have now (2130) delivered the full paper.

I have not yet had time to study this, and of course Alan has not seen it at all. I doubt if it is sensible to make use of any of the material* in the note before you have had the chance to talk it through with the Chancellor. The next opportunity for this will be your bilateral with him on Wednesday afternoon. I will try to ensure that you have some briefing on the paper in tomorrow evening's box.

* P.S. The first page of the material does now include a possible line for use at Questions.

PRG

PAUL GRAY

12 June 1989

MT

LO5AWE

file DS3AJA
15(A-B)

SIR ALAN WALTERS

FUNDING POLICY/INFLATION

There has been a lot of speculation in the press over the last week or so about possible changes to the details of funding policy and management of the money market. This had its origin in comments from Tim Congdon and others, including the suggestion of a return to over-funding.

The Treasury went out of its way at the end of last week formally to deny the stories that a fundamental review of the conduct of policy was underway. But my understanding is that the Chancellor has asked for a number of the technical suggestions to be looked at. I think it would be helpful on your return if you could quickly take stock with Michael Scholar and others of what work is underway, and ensure that you are fully involved in it. You might want to consider letting the Prime Minister have a note, say, for next weekend's box.

There is also a separate Treasury exercise under way you should be aware of. About ten days ago, the Prime Minister told the Chancellor she thought it would be helpful to have a note analysing the reasons why we have made no further progress in reducing the rate of inflation since 1983 and for the recent acceleration in the rate. The Chancellor responded that he had already asked Terry Burns to do some work on this. I am told that Terry has now done a first draft, which focused almost exclusively on the experiment in shadowing the ERM. The Chancellor has discussed this with him and asked him to revise it, particularly by extending the analysis to cover the 1985-86 period as well. (You will be aware that Tim Congdon, amongst others, has argued that it is in that earlier period, not just in the 1987-88 ERM shadowing, that things started to

B

go wrong.) You may like to make contact with Terry to check progress on this exercise; I have told the Chancellor's office that it would be helpful to have this note available within the next week or so.

PAUL GRAY
5 June 1989

DS3AJA

PRIME MINISTER

MARKETS

Sterling opened this morning at 92.6/1.5740/3.1255. This was little changed in effective terms but with the dollar weak it was 1.5 cents up but 1 pf. down. This outcome was helped by $100m. of intervention. The position remained the same until lunch-time when sterling weakened against both currencies reaching, at one point, DM3.1050. Further intervention brought the total for the day to $270m. By the close the position had stabilised at 92.3/1.5722/3.1137.

Sterling remains vulnerable and sentiment is poor. In the immediate future much depends on the Bundesbank tomorrow. If they do not raise rates (which the Bank think is the most likely outcome) the pressure on the £ could ease and provide a good basis for intervention. If it raises rates sterling could come under strong pressure, with the Government facing the choice between letting the rate fall or raising interest rates still further.

The Chancellor is in Paris tomorrow morning until about 1800 hours and is out of London on Friday. You are tied up with President Bush until the early afternoon. I have put a slot in the diary for 1830 on your return from Dulwich should it be necessary for you to confer. But this will be activated only if necessary.

AT MT

Andrew Turnbull

31 May 1989

MJ2DRA

14

PA

PRIME MINISTER

TODAY'S MARKETS

I had a word with Eddie George just after your return this afternoon to check the position in the markets.

The key points have been:

- The day started with considerable dollar strength against all currencies. The Japanese implemented their long-promised plan to raise their discount rate but, having been anticipated for so long, this had little effect. There was a modest round of concerted intervention, including some from the Germans, which we joined in; but the exercise was rather half-hearted so this too had little effect.

- In the early part of the day, our crossrate against the DM was down only a little, at around DM 3.15, but this afternoon it has weakened and now (1540) stands at just DM 3.14.

- Eddie says that trading has been very thin, and the situation does not require urgent action. But he does find things worrying, and the Bank will be keeping a careful eye on the market overnight and first thing tomorrow morning with a view to possible intervention. We have not done any unilateral intervention so far. There is no sign of significant upward pressure on interest rates in the money markets.

PAUL GRAY
30 May 1989
DS3AIT

SECRET

Subject cc Master

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

24 May, 1989.

In the course of their bilateral yesterday, the Prime Minister asked the Chancellor whether work was being done in the Treasury assessing the reasons why there had been no further progress in reducing the rate of inflation over the last few years, and the reasons for the recent increase in the rate. She had read the article in the Barclays Economic Review by Alan Budd, and would like to see a similar assessment by the Treasury. The Chancellor said that he had indeed asked the Chief Economic Adviser to put this work in hand. The Prime Minister said that it would be helpful to have such a paper available as soon as possible.

Paul Gray

Alex Allan, Esq.,
HM Treasury.

SECRET

SECRET

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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

24 May, 1989.

SUBJECT CC MASTER

INTEREST RATES

The Chancellor came to see the Prime Minister at 0925 this morning to continue the discussion at their bilateral yesterday about the position in the markets.

The Chancellor said that he had considered the position further this morning with Treasury and Bank advisers. The exchange rate had weakened further overnight, and the unanimous conclusion was that interest rates should be raised by 1 per cent. The Prime Minister agreed that, in the circumstances, there was no choice but to take this action. It was agreed that the Chancellor would arrange for the Bank of England to signal the 1 per cent increase at 0945 this morning.

Paul Gray

Alex Allan, Esq.,
HM Treasury.

SECRET

PA

10 DOWNING STREET

Prime Minister

CHANCELLOR'S RADIO INTERVIEWS

You may find it helpful before Questions tomorrow to glance through these transcripts of the radio interviews the Chancellor gave at lunchtime.

RRCB
24/5

TRANSCRIPT FROM 1 O'CLOCK NEWS, BBC RADIO 4, 24 MAY 1989

PRESENTER (JAMES NAUGHTIE): Joining us now from our radio car in Downing Street is the Chancellor, Nigel Lawson. Mr Lawson, hasn't this latest rise in interest rates been caused by what the Prime Minister said yesterday, perhaps ill advisedly, because the result was to send a jittery City running to sell the pound?

CHANCELLOR: I don't think you can attribute any one particular cause, though there have been a number of things happening -

NAUGHTIE: But it didn't help?

CHANCELLOR: There have been a number of things happening, notably the remarkable strength of the dollar in recent weeks. What had happened, quite simply, was that the pound was under pressure to the point where it was necessary to raise interest rates in order to keep monetary policy sufficiently tight. I have said all along that we have got to get inflation down, and that means interest rates have to be as high as is needed for as long as is needed, and I judged that the time had come, given what was happening in the foreign exchange market, to raise interest rates, and this is indeed has had a salutary effect. But what you have to look at, as Alan Budd quite rightly said, is what is happening to the domestic economy, and on the domestic economy things are going just as they should do. You have seen the housing boom has subsided, the amount of borrowing, therefore, which is largely liked to purchasing housing, that has come down, the retail spending has come down, we see the retail sales figures today, that has slowed down tremendously, and the progress of getting inflation down takes time, of course, but it is going according to plan.

NAUGHTIE: But you see, the reaction of the market yesterday to what Mrs Thatcher said was very sharp indeed, as you know, and to make that kind of comment off the cuff at question time against the background of the strong dollar against the background of 8% inflation, against the background, frankly, of a long standing

dispute between you and the Prime Minister about exchange rate policy, is surely ill advised, and almost certainly going to produce the kind of reaction that forced you to put up rates higher than you would want this morning?

CHANCELLOR: I really wouldn't attribute the market, what is happening in the foreign exchange market, to what the Prime Minister said, that is absurd. What this shows is the febrile nature of financial markets and the foreign exchange market in particular. That's something we have always known about, and that is one of the reasons why, within the G7 major industrial nations, we have tried to exercise a steadying influence over the years, because the nature of markets is such that they are extremely febrile and volatile.

NAUGHTIE: The Prime Minister said last year that you could not book the markets, you are saying that you have got to do it. Now looking back to what the Prime Minister said on that subject last Friday, she said that the inflationary trouble started, she said we actually picked it up, the inflationary tendency, during a time when we were trying to hold our pound level with the Deutschmark at 3 marks. Now that was a policy she didn't support, but you pursued. Isn't that the beginning of all our trouble?

CHANCELLOR: No, I'm really not going to go over all that. I think this is absurd. What is important is that we have a very, very strong economy, we have a highly successful economy, we have investment higher than it has ever been before, both in total and in terms of business investment, and as a proportion of the economy as a whole, we have productivity growing faster than it has ever grown before, and we have an excellently performing economy. Now we do have inflation too high, it is necessary to take steps to bring inflation down, those steps have been taken, and the further measure I took today shows quite clearly that the Government's resolve is total and absolute. Whatever is necessary to bear down inflation, we shall take those measures, and that is in stark contrast, if I may say so, with the Labour Party. We heard Mr Smith earlier, that every policy the Labour Party has will simply put inflation higher.

NAUGHTIE: Isn't it the case that we wouldn't have this kind of problem on the foreign exchange markets if we had been full members of the Exchange Rate Mechanism of the European Monetary System, earlier than now?

CHANCELLOR: I think it is impossible to say what the position would be if we had been members of the European Monetary System. But there are no magic answers, no magic solutions. The answer is that obviously there is a strong case for joining the ERM; that is why we have said very clearly, time and time again, that we will indeed join, when as a Government we decide the time is right.

NAUGHTIE: But economic advisers were saying the time was right in 1986! If we had gone in, we would not have this problem now.

CHANCELLOR: That is really not relevant to what we are discussing now, which is the measures to bear down on inflation. I mean, the underlying rate of inflation, if you strip aside mortgage payments, the underlying rate of inflation, even now, I think is far too high, but even now is lower than it ever was in the very best month in the whole of the period the Labour Party was in office.

NAUGHTIE: Do you think the interest rate is going to have to rise again this year?

CHANCELLOR: Well, I see no reason to say that, but as I say, I will do whatever is necessary at any time, but we had interest rates steady at 13% for a period of 6 months, which is the longest period we have had without any change in interest rates for a very, very long time, for a number of years.

NAUGHTIE: So we should not take literally what the Prime Minister said yesterday, namely that what you have done will control inflation? More may be necessary?

CHANCELLOR: Inflation is already coming round, not in the sense that the RPI figures will yet show, that will take a little bit longer, but it will certainly be visible during the course of this year. But already, as I have said, the scale of borrowing,

particularly the borrowing to buy houses, that has fallen very considerably, retail sales are not growing nearly as fast, the overheating in the economy, to use the cliche, is now on the way to subsiding, and I think everybody, you heard what Alan Budd said, everybody agrees that it is merely a matter of time before inflation will be coming down again. That is what really matters.

NAUGHTIE: Isn't there one clear signal that people are bound to take from today's action, namely that tomorrow's trade figures are going to be bad?

CHANCELLOR: I am not going to talk about tomorrow's trade figures. You will have to wait and see what they are tomorrow.

NAUGHTIE: Mr Lawson, thank you very much indeed.

No. 10

IRN interview - 24 May 1989

Chancellor there has been pressure on the pound and I have always said that we would keep interest rates as high as needed for as long as is needed to get on top of inflation. And with the pressure on the pound, with the pound slipping back a little bit, and largely because of the strong dollar, but nevertheless looking back that does threaten,if nothing is done, to undermine the strength of the anti-inflationary policy. Therefore it is necessary to restore it by putting interest rates up a point.

Moffitt Although there have been occasions in the past when the pound has been very weak against a strong dollar and that has not produced the sort of imported inflation that many outside observers thought it would ,why will it this time ?

Chancellor We've always taken the exchange rate into account,it's very important to do so, and I'm not saying that this is going to push inflation higher in itself. What I was saying is that if we had left it ,if I had left it, so that the pound was allowed to drift down any further, then I think this would undoubtedly have undermined the strength of the anti-inflationary discipline which it is necessary to put in place. And therefore this has been tightened by the only way possible, which is to raise interest rates.

Moffitt You have been trying to hold base rates at 13% despite relentless pressure from the City that you should put them up. How big a set back is this for you personally ?

Chancellor I think you can discount the relentless pressure from the City there are always a lot of voices in the City and they say different things. We have had interest rates at now 13% ,which was a high level, for six months, and during that time we saw the medicine working very satisfactorily. We saw the house price boom subsiding, and housing turnover indeed falling very considerably. We saw retail spending coming down so that is subsiding too. And

altogether everything happened just as it should, and so we were on track and that was fine. But as I say we've now had the developments in foreign exchange market which meant that if there had been no reaction the satisfactory progress that we have been achieving so far would have been undermined. And that I was not prepared to allow.

Moffitt You have previously made it clear that interest rates would stay high as long as they need to stay high in order to squeeze inflation out of the economy. This move has been forced on you by external circumstances; can we assume that this latest 1% rise might be reversed earlier than we might otherwise have expected?

Chancellor No, I don't think you can assume anything, except this: that I will always take whatever action I judge to be right in the interests of the economy, in the interests of getting inflation down, and also in the interests of having a strong economy. When I believe it is necessary to raise interest rates, interest rates are raised. I believe there is no point in shrinking from unpopular action; you have to do what is right, and equally when the time comes for interest rates to come down, they will come down. But of course, there is no way I can tell you when that will be.

PM2AQE

SECRET

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See by PM.
PRCG 23/5

PRIME MINISTER

LATEST RPI FORECAST

You might like to be aware, before your bilateral with the Chancellor this afternoon, of the Treasury's latest internal forecast for the profile of the RPI over the rest of this year.

I managed to extract this from the Treasury this morning, although the Chancellor may not be aware of this. I should therefore be grateful if you would avoid revealing to him you know the precise figures.

The figures are:

May/June - 8.4%
July - 8.3%
August - 7.4%
September - 7.5%
Dropping by December to 6.8%

As you will recognise, this is another upward revision. It is said to be based on present levels of interest rates and the exchange rate, and to assume that there will be some squeeze in retailers' margins during the rest of the year.

As in the earlier forecasts, there is still a substantial drop in August, when the main mortgage rate effect drops out, but at significantly higher levels. The Budget forecast of 5.5% for the fourth quarter now looks pretty sick.

PRCG.

PAUL GRAY

23 May 1989

SECRET

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PRIME MINISTER

WHY DO WE HAVE 8 PER CENT INFLATION?

You may like to see Professor Budd's analysis of what has gone wrong with economic policy, if only because Terry Burns' own analysis would be very similar. Like Tim Congdon, Alan Budd sees the difficulties beginning in 1985-86, long before the shadowing of the DM, though that gave things an extra push by causing the signals coming from MO in early 1988 to be overridden.

Although in the long run, Alan Budd is sympathetic to the ERM, he wishes to stick with MO targts for the time being, but with broad money being given greater emphasis than in the recent past.

It would be helpful to ask the Chancellor for a paper giving his own analysis of events. First, this would counteract his tendency towards secrecy and would reduce the risk that you and he get at cross purposes. Secondly, it would provide a basis for discussing a number of unresolved issues, e.g.,

- narrow ~~the~~ v broad money targets, and whether any weight can be put on the apparent return to trend of M3 velocity, see Alan Budd's figure 7;

- the effect of intervention when sterilised.

Thirdly, it would also help bring the Chancellor to acknowledge that mistakes have been made over a number of years without pinning them on factors which are attributable to him alone. There have been mistakes of Government, but since you have consciously strengthened the position of the Treasury

- by eliminating other sources of advice such as the CSD and CPRS;

- by discouraging second guessers in the Harold Lever role

the Treasury does have to take responsibility when things go wrong as well as take credit for the successes.

AT

ANDREW TURNBULL

22 May 1989

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FILE

KAYAVY

cc AT
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NOTE FOR THE RECORD

The Chancellor, who was attending the informal eco-fin meeting in Spain, rang the Prime Minister at around 12.30 on 20 May to discuss the press reports of the Prime Minister's interview the previous day with the BBC World Service.

The Prime Minister said she recognised the Chancellor would be distressed by the reports, as indeed she was herself. But the actual interview did not bear the interpretation the press had given it. She had never said that the Chancellor had been to blame for the pick-up in inflation; indeed if she blamed anyone for it, it was herself.

Continuing she said that, with the benefit of hindsight, when she had been asked whether the Chancellor had been wrong to seek to shadow the Deutschemark, she should have given a direct answer - refuting that suggestion and emphasising her support for the Chancellor. But at the time it had seemed important to give the answer she had done, refuting the report on the radio earlier that morning. The Prime Minister repeated that there was nothing in her remarks to say that she blamed the Chancellor. Indeed, she and the Chancellor stood together on economic policies.

The Chancellor said that, of course, he accepted everything the Prime Minister said. But the press reporting of her interview presented him with the most difficult situation he had yet faced. He was always happy to discuss policy fully with the Prime Minister in private, but it was very difficult if issues between them were brought out in the open. While again stressing he accepted everything the Prime Minister had said, he was not surprised by the interpretation that had been put on the interview by the press and by the Opposition. But his most immediate concern was that action should be taken to correct any misinterpretation in time for the Sunday newspapers.

The Prime Minister repeated her earlier remarks. She said

that, when the Chancellor came to give his press conference later in the day in Spain, she was happy for him to say that they had spoken and for him to emphasise her full support. As regards the Sunday press, she would be content for the No. 10 Press Office to take action to emphasise the key points.

In further discussion it was agreed that they were:

- The policies adopted by the Chancellor were those of the Government and were fully approved and supported by the Prime Minister.

- Those policies had brought great economic success to the UK; rising living standards, high employment etc.

- The present pick-up in inflation was a problem, but the right action had been taken - in full agreement - and would succeed.

The Chancellor repeated his request for the No. 10 Press Office to take positive action with the Sunday press to get this message over, and the Prime Minister and Chancellor asked me to put this into effect.

I then spoke to Bernard Ingham. His judgement was that to approach the Sunday press would be a mistake. During the morning the press had been showing very little interest in the story, and for us now to approach them would have the effect of stoking things up again. But he agreed that, if the press approached us on the story, he would emphasise the three points agreed. I also told him that it was possible the news would come back from Spain that a telephone conversation had taken place.

I then reported this conversation back to the Prime Minister. She accepted Bernard's judgement but asked me to pass out a further message to the party in Spain, explaining the attitude we were taking.

I then spoke to Nigel Wicks in the Chancellor's party and asked him to pass on this message.
At about 1500 Nigel Wicks rang me back to say that the Chancellor was deeply unhappy about the decision not to take positive action to contact the Sunday press. Even if such action had the effect of reviving the story, he would much prefer the record to be put straight and for the Prime Minister's support for him to be made absolutely clear. His concern was that, given the publication deadlines, time was now getting extremely short to influence the Sunday newspapers. I undertook to discuss this further with the Press Office.

As I was unable to contact Bernard Ingham I discussed the latest developments with Terry Perks. He concurred with Bernard's original judgement, and with the view that it was in any event probably now too late to influence the Sundays. But I said to him that, in view of the nature of the earlier conversation between the Prime Minister and the Chancellor and given the Chancellor's continuing unease, I thought he should speak to a selection of the Sunday papers - even if this had no impact on the stories they ran it would enable us to say that we had met the Chancellor's request. Terry Perks agreed to do so.

He rang me back at about 1600 to say he had spoken to the Times, Telegraph and Express. The Times had said that their political writers were not running anything on this story, but the economic staff were. The Telegraph and Express had yet to decide how to handle things. Terry had fed in the three key points to all of them. Terry said that he felt it would be totally counterproductive to approach any of the other papers, and I agreed.

At about 1700 I rang Nigel Wicks in Spain again. He was unavailable, but I left a message for him to the effect that "the action had been taken".
I subsequently reported these later events to the Prime Minister in a telephone call at about 1800.

PRCG.

PAUL GRAY

20 May 1989

Fly

NOTE FOR THE RECORD

I spoke to the Prime Minister about the press interpretation of her World Service interview. She confirmed that she had no intention of criticising the Chancellor publicly. She has agreed the following press line.

(i) It has been recognised that monetary policy became too loose; that is why it has now been tightened up.

(ii) Important to remember that the Chancellor was trying to avoid a recession following the stock market crash. In this he acted with the full support of the Prime Minister and was successful.

(iii) Her interview specifically drew attention to inflationary pressures elsewhere; hence not attributing current position on inflation entirely to UK policy.

(iv) She expressed the hope that the current stance on monetary policy will prove well judged and that a safe landing will be achieved.

(v) She has fullest confidence in the Chancellor.

She remarked to Terry Perks after the interview that she had not responded when the interviewer said (page 7 of the transcript)

"so the Chancellor was wrong on that point?".

This was because she was already moving on to counter the impression given by Mr. Christopher Johnston on the radio this morning that joining the ERM provided an easy way of reducing

inflation. The fact that she declined to answer that question should not, therefore, be interpreted as an acceptance of the criticism of the Chancellor.

I will relay these points to Peter Middleton and ask him to pass them to the Chancellor in Spain.

AT

ANDREW TURNBULL

19 May 1989

CONFIDENTIAL

Foreign and Commonwealth Office

London SW1A 2AH

12 May 1989

Dear Duncan

Guinness Mahon

Thank you for copying to me your letter of 8 May to Paul Gray. The Foreign Secretary agrees that the issue should be left to the commercial judgement of the parties.

