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PREM 19/2943

Part 21.

208 MT.

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Domestic Monetary Policy.

In folder: World Payments Report Aug. 1989
MONTHLY MONETARY ASSESSMENT MARCH 1990.

ECONOMIC POLICY.

Part 1: May 1979.

Part 21: Sept 1989.

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~6.9.89~~							
~~13.9.89~~							
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24.4.90							
PART ENDS							

PREM 19/2943

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PART 21 ends:-

EST circulation note 23/4/90

PART 22 begins:-

MO figures 3/5/90

est.to/gh/6.23.4

FROM: GINA HASKINS
DATE: 23 April 1990

MR BROOKS

MR BOLTON

cc
PS/Chancellor
PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Sir P Middleton
Sir T Burns
Mr Wicks
Mr Evans
Mr Odling-Smee
Mr Scholar
Mr Sedgwick
Mr Peretz
Mr Grice
Mr O'Donnell
Miss O'Mara
Mr Owen
Mr Ritchie
Miss Simpson
Mrs Williams

Mr Gray - No 10 (Personal)

PROVISIONAL MONEY FIGURES - MARCH 1990

The Economic Secretary was grateful for your submission of 20 April.

He is content with the line to take proposed in paragraph 16 of your note.

Gina Haskins

GINA HASKINS
Private Secretary

SECRET

Prime Minister[2]
To note.
BHP 20/4

11(A-R)

MAMC: A1

FROM: S BROOKS/M BOLTON
DATE: 20 APRIL 1990
x4605/4614

1. MR PERETZ
2. ECONOMIC SECRETARY

Not much change here. But if anything the broad money figures are showing a very gradual improvement.

20/4

cc Chancellor
Chief Secretary
Financial Secretary
Paymaster General
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 Owen
Mr Ritchie
Miss Simpson
Mrs Williams

Mr Gray - No 10 (Personal)

PROVISIONAL MONEY FIGURES - MARCH 1990

The Bank of England will publish the provisional estimates of the growth of the monetary aggregates in March on Monday 23 April at 11.30 am. The first part of this submission describes the latest figures. The second part discusses presentation and seeks your approval of the line to take and the briefing (primarily for Press Office use) which is attached at Annex A. Also attached is the press notice (Annex B) in which the Bank of England will announce the figures.

THE MARCH FIGURES

2. Table 1 below sets out the latest figures; table 2 (at the end of the submission) shows historical growth rates.

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Table 1: The March figures - Summary

percentage growth rates (unless specified otherwise)

	March 1990	February 1990	Average Aug 1989-Jan 1990
(a) MO Growth			
12 month growth rate (sa)	6.3	6.4	5.6
1 month growth rate (sa)	0.2	0.2	0.6
3 month growth rate (sa)*	0.5	3.2	7.6
6 month growth rate (sa)*	4.9	4.2	7.9
(b) M4 Growth			
12 month growth rate (nsa)	17.5	18.1	17.7
1 month growth rate (sa)	1.6	0.9	1.5
3 month growth rate (sa)*	15.6	18.2	18.7
6 month growth rate (sa)*	16.2	17.6	18.6
(c) M4 Lending			
12 month growth rate (nsa)	20.4	20.7	21.3
1 month growth rate (sa)	1.8	1.4	1.6
1 month increase (£bn) (sa)	9.2	7.1	7.5
3 month growth rate (sa)*	18.8	20.6	20.8
6 month growth rate (sa)*	18.5	19.5	21.3

sa - seasonally adjusted   nsa - not seasonally adjusted

* annualised

MO

3. MO's 12 month growth rate was 6.3 per cent in March just below February's 6.4 per cent. Underlying growth, as measured by the growth rate of notes and coin, was 6.4 per cent, down from 6.5 per cent in February. The three month and six month growth

rates are of little use: both are distorted by inadequate seasonal adjustment.

4. Figures now available for the first three weeks of April suggest a rise in the twelve month growth rate. But the problems of seasonal adjustment around Easter means that the April figures will be a poor guide to M0's underlying growth.

BROAD MONEY

5. Our preferred measure of broad money growth, the not-seasonally-adjusted twelve month growth rate of M4, fell back to 17.5 per cent in March from 18.1 per cent in February. While it has remained in the 16½-18½ per cent range since the summer of 1988, it has turned down in the last couple of months (table 2). The annualised three month and six month growth rates both slowed significantly. The three month rate is the lowest since January last year; the six month rate is the lowest since last April.

6. In March itself, M4 increased by 1.6 per cent, after seasonal adjustment, compared with increases of 2¼ per cent in each of the last three end-quarter months. (Growth is faster in end-quarter months at the moment because the interest credited to accounts in these months is currently historically high.) Total retail deposits increased by 1.5 per cent; their twelve month growth rate rose from 11.6 per cent in February to 12.0 per cent in March, probably reflecting higher interest crediting than a year ago. The published measure of the retail money supply, M2 (which includes a narrower range of deposits than retail M4), also grew fairly strongly because of interest crediting and its twelve month growth rate rose to 8.6 per cent from 8.3 per cent in February.

7. Within M4 retail deposits, the rise in bank deposits (2.3 per cent) was much faster than the rise in building society deposits (0.8 per cent). The relative strength of banks' retail deposits is surprising given that the recent round of interest rate rises, effective in most cases from 1 March, left the societies with slightly higher deposit rates than the banks. Within the societies' retail deposits there is continuing evidence of a shift

away from smaller, readily accessible deposits: their deposits in M2 fell by 0.4 per cent (seasonally adjusted), while the larger or less accessible deposits excluded from M2 but included in M4 rose by just over 3 per cent.

8. Overall the societies' retail inflow remained weak. A good deal of the 0.8 per cent increase was accounted for by interest crediting. About half the remainder was flows into offshore accounts outside the CRT net (worth around £0.2 billion). This figure will not be published but is the first sign in the statistics of the impact of independent taxation. Most if not all of these flows would have been switched from other building society accounts, with little or no overall effect on retail deposits or on M4.

9. Total wholesale deposits in M4 grew by 1.7 per cent after seasonal adjustment, slightly faster than retail deposits. The bulk of the inflow was to banks, as usual. Their rise of 1.3 per cent in March was, however, the same as in February and fairly modest by recent standards. Building societies' wholesale deposits in M4 grew strongly, after a weak month in February. Overall the societies' wholesale funding (including that outside M4), at about £1½ billion, was twice as great as in February, no doubt reflecting the problem of financing buoyant lending (see below) in the face of weak retail inflows.

LENDING BY BANKS AND BUILDING SOCIETIES

10. M4 lending (lending by banks and building societies) increased by 1.8 per cent (£9.2 billion) after seasonal adjustment in March - below the increase of 2.2 per cent in the previous two end quarter months. Its twelve month growth rate fell to 20.4 per cent from 20.7 per cent in February. This rate has now varied erratically in the range 20½-22 per cent since July last year. Lending's six month growth rate fell to 18½ per cent in March from 19½ per cent in February; its three month rate fell from 20½ per cent to 18¾ per cent.

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11. Within M4 lending, building society mortgage lending picked up sharply in March to £2.4 billion (seasonally adjusted) from £2.0 billion in February, bringing to an end a run of gentle declines since last September's £½ billion peak. Lending for house purchase by CLSB banks in March nearly at £0.4 billion, seasonally adjusted [NOT FOR USE], was a little up on February. Commitments (seasonally adjusted) fell a little from February's high level, but by no means back to the lows of December and January. It looks as if there has been an overall rise in mortgage lending, with some signs that it may continue, at least in the short run.

12. Lending by CLSB banks for consumption in February was nearly £0.3 billion in March after seasonal adjustment [NOT FOR USE] and about £0.4 billion before seasonal adjustment. The March increase is a little above that of February but below those in December and January. It could be that there has been switching at the margin from consumer credit to mortgage finance, reversing an opposite switch at the end of last year.

13. Lending to companies was probably £5-6 billion in March after seasonal adjustment, and perhaps £6½-7½ billion before seasonal adjustment [figures are NOT FOR USE]. CLSB banks lent £3½ billion (not seasonally adjusted) to companies. Two thirds of this went to the financial sector (£1.2 billion, more than accounted for by leasing £0.8 billion and insurance £0.5 billion) and to business and other services (£1.0 billion, of which property companies £0.3 billion). Garages, distribution, hotels and catering borrowed £0.7 billion. The manufacturing sector borrowed £0.3 billion, wholly accounted for by the food, drink and tobacco industries - some manufacturing industries made small repayments.

OVERFUNDING

14. The March figures permit the first estimate of overfunding in 1989/90 to be made: it was £1.8 billion taking into account carry-overs from previous years. The estimate is still liable to significant revision.

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PRESENTATION

The March figures compared with market expectations

	Outturn March	"Average" Market Expectations
M0 - one month change: %	+ 0.5 (+ 0.2)	(+ 0.3)
M4 - one month change: %	+ 2.2 (+ 1.6)	(+ 1.8)
Bank and building society lending: £ billion:	+10.7 (+ 9.2)	(+ 8.4)

(figures in brackets seasonally adjusted)

15. The growth rates of both M0 and M4 were slightly below market expectations. The twelve month M0 figure fell slightly, with six month growth within the target range, as last month. M4's twelve month growth rate fell again, towards levels seen in 1989Q3, and the three and six figures were the lowest for some time. Bank and building society lending exceeded market expectations, but the three, six and twelve month growth rates all fell. The twelve month figure is the same as in January, which was the lowest since February 1988, and the six month figure is the lowest since August 1987.

16. We suggest a general line to take as follows:-

"Although still outside target range, 12 month M0 growth rate slightly down. Growth in M4 and lending also appears to be slowing gradually. 12 month M4 figure lowest since November and three and six month growth rates lowest since early 1989. 12 month growth of bank and building society lending has also fallen from February, with six month growth rate lowest since August 1987.

S BROOKS/M BOLTON

SECRET
(Until publication)

TABLE 2

GROWTH RATES OF MONETARY AGGREGATES AND BANK & BUILDING SOCIETY LENDING

£ million

			Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	1990Jan	Feb	Mar
M0	Monthly change	sa	44	119	137	89	71	254	-25	132	113	157	-49	34	36
	Monthly % change	nsa	1.9	0.1	1.6	0.3	1.9	1.7	-1.1	0.1	0.8	7.6	-6.5	-1.4	0.5
	Monthly % change	sa	0.3	0.7	0.8	0.5	0.4	1.5	-0.1	0.8	0.6	0.9	-0.3	0.2	0.2
	3-month annualised % change	sa	-0.6	2.2	7.3	8.4	7.2	10.0	7.2	8.7	5.1	9.5	5.1	3.2	0.5
	6-month annualised % change	sa	1.3	2.6	3.9	3.8	4.7	8.7	7.8	7.9	7.5	8.4	6.9	4.2	4.9
	Annual % change	sa	6.1	5.8	6.2	5.9	5.2	6.1	4.5	5.2	5.7	6.0	5.8	6.4	6.3
M4	Monthly change	nsa	10064	1660	5400	9482	2685	5656	8962	2699	4456	8670	3250	2551	9582
	Monthly % change	nsa	2.8	0.4	1.4	2.5	0.7	1.4	2.3	0.7	1.1	2.1	0.8	0.6	2.2
	Monthly % change	sa	2.0	0.6	1.2	2.3	0.5	1.7	2.2	0.6	1.1	2.2	1.2	0.9	1.6
	3-month annualised % change	sa	18.5	16.4	16.4	17.9	17.5	19.8	19.4	19.9	17.1	16.8	19.2	18.2	15.6
	6-month annualised % change	sa	16.0	15.7	16.5	18.2	16.9	18.1	18.7	18.7	18.5	18.1	19.5	17.6	16.2
	Annual % change	nsa	18.1	17.9	18.1	18.5	16.5	17.3	17.3	17.2	17.5	18.2	18.4	18.1	17.5
M5	Monthly change	nsa	10166	2341	5438	9810	2841	5550	9314	2421	4462	9089	2675	2658	9664
	Monthly % change	nsa	2.7	0.6	1.4	2.5	0.7	1.4	2.2	0.6	1.0	2.1	0.6	0.6	2.2
	Monthly % change	sa	1.9	0.7	1.2	2.3	0.6	1.6	2.2	0.5	1.1	2.1	1.0	0.9	1.5
	3-month annualised % change	sa	18.0	16.2	16.3	18.3	17.5	19.5	18.9	18.8	16.4	16.3	18.5	17.6	14.7
	6-month annualised % change	sa	15.0	15.2	15.8	18.1	16.8	17.9	18.6	18.2	18.0	17.6	18.7	17.0	15.5
	Annual % change	nsa	17.1	17.3	17.5	18.0	16.0	16.7	16.8	16.7	16.9	17.9	17.9	17.7	17.1
NIBM1	Monthly change	nsa	900	-1723	322	277	-608	-137	283	-841	199	2260	-4326	460	1603
	Monthly % change	nsa	1.9	-3.6	0.7	0.6	-1.3	-0.3	0.6	-1.8	0.4	4.9	-9.0	1.1	3.6
	Monthly % change	sa	-0.4	-3.6	-0.7	0.1	-1.4	0.2	0.9	-0.6	-1.2	6.0	-5.4	0.3	1.1
	3-month annualised % change	sa	-18.4	-16.5	-17.3	-15.6	-7.8	-4.3	-1.3	2.1	-3.5	17.5	-3.8	1.9	-15.5
	6-month annualised % change	sa	-4.2	-11.8	-10.9	-17.0	-12.3	-11.0	-8.7	-3.0	-3.9	7.7	-0.9	-0.8	-0.3
	Annual % change	nsa	2.4	-1.3	-3.0	-3.5	-5.0	-4.7	-6.6	-7.6	-7.5	-5.5	-7.0	-6.3	-4.7
M4C	Monthly change	nsa	10747	2615	7934	12016	-12	7464	8862	6898	5868	8362	1922	3031	13585
	Monthly % change	nsa	2.7	0.6	1.9	2.9	0.0	1.7	2.0	1.5	1.3	1.8	0.4	0.6	2.9
	Monthly % change	sa	2.0	0.8	1.7	2.7	-0.1	2.0	2.0	1.5	1.3	1.9	0.7	0.9	2.3
	3-month annualised % change	sa	19.2	19.3	19.6	23.0	18.4	19.6	16.4	24.3	21.1	20.4	16.9	15.0	17.1
	6-month annualised % change	sa	16.1	17.0	19.3	21.1	18.8	19.6	19.7	21.3	20.4	18.4	20.5	18.0	18.8
	Annual % change	nsa	18.0	18.3	19.2	19.6	17.2	18.1	17.9	19.1	19.9	19.8	19.8	19.1	19.2
M4 Lending	Monthly change	nsa	9878	4961	6042	9091	7858	6784	11412	5070	4436	10966	5425	6584	10740
	Monthly % change	nsa	2.3	1.1	1.4	2.0	1.7	1.5	2.4	1.0	0.9	2.2	1.1	1.3	2.1
	Monthly % change	sa	1.9	1.4	1.4	1.7	1.7	1.7	2.2	1.1	1.0	2.2	1.2	1.4	1.8
	3-month annualised % change	sa	22.0	19.9	21.1	19.8	21.1	22.3	24.9	21.9	18.5	18.3	18.7	20.6	18.8
	6-month annualised % change	sa	21.8	21.3	21.3	20.9	20.5	21.7	22.3	21.5	20.4	21.5	20.3	19.5	18.5
	Annual % change	nsa	24.3	23.4	23.2	22.4	21.6	21.9	22.1	21.4	20.9	21.2	20.4	20.7	20.4

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ANNEX A: MONEY SUPPLY IN MARCH: PRESS BRIEFING

A LINE TO TAKE

Although still outside target range, 12 month M0 growth rate slightly down. Growth in M4 and lending also appears to be slowing gradually: 12 month M4 figure lowest since November and three and six month growth rates lowest since early 1989. 12 month growth of bank and building society lending has also fallen from February with six month growth rate lowest since August 1987.

B THE FIGURES IN DETAIL

(i) Changes in main monetary aggregates

	MO (per cent)	M4 (per cent)
12 month growth rate	+5.0 (+6.3)	+17.5 (+17.5)
Annualised six-month growth	(+4.9)	(+16.2)
Annualised 3-month growth	(+0.5)	(+15.6)
one month change	+0.5 (+0.2)	+2.2 (+1.6)

(Figures in brackets seasonally adjusted s.a.)

(ii) Funding (On new definition excluding Treasury bills.)

(a) March: Underfund of £1.8 billion; PSBR deficit in March of £1.6 billion.

(b) Financial year outturn:

£0.4 billion underfund, but overfund of £1.8 billion allowing for £2.2 billion overfund carried over from 1988-89 and earlier years.)

I

(iii) MO: growth rates (sa)

		3 month annualised	6 month annualised	12 month
1989	January	3.0	5.8	7.4
	February	0.5	3.5	6.6
	March	- 0.6	1.3*	6.1
	April	2.2	2.6	5.8
	May	7.3	3.9	6.2
	June	8.4	3.8	5.9
	July	7.2	4.7	5.2
	August	10.0	8.7	6.1
	September	7.2	7.8	4.5*
	October	8.7	7.9	5.2
	November	5.1	7.5	5.7
	December	9.5	8.4	6.0
1990	January	5.1	6.9	5.8
	February	3.2	4.2	6.4
	March	0.5	4.9	6.3

* distorted downwards by postal strike

(a) Annual growth rate: Seasonally adjusted rate better guide to underlying monetary conditions. Slightly down on February, and still below peak levels of 1988.

(b) 3 month growth rate Down on February. Lowest since March 1989.

(c) 6 month growth rate: Up on February, but excluding February lowest since July 1989.

[Note: Caution should be used in interpreting the 3 and 6 month growth rates because of uncertainties in the seasonal adjustments.]

(iv) Broad money

M4: growth rates

		3 month†	6 month†	12 month*
1988	May	17.7	15.8	16.0
	June	16.2	16.3	16.8
	July	23.2	20.0	17.4
	August	23.3	20.5	17.3
	September	24.5	20.3	18.7
	October	17.1	20.1	17.4
	November	16.2	19.7	17.7
	December	13.5	18.9	17.6
1989	January	15.1	16.1	18.1
	February	16.6	16.4	18.6
	March	18.5	16.0	18.1
	April	16.4	15.7	17.9
	May	16.4	16.5	18.1
	June	17.9	18.2	18.5
	July	17.5	16.9	16.5
	August	19.8	18.1	17.3
	September	19.4	18.7	17.3
	October	19.9	18.7	17.2
	November	17.1	18.5	17.5
	December	16.8	18.1	18.2
1990	January	19.2	19.5	18.4
	February	18.2	17.6	18.1
	March	15.6	16.2	17.5

† sa and annualised
* unadjusted

(a) One month growth (sa) Down on January. Lowest since October.

(b) 3 month growth rate Well down on February. Lowest since January 1989.

(c) 6 month growth rate Down on February. Lowest since March 1989.

(d) 12 month growth rate Down on February. Lowest since November 1989.

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(b) Bank and building society lending: growth rates

		3 month†	6 month†	12 month*
		%	%	%
1988	May	25.2	24.0	22.2
	June	27.3	25.1	22.9
	July	28.3	26.0	23.5
	August	27.5	26.4	24.1
	September	26.3	26.8	24.2
	October	22.7	25.5	24.7
	November	22.5	25.0	24.5
	December	21.6	24.0	24.6
1989	January	22.7	22.7	24.4
	February	21.6	22.0	24.3
	March	22.0	21.8	24.3
	April	19.9	21.3	23.4
	May	21.1	21.3	23.2
	June	19.8	20.9	22.4
	July	21.1	20.5	21.6
	August	22.3	21.7	21.9
	September	24.9	22.3	22.1
	October	21.9	21.5	21.4
	November	18.5	20.4	20.9
	December	18.3	21.5	21.2
1990	January	18.7	20.3	20.4
	February	20.6	19.5	20.7
	March	18.8	18.5	20.4

† s.a and annualised
* unadjusted

(c) <u>12 month growth rate</u> (unadjusted): Slightly down on February. Same as January, which was lowest since February 1988.

(d) <u>6 month annualised growth rate</u> (adjusted): Down on February. Lowest since August 1987.

(e) <u>3 month annualised growth rate</u> (adjusted): Well down on February. Comparable to low levels seen in November-January.

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(v) Lending

(a) One month changes:

		Bank and building society lending			
		sa		nsa	
		£bn	%	£bn	%
1989	January	+ 7.8	+1.9	+ 7.4	+1.8
	February	+ 5.0	+1.2	+ 4.5	+1.1
	March	+ 8.4	+1.9	+ 9.9	+2.3
	April	+ 6.3	+1.4	+ 5.0	+1.1
	May	+ 6.4	+1.4	+ 6.0	+1.4
	June	+ 7.6	+1.7	+ 9.1	+2.0
	July	+ 7.7	+1.7	+ 7.9	+1.7
	August	+ 8.0	+1.7	+ 6.8	+1.5
	September	+10.5	+2.2	+11.4	+2.4
	October	+ 5.2	+1.1	+ 5.1	+1.0
	November	+ 4.9	+1.0	+ 4.4	+0.9
	December	+10.7	+2.2	+11.0	+2.2
1990	January	+ 5.8	+1.2	+ 5.4	+1.1
	February	+ 7.1	+1.4	+ 6.6	+1.3
	March	+ 9.2	+1.8	+10.7	+2.1

One month growth rate: Higher than in January and February, but lower than in December, which was previous interest charging month.

(vi) CLSB lending

[Use with caution as coverage poor this month.]

- Lending for consumption in March (an interest charging month) up £0.4 billion, compared with fall of £0.2 billion in February, no change in January and rise of £0.6 billion in December, last interest charging month.

- Lending for house purchase rose by £0.4 billion, compared with no change in January and February, and rise of £0.4 billion in December.

- CLSB lending to business up £4.2 billion, compared with rises of £2.6 billion in February and £2.2 billion in January. (December figure £2.3 billion, but actual lending to businesses probably much higher, because of very poor coverage - which affects business figures more than consumption and house purchase figures.)

C **DEFENSIVE**

(i) **MO still outside target range?**

Over past 18 months good progress made in getting MO growth back towards target range. Policy remains firm and MO expected to reach target range in few months (see FSBR para 2.34).

(ii) **What is Government doing to restrain growth of M0?**

Already have firm monetary and fiscal policy in place, but may take few months before get into 1990-91 range. Reflects stubbornness of inflationary pressure.

(iii) **Revised M0 target for 1990-91 "moving goal posts"?**

No. Need to set realistic and credible target range. Lower range would have been difficult to reach without undue changes in level of interest rates and consequent disruption in wider economy.

(iv) **M4 still buoyant?**

Various monetary aggregates should not be expected to grow at same rate; have differing relationship with inflation. Some of growth of broad aggregates may reflect increase in firmly held savings rather than build-up of inflationary pressure.

M4 12 month growth rate fell in March, and six month figure lowest since April 1989. Generally, growth has remained broadly stable in range 16½-18½ per cent since June 1988.

(v) **How much of lending figure is lending for house purchase?**

CLSB figures suggest bank lending for house purchase remains subdued.

(vi) **Why one month increase in lending so high?**

Partly due to seasonal factors, sa increase smaller than nsa rise. Also March interest charging month, which only partially accounted for in seasonals. No other special factors identified, but one months figures can always be erratic.

(vii) **Financial year outturn for funding shows Government overfunding?**

As made clear in Red Book, sustained overfunding not sensible policy, although authorities prepared to depart from funding rule when circumstances warrant it. £1.8 billion overfund very close to full fund, given margins of error and uncertainties PSBR, £1 billion bigger surplus than expected at Budget time.

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SECRET
UNTIL 11.30 AM ON MONDAY 23 APRIL

INTEREST RATES: BRIEFING ON GENERAL POLICY

(i) **Policy**

(a) **Why base rates as high as 15 per cent?** Government's prime objective to reduce inflation and interest rates only effective way of doing this.

(b) **Future course of interest rates?** Interest rates will stay high for some time to come.

(c) **When will interest rates come down?** The moment they can be safely lowered, will do so. But to reduce them prematurely, only to increase them again, would be extremely damaging. Will be brought down when believe they are likely to stay down.

(d) **Interest rates bearing excessive burden in adjustment process?** Interest rates have powerful effect on economy. Discourage spending and borrowing and encourage saving, impacting directly on what Government wants to influence. Also flexible way of responding to rapidly changing situation. Important as deregulation and financial competition make traditional indicators of monetary stance difficult to interpret. All other major countries seek to control inflation through use of interest rates. No alternative if Government serious about reducing inflation.

(e) **One club policy?** No. Have never relied on interest rates alone. Government has maintained both firm monetary and fiscal policy, including strict public expenditure control. But inflation is monetary problem, so tight monetary policy needed.

(ii) Interest rates and industry

(a) Interest rate increases damage industry? [Latest figures show manufacturing output in 1989Q4 up 0.2 per cent on 1989Q3.]

- Only to be expected that output growth would slow in response to tightening of policy. But manufacturing output still above level a year ago. Company profitability has recently recovered to levels not seen for almost 20 years.

- Even for those 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? [January CBI Quarterly Industrial Trends Survey showed fall in investment intentions.]

With slowdown in output, pause in investment growth inevitable, but follows period of rapid growth; business investment increased by nearly 9 per cent last year, giving total of over 40 per cent in three years to 1989.

(c) Sharp fall in manufacturing investment in 1989Q4? [CSO estimate of investment by manufacturing industry, published 15 February.]

Fall in fourth quarter probably represents inappropriate seasonal adjustment factor. Manufacturing investment also fell by 7½ per cent between third and fourth quarters of 1988, but recovered subsequently.

SECRET till 1130 am Monday 23.4.90

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ANNEX B

Provisional estimates of monetary aggregates: March 1990

1 Provisional information suggests the following:

% changes		M0	M4	M5
March 1990	(not seasonally adjusted)	+0.5	+2.2	+2.2
12 months to March 1990	(not seasonally adjusted)	+5.0	+17.5	+17.1
March 1990	(seasonally adjusted)	+0.2	+1.6	+1.5
12 months to March 1990	(seasonally adjusted)	+6.3	+17.5	+17.1
6 months to March 1990	(seasonally adjusted, annual rate)	+4.9	+16.2	+15.5
3 months to March 1990	(seasonally adjusted, annual rate)	+0.5	+15.6	+14.7

2 Provisional counterparts to the changes in M4 and M5 are:

	M4		M5	
£ billions, not seasonally adjusted	March	latest 12 months	March	latest 12 months
A PSBR	+1.6	-8.0	+1.6	-8.0
B Debt sales to private sector (-) (a)	-0.1	+8.9	-0.3	+10.0
C External and foreign currency finance of public sector	+0.3	-2.1	+0.3	-2.1
D Public sector contribution (A+B+C)	+1.8 (b)	-1.2 (b)	+1.6	-0.1
E Sterling lending (c)	+10.7 (+2.1%)	+89.4 (+20.4%)	+11.0 (+2.1%)	+89.5 (+20.4%)
F Other external and foreign currency flows	-1.7	-10.8	-1.7	-10.8
G Net non-deposit sterling liabilities (-)	-1.2	-12.3	-1.2	-12.3
Total (D+E+F+G)	+9.6	+65.1	+9.7	+66.3
Sterling lending (seasonally adjusted)	+9.2 (+1.8%)	+89.4 (+20.4%)	+9.5 (+1.8%)	+89.5 (+20.4%)
(average of previous 6 months)	+7.4		+7.3	

(a) The M4 private sector comprises all UK residents other than the public sector, banks and building societies. The M5 debt sales counterpart excludes those items of public sector debt which are components of M5.

(b) The public sector contribution excluding Treasury bills was +£1.8bn in March and +£0.4 bn in the latest 12 months.

(c) M4 lending comprises lending by banks and building societies to the M4 private sector. M5 lending adds to M4 lending any change in the M4 private sector's holdings of bank acceptances.

3 Sterling lending is increased in March and other quarter months (and correspondingly depressed in non-quarter months) by the pattern of bank interest charging. As explained in a note on pages 86-87 of the February 1990 *Quarterly Bulletin*, this is true even in the seasonally adjusted figures, because the seasonal adjustments only partially smooth out the impact of quarterly interest charging in a period when interest rates and the stock of lending are materially higher than their level during the period from which the adjustments are estimated.

4 Full monetary statistics, including revised estimates of these figures, will be published on 2 May.

5 The information on this page is released on the Knight Ridder, Reuters, Telerate and Topic wire services under the following page references:

Knight Ridder	1792 - 1795	*Telerate*	393-398
Reuters	MSAA - MSAF	*Topic*	44790 - 44795

Bank of England
23 April 1990

Central Statistical Office

SECRET AND PERSONAL UNTIL RELEASE OF PRESS NOTICE AT 11.30AM ON 25 APRIL 1990 AND THEREAFTER UNCLASSIFIED

From: J E Kidgell
Date: 20 April 1990
Tel : GTN 270 6040

PS/CHANCELLOR

MARCH FIGURES OF OVERSEAS TRADE

I attach for the Chancellor's approval the draft Press Notice on the current account of the Balance of Payments in March.

Clearance is requested by **midday on Monday 23 April.** Publication is set for **Wednesday 25 April at 11.30 am.**

Details about trade flows during March are included in the Press Notice. The key points on the current account (seasonally adjusted, on a balance of payments basis) are:

- **current account** is estimated to have been £2.2 billion in deficit in March (£1.4 billion in February)
- **invisibles** projected to be in balance for months in the first quarter
- deficit on **visible trade** was £2.2 billion (£1.4 billion in February)
- **Imports** in March were £10.5 billion, a new record
- the underlying level of **non-oil import volume** has changed little over the past year
- the underlying level of **non-oil export volume** has slowed sharply in recent months
- in first quarter, **visible trade deficit** was £5.6 billion, £1.2 billion more than in previous quarter. However, nearly £1.1 billion of this deterioration is attributable to a deterioration in the balance in oil and erratic items.

Special factors this month

The three month on three month comparison of import volumes (excluding oil and erratics) shown in the draft press notice is inflated by the unusually low December and high January figures, and is significantly different from the change in the statistical trend. In line with earlier practice agreed with the Chancellor, a fifth point has been added to the section in the press notice on imports (as was done for exports in the press notice reporting the November figures).

SECRET AND PERSONAL UNTIL RELEASE OF PRESS NOTICE AT 11.30AM ON 25 APRIL 1990 AND THEREAFTER UNCLASSIFIED

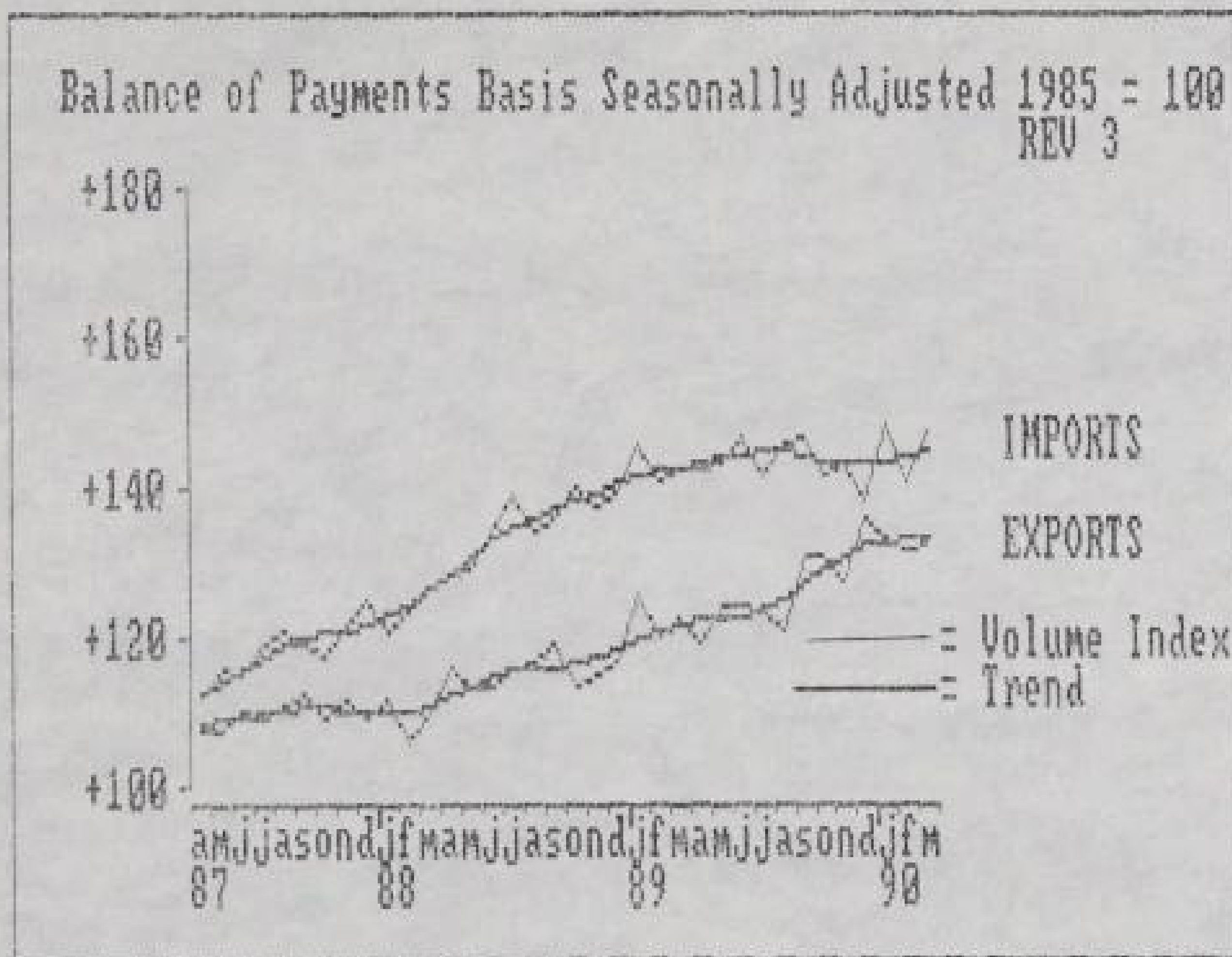
Imports in March were boosted by a substantial increase (£0.4 billion) in erratic items, notably aircraft and precious stones.

Copies of the draft press notice are being sent today to DTI.

J E KIDGELL

SECRET AND PERSONAL UNTIL RELEASE OF PRESS NOTICE ON 25 APR 90

VOLUME INDICES EXCLUDING OIL AND ERRATIC ITEMS



COPY NO		
1	Mr S Flanagan	PS/Financial Secretary, HMT
2	Mr B Potter	PS/Prime Minister (Economic Affairs)
3	Mr J Gieve	PPS/Chancellor, HMT
4	Mr R Evans	PS/Sir Peter Middleton, HMT
5	Mrs M Henson	PS/Sir Terence Burns, HMT
6	Mr M Scholar	Deputy Secretary, HMT
7	Mr P Tucker	PS/Governor, Bank of England
8	Mr J B Unwin	Chairman, HM C&E
9	Sir Jack Hibbert	Director, CSO
10	Mr M Pratt	Controller, HM C&E
11	Mr P Sedgwick	HMT, Economic Adviser
12	Mr D Owen	EA2, HMT
13	Mrs S Owen	EA2, HMT
14	Mr J Kidgell	Assistant Director, CSO
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17	Mr J Cottis	D1, CSO
18	Mr C Martin	D1, CSO
19	Mr G Eaton	D1, CSO
20	Mr J Wright	CSO Press Office
21	Mr I Scott	CSO Press Office
22	Mr G O'Donnell	HMT Press Office
23	File	D1, CSO

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SECRET AND PERSONAL UNTIL RELEASE OF THE PRESS NOTICE ON 25 APRIL 1990

CSO (90)58
25 April1990

UK BALANCE OF PAYMENTS - CURRENT ACCOUNT IN MARCH

In March the ***current account deficit*** was £2.2 billion, compared with a revised estimate of £1.4 billion in February.

In the first quarter there was a deficit of £5.6 billion compared with £5.1 billion in the previous quarter.

Visible balance

- in March the ***visible deficit*** was £2.2 billion compared with a revised estimate of £1.4 billion in February
- excluding oil and erratic items, the deficit rose by £0.4 billion
- in the first quarter there was a deficit of £5.6 billion, compared with £4.4 billion in the previous quarter.

Invisibles

- in March ***invisibles*** are projected to be in balance (a surplus on transactions by the private sector offset by a deficit on government transactions).

Exports of goods (balance of payments basis)

- in March the ***value*** of exports was £8.4 billion, 1 per cent lower than in February
- in the first quarter, the ***value*** of exports was 1½ per cent higher than in the previous quarter, and 16 per cent higher than a year earlier
- excluding oil and erratic items, these percentages were 2½ per cent and 14 per cent respectively
- excluding oil and erratic items, the ***volume*** of exports in the first quarter was 1 per cent higher than in the previous quarter and 8 per cent higher than a year earlier.

Imports of goods (balance of payments basis)

- in March the ***value*** of imports was £10.5 billion, 7½ per cent higher than in February
- in the first quarter, the ***value*** of imports was 5 per cent higher than in the previous quarter, and 11 per cent higher than a year earlier
- excluding oil and erratic items, imports in the latest quarter were 2½ per cent higher than in the previous quarter, and 7½ per cent higher than a year earlier
- excluding oil and erratic items, the ***volume*** of imports in the first quarter was 3 per cent higher than the previous quarter and 2 per cent higher than a year earlier
- These comparisons are distorted by the erratically low December figure and the erratically high January figure. Comparing the four months December to March with the previous four months and with the same four months a year ago shows a fall of ½ per cent and a rise of 1 per cent respectively.

All figures seasonally adjusted

SECRET AND PERSONAL UNTIL RELEASE OF THE PRESS NOTICE ON 25 APRIL 1990 AT 11.30AM AND THEREAFTER UNCLASSIFIED

Table 1
Current account

£ million, seasonally adjusted

		Current balance	Visible trade Balance	Exports fob	Imports fob	Invisibles balance[b]
1988		-15019	-20815	80772	101587	+5796
1989		-20851	-23112	92526	115638	+2261
1989	Q1	-4559	-6037	21733	27770	+1478
	Q2	-4890	-6335	22506	28841	+1445
	Q3	-6308	-6359	23314	29673	+51
	Q4	-5094	-4381	24973	29354	-713
1990	Q1	-5590	-5590	25303	30893	0
1989	Oct	-1920	-1682	8138	9820	-238
	Nov	-2019	-1782	8115	9897	-237
	Dec	-1155	-917	8720	9637	-238
1990	Jan	-2020[a]	-2020	8502	10522	0[a]
	Feb	-1394[a]	-1394	8433	9827	0[a]
	Mar	-2176[a]	-2176	8368	10544	0[a]
Oct-Dec 1989		-5094	-4381	24973	29354	-713
Jan-Mar 1990		-5590[a]	-5590	25303	30893	0[a]

a Invisibles for January to March 1990 are projections.
b Monthly figures are one third of the appropriate calendar quarter's estimate or projection.
Information relating to credits and debits can be found in Table 3.

DRAFT COPY
SECRET AND PERSONAL UNTIL RELEASE OF THE PRESS NOTICE ON 25 APRIL 1990

OTHER KEY POINTS

Trade in oil

- in March the surplus in oil was £0.1 billion, little changed from February
- in the first quarter, exports rose by £0.1 billion and imports rose by £0.3 billion, compared with the previous quarter; the surplus, at £0.4 billion, was £0.2 billion less than in the previous quarter.

Non-oil trade

- in March the deficit on non-oil trade was £2.3 billion, £0.8 billion less than in February
- in the first quarter the non-oil deficit rose by £1.0 billion.

Erratic items

- in March exports were little changed while imports rose by £0.4 billion
- in the first quarter exports fell by £0.3 billion while imports rose by £0.5 billion.

Analysis by commodity* (volumes excluding erratic items)

In the latest quarter:

- ***exports of manufactured goods*** were 1½ per cent up on the previous quarter
- ***exports of finished manufactures*** also rose by 1½ per cent
- within finished manufactures, exports of passenger motor cars fell by 7½ per cent while exports of other consumer goods rose by 9 per cent. Exports of intermediate goods rose by 2½ per cent while exports of capital goods fell by 1½ per cent
- ***imports of manufactured goods*** were 2 per cent up on the previous quarter
- ***imports of finished manufactures*** rose by 2½ per cent
- within finished manufactures, imports of passenger motor cars fell by 1 per cent while imports of other consumer goods rose by 2½ per cent. Imports of intermediate goods rose by 3½ per cent and imports of capital goods rose by 2 per cent.

Terms of trade

- in the first quarter, the export unit value index rose by 1½ per cent and the import unit value index rose by 1 per cent over the previous quarter, so that the terms of trade index rose by ½ per cent
- the export unit value index for fuels rose by 3½ per cent while that for non-oil exports rose by 1½ per cent
- the import unit value index for fuels rose by 3 per cent while that for non-oil imports rose by 1 per cent.

* *Overseas trade statistics basis*

Notes to editors

Invisibles

1. Estimates of invisibles are based on a variety of sources, mostly inquiries of those engaging in the various transactions. These are usually sample inquiries, and are variously held on quarterly, annual or periodic bases. For some components, data for recent periods are therefore incomplete and subject to significant estimation errors.

2. The figures shown for the invisibles balance in most months are the estimates for the relevant quarters, taken from the Balance of Payments accounts, expressed at a monthly rate. For the most recent months, however, the figures are projections, which are rounded to the nearest £100 million to emphasise their approximate nature. These projections are superseded by preliminary estimates from the Balance of Payments accounts when they are published around the middle of March, June, September and December.

Revisions

3. From January 1990 the "current updating" method of seasonal adjustment has been used; that is, the seasonal factors for the current and previous month have been estimated using the latest data. Further details are given in the Standard Notes.

Area (Table 11)

4. Low value consignments i.e. items of an individual value less than £600, are not analysed by country and are therefore excluded from the area data in Table 11. In addition the method of seasonal adjustment leads to further differences between the sum of areas and figures for total trade.

Monthly Review of External Trade Statistics

5. The Monthly Review supplements the information contained in this Press Notice. It gives longer historical runs of data and contains charts, tables on the UK Balance of Payments, UK exports and imports on an Overseas Trade Statistics basis, and certain international comparisons. The Monthly Review is available from the Central Statistical Office, in Branch D1, Room 62/3 at the address given below for an annual subscription of £43 which includes the annual supplement. The annual supplement for 1989 includes figures back to 1970. Individual copies are priced at £3, (£7 for the annual supplement).

CSO Databank

6. The data in the press notice and Monthly Review of External Trade Statistics can be obtained in computer readable form via the CSO Databank service which provides macro-economic time series data on magnetic tape or floppy disk. Details of the service offered and the schedule of charges may be obtained from the Databank Manager, CSO E1, Room 52 /4, Government Offices, Great George Street, London SW1P 3AQ (telephone: 01-270 6386). The CSO does not offer direct on-line access for the data, but a list of host bureau offering such a facility is available on request from the CSO.

Standard notes

7. There is a set of standard notes that describes the basis on which the figures in this Press Notice are compiled including the differences between the Balance of Payments (BoP) and the Overseas Trade Statistics (OTS) figures. Copies can be obtained by telephoning the public visible trade enquiry number below.

Issued by:

Central Statistical Office,
Government Offices,
Great George Street, London SW1P 3AQ

Telephone :

Press calls on visible and invisible trade: 01 270 6357/ 6512
Press calls on balance of payments and the economy: 01 270 5238
Public inquiries on visibles: 01 270 6263/ 6197/ 5962/ 6244
Public inquiries on invisibles: 01 270 6363/ 6364

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CURRENT BALANCE VISIBLE TRADE AND INVISIBLES

Table 2

(Balance of Payments basis)

£ million, Seasonally adjusted

	Current Balance	Visible Trade: Exports fob	Imports fob	Visible Balance	of which: Oil	Non-oil	Invisibles Balance[b]
1988	-15019	80772	101587	-20815	+ 2797	- 23612	+ 5796
1989	-20851	92526	115638	-23112	+ 1481	- 24593	+ 2261
1989 Q1	- 4559	21733	27770	- 6037	+ 229	- 6266	+ 1478
Q2	- 4890	22506	28841	- 6335	+ 228	- 6563	+ 1445
Q3	- 6308	23314	29673	- 6359	+ 397	- 6756	+ 51
Q4	- 5094	24973	29354	- 4381	+ 627	- 5008	- 713
1990 Q1	- 5590	25303	30893	- 5590	+ 404	- 5994	0
1989 JUL	- 1991	7677	9685	- 2008	+ 130	- 2138	+ 17
AUG	- 2361	7541	9919	- 2378	+ 163	- 2541	+ 17
SEP	- 1956	8096	10069	- 1973	+ 104	- 2077	+ 17
OCT	- 1920	8138	9820	- 1682	+ 212	- 1894	- 238
NOV	- 2019	8115	9897	- 1782	+ 205	- 1987	- 237
DEC	- 1155	8720	9637	- 917	+ 210	- 1127	- 238
1990 JAN	- 2020a	8502	10522	- 2020	+ 121	- 2141	0a
FEB	- 1394a	8433	9827	- 1394	+ 145	- 1539	0a
MAR	- 2176a	8368	10544	- 2176	+ 138	- 2314	0a
JAN-MAR 1989	- 4559	21733	27770	- 6037	+ 229	- 6266	+ 1478
OCT-DEC 1989	- 5094	24973	29354	- 4381	+ 627	- 5008	- 713
JAN-MAR 1990	- 5590a	25303	30893	- 5590	+ 404	- 5994	0a
% Change							
Latest 3 months							
- on previous 3 months		+ 1½	+ 5				
- Same 3 months one year ago		+ 16	+ 11				

a Invisibles for January to March 1990 are projections.

b Monthly figures are one third of the appropriate calendar quarter's estimate or projection.

INVISIBLES

Table 3

(Balance of Payments basis)

£ million, Seasonally adjusted

	All Sectors: Credits	Debits	Balance	of which: Services	Interest Profits Dividends	Transfers	Private Sector and Public Corporations[d]: Credits	Debits	Balance
1987	79806	73297	+ 6510	+ 5664	+ 4248	- 3402	74407	61802	+ 12605
1988	88571	82774	+ 5796	+ 4020	+ 5346	- 3570	82774	70730	+ 12043
1989	108530	106268	+ 2261	+ 3980	+ 3008	- 4727	102265	92634	+ 9631
1987 Q4	19716	18595	+ 1122	+ 1120	+ 897	- 895	18643	15868	+ 2776
1988 Q1	20750	19725	+ 1025	+ 1024	+ 989	- 988	19365	16733	+ 2632
Q2	21714	20053	+ 1661	+ 1122	+ 1474	- 935	20157	16890	+ 3267
Q3	22854	20614	+ 2240	+ 1017	+ 1434	- 211	21338	18239	+ 3099
Q4	23253	22382	+ 870	+ 857	+ 1449	- 1436	21914	18868	+ 3045
1989 Q1	25866	24388	+ 1478	+ 897	+ 1320	- 739	24102	21203	+ 2899
Q2	27173	25728	+ 1445	+ 1327	+ 1006	- 888	25453	22507	+ 2946
Q3	26742	26690	+ 51	+ 993	+ 492	- 1434	25454	23277	+ 2176
Q4	28749	29462	- 713	+ 763	+ 190	- 1666	27256	25647	+ 1610

d ie excluding general Government transactions and all transfers.

EXPORT AND IMPORT UNIT VALUE AND VOLUME INDEX NUMBERS — Table 4

Balance of Payments basis — Indices, 1985 = 100

	Unit Value (Not seasonally adjusted)			Volume (seasonally adjusted)	
	Exports	Imports	Terms of Trade[e]	Exports	Imports
1988	94.5	97.6	96.8	110.9	129.8
1989	101.2	103.8	97.5	117.0	139.9
1989 Q1	97.8	99.4	98.4	112.8	140.5
Q2	100.8	102.7	98.1	113.5	140.3
Q3	102.2	105.4	97.0	117.2	141.0
Q4	103.9	107.5	96.6	124.4	138.0
1990 Q1	105.5	108.6	97.2	124.8	147.1
1989 JUL	102.2	105.2	97.1	115.6	138.5
AUG	102.2	105.0	97.4	114.5	141.2
SEP	102.3	106.0	96.5	121.5	143.3
OCT	103.6	106.8	96.9	122.8	139.5
NOV	103.7	107.2	96.7	121.9	140.4
DEC	104.5	108.5	96.3	128.4	134.2
1990 JAN	105.7	108.6	97.4	125.3	150.4
FEB	105.8	109.0	97.1	124.3	139.6
MAR	105.1	108.3	97.1	124.7	151.4
JAN-MAR 1989	97.8	99.4	98.4	112.8	140.5
OCT-DEC 1989	103.9	107.5	96.6	124.4	138.0
JAN-MAR 1990	105.5	108.6	97.2	124.8	147.1
% Change					
Latest 3 months on					
- previous 3 months	+ 1½	+ 1	+ ½	+ ½	+ 6½
- Same 3 months one year ago	+ 8	+ 9	- 1	+ 11	+ 4½

e Export unit value index as a percentage of the import unit value index.

VALUE AND VOLUME OF EXPORTS AND IMPORTS EXCLUDING THE MORE ERRATIC ITEMS[f] — Table 5

Balance of Payments basis — Seasonally adjusted

	Value £ million fob		Volume Index 1985 = 100	
	Exports	Imports	Exports	Imports
1988	75114	97109	109.6	129.8
1989	85250	110844	114.4	140.3
1989 Q1	20172	26592	111.0	140.8
Q2	20706	27697	110.8	141.0
Q3	21483	28470	114.7	141.5
Q4	22889	28085	121.1	138.0
1990 Q1	23524	29092	122.9	145.2
1989 JUL	7087	9303	113.4	139.1
AUG	6950	9520	111.9	141.8
SEP	7446	9647	118.9	143.7
OCT	7603	9408	121.5	139.7
NOV	7379	9463	118.0	139.9
DEC	7907	9214	123.8	134.5
1990 JAN	7857	9858	122.8	147.4
FEB	7843	9434	122.3	140.1
MAR	7824	9800	123.6	148.2
JAN-MAR 1989	20172	26592	111.0	140.8
OCT-DEC 1989	22889	28085	121.1	138.0
JAN-MAR 1990	23524	29092	122.9	145.2
% Change				
Latest 3 months on				
- previous 3 months	+ 3	+ 3½	+ 1½	+ 5
- Same 3 months one year ago	+ 17	+ 9½	+ 11	+ 3

f These are defined as ships, North Sea installations, aircraft, precious stones, and silver.

TRADE IN OIL [g]

Table 6

(Balance of Payments basis)

Seasonally adjusted

	Balance of Trade in oil	EXPORTS					IMPORTS				
		TOTAL	CRUDE OIL (SITC R(3) 333.0)			Rest of Division 33	TOTAL	CRUDE OIL (SITC (R3) 333.0)			Rest of Division 33
	£ million fob	£ million fob	£ million fob	million tonnes	Avg value per tonne £ fob	£ million fob	£ million fob	£ million fob	million tonnes	Avg value per tonne £ fob	£ million fob
1988	+ 2797	6018	4515	70.4	64.0	1503	3221	1911	32.6	58.2	1310
1989	+ 1481	5907	4017	49.0	81.7	1890	4426	2753	36.5	75.7	1673
1989 Q1	+ 229	1200	739	10.4	70.6	461	971	632	10.0	63.5	339
Q2	+ 228	1406	948	11.4	83.2	458	1178	704	8.6	82.2	474
Q3	+ 397	1515	1075	13.1	82.1	440	1118	729	9.6	76.3	389
Q4	+ 627	1786	1255	14.2	88.4	531	1159	688	8.3	82.8	471
1990 Q1	+ 404	1911	1310	14.9	87.9	601	1507	981	11.8	83.1	526
1989 JUL	+ 130	517	370	4.4	83.4	147	387	244	3.2	75.2	143
AUG	+ 163	498	359	4.4	81.0	139	335	225	3.0	75.3	110
SEP	+ 104	500	346	4.2	82.5	154	396	260	3.4	77.4	136
OCT	+ 212	626	429	4.8	88.6	197	414	254	3.1	82.1	160
NOV	+ 205	589	421	4.8	88.7	168	384	229	2.8	81.3	155
DEC	+ 210	571	405	4.6	88.4	166	361	205	2.4	84.5	156
1990 JAN	+ 121	636	452	5.0	91.3	184	515	332	3.8	86.8	183
FEB	+ 145	638	431	4.9	88.0	207	493	313	3.6	86.3	180
MAR	+ 138	637	427	5.1	84.5	210	499	336	4.4	77.1	163
JAN-MAR 1989	+ 229	1200	739	10.4	70.9	461	971	632	10.0	63.3	339
OCT-DEC 1989	+ 627	1786	1255	14.2	88.6	531	1159	688	8.3	82.5	471
JAN-MAR 1990	+ 404	1911	1310	14.9	87.9	601	1507	981	11.8	83.1	526
% Change Latest 3 months on previous 3 months		+ 7	+ 4½	+ 5	- ½	+ 13	+ 30	+ 43	+ 42	+ ½	+ 12
- same 3 months one year ago		+ 59	+ 77	+ 43	+ 24	+ 30	+ 55	+ 55	+ 18	+ 31	+ 55

g Trade in petroleum and petroleum products. These figures differ from those published by the Department of Energy which are on a time of shipment basis (see paragraph 10 of the standard notes).

TRADE IN GOODS OTHER THAN OIL

Table 7

(Balance of Payments basis)

	Total								Excluding erratics[f]			
	Value, £ million, fob (seasonally adjusted)			Unit value index 1985 = 100 (not seasonally adjusted)			Volume index 1985 = 100 (seasonally adjusted)		Value £ million fob (seasonally adjusted)		Volume index 1985 = 100 (seasonally adjusted)	
	Balance of non oil trade	Exports	Imports	Exports	Imports	Terms of Trade[e]	Exports	Imports	Exports	Imports	Exports	Imports
1988	-23612	74754	98366	108.9	104.2	104.6	115.1	132.3	69096	93888	113.8	132.4
1989	-24593	86619	111212	114.8	109.8	104.6	127.8	142.7	79343	106418	125.4	143.3
1989 Q1	- 6266	20533	26799	112.0	105.9	105.8	124.2	142.6	18972	25621	122.8	143.1
Q2	- 6563	21100	27663	113.8	108.3	105.1	124.9	143.2	19300	26519	122.3	144.1
Q3	- 6756	21799	28555	116.2	111.4	104.3	127.4	144.1	19968	27352	125.0	144.9
Q4	- 5008	23187	28195	117.2	113.5	103.3	134.7	141.1	21103	26926	131.3	141.2
1990 Q1	- 5994	23392	29386	118.8	114.6	103.7	134.3	147.7	21613	27585	132.6	145.6
1989 JUL	- 2138	7160	9298	115.6	111.2	104.0	125.7	141.0	6570	8916	123.6	141.8
AUG	- 2541	7043	9584	116.6	111.1	104.9	123.6	145.4	6452	9185	121.0	146.2
SEP	- 2077	7596	9673	116.3	112.0	103.8	133.0	146.0	6946	9251	130.5	146.6
OCT	- 1894	7512	9406	116.6	112.9	103.3	131.5	141.5	6977	8994	130.5	141.9
NOV	- 1987	7526	9513	116.9	113.1	103.4	131.6	143.8	6790	9079	127.2	143.4
DEC	- 1127	8149	9276	118.0	114.4	103.1	141.2	137.8	7336	8853	136.2	138.4
1990 JAN	- 2141	7866	10007	118.5	114.2	103.7	135.8	151.6	7221	9343	133.3	148.4
FEB	- 1539	7795	9334	119.1	114.8	103.8	133.8	140.2	7205	8941	132.0	140.7
MAR	- 2314	7731	10045	118.9	114.8	103.6	133.3	151.1	7187	9301	132.5	147.6
JAN-MAR 1989	- 6266	20533	26799	112.0	105.9	105.8	124.2	142.6	18972	25621	122.8	143.1
OCT-DEC 1989	- 5008	23187	28195	117.1	113.4	103.3	134.7	141.0	21103	26926	131.3	141.2
JAN-MAR 1990	- 5994	23392	29386	118.8	114.6	103.7	134.3	147.6	21613	27585	132.6	145.6
% Change												
Latest 3 months on												
- previous 3 months		+ 1	+ 4	+ 1½	+ 1	+ ½	- ½	+ 4½	+ 2½	+ 2½	+ 1	+ 3
- same 3 months one year ago		+ 14	+ 9½	+ 6	+ 8	- 2	+ 8	+ 3½	+ 14	+ 7½	+ 8	+ 2

f These are defined as ships, North Sea installations, aircraft, precious stones, and silver.

e Export unit value index as a percentage of the import unit value index.

TRADE BY COMMODITY: VALUE

Table 8

Overseas Trade Statistics basis — £ million, Seasonally adjusted

	Total	Food beverages and tobacco	Basic Materials	Fuels	Total Manufactures	Manufactures excluding erratics[h] Total	Semi-manufactures excluding precious stones & silver (PS) Total	Chemicals	Other	Finished manufactures excluding ships, North Sea installations and aircraft (SNA) Total	Passenger Motor Cars	Other Consumer	Intermediate	Capital
SITC (REV 3)	0-9	0+1	2+4	3	5-8	5-8 less SNAPS	5+6 less PS	5	6 less PS	7+8 less SNA	j	j	j	j
Exports fob														
1988	82097	5534	2120	6260	66195	59968	21911	11331	10579	38057	2032	6645	16011	13369
1989	93645	6555	2348	6164	76291	69111	24555	12350	12206	44556	2637	8028	18238	15653
1989 Q1	21964	1611	541	1260	18021	16503	5858	2953	2905	10645	620	1968	4403	3654
Q2	22773	1612	577	1461	18573	16797	6042	3014	3028	10755	654	1924	4382	3796
Q3	23663	1622	609	1586	19274	17463	6150	3105	3046	11313	618	2039	4704	3951
Q4	25246	1710	620	1856	20423	18348	6505	3278	3227	11842	745	2097	4749	4251
1990 Q1	25514	1711	540	1960	20707	18941	6724	3330	3394	12217	704	2325	4885	4304
1990 JAN	8581	608	182	674	6912	6269	2267	1148	1120	4002	225	788	1585	1403
FEB	8495	553	184	632	6915	6325	2215	1088	1127	4110	248	771	1650	1441
MAR	8439	551	174	654	6880	6347	2242	1094	1147	4106	231	765	1650	1460
JAN-MAR 1989	21964	1611	541	1260	18021	16503	5858	2953	2905	10645	620	1968	4403	3654
OCT-DEC 1989	25246	1710	620	1856	20423	18348	6505	3278	3227	11842	745	2097	4749	4251
JAN-MAR 1990	25514	1711	540	1960	20707	18941	6724	3330	3394	12217	704	2325	4885	4304
% Change														
Latest 3 months on														
- previous 3 months	+ 1	0	- 13	+ 5½	+ 1½	+ 3	+ 3½	+ 1½	+ 5	+ 3	- 5½	+ 11	+ 3	+ 1
- same 3 months one year ago	+ 16	+ 6	- ½	+ 56	+ 15	+ 15	+ 15	+ 13	+ 17	+ 15	+ 14	+ 18	+ 11	+ 18
Imports cif														
1988	106571	10615	5984	5038	83484	78623	26738	9314	17424	51885	6752	12604	17913	14617
1989	120788	11430	6482	6235	95075	90423	29961	10441	19520	60463	7618	14827	21202	16816
1989 Q1	29053	2616	1639	1415	22992	21827	7355	2529	4826	14473	1809	3524	5092	4047
Q2	30124	2834	1636	1627	23621	22499	7520	2586	4934	14980	1801	3683	5220	4275
Q3	31026	2982	1703	1537	24424	23242	7574	2643	4931	15668	2049	3819	5462	4337
Q4	30586	2998	1504	1657	24039	22855	7512	2683	4830	15343	1958	3800	5428	4156
1990 Q1	32197	3164	1609	1961	25026	23282	7495	2627	4868	15788	1902	3935	5694	4257
1990 JAN	10931	1093	568	684	8444	7818	2496	884	1612	5322	634	1331	1923	1435
FEB	10268	1001	510	635	7982	7596	2382	826	1556	5215	634	1311	1885	1384
MAR	10999	1070	532	641	8600	7868	2617	917	1701	5251	633	1293	1886	1438
JAN-MAR 1989	29053	2616	1639	1415	22992	21827	7355	2529	4826	14473	1809	3524	5092	4047
OCT-DEC 1989	30586	2998	1504	1657	24039	22855	7512	2683	4830	15343	1958	3800	5428	4156
JAN-MAR 1990	32197	3164	1609	1961	25026	23282	7495	2627	4868	15788	1902	3935	5694	4257
% Change														
Latest 3 months on														
- previous 3 months	+ 5½	+ 5½	+ 7	+ 18	+ 4	+ 2	0	- 2	+ 1	+ 3	- 3	+ 3½	+ 5	+ 2½
- same three months one year ago	+ 11	+ 21	- 2	+ 39	+ 9	+ 6½	+ 2	+ 4	+ 1	+ 9	+ 5	+ 12	+ 12	+ 5

h These are defined as ships, North Sea installations, aircraft (together comprising SITC (REV 3) 792 and 793), precious stones (667), and silver (681.1).

j Based on the United Nations Broad Economic Categories end-use classification.

TRADE BY COMMODITY: VOLUME INDICES

Table 9

Overseas Trade Statistics basis — 1985 = 100, Seasonally adjusted

						Manufactures excluding erratics[h]								
							Semi-manufactures excluding precious stones & silver(PS)			Finished manufactures excluding ships, North Sea installations and aircraft (SNA)				
	Total	Food beverages and tobacco	Basic Materials	Fuels	Total Manufactures	Total	Total	Chemicals	Other	Total	Passenger Motor Cars	Other Consumer	Intermediate	Capital
SITC (REV 3)	0-9	0+1	2+4	3	5-8	5-8 less SNAPS	5+6 less PS	5	6 less PS	7+8 less SNA	j	j	j	j
Exports														
Weights	1000	64	28	214	670	619	234	121	114	385	17	65	180	122
1988	112.0	112.3	99.9	93.8	118.9	116.0	116.5	117.3	115.7	115.8	122.8	122.5	102.8	130.2
1989	117.8	123.4	104.3	75.1	131.9	128.8	121.1	118.3	124.1	133.6	153.1	144.4	114.6	153.0
1989 Q1	113.5	129	100	69	127	126	120	118	121	129	148	146	112	143
Q2	114.3	123	103	69	129	125	120	116	124	129	156	138	111	147
Q3	118.4	118	106	78	132	129	119	116	123	135	140	145	118	155
Q4	125.2	124	108	84	139	135	126	123	129	141	168	149	117	167
1990 Q1	125.0	121	95	86	140	137	128	123	134	143	155	162	120	165
1990 JAN	125.8	133	96	86	140	136	130	128	132	140	147	165	117	161
FEB	124.2	116	99	83	139	137	126	120	133	143	163	161	121	165
MAR	125.1	114	91	90	140	139	129	122	137	145	157	160	122	168
JAN-MAR 1989	113.5	129	100	69	127	126	120	118	121	129	148	146	112	143
OCT-DEC 1989	125.2	124	108	84	139	135	126	123	129	141	168	149	117	167
JAN-MAR 1990	125.0	121	95	86	140	137	128	123	134	143	155	162	120	165
% Change														
Latest 3 months on														
- previous 3 months	0	- 2½	- 12	+ 2½	0	+ 1½	+ 2	0	+ 4	+ 1½	- 7½	+ 9	+ 2½	- 1½
- same 3 months one year ago	+ 10	- 6½	- 4½	+ 25	+ 9½	+ 9½	+ 7½	+ 4½	+ 10	+ 11	+ 5	+ 11	+ 7	+ 15
Imports														
Weights	1000	109	65	125	686	647	230	81	148	417	49	106	143	119
1988	130.1	115.0	118.1	108.3	138.0	137.6	131.8	129.6	133.1	140.8	127.2	141.7	145.8	139.6
1989	140.1	118.3	116.7	113.6	151.0	152.0	140.2	142.6	138.8	158.6	131.3	159.1	164.9	161.7
1989 Q1	140.6	113	125	119	151	152	141	139	142	158	132	158	164	160
Q2	140.4	119	119	114	151	153	141	141	141	159	125	159	165	166
Q3	141.3	123	119	111	153	154	141	144	139	161	136	161	167	164
Q4	137.9	119	104	111	149	150	139	146	134	157	131	158	164	157
1990 Q1	145.8	124	114	131	155	153	140	144	138	161	130	162	170	160
1990 JAN	148.7	129	118	131	159	155	141	146	138	163	132	164	173	163
FEB	138.6	118	107	123	148	149	133	136	132	158	129	160	168	155
MAR	150.2	125	117	138	160	156	147	151	144	161	129	163	168	163
JAN-MAR 1989	140.6	113	125	119	151	152	141	139	142	158	132	158	164	160
OCT-DEC 1989	137.9	119	104	111	149	150	139	146	134	157	131	158	164	157
JAN-MAR 1990	145.8	124	114	131	155	153	140	144	138	161	130	162	170	160
% Change														
Latest 3 months on														
- previous 3 months	+ 6	+ 4	+ 9½	+ 17	+ 4	+ 2	+ 1	- 1	+ 2½	+ 2½	- 1	+ 2½	+ 3½	+ 2
- same 3 months one year ago	+ 3½	+ 10	- 9	+ 10	+ 3	+ 1	- ½	+ 4	- 3	+ 2	- 2	+ 2½	+ 4	0

h These are defined as ships, North Sea installations, aircraft (together comprising SITC (REV 3) 792 and 793), precious stones (667), and silver (681.1).

j Based on the United Nations Broad Economic Categories end-use classification.

TRADE BY COMMODITY: UNIT VALUE INDICES

Table 10

Overseas Trade Statistics basis — 1985 = 100, Not seasonally adjusted

	Total	Food beverages and tobacco	Basic Materials	Fuels	Total Manufactures	Manufactures excluding erratics[h]: Total	Semi-manufactures excluding precious stones & silver (PS): Total	Chemicals	Other	Finished manufactures excluding ships, North Sea installations and aircraft (SNA): Total	Passenger Motor Cars	Other Consumer	Intermediate	Capital
SITC (REV 3)	0-9	0+1	2+4	3	5-8	5-8 less SNAPS	5+6 less PS	5	6 less PS	7+8 less SNA	j	j	j	j
Exports														
Weights	1000	64	28	214	670	619	234	121	114	385	17	65	180	122
1988	94.7	107	99	40	110	111	107	107	107	113	122	110	115	111
1989	101.3	114	107	49	116	117	115	116	115	117	132	115	118	115
1989 Q1	97.9	108	105	44	113	114	112	111	112	115	127	113	117	113
Q2	100.9	111	105	51	115	116	115	115	114	116	128	113	118	114
Q3	102.3	118	109	49	117	118	117	118	116	118	135	116	119	116
Q4	104.0	120	107	53	118	119	118	119	117	119	136	118	120	116
1990 Q1	105.6	120	107	55	120	120	121	122	119	120	136	120	121	117
1990 JAN	105.9	119	108	58	119	120	120	121	120	120	139	119	121	117
FEB	105.9	121	107	55	120	121	121	123	119	120	136	119	122	117
MAR	105.2	119	105	53	120	121	120	122	119	121	134	120	122	119
JAN-MAR 1989	97.9	108	105	44	113	114	112	111	112	115	127	113	117	113
OCT-DEC 1989	104.0	120	107	53	118	119	118	119	117	119	136	118	120	116
JAN-MAR 1990	105.6	120	107	55	120	120	121	122	119	120	136	120	121	117
% Change														
Latest 3 months on														
- previous 3 months	+ 1½	0	- ½	+ 3½	+ 1½	+ 1½	+ 2	+ 2½	+ 1½	+ 1	0	+ 1½	+ 1½	+ 1
- same 3 months one year ago	+ 8	+ 10	+ 2	+ 26	+ 6	+ 6	+ 8	+ 9½	+ 6½	+ 4½	+ 7	+ 6	+ 4	+ 4
Imports														
Weights	1000	109	65	125	686	647	230	81	148	417	49	106	143	119
1988	97.5	101	93	45	107	107	107	106	109	107	128	102	104	106
1989	103.5	107	103	53	112	112	114	108	117	112	140	108	109	106
1989 Q1	99.3	103	96	47	108	109	111	107	113	108	134	104	105	103
Q2	102.4	106	101	54	111	111	113	108	116	110	139	105	107	104
Q3	105.1	109	106	53	114	114	115	109	118	114	142	111	111	108
Q4	107.2	110	108	57	116	116	117	109	121	116	144	113	114	109
1990 Q1	108.4	112	107	59	117	117	117	110	121	117	144	113	116	111
1990 JAN	108.3	112	108	61	116	117	117	110	121	116	140	112	115	110
FEB	108.8	112	106	60	117	117	117	110	121	118	146	114	115	112
MAR	108.0	112	106	54	117	117	118	111	122	117	145	113	116	111
JAN-MAR 1989	99.3	103	96	47	108	109	111	107	113	108	134	104	105	103
OCT-DEC 1989	107.2	110	108	57	116	116	117	109	121	116	144	113	114	109
JAN-MAR 1990	108.4	112	107	59	117	117	117	110	121	117	144	113	116	111
% Change														
Latest 3 months on														
- previous 3 months	+ 1	+ 2	- 1	+ 3	+ 1	+ 1	+ ½	+ 1	+ ½	+ 1	0	0	+ 2	+ 1½
- same 3 months one year ago	+ 9	+ 9	+ 11	+ 25	+ 8	+ 8	+ 6	+ 2½	+ 8	+ 8½	+ 7	+ 9	+ 10	+ 8

h These are defined as ships, North Sea installations, aircraft (together comprising SITC (REV 3) 792 and 793), precious stones (667), and silver (681.1).

j Based on the United Nations Broad Economic Categories end-use classification.

TRADE BY AREA

Table 11

Overseas Trade Statistics basis — £ million, seasonally adjusted

		Developed countries						Developing countries			
					North America						Centrally
			European	Rest of					Oil exporting		planned
	Total[k]	Total	Community	W Europe	Total	USA	Other	Total	Countries	Other	economies
Exports fob											
1988	82097	65638	40938	7411	12794	10715	4495	13637	5021	8616	1612
1989	93645	75015	47140	8120	14346	12099	5409	15554	5833	9721	1786
1989 Q1	21964	17558	10939	1934	3411	2852	1273	3604	1374	2230	433
Q2	22773	18424	11538	2003	3566	2961	1318	3728	1282	2446	423
Q3	23663	18768	11936	1962	3572	3105	1298	3992	1643	2349	414
Q4	25246	20265	12728	2221	3797	3180	1520	4230	1534	2696	517
1990 Q1	25514	20648	13023	2334	3842	3291	1449	3918	1319	2599	544
1990 JAN	8581	7071	4567	779	1222	1054	503	1310	424	885	181
FEB	8495	6759	4187	777	1313	1086	482	1327	472	855	171
MAR	8439	6818	4268	777	1307	1152	465	1281	423	858	193
JAN-MAR 1989	21964	17558	10939	1934	3411	2852	1273	3604	1374	2230	433
OCT-DEC 1989	25246	20265	12728	2221	3797	3180	1520	4230	1534	2696	517
JAN-MAR 1990	25514	20648	13023	2334	3842	3291	1449	3918	1319	2599	544
% Change											
Latest 3 months on											
- previous 3 months	+ 1	+ 2	+ 2½	+ 5	+ 1	+ 3½	- 4½	- 7½	- 14	- 3½	+ 5½
- same 3 months one year ago	+ 16	+ 18	+ 19	+ 21	+ 13	+ 15	+ 14	+ 8½	- 4	+ 17	+ 26
Imports cif											
1988	106571	91255	55807	14028	12903	10768	8517	12600	2085	10515	2031
1989	120788	103323	63495	15349	15185	12889	9295	14453	2314	12139	2281
1989 Q1	29053	24932	15225	3877	3622	3039	2208	3336	590	2745	567
Q2	30124	25586	15669	3921	3712	3155	2284	3534	501	3033	599
Q3	31026	26769	16502	3864	4019	3403	2385	3874	602	3272	605
Q4	30586	26374	16350	3756	3855	3309	2414	3664	618	3045	512
1990 Q1	32197	27712	16902	4215	4223	3605	2372	3745	847	2897	569
1990 JAN	10931	9424	5678	1498	1439	1190	809	1400	339	1062	194
FEB	10268	8740	5391	1290	1325	1123	734	1163	247	916	180
MAR	10999	9549	5833	1427	1460	1292	828	1181	261	920	195
JAN-MAR 1989	29053	24961	15246	3834	3652	3066	2229	3370	591	2780	575
OCT-DEC 1989	30586	26231	16236	3788	3840	3288	2368	3680	619	3061	531
JAN-MAR 1990	32197	27712	16902	4215	4223	3605	2372	3745	847	2897	569
% Change											
Latest 3 months on											
- previous 3 months	+ 5½	+ 5½	+ 4	+ 11	+ 10	+ 9½	0	+ 2	+ 37	- 5½	+ 7½
- same 3 months one year ago	+ 11	+ 11	+ 11	+ 10	+ 16	+ 18	+ 6½	+ 11	+ 44	+ 4	- 1

k See paragraph 6 Notes to Editors.

COMMODITY ANALYSIS OF VISIBLE TRADE

Table 12

Balance of Payments basis — £ million, Seasonally adjusted

SITC (R3)	Food Beverages and Tobacco 0 + 1			Basic Materials 2 + 4			Fuels 3		
	Exports fob	Imports fob	Visible Balance	Exports fob	Imports fob	Visible Balance	Exports fob	Imports fob	Visible Balance
1988	5482	9956	- 4474	2134	5447	- 3313	6260	4687	+ 1573
1989	6494	10721	- 4227	2354	5900	- 3546	6163	5901	+ 262
1988 Q2	1415	2426	- 1011	527	1302	- 775	1745	1160	+ 585
Q3	1397	2539	- 1142	547	1453	- 906	1556	1211	+ 345
Q4	1384	2563	- 1179	563	1413	- 850	1262	1123	+ 139
1989 Q1	1601	2441	- 840	543	1497	- 954	1260	1315	- 55
Q2	1595	2646	- 1051	579	1492	- 913	1461	1548	- 87
Q3	1603	2806	- 1203	610	1551	- 941	1586	1464	+ 122
Q4	1695	2828	- 1133	622	1360	- 738	1856	1574	+ 282
1990 Q1	1695	2980	- 1285	542	1474	- 932	2014	1839	+ 175
1990 JAN	604	1031	- 427	183	520	- 337	684	643	+ 41
FEB	547	942	- 395	184	467	- 283	664	596	+ 68
MAR	544	1007	- 463	175	487	- 312	666	600	+ 66

SITC (R3)	Semi Manufactures 5 + 6			Finished Manufactures 7 + 8			Total Manufactures 5 - 8		
	Exports fob	Imports fob	Visible Balance	Exports fob	Imports fob	Visible Balance	Exports fob	Imports fob	Visible Balance
1988	24095	28010	- 3915	40813	51774	-10961	64908	79784	-14876
1989	26817	31011	- 4194	48415	60356	-11941	75232	91367	-16135
1988 Q2	6020	6943	- 923	10122	12672	- 2550	16142	19615	- 3473
Q3	6233	7334	- 1101	10641	13497	- 2856	16874	20831	- 3957
Q4	6219	7264	- 1045	10494	13926	- 3432	16713	21190	- 4477
1989 Q1	6331	7708	- 1377	11466	14376	- 2910	17797	22084	- 4287
Q2	6693	7764	- 1071	11631	14943	- 3312	18324	22707	- 4383
Q3	6608	7818	- 1210	12342	15610	- 3268	18950	23428	- 4478
Q4	7185	7721	- 536	12976	15427	- 2451	20161	23148	- 2987
1990 Q1	7420	8072	- 652	13042	16034	- 2992	20462	24106	- 3644
1990 JAN	2511	2774	- 263	4320	5393	- 1073	6831	8167	- 1336
FEB	2446	2495	- 49	4380	5169	- 789	6826	7664	- 838
MAR	2463	2803	- 340	4342	5472	- 1130	6805	8275	- 1470

10(a-b) cc SC

PRIME MINISTER

BALANCE OF PAYMENTS

You asked why the balance of payments deficit for March was so large when the growth in retail sales is slowing down and the corporate sector is running a large financial deficit.

The March Trade Figures

As you know, the monthly deficit in March was £ 3/4 billion higher than in February at £2.2 billion.

Exports fell only slightly from the February figure. But the growth in exports in volume and value terms does appear to have flattened out in recent months following the surge in the second half of last year. This is consistent with the FSPR forecast which projected a fairly sharp slowdown in export growth throughout this year.

The increase in the deficit in March is therefore almost entirely accounted for by higher imports. Imports were at a record high. About half the rise in imports is accounted for by erratics - mainly higher imports of aircraft.

Most other categories of imports also rose in March.

(i) However, the rise in imports of consumer goods including cars was small - in fact in value terms they fell. So these import figures are not obviously inconsistent with the latest data showing less buoyant retail sales and car registrations.

(ii) Imports of capital goods also rose, but remain below the levels in the middle of last year.

(iii) The big rises in imports in March were in basic materials, fuels and semi-manufactures, i.e., categories which will, in part, feed through into higher exports later. These are the same categories

which accounted for a fall in imports during the fourth quarter of last year as firms appeared to begin reducing stock levels. So the recovery may indicate some rebuilding of stocks by firms - quite possibly in reaction to involuntary destocking in 1989Q4 as retail demand remained more buoyant than they had expected. This is consistent with firms adjusting stocks to target levels, consistent with their expectations of retail and export demand.

To put the figures in some perspective, the longer term volume trends remain quite favourable. Exports (including erratics) are 8% higher in the first quarter than a year ago, compared with a 2% rise in imports. While the visible trade deficit for the first quarter of this year is larger than in 1989Q4, it is still well below the high figures at the end of 1988 and in the first half of 1989.

The Quality of the Statistics

You also asked about the reliability of the figures. I will need to pursue this further. However, my understanding is that the visible trade statistics are quite reliable (albeit erratic from month to month). The invisible figures, however, are much less reliable. Indeed there is no monthly information on invisibles at all - the figures are based on a partial quarterly survey. The allocation of the balancing item is also important.

The CSO are preparing to undertake more work on these areas, particularly on capital flows and services. There would be a danger, however, in the CSO allocating the balancing item without careful consideration: if it went to capital inflows, it would only worsen the invisible balance. I am checking on whether revisions of this kind have had an effect on this month's figures.

BHP

BHP

20 April 1990

jd c:march

9

PRIME MINISTER

BALANCE OF PAYMENTS

I understand from the Chancellor's Office that the balance of payments figure for March will show a deficit of £2.175 billion. This is the second worst monthly figure on record.

As you are already aware, the export figures for March are broadly unchanged from the previous month. Invisibles are again projected to have a zero balance in March. But imports have risen substantially. Only about half of the increase in March is due to erratic items.

The figures will be released next Wednesday, 25 April. My guess is that the City will be expecting a balance of payments deficit for March of around £1.3-1.4 billion.

The recorded balance of payments figure is so bad that a major news management effort will be required to contain the potential damage to the exchange, and equities, markets. The Chancellor is already in discussion with his press office on how best to handle this.

BHP

B.H. POTTER
19 April 1990

A:\economic\payments (pmm)

I have spoken to the Chancellor. This figure is at odds with all the evidence - it needs to be most thoroughly investigated at once. The Chancellor knows - no need for further action.

MT

TJS / sh

PRIVY COUNCIL OFFICE
WHITEHALL, LONDON SW1A 2AT

17 April 1990

Dear David

TEN MINUTE RULE BILL FOR WEDNESDAY 18 APRIL 1990

Thank you for your letter of 10 April setting out your proposals for handling Ken Hargreaves' Ten Minute Rule Bill on National Lotteries which he is seeking leave to introduce on Wednesday 18 April.

I agree that there is no need to intervene and oppose the Motion and that, in the event of a division, Ministers should abstain. I also agree that the Bill should be blocked at Second Reading.

I note that you will be writing to Ken Hargreaves explaining the Government's position on the issue, and I am content for you to do so in the terms you describe.

I am copying this letter to the Prime Minister, members of L Committee, Douglas Hurd, Chris Patten, Richard Luce and to Sir Robin Butler and First Parliamentary Counsel.

GEOFFREY HOWE

Rt Hon David Waddington QC MP

File

PRIME MINISTER (Airborne)
From BARRY POTTER, 10 Downing Street.

The RPI and unemployment figures for March were released at 11.30 a.m. this morning. The announcements have left the exchange + equities markets more or less unaffected. At noon the exchange rate index was at 87.1, where it opened this morning. The Sterling/Dollar rate (1.6435), Sterling/DMs (2.7529), and FTSE were all little different from opening levels.

BP

12 April 1990

jd c:rpi

8(a-e)

PRIME MINISTER

ECONOMIC POLICY OVER THE NEXT YEAR

Perhaps I could leave you some valedictory thoughts on economic management over the next year or so. Some of the points have a bearing on the issues you will be discussing with the Chancellor next week.

The note is in three parts:

A. what went wrong?
B. where are we now?
C. where do we go from here?

A. What Went Wrong?

We have discussed several times the errors over the last two to three years. But it may be helpful, with the benefit of hindsight, to summarise the key issues; because there are morals to be drawn for the future.

Ever since 1985 the Government - and most outside commentators - have under-estimated the impact of three inter-related factors:

a) the effect of financial deregulation on ordinary peoples' ability and willingness to borrow. In the early 1980s it was still quite hard work for people to borrow from banks and building societies; managers made people think they were doing them an enormous favour granting a mortgage or a loan. Financial deregulation has changed all that; potential lenders are now queuing up to lend to anyone with any kind of security to offer.

b) For most people that security is their house. Two-thirds of people now have that asset. And the housing boom

meant that most people now have an asset whose value is substantially higher than the existing debt secured on it. This meant lenders were very relaxed about increasing secured loans; and potential borrowers quickly cottoned on to how easy it was to raise extra money. For those with mortgages below £30,000 - still very much the majority in the mid 1980s - there was the added tax incentive.

c) The success of supply side policies and the turnaround in the economy meant that people felt much more confident about spending and borrowing; and less concerned about saving for a rainy day. Indeed by 1987-88 more and more people believed that the economic cycle was a thing of the past and that growth (including rising house prices) would carry on indefinitely.

These three factors combined to make private sector expenditure much more buoyant. And it was just when that effect was at its peak that the main policy errors were made. These arose both in:

(i) Fiscal Policy. Even though we moved into a large fiscal surplus it was probably not big enough. Indeed it was unplanned and arose only because of the cyclical position. The private sector was running such a large deficit that - temporarily - we should have run an even bigger fiscal surplus. That is not to say the supply side reforms in the 1988 Budget were wrong; far from it. But the overall stance of that Budget, eg on excise duties, was too loose. And there was no doubt that people did increase their spending plans in 1988 partly as a result of it. This added to the inflationary pressures and the leakage into imports and a trade deficit.

(ii) Monetary Policy. This was the <u>big</u> problem. The former Chancellor could not have picked a worse time to reduce interest rates. To my mind that was a far bigger mistake than the heavy intervention (although I would not want to defend that either). Interest rates are the touchstone of overall monetary policy. And given the very high "demand

for money" (excuse the economic jargon) resulting from the factors described above, interest rates (the price of money) should not have been allowed to drop below, say, 12 per cent at any point. But in fact they were lower than that all the way from early 1986 to mid 1988.

B. Where Are We Now?

The present state of the economy is still very hard to read. Demand is surprisingly resilient, but I think it is clearly slowing down. Indeed if it were slowing more than it is, the threat of a recession would be very great. I would guess that the higher community charges to finance greater than planned local authority spending could on balance restrain demand a bit further. And hopefully the stagnation in the housing market will provide a salutary lesson for personal borrowers.

The key problems are the monetary aggregates and retail prices. Broad money will stay difficult to interpret, particularly as some of the new savings measures will increase it. Narrow money needs to decelerate but, with inflation higher than expected, the 1 - 5 per cent target range is pretty tight.

I will not dwell on the RPI, which you are rightly concerned about because of the effect it could have upon wage bargaining etc. But however great the short-term problems, I continue to caution against trying to change the index now. It won't improve people's perceptions of inflation, and you will add to the problems by attracting charges of fiddling the figures. Better, I believe, to explain the oddities of the RPI and take the benefits as they unwind next year.

As to policy adjustments, a key point is that the economic indicators we are seeing now have been influenced by the policy actions in 1988, and possibly 1987. The lags are long. And if the present policy levers are held still until you are sure they are working, changes will have been left too late. If you are to get the timing of changes to interest rates right, at some point you will have to take a bit of a gamble.

C. Where Do We Go From Here?

My present guess is that interest rates ought to be reduced before the end of 1990. I do not think you should move before the summer. That would be too soon and would give very much the wrong signal - both to the markets and to private sector - against the background of a high RPI.

The choice may lie between bringing rates down in late summer/early autumn or leaving it until nearer the year end. But whenever you start the process it will be crucial not to allow rates to fall too fast or too far. In my view you should not be contemplating rates below, say, 12 per cent at any point in the next 12-18 months.

The handling of interest rates will be inextricably linked to the ERM. I share your instinctive worries about fixed exchange rate systems. But the fact is that, since the markets believe that sterling's membership of the ERM would give overall economic policies greater credibility, then it will, at any rate for a period. The Chancellor is right to say that the prospect for achieving some reduction in interest rates over the next year will be considerably enhanced by being in the system rather than outside it. There is a good case for linking the date of entry closely to the point at which you decide it is safe to reduce interest rates.

But the main danger of ERM membership later this year is that, because for a period this will give the markets greater confidence in sterling, there could be strong pressures to reduce interest rates more than is prudent on domestic grounds. You must resist that, and so avoid a repeat of the early 1988 mistake.

That means ensuring that the Chancellor will agree, once we are a member, to insist on a revaluation of sterling if there is strong market pressure to push it up.

To revert to timing. If you judge that it is appropriate before the end of this year both to start to bring interest rates down and to join the ERM there seem to be two main possibilities:

a) late September/early October. There may just be enough of a drop in the RPI by then, and you could seize the initiative in the Party Conference season and before Parliament reassembles.

b) around the time of the Autumn Statement in November. This would come before the IGC, and so strengthen the UK's hand there. And this could be a good time to give policy a greater credibility in market terms because you may be forced in the Autumn Statement to present some uncomfortably high public expenditure numbers.

I make this last point because I believe the Chief Secretary was right the other week to stress just how difficult the public spending round will be.

I know the Treasury always says this. But I judge this year will be by far the most difficult since the early 1980s, both because of the cyclical effects and the strength of the pressures for more spending on politically sensitive programmes. And this will be the more difficult to handle because I do not think that the public sector surplus this year will turn out to be as high as the £7b forecast. We have constantly under-estimated the extent of the swings in the PSBR, and my guess is that, net of the £5b allowed for privatisation proceeds this year, we could well be running a deficit before the end of 1990-91. So you must be cautious on fiscal as well as monetary policy.

PAUL GRAY
11 APRIL 1990

a:\economic\economy.mrm

File [illegible]

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

11 April 1990

Dear Colin,

MR. KEN HARGREAVES MP'S TEN MINUTE RULE BILL

The Prime Minister has seen the Home Secretary's letter of 10 April to the Lord President and has noted the proposed handling of Mr. Ken Hargreaves' Bill for a national lottery for the benefit of the arts, sport and the environment.

I am copying this letter to the Private Secretaries to the members of L Committee, Stephen Wall (Foreign and Commonwealth Office), Roger Bright (Department of the Environment), Martin Le Jeune (Office of the Minister for Arts and Libraries) First Parliamentary Counsel, Sonia Phippard (Cabinet Office) and to the Secretaries to Legislation Committee.

Yours,

Paul

PAUL GRAY

Colin Walters, Esq.,
Home Office.

MCM

Read and replied to Home Office 16.6.20

CABINET OFFICE

Barry

You agreed to get the Prime Minister's views on

With the compliments of

this warrant.

Caroline
Do you deal with this?
BHP 11/4

Rosalind McCool
11/4

PS. I am not in the office so could you let the Lord President's office know whether she is content.

70 Whitehall, London SW1A 2AS
Telephone 01 270

QUEEN ANNE'S GATE LONDON SWIH 9AT

Prime Minister

To note the latest position on national lotteries.

10 April 1990

MR KEN HARGREAVES MP's TEN MINUTE RULE BILL TO MAKE PROVISION FOR A NATIONAL LOTTERY TO BE HELD FOR THE BENEFIT OF THE ARTS, SPORT AND THE ENVIRONMENT IN THE UNITED KINGDOM

Ken Hargreaves is to seek leave in the House of Commons on Wednesday, 18 April to bring in a Bill "to make provision for a national lottery to be held for the benefit of the arts, sport and the environment in the United Kingdom".

The policy on major lotteries, on a national scale, which H Committee has agreed, means that we are not in a position to allow Ken Hargreaves to proceed with his proposed Bill. It is doubtful if the Bill would be intended to provide for a state lottery, i.e. a national lottery run by the Government. If it were to provide, that would be contrary to our policies on deregulation and privatisation, as well as involving the state in the promotion of gambling. It is much more likely that Ken Hargreaves' aim is a single, monopoly major lottery, on a national scale, run by the private sector but subject to regulation to prevent fraud, with part of the profits intended to benefit specific causes (in this instance, the arts, sport and the environment).

H Committee has already agreed, in correspondence, that a collective decision on whether or not to amend the law to allow one or more such major lotteries should be deferred until we have seen how a major skill competition, "Skil-Ball", which is due to be launched later this month, fares. The relevant correspondence is my letter of 21 December 1989 to you in your capacity as Chairman of H Committee (a letter headed: 1. Paper on the introduction of a major lottery or lotteries; 2. "Skil-Ball" competition, copied to the Prime Minister, Douglas Hurd and Richard Luce), and your reply of 5 February conveying H Committee's agreement to the proposals in my letter.

My current aim is to circulate in the summer proposals on major lotteries for subsequent discussion in H. As proposed in my letter of 21 December, in the interim our position continues to be that we have no plan to amend the law to allow a major lottery or lotteries, but that we continue to keep the matter under consideration.

The Rt Hon Sir Geoffrey Howe, QC., MP.
Lord President of the Council
Privy Council Office
WHITEHALL, S.W.1.

/over....

My letter specifically anticipated that proponents of a national lottery for the arts, sport and the environment, including Ken Hargreaves and Lord Birkett, might attempt to further their cause by initiating a Parliamentary debate or by introducing a Private Member's Bill. H Committee agreed that, in such an eventuality, we should deploy arguments which seem to tell against major lotteries, although as factors which need to be taken into account rather than reasons firmly to conclude against any change in the law. Among these factors are that a major lottery or lotteries could:

(a) contrary to overall policy, stimulate gambling both directly and by leading to pressure for compensatory deregulation from the established gambling industry;

(b) prejudice Government revenue from established gambling, unless the lotteries were themselves subject to a specific, compensatory duty;

(c) even were they run exclusively for charitable purposes, possibly prejudice both current, small-scale charitable lotteries and personal charitable giving more widely; and

(d) embroil us in invidious decisions about which causes should benefit, and which should not.

