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SECRET & PERSONAL

PRIME MINISTER

1 July 1988

The State of the Economy

The unambiguous picture of the present state of the economy is one of increasing excess demand. The two major indicators of overheating in any economy are inflation (the difference between money GDP and real GDP) and the balance of payments deficit.

Inflation

Inflation is rising but not by much. The RPI after moving to over 7% in 1985 fell to 2.4% in mid-1986. It is now over 4% and expected to rise: most forecasts predict that it will rise to around 5-6%.

Balance of Payments

The real problem area is the balance of payments. This is where the excess demand which has been created is visible. Ever since the third quarter of 1986 the balance of payments has deteriorated: first the surplus was reduced and then since the end of 1986 we have been running a deficit which has grown progressively larger.

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Causes of the Growing Current Account Deficit

By definition a balance of payments deficit means that we are living beyond our means - consuming more than we are producing. Our current deficit is no exception: it is the result of expenditure growing more rapidly than output.

The reduction in the surplus and the emergence of a modest deficit was a deliberate act of policy. The unexpectedly large deficit this year however is the result of domestic expenditure being much greater than forecast. The Treasury tends to analyse this problem by looking at the increases in individual items of expenditure. On this basis the cause of the problem is seen by them as increased consumption due to a fall in the saving ratio and higher than expected corporate investment reflecting buoyant profits last year. It is now clear to the Treaury that at the time of the Budget output and expenditure were growing much more rapidly than was thought.

Analysing expenditure in this way is important. What it misses however is where policy itself has been wrong. Over the last two years public expenditure has been under control, the PSBR has been reduced and turned into surplus and the public sector deficit has also been reduced.

The real cause for concern is monetary policy. At present MO is the only monetary aggregate which we target. Table 1 and Charts 1 and 2 show that the growth of real money balances since 1985-6 have been increasing substantially. The engine driving money supply growth has been intervention in the foreign exchange markets. Table 2 shows changes in the level of reserves, which are a proxy for intervention even though intervention has been greater. As can be seen from the table the scale of intervention in 1986-7, judged by previous years has been enormous.

Given the continuation of current monetary and fiscal policies, both the Treasury and the Bank forecast a growing balance of payments deficit: the Treasury in their pre-budget forecast predicted the deficit rising to £8 bn a year in 1989-90 and the Bank's Economic Outlook forecast has the deficit rising to £13 bn a year in 1990. (Attached at Annex A).

The important feature of both these forecasts is that the deficit shows no sign whatever of being corrected.

What should be done?

All of the adjustment at present has to be borne by higher rates as

(a) it is difficult to change fiscal policy until the next budget;

(b) credit controls would introduce multiple distortions which would impair the supply-side of the economy.

The view of Treasury officials is that interest rates must rise to 11%: the Bank thinks it could be 12%. Interest rates need to be raised to ensure that MO growth is brought down within its target range of 1-5%. The Treasury's predictions for MO growth are shown in Chart 3 - on present assumptions MO does not come within target until November. This will produce a higher mortgage rate and dampen consumer expenditure.

The Treasury are concerned at the prospects of a sudden surge in the exchange rate as a result of higher interest rates. It would make no sense however to raise interest rates and then intervene to prevent the exchange rate from

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rising. With the present deterioration in the balance of payments and continued uncertainty about its trend in the near future, a sudden a permanent surge in the exchange rate would not seem very likely.

There was considerable difference of opinion in the meeting earlier this week between the Bank and the Treasury. My impression is that the Bank would like to see interest rates moved up quicker as the market is now ready and indeed expecting us to take this action. The major concern of the Treasury and the reason for moving in half percentage points has been to avoid newspaper headlines of "Sterling Crisis" which could adversely affect confidence and lead to a rise in the saving ratio, a fall in corporate investment and a significant slowing down of growth.

Conclusion

Having made mistakes over the conduct of monetary policy it is best to acknowledge them and take appropriate action as soon as possible - however unpalatable this may be. We should aim for 11% next week.