I am sending copies of this letter to Paul Gray (Number 10) and Neil Thornton (DTI).

Yours ever

Bob Peirce

(R N Peirce)
Private Secretary

Duncan Sparkes Esq
APS/Chancellor fo the Exchequer
HM Treasury, Parliament Street SW1

CONFIDENTIAL

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CONFIDENTIAL UNDER SECTION V
OF THE BANKING ACT 1987

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary 10 May 1989

GUINNESS MAHON

Thank you for your letter of 8 May, which the Prime Minister has seen. She has noted the intention to allow the offer from the Bank of Yokohama to proceed.

I am copying this letter to Robert Peirce (Foreign and Commonwealth Office) and Neil Thornton (Department of Trade and Industry).

(PAUL GRAY)

Duncan Sparkes, Esq.,
HM Treasury.

**CONFIDENTIAL UNDER SECTION V
OF THE BANKING ACT 1987**

chex.ps/ds/98

CONFIDENTIAL UNDER SECTION V OF THE BANKING ACT 1987

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

8 May 1989

P R C Gray Esq
Private Secretary to
Prime Minister
10 Downing Street
LONDON
SW1

Prime Minister! Content to continue the policy of allowing the Japanese to bid for Guinness Mahon? PRCG 9/5

Dear Paul,

You will recall that Alex Allan wrote to you on 21 October about a bid by a Japanese bank, Tokai, for the merchant bank Guinness Mahon. In view of our concerns about the access of British firms to the Tokyo Stock Exchange, the Chancellor had considered whether to block the bid, but had concluded that it was right to allow the Japanese offer to go ahead. Your reply on 24 October said that the Prime Minister noted this.

In the event, the Tokai bid fell through, and Guinness Mahon remained under the control of Equiticorp, a New Zealand company. Equiticorp subsequently fell into the hands of the New Zealand receivers, and control of Guinness Mahon passed to a consortium of banks (led by Montagus) which had provided Equiticorp with a loan to purchase their share of Guinness Mahon in the first place. The consortium of banks has in turn been trying to sell Guinness Mahon. There is now a short list of four possible purchasers, one of which is a Japanese bank. This is the Bank of Yokohama, a regional bank with a branch in London since 1973. The Bank do not have any prudential concerns about it.

The balance of arguments for and against allowing the Japanese bid to go ahead have not changed significantly since October. On the one hand, Guinness Mahon would obtain an owner in whom the Bank had confidence, which was not the case with Equiticorp, and could look forward to a more settled future. On the other hand, it is necessary to consider whether to withhold agreement in order to put pressure on the Japanese over access to Tokyo. There are, however, more suitable levers available to apply pressure on the Japanese. The main linkage which we have made in discussions with the Japanese relates to new authorisations for Japanese regional

banks to operate in London. The agreement to allow a Japanese bank already in London to acquire Guinness Mahon would be unlikely to weaken our bargaining position with the Japanese.

The Chancellor therefore agrees with the Governor that the right course is to allow the Japanese offer to go ahead. Lord Young has indicated that he does not wish to intervene.

I am sending copies of this letter to Robert Peirce (FCO) and Neil Thornton (DTI).

Yours,

Duncan

DUNCAN SPARKES
Assistant Private Secretary

PRIME MINISTER

MARKET REPORT

You will see from the attached Evening Report that the markets were in a slightly rocky mood this afternoon. This reflected a combination of:

- adverse reaction to the money supply - and in particular the bank lending - figures;

- a surprise move by the Germans to push their interest rates up by ½ per cent;

- reaction to the news that the latest North Sea accident could have a significant balance of payments effect.

In the equity market, all this caused quite a sharp reversal, with the FT-SE 100 moving to some 30 points down on the day, having started the day up.

On the foreign exchanges, the DM strengthened and sterling initially held with it. But then after a period, with growing reports of the possible need for a further UK interest rate increase, we weakened a bit to under DM 3.17. But we remained stronger on the day against the dollar. The overall effective drop was only about 0.3.

Tomorrow's figures on consumers expenditure in the first quarter (reported in a separate note in the box) may help to ease the stories of pressures for a UK interest rate rise. We have also had good news today of a reduction in the earlier estimate of imports and the trade deficit in March; see separate note in the hot box.

PAUL GRAY

20 April 1989

EL3DMP

PA

PRIME MINISTER

TOMORROW'S ECONOMIC FIGURES

Figures for consumer expenditure for the first quarter (flag A) and the latest cyclical indicators (flag B) are published tomorrow. Given the differences of measurement we cannot place too much reliance on the consumer expenditure figures, but they do suggest some degree of slow down. As usual the cyclical indicators tell us virtually nothing.

PAUL GRAY

20 April 1989

PRIME MINISTER

THE MARKETS AND THE LATEST ECONOMIC FIGURES

You may like to have a brief resumé of developments in the markets this week, the reaction to the week's economic figures and the figures coming out next week.

The Markets

Things have turned out rather better than we might have feared in the light of the trade figures published on Wednesday. On Tuesday, in advance of publication, sterling was weak and dropped about one per cent on the effective rate. But it was pretty steady, slipping only marginally, on Wednesday and Thursday. And today, Friday, sterling has strengthened a little - see the market report at Flag A.

Intervention has been light - a little under $100 million on both Tuesday and Wednesday, but virtually nothing in the last two days.

Relative quietness in the exchange markets has owed a good deal to the fact that the G7 meeting is coming up this weekend; although there have been sustained bouts of dollar strength the markets have generally been adopting a wait and see attitude. It may be that, with the markets focussing on prospects for the dollar, judgement has been reserved on sterling. That said, there has been evidence of increased nervousness about the prospects for sterling; and the latest trade figures got a very critical reception in the press on Thursday. Once the G7 is out of the way, we could be in for a more lively time in the markets.

The other main feature of the week has been the strengthening oil price. As you will see from Flag A Spot Brent topped $20 today. I have included separately in the box a note by the Policy Unit on the impact of the Alaska oil spillage.

Latest Economic Figures

The main news has of course been the trade figures. But we have also had figures for personal disposable income and industrial and commercial companies - summarised in the weekly DTI note at Flag B.

The main press attention on the personal disposable income figures centred on the 1988 savings ratio being the lowest for 33 years. But what most of the press ignored was that the latest savings figures have been substantially revised upwards from the earlier estimates. Whereas the earlier estimate for 1988 Q3 was 1.3 per cent that has now risen to 3.1 per cent, with 4.1 per cent in Q4. That is of course still a lot lower than we want to see; but the revisions underline the fragility of the figures we are dealing with.

I also attach at Flag C the latest weekly M0 figures. These are continuing to edge down slowly, with the latest 12 month rate at 6.2 per cent.

Next Week's Figures

Next week is fairly quiet, but we do have on Monday the final February figures for retail sales (Flag D) and February credit business (Flag E):

- the retail sales have been revised upwards, so February is now slightly above the previous peak in October. The DTI note argues that the underlying trend is still broadly flat over the last six months or so, and that may well be right. But the figures remain very difficult to interpret, and the markets may well be disappointed by the upward revision;

- credit business shows only a modest increase.

The only other significant figure next week will be the March

reserves on Tuesday. These will reveal the significant scale of intervention over the month as a whole - see the figure in the market report at Flag A.

PAUL GRAY

31 March 1989

DA1ABA

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CONFIDENTIAL

FROM: S BROOKS
DATE: 21 March 1989

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns
Mr Wicks
Mr Scholar
Mr Peretz
Mr Sedgwick
Mr Gieve
Mr Grice
Miss O'Mara
Ms Ryding
Mr Kerley
Mr Sheath
Mr Gray (No 10)
MAWL A1

PROVISIONAL MONEY FIGURES - FEBRUARY 1989

You asked whether declining NIBM1 just reflects the introduction of the new interest bearing current accounts (Mr Sparkes minute of 20 March).

2. The twelve month growth rate of NIBM1 declined to 7.3 per cent in January and 5.3 per cent in February after being in the 10-15 per cent range (with little sign of any trend within this range) for the previous eleven months. Over the longer term NIBM1's growth has been erratic, as the chart below shows; we believe it to be very interest rate sensitive. NIBM1 fell sharply in January, by £1.6 billion, seasonally adjusted. Half this fall was accounted for by lower holdings of notes and coin - presumably a run down after the Christmas build up. The other half reflected an unusually large fall in NIB sight deposits. While we cannot be sure of the reasons for this, it seems likely that four factors played a part:

- a correction following an unusually large rise in NIB sight deposits in December;

- a reduction of deposits to pay taxes;

- switching out of non-interest bearing deposits following the rise in banks' retail deposit rates at the turn of the year (the banks delayed their reaction to November's base rate rise);

- switching into the interest bearing current account already operated by Lloyds.

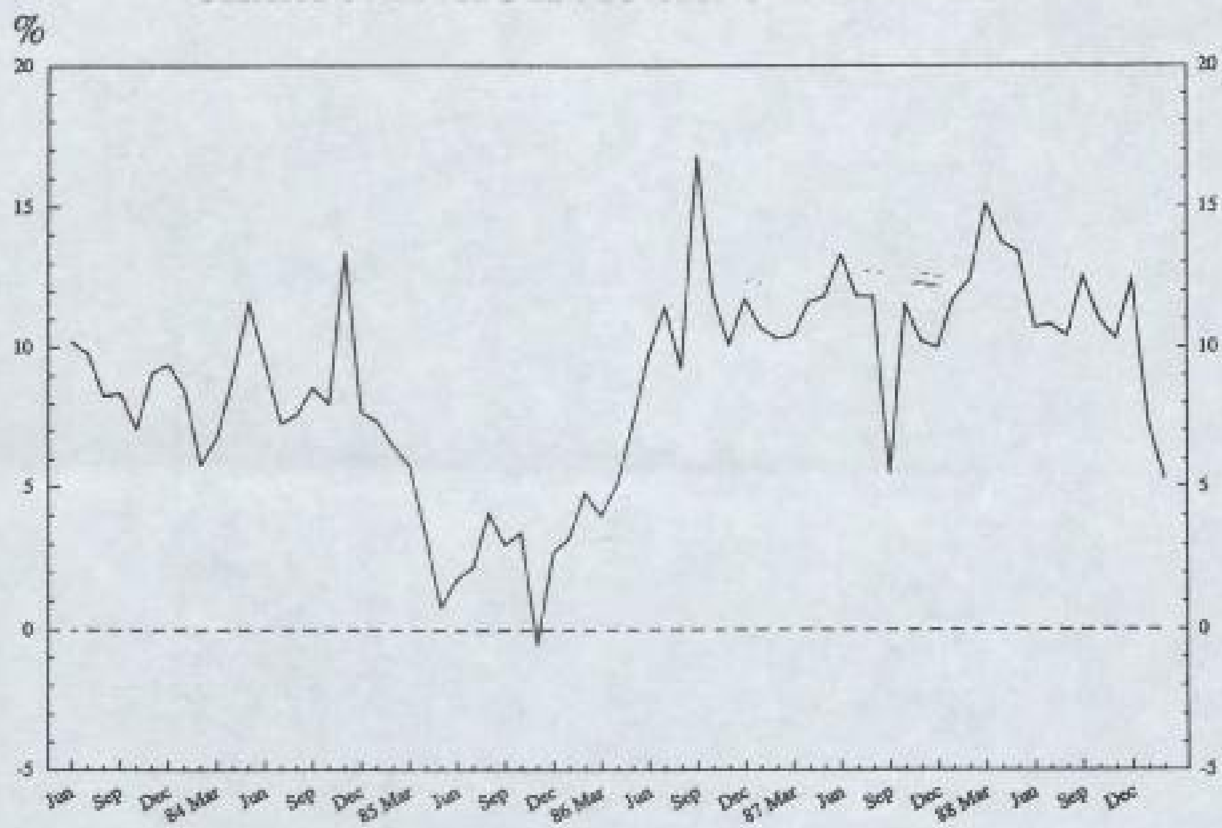
3. In February, banks' NIB sight deposits fell slightly after seasonal adjustment. As they had risen strongly in February last year, this was reflected in a decline in NIBM1's twelve month growth rate. An increase in banks' total retail deposits in February was to be expected as deposits were rebuilt following the payment of taxes in January. In the event retail deposits increased by £1.6 billion, after seasonal adjustment, one of the largest increases of the past year. But with non interest bearing deposits falling the increase was more than accounted for by rises in interest bearing deposits. This could suggest that the rebuilding of deposits was combined with switching into the new interest bearing current accounts (operated by three of the big four clearing banks in February). The Bank of England reckon that the new accounts increased by around £1 billion in February (FIGURE NOT FOR USE) as a result of switching out of other M4 accounts.

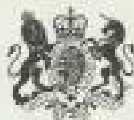
Conclusion

4. The slowdown in NIBM1 growth in the last two months may be explicable in terms of a number of special factors, though no doubt the higher interest rates have played a part. The effect of switching into the new accounts may well persist for several months yet, leading to low figures for NIBM1 growth. But if, as we believe, there is little wider macroeconomic significance in these developments and that the growth rate may rise again when the special factors cease to operate, then our advice would be not to highlight the slower NIBM1 growth in the briefing.

S BROOKS

CHART : NIBM1's 12 MONTH GROWTH RATE





Department of Employment
Caxton House, Tothill Street, London SW1H 9NF
Telephone 01-273 5803
Telex 915564 Fax 01-273 5821

Secretary of State

Paul Gray Esq
10 Downing Street
LONDON
SW1A 0AA

15 March 1989

Dear Paul

I enclose our standard revised brief for unit wage and salary costs and productivity, which are to be issued on Thursday. The figures are personal and confidential until 11.30 am Thursday 16 March.

I am copying this to Alex Allan (Treasury), Sir Peter Middleton (Treasury), Mr Hibbert (CSO), Mr Footman (Bank of England), Neil Thornton (DTI), Sir Brian Hayes (DTI), and Andrew Dunlop (No.10 Policy Unit).

Yours ever,

Angela

ANGELA WILKINS
Private Secretary

Employment Department · Training Agency
Health and Safety Executive · ACAS

SECRET

PRIME MINISTER

EVENING REPORT

Tonight's Evening Report (attached) confirms the continuing strength of sterling today in the light of the Budget.

You may however be surprised to see market intervention of $111 million recorded. I have enquired into the background to this. Apparently, this was action undertaken by the Bank without reference to the Treasury. It is said not to have been any sort of attempt to hold the rate down. The Bank say they were approached by market operators wishing to sell them dollars in order to close out some contracts that remained open following the intervention ten days ago when the Bank were selling dollars. Given the movement of the rate since then, this presented the Bank with an opportunity to close out their earlier position at a significant profit. They decided to take this opportunity, both to make a trading profit and to use it as the opportunity to acquire part of the regular $300 million buying programme to finance our German defence obligations.

This sounds more or less plausible, and the operation does not seem to have become known to the market.

PAUL GRAY

15 March 1989

SECRET

EAMAQC

10 DOWNING STREET

PRIME MINISTER

We had to cancel today's meeting with Alan Walters; you will now be seeing him tomorrow after Questions.

PRG
13/7

8

PRIME MINISTER

BILATERAL WITH ALAN WALTERS: 15 MARCH

We have allowed an hour tomorrow afternoon for you to talk to Alan.

The Budget package is fairly closely in line with the approach Alan suggested when you last talked to him in January. So I imagine he will have no great worries on that score.

He will also be content with the firm words about the stance of monetary policy in the Budget Speech. But you might like to discuss with him his views on the present level of interest rates. Is it right to plan to stick at 13% over the coming months?

PRCG.

PAUL GRAY

14 March 1989

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PA

PRIME MINISTER

POSITION IN THE MARKETS

As I mentioned on your return, today has been a rather rocky day in the markets. The market report attached summarises the position.

You will obviously want to take stock of the position when you see the Chancellor for your bilateral on Wednesday afternoon. That will be after the publication of the trade figures at 1130 on Wednesday morning, and it will be possible to assess then the immediate impact on the markets. As of now, however, the markets do not seem to be anticipating that the trade deficit will be quite as high as it is.

Meantime, I thought you would find it helpful to know how Eddie George views the position. I have, therefore, had a private conversation with him; you should not rewal your knowledge of Eddie's views to the Chancellor.

Eddie says that the markets are currently taking a more jaundiced view of the position of those countries with large external deficits protected by high interest rates. That covers Australians and Canadians as well as us. The change of sentiment is influenced by increasing interest rates elsewhere, for example, the Fed's increase in the discount rate of 7 per cent on Friday, and talk of a further German interest rate increase later this week.

In this mood of nervousness, the markets will be paying particular regard to Wednesday's trade figures.

You will see that total intervention today has been of the order of $200 million. Eddie tells me this was carried out in three separate waves. He was slightly doubtful about the merits of this operation, fearing that it would have little effect. In the event, he thinks it has had some effect in holding the ~~interest~~ exchange rate higher than it would otherwise have

been.

Looking ahead, Eddie thinks there will be further nervousness when the trade figures come out, with the DM 3.15 level being tested. The pressure will be greater if it then seems likely that the Germans will be increasing their rates. Eddie himself hopes to get a clear indication from the Germans of their intentions on Wednesday; but we may not have any advance notice before they announce their decision on Thursday morning.

Subject to developments later in the week, Eddie does not think that we should be contemplating a further interest rate increase immediately after the trade figures announcement. He considers that, if there is downward pressure on the rate then, we should try a heavy bout of intervention - by which he means a figure of up to $1 billion over a 1-2 day period. But if that does not work, he would then favour an interest rate increase.

Assessment

My own view is that, if downward pressure on the exchange rate continues, now is the time to contemplate heavy intervention. The Reserves are very high, and are there to be used in conditions like this. The monetary effect of running down the Reserves is helpful. And the last thing we want to see at the moment is a sliding exchange rate.

At the same time we should if possible try to avoid a further interest rate increase at this stage. The political and other difficulties of such a move in the run-up to the Budget speak for themselves, and on the underlying merits the balance of the present evidence is that 13 per cent interest rates probably are high enough to produce the desired slow-down in economic activity. A further increase could easily produce over-kill; particularly as, if the skids really get under the ~~interest~~ exchange rate, a 1 per cent interest rate increase may not be enough to calm the markets.

C

Obviously, we need to judge the position day by day.

If you agree with this analysis, you may want to take the opportunity on Wednesday of pressing the Chancellor to authorise substantial short-term intervention. If it works, all well and good, and if it doesn't, we have lost very little; the Reserves will still be far higher than they were in mid-1987.

PRCG.

PG

27 February, 1989.

chex.md/ds/5

PA

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

17 January 1989

P R C Gray Esq
Private Secretary to
Prime Minister
10 Downing Street
LONDON
SW1

Dear Paul,

— with PG?

Further to my letter of yesterday enclosing the information underlying the tables at Annexes 4 to 7 of Section L of the Treasury Weekly Brief, the Chancellor has asked me to point out that the slight increase in the total tax burden for the man on average earnings between 1978-79 and 1988-89

(i) reflects the sharp rise in average earnings in real terms: for someone on <u>unchanged</u> real earnings the total tax burden has fallen;

(ii) is made up of a slight reduction in the burden of income tax and NICs which has been more than offset by an increase in taxes on spending (affected by decline in personal savings ratio) and rates (affected by local authority spending decisions).

Yours sincerely,

Duncan Sparkes

DUNCAN SPARKES
Assistant Private
Secretary

chex.ps/ds/53

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

16 January 1989

P R C Gray Esq
Private Secretary to
Prime Minister
10 Downing Street
LONDON
SW1

Dear Paul,

You asked for the information underlying the tables at Annexes 4 to 7 of Section L of the Treasury Weekly Brief. I attach figures on:

(i) earnings, (Annex 1)

(ii) amount paid in income tax,)

(iii) amount paid in NICs,) (Annex 2)

(iv) amount paid in indirect taxes,)

(v) changes in real take-home pay, (Annex 3)

all at 1988-89 prices for people on half, three-quarters and average earnings, from 1978-79 to 1988-89. The RPI has been used throughout to adjust to 1988-89 prices.

Annex 2 is an edited version of a Written Answer (OR Vol 144 No.25, 10 January 1989, cols 633-656) which in its original form gives figures up to 2,000 per cent of average earnings.

The briefing has not yet been approved by the Chancellor.

