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21 September 1989

Paul Gray Esq
PS/Prime Minister
10 Downing Street
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Dear Paul

MARKETS

The Chancellor has asked me to write to you to let you know the conclusions reached at a discussion he held this morning with the Governor, together with Treasury and Bank officials, to consider how best to handle the markets following publication of the August trade figures on 26 September.

... I am attaching a note by Treasury officials analysing the trade figures in greater detail.

The trade figures will, clearly, be a disappointment to the markets, which suspended judgement on the poor July figures and on the August money figures which were published this week. There must be a risk that we will face substantial downward pressure on sterling after the trade figures are published on Tuesday 26 September. The Chancellor believes nevertheless that it may be possible to contain that pressure by determined intervention, and he has authorised the Bank to act accordingly on the lines that were agreed on a contingency basis last month.

If, however, intervention proves insufficient to resist a significant fall in the exchange rate, the Chancellor believes that it will be necessary to raise interest rates, in order to support the exchange rate and maintain the credibility of the

Government's anti-inflationary stance, at a time when MO growth remains stubbornly above the top of its target range. He hopes that this will not arise. I will in any case telephone you from Washington should events take an unpleasant turn.

Yours sincerely

JSG. Gieve

JOHN GIEVE

The August Trade Figures

1. The August trade figures, to be published on Tuesday 26 September, will show a current account deficit of £2.0 billion which compares with last month's deficit of £2.2 billion. This will not be well received: the markets are predicting a deficit of around £1.7 billion, the monthly average for the year to date. It bring the total deficit for the year to date to £13.9 billion. It is clear therefore that the deficit for the year as a whole will be significantly above the Budget forecast of £14½ billion.

Table 1: Current Account

£ billion

		1988			1989				
	1988	Q2	Q3	Q4	Q1	Q2	June	July	August
Non-oil visibles	-23.6	-5.5	-6.4	-6.9	-6.2	-6.2	-2.1	-2.5	-2.4
Oil	2.8	1.0	0.6	0.4	0.2	0.3	0.2	0.1	0.1
Total visibles	-20.8	-4.5	-5.7	-6.5	-6.0	-5.8	-1.9	-2.5	-2.3
Invisibles	6.2	1.7	2.3	1.1	1.2	1.0	0.3*	0.3*	0.3*
Current balance	-14.6	-2.8	-3.4	-5.4	-4.8	-4.9	-1.6	-2.2	-2.0
Memo Items:									
Balancing Item	12.3	3.7	2.9	5.2	1.2	6.6	-	-	-
Non-oil deficit as per cent of GDP	5.1	4.8	5.4	5.7	5.0	4.9	4.8	5.9	5.5

* CSO projections

2. As far as we can ascertain there are no special factors that have distorted the August figure. The dock strike may have had some impact on the figures but the effects are unlikely to have been large.

3. The current account figures are only estimates and are frequently revised substantially. In the past the quarterly

invisibles surplus has tended to be revised upwards. The monthly invisibles figures are only projections as most of the data are only available quarterly or annually (and in some cases at even less frequent intervals). The balancing items - which represent an unknown combination of unidentified capital inflows and unrecorded net exports - have been particularly large in the last few years, and notably in the second quarter of this year. Any errors in the net export figures are likely to be mainly in the invisibles statistics. The visible data are thought to be relatively reliable.

Composition of the Deficit

4. Over the past six month the deficit in consumer goods appears to have deteriorated by slightly less than the deficit in other industrial groups (see table A1). Capital goods imports continue to grow very rapidly reflecting the high level of investment in the economy as a whole and capacity constraints in UK capital goods industries. There is a particular shortage of skilled labour in this sector. Capacity constraints have eased in other industries but remain at historically high levels (see chart 2). Around half of the deterioration in the visible deficit over the past year as a whole is due to increased deficits on fuel and cars, (see table A2). The oil balance has been badly affected by the various accidents in the North Sea and should improve as output comes back on stream. The rest of the deterioration in the deficit was spread fairly evenly across a number of industries.

5. Non-oil imports are now around a third higher than non-oil exports in value terms. Therefore with imports growing by 12 per cent in the latest 3 months compared to the same period a year ago, exports would have had to grow by 15½ per cent simply to prevent the deficit getting bigger. In fact export growth, at 14 per cent, is now in excess of import growth but the gap is clearly not yet sufficient to improve the deficit.

Assessment

6. Import growth should in due course decline in response to slower demand growth and as new capacity comes on line after the recent investment boom. But this process is taking longer than expected.

