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THE ECONOMIC AND MONETARY SITUATION IN THE UNITED KINGDOM
(Note for the attention of the Monetary Committee)

- Issues for discussion and questions -

The period since 1985 has seen striking changes in the UK economy in almost every area. **Unemployment**, which in 1985 was above the EC average and still rising, has since fallen sharply as a result of a burst of very rapid **growth**; it is now lower than in any EC country except Luxembourg. On the other hand, **inflation** dipped only briefly after the 1986 oil price fall. Moreover, it has in the last year accelerated rather sharply, provoking a monetary policy reaction that may now produce a period of slightly below-trend growth. **The current account**, still in surplus in 1985, has swung into very heavy deficit. Only part of that swing can be accounted for by a decline in the positive **oil balance**, but in overall terms the importance of oil in the UK economy has been much reduced. In contrast, the **public finances** have moved into equally large surplus, mainly as a result of a sharp reduction in public spending as a share of GDP. **Monetary policy** has had a difficult - and not entirely successful - role to play, and may now be seen by the markets to be directed to short-term stabilization.

The major constant in this changing picture has been the government's continued emphasis on **supply-side** improvement. This has borne fruit in fast growth of productivity, at least in manufacturing, fast-growing real wages, a renascence of entrepreneurial confidence and an extremely strong upsurge in investment. It is within this context of a changed - and changing - supply side of the economy that the problem of inflation, the issue of the current account and the challenges facing policy must all be seen.

Economic growth: driven by animal spirits

The acceleration in growth that began in 1986 was largely the product of an upsurge in consumer and industrial confidence. It coincided with the oil price fall, but since sterling also depreciated, the route was not principally one of increased real wages induced by improved terms of trade. Instead, the personal

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savings rate fell sharply (although this was not true of total private savings) and investment intentions increased as the perceived rate of return rose to historically and internationally high levels. As compared with other European countries, a high level of marketable personal wealth and wide and expanding personal borrowing opportunities allowed improved confidence in future prospects - reflected in a very strong stock market - to be translated much more readily into current personal spending. On the company side, rising share values, associated with increased managerial assertiveness and an improved industrial relations climate, cut the cost of capital and stimulated investment intentions. In some respects the UK economy over the past few years has been a classic - and unusual - example of the supply outlook creating its own demand.

Present overheating: causes and consequences

Demand has over the last year or so outstripped current domestic supply. When supply expectations and consumer and industrial confidence improve, spending reacts immediately, while it takes some time - perhaps several years - before supply capacity responds fully. In such circumstances the emergence of a current account deficit is inevitable and desirable if the period of adjustment is not to be marked by sharply-increased inflationary pressures. But in an economy such as the United Kingdom's which is not completely open, policy measures to restrain output are also needed when overheating is a threat. With hindsight, it can be seen that appropriate measures were not taken early enough when signs of incipient strain in the economy began to appear in 1987 and into 1988. Indeed, short-term interest rates were reduced by 2½ % between the October 1987 crash and the early summer of 1988; monetary policy did not react fully to overheating until November 1988, although some tightening began in the late Spring of 1988. Inflation(*) has accelerated from 4 % during most of 1987 to 6 % by April 1989. Unit labour costs are also accelerating, and the tight monetary policy now in place thus implies that a profits squeeze is in prospect for this year.

Evaluating and responding to the risks

Substantial risks are present in the outlook both for inflation and the current account. On inflation, the imponderable is the extent and duration of the slowdown in activity that will be required to eliminate and reverse the current acceleration of prices. The response of wage negotiators will be crucial in this respect - perhaps not so much in the current wage round, when an acceleration in unit labour costs can be absorbed without too much difficulty through a reduction in presently-high profit margins, but in the 1989/90 wage round that will begin in the autumn. If this year's likely increase in unit labour costs (8.1 %) were to carry through into 1990, a continuing period of monetary tightness and a more prolonged and severe period of below-trend growth could result.

(*) On the basis most comparable with other countries, i.e. the twelve-month increase in retail prices excluding mortgage interest payments.

That prospect could in turn have implications for the financing of the current account deficit. A period of stagflation would be clear evidence that changes in labour market structure and behaviour had not been sufficiently radical; it would also threaten investment intentions and confidence in the medium-term output and productivity outlook. In such circumstances, downward pressure could emerge on sterling, posing a difficult choice for the authorities between allowing an additional import-cost twist to the inflation process on the one hand and raising interest rates on the other - either option worsening a possible stagflation problem.

However, the probability of the stagflation outturn at present seems low: pressure on profit margins is already evident; signs of a slowdown in activity are becoming more widespread; in an international context the upward trend in commodity prices appears to have been broken; and the next wage round should take place in a context of decelerating retail price inflation (as the effect of increases in mortgage rates last summer and autumn drop out of the index). Investment intentions remain strong; and managers are seemingly much more confident of their ability to cope with short-term trading difficulties and labour market pressures than in periods before the government's supply-side policies were implemented.

The optimistic assessment is that the UK economy needs a pause in the hectic pace of growth in which to catch breath but that thereafter sustained growth in output - fast enough to reduce unemployment further - can resume.

Difficulties for the macroeconomic policy framework ?

Nevertheless, in current conditions, the attainment of the government's repeatedly stated objective of reducing and ultimately eliminating trend inflation looks likely to be long-delayed - and lacks market credibility. And the reining-back of increased inflation via monetary tightness is likely to lead to at least some period of below-potential growth, even if a "soft-landing" is achieved and prolonged stagflation avoided. On the face of it, this looks like a failure for the government's Medium Term Financial Strategy (MTFS) which over the last ten years has aimed at supporting supply-side improvement and providing the macroeconomic conditions for durable growth in output and employment by maintaining steady downward pressure on inflation expectations and inflation itself. The problem for the MTFS has been twofold:

- the violence of the private sector demand reaction to improved perceptions of supply-side prospects;

- the difficulty of interpreting the monetary stance in a period of rapid change in financial institutions and markets.

The government's underlying philosophy of the role of the public sector vis-à-vis the private sector implies that budgetary policy should not be used to offset movements in private sector demand: private sector agents can be left to make up their own minds about future prospects and thus about consumption possibilities and the incentive to invest. Budgetary policy has itself been moving in an unambiguously restrictive direction over the whole period since the last examination and most notably in 1986 (when growth "took off") and in 1988. But there was little further movement towards restriction in 1989 and, looking forward, the government's intention to return to budget balance by 1992/3 implies a gradual loosening of the budgetary stance in the future. Thus the burden of stabilizing the economy in the short-term inevitably falls primarily on monetary policy. But this task has fallen to monetary policy at a time when it is more and more difficult to assess the monetary stance. In these circumstances, and given successive underestimates of the growth of nominal GDP, policy in the UK may lack the firm nominal anchor which the MTFS was supposed to provide.

Is there an alternative policy rule ?

The UK authorities made a crucial strategic decision in 1985/86: instead of following the ERM currencies and thus allowing the oil price fall to be translated into a major reduction in inflation, they chose to let the real exchange rate depreciate. Had they decided instead to participate in the ERM over this period, the UK trend inflation rate might now be considerably lower than it has in fact been. However, the acceleration in UK growth and the fall in unemployment might have been less pronounced.

Once given the decision not to participate in the ERM in 1985/86, it is now clear with hindsight that the exchange rate during 1987 in fact and early 1988 was too low. And looking forward, the present excess of demand over supply - as reflected in the current account deficit and the high rate of inflation - poses a problem for ERM participation in a short-term perspective. That deficit, whether or not it is acceptable for now, cannot be sustained indefinitely. An eventual absorption of the deficit will involve a reduction of demand. Balancing the economy when that happens will inevitably require a substantial real depreciation of sterling. Achieving such a depreciation without a nominal effective depreciation (and, in all probability, a greater depreciation against ERM countries) would require the UK inflation rate to dip below that in partner countries over a period of time. That, in turn, would probably imply a UK recession, followed by an eventual rebound in the inflation rate to match the ERM average.

However, ERM participation would offer significant advantages. Such participation would represent the strongest form of precommitment of policies. It would therefore be the most effective way of improving the credibility of the MTFS in achieving a significantly lower trend rate of inflation; and the output costs of actually arriving at such a lower rate of inflation would be thereby minimized.

Questions

Macroeconomic performance

1. Do the UK members of the Committee agree that the rapid growth in the UK economy since the last examination has been driven primarily by improved private sector confidence ? Is there still scope for growth fast enough to reduce unemployment further over the medium term, or is the current level of unemployment already below the rate at which, given present labour market and other structural factors, underlying inflation accelerates ? How serious is the threat of a prolonged period of stagflation ?

2. How should the large current account deficit be interpreted ? To what extent does it reflect the reaction to improved supply perceptions rather than possible deficiencies in the policy mix ?

3. To what do the UK members attribute the UK's above-average inflation rate of recent years ? To what extent did the depreciation of sterling in 1986 reflect an assessment that a gradual rather than an abrupt reduction in inflation was appropriate, especially given the downward pressure on the real exchange rate implied by the oil price fall ? With hindsight, was an opportunity missed at that time ?

4. Why were the UK authorities unable to head off, in 1987/88, the acceleration in inflation that became evident in 1988 ? Were forecasting errors alone to blame, or were there deficiencies in policy design ? Was insufficient attention given to the monetary aggregates ?

Policy issues

5. Under what circumstances, if any, should the authorities take macroeconomic policy measures aimed specifically at reducing the current account deficit ? What is the impact of monetary tightness on the deficit ? Is the appropriate role for budgetary policy one of ensuring that private sector savings/investment decisions are not distorted by the government's financial operations, or should it be used more actively to influence the current account ?

6. If budgetary policy continues to follow, in the main, a medium-term and supply-side oriented path, does the MTFS dispose of sufficient instruments to achieve, in a period of rapidly changing demand/supply balance in the economy, both short-term stabilization and medium-term disinflation ? What are the relative weights that should be given to these two last objectives ?

7. In their supply-side policies, do the authorities pay sufficient attention to externalities in such areas as training and infrastructure investment ? What factors should affect the balance between tax cuts and additional spending in such areas as budget surpluses are gradually reduced ? In what ways are the authorities preparing for the challenge of the open internal market ? In what respects have their supply-side policies served, or could they serve in future, as a model for other Community countries in the run up to 1992 ? To what extent might they need to be modified in the same context ?

8. Does the MTFS provide a sufficiently firm and credible nominal anchor ? Would ERM participation provide a superior rule both in operational terms and in the strength of precommitment and hence credibility ? Could it complement the MTFS or would it have to replace it ?

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(Note for the attention of the members of
the Monetary Committee)

ANALYTICAL NOTE

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A. Analytical Note

Introduction

The economic and financial situation in the United Kingdom was last examined in September 1985. At that time, the UK economy was experiencing a resumption of **growth** after the recession of the early 1980's and a number of **structural reforms** had been implemented. However, the economy had not really "taken off" and **unemployment** was high and rising. Another concern was that **inflation**, after decelerating sharply in 1981/3, seemed stuck at around 5 %. It was noted that the **current account** surplus depended entirely on the oil account; with declines in oil exports expected over the following four years (to 1989), it seemed likely that a current account deficit could develop.

In the area of policy, the Commission services considered at the time that it might be necessary to loosen **budgetary policy** somewhat to maintain or increase the growth rate and produce a stabilization, and subsequently a fall, in unemployment. It was also considered that there might be a shortage of effective instruments of **monetary policy** in a highly innovative financial system. Given this, the time might be ripe, it was thought, to reconsider **ERM participation**.

The present note describes and assesses developments since the last examination. Chapter 1 gives an overview of **developments in the main economic aggregates** since 1985, noting in particular the sharp acceleration in growth and, more recently, inflation and the emergence of a large current account deficit. The chapter includes a box on savings in the UK economy. Chapter 2 addresses a number of questions concerning the **overall policy framework** in Britain, which has now in principle remained unchanged for ten years. Chapter 3 analyses and interprets two issues that have recently assumed key importance: inflation and the current account deficit.

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Budgetary policy developments, particularly in a medium-term context, are described and analysed in chapter 4, with an emphasis on understanding the reasons behind the emergence of a surplus and its implications; and in chapter 5 **monetary and exchange-rate developments**, as well as the evolution of and prospects for monetary guidelines in a system without an apparent nominal anchor, are discussed. A box in this chapter reviews the monetary impact of **budget financing**. **Supply-side policies**, which are at the heart of the government's approach, are the focus of chapter 6.

Ongoing, rapid and far-reaching change in **financial markets** is reviewed in Annex I. **Balance of payments** developments, on both current and capital account, and movements in the United Kingdom's net external assets, are analysed in some detail in Annex II. Annex III describes recent developments in the monetary aggregates, interest rates and exchange rates and describes the Bank of England's money market techniques.

1. Overview of recent developments

1.1 Demand and output(*)

The expansion of the UK economy, under way since mid-1981, has continued at a rapid pace since the last Monetary Committee examination in 1985. In the four years to 1988 real GDP grew by some 3,8% per year, faster than the average of the rest of the Community and above the UK's potential output growth rate of almost 3%. Domestic demand expanded even more rapidly (by 4,6% per year). Overheating in the UK economy, as shown by rising inflationary pressures and a sharp widening of the current external deficit, led to a major tightening of monetary policies from mid-1988. There are now indications that demand and output started to slow towards the end of 1988 and in the early months of 1989. The latest Commission forecasts suggest real GDP growth of 2,4% in 1989 and 2,1% in 1990 after 3,7% in 1988 (Table 1.1).

Following the recession years of 1980 and 1981, domestic demand expanded at an annual average rate of 3,1% in the four years to 1985 (Table 1.2). Private consumption grew at an average 2,7% and fixed investment, after the very sharp falls of the recession years, by an average 5,7%. Public consumption, constrained by tight expenditure control, grew by only 0,9% p.a. From 1986 private consumption grew very rapidly. In 1986 its growth was 5,7%; and in 1987 almost as fast, 5,4%. In 1988, on the latest available figures, growth was 6,5%. Business investment which had risen rather strongly between 1982 and 1985, paused in 1986, although private residential investment growth accelerated strongly (Table 1.4). Fixed investment grew in 1986 by only 1,7%, among which investment in private dwellings grew by 8,3%. 1987, however, was the beginning of a very significant increase in investment, with growth of over 8% in volume, and almost 12% in 1988 (where there are also reasons to think growth is still understated). Survey evidence indicates that business investment should remain strong in 1989.

The rapid expansion of domestic demand has only partly been met from domestic production and there has been a strong rise in import volumes, accelerating to 12% in 1988 from 6 1/2% in 1986 and 7 1/2% in 1987. Exports have risen much more slowly and actually fell in 1988; consequently the contribution to growth from the real foreign balance has been negative.

(*) The development of demand and output in the UK economy in recent years is clouded by very large statistical discrepancies. Inparticular, the output measure of GDP shows stronger growth, especially in 1988, than the average measure used here.

Some of the causes of the upturn in private consumption are discussed in the box on saving. They appear to involve a combination of increased consumer confidence, wealth (particularly because of higher residential property prices), borrowing and real wage growth. The origins of the recent growth surge thus appear to lie partly with a general recognition that the performance of the economy was improving favourably, allied with rapid growth in real incomes. This process was reinforced by the rapid expansion of credit opportunities available to households.

Growth of output has been distributed fairly evenly through most sectors of the economy, with the exception of agriculture and energy output. North Sea oil output has been in underlying gradual decline since 1986; a series of accidents in the North Sea has resulted in a sharp drop in oil output in the second half of 1988 and early in 1989 which should be only temporary.

1.2 Employment, unemployment and productivity

A pronounced decline in unemployment and an even stronger growth in employment have been two of the most positive features of the recent expansion. Unemployment has fallen steadily from a peak of 11,2% of the workforce (national definition) in mid-1986 to reach 6,5% by April 1989; total employment expanded by an average of 1 3/4% p.a. between mid-1983 and mid-1987 and by over 3% in the year to mid-1988.