Yours,

Duncan Sparkes

DUNCAN SPARKES
Asst. Private Secretary

fp.nh/sf/83

ANNEX 1

AVERAGE ADULT MALE EARNINGS AT 1988-89 PRICES
(£ PER WEEK)

1978-79	197.22	
1979-80	200.51	
1980-81	207.41	
1981-82	206.31	
1982-83	207.95	
1983-84	215.94	
1984-85	222.25	
1985-86	225.26	
1986-87	235.01	
1987-88	247.02	
1988-89	254.10	(assuming growth of 8¾ per cent on 1987-88)

AMOUNT OF EARNINGS TAKEN IN INCOME TAX, NICS AND INDIRECT TAXES

50 per cent. of average male earnings (£127·05 a week in 1988-89)

	Single			Married no children			Married both working			Married two children		
	£ per week	£ per week 1988-89 prices	per cent. of gross earnings	£ per week	£ per week 1988-89 prices	per cent. of gross earnings	£ per week	£ per week 1988-89 prices	per cent. of gross earnings	£ per week	£ per week 1988-89 prices	per cent. of gross earnings
1978-79												
Income tax	7·91	16·81	17·0	4·42	9·39	9·5	0·00	0·00	0·0	−1·88	−3·99	−4·1
NIC	3·02	6·42	6·5	3·02	6·42	6·5	3·02	6·42	6·5	3·02	6·42	6·5
Total	10·93	23·22	23·6	7·44	15·81	16·0	3·02	6·42	6·5	1·14	2·42	2·5
1979-80												
Income tax	8·95	16·42	16·4	5·20	9·54	9·5	0·00	0·00	0·0	−2·80	−5·14	−5·1
NIC	3·55	6·51	6·5	3·55	6·51	6·5	3·55	6·51	6·5	3·55	6·51	6·5
Total	12·50	22·93	22·9	8·75	16·05	16·0	3·55	6·51	6·5	0·75	1·38	1·4
1980-81												
Income tax	11·78	18·58	17·9	7·33	11·56	11·2	0·00	0·00	0·0	−1·21	−1·91	−1·8
NIC	4·43	6·99	6·7	4·43	6·99	6·7	4·43	6·99	6·7	4·43	6·99	6·7
Total	16·21	25·57	24·7	11·76	18·55	17·9	4·43	6·99	6·7	3·22	5·08	4·9
1981-82												
Income tax	13·95	19·74	19·1	9·51	13·45	13·0	1·58	2·24	2·2	−0·35	−0·50	−0·5
NIC	5·65	7·99	7·7	5·65	7·99	7·7	5·65	7·99	7·7	5·65	7·99	7·7
Total	19·60	27·73	26·9	15·16	21·45	20·8	7·23	10·23	9·9	5·30	7·50	7·3
1982-83												
Income tax	14·58	19·26	18·5	9·50	12·55	12·1	0·48	0·63	0·6	−1·44	−1·90	−1·8
NIC	6·89	9·10	8·8	6·89	9·10	8·8	6·89	9·10	8·8	6·89	9·10	8·8
Total	21·47	28·37	27·3	16·39	21·66	20·8	7·37	9·74	9·4	5·45	7·20	6·9
1983-84												
Income tax	15·35	19·38	18·0	9·53	12·03	11·1	0·00	0·00	0·0	−2·65	−3·35	−3·1
NIC	7·70	9·72	9·0	7·70	9·72	9·0	7·70	9·72	9·0	7·70	9·72	9·0
Total	23·05	29·10	27·0	17·23	21·75	20·2	7·70	9·72	9·0	5·05	6·38	5·9
1984-85												
Income tax	16·18	19·44	17·5	9·55	11·48	10·3	0·00	0·00	0·0	−3·71	−4·46	−4·0
NIC	8·33	10·01	9·0	8·33	10·01	9·0	8·33	10·01	9·0	8·33	10·01	9·0
Total	24·51	29·45	26·5	17·88	21·49	19·3	8·33	10·01	9·0	4·62	5·55	5·0
1985-86												
Income tax	17·05	19·34	17·2	9·84	11·16	9·9	0·00	0·00	0·0	−3·96	−4·49	−4·0
NIC	8·93	10·13	9·0	8·93	10·13	9·0	7·54	8·55	7·6	8·93	10·13	9·0
Total	25·98	29·48	26·2	18·77	21·30	18·9	7·54	8·55	7·6	4·97	5·64	5·0
1986-87												
Income tax	17·92	19·69	16·8	10·56	11·61	9·9	0·00	0·00	0·0	−3·64	−4·00	−3·4
NIC	9·60	10·55	9·0	9·60	10·55	9·0	6·62	7·28	6·2	9·60	10·55	9·0
Total	27·52	30·25	25·8	20·16	22·16	18·9	6·62	7·28	6·2	5·96	6·55	5·6
1987-88												
Income tax	18·94	20·03	16·2	11·83	12·51	10·1	0·00	0·00	0·0	−2·67	−2·82	−2·3
NIC	10·51	11·11	9·0	10·51	11·11	9·0	7·24	7·66	6·2	10·51	11·11	9·0
Total	29·45	31·14	25·2	22·34	23·62	19·1	7·24	7·66	6·2	7·84	8·29	6·7
1988-89												
Income tax	19·24	19·24	15·1	12·08	12·08	9·5	0·00	0·00	0·0	−2·42	−2·42	−1·9
NIC	11·43	11·43	9·0	11·43	11·43	9·0	7·88	7·88	6·2	11·43	11·43	9·0
Total	30·67	30·67	24·1	23·51	23·51	18·5	7·88	7·88	6·2	9·01	9·01	7·1

75 per cent. of average male earnings
(£190·57 a week in 1988-89)

	Single			*Married no children*			*Married both working*			*Married two children*		
	£ per week	*£ per week 1988-89 prices*	*per cent. of gross earnings*	*£ per week*	*£ per week 1988-89 prices*	*per cent. of gross earnings*	*£ per week*	*£ per week 1988-89 prices*	*per cent. of gross earnings*	*£ per week*	*£ per week 1988-89 prices*	*per cent. of gross earnings*
1978-79												
Income tax	15·56	33·06	22·04	12·07	25·65	17·3	5·28	11·22	7·6	5·66	12·03	8·1
NIC	4·52	9·60	6·5	4·52	9·60	6·5	4·52	9·60	6·5	4·52	9·60	6·5
VAT	1·80	3·82	2·6	1·67	3·54	2·4	2·02	4·30	2·9	1·82	3·88	2·6
Other indirect	6·24	13·26	9·0	7·19	15·29	10·3	8·27	17·58	11·9	7·00	14·87	10·1
Total of above	28·12	59·75	40·4	25·45	54·08	36·6	20·10	42·70	28·9	19·00	40·38	27·3
Domestic rates	2·38	5·07	3·4	2·35	4·99	3·4	2·89	6·13	4·1	2·37	5·03	3·4
Total	30·50	64·81	43·8	27·80	59·07	39·9	22·98	48·84	33·0	21·37	45·41	30·7
1979/80												
Income tax	17·15	31·46	20·9	13·40	24·58	16·3	6·17	11·32	7·5	5·40	9·91	6·6
NIC	5·33	9·78	6·5	5·33	9·78	6·5	5·33	9·78	6·5	5·33	9·78	6·5
VAT	3·33	6·10	4·1	3·03	5·56	3·7	3·62	6·64	4·4	3·37	6·19	4·1
Other indirect	7·04	12·92	8·6	8·02	14·70	9·8	9·16	16·81	11·2	7·87	14·45	9·6
Total of above	32·85	60·26	40·1	29·78	54·62	36·3	24·28	44·54	29·6	21·98	40·32	26·8
Domestic rates	2·84	5·20	3·5	2·79	5·11	3·4	3·42	6·28	4·2	2·81	5·16	3·4
Total	35·69	65·47	43·5	32·56	59·73	39·7	27·70	50·82	33·8	24·79	45·48	30·2
1980/81												
Income tax	21·63	34·12	21·9	17·19	27·11	17·4	9·26	14·61	9·4	8·65	13·64	8·8
NIC	6·65	10·49	6·7	6·65	10·49	6·7	6·65	10·49	6·7	6·65	10·49	6·7
VAT	4·09	6·45	4·1	3·77	5·95	3·8	4·44	7·01	4·5	4·10	6·47	4·2
Other indirect	8·26	13·04	8·4	9·39	14·80	9·5	10·66	16·82	10·8	9·18	14·48	9·3
Total of above	40·63	64·09	41·2	37·00	58·36	37·5	31·02	48·92	31·5	28·58	45·08	29·0
Domestic rates	3·71	5·85	3·8	3·62	5·70	3·7	4·37	6·90	4·4	3·65	5·76	3·7
Total	44·34	69·94	45·0	40·61	64·06	41·2	35·39	55·82	35·9	32·23	50·84	32·7
1981/82												
Income tax	24·89	35·21	22·7	20·45	28·93	18·7	12·52	17·71	11·4	10·59	14·98	9·7
NIC	8·48	12·00	7·7	8·48	12·00	7·7	8·48	12·00	7·7	8·48	12·00	7·7
VAT	4·53	6·40	4·1	4·11	5·82	3·8	4·80	6·79	4·4	4·55	6·43	4·2
Other indirect	9·61	13·60	8·8	10·89	15·40	9·9	12·38	17·52	11·3	10·80	15·28	9·9
Total of above	47·51	67·22	43·4	43·93	62·15	40·1	38·19	54·03	34·9	34·41	48·69	31·5
Domestic rates	4·56	6·45	4·2	4·45	6·30	4·1	5·43	7·68	5·0	4·50	6·36	4·1
Total	52·06	73·66	47·6	48·38	68·45	44·2	43·62	61·71	39·9	38·91	55·05	35·6
1982-83												
Income tax	26·39	34·87	22·4	21·31	28·16	18·1	12·28	16·23	10·4	10·37	13·70	8·8
NIC	10·33	13·65	8·8	10·33	13·65	8·8	10·33	13·65	8·8	10·33	13·65	8·8
VAT	4·68	6·19	4·0	4·25	5·62	3·6	5·01	6·62	4·2	4·74	6·27	4·0
Other indirect	10·01	13·23	8·5	11·39	15·05	9·7	13·04	17·23	11·0	11·27	14·90	9·5
Total of above	51·42	67·94	43·6	47·28	62·48	40·1	40·66	53·72	34·4	36·72	48·51	31·1
Domestic rates	4·98	6·58	4·2	4·89	6·47	4·1	6·01	7·94	5·1	4·94	6·53	4·2
Total	56·40	74·52	47·8	52·18	68·94	44·2	46·67	61·67	39·5	41·65	55·04	35·3
1983-84												
Income tax	28·18	35·57	22·0	22·35	28·21	17·4	12·05	15·21	9·4	10·17	12·84	7·9
NIC	11·54	14·57	9·0	11·54	14·57	9·0	11·54	14·57	9·0	11·54	14·57	9·0
VAT	5·20	6·56	4·1	4·75	5·99	3·7	5·63	7·11	4·4	5·30	6·70	4·1
Other indirect	10·95	13·83	8·5	12·45	15·72	9·7	14·32	18·08	11·2	12·31	15·54	9·6
Total of above	55·87	70·53	43·6	51·09	64·50	39·8	43·54	54·96	33·9	39·32	49·64	30·7
Domestic rates	5·04	6·37	3·9	4·96	6·27	3·9	6·09	7·69	4·8	5·02	6·34	3·9
Total	60·91	76·90	47·5	56·05	70·76	43·7	49·63	62·65	38·7	44·35	55·99	34·6
1984-85												
Income tax	30·06	36·12	21·7	23·42	28·14	16·9	11·86	14·25	8·5	10·16	12·21	7·3
NIC	12·49	15·01	9·0	12·49	15·01	9·0	12·49	15·01	9·0	12·49	15·01	9·0
VAT	6·35	7·63	4·6	6·02	7·24	4·3	6·99	8·39	5·0	6·40	7·69	4·6
Other indirect	11·82	14·21	8·5	13·48	16·20	9·7	15·52	18·66	11·2	13·39	16·10	9·7
Total of above	60·72	72·97	43·8	55·41	66·59	39·9	46·86	56·31	33·8	42·44	51·00	30·6
Domestic rates	5·45	6·55	3·9	5·35	6·43	3·9	6·52	7·84	4·7	5·44	6·54	3·9
Total	66·17	79·51	47·7	60·76	73·02	43·8	53·38	64·15	38·5	47·88	57·54	34·5
1985-86												
Income tax	31·94	36·24	21·5	24·73	28·06	16·6	12·01	13·63	8·1	10·93	12·40	7·3
NIC	13·40	15·20	9·0	13·40	15·20	9·0	11·91	13·51	8·0	13·40	15·20	9·0
VAT	7·04	7·99	4·7	6·66	7·56	4·5	7·88	8·94	5·3	7·00	7·94	4·7
Other indirect	12·46	14·14	8·4	14·21	16·12	9·5	16·57	18·80	11·1	14·07	15·97	9·5
Total of above	64·85	73·57	43·6	59·00	66·94	39·6	48·37	54·88	32·5	45·40	51·51	30·5
Domestic rates	5·85	6·63	3·9	5·76	6·53	3·9	7·08	8·03	4·8	5·82	6·61	3·9
Total	70·69	80·20	47·5	64·76	73·47	43·5	55·45	62·91	37·2	51·23	58·12	34·4
1986-87												
Income tax	33·39	36·70	20·9	26·03	28·61	16·3	13·01	14·30	8·1	11·83	13·00	7·4
NIC	14·40	15·83	9·0	14·40	15·83	9·0	13·12	14·42	8·2	14·40	15·83	9·0
VAT	7·60	8·35	4·7	7·15	7·86	4·5	8·36	9·19	5·2	7·44	8·17	4·6
Other indirect	13·50	14·84	8·4	15·28	16·80	9·5	17·84	19·61	11·1	15·22	16·73	9·5
Total of above	68·89	75·71	43·0	62·86	69·09	39·3	52·33	57·51	32·7	48·89	53·73	30·5
Domestic rates	6·57	7·22	4·1	6·45	7·09	4·0	7·93	8·71	5·0	6·50	7·14	4·1
Total	75·46	82·93	47·1	69·32	76·18	43·3	60·26	66·23	37·6	55·39	60·87	34·6

1987-88												
Income tax	34·71	36·70	19·8	27·60	29·18	15·8	15·01	15·87	8·6	13·10	13·85	7·5
NIC	15·77	16·67	9·0	15·77	16·67	9·0	14·37	15·19	8·2	15·77	16·67	9·0
[illegible]T	8·47	8·96	4·8	7·88	8·33	4·5	9·05	9·57	5·2	8·06	8·52	4·6
[illegible]r indirect	14·23	15·04	8·1	15·93	16·84	9·1	18·52	19·59	10·6	15·83	16·73	9·0
Total of above	73·18	77·28	41·8	67·17	71·03	38·1	56·05	60·22	32·5	52·75	55·78	30·1
Domestic rates	7·05	[illegible]	4·0	[illegible]	[illegible]	[illegible]	[illegible]	9·96	4·8	6·89	7·29	3·9
Total	80·23	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	69·18	37·3	59·65	63·07	34·0
1988-89												
Income tax	35·12	35·12	18·4	27·96	27·46	14·7	15·43	15·43	8·1	13·46	13·46	7·1
NIC	17·15	17·15	9·0	17·15	17·15	9·0	15·63	15·63	8·2	17·15	17·15	9·0
VAT	9·63	9·63	5·1	8·97	8·97	4·7	10·20	10·20	5·4	9·12	9·12	4·8
Other indirect	15·49	15·49	8·1	17·26	17·26	9·1	19·81	19·81	10·4	16·95	16·95	8·9
Total of above	77·39	77·39	40·6	71·34	71·34	37·4	61·07	61·07	32·0	56·68	56·68	29·7
Domestic rates	8·20	8·20	4·3	7·95	7·95	4·2	9·66	9·66	5·1	7·93	7·93	4·2
Total	85·59	85·59	44·9	79·29	79·29	41·6	70·73	70·73	37·1	64·67	64·62	33·9

100 per cent. average male earnings (£254·10 a week in 1988-89)

	Single			*Married no children*			*Married both working*			*Married two children*		
	£ per week	*£ per week 1988-89 prices*	*per cent. of gross earnings*	*£ per week*	*£ per week 1988-89 prices*	*per cent. of gross earnings*	*£ per week*	*£ per week 1988-89 prices*	*per cent. of gross earnings*	*£ per week*	*£ per week 1988-89 prices*	*per cent. of gross earnings*
1978-79												
Income tax	23·32	49·34	25·0	19·73	41·92	21·3	12·32	26·18	13·3	13·32	28·30	14·4
NIC	6·03	12·81	6·5	6·03	12·81	6·5	6·03	12·81	6·5	6·03	12·81	6·5
VAT	2·48	5·26	2·7	2·38	5·07	2·6	2·79	5·94	3·0	2·44	6·19	2·6
Other indirect	7·59	16·12	8·2	8·55	18·17	9·2	9·57	20·33	10·3	7·98	16·95	8·6
Total of above	39·31	83·53	42·4	36·70	77·97	39·5	30·71	65·26	33·1	29·77	63·2	32·1
Domestic rates	2·87	6·10	3·1	2·70	5·74	2·9	3·08	6·54	3·3	2·79	5·92	3·0
Total	42·18	89·63	45·5	19·40	83·72	42·5	33·79	71·79	36·4	32·56	69·18	35·1
1979-80												
Income tax	25·35	46·51	23·2	21·60	39·63	19·8	14·16	25·98	13·0	13·60	24·95	12·4
NIC	7·10	13·03	6·5	7·10	13·03	6·5	7·10	13·03	6·5	7·10	13·03	6·5
VAT	4·60	8·43	4·2	4·36	8·00	4·0	5·01	9·19	4·6	4·53	8·30	4·1
Other indirect	8·67	15·91	7·9	9·65	17·7[illegible]	8·8	10·69	19·61	9·8	9·13	16·75	8·4
Total of above	45·72	83·87	41·8	42·71	78·36	39·1	36·96	67·80	33·8	34·36	63·03	31·4
Domestic rates	3·43	6·30	3·1	3·22	5·91	2·9	3·65	6·69	3·3	3·33	6·10	3·0
Total	49·15	90·18	45·0	45·93	84·27	42·0	40·61	74·50	37·2	37·68	69·13	34·5
1980-81												
Income tax	31·49	49·67	24·0	27·05	42·67	20·6	19·11	30·14	14·5	18·51	29·20	14·1
NIC	8·87	13·99	6·8	8·87	13·99	6·8	8·87	13·99	6·8	8·87	13·99	6·8
VAT	5·65	8·90	4·3	5·41	8·53	4·1	6·13	9·67	4·7	5·52	8·70	4·2
Other indirect	10·21	16·11	7·8	11·33	17·88	8·6	12·44	19·63	9·5	10·70	16·87	8·1
Total of above	56·22	88·67	42·8	52·66	83·06	40·1	46·55	73·43	35·4	43·59	68·76	33·2
Domestic rates	4·51	7·12	3·4	4·20	6·62	3·2	4·67	7·37	3·6	4·34	6·85	3·3
Total	60·73	95·79	46·2	56·86	89·69	43·3	51·23	80·80	39·0	47·93	75·61	36·5
1981-82												
Income tax	35·84	50·71	24·6	31·39	44·41	21·5	23·46	33·19	16·1	21·53	30·46	14·8
NIC	11·31	16·00	7·8	11·31	16·00	7·8	11·31	16·00	7·8	11·31	16·00	7·8
VAT	6·29	8·89	4·3	5·96	8·43	4·1	6·71	9·49	4·6	6·14	8·69	4·2
Other indirect	11·87	16·80	8·1	13·15	18·61	9·0	14·44	20·43	9·9	12·54	17·74	8·6
Total of above	65·31	92·40	44·8	61·81	87·45	42·4	55·92	79·11	38·3	51·53	72·90	35·3
Domestic rates	5·54	7·84	3·8	5·17	7·31	3·5	5·80	8·20	4·0	5·34	7·56	3·7
Total	70·85	100·24	48·6	66·98	94·76	45·9	61·71	87·31	42·3	56·87	80·45	39·0
1982-83												
Income tax	38·19	50·46	24·3	33·11	43·75	21·0	24·09	31·83	15·3	22·17	29·29	14·1
NIC	13·77	18·19	8·7	13·77	18·19	8·7	13·77	18·19	8·7	13·77	18·19	8·7
VAT	6·50	8·59	4·1	6·16	8·14	3·9	6·98	9·23	4·4	6·40	8·45	4·1
Other indirect	12·38	16·35	7·9	13·74	18·15	8·7	15·16	20·03	9·6	13·09	17·29	8·3
Total of above	70·84	93·60	45·0	66·78	88·24	42·4	60·00	79·28	38·1	55·42	73·23	35·2
Domestic rates	6·05	7·99	3·8	5·67	7·49	3·6	6·41	8·47	4·1	5·85	7·73	3·7
Total	76·89	101·59	48·8	72·45	95·73	46·0	66·41	87·75	42·2	61·27	80·96	38·9
1983-84												
Income tax	41·00	51·76	24·0	35·18	44·41	20·6	24·88	31·41	14·5	23·00	29·04	13·5
NIC	15·39	19·43	9·0	15·39	19·43	9·0	15·39	19·43	9·0	15·39	19·43	9·0
VAT	7·20	9·09	4·2	6·85	8·65	4·0	7·80	9·85	4·6	7·12	8·99	4·2
Other indirect	13·55	17·11	7·9	15·02	18·96	8·8	16·65	21·02	9·7	14·30	18·05	8·4
Total of above	77·14	97·39	45·1	72·44	91·45	42·4	64·72	81·71	37·9	59·81	75·51	35·0
Domestic rates	6·12	7·72	3·6	5·74	7·25	3·4	6·49	8·20	3·8	5·94	7·50	3·5
Total	83·26	105·11	48·7	78·18	98·70	45·7	71·22	89·90	41·6	65·76	83·01	38·5
1984-85												
Income tax	43·93	52·79	23·7	37·30	44·82	20·2	25·73	30·92	13·9	24·04	28·89	13·0
NIC	16·65	20·01	9·0	16·65	20·01	9·0	16·65	20·01	9·0	16·65	20·01	9·0
VAT	8·46	10·17	4·6	8·32	10·00	4·5	9·48	11·40	5·1	9·00	10·82	4·9
Other indirect	14·56	17·50	7·9	16·24	19·51	8·8	17·98	21·60	9·7	15·46	18·58	8·4
Total of above	83·61	100·47	45·2	78·51	94·34	42·4	69·84	83·93	37·8	65·15	78·29	35·2
Domestic rates	6·61	7·94	3·6	6·19	7·44	3·3	6·96	8·36	3·8	6·43	7·73	3·5
Total	90·21	108·41	48·8	84·70	101·79	45·8	76·80	92·29	41·5	71·59	86·02	38·7