Robin Ferrers deployed these considerations in responding, on 28 February, to a debate in the House of Lords on a national lottery for the arts, sport and the environment, which Lord Birkett had initiated. I would similarly deploy them in a letter to Ken Hargreaves, after the introduction of his Bill but before the date scheduled for its Second Reading, explaining why we cannot support it.

In the light of the policy position agreed by H Committee, I imagine that you and colleagues on L Committee will agree that Ken Hargreaves' Bill cannot be allowed to proceed. I do not think that the motion need be opposed and I suggest that, if there is a division, Ministers should abstain. But any Bill should be blocked at Second Reading.

I am copying this letter to the Prime Minister, other members of L Committee, the Foreign and Commonwealth Secretary, the Secretary of State for the Environment, the Minister for Arts and Libraries, Sir Robin Butler, First Parliamentary Counsel and the Secretaries to Legislation Committee.

R5/4 A

COPY NO 1

PERSONAL AND CONFIDENTIAL

OUTLOOK FOR RPI\TPI: MARCH AND APRIL 1990

March's figures

In March the RPI is expected to show a rise in the annual rate of inflation to about 8.1 per cent, from February's 7.5 per cent. This mainly reflects the latest increases in mortgage interest rates. Excluding mortgage interest payments the annual rate is likely to rise slightly to 6.3 per cent in March from February's 6.2 per cent.

2. The annual rate for the TPI is expected to increase to around 6.8 per cent, following 6.2 per cent recorded for February.

3. Between February and March the all-items RPI is expected to show an increase of some 1.0 per cent compared with 0.4 per cent over the same period a year ago. In addition to the increase in mortgage interest rates which added about 0.4 per cent to the RPI this March, there were further increases in food prices, some rises for household goods and clothing reflecting the ending of many seasonal sales discounts, and some increase in the prices of second-hand cars.

Outlook for April's RPI

4. The annual rate of inflation is likely to rise sharply in April to about 10 per cent or a little above. The index is now expected to rise by some 3.6 to 3.8 per cent between March and April, around 2 per cent more than in April 1989. There are many price rises which traditionally take place in April, but for many items the increases this year will be greater than a year ago: Community charge (compared with rates), rents and utilities and the effect of duty increases on alcohol, tobacco and petrol announced in the Budget. Some further rises are likely for milk and other food items. The annual rate excluding mortgage interest payments is likely to rise to some 8.5 to 8.7 per cent in April.

PERSONAL AND CONFIDENTIAL

Percentage changes

	RPI: all items		RPI excluding mortgage interest payments	TPI
	over 1 month	over 12 months	over 12 months	over 12 months
1989				
Sept	0.7	7.6	5.8	7.6
Oct	0.8	7.3	6.1	6.0
Nov	0.9	7.7	6.1	6.4
Dec	0.3	7.7	6.1	6.4
Jan	0.6	7.7	6.1	6.3
Feb	0.6	7.5	6.2	6.2
Outlook				
1990				
March	1.0	8.1	6.3	6.8
April (likely range)	3.5-3.7	9.9-10.1	8.4-8.6	8.2-8.4

The final figures for March will be circulated next Tuesday pm, in advance of publication on Thursday 12 April.

BRANCH E2
CSO

6 APRIL 1990

chex.kf/ds/92 **CONFIDENTIAL**

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

PRIME MINISTER

RPI FOR MARCH AND PROSPECTS FOR APRIL

I have just seen the CSO's note of 6 April giving the outlook for the RPI over the next two months.

The likely outturn for March is precisely in line with our expectations. All-items RPI inflation is expected to rise to 8.1 per cent, with a small rise in the rate excluding mortgage interest payments to 6.3 per cent.

However, the CSO have significantly revised up their earlier forecast of the likely inflation rate in April (prepared as recently as 22 March) from a range of 9.4 - 9.6 per cent to 9.9-10.1 per cent now.

A number of factors have combined to make them more pessimistic about April's inflation outlook. Shell, Esso and Texaco have announced petrol price increases in the wake of an increase in the Rotterdam spot petrol price in the last week or so. This seems to reflect uncertainties about supply and buoyant European demand.

Another factor is that CSO have revised down their estimate of domestic rates per head last year to compared with the community charge this year. The upshot is that because the base is lower in

N.B. Then the RPI has been too high ever since last year and should be lowered retrospectively. They cannot have it both ways.

1989, the increase in community charge next month is bigger and has a larger impact on the RPI. This is a further one-off problem associated with switching from rates to community charge. We will not have the same problem next year because this year's community charge will be a fixed and unalterable base. Even so, I have asked my officials to pursue with CSO whether the downward revision to rates per head last year is justified. We shall see.

CSO have made no allowance in their April estimate for community charge capping. They are investigating their guidelines to see whether there is scope to make allowances for it by the time they actually publish the April number. As it stands the guiding principle laid down by RPIAC suggests that we have to use the current liability for community charge, and to make the actual change to the RPI when the new capped figure becomes operational. But there may still be room to take the effect into account. If there is, the April figure could be lower by up to 0.1 per cent.

But on present information inflation is still likely to be around 10 per cent in April. Such a prospect is very worrying, and there are no practical policy options to reduce this. But I am increasingly disturbed that such a key concept as the RPI is so badly defined. It includes mortgage interest payments which means that essential counter-inflationary interest rate increases perversely raise inflation. Canada apart, we are the only major country to include such effects in their measure of consumer prices.

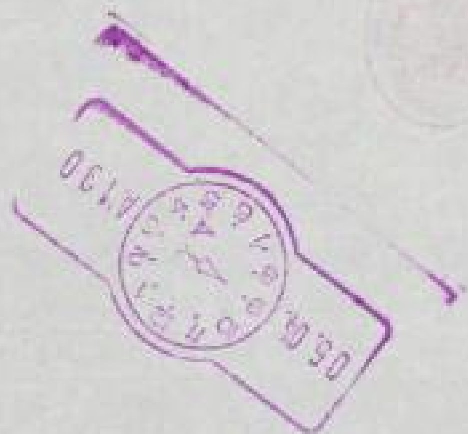
It also includes community charge, which arguably it should not. And the RPIAC, whose recommendations are so seemingly important to the methodology of the RPI, have a record of taking decisions which, no matter how well-meaning (or perhaps self-serving on the part of the lobbies represented), present us with great difficulties.

These latest developments all confirm yet again the damaging consequences of being guided by such a body as the RPIAC as it is now constituted. When their current work programme is completed, I am minded to alter the composition of the Committee and I am considering other options. One approach which has attractions would be to take an initiative in the EC to investigate a measure of retail prices which might find agreement among all member countries. There must be a better way to measure them than we currently do. If you agree I could suggest this to Christopherson when next I write to him. I am sure that given the current practice in other European countries any such investigation would not endorse the inclusion of mortgage interest payments but the process of reaching agreement could be long drawn out. However, before embarking upon this course, I have asked officials to prepare an urgent note on the policy implications of a public posture that will imply we are contemplating a significant change to the RPI.

John M.

[J.M.]

6 April 1990



MAMC: F1

COPY NO. 4 OF 17 COPIES

FROM: MISS M O'MARA (MG1)
DATE: 6 April 1990

1. SIR PETER MIDDLETON
2. CHANCELLOR OF THE EXCHEQUER

cc: Sir T Burns
Mr Wicks
Mr H P Evans
Mr Monck
Mr Odling-Smee
Mr Scholar
Mr Peretz
Mr Riley
Mr Sedgwick
Mr Walsh
Mr Grice OR
Mr O'Donnell
Mr Brooks
Mrs C Williams
Mrs Chaplin
Mr Tyrie

Mr Cassell-Washington

Copies attached for:

Chief Secretary
Financial Secretary
Economic Secretary
Paymaster General

MONTHLY MONETARY ASSESSMENT: MARCH 1990

This note records the discussion at Sir Peter Middleton's monthly meeting on monetary conditions held on 4 April. The usual Monetary Assessment is attached.

Sir Peter Middleton's meeting

2. Invited to open the discussion, Mr Scholar said the main changes from the February assessment had been the rise in mortgage interest rates implemented from 1 March and the associated fall in consumer confidence. Against those had to be placed the strong retail sales figure for February and the rise in building society commitments in the same month. These developments apart, the picture did not differ greatly from that which he had presented when he had last attended the meeting two months previously.

3. The monetary indicators remained pretty much out of kilter with those for the real economy. The acceleration in MO growth seemed to have checked in March but MO showed no sign of returning to its target range. The growth of broad money remained stuck in

the upper teens, with measures of retail money gradually slowing but wholesale money accelerating to reach a 12-month growth rate of 35 per cent. The exchange rate was more or less exactly where it had been a month before, having fallen to 85.3 in effective terms in the interim. Money market interest rates were also largely unchanged, although they had risen towards danger levels for a short period around the time of the mid-Staffordshire by-election. The real economy looked pretty flat in general. Car sales were sharply down in February and the fall in commercial vehicle registrations might lend weight to the view (reflected in the CSO's figures for 1989Q4) that company spending was at last beginning to react to the tightening of policy.

4. We had been concerned in recent months that the uptick in retail sales, together with the acceleration of M0, might suggest that the gradual slowing-down of the economy throughout 1989 could have come to an end or even been reversed. This should continue to be entertained as a possible hypothesis; the markets too would watch the next crop of indicators very carefully and edgily.

5. As to policy, Mr Scholar said he continued to believe there had been, to some degree, an unintended overall easing of policy: the effective exchange rate had averaged 88 since end-September, compared with 93 in the preceding six months, and although short-term interest rates went up about 1 per cent between these two periods, real rates were falling and were set to fall further as the RPI rose in the coming months. Fiscal policy had either loosened (mainly through higher public expenditure) or had turned out looser than originally thought (through lower corporation tax receipts) - probably a bit of both - and had been largely unaltered by the Budget. Meanwhile, underlying inflation had been drifting up over the last 2-3 years. This suggested that the original policy had not been sufficiently tight.

6. Mr Scholar suggested economic developments over the last month or more had not altered the earlier judgement on the balance of risks between an unchanged and a tightened monetary policy. There was therefore no occasion to recommend a change in current

policy. But he hoped for a spontaneous rise in the exchange rate and noted that raising interest rates could not in any case be guaranteed to tighten policy through a rise in the exchange rate. He would not want to accommodate any further loosening, if sterling were to weaken.

7. Mr Coleby said he agreed with Mr Scholar's policy conclusion and, very largely, with his analysis. On policy, the Bank were also concerned about the implications of the exchange rate's behaviour for the stance of policy and the consequences of lower real interest rates, stemming from higher inflation. He noted the behaviour of the markets had been nothing like as damaging as might have been feared over the last month; they had showed encouraging resilience in the face of discouraging events. Nevertheless, they remained extremely vulnerable and if the exchange rate weakened, it might prove necessary to tighten interest rates. However, he pointed out that on recent occasions of exchange rate weakness, it had been clear that a rise in interest rates would not have been helpful.

8. On the analysis, Mr Coleby suggested that the authorities needed to continue to keep an open mind about the behaviour of personal spending. Corporate spending appeared to be declining fairly decisively and he regarded the February figures for bank lending to the corporate sector as entirely consistent with that view. However, he remained uneasy about the growth of personal spending: real incomes were continuing to grow at rates that could support an increase of 2 per cent or more in consumption. He noted the difficulty of interpreting monthly growth rates for M0, given the problems of seasonal adjustment. It was therefore probably best to focus on the 12-month rate.

9. Sir Terence Burns agreed in general. There were some signs that the corporate sector was now quite weak but the personal sector appeared to have strengthened slightly. Almost all the real indicators for the corporate sector indicated some slowdown but the growth of retail sales seemed to have picked up and the growth of notes and coin exhibited a similar pattern. There also

appeared to be some evidence of a pickup in the housing market. He thought it required a degree of optimism to expect that the decline in the corporate sector would offset the growth of personal spending.

10. MO and the exchange rate caused him most concern and he noted that inflation had taken a distinct turn for the worse in the last two months, as the underlying rate began to edge up, after reaching a plateau. GDP growth also still seemed to be above expectations. Nevertheless, he agreed there was no stronger case than before for higher interest rates, although the date when they might be reduced now looked further away. In general, the picture was a disappointing one: we were facing a longer, tougher and harder road than we had earlier expected.

11. In discussion of the external position, it was pointed out that neither the Bank nor the Treasury (in the G7 deputies context) had gained the impression that the Germans were actively considering an increase in interest rates. However, it was possible that if the German Government did not adopt the Bundesbank's proposals on the rate of conversion between ostmarks and deutschemarks, the Bundesbank might raise German interest rates in retaliation. The Germans had to publish their legislative proposals on GEMU in early May but it was not known whether they had to decide on the conversion rate by then. It was unclear what implications a rise in Japanese interest rates would have for other countries.

12. Summing up, Sir Peter Middleton drew attention to the conflicting signals given by the economic indicators from one month to the next. It was difficult to rely on any: interpretation of MO growth was clouded by seasonal adjustment problems, it was hard to judge how much of M4 represented longer term saving (and would be harder still, following the Budget measures), while the retail sales figures appeared to be distorted by special promotions. If the Government was to meet its inflation objective, a tighter policy was clearly desirable but all recognised the constraints and the dangers of overkill.

However, this was just the risk the authorities had run a year ago. The overall picture had changed very little from the previous month. Although the personal sector might have strengthened, the corporate sector showed signs of slowing and the external threat had receded but had not disappeared. Nevertheless, there remained a definite risk that interest rates would have to be increased to prevent a weakening of the exchange rate. The longer the ambiguity about the extent of the economy's adjustment remained, the stronger the case for tightening policy, depending on the priority which was attached to meeting the Government's inflation objective.

MOM

MISS M O'MARA

cc: Governor)
Deputy Governor)
Mr Flemming)
Mr Coleby) Bank of England
Mr Plenderleith)
Mr Allen)

Professor Griffiths No.10

SECRET

MONTHLY MONETARY ASSESSMENT: MARCH 1990

Summary Assessment

While signals from the real side of the economy are not unanimous, their balance is that the economy probably continues to slowdown. Recent figures however suggest a slight recovery in the personal sector, offset by continued slowdown in company spending. The message of the monetary indicators remains less comforting, with the resilience of MO's growth rate consistent with some recent buoyancy in consumption. International prospects for interest rates and inflation remain potential threats.

Main Points

MO's twelve month rate was 6.3 per cent in March, (February 6.4 per cent). MO is projected to fall within the 1-5 range by the end of the year. (paras 34-36)

M4's twelve month growth in February was 18.1 per cent. M4 lending increased more strongly than last month, by 1.4 per cent (£7.3 billion); its 12 month rate rose to 20¾ per cent from 20½ per cent. Company borrowing increased sharply. (paras 38, 45, 49)

Sterling's effective rate is 87.9, ¼ per cent higher than at the last Assessment and 8 per cent below its level in March 1989. (para 32)

Internationally, interest rates have risen in Japan and are likely to rise in Germany. No change is expected in the US. (para 5)

Retail sales rose sharply in February, by 2½ per cent. But consumer confidence dropped to record lows in March following the mortgage rate rise. (para 11)

RPI inflation fell to 7.5 per cent in February but is expected to be higher in March. Excluding mortgage interest payments inflation was 6.2 per cent in February having previously stuck at 6.1 per cent for four months in a row. (para 19)

House prices have levelled out, although the 12 month change continues to fall, with prices now at the same level as a year ago. Housing market activity seems to have picked up slightly. (paras 23-24).

ANNEX: PROFITABILITY IN MANUFACTURING
MG2 Division
6 April 1990

SECRET

Monetary developments

Latest outturns available at time of:

	Sept Report	Jan Report	Feb Report	Mar Report
Monetary aggregates (12 month % growth)	**(Aug)**	**(Dec)**	**(Jan)**	**(Feb)**
MO (sa)	6.1	6.0	5.8	6.4*
M4	17.3	18.2	18.4	18.1
M5	16.8	17.9	17.9	17.7
Bank & building society lending	21.9	21.2	20.4	20.7
Interest rates (%)	**28 Sep**	**8 Feb**	**8 Mar**	**5 Apr**
3 month interbank	14.3	15.1	15.2	15.2
20 year gilt-edged (par yield)	9.8	10.6	11.3	11.4
Yield gap	4.5	4.5	3.9	3.8
UK real 3 month interbank	7.1	8.1	7.2	6.9
Equity dividend yield (all share)	4.2	4.4	4.7	4.9
IG yield (2001) assuming 5% inflation	3.6	4.0	4.2	4.3
3 month UK interest differential with				
Germany	6.8	7.0	6.8	7.0
US	5.3	6.8	6.8	6.8
World basket	5.4	6.1	6.1	6.2+
Exchange rate				
$/£	1.61	1.69	1.64	1.64
Yen/£	226	244	248	259
DM/£	3.03	2.82	2.79	2.79
ERI	91.2	89.1	87.7	87.9
Oil adjusted ERI**	98.7	94.3	94.0	95.0
Asset prices				
FT-A Index (% pa)	23.2	8.2	3.5	4.5
FT-A Level (July 1989 peak: 1239)	1166	1164	1117	1111
Halifax house index (% pa)***	14.2	2.8	3.0	1.6

* March 6.3 per cent (estimate)

** The oil adjusted ERI shows whether the joint effect of oil price and exchange rate changes has been counter-inflationary or otherwise, relative to the base period Jan 1983-Nov 1985, on the assumption that the inflationary effect of a 4 per cent rise in oil prices is exactly offset by a 1 per cent rise in the exchange rate.

*** 12 month growth rates shown are for August, December, January and February. March 0.0 per cent. See table 11 for further details

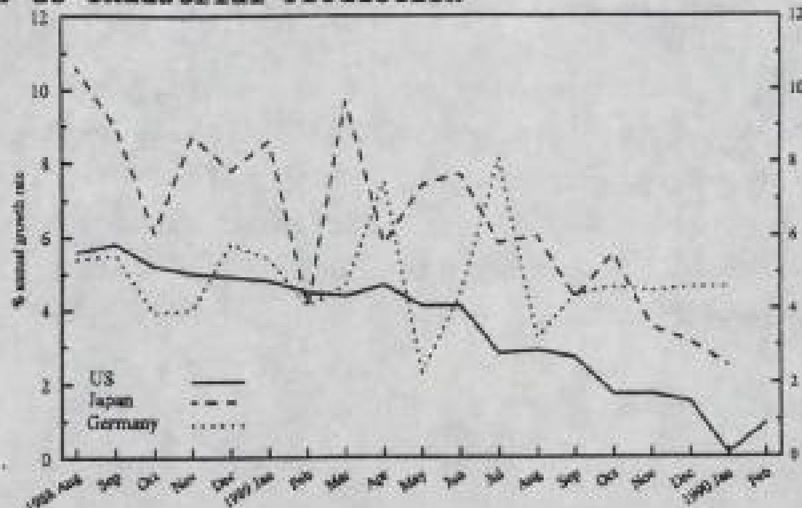
\+ estimate

A. EXTERNAL DEVELOPMENTS

Activity and Inflation

1. **Activity** in the US may now be picking up a little; employment growth in February was unexpectedly strong, capacity utilisation in manufacturing rose, and industrial production increased by 0.9 per cent (but was still less than 1 per cent higher than a year earlier). GNP in 1989Q4 has been revised up slightly - the annual growth rate is around 2½ per cent. Although Japanese industrial production rose by only 2.5 per cent in the year to January, underlying growth there remains strong - GNP increased by 4.7 per cent in the year to 1989Q4. German industrial production rose by 4.6 per cent in the year to January and revised GNP figures show 3.6 per cent growth in 1989Q4 on a year earlier.

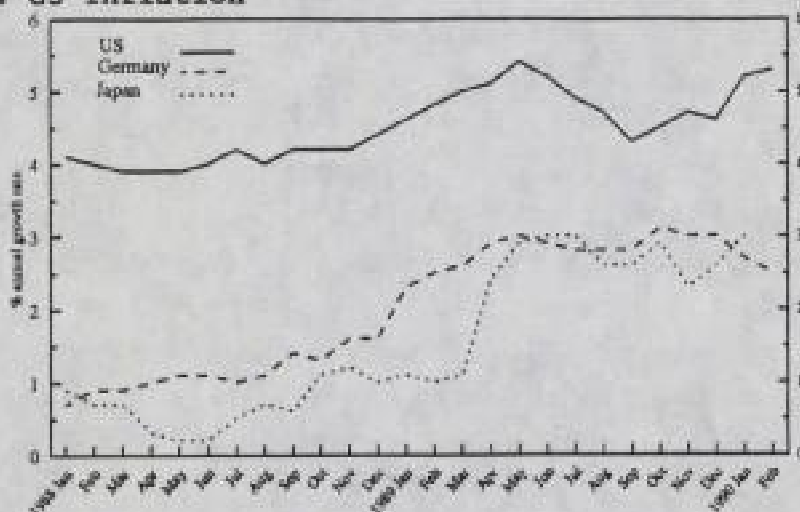
Chart: G3 Industrial Production



2. **Inflation** showed little change in February in the major economies, after January's increase. German consumer price inflation fell to 2.5 per cent in February from 2.7 per cent in January; producer price inflation edged up from 1.6 per cent to 1.7 per cent. US consumer price inflation increased slightly from 5.2 per cent to 5.3 per cent. Producer prices changed little overall in February - non-energy goods prices rose while energy goods prices fell back after January's sharp rise; the overall twelve month rate dropped to 5.1 per cent from 5.8 per cent in January, largely reflecting a

sharp rise in prices a year ago which has now dropped out of the calculation. Japanese wholesale prices increased by 0.1 per cent in February and were 3.5 per cent up on a year earlier (January 3.7 per cent).

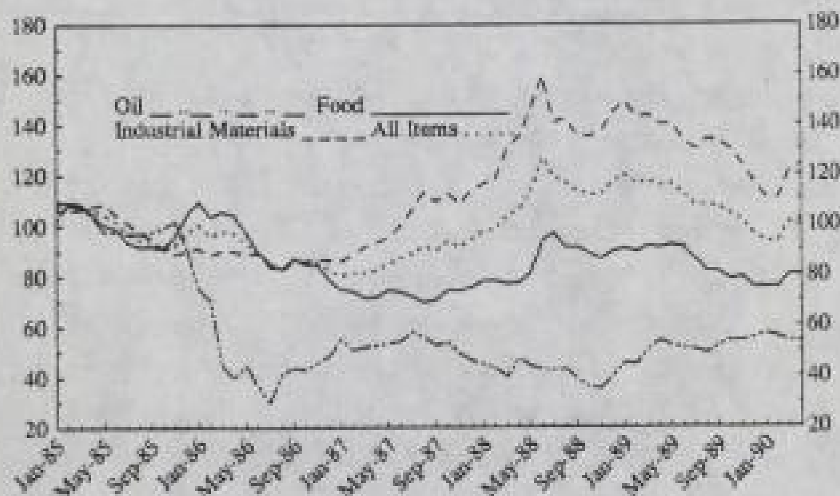
Chart: G3 Inflation



Commodity Prices

3. **Non-oil commodity prices**, measured in SDRs, have risen by about 3 per cent since the last Assessment. Metals, food and non-food agricultural prices were all slightly up. **Oil prices** have fallen on continued Kuwaiti over-production, with Brent down from just under $19 barrel at the last Assessment to $18.

Chart: Commodity Prices



Current Accounts

4. The US fourth quarter current account deficit fell to $20.6 billion due to improved net IPD receipts. The total for 1989 was $106 billion (2.0 per cent of GNP), down from $127 billion (2.6 per cent of GNP) in 1988. The Japanese current account was temporarily in deficit in January due to higher oil prices and various seasonal influences. The US deficit and Japanese surplus are expected to increase slightly as percentages of GNP in 1990, but the German surplus should fall as resources are diverted to the reconstruction of the GDR.

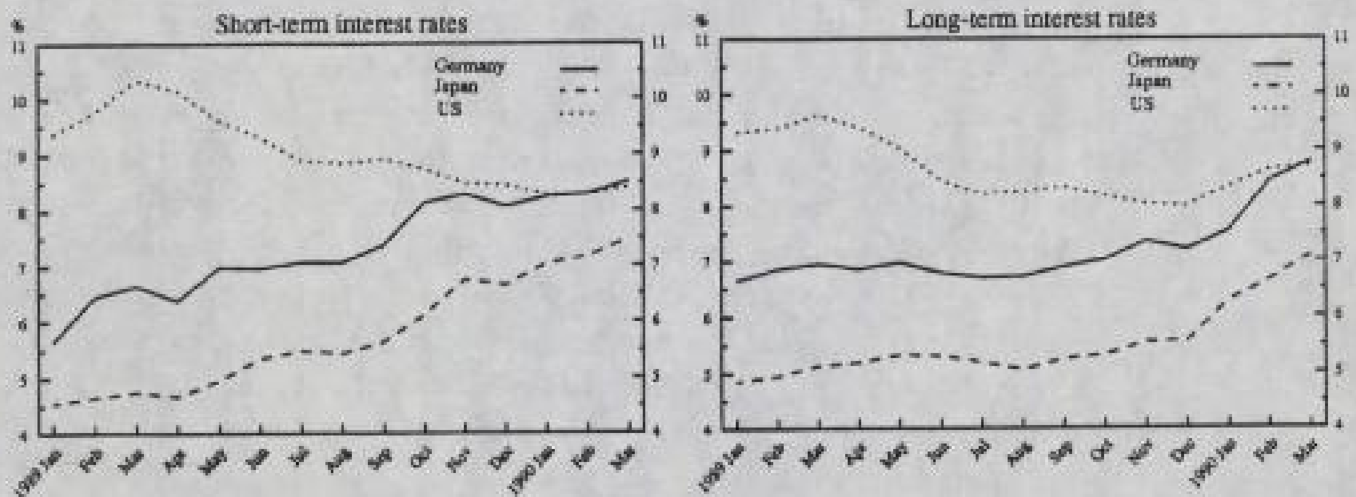
Financial Markets

5. Japanese official interest rates rose by 1 per cent on 20 March to 5.25 per cent, after continued intervention had failed to stop the yen's slide. But the Japanese markets' initial reaction was that the rise may not be sufficient. Short term market interest rates had risen in advance of the well advertised rise in the official rate, and at 7.5 per cent are less than ½ per cent higher than at the last Assessment. In the US, short-term interest rates are little changed since the last Assessment, and no change is expected in official rates. In Germany market rates have fallen a little, reflecting, perhaps, confidence in the authorities' insistence that inflationary pressures arising from German re-unification will be controlled. But further increases in German official interest rates are still likely before the end of the summer - perhaps when ostmarks become convertible for deutschemarks.

6. Bond yields are hardly changed in the US or Japan since the last Assessment. But in Germany they have fallen around ½ per cent, reinforcing the view that financial markets now have greater confidence in the authorities' determination to avoid inflation.

7. Share prices in the US have risen a little since the last Assessment - up about 1 per cent (chart 14). But in Japan they have fallen another 19 per cent and are about 28½ per cent below their peak of December last year. The sharp fall reflects an end to the expectation of continuing capital gains which had been necessary to keep up interest in Japanese equities at negligible yields. Confidence has been hit by the prolonged public wrangle between the BoJ and the Ministry of Finance about monetary policy and by higher bond yields worldwide. If prices stabilise near current levels, no reaction is expected from the BoJ. Nor are the macroeconomic effects arising from the fall in asset holders' wealth expected to be significant: investment trusts have large reserves; and the exposure of financial companies is, on the whole, small. Currently, the main worry is that a consequential fall in land prices would affect the security backing many corporate loans.

Chart: Long Term and Short Term Interest Rates

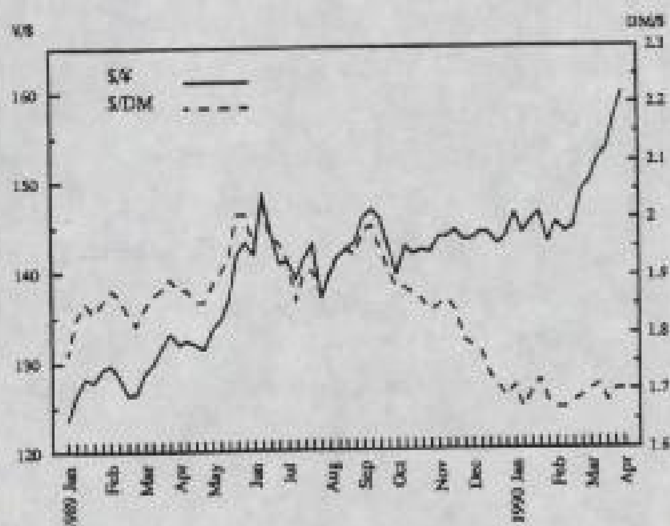


<u>Dollar</u>

8. The dollar has been out of the spotlight, falling ½ per cent to DM1.70 but rising 4½ per cent to Y158 since the last Assessment. The deutschemark strengthened briefly as the East German election results were seen as accelerating the path to German re-unification, but eased later on concern

about the Baltic states. The yen was adversely affected by the weakness in Japanese equity prices and the postponement of the expected rise in Japanese discount rate which, when it came, failed to relieve the pressure. Amidst continuing market uncertainty and the absence of any apparent results from the Brady/Hashimoto talks, the yen fell below Y160 before a minor recovery on hopes that G7 might agree a support package for the yen. Japan and the US intervened in support of the yen - Japan selling $3 billion and the US buying $¼ billion worth of yen. The ERM traded inside its margins with the lira consistently at the top.

Chart: G3 Exchange Rates



B. DOMESTIC ACTIVITY AND INFLATION

9. Overall, the economy seems to be growing slowly at present. But it is not clear whether demand growth is slowing further or, on the contrary, starting to pick up again. The FSBR forecast projects a small fall in the level of domestic demand in 1990. But strong net export growth means that real GDP is forecast to grow at 1 per cent. Retail price inflation is forecast to rise sharply in March and April, but thereafter to fall to 7¼ per cent in the fourth quarter of 1990 and 5 per cent in 1991Q2.

10. In 1989, GDP growth was 2¼ per cent. **Non-oil GDP(O)** grew by nearly 3¾ per cent but it slowed rapidly during the year, and in the second half was only 2.7 per cent higher than a year earlier - about the same as the economy's sustainable rate of growth. The growth of the GDP deflator for 1989-90 as a whole is now forecast at 6¾ per cent, down from 7 per cent in the Autumn Statement - largely reflecting lower than expected quarterly outturns to date for consumer prices. But the forecast for money GDP growth is unchanged from the Autumn Statement forecast at 8½ per cent. It is projected to slow to 7½ per cent in 1990-91.

Demand

11. **Retail sales** in February were nearly 2½ per cent higher than in January. In the latest 3 months, they were over 2 per cent higher than a year earlier, and 1¾ per cent higher than in the previous three months. Both figures represent an increase compared with the end of last year. Part of the February rise looks to be a seasonal pattern in food sales, but the increase also reflects higher sales of household goods - a sector recently in the doldrums. These figures by themselves suggest that retail sales growth may have picked up since December. But other monthly indicators do not support this.

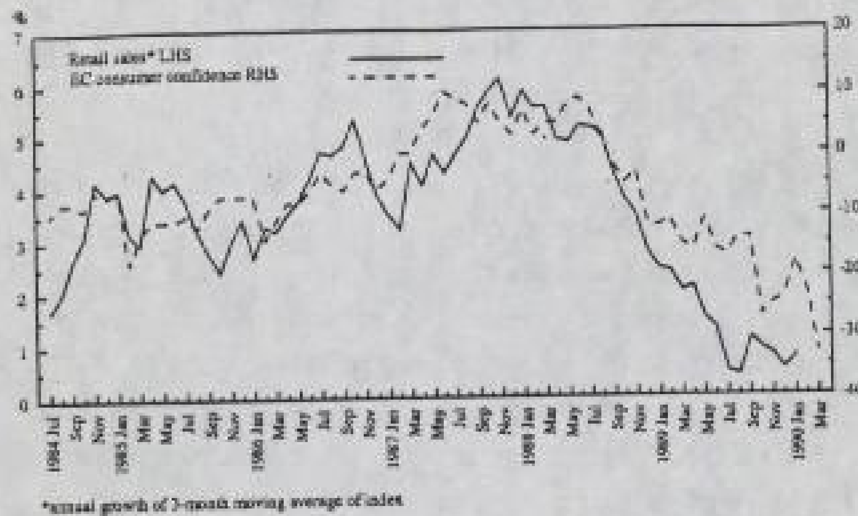
- The **EC/Gallup consumer confidence index** for March fell sharply from the already depressed February level to a new record low following the mortgage rate increase (see chart below).

- **John Lewis's sales** in the six weeks ending 10 March, were only 5 per cent higher in value terms than a year earlier, implying lower sales volumes (more recent figures are distorted by the difference in the timing of Easter in 1989 and 199). Food sales were 9½ per cent higher (reflecting at least in part high food price inflation) but department stores' sales rose only 1¼ per cent. Other major retailers also seem to think that spending was weaker in February than indicated by the official figures.

- The **CBI/FT distributors' survey** showed the balance of retailers reporting sales in February higher than a year earlier down from January's erratically high figure, though this survey has not been a reliable indicator.

12. The FSBR forecast projects virtually no change in consumers' expenditure during 1990, with a rise of ½ per cent between 1990Q4 and 1989Q4. The savings ratio, which is thought to have risen by 1¼ percentage points during 1989, is expected to rise another ½ per cent during 1990. But the projected slowdown in consumption growth largely reflects lower real income growth.

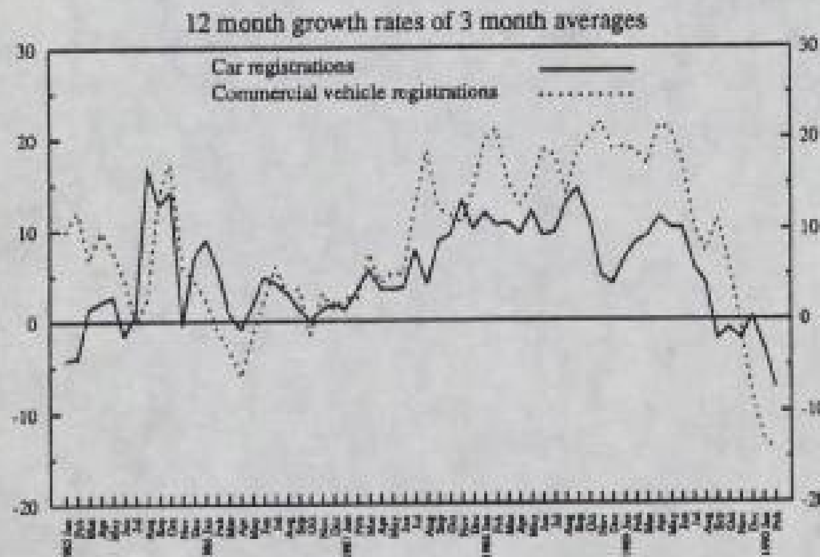
Chart: Retail Sales and Consumer Confidence



*annual growth of 3-month moving average of index

13. **Total car registrations** continue to fall: **new car registrations** in February they were 15½ per cent lower than a year earlier. In the latest three months they were nearly 8¾ per cent lower than a year earlier, and ¼ per cent down on the previous three months. Within the total personal sector registrations were 19 per cent lower in February than a year earlier, and companies' registrations 12½ per cent lower.

Chart: Car and Commercial Vehicle Registrations

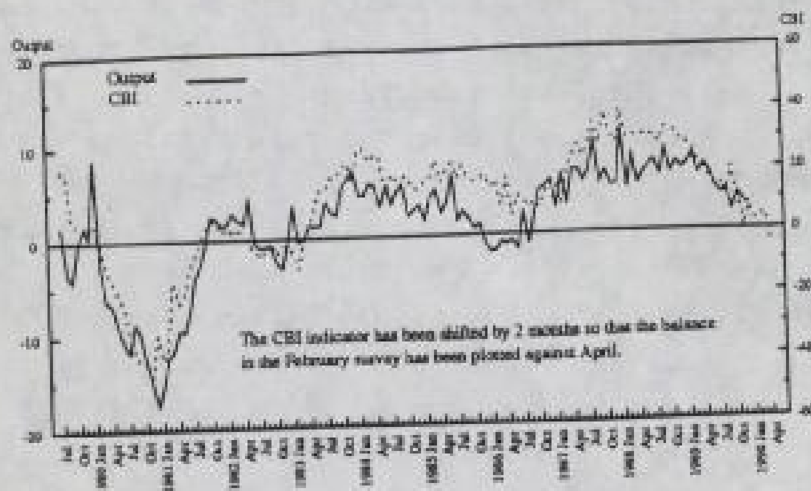


14. **Commercial vehicle registrations** were 10 per cent lower in the three months to February than in the previous three months, and 14½ per cent lower than a year earlier. Apart from this there is no news on company sector spending so far in 1990. **Business investment** fell in the fourth quarter of 1989, which also saw the first signs of significant destocking by manufacturers. It could be that firms have started to react to the pressure on their profits in the second half of last year (see also Annex). ICCs' financial deficit is estimated at £23½ billion in 1989 (subject at this stage to wide margins of error). If confirmed, this would be three times are large as in 1988. The ease with which firms are able to finance this deficit (rather than being forced into action to reduce it) will be crucial to of the adjustment of the economy as a whole. The latest CBI survey suggests firms expect little change in output over the next few months. Total order books fell again, while export order books increased from an already high level (table 7). The proportion of firms reporting stocks higher than adequate rose significantly in the March CBI survey.

Output

15. **Manufacturing output** fell by ½ per cent in January, and in the latest three months was less than 2 per cent higher than a year earlier. There has been no trend recently in manufacturing output - in the latest three months it was slightly lower than in the previous three, and it has been more or less unchanged since the start of 1989. **Energy and water output** fell 2½ per cent in January and in the latest three months was 1½ per cent lower than a year earlier. The halt to the recovery in output is said to be due to storms in the North Sea and the mild weather in January, with lower than usual energy demand. Total **industrial production** therefore remains weak and in the latest three months was only 1 per cent higher than a year earlier.

Chart: Manufacturing Output and the CBI Survey



16. **Construction orders fell again in January.** Total new orders in the latest three months were 10 per cent lower than in the preceding three months and 17 per cent down on a year earlier. Private housing orders fell particularly sharply and remain on a strong downward trend; in the latest three months they were 40 per cent down on year earlier. Public housing orders picked up a little in January (probably orders from housing associations). Private industrial and commercial orders remain low, down 10 per cent on a year ago. Construction output itself remains weak. Despite rising over 2 per cent in 1989Q4, it was still below its level in the first half of 1989, although 2½ per cent higher than a year earlier.

Trade Flows

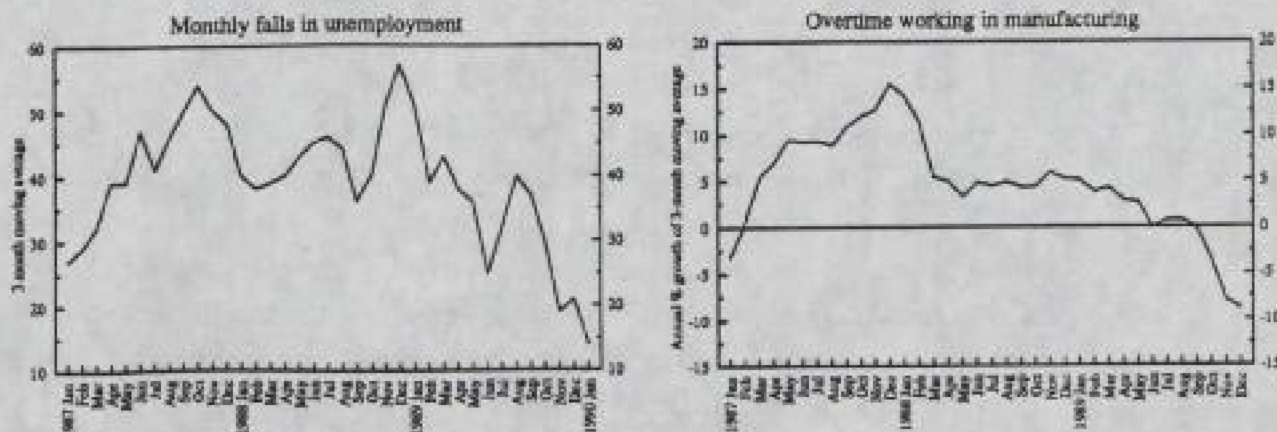
17. **Trends in trade volumes remain favourable.** In the three months to February, export volumes (less oil and erratics) were 3½ per cent higher than in the previous three months and 11 per cent higher than in the same period a year earlier. Import volumes (less oil and erratics) fell by 1 per cent and were only ½ per cent higher than a year

earlier. The latest figures are further evidence that the current account deficit is narrowing: in the three months to February the deficit was £4.6 billion compared with £5.9 billion in the previous three months. While the balance of invisibles was negative in 1989Q4, this reflected an erratic concentration of net outflows, and some recovery is expected.

Labour Market

18. The labour market statistics now seem to be reflecting the slow-down in demand and output growth through 1989. Seasonally adjusted **adult unemployment** fell by 2,000 in February, with the slowdown now affecting all regions, and the trend of **vacancies** continued downwards. **Overtime** working in manufacturing remains significantly lower than in most of 1989 despite a slight rise in January, and manufacturing employment fell. But revised estimates of whole economy **employment** show stronger growth than previously thought - in the year to September 1989, employment rose by over ¾ million. This would not be significantly slower than the rapid growth over the previous three years.

Chart: The Labour Market



Retail Prices, Producer Prices and Earnings

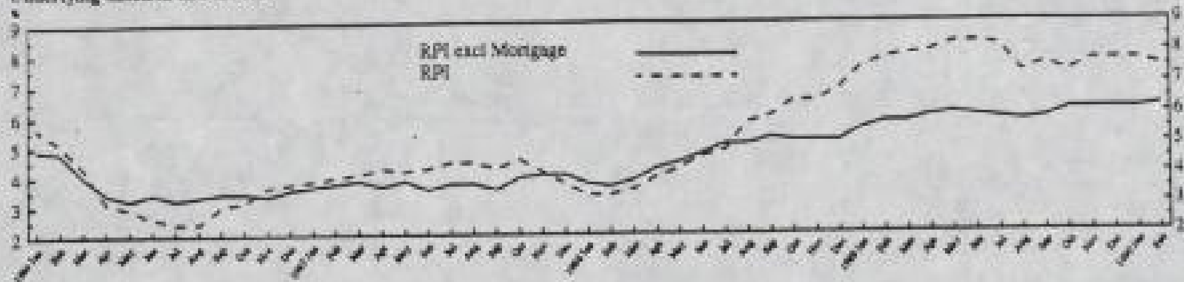
19. **All-items RPI inflation** fell by 0.2 per cent in February to 7.5 per cent, as last February's mortgage rate rise dropped out of the calculation. But underlying inflation rose: **RPI inflation excluding mortgage interest payments** increased to 6.2 per cent, having stuck at 6.1 per cent for the previous four months. Food price inflation rose sharply again and there were significant increases in the prices of DIY materials and insurance premiums. There was also a small rise in 'mainly retailed items' inflation, from 4.9 per cent in January to 5.0 per cent in February: this has hardly varied from 4.9-5.0 per cent since May last year.

20. All-items inflation is forecast to rise by 0.6 per cent in March to 8.1 per cent mostly because of the rise in mortgage rates. In addition, the latest increase in domestic gas prices will start to impact, and some further rise in food price inflation is likely. Excluding mortgage interest payments the twelve month rate may rise to 6.3 per cent. The index in April will also be affected by the introduction of the Community Charge and increases in rents and some public sector utility prices.

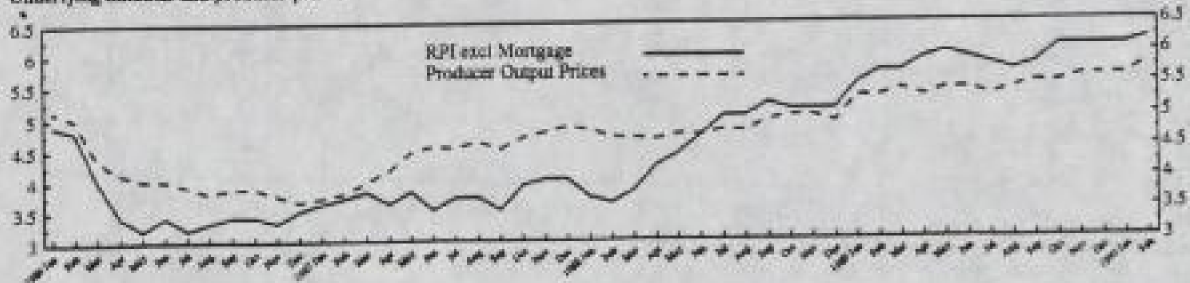
21. **Manufacturing input price inflation (excluding food, drink and tobacco)** fell by 1½ per cent in February to 0.9 per cent, reflecting falls in the prices of metals and other imported materials. But **output price inflation** picked up from 5.5 per cent in January to 5.6 per cent in February. This surprising: a pick up would be more likely in January when many manufacturers review their price lists. Nevertheless, upward revisions to both the December and January figures mean that the February outturn cannot be discounted as erratic.

Chart: Measures of Inflation

Underlying inflation and the RPI



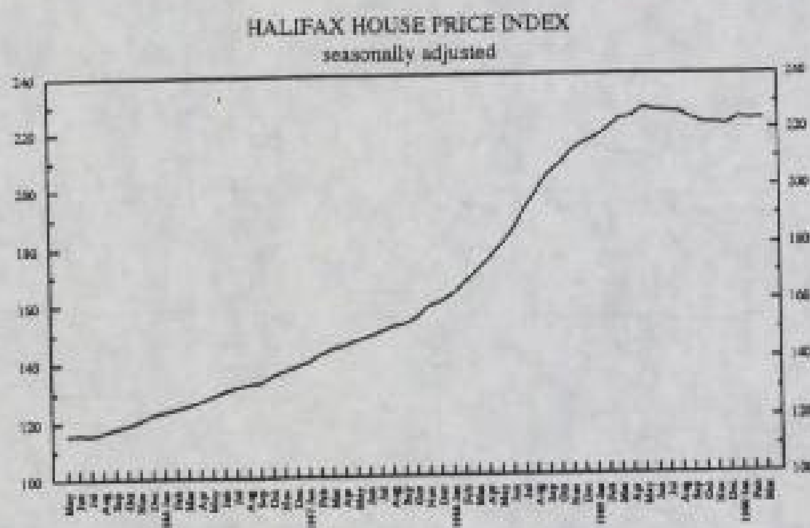
Underlying inflation and producer prices



22. **Whole economy underlying earnings growth** remained at 9¼ per cent in January (private sector 9 per cent - up from 8¾ per cent in December). Lower overtime and increased short-time working continue to reduce manufacturing earnings growth by about ½ per cent; the downward effect on whole economy earnings growth is now between ¼ and ½ per cent. DE's own confidential data show **private sector settlements** averaging 8.4 per cent in January, but the provisional outturn for February is lower at 7.6 per cent. DE expect whole economy underlying earnings growth to rise to 9½ per cent in February and to be between 9½ and 9¾ per cent in March. Some pick up in private sector wage demands seems likely in the next few months, given the expected rise in inflation. The outlook for settlements therefore depends largely on companies' response to slower domestic demand.

Housing Market

Chart: House Prices

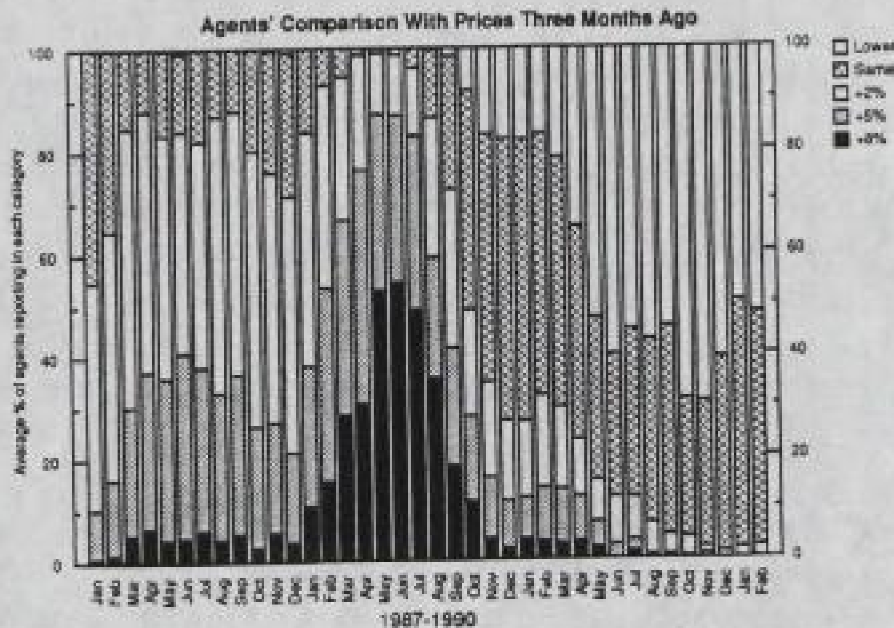


23. The Halifax house price index, after seasonal adjustment, was the same in March as in February (it rose ½ per cent before seasonal adjustment). The twelve month growth rate fell to zero from 1.6 per cent in February, and the trend in house prices is now more or less flat. The latest quarterly regional breakdown shows that prices rose in only three regions (North, North West, and Wales) in the first quarter. In East Anglia they fell 5 per cent and were nearly 20 per cent lower than a year earlier. Prices also fell significantly in the fourth quarter in the South West and the South East.

24. **The February RICS survey** reported that the rise in mortgage rates had put a stop to the increase in activity over the last two months. Unexpectedly high community charges have also dampened market confidence. Nevertheless the market was still active in East Anglia, particularly for first time buyers and for large houses, reflecting lower prices and special mortgage inducements. The North and North West were still fairly active, but recent increases in activity in Yorkshire, Humberside, the East Midlands and the

South West have come to an end. Overall, the market was slightly more depressed, with a few more agents reporting lower prices at the expense of those reporting stable prices. In the South East, 61 per cent of agents reported lower prices, and activity was half the national average.

Chart: The RICS Survey



C. PUBLIC SECTOR FINANCES AND THE FISCAL STANCE

25. The latest evidence does not alter our view of the fiscal stance in 1989-90, which looks to have turned out rather looser than projected at the time of the 1989 Budget. The 1990 Budget does not modify the fiscal stance significantly.

26. Table 9 gives the main indicators of fiscal stance. The PSDR in February was £1.0 billion, £0.3 billion below last month's forecast. The shortfall reflects £0.6 billion higher borrowing than forecast by local authorities partly offset by higher than expected repayments by public corporations and on central government own account. The public corporations' net repayment was slightly higher than forecast despite the fact that the proceeds from Giroleasing (£0.3 billion) did not come through in February as assumed, but in March.

27. In the first eleven months of 1989-90 the PSDR was £9.6 billion. The latest PSDR forecast of £7.1 billion in 1989-90 whole is consistent with slightly lower borrowing in March 1990 than in March 1989, adjusting for privatisation proceeds. Excluding special factors, local authorities are expected to borrow more than in March than last year, but this is more than offset by a slightly higher repayment by public corporations (Giroleasing) and slightly lower borrowing by central government.

Table: The PSBR

	outturns		forecasts				
			1989-90		1990-91		
	APRIL-FEB	FEB	MARCH	TOTAL	APRIL	MAY	TOTAL
CGBR	- 7.6	-1.6	2.7	-4.9	1.5	1.5	-4.8
CGBR(O)	-10.0	-0.9	5.2	-4.8	0.5	1.4	-7.7
PSBR	- 9.6	-1.0	2.6	-7.1	0.8	0.9	-6.9

Funding

28. There was a small underfund of £0.2 billion in January (see table below). Net repayments of gilts totalled £1.3 billion, mainly accounted for by maturities of £1.2 billion. Banks and building societies disposed of £0.4 billion net, leaving £0.9 billion of net disposals to score towards (un)funding (of which the overseas sector accounted for £0.6 billion). There were also withdrawals of £0.2 billion of National Savings.

Table: Funding in February

TOTAL FOR FUNDING	£ bn	FUNDING	£ bn
PSBR	-1.0	Net gilt sales to private sector & overseas	-0.9
Reserves	+0.1	National Savings, etc	-0.2
Total (ex maturities)	-0.9	**Total** (inc maturities)	-1.1

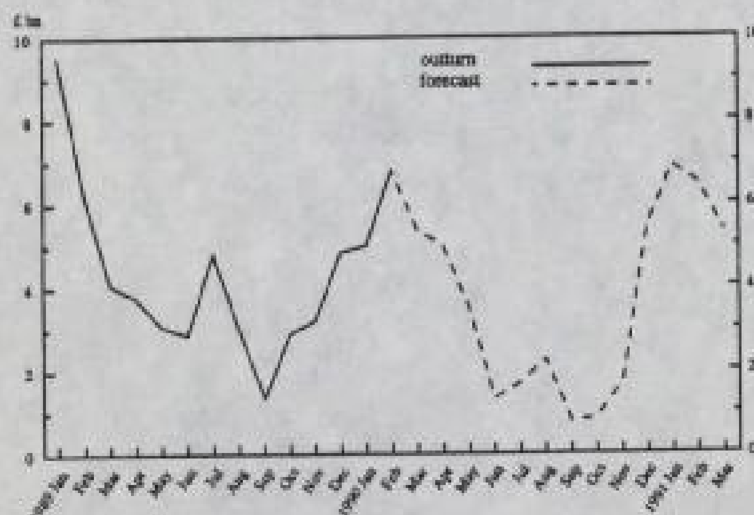
29. Assuming no buying-in from now on, a cumulative overfund (ie including carry overs from past years of £2.2 billion) of £0.3 billion is expected for 1989-90. On current assumptions buying-in of £1.1 billion will be required for a full fund in 1990-91 (table 20). This is predicated on net sales of gilts by banks and building societies falling back from over £4 billion in each of the last two years to £1 billion (higher net sales by banks and building societies would increase the amount of buying-in required).

Money Market Assistance

30. **Money market assistance** increased from £5 billion at the end of January to £6.8 billion at the end of February, £1¾ billion more than expected. The prospect, consistent with the funding assumptions above, is for the stock of assistance to fall back to £5¼ billion in March. With the Treasury Bill tender remaining at £700 million, the stock of Treasury Bills in the market is expected to rise by £3 billion during 1990-91 to £13 billion. This is enough to offset the expected expansion of bankers' deposits from other factors, and money market assistance is expected to end 1990-91 at £5¼ billion, the same as at the end of 1989-90. The main expansionary influences are sales of gilts by banks and building societies (£1 billion), higher net deposits of local authorities (£1-1¼ billion) and in-year underfunding (£½ billion).

31. On the conventional assumption that buying-in is evenly spread throughout the year, the stock of assistance is expected to be at fairly low levels during the summer - £1¼ billion in June and below £1 billion in September and October, reflecting the usual seasonal pattern of the CGBR. These figures are more than £¾ billion higher than in last month's forecast.

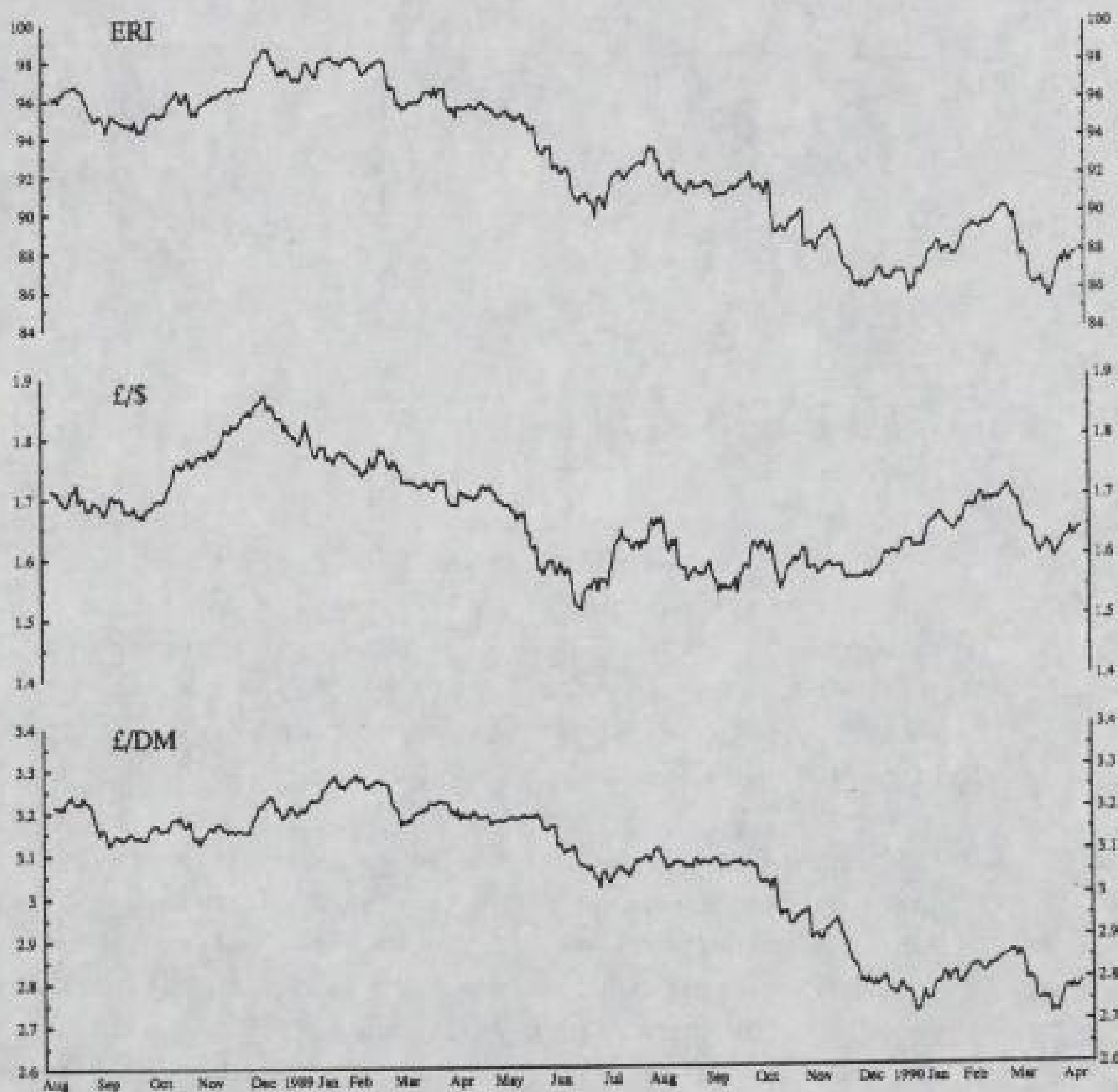
Chart: Money Market Assistance



D. EXCHANGE RATES

32. Sterling rose ¼ per cent to ERI 87.9 but was unchanged at DM2.79 and $1.64 since the last Assessment. It weakened at first to ERI 85.3 on political worries but after the Budget it recovered on reports of large Middle Eastern demand and short-covering. Sterling soon recovered from its sharp losses following the riot in London, helped by increased focus on high interest rates. The Bank's net market intervention was nil, after providing support for the pound early in the period.

Chart: Exchange Rates

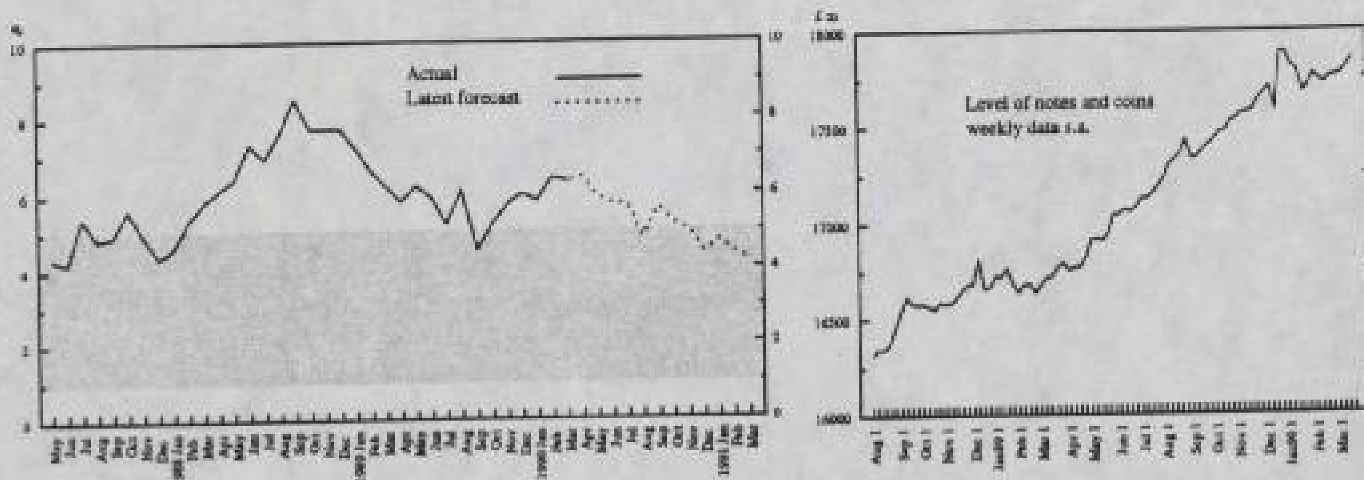


33. UK market interest rates are now the same as at the last Assessment (15.2 per cent), having been higher in the interim. With US rates also unchanged, sterling's interest advantage against the dollar remains at 6.8 per cent. German interest rates have fallen, so the pound's interest advantage against the deutschemark now stands at 7.0 per cent, up from 6.8 per cent at the last Assessment.

E. DOMESTIC MONETARY AND FINANCIAL MARKET DEVELOPMENTS

Narrow Money

Chart: MO Growth

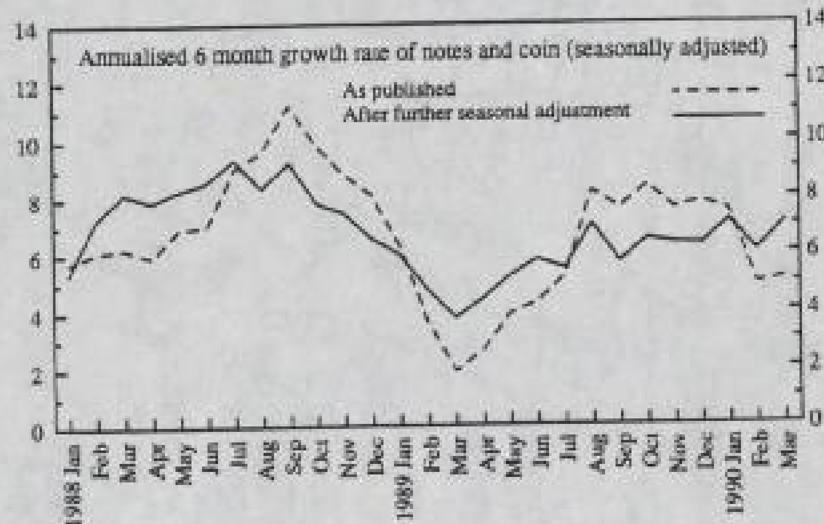


34. MO increased by 0.2 per cent, seasonally adjusted, in March; its twelve month growth rate fell slightly to 6.3 per cent from 6.4 per cent in February. Underlying growth, given by the twelve month growth rate of notes and coin, was 6.4 per cent, just below February's 6.5 per cent. The six month growth rate of notes and coin rose to 5.1 per cent from 4.9 per cent.

35. That the six month rate is well below the twelve month rate should not be taken as a sign of an imminent fall in the twelve month rate. The right hand chart above shows clearly how notes and coin's slow growth this winter matches equally slow growth last year, and this plateau in the early months of the year is characteristic even though the series

is seasonally adjusted. The chart below shows the six month growth rate of notes and coin growth with crude estimated corrections for residual seasonality. On this basis the six month growth rate looks to have been 6-7 per cent since last August.

Chart: Residual Seasonality in Notes and Coin Growth



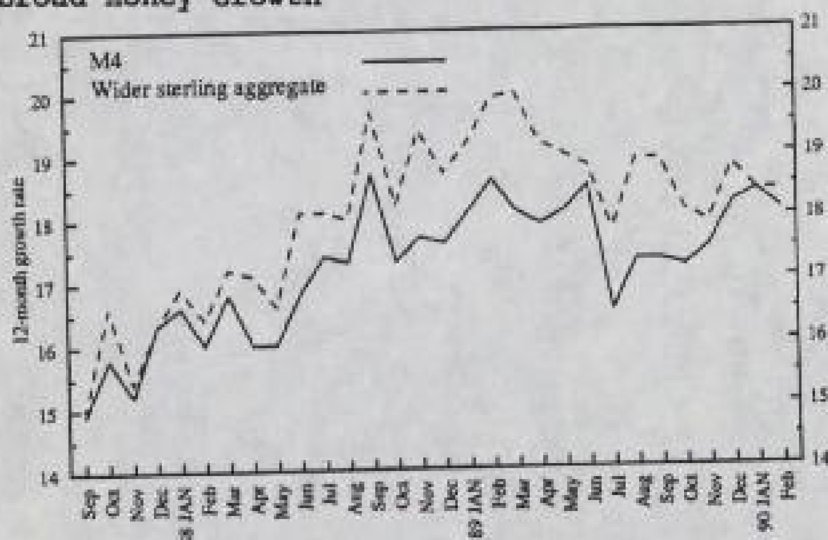
36. MO's average twelve month growth rate in 1989-90 was 5.8 per cent, lower than the 7.1 per cent of the previous year, but it was always above the upper limit of the 1 to 5 per cent target range (apart from in September, with the help of the postal strike of the previous year). The forecast (table 23 and chart above) shows MO growth slowing from now on, getting properly into the target range in the fourth quarter of the calendar year. But the starting position is worse than it was a year ago: in March 1989, notes and coin growth rate was 6.5 per cent and had been falling steadily over the previous few months; while notes and coin growth rate is now a little lower than a year ago at 6.4 per cent, it has been rising for several months.

Broad Money

37. Broad money growth as measured by the wider sterling aggregate M4W (which includes the sterling deposits of residents and non-residents) was unchanged in February at

18.4 per cent. As shown by the chart below, M4W's twelve month growth rate has come more into line with M4's growth rate as non-residents ran down their deposits at the end of last year, presumably because they found the exchange risk more than sufficient to outweigh sterling's interest advantage.

Chart: Broad Money Growth



38. M4 itself increased by 0.9 per cent (seasonally adjusted) in February, just below the average increase of the previous six non end-quarter months (1.0) per cent. The twelve month growth rate fell to 18.1 per cent from 18.4 per cent in January. It still remains in the 16½-18½ per cent corridor of the last 18 months or so, but February's figure brings to an end the upward drift since July of last year. The three month and six month growth rates also fell in February. They remain close to the twelve month rate.

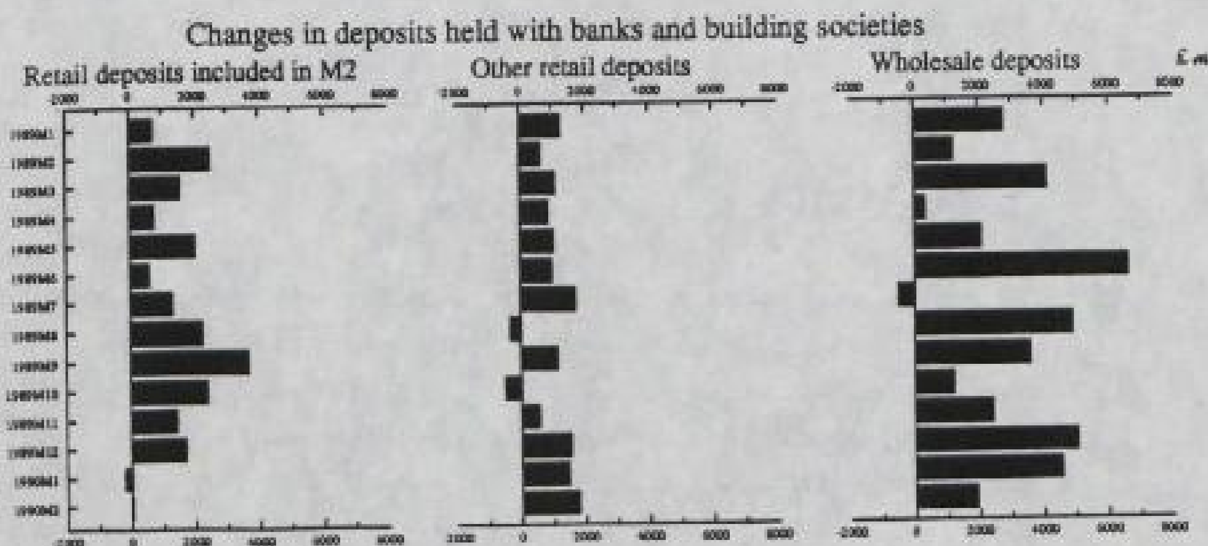
39. Retail deposits in M4 rose by 0.7 per cent in February, in line with the most recent non-end quarter months but below the average increase of the last six (0.9 per cent). Their twelve month growth rate fell to 11.6 per cent (from 12.2 per cent in January), the lowest figure since the first compilation of the series in January 1988. The alternative measure of retail deposits, M2, also slowed in February: its twelve month growth rate fell to 8.3 per cent, the lowest figure since the summer of 1985.

40. The available evidence continues to support the view that the stock of M4 is being switched into less accessible forms and is thus likely to be more firmly held:

- The faster growth of M4 itself than of retail M4 indicates a switch towards larger or more difficult to access deposits. These wholesale deposits' twelve month growth rate rose to 35.4 per cent in February from 34.7 per cent in January. But the wholesale deposit inflow was relatively modest, by recent standards, in February itself: less than £2 billion for only the second time in seven months.

- Retail M4 includes building society retail deposits of over £100,000 or for which more than on month notice of withdrawal is required, which are excluded from M2. Thus the faster growth of retail M4 compared to M2 means that there is a switch within building society retail deposits in favour of larger or less accessible deposits. In February, building societies' M2 deposits fell by £0.9 billion (seasonally adjusted) while their less accessible retail deposits (those included in M4 but not in M2) increased by £1.8 billion).

Chart: Sterling Deposits of UK Residents



The Building Societies' Position

41. **Building society net retail inflows** in February remained weak, even allowing for inflows of £5-6 million a day to the offshore subsidiaries established recently in anticipation of independent taxation. The announcement of the abolition of CRT in 1991 is likely to slow down or halt the establishment of these subsidiaries. But further switching of building society funds into other investments or offshore into bank subsidiaries may occur.

42. The trend in the composition of building societies retail deposits towards the 'less accessible' end of the spectrum must be putting further pressure on societies' margins (see also para 44): the retail money in the top slice of the market now costs the same as wholesale funding. But the recent rise in retail deposit rates gives the societies a competitive advantage of around ¼ per cent over the banks (the largest differential since December 1987) over a broader band of accounts and it may be that building societies retail inflows will show a marked improvement from now on - especially as societies are likely to offer special inducements in the run up to the 1991 abolition of CRT.

43. **Building society total wholesale inflows** (only some of which are scored in M4) increased in February by £0.8 billion, the lowest figure since August. Even so the inflow was still large by the standards of 1987 and 1988. It consisted of CDs (£0.6 billion) and Eurobond issues (£0.4 billion) - time deposits fell by just over £0.1 billion.

Building Society Interest Rates

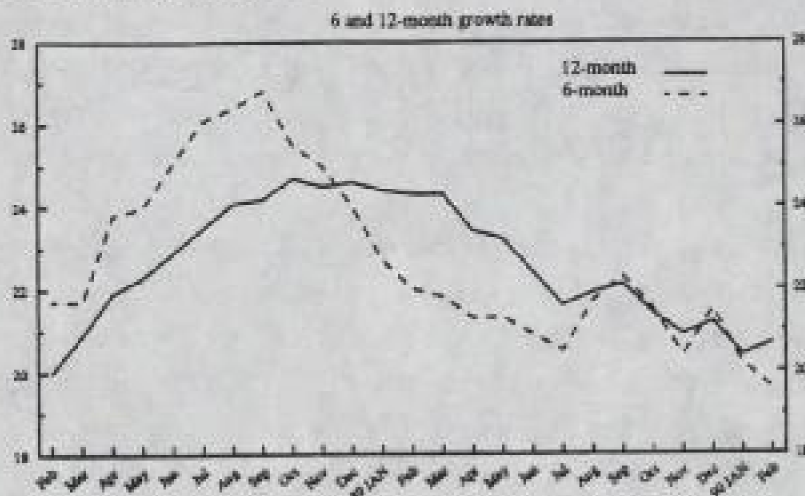
44. The recent rise in **mortgage rates and deposit rates** has raised building societies' margins slightly, but they still remain under pressure. The gap between base rates and building society (and bank) mortgage rates is still very low compared with the period before mid 1988. The societies are

still hedged in by strong competition. At this stage a further rise in mortgage rates seems unlikely in the absence of a further rise in base rates. But higher base rates would almost certainly prompt higher mortgage rates.

M4 Lending

45. **M4 lending** rose by 1.4 per cent (seasonally adjusted) in February, a little more than the average increase of the last three non-end quarter months (1.1 per cent) but a little less than in the previous three (1.6 per cent). The twelve month growth rate rose to 20.7 per cent from 20.4 per cent in January. As the chart below shows, its downward trend has flattened off in the last few months, remaining at a high level. The six month growth rate fell to 19.6 per cent in February, while the three month rate rose to 20.7 per cent.

Chart: M4 Lending Growth

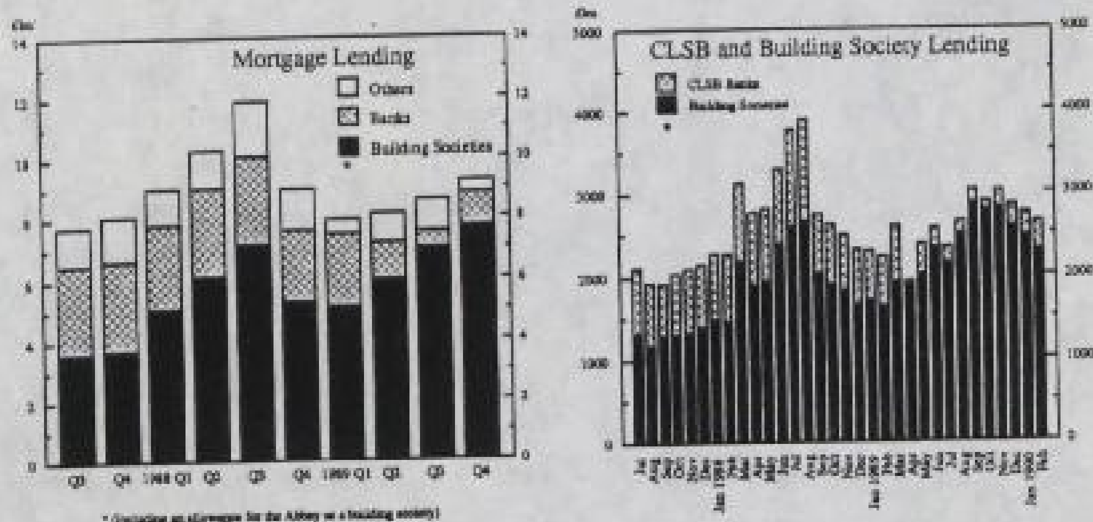


Mortgage Lending

46. **Mortgage lending by building societies** was £2.0 billion, seasonally adjusted, in February, compared to £2.1 billion in January. This continues the slow fall from the peak reached in September. **Lending for house purchase by CLSB banks** was over £0.3 billion, continuing the mild increase of the last few months. But this rise did not

offset the fall in building societies' lending, and the total continued to decline.

Chart: The Mortgage Market



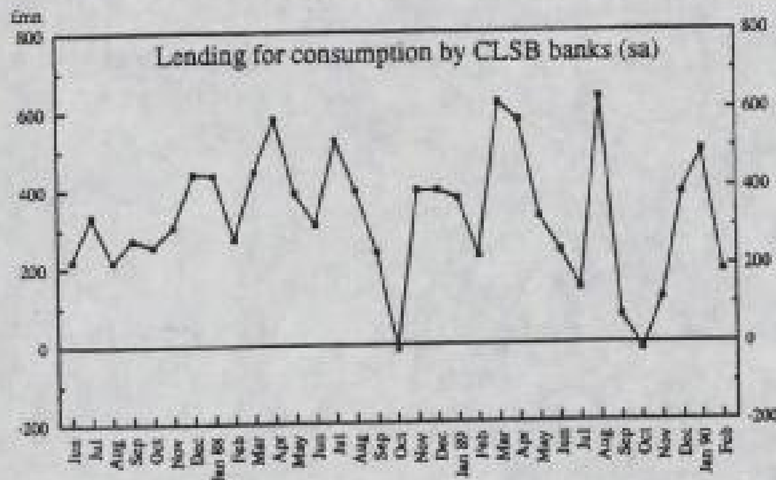
47. New building society **commitments** rose to £4.1 billion (seasonally adjusted) in February compared to January's £3.6 billion - the first rise since August last year. Such a sharp rise is particularly surprising given the rise in mortgage rates. It probably reflects substantial remortgaging rather than a pick up in the housing market. Perhaps as much as a third of all recent commitments have been for remortgages, compared with about one-fifth in 1989. Some of the remortgaging is "distress borrowing", intended to reduce total outgoings by clearing bank overdrafts and credit card bills and consolidating all debt into mortgages.

<u>Other Lending to Persons</u>

48. **Lending for consumption** by CLSB banks was £0.2 billion, seasonally adjusted, in February. This was around £¼ billion lower than in December and January, but still higher than in the August to October period of last year. It is still difficult to assess the trend in the series. But it is important to interpret them in the light of the

apparent extensive remortgaging which will artificially depress them. The consumer credit figures show a pick up, with an increase of £¾ billion (seasonally adjusted) in the three months to February, compared with an increase of £½ billion in the previous three months. But latest data on the volume of consumer credit searches shows a decline in the first part of the year over the corresponding period last year.

Chart: Lending for Consumption



Lending to Companies

49. **Lending to companies** by banks and building societies was probably £4½-£5 billion (seasonally adjusted) much higher than in January (perhaps up to £3 billion). No special factors have been identified which explain this rise. CLSB banks accounted for about half of lending in February: their detailed figures show that lending was once again well spread amongst sectors. Monthly figures are erratic. Nevertheless this development is disturbing, given that a slowdown in company spending is critical to the overall adjustment of the economy. Given the wide sectoral spread of the lending, and the still healthy level of profit margins (albeit lower than early last year), it could reflect some bouyancy in companies spending, rather than distress borrowing.

50. The amount of **sterling commercial paper** outstanding rose £0.3 billion to stand at £4.6 billion at the end of February.

51. UK borrowers announced **total sterling issues** of £1¼ billion in February, the same as in January. The February total consisted of £½ billion equities (mostly by ICCs), nearly £¼ billion floating rate issues and about £½ billion in fixed rate issues (overseas borrowers announced another £½ billion of fixed rate sterling issues). The March figures to date are much lower, with only £0.1 billion of equities announced (all ICCs), £0.2 billion floating rate issues and £0.3 billion of fixed rate sterling issues.

<u>Broad Money Forecast</u>

52. **M4** is expected to rise by 2 per cent (seasonally adjusted) in March, faster than in February because of the crediting of historically high interest to accounts as the end of the quarter. The twelve month growth rate is expected to be close to 18 per cent. **M4 lending** will also be higher than in February, this time because of interest charged on loans. It is expected to rise by 1¼ per cent (£9 billion) after seasonal adjustment, with its twelve month rate around 20¼-20½ per cent.

<u>Interest Rates and Capital Markets</u>

53. At the time of the last Assessment the one month interest rate was 15.0 per cent, the three month rate 15.2 per cent and the twelve month rate 15.6 per cent. The one month interest rate now stands at 14.9 per cent, the three month rate remains at 15.2 per cent and the twelve month rate is 15.4 per cent.

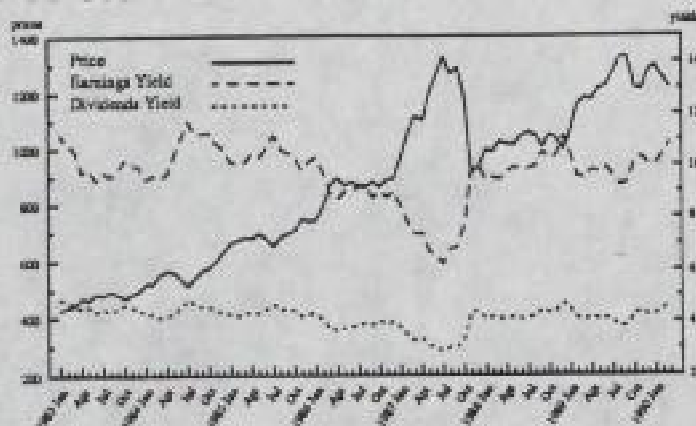
54. The yield curve of longer term rates is little changed. Conventional gilts began the period with the index at 77.79 and yields on shorts, mediums and longs at

12.7, 12.2, and 11.3 per cent respectively. At the end of the period, the index stood at 77.64 with par yields at 12.7, 12.2, and 11.4 per cent. The index has tracked sterling's movements for most of the period, and moved in sympathy with international bond markets. The market lost ground on the Budget, improved on the inflation figure, weakened on the disturbances in London. The announcements of the fourth conversion offer and the reserve figures had little effect.

55. Real yields on **index linked stock** which began the period at 4.2 per cent for mediums and 4.1 per cent for longs now stand at 4.3 per cent for mediums and 4.2 per cent for longs. **Break even yields** for index-linked Treasury 1992 and 2006 - the average rates of inflation at which indexed and equivalent conventional stocks would yield the same over their lives - have risen a little: they are currently 9.7 per cent and 7.7 per cent compared to 9.7 per cent and 7.6 per cent at the beginning of the period.

56. **UK equity prices** have hardly changed since the last Assessment, falling ½ per cent overall. The dividend yield has risen from 4.7 per cent to 4.9 per cent. Share prices are now 4½ per cent higher than a year ago.

Chart: The FT-500 Index



57. **Unit trusts'** net inflow was £0.3 billion in February, more than twice as high as in January and just below the average monthly increase in 1989.

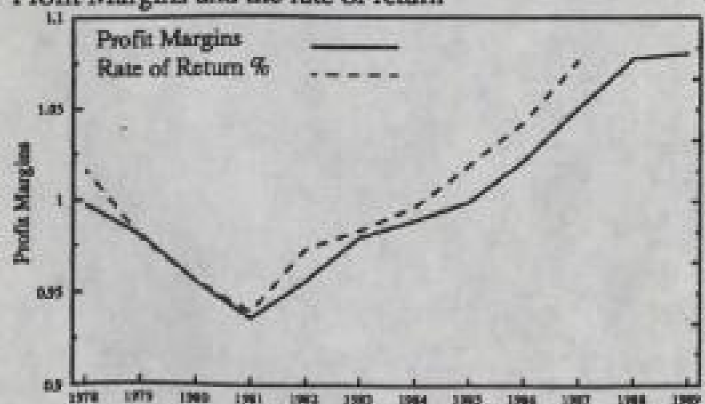
ANNEX: PROFITABILITY IN MANUFACTURING

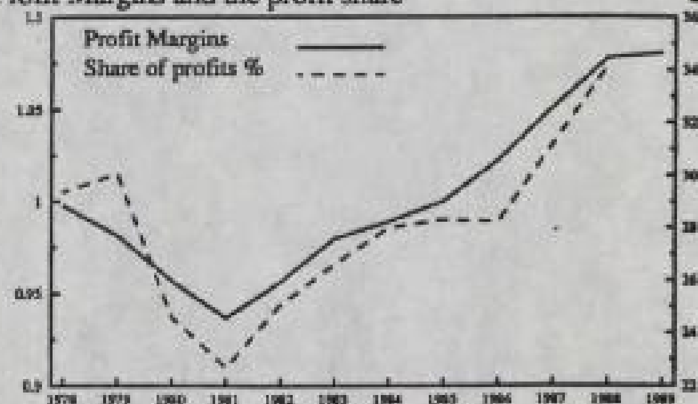
1. Assessing the current state of profitability is an important part of the assessment of economic conditions. Both the Treasury and the Bank of England have measures of profit margins. A squeeze on margins can be one of the ways in which counter-inflationary policy measures have their effect. This annex describes the Treasury and Bank measures and appraises where the economy now stands.

2. Assessing profitability is difficult. Figures for the rate of return are published on an annual basis about nine months after the end of the year to which they relate. The share of profits in manufacturing output is similarly only available on an annual basis after a considerable interval. While it is possible to construct estimated quarterly versions of these measures, they rely on early estimates of profits which are notoriously subject to revision. The profits of manufacturing firms are not available at all on a quarterly basis.

3. We have to rely instead on constructed measures of profit margins calculated from input and output prices and unit labour costs. Our constructed measure of margins is a good predictor of other measures of profitability, particularly of the rate of return, as the charts below show.

Chart: Measures of Profitability in Manufacturing





4. Profit margins are measured as the ratio of output prices to unit costs. Data are not compiled by the CSO for unit costs and have to be estimated. In the Treasury's measure, which has been used in published forecasts, unit costs are defined as a weighted sum of a wide range input prices as shown in the table below. The weights are derived from a survey of firms' purchases of goods and services of other UK firms and of imports. Although the weights are now a little out of date (they relate to 1984), this is not likely to be a significant source of error: purchasing practices as revealed in the series of surveys are surprisingly stable:

Table: Definition of Unit Costs in Manufacturing

	WEIGHT	PERCENTAGE INCREASE IN 1989Q4 COMPARED WITH	
		1989Q3	1988Q4
Unit Labour Costs	45	2.2	4.8
Bought-in Services	19	2.0	10.3
Nat. Industry Prices*	6	7.9	4.3
Domestic Oil Prices	2	7.8	57.8
Imported Manufactures	22	0.6	5.3
Imported Basic Materials	1	0.5	9.0
Imported Services	1	2.7	13.1
Imported Foods, etc	1	3.6	8.0
Imported Fuels	1	7.1	43.8
Taxes	3	1.4	7.8
Total Costs	100	2.1	6.5

* includes also industrial gas prices.

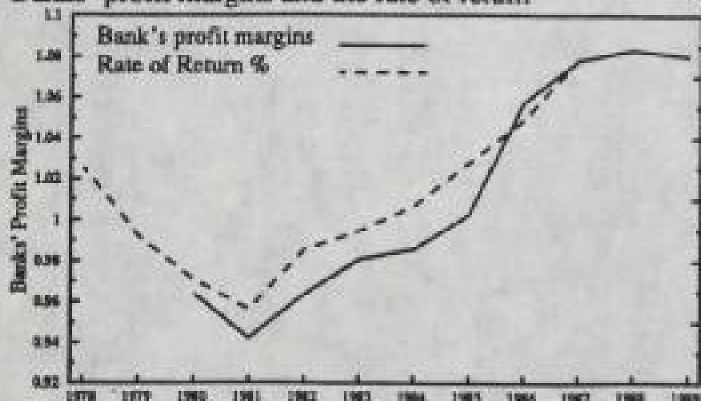
5. The direct unit labour costs of manufacturers themselves account for nearly half of total unit costs. As the costs of bought-in services (construction, catering, cleaning, design and advertising, legal advice etc) are proxied by the unit labour

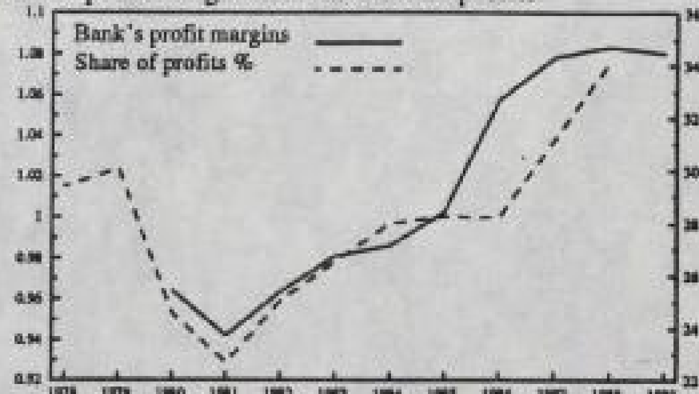
costs in the non-manufacturing sector, labour costs as a whole, both direct and indirect, account for nearly two thirds of total costs.

6. The other major item is the cost of imported manufactures, which includes both semi-manufacturers (like bulk chemicals) and finished manufacturers (like car batteries and tyres, computer chips and other manufactured components of manufactured goods). The remaining items, accounting for around 15 per cent of total costs, are mainly fuels and unprocessed basic materials.

7. The Bank of England measure of costs, while broadly similar to the Treasury's differs significantly in that it uses the CSO's measure of the prices of materials and fuels (ie producer input prices) instead of the various individual input prices. Because producer input prices exclude the prices of all manufactured inputs, the Bank measure neglects any influence on UK manufacturers costs from changes in the prices of any manufactured components they may import.

Chart: Bank Measure of Profit Margins and the Rate of Return





8. Both the Treasury and the Bank measures use the producer price of manufacturers as the measure of the selling price of manufacturers. Producer prices have risen by 5.8 per cent over the last year by 2.0 per cent over the last three months - the

recent high rise reflects to some extent the annual revision of many firms' price lists in January.