Total employment fell to a trough of 23,6 million in June 1983. In the five years to June 1988, it increased by 2,59 million, including a very substantial proportion of self-employed (0,76 million) (Table 1.5). Employment in industry and construction fell by 0,45 million over this period while service sector employment rose by just under two million, of which 0,72 million was in financial services. Women have been notable gainers from the expansion in employment, their numbers increasing by 1,2 million, including the major part of the increase in part-time employment (0,64 out of 0,89 million). The number of male employees changed little until 1987, but has recently also been climbing.

Up until 1986 the gain in employment fell somewhat short of the expansion of the labour force (Graph 1.6); unemployment thus continued to rise (Graph 1.7). Since 1986 the fall in unemployment, by 4,7% of the workforce up to this spring, has been substantially more rapid than in the rest of the Community. While part of the fall in the registered number of unemployed undoubtedly at first represented the deterrent effect of tougher registration criteria and the mopping up of the otherwise potentially unemployed on government sponsored employment schemes, the scale of the reduction points to the genuine underlying improvement in the labour market.

This improvement in the overall labour market has accompanied the even stronger output growth. In consequence labour productivity, driven by improvements in the manufacturing sector, has increased at a significantly faster pace than in the 1970s. Manufacturing productivity growth of 4 1/2% p.a. since 1979 has actually been faster than the 1960-73 period (3 1/2% p.a.) and sharply different from the intervening period (3/4% p.a.). In international comparison manufacturing productivity growth in the 1980s has comfortably exceeded that in other major industrialized countries, where growth has slowed from the pre-1973 period. However, evidence from the 1988 Labour Force Survey of a sharp acceleration in employment growth also gives ground for caution. Manufacturing productivity gains have been strongly boosted by output growth. There has thus been a strong cyclical element which will weaken with slower growth of production. It also seems clearer that service sector productivity growth has not undergone any dramatic change in recent years, and that international differences in productivity growth are less marked than had previously appeared to be the case. Moreover, levels of whole economy productivity in the UK remain generally lower than in other major countries with the exception of Japan (Graph 1.8). Commission data confirm that whole economy productivity in the UK remains well below the levels of France and Germany and only somewhat ahead of Italy, while in the industrial sector alone the UK still records a substantially worse performance than in all three other countries, reflected in a lower level of employee compensation.

1.3 Inflation

The UK has not carried forward its major success in braking the high level of inflation at the beginning of the decade. Inflation fell abruptly to the end of 1982, but up to 1988 moved within a fairly limited range of 3 1/2-5 1/2% p.a., with the average annual rise in the private consumption deflator for 1983-87 being 4,7%. During this period inflation in the Community as a whole fell from 10 1/2% to 3 1/2%; France and Belgium, with very similar rates of inflation to the UK in 1982, had inflation rates lower than the UK and still declining by the end of this period (Graph 1.12).

The upward trend in inflation evident since early 1988 has been a disappointing feature of the United Kingdom's economic performance. The deteriorating trend since the beginning of last year is indeed exaggerated if changes in the most publicised price index, the Retail Prices Index (RPI) is taken as the measure of inflation. This is because changes in mortgage interest rates have generally amplified movements in other elements in the index since late 1987. Nevertheless, the RPI excluding the effect of mortgage interest costs and other price indices, such as manufacturers' output prices and the GDP deflator, tell an essentially similar picture : inflation bottomed out at 3 1/2-4% p.a. during 1987, then rose steadily during the course of 1988, to reach about 6% p.a. in the first half of 1989, with few encouraging signs of the upward momentum yet having been arrested (Graph 1.13).

Apart from the depreciation of sterling in 1986 which partly offset the potential gains from lower oil prices and the relative decline of the dollar, the sources of poor inflationary performance are home-grown. **The rise in wage costs failed to decelerate in response to better price performance in the mid-1980s**, earnings per head growing remarkably steadily at around 7 1/2% p.a. before accelerating to 9% during 1988. In the manufacturing sector, with rapid productivity growth, this implied only very limited growth of unit labour costs; for the whole economy, with no differentiated pattern of earnings growth between manufacturing and services, unit labour cost growth has been much higher, about 5% in 1987 rising to over 7% in 1988. Added to this has been a substantial expansion of profit margins, particularly in manufacturing. This was especially the case in 1985-86, when output prices only moderately reflected cheaper imported inputs, but has continued through 1987 and 1988. The strength of demand and the high level of capacity utilization has enabled producers to widen profit margins and has probably made them less inclined to resist wage pressures. For the whole economy this recovery in profitability to a more internationally comparable level has encouraged a higher level of investment. On the other hand, given the failure to achieve wage moderation, it has contributed in the arithmetic sense to inflation having, first, failed to fall to the extent registered in other major countries, then having accelerated.

1.4 Balance of payments

The UK current account has tended to deteriorate since the beginning of the 1980s. The trend has been particularly evident since 1985, the balance falling from a surplus of 0,7% of GDP to a deficit of 3,2% in 1988; Commission forecasts show the deficit remaining high in 1989 and 1990 (Table 1.7). The main components of the current account - oil and non-oil visible trade and invisibles - have all contributed to the worsening in performance (Graph 1.14). The non-oil trade deficit has grown from 2,9% of GDP in 1985 to 4,9% in 1988. The surplus on trade in oil, which reached a maximum of 2,3% of GDP in 1985, has fallen with declining production and the generally much lower level of oil prices; in 1988 it was only 0,5% of GDP. The net surplus on invisibles has also tended to decline falling from 1,6% of GDP in 1985 to 1,3% in 1988. Despite substantial identified direct and portfolio net outflows, the current deficit has been financed without undue difficulty, partly through net bank borrowing and partly through unidentified net inflows. The latter is the balance of payments balancing item, which the authorities think principally reflects additional private capital inflows.

Strong internal demand growth appears to be an important determinant of the worsening of the trade balance. Since the beginning of the 1980s, growth in the UK has generally exceeded that of its main partners. Compared with the Community, the difference has been particularly marked : 1 3/4% p.a. on average between 1981 and 1988, with differences of over 4% in 1983 and 1988. This explains in part the strong growth in import volumes (excluding oil, over 7% p.a. between 1981 and 1988) and possibly a diversion of production capacity from exports to the domestic market.

Nevertheless, cyclical differences alone are insufficient to explain the deterioration of the current balance fully. Exporters' cost competitiveness improved until the end of 1986. Since then, however, the position has worsened sharply, as a pronounced strengthening of the exchange rate has aggravated the tendency for UK unit labour costs to rise faster than in its main partners. Relative unit labour costs in manufacturing measured in a common currency had thus risen by some 20% between the fourth quarter of 1986 and the first quarter of 1989.

An analysis over a longer period suggests in addition that more fundamental factors have influenced the UK's commercial performance. Import penetration ratios in virtually all the principal sectors of manufacturing have increased significantly since the beginning of the 1980s, in total rising from 28% in 1981 to 35% in 1987 and no doubt higher in 1988, at the same time that margins of domestic capacity remained unused in certain industries. The trend in manufactured exports is more encouraging : the steep decline in world market share before 1982 was substantially arrested up to 1987, though the share slipped again in 1988. On balance, apart from cyclical effects, it seems that the underlying tendency for trade performance to worsen continues to reflect structural weaknesses accumulated in earlier years.

Saving in the United Kingdom

Substantial shifts have been occurring in personal sector saving behaviour and in the sectoral pattern of saving in recent years. The personal saving ratio has been on a sharply declining trend since 1980 (Graph 1.5 A). In 1988 the saving ratio (*) reached only 3,9% of personal disposable income, the lowest since the 1950s. The decline started when real personal incomes were being squeezed during 1981 and 1982, but it has continued throughout the subsequent period of rapid real income growth. But the estimates of personal saving derived from the income and expenditure accounts (which are subject to wide margins of error and have undergone substantial revisions in recent periods) may overstate the steepness of the decline; other estimates derived from financial transactions and investment data (admittedly also subject to uncertainties and lacking full coverage) confirm the decline in the saving ratio but suggest that it has been more gradual and less marked. Among the factors which have influenced personal saving in the 1980s are :

- the marked slowing in the inflation rate between 1980 and 1983 which lessened the need to save in order to maintain the real value of accumulated savings (real balance effect);

- the expansion of employment from 1983 onwards and the decline in unemployment from 1986 which had a favourable impact on consumer confidence and weakened the precautionary motives for saving;

- a more general improvement in perceptions of future prospects, reflected in the rapid increases in the prices of equities and property held by the personal sector (wealth effect);

- deregulation and innovation in the financial sector, which have widened the opportunities for and greatly facilitated personal borrowing; the stock of financial liabilities of the personal sector rose from 73% of personal disposable income at end 1983 to over 110% at end 1988; the decline in the saving ratio is a reflection not so much of a slower rate of asset accumulation but rather of a faster expansion of indebtedness;

- demographic (e.g. age structure) and social developments which have led to a rapid rise in the number of households, despite slowing population growth; the setting up of new households, as well as a very active housing market, is associated with increased spending on consumer durables, etc.;

- actuarial surpluses in private sector pension funds in recent years have made possible a reduction in employers' contributions to these funds (equivalent to some 2% of personal disposable income between 1983 and 1988), which is recorded as a reduction in both personal income and saving.

(*) Measured net of stock appreciation.

Although personal saving has been declining, relative to both personal income and GDP as a whole, there have been some offsetting movements in saving by other domestic sectors (Graph 1.5 B). In particular the enterprise sector (*), benefiting from a recovery in profits, has seen a substantial rise in its saving relative to GDP since 1980, partly compensating the fall in personal saving. At the same time the general government sector has moved from being a dissaver in the early years of the decade to making positive saving in 1988. For the whole economy, therefore, saving as a % of GDP has remained reasonably stable (varying within the range 17,0 - 18,4% since 1980).

The upward movement in the investment ratio since 1981 and especially its upsurge in 1988 (particularly concentrated in the private business ector) led to a swing of 4,2% of GDP in the whole economy saving/investment balance over the same period (Graph 1.5 C). The counterpart of this was the deterioration in the current external balance, which moved from a surplus of 2,7% of GDP in 1981 to a deficit of 3,2% in 1988, a recorded swing of 5,9% of GDP (Graph 1.5 D). Deficiencies in the statistics mean that not all the change in the current account can at present be explained by the movements in domestic saving and investment, especially in 1988, when the saving/investment deficit widened by 1,0% of GDP while the current external deficit was 2,5% of GDP larger than in the previous year (Table 1.3).

(*) Including public corporations.

2. The policy framework

Throughout the present decade, the government's stated policy aims and intentions have remained the same: to reduce inflation gradually but continuously and to improve the supply-side of the economy, thus providing a firm basis for durable growth in output and employment. The reduction of inflation has been seen to require a coordinated framework for money and fiscal policies over a number of years. This framework has been expressed in the Medium Term Financial Strategy (MTFS), introduced in 1980. The MTFS lays down medium-term projections for monetary aggregates and the public finances. It is intended to be a nominal framework, within which the split between real output growth and inflation is determined by supply-side developments, as influenced by policies on reducing public expenditure and the tax burden, stimulating enterprise and initiative, and improving the functioning of markets. Supply-side policies are treated in chapter 6; the present chapter concentrates on the framework within which monetary and budgetary policies have been operated.

2.1 Foundations

The need, at the beginning of the present decade, to improve the performance of the British economy was evident. To this end, the authorities relied on supply-side policies to bring about wide-ranging and far-reaching reforms. But the MTFS \$ addition implied that the essential contribution of macroeconomic policy lay in bearing down on inflation. Both monetary and budget policies were called on to operate in a coordinated fashion. A deceleration in monetary growth was the essential prerequisite in reducing inflation. The role of fiscal policy was to allow a deceleration in money growth without excessive reliance on high interest rates, which were judged deleterious to investment. The PSBR would be adjusted (in relation to a downward trend) in the light of the pressure exerted on interest rates by that money deceleration. There was to be no recourse to incomes policy - other than firmness in the face of public sector disputes.

The MTFS, from its inception, was aimed at guiding nominal demand onto the desired medium-term path. In the early years of the strategy, given the confrontation of tighter monetary conditions with slowly-adjusting expectations and wage-setting behaviour, the nominal setting of the strategy implied: (i) an acceptance of short-term declines in real activity; (ii) the likelihood that budgetary policy would be procyclical(*). These implications

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(*) Declines in activity would tend to increase the PSBR, so that policy would have to be tightened to keep as near as possible to the medium-term path (as in the 1981 budget). In addition, high interest rates produced by stubbornly-high wages and prices would tend to require a downward adjustment of the projected PSBR path.

were no doubt accepted on the basis of one or more of several propositions: that there was no short-term Phillips curve to exploit; alternatively, that exploiting any short-term Phillips curve would have damaging medium-term effects by reducing the credibility and delaying the realization of a sustained reduction in inflation; that the effect of fiscal expansion on activity was weak or perverse ("crowding out"); or that a recession, or at least the threat of one, was necessary if the private-sector was to be shocked into the necessary changes in supply-side behaviour.

2.2 Implementation

The medium-term nature of the framework was expressed in the setting of current-year monetary targets and projected medium-term paths for monetary aggregates and the PSBR. As shown in Tables 2.1 and 2.2 of the statistical annex, there have been changes in the targeted monetary aggregates, and outturns have often departed from the projected path.

At least until 1985, the MTFS seemed to be succeeding well in its main intermediate objective of progressively slowing the growth of money GDP. Since then, however, progress seems to have stopped (except for a dip in 1986 related to the reaction to falling oil prices, and especially North Sea prices(*)). The split between real output and inflation seemed to maintain an improving trend until more recently, with a deterioration evident only in 1988.

Money GDP(*), volumes and prices
(% change)

	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
Money GDP(1)	17.5	16.9	10.0	9.5	9.1	6.9	9.4	6.9	9.5	10.5
Real GDP(2)	2.7	-2.3	-1.1	1.8	3.7	1.8	3.7	3.0	4.5	3.8
GDP deflator(3)	14.3	19.7	11.4	7.6	5.1	4.6	5.7	3.5	4.7	6.6

(1) Average estimate, market prices
(2) Average estimate, factor cost
(3) Expenditure estimate, market prices

(*) In terms of private consumption deflators however - more closely related to welfare considerations - the deceleration continued into 1987 (see chapter 3).

But, after rapid disinflation until 1983, further progress towards price stability had been slower than anticipated even before the recent upturn in inflation.(*) Particularly noticeable is that expected medium-term progress towards price stability was pushed back in the 1986 MTFS statement, even though oil prices had fallen sharply and actual inflation in 1986 turned out to be significantly lower than in the previous year. In retrospect, 1986 seems to mark a watershed in the history of the MTFS, at least in terms of outside perceptions. Since then, an important problem of policy management has been that of assessing and reacting to the strength of the private sector demand response to improved perceptions of medium-term prospects and to the increased availability of borrowing opportunities. The strength of this response was underestimated by all forecasters.

For instance, the 1986 MTFS projected 3 % real growth in 1986/87 but a deceleration to 2½ % thereafter, whereas growth in fact accelerated sharply over the following two-year period. Growth continued to be underestimated in the 1987 and 1988 MTFS statements. Although this underestimation of demand strength was also a feature of market forecasts, the acceleration in inflation that eventually became evident created market doubts about the ability of the MTFS to maintain downward pressure on inflation expectations.

In addition, doubts have been expressed as to whether the coordination of monetary and budgetary policies is now as close as in the original MTFS conception. When the authorities recognized - by the summer or autumn of 1988 - the severity of overheating in the economy, they reacted virtually exclusively by raising interest rates. Budgetary policy - which now has its own medium-target of a balanced budget - appears to have been tightened only fractionally in the subsequent (March 1989) budget from an already very tight stance.