	£ per week	£ per week 1988-89 prices	per cent of gross earnings	£ per week	£ per week 1988-89 prices	per cent of gross earnings	£ per week	£ per week 1988-89 prices	per cent of gross earnings	£ per week	£ per week 1988-89 prices	per cent of gross earnings
1985-86												
Income tax	46·87	53·13	23·6	39·62	44·95	20·0	26·90	30·52	13·6	25·82	29·29	13·0
NIC	17·87	20·27	9·0	17·87	20·27	9·0	17·07	19·37	8·6	17·87	20·27	9·0
VAT	9·39	10·65	4·7	9·21	10·45	4·6	10·59	12·01	5·3	9·89	11·22	5·0
Other indirect	15·36	17·42	7·7	17·11	19·41	8·6	19·09	21·65	9·6	16·25	18·44	8·2
Total of above	89·44	101·47	45·1	83·81	95·09	42·2	73·64	83·55	37·1	69·83	79·23	35·2
Domestic rates	7·08	8·04	3·6	6·66	7·55	3·4	7·53	8·54	3·8	6·88	7·81	3·5
Total	96·53	109·51	48·6	90·47	102·64	45·6	81·17	92·09	40·9	76·71	87·03	38·6
1986-87												
Income tax	48·86	53·70	22·9	41·50	45·61	19·4	28·48	31·30	13·3	27·30	30·00	12·8
NIC	19·21	21·11	9·0	19·21	21·11	9·0	17·50	19·23	8·2	19·21	21·11	9·0
VAT	10·15	11·15	4·8	9·92	10·90	4·6	11·41	12·54	5·3	10·58	11·63	5·0
Other indirect	16·69	18·34	7·8	18·49	20·32	8·7	20·72	22·77	9·7	17·68	19·43	8·3
Total of above	94·91	104·31	44·5	89·12	97·95	41·8	78·11	85·85	36·6	74·77	82·17	35·0
Domestic rates	7·97	8·76	3·7	7·47	8·21	3·5	8·46	9·29	4·0	7·70	8·46	3·6
Total	102·88	113·06	48·2	96·59	106·16	45·3	86·57	95·14	40·6	82·47	90·63	38·6
1987-88												
Income tax	50·48	53·38	21·6	43·37	45·86	18·6	30·78	32·55	13·2	28·87	30·53	12·4
NIC	21·02	22·23	9·0	21·02	22·23	9·0	19·16	20·26	8·2	21·02	22·23	9·0
VAT	11·37	12·02	4·9	11·02	11·66	4·7	12·50	13·22	5·4	11·62	12·29	5·0
Other indirect	17·73	18·74	7·6	19·43	20·54	8·3	21·69	22·93	9·3	18·59	19·66	8·0
Total of above	100·59	106·37	43·1	94·84	100·28	40·6	84·13	88·96	36·0	80·10	84·70	34·3
Domestic rates	8·58	9·07	3·7	8·01	8·47	3·4	9·05	9·57	3·9	8·20	8·67	3·5
Total	109·17	115·44	46·7	102·85	108·75	44·0	93·19	98·53	39·9	88·31	93·37	37·8
1988-89												
Income tax	51·00	51·00	20·1	43·84	43·84	17·3	31·31	31·31	12·3	29·34	29·34	11·5
NIC	22·87	22·87	9·0	22·87	22·87	9·0	20·84	20·84	8·2	22·87	22·87	9·0
VAT	12·94	12·94	5·1	12·58	12·58	4·9	14·15	14·15	5·6	13·20	13·20	5·2
Other indirect	19·35	19·35	7·6	21·14	21·14	8·3	23·31	23·31	9·2	20·01	20·01	7·9
Total of above	106·17	106·17	41·8	100·42	100·42	39·5	89·61	89·61	35·3	85·42	85·42	33·6
Domestic rates	10·01	10·01	3·9	9·27	9·27	3·6	10·34	10·34	4·1	9·48	9·48	3·7
Total	116·18	116·18	45·7	109·69	109·69	43·2	99·95	99·95	39·3	94·90	94·90	37·3

Notes to tables

Income tax payments are calculated on the assumption that the tax units have no other tax reliefs apart from the standard allowances. Earners, including working wives, are assumed to pay Class 1 NI contributions at the contracted in rate. The figures for NI contributions are financial year averages.

2. Average earnings are taken to be the average gross weekly earnings of all full-time males on adult rates with pay unaffected by absence. The levels of average earnings in each year are given below:

	£ per week
1978-79	92·80
1979-80	109·30
1980-81	131·40
1981-82	145·90
1982-83	157·40
1983-84	171·00
1984-85	185·00
1985-86	198·50
1986-87	213·40
1987-88	233·60
1988-89	[1]254·10

[1] Assuming growth of 8¾ per cent. on 1987-88.

3. The two earner married couple is assumed to have joint earnings of the various multiples of average earnings. In calculating disposable income it is assumed that the joint earnings are split between husband and wife in the ratio 60:40.

4. For the married couple with two children, child benefit is treated as a negative income tax. For this purpose, financial year averages are used for child benefit.

5. The estimates of indirect taxes are derived from the 1985 family expenditure survey and are based on the illustrative assumption that 10 per cent. of disposable income is saved. Estimates cannot reliably be made outside the income range for which figures are shown. There are also quite wide variations in spending patterns between households with similar incomes and composition and, because of sampling variation, there can be substantial differences between the estimates obtained from different family expenditure surveys.

ANNEX 3

INCREASE IN REAL TAKE-HOME PAY 1978-79 TO 1988-89
(£ PER WEEK IN 1988-89 PRICES)

	Multiple of average male earnings		
	50%	75%	100%
Single person			
Take-home pay 1978-79	75.38	105.24	135.06
Take-home pay 1988-89	96.38	138.30	180.23
Increase	21.00	33.06	45.17
Married couple, no children			
Take-home pay 1978-79	82.80	112.66	142.48
Take-home pay 1988-89	103.54	145.46	187.39
Increase	20.74	32.80	44.91
Married couple, 1 child			
Take-home pay 1978-79	89.62	119.46	149.30
Take-home pay 1988-89	110.79	152.71	194.64
Increase	21.17	33.25	45.34
Married couple, 2 children			
Take-home pay 1978-79	96.19	126.28	156.10
Take-home pay 1988-89	118.04	159.96	201.89
Increase	21.85	33.68	45.79

Note: "take-home pay" is gross earnings minus income tax and NICs, plus child benefit.

PRIME MINISTER

HM TREASURY'S MONTHLY MONETARY ASSESSMENT

You may wish to glance through the attached Treasury Monthly Assessment. As usual, it gives a very helpful summary of the latest indicators, not just for the monetary position but also the economy more generally.

I have highlighted key passages. Particular points to note are:

- The evidence on whether consumer spending has started to slow down is still contradictory. The annex on indicators of consumers expenditure is worth looking at.

- But the housing market clearly has now slowed down. Paragraphs 50-52 also highlight the deceleration in mortgage (and other consumer credit) lending.

- MO has yet to show any significant slow down on a twelve monthly basis. But paragraphs 41-42 indicate that the latest figures for notes and coin have shown very little growth. Table 26 at the back of the reports shows the Treasury expect a very rapid deceleration in the twelve monthly growth rate during the course of 1989/90. But we know from earlier this year the fragility of forecasts in this area. I would certainly not regard any of the latest evidence as firm enough to indicate the scope for any early reduction of interest rates. Indeed, we cannot yet rule out the possibility that market conditions could dictate the need for a further tightening - but hopefully it will not come to that.

PAUL GRAY
13 December 1988

DS2AMB

PRIME MINISTER 8 December 1988

THE ECONOMY: CONFUSING SIGNALS

The effects of higher interest rates on the economy are not easy to assess. Consumer confidence (EC/Gallup survey) has fallen further and there is strong evidence of a slowdown in the housing market (despite large regional differences). On the other hand, the October retail sales figure was very strong (a rise of nearly 2%), producer confidence has held up, money GDP is expected to be a little above the 11% Treasury forecast in October (the upward revision is due to faster real growth) and money supply growth (MO) is still running at 7.6%.

Intervention Tactics in the Exchange Markets

Against this background, the government must not give confusing signals.

It is important that inflation is brought down to 3% or less by 1990 and that the real economy, having suffered some setback as inflation is reduced, is growing again in a healthy way before the next election. Far better to take the medicine now, than delay. However, this means high interest rates for some time. It also means a strong pound. Current intervention in small amounts is difficult to understand in this context. One also suspects it has little effect in keeping the pound down.

I am nervous that either the Chancellor or the Bank might suggest that a 'final' major assault on market expectations is needed if the exchange rate is to be prevented from rising further. I believe such a step should be resisted. It is a confusing signal to the market. It undermines

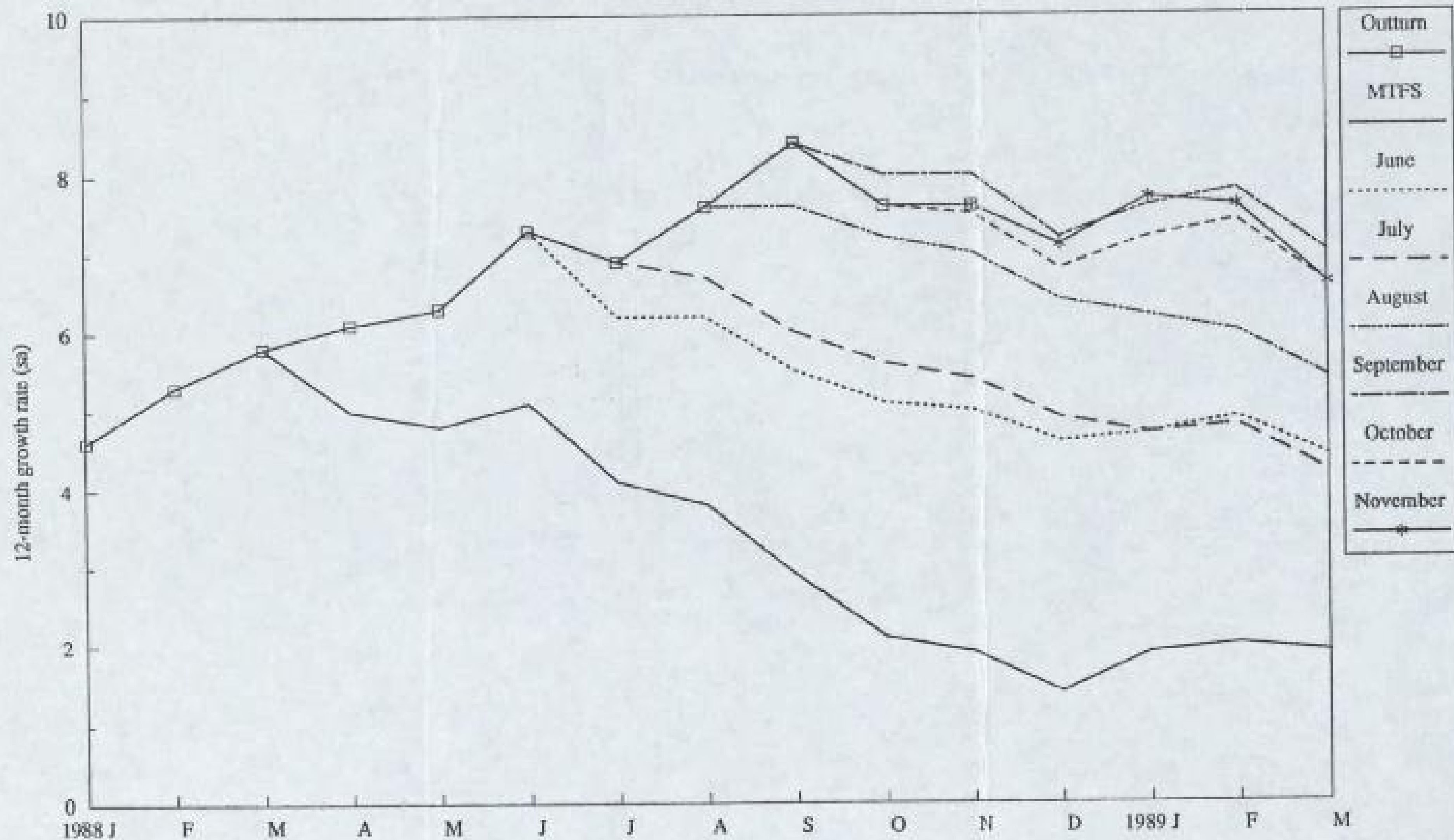
directly the effect which higher interest rates have in reducing the demand for money because it provides extra cash to the market. Sterilisation then produces further adverse side effects - not least on the pound itself!!

Recommendation

Allow the pound to continue rising to say 3.35 DM or 82 effective rate before being worried about overkill.

BRIAN GRIFFITHS

CONFIDENTIAL



Forecasts as circulated in Monthly Assessment

SECRET AND PERSONAL

File MM

4

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary 7 December 1988

AN INDEPENDENT CENTRAL BANK

The Prime Minister and the Chancellor discussed yesterday the Chancellor's minute of 25 November. They concluded that the time was not right to consider further the possibility of an independent Central Bank.

PAUL GRAY

A. C. S. Allan, Esq.,
HM Treasury.

SECRET AND PERSONAL

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NOTE FOR RECORD

AN INDEPENDENT CENTRAL BANK

At their bilateral meeting on 6 December the Prime Minister and the Chancellor discussed the proposal in the Chancellor's minute of 25 November for an independent Central Bank.

The Chancellor said that, after careful consideration, he had concluded it would be a better arrangement to change to the sort of independent Central Bank model operated in the United States and in Germany. This would assist in establishing the credibility in the markets of the commitment to bear down on inflation.

The Prime Minister responded that she had given the idea of an independent Central Bank serious consideration in the late 1970s. But she had concluded then that it would not be appropriate. In the present circumstances she was even more firmly of this view. There could be no question of the Government being seen to hand over responsibility for counter- inflationary policy unless the Government had established firm control. At the moment we were encountering a temporary increase in the rate of inflation. It was one of the Government's fundamental duties to maintain the stability of the currency, and the priority for Government must be to ensure that inflation was got down. The possibility of an independent Central Bank could only begin to be contemplated if, say, the inflation rate had been reduced to 2% and held at that rate for 2 or 3 years. In any event, it would be essential for ultimate control for maintaining the stability of the currency to rest with the Government rather than with Parliament. The Prime Minister also questioned the suitability of an independent Central Bank for the British system; it was arguable that this was a more appropriate approach in Federalist countries.

Following further discussion the Prime Minister summed up by saying that the idea of an independent Central Bank should not be considered further at this time. If, as she sincerely hoped, inflation was got down to a very low level and held there, it might be appropriate to reconsider the idea in, say, 4 years time.

PRCG.

P. GRAY

7 December 1988

PRIVY COUNCIL OFFICE
WHITEHALL, LONDON SW1A 2AT

2 December 1988

Dear Douglas

INCREASES IN MONETARY LIMITS ON LOTTERIES UNDER THE LOTTERIES AND AMUSEMENTS ACT 1976

Thank you for your letter of 7 November seeking H Committee's agreement to your initiating consultations on proposals to increase the monetary limits for individual lotteries.

The Prime Minister, Nicholas Ridley, Tom King, Malcolm Rifkind, Norman Lamont and Richard Luce indicated that they were content for consultations to proceed on the basis you proposed, but the latter indicated that he would prefer to see larger increases in the monetary limits and that the view of the Arts Council and Museums and Galleries Commission should be canvassed in the course of the consultation exercise. Malcolm Rifkind said that, subject to the outcome of the consultation process, he would be content for identical increases to those you proposed for England and Wales to apply in Scotland; and Tom King indicated that he would wish to review the position in Northern Ireland in the light of the final decisions reached for Great Britain. Norman Lamont confirmed that the Commissioners of Customs and Excise were willing to make a parallel increase in the pool betting duty exemption limits; and I understand that he is satisfied that your proposals will not give rise to any problems of public expenditure control.

No other colleague commented and you may take it that you have H Committee's agreement to go out to consultation on the basis you proposed, subject to the bodies mentioned by Richard Luce being included in that exercise.

I am copying this letter to the Prime Minister, colleagues on H, Patrick Mayhew, Richard Luce and Sir Robin Butler.

Yours ever

JOHN WAKEHAM

The Rt Hon Douglas Hurd CBE MP
Home Secretary

SECRET 2

PRIME MINISTER

MEETING WITH SIR ALAN WALTERS

You are seeing Alan Walters tomorrow after Cabinet.

I imagine you will want to talk to him about the latest economic position. When I saw Alan two or three weeks ago he said he was quite content with the stance of policy. He thought it was too early to judge the effect of interest rates at 12 per cent, but thought the early signs were this would be enough. You will want to ask him now whether, in the light of the latest trade figures and other evidence, he thinks 13 per cent is about right.

As general background you may like to glance at the enclosed note Alan sent me the other day about sterilised intervention. This repeats Alan's familiar argument that sterilised intervention is ineffective, except perhaps in the very short run.

You will want to judge whether to mention to Alan the play that Gordon Brown made in yesterday's debate about some of his earlier comments. There may be no harm in reminding him of the potential sensitivity of anything he says in public or to the press.

PRG.

PAUL GRAY

30 November 1988

PM2AIF

SECRET

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SIR PETER MIDDLETON'S NIESR JUBILEE LECTURE
MONDAY 28 NOVEMBER 1988

ECONOMIC POLICY FORMULATION IN THE TREASURY IN THE POST-WAR PERIOD

Introduction

1. It is a great honour to be invited to deliver this lecture to mark the National Institute's Jubilee. The Treasury and the National Institute have been neighbours since the Institute moved to Westminster during the war. We have benefitted from the exchange of staff and ideas. And I am delighted that the present Director is a former colleague from the Treasury.

2. The Dialogus, in 1177, said that:

> "The institution of the Treasury is confirmed well by its antiquity and also by the authority of the great men that sit there."

Robert Hall, whose Memorial Service took place earlier today, was one of those great men. He made a notable contribution to Government over many years and followed that by equally distinguished guidance to the National Institute after he retired.

3. My objective in this lecture is not to conduct a detailed examination of how the Treasury has approached economic policy since the war, still less to compare the performance of different administrations. Rather I want to give a personal view of the way in which the policy-making environment has changed and the main reasons for those changes.

4. I joined the Civil Service in 1960, 15 years after the war. GDP was rising at about 5 per cent but slowing down. Unemployment was under 2 per cent and falling. The current account deficit was about 1 per cent of GDP and diminishing. Inflation was about 3 per cent but rising. Wages were growing by over 5 per cent.

5. It was a period of confidence and consensus in the Treasury. A post-war deflation had been avoided. The commitment in the war-time White Paper on Employment Policy to maintain a high and stable level of employment had been achieved to an extent greater than anyone expected - and was reiterated both in the 1956 White Paper on the Economic Implications of Full Employment and in the Radcliffe Report in 1959. We had lived within the Bretton Woods arrangements - a little precariously at times but successfully.

6. Though the late A J Brown baptized the years 1939-51 as the period of "The Great Inflation" - a period when price increases averaged about 6 per cent a year - inflation was not regarded as a serious problem. Tight fiscal policy and price control during the war had suppressed inflation, and though it rose in the UK as it did elsewhere in the world following the Korean War in the early 1950s, it fell again quite quickly. If inflation was a worry, it was more because of its implications for international

competitiveness and confidence in sterling than for its own sake. Indeed the low levels of inflation that we experienced were generally regarded as a bit of lubrication in the economic process. People were broadly content to think in terms of money values and a gently rising price level was thought to be good for confidence in industry and certainly good for the Government's finances.

7. There were three instruments of policy: fiscal policy, direct controls and monetary policy. The first two, fiscal policy and direct controls including hire purchase controls, deployed in conjunction with increasingly sophisticated forecasting from 1947 onwards, were thought to be sufficient for stabilisation policy. Monetary policy was not seen as important in this context.

8. Indeed one of my earliest memories in the Treasury was being told that Mr Thorneycroft when Chancellor of the Exchequer had the eccentric notion that controlling the supply of money or the level of expenditure in money terms might have a part to play in economic management. But this line of reasoning did not survive his resignation in 1958. It had influenced policy neither before nor since and was of purely historical interest. The report of the Radcliffe Committee in 1959 fully supported this view. While not regarding the supply of money as unimportant, it was seen as part of the wider structure of liquidity which might be influenced by the structure rather than the level of interest rates.