9. The charts below show the quarterly path of the Treasury's measure of margins. The raw series is rather erratic and subject to seasonal influences. The latter arise because:

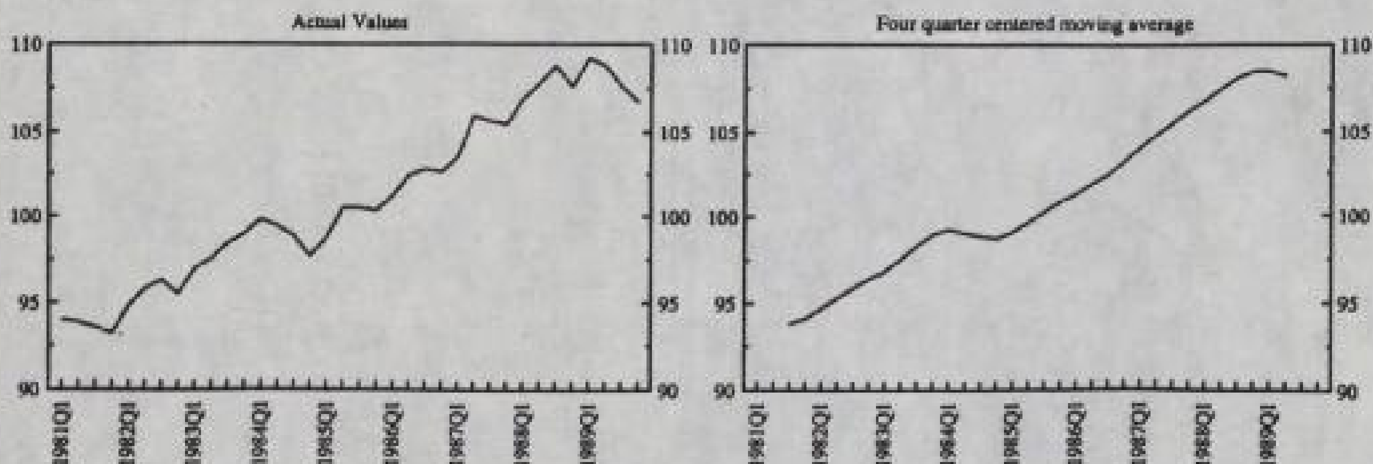
- output (selling) prices rise sharply in January of each year as firms adjust price lists;

- the prices of electricity and coal vary over the year, being much higher in the winter than in the summer [(this would affect the Bank measure much more than the Treasury measure given the greater implicit weight of electricity prices in total costs)];

- unit labour costs vary seasonally reflecting the wage round and variations in productivity.

A centred four quarter moving average is shown on the right hand panel. This both smooths away some of the erratic fluctuations in the series and, crudely, corrects for the seasonality.

Chart: Quarterly Path of Profit Margins



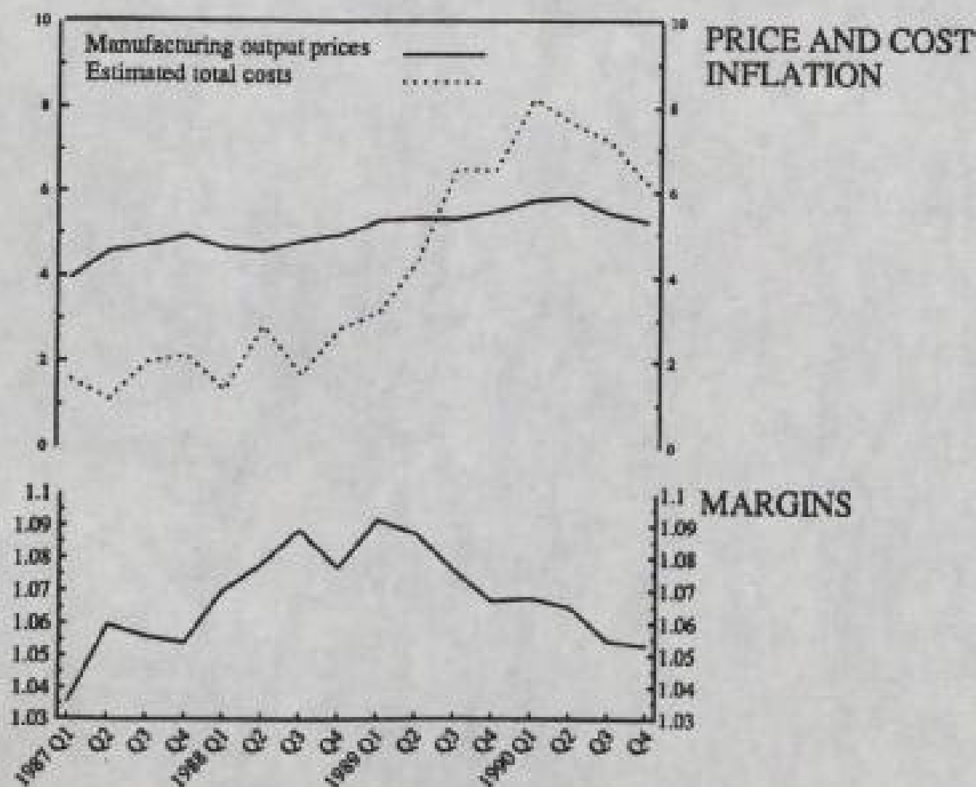
10. For several years calculated profit margins have shown a strong upward trend. The only interruptions to this have occurred

in 1985 and over the last few quarters. Both are periods in which output growth has slowed in response to tighter policy. Weak demand has meant that firms have not been able to pass on higher costs. It looks likely that margins peaked at the beginning of last year and have been declining since then. The measure's good track record suggests the observed slowdown in margins will in due course be reflected in the rate of return when it is eventually calculated.

Future Prospects

11. The FSBR forecast shows profit margins in manufacturing falling by 2 per cent in 1990, having risen slowly, by only ¼ per cent, in 1989. Margins are thought to have peaked in the first quarter of last year and are expected to fall steadily until the fourth quarter of this year to a level around 3½ per cent below the peak. Given the likely trends in costs, it is important that margins continue to fall this year if producer price inflation is to meet the 5¼ per cent FSBR forecast for the fourth quarter: if margins fail to fall, then, other things equal, producer price inflation will turn out at about 6½ per cent.

Chart: Prices, Costs and Margins



SECRET

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Table 1

GERMANY KEY FIGURES

		Industrial Production index (1)	Consumer Prices	Trade Surplus (2) $bn	Money Supply M3	Broad Money (3)
1984		3.0	2.4	1.6		
1985		5.0	2.2	2.1		
1986		1.7	-0.1	4.3		
1987		0.3	0.2	5.5	7.3	6.9
1988		3.7	1.3	6.1	7.2	6.7
1989		4.8	2.8	6.0	7.1	6.6
1987	Q1	-1.1	-0.6	5.3	7.5	
	Q2	0.6	0.1	5.4	8.0	
	Q3	-0.2	0.5	5.2	7.2	
	Q4	1.8	0.9	6.2	6.6	
1988	Q1	3.2	1.0	5.1	6.0	
	Q2	2.3	1.2	6.7	6.4	
	Q3	4.7	1.3	6.0	6.4	
	Q4	4.4	1.7	6.6	6.8	
1989	Q1	4.8	2.4	6.6	6.9	8.7
	Q2	4.6	2.9	5.8	5.9	8.3
	Q3	5.1	2.8	6.2	5.5	8.2
	Q4	4.7	3.0	5.3	4.6	8.3
1988	Jul	3.2	1.2	6.3 (5.9)	6.3	
	Aug	5.4	1.2	6.6 (6.2)	6.2	
	Sep	5.5	1.5	5.3 (6.3)	6.7	
	Oct	3.9	1.5	6.2 (6.3)	6.5	
	Nov	4.0	1.7	7.1 (6.6)	6.7	
	Dec	5.6	1.8	6.4 (6.3)	7.0	
1989	Jan	5.4	2.3	6.8 (6.4)	7.2	8.5
	Feb	4.1	2.5	6.5 (6.4)	6.8	8.7
	Mar	4.7	2.6	6.4 (6.6)	6.7	8.9
	Apr	7.5	2.9	5.8 (6.5)	6.4	8.6
	May	2.3	2.9	5.1 (6.2)	6.0	8.2
	June	4.4	2.9	6.4 (6.2)	5.4	8.2
	July	8.1	2.8	6.0 (6.0)	5.6	8.6
	Aug	3.2	2.8	6.9 (6.1)	5.8	8.0
	Sep	4.4	2.9	5.8 (6.0)	5.1	8.0
	Oct	4.6	3.1	5.3 (5.9)	5.0	8.6
	Nov	4.5	2.9	5.4 (6.0)	4.4	8.1
	Dec	4.6	3.0	5.2 (5.8)	4.5	8.3
1990	Jan	4.6	2.7	8.0 (6.1)	4.5	
	Feb		2.5			
Forecast (4)					Target 4-6	
1990		5	2	6½	(5.9)	
1991		4	2	6½		

1 Percentage change on a year earlier.
2 Yearly and quarterly figures are monthly averages. Monthly figures in brackets are 6 month moving averages.
3 Aggregate comprised of M3 plus marks held on deposit at foreign branches and subsidiaries of German banks.
4 FSBR.

* provisional.
** Bracketed figure is growth over target period; Q4 1989 to latest month at an annual rate compared with target for 1990 of 4-6 per cent.

Table 2: Developments and prospects in the G7 countries*

	Activity			Money supply		Costs and prices		
	Nominal GNP	Real GNP	Industrial production	M1	M3**	Unit labour costs	Consumer*** prices	GNP deflator
1984	9.2	4.8	8.2	7.0	9.0	-0.3	4.4	4.2
1985	7.1	3.3	2.8	8.5	8.7	1.8	3.8	3.7
1986	6.1	2.6	1.0	11.0	8.3	2.3	2.0	3.4
1987	6.6	3.5	3.3	11.3	8.5	-0.5	2.8	3.0
1988	7.8	4.5	6.0	6.7	8.3	-0.1	3.2	3.2
1989			3.8				4.3	
1987 Q1	5.6	2.4	1.1	13.6	8.7	-1.4	1.7	3.1
Q2	6.0	2.8	2.4	12.9	8.8	0.2	2.8	3.1
Q3	6.8	3.8	4.1	10.6	8.4	-0.2	3.1	2.9
Q4	7.9	4.8	5.6	8.5	8.2	+0.9	3.4	2.9
1988 Q1	8.1	5.3	6.4	7.1	8.1	-1.4	3.0	2.7
Q2	7.7	4.6	6.3	6.6	8.2	-0.2	2.9	3.0
Q3	7.9	4.4	6.2	6.9	8.5	-0.3	3.2	3.4
Q4	7.4	3.6	5.3	6.6	8.4	+0.8	3.5	3.7
1989 Q1	7.9	3.7	4.8	7.1	8.2	0.6	4.0	4.0
Q2	7.8	3.5	4.5	4.5	7.5	0.6	4.7	4.1
Q3	7.2	3.3	3.3	3.5	7.2	1.9	4.4	3.8
Q4			2.6				4.3	
1988 Jan			6.9	7.1	7.9		3.1	
Feb			6.2	7.1	8.1		2.9	
Mar			5.9	7.0	8.3		2.9	
Apr			6.4	6.7	8.2		2.9	
May			6.0	6.4	8.1		2.9	
Jun			6.2	6.8	8.3		3.0	
Jul			5.8	7.6	8.7		3.2	
Aug			6.4	6.7	8.4		3.2	
Sep			6.4	6.6	8.4		3.3	
Oct			4.8	6.2	8.3		3.4	
Nov			5.6	6.1	8.3		3.5	
Dec			5.6	7.3	8.6		3.6	
1989 Jan			5.0	7.0	8.2		3.9	
Feb			4.3	7.1	8.2		4.0	
Mar			5.0	7.1	8.2		4.1	
Apr			5.0	5.6	7.8		4.5	
May			4.1	4.4+	7.3		4.8	
Jun			4.3	3.4+	7.4		4.7	
Jul			3.7	5.1	7.3		4.6	
Aug			3.4	5.4	7.2		4.3	
Sep			2.9	3.5	7.2		4.2	
Oct			2.9	3.3	6.9		4.4	
Nov			2.4		6.8+		4.3	
Dec			2.4				4.3	
1990 Jan							4.7	
Feb							4.9	
Forecast++								
1990	6¼	2¼	2¼				4¼	3¼
1991	6¼	2¼	3				3¼	3¼

* Percentage changes on a year before.
** M2 + CDs for Japan, M4 for UK.
*** 1988 consumption weights.
\+ Partly estimated
++ FSBR

mg2.cc/Sheath/91g2.17.3

TABLE 3

THREE MONTH INTEREST RATES

		United States	Japan	Germany	France	UK	G7
1983		9.1	6.7	5.8	12.5	10.1	9.3
1984		10.4	6.5	6.0	12.2	9.9	9.7
1985		8.1	6.6	5.4	10.0	12.2	8.5
1986		6.5	5.1	4.6	7.7	10.9	7.1
1987		6.9	4.2	4.1	8.3	9.7	6.8
1988		7.7	4.5	4.3	7.9	10.3	7.3
1989		9.1	5.4	7.1	9.3	13.9	9.0
1987	Jan	5.9	4.3	4.5	8.6	11.1	6.6
	Feb	6.1	4.2	4.0	8.5	10.9	6.6
	Mar	6.2	4.2	4.0	8.0	10.0	6.4
	Apr	6.5	4.1	3.9	7.8	9.8	6.5
	May	7.0	3.8	3.8	8.2	8.8	6.6
	June	7.0	3.9	3.7	8.3	8.9	6.6
	July	6.7	4.0	3.8	7.8	9.2	6.6
	Aug	6.8	4.0	4.0	7.8	10.0	6.7
	Sept	7.4	4.2	4.0	7.8	10.2	7.1
	Oct	8.0	4.8	4.7	8.3	9.9	7.5
	Nov	7.2	4.3	3.9	8.8	9.0	6.9
	Dec	7.7	4.5	3.7	8.6	8.8	7.0
1988	Jan	6.9	4.3	3.4	8.3	8.9	6.6
	Feb	6.6	4.3	3.3	7.7	9.2	6.5
	Mar	6.6	4.4	3.4	8.0	8.9	6.5
	Apr	6.9	4.2	3.4	8.1	8.3	6.6
	May	7.2	4.2	3.5	7.9	8.0	6.7
	June	7.5	4.4	3.9	7.4	8.9	6.9
	July	7.9	4.7	4.9	7.4	10.5	7.4
	Aug	8.4	4.3	5.3	7.7	11.4	7.8
	Sep	8.2	5.0	5.0	8.0	12.1	7.8
	Oct	8.4	4.7	5.1	8.0	12.1	7.8
	Nov	8.8	4.4	4.9	8.1	12.3	8.0
	Dec	9.3	4.5	5.3	8.5	13.2	8.4
1989	Jan	9.3	4.6	5.7	8.5	13.1	8.5
	Feb	9.6	4.7	6.5	9.2	13.0	8.9
	Mar	10.1	4.8	6.6	9.1	13.0	9.2
	Apr	10.0	4.7	6.4	8.8	13.2	9.0
	May	9.6	5.0	7.0	8.9	13.1	9.0
	June	9.2	5.4	7.0	9.0	14.1	9.0
	July	8.8	5.5	7.1	9.2	13.9	8.9
	Aug	8.7	5.4	7.0	9.0	13.8	8.8
	Sept	8.8	5.6	7.4	9.2	14.0	9.0
	Oct	8.7	6.1	8.1	9.9	15.0	9.2
	Nov	8.4	6.8	8.3	10.5	15.1	9.3
	Dec	8.3	6.7	8.1	10.7	15.1	9.3
	Jan	8.2	7.0	8.3	11.3	15.2	9.4
	Feb	8.2	7.2	8.3	11.0	15.1	9.4
	Mar	8.4	7.5	8.5	10.6	15.4	9.6
	Apr 5	8.4	7.3	8.2	10.2	15.2	9.4

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

mg2.cc/Sheath/91g3.17.3

TABLE 4

EFFECTIVE EXCHANGE RATE INDICES (1985 = 100)*

	United States	Japan	Germany	France	UK	YEN/$	[illegible]/$
1980	68.4	76.3	97.1	129.9	117.7	225.8	1.82
1981	76.6	87.5	92.4	120.5	119.1	219.5	2.25
1982	85.5	83.0	97.4	111.1	113.7	248.8	2.43
1983	89.7	91.8	101.1	103.3	105.3	237.4	2.55
1984	96.8	97.9	100.0	99.0	100.6	237.5	2.85
1985	100.0	100.0	100.0	100.0	100.0	238.3	2.94
1986	85.2	124.4	108.8	102.8	91.6	168.3	2.17
1987	70.3	133.2	115.4	103.0	90.1	144.7	1.80
1988	66.0	147.4	114.6	100.8	95.5	130.4	1.74
1987 Q1	72.6	127.5	115.7	103.6	86.7	153.2	1.84
Q2	70.1	135.0	114.9	102.9	90.5	142.6	1.81
Q3	71.3	132.3	114.6	102.7	90.4	147.0	1.84
Q4	67.0	137.9	116.4	102.7	92.8	134.0	1.71
1988 Q1	64.9	144.6	116.2	102.4	93.4	128.1	1.68
Q2	64.5	148.0	114.9	101.4	96.8	125.7	1.71
Q3	68.7	145.5	113.2	100.0	95.2	133.6	1.86
Q4	65.7	151.4	114.0	99.4	96.6	134.0	1.71
1989 Q1	67.2	150.2	112.6	98.8	97.1	128.5	1.85
Q2	70.4	143.5	112.4	99.2	93.7	138.0	1.93
Q3	70.8	138.8	112.8	99.6	91.7	142.2	1.92
Q4	69.2	135.1	116.3	101.5	88.0	143.1	1.81
1987 Oct	69.8	133.8	114.9	102.7	91.4	143.3	1.80
Nov	66.5	137.4	117.0	102.5	93.2	135.3	1.68
Dec	64.5	142.5	117.2	102.9	93.6	123.4	1.65
1988 Jan	64.5	144.2	116.7	103.0	92.9	127.9	1.65
Feb	65.6	144.4	116.0	102.4	92.2	129.2	1.70
Mar	64.5	145.2	115.9	101.8	95.3	127.1	1.68
Apr	63.8	147.4	115.5	101.5	97.2	124.9	1.67
May	64.1	148.3	115.0	101.4	97.7	124.8	1.69
Jun	65.9	148.3	114.2	101.3	95.4	127.4	1.76
Jul	68.1	145.3	113.3	100.6	94.8	133.1	1.85
Aug	69.1	146.3	112.7	99.5	96.0	133.7	1.89
Sept	69.0	145.1	113.6	99.7	94.8	134.5	1.87
Oct	67.1	149.1	113.7	99.8	95.7	128.9	1.82
Nov	65.2	152.7	114.3	98.9	96.4	123.1	1.75
Dec	64.8	152.3	113.9	99.5	97.7	123.5	1.76
1989 Jan	66.7	150.9	112.6	98.7	97.9	127.4	1.84
Feb	67.0	151.1	112.4	98.1	97.5	127.6	1.85
Mar	67.9	148.8	112.6	99.3	95.9	130.4	1.87
Apr	68.2	147.1	112.8	99.6	95.4	132.0	1.87
May	70.6	143.9	112.1	99.0	94.3	138.0	1.95
June	72.4	139.3	112.4	98.9	91.3	144.1	1.98
July	70.0	139.5	113.3	99.6	92.3	140.4	1.89
Aug	70.6	139.8	112.6	99.5	91.6	141.2	1.93
Sep	71.7	137.1	112.6	99.6	91.3	145.1	1.95
Oct	69.9	137.5	114.7	100.6	89.7	142.2	1.87
Nov	69.6	135.2	115.9	101.3	87.0	143.5	1.83
Dec	68.1	132.4	118.3	102.6	86.5	143.7	1.74
1990 Jan	67.2	129.2	119.0	103.6	87.9	145.0	1.69
Feb	67.1	127.8	118.9	103.7	89.6	145.6	1.68
Mar	68.5	122.6	118.9	104.4	87.0	153.2	1.71
Apr 5	68.7	118.9	118.9	104.8	87.9	157.6	1.70
% Change since dollar peak (Feb 85)	- 39.3	19.7	22.7	8.4	- 3.3	-39.6	-50.5
% Change since Plaza (Sept 85)	- 30.5	7.7	17.0	3.9	-15.8	-34.9	-41.4
% Change since Louvre Accord (Feb 87)	- 5.4	- 6.3	2.4	0.8	2.7	2.6	- 7.0

* Effective exchange rate indices calculated on basis of IMF index (1985=100)

TABLE 5

ECONOMIST COMMODITY PRICE INDICES 1985=100 BRENT OIL

	All items indices				SDR indices			BRENT OIL
Annual	SDR	Dollar	Sterling	Real*	Food	Nfa**	Metals	
1981	99.3	115.2	73.5	105.3	93.7	104.7	106.2	
1982	91.8	99.9	73.4	94.3	89.3	96.0	93.8	
1983	107.2	112.7	95.7	110.4	102.0	116.6	110.1	
1984	110.3	111.5	107.2	113.1	112.3	111.6	106.2	
1985	100.0	100.0	100.0	100.0	100.0	100.0	100.0	
1986	89.8	103.7	90.6	86.4	92.4	89.9	85.4	
1987	87.4	111.5	87.1	82.2	73.0	103.3	100.6	
1988	111.4	147.4	106.3	103.3	85.7	109.6	156.2	
Quarterly								
1988 Q1	99.8	134.6	95.9	93.9	77.6	105.5	133.4	15.85
Q2	115.5	155.7	108.8	109.1	84.0	115.1	169.1	16.35
Q3	116.4	148.8	112.4	111.7	92.9	114.0	157.9	14.47
Q4	113.7	150.3	107.9	107.7	88.3	103.6	164.4	13.50
1989 Q1	118.0	153.0	112.1	112.5	90.4	107.1	172.4	16.70
Q2	114.8	143.6	113.2	107.1	91.3	108.8	158.9	17.98
Q3	107.8	133.5	107.2		83.1	111.7	147.1	17.27
Q4	100.9	127.5	103.1		77.7	107.9	135.3	18.89
1990 Q1	95.7	124.1	96.1		76.9	106.3	120.1	19.52
Monthly								
December	117.3	156.4	110.1		89.5	101.7	175.5	14.92
January	119.9	156.8	113.2		90.4	107.1	179.0	16.25
February	116.3	150.6	110.2		89.3	106.2	169.2	16.03
March	117.7	151.6	112.9		91.6	108.0	169.0	17.82
April	115.6	148.1	111.4		90.8	107.0	163.8	19.03
May	116.3	145.3	114.5		92.1	108.5	163.0	17.75
June	112.4	137.3	113.6		91.0	110.8	150.0	17.17
July	100.4	134.7	106.8		86.2	112.0	132.0	17.33
August	107.8	134.2	107.2		81.6	111.0	150.5	16.81
September	107.4	131.7	107.6		81.4	112.1	148.2	17.68
October	104.3	130.9	105.8		78.3	109.1	145.2	18.56
November	101.8	128.0	104.4		79.3	108.7	135.0	18.65
December	96.5	123.5	99.0		75.5	105.8	125.6	19.45
January	93.1	121.0	94.0		75.2	104.8	115.2	20.27
February	93.1	121.7	91.9		75.5	106.0	113.8	19.66
March	100.9	129.5	102.4		80.1	108.0	131.4	18.63
Weekly								
Mar 6	99.1	128.0	99.5		79.1	107.6	127.1	19.38
Mar 13	101.1	129.2	103.5		80.4	107.2	131.9	18.65
Mar 20	102.0	131.3	104.5		80.3	107.6	134.8	18.10
Mar 27	101.5	129.4	102.0		80.5	109.5	131.7	18.38
Apr 3(prov)	102.2	130.6	102.3		80.4	110.0	133.6	18.60
% ch. on one yr	-10.5	-11.0	-7.1		-11.2	1.2	-15.6	-6.50

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

TABLE 6

RECENT INDICATORS OF ACTIVITY AND INFLATION
(per cent changes on year earlier)

	OUTPUT AND ACTIVITY					PRICES AND UNIT LABOUR COSTS					
	MONEY GDP		GDP(O)	MANUFACTURING OUTPUT	RETAIL SALES *	RPI	RPI EXCL. MORTGAGE PAYMENTS	PRODUCER PRICES ** OUTPUT	PRODUCER PRICES ** INPUT	UNIT WAGE COSTS MANUFACTURING	UNIT WAGE COSTS WHOLE ECONOMY
1985-86	9.3	1986	3.0	0.9	5.3	3.4	3.6	4.1	-10.5	4.5	5.5
1986-87	7.2	1987	4.9	5.6	5.9	4.2	3.7	4.4	5.0	1.3	4.1
1987-88	10.8	1988	4.6	7.0	6.9	4.9	4.6	4.8	4.8	2.9	6.8
1988-89	10.9	1989	2.7	4.8	2.2	7.8	5.9	5.4	5.3	4.5	N/A
1986 Q1	7.6		2.6	-1.5	4.7	4.9	4.6	4.8	-11.3	8.1	6.1
1986 Q2	6.3		1.9	-1.2	4.9	2.8	3.3	4.0	-13.5	6.5	6.9
1986 Q3	7.0		3.4	1.0	5.3	2.6	3.3	3.8	-11.8	3.6	4.6
1986 Q4	7.8		4.1	5.1	6.2	3.4	3.4	3.7	-5.0	-0.4	4.5
1987 Q1	7.9		4.0	4.0	5.0	3.9	3.7	3.8	-0.7	1.0	3.7
1987 Q2	9.3		4.7	6.2	5.8	4.2	3.7	4.4	5.4	-0.1	3.5
1987 Q3	10.9		5.3	7.1	6.5	4.3	3.6	4.5	10.8	1.2	4.0
1987 Q4	11.4		5.3	5.5	6.3	4.1	4.0	4.8	5.1	3.4	5.1
1988 Q1	11.7		5.8	7.9	8.3	3.5	3.7	4.7	3.6	2.0	6.1
1988 Q2	11.1		4.8	6.1	7.0	4.3	4.4	4.7	6.2	4.4	6.5
1988 Q3	11.1		4.3	7.5	6.5	5.5	5.1	4.8	4.2	2.4	6.9
1988 Q4	11.1		3.6	6.7	5.8	6.5	5.2	5.0	5.1	3.3	7.7
1989 Q1	10.9		3.4	7.1	3.7	7.7	5.6	5.3	7.0	3.0	8.6
1989 Q2	10.3		2.7	5.9	2.9	8.2	6.0	5.4	6.2	3.7	9.0
1989 Q3	8.2		2.1	3.3	1.2	7.7	5.8	5.4	3.6	6.1	10.2
1989 Q4	7.7		2.4	3.1	1.1	7.6	6.1	5.6	4.5	5.1	N/A
		1988	JUNE	7.0	7.0	4.6	4.7	4.7	7.4	2.7	
			JULY	7.5	7.6	4.8	5.0	4.8	4.7	2.4	
			AUGUST	6.0	6.9	5.7	5.0	4.8	3.9	3.4	
			SEPTEMBER	8.9	6.4	5.9	5.2	4.9	3.9	0.9	
			OCTOBER	6.2	6.1	6.4	5.1	5.0	3.5	2.7	
			NOVEMBER	7.3	5.7	6.4	5.1	5.0	5.6	2.5	
			DECEMBER	6.7	5.7	6.8	5.1	4.9	6.3	2.7	
		1989	JANUARY	7.1	4.4	7.5	5.5	5.3	7.2	3.1	
			FEBRUARY	8.2	4.0	7.8	5.7	5.3	6.2	2.8	
			MARCH	6.1	3.7	7.9	5.7	5.4	7.5	3.0	
			APRIL	7.1	3.8	8.0	5.9	5.3	7.7	3.0	
			MAY	6.1	3.9	8.3	6.0	5.4	7.1	3.3	
			JUNE	4.6	2.9	8.3	5.9	5.4	4.0	4.5	
			JULY	3.8	2.2	8.2	5.8	5.3	2.8	5.7	
			AUGUST	4.1	1.1	7.3	5.7	5.4	3.2	5.2	
			SEPTEMBER	1.9	1.1	7.6	5.8	5.5	4.8	7.6	
			OCTOBER	3.8	1.2	7.3	6.1	5.5	4.5	4.9	
			NOVEMBER	3.1	1.1	7.7	6.1	5.6	4.8	5.2	
			DECEMBER	2.4	1.0	7.7	6.1	5.7	4.2	5.4	
		1990	JANUARY	0.2	1.5	7.7	6.1	5.6	2.2	7.3	
			FEBRUARY		2.1	7.5	6.2	5.8	0.9		

* Monthly figures show three months on a year earlier
** Excluding food, drink and tobacco

Table 7

BUSINESS CONFIDENCE SURVEYS

NOT FOR USE - SEASONALLY ADJUSTED

	CBI INDUSTRIAL TRENDS SURVEYS (percent balances)					EUROSTAT EC GALLUP CONSUMER CONFIDENCE
	TOTAL ORDER BOOK	EXPORT ORDER BOOK	EXPECTED OUTPUT	EXPECTED PRICES	STOCKS	
1987 A	3	-4	24	23	5	4
M	5	-2	28	30	0	6
J	4	8	35	26	-1	10
J	9	7	28	24	1	9
A	11	9	38	26	-1	8
S	11	6	31	26	3	5
O	15	6	28	24	-7	8
N	13	9	39	27	-5	55
D	15	4	30	25	2	3
1988 J	22	8	31	29	-1	7
F	16	8	30	27	-2	3
M	16	6	31	24	1	5
A	16	5	30	28	2	5
M	16	3	31	20	-3	8
J	16	1	28	28	-1	9
J	17	3	33	28	1	7
A	17	1	32	27	0	2
S	17	4	32	32	0	-2
O	15	2	28	33	1	-5
N	15	-6	28	32	6	-4
D	11	-5	26	31	1	-12
1989 J	8	-7	22	26	7	-12
F	-1	-11	20	27	6	-11
M	2	-13	16	27	9	-15
A	3	-4	14	27	12	-16
M	-9	-10	15	27	8	-11
J	-3	-14	11	28	9	-16
J	-2	-12	20	31	9	-17
A	-4	-1	11	30	11	-14
S	-6	-8	0	27	9	-14
O	-9	-8	7	30	13	-27
N	-16	-16	3	20	14	-25
D	-14	-7	3	24	15	-24
1990 J	-15	2	5	26	14	-18
F	-21	-3	-5	22	10	-23
M	-25	0	-5	24	16	-33

TABLE 8: Forecasts for real GDP and RPI growth

Percentage increases on a year earlier

	HMT		OUTSIDE FORECASTS	
	latest internal forecast	latest published forecast	Non-City average (2)	City average
GDP: 1990 (f) (1)		1.0	1.6	1.2
RPI: 1990 Q4 (f)		7 1/4	5.8	5.4
1989 Jan	7.5			
Feb	7.8			
Mar	7.9			
Apr	8.0			
May	8.3			
Jun	8.3			
Jul	8.2			
Aug	7.3			
Sep	7.6			
Oct	7.3			
Nov	7.7			
Dec	7.7			
1990 Jan	7.7			
Feb	7.5			
Mar (f)	8.1			

(f) forecast
(1) 1985 prices, at factor cost
(2) Average of NIESR, LBS, DRI, IMF, Henley, Cambridge Econometrics, Liverpool, CBI, OECD, Oxford, EC

TABLE [illegible] :INDICATORS OF FISCAL STANCE

	PSBR		PSBR EXCLUDING PRIVATISATION PROCEEDS		PSFD	
	Cash £ billion	Ratio to GDP (per cent)	Cash £ billion	Ratio to GDP (per cent)	Cash £ billion	Ratio to GDP (per cent)
1970-71	0.8	1.5	0.8	1.5	-0.2	-0.4
1971-72	1.0	1.6	1.0	1.6	0.7	1.2
1972-73	2.4	3.6	2.4	3.6	2.0	3.0
1973-74	4.3	5.8	4.3	5.8	3.5	4.6
1974-75	8.0	9.0	8.0	9.0	6.0	6.7
1975-76	10.3	9.2	10.3	9.2	8.1	7.3
1976-77	8.3	6.4	8.3	6.4	7.4	5.7
1977-78	5.4	3.6	5.9	3.9	6.6	4.4
1978-79	9.2	5.3	9.2	5.3	8.3	4.8
1979-80	9.9	4.8	10.3	4.9	8.1	3.9
1980-81	12.5	5.3	12.7	5.4	11.6	4.9
1981-82	8.6	3.3	9.1	3.5	5.5	2.1
1982-83	8.9	3.1	9.4	3.3	8.5	3.0
1983-84	9.7	3.1	10.8	3.5	11.7	3.8
1984-85	10.1	3.1	12.2	3.7	13.4	4.0
1985-86	5.6	1.6	8.4	2.3	7.7	2.1
1986-87	3.6	0.9	8.0	2.1	8.0	2.1
1987-88	-3.4	-0.8	1.7	0.4	0.6	0.1
1988-89	-14.5	-3.0	-7.4	-1.6	-8.7	-1.8
1989-90						
FSBR forecast	-13.8	-2.75	-8.8	-1.75	-7.3	-1.5
AS forecast	-12.6	-2.5	-8.3	-1.5	-6.8	-1.25

(b) Quarterly Data

£ billion		PSBR		PSBR excluding privatisation		PSFD	
		sa*	ua	sa*	ua	sa+	ua
1986	Q2	2.1	2.5	3.2	3.6	1.7	3.3
	Q3	1.8	3.6	1.8	3.6	3.0	3.8
	Q4	-0.6	-1.7	1.6	0.5	1.3	-0.9
1987	Q1	0.2	-0.8	1.4	0.3	2.0	1.8
	Q2	0.0	1.4	2.4	3.8	1.3	2.9
	Q3	-0.2	0.5	1.4	2.1	0.2	1.0
	Q4	-1.7	-2.5	-0.5	-1.3	0.1	-2.2
1988	Q1	-1.5	-2.8	-1.5	-2.8	-0.7	-1.2
	Q2	-2.7	-1.7	0.0	1.0	-1.2	0.7
	Q3	-3.4	-2.1	-1.2	0.1	-2.7	-1.7
	Q4	-4.2	-5.0	-3.0	-3.9	-1.9	-4.3
1989	Q1	-4.3	-5.7	-3.3	-4.7	-2.9	-3.3
	Q2	-1.1	0.0	0.7	1.7	-0.8	0.8
	Q3	-1.7	-0.6	-0.5	0.6	-1.4	0.0
	Q4	-2.2	-2.8	-1.5	-2.1	-2.6	-5.0

*financial year - constrained
+calendar year - constrained

Table 10: CGBR(O): Differences from Budget profile

	April-February (outturn)	
	£ billion	Percentage
Receipts		
Inland Revenue	0.4	½
Customs and Excise	-0.4	- ½
NICs	-1.2	-4
Interest and dividends	0.2	2½
Other receipts	-0.1	-2½
Total receipts	-1.0	- ½
Expenditure		
Privatisation proceeds	1.1	24
Interest payments	0.6	4½
Departmental expenditure[1]	-0.9	- ½
Total expenditure	0.9	½
CGBR(O)	1.8	
CGBR(O) excluding privatisation proceeds	0.7	

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

TABLE 11

HALIFAX STANDARDISED INDEX OF ALL HOUSE PRICES

		Index		Percentage Change On Previous Period		% Growth Annualised 3 Mth	% Growth Annualised 6 Mth	Percentage Change On Previous Year
Annual Data		nsa	sa	nsa	sa	sa	sa	nsa
1984		107.2						7.2
1985		117.0						9.1
1986		129.9						11.0
1987		149.9						15.4
1988		184.8						23.3
1989		223.1						20.7
Quarterly Data								
1988	Q2	180.2	179.8	9.3	7.5			17.3
	Q3	198.9	197.2	10.4	9.7			22.3
	Q4	212.0	211.3	6.6	7.2			30.3
1989	Q1	217.8	220.8	2.7	4.5			34.0
	Q2	226.8	226.4	4.1	2.5			25.9
	Q3	227.3	225.4	0.2	-0.4			14.3
	Q4	222.8	221.9	-2.0	-1.6			5.1
1990	Q1	220.6	223.6	-1.0	0.8			1.3
Monthly Data								
1989	Jan	213.4	217.2	-0.8	0.8	19.6	28.4	33.6
	Feb	216.9	219.9	1.6	1.2	14.9	23.5	32.0
	Mar	221.6	223.7	2.1	1.7	16.3	19.8	31.1
	Apr	224.3	224.5	1.2	0.4	14.1	16.8	28.5
	May	228.0	227.8	1.7	1.5	15.2	15.0	26.9
	Jun	228.3	226.8	0.1	-0.4	5.7	10.9	23.1
	Jul	228.5	226.5	0.1	-0.1	3.6	8.7	18.1
	Aug	227.7	226.1	-0.3	-0.2	-3.0	5.7	14.2
	Sep	226.0	223.8	-0.7	-1.0	-5.2	0.1	9.5
	Oct	224.0	222.2	-0.9	-0.7	-7.4	-2.0	7.0
	Nov	222.5	222.0	-0.7	-0.1	-7.1	-5.0	4.5
	Dec	221.2	221.5	-0.6	-0.2	-4.0	-4.6	2.8
1990	Jan	219.8	223.8	-0.6	1.0	2.9	-2.4	3.0
	Feb	220.4	223.4	0.3	-0.2	2.5	-2.4	1.6
	Mar	221.5	223.6	0.5	0.1	3.8	-0.2	-0.0

REGIONAL STANDARDISED INDICES

Region	1990 Q1	Percentage change on :- previous quarter	previous year
UK		-0.9	1.3
Greater London		-0.7	-8.1
South East		-3.2	-13.3
North		2.4	25.2
Yorkshire & Humberside		-0.4	14.9
North West		1.9	23.4
East Midlands		-1.7	-1.2
West Midlands		-0.9	-2.0
East Anglia		-5.0	-19.5
South West		-2.8	-12.1
Wales		1.6	8.0
Scotland		-0.3	16.7
Northern Ireland		-2.2	-1.1

TABLE 12

EXCHANGE RATES

DATE	Exchange Rate Index*	Real Exchange Rate @	Oil Adjusted ERI +	Dollar : sterling exchange rate	D-Mark sterling exchang rate	Interest rate differentials UK-USA	Interest rate differentials UK-Germany	Brent spot price ($/bl)
1986 q2	96.0	97.1	109.3	1.51	3.39	+3.2	+5.6	12.8
q3	90.2	91.3	103.1	1.5	3.10	+3.8	+5.4	12.4
q4	85.1	86.4	94.9	1.43	2.87	+5.1	+6.5	14.8
1987 q1	86.8	87.5	94.0	1.54	2.83	+4.3	+6.5	17.9
q2	90.4	92.0	97.2	1.64	2.96	+2.1	+5.4	18.6
q3	90.5	91.9	96.9	1.62	2.97	+2.8	+5.8	19.0
q4	92.9	94.1	100.4	1.76	2.99	+1.2	+4.6	18.1
1988 q1	93.3	95.0	103.2	1.78	3.01	+2.2	+5.6	15.7
q2	96.7	99.7	106.4	1.84	4.14	+1.0	+4.7	16.2
q3	95.1	98.9	101.9	1.62	2.97	+2.8	+6.2	19.0
q4	96.7	100.4	104.8	1.80	3.17	+3.6	+7.3	13.6
1989 q1	97.3	101.1	105.7	1.75	3.24	+3.2	+6.9	17.8
q2	93.7	99.0	100.7	1.65	3.15	+3.7	+6.8	18.7
q3	91.7	97.2	99.6	1.60	3.08	+5.1	+6.7	17.6
q4	88.0	93.5	94.0	1.58	2.87	+6.6	+7.1	19.4
1988 Aug	96.0	99.7	107.1	1.70	3.20	+2.8	+5.9	14.8
Sep	94.7	98.6	107.2	1.68	3.14	+3.9	+7.2	13.3
Oct	95.9	99.6	109.4	1.75	3.16	+3.5	+6.9	12.6
Nov	96.6	100.3	109.7	1.81	3.16	+3.6	+7.2	13.0
Dec	97.6	101.4	108.5	1.83	3.20	+3.8	+7.8	15.2
1989 Jan	97.8	101.7	106.6	1.77	3.25	+3.7	+7.8	17.2
Feb	97.5	101.4	107.0	1.76	3.25	+3.3	+6.5	16.8
Mar	96.5	100.0	103.4	1.73	3.21	+2.7	+6.3	19.5
Apr	95.4	100.4	101.5	1.70	3.18	+3.2	+6.7	19.8
May	94.5	99.7	101.7	1.64	3.18	+3.4	+6.9	18.6
Jun	91.2	96.8	99.1	1.60	3.10	+4.4	+6.8	17.7
Jul	92.5	97.5	100.0	1.63	3.08	+5.1	+6.8	17.8
Aug	91.4	97.1	100.0	1.60	3.10	+5.0	+6.8	17.1
Sep	91.3	97.1	98.9	1.57	3.07	+5.2	+6.6	17.8
Oct	89.6	95.5	96.1	1.58	2.96	+6.5	+7.2	19.1
Nov	88.0	93.6	93.9	1.57	2.89	+6.6	+7.0	19.4
Dec	86.5	91.7	92.0	1.60	2.77	+6.7	+7.0	19.7
1990 Jan	87.9	92.8	92.4	1.65	2.79	+6.8	+7.1	21.2
Feb	89.6		94.2	1.69	2.85	+6.8	+6.8	20.0
Mar	87.1		93.0	1.63	2.77	+6.9	+7.0	18.6
Apr 5	87.9			1.64	2.79	+6.8	+7.0	18.1

\+ The oil adjusted ERI shows whether the joint effect of oil price and exchange rate changes has been counter-inflationary or otherwise, relative to the base period Jan 1983-Nov 1985, on the assumption that the inflationary effect of a 4 per cent rise in oil prices is exactly offset by a 1 per cent rise in the exchange rate.

* 1985 = 100

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TABLE 13

NOMINAL AND REAL INTEREST RATES

	Three month interbank	Three month Eurodollar	Base rate	Long Rate (20 year Gilts)	Expected inflation over 12 months *	Real 3-month interbank rate	Yield on index-linked Gilts**		
							1990 ------- 1992	2001	2011
1986 q1	12.4	7.9	12.3	10.2	3.9	8.2	4.3	4.2	3.8
q2	10.2	7.0	10.4	9.0	3.6	6.5	3.6	3.6	3.4
q3	10.0	6.2	10.0	9.7	3.4	6.5	3.7	3.9	3.5
q4	11.2	6.1	11.0	10.7	4.1	6.8	3.7	4.1	3.8
1987 q1	10.6	6.3	10.8	9.6	4.3	6.0	3.0	3.7	3.5
q2	9.2	7.1	9.4	9.0	3.8	5.2	2.4	3.8	3.6
q3	9.9	7.1	9.7	9.8	3.7	6.0	2.6	4.2	3.9
q4	9.2	7.8	9.0	9.5	4.0	4.7	2.4	4.1	3.8
1988 q1	9.0	6.9	8.7	9.4	4.1	4.8	2.2	4.0	4.0
q2	8.4	7.4	8.0	9.2	4.0	4.5	2.0	3.8	3.8
q3	9.9	7.1	9.7	9.8	3.8	5.9	2.6	4.2	3.9
q4	12.5	8.9	12.7	9.3	6.7	5.5	3.4	3.7	3.7
1989 q1	13.0	9.7	13.0	9.2	6.6	6.1	3.1	3.6	3.6
q2	13.4	9.7	13.7	9.7	6.6	6.5	3.5	3.7	3.7
q3	13.9	8.8	14.0	9.5	6.7	6.7	3.2	3.5	3.6
q4	15.1	8.5	15.0	9.9	6.8	7.8	4.1	3.7	3.7
1988 Oct	12.0	8.6	12.0	9.2	6.4	5.3	2.6	3.7	3.8
Nov	12.3	8.8	13.0	9.3	7.1	4.9	2.8	3.6	3.7
Dec	13.2	9.4	13.0	9.5	6.5	6.3	3.7	3.8	3.8
1989 Jan	13.1	9.4	13.0	9.3	7.5	5.2	3.5	3.8	3.8
Feb	13.0	9.7	13.0	9.1	6.7	5.9	3.0	3.6	3.6
Mar	13.0	10.1	13.0	9.2	5.5	7.1	2.7	3.5	3.5
Apr	13.3	10.1	13.0	9.6	5.9	7.0	3.0	3.6	3.6
May	13.1	9.7	14.0	9.5	6.8	5.9	2.8	3.6	3.6
Jun	14.1	9.3	14.0	9.9	7.1	6.5	4.0	3.9	3.8
Jul	13.9	8.8	14.0	9.5	7.0	6.4	3.4	3.6	3.6
Aug	13.8	8.8	14.0	9.4	6.5	6.9	2.9	3.5	3.5
Sep	14.1	8.9	14.0	9.6	6.7	6.9	3.2	3.5	3.6
Oct	15.2	8.7	15.0	9.8	6.4	8.3	4.1	3.7	3.7
Nov	15.1	8.5	15.0	10.0	6.9	7.7	3.9	3.7	3.7
Dec	15.1	8.4	15.0	9.9	7.0	7.6	4.2	3.7	3.7
1990 Jan	15.1	8.3	15.0	10.2	6.5	8.1	4.5	3.8	3.8
Feb	15.1	8.3	15.0	10.7	6.9	7.7	4.9	4.0	3.9
Mar	15.3	8.4	15.0	11.5	7.8	7.0	5.2	4.3	4.1
Apr 5	15.2	8.4	15.0	11.4	7.8	6.9	5.2	4.3	4.1

* Unweighted average of forecasts by Phillips and Drew, National Institute, LBS, James Capel, Oxford Economic Forecasting and Goldman Sachs; the expected rate of inflation for a given month is the change in the price level between six months earlier and six months ahead. This is assumed to approximate roughly to average inflation expectations over the three months immediately ahead.

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

All figures except base rate are averages over the month/quarter; base rates are end month.

TABLE 14: CURRENT ACCOUNT

percentage change on previous year

	1985=100 EXPORT VOLUMES less oil and erratics	1985=100 IMPORT VOLUMES less oil and erratics	1985=100 TERMS OF TRADE AVIs	CURRENT BALANCE £mns
1982	0.8	8.7	-0.4	4606
1983	-0.6	10.3	-0.7	3793
1984	8.6	10.8	-1.2	1954
1985	6.8	4.0	1.4	3161
1986	2.1	6.8	0.6	-41
1987	7.1	8.5	0.7	-4395
1988	4.0	14.2	2.2	-15019
1989	10.2	8.2	-0.5	-20851
1988 Q4	4.4	14.5	2.0	-5467
1989 Q1	12.7	15.5	1.2	-4559
Q2	7.0	10.6	0.6	-4890
Q3	6.8	6.3	-1.5	-6308
Q4	14.3	1.6	-2.1	-5094
1988 Jan	6.9	14.7	3.6	-855
Feb	-8.0	13.0	3.9	-1225
Mar	2.8	15.6	3.1	-1185
Apr	7.9	15.2	2.0	-680
May	5.4	11.2	1.7	-1073
Jun	3.6	16.3	0.9	-1180
Jul	5.9	16.8	1.9	-1462
Aug	5.1	11.0	2.8	-942
Sep	5.8	13.9	1.3	-949
Oct	4.0	19.1	1.6	-2061
Nov	2.5	13.0	1.5	-1840
Dec	6.5	11.3	2.7	-1566
1989 Jan	13.2	20.6	1.9	-1393
Feb	13.5	13.8	0.7	-1753
Mar	11.4	12.2	0.9	-1413
Apr	2.8	11.3	0.9	-1671
May	9.4	11.0	1.0	-1489
Jun	8.9	9.5	0.1	-1730
Jul	6.8	2.1	-1.0	-1991
Aug	3.8	9.1	-1.6	-2361
Sep	9.8	7.7	-1.9	-1956
Oct	15.2	1.4	-1.4	-1920
Nov	10.8	4.1	-1.7	-2019
Dec	16.9	-0.5	-3.3	-1155
1990 Jan	5.7	1.6	-0.4	-2020
Feb	10.8	0.4	-0.0	-1395

SECRET

TABLE 15 (Until publication - except for the wider sterling aggregate which is not published and remains secret)

GROWTH RATES OF MONETARY AGGREGATES AND BANK & BUILDING SOCIETY LENDING

£ million

			1989Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	1990Jan	Feb
M0	Monthly change	sa	-69	44	119	137	89	71	254	-25	132	113	157	-49	34
	Monthly % change	nsa	-2.2	1.9	0.1	1.6	0.3	1.9	1.7	-1.1	0.1	0.8	7.6	-6.5	-1.4
	Monthly % change	sa	-0.4	0.3	0.7	0.8	0.5	0.4	1.5	-0.1	0.8	0.6	0.9	-0.3	0.2
	3-month annualised % change	sa	0.5	-0.6	2.2	7.3	8.4	7.2	10.0	7.2	8.7	5.1	9.5	5.1	3.2
	6-month annualised % change	sa	3.5	1.3	2.6	3.9	3.8	4.7	8.7	7.8	7.9	7.5	8.4	6.9	4.2
	Annual % change	sa	6.6	6.1	5.8	6.2	5.9	5.2	6.1	4.5	5.2	5.7	6.0	5.8	6.4
M4	Monthly change	nsa	3095	10064	1696	5406	9479	2691	5668	8979	2701	4474	8690	3241	2558
	Monthly % change	nsa	0.9	2.8	0.5	1.4	2.5	0.7	1.4	2.3	0.7	1.1	2.1	0.8	0.6
	Monthly % change	sa	1.2	2.0	0.6	1.2	2.3	0.5	1.7	2.2	0.6	1.1	2.2	1.1	0.9
	3-month annualised % change	sa	16.6	18.5	16.4	16.4	18.0	17.5	19.8	19.5	19.9	17.1	16.8	19.2	18.2
	6-month annualised % change	sa	16.4	16.0	15.8	16.5	18.2	17.0	18.1	18.7	18.7	18.3	18.2	19.6	17.6
	Annual % change	nsa	18.6	18.1	17.9	18.1	18.5	16.5	17.3	17.3	17.2	17.5	18.2	18.4	18.1
M5	Monthly change	nsa	2998	10166	2377	5444	9807	2847	5562	9331	2415	4482	9105	2675	2587
	Monthly % change	nsa	0.8	2.7	0.6	1.4	2.5	0.7	1.4	2.3	0.6	1.1	2.1	0.6	0.6
	Monthly % change	sa	1.2	1.9	0.7	1.2	2.3	0.6	1.6	2.2	0.5	1.1	2.1	1.0	0.9
	3-month annualised % change	sa	15.3	18.0	16.2	16.4	18.4	17.5	19.5	19.0	18.8	16.5	16.3	18.6	17.5
	6-month annualised % change	sa	15.5	15.0	15.2	15.8	18.2	16.9	17.9	18.7	18.2	18.0	17.6	18.7	17.0
	Annual % change	nsa	17.8	17.1	17.3	17.5	18.0	16.0	16.8	16.8	16.7	17.0	17.9	17.9	17.7
NIBM1	Monthly change	nsa	103	900	-1723	322	274	-605	-141	283	-842	198	2266	-4367	487
	Monthly % change	nsa	0.2	1.9	-3.6	0.7	0.6	-1.3	-0.3	0.6	-1.8	0.4	5.0	-9.1	1.1
	Monthly % change	sa	-0.5	-0.4	-3.6	-0.7	0.1	-1.4	0.2	0.9	-0.6	-1.2	6.0	-5.5	0.3
	3-month annualised % change	sa	-4.0	-18.4	-16.5	-17.3	-15.6	-7.8	-4.3	-1.3	2.0	-3.5	17.5	-4.1	1.8
	6-month annualised % change	sa	2.1	-4.2	-11.8	-10.9	-17.0	-12.3	-11.0	-8.7	-3.0	-3.9	7.7	-1.1	-0.9
	Annual % change	nsa	5.3	2.4	-1.3	-3.0	-3.5	-5.0	-4.7	-6.6	-7.6	-7.5	-5.5	-7.1	-6.3
M4C	Monthly change	nsa	5200	10747	2651	7940	12013	-6	7476	8879	6847	5886	8382	1896	3021
	Monthly % change	nsa	1.3	2.7	0.6	1.9	2.9	0.0	1.7	2.0	1.5	1.3	1.8	0.4	0.6
	Monthly % change	sa	1.7	2.0	0.8	1.7	2.7	-0.1	2.0	2.0	1.5	1.3	1.9	0.7	0.9
	3-month annualised % change	sa	19.1	19.2	19.3	19.6	23.0	18.4	19.6	16.5	24.2	21.0	20.4	16.9	15.0
	6-month annualised % change	sa	16.5	16.1	17.0	19.3	21.1	18.9	19.6	19.7	21.3	20.4	18.4	20.5	18.0
	Annual % change	nsa	18.0	18.0	18.3	19.2	19.6	17.2	18.1	17.9	19.2	19.9	19.8	19.9	19.1
Wider Sterling Aggregate	Monthly change	nsa	3649	11678	2525	4956	8516	4995	6809	10603	1798	4142	9209	4953	4227
	Monthly % change	nsa	0.9	2.9	0.6	1.2	2.0	1.2	1.6	2.4	0.4	0.9	2.0	1.1	0.9
	Monthly % change	sa	1.2	2.2	0.8	1.0	1.8	1.0	1.8	2.3	0.4	0.9	2.0	1.4	1.2
	3-month annualised % change	sa	18.7	22.9	17.9	16.8	15.3	16.4	20.3	22.7	19.6	15.6	14.2	19.0	20.0
	6-month annualised % change	sa	19.3	18.8	18.1	17.7	19.0	17.2	18.5	19.0	18.0	17.9	18.4	19.3	17.8
	Annual % change	nsa	19.9	20.0	19.2	19.0	18.8	17.8	18.9	18.9	18.1	17.9	18.8	18.4	18.4
M4 Lending	Monthly change	nsa	4490	9878	4961	6042	9093	7856	6786	11412	5069	4435	10963	5386	6715
	Monthly % change	nsa	1.1	2.3	1.1	1.4	2.0	1.7	1.5	2.4	1.0	0.9	2.2	1.1	1.3
	Monthly % change	sa	1.2	1.9	1.4	1.4	1.7	1.7	1.7	2.2	1.1	1.0	2.2	1.1	1.4
	3-month annualised % change	sa	21.6	22.0	19.9	21.1	19.8	21.1	22.3	24.9	21.9	18.5	18.3	18.7	20.7
	6-month annualised % change	sa	22.0	21.8	21.3	21.3	20.9	20.3	21.7	22.3	21.5	20.4	21.5	20.2	19.6
	Annual % change	nsa	24.3	24.3	23.4	23.2	22.4	21.6	21.9	22.1	21.4	20.9	21.2	20.4	20.7

TABLE 16

REAL PERCENTAGE GROWTH RATES OF MONETARY AGGREGATES

	RPI excluding MIPs	M0	M4	M5
FINANCIAL YEARS (12 month % changes to March)				
1981-82	9.8	-6.5	3.7	3.0
1982-83	5.9	-0.6	7.9	8.0
1983-84	4.6	1.0	6.8	6.1
1984-85	5.2	0.2	8.2	8.2
1985-86	4.0	-0.6	10.1	9.1
1986-87	3.8	0.6	9.9	9.3
1987-88	3.8	1.7	12.5	12.3
1988-89	5.7	0.4	11.7	10.8
1989 Jan	5.5	1.8	11.9	11.2
Feb	5.7	0.9	12.2	11.4
Mar	5.7	0.4	11.7	10.8
Apr	5.9	-0.1	11.3	10.8
May	6.0	0.2	11.4	10.8
Jun	5.9	0.0	11.9	11.4
Jul	5.8	-0.6	10.1	9.6
Aug	5.7	0.4	11.0	10.5
Sep	5.8	-1.2	10.9	10.4
Oct	6.1	-0.8	10.5	10.0
Nov	6.1	-0.4	10.7	10.3
Dec	6.1	-0.1	11.4	11.1
1990 Jan	6.1	-0.3	11.6	11.1
Feb	6.2	0.2	11.2	10.8

TABLE 17

CONFIDENTIAL (Until Publication)

M0 : THE WIDE MONETARY BASE

Monthly data	Level £ million (Change in brackets)							% change on previous month		3 month % growth annualised		6 month % growth annualised		Percentage change on previous year			
	Notes and Coin (nsa)	Notes and Coin (sa)		Bankers' Deposits	M0 (nsa)	M0 (sa)		Notes & Coin (sa)	M0 (sa)	Notes & Coin (sa)	M0 (sa)	Notes & Coin (sa)	M0 (sa)	Notes and Coin (nsa)	Notes and Coin (sa)	M0 (nsa)	M0 (sa)
1989 February	16351	16657	(-68)	152	16504	16810	(-70)	-0.4	-0.4	0.9	0.5	3.6	3.5	6.5	6.5	6.6	6.6
March	16695	16734	(77)	119	16815	16853	(43)	0.5	0.3	0.6	-0.6	1.9	1.3	7.1	6.5	6.8	6.1
April	16630	16778	(44)	194	16824	16972	(119)	0.3	0.7	1.3	2.2	2.6	2.6	5.3	6.1	5.0	5.8
May	16922	16944	(166)	166	17088	17110	(138)	1.0	0.8	7.0	7.3	3.9	3.9	6.6	6.3	6.5	6.2
June	17003	17062	(118)	136	17139	17198	(88)	0.7	0.5	8.1	8.4	4.3	3.8	5.8	6.2	5.5	5.9
July	17339	17149	(87)	120	17459	17269	(71)	0.5	0.4	9.1	7.2	5.2	4.7	5.7	5.7	5.2	5.2
August	17558	17329	(180)	196	17734	17525	(256)	1.1	1.5	9.4	10.0	8.2	8.7	5.9	5.9	6.1	6.1
September	17416	17361	(32)	139	17555	17500	(-25)	0.2	-0.1	7.2	7.2	7.6	7.8	4.7	4.7	4.3	4.5
October	17412	17473	(112)	160	17572	17633	(133)	0.6	0.8	7.8	8.7	8.4	7.9	5.5	5.5	5.3	5.2
November	17552	17581	(108)	167	17719	17748	(115)	0.6	0.6	5.9	5.2	7.6	7.5	5.7	5.8	5.6	5.7
December	18871	17714	(133)	186	19057	17900	(152)	0.8	0.9	8.5	9.5	7.8	8.4	5.6	6.0	5.6	6.0
1990 January	17739	17777	(63)	76	17815	17853	(-47)	0.3	-0.3	7.2	5.1	7.5	6.9	6.1	6.3	5.6	5.8
February	17429	17749	(-28)	141	17570	17890	(37)	-0.2	0.2	3.9	3.2	4.9	4.2	6.6	6.5	6.4	6.4
March (4/4) @	17526	17800	(51)	125	17650	17925	(35)	0.3	0.2	1.9	0.5	5.1	4.9	5.0	6.4	5.0	6.3

Weekly data	Level £ million (Change in brackets)						Percentage change on previous week	Percentage change on previous year			
1990	Notes and Coin (u/a)	Notes and Coin (s/a)	(s/a)	Bankers' Deposits	M0 (sa)		M0 (sa)	Notes and Coin (nsa)	Notes and Coin (sa)	M0 (nsa)	M0 (sa)
January											
3rd	18592	17886	(0)	57	17943	(-96)	-0.5	7.2	6.9	6.4	6.2
10th	17822	17816	(-70)	88	17904	(-39)	-0.2	6.9	6.6	6.3	6.0
17th	17513	17794	(-22)	54	17848	(-56)	-0.3	6.3	6.1	5.8	5.7
24th	17355	17676	(-118)	144	17820	(-28)	-0.2	5.9	5.9	5.8	5.8
31st	17412	17714	(38)	38	17752	(-68)	-0.4	6.4	6.5	6.1	6.1
February											
7th	17434	17775	(61)	26	17801	(49)	0.3	6.6	6.6	5.7	5.6
14th	17395	17740	(-35)	116	17856	(55)	0.3	6.4	6.3	5.9	5.9
21st	17409	17723	(-17)	245	17968	(112)	0.6	6.5	6.6	7.0	7.0
28th	17478	17758	(35)	178	17936	(-32)	-0.2	6.4	6.5	7.0	7.1
March											
7th	17474	17762	(4)	166	17928	(-8)	0.0	6.3	6.3	6.3	6.3
14th	17489	17774	(12)	114	17888	(-40)	-0.2	5.9	6.3	5.5	5.9
21st	17534	17811	(37)	191	18002	(114)	0.6	3.1	6.2	4.1	7.2
28th	17605	17853	(42)	28	17881	(-121)	-0.7	2.9	6.3	2.1	5.4

@@ The figures have been corrected for the write-off of £51 million of notes on 1 June 1989 under the terms of the 1983 Currency Act.

TABLE 18

CONFIDENTIAL

BUILDING SOCIETY BALANCE SHEET FLOWS

Unadjusted # million

		ASSETS			LIABILITIES			
	Total Flow	Net Mortgage Advances & Unsecured Lending	Liquid Assets	Fixed Assets	Retail principal	Interest credited	Wholesale funds	Other (eg reserves)
1987 *	1650	1268	339 (16.9)	43	630	570	194	256
1988 *	2565	2062	435 (16.8)	69	1101	621	451	391
1989 *	2568	2210	233 (16.0)	125	641	815	696	418
1987 Q3*	1547	1288	215 (16.1)	44	409	516	337	285
Q4*	2063	1390	692 (16.9)	-19	1038	785	222	18
1988 Q1*	1870	1686	10 (16.5)	174	1027	626	113	104
Q2*	3176	2205	925 (17.0)	46	1349	407	697	716
Q3*	2636	2506	116 (16.4)	14	986	554	641	456
Q4*	2578	1849	688 (16.8)	41	1043	896	353	286
1989 Q1*	2088	1782	70 (16.4)	236	912	773	161	241
Q2*	2407	2232	123 (16.4)	52	568	615	318	916
Q3*	2736	2294	391 (15.6)	51	721	728	888	399
Q4*	3039	2530	349 (15.4)	160	363	1142	1416	117
1989 Dec	3249	2471	302 (15.4)	476	187	2725	2145	-1808
1990 Jan	2281	2143	281 (15.3)	-143	335	2250	959	-1263
Feb	2392	2077	186 (15.2)	129	314	178	857	1043
Forecast								
1990 March	2453	1823	560 (15.3)	70	600	273	500	1080

* Monthly averages
Figures in ( ) are end period liquidity ratio, unadjusted
Figures for July onwards exclude the Abbey National.

TABLE 19

THE COMPONENTS OF M4 AND M5

	NOTES & COIN	RETAIL DEPOSITS[1]	WHOLESALE DEPOSITS	M4	NATIONAL SAVINGS	MONEY MARKET INSTRUMENTS[2]	M5
% CHANGES							
Financial years[3] (nsa)							
1984-85	4.5	13.0	19.6	13.8	4.5	31.8	13.8
1985-86	3.0	13.9	19.6	14.5	5.4	-12.4	13.5
1986-87	-2.1	12.9	21.4	14.1	9.7	-4.9	13.5
1987-88	14.3	13.0	28.2	16.8	11.3	16.0	16.6
1988-89	3.0	15.8	26.2	18.1	4.5	-20.8	17.1
1989 Feb	4.7	16.5	26.2	18.6	5.9	-7.3	17.8
Mar	3.0	15.8	26.2	18.1	4.5	-20.8	17.1
Apr	5.4	15.4	26.5	17.9	3.9	5.5	17.3
May	5.3	14.9	28.2	18.1	3.3	7.9	17.5
Jun	6.4	13.8	32.5	18.5	2.6	19.6	18.0
Jul	1.0	13.7	25.8	16.5	2.0	18.6	16.0
Aug	5.8	13.0	29.5	17.3	1.7	15.9	16.8
Sep	3.4	12.9	30.1	17.3	1.7	16.9	16.8
Oct	3.8	12.3	31.1	17.2	1.8	11.8	16.7
Nov	6.4	12.8	30.6	17.5	1.6	11.4	17.0
Dec	5.7	12.5	33.9	18.2	1.1	43.5	17.9
1990 Jan	5.9	12.2	34.7	18.4	1.4	23.3	17.9
Feb	6.1	11.6	35.4	18.1	1.4	27.9	17.7
Over 6 months (sa)							
1989 Sep	9.6	13.0	33.7	18.7	2.7	68.4	18.7
Oct	-3.8	13.2	35.4	18.7	3.2	14.6	18.2
Nov	7.6	12.1	35.3	18.5	2.4	18.8	18.0
Dec	8.8	13.8	28.3	18.2	1.4	16.5	17.6
1990 Jan	0.6	12.2	37.5	19.6	2.1	-8.0	18.7
Feb	3.1	12.0	30.7	17.6	1.2	2.8	17.0
CHANGES £ MILLION							
(sa)							
1989 Sep	515	4756	3564	8835	36	166	9037
Oct	-501	1879	1206	2584	38	-314	2308
Nov	286	1940	2407	4633	-17	159	4775
Dec	697	3206	5023	8926	-33	341	9234
1990 Jan	-932	1257	4538	4863	56	-395	4524
Feb	150	1815	1901	3866	-8	110	3968

[1] Net inflow including Term shares and SAYE.
[2] Treasury bills, bank bills, LA temporary debt, and CTDs.
[3] March on March.

TABLE 20 SECRET 30/03/90

FUNDING : FINANCIAL YEARS 1989-90 AND 1990-91

£million

	1989-90			1990-91
	Forecast	Outturn	Residual	Forecast
	1989-90	April-Feb 90	Mar 90	
Within Year Contribution to Funding Requirement:				
1 PSBR (+)/PSDR (-)	-7058	-9641	2583	-6900
2 Intervention (increase in reserves +)	-5860	-5600	-260	0
3 Maturities	9889	9108	781	5781
4 TOTAL FOR FUNDING	**-3029**	**-6133**	**3104**	**-1119**
FUNDED BY:				
Non-gilts				
5 National Savings	-1800	-1624	-176	-1000
6 CTDs sales to M4PS	218	218	0	0
7 Other public debt sales to M4PS and overseas	-1875	-1775	-100	-400
8 Total non-gilt funding	**-3457**	**-3181**	**-276**	**-1400**
Gilts				
9 Gilt sales to M4PS and overseas needed for full fund within year	428	-2952	3380	281
10 Net gilt sales to banks, building socs and other public sector	-4369	-4169	-200	-1000
11 Required gross official gilt sales	**-3941**	**-7121**	**3180**	**-719**
12 Actual gross gilt sales to date		-5800 (-527)		
13 Over(+)/Under(-)funding	-2199	1321	-3520	-340
14 Remaining gross gilt sales required			**-340 (-340)**	
15 Gross gilt sales required over whole year	-6140			-1059

(Figures in brackets in lines (13) and (15) are monthly averages)

Relationship between lines:

(4)= (1)+(2)+(3)
(8)= (5)+(6)+(7)
(9)= (4)-(8)
(11)= (9)+(10)
(13): Col(1) Underfunding required in 1989-90 to offset previous cumulative overfunding
Col(2) Line (12) - line (11)
Col(3) By residual from cols(1) and (2)
(14)= (11)+(13)
(15)= (12 col 2)+(14 col 3)

Table 21:- BORROWING BY PRIVATE SECTOR EXCLUDING BUILDING SOCIETIES (£ million)

	Banks	B Soc	TOTAL	Sterling Commercial Paper(*)	Ordinary Shares (*)	Preference & Euro-Sterling (**)	TOTAL	Sterling	Foreign Currency	TOTAL
	BANK/BUILDING SOC. STERLING BORROWING			OTHER STERLING BORROWING				ALL BORROWING		
Change in Quarter										
1986										
Q1	7157	3967	11124	0	471	959	1430	12554	2362	1491
Q2	5189	5220	10409	0	1369	949	2318	12727	1575	1430
Q3	4877	5738	10615	23	1431	738	2192	12807	3688	1649
Q4	10138	4782	14920	68	2338	229	2635	17555	623	1817
1987										
Q1	7147	3619	10766	416	1553	764	2733	13499	7142	2064
Q2	8692	4240	12932	597	2259	1342	4198	17130	4733	2186
Q3	10855	3889	14744	259	5950	1663	7872	16911	-1152	1575
Q4	10908	3926	14834	-167	3746	764	4343	19177	-178	1899
1988										
Q1	13154	4980	18134	909	370	1724	3003	21137	-376	2076
Q2	13154	4980	18134	597	1028	1742	3367	21501	1022	2252
Q3	15002	7414	22416	160	1560	1989	3709	26125	3034	2915
Q4	14163	5416	19579	-344	2232	2488	4376	23955	3152	2710
1989										
Q1	15353	6422	21775	821	-1536	2932	2217	23992	6505	3049
Q2	12646	7450	20096	-198	2581	1999	4382	24478	2479	2695
Q3	19367	6687	26054	-570	1870	2372	3672	29726	4565	3429
Q4	12861	7606	20467	-761	1375	1177	1791	22258	2968	2522
Annual totals										
1985	19693	14733	34426	0	3414	1963	5377	39803	1185	4098
1986	27361	19707	47068	91	5609	2875	8575	13911	2062	1597
1987	37602	15674	53276	1105	13508	4533	19146	16679	2636	1931
1988	30455	12055	42510	1322	5190	7943	14455	17739	1134	1887
1989	60227	28165	88392	-708	4290	8480	12062	100454	16517	11697
Change in Month										
1989 JANUARY	5522	1885	7407	552	220	1263	2035	9442	3503	1294
FEBRUARY	2406	2084	4490	-5	43	846	884	5374	701	607
MARCH	7425	2453	9878	274	-1799	823	-702	9176	2301	1147
APRIL	2696	2265	4961	373	826	188	1387	6348	-998	535
MAY	3199	2843	6042	-317	322	908	913	6955	480	743
JUNE	6751	2342	9093	-254	1433	903	2082	11175	2997	1417
JULY	5972	1884	7856	1	874	970	1845	9701	1088	1078
AUGUST	4577	2209	6786	7	148	607	762	7548	2769	1031
SEPT	8818	2594	11412	132	848	795	1775	13187	436	1362
OCTOBER	2435	2634	5069	-431	913	323	805	5874	1766	764
NOVEMBER	1792	2643	4435	297	305	814	1416	5851	738	658
DECEMBER	8634	2329	10963	-627	157	40	-430	10533	464	1099
1990 JANUARY	3325	2061	5386	668	284	426	1378	6764	531	729
FEBRUARY	4727	1988	6715	280	776	521	1577	8292	-425	786

* UK ICCs only
** Announced issues by UK ICCs and OFIs
** Gross issues announced by UK ICCs and OFIs. From Jan 1990 net issues by ICCs & OOFIs.

Table 22:- FINANCE OF U.K. INDUSTRIAL AND COMMERCIAL COMPANIES (£ million)

				OTHER BORROWING				ALL BORROWING
	Sterling	Foreign Currency	TOTAL	Sterling Commercial Paper	Ordinary Shares	Preference & Euro-St ICC's	TOTAL	TOTAL
Change in Quarter								
1985								
Q1	3344	-352	2992		924	405	1329	4321
Q2	723	207	930		1092	557	1649	2579
Q3	197	1371	1568		873	404	1277	2845
Q4	847	1377	2224		525	289	814	3038
1986								
Q1	3722	108	3830	0	471	559	1030	4860
Q2	-314	108	-206	0	1369	669	2038	1832
Q3	-26	1128	1102	23	1431	521	1975	3077
Q4	5360	-15	5345	68	2338	229	2635	7980
1987								
Q1	1136	2028	3164	416	1553	449	2418	5582
Q2	602	687	1289	597	2259	1007	3863	5152
Q3	3524	-34	3490	259	5950	1302	7511	12382
Q4	4232	544	4776	-167	3746	278	3857	8633
1988								
Q1	7539	2099	9638	909	370	1039	2318	11956
Q2	4474	2080	6554	597	1028	794	2419	8973
Q3	4951	2302	7253	160	1603	1227	2990	10243
Q4	6061	1863	7924	-344	1916	1851	3423	11347
1989								
Q1	6449	2470	8919	821	-1506	2064	1379	10298
Q2	4973	1776	6749	-198	1498	1195	2495	9244
Q3	10002	3406	13408	140	1447	847	2434	15842
Q4	5027	956	5983	-761	1379	404	1022	7005
Annual totals								
1984	6995	271	7266	0	1129	586	1715	8981
1985	5111	2603	7714	0	3414	1655	5069	12783
1986	8742	1329	10071	91	5418	1978	7487	17558
1987	9494	3225	12719	1105	12236	3036	16377	29096
1988	23025	8344	31369	1322	4833	4911	11066	42435
1989	26451	8608	35059	2	2818	4510	7330	42389
Change in Month								
1989 JANUARY				552	227	662	1441	
FEBRUARY				-5	46	844	885	
MARCH				274	-1791	558	-959	
APRIL				373	800	89	1262	
MAY				-317	257	205	145	
JUNE				-254	443	901	1090	
JULY				1	761	405	1167	
AUGUST				7	154	47	208	
SEPTEMBER				132	539	395	1066	
OCTOBER				-431	831	100	500	
NOVEMBER				297	261	264	822	
DECEMBER				-627	157	40	-430	
1990 JANUARY				668	284	304	1256	
FEBRUARY				280	776	359	1415	

* Gross Issues announced by U.K. ICCs. Net issues from Jan 1990.

TA[illegible] 23: M0 Forecast (all series seasonally adjusted)

	Levels		percentage growth rates			
			6 months		12 months	
	Notes & coin	M0	Notes & coin	M0	Notes & coin	M0
1988-89 *	16417	16587			7.3	7.1
November	16621	16788	8.8	8.5	7.8	7.6
December	16707	16880	8.1	8.0	7.5	7.4
January	16724	16879	6.3	5.8	7.6	7.4
February	16658	16810	3.6	3.5	6.5	6.6
March	16734	16854	1.9	1.3	6.5	6.1
1989-90						
April	16779	16973	2.6	2.6	6.1	5.8
May	16944	17110	3.9	3.9	6.3	6.2
June	17063	17199	4.3	3.8	6.2	5.9
July	17150	17272	5.2	4.7	5.7	5.2
August	17330	17526	8.2	8.7	5.9	6.1
September	17362	17501	7.6	7.8	4.7	4.5
October	17473	17633	8.4	7.9	5.5	5.2
November	17579	17746	7.6	7.5	5.8	5.7
December	17717	17903	7.8	8.4	6.0	6.0
January	17778	17854	7.5	6.9	6.3	5.8
February	17749	17890	4.9	4.2	6.5	6.4
March(e)	17800	17925	5.1	4.9	6.4	6.3
Forecast						
1990-91						
April	17883	18058	4.7	4.9	6.6	6.4
May	17943	18118	4.2	4.2	5.9	5.9
June	18009	18184	3.3	3.2	5.5	5.7
July	18086	18261	3.5	4.6	5.5	5.7
August	18197	18372	5.1	5.5	5.0	4.8
September	18304	18479	5.7	6.3	5.4	5.6
October	18382	18557	5.7	5.6	5.2	5.2
November	18450	18625	5.7	5.7	5.0	5.0
December	18522	18697	5.8	5.7	4.5	4.4
January	18517	18692	4.8	4.8	4.2	4.7
February	18495	18670	3.3	3.3	4.2	4.4
March	18498	18673	2.1	2.1	3.9	4.2
1989-90 *	17394	17544			6.0	5.8
1990-91 *	18274	18449			5.1	5.2

(e) - estimate
* average of monthly figures

CONFIDENTIAL 30/3/90

TABLE 24 : M4 COUNTERPARTS AND FORECAST £ million

OUTTURN: FEBRUARY 1990

PSBR	-1038
LA and PC debt sales to M4ps (-)	-2
CG debt sales to M4ps (-)	
o/w Gilts	338
Treasury bills, other	-223
National Savings	174
CTD's	33
Public sector external & fc finance	368
PUBLIC SECTOR CONTRIBUTION (-)	-350
(o/w over(-)/under(+) funding)	193
Sterling lending nsa	6715
(sa)	(7269)
Banks' and B Socs' externals	-1909
Banks' and B Socs' £NNDLs	-1898
TOTAL M4	2558
Monthly % growth nsa	0.6
sa	0.9
Annual % growth nsa	18.1
sa	17.9

FORECAST: MARCH 1990

PSBR	2505
LA and PC debt sales to M4ps (-)	0
CG debt sales to M4ps (-)	
o/w Gilts	602
Treasury bills, Other	-100
National Savings	229
CTD's	20
Public sector external & fc finance	-152
PUBLIC SECTOR CONTRIBUTION (-)	3104
(o/w over(-)/under(+) funding)	3304
Sterling lending nsa	10511
sa	(9000)
Banks' and B Socs' externals & £NNDLs	-2330
TOTAL M4	11285
Monthly % growth nsa	2.6
sa	2.0
Annual % growth nsa	18.0
sa	17.9

Table 25 MONEY MARKET ASSISTANCE SECRET 30/03/90

	OUT-TURN		1990-91 FORECAST													TOTAL	TOTAL
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	89/90	90/91
INFLUENCES ON BANKERS' BALANCES																	
1 CGBR (+)	-5398	-1598	2735	1452	1524	2185	-1114	-414	1485	-2414	-1014	-2815	-4914	186	1089	-4910	-4764
2 CG bank deposits (+)	-211	-166	0	0	0	0	0	0	0	0	0	300	-300	0	0	18	0
3 Reserves etc (+)	17	113	-260	0	0	0	0	0	0	0	0	0	0	0	0	-5837	0
4 Notes & Coin (-)	2100	-78	-619	71	53	-330	166	-269	-183	588	-489	-1402	1801	50	-125	-687	-89
5 National Savings (-)	-26	109	299	83	83	83	83	83	83	83	83	83	83	83	87	1800	1000
6 CTDs (-)	38	23	0	0	0	0	0	0	0	0	0	0	0	0	0	-252	0
BGS (-)																	
Gross sales (-)	374	115	75	88	88	88	88	88	88	88	88	88	88	88	91	5800	1059
Maturities (+)	1409	1216	781	0	432	553	938	0	0	1573	490	0	1795	0	0	9889	5781
7 Net sales (-)	1783	1331	856	88	520	641	1026	88	88	1661	578	88	1883	88	91	15689	6840
o/w																	
M4ps & Overseas (-)	784	924	656	5	437	558	943	5	5	1578	495	5	1800	5	8	11320	5840
Banks/B Socs/OPS (-)	999	407	200	83	83	83	83	83	83	83	83	83	83	83	83	4369	1000
8 Other	276	92	0	0	0	0	0	0	0	0	0	0	0	0	0	-347	0
9 TOTAL INFLUENCES ON BANKERS' BALANCES	-1421	-174	3011	1694	2180	2559	161	-512	1473	-82	-842	-3746	-1447	407	1142	5474	2987
OPERATIONS																	
10 Issue Department Commercial Bills	1179	1127	-1480	-354	-1504	-2166	360	561	-1473	82	842	3746	1447	-407	-1142	1160	-8
11 Other	-1004	535	0	0	0	0	0	0	0	0	0	0	0	0	0	114	0
12 ASSISTANCE	175	1819	-1480	-354	-1504	-2166	360	561	-1473	82	842	3746	1447	-407	-1142	1274	-8
13 LEVEL OF ASSISTANCE	4995	6814	5334	4980	3476	1310	1670	2231	758	840	1682	5428	6875	6468	5326		
14 Treasury bills (exc repos)	1133	-1505	-1531	-1340	-676	-393	-521	-49	0	0	0	0	0	0	0		
15 TOTAL OPERATIONS	1308	314	-3011	-1694	-2180	-2559	-161	512	-1473	82	842	3746	1447	-407	-1142		
16 Treasury bills: amount outstanding	6998	8503	10034	11374	12050	12443	12964	13013	13013	13013	13013	13013	13013	13013	13013		
Memo items:																	
17 Bankers' balances	-112	140	0	0	0	0	0	0	0	0	0	0	0	0	0		
18 Level of ID commercial bills	3968	5095	3615	3261	1757	-409	-49	512	-961	-879	-37	3709	5156	4749	3607		

Relationship between lines:
9 = 1+2+3+4+5+6+7+8 = 15-17
12 = 10+11
13 = previous month's level + 12
15 = 12+14 = 9+17
Signs in lines 1-9 indicate increase + or - and therefore the effect on Bankers' Balances; the effect on assistance is in the opposite direction

TABLE 26

GILT REDEMPTIONS UP TO END FINANCIAL YEAR 1990/91

			amount outstanding (£ millions)
Financial year 1989/90			
1990	March	Exchequer 12 1/2	1250
Financial year 1990/91			
	May	Treasury 3	550
	June	Treasury 8 1/4	600
	July	Treasury 8	956
	October	Treasury 10 conv	1887
	November	Exchequer 2 1/2	500
1991	January	Treasury 11 3/4	2200

MONTHLY MONETARY REPORT : CHARTS

1 Exchange Rates

2 World interest rates

3 Broad Money Growth

4 Real M0 growth

5 M0 forecast

6 M4 forecast

7 Bank and Building Society Lending

8 Corporate bond issues

9 Money Market Assistance

10 Nominal Interest Rates

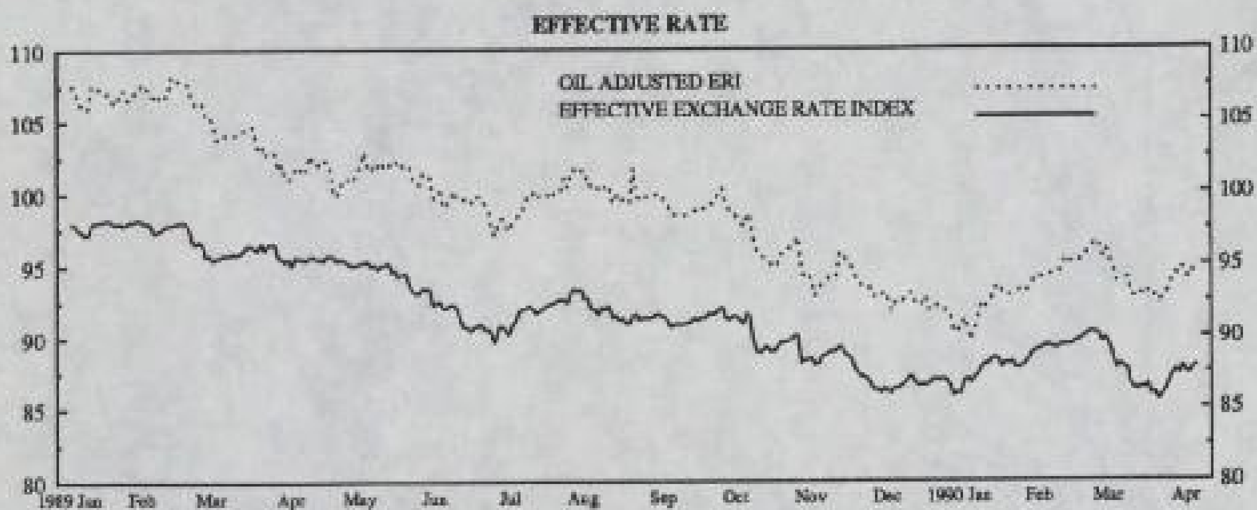
11 Yield Curve

12 Real Yields

13 House prices

14 Stock indices

CHART 1: EXCHANGE RATES



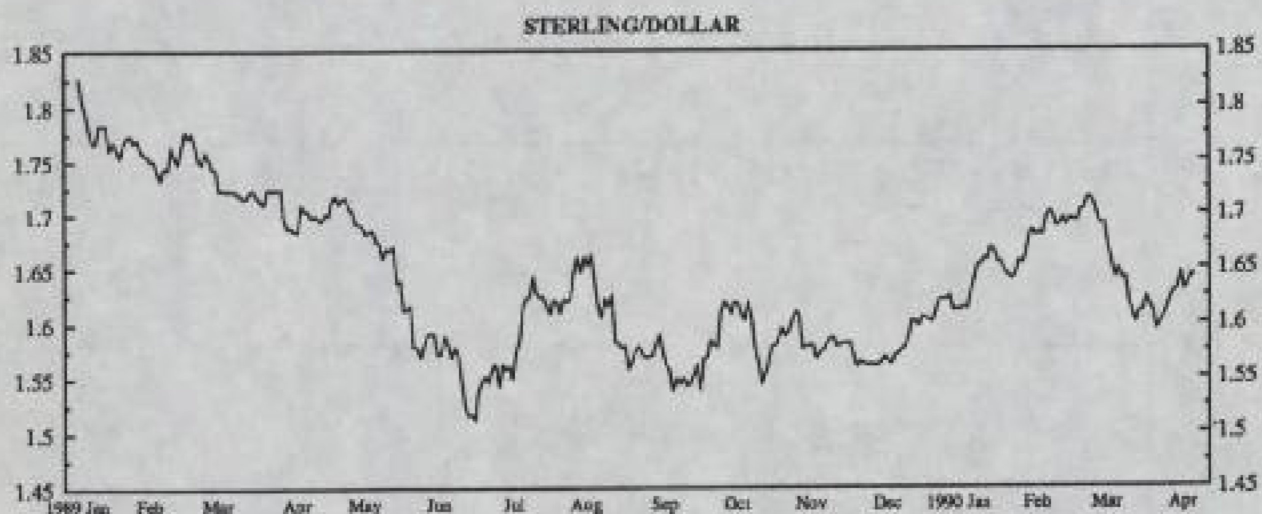
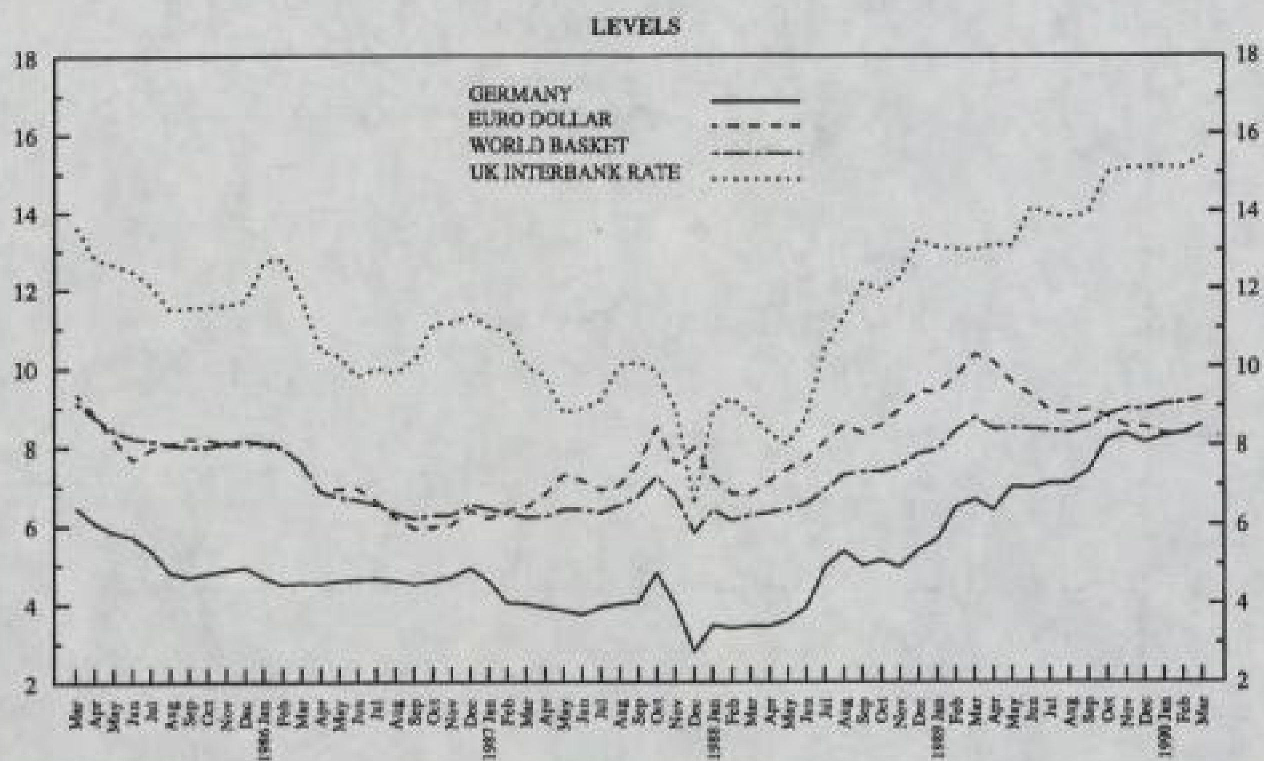