However, these developments reflect an adaptation to changing circumstances rather than a weakening of coordination. Overheating in the economy to a considerable extent reflected the bringing-forward into current demand, both for consumption and investment, of expected future increases in real income. In such circumstances, - sharply different from those of the early 1980's, when expectations were depressed - an increase in real interest rates was appropriate and in some respects desirable on medium-term as well as short-term grounds. Moreover, the speed at which the medium-term budget target is approached will depend on, among other things, the likely impact of reduced surpluses on market sentiment, with the aim of avoiding additional increases in interest rates to levels even higher than warranted by favourable supply-side prospects, as perceived by the authorities.

Thus although the specific weighting of the policy mix may have changed in the recent past, the broad principles underlying the coordination of monetary and budgetary policies within the MTFS remain unchanged: to bear down on inflation via monetary deceleration while adapting budgetary policy in the light of supply-side needs.

(*) Chapter 3 considers the apparent stickiness of the trend inflation rate since 1983 in more detail.

2.3 Assessment

The policy framework in the 1980's has been characterized by a number of constant elements: a strong emphasis on improved supply-side performance as the only route to sustained growth in output and employment; a repeated intention to reduce inflation; the identification of monetary policy as the main anti-inflationary tool, with no use of incomes policy; a disinclination to use budgetary policy as an instrument of short-term policy; and a determination to put the public finances on a sound footing.

The MTFS achieved considerable success in the early 1980's, when policy to reduce inflation had to be accompanied by measures to revive the private sector and improve underlying supply conditions. But in more recent years that very success has complicated the task of further reducing the inflation rate. The evolution of the policy mix has been justified in the light of changing circumstances. But, largely because of the scale of shocks, both to the demand for money and to aggregate demand, interpreting the monetary stance and setting monetary policy has become more difficult. As a consequence of these difficulties, it seems that the policy framework has not succeeded in establishing the credibility of a reduction of trend inflation to rates close to those in France or Germany. Further, the authorities were unable, in a period of rapidly-changing private sector demand behaviour, to move rapidly enough to head off overheating in the economy; and the subsequent tightening of policy has had to be more severe because of its tardiness. Even to the extent that overheating in the UK economy has reflected widely-shared errors in forecasting rather than in the basic policy design, the credibility of policy, and in particular of monetary policy, has been reduced.

3. Major policy concerns

This chapter analyses two questions whose implications have given rise to much discussion:

(i) the apparent stickiness of trend inflation and the recent acceleration under the influence of overheating;

(ii) the emergence of a very large current account deficit.

In particular, the chapter attempts to set these phenomena in the context of an overall policy biased towards supply-side improvement and asks whether they can be regarded as consistent with a degree of success of such policy.

3.1 The problem of inflation

The problem of inflation in Britain has two aspects. Inflation fell sharply during the early 1980's. But, the trend rate (measured by the annual rate of change of the consumer price deflator) has not durably decreased since as long ago as 1983, despite repeated statements by the government of its intention to continue reducing inflation and ultimately eliminate it:

Inflation intentions and outturns
(GDP deflator, % change)

In / For	1985/6	1986/7	1987/8	1988/9	1989/90	1990/1	1991/2	1992/3
1985/6 MTFS	5	4 1/2	3 1/2	3				
1986/7 MTFS		3 3/4	3 3/4	3 1/2	3			
1987/8 MTFS			4 1/2	4	3 1/3	3		
1988/9 MTFS				4 1/2	4	3 1/2	3	
1989/90 MTFS				7 1/4	5 1/2	4	3	2 1/2
Outturn	6	3 1/2	5	7 1/4(1)				

(1) Forecast of 1989/90 MTFS

A comparison of successive MTFS statements shows a pushing back of future inflation reduction (this was so, for the medium-term projections, even as between the 1985/6 and 1986/7 MTFS statements despite the intervening oil price fall). Second, there has been a clear acceleration in inflation over the past year (largely the result of rapidly-rising profit margins as well as an acceleration in unit labour costs - see section 1.3 and Table 3.1). This has triggered a belated but sharp monetary policy response that will temporarily produce below-potential growth. This experience, coupled with long-term yields at around 10 %, tends to suggest that, while markets expect inflation to be reined back, they are

more sceptical about the prospects for achieving 2½ % inflation within the current MTFS horizon(*).

3.1.1 The stickiness of the trend rate

The trend of inflation in the UK appears, on the basis of outturns and Commission forecasts, to show very little variation from a rate of around 5 % since 1983. This is in marked contrast to the ERM group of countries, and in particular Germany:

Deflators of private consumption

	1982	1983	1984	1985	1986	1987	1988	1989[1]	1990[1]
UK	8.8	4.8	5.1	5.3	4.4	3.9	5.0	5.9	5.3
D	4.7	3.2	2.4	2.1	-0.2	0.7	1.3	3.0	2.9
ERM	10.0	8.4	6.6	5.2	2.3	2.6	2.8	3.5	3.3

(1) Commission forecasts, May 1989

In particular, the dip in inflation as a result of the 1986 oil-price fall was delayed and less marked in the United Kingdom than in Germany or the ERM group as a whole. This clearly reflected a sharp depreciation of sterling through 1986 (Graph 5.3) that made a significant contribution to price rises in the UK in 1986, offsetting most of the favourable impact of falling world trade prices (table 3.1). In other ERM countries, in contrast, in 1986 the movement of the nominal effective exchange rate reinforced the negative price contribution of import prices. The UK authorities permitted sterling's depreciation during 1986 on the grounds that the fall in the oil price implied the need for a real depreciation of sterling; and that this real depreciation could come about without a deleterious impact on the price level because falling oil prices would offset it.

Over the past ten years, two elements of inflation experience stand out:

- at the beginning of the decade, the authorities were able and willing to achieve a sharp deceleration in inflation (taking it below the Community average by 1983), with a rise in unemployment a perhaps inevitable accompaniment given the recognized structural deficiencies of the economy at the time;

- it would have been possible to embark on a new phase of disinflation from 1986 onwards. But this might have been at the cost of a period of substantially less dynamic growth and less resurgent private sector confidence and a postponement of what turned out to be a much more marked fall in unemployment than elsewhere.

(*) The authorities are, admittedly, "putting their money where their mouth is" in their funding operations by continuing to issue index-linked stock and longer-dated stock, despite an overall buying-in policy, thus signalling their belief that the market's longer-term inflation expectations are too pessimistic.

In the light of this experience and the apparent emergence in recent years of markedly different productivity trends as between manufacturing and other sectors of the UK economy, it seems that the UK economy in the 1982-88 period may have been following the Japanese model of the 1950's and the 1960's, in which relatively high inflation was combined with strong output growth and rapid productivity increases in manufacturing.

In sum, the divergence between UK experience and the experience of other countries following the oil price fall did not in itself represent a radical divergence from or failure of the MTFS. The strategy had always emphasized the need for a steady deceleration of inflation as a prequisite for sustained growth in output and employment. In 1986 and 1987, this strategy was well on course, after a pause in 1984 and 1985. However, the slight deceleration in inflation in 1987 did not become embedded in expectations. Moreover, that deceleration has more recently given way, as described in chapter 1, to a move above the post-1982 trend whose duration and consequences are far from certain.

3.1.2 The recent acceleration of inflation

With hindsight, it now appears clear that monetary policy was not tightened early enough to cope with the strength of activity that had built up by late 1987 and carried through into 1988, when GDP growth was strong, unemployment fell particularly rapidly and capacity utilization rose to historically high levels.

Table 3.1 shows that the price contributions both of import prices (excluding the effect of nominal exchange rates) and of domestic costs, particularly profit margins, increased in 1988. A rise in sterling provided an arithmetic offset of the impact of import costs, but it came too late and was too small to have an immediate restraining effect on domestic costs. For 1989, the impact of a higher exchange rate (in annual average terms)(*) will probably not be enough to offset the increase in import costs, and unit labour costs are likely to accelerate further as a result of higher wage settlements and a slowdown in productivity as the pace of activity slows.

Unfortunately, it is not easy to determine whether the UK economy exceeded temporary speed limits in 1987/88 (i.e. output grew and unemployment fell too rapidly) or whether the economy is now operating at a level of unemployment too low to be consistent with stable inflation. The first interpretation would imply that, after a rather brief catching of breath to enable inflation to be brought back to around 5 %, unemployment could resume a downward course. The second would imply that, in the absence of any further structural improvement in the labour market or in the

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(*) The table was based on the assumption of an effective exchange-rate higher than the end-June rate.

credibility of policy, a possibly-substantial and permanent rise in unemployment would be needed simply to prevent a further acceleration in inflation(*).

Commission forecasts (see text table above and chapter 1) are relatively optimistic in this respect, suggesting that the current period of tight policy will rein inflation back with only a rather slight dip in growth below potential. And there remains a good deal of optimism about medium-term output prospects. There appears to be a number of reasons for this optimism, involving: high profit margins; a growing proportion of productivity-related and profit-related pay in total employee compensation; more workplace flexibility; more aggressive management of labour inputs; relatively exiguous shortages of skilled labour; and strong business investment and investment intentions.

Some compression of profit margins can probably be absorbed in 1989. But the major test of optimism will come in 1990 when, for the first time since the early 1980's, there could be a clear potential conflict between accelerating labour costs and employment. How radical the change in labour market behaviour in Britain has been since the early 1980's will then become much clearer.

3.2 The current account deficit

The UK current account deficit, at more than 3 % of GDP, is now very large by historical standards. Among other countries (other than very small ones), this experience finds a parallel only in the US deficits since the mid-1980's. A deficit of such size gives rise to questions about its origin and sustainability.

3.2.1 The nature of the deficit(**)

The current account, which was in surplus to the tune of 1 % of GDP in 1985, is currently recorded as being in deficit by 3.2 % of GDP in 1988; Commission forecasts indicate little reduction in the deficit in 1989 or 1990. As shown in chapter 1 all the major elements of the current account have contributed to this swing.

The swing in the current balance can be explained in terms of stronger demand growth in the UK than among partner countries (a gap of 2 % a year on average vis-à-vis other EC countries during the 1980's: see table A II 11), a deterioration in cost competitiveness (10 % over the last two years: graph A II 1), and continuing weaknesses in some areas of the industrial structure.

(*) The wage equations in the Treasury model show a much bigger impact from the change in unemployment than from its level, supporting the more favourable, "speed limits" interpretation of recent developments.

(**) Annex II to the present note describes balance of payments developments in some detail.

However, to understand the significance of the deficit, it is necessary to place it in context. Domestic demand per capita in the UK is, despite recent sharp increases, not high in comparison with the other G-5 countries (or many smaller OECD countries). But output is even lower on this comparison. Thus the deficit reflects a current level of UK productivity that, although relatively improved in recent years, cannot support a level of desired absorption that is far from excessive by international standards.

But while the deficit reflects the historical weakness of output and productivity, its emergence is not necessarily an indication of a worsening of structural problems. Indeed it may, at least to an extent, be a sign of structural improvement in prospect. Consumer and business confidence improved sharply in 1987. The ex post rate of return had risen above that in any other industrialized country, and by the time of the stock market crash share prices had almost quadrupled from 1983 levels (even after the correction involved in the crash, the stock market is now 40 % higher than at the end of 1986). Productivity, real wages and employment were all rising fast, and the emergence of a budget surplus created expectations of large future tax cuts. It seems very likely, then, that the perceived ex ante rate of return on capital increased and households became more optimistic about their future real income prospects.

The increase in demand that flowed from these favourable perceptions outstripped current capacity: productive capacity reacted only slowly to new investment; and demand was boosted to a level above even the expected longer-term level of output, since part of that increase was a sharp adjustment in the desired stock of producer and consumer durables. In these circumstances, a swing into current account deficit was necessary to limit inflationary pressure in the domestic economy.

A consequence of a large current account deficit is a reduction in the net external assets of the nation(*). However, the UK's stock of net external assets has been extremely large. Given this, and the contractionary nature of budgetary policy (chapter 4), the emergence of a large current account deficit can be seen as the result of both an extension of domestic borrowing opportunities and an improvement in the attractiveness of domestic investment opportunities leading to a running down of overseas financial assets.

(*) This is not necessarily true in stock terms, because of revaluation effects. In addition, even in flow terms no reduction in net assets is recorded for 1988, since the positive balancing item in the balance of payments was equal to the current deficit (see Annex II).

3.2.2 The sustainability of the deficit and prospects for reducing it

This interpretation of the deficit was reflected in 1988 in the strength of sterling and a tendency for the reserves to rise(*). It nonetheless remains the case that such a large deficit cannot be financed indefinitely. It is thus important to know in what circumstances the deficit could be expected to decline endogenously; what are the risks of a "hard landing"; what is the likely impact of current policy; and how policy might have to be adapted.

If the foregoing analysis of the current account in terms of favourable supply-side expectations is correct, then the prospects for a gradual and relatively painless reduction in the deficit depend on the maintenance of those expectations and their realization. As the stock-adjustment of demand was completed and new capacity - the lagged result of the investment boom - came onstream, the deficit would be reduced endogenously. This process might take some years, but there would be no financing difficulties. Over the same period, the changing demand/supply balance in the economy would appropriately lead to a gradual real depreciation of sterling.

However, there is a risk that supply-side expectations might change in a less favourable direction. This could happen if, for instance, trend productivity growth appeared to stall or if a more severe and prolonged period of below-potential growth than currently forecast came to seem necessary in order to check inflation. In such a case, investors would be much less willing to finance a deficit and early and severe downward pressure on sterling would emerge. And to the extent that UK firms and households were becoming less confident, domestic demand would subside rapidly and substantially.

All in all it appears that supply-side expectations and the extent to which they are realized will be the key determinants of current account developments and prospects. To the extent that expectations remain optimistic and turn out to be justified, no policy adjustment will be required.

As of now, the policy reaction to the deficit appears to be consistent with an optimistic view of supply-side prospects: inflation, rather than the deficit, has been the main focus of policy attention. However, recent downward pressure on sterling poses a dilemma for the authorities. As long as the authorities themselves maintain an optimistic view of supply-side prospects - and especially in view of the current inflation problem - they will be reluctant to see sterling fall. On the other hand, increases in interest rates to maintain sterling in the face of downward pressure might slow activity more than the authorities feel necessary and could have a dampening effect on investment.

(*) The precise channels through which the deficit was financed are not clear, given the existence of an unidentified positive balance item as large as the current account deficit itself.

3.3 Conclusions

The British economy faces a very testing period over the next year or so. The main question marks concern the degree of resilience of investment and of medium-term output expectations in the face of a currently restrictive monetary policy. In this respect, the policy issue is not so much one of macroeconomic policy design but of the effectiveness of the supply-side strategy pursued for the last ten years. To a considerable extent, it is now up to the private sector to justify by its behaviour the optimistic expectations that it had developed in recent years.

4. BUDGETARY POLICY

4.1 General strategy

The gradual reduction of the PSBR - which stood at 6% of GDP in 1979 - was the central element of the Financial Strategy up to 1987/88. That objective has more than been achieved, with public finances having shown a surplus in 1987/88. The authorities' future aim is to reduce that surplus gradually and to return to a position of balance by 1992/93. The aim of maintaining a balanced situation in future is motivated by the determination to ensure that the public sector's role in the economy is neutral rather than by a desire to reduce the debt/GDP ratio.

With a view to reducing state intervention in economic activity, the Government has adopted the aims of reducing expenditure as a proportion of GDP and of easing the tax burden. Although some tax rates have been cut, non-oil revenue has not yet fallen appreciably as a porportion of GDP. The prevailing approach is to alleviate the tax burden gradually in line with the success achieved in curbing expenditure. In practice, the 1979-81 recession and the slow growth of the first half of the 1980s led to an acceleration in spending; taxation was increased during that period so as not to undermine the priority objective of improving the budget position.

Expenditure targets have also had to be adjusted to circumstances. At the beginning of the 1980's, the Government aimed to reduce expenditure in real terms. But the wide margins by which spending overshot the targets set for it led the Government, from 1986/87, to limit itself to an objective of a moderate rise; against a background of strong growth and declining unemployment, expenditure has subsequently fallen appreciably as a proportion of GDP.