9. Micro-economic policy was still heavily influenced by the pre-war and wartime legacy of controls. At its height this had involved rationing affecting a third of consumption expenditure, control of investment by licensing, control of imports and controls over the currency and banking. Building licensing was still in place until the end of 1954 and it was some time later that imports were fully decontrolled. Markets were freer but they were regarded with suspicion. Government stood ready to step in to set things right and would probably need to do so.

10. The role of Government more generally had certainly increased, but appeared to be in a fairly stable state. General government expenditure as a percentage of GDP had been in the low teens before the First World War, in the mid-twenties between the wars and since the Second World War had settled down in the mid-thirties.

11. Yet 15 years later this confidence in policy making had evaporated. The UK which had entered the 1960s as a relatively low inflation country had been transformed into a high inflation country. There was no improvement in other aspects of UK industrial performance. Policy swung between expansionary measures to reduce unemployment and contractionary measures to correct the current balance. Devaluation was tried in 1967 in an attempt to create more room for expansionary measures by easing the perceived balance of payments constraint. But, after each episode the economy emerged in worse shape. By the early 1970s we had both rising unemployment and rising inflation.

12. Something had clearly gone badly wrong. How, instead of creating a record of stability building on the 1950s, did we

manage to establish a reputation for profligacy and an inability to compete which is still remembered?

What went wrong?

13. I think we must start with one legacy of the 1950s that did great damage: the inference, based on the Phillips curve, that a long-term trade off existed between inflation and unemployment. You could have less unemployment if you were prepared to put up with more inflation.

14. Second, was the increasing dissatisfaction, quite rightly in my view, with the United Kingdom's poor growth record relative to its competitors.

15. Put these two factors together in the prevailing climate and it is easy to see what happened. If macro-economic policy could be set free it might not only support employment but also increase output by maintaining high levels of demand. Something else was needed to deal with inflation. That new instrument was prices and incomes policy.

16. There was of course some concern about the effect of these policies on the flexibility of the economy, but a move in this direction was quite in line with the general suspicion of markets. And any disadvantages could be compensated for by the boost to demand.

17. Prices and incomes policies did not, however, do the main job they were intended to do. They did not control inflation - even of the "wage push" variety about which it was so fashionable to speak. Wages may have been held down by controls for a year or two, but they then caught up again. And with macro economic policy aiming to maintain a high level of demand, it is not surprising that inflation rose over time.

18. Moreover, as the Government regarded it as part of its natural role to intervene in markets to set things right it faced a daunting task. The economy was clearly not responding as it was expected to do. So there was an increase in intervention throughout the 1960s and 1970s. This is not in my view because we were unaware of what was happening in other countries, but because we looked rather myopically and imitated them selectively. We asked what governments were doing, not what markets were doing. And institutions were set up on foreign models such as NEDC, inspired by France, and the Industrial Re-organisation Corporation, inspired by Italy.

19. Too much industrial policy ended up as support for the inefficient. While it is easy for a consideration of short term costs and benefits to justify individual cases of intervention, cumulatively this process had all sorts of harmful effects. It slowed down the natural process of industrial adjustment, under which some industries expand and others decline according to changes in the UK's comparative advantage. It gave the wrong incentives to management and unions: government help, rather than bankruptcy and redundancy, might be the reward of incompetence and intransigence. And, of course, the cost of government support was

borne out of the profits earned and wages paid by other firms, their successful competitors.

20. The large nationalised industry sector meant that Ministers and civil servants found themselves involved in business decisions in some of the largest enterprises in the country. Governments were tempted into using their power in this area to further other policy objectives. Nationalised industry pricing decisions became part of counter inflation policy; they ceased to be taken so that resources involved in the industries were allocated efficiently. The result was low profitability and low morale in the industries affected - and some very strange pricing policies. One recalls, for example, the decision to freeze domestic gas prices in 1974 following the first oil shock.

21. By the mid-1970s there was little sign of the economy having benefitted from all this intervention. Indeed it had clearly become less competitive. Productivity grew only slightly quicker than in the 1950s, and well below the rate in other major countries - except for the United States. Productivity growth was also lower than the growth of real wages, so profits' share in national income fell and profitability with it. The UK slowed down with the other countries after 1973 and output per head fell further below that in leading countries. UK exports continued to lose share in world markets.

22. New ideas - or rather old ideas - began to arrive in the 1960s. Friedman, Brunner and others, by a combination of economics and presentational skills restored interest in the idea that inflation - which is after all a fall in the value of money - might in some way be related to the quantity of money put into circulation. Harry Johnson played a seminal part in extending these ideas to open economies such as the UK. But they did not really interest the Treasury, despite their obvious relevance to the way financial markets behaved and hence to policy.

23. In retrospect, it is clear that the Bretton Woods exchange rate arrangements acted as a powerful financial discipline. The UK had inflated broadly in line with the United States except when, predictably, we inflated faster following the 1949 and 1967 devaluations. But that was not how it was seen by mainstream opinion at the time. Instead, as in the 1960s when devaluation was thought by many to be the key which would open the door to continental growth rates, the exchange rate was still seen as a constraint. If it could be eased, tried policies of demand management and direct intervention in the economy would enable us to rise above our difficulties.

24. It was thus that the breakdown of Bretton Woods was regarded not so much as a source of regret but as an opportunity to achieve the growth we so much needed. Prices and incomes policy was still expected to deal with inflation; fiscal and monetary policy to maintain demand, and a declining exchange rate could take care of competitiveness.

25. One only has to ask how these policies would appear to anyone without a deep sense of post-war UK thinking to see that trouble would result. And our fortunes were increasingly bound up with

such people. The UK's position in the world had become quite different from what it was in the 1950s. Foreign trade in goods grew rapidly, the production and sale of goods and services was increasingly organised on multilateral lines. Capital flows grew even more rapidly than trade. Foreign banks became an increasing influence in London. The Euromarkets began what has been a spectacular development. And of course we joined the EEC in 1973.

26. Though exchange controls remained in force, the relative power of the Government and that of the foreign exchange markets began to change noticeably. Leads and lags in trade payments and capital transactions other than by Government made adverse external perceptions increasingly difficult to combat. And the easing of the exchange rate constraint without the application of some other nominal discipline simply let inflation loose.

27. The UK response to the oil shock at the end of 1973 is very instructive against this background. The UK, unlike most other Western countries, decided to respond to what was a sharp relative price increase by offsetting its deflationary effects and allowing most of the strain to be taken eventually on the general price level. Both fiscal and monetary policy were used. The PSBR rose sharply, from 3½ per cent of GDP in 1972-73 to 9 per cent in 1974-75 and 1975-76.

28. Other countries to a greater or lesser degree applied restrictive policies in order to prevent the rise in the relative price of oil from feeding into prices in general. The significance of this episode was not so much whether we were right or wrong - the recycling of the surpluses of the oil producers raised interesting theoretical possibilities - but that we imagined our position could possibly seem tenable in the financial markets who could clearly see others taking a much tougher stand against inflation.

29. Not surprisingly the Government's credit began to crumble. We found it easier to borrow via the nationalised industries than on the Government's own credit. Eventually we could borrow no more, and the IMF arrived for a prolonged stay in the autumn of 1976.

Policy changes from the mid-1970s

30. Though we have a vast amount to be grateful to the IMF for, the turning point in macro-economic policy thinking had, I believe, already happened. From the mid-1970s attempts were made to put counter-inflation policy under some sort of monetary umbrella. The words began to change - a bit too subtly perhaps - towards giving fiscal and monetary policy an increasing role in restraining inflation, while prices and incomes policy had the very different emphasis of securing a high level of employment through the control of costs and stimulating efficiency.

31. Among the influences were two changes in the theoretical conventional wisdom. First, the ability of changes in fiscal or monetary policy to alter the level of output or employment for more than a temporary period was increasingly questioned. Secondly, the belief in a long-run trade-off between unemployment

and inflation - the Phillips curve - broke down. There were no long-run gains in terms of lower unemployment to be had from tolerating a higher level of inflation.

32. But in the minds of the markets, and probably also in terms of public perceptions within the UK, the IMF agreement marked a decisive point. What exactly was decisive about it?

33. First, in my view, was the explicit embracing of monetary policy. This enabled us to join those other countries which established monetary targets as a way of imposing financial discipline in a world of floating exchange rates and differential inflation. Monetary targets are intermediate objectives which enable countries to establish programmes to reduce inflation in line with their own particular circumstances. If further demonstration was needed that things were different, the choice was made in 1977 to stick to the monetary policy by allowing sterling to float upwards - something which would have been impossible 5 years earlier.

34. The importance of this episode is nothing to do with text book monetarism, though there was quite an industry at the time to work out who was a dedicated monetarist, who was a reluctant monetarist and who went along with it because the markets believed it although they didn't (the disbelieving monetarist). It was the first step in acknowledging that we really were part of the world system and that we could no longer ignore financial markets or treat them as enemies. We became prepared to espouse what everyone else - both markets and governments - regarded as essential priorities.

35. Second, we succeeded because the IMF insisted on ceilings for public borrowing as well as domestic credit expansion, in getting all the instruments of macro-economic policy - fiscal and monetary - pointing in the same direction: the direction of lower inflation.

36. This had one other important benefit for the Treasury. It created a climate in which it was possible to implement an effective system of cash control of public expenditure. Since the Plowden report in 1961 public expenditure control had become an esoteric and to a considerable extent an incomprehensible process, even in the Treasury.

37. Much of what Plowden said was entirely sensible and remains the basis of the public expenditure planning system - looking at the whole of expenditure annually and reviewing forward plans. And it was absolutely right to stress the importance of this system in providing a basis on which departments and others could improve management and produce good value for money - their will and enthusiasm determine the efficiency of the public sector.

38. Unfortunately, the way in which Plowden was implemented effectively meant that public expenditure went out of control for a decade and a half. Planning was in terms of specific volumes of services, so departments could expect their spending to be preserved irrespective of the rate of inflation. And planned volumes were based on assumptions about GDP growth which were

often over optimistic, because of course it was imagined that we could achieve the necessary growth in GDP through demand management supported by intervention. The frontiers of the state were therefore expanded almost by accident and rises in inflation were accommodated. General government expenditure rose from 36 per cent of GDP in the mid-1960s to 41 per cent in the early 1970s and then to a peak of 48 per cent in the mid-1970s.

39. But it is easier to install such a system than to correct it. And though public expenditure was gradually transformed to a cash basis, the process was not completed till 1981. Value for money in public expenditure at the same time was pursued much more thoroughly and comprehensively.

40. The third major advance was that the IMF agreement introduced the principle of setting fiscal and monetary policy objectives for a number of years ahead. This was to demonstrate the commitment to a progressive improvement in the balance of payments and inflation.

41. The Medium Term Financial Strategy, introduced - without external pressure - in 1980, marked a further advance in setting policy in a medium term nominal framework. Medium term horizons are important in three respects. They give policy a sense of purpose which can be presented with simplicity, coherence and clarity. Second, it implies the intention to eschew measures which might bring short-term benefits but with long term costs. Third, the medium term dimension to policy itself adds greatly to market credibility and the chances of success.

42. The international developments to which I referred earlier have since increased in pace. Direct investment has grown at twice the speed of world trade. The value of foreign exchange transactions is 40 times greater than visible trade. Turnover in the Euromarkets is twice the value of world exports. And financial markets trade around the world 24 hours a day. Closing the markets - something I was instructed to arrange on a number of occasions in my early days in the Treasury - would now be a completely futile gesture.

43. This is a hard world to live in for everyone. For business, it is fiercely competitive and cost conscious. For governments it can seem equally brutal. Huge amounts of money flow in and out of countries, sometimes on the basis of half truths and misconceptions. Minor transgressions in the eyes of the market can bring huge penalties. Governments, much like business, are competing with each other in these markets.

44. Credibility and expectations in financial markets are crucial to policy making in today's world of global markets. It is no use thinking that those involved in financial transactions will take the trouble to understand the nuances of domestic economic policy. They are not interested in economic theories, political strategems, or social considerations. They are concerned with much cruder things: confidence in the authorities, confidence in the country and the broad priorities of economic policy. They are certainly not likely to suffer from money illusion when faced with differential inflation prospects between countries. Track record

is by far the most important thing - consistent, coherent, credible policies are of the essence. Without these the economy is likely to be subject to massive pressures whenever there is a temporary shock. Effective policy-making becomes much more difficult, if not impossible.

45. Confidence in the authorities has a peculiar dimension in the UK. Ours is a system without checks and balances. The Government has all the levers of macro-economic power at its disposal. It is able to tackle problems with the full panoply of instruments. The economy is also able to go completely off the rails very quickly. So it is especially important for the UK to demonstrate its commitment to the right things in order to secure the increased prosperity which comes with trade and integration. But equally it is in a very good position to establish this commitment and so to secure the advantages - which no one disputes - from the growth in world trade.

46. Building up a track record takes time and careful presentation at home and abroad. It depends on achieved results more than words or philosophy. It can be helped by certain things - medium term approaches, constant vigilance against inflation, supply side policies which are outward rather than inward looking. But achievement in terms of inflation and the dynamism of the economy count most.

47. Against this background, I see policy since the mid-1970s as painfully establishing the sort of macro-economic track record with the rest of the world that will enable us to enjoy to the full the benefits of the world market while staying resilient to shocks. Policy is now firmly within a medium term umbrella based on money values. Its precise expression has changed as events have changed. Fiscal policy, monetary policy and the exchange rate have received different emphases at different times. There is no reason why they should not be adjusted intelligently to changing circumstances. But the objective of having them move compatibly in support of a counter-inflation approach has remained.

48. Fiscal policy has been given more of a structural role in the UK, as in most countries. The international community, with the UK alongside, has resisted attempts to design policy on the assumption that because we have forecasts we are clairvoyant. We have tried to develop an approach which is robust to different outcomes. The actual deficit will of course vary with the cycle; discretionary tax and expenditure changes have to be sustainable - and seen as such - to be effective. The dangers of using fiscal action to deal with unexpected changes in activity are acutely felt. There are long lags, volatile tax and expenditure changes are extremely damaging, and of course it is always easier to reduce taxes and raise expenditure than vice versa. Deficits are easy to increase and incredibly difficult to reduce.

49. Monetary policy, also set in a medium term framework, has assumed the role for which it is best suited: the achievement of whatever goals are set for nominal demand. Interest rates can adjust quickly and affect all components of spending to some degree.

50. Direct controls have more or less dropped out of the armoury of economic policy instruments. Restrictions on financial intermediaries are likely to cause them to take their business elsewhere, something which they can all do to a greater or lesser extent with the greatest ease. And when faced with the present multiplicity of instruments and organisations it is difficult to envisage a set of controls which would have much effect, quite apart from the costs in terms of lost efficiency in the financial system and distortions caused in the rest of the economy.

51. The international context of macro-economic policy is important. Policy here is inevitably affected by policy in other countries and, as I have said, the behaviour of financial markets and other economies. This means that Governments need to agree and support rules for international trade and monetary systems so as to provide a framework within which the private sector can trade and invest with confidence. They also need to co-operate in seeking compatible policies - policies which avoid excessive divergencies and the disturbances to which they lead. In this way it is possible to reap the rewards of economic interdependence while achieving economic stability.

52. It will be pretty obvious from the comments which I have made on the 1960s and 1970s that there is much more to economic policy-making than macro-economic policy. Indeed that should be the easy part. The difficult problems lie with the supply performance of the economy. Only if this is successful will the real benefits of expanded world markets arise, and resilience be built up against unpleasant surprises.

53. Quick results on the supply side are hard to come by. Policies have to be long term. They bring few immediate benefits, political or otherwise. There are gainers and losers - and losers complain loudly while thanks are thin on the ground. And the international dimension is very difficult to handle, as we are only now beginning to understand.

54. Despite the shift in macro-economic priorities in 1975, the twin pillars of the government's strategy, endorsed by the IMF, were the incomes policy and the industrial strategy. My view at that time was that there were not many options for macro-economic strategy if we wanted to re-establish our reputation in the world. But the choice between a controlled approach and a free market approach to the supply side of the economy was very much a matter of preference. Really it was an empirical question : which worked best in the circumstances of this country?

55. There is no doubt about the direction in which the world has been trying to go. It is in the direction of questioning policies long taken for granted, accepting that policies are most likely to be effective when their limitations are recognised. The tendency has been towards less government but more efficient government; towards freer markets and increased competition; and towards forcing managers to survive in a highly competitive world environment, so that the economy becomes more flexible and responsive to change. International organisations - such as OECD

- now spend at least as much of their time on these issues as on the broad sunny uplands of macro-economic policy.

56. There are considerable advantages from going in this direction. It is an economical use of government itself. I am quite sure of one thing. Government is a finite resource. There is not an unlimited supply of any sort of government and there certainly is not an unlimited supply of good government. Governments like other organisations have to choose, if they are to provide value for money and allocate their own resources efficiently.

57. There are some things which governments have to do. However successful a government is in its public expenditure aspirations, there is a huge chunk of resources to manage and taxes to raise. Carrying out these functions efficiently is important in its own right, quite apart from their role in stimulating efficiency elsewhere in the economy. The present emphasis on value for money in the public sector through policy review, considering new forms of organisation, tight control over costs and performance related pay, seems to me to be wholly desirable.

58. This, together with maintaining credible macro policies and dealing with the international aspects of economic policy, is a massive task. Arguably it is enough. Even if you have a badly functioning economy - which in many ways we still do - it is always possible to make it worse by government initiatives unless they are very delicately honed. So it is not surprising that the present international climate is based on allowing the private sector - imperfect though it is in practice - to get on with its own job with a minimum of regulation.

59. The signs are that the British economy has become more flexible and competitive in the 1980s. Supply performance has improved and productivity - where it can be measured - is growing more rapidly than in any country except Japan. Our share of world trade is no longer declining. But there is still a long way to go. And it will be for the lecturer on your next anniversary to comment on the all important question: whether the improvement has been sustained and become part of the British way of life.

<u>Conclusions</u>

60. Let me end by drawing together the main themes of the lecture. And then offer a postscript

61. Economic policy is heavily constrained by the nature of the world we live in. Policy-makers have to be sensitive to changes in the environment and ready to adjust their policies as appropriate. With global financial markets, the main effort must be directed towards maintaining the credibility and reputation of macro-economic policy so that financial markets behave in a way which generally supports it. It is not possible to intervene in financial markets to produce directly the results the government wants.

62. More generally, the power of governments to influence the economy is limited. Even in the confident days of the 1960s it

was more limited than was believed at the time, as the difficulties of the 1970s revealed. The key to good government is to recognise the limits of the government's ability to influence the economy, to resist pressure to do something about problems which government cannot solve, and to make sure that those things for which the government <u>is</u> directly responsible - macro-economic policy, taxation and the provision of public services - are done as efficiently as possible.

63. The postscript is this. My time in the Treasury has been dominated by the problems of inflation. But so in reality has the whole of the period since the National Institute was created. In the half century up to 1938 the annual price increase averaged 1½ per cent; prices had not quite doubled. Going back further, in the 50 year period to 1888 prices actually fell by around a quarter.

64. In the 50 years as a whole since 1938, inflation has averaged some 6½ per cent: prices on average are now 23 times higher than they were when the Institute was founded. Over the last 20 years as a whole it had averaged virtually 10 per cent.

65. During the last 5 years we have been more successful but, even so, inflation has averaged about 4 3/4 per cent. This is still significantly higher than the inflation rate of 1¼ per cent in the 5 years up to the foundation of the Institute in 1938. I hope that the recent improvement will continue during the Institute's next 50 years, as it should do if the lessons we have so painfully learned over the first 50 years are not forgotten. You can then all hope to celebrate an inflation performance even better than when the Institute was founded.

PA → Nigel Wicks

R29/11

Nigel

These are all exactly as in written text.

Alan

REPORT ON MIDDLETON NATIONAL INSTITUTE LECTURE

Transcript from: BBC Radio 4, Financial World Tonight, 28 November 1988

PRESENTER: (Johnathan Charles) Good evening, tonight the top civil servant at the Treasury implies the Chancellor has to do more than just talk about getting the economy back on course. The £ rises sharply on the foreign exchanges, although the $ strengthens as Americans' banks increase their prime rates. And Lonro sells its European drinks business to Brent Walker for £180 million. According to one Conservative MP this evening the jury is out on the Chancellor of the Exchequer, Nigel Lawson. He's on political trial after Friday's bad trade figures and the rise in bank base rates. Tomorrow he'll defend himself at the end of the debate on the Queen's Speech. And in the past few hours he's received both praise and implied criticism from an unusual source. The National Institute of Economic and Social Research's golden jubilee lecture was given by the Permanent Secretary to the Treasury, Sir Peter Middleton, and he said that confidence that economic policy is right is the highest priority for the financial markets.

MIDDLETON: "... Credibility and expectations are crucial to policy making in today's world of global markets. It is no use thinking that those involved in financial transactions will take the trouble to understand the nuances of domestic economic policy. They're not interested in economic theories, political strategems, social considerations. They are interested in much cruder things, confidence in the authorities, confidence in the country and the broad principles and priorities of economic policy. ..."

PRESENTER: And Sir Peter went on to tell the audience that effective policy making was reliant on building up a track record of success. He said that depended on actually achieving results rather than on simply espousing words or philosophy. Those lines seemed to imply criticism of the Chancellor and a warning of what happens when economic forecasts go wrong.