CHART 2: WORLD INTEREST RATES



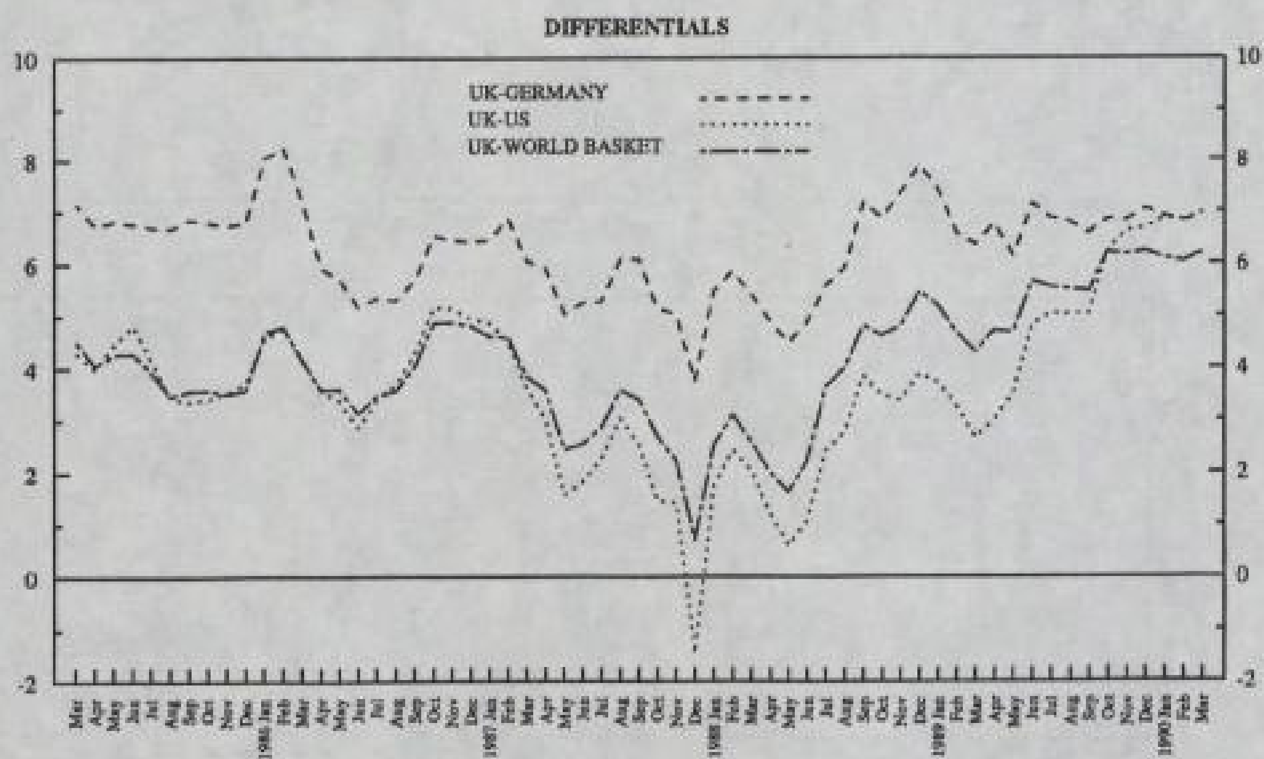


CHART 3: BROAD MONEY

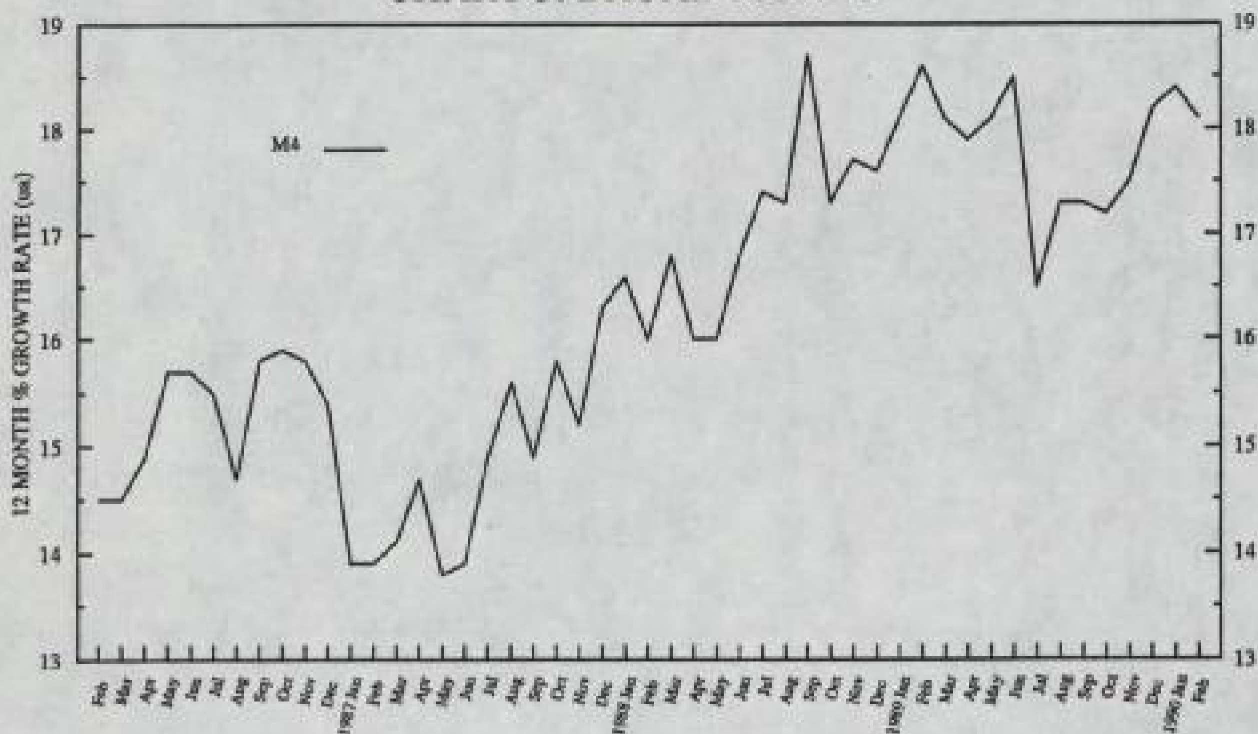


CHART 4: REAL M0

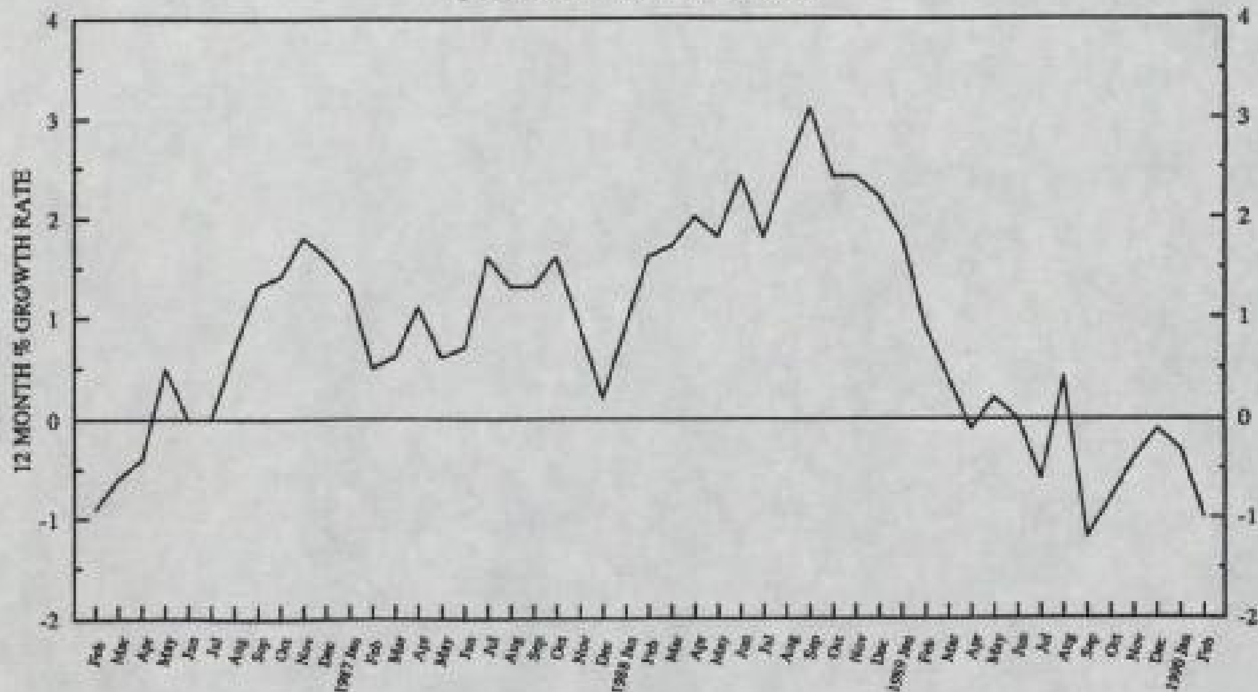


CHART 5: M0 FORECAST

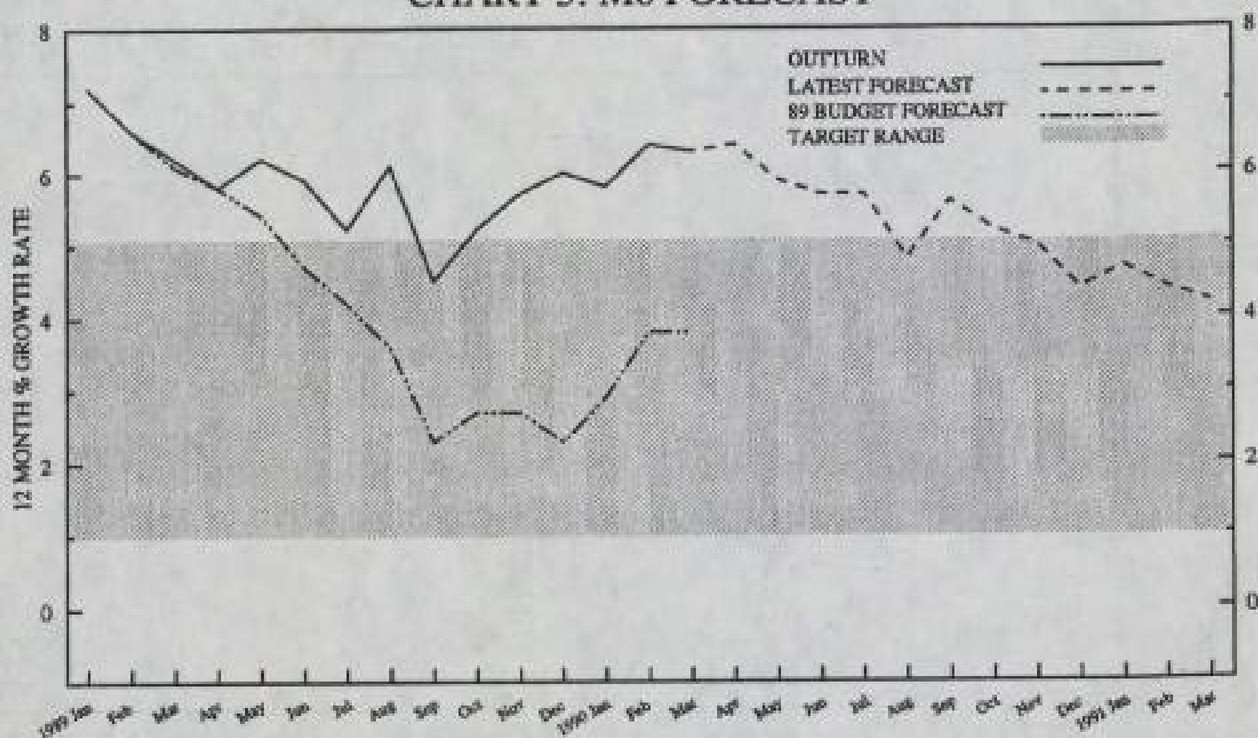


CHART 6: M4 FORECAST

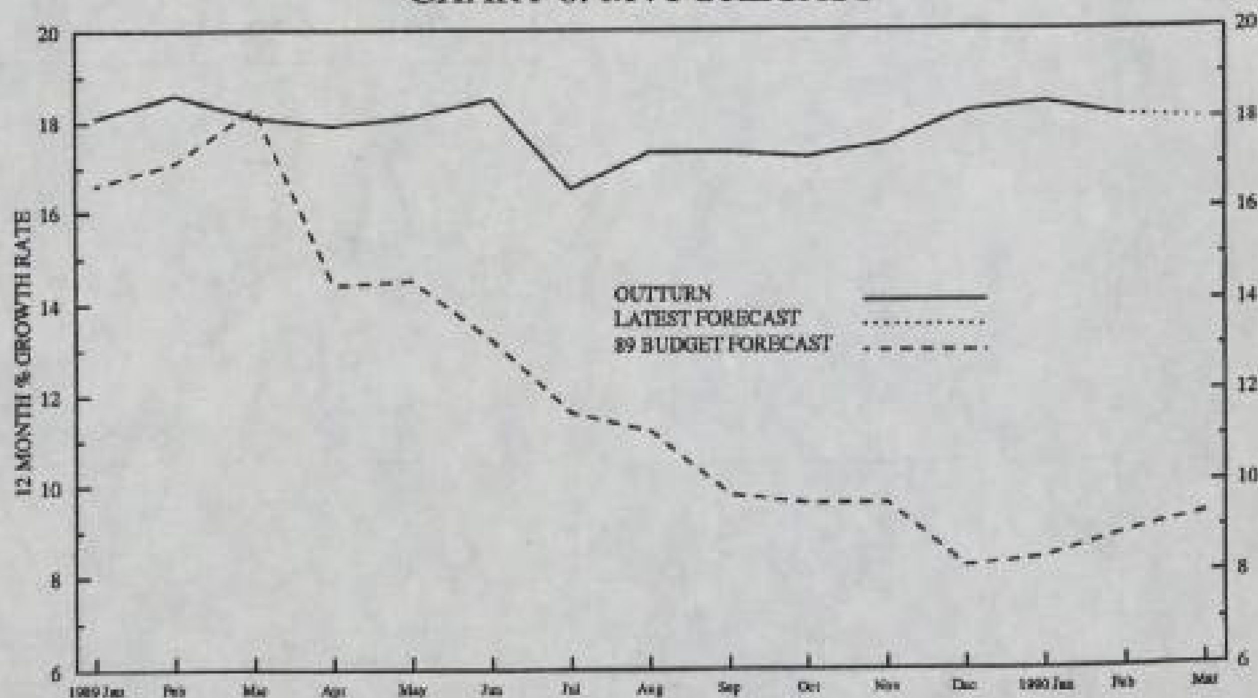


CHART 7: BANK & BUILDING SOCIETY LENDING

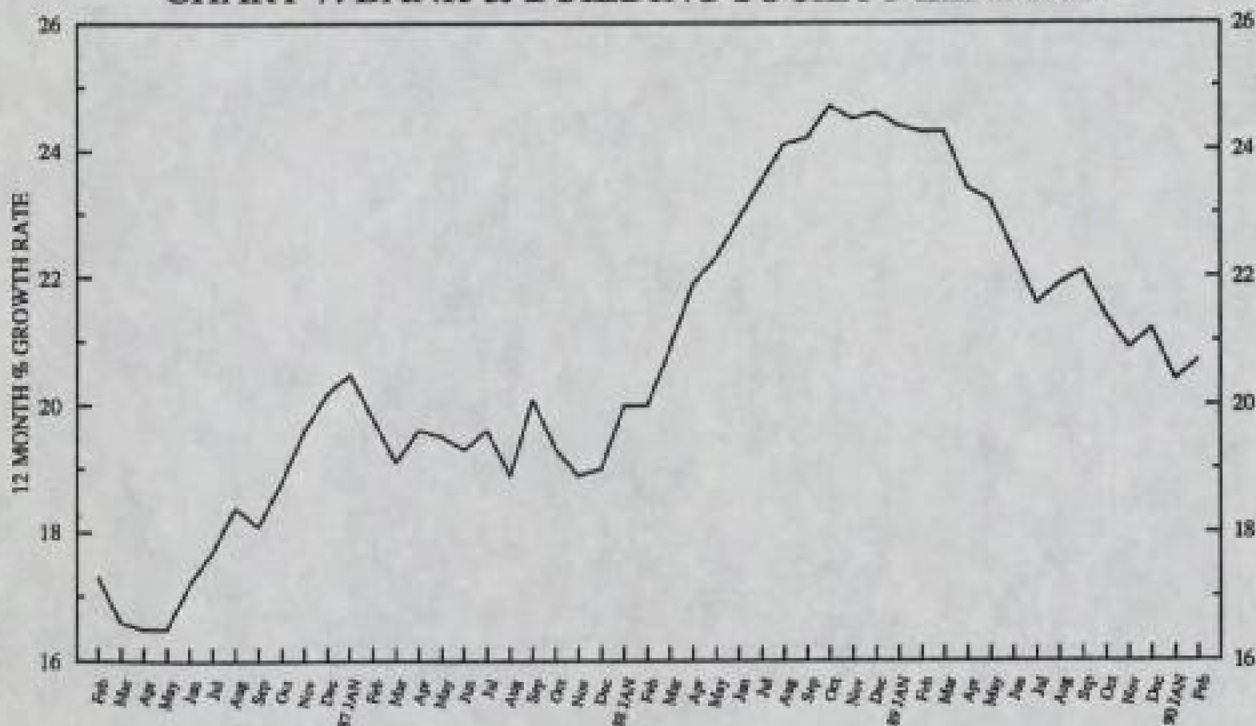


CHART 8: STERLING BOND ISSUES

(Domestic and Euro Markets)

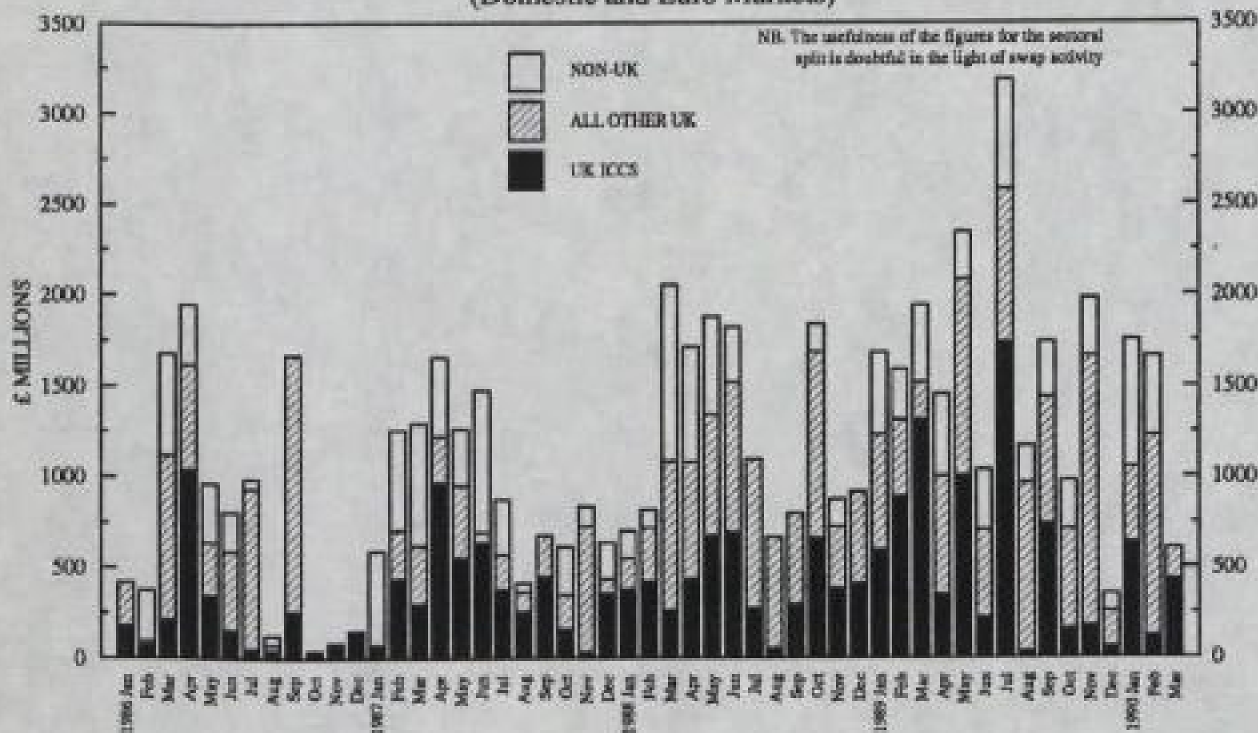


CHART 9: MONEY MARKET ASSISTANCE

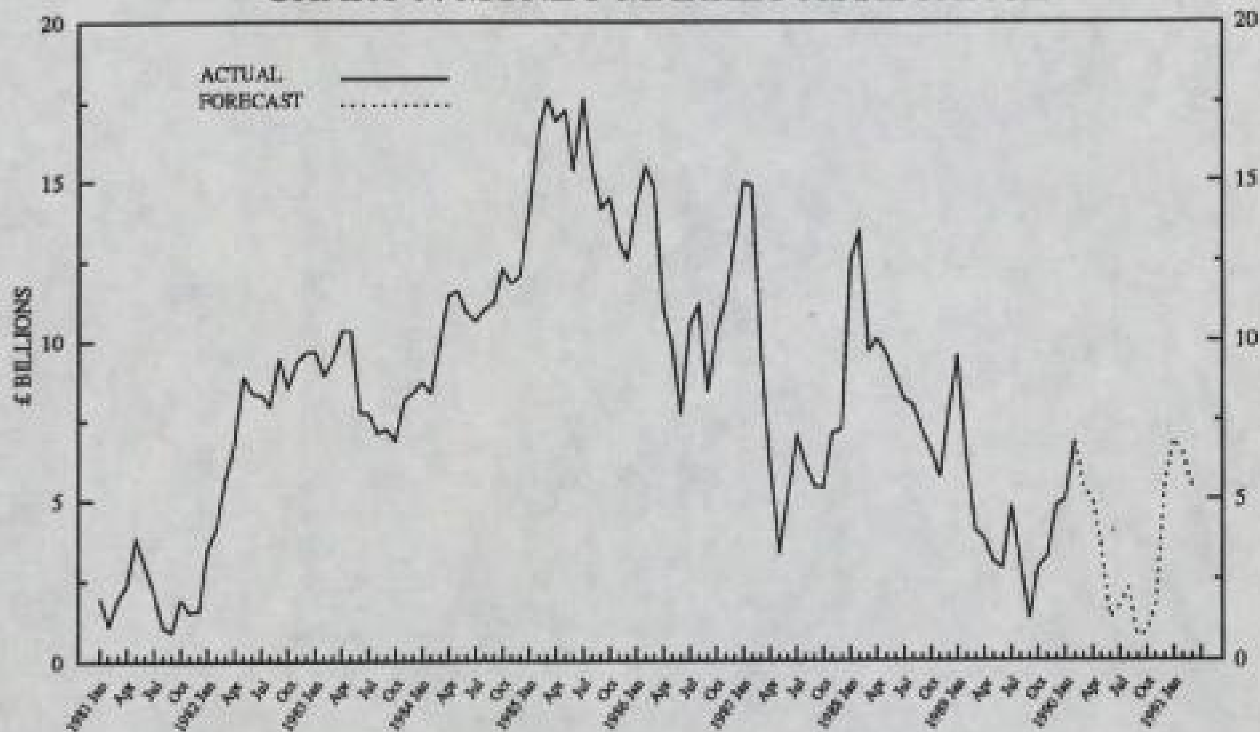


CHART 10: NOMINAL INTEREST RATES

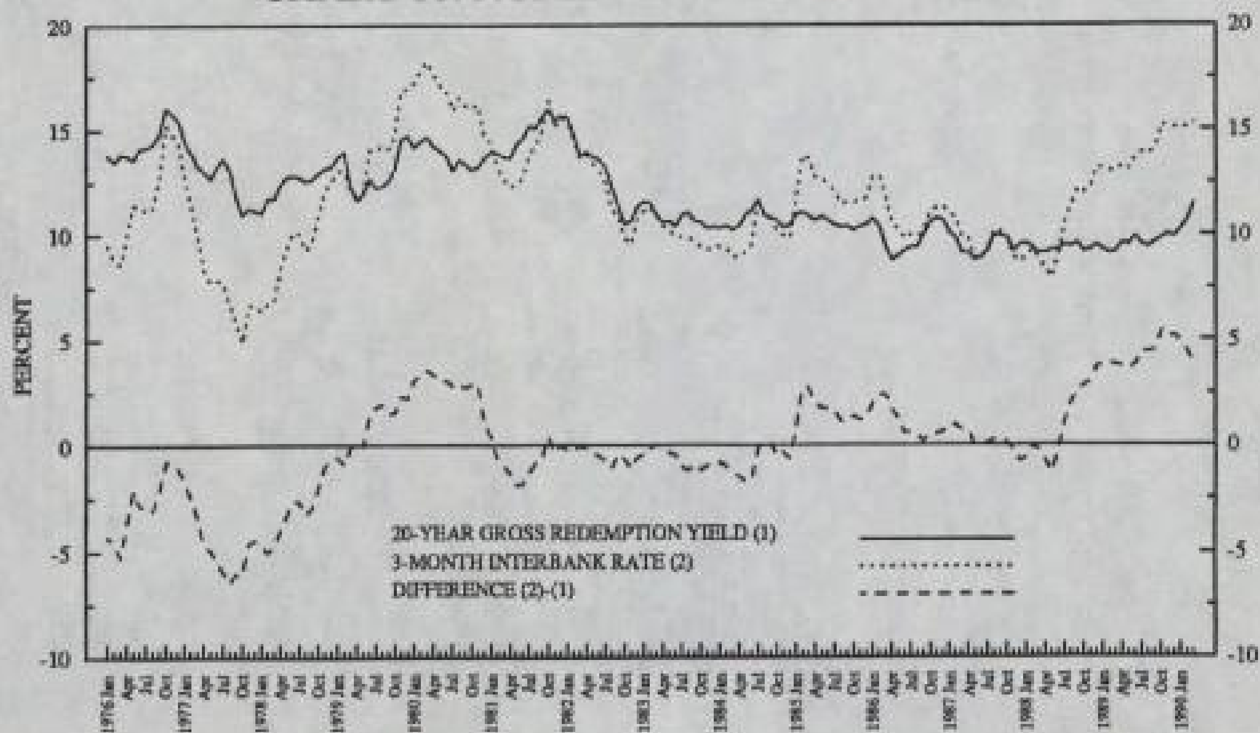


CHART 11

Time/Yield curves of British Government stocks

2nd April, 1990

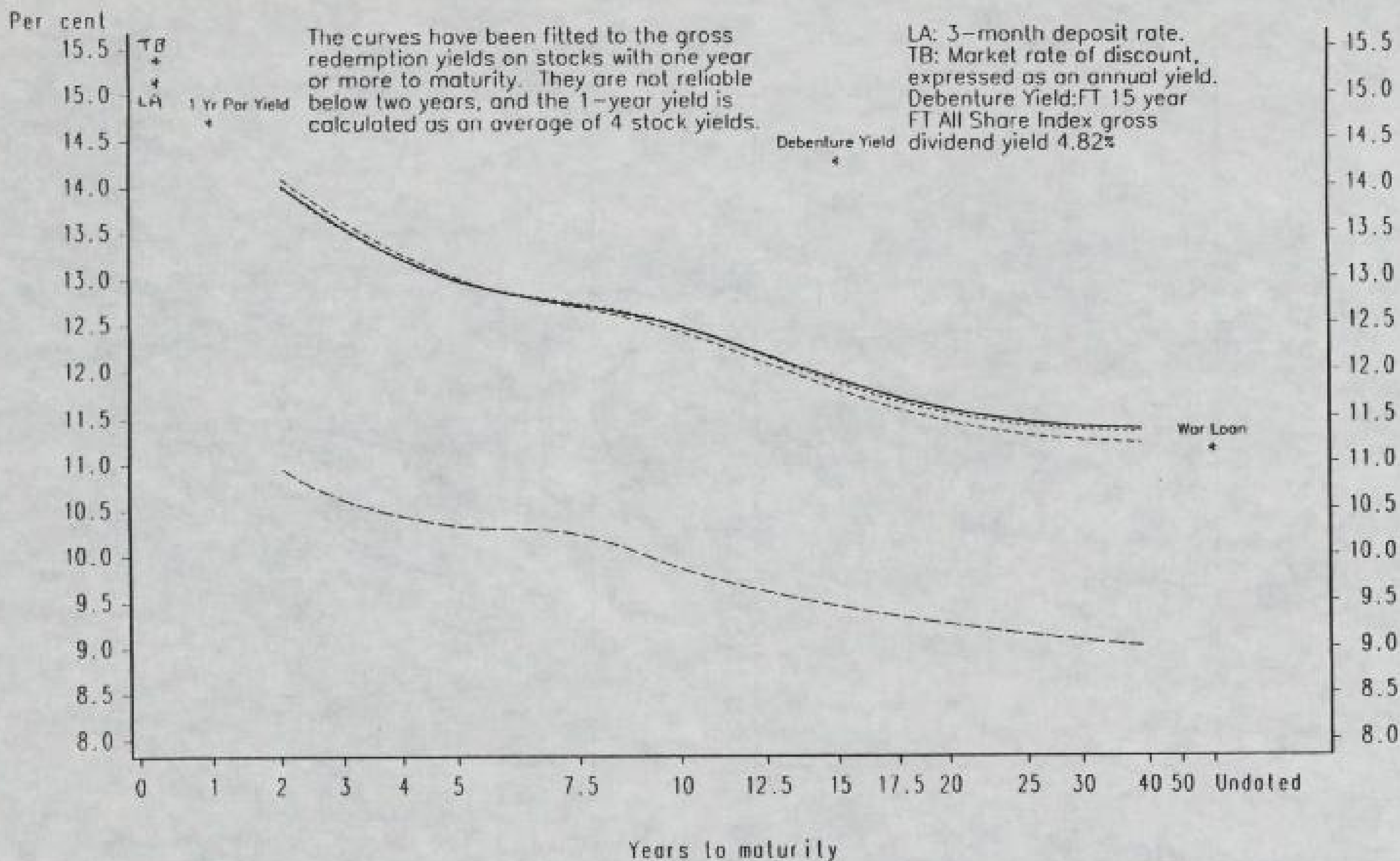
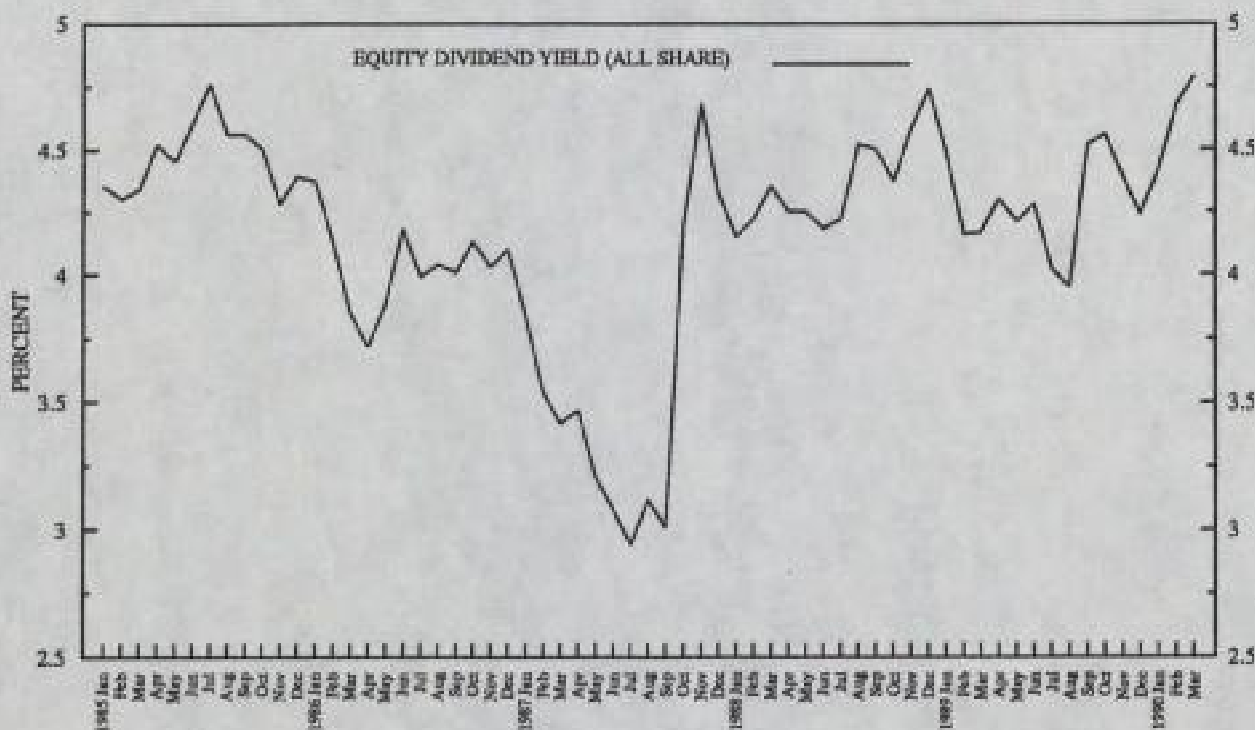


CHART 12: REAL YIELDS



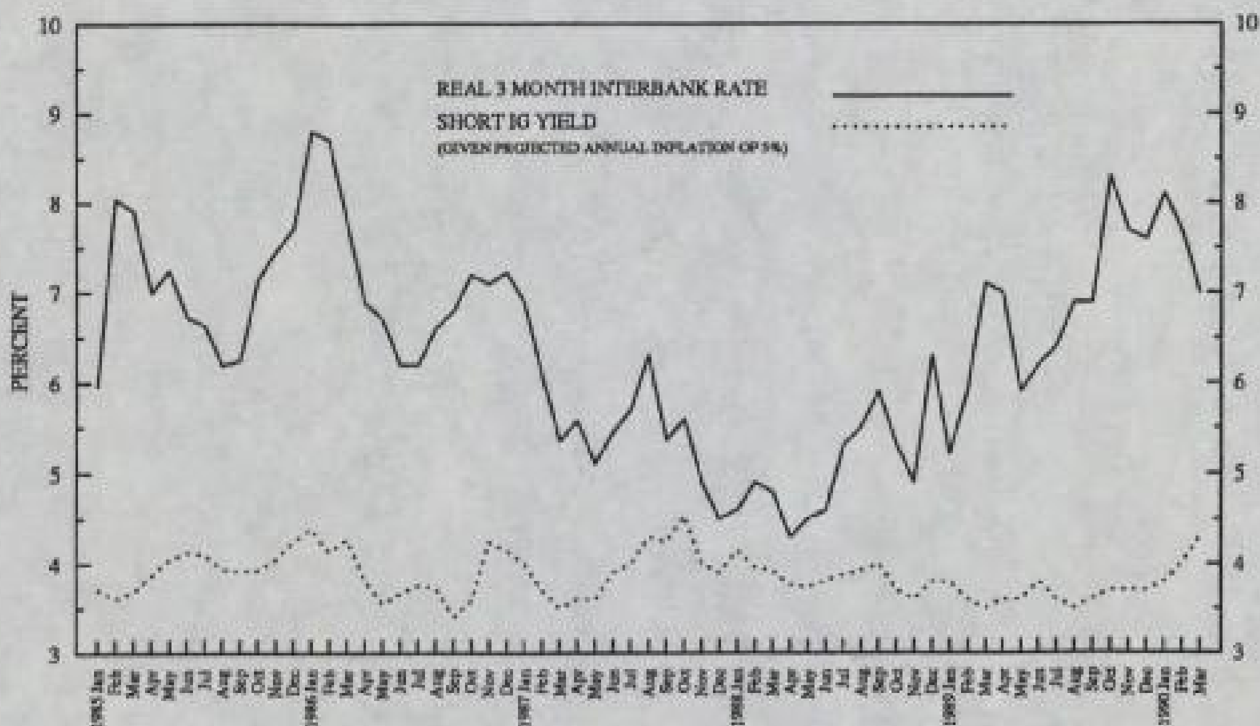
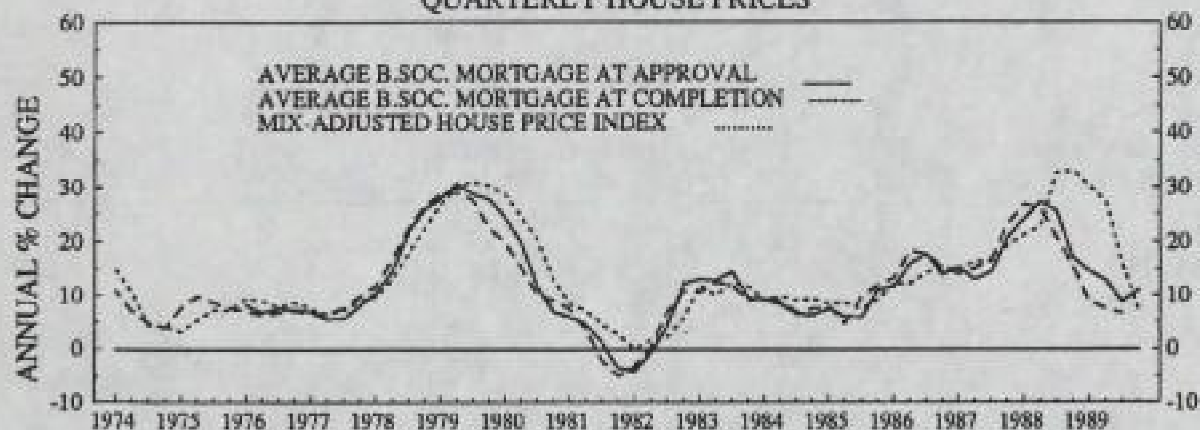
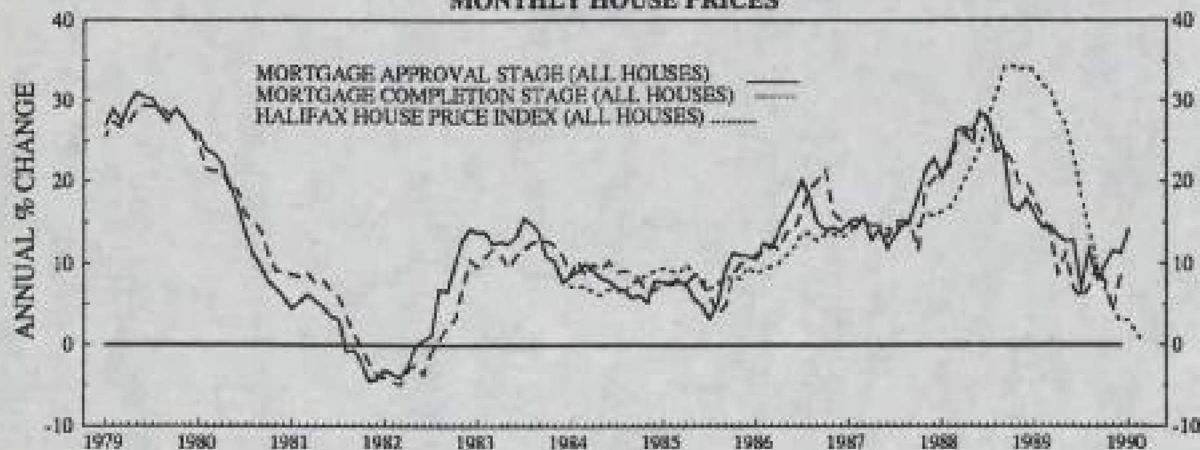


CHART 13 : HOUSE PRICES





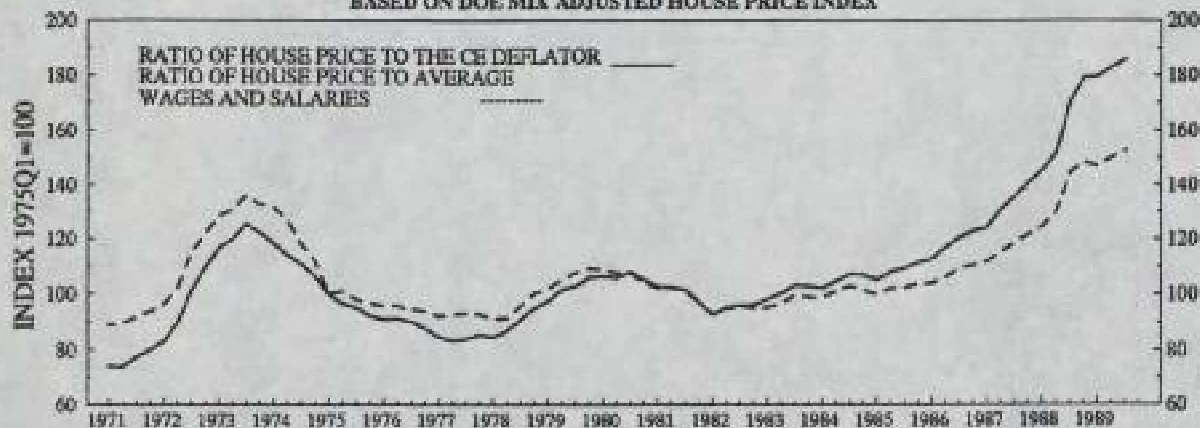
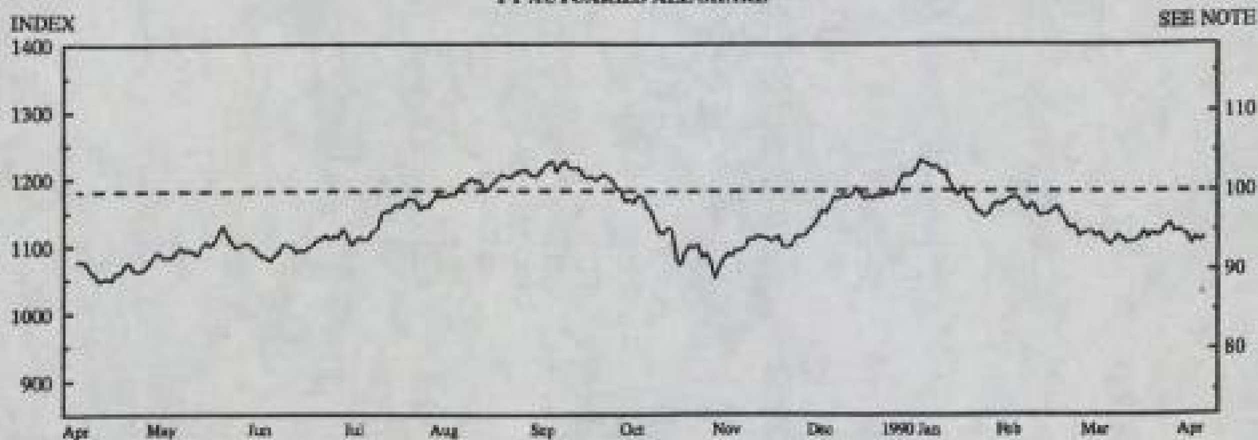
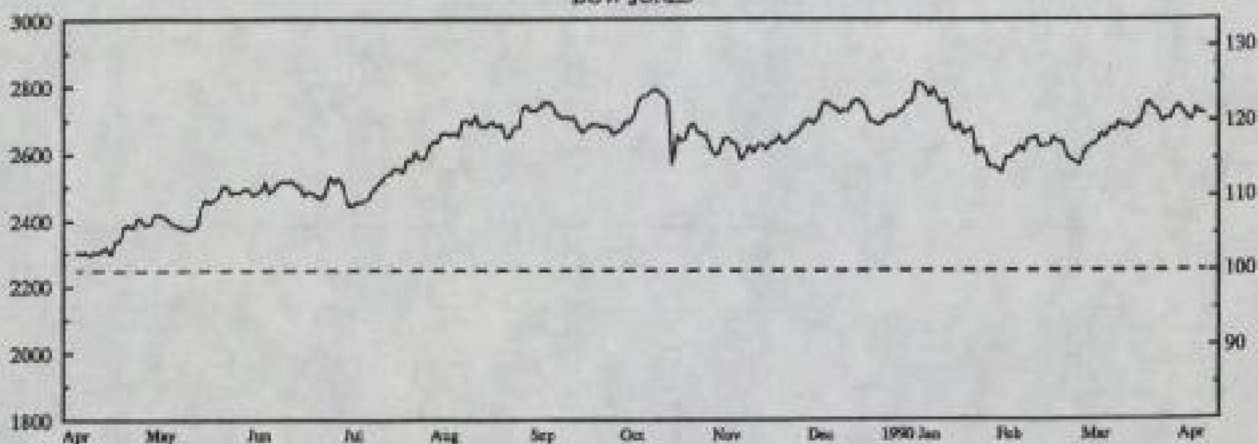
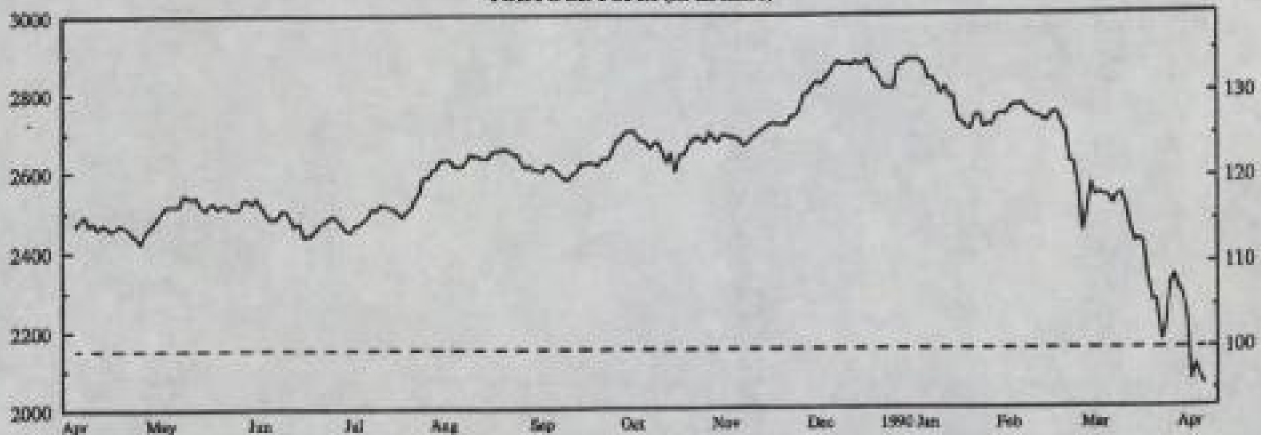


CHART 14: STOCK INDICES







NOTE: RIGHT HAND SCALE SHOWS LEVEL OF STOCK INDEX
RELATIVE TO PRE 1987 CRASH LEVEL (100)

AM364

020

A copy of this letter is also filed on ECON POL: Public sector pay

SCPU

CONFIDENTIAL

The Rt Hon Norman Lamont MP
Chie Secretary to the Treasury
HM Treasury
Parliament Street
LONDON SW1

Richmond House
79 Whitehall
London SW1A 2NS
Telephone 01 210 5155
From the Secretary of State for Health

05 APR 1990

Dear Norman,

I am becoming increasingly concerned about developments in public sector pay negotiations.

In your letter to me of 12 March you indicated that you were content with my proposals for an opening offer between 7 and 7.25% for NHS administrative and clerical staff and an overall full year cost for all non-Review Body NHS settlements at a maximum of 7.9%. The opening offer of 7.25% for administrative and clerical staff was rejected on 14 March and negotiations will be resumed on 11 April. In my letter of 1 March I referred to the likelihood of the RPI increasing in the coming months but at present we have the benefit of a fall to 7.5%.

It is disconcerting to see that British Rail unions rejected an opening offer of 8% (as against 7.9% authorised in your letter of 7 March). The Prime Minister commented that the proposed negotiating remit of up to 8.5% was very high and was justifiable only if it led to a quick settlement involving no reduction in the working week. Any reduction in the working week combined with concessions being made following industrial action in the Engineering Industry would have serious implications for other public sector pay negotiations. Cecil's reference in his letter of 30 March to various significant developments since the IFR was settled seems to suggest that affordability should be the paramount consideration for paybill costs in BR.

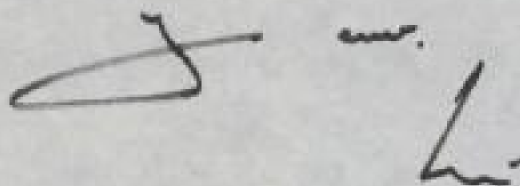
My concern is heightened by the suggestion in Cecil's other letter of 30 March that London Underground should make an identical opening offer at 8% with every expectation that it will also be rejected. Michael Howard in his letter of 7 March warned about the risk of the BR settlement again becoming the "norm" for other major sectors, including local government. It was no secret that the NHS ambulance unions had their sights set upon 8.8% when they started their dispute last year.

8.5% has been rejected in the Electricity Supply Industry and John Wakeham's letter of 16 March reported the unions' ballot for industrial action.

These opening offers are high, particularly if they are likely to be rejected. There is a further issue about the response to industrial action (or the threat of it). I firmly believe that last year excessive increases were too readily conceded and we are in danger of doing the same again.

Having stood firm through the ambulance dispute and secured an agreement where in a two year deal the second stage relating to this pay round was 7.9% I shall find it particularly regrettable if settlements elsewhere in the public sector give rise to rejections in the NHS for non-Review Body staff within the limits we have agreed as the maximum affordable from existing allocations without adverse effects on planned service provision. I imagine that the strategy for Post Office Counters set out in Eric Forth's letter of 30 March could also be jeopardised.

I am sending a copy of this letter to the Prime Minister, other members of E(PSP), Malcolm Rifkind, Peter Walker, Peter Brooke and Sir Robin Butler.



KENNETH CLARKE

C

PAY IN CONFIDENCE

THE RT HON JOHN WAKEHAM MP

Department of Energy
1 Palace Street
London SW1E 5HE
01 238 3290

The Rt Hon Norman Lamont MP
Chief Secretary
HM Treasury
Parliament Street
LONDON
SW1P 3AG

4 April 1990

Dear Norman

BNFL: 1990 PAY ROUND

BNFL has now put together their detailed negotiating strategy for this year's pay round. Preliminary meetings are planned with the industrial unions on 19 April, and the non-industrial unions on 25 April. As in previous year s it is not expected that these meetings will reach a settlement and further meetings have been arranged in May and June. The settlement date is 1 June.

The industrial unions have made a claim for a substantial but unspecified increase based on the increase in the cost of living, and the need to catch up with the terms agreed for the non-industrial unions after last year's pay dispute. The non-industrials have yet to make a claim.

BNFL are proposing to make an opening offer of 8.25% on basic rates, but not on bonuses which would only increase in line with inflation. The effect of a settlement at this level on the 1990/91 pay bill would be 6.8%, with 8.2% in a full year. BNFL believe that 8.25% is the minimum needed to avoid an immediate call by the unions for a strike ballot. If necessary they are then prepared to negotiate up to 9%, but may need to go slightly above this if the unions play heavily on the impact of the Gardner Report. Given the severe retention and recruitment problems the industry faces, the effects of the Gardner Report, and the fact that the electricity industry negotiations have now reached 8.5%, BNFL's proposal seems a realistic and sensible approach.

RETENTION AND RECRUITMENT PROBLEMS

Treasury are aware from last year's pay round of the extreme recruitment and retention problems that the Company faces. Despite the improvements in flexibility, promotion prospects, training and merit pay introduced following last year's pay dispute with the non-industrials, the position has worsened over the last 12 months.

PAY IN CONFIDENCE

There are problems at all BNFL sites. Their Engineering Division based at Risley has annual turnover rates ranging from 14-23% for professional engineers, to 40% for draughtsmen. THORP Division, the manning of which is essential to the successful completion of the plant and a good return on £1.8 billion of investment, has a turnover rate of over 15%. In the enrichment plant design office at Capenhurst the turnover rate over the last 12 months has been 30%, and for health physicists at Springfields and Capenhurst the turnover rates are 33% and 45% respectively.

The Company is also having difficulty recruiting staff to fill existing vacancies, and attracting people to man the large number of plants which will become operational at Sellafield over the next few years. The Gardner Report has further exacerbated the problems of recruitment at Sellafield. A recent recruitment drive for 250 operational staff led to a very poor response, and two external advertising campaigns for process engineers were completely abandoned because of the lack of response. The Company has been unable to recruit sufficient accountants for their audit management and management accounting work, and this is particularly worrying given the accounting changes needed with the introduction of fixed price trading.

Pay rates alone are not the only problem, and this is fully appreciated by the Company. They are, as you know, doing more to increase the autonomy of the business divisions and this is reflected in local pay flexibility and productivity schemes. These are working particularly well with all sites meeting their productivity targets last year. The overall level of salaries does however inevitably play a major part when it comes to retention and recruitment. BNFL has evidence of comparable pay rates in some of the local companies that have been recruiting BNFL staff. These are summarised in the attached table. They have also been advised by specialist recruitment companies that the salary levels and fringe benefits that they are currently able to offer do not match up to that available elsewhere.

I am copying this letter to the Prime Minister, members of E(PSP) and Sir Robin Butler.

Yours ever

John

JOHN WAKEHAM

COMPARABLE PAY RATES FOR CRAFTSMEN AT COMPANIES WHICH ARE ATTRACTING BNFL STAFF
(BNFL MAXIMUM RATE £195.52)

COMPANY	CRAFT MAX PAY RATES	% DIFF.	NEAREST BNFL SITE
Bass Brewery	£213.75	9.3	Capenhurst
Lever Bros	£254.22	23.0	Capenhurst
Nuclear Electric	£225.40	13.3	Industry Comparison
Consolidated Bathurst (Ex. Bowaters)	£277.70	42.0	Capenhurst
Ford Motor Company	£219.88	12.4	Capenhurst
Laporte Chemicals	£222.00	13.5	Risley/Capenhurst
Pilkingtons	£244.00	24.8	Risley/Springfields
Shell Chemicals	£266.00	36.0	Capenhurst/Risley
British Aerospace	£221.97	13.5	Springfields/Capenhurst
Marconi	£230.00	17.6	Capenhurst/Risley
Vauxhall Motors	£215.48	10.2	Capenhurst/Risley
Marchon	£209.79	7.3	Sellafield
Kamira Ince	£217.07	11.0	Springfields/Risley

Turnover of craft workforce at main BNFL sites.

Springfields	14%
Chapelcross	15%
Sellafield	20%
Capenhurst	22%

SAC4APR

QUEEN ANNE'S GATE LONDON SW1H 9AT

28 March 1990

Thank you for copying to me your letter of 8 March to Nicholas Ridley and the enclosed draft White Paper setting out the Government's response to the Jack Committee report. I note that you are planning to publish the White Paper before the Easter recess, and I am content for you to do so.

I was interested to learn of the bankers' decision to set up the Blunden Committee to draw up a code of practice on customer relations. I have a double interest in this area - in ensuring on the one hand that banking secrecy does not stand in the way of effective action to combat money laundering, while on the other, preserving the Government's general policy in regard to privacy and confidentiality. On the former, I am satisfied that the banking sector is alert to the dangers posed by money laundering, and is keen to co-operate actively with Government and the enforcement agencies in meeting the threat. So far as issues of confidentiality are concerned, I hope that the Blunden Committee will be encouraged to consult fully with the Data Protection Registrar. The Registrar is responsible for enforcing compliance with the Data Protection Principles, which have a direct bearing on the issue of disclosure.

I am copying this to members of E(A) and H Committee, Sir Robin Butler, and to the Governor.

Richard Ryder, Esq, OBE, MP
Economic Secretary
Treasury Chambers
Parliament Street
LONDON, SW1P

Econ Pol : Domestic Monetary Policy Pt 21.

Northern Ireland Office
Stormont Castle
Belfast BT4 3ST

Richard Ryder Esq OBE MP
Economic Secretary to the Treasury
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

21 March 1990

Dear Richard,

JACK COMMITTEE ON BANKING SERVICES LAW AND PRACTICE: PROPOSED GOVERNMENT RESPONSE

Thank you for my copy of your letter to Nicholas Ridley and of the draft White Paper setting out the Government's response to the report of the Review Committee on Banking Services Law and Practice.

I have noted that what is proposed will not interfere with disclosure of information under the Prevention of Terrorism Act 1989. There are otherwise no special Northern Ireland issues raised. In any case the local banks and consumer organisations will have further opportunities to comment on the White Paper and on the legislation when it is introduced. I am therefore content that you should publish before the Easter recess.

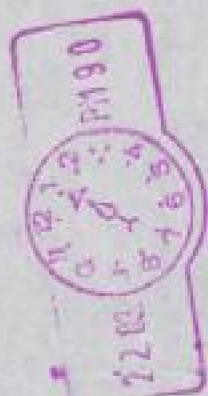
Copies of this letter go to members of E(A) and H Committees, Sir Robin Butler, and the Governor.

Peter

PB

PM/SOFS/2181

ECON POL: DMP pt 21



SCOTTISH OFFICE
WHITEHALL, LONDON SW1A 2AU

Richard Ryder Esq
Economic Secretary of the Treasury
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

21 March 1990

Dear Richard,

JACK COMMITTEE ON BANKING SERVICES LAW AND PRACTICE: PROPOSED GOVERNMENT RESPONSE

Thank you for copying to me your letter of 8 March to Nicholas Ridley enclosing your draft White Paper in response to the Jack Committee's Report.

I am satisfied that the draft properly reflects the points of particular Scottish interest arising from the Report. Some of the Scottish implications will need to be looked at further in any move towards legislation, but for the present I am content that the White Paper should be published as you propose.

I am copying this letter to members of E(A) and H Committee, Sir Robin Butler, and the Governor of the Bank of England.

Yours ever,

Malcolm

MALCOLM RIFKIND

EJD079P8

ECON POL : Govt Pt 6.

FROM THE RIGHT HONOURABLE THE LORD MACKAY OF CLASHFERN

HOUSE OF LORDS,
SW1A 0PW

DL 86/225/2

19th March 1990

Dear Richard,

JACK COMMITTEE ON BANKING SERVICES LAW AND PRACTICE: PROPOSED GOVERNMENT RESPONSE

Thank you for sending me a copy of your letter of 8 March to Nicholas Ridley enclosing a draft White Paper on Banking Services Law and Practice.

As you know, my officials have been in touch with yours about a number of aspects of the Government response. I am content that the draft White Paper should be published as you propose.

I am copying this letter to members of E(A) and H Committees, Sir Robin Butler, and to the Governor of the Bank of England.

Yours ever,

James.

Richard Ryder Esq MP
Economic Secretary to the Treasury
Treasury Chambers
Parliament Street
London
SW1P 3AG

dti
the department for Enterprise

Eric Forth MP
Parliamentary Under Secretary of State for
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MDPM
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19/3

Direct line 01-215 4301
Our ref AM7
Your ref
Date 16 March 1990

Dear Richard

JACK COMMITTEE ON BANKING SERVICES LAW AND PRACTICE : PROPOSED GOVERNMENT RESPONSE

You wrote to Nicholas Ridley on 8 March attaching a draft copy of the White Paper which you propose to issue in response to the Jack report.

I know that our officials have worked closely on a number of important aspects of the Paper and I am pleased to find that the resulting document balances well the interests of the banking industry and their customers. The industry's announcement of the establishment of a Committee to oversee the preparation of a code of banking practice was welcome. The commitment to consult the National Consumer Council and the Consumers' Association is important. I think it would also be sensible for the Committee to consult the Director General of Fair Trading who has much experience of codes of practice and has taken an interest in the Jack report recommendation's. Perhaps your officials could put that suggestion to the Committee.

Finally, I agree with your proposal that the White Paper should be published before the Easter recess. I am copying

dti

the department for Enterprise

this to members of E(A) and H Committee, Sir Robin Butler and to the Governor.

ERIC FORTH

the Enterprise initiative

Recycled Paper

Econ Pol: Domestic
Monetary Policy
A21

File KK

bc P.U.

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

15 March 1990

Dear Gina,

JACK COMMITTEE ON BANKING SERVICES LAW AND PRACTICE; PROPOSED GOVERNMENT RESPONSE

The Prime Minister has seen the Economic Secretary's letter of 8 March to the Secretary of State for Trade and Industry. She would be content for the draft White Paper to be published before the Easter Recess on the basis proposed.

I am copying this letter to the Private Secretaries to the Members of E(A) and H Committee, to Sonia Phippard (Cabinet Office) and to Paul Tucker (Bank of England).

Yours,

Paul Gray

(PAUL GRAY)

Miss Gina Haskins,
Economic Secretary's Office.

KK

MR GRAY   14 March 1990

JACK COMMITTEE ON BANKING SERVICES LAW AND PRACTICE
DRAFT WHITE PAPER

A Voluntary Code of Practice

The draft White Paper accepts the Jack Committee suggestion that the banks and building societies should devise a code of banking practice for themselves. There is a very broad measure of agreement amongst these institutions about the form which this code should take; and this extends to the consumer organisations which will be consulted. The Jack Committee recommended that the Government should reserve the right to impose a code by statute if it was dissatisfied with what emerged from the industry but that there is no reason to think that Sir George Blunden's Committee will fail to produce a document which will give customers a clear picture of what they can expect and be a proper source of reference for Ombudsmen settling disputes.

The draft White Paper broadly accepts the technical recommendations of the Jack Committee but on two important issues it dissents on changes in the complaints procedure and on the law of confidentiality.

Existing Ombudsmen schemes to be retained

On the question of Ombudsmen, the White Paper rejects the suggestion that the banking ombudsman scheme should be put on the same sort of statutory basis as that of the building societies. The present bank ombudsman scheme provides a perfectly satisfactory mechanism for solving disputes which is already available to almost all individuals who have bank accounts and the Jack Committee overstated the risk of inconsistent decisions being made by the separate bodies. There have been virtually no issues of that sort.

No Codification of Confidentiality Law

The Jack Committee called for the codification of the law on confidentiality. It took the view that there had been a 'massive erosion' of the banker's duty of confidentiality in recent years; in particular, it wanted to redraft the rules which compell disclosure of information by law. Many bankers, for example, have been critical of the proposals in the Criminal Justice (International Co-operation) Bill. The White Paper rejects this suggestion and argues powerfully that the basic framework of the rules established in the Tournier case of 1924 is still valid and that it would create all kinds of uncertainty if it were changed. I believe that view to be widely shared in the banking industry. The White Paper's more limited proposals for giving customers clearer information about the situations in which confidential information can be passed on are, however, acceptable to the consumer organisations, and, importantly, the individual should have the remedy of the Ombudsman under the proposed Code of Practice.

The wider issue - as to the way in which the Government should reconcile its need for information on criminal activities with the legitimate desire of the banks and their customers to preserve confidentiality - need not be an impediment to the Blunden Committee whose prime task is to give the ordinary customer clearer knowledge of the minimum standards which he can expect. It is important to stress that they will only be 'minimum standards'; the overriding aim is not to reduce competition in the standards of service and cost. The White Paper should be widely welcomed.

D A Lewis

pp HOWELL HARRIS HUGHES

RETURN TO C/F

Banking Services Law and Practice

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Foreword

by the Rt Hon John Major MP, Chancellor of the Exchequer

Customer confidence in the law and practice affecting the provision of banking services is fundamental to the financial system. Recent developments in banking make it important to ensure that the framework of law and practice is adapted to maintain this confidence in changing circumstances. For this reason in January 1987, the Government, along with the Bank of England commissioned the Review Committee under the Chairmanship of Professor R B Jack, CBE, to conduct a thorough assessment of the existing legislative framework for banking services. The Committee found that the legislative framework had stood the test of time remarkably well, and there were no major deficiencies or gaps, but they identified a number of areas where banking practice could be improved and where the law could be usefully clarified or tightened up.

We have seen enormous changes in the UK banking system over the past few years, with increased competition and rapid changes in technology which continue apace. This White Paper makes proposals to help meet these new challenges.

The Government wishes to express its appreciation to the Review Committee for their work and to all those who helped during the consultation process.

Banking Services Law and Practice: The Government's Response

The Evolution of Banking Services, Competition and the Consumer

1. This White Paper sets out the Government's response to the report of the Review Committee on Banking Services Law and Practice. The Government's proposals follow the objectives identified by the Review Committee, and are fully consistent with an important principle recognised in their Report: in this rapidly changing area it is necessary to preserve regulatory flexibility, and to ensure that competition and innovation are given room to develop.

2. In the past few years there has been a strong increase in competition in the banking sector, to the benefit of the consumer. Many building societies are now using the additional powers provided to them in the Building Societies Act 1986 to compete in the market for retail banking and other financial services. Competition amongst the major commercial banks and building societies for personal customers has clearly intensified. Interest-bearing current accounts, longer opening hours and a variety of card-based facilities are only a few recent examples of the benefits of competition to the retail customer.

3. Technological innovation has meant that new methods of payment can be offered to customers and this too has led to competition amongst innovators. There is also, for instance, evidence of growing competition for credit card services presented in the recent report of the Monopolies and Mergers Commission on this subject. It would be wrong to introduce legislation which might stifle further valuable developments of this kind.

4. Over recent years, it has been competition within a flexible regulatory framework that has benefited the consumer most and it is from this source that further improvements are most likely to come. This is the primary principle underlying the Government's response to the changes which the Review Committee have proposed.

The Report of the Review Committee

5. The Government, jointly with the Bank of England, commissioned the Review of Banking Services Law and Practice in January 1987. Much of the legal framework for the provision of banking services dates back to the last century and although it appeared to have stood the test of time well, it was not self-evident that it could cope with the rapid changes now being seen. Banking services have changed beyond all recognition since the main statutes were drafted, and it was felt that a full and coherent review of the law would be sensible and timely. The Committee was chaired by Professor R B Jack CBE, and the other members were Mrs Liliana Archibald and Mr G W Taylor.

6. The Review Committee's terms of reference were limited to services directly related to personal and business customers of banks and building societies. The remit therefore included payment and remittance services but excluded taxation, company law affecting banks, and issues related to banking supervision covered by the Banking Act 1987 and the Building Societies Act 1986.

7. The chief objective of the Review was to:

> "examine the law and its practical implications from the points of view of banker, customer and the general public interest in the availability, reliability, security and efficient and effective operation of payment, remittance and other banking services."

8. The Review Committee's Report followed a thorough process of consultation. The Review Committee issued five consultation papers in 1987, reproduced in Appendix A of their Report, and they received extensive comments from interested bodies.

9. The Review Committee recognised in their Report, which was published on 23 February 1989 (Cm 622), that an important constraint on any proposals in the field of banking services is the need to preserve flexibility, and to avoid cramping competition and innovation by excessive regulation. Against that background they considered that changes, where they are needed at all, should give priority to four objectives. They should aim:-

- to achieve fairness and transparency in the banker-customer relationship;
- to maintain confidence in the security of the banking system;
- to promote the efficiency of the banking system;
- and to preserve and consolidate the banker's duty of confidentiality to his customer.

10. To achieve these objectives the Review Committee considered the two main regulatory options, self-regulatory and statutory. It considered as a first and general possibility that there could be reliance on some form of regulation by the industry itself. Only if the industry showed itself unable to produce adequate rules would there be a case for imposing regulation on the industry from outside. Codes of good practice were considered as possible useful measures short of statutory regulation.

11. The Review Committee considered legislative measures might be appropriate in some circumstances, for example, the protection of weaker parties, the clarification of existing case law, or the elimination of confusion and anomaly. In addition, legislative measures might be needed to bring the law up to date with modern developments in banking practice and to provide backing, if necessary for a code of banking practice. The Review Committee found that, in general, banking services law had stood the test of time very well and there were no major deficiencies or gaps. Even so, there were a number of areas where the law could be usefully clarified or tightened up.

12. When the Report was published the Government invited comments on the recommendations set out in it. These recommendations are reproduced at Annex A to this White Paper. A list of those who submitted written comments is at Annex B. The Report was widely welcomed as presenting a clear and comprehensive critique of the present law, but reservations were expressed about some of the recommendations. The Government has carefully considered all these comments and this White Paper sets out its conclusions.

The Government's Response

13. A brief summary of the Government's main proposals is set out below. Annexes 1 to 8 discuss the main issues individually in more detail. The overall approach taken is to build on competition. Where this is not feasible, non-statutory self-regulation is proposed. Legislation has only been considered where it would either aid competition, correct areas where the law is inadequate or out of date, or where it is the only means of ensuring that consumers are protected. But it is worth commenting first on the broad approach taken to each of the Review Committee's four objectives.

14. First, **fairness and transparency**. Competition plays a crucial role in improving the fairness and transparency of banks' and building societies' dealing with their customers. Newspapers as well as specialist publications publish comprehensive and up-to-date comparisons of interest rates on different bank and building society accounts. Customers are therefore better informed of the choice available to them. But other matters, such as bank charges, and the terms and conditions under which the account is operated, are much less transparent. Legislation to increase transparency of bank charges and the operation of accounts would, however, be cumbersome and restrictive and the Government, therefore, proposes that increased transparency should be achieved by non-statutory means, as the Review Committee recommended, through a code of banking practice (the Committee's illustrative draft of which is reproduced at Annex C). The representatives of the banks and building societies have agreed to prepare and promulgate such a code. It was announced on 1 March 1990 that a Committee has been set up under the independent chairmanship of Sir George Blunden to oversee the preparation of the code, the terms of

reference of which include consultation with representatives of the consumer interests. The aim is that the main sections of the code should be ready and in place early in 1991.

15. The question of fairness is to a large extent linked with transparency. If a customer realises that his bank or building society is treating him less favourably than another would, he will consider moving his account. Competition therefore plays a major role. But a code of practice would establish the minimum standards of banking services which a customer could expect, and would provide a benchmark against which to judge banks' performance. At least one bank has already introduced a customer's charter on the lines of such a code; but the principle needs to be more widely extended.

16. One of the main ways to ensure fairness is for banks to provide access to a formal complaints procedure and, if that is exhausted, access to an Ombudsman scheme. Building societies are required to belong to an Ombudsman scheme set up under the framework provided in the Building Societies Act 1986. The major banks formed a voluntary Ombudsman scheme in 1986 which covers, at present, well over 90% of personal accounts. Awards made by the Banking Ombudsman are binding on the bank. The Government believes that this is a satisfactory scheme, and, since many of the Review Committee's recommendations have been adopted voluntarily by the Board of the Banking Ombudsman, it sees great advantage in its retention.

17. There is, however, a difference between the Ombudsman's scheme which applies to the banks and that which applies to the building societies. This difference could be eliminated either by amending the Building Societies scheme to make awards binding on a Building Society (at present a Society can reject an award providing it explains its reasons for doing so publicly); or by weakening the Banking Ombudsman's powers. On balance, the Government believes that it is sensible to leave the present arrangements as they are, rather than change two schemes both of which are working well. Steps are, however, being taken by the Board of the Banking Ombudsman to encourage more banks offering retail deposit accounts to join the Ombudsman scheme.

18. The Review Committee's second objective was to maintain confidence in the security of the banking system. There are a number of areas in which the Government agrees that confidence could be improved by legislation.

19. The Review Committee explained the advantages of a secure, non-transferable form of cheque, and recommended that this be achieved by introducing a new "bank payment order". That proposal has received little support during the consultation process. Those who have commented have argued that it would only add to the present confusion, rather than reduce it. The Government does not therefore propose to introduce such an instrument. But the present confusion over the status of crossings on a cheque and the meaning of terms such as "account payee only" is unsatisfactory and legislation will be introduced in due course to clarify the position and give legal force to those words.

20. The Review Committee also indicated the need to clarify the law on when precisely a payment is complete. While accepting the need for clarification, the Government is not persuaded that it should legislate immediately. A number of international initiatives in this area are currently under way and those who have commented have argued that it would be premature to enact legislation for the UK which could be overtaken by international developments.

21. Existing legislation in a number of other areas has stood the test of time and is familiar to practitioners. One example is the Bills of Exchange Act 1882 which, although more than 100 years old, continues to work well. The Government sees no need to revise this Act completely, as the Review Committee recommended, but proposes instead to make a number of changes to update it.

22. The third objective, of promoting the efficiency of the banking system, must largely be a matter for the banks themselves. But there are a number of areas where changes in legislation can help this process and these will be implemented in due course. For example, the introduction of legislation to permit the "truncation" of cheques (a process which replaces physical presentation with an electronic

message) would enable banks to make greater use of electronic means of data transfer and reduce the need to transport large numbers of cheques around the country to paying banks every day.

23. The fourth objective of the Review Committee was to preserve and consolidate the banker's duty of confidentiality to his customer. A banker has a primary duty of confidentiality to his customer except in certain defined cases. The exceptions were set by Lord Justice Bankes in his judgment in the celebrated case of Tournier v National Provincial and Union Bank of England (1924). The Government has been impressed by the evidence given during the consultation by those who have argued that the so called "Tournier rules" are clear, have worked well, and are widely understood by bankers, and that any attempt to codify them in legislation would be at best unnecessary and at worst likely to introduce new difficulties and confusion. The Government is persuaded, therefore that it should not codify the Tournier rules in statute solely for the sake of giving them legislative backing.

24. It is however clear that few customers are aware of the Tournier rules and the considerable protection they afford, and the Government believes that it would be desirable if bankers explained the effect of them in clear and simple terms. The code should contain an explanation of the general effect of the Tournier rules in order to clarify for personal customers the protection they already provide. It would not aim to set out the rules in great detail nor would it need to cover how they apply to corporate customers.

25. The Government shares the Review Committee's concern that confidential information about customers may be passed within a banking group for marketing purposes, and it is also aware that there is growing concern that information may be passed to credit reference agencies without the customer's knowledge or consent. The Data Protection Act 1984 requires that any information passed is obtained fairly, but any further legislation on such issues would inevitably be complex and inflexible and the Government believes that both matters would be more appropriately dealt with through the code of practice.

26. The Government does not accept the Review Committee's suggestion that there has been a "massive" erosion of the banker's duty of

confidentiality through the various statutory exceptions to the general duty of confidentiality such as those in the Drug Trafficking Offences Act 1986. These exceptions affect only the very small number of customers who use the banking system for dishonest purposes. They have no impact on the vast majority of honest customers. Before enacting such exceptions the Government always considers with great care the implications, including the impact on banking confidentiality. The Government only enacts such exceptions where the benefits outweigh any possible disadvantages.

Summary of Proposals

27. In summary, the approach favoured by the Government is to build, wherever possible, on competition for banking services, buttressing that, where necessary, with a voluntary and not a statutory code of banking practice. It believes that a voluntary code of practice is the best means toward that end. Where existing legislation or case law has worked well and is not in doubt, no changes are proposed. But legislation will be presented when other pressures on the legislative timetable permit to clarify and update the law in a number of areas.

28. In brief, therefore:

- The Government fully endorses the recommendation (16(1)) that representatives of the banks and building societies should draw up and promulgate a non-statutory statement of best practice covering broadly the areas in Appendix L of the Review Committee's Report; and it welcomes the steps that are already in hand to prepare it. The Government thinks it desirable that the code should specify that customers will be given information in clear and simple language about the terms of their contract with the banker and the rights and obligations that apply on both sides; customers should be told of the rights to privacy which the law already affords and the very limited circumstances in which any information about their personal finances may be passed on; how to lodge a complaint if it proves necessary, how such complaints will be dealt with, and how matters may be referred to the relevant Ombudsman; they should be told

what banking charges may be levied in what circumstances; and they should be given a simple explanation of the timing of the clearing cycle and when they could normally expect a cheque to be cleared. (Annex 1).

- The Government sees no need to codify the present rules on confidentiality in statute, but thinks it desirable that the code of banking practice should inform banks' customers of the rules' existence. The Government also thinks it is desirable that the code should lay down good practice on the use of information for marketing purposes and the procedures for passing information to credit reference agencies. (Annex 2).

- The Government proposes to leave the present Ombudsman schemes as they are, but steps are being taken by the Board of the Banking Ombudsman to encourage more banks to join the Banking Ombudsman scheme. (Annex 3).

- The Government will legislate in due course to extend to all payment cards the current £50 limit on customer liability for losses, which at present applies only to credit cards, and to ban the unsolicited mailing of cards and PIN numbers. (Annex 4).

- The Government sees no need to introduce a new "bank payment order" but will legislate in due course to clarify the present unsatisfactory position of crossings and markings on cheques. (Annex 5).

- Legislation will also be introduced, when other pressures on the legislative timetable permit, to allow for truncation of cheques, to amend and update the Bills of Exchange Act and to deal with a number of other detailed points raised by the Committee. (Annex 9 details the legislative proposals).

- Many of the subjects covered by the Review Committee may have implications for Scots law. In implementing the proposals, special consideration will be given to the different legal position in Scotland.

Annex 1. The Code of Practice

1.1 The Review Committee's Report contains twenty four recommendations to banks and building societies concerning standards of banking practice which would be contained in the proposed code. The code would be available to customers, enabling them to know the minimum standard of service to expect. It could be referred to by the Ombudsmen in settling disputes. The illustrative code which is set out in Appendix L to their report is reproduced in Annex C below. The code would not attempt to standardise levels of service. That would be counter-productive. In many areas the code will simply define the information the customer should expect to receive from the banker about the way his account should be run and his business conducted, to enable the customer to make sensible choices. Banks and building societies would continue to compete by offering better terms and conditions than any minimum specified.

1.2 Consultation has shown that there is general acceptance of the idea of a code of banking practice. The representative bodies of the banking industry have agreed to produce a code which would be followed by their members. It was announced on 1 March 1990 that a Committee has been set up under the independent chairmanship of Sir George Blunden to oversee the preparation of a code of banking practice by the British Bankers' Association (BBA), the Building Societies Association (BSA) and the Association for Payment Clearing Services (APACS). The other members of the Committee are Sir Alastair Burnet, Miss Margaret Reid, Mr Denis Child, Mr Malcolm Macaskill and Mr Geoffrey Taylor. Its terms of reference are:

i. To oversee the drafting of a code of banking practice, to be drawn up by the Banks and Building Societies in the light of the recommendations contained in the

Report by the Review Committee on Banking Services: Law and Practice, satisfying itself that consultation has taken place with customer and other interests.

ii. To consider, following discussions with the Bank of England and the Building Societies Commission, the most appropriate arrangements for promulgating the code to banks and building societies.

iii. To consider, following discussions with the Bank of England and Building Societies Commission, the most appropriate arrangements for ensuring adoption of the code and of compliance with its terms by banks and building societies.

iv. To keep the code under periodic review and to propose modifications, where necessary, after consultation with the Banking and Building Societies Ombudsmen.

It is intended that work on the code shall start in the spring in order that the main points of the code shall be in place by early 1991. The Government warmly welcomes this development as an indication of the positive way that the banks and building societies are responding to the challenge.

1.3 The particular areas of banking practice, or the specific recommendations which the Government thinks should be incorporated into a code, are addressed in detail in the remainder of this chapter. In setting out those proposals, the views of consultees have been taken into account. Clearly, some areas of the code will be more important than others.

1.4 The code is intended to be a statement of good practice and it is envisaged that all those offering retail banking services will adopt it. The code will also be available to the Banking and Building Society Ombudsmen who will be able to use it in making decisions. It will represent a standard of service against which a bank's operations can be gauged. If it is widely adopted by those offering retail banking services and its standards are met,

it should meet the concerns indentified by the Review Committee and the issue of statutory backing need not arise.

Contents of the Code of Best Banking Practice

(i) UNDERLYING ASPECTS OF THE BANKER-CUSTOMER RELATIONSHIP

1.5 Identity of customers. The Review Committee recommended (rec 6(2)) that, as an indication of what is required for the banks and building societies to secure the protection of section 4 of the Cheques Act 1957, they should initiate procedures which allow them to establish, to their reasonable satisfaction, the true identity of a person opening an account, so that if subsequently challenged they can refer to the action they took at the time.

1.6 The Government strongly supports this recommendation. It extends further than protecting the interests of the banker under section 4 of the Cheques Act 1957. Customers should be reassured that if a cheque is stolen, positive steps would have been taken by banks and building societies to minimise the chance of a criminal obtaining payment by setting up an account in a false name. Banks and building societies have already been encouraged by their regulators to check the identity of new customers in order to avoid accounts being used for money laundering. Such abuses are not in the interests of deposit taking institutions and they and their trade associations have recognised this. Guidance is normally provided by the trade bodies on methods of verifying the identity of new customers and many banks will follow that guidance. The Government urges those institutions which do not make thorough checks, perhaps because they only operate deposit accounts, to institute them.

1.7 Terms and conditions - communication to customer. The Review Committee recommended (Rec 6(3)) that, when a banker informs a customer of the terms of the contract between them, the banker should ensure that the customer receives a fair and balanced view of those terms, and of the rights and obligations

that exist on each side; and is given reasonable notice of any proposals for varying those terms.

1.8 The Government supports this recommendation and welcomes recent moves by some of the clearing banks to follow this suggestion by giving greater transparency to their charges. Competition should, in time, ensure that all areas of banking services become more transparent to the customer. Providing a fair and balanced view of the terms of a contract which would be both accurate and understandable to every customer may be a difficult task; but a customer who is aware of both his obligations and his rights is more likely to be satisfied with the service provided.

1.9 It is also desirable that reasonable notice should be given on any variation in the contract which a bank wishes to introduce, to enable a customer to choose whether or not to continue holding his account with that institution.

1.10 Complaints procedures. The Review Committee recommended (Rec 15(2)) that banks should establish clearly defined internal procedures for handling customer complaints. They should ensure that customers are informed how to lodge a complaint and how it will be dealt with, including the procedure for access to an Ombudsman if the internal procedure does not resolve a dispute. All building societies and many banks already have complaints procedures. The Government thinks it would be desirable if all personal customers were covered by these schemes. A number of banks and building societies advertise their membership of an Ombudsman scheme. The Government believes more widespread publication would benefit both the customer and the member banks. The code of banking practice should require a bank to tell its customers that it is, or is not, a member of the Banking Ombudsman scheme, Building Society Ombudsman scheme or the Finance Houses arbitration scheme.

1.11 Duty of confidentiality. The Review Committee recommended (Rec 5(2)) that the code of banking practice should also explain the rules surrounding the banker's duty of confidentiality. The

Government agrees with that recommendation. The question of confidentiality is discussed in more detail in Annex 2 which sets out the Government's reasons for rejecting the proposal that the existing "Tournier" rules, established in case law, should be codified in statute. The Government believes that there is merit in the code making the customer aware of the protection the law already affords him and the limited exceptions to it. There are, however, two areas of concern to the public where the Government believes that it would be desirable if the code provided for banks to restrict their existing practice in passing information. These are where the information is used for marketing purposes, and where "white" information is passed to credit reference agencies, without the customer's consent. ("White" information means credit information about customers who are not in default as distinct from "black" information which is about customers who are.)

1.12 The Review Committee recommended (Rec 13(4)) that banks and building societies and their subsidiary companies should exercise restraint in the direct marketing of their services. The Government supports this recommendation. The Government therefore proposes that the code of banking practice should contain a provision which will ensure that the customer is made aware that his personal information may be used by a bank for direct marketing purposes and may be passed to credit reference agencies. The customer should be given the opportunity to object. Any objections the customer makes to the use of personal information should be respected. The customer should be informed of the bank's practice in this area when an account is opened, and whenever the banker seeks to vary the terms of that account.

1.13 The Government urges banks to ensure that information relating to minors' accounts is handled with particular care. Credit marketing addressed to minors is prohibited by law. The code of banking practice should include a reassurance to customers that banks will take all reasonable precautions to ensure that marketing material is not inadvertently sent to customers who are minors.

1.14 The Government also supports the Review Committee's recommendation (Rec 5(2)) that banks should explain to their customers that they have right of access, under the Data Protection Act 1984, to their personal records held on computer files by banks and building societies.

1.15 <u>Bankers' opinions</u>. The Review Committee recommended (Rec 6(4)) that bankers should give customers a clear explanation of how the system of bankers' opinions works and invite them to give or withhold a general consent for the bank to supply opinions on them to other bankers in response to status enquiries.

1.16 The Review Committee found no evidence that the present arrangements were working against the customer's interest but they thought that the customer should be better informed. The Government believes that further protection to customers in this area is not needed, but the code should make it clear that if a customer requests information on how the system of bankers' opinions works, the banker should provide an explanation.

(ii) RULES APPLYING GENERALLY TO THE CUSTOMER'S ACCOUNT

1.17 <u>Availability of funds</u>. The Review Committee recommended (Rec 13(1)) that the code of banking practice should provide for banks and building societies to give their customers a simple explanation of the timing of the clearing cycle and the concept of cleared balances; that when a banker applies a "hold" period on cheques, that should also be explained; and that the banker should explain in what circumstances the bank has the right of reversal if a cheque is later returned unpaid.

1.18 There is undoubtedly demand from customers to be given a clear idea of their current, cleared balance, particularly when they would incur charges for an account being overdrawn. The Government accepts the arguments, in favour of the provision of more information, made by consultees. However, consultation also revealed a difficulty with this approach. Although it would be technically possible to show both cleared and uncleared amounts on

bank statements, it may risk confusing the customer. Statements would need to show changes in the cleared balance on days when no other transaction had taken place. To the financially sophisticated this may make sense, but many customers may see lengthier and more complex statements as unnecessarily bureaucratic. There may also be difficulty in providing both balances on ATM enquiries.

1.19 A compromise may be available which would enable the customer to determine the balance available to him, with minimum risk of confusion. A bank providing an uncleared balance could enable the customer to calculate a cleared balance by providing the information about the normal timing of the clearing cycle and the hold period put on cheques by the banker. This supports the intention that banks and building societies should give some clear explanation to their customers as to how they operate the account (that is, on the normal clearing cycle for credits and debits, the banker's hold time, and the reasons for a cheque to be returned); and it reinforces the case for including the provision of such information in the code of banking practice. The Government expects that the clearing time, particularly for debit card items, will be subject to some competition and would not wish to constrain this by specifying fixed times.

1.20 Truncation of cheques. The Review Committee recommended that banks should be permitted to truncate cheques. This would mean that cheques would no longer need to be returned to the paying branch; the information would be transmitted electronically from the receiving bank. The Government proposes to introduce legislation to allow truncation in due course. (The details of the proposals are covered in paragraphs 5.11-5.13 below.) The Government believes that it is important that the customer should have confidence in a system of cheque truncation if the banks wish to adopt it, and it is likely that this confidence would be enhanced if the customer knows that in the event of a disputed transaction, the banker would speedily resolve the problem or re-credit his account. The Review Committee recommended (Rec 7(14)) that, in the event of a dispute regarding a truncated cheque the bank should be given three working days to resolve the

dispute or re-credit the customer's account pending final resolution. Comments received during the consultation period suggest that a period of three working days from the complaint is too short for an absolute limit. The banks themselves should either suggest a single feasible period in the code of banking practice or make it clear in the code that the period would be notified to customers by their bank; the actual period being determined by the individual banks.

1.21 Validity of cheques. The Review Committee recommended (Rec 7(15)) that banks should not return a cheque within six months from the date of issue on the grounds that it was out of date. Existing legislation sets no specific time limit on returning cheques, referring instead to "payment within a reasonable time of its issue".

1.22 One major purpose of a code is to increase transparency and to improve the customer's understanding of how his account operates. It would be sensible to include this recommendation in the code of banking practice. Banks could specify a minimum time period for cheques and possibly a shorter time period for other forms of payment (for example girocheques). They would of course be free to exceed those minimum periods and make payment on a cheque on a date later than that specified.

1.23 Bank Giro Credits. The Review Committee recommended (Rec 7(16)) that banks should make available to their customer an explanation of the rights and obligations of the banker and customer in regard to transactions effected by bank giro credits. A bank giro credit is not defined in statute and conditions may therefore vary from bank to bank. However, the Government believes that any contractual arrangement between the banker and his customer should provide a clear explanation of the terms. This recommendation could therefore be subsumed in the general recommendation that the terms of operation of an account should be clearly stated.

1.24 Multi-function cards. Multi-function payment cards are now used extensively in the United Kingdom and as technology develops

they are likely to offer even more functions. The Review Committee recommended (Rec 11(2)) that banks should include three requirements in the code of banking practice concerning multi-function payment cards: customers should be free to select individual functions; other functions should be blocked off; and no liability should be borne by the customer for fraudulent use (other than on his own part) of the unauthorised functions.

1.25 The Government thinks it desirable that customers be given the choice to refuse to accept certain functions on the card. If so, it is reasonable that they should not bear any liability for those unused functions. If the banks are unable to block off particular functions then they should accept liability for the unused functions and, where relevant, should not issue personal identification numbers (PINs). These points should be covered in the code of banking practice.

1.26 Card notification organisations. The Review Committee raised a concern about card notification organisations. There is a possibility that a customer might believe that the organisation will be able to inform all the respective parties, even though one or more card-issuer may not recognise the card notification organisation and so would not accept notification of a loss of a card from that organisation.

1.27 Although this recommendation (Rec 11(4)) was generally accepted by consultees, the Government is not aware of any particular difficulties with card notification organisations. It believes that it is important for a customer, who accepts a contract with a card notification organisation, to be sure that the organisation will be able to carry out the service that he requires. The Government is not convinced that this issue should best be dealt with in the code of banking practice. It should be left for the terms and conditions of the contract between the cardholder, card notification organisation and the card issuer.

1.28 Countermand. The Review Committee recommended (Rec 12(1)) that the code of banking practice should include a provision which makes customers aware of the different countermand rules applying to payment systems. Countermand is an order to a banker to stop payment of a cheque, direct debit or other payment instruction which the customer has issued. A cheque backed by a cheque guarantee card may not be countermanded.

1.29 The Government believes that bankers should explain, through the code of banking practice, the circumstances when they could stop payment in the various clearing systems. They may also wish to explain to customers the fact that countermand does not cancel a debt. However, the Government would not support changes to the rules of payment systems to encourage an artificial period specifically to allow countermand. The customer, depending on the terms of the contract, may have a right to countermand, but that right is limited and should be exercised rarely (for example, where a cheque has gone missing and may have been stolen). It is usually the case that although a banker will attempt to countermand a cheque, that may not always be possible because the cheque has already been paid. In electronic payment systems the opportunity for countermand is further reduced because of the greater speed with which transactions are processed.

1.30 Charges. The Review Committee recommended (Rec 13(2)) that banks should explain to their customers the basis of charging for the normal operation of the account, including informing the customer about the charges which will be incurred with overdraft arrangements.

1.31 The Government strongly supports this recommendation. There is widespread support for greater transparency of bank charges. Many banks now routinely explain the basic charges for the operation of an account; and the recent moves towards publishing a full list of charges by major banks has been widely welcomed. The lists are to be sent to customers, displayed in branches and will

be regularly updated. The Government warmly welcomes this development. It is clearly desirable that customers should be made aware of charges they are likely to incur and, as far as possible, when they will be levied. Banks should not debit charges from a customer's account without prior warning of the amount, and that should be provided for in the code.

1.32 Foreign exchange transactions. The Review Committee's recommendation (Rec 13(3)) concerning foreign exchange transactions has already been accepted by banks and building societies. They advise customers of the relevant exchange rate and commission charge whenever possible. When the transaction requires a bank outside the UK to handle it or the customer orders currency to be collected at a later date it will not always be possible to offer anything other than an indication as to what the actual exchange rate or amount of commission might be.

1.33 Guarantees by individuals. The Review Committee recommended (Rec 13(5)) that bankers ensure that prospective guarantors, whether or not they are customers, are adequately warned about the legal effects and possible consequences of their guarantee, and about the importance of receiving independent advice.

1.34 The Government does not believe it is appropriate for bankers to be required to explain the legal effects and possible consequences resulting from an individual acting as a guarantor. That is a matter where proper legal advice should be sought. However it is important that bankers should advise prospective guarantors that they should seek independent legal advice before acting as a guarantor. The Government does not suggest that this recommendation need be included in the code of banking practice.

(iii) RULES SPECIFIC TO ELECTRONIC FUNDS TRANSFER

1.35 Authentication of customers' instructions. The Review Committee recommended (Rec 10(1)) that in the context of customer-activated EFT systems, the bank's principal and general duty should be to observe its customer's mandate. Therefore banks should adopt the principle that an EFT system should meet certain minimum standards of security in its authorisation procedures, so as to provide an acceptable degree of protection for the customer against the consequences of an unauthorised instruction.

1.36 The Government is not aware of any evidence of security shortcomings in existing technology. While identification of the customer is based only on a card and PIN there may be problems if the PIN becomes available to others. But that is a matter of customer practice rather than technology. It is in the banks' own interest to ensure that adequate standards exist. Banks have introduced more secure systems as new technology has become available and existing equipment is replaced. It is fundamental to all EFT systems operated by banks and building societies that the security and the protection of the interests of both the banker and the customer are paramount. Banks and building societies may wish to include a provision in the code of banking practice to state that they will continue to maintain minimum standards of security in their present and future EFT systems.

1.37 Issuing of cards and PINs. The Review Committee recommended (Rec 10(3)) that bankers take reasonable care when issuing cards and PINs to their customers. The unsolicited mailing of PINs should be banned and before a customer is able to make use of the service he should be required to acknowledge receipt of both card and PIN in writing.

1.38 It is clear both that the customer needs to take care of his card and protect his PIN number and that card issuers have an obligation to take reasonable care when issuing cards and PINs. The Government proposes (para 4.5 below) that legislation will be introduced in due course to ban the unsolicited mailing of all payment cards and PINs. In the case of the initial issue of a card which is requested, (for example when the customer opens an account or if he requests a new function or banking service) it is reasonable to expect the customer to acknowledge receipt of both card and PIN; but it does not seem necessary to extend that acknowledgement to the renewal of existing cards, where the existing PIN can be assumed to have reached the correct recipient. If that was required there would be a period between despatch of a new card and receipt of its acknowledgement when customers would be unable to use the card facilities. This would cause inconvenience to customers and impose unnecessary costs on the card-issuer.

1.39 <u>Privacy when customers use EFT systems</u>. The Review Committee recommended (Rec 10(4)) that banks ensure that maximum privacy is available to customers when they access EFT systems. The Government is satisfied that the banks already take steps to ensure that privacy is built into terminal design and that manufacturers will continue to develop better designs.

1.40 <u>Monitoring of ATM withdrawals</u>. The Review Committee recommended (Rec 10(7)) that banks and building societies should introduce systematic arrangements to monitor the patterns of automated teller machine (ATM) withdrawals. This recommendation arises from some well publicised cases where cash was illicitly removed using ATMs.