Brian Griffiths

BRIAN GRIFFITHS

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TABLE 1

REAL PERCENTAGE GROWTH RATES OF MONETARY AGGREGATES

	RPI less Mortgage Element	Weekly Averaged M0	M3	M4	M5
FINANCIAL YEARS (12 month % changes to calendar March)					
1981-82	9.8	-6.5	4.2	3.7	3.0
1982-83	5.9	-0.6	5.4	7.9	8.0
1983-84	4.6	0.8	3.3	6.8	6.1
1984-85	5.2	0.3	6.0	8.2	8.2
1985-86	4.0	-0.5	12.2	10.1	9.1
1986-87	3.8	0.3	14.8	9.9	9.3
1987-88	3.8	1.9	16.6	12.5	12.3
12 MONTH % CHANGES (ua except M0)					
1987 MAY	3.8	0.6	14.6	9.6	9.3
JUNE	3.5	0.7	15.3	10.0	9.8
JULY	3.7	1.6	16.7	10.9	10.3
AUGUST	3.7	1.0	17.8	11.5	10.9
SEPTEMBER	3.5	1.4	15.7	11.1	10.5
OCTOBER	3.9	1.6	17.9	11.5	11.0
NOVEMBER	4.0	0.9	16.8	10.9	10.3
DECEMBER	4.0	0.3	18.2	11.8	11.4
JANUARY	3.7	0.9	18.1	12.4	12.2
1988 FEBRUARY	3.6	1.6	16.3	12.0	11.6
MARCH	3.8	1.9	16.6	12.5	12.3
APRIL	4.2	1.9	14.6	11.3	10.9
MAY	4.4	1.7	13.4	11.1	10.5

TABLE 2:

CHANGES IN THE LEVELS OF OFFICIAL RESERVES (INCREASE -)

(£ million)

1981	-730
1982	1,709
1983	-1,763
1984	-1,282
1985	2,800
1986	-4,023
1987	-8,714

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CHART 1

CHART V REAL MO

Annual percentage growth (sa)