The Government has also embarked on a major privatization programme. Since 1979, the relative size of the public enterprises sector has practically halved in value added and employment terms(*).

4.2 Main developments

The ratio of the PSBR to GDP, which was cut by three percentage points between 1979 and 1984, has steadily fallen since then, from 3.2% in 1984 to a surplus (PSDR, or public sector debt repayment) of 2.6% in 1988.

(*) In 1979, public enterprises accounted for 9% of GDP, 11.5% of investment and 6.7% of employment. The corresponding figures in 1989 were 5%, 6% and 2.9% respectively.

Privatization proceeds, which reached a peak of 1.3% of GDP in the 1988/89 financial year, over the period as a whole, have made a major contribution to the achievement of this surplus. However, the public sector financial balance, which excludes privatization proceeds, has also improved appreciably, reflecting a very marked slowdown in spending, with scarcely any reduction in taxation (see Table 4.2). This over-adjustment in relation to projections has principally been due to an underestimation of economic growth.

Although the PSBR constitutes the Government's target variable, the expenditure and revenue trends described in this chapter relate only to general government on a national accounts basis. The financial balance derived from this account presents the advantage, compared with the PSBR approach, of providing a better idea of the direction of budgetary policy, in that it does not take account of the exceptional contribution made by privatization proceeds(*). Furthermore, it permits international comparisons to be made(**).

The public expenditure picture has changed appreciably. Measured as a proportion of GDP, it rose slightly in the early 1980's to nearly 44% by 1982/3 (the all-time high was 4-8 1/2% in 1975/76), but fell back to 39% in 1988, i.e. the lowest level since the mid-1960s. This ratio is currently the lowest among the Community countries; the corresponding figures for Germany and France in 1988 were 46% and 50% respectively.

Most expenditure categories have contributed to the decline in the overall ratio:

- **transfers** to households and enterprises have fallen as a percentage of GDP (by 1.4 and 1 percentage points respectively in four years) owing mainly to the fall in unemployment and the upturn in profits but also to measures to slow down the increase in pension payments;

- **public consumption** has been curbed, mainly through a reduction in the proportion of expenditure allocated to defence (down from 5.2% of GDP in 1984 to just over 4% in 1988), whereas spending on education and health has grown at the same rate as GDP;

- **interest payments** fell from 4.9% of GDP in 1984 to 3.9% in 1988 owing to a reduced national debt;

- **council house sales** by local authorities - shown as negative investment in the accounts - have cut capital expenditure by a little less than two percentage points of GDP in four years;

(*) In the PSBR, privatization proceeds are shown as negative expenditure.

(**) However, analysis of general government alone does mask the very considerable changes in the financial performance of **public corporations** (see table 4.6).

- public **capital expenditure**, which was cut sharply during the second half of the 1970s, has continued to fall; it stood at 1.7% of GDP in 1988. The corresponding figures for France and Germany were 3.4% and 2.4% respectively (see Table 4.4). Within this total, however, there have been significant real increases in spending on roads, railways and health, with substantial reductions in capital spending on education (as school rolls have fallen) and housing (reflecting an emphasis on encouraging private rather than public housebuilding).

Current revenue had increased appreciably between 1979 and 1982. The government increased VAT rates in 1979. In 1981, it deliberately did not offset fiscal drag, thereby increasing the effective tax rate, in the face of the impact of recession in raising public spending and keeping the PSBR above its projected level. In addition, oil revenues (tax revenue + royalties) were rising. Since then, revenue has declined slightly as a percentage of GDP (by 2.5 percentage points). However, this reduction has largely been the result of the fall in oil revenues, since the level of taxation excluding oil has hardly changed.

The overall level of **taxation** (direct and indirect taxes and social security contributions) stood at 36.2% of GDP in 1988, i.e. a level still markedly higher than that in 1979 (33.6%) but slightly down on the high reached in 1982 (37.8%). On an international comparison, the level of taxation in the United Kingdom is currently among the lowest in the European Community; in Germany and France, for example, this ratio stood at 41.5% and 44.7% respectively in 1988.

However, the fact that the overall level of taxation has virtually not changed since 1982 masks the major changes introduced as part of the **tax reform programme** which began in 1979 and has been continued in successive budgets since then.

While the main tax rates (income tax, corporate taxes and employees' social security contributions) have been cut, the amount of revenue has not yet been affected, because of a widening of the tax base. This has stemmed partly from the effects of economic growth and partly from specific measures such as the abolition of free depreciation for companies, which was regarded as sources of distortion.

Public sector debt (administrations and enterprises) fell as a proportion of GDP by seven percentage points in gross terms between 1985 and 1988; this ratio stood at 50% at the end of the 1987/88 financial year (see Table 4.9). The trend in net debt (40% of GDP at the end of 1987/88), has been even more favourable. Further changes are likely to have occured during the course of the 1988/89 financial year. The surplus achieved could reduce the debt/GDP ratio - already at a historically low level - by eight percentage points for this year alone.

4.3 Assessing the stance of budgetary policy

Various - and at times contradictory - factors must be taken into consideration in assessing the stance of budgetary policy. It would appear that the surplus has come about primarily as a result of a major retrenchment in spending and that, overall, the tax cuts have simply offset fiscal drag (although the shift in the tax burden from households to companies might conceivably have increased overall spending propensities).

A tentative quantification of the impact of budgetary policy, through an "index of fiscal expansion", gives supplementary information. Budgetary policy exerts a direct influence on demand via public spending and an indirect influence, via wealth effects, on private consumption. In turn, these effects depend on both the level of public debt and expectations regarding the future burden of taxation.

Impact of budgetary policy on aggregate demand
(as % of GDP)

	G	D	Debt	Total
1985	0.7	-0.9	2.2	2.0
1986	0.4	-1.2	2.0	1.2
1987	0.5	-1.3	2.0	1.2
1988	0.3	-1.8	1.9	0.4
1989	0.4	-1.7	1.5	0.2

The index (details of its calculation are given in a technical box) reflects these effects using the three variables given in the table: G represents the effects on aggregate demand of the difference between the current level of public expenditure and private-sector expectations of the future level of spending; D represents the effect of the sum of the current deficit (+) or surplus (-) and of the present value of expected future budget balances; "Debt" represents the debt effect. The overall impact on demand is given in the last column. Movements in the index are more significant than its absolute value (see box). In addition, the series is short, reflecting the volume of calculation involved.

Nonetheless, the results are suggestive: budgetary policy appears to have moved in a persistently restrictive direction in recent years, and notably in 1986 and 1988. Several factors account for this: a faster fall in the actual level of spending than in spending anticipated for future years; an increase in anticipated surpluses, the increase being particularly marked in 1988; lastly, the negative wealth effect of a sharp reduction in the level of debt. In 1989, the calculation includes a small positive swing in the effects of spending and anticipated budget balances in response to expectations of a less rapid reduction in spending and smaller surpluses in the future.

4.4 Prospects

The projections for the period from 1989/90 to 1992/93 announced in the March 1989 budget reflect the Government's determination to reduce public spending and the tax burden further as percentages of GDP (see Tables 4.7 and 4.8).

They can be summed up as follows(*):

- to reduce spending as a proportion of GDP (for general government, less privatization proceeds) by 1.5 percentage points over four years; given the lower level of spending in some areas, notably the interest burden and unemployment benefits, the Government is able to plan increases in other priority areas such as health, education and defence;

- to cut tax rates (with the ultimate aim of reducing the standard marginal rate of income tax to 20%) and reduce the tax burden; leaving aside oil, the tax burden is forecast to fall by just over 2 percentage points of GDP between now and 1992/93 (from 37.5% to 35.25%)(**);

- to bring about a gradual return to a balanced budget, by way of a planned reduction in the surplus (PSDR) from 3% of GDP in 1988/89 to 0.5% in 1992/93.

To judge the expediency, solely from a budgetary viewpoint and not with regard to the policy mix, of eliminating budget surpluses over the next few years, potential pressures on spending need to be assessed. It is sometimes argued that budget surpluses should be built up in order to cope with the future costs of an ageing population. An examination of the main structural factors that will influence public revenue and expenditure in the United Kingdom shows, however, that such an approach would not be justified.

Demographic developments are not expected to lead to higherspending over the next ten years. According to a recent OECD study on the effects of ageing populations in the industrialized countries(***), the pressures on public spending will materialize only after the year 2000 and will be relatively limited. The increase in expenditure in absolute terms, could be greater than in, for example, Germany and Italy: assuming constant real per capita spending within each age group, an index of total spending

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(*) Financial Statement and Budget Report ("Red Book"). The economic assumptions underlying these projections include a decline in the inflation rate (from 5.5% to 2.5% for the GDP deflator) and a GDP growth rate of between 2% and 2.75% in real terms, as compared with a potential rate of growth of GDP put at 3%.

(**) Non-oil taxes and social security contributions as % of non-oil.

(***) OECD, Working Paper No. 61, January 1989, "Ageing populations: economic effects and implications for public finance".

(education, family allowances, health and pensions) in real terms could increase from 100 in 1980 to 110 in 2040 in the United Kingdom(*), 107 in Italy and 128 in France but fall to 97 in Germany. However, the trend in dependency ratios(**) is likely to be more favourable in the United Kingdom than in most other European countries, suggesting that the increase in the ratio of social spending to GDP could be less marked than elsewhere. In part this reflects the fact that UK governments were not led to institute overgenerous schemes of social provision during a past, temporary, period of favourable short-term demographic factors. In addition, the budgetary burden of pensions might be alleviated in future given the Government's policy of encouraging the development of private pension schemes.

The gradual disappearance of certain of the favourable factors of the 1980s such as privatization proceeds and oil revenues must, it is true, be taken into consideration(***); but the current surpluses, the prospect of a reduction in the level of debt and the favourable forecasts for growth and employment betoken the absence of any foreseeable pressures on current spending.

In these favourable circumstances, the United Kingdom authorities have opted for, as a priority, a reduction in the tax burden within the limits of maintaining a balanced budget. But, given the major deficiencies in the country's infrastructures, this priority can be questioned: there could also be some scope for using the budgetary headroom, at least in part, to boost capital spending. Such a decision could be justified on two grounds. First, the completion of the single market in 1992 will demand a special effort, notably in the fields of transport and training. Second, such a move would not hamper continuation of the tax reform as a means of improving supply-side conditions, although it would not have as its specific aim a reduction in tax receipts as a proportion of GDP. The recent announcement of a road-improvement programme is a move in this direction.

(*) This is the result of a strong increase in spending on health and pensions (to index values of 121 and 130 respectively), partly compensated for by a fall in spending on education and family allowances (85 and 86).

(**) This development masks a sharp rise in spending on health and pensions (to 121 and 130 respectively) that will be partially offset by a decline in spending on education and family allowances (to 85 and 86).

(***) Oil revenues are in any case already small as a percentage of GDP (0.6% in 1989/90).

AN INDEX OF FISCAL EXPANSION

Many attempts have been made to measure fiscal stance. None of them are "model free". The "model" underlying the index of fiscal stance referred to in the text has the following mainfeatures:

- agents are forward-looking and rational;
- they have finite rather than infinite horizons;
- they are not subject to liquidity constraints;
- government spending and taxation have no allocative effects.

Using these elements, a consumption function including human and non-human wealth variables can be derived. This in turn permits the impact of fiscal policy to be depicted by two elements: the direct impact on demand of government spending, and the indirect effect on spending via fiscal policy effects on non-human wealth (via the stock of public sector debt) and human wealth (via the expected sequence of taxes).

Specifically, an index of fiscal expansion (x) can be written as*:

$$(1)\quad x_t = (p + \theta)\left[D_t - \int_t^{\infty} T_{t,s}\, e^{-\frac{(r+p)(s+p)}{}}\, ds\right] + Gt$$

where D is the level of net public sector debt at market values held by the domestic private sector;

T is net taxes (i.e. taxes minus transfer payment);

G is "exhaustive" spending (i.e. public consumption plus public investment);

θ is the individual rate of time preference;

p is the subjective instantaneous probability of death (this can also be thought of intuitively, though not quite accurately, as the inverse of the horizon);

r is the ex ante real rate of interest (assumed to be constant);

and D, T and G are expressed as percentages of trend GDP.

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* See O.J. Blanchard, "Debt, deficits and finite horizons", Journal of Political Economy, vol. 93, no. 2, April 1985.

(1) can be re-arranged as

$$(2)\ x_t = G_t - (p+\theta)\int_t^{\infty} G_{t,s}\, e^{-(r+p)(s+t)}\, ds + (p+\theta)\left[D_t + \int_t^{\infty}(G_{t,s} - T_{t,s})e^{-(r+p)(s+t)}\, ds\right]$$

The first line of (2) gives the impact of current government spending relative to the expected sequence of government spending in the future. The second line gives the impact of debt and of the expected sequence of (net-of-interest) budget deficits or surpluses. Given this, the index values given in the text are based on the following assumptions about parameter values :

$r = p = \theta = 0.03$;

and on a series of expected sequences of spending and deficits/surpluses:

	expected in:									% potential GDP
	1985/6		1986/7		1987/8		1988/9		1989/90	
	G	G-T	G	G-T	G	G-T	G	G-T	G	G-T
1985/86	22.0	-1.2								
1986/87	22.0	-0.7	22.2	-1.1						
1987/88	22.2	-0.3	22.4	-0.6	22.0	-2.5				
1988/89	21.7	-0.4	22.0	-0.7	21.5	-2.3	21.4	-3.1		
1989/90	21.2	-0.6	21.6	-1.1	21.0	-1.5	20.9	-2.8	21.0	-4.3
1990/91	21.2	-0.6	21.6	-1.2	21.0	-0.9	20.9	-2.1	20.3	-2.8
1991/92	21.5	-0.6	22.0	-1.0	21.3	-0.9	20.3	-1.2	20.6	-1.8
1992/93	21.0	-1.0	21.5	-1.3	20.8	-1.3	19.8	-1.1	20.3	-1.5
1993/94	20.5	-1.0	21.0	-1.6	20.3	-1.7	19.7	-1.5	20.0	-1.9
1994/95	20.5	-0.9	20.9	-1.7	20.3	-1.6	19.6	-1.5	20.0	-1.6
1995/96	20.5	-1.0	20.8	-1.3	20.6	-1.3	19.5	-1.6	20.0	-1.5
1996/97	20.5	-1.0	20.8	-1.3	20.1	-1.2	19.5	-1.6	20.0	-1.3
1997/98	20.5	-1.0	20.8	-1.3	19.6	-1.2	19.5	-1.6	20.0	-1.3
1998/99	20.5	-1.0	20.8	-1.3	19.5	-1.2	19.5	-1.6	20.0	-1.3
.	.		.		.		.		.	
.	.		.		.		.		.	
∞	20.5	-1.0	20.8	-1.3	19.5	-1.2	19.5	-1.6	20.0	-1.3

The assumption that $\theta = r$ is a conventional one, as is the assumed value of 0.03. The value of 0.03 for p gives an MPC out of wealth of 0.06, which is again a fairly conventional value.

The sequences of spending and deficits/surpluses corresponding, empirically to the Public Sector Financial Balance net of interest, were derived from:

- successive MTFS statements;

- assumptions about the credibility of these statements based on actual outturns, output cycles, electoral cycles and changing public perceptions of the relative desirability of alternative budgetary paths.

Potential GDP adjustments to actual GDP are:

(%)

1985/6	1986/7	1987/8	1988/9	1989/90
+ 2.75	+ 1.75	+ 0.6	- 0.5	- 0.25

These are calculated using 3% as the potential growth rate and a benchmark year 1988/89 in which actual output is 1/2% above potential; this is consistent with Commission forecasts that show inflation falling back in 1990 with a slightly below-potential growth rate . The adjustments are clearly different from mechanical "backward looking" calculations of potential GDP that react only very slowly to improvements in supply conditions. Such backward-looking calculations would clearly be inappropriate in an index of the kind used here.

