



10 DOWNING STREET

Prime Minister

10/5

The first sentence of
Messels' Monitor is
typical of all the
reactions in the City.

It is a measure of

- (a) the confidence in your policies, and
- (b) the belief that only a government under your leadership will carry them through.

I thought you ought to know.

AW

Messel's Weekly Economic Monitor

7th May 1982

The main worry for financial markets created by the Falklands crisis is the threat to Mrs. Thatcher and her government if there is a military or diplomatic fiasco. There may still be a military or diplomatic fiasco, but the Opposition has bungled the affair badly and it is difficult to see how Messrs. Foot and Benn can extract any political capital. So it is not clear that financial markets should remain particularly anxious. But we must wait and see.

The better news on the US Budget reinforces the widespread view that dollar interest rates are headed downwards. But will UK interest rates also be allowed to follow? The consensus seems to be that, without the Falklands crisis, base rates would be 1% lower. There is an objection, however. Bank lending to the private sector has been very strong for many months and may make it impossible to attain even the generous 1982/83 8%-12% target for sterling M3. Furthermore, as we explained in our May Messel's Market Watch, the growth in PSL2 will probably be higher than sterling M3 growth.

Not
the
same

Because of the severe difficulties in interpreting monetary trends, there has been a shift of emphasis away from sterling M3 in decisions about interest rate policy. Most comment has been directed towards the exchange rate, but also very relevant are domestic economic conditions. A priority for the government must be to stop the rise in unemployment. This may not be inconsistent with further progress on inflation. One characteristic monetarist argument is that the pace of wage increases decelerates if unemployment is above the "natural rate". We cannot estimate the natural rate precisely, but we do know that wage increases were much less in the 1981/82 pay round than in 1980/81. It follows that in 1981 unemployment was above the natural rate. In 1982 the numbers out of work are still rising. It follows that unemployment is now even more above the natural rate - and that the downward pressure on wages is even greater.

Of course, there is room for debate about whether the economy will remain depressed and unemployment continue to increase. As we show in a note on pages 5 to 7, the housing industry, a classic advance indicator for the economy as a whole, is recovering vigorously. But the latest CBI survey was a disappointment, with the deteriorating export outlook a particularly notable reversal compared to previous months. On balance, it seems likely that the authorities will permit a base rate cut when US rates go down.

Economic statistics this week

We summarise our assessment of the market's expectation for four important statistics in the following table. L. Messel & Co.'s view coincides with the market in all cases, except for sterling M3 where we expect a rise above 1%. The central expectation for the US M1 figure, released by the Fed on 7th May, is a fall of \$3b. to \$4b.

	Day and time of announcement	Better than expected	As expected	Worse than expected
Visible trade	Monday 3.30 p.m.	Surplus above £150m.	Broad balance	Deficit above £150m.
Wholesale prices (output)	Tuesday 2.30 p.m.	Rise below $\frac{1}{4}\%$	Rise of $\frac{1}{4}$ to $\frac{3}{4}\%$	Rise above $\frac{3}{4}\%$
Provisional Sterling M3	Tuesday 2.30 p.m.	Rise under $\frac{1}{2}\%$	Rise of $\frac{1}{2}$ to 1%	Rise above 1%
CGBR	Wednesday 2.30 p.m.	Deficit above £750m.	Deficit of £750m. to £1,250m.	Deficit above £1,250m.

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