MIDDLETON: "... Track record is by far the most important thing. Consistent, coherent, credible policies are of the essence. Without these the economy is likely to be subject to massive pressures whenever there is a temporary shock. ..."

PRESENTER: And in a comment about the dangers of badly timed Government intervention Sir Peter emphasised the need for a cautious approach in correcting problems.

MIDDLETON: "... If you have a badly functioning economy, which in many ways we still do, it is always possible to make it worse by Government initiatives unless they are very delicately honed. ..."

PRESENTER: The Permanent Secretary to the Treasury, Sir Peter Middleton.

REPORT ON MIDDLETON NATIONAL INSTITUTE LECTURE

Transcript from: BBC Radio 4, Today, BUSINESS NEWS

PRESENTER: (Peter Day) Top civil servants at the Treasury are not renowned for saying things in public. So the Permanent Secretary to the Treasury must have kicked himself just a little when he realised that his lecture to celebrate the golden jubilee of the National Institute last night happened to fall on the eve of the Commons debate on the economy when the Chancellor will be fighting to retain his political credibility. Sir Peter Middleton told the National Institute audience that crude confidence is what financial markets are seeking not subtle economic policies.

MIDDLETON: "... Track record is by far the most important thing. Consistent, coherent, credible policies are of the essence. Without these the economy is likely to be subject to massive pressures whenever there is a temporary shock. ..."

PRESENTER: And Sir Peter also had a warning for the incautious and the over-ambitious.

MIDDLETON: "... If you have a badly functioning economy, which in many ways we still do, it is always possible to make it worse by Government initiatives unless they are very delicately honed. ..."

PRESENTER: Sir Peter Middleton, the top civil servant at the Treasury.

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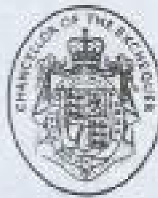

Treasury Chambers, Parliament Street, SWIP 3AG
01-270 3000

PRIME MINISTER

AN INDEPENDENT CENTRAL BANK

One of the most important achievements of this Government has been to place the defeat of inflation at the very heart of our economic policy. Although we are still only part of the way there, we have unequivocally reversed the rake's progress of the 'seventies and brought about a major cultural change.

I have been giving a great deal of thought to how we can best entrench that hard-won change, and make it a permanent feature of UK economic policy, while at the same time assisting us in the completion of our present task. I have reached the view that the best way to do this would be to give statutory independence to the Bank of England, charging it with the statutory duty to preserve the value of the currency, along the lines already in place and of proven effectiveness for the US Federal Reserve, the National Bank of Switzerland, and the Bundesbank.

Such a move would enhance the market credibility of our anti-inflationary stance, both nationally and internationally. It would make it absolutely clear that the fight against inflation remains our top priority; it would do something to help de-politicise interest rate changes - though that can never be completely achieved; above all there would be the longer term advantage that we would be seen to be locking a permanent anti-inflationary force in to the system, as a counter-weight to the strong inflationary pressures which are always lurking.

It would also, incidentally, make clear that we see a very different role for the Bank of England than absorption into some European central banking federation.

Clearly, since we have no written constitution, it would in theory be open for any future Government to repeal the legislation. But in practice there would be a powerful market sanction against that: the mere announcement of the intention to do so would in itself be so damaging to market confidence that any Government would be extremely reluctant to attempt it. And of course the longer the independent central bank had been in place, the more effective that sanction would be.

I have had some work done on this proposal by a very small, high level group in the Treasury (I have not mentioned any of this to the Bank of England at this stage). It is clear that the move would be perfectly feasible. The heart of the scheme would consist of the following division of responsibilities:

(a) The Bank would assume sole responsibility for the operation of monetary policy, with a statutory duty to protect and maintain the value of the currency. It would thus be responsible for setting short term interest rates and monetary targets.

(b) The Government would remain responsible for determining the exchange rate framework - for example, whether we were part of any international agreement, of whatever kind, formal or informal. The Bank would then be responsible for the conduct of exchange rate policy within that framework.

I have set out in an annex a number of other points which would probably be necessary to define the new arrangement and ensure it worked successfully.

While there was of course a time, in the era of the gold standard, when the Bank of England possessed more independence than it enjoys today, there is no doubt that what I am proposing would constitute a radical change. But I believe it has substantial merit: it would provide a beneficial jolt to inflationary expectations and would help to lock into the body politic of this country a permanent anti-inflationary force. If you are content, the next step would be to bring the Bank of England into this discussion. My plan would be to publish a White Paper on Budget Day, with the necessary legislation introduced in November 1989.

I should be happy to discuss this when we next meet.

[NL]

25 November 1988

ANNEX

Further characteristics of an independent Bank of England

(i) The Bank would be obliged, as is the Bundesbank, to conduct monetary policy within the framework of the Government's economic policy as a whole, but only so far as that is consistent with its primary function of safeguarding the currency. There would also, and within this context, be a joint obligation on the Government and the Bank to work closely together in the conduct of of economic policy.

(ii) The Treasury would be responsible for funding the Government's borrowing requirement (or for buying in debt when the Government was in surplus). But it would not be permitted to do this in a way which added to money or liquidity - ie it would have to sell longer term instruments. This is the arrangement followed in Germany.

(iii) A portion of the reserves would be available to the Bank for use in intervention, but the Government would be able to set limits on total intervention (in either direction) and the Bank would have to obtain the Government's agreements before those limits were exceeded.

(iv) The Bank would, at least for the time being, retain responsibility for supervising the banking system and the wholesale and gilt-edged markets. It would, of course, continue to discharge traditional central bank functions such as issuing notes and acting as the bankers' bank.

(v) We should probably [illegible] to make the Bank of England answerable to Parliament in the sense that the Governor would appear regularly before a suitable Select Committee. But we would want this to be set up in a way which did not subject the Bank to unwarranted Parliamentary pressure.

(vi) The Court would be made up, as now, of a Governor, Deputy Governor, Executive Directors and non-Executive Directors. They would be appointed by the Government, though there might well be a case for making the appointments of all but the Governor himself subject to the approval of the Select Committee. Members of the Court would be appointed for a long period, to ensure their independence - probably for a term of 8 years. The appointments could be arranged so that one new non-Executive member came up for appointment each year.

(vii) We should also take the opportunity of a new Bank of England Act to put the Bank's finances on a proper statutory footing.

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PRIME MINISTER

AN INDEPENDENT CENTRAL BANK

The Chancellor of the Exchequer's minute below puts forward the most radical proposal to come from the Treasury during your time in Government. It is:

> to give statutory independence to the Bank of England, charging with it the statutory duty to preserve the value of the currency.

He wants to announce this proposal in a White Paper at Budget time with legislation next Session.

My first reaction and Paul's is that the Chancellor's objective - to entrench a non-inflationary psychology ~~stance~~ - is obviously right. We believe too that technically the proposed scheme is feasible in the sense that it would permit the implementation of Government's economic policy, though there are some formidable technical issues which would need to be solved. But the real issues are not technical economic ones. They are:

(i) Political
(ii) Constitutional
(iii) Presentational

And I doubt whether we have got sufficient of the right people at present

(i) Political

This Government has made control of inflation the cornerstone of its economic policy. You have consistently argued that inflation is a monetary phenomenon and it is the Government's responsibility to control inflation. There is surely some inconsistency in a decision whereby Ministers surrender responsibility for this cornerstone of economic policy. Why,

it will be asked, if you attach so much importance to the control of inflation, do not Ministers themselves continue to take responsibility for controlling it? The obvious implication behind the Chancellor's proposals is either that a Conservative Government cannot be trusted to keep inflation down or that the Government needs to plan for circumstances in which it could lose an election. Neither are comfortable propositions.

There must be some doubt too about one of the assumptions underlying the Chancellor's view of the effectiveness of the scheme - ie a future Government would be inhibited from repealing legislation because the mere announcement of any such attention would damage market confidence. Maybe. But Mr. Kinnock might on the announcement of legislation give a commitment to repeal it and use any chaos caused at the time of the repeal to introduce even more draconian controls.

(ii) Constitutional

It would be unprecedented under our (non-Federal) Constitution for responsibility for such a fundamental Governmental objective, the control of inflation, and for the exercise of such an important function, interest rate policy, to be moved outside Ministerial control. Certainly our Constitutional structure might be adapted to accommodate such a scheme. But such adaptation would require

- making the Bank accountable to the Courts through a judicial review procedure

or

- making the Bank accountable to some body other than Ministers - which can only be Parliament.

The first route - accountable to the Courts through judicial review - seems inconceivable. Courts would be asked effectively to arbitrate on economic policy. That is not what

the Courts are for. The second route - accountability to Parliament - seems, according to points v and vi of the note attached to the Chancellor's minute, to be the route chosen by the Chancellor; in point v there is a reference to the Bank being "answerable to Parliament"; and in point vi to the possibility of the appointment of the Directors to the Bank being "subject to the approval of the Select Committee".

Such an arrangement amounts to a form of oversight by Parliament and would be the first time, I think, that Parliament had been given direct (without Ministerial intermediation) powers over such an important function. You will want to consider the consequences of such a Constitutional step and whether there would be pressures for it to be extended.

(iii) Presentational

The Chancellor wishes to announce the proposal at Budget time. Then inflation could be over 7 per cent, perhaps a little more, if today's base rate puts up the mortgage rate. This is hardly a good backdrop for the scheme's presentation.

The political, constitutional and presentational issues are formidable. But I do not think they are necessarily insuperable. The crucial judgment, and it has to be a political one, is whether the prospect of the benefits of an independent Central Bank - entrenching the fight against inflation - are worth the costs outlined above.

You need to decide whether:

(a) the scheme is so fundamentally unattractive that you would not wish it to be discussed with the Bank as the Chancellor wants

or

(b) you do not necessarily rule out the scheme and, while reserving judgment on its principles, are willing for it to be considered with the Bank.

Paul and I would welcome a word. When we have your reaction, we can prepare a more detailed brief for your talk with the Chancellor.

N.L.W.

N. L. WICKS

25 November 1988

KAYALW

Inland Revenue

Savings and Investment Division
Somerset House

FROM : J R STREETER
23 November 1988

1. MR O'CONNOR
2. MR CORLETT
3. MR ISAAC
4. FINANCIAL SECRETARY

DETERMINATION OF COMPOSITE RATE FOR 1989/90

1. This note seeks your approval

   a. to a determination of the 1989/90 composite rate for building societies, banks and local authorities at 21.75% (a drop of 1.5% from the current rate), and

   b. for laying a Treasury Order to that effect (with accompanying Press Release) in the near future.

Background

2. The composite rate is the rate at which tax has normally to be accounted for on interest paid to individual investors by building societies, banks and local authorities. It is a final tax and cannot be repaid to those who are not otherwise liable. It has to be statutorily fixed each year. It is determined on

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cc. Chancellor
Chief Secretary
Economic Secretary
Sir P Middleton
Mr Culpin
Mr Peretz
Mr Gilhooly
Mr Gieve
Mrs Chaplin
Mr Tyrie
Mr Isaac
Mr Corlett
Mr Davenport
Mr Calder
Mr O'Connor
Mr Dearman
Mr Streeter
Miss Boland
Mr Willmer
Mr McCarney
Mr Green
PS/IR

the basis of data for the preceding rather than the current year, and has to be, as nearly as maybe, revenue neutral (ie it should yield the same amount of tax as would be raised if those investors who were liable at basic rate suffered tax at that rate, and those who were not liable suffered no tax).

3. It is announced by Treasury Order, before, at the latest, 31 December preceding the relevant tax year starting the following 6 April. Thus the rate for 1989/90 has to be determined before 31 December 1988. The normal practice is to lay the Order earlier. Last year the Order was laid on 8 December and it is desirable to work to a similar timetable this year so that the institutions have as much advance notice as possible.

Parliamentary Procedure

4. The Order falls to be made by statutory instrument which is subject to the negative resolution procedure. It remains subject to this procedure for forty sitting days and under a House practice rule statutory instruments should, where practicable, not come into force before 21 calendar days after they have been laid.

Recommendation on 1989/90 rate

5. When banks were brought into the composite rate scheme in 1985, followed by local authorities in 1986, no data was available showing the ratio of taxpaying and non-taxpaying depositors in these institutions. Transitional rules were therefore included in the Finance Act 1984 which provided that the composite rate for the four years 1985/86, 1986/87, 1987/88 and 1988/89 should be calculated by reference to data relating only to building societies.

6. For 1989/90 and subsequent years the tax status of depositors in all the institutions covered by the scheme must be taken into account. Our Statistics Division has therefore extended the normal 4-yearly examination of building society accounts to include a sample of accounts held by other deposit-takers. The evidence supports a composite rate of 21.75 per cent for 1989/90 (a drop of 1.5 per cent from the 1988/89 rate of 23.25 per cent). Further details of the calculation are included in Annex A.

Court action by the Woolwich Equitable Building Society

7. Last year we warned that the Order determining the rate for 1987/88 might be challenged in the Courts. Following the successful challenge by the Woolwich Equitable Building Society of the Regulations which govern composite rate tax paid by building societies we assessed the possibility of a challenge to last year's Order as remote. The decision in favour of the Woolwich is subject to appeal by the Revenue. The possibility of a challenge against this year's Order remains but has not increased.

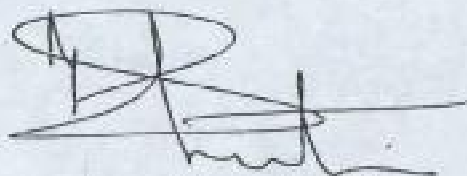
Summary

8. We seek your approval for

a. composite rate for 1989/90 to be set at 21.75% (paragraph 6 and Annex A);

b. the laying of a Treasury Order as soon as possible (paragraphs 3 and 4);

c. the issue of the draft Press Release.



J R STREETER

INLAND REVENUE

Press Release

INLAND REVENUE PRESS OFFICE, SOMERSET HOUSE, STRAND, LONDON WC2R 1LB
PHONE: 01-438 6692 OR 6706

[3x] November 1988

COMPOSITE RATE FOR BUILDING SOCIETIES, BANKS AND LOCAL AUTHORITIES ETC FOR 1989-90

A Statutory Instrument was laid before the House of Commons today fixing at 21.75 per cent the rate at which building societies, banks, local authorities and other deposit-takers will account for tax on interest paid in 1989-90 to individuals resident in the United Kingdom.

The Statutory Instrument, which has the title "The Income Tax (Reduced and Composite Rate) Order 1988" will be published on

Copies will be obtainable from HMSO.

Notes for Editors

The composite rate is a fixed rate of tax on interest which is not repayable. It is set (on the basis of a periodic statistical survey of depositors) at a level which will achieve revenue neutrality - that is, a rate which will result in the same amount of tax in total becoming payable as would be payable if tax were charged on investors according to their own individual tax rates.

The 21.75 per cent rate now determined for 1989-90 is a reduction of 1.5 per cent from that for 1988-89.

STATUTORY INSTRUMENTS

1988 No.

INCOME TAX

The Income Tax (Reduced and Composite Rate) Order 1988

Made	1988
Laid before the House of Commons	1988
Coming into force	6th April 1989

The Treasury, in exercise of the powers conferred on them by section 483 of the Income and Corporation Taxes Act 1988(a), hereby make the following Order:

1. This Order may be cited as the Income Tax (Reduced and Composite Rate) Order 1988 and shall come into force on 6th April 1989.

2. The Treasury hereby determine that the rate which, under the provisions of the said section 483, shall for the year 1989-90 be the reduced rate (for building societies) and the composite rate (for deposit-takers) shall be 21.75 per cent.

1988 Two of the Lords Commissioners of Her Majesty's Treasury

(a) 1988 c.1.

EXPLANATORY NOTE

(This note is not part of the Order)

By virtue of the Income Tax (Building Societies) Regulations 1986 (S.I. 1986/482; amended by S.I. 1987/844 and S.I. 1988/1011) a building society is required to pay to the Inland Revenue in respect of payments of dividends and interest an amount representing income tax on certain sums calculated in part at the basic rate and in part at "the reduced rate".

Under the provisions of section 479 of the Income and Corporation Taxes Act 1988 ("the Act") a deposit-taker on making payments of interest in respect of a relevant deposit is liable to account for and pay an amount representing income tax on such payments. The amount is calculated by applying "the composite rate" determined in accordance with section 483 of the Act.

Section 483 of the Act provides that the Treasury shall by order made by statutory instrument determine a rate in each year of assessment which for the following year of assessment shall be the reduced rate (for building societies) and the composite rate (for deposit-takers). This Order determines the rate at 21.75 per cent. for the year 1989-90. The rate for the years 1985-86 and 1986-87 was 25.25 per cent. (S.I. 1984/1674 and S.I. 1985/1836), for the year 1987-88 24.75 per cent. (S.I. 1986/2147) and for the year 1988-89 23.25 per cent. (S.I. 1987/2075).

ANNEX A

CONFIDENTIAL

EVIDENCE ON A REVENUE-NEUTRAL RATE FOR COMPOSITE INTEREST

Assembly of New Evidence

1. The rate to be set for 1989-90 is the first one which is not exempted (by ICTA Section 48 3(4)) from having to take account of the inclusion of bank depositors within the scope of composite rate, which took effect from 1985-86.

2. To enable bank composite rate interest to be included in the calculation of what level of composite rate produces revenue-neutrality, a Composite Rate Statistical Investigation has been carried out. The savings institutions, including banks, drew a sample of their composite rate accounts, and supplied to the Inland Revenue the names and addresses of the account holders, and the amount of interest paid and credited in the year to April 5 1987. Most of them managed to meet the due date for doing so, the end of June 1987. By the end of January of this year, almost all the details of sampled investors had been supplied; the tax district most likely to deal with their affairs had been identified and had been asked to provide tax or income information relevant to the calculation of what proportion of their interest would be liable to tax in the absence of a composite rate system.

3. The sample of accounts with which tax districts were asked to deal numbered about 86,000. They responded well, supplying details for about two thirds of account-holders by the end of July. However, locating the right tax district from the name and address supplied by the savings institutions was not straightforward in the case of a substantial minority of account-holders. For many, no record was traceable. Such account-holders could not be assumed to be non-taxpayers simply because no tax record could be traced, and they were, if necessary, asked to complete a return of income.

4. Gathering the necessary information about a large minority of account-holders was thus rather time-consuming, and by mid-October it was still not available for about 15 per cent of the sampled account-holders. Assumptions about the liability to tax of their interest have therefore had to be made. The assumptions are backed by the use of indications about the stage to which the action in tax districts had progressed (for example, in some cases the final stage of awaiting a return of income from the investor had been reached). But the need to use those assumptions does introduce an additional degree of uncertainty into calculating a revenue-neutral rate for 1989-90.

The change to the level of composite rate resulting from the new evidence

5. The inclusion of banks and other deposit takers within the scope of the calculations has exerted a slight downward pressure on the rate. A rate calculated on the assumption that composite rate applied to bank depositors alone is about 3/4 percentage point lower than a rate calculated on the assumption that it still applied only to building society investors. However about four-fifths of composite rate interest is paid out by building societies, so the effect, on the rate, of the lower liability of bank depositors is less than 0.2 percentage points.

6. A more substantial, and upward, impact on the rate has arisen from changes made to methods of tracing an account-holder's tax record and to the way of treating the interest where no tax record could be traced. Though it is difficult precisely to establish the impact of each change, because of the way they interacted, the two changes in order of importance were as follows;

i) An extra means of locating the investor's tax district was available for this statistical investigation. This was the computerised National Index, which held the name and an address for all individuals with a PAYE

x An interesting "efficiency" gain from investment in new technology. The annual [illegible] ... the total cost of the

record, and the tax district dealing with their affairs. In the previous statistical investigation, paper records, held by the tax district in whose area the investor lived, very often failed to show which tax district was responsible. A letter had to be sent to the investor seeking the information, to which there was often no response. Such letters were much less frequently needed in the new statistical investigation.

ii) Where these letters did need to be sent in the new investigation, but were not responded to, one or in many cases two, further steps were taken. The electoral roll was examined to obtain an indication of whether the investor was likely to be a minor, or to have moved away from the address provided by the savings institution. If so, an appropriate assumption about tax liability could be made. But if neither of these indications was present, the investor was required to complete a return of income. The liability to tax of the investor's income was calculated from the return, or if no reply was received, it was assumed to be as likely to be liable to tax as the interest of those who did respond. By contrast, in the previous investigation, neither of these steps was taken. Instead, a relatively low likelihood of liability to tax was assumed. These assumptions dated from the time composite rate was negotiated with the Building Societies Association. They continued to be used during the time when the rate was determined, as there was nothing better to put in their place until a new statistical investigation could be completed.

The level of composite rate for 1989-90

7. The table below shows the various factors affecting the level of composite rate since the rate of 23.25 per cent was determined a year ago.