The results of the calculations clearly need to be used with a great deal of caution given:

(i) the restrictive assumptions used as the theoretical basis of the index;

(ii) the uncertainty about parameter values;

(iii) the hazardous nature of an exercise that involves not only measuring current expectations for the future but also "backcasting" expectations held in earlier years;

(iv) the derivation of potential output, which has an impact on the expected future path of deficits/surpluses.

Further, absolute values of the index give a misleading impression. Strictly speaking, the impact of debt levels on spending "decays" at an annual rate equal to p. Thus for a "static" budgetary policy (i.e. a constant debt/GDP ratio and unchanged expected sequences of spending and deficits/surpluses), the demand impact would decline asymptomatically over time. However, difficulties in establishing a sufficiently long debt series meant that this could not be taken into account in calculating the index.

But as emphasized at the outset, no attempt to measure fiscal stance is model free. It is believed that the index constructed here is more realistic - through being explicitly forward-looking - than conventional measures whose implicit assumptions turn out to be unacceptable.

5. Monetary and exchange-rate policy(*)

This chapter first considers the evolution of the targets and indicators of monetary policy in Britain in the 1980's, with particular attention to the relationships between the monetary aggregates and the exchange rate. It then assesses the available instruments of monetary policy and finally presents some concluding comments on the efficacy of the monetary framework.

5.1 The monetary aggregates and monetary conditions

Throughout the last ten years, the main final objective of macroeconomic policy has been to set a downward path of nominal GDP(**) consistent with eliminating inflation over a period of years. Monetary policy has always been seen as the main tool for influencing money GDP and short-term interest rates as the operating instrument.

Within this general framework the weighting of intermediate targets or indicators has changed over time. Monetary aggregates have always had an important role, but they have been supplemented, at various times and in varying degrees, by a range of other indicators including by the exchange rate and asset prices, particularly house prices.

Monetary targeting, first publicly introduced in the UK in 1976, had pride of place in the original 1980 MTFS. Subsequent annual statements of the MTFS have continued to indicate target ranges for a monetary aggregate or aggregates (for the year in question, followed by conditional projections for the out-years). They have always been shown as gradually decelerating over a period of years, the intention being thereby to guide and influence private sector expectations and behaviour.

The monetary aggregates preferred by the authorities have changed frequently during the 1980's. The original MTFS chose sterling M3 as an intermediate target variable, since a reasonably stable demand function appeared to have existed in the 1960's and 1970's. Moreover, it was believed that sterling M3 could be closely linked, via a counterparts analysis, to budgetary policy. However, sterling M3 immediately began to exceed its target by significant margins at the same time that interest rates rose to very high levels, the exchange rate was appreciating sharply and economic activity was declining. With hindsight, the authorities recognized that monetary conditions had been considerably tighter than signalled by the rate of growth of sterling M3.

(*) Annex I contains information on change in financial markets; Annex III reviews recent developments in money aggregates, interest rates and the exchange rate and provides information on the Bank of England's money-market techniques.

(**) The final targets of overall policy have been to reduct inflation and to create the conditions for durable growth in output and employment. But, as explained in chapter 2, the macroeconomic framework has always been expressed in nominal terms.

As it became clearer that structural shifts, related to financial market change and in particular to the deregulation of credit, in the demand for sterling M3 were taking place, the authorities began to take into account - and in some cases to target (Table 2.1) - a wider and varying range of aggregates. These included both narrower ones (M1 and a newly-defined M2, intended to correspond more closely to transactions balances) and broader ones (PSL1 and PSL2, including deposits with non-banks) during the first half of the 1980's.

However, continuing structural and institutional change meant that none of these aggregates turned out to have a stable relationship with nominal incomes; and in many years targets for one or more aggregates were overshot by wide margins. By 1986, sterling M3 targets were dropped. And in 1987, funding policy was reframed in term of a broader M4 aggregate including deposits with building societies, who were behaving increasingly like banks (Annex I).

Given these difficulties of interpreting the monetary aggregates, the authorities have increasingly focussed on narrow money. By the mid-1980's, the authorities had begun publishing explicit projections for the path of nominal GDP, alongside the targets for broad aggregates, and for a narrow money measure (MO), which was believed likely to bear a more stable relationship to nominal GDP. From late 1986 onwards, MO has been the only aggregate for which a target range and projected medium-term path are set, although the authorities continue to look at broad money as an additional indicator of monetary conditions.

5.2 The role of the exchange rate

The need to look at the exchange rate as an additional indicator of monetary conditions had already been acknowledged in the 1981 MTFS, and at various times thereafter monetary policy - in the form of interest rates (see section 5.3 below) reacted quite sharply to undesired movements in the exchange rate, most notably in response to unwelcome downward pressure on sterling at the beginning of 1985.

However, the exchange rate has not in itself been a target, but rather an indicator among others(*). In 1986, for example, the authorities explicitly accepted a trade-off between oil prices and the exchange rate. Sterling was allowed to depreciate quite substantially while the so-called "oil-adjusted" exchange rate was held rather steady. The logic behind this strategy was twofold:

(i) the fall in the oil price reduced sterling's equilibrium real exchange rate;

(ii) the price level effects of depreciation were compensated for, or more than compensated for, by falling oil prices.

(*) A discussion of the joint interpretation of movements in monetary indicators can be found in "Monetary policy guidelines for 1989", II/334/88, note for the attention of the Monetary Committee.

After the Louvre Accord of February 1987, additional emphasis was placed on achieving stability of the exchange rate to the extent that this was consistent with maintaining downward pressure on inflation. But any tension between exchange rate stability and reducing inflation would have to be resolved in favour of the inflation objective. Tensions did emerge at times during 1987, especially as broad money growth accelerated and asset prices boomed (Graph 5.3). However, the authorities judged, on the basis of the forecasts made at the time, that overall developments allowed the maintenance of a narrow range for sterling against the DM, especially as the dollar's continuing depreciation implied a rise in sterling's effective rate. And the October 1987 stock market crash appeared to resolve tensions more clearly, allowing a reduction in interest rates. Nonetheless, intervention continued on a considerable scale to prevent sterling breaking through the DM 3.00 level.

By early 1988 the authorities conceded that such large-scale intervention could no longer be maintained, and sterling was allowed to rise. However, the authorities once again seemed to engage in a trade-off, this time between interest rates and exchange rates. There was widespread market speculation, not discouraged by the authorities, that a certain rise in sterling was "worth" a certain cut in bank base rates, on the basis that these two stimuli had equal and offsetting impacts on activity in the Treasury model. Thus while the authorities abandoned a DM 3.00 peg, they initially restrained sterling's rise by reducing interest rates.

To judge from the behaviour of nominal long-term interest rates (which stayed very stable in the face of a sudden real appreciation) this trade-off was initially successful in maintaining monetary conditions little changed. However, booming private sector demand was soon reflected in a rapid acceleration of M0 (Graph 5.3) to around 8 %, compared with a target range of 1 - 5 %.

By the summer and autumn of 1988, the overshooting of M0 and signs of an upturn in inflation signalled the need for tighter policy. Interest rates were raised in several steps, usually when sterling suffered bouts of foreign exchange market pressure, culminating in a one-point rise in base rates to 13 % in November 1988, compared with a low of 7.5 % just after the DM 3.00 parity was abandoned.

At times since then there has been downward pressure on sterling. Until May 1989, the authorities responded by intervening. However, following a worse-than-expected (8 %) increase in retail prices in the 12 months to April, downward exchange-rate pressure induced a further 1 point increase in short-term interest rates in late May.

At present, the role of the exchange rate is seen as that of imparting a discipline to wage and price behaviour: the authorities have stated that the exchange rate (which they consider to be best measured by the effective rate) would not be allowed to depreciate to validate excessive cost increases. However, this formulation does not necessarily preclude a fall in the rate if and when the domestic economy slowed to such an extent that cost pressures subsided and output threatened to fall short of potential by too much or for too long.

5.3 The instruments of monetary policy

The key instrument of monetary control in the United Kingdom is the short-term interest rate(*). Indeed, the authorities acknowledge that it is the only instrument at their disposal. This provides an additional reason for targeting M0, since it is believed to be responsive to interest-rate changes. By contrast, the response of M4 (which is largely interest-bearing) to changes in short-term rates is believed to be ambiguous.

Since the abandonment of the "corset" (which restricted the growth of the liabilities side of the banks' balance sheets), the authorities have made no attempt to impose direct controls, either on the banks or on borrowers. They take the view that money is the most fungible of all commodities, especially since the abolition of exchange controls, the disappearance of traditional barriers between different financial functions and of distinctions between different financial activities, and the development of a commercial paper market in London. The authorities therefore consider that controls would be ineffective and distortionary and have to be extended to more and more areas to head off successive leakages from those already in place.

Required reserve requirements in the U.K. are very low (0.45 %), and are intended to provide the Bank of England with an amount of seignorage revenue sufficient to meet its own operating expenses rather than to serve as an instrument of monetary control. The authorities consider that the main effect of increasing these requirements would be to impose a competitive handicap on UK banks.

Since 1985 the authorities have no longer sought to overfund the Government deficit or surplus. In other words, they have not sought to use sales or purchases of government bonds to offset movements in bank lending to the private sector. Overfunding increased the need for money-market assistance, producing systemic shortages of cash in the money market that had to be relieved by large purchases of commercial bills by the Bank of England. This situation was seen by market commentators as creating severe money market distortions, undermining the credibility of the monetary stance and crowding out corporate issues. More fundamently, as

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(*) Details of money market techniques for influencing short-term rates can be found in Annex III.

long as the Bank of England seeks to - and can - produce a particular level of short-term interest rates, the presence or absence of overfunding has little independent impact on the monetary aggregates and no independent impact on monetary conditions. Since 1985, therefore, the authorities have sought a "full fund" of the deficit (or a "full unfund" of the surplus in current circumstances) so as to produce a neutral effect of government finance on sterling liquidity, as now measured by M4. To this end, the authorities aim to conduct, over the course of each financial year, sales or repayments of debt outside the domestic banking and building society sectors equal to the net total of:

- maturing debt;
- the PSBR (or PSDR);
- any underlying change in official foreign exchange reserves.

A possible switch in operating procedures to monetary base control (MBC) was rejected at the beginning of the 1980's, and the view of the authorities remains that such a procedure would be unattractive. The traditional objections to MBC - or to any procedures aimed at imposing quantitative restrictions on the supply of reserves to the banks - are that unnecessarily large, unpredictable and disruptive changes in interest rates could result, and that changes in the money multiplier are also unpredictable.

5.4 Assessment

The monetary policy record in the 1980's is a mixed one. Intermediate targets have consistently been missed; there has been little apparent consistency in the choice of intermediate targets; progress in reducing trend inflation had stopped by the mid-1980's; monetary policy was unable to prevent overheating in 1988 and a consequent acceleration in inflation; the market credibility of policy has suffered as a result.

On the other hand, it can be argued, that, on most occasions, overshooting of targets has reflected structural changes in money demand that it would have been unwise to frustrate. Moreover, given the shocks - to the demand for money, to private sector demand for goods and services and to aggregate supply - that have affected the UK economy over the past ten years, an eclectic approach to the monitoring of monetary conditions - involving examination of a number of indicators was probably inevitable. Such an approach has also been accepted in the United States, Japan and - though to a lesser extent - in Germany, most notably during the period of dollar decline. The difficulty for monetary management in the United Kingdom has been that the shocks have been particularly large and, before the benefit of hindsight became available, underestimated.

Looking ahead, it is difficult to avoid the conclusion that - from the point of view of short-term stabilization - a continuation of an electic approach will be necessary. The process of structural change in money demand may slow down. In contrast, with the United Kingdom still in a position to catch up with a number of other industrial countries in terms of real incomes, and with the current account not in long run equilibrium, continuing swings in the balance between aggregate demand and aggregate supply can be expected. As a result, there may be a presumption that over the next few years, although a range of indicators would continue to be taken into consideration, money aggregate indicators are likely to carry more weight than exchange-rate indicators in assessing the appropriate short-term stance of policy.

However, the authorities' declared aim of reducing the trend inflation rate over a period of years might be seen to imply a different conclusion.

The authorities could attempt to reduce trend inflation without changing the framework. But policy management needs to have an extremely successful track record if the target of 2½ inflation - and ultimately stable prices - is to be credible, and thus attainable at the lowest cost in terms of disruption of activity and reduced efficiency of markets. At present, policy appears to lack, at least in the market, such medium-term credibility.

Alternatively, they could decide to enter the ERM. Such a move would probably have a pronounced effect on the credibility of the MTFS and of monetary policy in particular. And within the ERM, the drawbacks of reducing trend inflation via an overshooting exchange rate - with a major impact on activity in consequence - could be avoided. The trend inflation rate could be reduced in a smoother and less costly fashion, as the experience of the French economy in recent years tends to show.

BUDGET BALANCES AND GOVERNMENT FINANCING

Budget financing in the United Kingdom is officially analysed in terms of the accounting identity linking M4 and its counterparts:

> change in M4 **equals** PSBR **less** purchases of public debt by UK non-bank private sector **less** external and foreign currency financing of public sector **plus** sterling lending to the UK private sector by banks and building societies (including purchases of commercial bills by the Issue Department of the Bank of England) **less** net non-deposit sterling liabilities of banks and building societies **less** net external and foreign currency counterparts of banks and building societies.

The grouping of counterparts is now different from that originally introduced in the UK at the end of the 1960's. At that time, with the exchange rate fixed and controls on capital flows in force, the emphasis was on counterparts comprising DCE, on the one hand, and external counterparts on the other. However, since 1983 the present framework, which recognizes the importance of the changed exchange-rate régime and the greater international substitutability of financial assets, has been used.

The new framework gives rise to the **funding rule** for the public sector borrowing requirement (PSBR) or public sector debt repayment (PSDR), which is intended to produce a neutral effect of government finance on sterling liquidity, as measured by M4. To this end, the authorities aim to conduct, over the course of each financial year, sales or repayments of debt outside the domestic banking and building society sector equal to the net total of:

- maturing debt;
- the PSBR (or PSDR)
- any underlying change in the official foreign exchange reserves (since the PSBR is a net concept, and an increase in reserves represents an increase in the financial assets of central government and therefore counts as negative financing of the PSBR).

By implication, "monetary financing" of the PSBR is thus equal to sterling lending to the public sector by the banks and building societies **plus** borrowing via notes and coin less net purchases of Commercial bills by the Issue Department.

Financing of the PSBR, 1979/80-1987/88

UKL billion

	PSBR(1)	Financing by:			
		UK private sector(2)	External and foreign currency	Bank & building societies (public sector contribution to M4)	Change in M4
1979/80	9.9	8.3	-0.4	2.0	12.2
1980/81	12.5	9.5	0.1	2.9	17.3
1981/82	8.6	10.3	1.0	-2.7	16.4
1982/83	8.9	7.9	2.3	-1.3	20.3
1983/84	9.7	10.5	1.3	-2.2	18.8
1984/85	10.1	12.4	2.0	-4.3	24.9
1985/86	5.7	4.2	1.8	-0.3	29.9
1986/87	3.4	5.3	1.5	-3.5	33.2
1987/88	-3.6	6.2	-8.1	-1.4	45.4

(1) Plus = deficit, minus = surplus
(2) Excluding banks and building societies

On the authorities' definition, "monetary financing" was substantial in the first two fiscal years of the governments tenure of office, was insignificantly positive in 1981/82 and has thereafter been negative. It was heavily so in a number of years, notably as a result of the policy of overfunding, eventually abandoned towards the end of 1985 (see section 5.3). Of the "non-monetary" financing items, sales of debt to the UK non-bank-and-building society private sector were heaviest during the overfunding period. Overseas and foreign currency financing was moderate throughout most of the period but became substantially negative in 1987/88 as the offical reserves (negative financing of the PSBR) increased substantially.