1.41 It is not clear that continuous monitoring would solve this problem. It is possible that it could reduce the occurrence of blatant fraud. But there is a danger in monitoring ATM usage that legitimate transactions could be stopped accidentally. Customers would suffer inconvenience if their transactions were stopped without warning and the banker could become liable for damages. Nevertheless banks may wish to introduce, subject to normal data protection arrangements, systematic monitoring of ATM withdrawals, which they would then include in their contract with the customer.

1.42 <u>Rights to have a written record of ATM withdrawals</u>. The Review Committee drew attention to the customer's entitlement, under the Data Protection Act 1984, to demand a written record of an EFT transaction which must be supplied within 40 days. The option of a written record at the time of the electronic funds transfer is already the existing practice with the majority of transactions. But it is not always possible to ensure that a written record will be immediately available if the machine runs out of paper.

1.43 The Government believes that this recommendation (Rec 10(8)) should be reflected in the code of banking practice on the basis that a written record should normally be available if the customer wishes it, at the time of an EFT transaction. This record would

be in addition to the written record which must be supplied in response to a customer's request under the Data Protection Act 1984.

1.44 Customer's right of action in disputed EFT transactions. The Review Committee recommended (Rec 10(9)) that the code of banking practice should detail the customer's right of action in the case of a disputed EFT transaction. The bank should acknowledge, as card issuer, that it would deal with its own customer, as card holder, in the cases of any complaint.

1.45 In disputed EFT transactions which involve more than one party, (for example, if the customer uses an ATM machine which does not belong to the bank which issued his card, and experiences difficulty) the customer may be left unsure as to whom to address his complaint. The Review Committee believed that it was sensible for the customer to complain initially to the institution that issued the card. It should be for them to ensure that steps are taken to consider the customer's complaint.

1.46 The Government understands from consultation that there are difficulties in implementing this specific recommendation (Rec 10(9)) in the code of banking practice. It nevertheless suggests that banks and building societies should include in the code of banking practice the principle that a customer should be made aware of who would deal with any complaint.

1.47 Apportionment of loss in disputed EFT transactions. The Review Committee recommended (Rec 10(13)) that the code of banking practice should make clear to customers the rules concerning apportionment of loss arising from a disputed EFT transaction. The general question of apportionment of loss is covered in paras 4.8-11 below.

Annex 2. Confidentiality and the disclosure of information

2.1 It is a long established legal principle that a banker owes a duty to his customer not to disclose to any third party information about the customer's personal affairs. That principle is subject to qualification only in certain circumstances.

2.2 The law which governs the bankers' duty of confidentiality was established in the case of Tournier v National Provincial and Union Bank of England in 1924. The judgment of Lord Justice Bankes in this case set out four exceptions under which a bank could legally disclose information about its customer: (a) where disclosure is under compulsion by law; (b) where there is a duty to the public to disclose; (c) where the interests of the bank require disclosure; (d) where disclosure is made by the express or implied consent of the customer.

The Committee's Proposals

2.3 The Review Committee stated that all their consultees agreed that the duty and the stated exceptions are still relevant to present day circumstances. But there was some concern among consultees that the exceptions were not closely enough defined for today's conditions, and so might be open to abuse. The Review Committee therefore recommended (Rec 5(1)) codification of the Tournier rules in statute and proposed that the exceptions should be redefined to reflect those concerns.

2.4 The concerns can best be summarised by grouping the four exceptions into pairs, as in the Report. The first pair of exceptions (a and b above) relates to disclosure under compulsion by law, and where there is a duty to the public. The Review Committee was concerned that, although individually worthy, the

cumulative effect of recent statutory exemptions constituted a serious inroad into the whole principle of customer confidentiality. The extent of the obligations under law led the Review Committee to question the need for the second exception: where there is a duty to the public.

2.5 The Review Committee therefore proposed that on codifying the duty of confidentiality, the first exception, where disclosure is under compulsion by law, should be redrafted. All existing statutory exemptions should be consolidated in new legislation and any future statutory exemptions should be made by reference to this new provision. The second exception, where there is a duty to the public to disclose, should be abolished. The legislation should make clear that no general disclosure provision exists.

2.6 The second area of concern which the Review Committee identified relates to commercial matters and is covered by the two exceptions (c and d above) which deal with circumstances in which disclosure is made "in the interests of the banker" or with the express or implied consent of the customer.

2.7 The Review Committee considered that there are two areas where banking practice has changed since the time of the Tournier judgment. Firstly, banks are now much more likely to be part of a group which includes non-banking subsidiaries such as estate agents or insurance companies and there is growing concern that information is being passed within a banking group for the benefit of the group's marketing activities, using the third of the Tournier exceptions. The Review Committee recommended that the third exception (where the interests of the bank require disclosure) should be limited. It should only allow disclosure between banking companies within the same group, of information that was necessary for the specific purpose of protecting the bank and its banking subsidiaries against loss, in relation to the provision of normal banking services.

2.8 The second area of concern was with the growing use of credit reference agencies and the release of information to them. The Report accepts that it should be possible for negative or

"black" credit information to be released where the interests of the bank require disclosure. But the Review Committee believe it is unclear what view the courts might expect to take on whether banks would be able to release positive or "white" information to agencies without the consent of the customer. (White information is credit information about customers who are not in default, whereas black information concerns customers who are in default).

2.9 The Report does not suggest that consumers are greatly concerned over the question of credit reference agencies as such. It acknowledges that the Director General of Fair Trading has, in practice, adequate powers to ensure that the agencies transmit credit information about individuals strictly for the purpose intended, and not for their subscribers' marketing purposes; and that they are always careful to check that their subscribers are bona fide operators. The Review Committee also recognised that there is considerable support within Government for the provision of information to agencies, to protect imprudent customers from overstretching themselves financially and taking on multiple debts which they cannot repay.

2.10 The Review Committee made two recommendations which would affect information being provided to credit reference agencies. It recommended that the fourth Tournier exception should be altered to require the express consent of the customer (that is, no longer ".... express or implied consent"). Express consent should be given in writing and state the purpose for which it is given. It also recommended that a new exception should be added. This would operate where there has been a breakdown of the banker-customer relationship arising through customer default. The effect of these two changes would be to allow the provision of "black" information to credit reference agencies, but not "white" information without the consent of the customer.

2.11 The Review Committee also believed that legislation should provide for damages for a breach of confidentiality and should include compensation for distress, embarrassment or inconvenience, regardless of whether financial loss could be proved.

The Government Response

2.12 The Government has considered very carefully the arguments put by the Review Committee and by those who have submitted comments during the consultation period. Several of those consulted argued that the present Tournier rules are very clear as they stand, they have worked well and they are well understood by bankers; it is unnecessary to codify them in statute, and any attempt to do so, or to refine them, risks introducing unwelcome and unintended difficulties and confusion. The Government finds these arguments persuasive. The particular concerns which have been expressed relate to specific, narrow areas of banking confidentiality rather than to the basic framework. That framework has worked well since the Tournier judgment and the Government is reluctant to interfere with an area of law which is long-established and familiar to practitioners. It does not therefore propose to codify the Tournier judgment in statute. However, a number of measures are proposed to tackle the specific concerns raised in the light of changes in banking practice.

2.13 The Government does not accept the Review Committee's view that there has been a "massive" erosion of the banker's duty of confidentiality over recent years through the various statutory exemptions from the general duty of confidentiality, such as those in the Drug Trafficking Offences Act 1986 and the Prevention of Terrorism Act 1989. These require bankers to disclose on suspicion, the location of funds which might be used for, or derived from, possible offences under the Acts. These and other similar statutory exemptions from the general duty are only enacted after the most careful consideration of all the implications. These are measures which would not apply to the vast majority of customers. In framing all such legislation, the effect on the normal confidential relationship between banker and customer is taken fully into account. These are, however, areas in which broader public policy will override the need to preserve that confidentiality.

2.14 The Government also believes that there is still a need for the second of the Tournier exceptions, where there is a duty to

the public to disclose. This exception gives a banker a safeguard if he believes that he must disclose information in the public interest. The statutory route requires information from the banker; this exception permits him to disclose. The increasing sophistication of financial crime means that there may well be cases in which a banker wishes to disclose information in the public interest, but he may be uncertain whether there is a specific statutory gateway for him to do so. The public interest gateway also allows a banker to disclose information to a supervisory authority (for example the Bank of England or the Building Societies Commission) where he considers that this would enable or assist that authority to discharge its supervisory functions even though the authority has not required the information to be provided under its powers.

2.15 The Government does, however, accept that changes in banking practice since the Tournier judgment may have affected the use of the third and fourth exceptions, namely where disclosure is in the interest of the bank, and with the consent of the customer. It believes that modifications to banking practice, rather than legislation, which might prove unnecessarily restrictive, would provide the most effective remedy. These changes should be reflected in the code of banking practice (discussed in Annex 1), and would therefore, be available to the Ombudsmen in dealing with complaints about use of confidential information.

2.16 The Government believes that disclosure between companies within the same banking group should continue to be allowed where the purpose of the disclosure is to protect the bank and its banking subsidiaries against loss. The Government believes, however, that banks should not pass confidential financial information outside banking companies in the same group for marketing purposes. In particular banks should not pass on edited information which implicitly reveals the financial status of the customer, such as a list of customers with "gold" credit cards. If a banker wishes to pass on confidential financial information for marketing purposes or to parties other than companies within the banking group, he should seek the consent of the customer.

2.17 Bankers must also continue to be able to pass "black" information to credit reference agencies. The Review Committee noted in their report that the Government favours the fullest possible transfer of credit information to agencies, subject to confidentiality considerations. They provide the best means of ensuring that potential borrowers are creditworthy. This is to the benefit of most consumers who would otherwise have to bear the cost of bad debts through higher charges.

2.18 The fourth of the Tournier exceptions, where the disclosure is made with the express or implied consent of the customer, is also relevant to information provided to credit reference agencies. It is possible that a banker may use the implied consent of the customer to provide "white" information about a customer to a credit reference agency. As the Review Committee point out, it is uncertain what view the courts may take of this. Consultation has shown that those representing consumer interests see this as an important issue. They would like banks to be required to seek the customer's consent and to ensure that the customer is fully aware of the bank's practice on passing information. However there is also general concern about consumer indebtedness, and the Government would not want to discourage the sharing of credit information where it contributes to responsible lending.

2.19 The Government therefore proposes that the code should require that where a bank intends to release to credit reference agencies confidential financial information which goes beyond the "black" information normally passed to such agencies, it should seek its customers consent. It should also explain why this is being done and give the customer a clear opportunity to object. If the customer decides to object to this information being passed, the bank should explain the possible consequences of such a decision. The customer should be informed of the bank's practice in this area, when he first opens his account with the bank, and existing customers should be reminded of the procedures when the terms of the account are varied.

2.20 This approach may not go quite as far as the Review Committee wished. However, the Government is persuaded that a system which required the specific consent of the customer every time information was passed would be impractical. It could result in information being passed much more slowly and possibly reduce the choice of credit to the consumer.

2.21 The Government believes that these changes are most sensibly implemented through the Code of Banking Practice. If they are included in that code, complaints about breach of confidentiality could be dealt with by the Ombudsmen, and the Government believes that that would generally provide a satisfactory means of redress for the customer.

Annex 3. Procedures for resolving disputes

3.1 The Government agrees with the Review Committee's desire to ensure that there is a satisfactory and comprehensive framework for resolving disputes between bankers and their customers.

3.2 The Review Committee recommended (Rec 15(1)) that all banks, except those with only a small number of customers, should be required by law to be a member of one or more recognised Ombudsman schemes, much on the lines of the arrangements for building societies. Building societies are already required by the Building Societies Act 1986 to belong to a recognised Ombudsman scheme which meets the minimum criteria set out in that Act and is approved by the Building Societies Commission.

3.3 At present the great majority of banks' personal customers are covered by a voluntary scheme. This was set up in 1986 by the banks and appears to enjoy the goodwill of both the member banks and the consumer bodies. Awards made by the Banking Ombudsman under this scheme are binding on the member banks.

3.4 The Banking Ombudsman scheme has recently been modified to take account of many of the concerns raised by the Review Committee. The revised terms of reference of the scheme are now based on similar lines to the statutory scheme for building societies, the only major difference being that the Building Societies Ombudsman's awards are not binding on the society: exceptionally, building societies can reject an award against them if they give their reasons for doing so publicly. The Government welcomes the changes made to the Banking Ombudsman scheme and views them as a further demonstration of the goodwill behind that scheme.

3.5 The scheme allows any deposit-taking business authorised by the Bank of England to apply for membership, subject to the approval of the Board. The present scheme covers 20 member banks (and a number of their associates) and includes all the major banks. It is noted in the 1989 Annual Report of the Banking Ombudsman that an independent market research survey commissioned by APACS shows that in the year ending June 1989 of all people who had bank accounts of any kind 99 per cent had their accounts with the banks which are members of the Ombudsman's scheme. As the Review Committee noted, there are a number of authorised banks for whom membership of the Ombudsman scheme is not appropriate, for example, merchant banks and banks with few, if any, personal customers. Other banks whose business is mainly providing credit are members of the Finance Houses arbitration scheme though at present this is limited to credit or hire agreements and does not cover other retail banking services provided by its members. There are also some smaller banks, with a branch network offering retail services, and some subsidiaries of the larger banks which are not members of any Ombudsman or arbitration scheme.

3.6 There are good arguments, which the Review Committee set out in their report, for seeking further consistency and convergence between the two Ombudsmen's schemes (Rec 15(3)). In theory, though probably not in practice, it may be confusing to customers that there should be different schemes applying to the provision of the same banking services by different institutions; and in theory it could lead to inconsistent decisions about the merits of similar cases, though again there is no evidence there that is a real problem in practice. Full consistency between the schemes could only be achieved, however, by removing from the Building Society Ombudsman scheme the option of rejecting an award and explaining publically the reasons for doing so, or by weakening the Banking Ombudsman's powers to make binding awards.

3.7 Opinions among the consultees were divided on this and the decision is a fine one. But on balance the Government believes that it is not worth disrupting two schemes which are working well, and proposes to leave the present arrangements as they are

for now. The Board of the Banking Ombudsman is taking steps to encourage more banks to join the scheme. Those who are members are encouraged to inform their customers and display notices prominently in their branches stating that they are members of the scheme. The Government will keep the situation under review and discuss with the representatives of the banks and building societies whether any further steps can be usefully made in the longer term to bring the two schemes closer together.

3.8 The Review Committee recommended that the Banking Ombudsman scheme should be extended to cover small businesses. The current schemes already deal with a very large number of complaints from unincorporated businesses including partnerships. The Government does not support any extension of the scheme to cover incorporated businesses. Ombudsmen are set up to give an individual the means of redress on a complaint without recourse to the courts. It is normally assumed that companies will be in a better position to take legal action through the courts.

3.9 Finally, the Review Committee suggested (Rec 15(2)) that banks should establish internal complaints procedures and inform customers of those procedures and of the existence of the Ombudsman scheme. The Banking Ombudsman contained the same proposals in his annual report for 1987/88. It is proposed that this should be covered in the code of banking practice which should also require banks to tell their customers whether they are, or are not, members of one of the Ombudsman schemes or the Finance Houses arbitration scheme.

Annex 4. Electronic Funds Transfer

4.1 In recent years, advances in technology have revolutionised banking services through the introduction of electronic funds transfer (EFT). This has led to more convenient banking for many customers at a lower cost than would otherwise have been possible. If such desirable innovation is to realise its full potential, it is important that the various problems that have arisen so far should be dealt with to reinforce consumer confidence but without imposing unnecessary restrictions on future developments.

4.2 The Review Committee recognised that flexibility is necessary but concluded that some steps should be taken to offer protection to consumers when using customer activated EFT systems. The Government accepts that limited legislation would be helpful.

<u>Unsolicited Mailing of Cards and Financial Limits on Liability</u>

4.3 The Consumer Credit Act 1974 provides protection to the consumer when taking credit. As a result of this legislation credit cards and certain other similar credit facilities are subject to a number of consumer protection measures.

4.4 The Review Committee recommended (Rec 10(2)) that section 51 of the Consumer Credit Act should be extended to cover the unsolicited mailing of all payment cards and (Rec 10(10)) that sections 83 and 84 which set the limits of legal liability should also be extended to cover all payment cards.

4.5 Section 51 of the Consumer Credit Act bans the unsolicited mailing of credit cards and certain other similar credit facilities. The Government intends to introduce legislation in due course to ban the unsolicited mailing of all payment cards

including ATM and cheque guarantee cards. This would not apply to renewal cards for existing customers.

4.6 Sections 83 and 84 of the Consumer Credit Act 1974 provide that the customer is only liable for any losses incurred as a result of the loss or theft of the card up to the point where he notifies the card issuer, subject to a financial limit which is currently fixed at £50. Again, the Act only applies to credit cards and certain other similar credit facilities. The Government intends to introduce legislation in due course to provide the same protection in respect of all payment cards. The card issuer will be liable for any losses incurred after notification, but will have a right of redress against a third party who can be shown to have contributed to the loss by fraudently using any EFT system. The card issuer should not be liable in cases where negligence on the customer's part enables a person to find out the PIN applicable to the card, for example where the number has been written on the card.

<u>Liability in Event of Failure of EFT Equipment</u>

4.7 The Review Committee recommended (Rec 10(11)) that customers should be compensated for any direct, or clearly consequential, loss due to the failure of customer-activated EFT equipment. Under current law a bank which undertook to transfer funds by means of an EFT system would be contractually liable for any failure in that system, except to the extent that it excluded the liability under contract. In the absence of any exclusion, damages will be awarded for any losses that were reasonably forseeable or were specifically contemplated by the bank and the customer. At present banks can exclude such liability in their contracts subject to the Unfair Contract Terms Act 1977. The Government proposes that, in the case of customer activated EFT systems, banks should not be permitted to exclude their liability by contract. Legislation will be introduced in due course which will enable an individual customer to be compensated for forseeable losses (and specifically contemplated losses) due to the failure of customer-activated EFT equipment despite any contract terms which restrict the bank's liability.

Disputed EFT transactions

4.8 Disputed EFT transactions are a matter which has caused some public concern. One of the recommendations put forward by the Review Committee (Rec 10(12)) was that there should be apportionment of loss in these cases. At present the terms and conditions imposed by the card issuers generally put the burden of proof on the customer. The evidence relating to disputed transactions taken to the Ombudsmen in the past indicates that many of them occur because a card has been used without the customer's knowledge or consent by a member of the family, a close personal friend or a colleague at work. Generally, the card and PIN were used at an ATM close to the complainant's home or place of work. Frequently, however, the customer asserts that he protected his card and PIN but bank records show a debit using that card and PIN, and that money was paid out by the ATM with no evidence of difficulty or malfunction.

4.9 Questions about disputed transactions which cannot be resolved at branch level or by senior bank management can and often are taken by the customer to the relevant Ombudsman who will have to take into account all the circumstances of the case. After consulting the Banking and Building Society Ombudsmen the Government has concluded that there are practical difficulties in accepting the Review Committee's recommendation.

4.10 When a complaint is made to one of the Ombudsmen about a disputed customer activated EFT transaction he first considers whether there is a case to answer; all that is necessary is for the customer to show that there is a problem. The burden of proof then effectively falls on the card issuer (bank or building society) to show that the card and PIN have been used to make the disputed transaction and that this was not affected by any technical breakdown or other deficiency. This is done by producing copies of the relevant records generated by the use of the ATM system in question. Once the Ombudsman is satisfied that the card and PIN were used, the burden of proof effectively falls on the card holder (the customer) to show that his card and PIN

could not have been used. The Ombudsman will then consider the evidence supplied by both parties.

4.11 A power to apportion loss as recommended by the Review Committee would not be applicable in most cases because the evidence before the Ombudsmen will be sufficient to enable them to establish the facts of the case. The cases where the Ombudsmen might be expected to use their discretion to take the factors identified by the Review Committee into account will be rare. In these cases the Ombudsmen will be confronted by conflicting evidence and, as in a court, will have to decide in favour of one party or the other. The Government, in not accepting apportionment of liability, believes that although it is ultimately for the customer to establish his case, he has ample opportunity to do so.

Forgery and Counterfeiting Act 1981

4.12 The Review Committee highlighted in their Report the problem of the counterfeiting of payment cards. Provisions in the Forgery and Counterfeiting Act 1981 make it illegal to counterfeit payment cards. However section 5(5) which deals with offences relating to the control or custody of instruments which a person knows, or believes to be, false does not explicitly apply to payment cards.

4.13 The Review Committee recommended (Rec 11(5)) that section 5 should be extended to include all payment cards. The Government accepts that, for the avoidance of doubt, section 5(5) should be so amended.

4.14 The Review Committee also recommended (Rec 11(6)) that the Forgery and Counterfeiting Act should be amended to include a provision which would make it a specific offence to possess, or to sell, information that could be used in the manufacture of counterfeit cards, with the intent to defraud. Whilst agreeing in principle, the Government has concluded that this recommendation would require a wider consideration of criminal law and does not at present propose to accept it.

4.15 In Scotland neither the Theft Act 1968 nor the relevant provisions of the Forgery and Counterfeiting Act apply. Instead common law principles relating to fraud and forgery apply. The Review Committee have recommended (Rec 11(7)) that consideration should be given to the creation of statutory offences for forgery and counterfeiting under Scottish law, similar to those contained in the Forgery and Counterfeiting Act 1981. The Government is not aware that the absence of specific provisions in Scottish law has any adverse consequences in Scotland and so no need is seen to legislate on this issue.

Annex 5. Cheques and payment orders

5.1 The present use of cheques is governed largely by the Bills of Exchange Act 1882. The only significant amendment since then has been the Cheques Act 1957. Although the cheques legislation was enacted when few people had bank accounts, and cheque usage was relatively low, the provisions have subsequently worked well. The Review Committee recommended a number of changes to bring the law up to date, which they proposed be enacted in a new separate Cheques and Bank Payment Orders Act.

5.2 The Government does not accept that there is a need for a new Act (Rec 7(1)) but proposes that many of the changes recommended by the Review Committee should be enacted through amending legislation to existing statutes.

<u>Non Transferable Instrument</u>

5.3 The Review Committee identified a number of areas where problems arise in the use of cheques. These include the fraudulent cashing of stolen cheques, and the confusion that exists, in both the public mind and in the law, as to the significance of various markings often put on cheques, particularly crossings on cheques. It examined two ways of resolving these problems. The first was to introduce a new instrument, the bank payment order, which would operate alongside the cheque and would be non-transferable, that is it could not be paid into an account other than that of the payee named on the instrument. The second was to clarify the effect of the existing markings and crossings on cheques. The Review Committee recommended the first alternative (Rec 7(7)).

5.4 The Government accepts that there is a need for a non-transferable instrument with a clearly established legal status and that the increased use of such an instrument should help to reduce the opportunities for fraud. It is also evident that the present legal status of the various markings and crossings is unclear and that customers believe they afford a greater measure of protection than is in fact the case. However, after detailed consultation the Government found that there was little support for the introduction of a new "bank payment order", largely because its introduction might well result in even greater confusion in the public mind about the use of cheques. On balance therefore, it has decided to tackle the problems identified by the Committee by measures designed to clarify the existing law relating to cheques.

Cheque Crossings

5.5 In general, customers have a reasonable understanding of the effect of crossing a cheque with two parallel lines. The 1882 Act gave statutory force to the general crossing of two transverse parallel lines, (with or without "and Co"), indicating that payment must be made through a bank. Although the Act recognises the use of the words "not negotiable"; this expression is not generally understood. "Not negotiable" does not mean a cheque cannot be transferred; it means only that if it is transferred, the holder will not get better rights of ownership than the person from whom he received it had, so that if, for example, he received it from a thief (in good faith) it will prove worthless. The Committee recommended (Rec 7(4)) that in order to clarify this complex area, statute should recognise only one form of cheque-crossing, consisting of two transverse parallel lines, and that the effect of this crossing would be to ensure both that the cheque must be paid through a bank, and that it would be "not negotiable" in the sense explained above. As at present the crossing might be pre-printed on cheques, with or without the words "not negotiable"; either way it would be not negotiable in law. The use of words such as "and Co" or "and Company" would continue to be optional though they have no special effect in law. The Government accepts this recommendation as a useful clarifying

measure and will introduce legislation in due course to effect it. It also accepts the recommendation (7(3)), that the special crossing, which identifies the banker or branch to whom payment should be made, is no longer necessary and should be repealed.

Non-Transferable Cheques

5.6 The Government agrees that there is a need for a clear method of making cheques non-transferable and proposes that this should be met by giving legal status to the words "account payee" or "a/c payee", with or without "only", written on the face of a cheque. A customer who writes these words on a cheque will make it "non-transferable" so ensuring that the cheque can only be paid into the bank account of the named payee. If a collecting bank credited the proceeds of a non-transferable cheque to the wrong account it would be unambiguously liable to the payee named on the cheque; the paying bank would not be liable. The paying bank would not know whether the cheque had been paid into the account of the named payee. The collecting bank would, however, have a defence if it could show that it had acted in good faith and without negligence, where for example, the account name was indistinguishable from that of the payee on the cheque and it had taken steps to establish the identity of the customer to whose account the proceeds of the cheque had been credited (following Recommendation 6(2)). These proposals will not preclude the use of the existing methods of making cheques non-transferable, namely writing "pay John Smith only", together with the deletion of "or order" from pre-printed cheques; or adding the words "not transferable". These are not however often used at present and the Government expects that these expressions will be used even less frequently when clear statutory backing is given to the words "account payee".

5.7 The Review Committee suggested that giving legal status to "account payee" might be unduly onerous to the banks, but their response to the consultation exercise indicated that on balance they would prefer that to a new payment order.

5.8 It is clear that bank customers will need to be made aware of these measures. The effect of the words "account payee" and the general crossing will have to be explained so that customers can understand the purpose of a "non-transferable" cheque on the one hand, and of a cheque that is simply crossed (that is "not negotiable") on the other. Banks may feel it is sensible to inform their customers through the code of practice or in cheque books. The use of open cheques will, however, still be possible for payments to individuals with neither a bank nor a building society account, despite the attendant risk of fraud.

Protection for Banks and Building Societies

5.9 The Review Committee recommended two changes to the law which offers protection for banks. The first (Rec 7(5)) is that the various statutory protections available to the paying bank would be made subject to the condition that the bank had acted "in good faith and without negligence", currently expressed in a slightly different form in each of the relevant statutory provisions. The existing sections 60 and 80 of the 1882 Act, section 1 of the 1957 Act and section 19 of the Stamp Act 1853, would be repealed. This recommendation is designed to clarify several inconsistencies in earlier legislation whilst retaining the spirit of the existing provisions. The Government accepts the recommendation.

5.10 The Review Committee also recommended (Rec 7(6)) bringing the law in Scotland into line with that in England for section 4 of the Cheques Act. In Scotland the law does not recognise the tort of conversion and common law appears to provide a defence unless there has been bad faith; however the Government is not convinced that banks in Scotland have significant additional protection. The Review Committee's report offers no evidence that the different law in Scotland is causing problems. Accordingly no need is currently seen for legislation on this point; instead the Government proposes to refer the question of the banks' protection in Scotland to the Scottish Law Commission for consideration.

Cheque Truncation

5.11 The banks have for some years been pressing for an amendment to the 1882 Act to facilitate the truncation of cheques. The Review Committee recommended (Rec 7(8)) legislation, which would be permissive and allow the truncation of cheques. Banks would be able to obtain payment by presentation of electronic information rather than the paper cheque itself, as currently required by the 1882 Act. A photocopy or some other reproduction in legible form, suitably marked and authenticated, would also be accorded the status of "evidence of the receipt by the payee of the sum payable by the cheque".

5.12 The truncation of cheques would eliminate the transportation of millions of cheques around the country each day. The pieces of paper would remain at the bank branch at which they were paid in (or local clearing point) and the relevant information to permit the debiting of accounts would be transmitted electronically. Some European countries already have systems of truncation in place.

5.13 The Government accepts the Review Committee's recommendation and will introduce the necessary legislation in due course. If banks introduce cheque truncation, however, it is important for there to be safeguards to ensure that the customer does not suffer as a result of this innovation. The Government proposes that there should be a provision in the code of banking practice that, unless the evidence to resolve a dispute about a truncated cheque is produced within a specific number of working days of the complaint, the bank should re-credit the customer's account that has been debited. The code should either suggest a single feasible period or make it clear that the period would be notified to customers by their bank, with the actual period being determined by the individual banks. Customers should also have the right under the code to receive, within a reasonable time, a photocopy (or the original) of any cheque which has been truncated. Banks should be required to keep the original cheques for a reasonable period.

Determination of the Amount Payable on a Cheque

5.14 The Review Committee recommended (Rec 7(9)) that precedence should continue to be given to the amount in words over that in figures on a cheque. The Government believes the existing practice is working well and supports the Review Committee's view that the law should not be amended.

Attachment of Funds in Scotland

5.15 The Review Committee recommended (Rec 7(10)) that the "funds attached principle" in Scottish law should be abolished except in relation to negotiable instruments other than cheques. Under section 53(2) of the 1882 Act (which only applies to Scotland) where the drawer of a cheque has insufficient funds to meet a cheque, the bank must "attach" any available funds in the account. The available balance is transferred to a suspense account where it can be released only when the cheque is re-presented and met, or with the payee's consent, or after five years, or after a judicial settlement. Once attached the funds cannot be used to meet other cheques drawn by the customer.

5.16 The Review Committee took the view that this provision is expensive to administer for the banks; causes inconvenience and sometimes hardship for their customers; and does not give significantly more protection to payees than is available in English law. Their recommendation would, for cheques, bring the law in Scotland into line with that in England.

5.17 This issue was last addressed by Parliament in the 1984/85 session when the decision was taken to retain attachment in the case of returned cheques. The law was changed in 1985 to remove attachment when the drawer countermands payment.

5.18 Abolition of the "funds attached principle" would have implications for certain long-established principles of Scottish law and the Government would not wish to proceed with it unless there was clear evidence that a change in the law was necessary and desirable. Accordingly, the Government proposes to consult

interested parties in Scotland on this recommendation and will take account of their views in reaching a conclusion.

Payable Orders

5.19 Payable orders, or warrants, are documents issued mainly (but not exclusively) by one Government department to be drawn on the same or another Government department, such as a National Savings warrant. They are treated as cheques by banks and their customers though they are not cheques as defined in the 1882 Act. The rules of negotiability therefore do not apply. The Review Committee recommended (Rec 7(11), 7(12)) that legislation should be enacted to equate Government payable orders and warrants, (for the payment of interest or dividends, or for repayment of capital) with cheques.

5.20 The Review Committee's proposals are a useful tidying up of the law which would state unambigiously that such instruments are to be treated as cheques for all purposes. The Government accepts the Review Committee's recommendations on payable orders and legislation will be introduced in due course.

Bank Giro Credits

5.21 The Review Committee have also recommended (Rec 7(13)), for the avoidance of doubt, that legislation should make it clear that a transfer instruction by Bank Giro Credit does not constitute a legal assignment of the funds involved.

5.22 The Bank Giro Credit has been developed by the banks over the last twenty years but, unlike cheques, is not governed by any legislation. Apart from this one point of clarification the Review Committee considered that legislation was unnecessary. The majority of legal authorities share the Review Committee's view that a Bank Giro Credit is not a legal assignment, but is merely an instruction to the bank. However, the Government proposes to introduce into legislation a clarifying provision to avoid future uncertainty.

Annex 6. Negotiable Instruments

6.1 Negotiable instruments (other than cheques) include bills of exchange, Treasury bills, certificates of deposit and bearer shares. The law relating to such instruments is of interest and importance to a comparatively small number of companies, traders and banks who deal in these instruments. It does not normally affect personal customers. The Review Committee made a number of recommendations this area. In particular, it proposed a new Negotiable Instruments Act. Much of this would be a consolidation and codification of existing statute and case law. The Government does not believe that such an exercise would be warranted and this chapter makes proposals only where the Government believes that some change in the law would be positively helpful.

6.2 The main existing legislation governing negotiable instruments is the Bills of Exchange Act 1882. That Act has worked well but some limited changes are necessary to bring the law up to date with modern circumstances. The Review Committee believed that the structure and language of the 1882 Act should be preserved (Rec 8(2)), and the Government supports that view. Changes to the law will therefore be achieved by amending the 1882 Act, when other pressures on the legislative timetable permit.

DETAILED PROPOSALS

6.3 The Review Committee recommended (Rec 8(3)) that there should be a statutory test of negotiability under the new Act covering not only bills of exchange and promissory notes but other instruments as well. The Government does not intend to extend the 1882 Act to embrace other instruments at present, and so it does not accept this recommendation. Other instruments, of course, are

negotiable at common law and the Government does not propose to change this.

6.4 The Government accepts the Review Committee's recommendation (Rec 8(5)) that the sum payable on a negotiable instrument should no longer have to be certain at the date of issue provided it is "certain or ordinarily determinable" in accordance with provisions which will be set out in amending legislation. This proposal aims to facilitate the use of instruments denominated in units of account like the ECU. The 1882 Act will therefore be modified so that the amount of a bill instead of being "a sum certain in money" will be "a certain or ordinarily determinable sum" which would be defined to include "a monetary unit of account established by an inter-governmental institution". The Government is aware that there may be technical difficulties involved in defining a sum as "ordinarily determinable". The sum payable will need to be objectively ascertainable and not dependent on private standards peculiar to the parties. Even then there may be some residual uncertainty, for example there may be a variation in rate during the day on which an instrument is payable. However the Government believes that it should be possible to overcome such difficulties.

6.5 In the context of discussing Recommendation (8(5)), the Review Committee raised the question of whether floating rate instruments, where the rate of interest rather than the currency is the problem area, should be brought into the 1882 Act. Most bills are drawn for 90 days or less and are traded at a discount; bills including interest are very rare. The Government has therefore concluded that there is no need at present to make special provision for floating rate instruments.

6.6 Noting and protest are procedures for providing formal proof that a bill of exchange has been presented and dishonoured. Protesting is mandatory under the 1882 Act for foreign bills because some overseas courts will not otherwise accept that a bill has been dishonoured.

6.7 The Government proposes to abolish the mandatory requirement for noting and protesting a dishonoured foreign bill. However this procedure would be retained in a slightly modified form for use on a voluntary basis. Anyone entitled to take an oath would be able to give a simple certificate of the facts in order to fulfil the requirements in those countries where noting and protesting are still necessary.

6.8 The Review Committee mentioned giving recognition to the "aval" in para 8.16 of their report. The Government intends to give legal recognition to the "aval". An "aval" is where a third person guarantees the payment of a bill by signing it. It is a common practice on the Continent which has received only limited recognition so far under English law. The Government proposes to amend the 1882 Act to recognise a guarantee given by way of an aval.

6.9 The Review Committee recommended (Rec 8(9)) legislation to provide a clearer statutory basis for the transfer of negotiable instruments by electronic means in screen-based or book-entry depository systems. The purpose of this recommendation is to facilitate the development in the City of London of a system (or systems) for the electronic transfer of negotiable money market instruments (for example, bills of exchange, Treasury bills, certificates of deposit), which are at present walked around the streets of London.

6.10 The Government believes that such a system will provide a more efficient method of trading in these instruments. The Bank of England has already announced its intention to provide a service for screen-based settlement of negotiable instruments through the setting up of the Central Moneymarkets Office (CMO). In its initial phase the CMO will provide screen-based transfers for money market instruments held in paper form in a central depository, which will operate within existing legislation. There would be considerable gains in efficiency if such instruments could be "dematerialised" (that is to say issued and traded in purely electronic form). However the absence of a physical instrument would mean that the rules on negotiable instruments

would not necessarily apply. The Government intends to legislate, when other pressures on the Parliamentary timetable permit, to give transactions in dematerialised instruments the same status as transactions in negotiable instruments generally.

6.11 The Review Committee have recommended, (Rec 8(10)), the adoption of a further 40 technical changes to the 1882 Act. (Appendix N of the Review Committee's report.) Many of these recommendations would be sensible if the 1882 Act were to be completely rewritten. However, since the Government does not envisage introducing a new Act at this stage, it proposes instead to amend existing legislation to include only Technical Recommendation 36, which would allow notice of dishonour to be given by electronic communication or by telecommunication.

Annex 7. Other Aspects of Banking Law

7.1 This annex considers the remaining aspects of banking law on which the Review Committee have made recommendations. The Review Committee have recommended amendments to the Bankers' Books Evidence Act 1879, and the Statute of Frauds Amendment Act 1828 and have made proposals for new legislation on completion of payment and contributory negligence.

Bankers' Books Evidence Act 1879

7.2 The original purpose of the Bankers' Books Evidence Act was to overcome the difficulties faced by bankers in having to produce their books of account during court proceedings to which they were not a party. The 1879 Act allowed properly authenticated copies of entries to be admitted as evidence in court and gave courts the power to make orders for inspection and copying of relevant entries in certain circumstances.

7.3 The Review Committee considered whether various sections of the 1879 Act need to be altered or updated. As a result they have made five recommendations. These would repeal the sections specially providing for the admission of copies of physical book entries; allow inspection orders prior to the start of legal proceedings; extend the definition of "bankers' books" to include credit slips and paid cheques; include the Bank of England in the definition of a "bank" and provide for the discretion to permit reimbursement of banks for the cost of complying with court inspection orders.

7.4 Sections 3 to 5 of the 1879 Act contain special provisions for the admissibility in court of copy evidence, and for the verification of entries in bankers' books. The Review Committee

concluded that banks, like other businesses of a reasonable size, no longer keep the majority of their records in physical form. The banks can therefore be treated in the same way as other businesses, and so it is no longer necessary to have special provisions relating solely to bankers' books.

7.5 Section 6(1) of the Civil Evidence Act 1968 applies to all documentary evidence relating to civil proceedings. It is sufficient to cover the records of banks and other businesses, both those held in physical form and on computer. It also expressly refers to the production of copies. Sections 24 and 27 of the Criminal Justice Act 1987 apply in a similar way to criminal proceedings. The Government therefore accepts the Review Committee's recommendation (13(6)) that section 3 of the Bankers Books Evidence Act should be repealed as it is no longer required, though legislation on this is not urgent. This proposal is subject to the findings of the Scottish Law Commission which is currently considering the subject of criminal evidence.

7.6 The Review Committee recommended (Rec 13(7)) that the 1879 Act should be amended so as to permit a court to make an order for inspection and copying of entries in bankers' books if it thinks fit, whether or not legal proceedings had formally begun. The order would only be granted in circumstances where the court was satisfied that a double criterion was met. Proceedings would have to be seriously contemplated <u>and</u> there would have to be grounds to support a prosecution or an action over and above what might be discovered as a result of the order.

7.7 Following the publication of the Review Committee's report those consulted expressed strong reservations about this recommendation despite the safeguard against "fishing expeditions" that it contained. The Government shares those concerns. In view of the important principle of banking confidentiality which is involved, the Government would require clear evidence of the need for this amendment in defined circumstances before supporting a change in legislation.

7.8 The current definition of "bankers' books" under section 9 of the 1879 Act encompasses ledgers, day books, cash books, accounts books and all other records used in the ordinary course of business of the bank, whether in written form or kept on microfilm, magnetic tape or any other form of mechanical or electronic medium. The Review Committee recommended (Rec 13(8)) that this section be extended to include credit slips and paid cheques where this is necessary to identify, confirm or provide necessary detail of book entries, thus taking account of changes in banking accounting practices over recent years. The Government believes that a wider definition of section 9 would be helpful and will propose legislation accordingly, in due course.

7.9 The Government also proposes to take a legislative opportunity to include the Bank of England in the definition of a "bank" or "banker" in section 9 of the 1879 Act (Rec 13(9)).

7.10 The Review Committee also recommended (Rec 13(10)) that the 1879 Act should be amended so as to give a court discretion to order payment of a fee to the bank against which an order under section 7 of the Act is made, in order to reimburse the bank for the cost of compliance.

7.11 Currently, banks are unable to seek recompense for complying with section 7 orders where they are not a party to the litigation, despite the cost imposed upon them. The Government supports the Review Committee's recommendation to give a court discretion to order payment of a fee to the bank against which an order under section 7 of the 1879 Act is made (as amended above) and will seek to amend the law accordingly.

Statute of Frauds Amendment Act 1828

7.12 The Review Committee recommended that section 6 of the Statute of Frauds Amendment Act 1828 should be repealed. The assumption underlying this recommendation was that section 6, the only section of the 1828 Act which has not been repealed, was no longer used. However consultation has shown that this assumption

is not correct. The Government does not therefore propose to repeal that Act.

Completion of Payment

7.13 The Review Committee recommended (Rec 12(2)) new legislation to define when a payment is complete. The few cases there have been on completion of payment leave the law unclear in a number of areas. The Review Committee's case for a statutory definition is based on the perceived need to provide more certainty about the legal consequences of a transfer of funds in the event of a bank failure.

7.14 The Government agrees that it would be desirable to have greater legal certainty in this area. It is an important issue which is currently exercising bankers and others around the world. Current initiatives include the United Nations Commission on International Trade Law Working Group on International Payments which is drafting a model law on international credit transfers. There is also a major study of payment netting schemes and cross-border payment systems being conducted by major central banks and the Bank for International Settlements.

7.15 The Review Committee offered a definition which is intended to be a codification of existing English case law. The Government has a number of doubts about the proposed definition. Some of those consulted questioned whether the proposed definition did indeed reflect existing law. Furthermore, the Committee analysed payment completion solely in terms of bank failure. There are many other more commonplace situations in which payment completion is important; for example, death or insolvency of a customer, court orders, system error and fraud. In view of the importance of this subject, recognised by the Review Committee and others who have commented on their recommendations, the Government believes that there would be dangers in the premature adoption in statute of a provision based on the Review Committee's definition.

7.16 The Review Committee also recommended (Rec 12(3)) that the Bank of England should convene a working group of interested

parties to consider and report on the operational implications of their definition of payment completion. The Government proposes that this working group should not be convened until the international initiatives mentioned above (para 7.14) become clearer. When the various domestic and international developments have been considered further, the Government will review the need for legislation on completion of payment and decide whether a working group convened by the Bank of England would be helpful.

Contributory Negligence

7.17 The Review Committee recommended (Rec 6(1)) that there should be a statutory provision whereby, in an action against a bank in debt or for damages arising from an unauthorised payment, contributory negligence may be raised as a defence if the court is satisfied that the degree of negligence shown by the plaintiff is sufficiently serious for it to be inequitable that the bank should be liable for the whole amount of the debt or damages.

7.18 At present, if a bank makes an unauthorised payment (for example, pays a forged cheque), the bank is liable for the loss regardless of whether the negligence of a customer contributed to the loss. Following a 1985 case (Tai Hing Cotton Mill Ltd v Liu Chong Hing Bank and others) banks and others have expressed concern that the law is unfair and should be changed to redress the balance in cases of unauthorised payments.

7.19 The Government agrees that the law at present is unfair to banks and is disposed to make it more evenly balanced between banks and their customers. The subject of contributory negligence was examined by the Law Commission which published a consultation paper entitled "Contributory negligence as a defence in contract" in January 1990. The paper considers how the concept could be applied as a defence in legal cases involving banks as well as in many other areas. When it has considered the responses to this consultation the Commission will submit a final report. It would be premature for the Government to propose revisions of the laws affecting banks to allow the defence of contributory negligence, when a much wider revision may be necessary. The Government will therefore make its proposals to change the law in this area when it has received and considered the Law Commission's final advice.

Annex 8. Wider Banking Issues

8.1 In preparing their report, the Review Committee have commented on a number of issues which went wider than their terms of reference. These matters all have a banking dimension, but the Review Committee were only able to offer comments on the banking implications of these particular issues. Their recommendations generally suggest that further work and consultation is needed before the banking problems identified by them can be considered in depth.

Consistency Across the Field of Payment Cards

8.2 The Review Committee were sympathetic to the need to ensure consistency of legal treatment in the use of payment cards. They took the view that it was unreasonable and confusing to customers if their rights and obligations differed greatly depending on which card they used. The Review Committee therefore recommended (Rec 11(1)) that the Government should consider how consistency of law and practice, across the field of payment cards generally, can be best achieved in the case of payment cards issued by retailers and other non-bank institutions.

8.3 The Government accepts that consistency of law and practice across the field of payment cards generally is an issue on which further work may be necessary. This White Paper includes proposals which will have the effect of achieving consistency in the main areas where unjustifiable differences of treatment have been identified. Of course, in some areas differences of treatment may be appropriate, for example, if cards offer different facilities. Some payment cards offer credit whereas others are purely debit cards. The Government will keep the area under general review, in the light of developments in the banks'

code of practice, and will give careful consideration to any representations it receives about unjustified inconsistencies.

Connected Lender Liability

8.4 The concept of connected lender liability was introduced by section 75 of the Consumer Credit Act 1974. The rationale behind the rules of connected lender liability is that the connected lender and the seller are in effect engaged in a joint venture to their mutual advantage and their respective roles cannot be isolated. The 1974 Act provides that purchases made using a credit card are to be covered by the provisions of section 75. The Review Committee were impressed by the arguments put forward by the banks that the connected lender liability should be removed from credit cards.

8.5 The Government's recent review of the Consumer Credit Act confirmed the general rationale for connected lender liability. Since issuers of credit cards benefit from the purchases made with their cards the Government does not accept the Review Committee's recommendation (Rec 14(1)) that there should be an exemption from the connected lender liability provisions of the Consumer Credit Act for purchases financed by the use of credit cards.

Constructive Trust

8.6 The Review Committee drew attention in their report to the concept of the constructive trust, which arises when a person who has not been appointed to act as a trustee becomes involved in the affairs of a trust (for example providing banking services to trustees) as a result of which the liabilities of a trustee are imposed upon him. This concept has particular implications for banks since a bank can become subject to a constructive trust, for example, when it honours a cheque which it knows or ought reasonably to know is a misapplication of trust money. The Review Committee were concerned about the uncertainties surrounding the present state of the law and how it might evolve by judicial decision in the future. Therefore they recommended (Rec 14(2))

that the concept of constructive trust should be examined in depth by the Law Commission.

8.7 The concept of constructive trust extends to many areas of law and is not confined to banking. The Government will in due course determine with the Law Commission whether a general review of this topic would be of use. It is meanwhile considering with the Law Commission an examination of one aspect of this topic: the interrelationship of fiduciary duties and regulatory rules.

Set-off

8.8 The Review Committee identified a concern with the law of set-off. This was that section 323 of the Insolvency Act 1986 might have excluded contingent liabilities which are not due and payable at the commencement of the bankruptcy from being taken into account. This was thought to cast doubts on a banker's ability to set-off contingent liabilities which become actual liabilities after notification of insolvency.

8.9 The Government proposed an amendment in the Companies Bill to deal with the perceived doubt. However, on further consideration, the amendment whilst clarifying the position of some contingent claims, unacceptably widened the potential scope of those claims capable of inclusion in the set-off. The amendment was not therefore pursued.

8.10 Another concern identified by the Review Committee relates to the judgment of Mr Justice Millett in the case of <u>Re Charge Card Services Limited</u> (1986). He found that a creditor (eg a bank) cannot validly take a charge over a debtor's (eg a customer's) credit balance with the creditor as security for a loan made to that debtor. However, this form of security has in practice been used by the banks in order to obtain wider rights over a customer's credit balance than that available under statutory set-off and the judgment was therefore of great concern to them. The Review Committee recommended that the Government should institute a process of consultation with a view to removing the uncertainty surrounding Mr Justice Millett's judgment.

8.11 The Review Committee's concern relating to the validity of a charge over a credit balance in favour of the person with whom the balance is held involves complex issues. The Government is giving the matter further consideration to establish whether a solution can be found that is acceptable to all interested parties.

Bank Holidays

8.12 The Review Committee examined the banking implications of the mismatch of bank holiday dates as between England and Wales on the one hand, and Scotland on the other. There is also a mismatch with two dates in Northern Ireland. The problem for banks, particularly in Scotland, relates mainly to transactions passing through the electronic clearings and stems from the fact that settlement of these inter-bank transactions for the whole of the United Kingdom takes place in London. Thus when London is closed there is no settlement, whilst settlement does take place on days when there is a Scotland-only bank holiday. This can lead to extra costs for Scottish banks, and may give rise to confusion and complaint on the part of their customers.

8.13 The Government notes the Review Committee's concerns about the banking problems associated with the mismatch of bank holiday dates as between England and Wales, and Scotland. The Government does not propose to harmonise dates within the United Kingdom (Rec 14(4)) and believes that it is for the banks themselves to resolve this difficulty by contract or administrative procedures.

A Minor's Capacity to Contract

8.14 The Review Committee did not formally consult on the question of banking for minors but their attention was drawn to concerns that parents have expressed regarding banks' insensitivity about the banking activities of their minor children and the use made of information about minors with bank accounts. Bankers clearly face a dilemma arising out of the conflict between the rights and duties of a parent or guardian, and the bank's relationship with a young person for whom the parent or guardian

is responsible. The general legal principle is that during minority, the capacity to contract is severely limited and the minor is protected to the extent that many obligations incurred are not in fact enforceable. If a bank allows, or permits by accident, an overdraft on a minor's account, then the bank faces the delicate decision regarding parental involvement in obtaining repayment. In addition, credit marketing to minors is prohibited by law. The Government is concerned that banks should exercise particular care to ensure that information held on minors with bank accounts is not used for marketing purposes.

8.15 The Scottish Law Commission have recently examined the question of a minor's capacity to contract and the Review Committee have recommended that the Government should consider introducing into legislation the recommendations of that Commission. In addition the Review Committee recommended (Rec 14(5)) that the Government should consider instituting a similar review of the English law dealing with a minor's capacity to contract.

8.16 The Review Committee's concerns about the English law dealing with a minor's capacity to contract have been noted (Rec 14(5)). The Government has accepted the Scottish Law Commission's recommendations, which were included in a Private Members Bill in the last session of Parliament; unfortunately, this failed to make progress, but the Government remains committed to the principle of legislation. A similar review for England and Wales was undertaken by the Law Commission in 1984 which led to the passing of the Minors' Contracts Act 1987 and the Government does not believe that a further review in England is necessary at this time.

Evidential Requirements of the Criminal Law

8.17 The subject of the admissibility of computer produced evidence in court has been raised by the Review Committee in the context of fraud through EFT systems, though they recognised that it has much wider implications. The Review Committee concluded that if current evidential requirements hinder the conviction of

fraudsters then those requirements should be reviewed. Therefore they recommended that consideration should be given to a review of those requirements, insofar as they relate to the corroboration of computer-produced evidence in cases of fraud.

8.18 The Government would be ready to review the evidential requirements for computer produced evidence if it were shown that they were in practice hindering the prosecution and conviction of fraudsters.

Computer Hacking

8.19 The Review Committee recommended (Rec 14(7)) that action should be taken to make it a criminal offence to obtain unauthorised access to a computer by "hacking", as recommended by the Scottish Law Commission and to introduce "viruses" into computer programs.

8.20 The English Law Commission have also published a report on computer misuse, in which they recommend the creation of three new offences. These would cover the types of misuse identified by the Review Committee. In his response to the report, the Secretary of State for Trade and Industry stated that he was inclined to accept the recommendations. A Private Members' Bill was introduced into the House of Commons on 20 December 1989 to give effect, with modifications, to these recommendations. The Bill also takes into account earlier recommendations made in the Scottish Law Commission report referred to above.

Customer Choice in the Means of Payment

8.21 The Review Committee have recommended that the Government keep under periodic review the scope for customer choice as between different payment systems, and the related question of the acceptability of legal tender, to ensure that there is no unfair discrimination through contractual arrangements, charging or financial incentives (Rec 14(8)). In this recommendation the Review Committee were highlighting a general concern that as

payment systems develop, a customer's choice of payment method may be restricted.

8.22 It is of course important to bear in mind the needs of the those who do not have bank or building society accounts and who should be able to continue to tender with cash. At present in the United Kingdom although cash is legal tender, it is open to a person to refuse to enter into a transaction with another person who is only willing to pay in cash. A shopkeeper, for example, is not obliged to sell any of his goods simply because they are on display, and could, for instance, refuse to sell them except to someone who is prepared to pay for them by means of a cheque. If he has already entered into a transaction however, and is owed money for the goods sold, he cannot successfully pursue that person in the courts if offered legal tender in settlement. Discrimination in favour of one payment system or against another, whether through contractual agreement, charging or the use of financial incentives, might, in some circumstances, give rise to concern, particularly if the effect were anti-competitive. However the Government recognises that different payment systems incur different costs. The Government therefore accepts the principle behind the Review Committee's recommendations for periodic considerations of the scope for customer choice as between different payment systems (Rec 14(8)).

Future Review of Banking Services Law and Practice

8.23 The Review Committee concentrated on those areas of banking services law and practice which at the present time appear to them to require priority. Whilst they have done their best to allow for future developments they have emphasised that the development of electronic banking is expanding at an increasing rate. Therefore priorities will change with time and the Government should keep under review the possible need for further studies to deal with the rapid change in banking services. The Government accepts the need for further studies (Rec 17(1)) to deal with the priorities as and when they emerge in the field of banking services law and practice.

Annex 9. Scope of the Proposed Legislation

Legislation will be introduced, when other pressures on the legislative timetable permit, for the following purposes:

(a) banning the unsolicited mailing of all payment cards (Committee recommendation 10(2)/paras 4.4-5);

(b) restricting a customer's liability for loss in the case of payment cards (recommendation 10(10)/paras 4.6;

(c) imposing on banks liability for the failure of electronic funds transfer equipment (recommendation 10(11)/paras 4.7);

(d) clarifying the meaning of crossings on cheques and giving statutory recognition to the words "account payee" (recommendation 7(2), 7(4)/paras 5.6);

(e) permitting the truncation of cheques (recommendation 7(8)/paras 5.11-13);

(f) clarifying the status of payable orders and bank giro credits (recommendations 7(11),(12),(13)/paras 5.19-22);

(g) extending section 5(5) of the Forgery and Counterfeiting Act 1981 to apply to all payment cards (recommendation 11(5)/paras 4.12-13);

(h) repealing sections 3 to 5 of Bankers' Books Evidence Act 1879 (which relate to the admissibility in evidence of copies of entries in bankers' books) (recommendation 13(6)/paras 7.2-7.5);

(i) amending the Bankers' Books Evidence Act 1879:-

i. to extend the definition of "bankers' books" in section 9 to include cheques and credit slips (recommendation 13(8)/para 7.8);

ii. to extend the definition of "bank" and "banker" in section 9 to include the Bank of England (recommendation 13(9)/para 7.9); and

iii. to give a court discretion when making an order under section 7 to order payment of a fee to reimburse the bank for the cost of compliance (recommendation 13(10)/para 7.11);

(j) restructuring the various statutory protections available to the paying bank under the Cheques Act 1957, the Bills of Exchange Act 1882 and the Stamp Act 1853 (recommendation 7(5)/para 5.9);

(k) updating the Bills of Exchange Act 1882:-

i. to provide that the sum payable on a negotiable instrument will no longer have to be certain at the date of issue if it is "certain or ordinarily determinable" in accordance with the provisions set out in the Act (recommendation 8(5)/para 6.4);

ii. to remove the mandatory requirement for noting a protest of a dishonoured foreign bill, while retaining the procedure for use on a voluntary basis (recommendation 8(8)/ para 6.6-7);

iii. to permit transactions by way of screen based or book entry depository systems operated by an approved depository including transactions in "dematerialised" instruments (recommendation 8(9)/paras 6.9-10); and

iv. to allow notice of dishonour to be given by electronic communication or by telecommunication (Technical Recommendation 36) (recommendation 8(10)/para 6.11).

Annex A: Review Committee's recommendations

The Review Committee made 83 recommendations, 26 addressed to banks and building societies and the remainder to Government. The Government's response to individual recommendations (reproduced below) can be found in the following Annexes to the White Paper.

Annex 1: The Code of Practice

Recommendation 16(1): Banks should promulgate a Code of Banking Practice on matters that are the subject of Recommendations in this Report on standards of best practice addressed to banks, giving priority to the EFT area. If in any particular respects they can see good reason for departing significantly from the terms of the illustrative Code at Appendix L, they should consult consumer and other interests.

Recommendation 6(2): As an indication of what is required for banks to secure the protection of Section 4 of the Cheques Act 1957 (under the current legislation), they should initiate procedures which allow them to establish, to their reasonable satisfaction, the identity of a person opening an account, so that if subsequently challenged they can refer to the action they took at the time.

Recommendation 6(3): A standard of best practice should require a bank, in any communications to its customer of the terms of the banker-customer contract, to ensure he is given a fair and balanced view of those terms, and of the rights and obligations that exist on each side; and to give him reasonable notice of any proposals for variation of those terms.

<u>Recommendation 15(2)</u>: A standard of best practice should require banks to establish clearly defined internal procedures for handling customer complaints; to ensure in some appropriate way that customers are told how to lodge a complaint, and how it would be dealt with; and to ensure that, as and when a complaint arises, the customer is made personally aware of the existence of the bank's internal procedures, and of the relevant procedures of the Banking or Building Societies Ombudsman, as appropriate.

<u>Recommendation 5(2)</u>: A standard of best practice should enjoin banks to explain clearly to all their customers the rules on the banker's duty of confidentiality, once codified in statute law. It should require banks to remind customers of their right of access, under the Data Protection Act 1984, to computer records about themselves held by banks. It should state that express consent, in whatever form, should not be sought in such a way as puts the customer under pressure to give it. In the case of express consent to be obtained in tacit form for the giving of bankers' opinions, a letter should be sent personally by the bank to its customer, seeking his consent for this specific purpose(s).

<u>Recommendation 6(4)</u>: A standard of best practice should require a bank to give all its customers a clear explanation of how the system of bankers' opinions works, and to invite them to give or withhold a general express consent for the bank to supply opinions on them in response to status enquiries.

<u>Recommendation 13(4)</u>: A standard of best practice should require banks, in the direct marketing of their services, to exercise restraint, and in particular:

- to ensure that customers are aware of the marketing purpose for which they are being approached, and

- to respect any customer's objections to the use of personal information for marketing purposes, and to desist from such activity on request.

<u>Recommendation 13(1)</u>: A standard of best practice should require banks to give all their customers a simple explanation of the timing of the clearing cycle, and the concept of cleared balances. This would deal, especially, with the normal time taken to clear cheques and bank payment orders, should specify the "hold" period the bank is applying, and should say whether the bank has a right of reversal if the cheque or bank payment order is later returned unpaid. But it would cover other payment systems as appropriate, including the timing of direct debit procedures, and the customer's right of reversal under that system. Where needed, an explanation should be given of the system of truncation of cheques and bank payment orders, and of resulting changes, if any, in the timing of the clearing cycle. Banks should consider how their customers could usefully be given more information, in periodic statements of account and in ATM slips, about cleared as well as uncleared balances on their account.

<u>Recommendation 7(14)</u>: It should be a standard of best practice that, if the necessary evidence to resolve a dispute regarding a truncated cheque or bank payment order is not produced within three working days, the customer's account should be re-credited pending final resolution.

<u>Recommendation 7(15)</u>: There should be a standard of best practice to the effect that a bank should not return, within six months from the date of issue, an instrument covered by the new Cheques and Bank Payment Orders Act on the grounds that it was out of date.

<u>Recommendation 7(16)</u>: A standard of best practice should require banks to make available in a leaflet, or by other suitable means, an explanation of the rights and obligations of bank and customer in regard to transactions effected by BGC including the rules on countermand.

<u>Recommendation 11(2)</u>: A standard of best practice on multi-function cards should establish that:

- a customer should be free to choose which of the functions on his card should be available for use; a bank should not be at liberty to refuse a card for a single function if its customer does not require more;

- functions that the customer does not require should be blocked off, so that the card cannot be used for those purposes in a machine;

- if for whatever reason the card is nonetheless compromised, the customer should (fraud on his part excepted) have no liability on all functions that he has not authorised.

<u>Recommendation 11(4)</u>: All banks as card-issuers should, as a matter of best practice, inform all customers as cardholders:

- whether or not they themselves will accept notification of loss or theft of a payment card from a third party, presumably a card notification organisation;

- if so, the terms in which they would require cardholders to notify them, by a standard form of notice acceptable to card-issuers and signed by cardholders, of the appointment of an agent for this purpose;

- the effect, if any, on the cardholder's liability if an agent is appointed, especially the matter of whether notification to the agent discharges the cardholder's obligation to the card-issuer.

<u>Recommendation 11(3)</u>: Legislation should be introduced requiring card notification organisations to be licensed by the Director-General of Fair Trading. It should include a power by which the Director-General, if he saw fit, could impose on such organisations a requirement to take out a fidelity bond, and an errors and omissions policy in a suitable sum, as a condition of the grant or continuance of a licence.

<u>Recommendation 12(1)</u>: A standard of banking practice should require banks, when establishing countermand rules for individual payment systems, to allow customers a period of time for countermand wherever possible, only eliminating it where that is necessary for the efficient working of the system. Banks should take steps to make customers aware of the different countermand rules applying to different payment systems.

<u>Recommendation 13(2)</u>: A standard of best practice should require banks to explain to their customers the basis of charging for the normal operation of the account. Where an overdraft arrangement has been agreed in advance, a bank should ensure that its customer is aware, both in advance and as and when a change occurs, of the rate over base rate that will be charged, and of the timing of the debiting of interest. The customer should also be given full details of the method of calculation of fees and charges, when these are applied to his account, including charges applied where an overdraft occurs without prior agreement. The customer should also be told of any services other than lending for which he will be charged (stopping cheques, correspondence etc).

<u>Recommendation 13(3)</u>: A standard of best practice should require a bank, when undertaking a foreign exchange transaction for its customer, to ensure that he is made aware of the basis of the exchange rate to be applied, and of any associated charges.

<u>Recommendation 13(5)</u>: A standard of best practice should require banks to ensure that prospective guarantors, whether or not they are not customers, are adequately warned about the legal effects and possible consequences of guarantees, and about the importance of receiving independent advice.

<u>Recommendation 10(1)</u>: A standard of best practice should translate into the context of customer-activated EFT systems a bank's principal and general duty to observe its customer's mandate. Banks should therefore adopt the principle that an EFT system must meet certain minimum standards of security in its authorisation procedures, so as to provide an acceptable degree of

protection for the customer against the consequences of unauthorised instructions. In furtherance of that principle, they should accept a continuing commitment to upgrade their systems by the introduction, so far as practicable, of new technology based on the recognition of a signature or other personal characteristic.

Recommendation 10(3): A standard of best practice should require banks to take every reasonable care when issuing cards and PIN's to their customers. It should state that that obligation should be undertaken by banks on the explicit assumption that customers for their part will take every reasonable care at all times in handling their cards and PIN's. It should also ban the unsolicited mailing of PIN's by banks to customers, following the principle proposed for legislation in respect of the mailing of payment cards. A customer should be required to acknowledge receipt of both card and PIN, before he can avail himself of the service for which they are needed.

Recommendation 10(4): A standard of best practice should require banks to ensure the maximum privacy that is reasonably possible in customers' access to EFT systems. In particular banks should aim to ensure that it is physically impossible for a customer's PIN to be read by anybody else when he is keying it in.

Recommendation 10(7): A standard of best practice should require banks to introduce systematic arrangements where they have not done so already, to monitor patterns of ATM withdrawals, such as might give rise to suspicion of fraudulent misuse of the system.

Recommendation 10(8): A standard of best practice should draw attention to customers' entitlement, under the Data Protection Act 1984, to demand a written record of an EFT transaction if they wish to have it; and should require banks to interpret this in the sense that customers are given the option of a written record at the time of the transaction, rather than in due course.

Recommendation 10(9): A standard of best practice should require a bank, as card-issuer, to deal with its own customer, as

cardholder, in case of any complaint or claim arising on the customer's part from a dispute over a banking service provided through an EFT payment system. It should be for the card-issuer to take action against any other party involved, for example in an EFT-POS system or shared ATM network.

Recommendation 10(13): A standard of best practice should require banks to make customers who use the relevant services aware of this rule in Recommendation 10(12) on apportionment of loss arising from a disputed EFT.

Annex 2: Confidentially and the Disclosure of Information

Recommendation 5(1): The Tournier rules on the banker's duty of confidentiality, suitably updated to comply with modern conditions, should be codified in statute law.

Recommendation 5(3): The Government should not further extend the statutory exceptions to the duty of confidentiality, without taking full account of the consequences for the banker-customer relationship.

Annex 3: Procedures for Resolving Disputes

Recommendation 15(1): Statutory provision should be made for comprehensive coverage of authorised banks, except those with less than a given (small) number of customers, by one or more recognised Ombudsman schemes. Statutory responsibility for granting recognition to such a statutory scheme (or schemes), and for withdrawing any recognition it has granted, should be placed on the Bank of England. The statute should lay down matters to be provided for in a statutory scheme (or schemes) and the requirements for recognised schemes as regards matters of complaint, grounds of complaint, functions of the Ombudsman, etc. There should be statutory provision for periodic review and amendment of the terms of the scheme (or schemes).

The Review Committee's preference is for a single Scheme for authorised banks based on the present Banking Ombudsman Scheme,

except that responsibility for approving the Ombudsman's terms of reference, for appointing independent members of the Council, and for approving the appointment of the Ombudsman himself, or its renewal or termination, would pass from the Board to the Bank of England. The Board would remain responsible for finance. The membership of the Council should be increased to eight by the addition of one more independent member. Any individual should be precluded from serving on both the Board and Council of such a Scheme. A bank rejecting a non-mandatory award under such a Scheme should be required to publish its reasons for doing so. It should be considered whether a suitable eligibility criterion could be devised which would allow small businesses to be brought within the ambit of such a Scheme.

Under such a Scheme, the following specific amendments should be made to the Banking Ombudsman's terms of reference:

- The Ombudsman should be required, if a complaint has not been resolved in some other way, to make a determination by reference to what is, in his opinion, fair in all the circumstances.

- The Ombudsman should be given a power to compel production by a bank of any relevant documents or information.

- The power whereby a bank may withdraw from the Ombudsman's jurisdiction any complaint which has wide ramifications, or raises important legal issues (the "test cases provision"), should be exercised only with the concurrence of the Ombudsman.

- The Ombudsman should be allowed to publish information about a complaint if the customer consents.

- The present requirement that complaints must in all cases be made by "all beneficiaries" should be dropped.

- Banking services for bank employees and their dependants should be included within the scope of the Scheme, unless there is a disciplinary issue involved.

<u>Recommendation 15(3)</u>: The Government should consider the scope for rationalisation, in some form, between a statutory Banking Ombudsman Scheme and the Building Societies Ombudsman Scheme, to cover at least the banking services area; and for any limited convergence as between the two Schemes that could usefully be achieved meanwhile.

Annex 4: Electronic Funds Transfer

<u>Recommendation 10(2)</u>: A provision in statute law should ban the unsolicited mailing of all payment cards by banks to their customers, apart from credit cards already covered by Section 51 of the Consumer Credit Act 1974.

<u>Recommendation 10(10)</u>: A provision in statute law, applicable to any customer-activated EFT system, should set the limits of legal liability for loss due to fraud on the principles established in Sections 83 and 84 of the Consumer Credit Act 1974. The main provisions are that a customer should normally be liable for any losses incurred up to the point where he notifies his bank, subject to a financial limit currently fixed at £50; the bank should be liable for any losses incurred thereafter. Where gross negligence on the part of either party could be demonstrated, that party should be liable for any amount up to the full amount of the loss. The bank's duty should be in any event to its customer, but the bank should have a right of relief against a third party who could be shown to have contributed to loss by fraud through an EFT system.

<u>Recommendation 10(11)</u>: A provision in statute law, applicable to any EFT system, should make the bank normally liable to the customer for any direct, or clearly consequential, loss due to the failure of EFT equipment to complete a transaction, notwithstanding the terms of any contract to the contrary. Compensation may be reduced if the failure is due to causes beyond

the bank's control, of if intent or gross negligence on the customer's part has contributed to the fault. If, in the case of a customer-activated system, the customer should have been aware that the equipment was unavailable for use or malfunctioning, the bank's liabilities should be limited to the correction of any errors on the customer's account, and the refund of any charges or fees imposed on him as a result. It should be for the bank to resolve with third parties any question of liability on their part.

<u>Recommendation 10(12)</u>: A provision in statute law should apply, notwithstanding the terms of any contract to the contrary, to the apportionment of any loss arising from a transaction carried out through a customer-activated EFT, where it is in dispute whether or not that transaction was authorised. It should require that loss to be apportioned on an equitable basis, by reference to the extent to which the acts or omissions of the parties have contributed to the loss. Apportionment of the loss should take into account such factors as (i) the steps taken by the customer to protect the security of his card and PIN, (ii) the extent to which the system provided by the bank protects the customer against unauthorised transactions on his account, and (iii) the relative weight of the evidence adduced by the parties in support of their respective contentions that the transaction was, or was not, authorised.

<u>Recommendation 11(5)</u>: Section 5(5) of the Forgery and Counterfeiting Act 1981 should be made applicable, through amending legislation, to all payment cards generically.

<u>Recommendation 11(6)</u>: A provision should be inserted in the Forgery and Counterfeiting Act 1981 to make it a specific offence to possess, or to sell, information that could be used in the manufacture of counterfeit cards, with intent to defraud.

<u>Recommendation 11(7)</u>: Consideration should be given to the creation under Scots law of statutory offences in relation to card counterfeiting on the lines provided under 1981 Act, amended as under Recommendations 11(5) and 11(6).

Annex 5: Cheques and Payment Orders

Recommendation 7(1): The law relating to cheques should be re-enacted in a new Act, to be called the "Cheques and Bank Payment Orders Act". It should incorporate amendments recommended in [Chapter Seven of the Review Committee's report].

Recommendation 7(7): The new Act should include provisions permitting the introduction of a new non-transferable instrument (the "bank payment order") the proceeds of which could be collected only by a bank and solely for account of the named payee.

Recommendation 7(2): The new Act should contain a provision to the effect that nothing written on any cheque can take away the right to transfer it; this would deny legal effect to any annotation such as "Account Payee".

Recommendation 7(3): The new Act should provide for the special crossing, though banks should continue to be permitted to stamp their name and address on the face of cheques for collection purposes.

Recommendation 7(4): The new Act should recognise only one cheque crossing. It should consist of two transverse parallel lines as now, the effect of which would be to make the cheque "not negotiable" in addition to requiring payment only to a bank.

Recommendation 7(5): The new Act should bring together the various statutory protections available to the paying bank and each should be made subject to the condition that the bank had acted "in good faith and without negligence". The existing Sections 60 and 80 of the 1882 Act and Section 1 of the 1957 Act should be repealed.

<u>Recommendation 7(6)</u>: The new Act should contain a provision restricting, for Scotland, the banks' protection to that given for the rest of the UK in Section 4 of the 1957 Act.

<u>Recommendation 7(8)</u>: The new Act should amend the law, so far as cheques are concerned, to permit banks to obtain payment by presentment of electronic information rather than the instrument itself (as currently required by Section 45 of the 1882 Act). It should also accord to a photocopy, or some other reproduction in legible form, of a cheque, suitably marked as paid and authenticated by the collecting bank, the status of "evidence of the receipt by the payee of the sum payable by the cheque" (cf Section 3 of the 1957 Act).

<u>Recommendation 7(9)</u>: In determining the amount payable on an instrument covered by the new Act, precedence should continue to be given to the amount in words over that in figures.

<u>Recommendation 7(10)</u>: The "funds attached principle" in Scots law should be abolished except in relation to negotiable instruments other than cheques. The new Act should therefore provide that presentment would not operate as an assignation of the sum for which it is drawn, in relation to any instrument covered by the new Act, to any order to pay addressed to a bank otherwise than in writing, or to any such order to pay presented to the drawee otherwise than in writing.

<u>Recommendation 7(11)</u>: The definitions of a cheque and of a bank payment order should be drawn to include warrants for payment of interest or dividend or for repayment of capital and to include bankers' drafts.

<u>Recommendation 7(12)</u>: The new Act should specify that its provisions as to cheque or bank payment orders, as appropriate, extend to payable orders. "Payable Order" should be defined as "any document issued by a government department and drawn on the same or another government department, or issued by and drawn on one of the persons or bodies specified in [a Schedule] which, not being a cheque or bank payment order, is intended to enable a

person to obtain payment from the department or body on which it is drawn of the sum mentioned in the document".

<u>Recommendation 7(13)</u>: For the avoidance of doubt, the new Act should make it clear that a transfer instruction by BGC (Bank Giro Credit) does not constitute a legal assignment of the funds involved.

Annex 6: Negotiable Instruments

<u>Recommendation 8(1)</u>: There should be a new Negotiable Instruments Act covering not only bills of exchange and promissory notes, but also, insofar as their negotiability is concerned, all other negotiable instruments.

<u>Recommendation 8(2)</u>: The language and style of the 1882 Act should be retained in the new Act since it is clear, concise and well understood.

<u>Recommendation 8(3)</u>: An instrument should be negotiable if

(a) it is a bill of exchange or promissory note as defined in the new Act, or
(b) it falls into one of the categories set out in (ii)-(v). of [paragraph 8.09 of the Review Committee's report].

<u>Recommendation 8(4)</u>: The need for consideration as a test of negotiability should be abolished.

<u>Recommendation 8(5)</u>: The sum payable on a negotiable instrument should no longer have to be certain at the date of issue provided it is "certain or ordinarily determinable" in accordance with rules to be set out in the Act.

<u>Recommendation 8(6)</u>: The drawer or maker of an instrument should be permitted to choose which law is to govern the instrument he draws or makes and any subsequent variation should

be ignored. If no choice is made, the instrument should be governed by the law of the place of payment, as defined.

Recommendation 8(7): A protective rule in favour of other parties should be provided in relation to (a) forged drawers' or acceptors' signatures and (b) forged or unauthorised indorsements. That rule could be varied by contractual agreement.

Recommendation 8(8): The mandatory requirement for noting and protest of a dishonoured foreign bill should be abolished but the procedure should be retained, slightly modified for use on a voluntary basis.

Recommendation 8(9): The new Act should contain provisions giving to transactions taking place in a screen based or book entry depositary (or dematerialised) system operated by an Approved Depositary, and satisfying certain basic statutory requirements, the same status as equivalent transactions in negotiable instruments generally.

Recommendation 8(10): We also endorse a further 40 suggestions of a technical nature recommended by Professor Shea in his Report. These are set out at Appendix N.

Annex 7: Other Aspects of Banking Law

Recommendation 13(6): The provision of the Bankers' Books Evidence Act 1879 relating to the admissibility in evidence of copies of entries in bankers' books should be repealed.

Recommendation 13(7): Section 7 of the 1879 Act should be amended so as to permit a court to make an order for inspection and copying of entries in a banker's book if it thinks fit, whether or not legal proceedings have formally commenced. An order should be granted in such circumstances only where the court is satisfied (i) that proceedings are in serious contemplation, and (ii) that there are other grounds to support a prosecution or an action over and above what might be discovered as a result of the order.

Recommendation 13(8): The definition of "bankers' books" in Section 9 of the 1879 Act should be extended to include items such as credit slips and paid cheques (but not internal reference notes), insofar as they are required to substantiate and identify a transaction recorded in those books.

Recommendation 13(9): The Bank of England should be included in the definition of "bank" and "banker" in Section 9 of the 1879 Act.

Recommendation 13(10): The 1879 Act should be amended so as to give a court discretion to order payment of a fee to the bank against which an order under Section 7 of the Act is made, in order to reimburse the bank for the costs of compliance.

Recommendation 6(5): Section 6 of the Statute of Frauds Amendment Act 1828 should be repealed.

Recommendation 12(2): Rules to define completion of payment should be enacted in primary legislation. They should provide (a) that payment is to be regarded as complete at the point where the payee's bank (or its agent in the clearing), having actual or ostensible authority to accept payment on behalf of the payee, accepts a transfer of funds from the paying bank (or its agent in the clearing) for the payee's account- provided that the transfer is or has become unconditional; and (b) that, where the transfer is between two accounts at the same bank, payment should be regarded as complete when the bank has taken the decision to treat the instructions for transfer as irrevocable. The rules should be subject to modification by contractual arrangement, among parties to a contract governing a payment system.

Recommendation 12(3): The Bank of England should convene a working group of interested parties to consider and report on the operational implications of the completion of payment rules which we have recommended (Recommendation 12(2)), before they are enacted.

<u>Recommendation 6(1)</u>: There should be a statutory provision whereby, in an action against a bank in debt or for damages, arising from an unauthorised payment, contributory negligence may be raised as a defence, but only if the court is satisfied that the degree of negligence shown by the plaintiff is sufficiently serious for it to be inequitable that the bank should be liable for the whole amount of the debt or damages.

Annex 8: Wider Banking Issues

<u>Recommendation 14(1)</u>: The current review of the Consumer Credit Act 1974 should cover the desirability of an exemption from the connected lender liability provisions of that Act for purchases financed by the use of credit cards.

<u>Recommendation 14(2)</u>: The concept of constructive trust should be examined in depth and in its proper context, perhaps by the Law Commission.

<u>Recommendation 14(3)</u>: The Government should institute a process of consultation with a view to introducing legislation to clarify the right of set-off, and the validity of a charge over a credit balance in favour of the person with whom the balance is held.

<u>Recommendation 14(4)</u>: The Government should consider options for eliminating, at least for banking purposes, the two mismatches between Bank Holiday dates in Scotland on the one hand, and England, Wales and Northern Ireland on the other. Of four options discussed in Chapter Fourteen, that favoured from the standpoint of the operational efficiency of the banking system is to harmonise dates when banks north and south of the border are open for business.

<u>Recommendation 14(5)</u>: The Government should consider instituting a review, similar to that recently concluded by the Scottish Law Commission, of the English law dealing with a minor's capacity to contract. They should also introduce the legislation needed to implement the recommendations of the Scottish Law Commission.

Recommendation 14(6): Consideration should be given to a review of the evidential requirements of the criminal law, insofar as they relate to the corroboration of computer-produced evidence in cases of fraud.

Recommendation 14(7): Urgent action should be taken to make it a criminal offence (i) to obtain unauthorised access to a computer by "hacking", as recommended by the Scottish Law Commission, and (ii) to introduce a "virus" into a computer program.

Recommendation 11(1): The Government should consider how consistency of law and practice, across the field of payment cards generally, can best be achieved in the case of payment cards issued by retailers and other non-bank institutions, which fall outside the strict scope of banking services. Charge cards and store cards are the main types at issue. Where new standards of practice are introduced for such cards, they should be monitored and, by the use of appropriate sanctions, enforced.

Recommendation 14(8): The Government should keep under periodic review the scope for customer choice as between different payment systems, and the related question of the acceptability of legal tender, to ensure that there is no unfair discrimination through contractual arrangement, charging, or financial incentives.

Recommendation 17(1): The Government should keep before them the possible need for further studies to deal with new priorities as and when they emerge, in the field of banking services law and practice.

Other recommendations

The Review Committee also made the following two recommendations to banks and building societies:

Recommendation 10(5): Banks should introduce encryption in customer-activated EFT systems, where this can be operationally justified.

<u>Recommendation 10(6)</u>: Banks should make customer-activated EFT systems on-line, where this can be operationally justified.

The Government have also considered the following three recommendations concerning standards of banking practice.

<u>Recommendation 16(2)</u>: The Government should assess whether banks' Code of Banking Practice (see Recommendation 16(1)) constitutes an adequate response to the Recommendations of this Report. If so, it should ensure that the statement is formally presented to the Banking and Building Societies Ombudsmen as the impartial guidance on best banking practice of which they should take account in their adjudications.

<u>Recommendation 16(3)</u>: Against the possibility that the banks' statement which is the subject of Recommendation 16(1) proves to be inadequate, or is not forthcoming within a reasonable timescale, the Government should consider at what stage to enact enabling legislation (see Appendix S) to support a statutory Code of Banking Practice, and an associated duty on banks to "trade fairly" with their customers.

<u>Recommendation 16(4)</u>: The Government should appoint the Bank of England and the Building Societies Commission to monitor the continued observance and updating by banks of their published Code of Banking Practice. In support of these arrangements, the Banking and Building Societies Ombudsmen should be required, in their terms of reference, to comment in their Annual Reports on the extent to which banks are complying with, and, where necessary, keeping up-to-date their own published standards of best practice. (For example, new standards are likely to be needed before home and office banking, or smart/laser cards, come into general use.) If at any time monitoring reveals that these standards are not being complied with or updated as necessary, the Government should consider whether to implement the statutory fallback as in Recommendation 16(3).

Annex B: Consultees who submitted evidence following publication of Review Committees report

Access: The Joint Credit Card Company Limited
Association for Payment Clearing Services
Australian Federal Bureau of Consumer Affairs

The Banking Ombudsman
Mr Geoffrey S Beccle
British Bankers' Association
The British Computer Society
British Merchant Banking and Securities Houses Association
The Building Societies Association
The Building Societies Ombudsman

Clifford Chance
Close Brothers Limited
The Committee of London and Scottish Bankers
The Committee of Scottish Clearing Bankers
Consumer Credit Trade Association
Consumers' Association
Consumers in the European Community Group (UK)
The Council of the Banking Ombudsman
Coopers & Lybrand
Credit Card Sentinel (UK) Ltd
Mr Geoff Crocker

The Data Protection Registrar
The Director General of Fair Trading

Finance Houses Association
The Forum of Private Business

The General Council of the Bar
Girobank plc

Mr C M Johnston

The Law Society
The Law Society of Scotland
Local Authorities Co-ordinating Body on Trading Standards
London Chamber of Commerce

Mr Jeremy Mitchell

National Association of Citizens Advice Bureaux
National Consumer Council
National Council for Civil Liberties
National Westminster Bank plc
Nationwide Anglia Building Society
Northern Ireland Bankers' Association
Norwich and Norfolk Chamber of Commerce and Industry

O.E. Organetic Services Limited
The Office of the Banking Ombudsman

Pensioners' Voice (National Federation of Retirement Pensions Associations)

The Retail Consortium
Retail Credit Group

Scottish Consumer Council
Mr J Shell

Trades Union Congress

Annex C: Review Committee's illustrative code of banking practice

In Appendix L of their report the Review Committee prepared an illustrative non-statutory "Code of banking practice", which is reproduced below. The bold lettering indicates the operational requirements on banking and building societies.

Code of Banking Practice

A UNDERLYING ASPECTS OF THE BANKER-CUSTOMER RELATIONSHIP

A1 *Identity of a person opening an account.*

Banks should initiate procedures which allow them to establish, to their reasonable satisfaction, the identity of a person seeking to open a new account, so that if subsequently challenged they can refer to the action they took at the time. It is intended that this requirement will be an important element in determining the standards of care by which banks are to be assessed, if they are to benefit from the protection of [Section 4 of the Cheque Act 1957 as the legislation currently stands].

A2 *Terms and conditions - communication to the customer*

In any communication by the bank to the customer of the terms of the contract, the bank should ensure that the customer is given a fair and balanced view of those terms, and of the rights and obligations that apply on each side (not, for example, over-stressing the rights of the banker and the obligations of the customer). A customer should be

given reasonable notice of any proposals for variation of those terms.

A3 *Complaints procedures*

Banks should establish internal procedures for handling customer complaints. They should ensure in some appropriate way that customers are told how to lodge a complaint, and how it would be dealt with. They should also ensure that, as and when a complaint arises, the customer is made personally aware of the existence of these individual procedures and of the relevant procedures of the Banking or Building Societies Ombudsman, as appropriate.

A4 *Banker's duty of confidentiality*

The [Banking Services Act] imposes on a bank a duty not to disclose to any third party confidential information about its customers' private affairs. It also recognises four kinds of exception to that general duty. These exceptions call for the following comment:

(a) *Where disclosure is under compulsion by law.* Under the new Act there is no generalised provision obliging, or permitting, banks to disclose in the public interest anything about their customers' private affairs. Where disclosure is required under the provisions of specific statutes which have been consolidated in the new Act, a court order is still, in some though not all cases, required before confidential information may be disclosed.

(b) *Where the interests of the bank require disclosure.* The Act specifically limits such disclosure to certain narrowly circumscribed situations: (i) disclosure to a Court in the event of legal action to which the bank is a party, (ii) disclosure as between banking companies within the same group, for the specific purpose of protecting the bank and its banking subsidiaries against loss, in relation to the provision of normal

banking services, and (iii) disclosure for the purposes of, in connection with, and insofar as may be necessary for, the proposed sale of the ownership of the bank itself, or a substantial part of its undertaking. Thus, it does not provide a generalised permission for disclosures in the interests of the bank. The terms of the Act exclude, for example, disclosure of confidential information for any purpose, without express customer consent, to non-banking companies within the bank's group, or disclosure to banking subsidiaries for marketing purposes.

(c) *Where disclosure is made by the express consent of the customer.* The Act provides that, for a consent to qualify as express consent, it must be in writing, and must state the purpose for which it has been given. The only exception is the case of bankers' opinions (see A5 below), where consent in tacit form may be obtained provided a bank can show, first, that the customer has been made clearly aware of the purpose for which consent is required; secondly, that he has been advised that he is free to give or withhold his consent, which will be assumed unless he has, within a reasonable time, notified his bank that he does not wish to give it; and thirdly, that he has not given any such notification.

In addition to those statutory requirements, it should be a requirement of best practice that:

- express consent, in whatever form, should not be sought in such a way as puts the customer under pressure to give it;

- in the case of express consent to be obtained in tacit form for the giving of bankers' opinions, a letter should be sent personally by the bank to its customer, seeking his consent for this specific purpose.

(d) *Where there has been a breakdown of the banker-customer relationship arising through customer default.* The Act defines what is meant by a breakdown in the relationship: the case where no security has been given, and no satisfactory response has been received from the customer within 28 days of formal demand for repayment. The Act expressly limits disclosure of confidential information, in these circumstances, to approved credit reference agencies. It follows that the customer's express consent is still required for any disclosure of confidential information, even in the event of a breakdown of the relationship, to persons other than approved credit reference agencies or those covered by exceptions (a)-(b) above; and, in circumstances where there has been no breakdown in the relationship, to any persons (including credit reference agencies) other than those covered by exceptions (a)-(b) above.

Banks should explain to their customers the above rules, and exceptions, concerning the duty of confidentiality. They should remind all customers that they have a right of access, under the Data Protection Act 1984, to computer records about themselves held by banks.

A5 *Bankers' opinions*

Banks should give all customers, when they open an account or at the time this Code is first issued, a clear explanation of how the system of bankers' opinion works; and should invite customers to give or withhold a general consent for the bank to supply opinions on them in response to status enquiries, in accordance with the exception (c) to the duty of confidentiality as explained under Section A4 above. In the absence of such authority, the bank would, of course, be quite entitled to respond to the effect that the customer had not authorised it to reply to such enquiries. Failing a general authority, a customer could still give occasional specific authorities for its bank to respond to

particular enquiries, provided he could specify satisfactorily how such enquiries were likely to be framed and the source from which they might be received. But there would be no obligation on a bank to seek directions from a customer if it received an enquiry and had no general authority to respond.

A6 *Direct marketing of services*

Banks should exercise restraint in the direct marketing of their services, and should in particular:

- ensure that customers are aware of the marketing purpose for which they are being approached;

- respect any customer's objections to the use of personal information for marketing purposes, and desist from such activity on request.

B RULES APPLYING GENERALLY TO THE CUSTOMER'S ACCOUNT

B1 *Availability of funds*

Banks should give all their customers a simple explanation of the timing of the clearing cycle, and the concept of cleared balances. This would deal, especially, with the normal time taken to clear cheques and bank payment orders, should specify the "hold" period the bank is applying, and should say whether the bank has a right of reversal if the cheque or bank payment order is later returned unpaid. But it would cover other payment systems as appropriate, including the timing of direct debit procedures, and the customer's right of reversal under the system. Banks should consider how their customers could usefully be given more information, in periodic statements of account and in ATM slips, about cleared as well as uncleared balances on their account.

B2 *Truncation of cheques and bank payment orders*

Banks should give their customers an explanation, where needed, of what is involved in the truncation of cheques and bank payment orders, and of resulting changes, if any, in the timing of the clearing cycle. This should include an assurance that truncation will not detract from the bank's responsibilities, or add to the customer's obligations, in respect of the collection and payment of cheques and bank payment orders. If the necessary evidence to resolve a dispute regarding a truncated cheque or bank payment order is not produced within three working days, the customer's account should be re-credited pending final resolution.

B3 *Out of date cheques and bank payment orders*

A bank should not return, within six months from the date of issue, a cheque or bank payment order on grounds that it is out of date.

B4 *Bank Giro Credits*

Banks should explain the rights of bank and customer in regard to transactions effected by Bank Giro Credit.

B5 *Multifunction cards*

Banks should ensure that their terms and conditions for the use of multi-function cards include the following:

- a customer should be free to choose which of the card's functions he wishes to authorise for his own use; a bank should not be at liberty to refuse a card for a single function if its customer does not require more;

- functions that the customer does not require should be blocked off, so that the card cannot be used for these purposes in a machines;

- if for whatever reason the card is nonetheless compromised, the customer should (fraud on his part excepted) have no liability on any function that he has not authorised.

B6 *Card notification organisations*

Banks as card-issuers should inform all their customers who are cardholders:

- whether or not they themselves will accept notification of loss of theft of a payment card from a third party, presumably a card notification organisation;

- if so, the terms in which they would require cardholders to notify them, by a standard form of notice acceptable to card-issuers and signed by cardholders, of the appointment of an agent for this purpose;

- the effect, if any, on the cardholder's liability if an agent is appointed, especially the matter of whether notification to the agent discharges the cardholder's obligation to the card-issuer.

B7 *Countermand*

A bank should advise its customer of the different rules for each payment system in regard to countermand of instruction or authority. In formulating these rules, a bank should be guided by the principles that a period of time for countermand by the customer should be allowed where possible. It should only be eliminated where that is necessary for the efficient working of the system.

B8 *Bank charges*

A bank should explain to its customer the basis of charging for the normal operation of the account. Where an overdraft arrangement has been agreed in advance, a bank should ensure that its customer is aware, both in advance and as and when a change occurs, of the rate over base rate that will be charged, and of the timing of the debiting of interest. The customer should also be given full details of the method of calculation of fees and charges when these are applied to his account, including charges applied where an overdraft occurs without prior agreement. The customer should also be told of any services other than lending for which he will be charged (stopping cheques, correspondence, etc).

B9 *Foreign exchange transactions*

Where a bank undertakes a foreign exchange transaction for its customer, it should ensure that he is made aware before the transaction is completed of the basis of the exchange rate to be applied, and of any associated charges.

B10 *Guarantees*

Banks should ensure that prospective guarantors, whether customers or not, are adequately warned about the legal effects and possible consequences of guarantees, and about the importance of receiving independent advice.