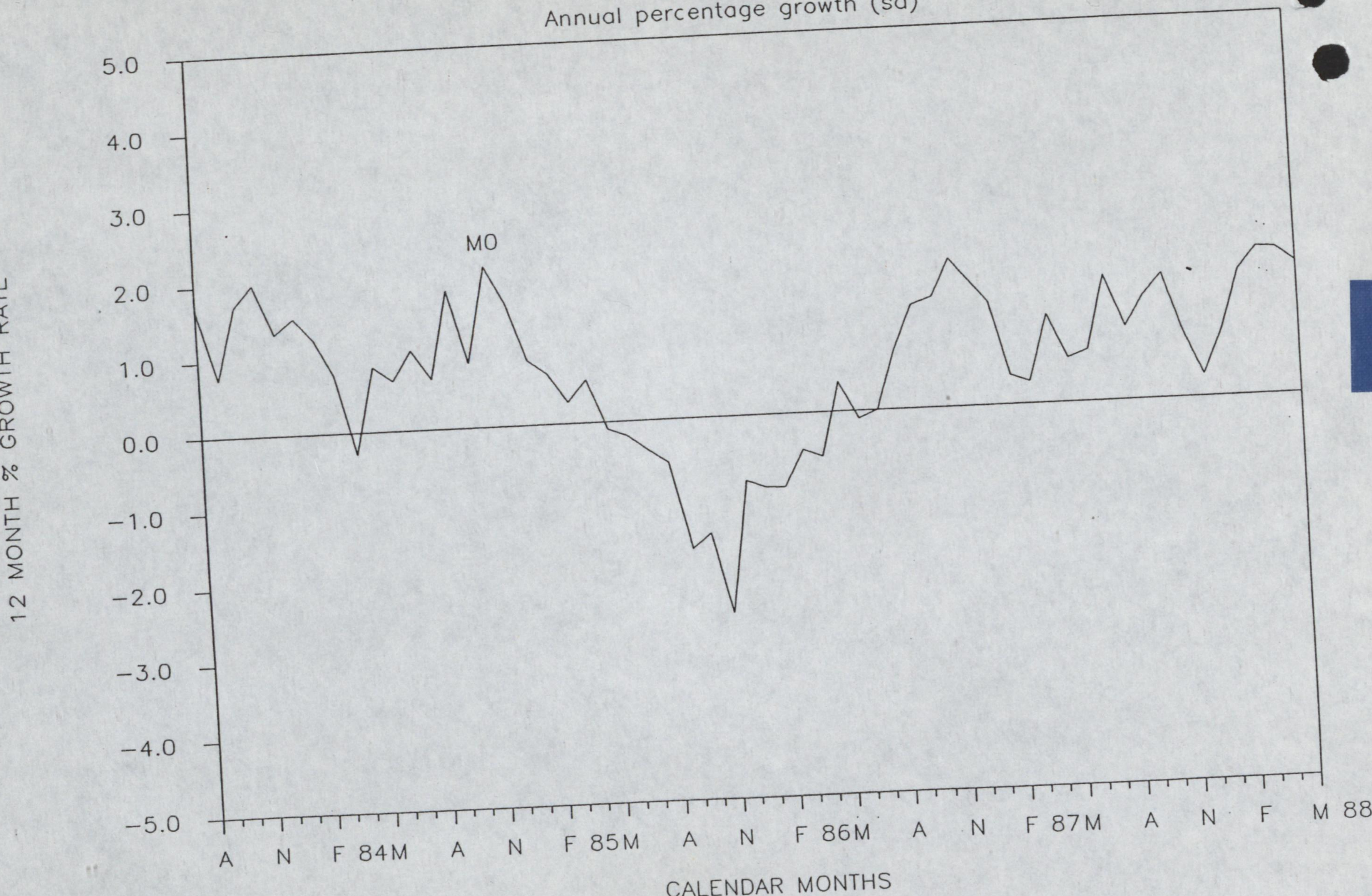

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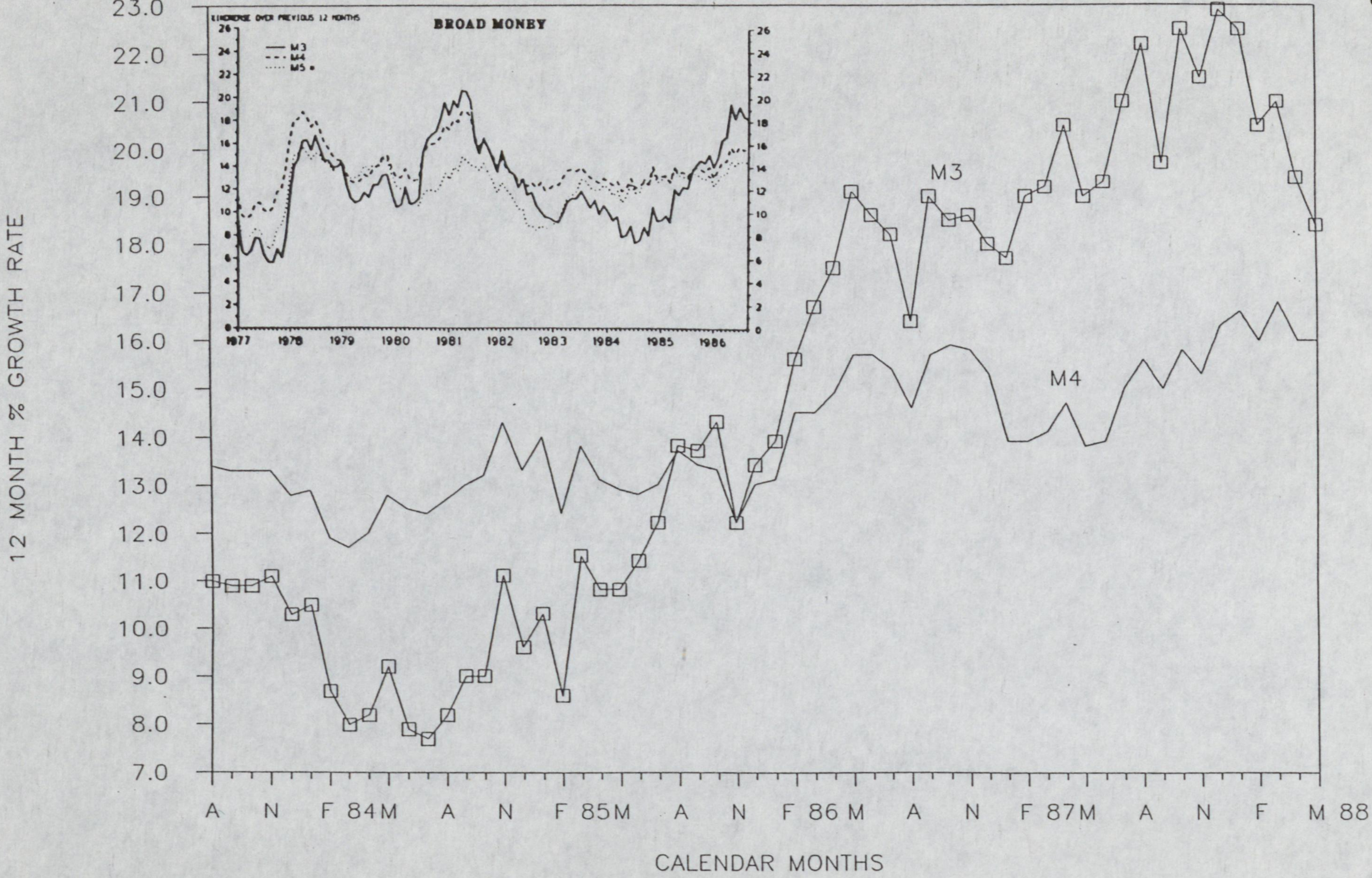
CHART 2