1.	Composite rate for 1988-89		23.25
2.	a)	effect of lower liability to tax of bank depositors	- 0.17
	b)	other effects of extending scope beyond building societies	- 0.13
	c)	better methods of establishing liability to tax	+ 0.61
3.	Growth in taxable incomes between 1987-88 and 1988-89		+ 0.34
4.	Raising of personal allowances		- 0.33
5.	Reduction in basic rate from 27% to 25%		- 1.75
6.	Total change (lines 2 to 5)		- 1.43
7.	Calculated revenue-neutral rate for 1989-90		- 21.82

8. In the past, composite rate has been varied in steps of not less than ¼ percentage point. Though the information is now better than it was, it would not be justifiable to regard it as

being sufficiently precise to enable smaller changes than ¼ percentage point to be calculated with confidence. This is particularly true this year, for the reason given in paragraph 4 of this Annex.

9. We would therefore recommend that to the nearest ¼ percentage point, 21.75 per cent is the rate most likely to achieve revenue-neutrality.

STATISTICS DIVISION
NOVEMBER 1988

Washington DC

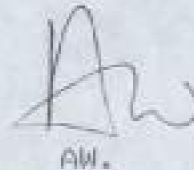
21st Nov 1988

Mr. Gray,

I have written the attached one-page note on sterilized intervention (Apologies for the American spelling !). I think it contains the essence of my argument that sterilized intervention is ineffective, except perhaps in the very short run - and I mean a matter of days rather than weeks.

I know that the Prime Minister has been bombarded with the argument that, with sterilization, intervention is not inflationary. That is largely true - but intervention is then ineffective and could conceivably be counterproductive.

You might like to pass this on to the Prime Minister when the issue of intervention is again raised. I suspect that will be in the near future.



AW.

Intervention and Sterilization

The Claims

There is no disputing the fact that monetary policy will have an effect on exchange rates. Thus if Britain lowers interest rates and increases the money supply, relative to the United States, the dollar value of sterling will decline. This increase in the quantity of sterling can be induced by exchange rate operations, that is by creating sterling deposits in order to buy dollars (which are then deposited in the official reserves). The increase in sterling deposits, cet par, will lead to inflationary pressures in the UK.

It is claimed, however, that, although intervention to support the dollar will increase the amount of money and so generate inflationary pressures, this can be avoided if the Bank simultaneously sells long gilts to mop up the sterling generated by the purchase of the dollars. Thus, the story goes, we can increase the sterling value of the dollar without generating a domestic monetary expansion. This is the "sterilized intervention" process.

The Reality

But the argument should be pursued further. In order to sell long gilts the price must be reduced, that is to say yields must be increased. The increase in British interest rates, relative to those of the United States, will then attract foreign capital to Britain and so drive up the sterling value of the dollar. Clearly this will offset the initial effects of the intervention. There will be a call for more intervention...and so the authorities may well be trapped in a self-perpetuating process.

Sterlized intervention is therefore generally ineffective and may well be harmful. There are however some cases where it may well be theoretically justified. If, for example, the putative exchange rate movements are due entirely to transitory portfolio shifts - for example a transient demand for sterling and a switch out of dollars - then it makes sense for the authorities to intervene in a sterlized operation. But, in practice, it is quite impossible to identify such portfolio shifts, as distinct from more permanent and fundamental movements in exchange rates.

The upshot is that sterilized intervention is virtually always an unsuitable policy option. And unsterilized intervention is simply a mutant of monetary policy.

SECRETARY OF STATE
FOR
NORTHERN IRELAND

NORTHERN IRELAND OFFICE
WHITEHALL
LONDON SW1A 2AZ

The Rt Hon Douglas Hurd CBE MP
Home Secretary
Home Office
50 Queen Anne's Gate
LONDON
SW1H 9AT

15 November 1988

Dear Douglas,

INCREASES IN MONETARY LIMITS ON LOTTERIES UNDER THE LOTTERIES AND AMUSEMENTS ACT 1976

Thank you for copying to me your letter of 7 November to John Wakeham on this subject.

As you know I had previously indicated my support in principle to a raising of the Great Britain lottery limits. Having now seen the details of your proposals you may take it that I have no objection to any aspect of these from a Northern Ireland standpoint.

I should mention that the Northern Ireland law, which has been in operation for little over a year, allows only one type of society's lottery and no society may hold more than one lottery in any period of 7 days. Here there is a limit of £80,000 on the turnover of any one lottery and £1 million on the total turnover of all lotteries run by any society in a year. No prize can exceed 10 per cent of the proceeds, ie £8,000. As in Great Britain, the maximum price of a ticket or chance is 50p.

JB 17289

In due course, I shall be re-examining these levels in the light of the developments on your side to see whether any revision might be necessary.

I am copying this letter to the Prime Minister, other members of H, the Attorney General, the Minister for Arts and Libraries, the Chief Whips in both Houses and Sir Robin Butler.

TK

JB 17289

ECON POL: Domestic Monetary Policy

Pt. 20

PRIME MINISTER

I saw Alan Walters today about his contract for returning to No.10. No problems here.

He will be seeing you early in December. But he asked me to pass you two messages.

(1) On the economy, he was satisfied about its progress. The higher interest rates appeared to be working faster than many had expected. It was too early to come to judgments about the Budget, but he thought that the priority area for action would be capital taxation. He believed that, despite the theoretical arguments for unifying the income and capital gains tax (CGT) rates, a CGT rate of 40 per cent was too high. It was effectively a tax on savings; and we needed more incentives to save, not disincentives. Moreover, a 40 per cent CGT would not, in Alan's view, raise as much revenue as a lower rate. This was because with the rate at 40 per cent, taxpayers would do their best to find capital losses to offset against their capital gains and so reduce their tax bills. If the CGT rate was lower, tax payers would have less incentive to do that and the working of the Laffer curve would produce higher net revenue.

Whatever the economic merits of Alan's point, the politics of divorcing the CGT and income tax rates only one year after so much credit has been taken for their unification, would be very difficult indeed.

(2) Alan thought that Mr. Bush would want to begin his Presidency with a dramatic economic gesture. His guess for that gesture was an oil import tax, which would be bad news.

N.L.W.

N. L. WICKS

11 November 1988

PM2AHC

2 MARSHAM STREET
LONDON SW1P 3EB

01-276 3000

My ref:

Your ref:

The Rt Hon Douglas Hurd MP
Home Office
Queen Anne's Gate
LONDON
SW1

11 November 1988

Dear Douglas

Thank you for copying to me your letter of 7 November to John Wakeham outlining your proposals to increase the monetary limits on lotteries under the Lotteries and Amusements Act 1976.

I am writing to say that I am content to agree the action proposed in the penultimate paragraph of your letter.

I am copying this letter to the Prime Minister, other members of H Committee, the Attorney General, the Minister for Arts and Libraries and the Chief Whips in both Houses and to Sir Robin Butler.

Yours ever

Nicholas

NICHOLAS RIDLEY

Econ Pol: Domestic Monetary Policy Pt 20

CC PU

SCOTTISH OFFICE
WHITEHALL, LONDON SW1A 2AU

MBPM
PR16
14/11

The Rt Hon Douglas Hurd CBE MP
Secretary of State for Home Affairs
50 Queen Anne's Gate
LONDON
SW1H 9AT

11 November 1988

Dear Douglas,

INCREASES IN MONETARY LIMITS ON LOTTERIES UNDER THE LOTTERIES AND AMUSEMENTS ACT 1976

FILE WITH PG

In your letter to John Wakeham of ~~7~~ November, which you kindly copied to me, you asked whether I would be ready to make the same increases in monetary limits for lotteries in Scotland as you propose for England and Wales.

As you know, I have earlier expressed support in principle for such increases and, having considered your detailed proposals, I am content for identical increases to apply in Scotland. Subject to a satisfactory outcome to consultation, a separate Scottish Order will be prepared to effect increased limits in Scotland. Copies of this letter go to the recipients of yours.

Yours ever,

Malcolm

MALCOLM RIFKIND

EML316F6

ECON POL: Domestic Monetary Policy Pt20

SRW
Ri/c

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary 11 November 1988

Dear Philip

INCREASES IN MONETARY LIMITS ON LOTTERIES UNDER THE LOTTERIES AND AMUSEMENTS ACT 1976

The Prime Minister has seen a copy of the Home Secretary's letter of 7 November to the Lord President. She is content with the proposal summarised in the Home Secretary's letter.

I am copying this letter to the Private Secretaries the members of H Committee, the Attorney General, the Minister for Arts and Libraries and the Chief Whips in both Houses and to Sir Robin Butler.

Yours ever

Dominic

(D. C. B. MORRIS)

Philip Mawer, Esq.,
Home Office.

From the Minister for the Arts

OFFICE OF ARTS AND LIBRARIES
Horse Guards Road
London SW1P 3AL
Telephone 01-270 5929

C88/5528

Rt Hon Douglas Hurd CBE MP
Home Office
Queen Anne's Gate
LONDON SW1

10 November 1988

Dear Douglas,

INCREASES IN THE MONETARY LIMITS ON LOTTERIES

I have been most interested to see the proposals attached to your letter of 7 November to John Wakeham.

I was particularly struck by the figures showing the decline in sales of lottery tickets since 1979/80 from £92 million to £21.5 million. As you know, I believe that there is a substantial amount of extra funding for charitable causes that could be unlocked by appealing to the lottery instinct, now that many people have more cash in their pocket. But it is clear that a very substantial increase in the maximum for prizes will be needed to tap this source of funds. I am disappointed both that you are not considering a higher maximum for prizes and that you do not propose to raise that for proceeds. This can only mean that the profits to an arts body would be reduced if it seeks to encourage more support by increasing its prizes. I do not follow the Gaming Board argument that there would be too great a risk of abuse if the proceeds limit were raised. Surely the question of management and accountability arises just as much at £120,000 as (say) £250,000?

I would have liked to see bigger stakes all round, in order to favour fund-raising as part of our overall strategy of encouraging the private sector. However, I would be content for you to consult the professional bodies in the gaming and charitable fields on the proposals as they stand. I would also ask you to invite the views of the Arts Council of Great Britain and the Museums and Galleries Commission at the same time, since they have responsibility for many of the bodies which would ultimately benefit from a revitalised lottery system.

I am copying this letter to those who received yours.

Richard

RICHARD LUCE

10 DOWNING STREET

Prime Minister!

LOTTERIES

You saw the papers below last night.

Can I take it you are content?

RRCG
10/11

Yes [illegible]

PRIME MINISTER 7 NOVEMBER 1988

INCREASES IN MONETARY LIMITS ON LOTTERIES UNDER THE LOTTERIES AND AMUSEMENTS ACT 1976

You have said that you do not want a Green Paper on the general issue of lotteries. But you have agreed that the Home Secretary should make regulations:-

i. rendering multiple lotteries unlawful; and

ii. increasing the present financial limits on lawful lotteries - these are run by charities, sports organisations and local authorities in the main.

Douglas Hurd has circulated a draft consultation paper on (ii) - he is already consulting on (i).

Proposed new limits on lotteries

(a) Maximum prizes will be increased thus:

	Current maximum prize	New maximum
Short term lottery	£3,000	£7,500
Medium term lottery	£4,500	£11,250
Any other lottery	£6,000	£15,000

Only schemes registered with the Gaming Board will be able to benefit from the new limits on prizes.

(b) The limits on the proceeds of lotteries will not be increased.

(c) The maximum price for a ticket will be increased from 50p to £1.

Comment

These proposals seem sensible for the following reasons:

- Local charitable lotteries appear to be in decline. This is certainly the case with lotteries supervised by the Gaming Board - figures for other lotteries are not available.

- An increase in prizes may give them a new lease of life.

- Lotteries continue to throw up examples of poor administration and fraud. It is therefore wise not to increase the limits on the proceeds of lotteries.

- Retaining the limits on proceeds also prevents local lotteries from getting entangled in the debate about NHS funding. It should remove the Treasury worry about successful lotteries leading to back door increases in public expenditure.

- The modest nature of the proposed changes should help to make them more acceptable to the Gaming Board. The latter are still likely to grumble at any increases in the limits - the Board's Report for 1987/88 argued that the present system of controls on local lotteries was not adequate.

Conclusion

Douglas Hurd's proposals should give a small fillip to local and charitable lotteries. This fits with the Government's general support for voluntary action in many social fields.

But given the doubts of the Gaming Board, and the damage which stories of fraud can do to charitable activities, it is sensible to proceed cautiously.

Recommendation

Agree with the Home Secretary's proposals.

CAROLYN SINCLAIR

Prime Minister
Policy Unit – see below – support this modest package.
Content for Mr. Hurd to go ahead?
PRCG 9/11

QUEEN ANNE'S GATE LONDON SWIH 9AT

7 November 1988

Dear John,

INCREASES IN MONETARY LIMITS ON LOTTERIES UNDER THE LOTTERIES AND AMUSEMENTS ACT 1976

I was grateful to colleagues for their swift agreement to the proposals in my letter of 28 September to you, that I should quickly announce an intention by regulation under the Lotteries and Amusements Act 1976 to prohibit "multiple" lotteries and, at the same time, by Order to increase monetary limits on individual lotteries under the Act. As you know, I made that announcement on 5 October. The statutory consultations about the regulation are under way.

In my letter I said that, as colleagues had asked, I would put any detailed proposals for modest increases in the monetary limits on single lotteries to them before proceeding to outside consultation. My proposals are contained in the enclosed paper, Monetary limits on lotteries under the Lotteries and Amusements Act 1976. You and colleagues may not necessarily wish to digest this lengthy paper in full. It provides a comprehensive account of the factors which determine the scope for increases, which may be of interest to some.

The specific proposals, recorded in paragraphs 35-42 of the paper, are that:

(i) the limits on maximum prizes for societies' and local lotteries promoted under schemes registered with the Gaming Board for Great Britain should be increased by 150%;

(ii) the limits on the proceeds of such lotteries should not be increased;

(iii) the maximum price of a ticket or chance should be increased by 100%;

(iv) there should be no increase in the limits on the maximum prize or proceeds in a society's lottery not promoted under a scheme registered with the Gaming Board.

/As the paper

The Rt Hon John Wakeham, MP
Lord President of the Council

As the paper explains, these proposals take account of the views, where they are known or can reasonably be forecast, of those active in the lotteries field. The essential aim of the proposal is to provide scope for a modest revival in lotteries promoted under schemes registered with the Gaming Board, without stimulating activity in societies' lotteries which are subject only to vestigial local authority control. By raising the maxima on individual prizes in "Board registered" lotteries, but keeping their proceeds limits as they are, such lotteries should be made more attractive and their operators should be able to sell their tickets more certainly and quickly up to the current proceeds maxima, without our putting lotteries into a bigger gambling league.

In earlier correspondence Norman Lamont asked for the opportunity to comment on whether the proposals for increased monetary limits would be likely to increase the scale of lotteries to an extent which might significantly exacerbate the difficulties of public expenditure control. This is addressed in paragraphs 30 and 31 of the attached paper. Norman may wish to say if he is content with the analysis there that, as far as can be estimated, increases in limits of the order proposed would seem most unlikely to stimulate lotteries activity to a level which should cause concern.

It would be helpful if Norman could also respond on the question of continuing to exempt lotteries from pool betting duty (paragraph 32 of the paper).

As the paper also explains, increases in limits on lotteries in Scotland will require a separate Order. I hope that Malcolm Rifkind would be ready to make the same increases in monetary limits for lotteries in Scotland as I make for those in England and Wales.

Outside consultations on the regulation to prohibit "multiple" lotteries began last month. I should like to add proposals on increases in monetary limits to those consultations quickly. I should therefore be grateful to know if colleagues are content with the proposals summarised in this letter by Friday 11 November.

I am copying this letter and the enclosed paper to the Prime Minister, other members of H Committee, the Attorney General, the Minister for Arts and Libraries and the Chief Whips in both Houses and to Sir Robin Butler.

Yours,
Douglas.

MONETARY LIMITS ON LOTTERIES UNDER THE LOTTERIES AND AMUSEMENTS ACT 1976

INTRODUCTION

The purpose of this paper is to explain proposals for increases in certain monetary limits on lotteries promoted under the Lotteries and Amusements Act 1976. The paper is in six sections:

A: Relevant provisions of the 1976 Act and history of limits (paragraphs 2-12)

B: Decline in lotteries activity/aims of encouragement (paragraphs 13-16)

C: Wishes of the lotteries 'industry' (paragraphs 17-23)

D: Constraints on increases in monetary limits (paragraphs 25-29)

E: Treasury/Customs and Excise considerations (paragraphs 30-32)

F: Proposals (paragraphs 33-42)

A: RELEVANT PROVISIONS OF THE 1976 ACT AND HISTORY OF LIMITS

Societies' lotteries and local lotteries

2. Under section 18 of the 1976 Act the Secretary of State may by Order vary certain monetary limits on societies' lotteries and local lotteries. A society's lottery is a lottery promoted on behalf of a society which is established and conducted wholly or mainly for one or more of the purposes of: (a) charity; (b) participation in or support of athletic sports or games or cultural activities; or (c) neither (a) nor (b) but neither private gain nor any commercial undertaking. A 'society' is defined as including any club, institution, organisation or association of persons, by whatever name called, and any separate branch or section of such a club, institution, organisation or association. Examples of societies include football supporters' clubs, and Friends of hospitals.

3. Local lotteries are those promoted by local authorities. A local authority may promote a local lottery for any purpose for which it has power to incur expenditure under any enactment.

Monetary limits and their history

4. A society or local lottery promoted under a scheme registered with the Gaming Board for Great Britain is subject to limits on its maximum prize and proceeds. The limits were increased in 1981 and 1985. The current limits and their predecessors are as follow:

	Maximum Prize	Maximum Proceeds
(a) Short-term lottery (eg one held weekly)	£3,000 (set in 1985; increased in 1981 to £2,000 from original £1,000)	£30,000 (set in 1985; increased in 1981 to £20,000 from original £10,000)
(b) Medium term lottery (eg one held monthly)	£4,500 (set in 1985; increased in 1981 to £3,000 from original £1,500)	£60,000 (set in 1985; increased in 1981 to £40,000 from original £20,000)
(c) Any other lottery (eg quarterly or annually)	£6,000 (set in 1985; increased in 1981 to £4,000 from original £2,000)	£120,000 (set in 1985; increased in 1981 to £80,000 from original £40,000)

5. The 1976 Act also provides for societies to run smaller lotteries, the schemes for which do not have to be registered with the Gaming Board. Only registration of the society with a local authority is required. The limits are:

	Maximum Prize	Maximum Proceeds
Lottery by society registered with a local authority	£2,000 (as increased in 1981 from original £1,000; no increase in 1985)	£10,000 (as increased in 1981 from original £5,000; no increase in 1985)

No more than half of the proceeds of any society's or local lotteries may be devoted to prizes, and this proportion is not variable by Order. As to expenses, where the proceeds do not exceed an amount set by Order, up to 25% may be appropriated for expenses. The current amount is £10,000, ie the same as the maximum proceeds of a lottery not under a scheme registered with the Gaming Board, and similarly set in 1981. Where the proceeds exceed £10,000, the percentage of them which may be appropriated for expenses is 15%, or such larger percentage as the Board may authorise within a ceiling of 25%.

7. No society or local authority may hold more than 52 lotteries in any period of 12 months, but when the date of two or more lotteries promoted on behalf of one society or local authority is the same, the lotteries may be treated as one provided that the total proceeds of the lotteries does not exceed a figure capable of variation by Order. The current figure is £30,000 (a figure set in 1985; in 1981 it had been increased to £20,000 from £10,000).

8. There is also a limit on the maximum price of a ticket or chance to be sold in either a society's or local lottery. That limit is currently 50p (increased to that amount in 1981 from the original 25p).

9. Thus all the limits described above were increased in 1981 by 100%. This was mostly to take account of inflation, which had been 90% since 1976.

10. In 1985, the limits on maximum prizes and proceeds in lotteries promoted under schemes registered with the Gaming Board (and also the proceeds limits on two or more 'small' lotteries, cf paragraph 7 above) were increased by 50%, in part because of inflation since 1981 (which had been 25%) but principally following representations from the commercial interests in the lotteries industry, whose ambitions were for greater increases, generally of 100%.

11. It will be noted that the limits on the maximum prize and proceeds in a society's lottery not required to be registered with the Gaming Board were not increased in 1985. This was to avoid a repetition of what had happened when these limits had been increased in 1981. Following the 1981 increases there had been a noticeable decline in the number of schemes registered with the Gaming Board (who have greater supervisory powers), apparently as a result of a shift to the promotion of lotteries requiring only registration of societies with local authorities (who have minimal supervising powers).

12. The maximum price of a ticket or chance was not increased in 1981 in the absence of representations from the industry.

B: DECLINE IN LOTTERIES ACTIVITY/AIMS OF ENCOURAGEMENT

13. The 1976 Act provides only for modest lotteries. But at the time of the legislation societies, firms of promoters and local authorities had high hopes of the capacity of lotteries to generate reliable, continuous income, and considerable efforts were made to sell tickets and chances. For example, the booth in the high street selling 'instant' tickets (where the punter discovers if he has won by rubbing off an opaque film covering numbers of symbols) became a common feature. The impetus has not been maintained. Information about societies' lotteries not registered with the Gaming Board is not collected centrally. But attached at A is a graph of the annual sales of tickets in lotteries promoted under schemes registered with the Board between 1977 and early 1988. From a peak of some £92 million in sales in 1979/80 (totalled from some £61 million in societies' lotteries and some £32 million in local lotteries) there has been a decline to a 1987/88 total of some £21.5 million in sales (some £18.5 million for societies' lotteries and some £3 million for local lotteries). The decline would be expressed more sharply if inflation were taken into account.