C RULES SPECIFIC TO ELECTRONIC FUNDS TRANSFER (EFT)

C1 *Authentication of customers' instructions*

(a) *Standards of system security*

The bank's principal and general duty to observe its customer's mandate has special implications for the security of EFT payment systems operated by banks. Banks should therefore adopt the principle that an EFT system must meet

certain minimum standards of security in its authorisation procedures, so as to provide an acceptable degree of protection for the customer against the consequences of unauthorised transactions. In furtherance of that principle, they should accept a continuing commitment to upgrade their systems by the introduction, so far as practicable, of new technology based on the recognition of a signature or other personal characteristic.

(b) Existing systems

In assessing the security of their existing systems for purposes of authenticating a customer's instructions, banks should have regard to or, where appropriate, ask their customers to have regard to, such matters as the following:

- Care of payment cards and Personal Identification Numbers (PIN's). Every reasonable care should be taken by banks when issuing cards and PIN's to their customers; but banks should make clear to their customers that this obligation is only assumed on the assumption that customers for their part will take every reasonable care at all times in handling their cards and PIN's. The Act provides that there should be no unsolicited mailing of payment cards by banks to customers. Banks should observe a similar rule in respect of the mailing of PIN's. A customer should be required to acknowledge receipt of both card and PIN before he can avail himself of the service for which they are needed.

- Privacy. Banks should ensure the maximum privacy that is reasonably possible in customers' access to EFT systems. In particular, banks should aim to ensure that it is physically impossible for a customers' PIN to be read by anybody else when he is keying it in.

- Monitoring suspicious patterns of withdrawals. Banks should introduce systematic arrangements, where they

have not done so already, to monitor patterns of ATM withdrawals, such as might give rise to suspicion of fraudulent misuse of the system.

C2 *Written records*

Customers are entitled, under the Data Protection Act 1984, to demand a written record of an EFT transaction if they wish to have it. Banks should interpret this provision in the sense that customers are given the option of a written record at the time of the transaction, rather than in due course.

C3 *Customer's right of action*

A bank, as card-issuer, should deal with its own customer, as cardholder, in case of any complaint or claim arising on the customer's part from a dispute over a banking service provided through an EFT payment system. It is for the card-issuer to take action against any other party involved. This applies, for example, to EFT-POS systems or to shared ATM networks.

C4 *Apportionment of loss arising from a disputed EFT*

Banks should explain to all customers who use customer-activated EFT services that the Act requires losses, arising from disputed transactions carried out through such systems, to be apportioned on an equitable basis, by reference to the extent to which the acts or omissions of the various parties have contributed to the loss. Apportionment of the loss should take into account such factors as (i) the steps taken by the customer to protect the security of his card and PIN, (ii) the extent to which the system provided by the bank protects the customer against unauthorised transactions on his account, and (iii) the relative weight of the evidence adduced by the parties in support of their respective contentions that the transaction was, or was not, authorised.

See by P.M.

PGCG 14/2

PRIME MINISTER

MORTGAGE RATES

We have just heard that the Abbey National will be announcing at around 12 noon an increase in their mortgage rates of 0.9 per cent. This will take the rate charged to small borrowers (below £60,000) to 15.4 per cent, and that for larger borrowers to 14.75 per cent. We are not yet clear when this will take effect, but it will presumably be either on 1 March or 1 April.

The Abbey National are the second largest mortgage lender, with 1.1 million borrowers. But they are not one of those who operate annual review schemes whereby actual payments are only adjusted yearly. So both the RPI and the actual impact on borrowers' cash flow will come at the same time.

I would guess that a number of other Societies may now follow suit.

PGCG.

PAUL GRAY
14 FEBRUARY 1990

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SECRET

PRIME MINISTER

MONTHLY MONETARY ASSESSMENT

You may find it helpful to glance at the attached regular monthly Treasury note.

It does not reveal anything very new about developments in the real economy. But the section on domestic monetary and financial market developments (paragraphs 32-56 plus Annex I and Table 23) is worth looking at. This provides a good analysis of the factors that may have been behind the continuing uncomfortably high rate of monetary expansion. Particular points to come out are:

- With MO growth continuing higher than expected, the forecast drop into the target range has been postponed until the late Summer/Autumn (see Table 23). But I doubt if much confidence can be placed on this prediction.

- Paragraph 40 reveals that a half per cent rise in mortgage rates is likely in the Spring. For most people there will be a long lag before it affects annual payments but the impact on the RPI is immediate. This is one of the reasons why the latest Treasury forecast, which you discussed at the recent seminar, is currently suggesting an April RPI of some 7.9 per cent.

- Annex I, summarising what is known about the extent of annual review schemes for mortgage payments is worth looking at.

PAUL GRAY

13 February 1990

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SECRET

Prime Minister [2]

Follows up the introduction of the Skill-ball competition idea (not a lottery but it has implications), 'H' is planning to discuss the pros and cons of lotteries? Mr Luce is here quite supportive of the idea for the Arts. I will keep you informed on 'H' discussions and show you papers in advance.

CC P1A

OFFICE OF ARTS AND LIBRARIES
Horse Guards Road
London SWIP 3AL
Telephone 01-270 5929

From the Minister for the Arts

C90/1013

The Rt Hon Sir Geoffrey Howe QC MP
Lord President of the Council
Privy Council Office
LONDON SW1

9 February 1990

Dear Geoffrey,

MAJOR LOTTERIES

I note from your letter of 5 Febrary to David Waddington that you would like H Committee to consider the question of major lotteries once the Skill-Ball competition has been launched and we are in a better position to assess its implications.

I look forward to this discussion. The pros and cons of introducing major charitable lotteries need to be carefully considered. The papers attached to David's letter to you of 21 December concentrate on the problems. These are not insuperable. Lotteries could have a useful role to play in stimulating additional private sector contributions to charitable causes, including the arts. I have been struck by the groundswell of support for them amongst the arts community.

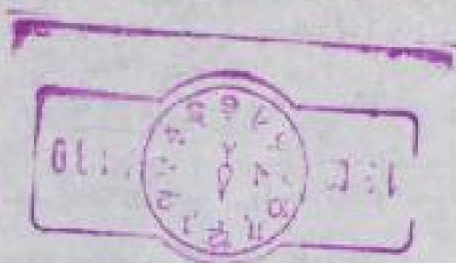
However it would be difficult to encourage greater private support in this way, if the resulting expenditure were then deemed to displace public expenditure as Richard Ryder's letter of 22 January implies. As you know it has been a central aim of my approach to support for the arts and museums and galleries to encourage increased private sector contributions through sponsorship, incentive funding and the encouragement of commercial activities by the national galleries and museums. We have been extremely successful in generating additional revenue. By agreement with Treasury this expenditure has not been counted as displacing public expenditure. It would therefore be essential that the proceeds of any major lotteries should be treated in the same way as other private sector funding for the arts.

I am copying this letter to the recipients of yours.

Richard

RICHARD LUCE

Econ Pol: Domestic Monetary Policy Pt 21



PRIVY COUNCIL OFFICE
WHITEHALL, LONDON SW1A 2AT

5 February 1990

Dear David

MAJOR LOTTERY OR LOTTERIES AND "SKILL-BALL" COMPETITION

Thank you for your letter of 21 December reporting progress on the decision whether to allow major lotteries and seeking colleagues' agreement to deferring a firm decision until the possible implications of the new skill competition "Skill-Ball", which is to be launched in April, are known.

John MacGregor, Richard Ryder and Colin Moynihan wrote supporting your proposals. John and Richard suggested however that the issue of a major national lottery should be discussed by H Committee as soon as possible after the launch of the "Skill-Ball" competition in April. I understand that you are content with this and that you hope to circulate proposals in the Summer.

No other colleague has commented and you may take it, therefore, that you have H Committee's approval for your proposals.

I am copying this letter to the Prime Minister, other members of H Committee, Douglas Hurd, Richard Luce, Tim Renton and Bertie Denham, and to Sir Robin Butler and First Parliamentary Counsel.

Yours ever
Geoffrey

GEOFFREY HOWE

The Rt Hon David Waddington QC MP

Econ Pol: Domestic
Mon Pol
Pt 21

DEPARTMENT OF THE ENVIRONMENT
2 MARSHAM STREET LONDON SW1P 3EB
01-276 3000

My ref

Your ref

26 JAN 1990

Dear David,

MAJOR LOTTERIES

Thank you for sending Chris Patten a copy of your letter of 21 December to Geoffrey Howe about the current position on major lotteries and in particular the proposed new "Skill-Ball" Competition. I am replying on the Secretary of State's behalf in view of his absence overseas.

I agree that there are insufficient reasons at present to ban "Skill-Ball" and that we should keep a close eye on its progress. I have an interest in the financial implications of "Skill-Ball" on the "Spot-the-Ball" competition since, as annex B to your letter acknowledges, it provides invaluable assistance to soccer. It is from this competition that the Pools Promoters Association funds the Football Trust and the Football Grounds Improvement Trust which have contributed substantially to improvement at football grounds.

I also agree that we should defer a conclusion on the question of a major lottery until we know the outcome of the "Skill-Ball" competition. I should add that I believe that there could be valuable long term benefits for sport and recreation from a major national lottery.

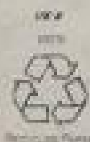
I am copying this letter to the Prime Minister, the Lord President, the other members of H Committee, the Foreign and Commonwealth Secretary, the Minister for Arts and Libraries, the Chief Whip in both Houses and to Sir Robin Butler.

Yours ever,

Colin

COLIN MOYNIHAN

Rt Hon David Waddington MP



Econ Pol
Domestic Monetary Policy
Pt 21

NBPM
At this stage

CCPU

QUEEN ANNE'S GATE LONDON SW1H 9AT

22/12

21 December 1989

Dear Geoffrey

1. PAPER ON THE INTRODUCTION OF A MAJOR LOTTERY OR LOTTERIES
2. "SKILL-BALL" COMPETITION

I thought that you and colleagues on H Committee might wish to know where matters stand on the question of major lotteries. In brief, I believe that we should defer a firm decision on whether or not to allow major lotteries until the possible implications of a new "skill" competition, Skill-Ball, which is to be launched next April and which may seem very like a major lottery, are clearer.

Paper on major lotteries

I inherited from Douglas Hurd an undertaking to circulate to the Committee a Home Office paper covering in some detail the pros and cons of amending the law to allow one or more major lotteries on a national scale, privately-run but subject to necessary regulatory machinery (this was last mentioned in a letter of 19 July from Douglas' Private Secretary to yours, reporting the prospective increases in the monetary limits on lotteries which are currently lawful). This paper has been prepared by my officials, in consultation with other interested Departments and with the Gaming Board for Great Britain. The working assumption is that we should not contemplate the introduction of a state lottery, ie a national lottery run by Government, which would involve the state in the promotion of gambling and seem to run counter to our policies of privatisation and deregulation. The Prime Minister said in the House last autumn that she had no intention of establishing such a lottery.

Similarly, the recommendation in the paper prepared by officials is that none of the options for amending the law to allow one or more privately-run major lotteries, on a national

/scale, commends

The Rt Hon Sir Geoffrey Howe, QC, MP
Lord President of the Council
Privy Council Office

scale, commends itself. Among the considerations are that such a major lottery or lotteries could: (a) contrary to our overall policy, stimulate gambling, both directly and by leading to pressure for compensatory deregulation from the established gambling industry; (b) prejudice Government revenue from established gambling, unless the lotteries were themselves subject to a specific, compensatory duty; (c) if Treasury public expenditure control rules were applied, lead to no real increase in the funding of public sector services, were the benefit of such services to be the object of the lottery or lotteries; (d) even were they run exclusively for charitable purposes, possibly prejudice both current charitable lotteries and personal charitable giving more widely; and (e) embroil us in invidious decisions about which causes should benefit, and so which should not. Officials' advice is also that, at present, there is no substance to the argument that we should allow our own 'national' lottery because major lotteries in other EEC countries are, or will be, entitled to operate here. These considerations are set ... out a little more fully in the attached brief note, Annex A.

Skill-Ball and its possible implications

The proposed Skill-Ball competition, which was publicised after the full paper on major lotteries had been prepared, may, however, make questionable a decision not to allow major ... lotteries founded on these considerations. Annex B enclosed with this letter gives a summary account of the plans for this competition and some assessment of the possible implications of the competition, if it were to succeed, for our gambling policy and, in particular, for a position on major lotteries. In short, Skill-Ball is intended to be a form of skill-with-prizes competition, rather like current newspaper "Spot-the-Ball", but with competition forms entered by computer terminals planned to be installed in thousands of retail outlets, with major prizes (£1 million guaranteed for the first two weeks) and, according to the promoters, a projected turnover of hundreds of millions of pounds, 30% of which would be directed to specific charities. If, as the promoters claim, Skill-Ball is a competition in which success depends substantially on the exercise of skill, it will not, under the current law, be subject to regulation as a form of gambling, or to any specific gambling duty. But, particularly were Skill-Ball to succeed on anything like the planned scale, and to survive any legal challenge to it which might be brought, the competition could appear, not least publicly and in Parliament, to be very like a major, but entirely unregulated, lottery.

/The possible

The possible implications of Skill-Ball for policy on major lotteries, and for major sectors of the gambling industry (including the football pools, betting and bingo) have already been identified by some in the industry and some journalists. Our line in response to enquiries from them is that: we are not in a position to say if a court would agree with its promoters that Skill-Ball will be lawful; and that, whilst there are no current plans to amend the gambling laws to apply them to skill competitions, the position is kept under review, and no assurance can be given that legislation will not be introduced at some stage which may affect the legality or viability of such competitions.

My officials will shortly invite their counterparts in other interested Departments, including in the Treasury, in the Scottish and Northern Ireland Offices and in the Departments of Health and of Trade and Industry, to offer any Departmental assessments of Skill-Ball and skill-with-prizes competitions in general. They have already been in touch with Customs and Excise officials who have, I understand, commissioned both an assessment of the possible impact of Skill-Ball on current revenue from gambling, and legal advice as to whether or not the promoters might be liable to pay pool betting duty (at the current rate of 42.5%) on the competition's turnover.

Position to take on Skill-Ball

Subject to the results of this action between and by officials, my current view is that Skill-Ball should be left to be launched next April, and that we might wait to see if it succeeds, both commercially and in the event of any legal challenge to it. There does not, at present, seem sufficient reason to move to ban the competition, which would require fresh and urgent legislation and which, in equity, would need to apply to all skill competition, including newspaper Spot-the-Ball, which provides soccer with vital income. It would also seem premature to announce a presumption that skill competitions should be brought within a statutory, regulatory framework. Regulation, at least to ensure that the claimed proportion of the proceeds of Skill-Ball is in fact made over to charity, might in due course be required. But that need would seem to arise only if Skill-Ball becomes established successfully and with a considerable flow of funds. The competition's very similarity to forms of gambling, such as newspaper "Spot-the-Ball" and the football pools, may limit its scope for success and permanence. And, whilst I do not at present propose that we should ourselves seek to bring the matter before a court, Skill-Ball might be challenged there, for example at the instigation of a competitor.

/Position on

Position on major lotteries

In the light of the Skill-Ball development, I believe that it would be premature to invite colleagues to reach a decision now on whether or not the law should be amended to allow a major lottery or lotteries. How Skill-Ball fares could evidently have a bearing on that decision, but possibly in any one of a number of ways. For example, if Skill-Ball fails commercially, that could be taken either as establishing that the market for a major charitable lottery is less than its advocates claim, or that a lottery proper should be given a chance to prove itself. Equally, if Skill-Ball succeeds, both commercially and against any legal challenge to it, it could be argued either that the need for a major charitable lottery (or something like it) had been met, or possibly that the competition's very similarity to a lottery helped to make the case for major lotteries themselves.

I recommend, therefore, that our position, both privately and publicly, should continue to be that we have no plan to amend the law to allow a major lottery or lotteries, but that we continue to keep the matter under consideration.

For the present, I envisage holding to that broad line at least long enough to be able to take the actual operation of Skill-Ball into account. Within that position, it may from time to time be necessary to deploy some of the considerations which seem to tell against major lotteries. A number of MPs have written to me asking about our attitude to the current campaign for a major lottery for the Arts, Sport and Environment, which is headed by Lord Birkett and Ken Hargreaves. Lord Birkett is seeking to initiate a debate in the Lords in support of such a lottery, and there is always the possibility of an attempt to introduce a Private Members' Bill to provide for it. In responding to these various inquiries and possible moves, I and my Home Office colleagues will as necessary draw on the considerations which seem to tell against major lotteries which I have summarised earlier in this letter and which are in Annex A attached. We will refer to them as factors which need to be taken into account rather than reasons firmly to conclude against any change in the law.

New NHS/Loto scheme

For completeness, I should perhaps take this opportunity to comment on the recent launch of a new lottery scheme by NHS (or National Hospital Trust)/Loto which, as colleagues may have seen, has been advertised widely in the press. It was attempts by this company last year to circumvent the current

/law and to

law and to introduce a major lottery by combining numerous small ones, which led Douglas Hurd, with the agreement of colleagues, to make regulations to prohibit such "multiple" lotteries, as well as to increase the monetary limits on lawful lotteries and to envisage circulating a paper on major lotteries. The new NHS/Loto scheme offers participation , either in combination or separately, in one or more different small, lawful lotteries (each with a maximum weekly prize of £2,000) and in a "free draw" with a jackpot prize of £500,000. This scheme does not seem to challenge the regulations prohibiting "multiple" lotteries. But the scheme does appear to have some doubtful aspects, which the Gaming Board have asked the Commissioner of Police of the Metropolis to investigate. At present, the nature of this new scheme seems to be such that whether or not it succeeds, and whether or not it is lawful, should not evidently have any significant implications for our positions on major lotteries or on prize competitions such as Skill-Ball. This is on the assumption that the "free draw" will prove either to be truly free, like many other, well-established draws, or in fact subsidised by the small lotteries, when long-established lotteries law would seem to make it unlawful.

Summary

You and colleagues may wish to note that officials will be obtaining and sharing advice on the proposed Skill-Ball competition, which is described in Annex B.

I should be grateful to know if you and colleagues agree that, otherwise:

(a) we should envisage waiting to see how Skill-Ball fares if and when it is launched next April; and

(b) we should therefore defer a conclusion on the question of a major lotteries, probably to take account of Skill-Ball's fate.

You and colleagues may also wish to note:

(c) the holding if discouraging terms in which, in the interim, we will as necessary respond to enquiries about any plan of our own for legislation on major lotteries, drawing from the considerations in Annex A; and

(d) the assessment of the new NHS/Loto scheme.

/I am copying

I am copying this letter and its annex to the Prime Minister, the other members of H Committee, the Foreign and Commonwealth Secretary, the Minister for Arts and Libraries, the Chief Whips in both Houses and to Sir Robin Butler.

Yours ever
[signature]

CONSIDERATIONS WHICH SEEM TO TELL AGAINST THE INTRODUCTION OF MAJOR LOTTERIES, ON A NATIONAL SCALE

Introduction

There is some Parliamentary and public pressure for a major lottery, on a national scale (or for a limited number of such lotteries), privately-run (but subject to necessary regulatory machinery) to profit one purpose or a specified range of purposes. The apparent attraction of that arrangement is to harness people's gambling habits and their wish to benefit good causes so as to benefit financially purposes or projects which various groups regard as worthwhile. This note summarises some of the principal considerations which seem to tell against amending the law to allow such a lottery or lotteries. In addition, paragraphs 9 and 10 of this note record that the argument that we need domestic major lotteries to pre-empt the promotion here of major lotteries based in other EC countries seems to be ill-founded.

(a) The implications for our general gambling regime

2. One of the principles of the policy on gambling of successive Governments is that of "unstimulated demand", ie. that the demand for gambling should not be stimulated, for example by advertising, and that the level of gambling facilities which is allowed should be sufficient only to satisfy the demand for such facilities which has not been stimulated artificially. Extensive promotion, including *via* television and other advertising media, is a vital part of major lotteries in other countries. It is therefore reasonable to assume that persistent, public promotion would be a necesary condition of success of major lotteries in this country. To allow this could have two consequences for current policy. First, it could itself appear to breach the principle of "unstimulated demand". Secondly, it would be hard to resist calls from other sectors of the gambling industry for compensatory deregulation for themselves, both in advertising and in respect of other controls to which they are subject at present.

(b) The possible impact of such lotteries on Government revenue from other forms of gambling

3. Because they are small-scale, 1976 Act lotteries are explicitly exempted (by Customs and Excise Order) from pool betting duty. All other forms of

public gambling are subject to duty to some degree, ranging from 8% general betting duty (ie. on bets in betting offices) to 42½% pool betting duty on the football pools. Total revenue from betting and gaming duties in 1988/89 was some £913 million. If major lotteries were to be allowed here, one question is whether they should be subject to duty, both in equity and to compensate for the likely loss of revenue from other forms of gambling (it is commonly assumed that people would divert current spending, in particular some of that on the football pools, to lotteries). Dependent upon the extent to which major lotteries diverted money from current forms of major gambling, there might be alternative consequences. Either there would be an overall loss of revenue for the Exchequer, if major lotteries were subject to no gambling duty or to such duty only at a very low level. Or major lotteries should be subject to a level of gambling duty sufficient at least to compensate for the loss of revenue from other forms of gambling; and that level might need to be so high as to impair the lotteries' viability, particularly as a means of raising funds for charitable or other "good" purposes.

(c) The possible implications for public expenditure control

4. The causes popularly favoured for benefit from the proceeds of major lotteries include some which are funded mainly from public expenditure, notably the National Health Service. To aim to provide any significant part of the funding of such a service by lottery could be controversial in itself (eg. "your life depends on a lottery"). There is, in addition, a public expenditure control consideration. This is the presumption that expenditure financed by lottery proceeds would have to displace public expenditure rather than add to it, eg. in the instance of the NHS, that a cash "addition" of, say, £500 million from lottery proceeds could require a proportionate reduction in the public expenditure provision for the service, resulting in a nil real addition. (It should be noted that there is some indication that the proponents of funding services from lotteries or similar acivities may be aware of this potential difficulty, and see that it might be avoidable by diverting the proceeds to activities not directly dependent upon public expenditure, eg. charities in the health or welfare fields.)

(d) The possible impact on charitable giving

5. Lotteries under the current law are to be run essentially for non-commercial purposes. Many such lotteries are promoted by charities, often small ones, and they are understood to provide sums which, whilst small compared to the proceeds of major gambling, are vital to the charities

concerned. One concern is whether major lotteries might damage these small, charitable lotteries. The proponents of major lotteries claim that the experience in some other countries, which have state or other major lotteries, is that small, charitable lotteries are not affected adversely. But it is difficult to judge how far such international comparisons could be relied upon, not least because no other comparable country appears to have as varied a gambling industry as there is here, with which any new gambling enterprise would have to compete.

6. In addition, a major lottery or lotteries might possibly have adverse implications for all forms of charitable giving. The concern is that, even if it could be shown, on good evidence, that major lotteries would attract new gambling money to specific charities, the lotteries might nonetheless draw from a pool which charities overall could otherwise tap directly and more cost-effectively.

(e) Possible Government involvement in deciding which causes should benefit, and so which should not

7. The advocates of a major lottery often argue for one for a particular cause or causes. An example is a current campaign for a major lottery for the Arts, Sport and the Environment. There is possibly some weight in the fear that otherwise a "free for all", ie. to allow a complete freedom to establish major lotteries, could be self-defeating. But the alternative, of effectively granting an exclusive licence to one lottery or a small number of lotteries could well be controversial. That would mean preferring one cause or set of causes to enjoy the privilege of benefitting from major lottery proceeds, over another cause or other causes which would be denied that benefit. It is difficult to see how the Government, in introducing or assisting legislation, could distance itself entirely from this invidious choice.

(f) Drawbacks of "free" competition

8. Instead of one lottery, or a limited number of lotteries, possibly relieved of advertising controls and the full weight of gambling duty because of the charitable destination of part of the proceeds, there might be a freedom to establish as many lotteries as might be feasible, for whatever purpose, subject to "standard" gambling duty and, possibly, to some restrictions on marketing. It is not certain this arrangement would be unworkable commercially, although it would certainly be less attractive than the arrangement sought by the proponents of various single major lotteries. Commercial unattractiveness is

not in itself a reason to continue to prohibit an activity (ie. the current prohibition on major lotteries). But there would seem to be political and presentational difficulties in responding to calls for major lotteries to benefit good causes by proposing, instead, legislation which, if it could be employed at all, would aim only to add to commercial gambling activity.

EC considerations

9. Our law prohibits the conduct or promotion of foreign lotteries here. Some MPs and others have claimed that our own national or otherwise major lottery is required to prevent a UK market or such a lottery from being taken by lotteries based in one or more of our fellow member states in the EC.

10. This claim does not seem to be well-founded. Our present understanding is that the law on gambling will not be affected by the advent of the Single European Market in 1992, and that a good defence of our prohibition on major lotteries could, if necessary, be made, should that prohibition be challenged under the Treaty of Rome as it stands. In addition, action is being pursued with the relevant authorities in the Federal Republic with a view to curbing the recent promotion here, by post, of West German states' lotteries (which has been portrayed, by some advocates of a British, domestic, major lottery, as a de facto if not de jure breach of our prohibition on major lotteries).

HOME OFFICE

GOLDEN GRID "SKILL-BALL" COMPETITION

Introduction

This note:

(i) describes the apparent plans of Golden Grid plc to launch in April 1990 a computerised spotting-the-ball competition Skill-Ball;

(ii) explains that "skill-with-prizes" competitions, such as the promoters claim Skill-Ball to be, are at present unregulated; and

(iii) indicates the possible implications of Skill-Ball, if it were to succeed, for the policy on gambling, particularly for the question whether or not to allow major lotteries in this country.

(i) Golden Grid's plans

2. Golden Grid plc is a recently-formed company, in which businessmen in the Republic of Ireland, including one with experience in running the Republic's National Lottery, appear to have a leading role. The company is said to have £12.5 million in backing. The company plans to launch in April 1990 Skill-Ball, which is claimed to be a skill competition with the following elements:

(i) entry to the competition is via a computer terminal located in a retail outlet (eg. a newsagent's);

(ii) a player views six, separate still photographs of a different moment in a soccer match, from each of which the ball has been erased; he also has a coupon, of six boxes, each divided into 36 numbered squares, and marks one square of each box as being where, in his judgement, the ball in the corresponding photograph will have been;

(iii) the retailer feeds the coupon into the computer terminal, which transmits the six selections to a central computer and issues, for the player, a ticket recording those selections;

(iv) the charge is £1 per six selections;

(v) there will be winners weekly, with the winning numbers announced in the press;

(vi) there will be a minimum guaranteed jackpot of £1 million for the first two weeks of the competition;

(vii) an initial 1,000 to 2,000 retail outlets are planned, with an eventual aim of 20,000 after 3 years;

(viii) of the net (ie. ex-tax such as VAT) turnover, some 50% will be prizes, some 30% will go to six charities (eg. RADAR, MENCAP and the Variety Club), and the remaining 20% will be devoted variously to operating costs (including 5% commission to retailers) and to shareholders' profits (8%);

(ix) illustrative projections of possible turnover vary considerably: Golden Grid aims for some £350 million in the first year, although press speculation is of £2,700 million annual turnover after five years.

(ii) Skill competitions are not a form of gambling

3. Golden Grid claims to have legal advice that Skill Ball will constitute a competition within, but not contravening, section 14 of the Lotteries and Amusements Act 1976. Among other provisions, section 14 makes it unlawful for a competition conducted in connection with any trade or business to offer prizes where success does not depend to a substantial degree on the exercise of skill. Golden Grid's legal advice is that success in Skill-Ball can be regarded as being dependent to a substantial degree on skill; and also that the competition is neither a lottery nor gaming (were it either, it would be unlawful).

4. Whether or not Skill-Ball will be a skill competition which complies with section 14 of the 1976 Act, and which does not fall foul of the law on gambling, would ultimately be a matter for the courts. It is possible that some interested party (eg. a pools company) might try to put the question to the test. Customs and Excise are also consulting their lawyers on the question whether Skill-Ball might, in revenue law, be subject to pool betting duty. But if Skill-Ball is regarded as, or found by the courts to be, a legitimate skill competition, it will not be subject to regulation as a form of gambling. In that event:

(i) there will be no control on the advertising of Skill-Ball;

(ii) there will be no specific statutory machinery for its regulation (eg. the submission of accounts to a local authority or to the Gaming Board);

(iii) there will be no limit either to the amount which players may spend, or to the size of the prizes which may be offered;

(iv) there will be no restrictions on the places in which the facility for participating in the competition may be provided;

(v) no betting or gaming duty will be payable on the stakes.

5. The 1978 report of the Rothschild Royal Commission on Gambling recommended that "skill with prizes" competitions in which a charge is made for participation should be made unlawful. This recommendation has not been implemented for a number of reasons, including that: (i) newspaper "Spot-the-Ball" is one such competition, and provides invaluable income to soccer; and (ii) there is a multitude of such competitions, none of which has caused serious concern and none of which has been seen directly to compete with major forms of gambling or, therefore, to call in question Government policy on gambling.

(iii) Possible implications of Skill-Ball for policy on gambling, particularly on major lotteries

6. Whether or not Skill-Ball has significant implications for the policy on gambling may in large part turn on whether or not the competition succeeds on any scale, and survives any legal challenge. If Skill-Ball were to establish itself as a major commercial success (providing large sums to charity), the public, press and Parliamentary perception of the competition could be that it was very like a form of gambling, particularly like a major lottery.

7. Following are major factors which have told against ready agreement to allow major lotteries: (a) they could stimulate gambling, both directly and in leading to pressure for compensatory deregulation from the established gambling industry; (b) they could pose serious problems of regulation, unless tight and possibly-expensive regulatory machinery to prevent fraud or mismanagement were put in place; (c) they could prejudice Government revenue from established gambling, unless the lotteries were themselves subject to a specific, compensatory duty; (d) where the objects of the lotteries were public sector

services, Treasury public expenditure rules could require a proportionate reduction in the public revenue support for the services to reflect the income from lotteries; and (e) even were they run for charitable purposes, major lotteries could prejudice both current charitable lotteries and personal charitable giving more widely.

8. To varying extents, each of the factors listed in paragraph 7 above seems to apply to Skill-Ball, or to any similar competition with which competitors might enter the field. The difference, evidently, is that whilst major lotteries are at present unlawful, Skill-Ball may prove to be lawful.

NOTE FOR THE RECORD

SIR ALAN WALTERS' BOOK

I spoke to Sir Alan Walters about the attached report. He confirmed that he is working on a book on fixed v. flexible exchange rates. He expects it to be published around April/May 1990.

He says it will be a discussion of the economic issues and will not, contrary to the report, discuss the constitutional questions raised by Mr. Lawson's resignation. It will be a piece of economic analysis rather than political biography. I asked whether it would touch on the advice he gave while retained by No. 10. He said it would not although he would want to get on record that he fully approved of the position on ERM taken at Madrid. He agreed to clear the draft with me.

The book will also contain his ideas for a commodity standard as an alternative to the Delors proposals for EMU.

Whether the book turns out to be a purely academic work remains to be seen, though if it succeeds in explaining his otherwise incomprehensible commodity standard ideas it would prove worthwhile.

AT

ANDREW TURNBULL

18 December 1989

cc: John Gieve, H. M. Treasury

c:\wpdocs\pps\walters

"Evening Standard"

6—MONDAY, 18 DECEMBER, 1989

LONDONER'S DIARY

Walters tells of Lawson resignation

JUST AS Nigel Lawson thought he could lie low and concentrate on rebuilding the fence at his Leicestershire home, the whole business of his resignation is to be aired again. Lawson's old old adversary, Prof Sir Alan Walters, is to publish a book in the new year, which according to his publishers will include a "balanced assessment of the Lawson issue".

This latest opus by Sir Alan, who rose from a Leicester slum to be adviser first to Edward Heath and

Sir Alan Walters

then Margaret Thatcher, and whose influence over the Prime Minister caused the Chancellor's resignation, is to be brought out jointly by Collins and the Institute of Economic Affairs. The IEA has published five previous works by Sir Alan.

The IEA's General Director Graham Mather tells me the author has neither decided on a title nor produced a complete draft, but such is the vigour of Sir Alan's literary endeavours that the book will be ready early in the new year.

"Alan is one of our closest pals here and we expect his book to be the most interesting economic work for years. Not only will it be authoritative and educational, it will also be very entertaining."

Helen Ellis, Collins publicity director, and Graham Mather confirm that the book will address the constitutional questions raised by Nigel Lawson's resignation. "It will not be a 'My Daily Diary' book," Mather tells me, "but it will cover everything relevant."

Mather is candidly thrilled at this coup for the IEA. "All we need now is Nigel Lawson's book as well," he says, overlooking Lawson's insistence that he has no intention of rocking the boat before the next election. Sir Alan was out on a run when I called him, so unable to comment.

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

PRIME MINISTER

BALANCE OF PAYMENTS FIGURES FOR 1989Q3

As you know from our earlier discussion, estimates of the balance of payments in the third quarter of 1989 will be published tomorrow. These will include the first estimate of the invisibles balance for this period - the invisibles surplus of £300 million a month, published with the trade figures for July to October, was a CSO projection.

2. The estimate of the invisibles surplus in the third quarter is better than we feared when we spoke but is very disappointing, at just £204 million. This compares with the previous projection of £900 million, and means that the current account deficit for the third quarter will be revised up by around £0.7 billion, to £6.5 billion. The invisibles surplus of £0.2 billion in the third quarter compares with surpluses of £0.8 billion in the second quarter and £1.4 billion in the first quarter. These figures will not be well received although much of the reduction is due to higher net contributions to the EC (see below).

3. The CSO will be reconsidering their projection of the monthly invisibles surplus over the next few days. It is very likely that the invisibles projection that will be published with the November trade figures on 29 December will be below the £300 million surplus used previously. On the basis of the revised figures for the first three quarters, the deficit this year looks likely to be in the range

£21-22 billion, compared with £20 billion in the Autumn Statement forecast. And the projected improvement of £5 billion in the current account next year depends in part on a £2 billion rise in the invisibles surplus, from £4 billion to £6 billion. In view of the deterioration in invisibles through 1989, this forecast now looks less secure.

4. The attached Treasury briefing note discusses the figures in detail. The main points are:

(i) The sharp fall of £0.6 billion in the invisibles surplus in the latest quarter reflects mainly a rise in the deficit on transfers (£0.5 billion) most of which is due to a fall in receipts from the EC following large receipts from the agricultural fund in Q1 and the social fund in Q2. Our net EC contributions are not expected to fall back much in Q4 but they should be substantially lower in 1990.

(ii) Also the CSO and Bank have identified some additional capital flows for recent years which have the effect of reducing the balancing item and the estimate of net overseas assets.

5. The latest estimates clearly give rise to concern that the recent weakening of invisibles might continue and offset any improvement in the visible balance in the months ahead. Our best guess is that this is unlikely. But estimates of invisibles, particularly for the most recent quarters, are notoriously unreliable. It is possible that the third quarter estimate is erratic and the transfers deficit in particular is unusually large. Although I would not expect this to improve in the fourth quarter, a substantially smaller deficit is forecast for the first half of 1990. The underlying trend in the services surplus is also expected to continue

upwards. The travel balance in particular should continue to respond to the tightening of monetary policy, which has caused consumers to cut back sharply on expenditure on overseas travel. However, we cannot be sure how fast the invisibles will improve and, even if they do, there is bound to be a lag of some months before this is reflected in the published figures.

John M.

J. M.

13 November 1989

SECRET AND PERSONAL UNTIL 14 DECEMBER 1989 AT 11.30AM
THEN CONFIDENTIAL

File E8

FROM: SUSAN OWEN (EA2)
DATE: 12 DECEMBER 1989
Ext : 5385

1. MR OWEN DWO

2. CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Economic Secretary
Paymaster General
Sir P Middleton
Sir T Burns
Mr Wicks
Mr Scholar
Mr Peretz
Mr Sedgwick o.r
Mr Ilett
Miss O'Mara
Mr O'Donnell
Mr Ritchie
Mr Patterson
Mr Turner
Mr Parkes
Mr Lind
Mrs Chaplin
Mr Tyrie
Mr Lightfoot

BALANCE OF PAYMENTS FIGURES: THIRD QUARTER 1989

These will be published at 11.30am on Thursday 14 December. They include first estimates of the invisibles balance and capital account transactions for the third quarter of 1989 and revised quarterly estimates back to 1986. We should receive the final CSO Press Notice tomorrow. Draft briefing for IDT will follow early tomorrow.

Summary

2. The main points are:-

(i) The invisibles surplus for 1989Q3 is estimated at £204 million, which combined with a visible trade deficit of £6717 million, gives a current account deficit of £6513 million.

(ii) This is disappointing compared with the projected invisibles surplus for Q3 of £900 million and projected Q3 current account deficit of £5817 million which were given with the September and October trade figures notices.

(iii) Revisions to invisibles in earlier periods result in slightly larger current account deficits in 1987 (up £150 million) and 1988 (up £55 million). A bigger deficit in 1989Q2 is offset by a smaller deficit in 1989Q1 giving an almost unchanged position for the first half of the year.

(iv) The invisibles surplus continues to deteriorate. It averaged about £1.5 billion a quarter in 1988 and 1989Q1 but fell by half a billion to £0.8 billion in 1989Q2 and by about the same amount again in Q3 to £0.2 billion. This is the lowest quarterly figure since 1980Q2 (and before that, 1972).

(v) The current account deficit in 1989Q3 is £6.7 billion on a not seasonally adjusted basis. On a similar basis, the capital account records net inflows of £5.1 billion, so a balancing item of £1.6 billion is required. This represents unidentified net inflows/unrecorded net exports. It is a reasonably small quarterly figure, but even so, the balancing item for 1989 as a whole is running at an annual rate of £15 billion.

(vi) The figures include upward revisions in recent years to the estimates of overseas take up of bonds issued by UK companies, and improved estimates of transactions in short term securities. This has resulted in the identification of additional net capital inflows of £1.5 billion on average in years 1986-1988 and downward revisions of a similar magnitude to the balancing item.

(vii) The CSO's revised projection for the monthly invisibles balance will be published with the November trade figures on 29 December. They have yet to finalise the projection,

but it is clearly likely to be below the £300 million published with the October figures.

Table 1: Balance of Payments Summary

£ billion

	1986	1987	1988	1988 Q1	1988 Q2	1988 Q3	1988 Q4	1989 Q1	1989 Q2	1989 Q3
Visibles balance	-9.4	-10.9	-20.2	-4.1	-4.5	-5.7	-6.5	-6.0	-5.9	-6.7
Services	6.3	5.7	4.2	1.0	1.2	1.1	0.9	1.0	1.4	1.1
IPD*	5.2	4.8	5.5	1.0	1.5	1.5	1.5	1.2	0.4	0.5
Transfers	-2.1	-3.4	-3.5	-1.0	-0.9	-0.2	-1.4	-0.8	-0.9	-1.4
Invisibles	9.3	7.1	6.2	1.1	1.7	2.4	1.0	1.4	0.8	0.2
Current account	0.0	-3.8	-14.7	-3.1	-2.8	-3.3	-5.5	-4.6	-5.1	-6.5

* Interest, profits and dividends

Deterioration in Invisibles

3. Table 1 shows that whilst invisibles deteriorated by around £½ billion between 1989Q1 and 1989Q2 and again in 1989Q3, the composition of the fall was different in each case.

Table 2: Changes in invisibles balance, £ billion

	1989Q1 to 1989Q2	1989Q2 to 1989Q3
Services	+0.4	-0.3
IPD	-0.8	+0.2
Transfers	-0.1	-0.5
Invisibles	-0.5	-0.6

In the third quarter services have fallen back a little but still show a trend improvement since the low point in 1988Q4. IPD showed a big deterioration in Q2 and in Q1, but actually improved in Q3. Transfers deteriorated the most in Q3, but these are mostly out of our control being made up of net EC payments.

4. In the Autumn Statement forecast we anticipated the deterioration on transfers, and the services surplus has turned out only slightly below expectations. However, the Q3 IPD recovery is weaker than forecast.

Services

5. Although the services balance in 1989Q3 fell to £1.1 billion, the Q2 figure was high, and there seems to be an underlying improvement since 1988Q4. The surplus on services has declined every year since 1985, reaching £4.2 billion in 1988. In the first three quarters of 1989, the surplus is £3.4 billion, and it is unlikely that the year as a whole will not show an improvement on 1988. Within services it is somewhat disappointing that the travel balance remained flat in 1989Q3 after an improvement in Q2. The travel deficit had worsened continuously since 1985 and was the main source of deterioration in the services balance. Circumstantial evidence such as tour operators' provisional bookings suggests that the travel balance will improve sharply in 1990.

IPD

6. Figures for this sector tend to be erratic and are derived in a variety of ways. There is actual data on bank interest payments for example, but the figures for portfolio dividend payments have to be estimated by applying a likely rate of return to estimates of the value of asset stocks.

7. The quarterly balance averaged about £1½ billion through most of 1988 but fell by £1.1 billion over the first half of 1989 to reach a low point of £0.4 billion in Q2. This deterioration was arrested in 1989Q3 with a slightly better IPD balance at £0.5 billion.

8. Table 3 shows that interest payments on bank lending and borrowing have both increased over the last year. This is because net money inflows have risen and because interest rates have risen.

Table 3: Recent interest payments on bank lending and borrowing (Sterling and foreign currency), £ billion

	1988 Q3	Q4	1989 Q1	Q2	Q3
Credits (earnings)	8.7	8.8	10.1	10.7	11.1
Debits (payments)	-9.3	-9.5	-11.2	-12.2	-12.6
Balance	-0.6	-0.7	-1.1	-1.5	-1.5

The net effect was a deteriorating balance in 1989Q1 and Q2. However, in 1989Q3 the net effect was unchanged from the previous quarter.

9. Given that a significant proportion of capital <u>inflows</u> are into sterling bank deposits, it is inevitable that high UK interest rates will increase IPD payments overseas. By contrast, a relatively high proportion of UK gross overseas assets are portfolio assets - in particular overseas equities. These earn a relatively low dividend yield, although the total return to the UK investor is higher because there will be a capital gain. But capital gains do not score as a credit (IPD or otherwise) in balance of payments figures.

<u>Transfers</u>

10. The deficit on transfers deteriorated in 1989Q3 by £0.5 billion to -£1.4 billion. This was made up of a fall in receipts from various EC funds following particularly large receipts from the agricultural fund in Q1 and the social fund in Q2. There was also a small increase in bilateral aid payments. Net EC contributions are expected to be substantially lower in 1990, which should reduce the deficit on transfers.

Identified capital transactions

Table 4: Capital Account, £ billion, not seasonally adjusted

Net flows*	1986	1987	1988	(1989) (Q1-3)	1989 Q1	Q2	Q3
Direct	-6.5	-10.5	-7.6	(-2.7)	-0.8	1.0	-2.8
Portfolio	-13.7	14.6	-3.9	(-20.8)	-6.8	-6.8	-7.2
Banks net lending abroad							
£	-0.4	3.9	9.0	(9.1)	4.7	-0.1	4.5
Foreign currency	10.5	-1.4	5.6	(7.6)	3.3	-0.9	5.2
Other	3.1	-0.8	2.9	(9.5)	2.6	1.8	5.1
Official reserves	-2.9	-12.0	-2.8	(3.0)	0.5	2.1	0.4
Total	-9.9	-6.2	4.2	(5.7)	3.5	-2.9	5.1

* - sign means net outflows

11. There are three main points to note:

(i) Direct investment abroad was little changed in the third quarter but overseas investment in the UK fell, producing net outward investment.

(ii) The continued strength of outward portfolio investment. This will in part reflect further rebuilding of overseas portfolios following the repatriation of assets which occurred after the 1987 stock market crash.

(iii) The resumed strength of inward net banking flows, in particular sterling (already mentioned in connection with high IPD interest payments). Some commentators will be arguing that this is "hot money" chasing high UK interest rates which reflect the need to "finance" the current account deficit.

New data and balancing item

12. As part of their efforts to reduce the size of the balancing item, the CSO and Bank have identified some additional capital inflows for recent years. In particular these latest estimates include upward revisions to the estimates of overseas take up of UK issued bonds in recent years. Discussions with securities dealers have also resulted in improved estimates of investment in short term instruments.

13. In the first draft of the Q3 balance of payments press notice the CSO had allowed for underrecording of overseas purchases of new corporate bond issues and the corresponding interest payments (IPD). These revisions have been offset to some extent in the final estimates to be published because additional new information on the redemption of such bonds has been included. Consequently the revisions to capital flows and reductions in the balancing item are not as large as we had previously expected. (The effect on IPD is reduced further because the CSO have made some offsetting revisions to the estimated rate of return on these bonds. The net revisions to IPD in recent years are therefore small.)

Table 5: Balancing Item

£ billion, NOT seasonally adjusted

	1986	1987	1988	1989 Q1	Q2	Q3
Current account balance	0	3.8	-14.7	-4.4	-5.9	-6.7
Net capital transactions	-9.9	-6.2	4.2	3.5	-2.9	5.1
Balancing item	9.9	10.0	10.5	0.9	8.8	1.6
(Balancing item, previous estimate)	11.0	11.3	12.3	1.2	6.6	

The effect of the new data is nevertheless an improved, ie reduced balancing item in recent years. However, this balancing items remain large at around £10 billion a year. In 1989 the value of unidentified transactions represented by the balancing item are relatively low in Q1 and Q3, but still very large in Q2. Thus the

revisions, though in the right direction, do not significantly improve the overall coherence of the overseas sector accounts.

Assessment

14. The invisibles figures to be published for Q3 are certainly disappointing. But invisibles estimates, particularly for recent quarters, are notoriously unreliable and subject to revision. Whilst investment income IPD has deteriorated from a year ago, it improved slightly in Q3 and there is no reason to expect it to fall further, indeed it is more likely to rise. The deterioration in the exchange rate should increase the value of the UK's overseas assets thereby increasing IPD credits in Q4.

15. The underlying trend in services is upward. The "damage" can be accounted for mainly by transfers which will improve markedly in 1990.

Susan Owen

SUSAN OWEN

SA-

SECRET AND PERSONAL

PRIME MINISTER 12 December 1989

MONETARY CONDITIONS

The last meeting of officials on this subject was a fairly gloomy affair: nevertheless there is no reason for pressing for higher interest rates at present.

On the international scene, the Bank's view was that the vibrations from the Bundesbank suggested the possibility of a rise in German rates early in the New Year - though the stronger mark might cause some delay. The Bank of Japan also wanted higher rates but there is an election in February. In the US the prospect of a decline in rates has receded into the future.

The evidence on the response of the economy to the current tightening is in three categories:

- evidence of a slowdown in consumer spending is in the recorded data, the most recent being the retail sales figure for November;

- evidence of a slowdown in company spending is in the surveys and intentions data, but not in business spending yet;

- evidence of balance of payments adjustment is not apparent but only forecast to happen.

Two causes of concern are inflation and the monetary indicators. The inflationary outlook has deteriorated since the Autumn internal forecast. With the futher worsening of pay settlements and the depreciation of sterling since the beginning of October, the inflationary outlook for 1990 has got worse - the best guess being that it might be as high as 6-6½% by end 1990.

B

SECRET AND PERSONAL

The monetary indicators, MO and M4, do not give much ground for hope. The growth of MO, while having fallen from a peak of over 8% in late 1988, is still outside of its target range, and the forecast for MO in 1990 is simply a reflection of the expected slow down in the real growth of the economy.

The growth of M4 carries on at 17%, but the composition of this growth is difficult to explain. There is a striking divergence between the behaviour of retail and wholesale deposits - retail deposit growth having fallen substantially but the growth in personal sector wholesale deposits being very large and difficult to explain.

Policy Response

There are risks in both directions:

Raising interest rates might cause unnecessary damage to the economy; but equally not raising rates carries the risk that inflation would not be on a firmly downward path in a reasonable period of time.

Striking a balance between these risks is difficult - and there are different views among officials on this subject and tactics on intervention.

The conclusion of the meeting was that monetary conditions were barely satisfactory to have confidence that inflation would definitely fall, but that there is no immediate reason to recommend higher rates.

Comment

My personal view is that it is but a short time before the corporate sector responds to the fall in retail spending - and that early

C

in the New Year we should expect de-stocking and an adjustment by companies of their production schedules.

In these circumstances, higher interest rates could well lead to overkill. Unless sterling comes under strong pressure, the case for higher rates has yet to be made.

Bh

BRIAN GRIFFITHS

Chart: MO growth

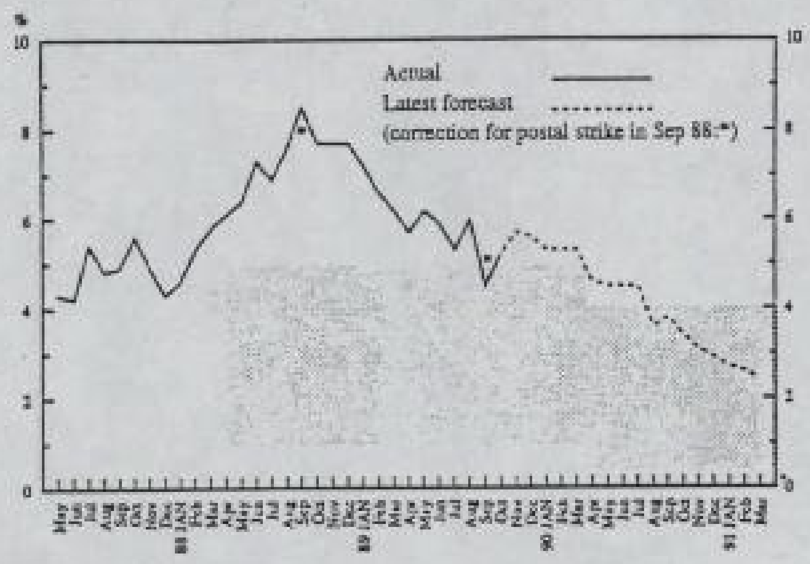
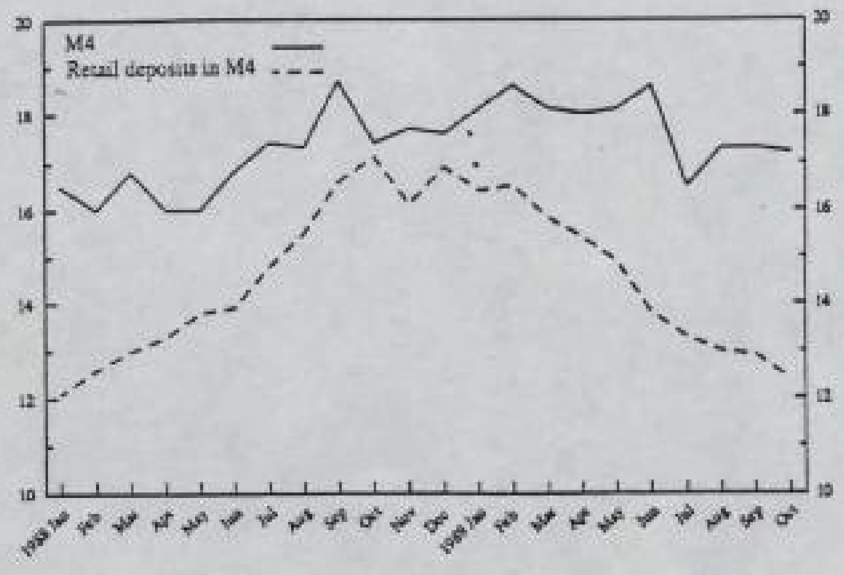


Chart: M4 growth



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HOUSE OF COMMONS

MINUTES OF EVIDENCE

TAKEN BEFORE

TREASURY AND CIVIL SERVICE COMMITTEE COMMITTEE

MONDAY 4 DECEMBER 1989

THE RT HON JOHN MAJOR, MP, SIR PETER MIDDLETON, KCB and SIR TERENCE BURNS

Thanks. 7/11

Evidence heard in Public Questions 196 - 295

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MONDAY 4 DECEMBER 1989

Members present:

Mr Terence L Higgins, in the Chair
Ms Diane Abbott
Mr Anthony Beaumont-Dark
Mr A J Beith
Mr Nicholas Budgen
Mr Neil Hamilton
Dr Lewis Moonie
Mr Giles Radice
Mr Brian Sedgemore
Mr John Townend
Mr John Watts

EXAMINATION OF WITNESSES

THE RT HON JOHN MAJOR, a Member of the House, Chancellor of the Exchequer, SIR PETER MIDDLETON, KCB, Permanent Secretary and SIR TERENCE BURNS, Chief Economic Adviser, HM Treasury, examined.

Chairman

196. Mr Chancellor of the Exchequer, may I begin by congratulating you on your appointment to your high office and to welcome you to the Committee this afternoon. We have, of course, the task of monitoring the work which the Treasury and indeed the Civil Service Department do and a major feature of our annual programme is, of course, the evidence which we take on the Autumn Statement. We are glad already to have received evidence from Sir Terence Burns and your officials and also, of course, last week from the Chief Secretary of the Treasury who was particularly concerned with the public expenditure aspects of the Autumn Statement.

This afternoon we would like to concentrate on the overall state of the economy. We hope then to produce a report before Christmas which no doubt will be debated early in the new year. So you are indeed very welcome. Perhaps I might make just one point at the beginning, the microphones do not of course amplify the sound in this room only for radio and television. The accoustics are somewhat better than upstairs but are still somewhat difficult and no doubt you and your colleagues will wish to bear that in mind. May I begin by asking whether there is any initial statement you would like to make and then perhaps begin in the traditional way by asking you to introduce your officials for the benefit of the shorthandwriters.

(Mr Major) Mr Higgins, thank you very much indeed and thank you for the welcome you gave me to my new job and to this Committee this afternoon. In so far as an opening statement is concerned, we have had a number of opportunities in the last month or so, rather more than ideally ~~one~~ I might have wished in the first few weeks of a new job, to make those statements on the floor of the House so I think I will not weary the Committee with an introductory statement. I suspect there are lots of questions to be asked and I think perhaps the sooner we get down to those the better. In so far as the accompanying officials with me are concerned, I think they are well known to Members of the Committee. On my immediate right is Sir Peter Middleton, the Permanent Secretary at the Treasury and on my left is Sir Terence Burns, who attended your Committee a few days ago and whom I am sure you will be pleased to see again. I have no further opening statement to make, I am quite content, if you are, Mr Higgins, to move straight to questioning.

197. You are indeed most welcome and I think the Committee are glad to proceed straight to questions. Perhaps I might begin in this way, in the debates which you have mentioned, you have pointed out yourself a

number of difficulties in the present economic situation and we wondered if you would like to start by giving us a brief explanation as to how you think those difficulties have arisen before we turn to analyse the sitaution of the present and for the future in greater depth.

(Mr Major) Yes, I am happy to do that. I did seek to make it clear in the Autumn Statement, and in the subsequent debate, that I think we will have a less easy year in the next year in terms of growth than we have had in the past and of course that entails a number of other attendant difficulties as well. In so far as how those have arisen I think there are a number of factors that one needs to take into account. It is I think clear in retrospect, though it was less clear at the time, that demand has probably been growing at a faster rate than was desirable right the way through 1987 and right the way through 1988. I think that is now perhaps quite clear. We have also seen a very considerable growth in borrowing, a very considerable growth in borrowing by the private sector and a very considerable growth in investment by the company sector, both of those, of course, have very materially added to demand over the period of the last two years or so. It is in essence I think the growth of that demand pressure that has led to the inflationary impulse we can see at the moment and the need to deal with that quite firmly with the consequent effect on growth over the period of the next twelve months or so. I think there were one or two other matters that it might be worthwhile to include in the catalogue of the background to the present situation. I think it is also clear that in company with all other commentators, both inside this House and beyond this House, at the time we misread the likely impact of the Stock Exchange crash at the end of 1987. It was our judgment at that time that that would have very substantial deflationary effects. As a result of that and because we did not wish to disturb the growth pattern that was

~~clearly benign at the time, we did not wish to disturb~~ and the growth in employment that was very welcome at the time and has been very welcome over the period of the last few years, ~~that~~ and at the time of the Stock Exchange crash, believing that there would be a very substantial slowdown (as indeed history would have suggested) we relaxed monetary policy. ~~at that time and~~ I think in retrospect it is clear that we relaxed monetary policy perhaps at precisely the moment that we should have made it a little more severe. I think that was a misjudgment that we made and that every other commentator shared as well at that time. I think there is perhaps one other ~~element~~ factor that I would touch upon and ~~I think~~ that was the changes we made to multiple mortgage relief in the 1988 Budget. For the best of reasons we allowed a timelapse between the announcement of the ending of multiple mortgage relief and the ~~absolute~~ actual ending of it. ~~We did so and~~ I take my own share of responsibility for the misjudgment. It is not something I seek to heap upon my predecessor; that was a view that all Treasury ministers took at the time ~~as~~ we considered the Budget. We were concerned about the social impact of the ending of multiple mortgage relief without any period of warning. We were concerned that lots of young people would have been in the midst of purchasing their own houses (and we of course are keen on an owner/occuping society). So we did allow a period for those completions to conclude and others to take place. I think probably in retrospect that proceeded on a far more rapid pace than we had any reason to expect; so I think in retrospect that was a policy misjudgment. It was done for the best of social reasons but nonetheless was a policy misjudgment that added to the growth of the housing market on the back of which there was ~~a~~ considerable ~~degree of~~ borrowing for other purposes. So I think those are the underlying reasons. I think those are overwhelmingly the main reasons: the Stock Exchange crash, the policy misjudgment in terms of the multiple mortgage

decision in the 1988 Budget and the fact that in retrospect we can see that demand was growing faster than we had then thought in 1987 and 1988. I think those are the factors that have led to ~~this~~ the bubble of demand that underpins the present inflation ~~that concerns us~~.

198. Perhaps I might restrict myself to one question before I turn to Ms Abbott who has some related questions to ask. The Committee has in the past drawn the rather simple minded analogy between the Chancellor of the Exchequer - both your predecessor and yourself - being on a tightrope with danger on one side being falling over into recession and on the other falling over the problems of inflation. As the forecasts now stand, within the margins of error of those forecasts, one could get both at the same time, what the late Ian McCloud used to call stagflation. May I ask do you think that is a danger and related to that has the forecast previously under-estimated the upturn in the economy which was to a considerable extent due to the expansion of credit? Do you think there is now a danger that they under-estimate the downturn with the result that we do go into a significant recession?

(Mr Major) Perhaps I can take the point ~~of~~ on recession first? There was some comment after the Autumn Statement that I might have plumped down, if I can use that expression, our forecasts for the next year so that it would seem during the course of the year we were performing better than I had imagined and I could proclaim an economic miracle. If I may say so, firstly to the Committee I neither plumped up nor plumped down ~~those~~ the forecasts that I put in the Autumn Statement. They are the ~~absolute~~ central forecasts of what we believe will be the outcome over the period of the next twelve months. It must be said on the back of that that they are forecasts and all forecasts are fallible, we have proved that in the past and so have all other forecasters so I cannot tell you whether they will be precisely

accurate. What I can say is that those forecasts do not forecast recession in any accepted definition. We actually anticipate growth at 1¾% or three quarters of a per cent in non North Sea oil terms over the period of the next twelve months and although we may over-estimate that it is equally true that we may under-estimate that. I do not in fact anticipate a recession. I think we will have a period of slow growth over the next twelve months or so. I think in terms of dampening down demand and helping to squeeze inflation out of the system not only will we have a period of very slow growth, it seems to me necessary now that we should have a period of very slow growth over the next twelve months or so. You touched in your second question on whether the under-estimate of demand that we made before might swing back to an over-estimate now and whether we might actually be in a recessionary situation for that reason. Again, I can only reiterate although it is perfectly true that we under-estimated the demand of growth in the fashion I explained a few moments ago we have taken that into account and we have made the best central forecast of what we believe demand will be over the next 12 months. That does assume that consumers' demand is absolutely flat. So, the danger clearly of the forecasts being inaccurate is always there. No-one could say now or at any other time we can be certain that the forecasts are right and we will have to watch the indicators over a period to see whether or not they are. One of the virtues of using monetary policy in the way that we use monetary policy is we are able to have a more flexible weapon at our hands than would otherwise be the case. I do not anticipate a dramatic swing back to a recessionary situation. We have actually produced forecasts that we think will lead to a lower growth level next year but nonetheless, we do believe there will be a growth next year. That does, and must, come with a health warning that all forecasts are always, of course, fallible.

Ms Abbott

199. You have just said that your forecasts are not foreseeing a recession within any accepted definition of the term, what is your definition of a recession?

(Mr Major) I think I would take as a definition of a recession the one that we have traditionally accepted and that is a reduction in gross domestic product over a measurable period of time, probably two or more quarters, although there is no formal and wholly agreed definition of recession. That is the sense in which I would use the term; a reduction in GDP over perhaps two or more quarters, at least a six month period.

200. What sort of reduction would you be looking at to call it a recession ~~reduction~~?

(Mr Major) Of course in other countries they have different definitions of recession. Some people in the United States from time to time would refer to a ~~smaller growth in one quarter being~~ a recession in one quarter if growth was smaller than the growth in the previous quarter. That is not the sort of definition I use. If we have a reduction in GDP over a measurable period of time then I think it is reasonable to begin thinking in terms of a recession but that is expressly not what we are forecasting at the moment.

201. You would accept, would you not, given you are, I think, forecasting a three-quarter of a per cent increase in non-oil GDP for the next financial year that a recession, in your own terms, is well within the margins of statistical error?

(Mr Major) I do not think there is any virtue in anyone seeking to talk us into a position that I am not forecasting. ~~and~~ If I thought that was ~~to be~~ the case I would have forecast that in the Autumn Statement. I reiterate what I said a moment ago ~~now~~, that the Autumn Statement is

absolutely and literally what I expect to happen over the next 12 months. You are right in saying that the forecast is fallible but I do believe that the forecast we have made is the most realistic one available and upon that basis I am not forecasting a recession over the next 12 months and I hope very much that we will find we do not have one.

202. On the question of your forecasts, obviously all the forecasts are based on assumptions and some of those assumptions are made explicit in the Autumn Statement, some are implicit. Your forecast about inflation rates is quite explicit, I think it is five and three-quarter per cent in the fourth quarter of 1990, but some forecasters are saying there is an implicit forecast about interest rates - that they are going to remain the same - and they say this by looking at some of your forecasts on your housing costs and so on. What are your assumptions about interest rates?

(Mr Major) Well, if I may say that comes in the definition of an extremely good try and you did it with great charm, but you will know and the Committee will know, for a number of the Committee present have lived through this exercise in previous years, that for perfectly good and understandable market reasons the Treasury never make public their assumptions on interest rates. I fear I must give you that deadpan answer again this afternoon. As far as our projection on inflation is concerned you are absolutely right, the projection on the average level of inflation for the fourth quarter of next year is five and three-quarter per cent and I hope very much we will be able to hit or beat that.

203. But in drawing up your forecasts you will admit that you do make an assumption about interest rates?

(Mr Major) It would be difficult for us to make a forecast on inflation without making assumptions about all sorts of things including interest rates, but for the reasons I set out a moment ago it is not in my

interest, or anybody else's interest, for those to be anything other than private assumptions. I am sure that is disappointing but I know you will understand why that must be the case.

204. You cannot make a present to mortgage payers, a Christmas present to them, of an end to their mortgage misery?

(Mr Major) I am not sure that revealing the underlying assumptions in that forecast of interest rates would actually turn out to be a present for mortgage payers. I do not know that ~~will~~ be the case. ~~I do not know that will be the case~~ at all. I do not believe it ~~will~~ be a wise thing to do and much as I would like to assist the Committee I think the Committee will understand I am not going to give that assumption.

205. Can I ask finally, there is a lot in the Autumn Statement about current account flows but there is very little explicit about capital account flows. It would certainly help the Committee if we had your forecasts and also what happened in the last financial years about capital outflows inwards and outwards. Will they be available?

(Mr Major) We take account in all our forecasts and calculations of what we think is happening on capital accounts but as you will know from your interesting exchanges with Sir Terence Burns at the last Committee meeting and I am aware he owes you a letter on this matter which will be with you very shortly ~~I understand~~ ~~but you will know from that~~ that we do not, in fact, make public our assumptions and our forecasts ~~on the question~~ of capital account. ~~and~~, again, although it is extremely tempting of you to invite me to do so I must decline I am afraid.

Mr Beith

206. Would we be right in assuming it is no longer the exchange rate which is determining the level of interest rates?

(Mr Major) Well, we have taken account of the exchange rate alongside a whole series of other monetary indicators in setting interest rates. That was the position before and that remains the position today. It was never, if I may use the expression in a different context, a one club policy as to how interest rates were determined.

207. Perhaps I was just struck by this phrase of the Prime Minister: "Look, you cannot have two priorities in life, our top priority is to bear down on inflation". She must have been meaning that you could not operate on this range of indicators, must she not?

(Mr Major) No, I do not think that is what she meant at all. It is an intriguing assessment of what the Prime Minister might have said at some unspecified time, but what the Prime Minister said was, in fact, perfectly clear: the Government's central concern is to bear down on inflation, that we think it is higher than we think it ought to be and we wish to bring it down, and in terms of doing that we will use monetary policy, to an extent we will use fiscal policy, and we will look at a whole range of indicators. But in so far as interest rates are concerned we will, as we traditionally have, take account of the exchange rate levels and also have a careful look at the monetary indicators and other matters as well. It is a range of these matters that we bear in mind when we set the interest rates.

208. Are you not making the dangerous assumption that interest rates do not influence inflation unfavourably? I am thinking particularly of the likely impact of wage increases and the pressure for wage increases arising from ever-increasing mortgage rates now that so many more people are buying their own homes.

(Mr Major) No, I make no such assumption in the way in which I approach the setting of interest rates. I do not make that assumption. I am bound to say on the subject of wage increases I think one of the more

worrying elements about wage increases is not so much the way in which they might feed into inflation but the way in which unjustified wage increases not wage increases justified by productivity which are perfectly satisfactory whatever that level might be, but unjustified wage increases that in my assumption are as likely to reflect in the levels of unemployment as they are to reflect in the levels of inflation.

209. What are you assuming about savings given the very low rate of personal savings when compared to most of our competitors? In the past you have tended to say when questioned in the House the higher rate of interest is itself a major attraction to savers but we still have this very low rate of personal saving, are you looking at other ways we can increase?

(Mr Major) We have had a fairly remarkable conjunction of events on the savings front over the last year or so and that is not unrelated to pressure we have seen in terms of demand. We have seen the very rapid change in the personal sector in terms of savings, that has been very remarkable. It has largely come about by an increase in borrowing rather than a reduction in absolute stock of savings. If you are asking me the direct question would I personally wish to see a higher level of personal savings I probably would, yes.

210. I hope it is something you look at in advance of the Budget.

(Mr Major) That is your assessment of what I will do rather than my indication that I will.

211. That is for the record. In your opening answer you mentioned the point about multiple mortgage interest, you recall your predecessor as Chancellor in appearing before this Committee conceded precisely this point in April of this year in answer to the Committee's questions but he blamed the computers rather than any error of judgment and said he had been advised the computers would take that long to work.

(Mr Major) I have always been very fond of computers myself and that being so I choose to accept whatever the computers might have said but in retrospect (which was the way I put it) it was perhaps an error.

Mr Beaumont-Dark

212. Do you agree with a former Chancellor of the Exchequer that a £20 billion trade deficit does not matter as long as you can borrow the money to cover it?

(Mr Major) I suppose the way in which one looks at that is to ask yourself the question would I prefer to have a £20 billion trade deficit or would I prefer not to have a £20 billion trade deficit? On that I think the balance of probabilities is ~~I would answer~~ I would prefer not to have a balance of trade deficit of £20 billion. I think the fact it has been readily financiable is a point that has been well understood ~~in the past~~ but I would prefer not to have a £20 billion trade deficit. ~~I am delighted to see t~~The forecast improvement next year is not as much as ideally I would like to see ~~it,~~ but it ~~it~~ is a very material change ~~in the forecast~~ if it proves to be correct (and I enter the health warning again) with the deficit coming down from £20 billion in the present year to £15 billion next year, that is in terms of GDP ~~something over~~ around a 1% change.

213. That is a wonderfully Delphic answer, I must say. If you take table 213 on page 6 from 1985 right through to 1989 stocks rose from 600 million to 5.4 billion, the forecast for 1990 is a fall of 0.3 billion.

(Mr Major) Yes.

214. Does this not represent a substantial and an intense period of de-stocking and cancelled order? Why do you think there is this huge turn round in de-stocking?

(Mr Major) I~~f I may say so,~~ of all the elements in the forecast the one that I think ~~in behavioural terms is the one that~~ gives me the most degree of concern is w~~hat actually is going to be~~ the position ~~in terms of~~ stocks. ~~In fact if you look at that~~ what we are actually ~~proposing~~ is that there will be a 300 million reduction in stocking during the period of 1990, ~~that is in essence what that table means~~. ~~I think~~, given all the information available to us, that that is probably - probably - the best ~~central~~ forecast that we will be able to make. Certainly we looked very carefully at that and I am very ready to acknowledge the ~~sensitivity~~ of that particular forecast but I think it is the best forecast we are in a position to be able to make.

215. I am glad it does disturb you because is this not really the crux of it: unless it is just a transitory thing, in other words the balance of payments only increases because of a very short term thing, it must mean there might well have been a fundamental shift because with small and medium term businesses borrowing at 18% (and your predecessor used to say how fluid industry was with money) I can tell him and you with small and medium businesses if you cannot afford to borrow at 18% (and many firms cannot, I can assure you of that) does this not mean that investment must drop because I can tell you now many smaller busienses in the Midlands, they are deferring investment plans. Does this not mean a recession could be very likely? Does it not mean we should try and get it into a straight downturn as soon as possible and use other weapons?

(Mr Major) Let me turn back to those stock building figures for a moment. I share your view they are important ~~to forecasts but~~ it is extremely important we look at them carefully. ~~The recent estimates themselves returned~~, 300 million for 1990 in stock building~~, that~~ represents the best judgment~~al case~~ that can be made by the Chief

~~Statistical Officer~~ Economic Adviser. He has looked very carefully at it, it is the best ~~adjustment~~ forecast he thinks he can make. ~~They are uncertain so~~ There must be uncertainty about the outlook for stocks. The important point ~~we are saying~~ is that we are not forecasting intense de-stocking which I think may lead to recessionary concern, which I think is in the back of your mind, what we He are forecasting is a slight fall in stocks after a very, very rapid build up in 1989. That is, I think, the central point of the forecast there. It is also true, and I think it is worthwhile making the point now, that the turn around in stock building between 1989 and 1990 very largely accounts for the depressed outlook for domestic demand. That is the principal single ~~factor~~ reason for the depressed outlook in domestic demand. If we look back at periods when ~~one first~~ the economy moved from ~~a~~ higher growth to lower growth ~~in the past that~~ that is is normal in any cyclical slow down in demand and output growth. So I think the recessionary fears that, I suspect, lay at the back of your mind are not perhaps as great as you wish.

216. Not wish.

(Mr Major) As you fear. Though it must be said in addition to that that if that huge change of 5¼ billion growth in stock building to a 300 million reduction were the only change and there were no other consequential changes, which there could be, that of itself ~~can~~ would cause a slight fall in GDP. I think Sir Peter Middleton might want to add to that.

(Sir Peter Middleton) I just wanted to say that as you know, and the committee knows as well, with national accounts we have great difficulty in making them absolutely coherent because of the errors in the statistics.

217. We know!

(Sir Peter Middleton) These show up, particularly as regards the past, in stock building and that is one of the elements one would look

to to make the figures add up, as it were, and the forecast for the future reflects what we have for the past as much as it does a judgment for the future.

218. Can I ask one more question, it is germane to this very point which obviously worries you as it does all of us. I am sure when it is used it does help because all of us in the end we have to export or die and manufacture or die. What kind of forecasting are we doing for companies' financial deficit if it does look as though the companies' financial deficit, in other words retained profits, is likely to be severely reduced? Would you not agree reducing direct taxation is inflationary because it puts more money into people's pockets directly and if there are any tax concessions available would it not be better to think along the lines of helping industry by lowering corporation tax or the national insurance charges than any other single thing to help keep this country moving along the right lines, which it has been now for two or three years?

(Mr Major) If I may say so I am grateful to Mr Beaumont-Dark for the first budgetary representation I have yet had ~~over the period of the last month or so~~ and I will take it into careful account as we look at options for the Budget over the period of the next few months, but I think that falls very much into the area of a budgetary judgment. I will note what Mr Beaumont-Dark says, if I may.

Chairman: We will remain in hope.

Mr Watts

219. At its inception the medium term financial strategy was intended to provide a declared policy framework for economic management and at the start had headaches over spending, borrowing money supply and so on. Your predecessor, as he explained to us, allowed the slow shifts of

emphasis in the spending on products and, therefore, abandoned targeting broad money so that at the end he was left targeting only MO and with a rather more general objective than keeping the exchange rates stable. Do you consider it helpful to have declared targets for such things as monetary growth, public spending borrowing or debt repayment and the exchange rates so that policy responses are to some extent predictable or do you think it is preferable to retain the discretion of responses flexible to changing conditions?

(Mr Major) Well, if I may, I think the truth is perhaps slightly different from the two options that you place before me. I certainly think that it is a wise proposition to have fairly firm financial policies and to set those out in a medium term financial strategy. I think that is right. I think that is the way for us to continue. It is perfectly true that there will need from time to time to be changes in emphasis of policy, and it seems to me in terms of my experience at the Treasury, both as Chief Secretary for two years until June and subsequently, the economy is a very moving and fluid thing. It is not always wholly consistent. It is sometimes like surfboarding on a fairly heavy sea, you have to take account at any time of the way in which circumstances are changing. So I think you do need a firm policy framework but I would not wish that firm policy framework to close out options that may be necessary. I have formed the impression over the last few weeks that a number of people want to see whether I am going to close down one option or another in terms of policy. I have observed they want to see me close down policy options, I am less inclined to do so. I believe we need a firm policy framework ---

Mr Beith

220. What is it?

(<u>Mr Major</u>) --- I hope we will continue to provide a firm policy framework but how we operate within that framework ~~may~~ will entirely depend on the particular sequence of events.

Mr Watts

221. Would you agree the overriding policy concern should be to maintain monetary policy sufficiently tight to keep inflation under control and that if that can be achieved then there should be little need for concern about external pressures on Sterling?

(<u>Mr Major</u>) We certainly need to keep monetary policy tight and to bear down on inflation. We have already touched upon that in questions Mr Beith asked a few moments ago. I agree we need to keep monetary policy tight and we need to keep fiscal policy tight as well. We have had over the last few months a strong monetary and fiscal position, I think it is desirable we should. We need to sustain that. I will take into account all the things set out earlier in terms of monetary policy to ensure we keep monetary policy tight and there should be no doubt ~~in terms of what we have said and done~~ that we believe in a tight fiscal policy and will sustain that too.

222. Do you agree pressures on currency tend to be either a reflection of its experience of inflation or of inflationary expectation and therefore the control of inflation is really a cornerstone for successful financial policy?

(<u>Mr Major</u>) I think it is the key to it. I do think from time to time there are other factors that put pressure on the exchange rate quite apart from inflationary expectation, ~~a whole range of things can do that~~ both in the short term and medium term. I agree with your underlying proposition that the confidence people have in the Government's anti-inflationary policy is essential to the exchange rate.

223. Why is it there is now no target for broad money and only M0 is targeted?

(Mr Major) It has been very erratic, broad money, and it is very difficult to draw policy conclusions that would be coherent from the movement of broad money over recent years. If there were a way one could draw coherent conclusions from the movement of broad money then I would look at that as well. If you look at what has happened to it over recent years, it is extremely difficult to argue that it has been the case. M0 has been a far more coherent guide and I think we must for the moment stick with that.

224. Is it so much a guide or rather more a record of what has happened?

(Mr Major) It certainly indicates retrospectively what has happened, that is certainly true, but I think if you talk in terms of a guide it is perfectly clear M4 is not a guide, broad money is not a guide. I have looked very carefully to see whether it could be made one. I do not think it can be made one at the moment and nobody has suggested to me how it can. In terms of narrow money that is the best guide we have in an uncertain field and that is the one to which policy is geared at the moment.

225. If a little attention had been paid to the growth of broad money in 1987 and 1988 you do not think that would have helped to have predicted the inflationary pressures which have now overwhelmed us?

(Mr Major) We do not ignore broad money. We certainly keep a close watch on what broad money is doing. What is less easy is to draw clear cut and coherent conclusions ~~from the~~ for policy ~~of~~ from broad money. If you actually see what has happened to it and relate it to what has happened to inflation at a measurable lagged period ~~of inflation~~ later on it is difficult to find broad ~~levels of proper coherence~~ rules that would enable one to make policy

decisions.

(Sir Peter Middleton) M4 growth was not very different in the years 1979/1980, 1985/1986/1987/1988 but inflation was very different.

Mr Townend

226. Can I raise a matter of principle which is important to England and particularly to the North and that is the allocation of Government resources to the various component parts of the United Kingdom. Can you confirm this year in your Autumn Statement the public expenditure for Scotland, Wales and Northern Ireland was based on the Barnet formula and is it correct when this formula was established in 1978 it was based on population?

(Mr Major) It was essentially based on population and that is certainly the method of allocating most but not all of public expenditure subsequently. So, on a pro rata per head basis, there would be a higher level of expenditure per head in Scotland, Wales and Northern Ireland; highest in Northern Ireland, second highest in Scotland and third highest in Wales. That is certainly the way in which things have worked out in recent years. If I may argue on behalf of the Scots, Northern Irish and Welsh they would also say they have a different pattern of problems to confront and they would also, in the case of Scotland particularly, argue that sparsity is a factor but that is a matter the Chief Secretary may have dealt with.

227. This is a matter of principle. Is it correct according to the Government's own actuary, the forecast is for the population of Scotland to continue to decline in the coming years and this is going to compound this unfairness? How can I, as a Northern MP, explain this as being fair to my

own constituents who have just as many problems as those in Scotland?

(Mr Major) As to whether the population continues to fall in Scotland relative to England we must wait and see. We have to look at the formula population system on a continuing basis and I have no proposals to change that. I understand the sensitivity you feel about this and I know historically you have had this in the past but there are a whole series of different factors which determine the allocation of public expenditure and those factors are considered on a year by year basis. In my judgment the method of distributing public expenditure using the formula, the principle, has worked out pretty well in recent years. There are some elements of expenditure which fall outside the formula: industrial expenditure is one illustration of this. So it would be a mistake to assume all public expendiure in Scotland, Northern Ireland and Wales operates in the formula system, they most expressly do not.

228. A lot has happened since 1978, would you not give us an open undertaking to look at the Barnet Formula before next year's Autumn Statement?

(Mr Major) I have no immediate plans to look at that formula before next year's Autumn Statement. I would be very unwise to give you an undertaking I would be changing that policy.

229. Very disappointing. Can I turn to fiscal policy. In the Autumn Statement you are forecasting the PSDR will fall from 12½ billion in 1989/1990 to 10 billion next year. Would you consider if that happens fiscal policy will have relaxed?

(Mr Major) At the moment the 10 billion is an illustrative assumption and I will provide a more formal forecast at the time of the Budget. I think it would not be surprising if the deficit were to fall back in a period of lower growth - clearly in a period of lower growth there are

going to be some tax revenues which will fall - ~~I think it will b~~e if tax revenues were consequently to fall ~~and~~ PSDR ~~to~~ fall from its historical high level. Having said that I still think that would leave fiscal policy extremely tight although all the definitions are not on precisely the same basis. I think one would be very hard put to find another nation with as tight a fiscal policy as we have ~~in so far as debt repayment is concerned and fiscal surplus is concerned~~. Japan, perhaps, has about the same ~~level~~ of GDP ~~as the surplus that~~ we have but I cannot immediately think of any other nation that would be remotely in that ballpark. Our policy is very strong, even if that illustrative assumption you have before you turns out to be ~~a real assumption~~ when we come to the Budget - forecast I should say rather than assumption - even if that forecast turns out to be reality I think we would still have a very tight fiscal policy now.

230. Those other countries you have mentioned, they have not anything like the private sector deficit we have got. Could it not be argued that we need a tighter fiscal policy to offset that large deficit and if we had a tighter fiscal policy we would be able to reduce interest rates sooner rather than later?

(Mr Major) I hope we are going to see a change in the private sector position. Certainly with the proceeding impact of the monetary policy I hope we will see a change in the private sector position. We will have to see how that turns out. I certainly hope that will prove to be the case.

231. You have changed the method of dealing with local authorities' self-financing expenditure for this year which I think we welcome, but if the expenditure by local authorities that is self-financed, within their own control, grows faster than you have forecast will that not compromise your economic policy or your fiscal stance?

(Mr Major) I think there are two different elements. If we have more local authority self-financed expenditure that effectively will reflect in a higher community charge, so in terms of demand within the economy it will be replacing demand in the hands of the individual with expenditure in the hands of local authorities and that, in its macro effect, could be broadly neutral. What would not be at all neutral would be levels of public expenditure themselves would rise as compared with private expenditure and that would put very considerable pressure on general Government expenditure. Self-financed expenditure under our own new proposals ~~are~~ outside planning total~~s~~ but ~~they are~~ within general Government expenditure and ~~they are, therefore, being within general Government expenditure~~, part of the ratios that we determine ~~to kee~~p our public spending targets ~~on track~~. So, if there was to be a very dramatic increase in self-financed expenditure reflecting ~~a~~ higher local government expenditure it would certainly put pressure on Government expenditure totals, but that is the principal damage it would do.

232. That would undermine your policy to keep expenditure down as a proportion of GDP?

(Mr Major) Unless we took corrective action it would, yes, but if local authority expenditure is higher than expected this year we ~~would~~ have to take that into account at the time of the next survey~~, what we see in public expenditure outturn this year~~. In the current year, as the Chief Secretary will have mentioned to you, public expenditure will be higher than we had anticipated largely because local authorities have ~~overspent, have~~ spent more than we anticipated and believed they should have spent, by around two and three-quarter billion and that effectively ransacks the whole of the resources that were available in the previous year's accounts. That is a matter of concern and if local authority expenditure is higher

than expected in the forthcoming year we will have to take that into account when we next come to consider the survey.

233. You say in your report there has been a further large drop in public sector debt and this has been one of the great achievements of the Government, what do you feel is a desirable level of Government debt or would you eventually like to see it all repaid?

(Mr Major) I am never sure in terms of debt that there is a desirable level. If I can speak on a domestic level, in my own home I would prefer ~~there is~~ to have no debt! If the underlying question is is it our policy to liquidate all national debt as policy -----

234. Progressively.

(Mr Major) That is not necessarily the aim of the policy. The aim of the policy is to stop the national debt rising. We are aiming over the medium term for a balanced budget which would mean the national debt would not rise in cash terms but would fall proportionately to GDP. That is certainly our policy but we have not extended our policy further to the actual liquidation of the national debt ~~as a policy~~. When we have a fiscal surplus we can take the opportunity to diminish the stock of debt and that is what we have done over recent years. If I can take the figures from memory, I think we have liquidated something in the region of £30 billion of debt, or will have done by the end of this financial year. Over the period of the last three years, That has been a very considerable liquidation of debt and that diminution of the stock of national debt has ~~this~~ a direct impact on national expenditure totals because it reduces ~~proportionately~~ the amount of interest paid on national debt. That reduction of interest has enabled us to make a significant increase in public expenditure programmes with priority like the health service and so on.

235. You have not got a medium term target as to the percentage of GDP you would like to see national debt fall down to?

(Mr Major) Not in that sense we have not, no. We want to maintain a balanced budget over the medium term. I have not set a particular target for the reduction of stock of debt, no.

Chairman

236. These are fairly technical questions but, nonetheless, questions which could have an immediate impact on our institutions. We understand the point about debt repayment and savings and interest charges but I wonder if I might examine with you the effect of public sector borrowing requirement or public sector debt repayment as far as economy management is concerned. You are at the moment continuing the policy your predecessor followed: if there is public sector borrowing requirement of funding it fully, or if public sector debt repayment was offered fully unfunding it. Could you tell us what you think the impact of a given size of PSBR is when you are adopting the policy of fully unfunding it? There are those who suggest it does not matter whether it is 15 billion or five.

(Mr Major) You say it is a technical matter and I think you have understated that, if I may say so. There are perhaps five people in the country who understand that and, fortunately, two of them are flanking me. Let me have the first crack at it.

237. I wonder who the fifth is!

(Mr Major) There are further flankers on either side, I accept that. ~~point without qualification.~~ I think the fiscal surplus in the present circumstance is a good thing for the reasons I have set out in the last few moments. It adds to the stock of public sector savings and total savings, ~~which~~ means Government is not a net borrower; we are not competing with

other borrowers, and ~~to drive~~ driving up national interest rates. It means we can diminish the national debt and the interest burden and that ~~can be taken as read,~~ I think, it is thoroughly desirable. Next ~~I said~~ you have to ask if you have future public sector surpluses, what do you do with them, ~~the public sector surplus~~? You can buy some~~thing in terms of~~ financial assets like ~~Treasury~~ bills. You cannot leave ~~it~~ the surplus to disappear in a black hole ~~like~~ as though it does not exist. So you essentially have two options: you can buy something with it ~~in terms of~~ like Treasury bills, a stock of financial assets, or you can buy in national debt, liquidate it and diminish the stock of debt and interest in the fashion that I have proposed. Now, what I think underlies your question is the question of whether one should overfund, that is for example not buy in debt for a while. I suspect that is what underlies your question, ~~not buy in debt for a while, and~~ Of course you can do that but not, I think, for very long. One of the reasons we welcome a public sector debt repayment is that it gives us an opportunity to damp down demand ~~in terms of what we do with that~~. It has been our funding policy for some time to actually neutralise that to avoid driving up short-term interest rates in the money market. One of our concerns is to draw a distinction between fiscal policy, ~~and~~ the arrival of the surplus, and our funding policy ~~in~~ (in the money markets). If we were to reduce the stock of money using our public surplus in terms of overfunding that might have the effect of driving up short-term interest rates and that, of course, is something we expressly would not wish to do. For that purpose we do tend to use our surplus to liquidate the historical stock of debt.

238. But that being so, why would one not limit the buying in of gilts to the extent necessary to maintain the banks' operational deposits? What has happened is that whereas before we rather commended the view of your predecessor that if there was a PSBR one ought to fund it fully to

prevent expansion of the money supply, you seem now by a policy of fully unfunding to give up any prospect of bearing downwards on the money supply?

(Mr Major) Let me come back to that point. That is a school of thought which I understand and which is advanced from time to time, though perhaps not as eloquently as you have just put it. ~~I think there are alternative views about that as well~~. Let me firstly come back to the point I made a moment ago about the impact ~~of~~ on long and short term interest rates. The concern I would have is if we do not neutralise the loss of liquidity that is implicit in a public sector debt repayment, we do stand the risk of forcing up short term interest rates through money market shortages. That is the concern we believe exists and which would be unwelcome. The second point which relates to that too is the need to neutralise the impact by buying-in gilts. If we do not do that, which I think is the proposition under-pinning your question, I think two consequences follow. Firstly, long term interest rates may rise and that could have the damaging effect ~~of damaging~~ on long term investment, and secondly interest rates generally might also follow. Those are the two fears we see if we were to follow that proposition. It is those fears that lead us to the conclusion funding policy should be neutral and not to distort monetary policy. It leaves monetary policy entirely free to do its own work through the impact of interest rates. That is the way I would respond to the point, but it may be either of the world's greatest experts would intervene and wish to add to that!

(Sir Peter Middleton) I think it is really very important to split this subject down, and I think there are three parts to it. The first one is fiscal policy, secondly monetary policy, and third is money market management. It is the confusion of those three together that tends to get us into this tangle. As far as fiscal policy is concerned, the

overwhelming factor, macro-economically speaking, is the size of the deficit or surplus, so if we have a surplus that is the thing which is going to be reducing private sector wealth and that is the main effect. Now of course if then you repay some debt, it will have a slight mitigating effect but one that nowhere near offsets the original effect of the fiscal policy. That is the first thing to get hold of. The second question you have to ask yourself is whether there is any monetary policy reason to fund, not fund, or do anything at all. I think by common consent the aspect of monetary policy this would affect is the broader monetary aggregates, M4. We have already had some questions on that and, as you know, our view is M4 is such an uncertain monetary aggregate it simply is not worth trying to control it by selling a lot of public sector debt. What is more, even when we did have M4 as a target, we never succeeded in controlling it by those means. The third thing is money market management: if you have a surplus you are withdrawing money from the system, you are doing that in an even bigger way if in addition to that you fund. We have taken the view that the best position to be in is a neutral one as far as the public sector is concerned, so you do not add to liquidity or subtract from it. If you did drain cash from the system on the scale which would be implied by doing nothing, or still worse funding if you had a surplus, what would happen is that your short term interest rates would be driven into the stratosphere. That you clearly could not allow to happen because by definition our short term interest rates are where we want them to control the narrow aggregates to which policy is directed. So you have to put money back into the system in those circumstances. You either have to make deposits, buy assets from the bank or adjust your position with local authorities, and so you find yourself in the position of borrowing long and lending short, putting up long term interest rates at the expense of short

ones, neither of which are very clever pieces of economic policy.

Chairman: Thank you. I think we must move on.

Mr Hamilton

239. Chancellor, I was surprised in your opening statement to hear you ascribe the up-turn in inflation to the fall-out from the Stock Exchange crash - I was not surprised to hear that but surprised to hear the importance you attached to what was actually a relatively minor tax change and yet you ignore entirely the consequences of your predecessor's policy of unofficially shadowing the deutschmark in the early part of 1988 which caused very substantial reductions in interest rates. Whilst that particular policy move may not have been the initial impulse to our present inflationary difficulties, do you not think it has protracted and intensified those difficulties?

(Mr Major) What I actually said about the Stock Exchange crash was that it was a component factor. I think it was an important component factor not because of the crash itself, but because of the impact that the crash had on the monetary policy we subsequently followed in terms of monetary policy with the reduction of interest rates, where in retrospect it might have been wiser if we had put them up. Looking back over the past two years that was a more material proposition than any other. I added to that the growth of demand that was clearly there, though it was not [illegible]seen at the time, and also the policy misjudgment we made at the time of the Budget. I did not explicitly exclude the shadowing of the deutschmark when setting out the real causes of the difficulty.

240. So you agree that the shadowing of the deutschmark at that time was another policy error which we could have done without?

(Mr Major) I do not think I want to get into that. I am here to discuss predominantly the future and the present, and I think that is the most productive thing to do. Thee are a variety of views in retrospect as to whether the policy, if indeed it was, of following the deutschmark was a wise thing to do, but certainly that is not what we are doing self-evidently now. I do not think I wish to delve back historically into what is now an arcane and historical argument.

241. I am surprised to hear you say that. It is perfectly true, unlike your predecessor, you have a future, whereas he has only a past in political terms. I do think it is an important element which we cannot put in the dustbin of history because we might find ourselves in similar circumstances again and we ought to learn from history rather than be condemned to repeat it.