The authorities recognize that the ex post accounting framework used here does not have direct implications for ex ante determinants of M4. For instance, a change in funding could be offset by a change in private sector credit. Similarly, the M4 impact of debt sales to the overseas sector will depend on how that sector finances such sales. Thus it is not possible to control M4 ex ante by varying the "public sector contribution" or monetary financing of the budget balance. This is all the more true in circumstances in which the authorities exert control through their influence on short-term interest rates.

It is also noteworthy that the present counterparts framework makes no distinction between borrowing from (or lending to) the central bank on the one hand and commercial banks and building societies on the other; in contrast, it does distinguish between commercial bank and building

society lending/borrowing to the government on the one hand and such lending to the private sector on the other. The approach is thus sharply differentiated from a conventional "monetarist" approach in which the main focus of attention is the monetary base and the money multiplier. In fact, the construction and presentation of UK monetary statistics (and in particular the accounting treatment of the Exchange Equalization Account and the Issue Department) make it difficult to identify the counterparts (from the assets side of the central bank balance sheet) of the monetary base directly. However, MO counterparts are officially analysed in terms of the central government borrowing requirement (CGBR) **minus** sales of central government sterling debt to all sectors **plus** the net increase in foreign exchange reserves:

Counterparts to MO

	1981/82	1982/83	1983/84	1984/85	1985/86	1986/87	1987/88	1988/89
CGBR	7.6	12.7	12.2	10.2	11.1	10.4	0.9	-6.9
Debt sales	6.3	10.2	11.5	8.5	11.3	11.1	11.3	-6.4
Foreign reserves	-1.4	-1.8	0.0	-1.0	0.9	1.1	11.4	1.5
MO	-0.1	0.7	0.7	0.7	0.7	0.4	0.9	1.0

In general, the story told by the above table is not dissimilar to that told by the M4 counterparts analysis, except that the monetary financing of central government was strongly positive in 1984/5. Once again, however, the main feature is the lack of an ex ante impact of changes in financing by the monetary authorities on the monetary base. The offsets are of course most evident during a period when the exchange rate was a major influence on policy (1987 and the early months of 1988), but are also present whenever interest rates, rather than bank reserves or the monetary base itself, are the main operating targets of the authorities.

6. Supply side policy

Policy towards improving the supply side has been promoted by the government as the fundamental means of increasing the underlying growth and improving the performance of the economy. The medium-term potential growth rate of the non-oil economy is now estimated by the Treasury at 3% p.a., and of the whole economy, taking account of the peak in oil production having been passed in 1985, at 2 3/4% p.a. This is significantly higher than that achieved over the cycle from 1973 to 1979 (1,5% p.a.) or from 1979 to 1988 (2,1% p.a.).

Supply-side policy is necessarily an umbrella term covering a very wide range of policies. For ease of presentation it is ordered below into a number of main areas :

- the labour market, including industrial relations, patterns of pre-and post tax remuneration and education and training;
- measures to encourage enterprise;
- markets for goods and services;
- financial markets.

6.1 The labour market

Measures to reform the pattern of industrial relations and limit the power of trade unions have been the most visible aspects of labour market policies. A series of reforms of industrial relations legislation has been introduced in the 1980's, removing most of the legal immunities previously enjoyed by trade unions. The chief measures have been to prevent supportive industrial action being taken other than in the enterprises directly concerned, to make unions liable centrally for the actions of branches, to require the direct election of union officials and to require membership ballots on official strike calls. The govern- ment has also recently proposed ending the pre-entry "closed shop", where potential employees are required already to be union members. Days lost through industrial disputes in the UK have fallen from an average of 580 days per thousand employees in the period 1977 to 1981 to 420 days in the period 1982 to 1986 but still seem somewhat higher than in many major industrial countries (lower than in Italy or Canada, but significantly higher than in Germany, France, the USA and Japan - see Graph 6.1); the UK does, however, seem to have shed its former image as a country particularly subject to such unrest. At the same time a more flexible attitude to work practices has been encouraged, with fewer problems over restrictive practices and demarcation disputes. These changes are often summed up as representing an increased "freedom for managers to manage" and have almost certainly been major factors in improving productivity and encouraging investment by foreign as well as domestic firms. Their impact on wage bargaining is less clear. For several years, fast productivity growth, at least in manufacturing, has enabled the economy to combine changes in industrial structure with strong output growth and a substantial rise in employment. Nevertheless, tighter labour market price pressures in 1989 have seen a renewed tension in wage bargaining and will be a more severe test of the new structures in place.

Attempts to influence pay bargaining have also been made via incentives to increase employee equity and profit-related schemes. The 1989 Budget in particular enhanced tax incentives for employee share schemes and profit-related pay. Privatisation has also played a role, typically favouring some distribution of shares to employees and in certain instances taking the form of management buyouts. Pension arrangements have also been liberalised. Personal ('portable') and corporate pension schemes have been encouraged, again with important incentives in the 1989 Budget.

The personal tax system has undergone radical revision with the aim of improving incentives. Since 1979 the basic rate of income tax has been reduced from 33% to 25%, with an objective of reducing it further to 20%. Higher tax rates have been cut dramatically, leaving a single higher rate of 40%. The basic allowances against income tax have been raised by over a quarter in real terms since 1978-79. From October 1989 employees' national insurance (social security) contributions will be given a more progressive structure by easing at the lower end.

Changes made or proposed in education recognise that standards in the UK have fallen behind those of other countries in key areas such as numeracy, and give rise to below-potential performance later in working life. Notable initiatives include the setting of a national core curriculum, periodic testing of pupils' attainment, greater parental responsibility for schools, and allowing schools to leave local authority control. The Government has also sought to promote close contact between education and industry by means of its Technical and Vocational Education Initiative (TVEI) for 14-18 year olds, the establishment of "compacts" between firms and schools in inner city areas, and the development of the City Technology Colleges, which will provide a competing model to established forms of education.

Extra effort is being placed on training. This is an area where the UK lacks a strong craft- or employer-based tradition. The Youth Training Scheme was introduced in 1983. The employment training programme (ET) began in September 1988, to provide training for the unemployed, especially those out of work for six months or more; take-up of places, provided with the cooperation of employers and voluntary bodies, has so far been somewhat disappointing. A White Paper published in January this year proposed a more comprehensive approach centred on local employer-led groups coordinating a range of programmes suited to the local labour market and backed up by a national training task force. A general review of the country's training qualifications is under way which is seeking to rationalize the existing system.

6.2 Measures to encourage enterprise

Measures taken to favour greater enterprise include reform of the corporate tax system, the aiding of business start-ups and the growth of small firms, and a significant change in the thrust of regional policy.

The corporate tax system was changed radically with proposals made in the 1984 Budget, moving to a broader base with lower rates. The corporation tax rate was reduced progressively from 50% for the 1983 financial year to 35% from 1986; fixed investment accelerated tax allowances were also phased out by 1986. The importance in favouring less capital-intensive production methods has yet to be reliably seen, but at the very least the new regime has gone hand-in-hand with an upsurge in fixed investment and strong upturn in profitability.

Business start-ups and small business have been promoted by softer corporate and value-added tax structures (both eased further in the 1989 Budget) and a number of special schemes. The Business Expansion Scheme favours equity funding of small firms; the Loan Guarantee Scheme eases the supply of finance for small firms; a third scheme, the Business Development Initiative, subsidises consultancy advice to small firms. Apart from government measures, the development of venture capital and relative ease of financing via such means as leveraged buy-outs (often also for larger companies) has progressed further in the UK than in the rest of the Community. The net result has been to promote greater firm mobility. Total VAT registrations, for example, rose by 30% between 1980 and 1987; the net stock of business registered rose steadily from some 1,3 million to over 1,5 million. The rate of creation of new businesses has recently accelerated to more than 1 000 per week.

Against the grain of most other areas of policy, **regional policy has become significantly more selective.** The former automatic regional development investment grants have been abolished. In their place have been introduced selective investment grants and consultancy services. In effect, more reliance is now placed on a mixture of intervention and market incentives.

6.3 Markets for goods and services

The general thrust of economic policy, including the areas of privatisation and labour law, has been to encourage a climate of greater competition in goods and services markets. In addition action has been taken to invigorate competition via more specific measures of deregulation and liberalisation and moves in the direction of a more explicit competition criterion as the basis of reviewing proposed mergers and restrictive practices.

Deregulation and liberalisation have had most scope for impact in the market for services. One channel for change has been the **privatisation programme.** While perhaps public finance aspects were dominant in the earlier years of the programme, as it has matured more attention has been given to stimulating the competitive environment in which the enterprises operate. The forthcoming privatisation of the electricity industry, for example, provides for a competititive splitting and deregulation of generation capacity whereas there was comparatively little basic change made in the gas industry when it was privatised in 1986-87. A potential conflict of interest is, however, apparent : the more monopoly profits are guarded in the proposed structure of an enterprise being privatised, the greater should be the returns to the government on its sale.

Services such as transport (air and buses), legal services (property conveyancing, with further reform proposed of general legal services) and telecommunications have been subject to extensive deregulation. **The public sector**, especially local government and the health service, has been encouraged to adopt a more rigorously competitive approach to the provision of services, often contracting out where in-house provision was previously quasi-automatic. In an international context the UK has often been seen as a leader in these areas and sectoral interests have often been explicitly confronted and overcome. Yet evidence from international price studies tends to suggest that services, at least to final consumers, are somewhat more expensive in the UK (relative to the price of final output as a whole) than in the Community on average and also than in the USA and Japan (with the notable exception of health care in the USA), and that this difference may have widened between 1980 and 1985 (see Graph 6.2 for 1985 data). This may be because of greater public subsidisation or inadequate profit levels elsewhere and the quality of services is of course difficult to measure; it may also, however, suggest scope for the reform programme in the UK to be carried forward and extended, as the government is planning to do in the area of legal services. The internal market programme is of importance in this respect, potentially bringing significant benefits to UK consumers of services as well as to producers. Even for an area such as financial services, for example, where the UK is thought to have a strong competitive advantage, research carried out for the Commission suggests that charges for particular services - consumer credit, home insurance and private equity deals - are high in the UK.

Policies on mergers and restrictive practices have long been characterised in the UK by a greater degree of official discretion as regards what is best in the "public interest" than, for example, in the USA or Germany where the impact on competition has been regarded as the unambiguous criterion for policy decisions. This emphasis is changing to some extent. A review of mergers policy published in March 1988 concluded that the potential effect on competition within the UK should be the main consideration in evaluating the reference of a proposed merger to the Monopolies and Mergers Commission; the fundamental structure of merger control nevertheless remained intact. March 1988 also saw the publication of a green paper (consultative policy document) proposing a more rigorous prohibition of anti-competitive restrictive trade practices.

6.4 Financial markets

Financial markets and the financial system have been subject to wide-ranging reform during the present government's period of office. Foreign exchange controls were abolished in 1979, exposing domestic companies to the need to earn more internationally comparable rates of return; the abolition of **dividend controls** in the same year can be seen in this light as a complementary measure. Identified capital outflows have been considerable, enabling the UK to build up a considerable stock of overseas assets at the time of earning large but temporary oil surpluses.

The ending of exchange controls has helped reinforce London's predominance as the chief European financial centre. This was also aided by the "Big Bang" reforms of the stock exchange of October 1986. These reforms, made by the institutions concerned under the threat of government intervention, ended a number of restrictive practices as regards dealing in stocks and shares and membership of the exchange and enhanced the introduction of new technology. The Financial Services Act of 1986 added a new system of regulation for the securities and life assurance business. The generally competitive environment has attracted considerable secondary dealing of non-UK securities. Sterling capital markets were further deregulated in the 1989 Budget, which included the abolition of the queuing system for new issues.

More domestically oriented financial deregulation has included giving building societies much more scope to compete with banks and other credit institutions over a wider range of services, to raise capital in the wholesale markets and to change their status from mutual to public companies. This has intensified competitive pressures in credit markets, which had already been given an earlier impetus by the abolition of hire purchase controls in 1982.

6.5 Assessment

The need to improve the performance of the UK economy through encouraging private enterprise and reducing the role of the state has been a central theme pursued by the UK government over the last ten years. This is evident both in the thrust of budgetary policy and in the range of more specifically supply-side micro policies reviewed in this chapter, designed to foster an enterprise philosophy and greater efficiency among economic agents. While some of the initiatives are at an early stage of implementation and their effects may be relatively slow to come through (this is particularly true of the important area of education and training) there are accumulating indications of changes in attitudes and of improvements in supply performance helping to reverse the UK's long-term relative economic decline, reflected in the rapid increase in employment and fall in unemployment and the strength of business investment. However, despite a reduction in the power of trade unions, the apparent rigidity of the wage formation process remains a potential source of concern. The real test of success of supply-side policies will be whether desirable structural change can continue under conditions of less buoyant demand, enabling a longer-term, sustainable higher growth path to be confirmed.

7. Problems and outlook for the British economy

The programme on which the British authorities embarked in 1979 was particularly ambitious, aiming at a fundamental improvement of the economy's performance by eliminating inflation and achieving higher and durable growth. Ten years later, in 1989, it is difficult to make an assessment, because the process of restructuring the supply side is still under way. The policy has not yet been uniformly successful: the results obtained are very positive on the growth and employment fronts; they are far less so as regards inflation and the current account balance.

Since 1985, **growth** has been very strong - more so than in the rest of the Community. It has been led by domestic demand, and primarily by consumption, with private investment taking up the running from 1987. Growth has been accompanied by remarkable productivity growth in manufacturing, and employment started to recover as early as 1983. **Unemployment** has fallen steadily and sharply since 1986; the rate is now one of the lowest in the Community.

These successes represent the credit side of the policies, which for ten years have formed part of a firm and unchanging **conceptual framework** . The objective has been to unleash market forces in order to restore private sector confidence and create an environment favourable to enterprise in which the State plays as small and neutral a role as possible. Nevertheless, the authorities have combined very great constancy in stating their policy aims with very great flexibility in the application of instruments.

This conceptual framework has been expressed in the **"medium-term financial strategy"** introduced in 1980 and maintained since then. Its fundamental purpose is to ensure that demand in money terms grows in such a way, given the productive potential of the economy, as to be consistent with the medium-term objectives for inflation. Monetary policy has always been the instrument for influencing nominal GDP, reinforced by fiscal policy. But with high interest rates now much more appropriate - given the improvement in underlying supply prospects - than in the early years of the Strategy, it has become possible to operate budgetary policy somewhat more independently of monetary policy. H owever, at least in the eyes of many market participants, monetary policy has recently been driven primarily by considerations of short-term stabilization, reacting to events rather than guiding expectations. These perceptions have undoubtedly reduced the credibility of the MTFS as a framework for maintaining a downward medium-term path for inflation.

Given the authorities' stated intentions, the principal unresolved problem is indeed that of **inflation** and its recent resurgence. The choice, in contrast to most other countries of the Community, of a policy of exchange rate depreciation at the time of the oil price fall was a major factor in keeping the UK inflation rate relatively high; and an acceleration in wage costs and the swelling of company profit margins have contributed to a recent upturn in inflation.

In order to contain the resurgence of inflation, there has had to be a major tightening of monetary policy from mid-1988, without the result yet being apparent. In this context, the outcome of wage negotiations and their implications for wage costs in the future will be the touchstone of the success of the strategy that has been followed up to now.

The **current account balance** has swung into very substantial deficit, a deficit that is set to persist. The present deficit is due to the strength of domestic demand, combined with a deterioration in price competitiveness and structural weaknesses in British exports. However, the upturn in private consumption and corporate investment is not the result of a fall in public sector saving. In part, this reflects renewed confidence in the prospects for the British economy. But the strength of consumption has also owed something to a boom, intensified by a period in which monetary policy turned out to have been too loose, in house prices. There has been no difficulty in financing the deficit, since international investors have, at least until recently, shared the optimism of domestic agents as regards the improvement of supply side conditions in the British economy. This can be seen as the result of the supply side policy which has been pursued with constancy for ten years. The current account could be brought smoothly back into balance over a period of years, in line with the expected slowdown in demand - partly endogenous, but partly reflecting the tightening of monetary policy and the recent turnaround in the housing market - and the bringing into service of the new capacity now being installed; but a precondition for this is that investor confidence is maintained throughout the process of adjustment. The risks that would be involved in any loss of confidence make the current account position properly one of concern.