CHART IV BROAD MONEY

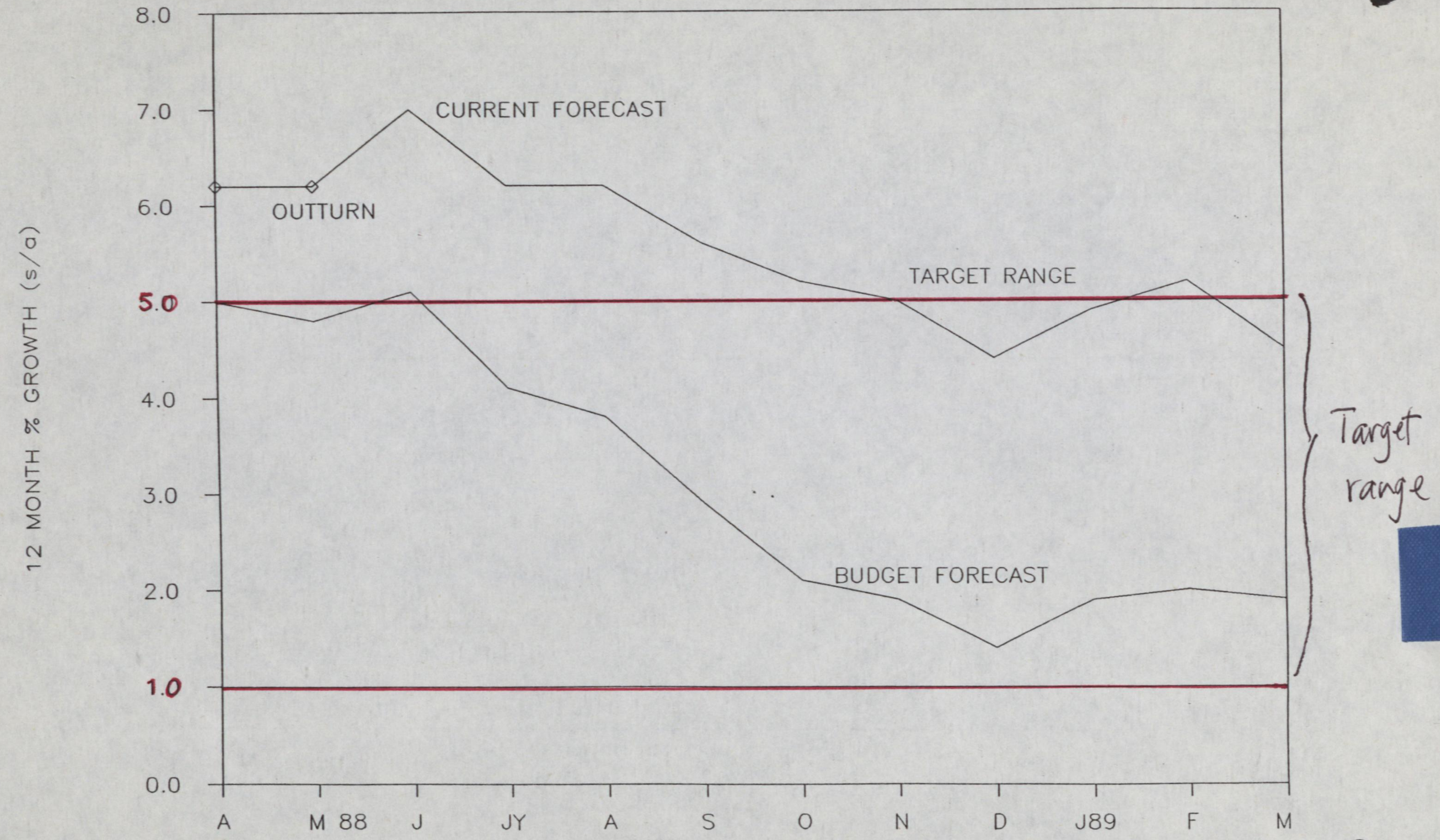
Annual percentage growth (ua)



CONFIDENTIAL (COVERING FORECAST)