(Mr Major) We all learn from history, and even chancellors are not immune from learning, and I will endeavour to do so.

242. I am sure Mr Budgen will take this point further in due course. He is a far more penetrating cross-examiner than I, having made money out of it!

(Mr Major) If I may say so, he is not going to make any money out of me!

Chairman: Whether he is the Bourbon of the Treasury Committee remains to be seen!

Mr Hamilton

243. I wonder if I could ask you another question about inflation: you have said interest rates can be brought down when inflation is brought down, can you tell us whether your measure of inflation for that purpose is the crude RPI or whether it is the underlying rate, ignoring changes in

interest rates?

(Mr Major) The forecast is on the crude level of the RPI. I think that is a precisely accurate description. That is certainly what is anticipated in the forecast.

244. In the Autumn Statement itself, in chart 2.15 which shows the growth rates of monetary aggregates, you will see that broad money is shown as broadly flat, albeit in the region of growth of around 17.5 per cent per annum, whereas the narrow measure of money, M0, has declined very substantially over the last year or so and is now just outside its target range at about 5 per cent a year. Do you think that this indicates that monetary policy is still rather too lax and that a further tightening might not be called for?

(Mr Major) There is always a time lag before existing policy reflects in the monetary aggregates, and that is always one of the things one has to take into account. It is certainly the case that narrow money is still outside its target range which at presents rest at 1 to 5 per cent and for next year is 0 to 4 per cent, so to that extent you can argue it is too lax. But there is always a time gap the M0 trend has been in the right direction. It has flattened a little more than I would have liked over the last few weeks but it is still I think in the right direction and I hope that will prove to be so. We do have a very tight policy, I think, still. It is our determination to keep it as tight as it is necessary to be in order to hit our targets and to bear down on inflation and that is certainly what we intend to do. I think you can see, if you look at the chart, the very considerable reduction there has been in narrow money over the past year or so. I think that that is clearly the result of the monetary policy that we have followed and that we shall have to continue to follow. But we have set a target for narrow money I wish to see us get

down to~~, and that is~~ it.

245. I am glad to hear you say that. I did, of course, hear previous exchanges in respect of broad money, therefore I was interested, looking at this chart and bearing in mind what you said earlier on, to see that in the latter part of 1987 and well into 1988 M0 expanded at a very rapid pace. If, therefore, it is an accurate predictor of what is going to happen in terms of price level, at <u>that</u> time one should have been pursuing a relatively restrictive policy, whereas perhaps our policy at that time was <u>not</u> as restrictive. As it has been declining very rapidly - not quite as rapidly as it rose, but nevertheless quite rapidly - over the last 18 months, does that indicate that you expect inflation to respond pretty smartly over the next 18 months or so, and therefore you will <u>not</u> be required to protract the slow-down in the growth of the economy which you have been talking about?

(<u>Mr Major</u>) I think there are two points about that. On the latter point firstly, inflation is a pretty stubborn proposition. As you mentioned a moment ago, our forecast for inflation is that it will get down to $5^{3}/_{4}$% by the fourth quarter of next year. That is where we think it will be. So it <u>will</u> be fairly stubborn, and in terms of getting inflation down to the sort of level that we would like ~~to see it~~ and getting it on a downward trend (which I think is equally important in terms of confidence) we have to maintain a pretty firm monetary policy for some time, in my judgement. On the growth of M0 ~~to A~~, if you look at ~~the~~ chart 2.15 it actually shows ~~a~~ rapid growth in the spring of 1988, and I think there are two points particularly to make about that. Firstly, interest rates were raised in advance of that. They were in fact raised in advance of the Stock Exchange crash, if I recall correctly, in August of 1987 (I think it was August). They went up unexpectedly in the market's eyes from 9% to 10%, as my

predecessor had seen the danger signals in terms of the growth of M0. But with the slackening of monetary policy after the Stock Exchange crash, for the reasons we set out before and which I think are well understood, you then see the growth in M0 in the middle of 1988. So I think that that is a material point. As for the future, we certainly do need to get inflation down from the level at which we find it at the moment. That is why, although I expect the measures we have got in hand to work, we will need to keep at it perhaps for some considerable time.

246. You see, what concerns me is that the broad money M4 trend, in so far as it can be discerned, is that it has flattened out at a level which is higher than at any other time in the last decade. Although M0 may be declining very rapidly, I personally cannot see how logically it can be a sensible predictor of what is going to happen, whereas broad money I think can be. Nevertheless, you still discount the importance of broad money?

(Mr Major) I discount it only because of its historical record. As I think Sir Peter pointed out earlier, broad money was at the same sort of level ~~the inflation level was~~ at ~~the approximate~~ times that levels of ~~broad money~~ inflation were very materially different. So ~~that~~ it is extremely difficult to draw ~~accurate~~ policy conclusions from broad money. If one had a firm framework in which one could be absolutely certain what was going to happen when one saw the change in levels of broad money, that would be extremely agreeable, but history tells us there is no ~~ps~~ relationship of that sort. Therefore, although you must clearly look at it, take it into account and see what it is doing and wonder what that might mean, I do not think you can actually pin firm policy decisions on it at the moment; it has just been too erratic historically.

Mr Budgen

247. Chancellor, I would like to give you an opportunity to reconsider one of your answers. You said somewhat earlier that in your opinion increases in wages, unjustified by productivity, were as likely to cause unemployment as they were likely to cause inflation. Could you explain to us how wage increases cause inflation? If they cause inflation, why do not we have a wages policy immediately?

(Mr Major) The latter part of the question is perfectly straightforward. If we were to seek to have a wages policy one would see, as in the past, that it was ~~an~~ unsustainable proposition; it would be bypassed in a hundred ways, as it was in the past. It was unfair, it was arbitrary, it was unworkable. Apart from that, I think it is undesirable.

248. But did it cause inflation?

(Mr Major) So for those reasons, I do not favour that. The extent to which wage increases may cause a rise in inflation is ~~in~~ the extent to which unjustified wage increases tend to be passed on in prices to the consumer. ~~I think that~~ In an increasingly competitive market (the point that I was seeking to make in answer to the earlier question), I suspect to a substantial extent that if there are unjustified wage increases, over a reasonable period - over a reasonable period - that is more likely to reflect in a loss of jobs as firms struggle to keep competitiveness than in an input to inflation. That is what I would expect to see, because in the competitive environment that exists at the moment companies need to keep a very tight control of their costs.

249. Chancellor, I am not arguing with you about the question of whether it causes unemployment or not. I am asking you to consider carefully what you mean by "causing". I put to you that there is only one way in which inflation is caused, and that is by an increase in the money

supply, something over which the Government has exclusive control, and that all the other things that you are talking about as causing inflation are merely consequences of it.

(Mr Major) I am perfectly well aware of what you are saying, and I am perfectly well aware of the theory that underpins it.

250. Have you abandoned it?

(Mr Major) It is not, if I may say so, a theory universally accepted (if I may quote from the outset of a famous novel). The point I was seeking to make, and which I thought I had made clearly before, was that the knock-on effect of wage increases before they manifested themselves in unemployment - which I think in a short while they might do - would be to increase the prices of goods in the market and consequently have an inflationary impact. After a while I think the increasingly competitive position in which companies have to operate these days could mean that that would be bound to reflect in unemployment, but in the short term it might not immediately do so.

251. Have you abandoned the theory?

(Sir Peter Middleton) No. If I might say so -----

252. Let the Chancellor answer for himself. It does seem to me to be a political point of some importance.

(Mr Major) I think that if Mr Budgen will answer a question for me, we might then be in a clearer position to deal with his particular question. On his point, which definition of money - M0, M4, some other M - does Mr Budgen think actually causes inflation? That is one of the first things that one needs to determine before one enters into an arcane discussion about whether monetarism pure and simple is the right way in which to manage the economy and to bear down on inflation.

253. It is not for me to be so impertinent as to answer your questions! I am here as a humble questioner! Surely the argument about the indicators is as to whether they are reliable as to the extent to which money is increasing in its supply. But the word that is important here is the word "cause". I am putting to you that inflation can only be caused by an increase in the money supply, however that may be either judged or later regulated. That theory used to be the theory that this administration followed, as you I believe conceded. Does the Government still follow that theory?

(Mr Major) I think you answered your own question yourself, Mr Budgen, when you said that used to be the theory, in your judgment, the Government may have followed some time ago. It certainly has not been the theory, ~~if indeed it is a theory,~~ that the Government have followed during any period ~~in which~~ I have been in the Treasury. I do not think you can boil down all the causes of inflation to such a simple and straightforward judgment. It is necessary to take a very careful control of the monetary aggregates and we have discussed earlier the extent to which we do that and ~~the extent to which we~~ keep monetary conditions tight and the extent we take into account a whole series of monetary indictors, including the exchange rate in doing so. I am myself dubious as to whether the argument rests simply on the straightforward monetary principle you enunciated and which under-pins your question.

254. So you presumably then also say that falls in the external value of the currency cause inflation?

(Mr Major) I think if you have a fall in the external value of the currency for a material period of time it is bound to loosen monetary conditions and therefore have an effect on the inflation rate, yes.

255. How does it loosen monetary conditions?

(Mr Major) I think Mr Budgen will be well aware in terms of the exchange rate policy we have followed for some time we have taken the view - and I share that view and I did when I was at the Treasury before and I do now - it is worthwhile to have a firm exchange rate to bear down on inflation with all the other elements of monetary and fiscal policy as well. That over a period of time has proved a successful policy for us, and it is the policy I shall continue to follow in the future. As to the judgment as to what is or is not a firm exchange rate, that is a matter which one has to consider as and when necessary, and it is undesirable to spell that out in a form on which you will subsequently question me, and I have no intention of responding to questions of that sort. What is absolutely clear is that we shall have to do whatever is necessary in order to keep inflation on a downward path, and I do not intend to allow a falling exchange rate or anything else to undermine that policy.

Chairman: I think we must move on.

Mr Budgen

256. Thirdly a change in the exchange rate affects some prices but not all prices. How can you say that a fall in the exchange rate causes inflation?

(Mr Major) I think, Mr Budgen, you may accept from me a fall in the exchange rate most certainly affects import prices.

257. Yes, some prices.

(Mr Major) And you will certainly, I hope, also acknowledge that import prices have a material effect - undoubtedly have a material effect - on the output prices in due course. To that extent a loosening of monetary conditions and a fall in the exchange rate must over a period of time affect the levels of inflation. I think that is a principle well

understood.

Dr Moonie

258. Chancellor, just to come back to the real world from the arcane realms of monetarism for a moment, I was interested in your statement earlier in these questions of your support for the Prime Minister's idea that the paramount policy is to bear down on inflation. In February of this year however you said, "The first economic duty of government is to safeguard the value of the currency." How do you reconcile those two statements?

(Mr Major) I would have thought bearing down on inflation was certainly necessary to safeguard the value of the currency. Nothing destroys a currency more than inflation.

259. So you were stating the same thing in two different ways?

(Mr Major) Yes.

260. In measuring the pound against the deutschmark, it was 3.29 and it is now 2.79, is that what you would call safeguarding the value of the currency?

(Mr Major) In terms of the mark there has been a very considerable shift in the exchange value, but there are two elements to that. One is the movement of sterling on the effective rate index and the other is the movement of the mark on the effective rate index. It is certainly the case that the exchange rate value of sterling rises and falls from time to time, that is undeniably the case. What we have to ensure over a period of time is that we maintain a firm exchange rate and that is what we will seek to do. That does not mean it will be a rigid exchange rate against each and every currency under the system we at present operate; that cannot be so.

261. We are not just talking about the mark, 50 per cent of our trade is with countries whose value is pegged against the mark.

(Mr Major) If you look at the exchange rate of sterling you will find it is to within a whisker of being precisely the same - and I am taking the effective rate index so it is against a basket of currencies rather than the mark, which is the ~~one rather bizarre~~ the example you give - ~~effective rate~~ as it was at the beginning of 1987.

262. Some of us might disagree with that.

(Mr Major) That is a matter of fact.

263. Why are you not cutting interest rates, since your battle is to control inflation? You are afraid of recession but your present high interest rates are certain to push us over into one. There are signs demand is falling now, should you not reduce interest rates rather than battle against inflation?

(Mr Major) I find it quite reassuring that I am being urged on one side (not necessarily on this Committee) to increase interest rates and on the other to reduce them. That suggests to me we might have the right interest rates at the present time. We will certainly look regularly at what interest rates are and we will certainly make our judgment on the basis I set out earlier to ensure we bear down on inflation, and what that means in the future for interest rates, what happens to monetary aggregates, the exchange rate and other factors as well.

264. How much have we spent on intervention over the past three months?

(Mr Major) The figures [for the changes in Reserves] were released this morning for the past month - at least I hope they were, somebody had better kick me if they have not been released yet - 931 million dollars for the last month. We spent 2.8 billion, 2.877 [2695] to be exact, in the month before, and in the month before it

was a relatively modest sum but I do not carry the third month in my head.

265. Would you agree a central element of your policy is to maintain the value of the pound at the present time?

(Mr Major) I think the intervention figures speak for themselves. We have been prepared to intervene to sustain a firm exchange rate and intervention is necessary in day-to-day market conditions.

266. Would you sum up what is your exchange rate policy?

(Mr Major) I set out the exchange rate policy perfectly clearly a few moments ago, and I will reiterate it again. Unless one uses the same incantation one runs into all sorts of difficulties with commentators who comment on these important matters, and in fact you run into all sorts of problems if you actually neglect to make the same incantation you made the week before, so I will be boringly tedious and say yet again ---

267. Why break the habit of a lifetime?

(Mr Major) ---- that was our policy and remains our policy.

268. Does a firm exchange rate policy therefore mean you have a commitment of no further fall in the value of sterling? Yes or no?

(Mr Major) I think nobody would be more surprised than you if I were to answer that question, except perhaps me! I admire your skill in attempting to get an answer to that unanswerable question!

Mr Sedgemore

269. I take it, Chancellor, that it is axiomatic from what you have said to Dr Moonie that a 15 per cent devaluation of the pound against the deutschmark, from 3.27 to 2.80, occurred not because of Government policy but in spite of Government policy?

(Mr Major) Of course the deutschmark has appreciated against all currencies almost without exception over the period of the last few months.

I do not think it would have been accepted by anyone in this Committee - indeed I might have been running into some difficulty had I admitted to shadowing the deutschmark over the period of the last few months. I concede freely, Mr Sedgemore, there has been a drop in the effective rate index over the last few weeks but I do not think necessarily taking the deutschmark as the benchmark is the most accurate reflection of what has been happening to the value of sterling.

270. So has the 10% devaluation against the dollar occurred because of or in spite of government policy?

(Mr Major) I think the effective rate index - which has declined, as I said a moment ago - is undesirable, but it has occurred, and from time to time currencies go up, exchange values go up and exchange values go down. That has happened before and no doubt will continue to happen again, both up and down. It depends which period of time you take. If you were to take, instead of the timescale that you are taking in your question - you are perfectly entitled to take that timescale, but if you were to take a longer timescale - and if you were to take from the beginning of 1987, as I remarked a moment or so ago to Dr Moonie you would find our effective rate index was precisely the same.

271. Chancellor, we only took that timescale because it related to a statement that you actually made in Hansard on 9th February 1989, Volume 146 column 1154. But leave that aside for the moment. During the first 10 months of this year we have had a visible trade deficit of £20 billion - the worst in our history. Reading your speech in Hansard of 28th November 1989, columns 595-597, you seem to be saying that that was a wonderful expression of the strength of our manufacturing industry. Is not that using words a bit like Humpty-Dumpty used them in Alice in Wonderland?

Would not it be fairer to say that the figures demonstrate a fundamental weakness in UK manufacturing industry?

(<u>Mr Major</u>) No, I do not think it <u>does</u> demonstrate a fundamental weakness in manufacturing industry. Indeed, if you actually look at the performance of manufacturing exports, I think that would argue <u>against</u> the fundamental weakness in manufacturing industry. The point I was seeking to make in the extract to which you have referred was the sheer scale of manufacturing capital investment in its future productivity capacity. I think that that is ~~a~~ desirable ~~thing to do~~. What is undesirable in the short term is that so much of that capital investment in new machinery has meant that the new machinery has had to be bought in from abroad and has widened the balance of payments in the short term. So you have had two effects. You have what I consider a very desirable thing, which is that the manufacturing industry is investing in fresh capital machinery to improve its productive capacity. All of us would agree that that is a good thing, because we wish to see the strongest possible manufacturing industry and the greatest productive potential of manufacturing industry. In the short term what is less immediately attractive is the effect ~~that~~ that has on the balance of trade, for clearly it widens it to the extent that that machinery is purchased abroad, and a good deal of it has been.

272. I think Mr Radice and I have agreed that he will blow you out of the water on that one, so perhaps I could move on. Both the previous Chancellor and the Chief Economic Adviser to the Government, who is sitting beside you, have told us that this mega-balance of payments deficit of £20 billion forecast for this year is self-correcting. I will pause for you to turn to the page, if that is all right. I must confess that generally I have not understood what either of them has been saying. Could I ask you what <u>you</u> think they have been saying? Could I give you a

quotation from Professor Brian Reading, who is sitting across there? I do not agree with Professor Reading on very much, but I think I do agree with him on this, and I suggest it is irrefutable. He says: "... the mechanism which automatically corrects a balance of payments deficit is the exchange rate. When the private sector can no longer borrow to go on overspending, the exchange rate falls. The payments balance is thus only self-correcting if the exchange rate is allowed to float freely. Trying to stabilise the pound is incompatible with treating the balance of payments deficit as self-correcting." I suggest to you that that is not only true by definition, it is almost tautological.

(Mr Major) In so far as Professor Reading is concerned, he perhaps should have the right of reply, since you say you do not always agree with him. No doubt he will take it up, but perhaps not in this particular forum. In so far as the remarks which you attribute to, I think, my predecessor and also to the Chief Economic Adviser are concerned - who is more than capable of answering for himself if he wishes to this afternoon - over a period, yes, the current account must be self-correcting; it has to be self-correcting over a period. The more relevant question - and I will return specifically to your question - is whether the deficit matters.

273. That is not my question.

(Mr Major) The best answer is, as to whether the deficit matters -----

274. That is not my question.

(Mr Major) I will come on to answer your particular question.

275. Could you answer my question?

(Mr Major) I will answer it, if I may, in my own way.

276. You can waste 10 minutes on that, but we are time-limited here. Will you answer the question I asked?

(Mr Major) I will if you will let me, but I will answer it in my own way and not in the way that you choose that I should answer it! The more relevant question is whether the deficit matters. The best way to answer that is whether you prefer to have it or not, and obviously not. What the deficit actually reflects is essentially a private sector deficit. A fall in private savings combined with a rise in private investment - that is actually what creates the deficit. Such a private sector financial deficit is very rare indeed. There was one in the 1940s. I do not know whether there has been another since the 1940s. The Chief Economic Adviser will perhaps tell us. That must mean - it can only mean - that the private sector is running down its net stock of financial assets. That is the only conclusion one can draw from that. If that is the case, that has to stop and it has to correct itself. Although it is not for me to define what was in my predecessor's mind when he answered the original question about whether the current account deficit is self-correcting, I can only assume it was that. To that extent the current account deficit must be self-correcting over a period of time.

277. But how can it correct itself unless you are using deflation, depreciation or some kind of import controls? What is the mechanism through which it self-corrects?

(Mr Major) Because the private sector financial deficit cannot continue. The stock of private sector financial wealth which is being run down cannot continue and must of necessity reverse itself. To the extent that it does reverse itself, it is bound to correct the current account deficit. That is the point, I am sure, that Nigel Lawson would have had in mind, and I think that is the way in which his answer should be interpreted.

278. Can I be clear? Are you saying that there is a fourth mechanism for dealing with a balance of payments deficit, which lies outside of devaluation and depreciation, which lies outside of deflation and which lies outside of some form of import control?

(Mr Major) No.

279. There is a fourth self-correcting mechanism?

(Mr Major) I think there is a form of self-correcting mechanism, and this is that eventually the private sector is going to move back into surplus. If that is so, as long as private sector financial wealth is maintained, the current account deficit will tend to cure itself as firms and individuals increase their savings or reduce their investment. I strongly suspect that the fall in private savings is probably in any case partly temporary - partly temporary. How temporary I cannot say, as it reflects the adjustment you have seen to the financial liberalisation we have seen in ~~the period of~~ the last decade and the inflation we have had in the 1980s. So I think that to that extent, yes, it is a self-correcting mechanism.

(Sir Terence Burns) Could I add one point, Chairman. Mr Sedgemore seeks to imply in the question today, as he did with me the other day, that somehow or other all that happens in the world is created by governments, that things only happen if governments do things.

280. No, I did not!

(Sir Terence Burns) The reality is, in which case I say to him how did the deficit arise in the first place, because it certainly did not arise through any of the factors that he is now suggesting as the only way in which it could be corrected. The deficit arose in the first place because of the behaviour of the private sector. That behaviour was not entirely, or it was not at all, in response to the movements of the

exchange rate, it was due to the balance of its saving and its spending. It seems to be eminently plausible that deficits can correct themselves in much the same way as they arose in the first place. I would simply point out that there are also many examples in history of deficits emerging and disappearing in periods of fixed exchange rates. The idea that you only see this kind of behaviour under floating exchange rates has no basis in history.

281. Then you deflate?

(Sir Terence Burns) It does not require deflation. It can be simply the product of the way in which individuals and companies react to circumstances, based upon the way that they have behaved in the past.

282. Could I ask you one last question, Chancellor, and it is about financing this deficit. I am sure you will be aware of the research of Nigel Pain from the National Institute who has pointed out that between 1988 and 1989 the current account has worsened by about £7 billion and the net capital outflow on long-term capital account has grown by about £18 billion. Gavyn Davies, who I believe is also in the room - I hate to quote these eminent establishment figures! - says: "Far from financing the current account deficit, long-term portfolio investment and direct acquisitions of foreign companies have also plunged deeply into the red. Therefore the outflow which has to be financed out of the reserves, or by attracting 'hot money' into the country, has more than doubled to over £50bn this year. These staggering sums show little sign of improving." If I understand that, what that means is that you have got two choices. One is that you can raise interest rates above 15%, and the other is that you can actually let the exchange rate depreciate. So given that it is probably politically impossible for you to raise interest rates to 16%, does that mean that as a matter of fact we should expect the exchange rate

to depreciate?

(Mr Major) If I can take the last point first, I think it would be very unwise to make the assumption if necessary interest rates would not rise. I think it would be very unwise to commence with that assumption. Insofar as the point you have attributed to Gavyn Davies is concerned, he is a very distinguished commentator and I read him with very considerable pleasure and I was not aware he was here - I am pleased he is. On the subject of the capital flows, it is very hard to be precisely sure about the composition of capital flows, very hard indeed. If you take the figures for example for 1988, there was a current account deficit of 14.5 billion, with identified capital inflows of only £2.5 billion, and that means there is a discrepancy of over 12 billion which we reflect as a balancing item. That reflects errors in either the capital or current accounts, but we do not know which, or perhaps in both. Either there have been larger net capital inflows or the current account deficit has been overstated; one is correct. Because banking flows tend generally to be well measured, I presume it is larger inward capital flows which are most likely to have been missed. The question then arises as to the use of the terminology you have used and which is regularly used - is that hot money? I ask the question, what precisely is hot money these days? The distinction between short and long term capital flows is neither easy to determine nor necessarily meaningful, because in the deregulated economy we have these days it is easy to acquire or dispose of most assets quickly and that is certainly the case and it is almost irrespective of what the nature of the investment might be. Investment in equities and bonds may be just as easy to liquidate as bank deposits, and even direct investment can be pretty highly volatile these days, as you yourself have remarked in debates on the floor of the House, particularly in the growth of

acquisitions and mergers and cross-border mergers most noticeably within the European Community. So not all bank deposits are short term and I think it is dangerous to refer to them as hot money.

Chairman: As to who is or who is not in the public gallery, the same rules apply here as apply on the floor of the House.

Mr Radice

283. Chancellor, you have explained the deficit, our very, very large deficit, mostly, as far as I can see, in terms of the British Government's invention, but if you look at the figures for 1987-89 you find 29 per cent of the deficit is accounted for by consumer goods and only 3 per cent by capital goods. So surely the answer which those figures suggest is that in fact there is a very large surge in imports which comes from consumption.

(Mr Major) There is a surge of both.

284. You did not mention that before, so it is worth pointing that out.

(Mr Major) If you had permitted me, I was about to mention it.

285. Good.

(Mr Major) There is certainly an element of both. I referred earlier to the extent to which the private sector can go into deficit. It is most unusual for there to be at the same time a fall in the private sector savings ratio and an increase in the private sector investment ratio. Maybe the Chief Economic Adviser can tell you when that last happened but it is certainly a very rare event indeed, and I think the conjunction of those two events clearly had a very dramatic impact on demand, and that dramatic impact on demand has of course reflected itself to a significant extent in the balance of trade and balance of payments figures overall.

That is undoubtedly the case. What is also true is there has been a significant amount of investment. The growth of investment in manufacturing industry, 14 per cent growth of investment over the past three years, is almost unprecedented. I cannot recall when there was such a growth over such a relatively brief time and, alas, a good deal of that growth is reflected in the import figures.

286. Granting the fact over the last three years there has been growth in manufacturing investment, and welcoming that, is it not also the case there are some disturbing features in our imports? The fact that in the early 1980s we had a surplus of manufactured goods whereas today we are running an over 17 billion deficit in manufactured goods? Does that not concern you?

(Mr Major) If I can talk about imports overall, because that is what reflects in the figures, it is perfectly true that import penetration has risen continuously over the period of the last 20 years. There is a chart somewhere. You can see there, whether you take the volume or value although volume is probably better, imports penetration has risen continuously almost in a straight line since 1970 over a period of the last 20 years from around 10 per cent of total domestic demand to 25 per cent of total domestic demand. That is as shown on chart 2.6. Rapid growth in demand also can cause a very rapid growth in import penetration, and that is what I think we have seen in the period of the last two years. Import penetration now is 25% of total domestic demand, as opposed to 10% in 1970. It is interesting to note, incidentally, that import penetration in Germany is even higher at 27% rather than the 25% we have and just under 25%, I think, in the United States. So it is a rising trend in a number of countries and I think probably reflects an increasing specialisation in production that we see these days.

287. That may be so, but of course West Germany has an advantage of being able to pay for those imports by exporting in sufficient quantity and at sufficient value. Unfortunately, that is not the case in this country. You have explained, in contrast to the previous Chancellor, that you believe that the deficit <u>does</u> matter, and you agree with Sir Terence Burns that no one is ever comfortable with deficits on this scale. Why do you think it matters?

(<u>Mr Major</u>) I think that self-evidently the deficit matters. ~~I think that in a curious way~~ .... Let me put it this way. A number of countries have run a deficit for a very considerable period of years. There is nothing unexpected or especially damaging ~~over~~ about running a deficit for a period of years. What has actually happened in the last year or so has been the very rapid move from surplus to deficit. I suppose in a curious way one of the most damaging aspects of that is not the reality of how you have to finance it, or what it actually means in terms of the productive capacity in a particular country present or future, it is the impact it has on other people's perceptions of what may actually be happening in the economy. I think that is something that ought not to be understated. What we saw, I think, over the last couple of years with that very rapid swing was firstly the very rapid growth in consumer demand, and a very rapid growth in consumer demand and private sector investment at a time when the productive capacity of domestic industry was fully utilised. What we are going to see in the future is a contraction of consumer demand, a falling back of investment. I think both personal savings ratios and the corporate sector investment ratio will improve, and also I think the supply side changes will improve the productive capacity of domestic industry. That should help us both in terms of more exports - and our export trend is still up - and obviously more import penetration substitution. I think we

are going to see an improving position, and that is reflected in our forecast.

288. That brings me to my second-to-last question. When you made your Autumn Statement I said to you on the floor of the House that the only way deficits can be reduced is either by recession or by depreciation, or both. You answered that I was entirely wrong, but if you look at the figures you will find that the value of the pound has depreciated 12% against the deutschmark since the beginning of the year, so there clearly has been depreciation. In answer to Ms Abbott, you made quite clear that there is going to be a considerable slow-down in demand and in fact it is within the range of error that there could be a recession. Your definition of that was two quarters of falling output. So in fact you were wrong to say to me that I was entirely wrong about that, were you not?

(Mr Major) I am grateful for your assessment that I was wrong. I am not sure that I entirely sign up to the proposition. I think that there are two other things that need considering. The first is the impact of supply changes and improvements. I think nobody doubts that there have been those and, indeed, they will reflect in the increasing capacity of domestic industry. Secondly, there is the question of competitiveness, for I suspect the best overall indicator of competitiveness is the share of world trade. That has changed very little really since 1981 following decades in which our share of world trade in this country actually declined; since 1981 it ceased to decline and remained flat and it actually increased slightly last year and we project it to remain flat again in 1990. So those are extra factors that you omitted which are worth considering.

289. Of course share of world trade is imports as well as exports, and as you have rightly pointed out import penetration has increased

considerably, so it is not surprising our world share of trade has not gone down.

(Mr Major) If you actually look at our projections of imports and exports next year, you will see we expect that although import penetration will increase as a proportion we forecast the balance will get better over the period of the next year.

290. I hope you are right.

(Sir Terence Burns) There have been many occasions in the past when the share of world trade has declined and import penetration has risen. That is not as unusual as Mr Radice suggests.

291. I think you have made clear this afternoon that you want to see a firm pound, would you like to see the pound firmer than it is at the present moment?

(Mr Major) I do not think, Mr Radice, that you would answer that question if I put it to you! I do not think you expect me to answer that question if you put it to me!

292. I will try you on another question: what is the impact of depreciation at the level we have had on inflation? I understand there is a Bank of England rule of thumb that a 10 per cent change in the exchange rate has an impact of 2 to 3 per cent on inflation over 2 years. Is that an accurate assessment?

(Mr Major) That is a question which might more prudently be asked of the forecasters than of me. Let me say I do not think you can look at it in that purely mechanistic fashion. At any time in the economy there are a whole series of different factors at work which will determine both the inflationary impact and have their own relative impact on the exchange rate. So I do not think that is a proposition which I think you can look at in quite the mechanistic fashion you put it to me.

293. That is interesting because in the new Treasury model project it is said a 5 per cent change in sterling leads to a change of 4 per cent in the RPI over 4 years, which is another way of saying the same thing, so it may be mechanistic but your own Treasury is saying precisely that.

(Sir Terence Burns) I can assure you there is nothing more mechanistic than the particular numbers you are quoting from, because that is more or less the way you could headline it.

294. I think you made quite clear to Mr Budgen, you explained to him very carefully, that depreciation does have an impact on inflation. You would accept that, would you not?

(Mr Major) I am not sure I convinced him!

Mr Radice: You have convinced the Committee as a whole. You have convinced me anyway!

Chairman

295. Chancellor of the Exchequer, we are very grateful to you for coming this afternoon. I wonder if I might try one last question: when the present Government came to power in 1979 it was said to be a monetarist government, that is to say a government whose economic policy was based on controlling the supply of money, although Professor Milton Friedman in evidence to our predecessor denied the policy which was being followed was indeed a monetarist policy. Would you agree that the essence of your present policy is one of controlling the price of money, that is to say interest rates, rather than the supply of money?

(Mr Major) I am not at all sure I would ~~except~~ accept quite the division that you have in mind. We are certainly concerned with monetary policy ~~or~~ and controlling the price of money. I think that and all the other policies we have in place have their own impact on the monetary aggregates, and as I

mentioned earlier we do look very carefully indeed at monetary aggregates. Monetarism has many fathers and many imitators and to the extent we look carefully at monetary aggregates we are certainly concerned with monetary policy, ~~that is undoubtedly so~~. But I think there are other things we can look at as well, and I have attempted to set out some of those for the Committee during the period of our discussion this afternoon.

Chairman: Chancellor, we are very grateful to you. I think we can all agree on one thing: that the degree of scrutiny of economic policy and certainly the extent of accountability of Ministers has been greatly enhanced by the development of the Select Committee system, and I think that that is something with which, after the last hour and three-quarters, you would agree. We are extremely grateful to you. We shall try to do our best to produce a report which is helpful in our task of monitoring the Treasury. We are very glad indeed that you and Sir Peter and Sir Terence have been able to be with us this afternoon. Thank you, all three of you, very much indeed.

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pf.dc.oct.31.3

UNCLASSIFIED

FROM M C SCHOLAR
DATE 31 OCTOBER 1989
EXTN 4389

MR GIEVE

Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Wicks
Mr Peretz
Mr Walsh
Mr O'Donnell

Mr Gray - No 10
Mr Footman - B/E

AN INDEPENDENT BANK OF ENGLAND: MR LAWSON'S SPEECH ON 31 OCTOBER

As you requested, I attach a line to take, which I have cleared with Sir Peter Middleton and Mr Gray at No 10.

MCS

M C SCHOLAR

UNCLASSIFIED

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Domestic Mon Pol

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DATE 31 OCTOBER 1989
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Mr Footman - B/E

RA

AN INDEPENDENT BANK OF ENGLAND: MR LAWSON'S SPEECH ON 31 OCTOBER

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MCS

M C SCHOLAR

UNCLASSIFIED

An independent Bank of England: Mr Lawson's speech on 31 October

Q **Is it true that Mr Lawson presented a fully-worked up scheme for an independent Bank of England to the Prime Minister last year?**

A I understand that Mr Lawson put a proposal to the Prime Minister in late 1988 on this subject.

Q **Why was the scheme turned down?**

A Not prepared to disclose confidential discussions within government which take place on many subjects.

Q **Were the Bank of England consulted?**

A. No. [The proposal did not get that far.]

Q. **May we see the paper? Will you publish it?**

A. No.

Q. **What did Treasury officials recommend?**

A. Not the practice to disclose official advice to Ministers.

Q. **Was the new Bank of England to be modelled on the Bundesbank/ Fed etc etc?**

A. Not the practice to disclose confidential official advice.

PRIME MINISTER

cc Mr Ingham
Mr Powell
Mr Gray

RESIGNATION OF MR LAWSON

Although Mr Lawson's explanation for his resignation may appear to be a direct attack on you, I believe that it is possible to turn it to advantage. There are signs that a more favourable interpretation of events is emerging e.g. today's Daily Mail and the Leader in The Times. Also market reaction is increasingly seeing Mr Lawson's departure as a boon.

I believe the correct interpretation of events is that at the end of 1985 Mr Lawson and Sir Geoffrey Howe made a pitch for sterling to join the EMS. They failed to persuade you but Mr Lawson then sought to get into the EMS via the back door.

This failed for two reasons. First, his timing was poor. He genuinely believed that pegging to a low inflation currency would ensure, taking one year with another, that policy in this country was kept tight. But he happened to choose a moment when sterling was recovering after a long decline against the DM.

Secondly, and more fundamentally, he failed his own test for a successful policy framework. He argued that a country such as Britain could run an independent monetary policy with a flexible exchange rate; or it could fix its exchange rate to a low inflation country, with monetary policy directed to sustaining that link; but not hybrid. But he did precisely that.

Because he did not disclose his exchange rate regime he incurred all the costs of trying to link to another currency without any of the advantages of being in a structured system. For example, if we had been in the EMS in 1988 it is possible that there could have been a small revaluation, say from DM3.00 to DM3.10. That, in my view, would have ended speculation abut a further move as the market would have regarded this as most unlikely in the foreseeable

future. In fact, pressures took sterling to DM3.28 and in seeking to resist it we reduced interest rates to levels which were quite inappropriate. (It was this rather than intervention which did the damage as most of the intervention was sterilised.) The Chancellor has also failed another of his own criteria. He endorses the principle that differences should be resolved either in private or collectively but his shadowing of the DM was neither.

The Times Leader attached says that:

> "There has been no major dispute over policy but merely honourable disagreement about emphasis on one part of it."

Three points follow from this:

- it is nothing to do with your present style or the role of advisers but relates to a difference of view about the timing of our entry into the ERM

- it has proved that dismissing your adviser would not have achieved anything as the disagreement would have remained

- it was the Chancellor who withdrew support for the policy position agreed, not you. If he wants to join the "EMS as soon as possible" camp that is his privilege, and he had done the right thing by resigning, but it is he who is departing from the agreement reached at Madrid.

On the line to take, I suggest that you do not highlight the historic origins of this dispute as there is no advantage in publishing the policy errors that it produced. It is more important to stress that there is an agreed position between you and the new Chancellor and Foreign Secretary, and that the conditions set out are not attempts to raise the bar to a height

which cannot be jumped but a genuine concern that when we join we do so successfully. We need to remind people that sterling has entered a European exchange rate regime before and has had to leave. We need to get across that the removal of exchange controls will be a major challenge which France and Italy need to negotiate successfully if the expanded ERM is to be launched in favourable conditions. For example, Italians are large scale savers, most of which is channelled into Government debt. If they are given the choice of financial assets across the world the Italian Government's monopoly will be broken, which could cause a major rethink about their fiscal policy.

Mr Baker is anxious to put across the view that there has been no major difference between you and the Chancellor. I see no point in trying to disguise this - the effort should be to stress the consistency of your position and the validity of the conditions you have set.

AT

Andrew Turnbull

1 November 1989

c: Lawson (MJ)

THE TIMES
WEDNESDAY 1 NOVEMBER 1989

1 Pennington Street, London E1 9XN Telephone: 01-782 5000

PANIC OVER

The Conservative Party has understandably been deeply disturbed by the crisis in the personal-political relationship between the Prime Minister and Mr Nigel Lawson, which led to the latter's resignation as Chancellor of the Exchequer. Though, as the recovery in financial markets has demonstrated, there is, and has been, no economic or financial crisis, and though no serious question has been raised about the broad lines of the Government's economic policy, the evidence of a significant disagreement between the Prime Minister and the former Chancellor over the British commitment to eventual membership of the ERM (exchange-rate mechanism) was serious enough to shake confidence in ministerial solidarity.

Mr Lawson was fully supportive of the Prime Minister and Cabinet in general terms yesterday, but he left no room for any doubt that the disagreement between himself and Mrs Thatcher had been a real one. Prime Ministers, he said, must appoint ministers they trust and differences between them should be resolved privately.

By implication he made it clear that he did not consider that these conditions had been fulfilled in his recent relationship with Mrs Thatcher. He also described the recent article by Sir Alan Walters which denigrated the ERM as only "the tip of a singularly ill-concealed iceberg," which left the Commons to make up their own minds about how far Mr Lawson considered the base of that iceberg to be largely Sir Alan's broader influence and how far it comprised Mrs Thatcher's own wish to put a brake on British membership of the ERM.

But it is now clear that a synthesis has been reached between the apparently different positions held by the Prime Minister on the one hand and other Cabinet ministers who are nearer to the position Mr Lawson has held. The clear commitment to that synthesis was perhaps the main point of Mr John Major's first speech to the Commons yesterday as Chancellor.

Over the weekend, Sir Geoffrey Howe had made a speech declaring that the Government must be seen to be acting in good faith in implementing the Madrid agreement and the commitment to enter the ERM. Mrs Thatcher, on the other hand, had so heavily stressed the conditions and the difficulties other member states might have in fulfilling them as to leave doubt about how far she was hoping they would not be fulfilled.

Mr Major, however, united these positions by both endorsing the conditions which Mrs Thatcher had enumerated and at the same time declaring unambiguously that Britain will join: "The question is not whether but when." That is henceforth the Government's position.

Whether Mr Major's enumeration of the conditions will satisfy Mr Lawson's criterion that we should seek membership at the earliest date remains to be seen. But it is a synthesis on which government policy can unite and on this assumption, the Conservative Party should now put behind them the temptation to panic to which some backbenchers have yielded, particularly in respect of the leadership, in recent days.

It is worth repeating again; there has been no major dispute over policy but merely an honourable disagreement about emphasis on one part of it. The party's backbenchers have no cause for timorous pessimism. Mr Major has made it clear that the Government's policies will continue and Mr Lawson has declared his confidence that they will lead to a fourth election victory under Mrs Thatcher. Tory backbenchers should respond accordingly and accept that now the drama is over, they should put the agitation of the last few days well behind them.

SUMMITRY AFLOAT

Yesterday's unexpected announcement that President Bush and President Gorbachov are to meet in the Mediterranean at the beginning of December was presented by spokesmen for both countries as little more than a familiarization exercise from which no agreements could be expected. The decision, reportedly initiated by Mr Bush, to bring the first superpower summit of his presidency forward by half a year will none the less raise hopes about what might be achieved.

leadership to stay in power, and at what cost? The Soviet leader would like an answer as he prepares for the next Communist Party Congress which is set to address such fundamental principles as private ownership and the role of the party.

President Bush and his advisers should be alert not only to the possibilities, but also to the pitfalls, of so hastily arranged a meeting. They might cast their minds back to the last summit called at short notice in a third country...

Getting to g[...] with 'hackin[...]

From the Chief Executive

Sir, Your leading article (26) states that the Gov may be reconsidering the of implementing the La mission's recommendati computer-misuse legislati

In my opinion delay issue would be most seric UK IT (information tech industry and its custom investing heavily in co security and it would be mistake if hackers and writers were permitted to c to attack our systems at w in ways which cost industr

Society is increasingly dent on complex compu tems and networks. The U not fall further behind countries in making del misuse of them illegal. Th Commission's report deal vincingly with all the arg and recommended specific tion. Judging by what ou tomers are telling us, UK in attaches a high priority to on this issue.

Yours sincerely,
A. B. CLEAVER, Chief Ex
IBM United Kingdom Ltd.
PO Box 41, North Harbour
Portsmouth, Hampshire.
October 26.

From Mr Eddy Feers

Sir, Your report (October the strident concern by l industrialists at the possibi the Government dropping hacking legislation highlight shareholders now need t directors questions about their companies are run. questions should address th tent of the hacking problem whether the industrialists' c concern is a direct result o experience. Furthermore, ho these companies intend to p their systems in the future?

Whilst anti-hacking legisl might raise public awarene the problem, industrialists' cerns demonstrate that the already sufficient business a ness. Parliament should be t to pass legislation which w force companies to disclose losses they had suffered thr computer abuse and make corporate responsibility to computer-held information se from unauthorised use, modi

ANDREW TURNBULL, AIRBORNE FROM PAUL GRAY, 10 DOWNING STREET

TODAY'S ECONOMIC DEBATE

The opening part of this afternoon's debate followed fairly predictable lines. John Smith made what was in parliamentary terms a witty and reasonably successful opening speech. But it was extremely low on real content. The centre-piece of it was an attempt at continued mischief-making and fun-poking over Alan Walters and alleged divisions within Government. The general drift was that the Prime Minister's plan was to let the Chancellor take the blame for the alleged economic mess and in due course to replace him. Meantime, Alan Walters and Bernard Ingham were being used to undermine his position.

Other points of interest during the speech were:

- Smith was pressed to spell out his conditions for joining the ERM, which he said included going in at the "right" exchange rate. Both the Chancellor and Conservative backbenchers sought to characterise this as a policy of devaluation.

- Smith quoted fairly extensively from Michael Heseltine's speech in Blackpool. This eventually led to exchanges in which Heseltine made three successive but not over-penetrating interventions. Smith won these exchanges on points.

- Smith recast his advocacy of credit controls, partly in terms of possible use of special deposits but mainly in the form of a request to the banks to co-operate in curbing their lending.

The Chancellor made a low key speech which was not particularly successful in parliamentary terms but passed satisfactorily. The content was very familiar and covered similar ground to his Party Conference and Mansion House speeches. In the course of it he repeated the line he took at Treasury Questions last week that Alan Walters' views on the EMS were not the views of the Government.

I gather that, following these opening speeches, the Chancellor has done various TV interviews which are likely to be on the evening news bulletins. I have not yet seen them. But I gather that a lot of the time was taken up with Alan Walters, and at one point the Chancellor said something to the effect that he believed it was a good convention for advisers not to make their views known publicly.

One other media event during the day - which I also did not hear - was that the BBC lunchtime news played a recording they had taken of a telephone call they put through to Alan Walters. This took the form of the BBC man asking Alan for an interview and Alan declining to give it. But the report then went on to add that Alan subsequently made clear that at an earlier stage the Chancellor had also agreed with his (Alan's) views on the EMS. We shall have to see what use is being made of this in this evening's bulletins.

B:ECONOMIC

Dick sent to plane 16.45 24/10

3

MR. TURNBULL

MARKET REACTION TO TRADE FIGURES

The pound opened this morning at $1.5995 and DM 2.956. It lost half a cent and one pfennig after the trade figures came out at 1130 but steadily made up ground during the day to close at $1.6035 and DM 2.954. It is holding that level currently in New York. I understand from the Treasury that there has been no intervention.

The FT-SE 100 index closed at 2159, 30 points down on the day. Most of this fall occured after 1430 when Wall Street opened and reflects a weakness in Wall Street rather than reaction to the trade figures here.

Developments expected in discussions on ambulance dispute over the next hour and I will telex these to you at Doha when we have further news.

DM

DOMINIC MORRIS
24.10.89

B:DM (SLH)

TOTAL P.01

MR. TURNBULL

MARKET REPORT: 17 OCTOBER, 1530 OUR TIME

The main event during the day has been the monthly US trade figures. The latest monthly deficit was $10.8 billion, much higher than was expected.

This has led to some worries in the markets on both sides of the Atlantic. Wall Street initially dropped 28 points on the Dow after the opening, but is now back to 18 points down. The FT-SE 100 dropped quite sharply after lunch to 35 points down on the day, but is now back to 26 points down.

On the foreign exchanges the dollar weakened a little on the news and sterling went down with it. Latest sterling rates are $1.582 and DM 2.929. But the effective is still at 89, the same as last night's close.

3 monthly money market rates are now exactly 15 per cent.

Patricia A. Parkin
p. **PAUL GRAY**

17 October 1989

C:MARKETS (SLH)

Cile

MR. TURNBULL

MARKETS: 17 OCTOBER

The London markets have opened very quietly this morning following the firm overnight tone in New York and Japan.

At 0945 the FT-SE 100 Index was up 11 points at 2175, but fell back at 1000 to the opening level.

On the foreign exchanges the pound is little changed on last night at a touch under $1.58 and DM 2.94. The effective index which closed last night at 89.0 is now 89.2.

In the money markets three-month rates are just a touch over 15 per cent.

PAUL GRAY
17 October 1989

B:MARKETS (slh)

FLASH!

A/D 002

16 OCT 1989

RECEIVED IN COMCEN

PRIME MINISTER (AIRBOURNE, FROM PAUL GRAY)

FINANCIAL MARKETS: 1800 HOURS OUR TIME

The latest position is:

(i) following late trading the FT-SE 100 improved further and closed at 70 points down on the day

(ii) Wall Street is now showing much less fluctuation, with the Dow fairly steady at some 30 points up on the day during the last hour.

(iii) currencies are little changed over the last hour, although we are now slightly <u>above</u> DM 2.94.

Unless there are further major developments during the evening we will not send a further report until Wall Street closes.

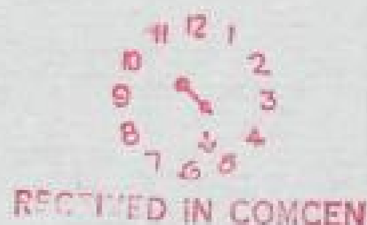
PRCG.

PAUL GRAY
16 October 1989

B:\MARKETS (slh)

16 OCT 1989

PAUL GRAY TO PRIME MINISTER, AIRBORNE



FINANCIAL MARKETS: MID AFTERNOON

The position at 1700 our time is:

i) the FT-SE 100 ended about 110 points down on the day, compared with 200 points down at its worst point around lunchtime.

ii) Wall Street has traded frantically in the first couple of hours. But after an initial drop of some 60 points, it is now some 40 points up on the day.

iii) On currencies, the dollar remains weak. Sterling is still around $1.58. It has strengthened a bit against the DM and is now just under DM 2.94.

iv) the three month market rates have been marginally below 15 per cent all day, and so do not point to any change.

PRG.

PAUL GRAY
16 OCTOBER 1989

B:markets.mrm

C: MARKETS, MEM

2 (A-B)

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

16 October 1989

SUBJECT CC MASTER

FINANCIAL MARKETS

The Prime Minister and the Chancellor this morning discussed developments in the financial markets.

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

The Chancellor said that the UK equity market had fallen by some 7 per cent at the opening this morning, but now seemed relatively calm. It was likely that dealers were awaiting developments on Wall Street when the American markets opened at 14.30. After a brief discussion it was agreed that it would be helpful for the Chancellor to issue a statement designed to calm the equity market; he would consider further whether this should issue at lunchtime or await the opening of the American markets.

Turning to the position on the foreign exchange markets the Chancellor said that sterling had this morning firmed against the dollar but had fallen substantially against the Dm. This was a cause for serious concern. Significant depreciation would undermine the Government's counter-inflation objective, particularly given the likelihood of the market overshooting. He therefore felt it was important to take action to resist depreciation.

The Prime Minister said that there was a strong case for a significant DM revaluation given the massive size of the trade imbalances; it now seemed the Germans were running a current account surplus of some £35 billion, while the United Kingdom was running a deficit of some £20 billion. As regards possible UK policy measures she felt very strongly that it would not be appropriate to consider a further interest rate increase. If there were strong downward market pressures on sterling then there was relatively little the authorities could or should do to counter this trend; and arguably the sooner the market adjusted to the new level the better. She accepted however that it could

be appropriate to take action to break any fall; although intervention of some $400 million a day, as had occurred in the previous week, was too much, there might be a case for bouts of intervention of, say, $50 million.

The Chancellor said that, if other policy instruments were not to be used, this strengthened the case for considering entry into the exchange rate mechanism (ERM) of the EMS, initially on the basis of wider margins. The Prime Minister said there could be no question of joining the ERM at this stage; we should stick to the position established at Madrid. The priorities had to be getting down the UK inflation rate and ensuring that other European countries removed foreign exchange and other restrictions.

Discussion then turned to the Chancellor's forthcoming Mansion House speech on Thursday and the draft paper on EMU that he wished to submit in advance of the Eco-Fin Council. On the latter it was agreed that the Prime Minister would take a meeting with a small group of colleagues immediately after her return from CHOGM. The Chancellor said that, meantime, he proposed to "lift the veil" a little on his thinking on the development of EMU in the Mansion House speech. The Prime Minister agreed he should lift the veil a little but not to go into any details; as regards the ERM nothing should be said that went beyond the post-Madrid statement.

PAUL GRAY

John Gieve Esq.,
HM Treasury

ZCZCLCB707
AAAA
161523Z OCT 89
FM AIIRBORNE
TO CABIINET OFFIICE 002 FLASH
BT

S E C R E T
FM AIIRBORNE P.M.
TO FLASH CABIINET OFFIICE
TELNO 002
OF 161523Z OCTOBER 89

FOR PAUL GRAY NO 10.
FROM CHARLES POWEL AIIRBORN

THE PRIIME MIINIISTER VERY ANXIIOUS TO HAVE REPORT ON THE STOCK MARKET
REACTIION FOLLOWIING OPENIING OF WALL STREET.

PLEASE TELEGRAPH HOURLY REPORTS - FLASH.
BT
GRS 00055
NNNN

The Economist

Prime Minister 2

I sent you in the first box (in the MG meeting folder for the Chancellor) a note by Alan Walters on the exchange rate. You may also like to glance at this Economist leader; while you will not agree with everything in it, the points in the highlighted passage are worth considering. PRCG 13/10

Through gritted teeth

AFTER ten years in government, Margaret Thatcher is facing her toughest test. At first glance that seems like hyperbole. A percent or two off sterling, a percent or two on interest rates—embarrassing, of course, to poor Nigel Lawson, her chancellor of the exchequer, but surely small stuff compared with the 1980-81 recession, the Falklands war, the miners' strike. That is true; and, in a way, that is the trouble.

Those earlier, deeper challenges posed a stark choice: victory or defeat. Certainly the Tories needed all their leader's nerve to succeed—but they had few doubts about where their political interests lay. Now there is no such clarity. In seeking to dig itself out of a pit of its own making, the government can abandon its principles for some soft economic options—and enjoy a burst of applause from most of its supporters. Or it can do what is best for the economy's long-term health—and risk a pasting that might weaken its chances at the next election. Political tests come no tougher than this.

What went wrong

The economy is in trouble for a depressingly simple reason: demand for goods and services has grown much too quickly in the past few years. Unusually, as Mr Lawson is always quick to point out, the cause was not the government's budget. The public sector is running a surplus so big that, if not for present distractions, it might be an embarrassment in its own right. Demand has surged because the private sector, and especially consumers, have been saving less and borrowing much more than they used to. Credit has fuelled both inflation (which has risen from 3% to 7% over the past three years) and the external deficit (which has swung from broad balance to a deficit of £20 billion a year). With fiscal policy, according to Mr Lawson, prudently tight throughout, the government has assaulted demand by doubling interest rates.

This has hit hardest at the mortgage-burdened, who are usually most inclined to vote Tory. As if that were not awkward enough, Mr Lawson has been faced with a run on sterling. No longer is he pushing up interest rates just to keep monetary policy tight; his main recent purpose has been to defend the pound. As a result, the headlines have been horribly reminiscent of sterling crises of old.

The government's critics note happily that ten years of Thatcherism have left at least one economic rule intact: as soon as the economy starts to grow at a decent pace, balance-of-payments difficulties bring its expansion to a sickening halt. In fact, it is a travesty to say that nothing has changed. Just look at the pattern of demand and output since 1983. In the three years to 1985, real demand grew by 10½% in all, and output grew by 9½%. In the following three years, output growth actually quickened, to a total of 12½%. The trouble is that growth in demand soared to 17½%, the fastest burst for decades. Yet that 12½% rise in output, after the recovery had been going for four years, shows that things really have changed. In the 1970s smaller surges in demand caused much bigger rises in inflation. So the past two years of higher inflation and lower pound are not proof that Thatcherism has failed to improve the economy's supply side. They are proof that the government mismanaged demand.

Mr Lawson could have made the monetary squeeze of the past year gentler and more effective if he had used his budgets since 1987 to make fiscal policy tighter than it already was. He didn't. So what matters now is to make sure that the squeeze on demand which has already been imposed curbs inflation as painlessly as possible. The key to this is to accept that some discomfort is unavoidable. The interest-rate tourniquet must be allowed to do its anti-inflationary work—even if it means a shallow recession next year. This is not exactly appealing. But consider the alternatives.

The policy with the greatest superficial appeal, and the greatest potential to do real damage, is to let sterling drop. If this happens, Mr Lawson (or his successor) will not lack for excuses. Industrialists are complaining that the pound is "overvalued", which in plainer English means that they have let their costs rise so are finding it hard to sell profitably in overseas markets. Industry also protests that interest rates are higher than is necessary to curb demand. Monetarists such as the prime minister's personal economic adviser, Sir Alan Walters, would broadly agree. They also object to exchange-rate targets on principle: let the market decide, they say.

So businessmen would applaud a lower pound and looser money, and enough academics could be wheeled on to justify the policy shift. And the voters? They would love it—at first.

But not for long. A fall in the pound would raise inflation by making imports and the goods that compete with them dearer. These price increases would fuel demands for higher wages. Companies would be happy to oblige: a currency devaluation would have bailed them out once, and would be counted on to do so again. With the anchor of a stable exchange rate cast aside, it would take a full-blown recession to get inflation down again. Everybody would hate that even more than they hate the latest rise in interest rates.

Some Tories would nonetheless like to bolster a "flexi-

ble" approach to sterling with other policies intended to grab votes. Credit controls would go down well, some reckon: blame the credit spree on the reckless banks. And cushion the coming slowdown by spending some of that fat budget surplus on schools, roads, hospitals and what have you. Never mind that previous attempts to use credit controls have been at best ineffective and at worst a microeconomic poison. Never mind that no sane government struggling to contain inflation could tell the financial markets that it is adopting a more expansionary fiscal policy. Please do something, anything, to appear sympathetic.

The kindness that kills

The mere possibility of such soft-headedness is harmful. The government's recent difficulties have been caused mainly by the fear that in the end it will let sterling slide. If the markets believed Mr Lawson's pledge to defend the pound, the present interest-rate differentials would be drawing in a much greater flow of capital; in other words, the pound could be held steady with lower interest rates. But the chancellor's promise has been continuously undermined by reports of disagreement between himself and Mrs Thatcher. This has neutralised a good part of the recent tightening, and may make even higher interest rates necessary.

The only certain way for Mrs Thatcher to help shave interest rates is to commit herself to a stable pound. To do that, much the best way would be to make sterling a full member of the European Monetary System. In the argument over the timing of membership, the balance has shifted decisively in favour of joining now. In last year's row with Mr Lawson, Mrs Thatcher could plausibly say that the domestic economy called for higher interest rates than would have been consistent with a stable pound. If, as it seems, she thinks this is no longer true, now is the time for a binding commitment to a stable exchange rate—in short, for the EMS.

Whatever the exchange-rate system, any government's best weapon against inflation is the credibility of its promise to control it. If its promise is believed, the task is easy: firms and workers set prices and wages accordingly. If it is not, inflation has to be clobbered with slower growth than would otherwise be possible, and perhaps with a recession.

For all its achievements, this government cannot expect its promises on inflation to be believed. Its decision in the mid-1980s to treat 4% inflation as a triumph instead of pressing on to stable prices (as it had promised to); its rejection of fiscal policy as an instrument for cooling demand; its tax break for mortagage credit; its internal squabbles over monetary policy—all these have left the markets with no choice but to say: don't tell us, show us. As a result, the coming months of disinflation will be far from painless. But the government can still choose, between a little pain or a lot. If it goes for the soft options, be prepared for a lot.

Make way for the Germans

They stand to be the main western beneficiaries of the upheavals in the East

POWER politics, like nature, abhors a vacuum. As Russia retreats from its 40-year-old dominance of Eastern Europe, who will fill the space? The answer is the twist in the tail of this tortuous twentieth century: Germany. It is an increasingly fair bet that Germany is set to win in peace the European supremacy that has twice eluded it in war.

The latest events in Eastern Europe show that the formula—communist ideology plus Moscow's military might—that created a "Soviet block" is breaking down. Marxism-Leninism? Hungary's ruling party has just said it was all a mistake and that it will contest the forthcoming free elections as a socialist party of the western type. The threat of Soviet force? The Poles have already acquired a non-communist government, and nobody has stopped them. Mr Mikhail Gorbachev's behaviour at East Germany's 40th birthday party last week was calculated to reinforce the message of non-interference: the days when that country's policy was decided in Moscow, he implied, are over.

This is a green light for change. The immediate result is mass demonstrations in still Stalinist-run East Germany and extraordinary leaps towards freedom in Poland and Hungary. But it also makes West German eyes gleam.

Leave aside for a moment the delicate question of German reunification. Liberalisation in Eastern Europe—and in the Soviet Union itself—means enticing opportunities for German influence and, in particular, for German business. Already West Germany is the leading trading partner for communist Europe. Communism's protectionist planners have so far kept sales to West Germany's markets in the East below 6% of its exports. As communist Europe goes capitalist, a market of 400m frustrated consumers beckons.

German businessmen are swarming in. Little noticed amid the excitement of the past week in Budapest and Berlin, the West German government has been busy too, pledging generous aid to help the reforms in Hungary and Poland. It is clearly set to become the biggest contributor to the bill for supporting Eastern Europe's reformers. This is not just charity (though the sense of repaying a historical debt for Germany's past aggression plays a part); it is a calculation that eventually Germany has the most to gain.

On the eve of last week's party congress in Budapest, the Bonn government told Hungary, which had so obligingly let East Germans through to the West, that it was doubling its limit for credit guarantees to DM1 billion ($530m). Baden-Württemberg and Bavaria then chipped in with similar offers worth DM250m each. West German help for Poland will be even bigger. On October 10th the two countries arranged (ahead of any agreement by the Paris Club of creditor governments) to reschedule DM2.5 billion of debt accumulated by Poland up to 1988; repayment is now put off to 1993-97. Half

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PRIME MINISTER 11 October 1989

INTEREST RATES AND STERLING

1. OVERKILL

Interest rates at 15 per cent are likely to give us a sharp recession in 1990 perhaps running into 1991. I have argued that for domestic reasons interest rates circa 12 per cent (or even 13 per cent in extremis) were appropriate and would deliver an inflation rate below 5 per cent by mid-1991. With the very important provision that we allow the market to determine the exchange rate, that is to say no "targetting" and intervention, I am still of the opinion that 12 per cent was correct.

Received Treasury opinion is that the interest rate rise to 15 per cent was needed because the domestic economy indicators were not obviously contracting fast enough. The Bank demurred, saying that the economy was slowing but admitted that it was not certain. (One might ask, is one ever certain?!) But the Dm 3.0 level was widely seen as the target which would trigger interest rate rises. With some but not too much reluctance, the Bank acquiesced to the "defence of sterling" policy.

2. EXPECTATIONS RULE

What is driving us is not the domestic economy but the convictions of market operators that we have an exchange rate policy. They see it as a combination of holding at certain levels (often called psychological parities such as Dm 3.0) and, if the exchange rate does go through the barrier, allowing only a slow movement. That is to say, the authorities are expected to counter any potentially sharp fall with intervention and interest rates.

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Sterling is a one way bet. It is expected to depreciate perhaps by some 10 per cent over the next year. If such an expectation is firmly held, the yield on sterling assets must offset this loss on the exchange rate. If the interest rate on one-year Dmark paper is 7 per cent, then the yield on sterling paper must be near 17 per cent.

Of course no movement of exchange rates is certain. But while the expected direction is down, the pressure on interest rates is always there. Under conditions of an expected fall, it is impossible to prevent a rise on the money markets. It was in this context that I believe you had no recourse but to acquiesce in the rise to 15 per cent last week.

The fault is in giving markets a one-way bet by pegging and then delaying or slowing the fall in the exchange rate to its new market value. Whether one believes that 12 to 13 per cent or 14 to 16 per cent is the right policy for domestic purposes is then irrelevant. You will automatically be driven to the high levels of interest rates. The Government can be accused of losing - indeed throwing away - control of monetary policy.

3. ADJUSTMENT OF EXCHANGE RATE AND THE PRICE LEVEL.

Weaning the market from these only-too-warranted expectations is a difficult task. But acquiescing will cost us dearly - as the 15 per cent illustrates.

The exchange rate will eventually go down. The longer we delay the fall, the longer will we have high interest rates. This fall will be a consequence of past monetary expansion. The fall will not cause inflation. Both inflation and the depreciation are consequences of excessive past monetary growth. We can only delay and distort both the consequential inflation and depreciation by price and exchange intervention (both forms of subsidy). But we cannot stop them.

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You took a strong line in 1988 to stop the attempt to keep sterling rising above Dm 3.00. Now you need to take an even more difficult decision of allowing sterling to fall freely to its new market value. As I have urged to the Chancellor, a 17 per cent interest rate would soon generate a deep recession. I suspect also that it would be simply politically unacceptable. On the other hand, sterling at Dm 2.80 and at $1.40 or so would be a basis which would generate a growth in exports and import substitutes in 1991. We would cease subsiding imports through an artificially maintained exchange rate.

4. A SUGGESTION

I suspect that the only way to make stick a policy consisting of monetary control and a free exchange rate is to announce it as a formal policy. It may be put forward as a medium term three year measure, rather like the old MTFS, because of the need to get our inflation rates and interest rates down to the OECD average. The Chancellor then could see it as an interim policy to get the inflation and exchange rate ready for a decision in 1992 or so on joining the ERM. It would get the Chancellor off the horns of his present dilemma.

Most important, the shadow of the Election in 1991 or 1992 will affect financial markets. If the present poll results do not turn sharply against Labour, portfolios will increasingly start to diversify out of the UK. This puts downward pressure on the exchange which, on past expectations, raises interest rates. This in turn will boost Labour's chances, so exacerbating capital flight ... and so on. This sorry process, loaded in favour of their financially irresponsible policy, must not be allowed to gather force and votes.

ALAN WALTERS

CONFIDENTIAL

chex.jp/jgl/7

Cc: J. Whittingdale

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

6 October 1989

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

Dear Paul

CREDIT CONTROLS IN UK AND OTHER COUNTRIES

You asked for a note on the use of credit and monetary controls in other countries following Mr Kinnock's and Mr Smith's comments that most other countries controlled lending in this way as an alternative to using interest rates.

The attached article from the Economic Progress Report for April this year sets out what happens in various other countries in some detail. You will see that it concludes that 'most major industrial countries now rely on interest rates as the main instrument of monetary policy. Some which previously relied on direct credit controls have either dismantled them altogether or no longer make use of them.' In particular, it states that the Federal Republic of Germany has never used controls on bank lending as an instrument of monetary policy.

In discussing this subject, it is important to distinguish four different things:

(i) direct controls on borrowing/lending either like hire purchase controls or schemes which penalise excess bank lending, for example the corset in the UK in the 1970s;

(ii) prudential requirements which exist in all countries for example on capital adequacy; and

(iii) the means by which different national authorities keep control over short term interest rates; in some countries

like the UK this is done by the sale and purchase of bills, in others like Germany it is done through reserve asset requirements.

One development since the article was written has been in Holland. The Dutch have recently introduced a form of credit control not dissimilar to the "corset" used in the UK until 1980. The Dutch guilder market and Dutch financial institutions are generally less well developed than in the UK and it may be that substantial leakages will take a little longer to appear than they would in the UK. But it would be surprising if they did not start to appear fairly quickly, for example in extra business channelled through London and extra domestic commercial paper issues.

... I also attach our standard briefing line. I hope this is helpful.

JOHN GIEVE
Principal Private Secretary

LINE TO TAKE - CREDIT CONTROLS

Credit controls simply would not work. Government inherited a variety of controls eg corset, HP controls which were abolished as they became increasingly ineffective.

With the abolition of exchange controls (which has been wholly beneficial) it would be even easier to circumvent UK credit controls; private sector can borrow or deposit money through offshore banks and UK banks can place business through offshore subsidiaries. Also with new financial instruments such as sterling commercial paper, there are even more ways open today to avoid controls.

Credit controls not only ineffective , but they also create distortions and inefficiencies in the market which act to the disadvantage of borrowers and savers alike, and they are unfair. They give unregulated and often less reputable lenders a competitive advantage. And they mean that less well paced borrowers have to pay more and are driven to loan sharks, while respectable lenders direct cheaper credit to the safest borrowers.

Even to the extent that any scheme could be made effective, would work simply by raising the cost of credit. This can be achieved more simply and effectively by increasing interest rates.

Other major countries like the USA, Japan, Germany and France, have also abandoned any controls they had on the amount of consumer lending, recognising them to ineffective, unfair and damaging. Like the UK, they rely on interest rates.

USEFUL QUOTE

> "..Of total household debt, some 85 per cent is on mortgages. The total of credit card and hire purchase lending - the two together- amounts to only a little over 5 per cent of household debt, so it is nonsense to imply that introducing controls on hire purchase or credit cards would do any significant to reduce the growth of consumer credit, or to allow interest rates to be one whit lower. In any event any such controls would be simplicity itself to get round.

(Chancellor of the Exchequer in House of Commons debate on economy 7 June 1989 c262)

Monetary control in other countries

Most major industrial countries now rely on interest rates as the main instrument of monetary policy. Some which previously relied on direct credit controls have either dismantled them altogether or no longer make use of them. This article explains why the change of emphasis has occurred and examines some of the techniques used by central banks to influence market interest rates.

Interest rates as the instrument of monetary policy

Changes in interest rates affect spending in a number of ways. Increases raise the price of borrowing and the return on savings and so encourage people to postpone spending and save instead. In addition, higher interest rates tend to reduce the value of financial and other assets, and consequently to reduce their holder's expenditure. Higher interest rates redistribute current income from borrowers to savers. When savers have a lower propensity to spend than borrowers, this too leads to a fall in aggregate expenditure. All of these effects of increased interest rates serve to restrain expenditure. A fall in interest rates works in the opposite direction.

Problems of using direct controls

Major countries that previously relied on quantitative controls on bank and other credit have found them to have serious costs and drawbacks.

First, they are inefficient. When credit is rationed there is no mechanism to ensure that it is allocated to those who can make most use of it. Some potential borrowers who could put the funds to good and productive use will be thwarted by the controls. Others will find themselves able to borrow but then use the money to less purpose. This source of inefficiency will be reinforced by the disincentive which direct controls offer to competition within the financial institutions. If their overall level of business is restricted, financial companies have little reason to compete vigorously with each other.

At the same time, direct controls are unfair. Some people will be lucky enough to be able to borrow as much as they want. Others with an equal or better claim will find themselves excluded just because the regulations do not allow enough lending in total to meet the amounts everyone wants to borrow. This has often led to government attempts to direct credit in one direction rather than another, replacing market forces with bureaucratic decisions.

Apart from being inefficient and inequitable, direct controls were also increasingly seen to be ineffective. They can only work if they prevent willing lenders giving credit to willing borrowers – otherwise they would in any case be redundant. But in these circumstances both parties have a strong incentive to find ways to evade the control. Moreover, direct controls are likely to be costly. Administrative costs alone are appreciable and must increase if the authorities attempt to counter rising circumvention. But perhaps more important is the deadweight cost imposed by the circumvention process itself. Energies expended in that direction could certainly be used more productively and with benefit to all concerned. Deregulation and increasing sophistication of financial markets in all major countries means evasion is much easier than it was even a few years ago.

A particularly important factor has been the increased international mobility of capital and the dismantling of exchange controls. National monetary authorities can no longer hope to isolate their financial markets from international influences. So domestic direct controls are inherently likely to fail.

Not surprisingly, in the light of all these drawbacks, direct controls have become increasingly unpopular. The next section looks at the position in major countries other than the UK. Most monetary authorities which used to rely on them have either ended them or are in the process of doing so.

Abolition of quantitative controls

Most countries in the OECD have used controls on bank lending as an instrument of monetary policy at one time or other. The main exceptions are Canada and the Federal Republic of Germany, which have never used them, and the United States, which applied them only briefly in 1980 in an effort to curb the expansion of consumer credit. Amongst the major industrial countries, Japan, France, the UK and Italy, who have all made extensive use of controls on bank lending at various times, now use interest rates as the main instrument of monetary policy.

Japan

In Japan, controls on lending by financial institutions used to be one of the most important instruments of monetary control. Under the system of 'window guidance', financial institutions eligible to borrow directly from the Bank of Japan were given guidance as to their appropriate growth of lending. The system was one of 'moral suasion'. There were no explicit penalties for institutions exceeding their guidelines, but they knew that to do so persistently could damage their relationship with the central bank.

Window guidance has not been used systematically to restrain lending since 1982. It was increasingly realised that it was only appropriate in a heavily controlled financial system, such as existed in Japan until the mid-1970s. The process of financial deregulation and innovation has had two effects. It has weakened the effectiveness of window guidance, because a major part of lending is now done outside the banking system. At the same time, it has made interest rates more effective, as much more credit is extended at market rates and less of it is rationed.

France

In France, quantitative controls on bank lending were enforced systematically from 1972 to 1984 as part of a set of more general restrictions in the banking system. The controls took the form of monthly norms for the growth of bank lending which, if exceeded, required the banks to make supplementary deposits at the Bank of France on a steeply rising scale. The system was modified over the period in which it was in force to alleviate the worst distortions arising from it. Different norms were set for different types of credit and banks were allowed to carry forward or sell to other banks unused rights to make loans.

But the system became increasingly complex to administer and also caused serious concern about adverse effects on allocation of resources. This, together with fears that Paris could be left behind as a major financial sector, led to the reform of the system in 1985 and the complete abandonment of quantitative controls from 1 January 1987.

Italy

In Italy, ceilings on bank loans remained in force, almost without interruption, from 1973 until June 1983. Initially controls were selective. They did not affect the most important projects, or foreign currency loans or loans of less than a certain amount. While there was some attempt to extend the coverage of the controls, they were never made comprehensive, so circumvention was relatively easy. The controls have been re-introduced on two separate occasions – early in 1986 and from September 1987 to March 1988 – to counter downward pressure on the lira. Used in conjunction with exchange controls, some of which remain in force in Italy, the authorities thought that direct controls had some effect.

Other countries

Among most of the smaller European countries the same trend towards abolishing controls has emerged. In the Netherlands, an informal agreement between the central bank and the banks to limit net credit creation lapsed at the end of 1987. In Luxembourg, Belgium, the Republic of Ireland and Denmark there are currently no explicit controls on credit creation, though some controls on bank lending remain in Spain, Greece and Portugal. Further afield, Australia and New Zealand have abolished a wide range of financial controls recently.

Reserve requirements

Although direct controls on credit are now the exception rather than the rule, confusion is sometimes caused by the fact that many countries impose reserve asset ratios on their banks. These are quite separate from direct controls. As explained below, their purpose is to ensure that monetary authorities can maintain control over short-term interest rates – the essential instrument of monetary policy.

Flexible pay in the civil service

Unions representing over 300,000 executive, clerical and secretarial civil servants have recently agreed long-term flexible pay agreements with the Treasury. Members of the National Union of Civil and Public Servants (NUCPS) and the Civil and Public Services Association (CPSA) have voted in favour of the deals in a series of ballots.

In the year ahead, pay increases will vary but will be contained within an overall paybill cost of 7 per cent in 1989-90, with the biggest increases going to the most experienced clerical staff and those in London.

Like previous flexible pay agreements, those with the NUCPS and CPSA have three main characteristics:–

- *flexibility* to vary pay by location and skills to meet recruitment and retention needs;
- *performance* pay related to how well an individual does the job;
- *agreed, stable, long-term* pay determination arrangements.

Taken with earlier agreements, it means that nearly all the half a million non-industrial civil servants are covered by flexible pay agreements.

Normally central banks influence interest rates generally by changing the rate of interest at which they are prepared to supply funds to the banking system. If a central bank wants to influence market rates more widely, it needs to ensure that the financial system has to borrow from it so that its own lending rate is transmitted into market rates. Reserve asset requirements facilitate this because they ensure that the commercial banks have a continuing need for reserve assets which the central bank can then supply at a price of its own choosing. Reserve assets generally consist of cash and sometimes other short-term liabilities of the monetary authorities. The following two examples show how such systems work.

US

In the United States, the commercial banks are required to hold reserves of notes and coin and deposits at the central bank against their deposits. The central bank, the Federal Reserve, can change the total amount of these reserves by buying or selling government and federal agency securities or, more often, engaging in repurchase or matched sale agreements. For example, if it wanted to raise interest rates it might sell securities. As payments are made for these securities, so the reserves of the commercial banks will fall. In order to replenish their stocks the banks will attempt to buy reserves in the market for reserves assets – the 'Fed funds' market – and in the process the Fed funds rate is bid up. An alternative source of funds for the banks is to borrow from the Federal Reserve 'discount window'. But in that case the Federal Reserve itself sets the rate at which the banks obtain funds. Although this rate, the discount rate, is usually below market rates, the Federal Reserve makes it clear that banks should not make regular and heavy use of this facility. Either way, the Federal Reserve can ensure that the cost of borrowing to the banks is raised. To maintain profit margins, the banks then have to raise their own lending rates, reducing the demand for credit.

Federal Republic of Germany

In Germany, the situation is similar to that in the US, in that the commercial banks are required to hold reserve assets against their liabilities. But differences in the market structure mean that the details of operations are different.

Normally, the banking system is short of the deposits it needs to hold with the Bundesbank as reserve assets. So it has to borrow them from the Bundesbank itself. They are usually provided by repurchase agreements ('repos') against the banks' holdings of government debt. At regular intervals, the Bundesbank offers to purchase debt from the banks temporarily, usually at rates of its choosing and the banks can use the cash they receive to meet their reserve requirement.

However, there have been occasions when the banking system has not needed to borrow from the Bundesbank. For example, when the Bundesbank has been selling deutschemarks to prevent the exchange rate rising, the reserve assets – the deutschemarks – in the financial system increase. To counter this the Bundesbank has increased the reserve asset requirements of the banks in order to reinstate the shortage and regain control of interest rates.

Reserve requirements and the UK

The main difficulty with reserve asset requirements is that they impose costs on the banking system by forcing the banks to hold low yielding assets in excess of what they require for prudential reasons to meet unexpected deposit withdrawals. Required reserve holdings as a proportion of banks' assets or liabilities vary markedly between different countries. Minimising the distortions arising argues for as low a requirement as possible.

If a country's reserve assets requirement is onerous, business may be driven elsewhere. In the UK, the only requirement, that banks hold 0.45 per cent of their eligible liabilities in the form of a non-operational balance with the Bank of England, is much smaller than other countries' reserve requirements and has no monetary policy functions. Nevertheless because the central government's short-term claims on the banking system (mainly bills held by the Bank of England) have exceeded its short-term liabilities to the banking system in recent years as a result of official operations, the banking system has generally been short of funds, which the authorities have been able to supply at a rate of their own choosing. Because of this the UK authorities have been able to maintain effective control over interest rates without a substantial reserve requirement.

Share ownership

The 1989 Budget contained a number of important measures aimed at further widening and deepening share ownership in Britain. These included changes to the personal equity plan rules; increases in the limits for employee share schemes; tax reliefs for employee share ownership plans; and changes to personal pensions. This article looks at the measures, and their likely impact. It also sets out findings of the 1989 Treasury/Stock Exchange share ownership survey.

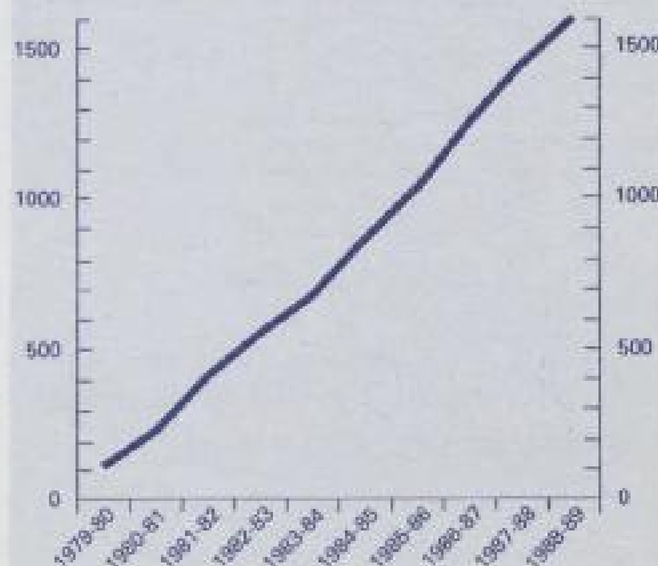
Benefits of share ownership

Government policies have actively encouraged individual share ownership. The benefits include:

- giving individuals a personal stake in the success of British companies;
- improving incentives and industrial relations through employee share ownership;
- reducing the cost of new equity to companies, so encouraging them to expand and invest.

Years to March

Approved all-employee share schemes



Source: Board of Inland Revenue

Share ownership survey

The 1989 joint Treasury/Stock Exchange share ownership survey shows that the individual investor remains firmly committed to direct investment in shares, despite the market downturn that followed the 1987 crash:

- there are now about 9 million adult share owners (about 10 million if unit trust holders are included);

population than the others. Output per head of population is affected by, among other things, international variations in participation and unemployment rates, by differences in the length of the working week and by different annual holiday entitlements. The centre column of the table shows estimates of *output per person employed*. On this basis, Japan's relative position is lower and those of France and Germany higher. The right-hand column shows estimates of *output per hour worked*. On this basis the other countries' advantage relative to the UK is reduced and the UK is shown to have a significantly higher productivity level than Japan.

Table 2 shows that part of the reason why the US and Japan have a higher gross domestic product (GDP) per head of population than the UK is that they have a higher proportion of the population in employment. It also shows that in the other countries the average hours worked by employed people per year are higher than in the UK. In part this reflects the relatively higher level of part-time female employment here. Additionally, the number of hours worked per year in Japan is much higher because of smaller annual holiday entitlements and widespread Saturday working. Allowing for this, Japanese output per hour worked appears to be little more than two thirds the UK level. It is probable that a high level of productivity in Japanese manufacturing is offset by relatively low productivity in some other sectors of the economy, such as agriculture.

As the note on PPPs explains, it is much more difficult to compare productivity levels within individual sectors of economies. The comparisons that have been published suggest that the UK's relative position is, if anything, less favourable in manufacturing industry than in the economy as a whole. This matches more qualitative evidence, from the car industry for example, which suggests that much of the UK's improvement in the 1980s has been motivated by the need to improve efficiency and so close the productivity gap between UK manufacturing plants and those overseas.

Readers' enquiries

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Purchasing power parities

In comparing output and productivity levels in different countries it is necessary to deflate national output measures to a common base. One possibility is to convert the various national currencies into a single currency using market exchange rates. However, it is more appropriate to use purchasing power parity (PPP) exchange rates, which equalise the purchasing power of the different currencies in their home economies. So, for example, US $100 converted into £ sterling at a PPP exchange rate shows the sum in £ sterling that would buy the same amount of a standard basket of goods and services here as $100 does in the United States. As any tourist knows, market exchange rates rarely coincide with PPPs – goods and services seem cheaper in some countries than in others when currency is converted at market rates.

Comparisons of output in different countries using market exchange rates will overstate output in relatively expensive countries and understate output in cheaper countries. Market exchange rates also change quickly and by large amounts for reasons which have little to do with relative price levels. As an example of the difference between market exchange rates and PPPs, at 1986 market rates Japan's GDP per head was over 60 per cent higher than the UK's, while using 1986 PPPs it was just 6 per cent higher.

Both Eurostat (for the EC) and the OECD (for the industrialised countries) regularly produce estimates of PPPs*. These are based on the prices of a large sample of goods and services in different countries. The various individual prices are combined to form an overall price for a standard basket of goods and services in each country and hence a corresponding PPP exchange rate for each currency. Unfortunately, PPPs can be quite sensitive to the weights used in combining the individual prices. The estimates in this article are based on the aggregate international weights produced by the OECD.

It is difficult to repeat this sort of exercise for individual sectors of the economy – PPPs calculated using economy-wide price and expenditure data are unlikely to be appropriate at an industry level. Estimates of relative productivity levels in manufacturing have been published by various researchers using comparisons based on whole economy PPPs, proxy PPPs derived from the whole economy numbers and market exchange rates (which may be less misleading in the case of tradeable than non-tradeable output). The various methods produce a wide range of estimates. For example, productivity in German manufacturing can be 20 to 100 per cent higher than in the UK, depending on which method of comparison is used. The most careful and reliable approach is probably the 'industry-of-origin' method which essentially deflates different countries' industrial output into physical volumes and compares productivity on that basis. Needless to say this is a very time consuming process and the currently available comparisons involving the UK are now very dated†.

*See, for example, T.P. Hill (1986) 'International price levels and purchasing power parities', *OECD Economic Studies no. 6, Spring* and D. Blades and D. Roberts (1987) 'A note on the new OECD benchmark purchasing power parities for 1985', *OECD Economic Studies No. 9, Autumn*.

†See, for example, Smith, Hitchens and Davies (1982) 'International industrial productivity', *National Institute of Economic and Social Research* (which uses data from the late 1960s), and Davies and Caves (1987) 'Britain's productivity gap' *National Institute for Economic and Social Research* (which uses data from the late 1970s).

File SH

SUBJECT CC MASTER

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

5 October 1989

Dear John,

INTEREST RATES

It may be helpful to record the outcome of the Prime Minister's discussions with the Chancellor on 3 and 4 October.

At the earlier meeting the Chancellor said there was uncertainty about the likely scale of any move by the Germans to raise their interest rates on 5 October. However, if the Germans were to implement a 1 per cent increase he felt it would be necessary for the United Kingdom to make a parallel move, notwithstanding the obvious difficulties. It was agreed, however, that efforts should be made to obtain further information about the Germans' intentions, and to reconsider the matter the following evening.

At the subsequent discussion on 4 October the Chancellor reported that it had been a very difficult day in the foreign exchange markets, with strong downward pressure on sterling, notwithstanding heavy intervention support. The latest information was that the Germans were likely on 5 October to raise their discount rate by 1 per cent, with probably the same increase in the Lombard rate. Against that background, he had concluded that the United Kingdom would have to raise interest rates also by 1 per cent. As to timing he would greatly prefer to defer a United Kingdom move until the Germans had made their announcement. But one difficulty with this course of action was the danger of further very strong downward pressure on the sterling during the period before the announcement.

Following a brief discussion it was agreed that, should the Germans raise their discount rate by 1 per cent on 5 October, the United Kingdom should make the same increase. It would not be appropriate to seek to give any signal to the markets overnight on 4/5 October of this intention. But consideration would be given on the morning of 5 October to whether the Bank of England would have to give a signal to the money markets during the course of the morning that it would not be undertaking dealings until the Germans had announced their intentions.

Yours,
Paul

PAUL GRAY

John Gieve, Esq.,
H. M. Treasury

CONFIDENTIAL AND PERSONAL

Cf- pc.

PRIME MINISTER

MARKETS

You will see from the attached note from Alan Walters that he is unhappy about today's developments. This is as you expected, and I have sought this evening to explain to Alan your thinking and your reasons.

You and the Chancellor are agreed on the appropriate action for the next 24 hours or so. But the point may well come over the next few days where the issue "are we defending DM3" has to be faced. Alan's comments in the last paragraph of his minute below are very relevant here. This may well be something you will need to discuss further with the Chancellor later this week or next week.

(Duty clerk)

pp Paul Gray

4 October 1989

CONFIDENTIAL AND PERSONAL

c;markets (MJ)

CONFIDENTIAL

PRIME MINISTER 4 October 1989

INTEREST RATES AND RECESSION

Base rates are to be raised to 15 per cent tomorrow, ostensibly in response to the Bundesbank rise of 1 per cent, but in reality in reaction to a threatened fall below DM3.00. We have spent some $1.2 billion so far today and no doubt we'll spend more in New York and Tokyo propping it up temporarily at 3.01 or so. This intervention is apparently designed to give the Chancellor the fig leaf of saying that he was not raising interest rates in response to a fall actually below DM3.00.

We have been caught yet again by the market's expectations of our Pavlovian reaction to the Dmark rate - intervention followed by an increase in base rates. We remain on a de facto DM standard of DM3.00 - where we started in 1987. Then it generated inflation: now it induces a recession. The cycle is complete.

The building societies and banks are likely to move quickly to increase mortgage rates (they have already withdrawn most of their fixed rate offers) by some 2 per cent or more. This will have serious political repercussions. The direct effects of borrowing costs on corporations will be more muted, but the indirect effects on orders etc will be quite severe.

PCG

I am fairly certain that the present squeeze was more than adequate to get the inflation rate into the "comfort zone" by the next election. And this recent increase in interest rates will have little or no effect on inflation before the Spring of 1991. But it will be very likely to induce a serious recession in 1990 which will persist into 1991.

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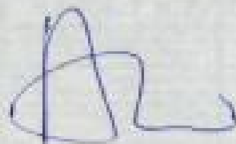
The pattern of events, like a Greek tragedy, is painfully familiar. And as long as we are seen to be defending parties, the pattern will be repeated over and over again as I have often argued so many times before.

As far as the immediate situation is concerned, I do not think that, at this juncture, there is any choice by to go along with the Chancellor's recommendation. But if sterling drops again - even to say 2.80 - it would be worth considering whether one must go up to 16 or 17 per cent base rates to defend the parity from falling further. Such high rates would devastate the economy and your electoral strategy. In such circumstances we must let the pound go.



ALAN WALTERS

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chex.jp/jg/57

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

2 October 1989

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

Dear Paul

BALANCING ITEMS

... I attach a note on balancing items in other country's overseas accounts and on what we are doing to reduce ours.

Yours

JG.

JOHN GIEVE

BALANCING ITEMS IN THE MAJOR ECONOMIES

Balancing items are found in the overseas accounts of all (major) countries. They occur when measured capital flows do not exactly match measured current account flows with the sign reversed.

The figures

2. Table 1 shows figures for balancing items for recent years for the major economies. (These are in $bn and as a share of GNP: they are the same as those used in the Bank's paper.) GNP is not necessarily the most appropriate standardising factor. An alternative would be the gross current and capital account flows across the exchanges. Errors in the accounts are in some instances likely to be proportional to the size of flows.

Table 1: BALANCING ITEMS IN MAJOR ECONOMIES, $bn (% of GNP)*

	US		Japan		Germany		UK	
1977	-2.0	(-0.1)	0.7	(0.1)	-3.4	(-0.7)	7.1	(2.8)
1978	12.5	(0.6)	0.3	(0.0)	-3.8	(-0.6)	3.7	(1.2)
1979	25.4	(1.0)	2.3	(0.2)	-1.3	(-0.2)	2.3	(0.6)
1980	25.3	(0.9)	-3.1	(0.3)	1.2	(0.1)	2.0	(0.4)
1981	18.7	(0.0)	0.5	(0.0)	1.6	(0.2)	1.2	(0.2)
1982	34.4	(1.1)	4.7	(0.4)	-0.2	(0.0)	-3.9	(-0.8)
1983	9.2	(0.3)	2.1	(0.2)	0.9	(0.1)	0.9	(0.2)
1984	23.9	(0.6)	3.7	(0.3)	0.7	(0.1)	7.9	(1.8)
1985	15.3	(0.4)	4.0	(0.3)	-1.1	(-0.2)	8.2	(1.8)
1986	11.3	(0.3)	2.5	(0.1)	-1.4	(-0.2)	16.2	(2.9)
1987	1.9	(0.0)	-3.9	(0.2)	-5.2	(-0.5)	18.6	(2.7)
1988	-10.6	(0.2)			1.3	(0.1)	21.9	(2.6)

* Data derived from country national accounts. GDP used for UK's which involves a slight upward bias as GNP is larger than GDP.

3. Table 2 gives more details (in £) on the large positive balancing items that have recently been recorded in the UK. These reflect unidentified credits or overstated debits on either current or capital account or both. The size of the UK balancing item is now unprecedented among major economies in recent years as a percentage of GNP. The US had a run of higher nominal balancing items in the early 1980s.

Table 2: THE UK BALANCING ITEM (£ billion, NOT seasonally adjusted)

	1986	1987	1988	1988 Q1	Q2	Q3	Q4	1989 Q1	Q2
Current account balance	0.1	-3.7	-14.6	-3.4	-3.2	-3.5	-4.5	-4.6	-5.7
Net capital transactions	-11.1	-7.7	2.3	2.9	-0.5	0.6	-0.6	3.4	-0.9
Balancing item	11.0	11.3	12.3	0.5	3.7	2.9	5.2	1.2	6.6

The discrepancy in the world's balance of payments statistics

4. Balancing items have more often been positive than negative. A similar problem is that there are insufficient recorded current account credits in the world as a whole, because the current account of all countries do not sum to zero, but to a deficit. The IMF estimated this world discrepancy at 0.32% of world GNP in the period 1959-68, 0.12% in 1969-78 and 0.43% in 1979-88. It narrowed markedly between 1984 and 1987, but provisional figures in the IMF's September World Economic Outlook suggest an increase in 1988 to 0.59%.