In the field of **public finance**, the objective of the gradual reduction of the deficit has been attained and even exceeded, since the public sector borrowing requirement (PSBR) has given way to a public sector debt repayment (PSDR) and it is clear that the stance of budgetary policy has been distinctly restrictive. This development has taken place as a result of a fall in **public expenditure** as a proportion of GDP - now the lowest in the Community - which reflects the authorities' determination to reduce the public sector's size and its role in the economy. Although it has increased over the period as a whole, the **tax burden** is now falling and is one of the lowest in the Community. Its overall increase conceals the effects of the radical reform of taxation embarked upon since 1979: the lowering of the main tax rates was more than offset by a broadening of the tax base as a result of growth and of the abolition of numerous allowances. The question that now arises is whether the fiscal headroom provided by current and prospective surpluses should best be used, as is currently the aim of the authorities, to reduce the tax burden and increase expenditure in priority areas.

Monetary policy remains the key instrument for attaining the desired path of nominal income. As the decade has progressed, the weighting applied to the various monetary policy indicators has - as in many other countries - varied with the circumstances. Broad money targets have been downgraded, but narrow money (M0) is still regarded as being closely related to nominal income and is now the targeted aggregate. The exchange rate is also accorded considerable importance as an indicator of monetary conditions. Unfortunately, a variety of shocks has complicated the assessment of monetary conditions, to such an extent that monetary policy turned out to be too loose during much of 1987 and 1988. As a result of the consequent acceleration in inflation, the credibility of monetary policy has been harmed. The nominal anchor constituted by the projected path of nominal income has not seemed firm enough to provide the markets with sufficient confidence in medium-term prospects. In these conditions, an exchange-rate rule such as **ERM participation** would provide monetary policy with a more obvious anchor, restore greater credibility to the MTFS and thereby make the task of reducing the trend inflation rate less costly.

Standing at the centre of the British authorities' economic philosophy, the **improvement of supply side conditions** has been pursued with determination. Measures have been taken in virtually all areas to deregulate and to encourage enterprise; these areas include the labour market and industrial relations (trade union responsibility, wage differentiation, more flexible working practices, spread of profit sharing, etc.) companies (lower tax rates and phasing-out of allowances) and in particular small businesses (wider range of financing possibilities, reduction of direct taxation), the markets for goods and services (privatization, deregulation) and the financial markets (abolition of exchange controls and dividend controls, banking deregulation, "Big Bang"). These measures of a microeconomic nature take time to bear fruit and it is probably too early to make a judgment on their effectiveness. Nevertheless it appears that they have already succeeded in changing the behaviour of economic agents and in restoring their confidence in the future of the British economy.

COMMISSION
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THE ECONOMIC AND MONETARY SITUATION IN THE UNITED KINGDOM

(Note for the attention
of the members of the Monetary Committee)

ANNEXE I

FINANCIAL MARKETS

Structural characteristics and reforms

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FINANCIAL MARKETS

Structural characteristics and reforms

1. Introduction

The United Kingdom has succeeded, through accumulated expertise, flexibility and reforms, in maintaining its importance as an international financial centre, especially in the international banking markets, despite the rise of competition worldwide and the emergence of new centres, especially that of Tokyo.

The purpose of this note is to highlight certain structural aspects of the financial sector in the United Kingdom, and provide a measure of its importance for the British economy, as well as of its role in the international financial system. Against this background information, the major reforms of the financial markets in the UK during the last decade are examined, and an outline is given of their impact on the competitive position and regulation of the markets. The prospects of the City in the after 1992 era are briefly examined.

2. International role and structural characteristics

London ranks among the three top centres along with New York and Tokyo (though it has lost international business to the benefit of Tokyo) and is the leading one in Europe. This remarkable performance of the UK, and London in particular, in the international financial business - while the weight of the UK in world output and trade has declined and sterling's role as a reserve currency diminished - can be only partly attributed to the long tradition, expertise and established international links. It also reflects a flexibility to attract new business, such as the Eurocurrency and Eurobond market, and to compensate thus for the erosion in other segments of the market.

A general measure of the financial openess of the UK in comparison with the rest of the Community countries, as well as with the US and Japan, is provided in table 1 below. These indicators are based on balance of payments data and are calculated as the ratio of a country's international financial flows (gross capital movements) over its real flows (imports and exports of goods and services).

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Table 1 FINANCIAL OPENESS INDICATOR (1)

*BLEU	0.80	Spain	0.13
Japan	0.70	France	0.12
UK	0.45	Greece	0.12
USA	0.28	Ireland	0.09
Denmark	0.17	Italy	0.06
Germany	0.15	Portugal	0.04
Netherlands	0.15		

(1)Ratio of a country's international capital flows over its flows of goods and services (average 1985-87).
(*)Recent data point to an indicator of over 1.0.

UK's international financial role is reflected in its high indicator, 0.45, which is second to Luxemburg in Europe and after Japan on a worldwide scale. Noteworthy, in this respect is the dramatic increase of the financial role of Japan: its financial openess indicator passed to 0.70 up from 0.21 in just five years (530% increase in international financial flows, 52% increase in real flows).

The following additional elements underline London's weight in international finance.

- London's share of international banking business was 20.9% at the end 1988, behind the US, 28.6% and practically at the same level with Japan, 21%. Although it fell during the last three years (balanced by an increase in Japan's share), London continuous to have by far the largest share of foreign currency lending to non-residents.

- The number of foreign owned banks in London was more than quintupled between the mid-sixties and the mid-eighties. In a number of cases a substantial part of the foreign countries international business is in fact carried out by London branches or subsidiaries.

- London's share in the Eurosector is even higher with the major share of turnover in the secondary Eurobond market passing through London.

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- London International Stock Exchange ranks third in the world in terms of market capitalization, substantially behind Tokyo and New York, but well ahead of other European bourses, Table 2.

Table 2 STOCK MARKET CAPITALIZATION

	bn $	%
Europe*	1.873	20.2
(UK)	(721)	(7.8)
Pacific basin	4.361	47
(Japan)	(3.830)	(41.3)
N. America	3.041	32.8
(USA)	(2.857)	(30.8)
World	9.275	100

Source: James Capel & C°
* 14 leading European bourses

An important international financial role must be supported by a solid domestic base and UK makes no exception to this rule. Its financial sector beyond its role of intermediary between lender and borrower units, contributes also considerably to the growth of the economy by generating income and employment opportunities, through a wide range of services. Moreover, the sector's overseas earnings, especially from banking and insurance services, have been a positive factor for the balance of payments equilibrium.

Although the output (on a national accounting basis) of the financial services sector is difficult to measure, a useful indicator thereof is given in table 3. The share of the financial sector in the UK is significant, second in importance only to Luxemburg among EC economies (1986 data for most of the countries).

Table 3 VALUE ADDED OF THE FINANCIAL SECTOR % of GDP

Luxembourg	24.5	Italy	5.3
UK	18.0	Germany	5.2
Portugal	6.9	Netherlands	5.1
Spain	6.4	France	5.0
Belgium	5.9	Denmark	2.8
Ireland	5.6	Greece	2.2

Source : Eurostat.

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In terms of sector's employment, a steady growth took place in the 80's, although the sector's share in total employment (3.5% in 1986) is much lower than that of the value added. In 1987 the banking and bill discounting segment accounted for over half the number of jobs in the financial sector.

During the 1970s there has been a significant increase in the importance of non-bank financial intermediaries in the UK financial system.

Table 4 SHARE OF MAIN INTERMEDIARIES (in % of total liabilities)

Banks	Building Soc.	Insurance	Pension	Other
26	18	26	27	3

Building societies have grown substantially in recent years. Sterling liabilities of these institutions to the public are greater than those of the clearing banks and in terms of deposits from the personal sector, larger than the total for all banks. Recent legislation in the form of the 1986 Building Societies Act permitted them to increase their banking activities.

Other financial institutions, which include insurance companies, pension funds and unit trusts, are generally more important than elsewhere in the Community and accounting for over one half of domestic intermediation. Life insurance and pension funds have become major channels of personal savings, collecting about two thirds of all personal sector saving and holding approximately a half of British government stocks and of the total share issue of quoted UK companies.

3. Major reforms and their impact

The principal reforms of the financial markets in the United Kingdom over the last decade can be distinguished in two broad categories according to their nature, scope and policy implications :

- The abolition of all foreign exchange controls for UK residents, in 1979, besides its practical implications, reflected also a more broad policy shift towards market orientated economic policies and the removal of controls in general.

- The aim of the more recent reforms which took shape mainly during 1986 and 1987, was the setting-up of a framework for the regulation and supervision of the financial markets, with parallel measures of liberalization, easier access to the markets and higher market efficiency.

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SUMMARY OF MAIN REFORMS

In 1979

The abolition of all foreign exchange controls for UK residents, was a major step towards the internationalisation of the domestic market and marked a turn towards more market orientated economic policies. The conduct of monetary policy was directly affected by the removal of foreign exchange controls: credit controls (corset) became ineffective and were abolished in 1980.

During 1986-87

1. Reorganization of the Stock Exchange (the Big Bang), 1986. Fixed broking commission and single capacity (brokers - jobbers) rules were abandoned. Removal of barriers to outside ownership aimed at new entries, improved capitalization and rise in price competition. A computerised equity trading system was introduced. New structure for the gilt-edged market was adopted.

2. The Financial Services Act, 1986, provided a comprehensive statutory framework for the regulation of the securities and investment business. Regulatory powers were delegated to the securities and investment board. The principle of self-regulation is adopted and five self-regulatory organizations (SRO's) are recognized.

3. The Building Societies Act, 1986, allows BS to undertake new forms of lending and accept current account deposits. A new Building Societies Commission assumes the responsibility for the prudential supervision.

4. With the Banking Act, 1987, the supervisory framework of the banking business was set-up and a single set of criteria was introduced for the authorisation and supervision of all institutions. The Bank of England will continue to supervise banks and have special responsibility for wholesale money markets as well as gilt-markets.

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The study of the domestic and international economic environment leads to the conclusion that the impetus for reform in UK's financial markets came from the combination of both market forces and more broad policy choices.

Advances in communications technology and data processing were leading to the integration of world financial markets. Moreover with the sharp fall in the cost of information and communication, barriers to competition between the world financial centres were disappearing. These technological developments along with investors' strategies towards international portfolio diversification and borrowers interest and search for lower financing costs, were powerful forces behind the government decisions for reforms.

On the other hand ambitions to maintain (and enhance) London's leading position in the world financial markets appeared incompatible with conditions of exchange controls.

Parallel to the movement towards "geographical" integration, a "functional" integration between different segments of the financial markets - the phenomenon of universal banking being the most obvious - necessitated a new approach to the design of a regulatory framework and the implementation of the supervisory role of the authorities. The Financial Services Act of 1986 is the centrepiece of the new regulatory regime in the United Kingdom.

The impact of the reforms was considerable as liberalization measures have increased competitive pressure and cost efficiency while market segmentation has declined. The effect has been most pronounced in the securities market.

Big Bang more than doubled the number of equity market-makers and led to a sharp increase in turnover and a substantial fall in transactions costs, as greater liquidity and extra competition put pressure on the newly freed commission rates and market spreads. Commission rates for large equity deals were cut by half but rates on small transactions only declined marginally.

A noteworthy recent development is the increasing role of London as a centre of international equity trading. At the end of 1987 the SEAQ international, London's electronic, screen-based automated quotations system-introduced with the Big-Bang reforms - provided quotations for 656 foreign stocks. Indicative of the international pre-eminence of London stock exchange is the fact that during certain days more stocks of some Japanese firms are traded in London than in Tokyo (source : Euromoney). Its settlement system presents nevertheless, certain operational weaknesses and is currently under restructuring.

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On the **gilt-edged market** there was an influx of new firms and a substantial injection of additional capital, turnover more than tripled with a marked increase in participation by overseas investors. Dealing spreads have generally halved with commission in the wholesale market largely disappearing and the speed of execution of deals has become significantly faster.

Liberalization has however complicated the task of **prudential supervision.** The whole framework of financial market supervision has been modified and extended, based on the general principle of a system of statute based self-regulation in the securities sector and a comprehensive new set of investor protection rules.

The Financial Services Act lays down three criteria in order to reconcile the above two aims (protection-competition) of the reforms :

(i) the authorised financial institutions should have adequate capital resources (are "fit and proper");

(ii) investors' protection is served by the "Chinese walls" whose aim is to avoid conflicts of interest by strictly separating corporate finance and market-making activities of an institution;

(iii) competition should not be restricted more than is necessary to protect investors adequately.

The application of the Financial Services Act over the last three years, revealed a number of weaknesses (its structure is considered as complex and operationally expensive by the financial Community in London). The Securities and Investment Board, aware of the problem, is currently in the process of re-examining its rule book with a view to simplification.

As far as **monetary policy** is concerned, the removal of the exchange controls, the increasing integration of the international financial markets and the financial innovation are the most important variables which affect the transmission mechanisms of the monetary policy and, therefore, the instruments chosen in order to preserve its effectiveness.

In the UK, the abolition of the exchange controls in 1979 rendered the implementation of the monetary policy through credit controls ineffective, as companies and other borrowers were able to obtain funds across the exchanges. Credit controls (the Corset) were abandoned in 1980.

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4. 1992 and the City

Would London retain - or even enhance - its position as a leading financial centre in the unified Community market of after 1992 ?

An answer to this question would ask for the identification of the nature and the sources of London's comparative advantage in the financial field, as well as the probability that these factors will continue to exert their influence in the future. The ability to develop and exploit new sources of advantages in the financial intermediation and risk management seems essential in this respect.

Three main categories of London's advantages are identified:

1. The "critical mass" factor. London has achieved a volume of transactions, a range of financial services and of markets development that enable it to function effectively in the world financial markets.

2. The second category includes all the elements that enabled London to develop to its present leading position :

   - the accumulated technical experience in finance, risk management and market supervision;
   - tradition in the business and the existence of a "financial culture";
   - international orientation of the market plus the asset of an internationally used (english) language;
   - competitive transactions costs and communication - computing facilities.

3. Flexibility and ability to capture new business and identify market trends. The example of the Euro-market whose activity passes, to a great extent, through London is indicative in this respect.

The "critical mass" argument seems to be an important one to the extent that the optimum size of an international financial centre implies high fixed costs and restricts, thus, the number of club members. Capability to mobilize low-cost equity capital seems important in order to strengthen relative position.

As regards the advantages of the second category, these are not permanently in favour of London. The unified European market of 1992 is expected to create development opportunities for the other financial centres in the Community.

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For a financial intermediary to take full advantage of the opportunities offered by this unified market, a European strategy and the development of a European culture are considered as essential factors. The necessary "solid domestic base" for succesful international presence becomes now "solid European base". In concrete terms this principle means European scale marketing efforts and services support systems. The necessity for this European strategy derives basically from the European dimension of the activities of firms : financial intermediaries with European ambitions are expected to be aware of the needs of this type of customers and able to provide them services on a European scale.

Market analysts suggest that there are going to be relatively few profitable survivors in the "fully global core markets". By contrast there will be lots of profitable survivors in non-core markets and functions ("niche" markets and functions). If this analysis is correct it implies strategic orientations and commitment of resources, skills etc. in the targeted field.

The factor of flexibility and adaptability seems important but once the right strategic decisions have been taken and capital and human resources have been committed.

In conclusion, it seems probable that London would retain its role as the leading European financial centre in the after 1992 period. Its comparative advantages point rather to the importance and, possibly, further development of its international role with a parallel development of other Community centres in various segments of the financial market activity. This view is supported by the prospects that the financial intermediation business will grow further in the coming years.