CHART 3 M0 : 1988 BUDGET FORECAST

COMPARED WITH OUTTURN & LATEST FORECAST



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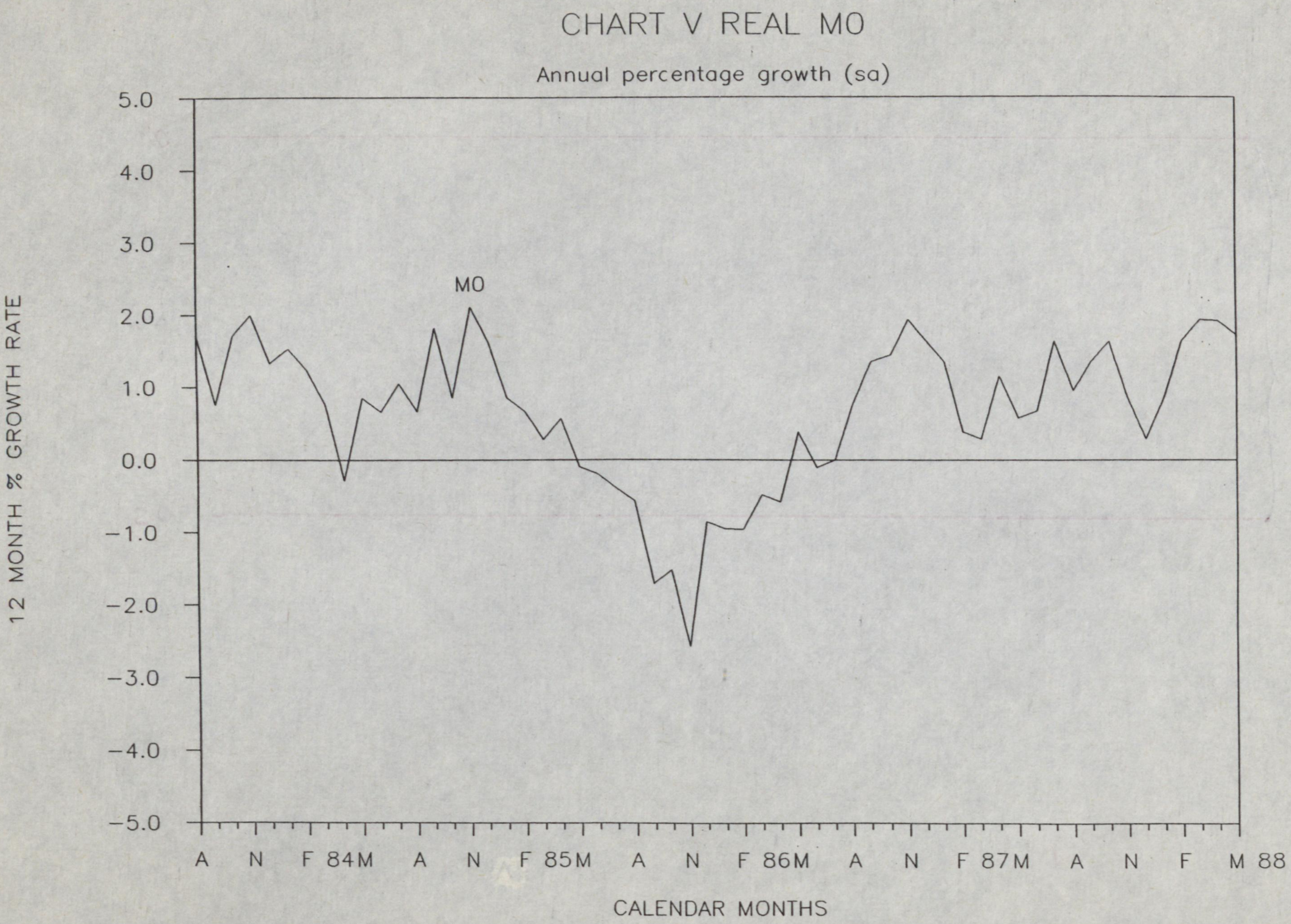

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ANNEX A

ECONOMIC OUTLOOK

THE BANK FORECAST TO 1990

1 The forecast assumes the continuation of current monetary and fiscal policies. **Monetary policy** is assigned to counter-inflationary objectives. Sterling is likely to come under appreciable downward pressure during the next three years, mainly reflecting a widening current account deficit. We envisage the authorities responding by raising domestic interest rates, on both external and domestic grounds. Overall, we see the **UK effective exchange rate** weakening somewhat in the second half of this year, and then depreciating by 5% pa from the beginning of 1989 onwards. Banks' **base rates** rise to 10% in the fourth quarter of this year, 11% at end-1989 and 12% at end-1990.

2 **Fiscal policy** continues to entail further reductions in **public expenditure** as a proportion of GDP and additional cuts in the **basic rate** of income tax (in this forecast to 23p in the 1989 Budget and 22p in the 1990 Budget).

3 **Output** growth is expected to slow from the current rate of 4 1/2% to only 2% by the end of this year (although this still delivers year-on-year growth of 3 1/2%). Thereafter growth settles at nearly 3% pa. The slowdown this year is due to worse net trade, reflecting the deterioration in competitiveness associated with the rise in the exchange rate over the last 18 months, coupled with the inertia of UK nominal earnings. In 1989 and 1990, UK domestic demand slows, but the impact of this on growth is offset by improving net trade, largely reflecting the falling exchange rate.

4 **Retail price inflation** is forecast to be 4 1/2% in the second half of this year, rising to 5 1/2% by end-1989 and stabilising at that level thereafter. The increase in inflation is mainly due to faster unit labour cost growth, in turn reflecting higher earnings increases in the current and 1988/89 payrounds than in the last round and a slowing in productivity growth. Wider measures of inflation, in particular the **GDP deflator,** suggest that inflation will lie in a band of 5 1/2-6% pa during 1988-90.

5 Measured **unemployment** falls to 2 1/4 million by end-1988 and 2 million a year later.

6 The **PSBR** is expected to be in considerably greater surplus throughout the forecast period than envisaged by the Chancellor at Budget time. We think the public accounts could be in surplus by as much as £8 bn in FY 1988/89, and that similar surpluses are likely in each of the following two financial years.