Chart 1: Non-oil Visible balance

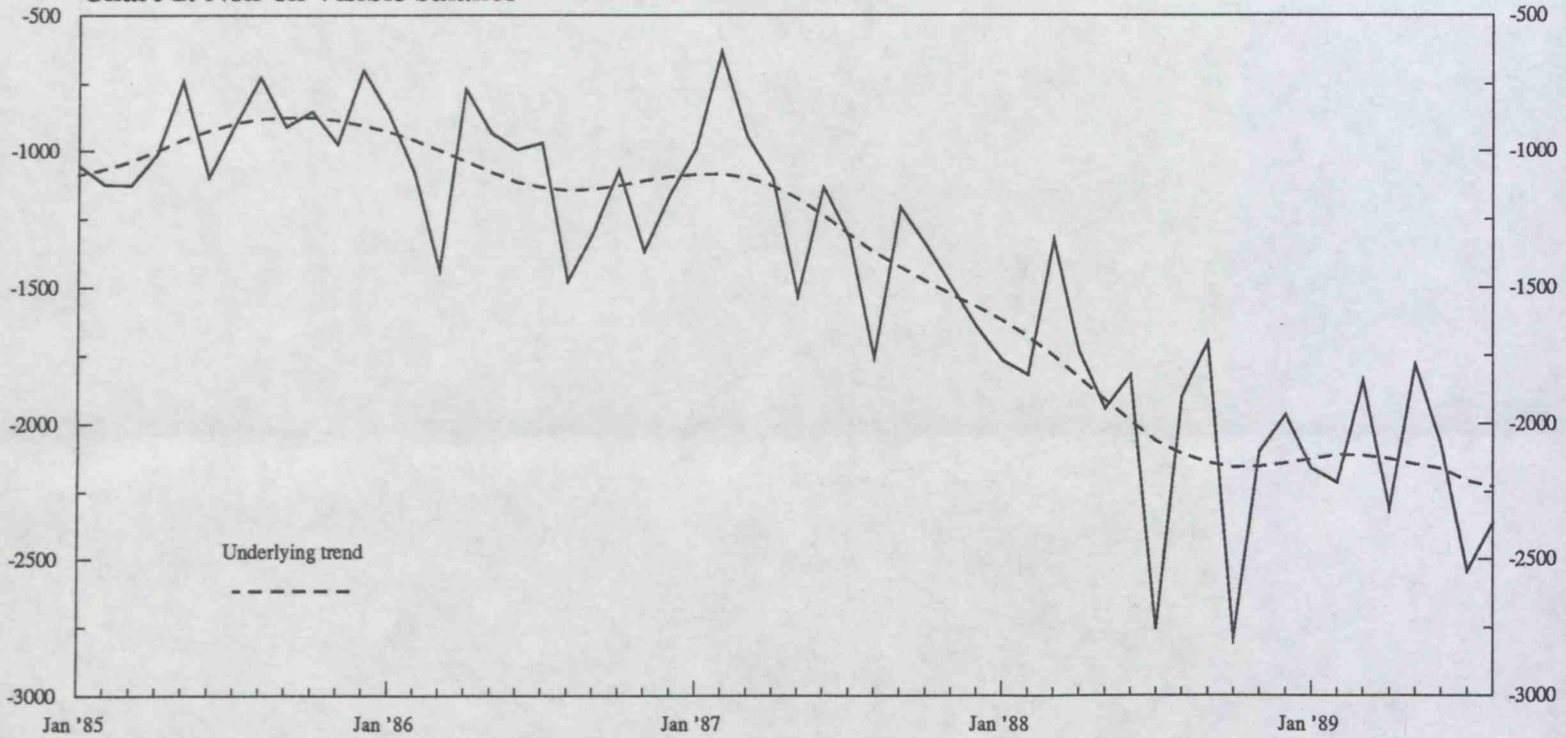

Chart 2: The deficit and Capacity utilisation

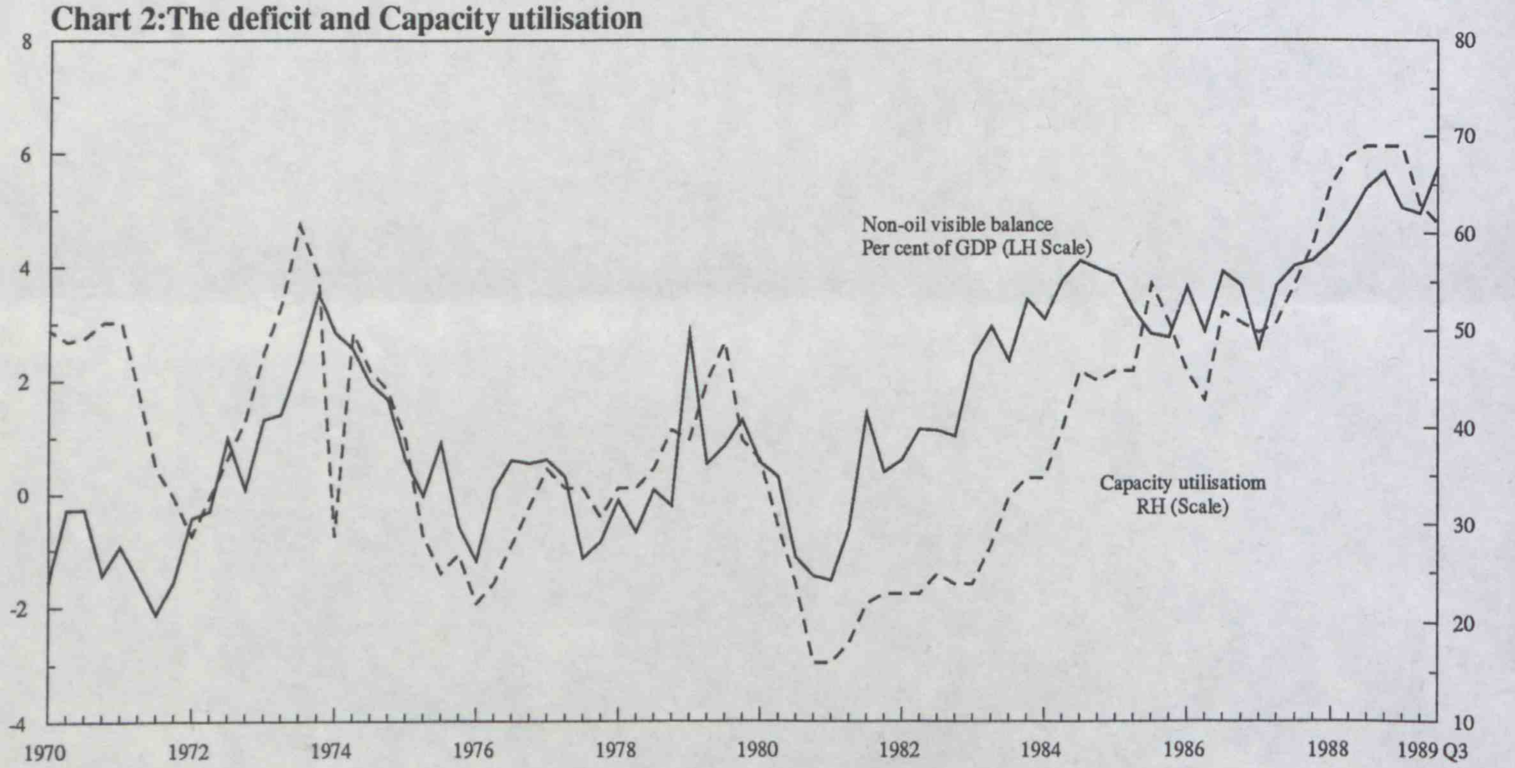

Table A1: Trade performance by category of manufactured goods (OTS, excl erratics)

	Latest 12 months on previous 12 months			Change in trade balance between latest two 6 mth periods (£bn)
	Export growth (%)	Import growth (%)	Change in trade balance (£bn)	
Consumer goods	12½	19½	- 2.4	- 0.1
Capital goods	18½	18½	- 0.3	- 0.3
Intermediate and semi-manufactured goods	10	16	- 3.2	- 0.2

Table A2: Trade performance at industry level (OTS basis)

	Latest 12 months on previous 12 months			Change in trade balance between latest two 6 mnth periods (£bn)
	Export growth (%)	Import growth (%)	Change in trade balance (£bn)	
Fuels	-25½	5½	- 2.1	- 0.3
Road vehicles	15½	24	- 1.7	0
Electrical engineering	14½	17½	- 1.0	- 0.2
Clothing and footwear	- 2½	12½	- 0.5	- 0.2
Basic materials	12	12	- 0.5	0 (-)
Mechanical engineering	13½	18	- 0.3	0 (+)
Metals	21	24	- 0.3	- 0.1
Chemicals	9	13½	- 0.2	0 (+)
Scientific and photographic app.	8	15	- 0.2	- 0.1
Metal manufacture	11	16	- 0.2	0 (-)
Food, drink and tobacco	10½	5	- 0.1	0 (+)
Textiles	9	2	+ 0.1	0 (+)
Total	9	15	- 7.8	- 0.4