14. The reduced popularity and success of lotteries have not only diminished lotteries' income. They are reported also to have exacerbated difficulties in complying with the requirements, unalterable by Order, that at the most no more than 25% of the proceeds may be appropriated for expenses. The bulk of expenditure on expenses is likely to be incurred at the start of a lottery, on printing and promotion. To comply with the law, the proceeds from sales of tickets or chances need to be at least four times the cost of expenses. If sales are worse than expected, either the legal limit on the proportion allowable for expenses is breached, or the expenses have to be subsidised from other income.

15. It does not follow that the aim of increases in monetary limits should or can be an attempt to restore ticket sales to their peak. The 1976 Act has been criticised for weaknesses in its provision for financial and other controls over lotteries virtually since its inception (for example in the 1978 reports of the Rothschild Royal Commission on Gambling and of the Gaming Board). In past years there have been lotteries scandals, some resulting in convictions and sentences of imprisonment. The reduced popularity of lotteries has had the incidental benefit of making them less attractive to the fraudulently minded. As is noted in section D below, the Gaming Board nonetheless remain concerned about the potential for fraud and mismanagement. In any event, as also noted in section D, the power by Order to vary monetary limits cannot be used to alter the purpose or effects of the primary legislation (ie to make 'big' lotteries out of 'small').

16. But the promotion of lotteries remains a proper and potentially useful means of legitimate fund-raising. As is explained more fully in section C below, the depression in lotteries activity is principally attributed to the current limits on maximum prizes. If that is right, increases in prizes in particular (within the scope of the Order-making power and taking account of the cautionary history of the Act) could revive lotteries to a worthwhile if modest extent. This would be timely when the Government is encouraging citizens to pursue the charitable and other social causes which 1976 Act lotteries are intended to benefit. The rest of this paper considers the scope for increases which might most usefully be made.

C: WISHES OF THE LOTTERIES INDUSTRY

Lotteries Council

17. The Lotteries Council represents the commercial element of the lotteries industry (firms of promoters and ticket printers) and some societies. On their own initiative representatives of the Council have recently put their current views to Home Office officials. The Council's principal ambitions are for increases in maximum prizes in lotteries under schemes registered with the Gaming Board. They would like to go up to £25,000 as the maximum prize for long-term lotteries, with the other prize maxima increased pro-rata (ie increases of some 400%). But their minimum immediate ambition is to get into five figures, eg possibly a scale of £5,000, £7,500 and £10,000 to replace the current £3,000, £4,500 and £6,000.

18. The Council also want an increase in the maximum permitted stake, from 50p to £1 to enable punters more readily to chance more for the prospect of a higher prize.

19. The Council representatives did not seek an increase in the limits on proceeds, because of the current difficulties of achieving ticket/chance sales even up to those limits. Their belief is that higher maximum prizes, for the chance for which punters might be ready to pay more, would enable them to increase their profits, and the income of their clients, by attracting punters to subscribe fully and quickly within the current proceeds maxima.

20. The Council specifically advised that there should be no increase in the limits on maximum prizes and proceeds for societies' lotteries not promoted under schemes registered with the Gaming Board (ie those currently of £2,000 and £10,000 respectively).

Local Authorities

21. The principal lotteries organisation of the local authorities in England and Wales is the Lotteries Action Group (LAG), representing the Association of District Councils. There has been no recent Home Office or Gaming Board contact with the LAG on the question of monetary limits. Historically the LAG's concerns have been for changes in the 1976 Act which would require primary legislation (tighter controls on societies' lotteries not registered with the Gaming Board, and an increase in the proportion of lotteries proceeds which may be taken for expenses). The LAG's response to proposed increases in monetary limits on lotteries might be equivocal. As is shown in the attached graph, the decline in lottery ticket sales has hit local authorities harder than societies (on the most recent information available to the Gaming Board, in the 12 months ending 31 August 1988 average turnover per local lottery was some £8,500 compared to nearly £20,000 for each society's lottery promoted under Board registration). Some in the LAG might be fearful that substantial increases in limits could lead to larger societies swamping the market and effectively further squeezing out the small operator. Equally, others in the LAG might see advantage in some increase in the prize limits as a means of boosting turnover and thus easing pressure on expenses.

22. In a recent letter about lotteries to the Home Office, the Association of Metropolitan Authorities (AMA) did not refer directly to the monetary limits and focussed on changes requiring primary legislation. But interestingly the AMA appear to be under the misapprehension that donated prizes are to be counted within the 50% maximum proportion of proceeds allowable for prizes. In fact, the one limit on any donated prize is that it must not exceed in value the limit as to the maximum prize. A benefit of increasing the prize maxima is that greater giving of prizes could be encouraged and allowed. There is evidence from the latest report of the Gaming Board that some potential donors, for example of new motor cars, have been frustrated by the current limits.

Charity Fund-Raisers

23. The views of charities will be tested by consulting bodies such as the Institute of Charity Fundraising Managers. Individual charities may have different views, according to their size (ie the larger charities capable of taking readier advantage of increased limits might be more enthusiastic). Coincidentally, the Institute is issuing a Code of Practice on lotteries for their members, which should be useful to charities wishing to enter or expand in the lotteries field following increases in monetary limits.

D: CONSTRAINTS ON INCREASES IN MONETARY LIMITS

Scope of the Order-making power

24. Section 18 of the 1976 Act does not give the Secretary of State an unfettered discretion to vary monetary limits. There could be challenge, including from the Joint Committee on Statutory Instruments, to proposed increases which threatened to vary the purposes or effects of the primary legislation. As has been noted, the 100% increases in the 1976 limits in 1981 were largely accounted for by inflation of 90% in the intervening period, and by the time the 1985 increases of 50% took effect more than half of that percentage was also covered by inflation. It is not possible to say precisely what order of increase would be seen as altering the intention of the statute, but a multiple of four or five could run a serious risk of challenge and it could well be prudent to aim lower.

Likely views of the Gaming Board for Great Britain

25. Proposals for increases have yet formally to be put to the Gaming Board. Informal soundings of Board officials suggest that the Board would feel obliged to enter reservations about any proposed increases at all. In correspondence at the turn of 1987/88, the Chairman of the Board explained that, following a sample programme of inspections of societies' lotteries by his Inspectorate, without further statutory powers the Board could give no assurances that the lotteries they seek to supervise were being conducted in accordance with the law.

26. But the Board might also be expected to recognise the force of the arguments for some increases, following the interest in lotteries stimulated by the National Hospitals Trust/Loto schemes. In that context, the Board might be less concerned about increases in the limits on maximum prizes in schemes required to be registered with them.

27. The Board might have stronger reservations about increases in the limits on proceeds in such lotteries, since their worry is about the management and accounting of the flow of lotteries funds.

28. The Board could also be expected to argue (like the Lotteries Council) that there should be no increase in the prize or proceeds limits for societies' lotteries promoted under schemes not required to be registered with them. Their reason would be to prevent societies switching from Gaming Board registration to local authority registration, in avoidance of the more stringent Board controls.

29. The Board might see some advantage in increasing the maximum stake, if that eased the administrative problems for societies not fully geared to promoting lotteries with very large numbers of tickets on sale and also helped the full sale of the tickets on offer. The Board could, however, enter reservations of principle about taking lotteries into a bigger gambling league, although the sharper focus of that concern could be on prize and proceeds limits.

E: TREASURY/CUSTOMS AND EXCISE CONSIDERATIONS

Public Expenditure Control

30. In a letter of 31 August to the Home Secretary the Financial Secretary to the Treasury asked that proposals for increases in monetary limits should be considered by H Committee before they were put to outside consultation, to enable consideration of whether the proposed new limits would be likely to increase the scale of lotteries to an extent which might significantly exacerbate the difficulties of public expenditure control.

31. It is understood that questions of public expenditure control could arise were lotteries' cash income to be donated to bodies (for example NHS hospitals) which benefit from public expenditure, since such donations would be counted as additions to public expenditure. (Donations in kind, for example hospital equipment, would not be so counted). There is no information available to the Home Office about the amount of monies from lotteries which may have been donated to bodies supported by public expenditure. Nor is it possible accurately to estimate the extent to which such donations might increase if lotteries' income grows as a result of increases now in monetary limits. But

it would seem unlikely that any increases in limits which can be made would return lotteries' turnover in real terms to the levels reached in the initial years following the 1976 Act. The best guess, therefore, might be that even with increases in monetary limits the flow of lotteries funds to public expenditure supported bodies could well be less and nearly certainly not more than contemplated when the legislation was enacted.

Pool betting duty

32. Customs and Excise regard lotteries as a form of pool betting. Depending on the form of pool betting involved, the amount of stake money paid and the expenses and profits of the promoter are normally subject to a duty of 33 1/3% or 42½%. Societies and local lotteries operated within the current, 1985 monetary limits under the Lotteries and Amusements Act 1976 are exempted from pool betting duty by a parallel, 1985 Order under the Betting, Gaming and Duties Act 1981. The Home Office would hope that the Commissioners of Customs and Excise would be prepared to continue the exemption of lawful lotteries, with higher monetary limits, from the duty. Otherwise, the benefits and purpose of increasing monetary limits would be negated.

F: PROPOSALS

33. The Secretary of State is not required by the 1976 Act to consult outside bodies before increasing monetary limits. But the earlier increases were the subject of consultation and on 5 October the Home Secretary announced that he would follow that precedent. Those to be consulted on his behalf include the Gaming Board for Great Britain, the Lotteries Council, the Lotteries Action Group and the Institute of Charity Fund-Raising Managers. An Order by the Home Secretary will apply to England and Wales and a similar Order is also to be made by the Secretary of State for Scotland making identical increases.

34. The Home Secretary announced that the aim is to increase monetary limits in the same timetable as a regulation to prohibit 'multiple' lotteries. That regulation is required quickly, and has already been put out to consultation. The proposals as to increases in monetary limits might, therefore, seek as far as is reasonable to anticipate the wishes and reservations of those to be consulted to try to achieve their swift acceptance.

35. Taking into account the considerations set out in this paper, the proposals about which consultations are envisaged are as follows:

Maximum prizes in societies' and local lotteries promoted under schemes registered with the Gaming Board (section 11(7) of the 1976 Act)

36. The limits on these prizes should be increased by 150%, that is:

	Current maximum prize	New maximum
Short term lottery	£3,000	£7,500
Medium term lottery	£4,500	£11,250
Any other lottery	£6,000	£15,000

37. Such increases, which fall within the middle of the range sought by the Lotteries Council, are probably about the highest which could be justified under the Order-making power. That justification would be that the increases are intended not to alter the intention of the primary legislation, but rather to meet that intention by enabling the promoters of lotteries to sell their tickets more certainly and quickly up to the current proceeds maxima (see paragraphs 38-39 below).

Maximum proceeds in societies' and local lotteries promoted under schemes registered with the Gaming Board (section 11(9) of the 1976 Act)

38. The limits on proceeds should not be increased.

39. With the lotteries involved, it is on the proceeds limits that the principal concern about potential mismanagement and fraud focusses. As to mismanagement, the legislation expresses the amounts of a lottery which may be appropriated for prizes in total, and for expenses, as proportions of the proceeds. Promoters already sometimes fail to achieve sales of tickets up to the current proceeds limits, so inadvertently - or deliberately - breaching the related proportions, particularly as to expenses. Higher proceeds limits could exacerbate their difficulties, by tempting promoters to over-reach themselves in their ambitions and assumptions about ticket sales. As to fraud, higher proceeds limits would potentially produce bigger individual lotteries. The chance of putting their fingers in these bigger pies could tempt the fraudently-minded. This could include the return to the lotteries world of dubious operators who exploited the enthusiasm for lotteries in the early days

of the 1976 Act. It is for these reasons that the Gaming Board would be likely to advise against increases in proceeds limits. Their concerns should be taken seriously. In addition, the Lotteries Council, who might be expected to argue for increases, have explicitly said they do not seek them. It would seem right tacitly to welcome their acceptance that the current legislation provides for, and can only cope with, essentially modest lotteries.

Maximum price of ticket or chance (section 11(2) of the 1976 Act)

40. The maximum price of a ticket or chance should be increased by 100%, from 50p to £1.

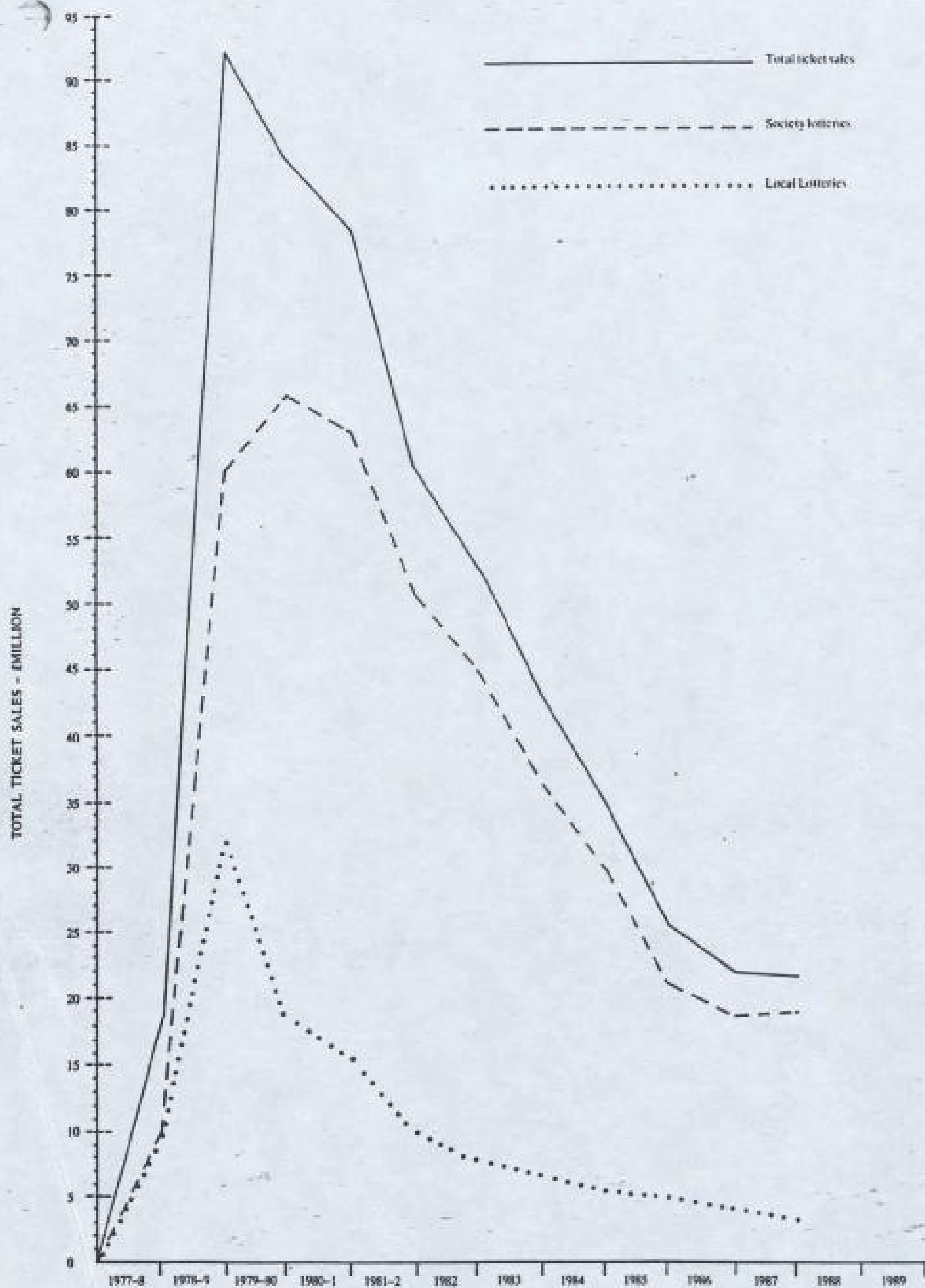
41. This increase should be unexceptionable. Punters may already risk more in a lottery (by buying a number of 50p tickets) and the limit has not been increased since 1981. The Lotteries Council contend that it will be easier to sell one £1 ticket than two at 50p and, whilst this is notionally arguable (since the more the tickets, the more the number of chances) it seems reasonable to give the Council the opportunity to put their commercial assessment to the test.

Maximum prize and proceeds in a society's lottery not required to be promoted under a scheme registered with the Gaming Board (sections 5(3)(d)(i), 11(5) and 11(13)(a) and (b) of the 1976 Act)

42. No increase in the limits of £2,000 on the maximum prize and £10,000 on the proceeds of societies' lotteries which do not come within the supervision of the Gaming Board will be proposed. Those to be consulted will be given the opportunity to comment on this, but any who wanted increases would be expected to adduce weighty arguments, sufficient to overcome the likely reservations of the Gaming Board, local authorities and even the Lotteries Council.

Home Office
November 1988

STATISTICS OF LOTTERIES PROMOTED UNDER REGISTRATION WITH THE BOARD



Note Up to and including 1981-82, figures relate to period 1 May - 30 April. Subsequent figures relate to calendar year.

ECON POL: Dom monetary policy pt 19.

PRIME MINISTER

ECONOMIC STATISTICS NEXT WEEK

It is a relatively thin week for figures next week.

On Monday we have retail sales (Flag A) and credit business (Flag B). The retail sales figures are moderately encouraging in suggesting there has been some slowdown in September - albeit from a very high level in July and August. Similarly, credit business has also slowed down in September to the average levels seen over the last year rather than the exceptionally high August figure.

The only other significant economic publication next week will be the Bank of England quarterly bulletin on Thursday.

I also attach (Flag C) the latest weekly M0 figures. These, too, are moving in the right direction, although there is a very long way to go.

All in all, it is as satisfactory a picture as we could hope for at the moment.

PAUL GRAY
4 November 1988

EAMAFN

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PG to PM 28.10.88

PART 20 begins:-

PG to PM 4.11.88

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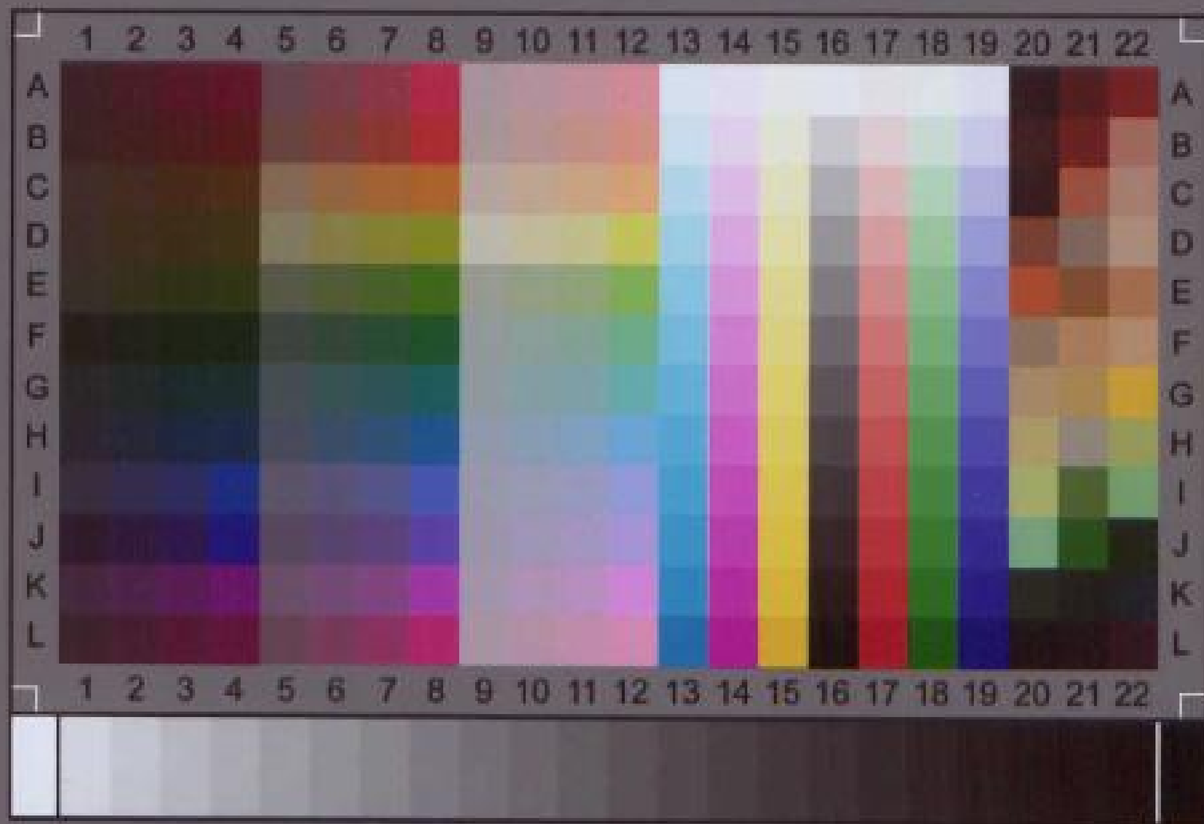

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