7 The **current account** is in deficit by £6 1/4 bn (1 1/4% of GDP) this year, rising to £9 1/2 bn (2% of GDP) in 1989 and nearly £13 bn (2 1/4% of GDP) in 1990. These mounting deficits reflect much faster growth of domestic demand at home than abroad, the adverse impact on competitiveness of the strengthening of sterling from end-1986 until recently coupled with the resilience of UK earnings growth, and declining North Sea oil production.

8 Broad money continues to grow considerably in excess of nominal incomes throughout, although rising interest rates may induce some slowing. We see **M3** growth falling from around 20% this financial year and last to 16% in 1989/90. **M4** growth may slow by less, from 16 1/2% this year to 14% in 1989/90, reflecting some regaining of market share by the building societies. **M0** is likely to grow somewhat more rapidly in 1988/89 than the target range of 1-5%.

THE BACKGROUND

The World Economy

The UK projections are based on the latest Bank World Economy Forecast (WEF), slightly updated to take account of developments since it was finalised in April. Overall, the world outlook is for only moderate growth coupled with subdued inflation. World GDP grows by 3% this year, but by only 2% pa thereafter; this is associated with world trade growth of around 4 1/2% pa. World consumer price inflation averages 3% over the next three years.

Domestic Assumptions

The crucial assumptions lie in the area of **monetary policy**. From the end of 1986 until recently sterling has strengthened (by over 10% in effective terms). We think that this reflects an uprating of the UK by international investors in the light of the strong performance of the economy last year, as well as the perceived absence of downside foreign exchange risk given the generally anti-inflationary stance of policy.

Nevertheless, we see sterling coming under appreciable downward pressure during the forecast period, mainly reflecting the widening current account imbalance. It is assumed that current policy entails the authorities offering resistance to exchange rate depreciation by raising domestic interest rates. Higher interest rates also appear warranted on domestic grounds: the GDP deflator is expected to rise this financial year by nearly 2% points above the rate envisaged at Budget time; domestic demand growth remains rapid; both credit and broad money seem likely to continue to grow much more quickly than nominal incomes; M0 may well breach the target range throughout the forecast period; and house price increases, although slowing, are expected to remain in double digits.

The upshot of these forces is that the **effective exchange rate** weakens somewhat in the second half of this year and depreciates by 5% pa thereafter. At the same time, we envisage **banks' base rates** rising to 10% by the end of this year, 11% by end-1989 and 12% by end-1990.

On **fiscal policy** we incorporate a £3 bn fiscal adjustment in the next Budget, as envisaged in this year's Budget statement. This allows the **basic rate of income tax** to be reduced to 23p. We see the basic rate being further reduced in the 1990 Budget (by 1p) towards the Chancellor's 20p target. Despite these tax cuts and public spending overruns after this year (of nearly £3 bn in FY 1989/90), the continued buoyancy of the economy means that the PSBR is in surplus by £8-9 bn in each of the three financial years 1988/89-1990/91.

DEMAND AND OUTPUT

Demand

Consumers' expenditure has grown by 5% pa on average during the last three years. It is expected to rise by over 5% this year before decelerating somewhat to a 4% increase in 1989 and 3 1/2% in 1990. The continued buoyancy of consumption is a major factor behind the projections for growth, the PSBR and the current account. The strength of consumer spending is mainly due to the continued rapid pace of real personal disposable income growth (4 1/4% pa over the forecast period). This reflects earnings increases well in excess of price inflation (see below), some further growth in employment, and tax cuts. We think the savings ratio will rise only modestly from current levels, notwithstanding rising interest rates and household gearing ratios and higher inflation. Indeed, in the current environment of financial innovation, the ratio could fail to rise at all, or even fall further.

TABLE 1 DEMAND AND OUTPUT
(% change on year earlier)

	1986	1987	1988	1989	1990
Private Consumption	6.0	5.2	5.2	4.0	3.6
Public Consumption	1.2	1.2	1.7	1.7	1.8
Total Investment	-0.3	3.5	9.6	5.6	4.6
of which: Industrial	-2.4	9.6	10.5	7.1	5.5
Stockbuilding *	0.0	0.1	0.1	0.1	0.0
Domestic demand	3.8	4.2	5.4	4.0	3.4
Exports	3.2	5.6	1.2	4.2	4.5
Imports	6.3	7.6	7.6	7.6	5.4
GDP (expenditure)	2.6	3.3	3.3	2.8	3.2
Memorandum items:					
GDP (Output)	2.9	4.8	3.4	2.8	3.0
GDP (Average)	3.0	4.3	3.3	2.8	3.0

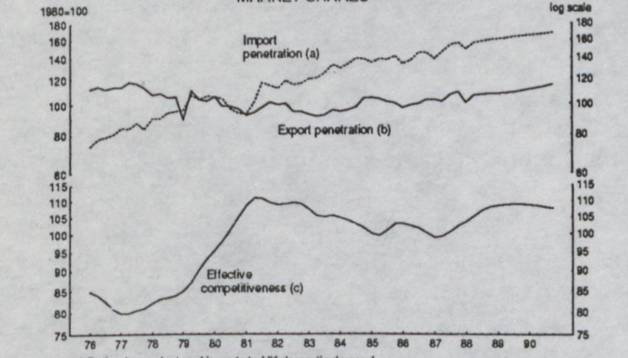
* Change over previous year expressed as a % of gdp

Industrial fixed investment rose by nearly 10% last year. Further substantial increases are envisaged over the forecast period supported by the continued buoyancy of output growth and the high rate of return to physical assets relative to financial assets. Nevertheless, as interest rates rise some slowing in investment occurs.