5. The IMF suggest that most of the discrepancy can probably be attributed to developing countries, but in 1983 for example about $14 (out of $75) billion was attributed to OECD economies. A detailed IMF study found errors largely on the invisibles side, with investment income and shipping/transportation as the main causes. Visible balances were thought to be only slightly under-recorded.

Why differences in balancing items occur

6. Differing methods of data collection and institutional factors probably account for the variation between countries' balancing items.

(i) Measurement methods differ. The French, the Italians, the Germans and the Japanese all use some form of exchange control or direct reporting to banks. In contrast, countries like the United States and the United Kingdom use a greater variety of unrelated sources, notably surveys of transactors.

(ii) Deregulation has contributed to the greater relative scale of international capital flows and at the same time made measurement more difficult. The UK has moved much further down this path, and much more quickly than other G7 countries. The balancing item jumped in 1984: the run up to the "Big Bang" saw rapid growth of trade in financial instruments and (probably) international movements of capital in advance of the internationalisation of capital markets that Big Bang involved. Deregulation may also mean that transactions bypass UK institutions, and, therefore, the existing surveys. International institutional investment is almost certainly more regulated in Japan and Germany (and indirectly in the US, for example via moral suasion on pension funds to invest in US Treasury Bills).

What other countries do about balancing items

7. We can find no documentary evidence of attempts to remove or reduce the balancing item by adjusting the measured figures prior to publication. However, the CSO has been in touch with those who compile balance of payments figures in the US. The latter said they do not make regular adjustments, and pointed out that their annual balancing items conceal much larger quarterly ones.

8. Some countries have made considerable efforts to improve their data. Examples include:

(i) In Germany the Bundesbank has improved the quality of its capital flows statistics, with the improvements split roughly evenly between the current and capital accounts. The capital account corrections mostly reflect unrecorded outflows to banks in Luxembourg and the UK, possibly as German investors try to evade tax. The UK could well have a similar problem with the Channel Islands;

(ii) The US has recently increased significantly its coverage of services and investment income to take account of such items as improved measurements of telecommunications services. This has added around \$20 bn to exports and \$10 bn to imports per year. Worries about the balancing item led to further new surveys in 1988. (Additional resources are of course required to mount such surveys together with some increase in form filling.)

The UK balancing item and measures to reduce it

9. A balancing item averaging £11.5bn p.a in 1986-1988 could be taken to imply a misleading current account estimate. Although it is likely that a substantial part of the balancing item reflects unidentified net capital inflows, it is also possible there are still errors and omissions in the current account. For instance much of the data on financial services and investment are either estimated or based on irregular survey material. However, to the extent that unidentified net capital inflows do increase UK overseas liabilities, there will be some underrecording of investment income outflows on the current account.

10. The balancing item in the UK balance of payments has been recognised as a major problem for some time and a Treasury/CSO working group was established in 1987. The Pickford Scrutiny report on economic statistics also emphasised the problem (a copy of the relevant paragraphs is attached:- the balancing item in the balance of payments was considered alongside the large balancing items in the accounts for sectors of the domestic economy). The CSO and the Bank of England which collects most of the capital account data are making an effort to improve the quality of the data. The recent thrust of the CSO work programme is aimed at the capital account, especially portfolio flows which are thought to be particularly badly measured. The new inquiries include:

- extended coverage of securities dealers' overseas activity;
- constructing a database of bond issues;
- a new share register survey.

Initial results from the first of these have not yet resulted in any reduction in the balancing item. The latest quarterly figures for 1989Q2 show the highest balancing item on record at £6.6 billion.

11. Much of the new work takes the form of improvements to existing sources. One view is that these efforts will at best prevent the balancing item rising further. It is far more likely that there are large areas of activity which the present approach to data collection cannot hope to keep pace with or may fail to capture at all. This must surely be a problem in the financial services sector where

recording has probably not yet caught up with the moves towards deregulation epitomised by 'Big Bang', and where firms continue to innovate in anticipation of the opportunities which 1992 will bring.

12. Clearly one possibility is to follow the US line and mount new surveys. Although there is much to recommend this approach, there are always likely to be some problems with the data in a deregulated economy.

EA2 Division
HM Treasury

21 SEP 1989
MR SEDGWICK
CST FST SIR P MIDDLETON
SIR T BURNS MR ODLING-SMEE
MRS DUNNETT MR HUDSON
MR MS TURK MRS CHAPLIN

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

20 September 1989

Dear John,

BALANCING ITEMS

I told you earlier in the week that Sir Hector Laing had drawn to the Prime Minister's attention a report indicating that the balancing item in the UK's external financing accounts was far greater than for other G7 countries.

I have now identified this document as the enclosed report to the Court of the Bank of England, which the Deputy Governor's office have kindly let me have. The relevant tables are those in the statistical annex. I should be grateful if you could arrange for a note to be prepared for the Prime Minister which summarises what is known about the treatment of the balancing item in other countries accounts; for example, do any of them adopt methods of allocating out part of the original balancing item to other lines in the accounts? It would be helpful if the note could also indicate what work is in hand to seek to reduce the size of the balancing item in the UK's accounts.

I should be grateful if this material could be provided by next Wednesday, 27 September, so that it is available in advance of the Prime Minister's next bilateral meeting with the Chancellor.

Yours,

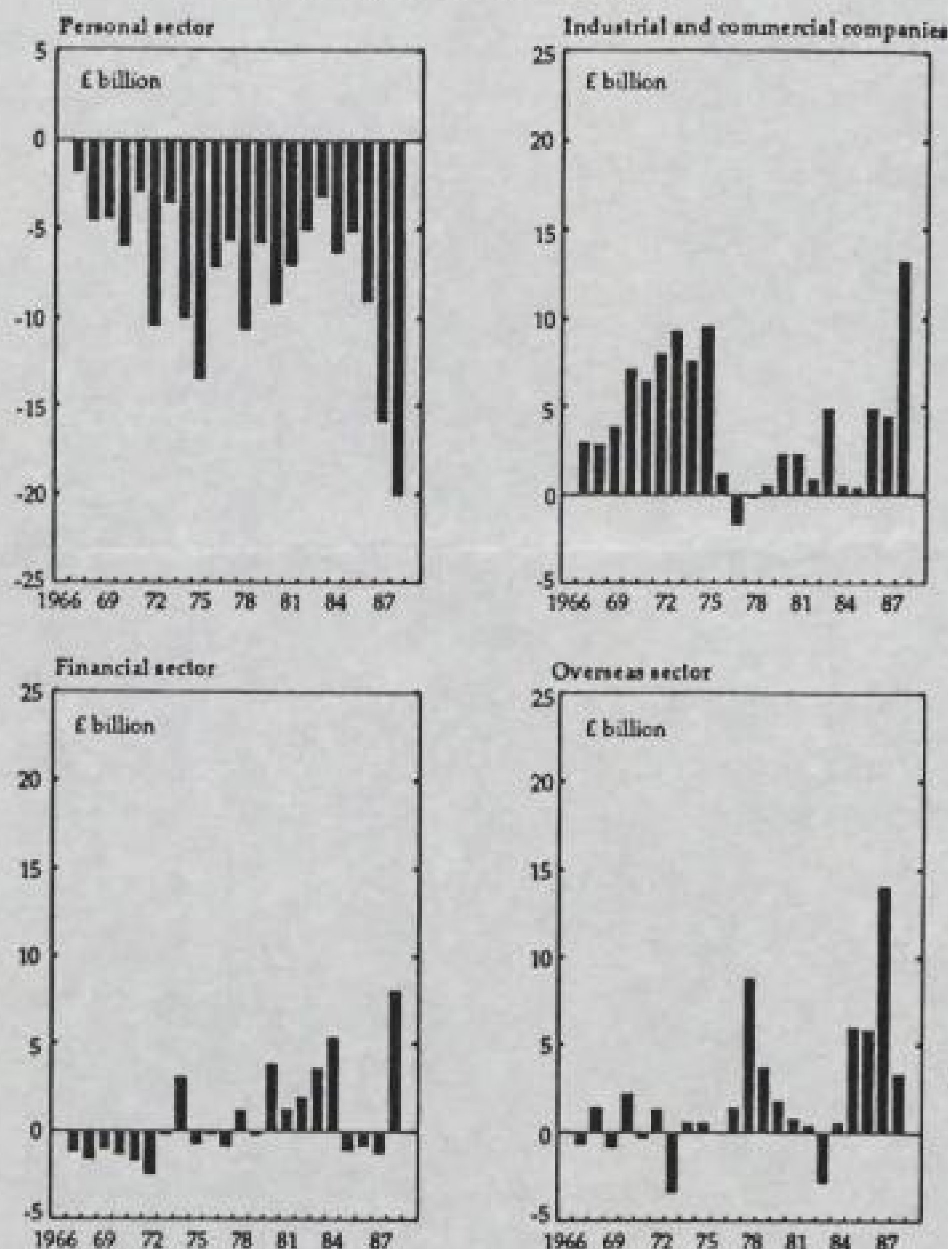
Paul

(PAUL GRAY)

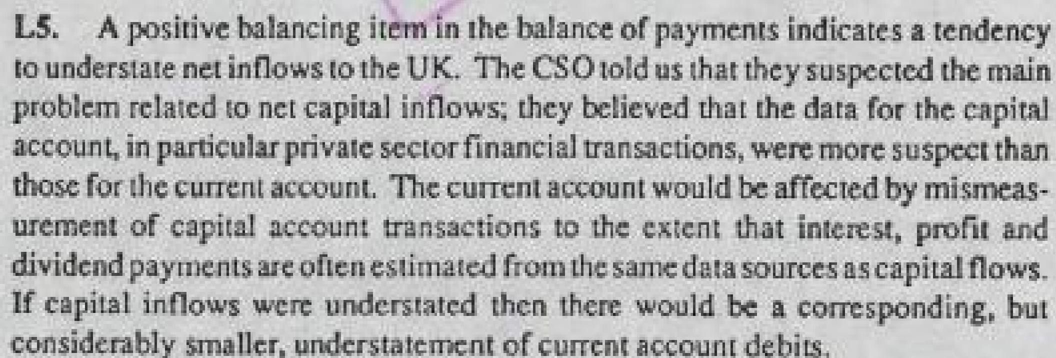
John Gieve, Esq

Extracts from the Scrutiny ('Pickford') Report

Chart 2 Sector balancing items at 1985 prices

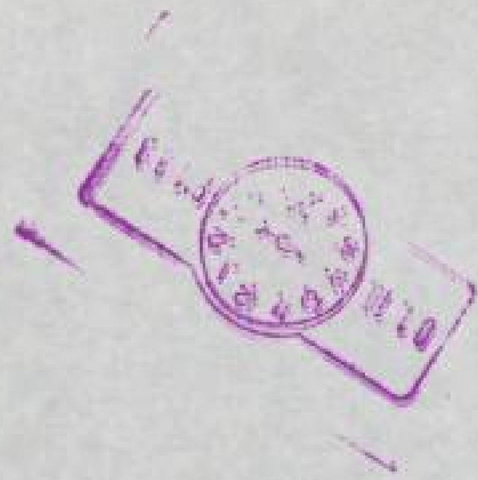


Balancing items are now so large in relation to some key economic indicators that they make it very difficult to interpret the figures. In 1987 the personal sector's balancing item was equivalent to 8% of its disposal income while the measured saving ratio was 5½%. As a result some commentators have concluded that the saving ratio is substantially under-recorded. The overseas sector's balancing item in 1987 was £3½billion compared with a balance of payments current account deficit of £2½billion; if the balancing item arose entirely because exports were under-recorded, the current account would instead have been in surplus.



L5. A positive balancing item in the balance of payments indicates a tendency to understate net inflows to the UK. The CSO told us that they suspected the main problem related to net capital inflows; they believed that the data for the capital account, in particular private sector financial transactions, were more suspect than those for the current account. The current account would be affected by mismeasurement of capital account transactions to the extent that interest, profit and dividend payments are often estimated from the same data sources as capital flows. If capital inflows were understated then there would be a corresponding, but considerably smaller, understatement of current account debits.

L8. The above exercises should help to resolve some of the current problems with the balance of payments statistics. However an underlying concern is that the statistical systems used to compile the figures are diverse, and do not keep pace with the changes in the financial world. In recent years the transactions of new financial institutions and instruments have not been recorded adequately in official statistics. As a first step towards identifying problem areas more quickly we believe the Bank of England should advise the CSO regularly on developments in financial markets, and their implications for financial statistics.



Report sent to HMT

File KK. Gieve

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I should be grateful if this material could be provided by next Wednesday, 27 September, so that it is available in advance of the Prime Minister's next bilateral meeting with the Chancellor.

(PAUL GRAY)

John Gieve, Esq.,
HM Treasury.

WORLD PAYMENTS REPORT

AUGUST 1989

WORLD ECONOMY GROUP

INTERNATIONAL DIVISION

0087p

WORLD PAYMENTS REPORT - JULY 1989

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WORLD PAYMENTS REPORT - AUGUST 1989: HIGHLIGHTS

* World trade grew by 9% in 1988, the strongest performance this decade.

* The US current account deficit was reduced to 2 1/2% of GNP ($127 bn) in 1988 from 3 1/4% in 1987, aided by very rapid growth in exports. Falling net investment income hampered the adjustment process.

* The Japanese surplus fell to 2 3/4% of GNP ($87 bn) from 3 1/2% in 1987 as imports of goods and services expanded strongly.

* The German surplus remained at 4% of GNP.

* The UK current deficit rose sharply to 3 1/4% of GNP from 3/4% in 1987.

* The US current deficit was almost entirely financed by private capital inflows, in contrast to 1987 when official flows were predominant. Net direct investment flows to the US rose to $40 bn in 1988 from broad balance in 1987.

* Net portfolio outflows from Germany increased massively in 1988, partly in anticipation of the introduction of the withholding tax in January 1989 (and which has been abolished subsequently). The flows were partly financed by large official sales of dollars to support the deutschemark.

* Net bank borrowing played a reduced role in intermediating international capital flows, with the notable exception of inflows to the UK.

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WORLD PAYMENTS REPORT - 1989

Summary

1 The attached report is the latest in an annual series analysing the major trends in international trade and associated financing patterns.

2 Unexpectedly strong demand growth in the industrial economies last year was associated with a very rapid expansion in the volume of world trade, which grew according to IMF estimates at 9%, the strongest performance this decade. The stimulus to trade from demand growth in the industrial countries gave a boost to the developing countries and was in addition supported by some trade liberalising measures, particularly in the Far East. As demand and output growth in the major economies slows down in response to the monetary tightening over the last fifteen months, world trade growth is likely to ease.

3 Further progress was made last year in reducing the US current account deficit and the Japanese current surplus, particularly when measured as a proportion of GNP. The German surplus, however, remained at 4% of GNP. The US current deficit improved from 3 1/4% of GNP in 1987 to 2 1/2% in 1988 ($144 bn to $127 bn) as export volumes of goods rose by an extraordinary 22%, helped by strong demand growth overseas and by previous competitiveness gains. The improvement in the current account was more than fully accounted for by the improvement in visible trade, with the deficit improving by well over $30 bn, but as US net external liabilities continue to rise, debt servicing costs continue to mount. This factor led to a deterioration in the invisibles account of some $15 bn between 1987 and 1988. The trend deterioration in the invisibles account as external debt builds up adds to the difficulty of reducing the current account deficit. The Japanese and German invisibles accounts also deteriorated last year, as rapidly rising spending on foreign services, particularly tourism, more than outweighed the growing net investment income receipts from rising net external assets. In the Japanese case, this was a major factor underlying the fall in the current account surplus from 3 1/2% in 1987 to 2 3/4% in 1988 of GNP (from $87 bn to $80 bn) although the trade surplus also fell as the volume of imports of goods rose by almost 17%. In Germany,

however, the growing deficit on invisibles was more than outweighed by a rising surplus on trade as export volumes continued to perform strongly and the volume of imports rose more slowly than in any other member of the G7. The rapid deterioration in the UK current account in 1988 was the major development outside the three largest economies.

4 Prospects for further improvements in reducing the US deficit and the Japanese surplus (and of some improvement) in the German surplus (which increased to around 5% of GNP in the first half of this year) depend on the pattern of domestic demand growth relative to overseas and movements in competitiveness and trade prices. Charts 3 and 4 in the Report show movements over the 1980s in these measures and indicate that relative demand growth has been moving favourably for adjustment over the last two years in the US and Japan, but not in Germany. These trends have continued into this year. The benefit from the large improvement in US competitiveness between 1985 and 1987 may now be beginning to fade, whilst the rise in the dollar this year is unhelpful for further current account adjustment over the medium term. Movements in trade prices have also partially offset the effects on competitiveness of the dollar fall from 1985, as US exporters have tended to widen profit margins whilst Japanese and German producers have reduced theirs to maintain market share.

5 It is possible that the rapid growth of direct investment into the US in 1988 and continuing into this year (a net inflow of $40 bn last year from broad balance in 1987) will facilitate current account adjustment over the longer term, as the relocation of production from overseas into the US displaces imports and promotes exports. In the short term, however, this direct investment inflow might actually increase the US current deficit, as relocating firms import components and capital equipment from their overseas parents or trading affiliates.

6 Direct investment apart, the key development in financing flows last year was the marked turnaround in the financing of the US current deficit from largely official finance in 1987 associated with intervention to support the dollar, to almost entirely private finance in 1988 and into this year; indeed 'overfinance' in the most recent period as central banks have intervened to hold down the dollar. Factors underlying this radical change in sentiment over the last eighteen months or so include, the widening interest differentials in favour of dollar assets (true for Japanese investors but not for investors from many other countries, and a factor pushing in the opposite direction more recently); greater confidence that major central banks will underpin any perceived fall in the dollar following the experience of 1987 and achieve the goal of promoting greater stability in exchange

rates; greater faith in the management of the US economy, particularly in the operation of monetary policy; special factors such as the withholding tax in Germany which led to strong capital outflows, and more recently heightened political uncertainty in various regions which have improved the attractiveness of the dollar as a 'safe haven'.

7 Other interesting features of last year, include the general decline in the importance of international banks in intermediating capital flows, with the notable exception of inflows into the UK. This general development may be partly related to the impact of the new Basle capital requirements, but also reflects reduced hedging behaviour by Japanese investors in particular as they became more confident about exchange market stability. The introduction of the withholding tax was a major factor associated with the massive increase in German portfolio investment overseas in 1988, whilst a reassessment of prospects for the Tokyo stock market led to a large non-resident inflow of capital, a factor underlying the reduction in net Japanese portfolio outflows.

WORLD PAYMENTS REPORT - AUGUST 1989

Section 1: WORLD TRADE

1 The strength of economic activity in the industrial countries has been accompanied by a rapid expansion in world trade. According to the IMF, world trade volumes rose 8.9% in 1988 (6.5% in 1987), the highest rate recorded in this decade (Table 1). Three main reasons for this continued growth in world trade are evident.

Source:IMF WEO and OECD

Table 1: World Trade(Annual changes,in %)	1981	1982	1983	1984	1985	1986	1987	1988
Volume	1.2	-1.8	2.7	8.6	2.9	4.5	6.5	8.9
Volume of Trade Export Volumes								
Industrial countries	3.8	-2.0	3.0	9.8	4.7	2.6	5.5	8.8
Developing countries	-5.5	-6.6	1.6	7.0	0.7	8.8	11.2	10.9
Import Volumes Industrial countries	-1.6	-0.6	4.5	12.3	4.7	8.6	7.2	9.5
Developing countries	8.0	-3.4	-2.8	2.6	-0.6	-4.4	5.7	10.2
OECD Manufactured export prices local currency	8.3	7.6	2.7	4.8	2.7	-3.7	-1.2	1.8
OECD Domestic producer prices manufactures	8.6	5.9	4.0	4.8	2.8	-1.6	0.8	2.5
OECD Unit Labour costs manufacturing	7.4	5.4	0.7	0.5	2.3	3.1	0.7	-0.5
OECD GDP deflator export weighted	8.6	7.5	5.5	4.8	4.2	3.9	3.1	3.5

(1) Rapid growth in demand in the industrial countries, associated with buoyant investment growth, led to a marked increase in imports.

(2) Strong domestic demand, earlier competitiveness changes, and the relaxation of some trade barriers in Japan contributed to a marked increase in import volume growth last year, although there was a slowdown through the year. Rapid demand growth, trade liberalisation, and a loss of competitiveness in Taiwan and Korea (reflecting currency appreciation and rising wage inflation) helped to maintain import volume growth in the Asian newly industrialising economies - the NIEs (Taiwan, Korea, Singapore and Hong Kong) at almost 30%. Rising non-oil commodity prices resulted in terms of trade gains for many other LDCs. This factor, together with stronger growth in export volumes, led to a slight relaxation in the financing constraint facing indebted LDCs and allowed their import volumes to rise faster in 1988 than at any time this decade.

(3) Export prices of manufactured goods have risen less rapidly than domestic prices for the industrial countries as a whole between 1986 and 1988 and this may have stimulated trade. Manufactured export prices in local currency terms for the OECD rose 1 3/4% in 1988 while domestic producer prices rose by 2 1/2% and the GDP deflator by 3 1/2% (see Table 1). However, according to the OECD, this trend was reversed in the second half of the year.

Section 2: CURRENT ACCOUNT DEVELOPMENTS IN THE WORLD ECONOMY

2 This section charts the main developments in world current account positions during 1988 and the extent to which international adjustment has taken place.

3 Large movements in exchange rates during the 1980's have led to a significant redistribution of world export market shares and current account balances have diverged significantly. Chart 1 indicates the extent of this divergence. The US current balance deteriorated from a relatively small deficit in 1982 to a deficit of $127 bn in 1988 (although an improvement from $144 in 1987)* while the Japanese and German surpluses have risen from $7 bn and $5 bn in 1982 to $80 bn and $49 bn respectively. The UK's current account balance switched from a surplus of $8 bn in 1982 and broad balance through the mid 1980's to a deficit of $27 bn in 1988 while the aggregate position of the other OECD economies (Canada, Italy, France and smaller OECD) has deteriorated by over $20 bn in the last two years from a position of broad balance between 1983 and 1986. The current account of the NIEs has improved from a position of broad balance in the early 1980's to a surplus of around $30 bn more recently, whilst the current account deficit of the LDCs (non-OPEC,

---

* Revised figures. Chart 1 has been based on figures before revision which gave a deficit around $10 bn larger in recent years.

Chart 1

WORLD CURRENT ACCOUNT BALANCES

$ BNS

200 200

100 100

0 0

−100 −100

−200 −200

82 83 84 85 86 87 88

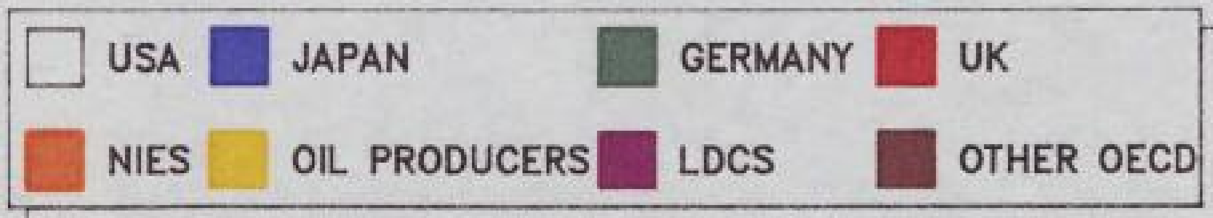

TABLE 2: MEASURES OF INTERNATIONAL ADJUSTMENT

CURRENT BALANCES
$ billions

	1986	1987	1988
US	-133.2	-143.7	-126.5
JAPAN	85.8	87.0	79.6
GERMANY	39.2	45.2	48.5
CANADA	-7.6	-8.0	-9.2
FRANCE	3.1	-4.1	-3.8
ITALY	2.6	-1.5	-5.2
UK	0.2	-4.8	-26.6
OTHER OECD (EO)	-4.0	-9.3	-11.6
OIL EXPORTERS (WEF)	-28.1	-9.5	-22.3
ASIAN NIES (WEF)	21.2	31.5	28.5
LDCS (WEF)	-31.7	-24.0	-25.6
OTHERS* (WEF)	8.7	8.4	8.3

INVISIBLES, NET
$ billions

	1986	1987	1988
US	11.9	15.8	0.7
JAPAN	-7.0	-9.4	-15.4
GERMANY	-13.3	-20.7	-24.3
CANADA	-14.6	-16.6	-17.2
FRANCE	5.0	4.8	5.3
ITALY	-1.9	-1.4	-4.4
UK	13.0	12.1	9.9
OTHER OECD (WEF)	5.2	7.7	3.3
OIL EXPORTERS (WEF)	-38.9	-42.8	-41.6
ASIAN NIES (WEF)	2.1	0.8	0.3
LDCS (WEF)	-13.5	-9.2	-7.4
OTHERS* (WEF)	-2.7	-9.0	-3.2

EXPORT VOLUME GROWTH (GOODS)
Annual changes, in percent.

	1986	1987	1988
US	5.2	15.0	21.9
JAPAN	-0.6	0.4	4.4
GERMANY	1.3	2.8	7.4
CANADA	3.5	7.3	10.0
FRANCE	-0.2	2.3	8.7
ITALY	3.8	3.0	5.7
UK	3.4	5.5	0.3
OTHER OECD (EO)	2.1	5.5	6.6
OIL EXPORTERS (WEF)	6.8	2.2	6.1
ASIAN NIES (WEF)	15.1	21.0	15.2
LDCS (EO)	11.2	2.4	6.1
OTHERS* (EO)	2.0	4.9	3.7

IMPORT VOLUME GROWTH (GOODS)
Annual changes, in percent.

	1986	1987	1988
US	12.1	6.5	7.0
JAPAN	9.7	9.1	16.7
GERMANY	6.1	5.4	6.7
CANADA	7.5	9.1	14.6
FRANCE (WEO)	7.0	6.7	9.0
ITALY	7.6	10.8	6.9
UK	6.5	7.1	13.4
OTHER OECD (EO)	6.5	6.6	9.4
OIL EXPORTERS (WEF)	-9.7	7.6	-0.8
ASIAN NIES (WEF)	11.4	27.4	28.4
LDCS (EO)	5.1	-0.8	6.3
OTHERS* (EO)	-16.0	-4.1	7.7

CURRENT BALANCE AS A PERCENTAGE OF GNP
Source:WEO

	1986	1987	1988
US	-3.2	-3.2	-2.6
JAPAN	4.3	3.6	2.8
GERMANY	4.4	4.0	4.0
CANADA	-2.1	-1.7	-1.7
FRANCE	0.4	-0.5	-0.4
ITALY	0.4	-0.2	-0.6
UK	-	-0.7	-3.2

TRADE BALANCES
$ billions

	1986	1987	1988
US	-145.1	-159.5	-127.2
JAPAN	92.8	96.4	95.0
GERMANY	52.5	65.9	72.8
CANADA	7.0	8.6	8.0
FRANCE	-1.9	-8.9	-9.1
ITALY	4.5	-0.07	-0.8
UK	-12.8	-16.9	-36.5
OTHER OECD (EO)	-9.2	-17.0	-14.9
OIL EXPORTERS (WEF)	10.8	33.3	19.3
ASIAN NIES (WEF)	19.1	30.7	28.7
LDCS (EO)	-16.9	-6.5	-3.1
OTHERS* (EO)	11.4	17.4	11.5

* CENTRALLY PLANNED ECONOMIES

non-NIEs) was reduced rapidly after 1982 as the onset of debt servicing difficulties led to a sharp reduction in finance. The aggregate deficit was $26 bn in 1988 compared to $66 bn in 1982. The current account position of the major oil producers has moved largely in line with the oil price, improving earlier in the decade to record a small surplus in 1985 but then deteriorating again as prices fell back. World current account surpluses are concentrated in Japan, Germany and the NIEs (particularly Korea and Taiwan) with the deficits concentrated in the US, the UK and other country blocs.

4 Most indicators suggest that further adjustment of the Japanese surplus and US deficit occurred during 1988 but that these movements were concentrated earlier in the year as the effects on trade flows of post-Plaza dollar depreciation unfolded. The US deficit fell from 3.2% of GNP in 1987 to 2.6% in 1988 while the comparable figures for the Japanese surplus were a decline from 3.6% to 2.8%. In Germany, however, there is little sign of adjustment and the surplus remained at 4.0% of GNP. More recent data indicate that the adjustment process is continuing in the US and Japan, but not in Germany where the surplus has risen markedly so far this year.

5 Care should be taken in interpreting international current account movements; Chart 1 indicates that identified deficits substantially outstrip identified surpluses. The gap between the two, known as the world current account discrepancy, is thought to be largely associated with the measurement of international investment income which is underrecorded on average. This underrecording is partially outweighed by an overestimate of trade positions on average. The world discrepancy narrowed markedly between 1984 and 1987, attributed by the IMF in part to the strength of world trade in dollars which in turn partly reflected the marked depreciation of the dollar between 1985 and 1987. In 1988 the world current account discrepancy increased markedly on provisional figures. This may be related to the strengthening of the dollar (weakening the rise in world trade in dollars), and to the increases in worldwide interest rates and profits leading to higher investment income payments. As these tend to be underrecorded the IMF suggest that the mismeasurement might increase at a time when investment income payments are rising strongly.

Major Economies

6 The US current account deficit was $127 bn in 1988, down from $144 bn in 1987. Trade volumes moved favourably (see Chart 2 and Table 2). Export volumes of goods rose 22% in 1988 (15% in 1987) and accounted for approximately one-third of the increase in world trade; while imports maintained a more moderate growth rate of 7%

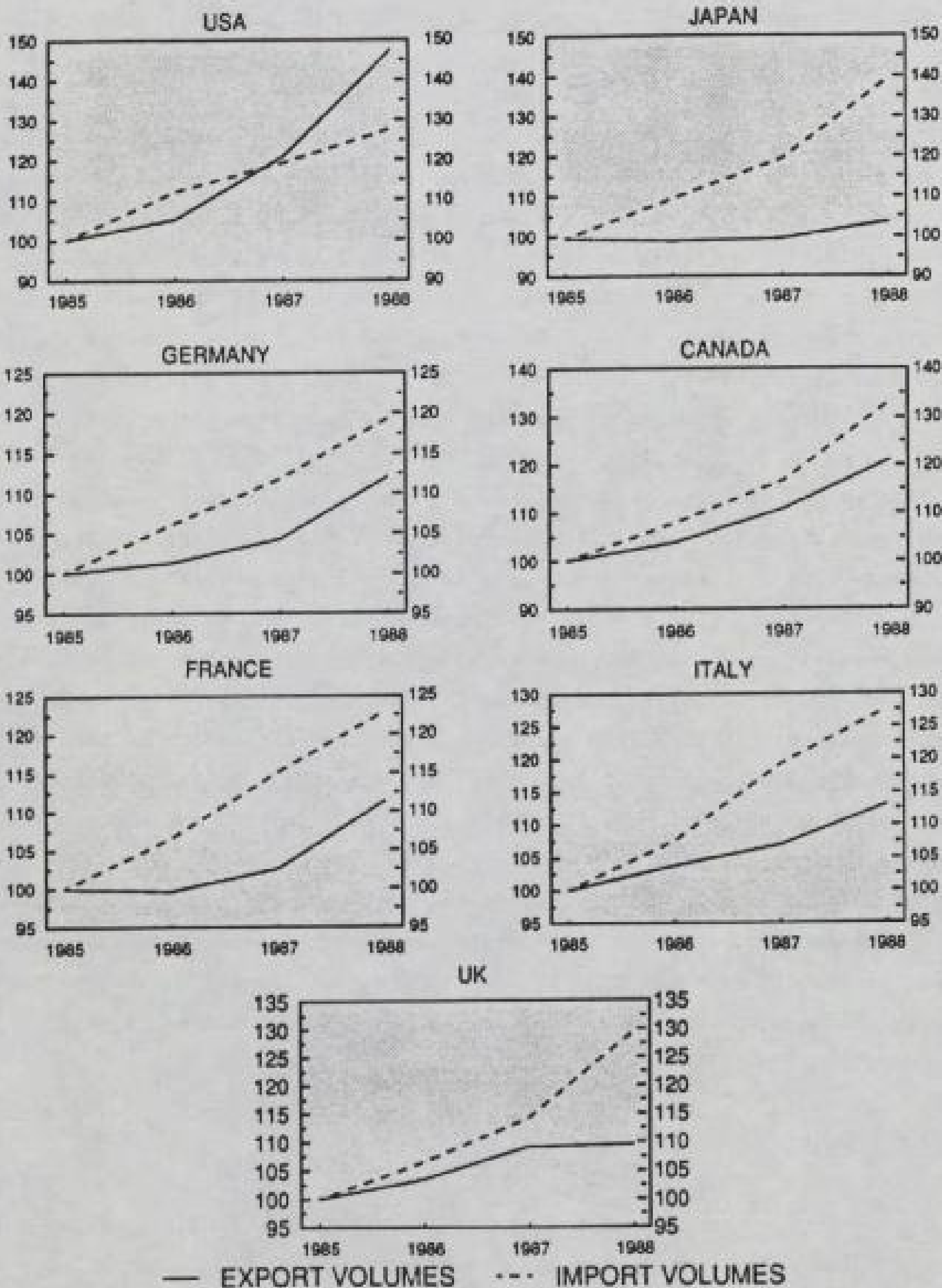

CHART 2: MAJOR SEVEN EXPORT AND IMPORT VOLUMES
USA
JAPAN
GERMANY
CANADA
FRANCE
ITALY
UK
1985
1986
1987
1988
EXPORT VOLUMES
IMPORT VOLUMES

(6 1/2% in 1987 and 12% in 1986). The nominal current surplus in Japan fell to $80 bn in 1988 from $87 bn in 1987. In volume terms and as a proportion of GNP, adjustment was more pronounced. Import volumes rose 17% (9% in 1987) whilst export volumes rose by 4 1/2% in 1988 (1/2% in 1987). On the other hand, the German current account surplus continued to grow in dollar terms. It rose to $49 bn in 1988 ($45 bn in 1987) as strong external demand stimulated exports while a steady rise in domestic demand left the growth of imports little changed. In volume terms, exports of goods were up 7 1/2% in 1988 (2 3/4% in 1987) while imports rose by 6 3/4% (5 1/2% in 1987).

7 Trends in investment income are hindering balance of payments adjustment. Net investment income inflows into the US fell to only $3 bn in 1988 from $20 bn in 1987 as US net external debt continued to increase. Indeed, the surplus of less than $1 bn on the invisibles account was the smallest since 1972. This partly offset the improvement in the trade deficit and the trend deterioration in the invisibles account means that through time the US will require an even larger export surplus to finance both its import bill and growing debt service payments. Conversely, investment income continued to rise in Japan and Germany as a counterpart to their improved external asset positions associated with the run of large current surpluses. However, in contrast to the US, invisibles in total helped to support adjustment in both countries as the growth in service payments, particularly on tourism, exceeded the increase in investment income.

8 The current account positions of all the other major economies deteriorated in 1988, as domestic demand continued to grow strongly which attracted imports, particularly of capital equipment. The largest deterioration occurred in the UK current deficit which rose to almost $27 bn in 1988 (3 1/4% of GDP) from $5 bn in 1987. This was accounted for by an increase in import volumes of over 13% as domestic demand rose rapidly whilst export volumes rose only 1/4%. The Canadian current deficit increased to over $9 bn in 1988 from $8 bn in the previous year (remaining at 1 3/4% of GDP) as Canadian domestic demand continued to rise strongly and as competitiveness deteriorated (Chart 3). The Italian current deficit increased to over $5 bn (from well under $2 bn in 1987) whilst the French deficit stayed around $4 bn. In both countries the deficit in 1988 was around 1/2% of GDP. Chart 2 indicates that import volumes have been rising faster than export volumes in all the major OECD economies (except the US) in the last two years.

Developments in the Smaller OECD Economies

9 The current account position in the smaller OECD economies in aggregate worsened in dollar terms in 1988. The aggregate deficit rose slightly to almost $12 bn from

just over $9 bn in 1987. Rapid domestic demand growth gave rise in some cases to increased inflationary pressures and a deteriorating external balance, for example in the Iberian economies and some in Scandinavia. However, the aggregate trade balance in nominal terms recorded a slight improvement in 1988, as a strengthening in the terms of trade offset the deterioration in volumes, with the main contributory factor to the worsening current deficit a decline in receipts from net invisibles as investment income payments rose, particularly in Australia and Spain. Within the total, the surplus of the Netherlands almost doubled to 2 1/4% of GNP, while Switzerland's surplus declined from 4 1/4% in 1987 to 3 1/2% in 1988. In terms of GDP, the largest deficits were for Australia (4 1/2%), Iceland (4 1/4%) and Norway (4%), whilst the New Zealand deficit fell from 5% of GDP in 1987 to under 2% in 1988.

Current Account Developments in the NIEs

10 In 1988, the current account surplus of the NIEs stood at $29 bn, slightly lower in dollar terms than in 1987 (and a bigger reduction in terms of GNP). Korea and Taiwan continue to account for almost all of the surplus. In aggregate, export volumes rose 15% in 1988 (21% in 1987) but imports rose 28% (27% in 1987). Some loss in competitiveness associated with appreciating exchange rates and rising wages, strong domestic demand coupled with capacity constraints in Singapore and Hong Kong, and exceptional gold imports into Taiwan which reduced the current surplus by $3 bn, were the main factors behind this.

Developments in the Major Oil Producers

11 The aggregate current balance of the major oil producers has been in deficit throughout the 1980's (except for a small surplus in 1985) but worsened significantly in 1988 as the oil price fell sharply. The current deficit was $22 bn in 1988 ($10 bn in 1987) owing to a sharp drop in the trade surplus to $19 bn in 1988 from $33 bn in 1987. Lower oil prices entirely accounted for this deterioration as export volumes rose 6% in 1988 (up from 2% in 1987) whilst import volumes declined slightly.

Developments in the other LDCs

12 During the 1980s, the severe financing constraint facing the other LDCs following the onset of debt servicing difficulties in many countries forced an improvement in their aggregate current account position. Nevertheless the aggregate deficit in 1988 was slightly wider than 1987 as the trade balance deteriorated and

as higher average interest rates in creditor countries increased interest payments. Export market growth was a substantial 15% (10% in 1987) for the non-oil Asian economies (excluding the NIEs) as they benefited from the dynamism of the Pacific rim area and 9% (5% in 1987) in the other non-oil developing countries. For the Asian economies (excluding the NIEs) both exports and import volumes rose about 15% in aggregate in 1988, whilst the terms of trade strengthened slightly. In contrast, Sub-Saharan African economies benefited less from the strength of demand in the industrial countries because of their narrow export base. Export earnings were adversely affected by weaknesses in the market for oil and tropical beverages. In Latin America export volume growth of around 10% coupled with an improvement in the terms of trade, allowed import volume growth of almost 10% (the highest rate since 1980). Nevertheless, despite the better external environment, domestic economic difficulties worsened in some countries, and were reflected in rising inflation.

Section 3: THE PERSISTENCE OF CURRENT ACCOUNT IMBALANCES IN THE THREE MAJOR ECONOMIES

13 Not only have current account imbalances widened over the decade, but the distribution of deficits and surpluses have become concentrated in a few economies, with the US, Japan and Germany accounting for the largest shares. In addition, most forecasts point to a continuation in these large current imbalances. Many reasons have been given for this uneven development in the world economy, which are analysed under two broad headings below.

(i) The role of the exchange rate.
(ii) The evolution of domestic demand and the fiscal/monetary policy mix.

(i) The role of the exchange rate

14 Floating exchange rates in simple theoretical terms allow an alternative to deflation and reflation in bringing about adjustment in external positions. In countries with balance of payments deficits, a depreciation has the effect of increasing the relative price of foreign goods compared to domestic goods and thus inducing the public to buy less from abroad and more home-produced goods, and providing an incentive to produce exports. In simple theory under normal conditions, devaluation of the currency will tend to eliminate payments deficits. In reality, the effect of exchange rates on competitiveness is not as simple and direct. For example changes in nominal exchange rates may give rise to changes in wages and prices which

act to offset the effects of the original exchange rate movement. The final change in the real exchange rate (after adjusting for differential changes in prices and costs) may be substantially less than the initial change in the nominal rate. For example, Chart 3 (using relative normalised unit labour costs as a measure of the real exchange rate) indicates that despite a 50% appreciation in the nominal effective exchange rate of the yen since 1985, the Japanese real effective exchange rate has risen by only 30%. In contrast, competitiveness in the UK and Canada has deteriorated more than the nominal exchange rate suggests as unit labour costs have risen more rapidly than in competitor countries. In addition, changes in the relative costs of foreign and domestic goods may be counteracted to some extent by possible adjustments in firms' profit margins. Chart 3 indicates that the terms of trade in the major economies have not moved to the extent that exchange rates have, and in some cases have moved perversely. For example, in the US, although the effective exchange rate depreciated by about 35% between 1985 and 1988, the terms of trade have remained broadly stable. A BEQB article on profit margins* indicated that US exporters have continued to raise prices and profit margins, thus reducing the opportunities to increase international market share for US exports during this period, some of which had been lost during the strong and prolonged appreciation in the dollar's exchange rate in the early to mid-80s. Conversely, in Japan the terms of trade actually declined in 1987 despite a persistent appreciation in the yen effective exchange rate, suggests that Japanese exporters were engaging in margin restraint to reduce the erosion in export markets. This behaviour was also evident in Germany.

15 The reserve currency status of the dollar may also have diminished its potential role in reducing the US current account deficit. Many LDC currencies are pegged to the US dollar, and as the dollar depreciated in 1986 and 1987 these countries may have experienced some gains to competitiveness in third markets which would have reduced their deficits and provided less scope for US exporters to regain market share. The surpluses of the NIEs were boosted for the same reasons. In addition, in its role as an international reserve currency, the dollar may be subject to changes in sentiment associated with revised assessments of political stability which may at times become subject to bandwagon effects as participants in the foreign exchange market feel obliged to follow short term trends. Associated changes may not necessarily be compatible with underlying domestic economic fundamentals and may be a source of volatility.

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* "Trends in profit margins" by R L Wales and W J Niffikeer BEQB May 1989.

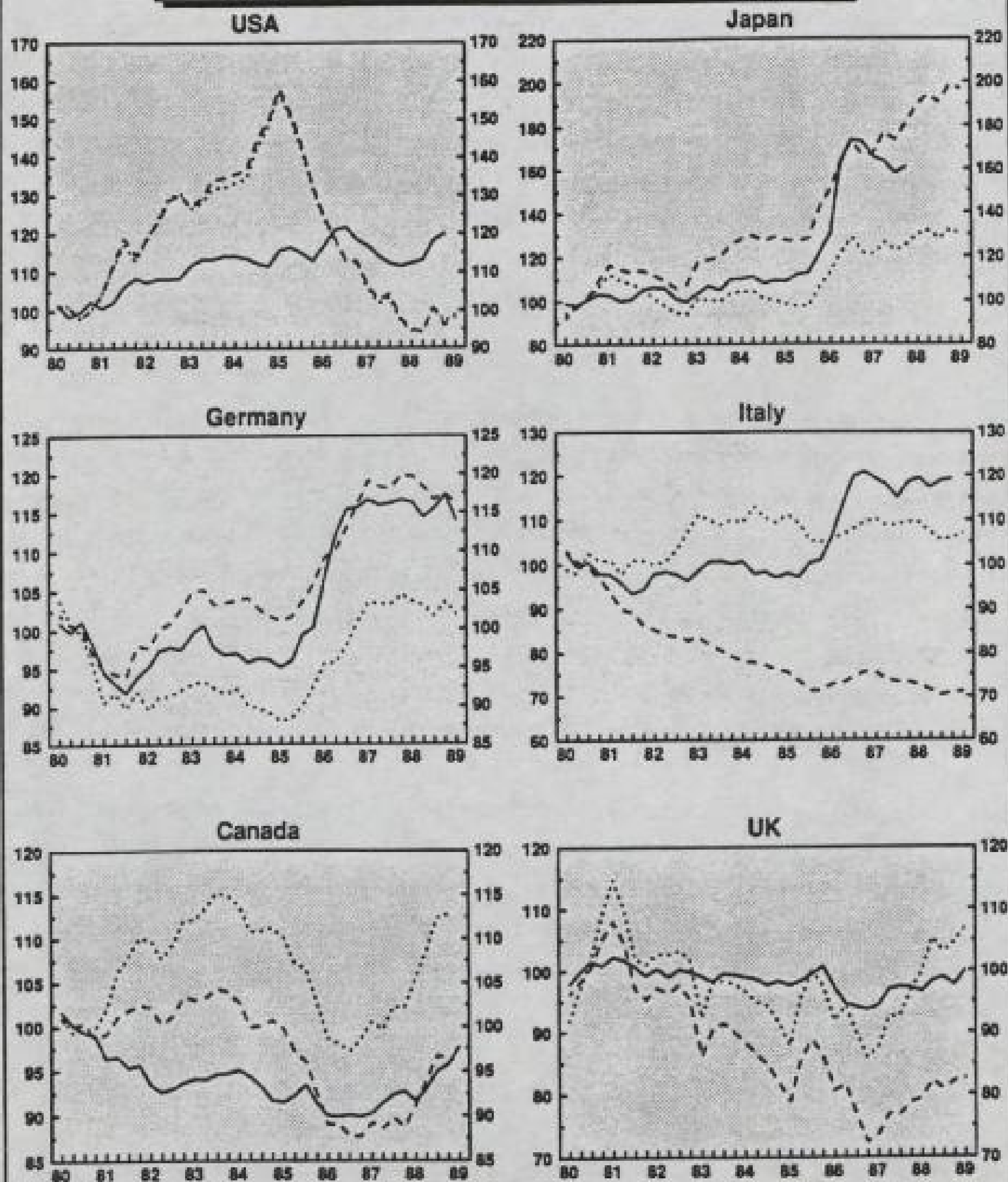

Chart 3:
Terms of Trade and Effective Exchange Rates
1980=100
USA
Japan
Germany
Italy
Canada
UK
80
81
82
83
84
85
86
87
88
89
Terms of Trade
Real Effective Exchange rates
Nominal Effective Exchange rates

16 More recently, exchange rates themselves have moved in the opposite direction to those consistent with balance of payments equilibrium. The currencies of the major deficit economies have been strengthening while those of surplus economies have weakened. This may be partly rationalised by approaches to exchange rate determination which focus more on capital account rather than current account factors. The volume of transactions in foreign exchange markets is much larger than the volume of trade in goods, which together with the fact that financial market prices move more quickly than relatively sticky traded goods prices, means that it is quite possible that equilibrium in the foreign exchange market induced by changes in interest rate policy or even expectations of such changes may at times work counter to equilibrium in the goods market. For example, following heavy and relatively successful co-ordinated intervention in 1987, the market has been more confident recently of central banks' abilities to stabilise rates. The 'promise' of stability made the dollar attractive despite this being unhelpful for longer term current account adjustment.

17 There is of course nothing sacrosanct or even (particularly) desirable about current account balance. Moreover, liberalisation of capital markets has made it easier to finance current deficits than in the past, reducing the likelihood of any short run balance of payments constraint. It has meant that national investment is now less dependent on national saving as the major source of finance and overseas capital (both short-term and long-term) has become an important source of funds. Providing the funds are used effectively for productive investment, this process of liberalisation adds to global welfare. Over the longer-term, investors from capital surplus countries will receive the returns yielded by the investment.

18 However, there is no guarantee that adjustment will be smooth and large surpluses and deficits clearly give rise to some potential vulnerability. Short-term capital flows could prove to be volatile, in which case the absence of foreign exchange controls may at times lead to wider interest rate differentials than would otherwise be the case. Deregulation in capital markets contains some elements of a double-edged weapon.

(ii) <u>The evolution of domestic demand and savings/investment balances</u>

19 The evolution of domestic demand in the major industrial countries also underlies the development and persistence of large payments imbalances. Chart 4 illustrates the growth of real domestic demand in each of the major 7 industrial countries, as compared with the aggregate rate of real domestic demand growth in the other six economies weighted according to GNP. Growth in demand is also compared with the IMF

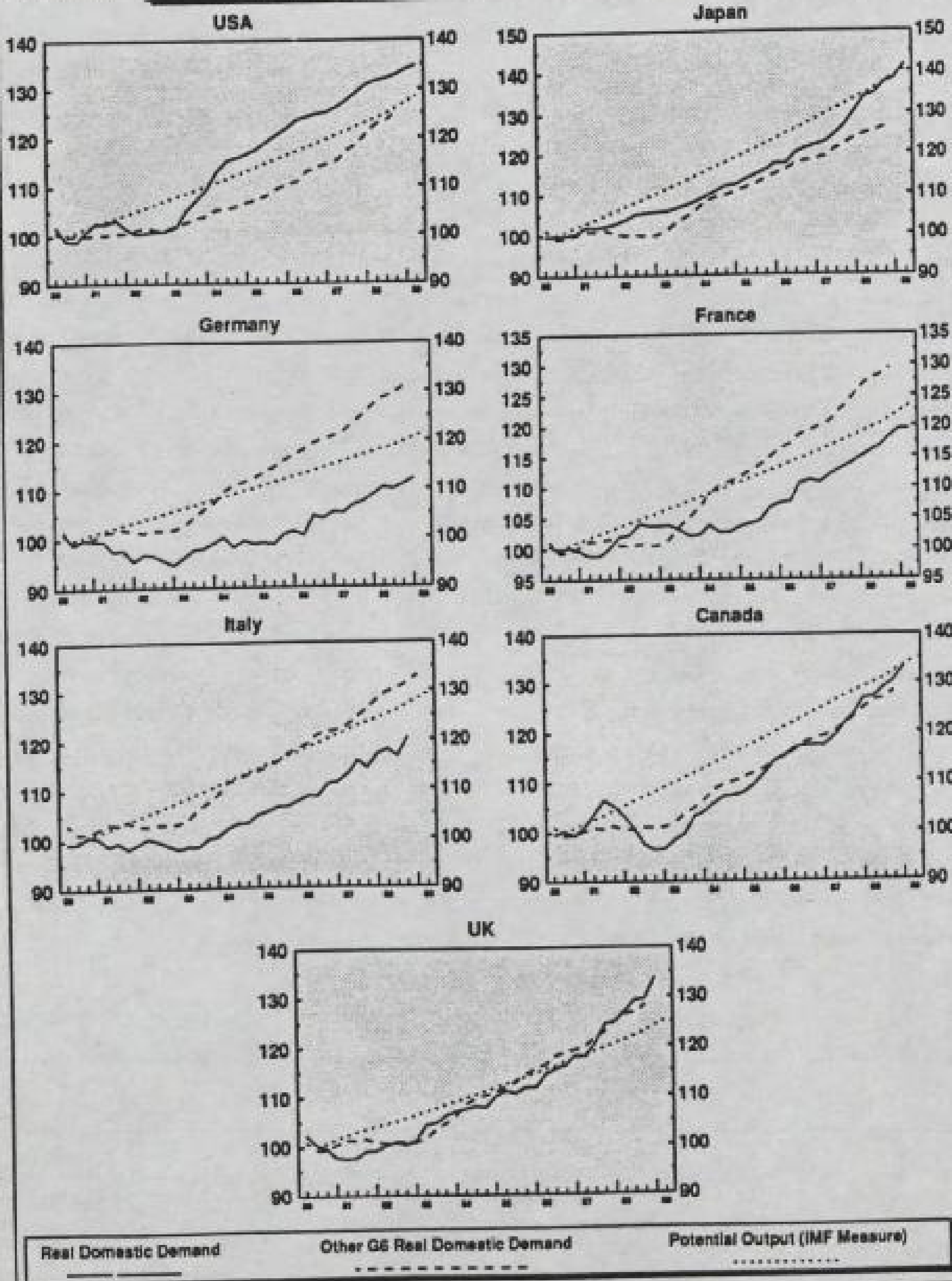
Chart 4:
G7 Domestic Demand and Potential Output 1980=100
USA
Japan
Germany
France
Italy
Canada
UK
Real Domestic Demand
Other G6 Real Domestic Demand
Potential Output (IMF Measure)

measure of domestic potential output growth*. The chart indicates that domestic demand in Japan exceeded domestic demand growth overseas during the decade with a substantial widening in the last two years, when demand has also risen more rapidly than non inflationary supply. In some contrast German domestic demand has grown much less rapidly than in the other G6 and there has been no narrowing recently. This helps to explain the continued rise in the trade surplus. There is also a large gap between domestic demand and non inflationary supply (compared to the position in 1980) which has been filled to an extent by exports. In the US, the demand gap (relative to that overseas) has narrowed recently whilst the opposite has been the case in the UK (until the end of 1988 at least). Recent signs of a slowdown of domestic demand in both countries will help to narrow the gap.

20 A counterpart to the rise in domestic demand in the deficit economies has been a simultaneous decline in the savings ratio, particularly in the personal sector. According to the OECD, the decline in household saving can be attributed to the positive effects of disinflation and buoyancy in the stock and property markets on net wealth positions while reductions in uncertainty may also have induced individuals to reduce precautionary saving. Demographic factors may also be contributing to the changes in savings behaviour. In the major economies the ageing population problem is most serious in Germany and Japan, and may be a factor underlying the relative stability of national savings in those two countries. The liberalisation of international capital markets has facilitated a shift in savings behaviour by making domestic savings more internationally mobile. Consequently the pursuit of the highest risk-adjusted, after-tax rates of return has led to greater flows of capital overseas to countries with higher marginal efficiency of investment (as indicated by relative interest rates) - the deficit economies. In Japan, Germany, the Netherlands, Taiwan and Korea, the current account surplus reflects the fact that the investment ratio has fallen by more than the aggregate saving ratio and vice versa for the USA where the fiscal deficit further adds to the claim on savings. These cross-national developments in the savings/investment gap lie behind the persistence of the current account imbalances which have emerged over the last few years.

21 Another related explanation for the persistence of large payments imbalances can be attributed to an inappropriate mix of monetary and fiscal policy, particularly in

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* It should be noted that all the lines on the chart are normalised on 1980. Consequently the level of demand relative to that overseas and relative to potential supply should be interpreted with care - the gaps refer to relative changes compared with the position in 1980.

the US. In the US, the size of the budget deficit has reduced national savings and put further upward pressure on interest rates. As monetary policy has been tightened to combat rising inflationary tensions, increases in interest rates have induced capital inflows and have been at times associated with a rise in the dollar, which although helpful from a counterinflationary perspective may be harmful for current account adjustment. A tighter fiscal stance would ease the burden on monetary policy and help to achieve the twin goals of reducing inflation and the current account deficit.

Section 4: CAPITAL ACCOUNT DEVELOPMENTS

(i) Financing current deficits

**Table 3:
G7 Total changes in Reserves
(- = increase)**

	1986	1987	1988
US	0.3	9.1	-3.6
JAPAN	-15.7	-39.2	-16.2
GERMANY	-1.3	-17.8	18.5
FRANCE	-1.2	9.8	0.6
ITALY	-1.4	-5.1	-9.1
CANADA	-0.5	-3.4	-7.7
UK	-4.2	-19.7	-4.9
TOTAL	-24.0	-66.3	-22.4

22 In 1987 the pattern of external financing flows was strongly influenced by large scale official purchases of US assets reflecting exchange market intervention to support the dollar. In 1988 however, private financing flows were the main counterpart to the US current account deficit although some official intervention was evident earlier in the year in support of the dollar and later in the year in the opposite direction, with Germany intervening heavily to support the deutschemark. Financing current account deficits became easier in 1988 partly because markets became more confident that the aim of the major countries to promote greater stability in exchange rates would succeed. This view was encouraged by timely rounds of official intervention and by some progress in reducing the US current deficit. As market participants became more confident that a floor for the dollar would be supported by the major central banks, they tended to pay greater attention to short run nominal interest differentials which attracted private capital flows into the US, and also into other deficit countries. Nevertheless the dollar was well above estimates of the floor for most of the year (and at times pushing against a ceiling) which should have

implied that any perceived limit to the potential short run downside risk should not have affected behaviour very much.

23 The issue of the sustainability of financing a current account deficit depends partly on the extent to which the counterpart to the current account deficit lies in long-term or short-term capital flows. Long-term flows such as direct investment and to a lesser extent bond purchases may be more permanent than short-term "hot money" flows through the banking system because they are less liquid than short-term instruments and arguably less susceptible to changes in market sentiment. Clearly though this point should not be overstressed, particularly in the context of international bond markets where liquidity and short term trading opportunities are important considerations.

24 During 1988, the US current account deficit was financed largely by direct and portfolio investment inflows. Direct investment switched from a very modest net inflow of $3 bn in 1987 to a substantial net inflow of $41 bn associated especially with large foreign takeover and merger activity. In addition, foreign direct investment in the US continued to be strong in the first quarter of 1989. Net portfolio investment in the US was slightly higher in 1988 than 1987 with additions to liabilities to the private sector surpassing increases in liabilities to the foreign official sector (some of which may have reflected portfolio reallocation from intervention in 1987 which was not captured in US capital account statistics). Investment by foreign corporations and residents in the US was concentrated in US Treasury securities which recorded net inflows of $20 bn in 1988 compared to a net outflow of $8 bn in 1987. It is also noteworthy that the preliminary estimate of foreign investment in US Treasury securities in the first quarter of 1989 was $9 bn (greater than the figure for the whole of 1987). The main explanations for this increase in US bond purchases relate to greater pessimism about the equity market post-crash, favourable interest rate differentials particularly for Japanese investors (particularly after adjusting for their revised perception of the downside exchange rate risk), and possibly greater relative optimism about the containment of US inflation than for other industrial countries compared to earlier expectations. Net banking inflows slowed to $14 bn in 1988 ($51 bn in 1987) and non-bank inflows recorded a small increase during 1988. In total, net inflows into the US capital account exceeded the current account deficit in 1988 and reserves rose by $4 bn, the first annual increase recorded in 3 years. This tendency has continued in 1989 as the dollar has strengthened.

25 As in the US, the current account deficit in the UK was financed by the foreign private sector but in contrast to the US, the finance was entirely in the form of

sho[illegible]term deposits through the banking system while net direct and portfolio investment recorded large net outflows. These structural capital outflows further increased the requirement for short-term finance and hence may make the UK payments deficit rather more vulnerable than the US deficit to short-term shocks, although the danger is somewhat attenuated by the relatively strong UK external asset and reserves position. The growth in net international liabilities of UK banks rose from $4 bn in 1987 to $26 bn in 1988 with a further large inflow in the first quarter of 1989. Non-bank flows, which are largely transactions by residents with banks abroad, switched from net outflows in 1987 of $2 bn to inflows of $6 bn in 1988. Total identified inflows fall far short of matching the current account deficit; the large statistical discrepancy in the UK balance of payments is believed to reflect mostly unrecorded inflows probably of a short-term nature.

26 The deficits of the other major OECD economies were financed by a mixture of short and long-term inflows. Long-term non-banking inflows in Italy were $8 bn ($3 bn in 1987), while net bank borrowing doubled to $9 bn. In addition, both direct and portfolio investment recorded net inflows in 1988 perhaps in part associated with the removal of some exchange controls during the year. The strength of inflows meant that despite a current deficit in 1988 which was over $5 bn, reserves rose strongly. In contrast the French current deficit was financed largely by short-term private capital inflows and by portfolio flows while direct investment recorded large net outflows of $6 bn in 1988 ($4 bn in 1987). Net Canadian direct investment overseas was outweighed by overseas purchases of Canadian securities which together with other short-term inflows more than financed the current deficit. Reserves rose strongly as the Bank of Canada intervened to limit the appreciation of the Canadian dollar.

27 Current deficits in the major oil producers were financed in 1988 mainly by borrowing in the case of the non-Arab countries (eg Venezuela and Nigeria) and by drawing down reserves and delaying payments in the Arab countries.

28 Despite the relatively favourable external outlook for many developing countries in 1988, new borrowing continued to be extremely scarce, and was dominated by the package to clear Brazilian arrears (of $12.6 bn) and by Chinese and Indian borrowing to finance current account deficits. Direct investment inflows increased, partly reflecting various debt/equity conversion schemes, but remains relatively small in value. The dearth of new finance from banks underlies the new proposals for middle income debtors put forward by US Treasury Secretary Brady. His proposals advocate a case-by-case approach to debt and debt service reduction together with the option of new lending as a means of providing financial support to individual debtor countries.

The first financing package along these lines has recently been agreed between Mexico and its Bank Advisory Committee.

(ii) Deployment of world current account surpluses

29 The Japanese current surplus continued to be deployed in long-term private capital outflows and rising official reserves. In comparison with 1987, the Japanese capital account demonstrated three important features in 1988. Firstly, net direct investment overseas rose sharply (to $35 bn from $18 bn in 1987). Factors underlying this strong rise include a desire by Japanese exporters to avoid tariff and other protectionist barriers, while capacity and production cost constraints at home have increased the attraction of overseas production. In addition, the appreciation of the yen since 1985 has made the acquisition of physical assets overseas considerably cheaper. Net portfolio investment abroad declined from $97 bn in 1987 to $65 bn in 1988. This reflects both a slowdown in Japanese purchases of foreign securities and a big reversal in non-resident transactions in Japanese securities which turned into a net inflow of $20 bn in 1988 from an outflow of $6 bn in 1987. The rapid recovery of the Japanese stock market post-crash and the actual and expected appreciation of the yen appear to be the main motivating factors. Finally, capital inflows via the banking system were much below the 1987 peaks with short-term borrowings down to $62 bn in 1988 ($96 bn in 1987). The BIS Annual Report argues that the background of higher short-term interest rates abroad and greater stability in exchange markets in 1988 probably reduced incentives for resident investors to hedge as large a share of their foreign investment as in 1987 through short-term borrowing in foreign currency. New capital adequacy requirements may also have dampened growth of intermediation through banks.

30 Despite a further rise in the German current surplus, foreign exchange reserves fell by $19 bn in 1988. This reflected substantial intervention by the monetary authorities to support the deutschemark in the foreign exchange market given sharp downward pressure arising from strong demand for foreign currency assets. Net German residents' purchases of foreign securities was $37 bn in 1988 compared with net sales of $5 bn in 1987. Investors were attracted by significant interest rate differentials in some countries announcement and by the desire to avoid paying the withholding tax introduced in January 1989 (subsequently abolished following an announcement in April with effect from July) on domestic interest income. Latest monthly data suggest however that capital may be returning. In the second quarter there was a slight net portfolio inflow, compared with a massive net outflow of over $15 bn in Q1.

31 The current account surpluses of the Asian NIEs are also associated with large capital outflows although the situation is different for Taiwan and Korea. The relaxation of foreign exchange controls in Taiwan and the temporary collapse of the very volatile Taiwanese stock market led to massive outflows of mainly illegally deposited funds from overseas to Hong Kong and Singapore. There has also been a large rise in direct investment abroad particularly in other SE Asian economies for example Thailand and also in China. Labour shortages at home, pollution legislation and wage pressures underpin this movement. Foreign exchange reserves fell by $3 bn in 1988 (although a large part was switched into gold). In Korea long-term capital exports (investments and repayments of debt) have continued in 1988 as a counterpart to its growing current account surplus. Indeed, Korea is expected to become a net creditor country by the end of 1989. Certain relaxations in foreign exchange controls and some appreciation of the won have assisted the Korean economy to become more integrated with the world economy while future plans for liberalisation of the securities markets will contribute further to this process.

32 In conclusion, the extent to which surplus economies can aid international adjustment depends on whether their excess savings are being used to support productive investment in the deficit economies. In the longer term, investment by the surplus economies in deficit economies is likely to raise capacity and relieve demand pressures which may reduce imports and promote exports by the deficit economy (providing the funds are used productively and not, for example, supporting government consumption) although in the short-term foreign-owned firms may worsen the deficit by importing equipment and components from their parent companies and trading partners at home. A recent paper published by the Royal Institute of International Affairs* estimates that in the US, foreign-owned firms were responsible for one third of US imports and a quarter of US exports in 1986. Japanese multinational firms send both more exports to and receive more imports from their affiliates abroad then do US multinationals as a percentage of total exports and imports. It is still too early to tell whether international shifts in production will ultimately lead to adjustment in world current account imbalances.

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* "Inward Investment and Foreign-Owned Firms in the G5" RIIA Discussion Papers #12

WORLD PAYMENTS REPORT

AUGUST 1989

STATISTICAL ANNEX

EXTERNAL FINANCING TABLES

Table A1: United States

Table A2: Japan

Table A3: Germany

Table A4: France

Table A5: United Kingdom

Table A6: Italy

Table A7: Canada

TABLE A3:

UNITED STATES: EXTERNAL FINANCING

(billions of dollars; seasonally adjusted)

	1986	1987	1988	1988 Q1	Q2	Q3	Q4	1989 Q1
Identified current account	-133.2	-143.7	-126.5	-27.6	-33.9	-36.9	-28.2	-26.1
Financed by:								
Direct investment, net	7.8	2.7	40.8	3.0	12.9	7.0	18.0	10.6
Portfolio investment, net	103.7	74.0	81.7	31.4	22.5	6.1	21.8	20.1
Assets	-4.3	-5.3	-7.8	-4.5	1.3	-1.6	-3.0	-2.6
Liabilities	107.9	79.3	89.6	35.9	21.2	7.7	24.8	22.6
Foreign official	33.2	44.8	43.0	27.5	6.1	-3.2	12.6	5.3
Foreign private	74.8	34.5	46.6	8.4	15.2	10.9	12.2	17.3
Bank borrowing, net	21.0	50.8	14.0	-3.6	18.6	-1.2	0.3	-10.7
Assets	-60.0	-42.1	-54.5	15.3	-12.6	-26.2	-30.9	-22.6
Liabilities	81.0	92.9	68.5	-18.9	31.2	25.0	31.2	11.9
Foreign official	1.2	3.9	-0.3	-1.8	0.8	1.7	-1.0	1.5
Foreign private	79.8	89.0	68.8	-17.1	30.5	23.3	32.2	10.4
Gvt borrowing, net (1)	0.1	-1.5	1.7	-2.0	-1.3	1.8	3.3	0.5
Non-banks', net	-10.9	4.6	2.4	0.7	-6.9	2.1	6.5	0.5
Official financing balance (-=increase in reserves)	0.3	9.1	-3.6	1.5	0.0	-7.4	2.3	-4.0
Balancing item (2)	11.3	1.9	-10.6	-3.4	-12.0	28.6	-23.9	9.2

(1) Securitised Treasury borrowing included under portfolio investment

(2) Reflects unidentified net flows, which may be either current or capital account items

Memo item

	1986	1987	1988	1988 Q1	Q2	Q3	Q4	1989 Q1
Nominal effective exchange rate 1985=100	80.2	70.3	65.9	64.9	64.5	68.7	65.6	67.2

TABLE A2:

JAPAN: EXTERNAL FINANCING

(billions of dollars; not seasonally adjusted)

	1986	1987	1988	1988 Q1	Q2	Q3	Q4	1989 Q1
Identified current account	85.8	87.0	79.6	18.4	18.6	19.1	23.6	15.8
Financed by:								
Direct investment, net	-14.3	-18.4	-34.7	-7.7	-8.0	-8.6	-10.4	-9.0
Portfolio investment, net	-105.1	-97.1	-64.7	-6.4	-25.4	-19.3	-13.6	6.9
Bank borrowing, net	55.1	79.8	46.8	-6.2	23.1	21.4	8.4	-14.4
of which: long-term	-9.3	-16.3	-15.3	-4.1	-2.6	-5.1	-3.6	-5.4
short-term	64.4	96.2	62.1	-2.1	25.7	26.5	12.0	-9.0
Non-banks', net	-8.2	-8.3	-13.4	-2.1	-3.0	-3.9	-4.5	-1.4
of which: trade credits	-3.3	-0.8	-7.8	-0.9	-1.3	-1.9	-3.7	-1.0
other	-4.9	-7.5	-5.8	-1.2	-1.6	-2.1	-0.9	-0.4
Official financing balance (-=increase in reserves)	-15.7	-39.2	-16.2	-3.4	-2.8	-3.5	-6.5	-1.7
Balancing item (1)	2.5	-3.9	2.8	7.4	-2.4	-5.2	3.0	3.8

(1) Reflects unidentified net flows, which may be either current or capital account items

Memo items

	1986	1987	1988	1988 Q1	Q2	Q3	Q4	1989 Q1
¥ per US$ (period average)	168.5	144.6	128.2	128.0	125.6	133.7	125.3	128.5
Nominal effective exchange rate 1985=100	124.4	133.2	147.4	144.6	148.0	145.5	151.4	150.3

TABLE A3:

GERMANY: EXTERNAL FINANCING

(billions of dollars; not seasonally adjusted)

	1986	1987	1988	1988 Q1	1988 Q2	1988 Q3	1988 Q4	1989 Q1	1989 Q2
Identified current account	39.2	45.2	48.5	9.7	14.4	8.7	15.8	15.8	13.7
Financed by:									
Direct investment, net	-8.5	-7.1	-8.8	-1.7	-3.9	-2.0	-1.3	-1.3	-2.4
Portfolio investment, net	24.3	4.4	-37.1	-9.0	-10.8	-8.2	-9.2	-15.3	1.5
Bank borrowing, net	-22.2	-4.2	-4.6	7.5	-3.0	-6.1	-2.3	12.8	-5.5
of which: long-term	5.0	-0.8	6.9	-0.8	0.3	4.2	2.9	2.4	2.5
short-term	-27.2	-3.4	-11.5	8.3	-3.3	-10.3	-5.2	10.4	-8.0
Government borrowing, net	-5.2	-9.0	-8.0	-3.6	-1.8	-2.6	-0.1	-2.5	-1.6
Non-banks', net	-25.2	-7.2	-10.4	-7.5	0.0	-3.8	-2.3	-11.4	-5.3
Official financing balance (-=increase in reserves)	-1.3	-17.8	18.5	1.8	5.2	11.0	0.1	4.8	4.3
Balancing item (2)	-1.1	-4.4	1.8	2.8	0.0	-8.1	-0.7	-3.0	-4.9

(1) Totals in US$ calculated using the relevant period average exchange rate. For this reason, quarterly totals may not sum to annual totals.

(2) Reflects unidentified net flows, which may be either current or capital account items

Memo items

	1986	1987	1988	1988 Q1	1988 Q2	1988 Q3	1988 Q4	1989 Q1	1989 Q2
DM per US$ (period average)	2.17	1.80	1.76	1.68	1.71	1.87	1.78	1.85	1.93
Nominal effective exchange rate 1985=100	108.8	115.4	114.6	116.2	114.9	113.2	114.0	112.7	n\a

TABLE A4:

FRANCE: EXTERNAL FINANCING

(billions of dollars; not seasonally adjusted)

	1986	1987	1988	1988 Q1	Q2	Q3	Q4
Identified current account	3.1	-4.1	-3.8	-0.5	-0.3	-0.4	-2.6
Financed by:							
Direct investment, net	-2.6	-4.2	-6.0	-1.2	-1.1	-0.6	-3.1
Portfolio investment	1.9	4.5	7.7	-0.6	6.4	-2.7	2.7
Long-term capital net of which:	-6.9	1.5	2.1	0.9	0.3	0.5	0.6
Official sector, net	-6.4	-4.7	-4.1	-0.7	-1.1	-1.2	-1.1
Bank's net	0.8	5.0	1.3	0.9	0.2	-0.4	0.6
Non-Bank private, net	-1.2	1.3	4.9	0.7	0.9	2.2	1.0
Short-term capital net of which:	4.0	-5.3	3.8	3.7	-6.0	2.8	3.3
Official sector, net	-0.5	1.9	4.3	0.7	-0.9	1.5	3.1
Bank's net	2.4	-9.5	1.4	3.5	-3.6	2.6	-1.1
Non-Bank private, net	2.1	2.4	-1.9	-0.5	-1.5	-1.3	1.3
Other flows	1.1	-3.0	-4.9	0.7	-0.6	-2.3	-2.7
Official financing balance (-=increase in reserves)	-1.2	9.8	0.6	-5.2	-0.4	1.5	4.6
Balancing item (2)	0.7	0.6	0.6	2.2	1.9	-0.9	-2.7

(1) Totals in US$ calculated using the relevant period average exchange rate. For this reason quarterly totals may not sum to annual totals.

(2) Reflects unidentified net flows, which may be either current or capital account items

Memo items

	1986	1987	1988	1988 Q1	Q2	Q3	Q4
FF per US$ (period average)	6.93	6.01	5.96	5.67	5.78	6.32	6.06
Nominal effective exchange rate 1985=100	102.8	103.0	100.9	102.4	101.4	100.0	99.6

TABLE A5:

UNITED KINGDOM: EXTERNAL FINANCING

(billions of dollars; not seasonally adjusted)

	1986	1987	1988	1988 Q1	1988 Q2	1988 Q3	1988 Q4	1989 Q1
Identified current account	0.2	-4.8	-26.6	-6.1	-6.1	-6.2	-8.2	-8.0
Financed by:								
Direct investment, net	-9.5	-17.5	-13.0	0.7	-6.1	-3.6	-4.0	-3.5
Portfolio investment, net	-25.8	18.3	-12.0	-4.4	-6.6	3.6	-4.9	-12.5
Bank borrowing, net	14.5	4.1	26.0	5.3	9.9	0.7	10.5	14.2
of which : assets	-78.5	-82.6	-34.3	2.8	-16.1	-28.3	8.3	-26.4
liabilities	93.5	86.7	60.3	2.6	26.0	29.0	2.2	40.6
Government borrowing,net	-0.5	1.3	0.0	-1.1	0.0	-0.6	1.8	-0.6
Non-banks', net	5.1	-2.1	5.8	3.7	1.4	1.7	-1.1	3.0
Official financing balance (-=increase in reserves)	-4.2	-19.7	-4.9	-1.2	-1.2	-1.7	-0.9	0.9
Balancing item	20.1	20.3	24.7	3.1	8.8	6.1	6.8	6.5
Memo Items								
£ per US$ (period average)	0.68	0.61	0.56	0.56	0.54	0.59	0.56	0.57
Nominal effective exchange rate 1985=100	91.6	90.1	95.5	93.4	96.8	95.2	96.7	97.1

TABLE A6:

ITALY: EXTERNAL FINANCING

(billions of dollars; not seasonally adjusted)

	1986	1987	1988	1988 Q1	Q2	Q3	Q4
Identified current account	2.6	-1.5	-5.2	-5.2	1.0	0.2	-1.5
Financed by:							
Non-banks', net	-2.8	5.0	6.7	3.6	-1.3	4.7	-0.4
of which: long-term	-2.7	3.2	7.8	3.1	-0.9	4.8	0.6
short-term	-0.1	1.9	-1.2	0.5	-0.4	-0.2	-1.1
Bank borrowing, net	3.4	4.2	8.6	2.1	3.2	-0.6	4.2
Official financing balance (-=increase in reserves)	-1.4	-5.1	-9.1	-2.5	-0.5	-2.8	-3.3
Balancing item (2)	-1.7	-2.6	-0.9	2.0	-2.3	-1.5	1.0

(1) Totals in US$ calculated using the relevant period average exchange rate. For this reason, quarterly totals may not sum to annual totals.

(2) Reflects unidentified net flows, which may be either current or capital account items

Memo items

IFS Data

	1986	1987	1988	1988 Q1	Q2	Q3	Q4
Direct investment							
Portfolio investment							
LIT per $ (period average)	1490.8	1296.1	1301.6	1235.3	1268.1	1385.9	1317.3
Nominal effective exchange rate 1985=100	101.4	101.2	97.8	99.5	97.8	96.5	97.3

TABLE A7:
CANADA: EXTERNAL FINANCING

(billions of dollars; not seasonally adjusted)

	1986	1987	1988	1988 Q1	Q2	Q3	Q4	198 Q1
Identified current account	-7.6	-8.0	-9.2	-3.8	-1.1	-0.4	-3.8	-5.1
Financed by:								
Direct investment, net	-2.1	-1.2	-2.5	0.1	-1.3	-0.4	-0.7	-0.8
Portfolio investment, net	16.1	8.8	10.1	2.2	2.9	3.8	1.4	5.1
Bank borrowing, net	-4.0	1.7	2.1	1.0	-2.7	4.1	-0.3	-3.2
Government borrowing, net	1.3	0.7	5.2	2.3	2.7	-0.5	0.6	1.4
Non-banks', net	-0.8	3.6	2.0	0.1	2.9	-4.7	3.7	1.7
Official financing balance (-=increase in reserves)	-0.5	-3.4	-7.7	-4.4	-3.7	1.5	-1.0	-0.2
Balancing item (2)	-2.4	-2.2	-0.4	2.3	0.5	-3.3	0.1	0.9

(1) Totals in US$ calculated using the relevant period average exchange rate. For this reason, quarterly totals may not sum to annual totals.
(2) Reflects unidentified net flows, which may be either current or capital account items.

Memo items

	1986	1987	1988	1988 Q1	Q2	Q3	Q4	198 Q1
C$ per US$ (period average)	1.39	1.33	1.23	1.27	1.23	1.22	1.21	1.19
Nominal effective exchange rate 1985=100	91.7	92.4	98.1	94.6	97.5	100.4	100.0	102.0

R19/9

BANK OF ENGLAND
LONDON EC2R 8AH

THE DEPUTY GOVERNOR

18 September 1989

P R Gray Esq
Prime Minister's Office
No 10 Downing Street
London SW1A 2AA

PG

Dear Mr Gray

As requested, I attach a copy of the paper which Sir Hector Laing drew to the attention of the Prime Minister. It is the Bank's World Payments Report, based on published information. The data on balancing items in different countries' balance of payments statistics are to be found in the annex to the paper.

Clive Briault

C B Briault
Private Secretary to the Deputy Governor

chex.dc/jg/3

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

13 September 1989

Paul Gray Esq
PS/Prime Minister
10 Downing Street
LONDON
SW1

Dear Paul

ARTICLE BY TIM CONGDON

I attach a note prepared by economists here assessing Congdon's arguments.

Yours

JG

JOHN GIEVE
Principle Private Secretary

ARTICLE BY TIM CONGDON

Congdon's article considers how the economy needs to develop over the next few years if inflation is to be brought back under control and the current account deficit is to be reduced. He bases his article on two familiar and uncontentious arguments:

- that in the process of reducing inflation it is likely that the growth of output will fall temporarily below the growth of productive potential;

- that domestic demand will grow less than domestic output as the balance of payments improves.

The contentious part of his article lies in the quantification provided on these two issues. The adjustment process to lower inflation and an improving current account could well be painful, but not as painful as Congdon's rather pessimistic figuring implies.

Output growth and unemployment

2. Congdon argues that higher unemployment cannot be avoided if inflation is to come back down to 5% or less. More specifically, he argues that the unemployment rate may have to rise to 9% or more (compared with 6½% now) - the level in late 1987 when pay settlements were last broadly flat - in order to produce the desired effect. He translates this 2½% rise in unemployment into a shortfall in output growth relative to productive potential of 1½-2% per annum for three years - i.e. a cumulative total of 4½-6%.

3. There are a number of reasons for thinking that these figures are unduly pessimistic. First, there is a good deal of evidence, for both the UK and other countries, to suggest that the rate at which unemployment is changing is a more important factor than the absolute level of unemployment in determining the degree of upward pressure on wage settlements. This is certainly consistent with

the continuing buoyancy of real wages in the mid-1980s, at a time when the unemployment rate was very high by past standards. In the last three years we have seen a very rapid decline in unemployment, and not surprisingly this has eventually fed into higher wage settlements. But the decline in unemployment is already slowing, and may soon come to an end. If we are correct about the particular importance of unemployment changes, this in itself will reduce the pressure on wage settlements.

4. Second, the labour market reforms which we have implemented progressively in the 1980s will have reduced the rate of unemployment which is compatible with declining inflation. This may be one reason why the extent to which earnings growth has risen - from 7½% per annum between 1985 and 1987 to about 9¼% now - is surprisingly small given the scale and pace of the decline in unemployment since 1986.

5. Third, as Congdon recognises, there are other mechanisms involved in bringing inflation down: we are not relying only on pressures in the labour market. So long as we do not accommodate inflationary pressures by relaxing our monetary stance, all these mechanisms will come into play. Companies will find it increasingly difficult to raise prices, and the resulting pressure on profit margins (which have been very healthy) will provide an additional source of downward pressure on costs.

6. Adjustment to lower and declining inflation may require some rise in unemployment from present levels, but this is by no means certain. The outcome is not in the Government's hands, but depends on how quickly employees and employers act to moderate the rate of growth of pay. But on the basis of past experience, Congdon's figuring seems unduly pessimistic.

7. Even if one accepts Congdon's assessment of the rise in unemployment required to bring inflation down, his calculation of the cumulative shortfall in output growth relative to productive potential is too big; we would not expect it to be double the

percentage rise in unemployment, as he suggests. Combined with his pessimistic view on unemployment this yields a cumulative loss of output which is some way above our own estimates.

8. The task we set ourselves in this year's MTFS was to bring the growth of money GDP down from about 11% per annum in 1987-88 and 1988-89 to 6% or below in the next year or so. This would be consistent with inflation falling to around 3% by 1991-92, a somewhat more ambitious objective than Congdon seems to envisage. The MTFS also assumed that this would be consistent with output growth of 2% per annum for two years, implying a cumulative shortfall of around 2% relative to productive potential - under half of the 4½-6% which Congdon suggests.

<u>The current account and domestic demand</u>

9. Congdon argues that a substantial fall in the current account deficit must occur, to perhaps 2% of GDP, if we are to maintain a stable exchange rate over the next few years and at the same time allow interest rates to fall. His argument is based on the view that the present deficit is being financed by short term capital flows which cannot be sustained <u>without</u> high interest rates. In fact, of course, the errors and omissions in the balance of payments statistics are so great that we do not know the true counterparts of the current account deficit. Moreover it is misleading in today's integrated capital markets to single out particular forms of finance as being noticeably more volatile than others. As long as we maintain prudent non-inflationary policies we should be able to finance a deficit of around the level we currently expect; there is no need for the short term target reduction in the deficit that Congdon implies.

10. There should of course be an improvement in the current account, as a share of GDP, with the policies presently in place. And Congdon is right to argue that a reduction in the deficit will require growth of domestic demand to be below the growth of domestic output. This inevitably means a sharp slowdown of domestic demand growth in relation to recent rates: 6½% in 1988 and an average of 4% per annum over the last six years. But it

should not be necessary for domestic demand growth to slow down to under 1% per annum over the next three years as Congdon argues; this reflects his very pessimistic view about output growth.. In the MTFS we envisaged domestic demand growing at an average rate of about 1½% per annum over the next two years.

10. Congdon seeks to add credence to his figures for domestic demand by referring back to the aftermath of the Barber boom of 1972-73 and the Healey boom of 1978-79. He points out, quite correctly, that domestic demand actually fell by 4% in both these cases. However, these episodes were entirely different from the present position. Inflation was very much higher in both cases, and rising sharply; this is not the situation we face now. In the previous episodes we were having to adjust to major oil price shocks; and in the Barber period the rise in oil prices caused a major deterioration in our terms of trade.

11. There are, of course, clear signs that domestic demand is already slowing down, although this has yet to be reflected in any significant improvement in the current account. How quickly the current account is likely to improve is difficult to judge but it is bound to be a slow process. Imports have continued to grow strongly this year; but the strength of exports is more encouraging, and fits in with recent academic work which has identified a marked improvement in underlying export performance dating from the early 1980s.

Conclusion

12. Congdon is right to argue that output will have to grow somewhat below productive potential over the next year or so, and domestic demand somewhat slower still, if inflation is to be brought back down and the current account is to improve. It has to be accepted that the extent to which output must slow down, and the accompanying path of unemployment, is uncertain. But Congdon paints a bleaker picture than can be justified as a central forecast.

Econ Pol: Domestic Monetary Policy Pt 21

FILE

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

6 September 1989

ARTICLE BY TIM CONGDON

The Prime Minister has seen the attached article by Tim Congdon in Monday's Times. She would be grateful for an assessment of Congdon's arguments, which she could then discuss with the Chancellor at one of their bilateral meetings. It would be helpful to have this within the next week.

BF

PAUL GRAY

J. Gieve, Esq.,
HM Treasury

VL6

Tim Congdon compares today's outlook with previous squeezes

Three years of austerity to bring down inflation

Everyone agrees that the economy has to slow down if inflation and the balance of payments are to be brought back under control. But how much of a slowdown is needed? And how long does it need to last?

The Keynesian framework of national income accounting provides a useful and familiar approach for answering these questions. This framework gives an incomplete description of the economy since it does not properly recognize the role of such important influences as credit and money. Nevertheless, it does suggest two ideas which are basic to quantifying the scale and duration of the coming period of austerity.

The first is that the actual growth rate of output needs to be beneath the trend growth rate if there is to be a margin of spare resources sufficient to moderate inflationary pressure. The second is that the growth rate of domestic demand needs to be less than the growth rate of output if extra output is to become available for improving the balance of payments. These two requirements can be considered in turn.

To refer to the "margin of spare resources" is really a polite and impersonal way of talking about unemployment. Casual remarks such as "unemployment needs to be higher if pay settlements are to be brought down" beg the politically awkward question of how much higher it has to go.

The last time that pay settlements were stable was in late 1987 when the unemployment rate was over 9 per cent. Assuming that the structure of the labour market is broadly the same now as it was then (which seems a sensible view to take), unemployment needs to move back towards this figure from its present level of about 6.5 per cent if pay settlements are to start falling again.

The implied 2.5 per cent increase in unemployment — from the present 1.8 million to about 2.5 million — appears to determine the amount by which actual output growth needs to be beneath trend to dampen inflation. If the trend growth rate is taken to be 3 per cent a year, actual growth of a little above 2 per cent a year for three years would seem to do the trick.

Unfortunately, a cyclical characteristic of the economy is that employment responds more sluggishly than output to changes in demand. As a result, output growth will have to be even weaker, at perhaps 1 per cent to 1.5 per cent a year over three years, to eliminate inflationary pay demands.

These numbers are hardly precise. They are informed guestimates, rather than exact econometric calculations. But, in view of the large errors made by econometric models in the last few years, this may not be a bad thing. At any rate, it is clear from recent experience that an unemployment rate of under 7 per cent is associated with severe labour shortages, rising pay settlements and deteriorating inflation. Somewhat higher unemployment cannot be avoided if inflation of 5 per cent or less is to be restored.

The extent of the desired reduction in the external payments deficit is, if anything, yet more problematic. The official view is that, while the Government is running a large budget surplus, the external deficit is entirely the result of private-sector decisions. Since the private sector is the best judge of its own interests, the deficit is not a policy problem and no corrective action should be taken.

Lawson: presiding over a big increase in unemployment?

This argument appears logically watertight. But practically it is open to several kinds of criticism. Perhaps the most important is that the payments deficit is at present being financed largely by short-term capital inflows. These inflows are motivated by the high level of sterling interest rates, which are determined by government policy, not private decision.

If sterling interest rates fall (as everyone hopes will happen eventually), it will be difficult to reconcile a current account deficit of about 4 per cent of national income with a stable exchange rate.

The Government would probably feel safer if the payments deficit were lower. No one knows exactly what constitutes a "safe" and "appropriate" deficit and, in any case, the Government cannot fix the deficit in a world of freely-flowing international capital. But suppose, for the sake of argument, that a payments deficit of 2 per cent of national income is regarded as suitable. It follows that — in each of the three years — the rate of growth of domestic demand has to be less than the rate of output growth by between roughly 0.5 per cent and 0.75 per cent of national income.

If the two requirements for an improvement in [the] inflation rate and the balance [of] payments are combined, the conclusion is that the growth rate of domestic demand needs to be held at under 1 per cent a year for three years. This contrasts with increases in domestic demand of 6.5 per cent in 1988 and 5 per cent in 1987, and an average increase in the six years to 1988 of more than 4 per cent a year.

It emphasizes just how difficult the task of macroeconomic adjustment facing the Government now is, as it ponders the run-up to both the next general election and the next phase of European financial integration.

The arithmetic set out in this article may seem harsh, perhaps implausibly so. A cross-check is given by looking at other periods of demand restraint. The two previous periods of adjustment were after the Barber boom of 1972-73 and the Healey mini-boom of 1978 and early 1979.

The downturns which followed those episodes of financial excess saw domestic demand *fall* by over 4 per cent in two years. The economic medicine prescribed here for the early 1990s is mild by comparison.

The author is economic adviser to Gerrard & National Holdings. This article is based on the September issue of the Gerrard and National Monthly Economic Review, *published today.*

PRIME MINISTER

ARTICLE BY TIM CONGDON

You may like to glance at the attached article by Tim Congdon in yesterday's Times. It provides a sobering and rather worrying assessment of the action necessary to achieve the inflation and balance of payment objectives. It could be said to be over-pessimistic, but I do not think it can be regarded as outside the range of plausible scenarios.

Would you like to have a Treasury assessment of Congdon's case, which you could then discuss with the Chancellor at a bilateral? Yes please

PAUL GRAY

5 September 1989

KAYBAJ

Tim Congdon compares today's outlook with previous squeezes

Three years of austerity to bring down inflation

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This argument appears logically watertight. But practically it is open to several kinds of criticism. Perhaps the most important is that the payments deficit is at present being financed largely by short-term capital inflows. These inflows are motivated by the high level of sterling interest rates, which are determined by government policy, not private decision.

If sterling interest rates fall (as everyone hopes will happen eventually), it will be difficult to reconcile a current account deficit of about 4 per cent of national income with a stable exchange rate.

The Government would probably feel safer if the payments deficit were lower. No one knows exactly what constitutes a "safe" and "appropriate" deficit and, in any case, the Government cannot fix the deficit in a world of freely-flowing international capital. But suppose, for the sake of argument, that a payments deficit of 2 per cent of national income is regarded as suitable. It follows that — in each of the three years — the rate of growth of domestic demand has to be less than the rate of output growth by between roughly 0.5 per cent and 0.75 per cent of national income.

If the two requirements for an improvement in the inflation rate and the balance of payments are combined, the conclusion is that the growth rate of domestic demand needs to be held at under 1 per cent a year for three years. This contrasts with increases in domestic demand of 6.5 per cent in 1988 and 5 per cent in 1987, and an average increase in the six years to 1988 of more than 4 per cent a year.

It emphasizes just how difficult the task of macroeconomic adjustment facing the Government now is, as it ponders the run-up to both the next general election and the next phase of European financial integration.

The arithmetic set out in this article may seem harsh, perhaps implausibly so. A cross-check is given by looking at other periods of demand restraint. The two previous periods of adjustment were after the Barber boom of 1972-73 and the Healey mini-boom of 1978 and early 1979.

The downturns which followed those episodes of financial excess saw domestic demand *fall* by over 4 per cent in two years. The economic medicine prescribed here for the early 1990s is mild by comparison.

The author is economic adviser to Gerrard & National Holdings. This article is based on the September issue of the Gerrard and National Monthly Economic Review, *published today.*

Sins of the father that can never be erased

Raymond Plant

The mind's eye is all

PART 20 ends:-

PG to HMT 21.8.89.

PART 21 begins:-

PG to PM 5.9.89.

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