We continue to detect an appreciable improvement in the **supply performance** of UK manufacturing and, as in recent forecasts, we assume that substantial further improvements will occur. Nevertheless the growth of UK manufactured **exports** slows from 9% last year to only 3 1/2% in 1988, reflecting the loss of competitiveness due to exchange rate movements over the last eighteen months. However, because of the turn-round in the exchange rate, manufactured exports grow by 5-6% pa in 1989 and 1990. **Imports** of manufactures grew by over 10% last year. Despite UK supply-side improvement, these imports grow by a similar amount this year reflecting the buoyancy of domestic demand and the unfavourable competitiveness effect referred to above, but slow down subsequently (to an 8% rise next year and 6% in 1990) as domestic demand growth eases and the contribution of competitiveness is less adverse.

CHART 1

COMPETITIVENESS AND UK MANUFACTURERS' MARKET SHARES



(a) Ratio of manufactured imports to UK domestic demand

(b) Ratio of UK manufactured exports to overseas demand

(c) Average of price and cost competitiveness in export and import markets, allowing for delays in the response of trade volumes

Output

Worse net trade leads to **GDP growth through** this year of only 2 1/4%. Thereafter decelerating domestic demand is compensated by improving net trade and growth stabilises at around 3% pa. Growth during 1988-90 is broadly based, with both the manufacturing and the services sectors expanding at similar rates.

The buoyancy of the services sector last year was a major factor behind growth in the **employed labour force** of nearly 1/2 million in the year to 1987 Q4. Reflecting the continued strength of this sector we see further substantial increases in the employed labour force, averaging over 1/4 million pa during the forecast period.

This, together with the continuing impact of the Restart scheme, means that measured **unemployment** is likely to be around 2 1/4 million by end-1988 and 2 million by the end of next year.

TABLE 2 STRUCTURE OF PRODUCTION
(% change on year earlier)

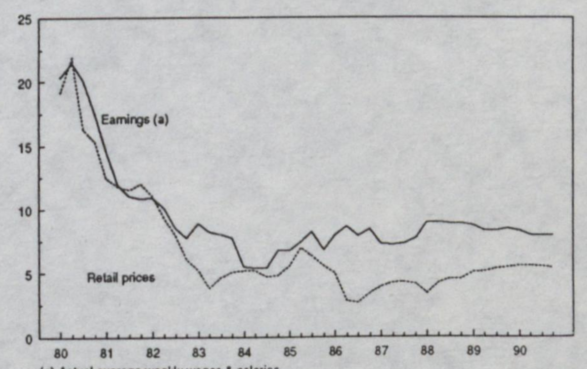
	Weights in 1980	1986	1987	1988	1989	1990
GDP (output)	100.0	2.9	4.8	3.4	2.8	3.0
North Sea	4.4	1.8	-2.6	-3.6	-3.4	-3.6
Non-North Sea	95.6	3.0	5.2	3.8	3.1	3.3
Public sector (non-trading)	14.7	1.2	1.2	1.7	1.7	1.8
Manufacturing	26.6	0.3	5.5	4.2	3.5	3.8
Other (incl. Public Corps.)	54.3	4.7	6.1	4.1	3.3	3.5

INFLATION

Wage settlements are higher in this payround than last, reflecting the exceptional buoyancy of the economy last year, and possibly higher inflationary expectations. Nevertheless settlements do not fall back in either manufacturing or private services during the forecast period. While continued tax cuts and the effect of rising interest rates on corporate finances may dampen wage settlements, the rise in inflation over the next year or two, continued employment increases and buoyant corporate profits point in the opposite direction. However, wage drift eases back from the exceptional increases seen last year as productivity growth slows. Overall, **average earnings** growth declines modestly, from nearly 9% in this payround to 8 1/2% in the 1988/89 payround and to 8% pa thereafter.

CHART 2

EARNINGS & PRICES
% change on year earlier



(a) Actual average weekly wages & salaries

These figures entail **whole economy unit labour cost** growth stepping up from 2 1/2% last year to around 5 1/4% pa throughout 1988-90. However, we envisage **RPI** inflation rising only moderately, from 4% in the year to 1987 Q4 to 4 1/2% in the year to end-1988 and 5 1/2% pa subsequently. RPI inflation is restrained this year by the weakness of **import prices** (reflecting sterling's recent strength and subdued world inflation), and subsequently by slower growth of manufacturers' margins as demand and output growth become established at rates well below the high increases of last year.

Nevertheless, wider measures of inflation, in particular the **GDP deflator**, do not tell a particularly sanguine story: the GDP deflator rises over 6 1/4% this financial year, nearly 2% points higher than the official Treasury projection.

TABLE 3 INFLATION
(% change on year earlier)

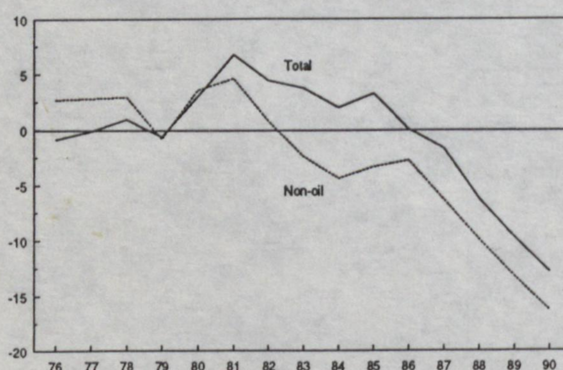
	1986	1987	1988	1989	1990
RPI	3.4	4.1	4.2	5.2	5.5
RPI excluding mortgage interest	3.6	3.6	4.2	4.6	4.9
Unit labour costs: Manufacturing	4.1	-0.1	2.9	3.6	4.3
Whole Economy (ex. N.Sea)	4.8	2.4	5.4	5.2	5.2
GDP deflator	2.9	4.4	6.0	6.0	5.6
Import AVI	-3.7	2.3	-0.4	4.3	5.7

CURRENT ACCOUNT

The **current account** deteriorates from a deficit of £1 3/4 bn (1/2% of GDP) last year to deficits of £6 1/4 bn (1 1/4% of GDP) this year, £9 1/2 bn (2% of GDP) in 1989 and nearly £13 bn (2 1/4% of GDP) in 1990. While the current account may not be as much in deficit at present as the published figures suggest, the adverse trend highlighted in these projections, which was also a major feature of our Autumn forecast, remains.

CHART 3

CURRENT BALANCE
(£billion)



A number of factors lie behind the adverse trend. During the forecast period, UK domestic demand grows considerably more quickly than demand overseas, which naturally tends to induce higher growth in UK imports than in our exports. Another unhelpful factor is the strengthening of sterling in the eighteen months to early-June 1988, which together with the inertia of UK earnings yields effective competitiveness 5% worse this year than last, and a further 2 1/2% deterioration next year. In addition, declining North Sea output induces a deterioration in the visible oil balance, which declines from a surplus of £4 1/4 bn last year to one of £2 3/4 bn in 1990.

THE FINANCIAL FORECAST

Broad **monetary growth** remains strong throughout FY 1988/89; credit growth is boosted by past falls in interest rates, strong income growth and a switch away from equity finance following last October's stock market crash. Lending for house purchase is particularly buoyant in the first half of this financial year. Within the total building societies regain a considerably higher share of market. A more competitive attitude, the raising of the wholesale funding ceiling and plentiful retail inflows all contribute. Takeover and merger activity shows little sign of slackening at present, and lending for this purpose, and to property companies, also boosts bank lending this year.

Later in the forecast period increasing interest rates lead to a considerable deterioration in the income gearing of both industrial companies and the household sector. Credit growth slows progressively, in particular the housing and non-residential property markets cool down, but lending for takeovers may be encouraged somewhat by the approach of the Single European Market in 1992. The full funding arithmetic, together with large PSBR surpluses, entails substantial net redemptions of gilts. The deteriorating current account imparts a strongly negative influence on money throughout.

TABLE 4 MONETARY AGGREGATES
(% change on year earlier)

	1986/87	1987/88	1988/89	1989/90	1990/91
M0	2.4	5.4	6.2	7.6	6.3
M3	18.7	20.4	19.6	16.2	13.3
M4	15.4	15.5	16.6	14.0	11.0
M5	14.7	15.0	15.7	13.3	10.5
Velocity of M4	-7.5	-4.7	-6.0	-4.9	-2.3
Nominal GDP	6.8	9.9	9.5	8.9	8.9

Overall, we envisage **M3** growth slowing marginally from 20 1/2% in FY 1987/88 to 19 1/2% this year, before declining further to around 13% in FY 1990/91. In contrast **M4** accelerates this year - from 15 1/2% growth in FY 1987/88 to 16 1/2% in FY 1988/89 - reflecting some rise in building societies' market shares, but subsequently M4 also decelerates. Despite slower broad money growth projected for the future, further falls in velocity are in prospect, notwithstanding money GDP growth over the next three years substantially above that envisaged at Budget time. **M0**, proxied by notes and coin in circulation, seems likely to exceed the target range of 1-5% this year and to remain significantly above the illustrative range of 0-4% in the later years.