COMMISSION
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Directorate-General
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THE ECONOMIC AND MONETARY SITUATION IN THE UNITED KINGDOM

(Note for the attention of
the members of the Monetary Committee)

Annex II

The balance of payments

1. Evolution over the period 1981-88

2. Analysis of foreign trade

   2.1 Principal developments

   2.2 Determinants of foreign trade

3. Capital movements

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THE BALANCE OF PAYMENTS

1. Evolution over the period 1981-88

The current account of the balance of payments has tended to deteriorate since 1981: the surplus, which was equivalent to 2.7 % of GDP, fell almost continuously until 1986 and since then has been converted into a growing deficit. The deficit became particularly large in 1988, reaching 3.2 % of GDP and according to Commission forecasts it will remain high in 1989 and 1990 (see Table II.1).

This evolution is largely due to the widening of the trade deficit which stood at 4.5 % of GDP in 1988. The balance of trade on manufactured products has been deteriorating since 1981, and the effect of the fall in the oil surplus has been an additional factor since 1986.

The balance of invisibles remains in surplus (1.3 % of GDP in 1988), but recently a downward trend has become evident, mainly because of an increase in the deficit on tourism.

The acceleration of private capital outflows which followed the abolition of exchange controls in 1979, continued until 1986. The stock market events of 1987 resulted in net portfolio disinvestment abroad, but from 1988 private capital movements again produced a deficit of 2.8 % of GDP. The banking sector's operations have given rise to net capital inflows throughout the period.

These movements as a whole (current account, private capital and operations of the banking sector) have resulted in a virtually permanent deficit. However, since 1985, the foreign exchange reserves have risen. It should be noted that the balancing item has increased sharply in recent years, and now represents 3.4 % of GDP in 1988. One possible explanation for this result is that capital inflows have been underestimated.

2. Analysis of foreign trade

2.1 Principal developments

The trade balance valued on an f.o.b.-c.i.f. basis deteriorated by some 6 points of GDP between 1981 and 1988 (see Table II.4).

This development was mainly due to an acceleration of imports which increased at an average rate of close to 8 % a year in volume terms, whereas exports remained relatively weak, and slowed down markedly in 1988.

The analysis of trade by product category shows a distinct deterioration in the machinery and transport equipment sector (-3 points of GDP). Within this category, the largest deficits relate to goods intended for consumption such as motor cars, personal computers, television sets, and electric household appliances.

Until 1984-85 the oil surplus increased, reaching 2.3 % of GDP; since then it has fallen sharply, representing no more than 0.5 % in 1988.

Almost 50 % of the present deficit stems from trade with the rest of the Community, which also represents substantial proportion of total trade (50 % of exports in 1988 and 51 % of imports). The deficits with EFTA and Japan are equivalent to 1.4 % and 1.1 % respectively of GDP. The deficit with the United States is small (0.3 % of GDP) but represents a considerable deterioration compared with the period 1985-87 (see Table II.5).

2.2 Determinants of foreign trade

The deterioration of the trade balance since 1981 seems to be linked with a generally unfavourable relative cyclical position vis-à-vis the principal trading partners; this factor was particularly marked in 1988. Nevertheless, a number of considerations raise the question of whether other more fundamental factors have exacerbated the situation, and are likely to bear adversely on external equilibrium in the longer term.

Since the beginning of the 1980s, the United Kingdom has generally experienced faster demand growth than its trading partners (see Table II.11):

- vis-à-vis the Community countries, the cyclical lag has been positive since 1981, and widened to 4 % in 1983 and 1988;

- vis-à-vis 19 partners the growth differential has been less pronounced; in 1984-85 it was actually negative, but since then it has again become positive.

For 1989, recent Commission forecasts indicate the persistence of a positive growth differential of some 1 % in relation to the partners as a whole.

The evolution of the trade balance reflects variations in the relative cycle, with in particular a sharp deterioration in 1983 (-1.2 points of GDP) and in 1988 (-2.5 points). However, the cyclical lag does not by itself explain the underlying trend which has been seen since the beginning of the 1980s. In addition to the pressure of domestic demand, it seems that other factors are adversely affecting the United Kingdom's commercial performance.

First, although the evolution of price competitiveness at macroeconomic level was favourable to British exports until 1986, it has deteriorated since then: the real exchange rate valued on the basis of unit wage costs for the whole of the economy fell by 20 % between 1981 and 1986 vis-à-vis 19 partners, but has appreciated by 10 % in the last two years. The same indicator valued for manufacturing industry reflects a similar trend, although the deterioration in competitiveness was more recent and smaller (see Graphs 1 and 2).

Second, an analysis of exports and imports by industry suggests that some industries have difficulties in coping with foreign competition, which may be due either to specific problems of price competitiveness or to more qualitative factors such as the composition of production, the quality of products, etc. This finding is based on the following factors:

- the import penetration rate in manufacturing industry has increased appreciably: it has risen from 28 % in 1981 to 35 % in 1987, and probably more in 1988 (see Table II.8). The question is whether this particularly rapid rise (1) which partly reflects the greater specialization generated by the intensification of international trade, is also connected with problems of production capacity, or with problems of competitiveness. Admittedly, the level of capacity utilization has risen markedly since the beginning of the 1980s: for manufacturing industry as a whole, it rose from 75 % to 90 % in 1988 (2).

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(1) For an idea of how this compares in international terms, it should be noted that penetration rates for industry rose from 23 % during the 1970s to 35 % in the first half of the 1980s in the United Kingdom. The corresponding figures for France and Germany are rises from 20 % to 30 % and from 15 % to 22 % respectively.

(2) Commission estimates on the basis of Confederation of British Industry surveys.

Nevertheless in many industries the margin of spare capacity remains relatively large: according to the April 1989 CBI survey, the percentage of firms which considered their capacity to be more than adequate was still 57 % in the textile industry, 53 % in electrical and electronic engineering and 55 % for the automobile industry. This could indicate that the rise in import penetration rates which has in particular been appreciable in these same industries is not solely connected with capacity shortages during periods of high activity; consequently a slowdown in demand would not be sufficient to bring them down;

- the poor export performance started well before the sharp upturn in domestic demand and cannot therefore be entirely explained by production being diverted to the domestic market. British exporters have tended to lose market shares since the end of the 1970s whereas up to 1985 export ratios as a percentage of sales went on increasing in most industries (see Table II.9); this suggests that exporters did not choose to concentrate on the domestic market and therefore that losses of market shares may reflect competitiveness problems in the broad sense. The losses have been particularly marked in the textile and clothing and automobile industries. In general, the evolution of sales of investment goods abroad has been rather favourable whereas exports of consumer goods have not followed demand.

The indicators used show that the situation in manufacturing industry is variable and that some industries (textiles, the motor industry) are having difficulties in facing up to foreign competition, while others are performing well. The latter include certain branches connected with the production of investment goods which have both experienced a fall in the export ratio, a fall or a limited rise in the import penetration rate and a very high level of capacity utilization. It therefore seems that if the deficit has widened in these industries, it is because of shortage of capacity and it is probable that a slowdown in domestic demand and/or an increase in capacity-expanding investment would translate into an increase in their exports.

On the whole, the situation therefore seems to vary widely according to the branches of activity, and none of the factors of deterioration mentioned can be said to apply generally. In any event, it seems that the existence of underlying problems of a structural nature cannot be ruled out, and that the effects of a largely positive cyclical lag have been an additional factor.

3. Capital movements

Throughout the decade, private capital movements have resulted in net outflows, which were particularly large between 1984 and 1986, averaging 5 % of GDP a year. The large deficit during the period 1984-86 was the result of an acceleration of British investment, in particular portfolio investment abroad. In addition, in 1984 direct disinvestment by foreigners in the United Kingdom, probably connected with the difficult economic and social climate (miners' strike), also helped to widen the deficit.

The 1987 outturn was heavily influenced by the stock market events in the fourth quarter; sales of shares held abroad by British financial institutions totalled UKL 5.6 billion (or 7 % of their stock). 1988 seems to be marking a return to a "normal" situation insofar as net capital outflows have again been recorded, but at a level closer to the long term trend. Recent developments could indicate a change in British investors' preferences, caused by the higher rate of return on capital and the favourable economic outlook. Both direct and portfolio investment abroad was relatively low in 1988.

While private capital outflows are virtually permanent, large imports of funds by the banking sector have been recorded, with the growth of such imports partly offsetting the fluctuations in the balance of private capital. Net inflows of bank capital were particularly large in 1984-86 (some 2.5 % to 3 % of GDP per annum) and in 1988 (3.2 % of GDP). In addition, private capital inflows are probably underestimated, as evidenced by the size of a continually positive balancing item since 1984 (1). This explains why despite the net outflows recorded, it has always been possible to finance the growing current account deficit without a drain on the reserves.

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(1) According to the Bank of England Quarterly Bulletin, November 1988, it is unlikely that this item represents an error in estimating merchandise trade. Admittedly, it may relate to services, transfers or investment income, but it probably for the most part represents errors and omissions on the capital account such as unrecorded net portfolio inflows, commercial credits (which tend to increase when the trade deficit widens), exchange brokers' operations, etc.

4. External position

Reflecting the trend of capital movements, the United Kingdom's net external assets have increased virtually continuously since the end of the 1970s. They grew from UKL 12 billion at the end of 1979 (or 6 % of GDP) to UKL 113 billion at the end of 1986 (28 % of GDP), to fall back to UKL 90 billion at the end of 1987 (20 % of GDP).

If compared internationally, their relative level is particularly high (1). Admittedly, this position might be less favourable in reality, given the size of the balance of payments balancing item. Nevertheless, even on the extreme assumption that this item had come entirely from an underestimate of private capital inflows, which would be mirrored by an equivalent overestimate of the net external position, the latter would still be relatively high, and close to Germany's level, namely 12 % of GDP at the end of 1987.

(1) These comparisons must nevertheless be treated with caution because of differences in methodology.

TABLE II.1 : BALANCE OF PAYMENTS
(TRANSACTION BASIS - % GDP)

	79	80	81	82	83	84	85	86	87	88	89 (1)	90 (1)
1. Current account	-.3	1.4	2.7	1.7	1.3	.6	1.0	.0	-.7	-3.2	-3.4	-2.8
1.1 Visibles	-1.7	.6	1.3	.8	-.4	-1.4	-.7	-2.3	-2.5	-4.5	-4.4	-3.8
Of which : non-oil	-1.4	.5	.1	-.9	-2.7	-3.6	-3.0	-3.4	-3.5	-5.1		
1.2 Invisibles	1.5	.8	1.4	.9	1.6	2.1	1.6	2.4	1.8	1.3	1.0	.9
Of which : Services (2)	2.0	1.7	1.5	1.0	1.2	1.2	1.7	1.5	1.3	.8		
Int. , prof. & div.	.6	-.1	.5	.5	.9	1.4	.8	1.4	1.3			
Transfers.	-1.1	-.9	-.6	-.6	-.5	-.5	-.9	-.6	-.8	-.8		
2 Non bank capital flows (net)	-1.7	-2.0	-3.6	-2.7	-2.6	-5.9	-4.4	-5.5	.0	-2.8		
2.1 Direct invest.	-1.5	-.2	-1.2	-.4	-.7	-1.9	-1.4	-1.7	-2.6	-1.7		
2.2 Portfolio invest.	.3	-.8	-1.6	-2.7	-1.8	-2.6	-3.5	-4.7	2.7	-1.5		
2.3 Other net trans. of non pub. sec.	-.4	-.8	-.7	.2	.2	-1.1	.8	.9	-.3	.6		
2.4 Net transactions of general govnt	-.2	-.1	.0	.1	-.4	-.2	-.2	-.1	.2	-.2		
3. Net overseas transfert of UK banks	1.9	.4	-.3	1.4	.9	3.2	2.2	2.6	.6	3.2		
4. Subtotal	-.1	-.2	-1.1	.3	-.4	-2.0	-1.2	-2.9	-.1	-2.9		
Financed by:												
5. Change in official reserves (3)	-.5	-.1	1.0	.5	.2	.3	-.5	-.8	-2.9	-.6		
6. Balancing item (4)	.7	.4	.2	-.8	.2	1.8	1.7	3.6	3.0	3.4		

(1) Economic forecasts of the Commission Services, January 1989
(2) Includes net labour income from abroad.
(3) Increase in reserves : (-).
(4) Including allocations of SDR.
Source : CSO.

TABLE II.2 : EXTERNAL TRADE, EXPORTS.

(as % of total)

	79	80	81	82	83	84	85	86	87	88
Food,beverages,vegetable oils (1)	7.0	6.6	6.7	6.9	6.9	6.6	6.7	7.6	7.2	6.6
Crude materials, inedible	2.7	2.7	2.3	2.1	2.3	2.5	2.5	2.4	2.2	2.3
Mineral fuels and lubricants	10.1	13.1	18.3	19.4	21.4	21.6	21.6	12.0	11.0	7.0
Chemical products	10.7	9.4	9.1	9.1	9.4	9.5	10.0	11.3	11.2	11.7
Semi-manufactures (2)	22.0	20.6	16.4	15.8	14.3	13.9	13.2	15.0	14.7	15.3
Machinery and transport equipment	32.0	34.5	33.6	33.3	31.4	31.4	31.2	34.5	35.6	38.3
Miscellaneous manufactured articles	9.1	9.0	9.1	8.8	9.3	9.6	10.1	11.6	12.2	12.7
Goods not elsewhere classified	6.4	3.9	4.3	4.7	5.0	4.9	5.1	5.5	5.7	6.1
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

(1) Sitc 0,1,4.
(2) Sitc 6 (Manufactured goods classified chiefly by material).
Source : OSCE.

TABLE II.3 : EXTERNAL TRADE, IMPORTS.

(as % of total)

	79	80	81	82	83	84	85	86	87	88
Food, beverages, vegetable, oils (1)	14.2	12.7	12.8	12.6	12.2	11.9	10.6	12.2	11.3	9.9
Crude materials, inedible	7.3	6.5	6.4	5.6	6.2	5.8	5.4	5.2	5.3	4.9
Mineral fuels and lubricants	11.7	13.1	13.5	12.2	10.6	12.7	12.5	7.1	6.6	4.3
Chemical products	6.6	5.6	6.2	6.4	7.0	7.2	7.3	7.9	8.0	7.7
Semi-manufactures (2)	21.6	23.0	19.1	18.7	17.6	16.8	16.9	17.8	17.9	17.7
Machinery and transport equipment	24.3	25.4	27.1	29.3	31.8	31.0	31.6	33.4	34.5	35.8
Miscellaneous manufactured articles	9.9	10.1	11.4	11.2	11.4	11.8	11.9	13.2	13.6	13.3
Goods not elsewhere classified	4.4	3.6	3.5	4.0	3.2	2.7	2.7	3.0	2.8	6.2
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

(1) Sitc 0,1,4.
(2) Sitc 6 (manufactured goods classified chiefly by material).
Source : OSCE.

TABLE II.4 : BALANCE OF EXTERNAL TRADE BY BRANCH

(as % of GDP)

	79	80	81	82	83	84	85	86	87	88
Food, beverage, vegetable, oils (1)	-2.0	-1.4	-1.3	-1.3	-1.3	-1.5	-1.4	-1.3	-1.1	-1.3
Crude materials, inedible	-1.2	-.9	-.9	-.8	-.9	-.9	-.8	-.7	-.8	-.8
Mineral fuels and lubricants	-.7	-.1	1.0	1.4	2.0	1.6	1.7	.7	.6	.2
Chemical products	.7	.8	.6	.5	.4	.3	.4	.4	.3	.2
Semi-manufactures (2)	-.5	-.7	-.6	-.7	-1.0	-1.1	-1.2	-1.2	-1.3	-1.5
Machinery and transport equipment	1.0	1.7	1.3	.6	-.7	-.7	-.7	-1.0	-1.0	-1.8
Miscellaneous manufactured articles	-.4	-.3	-.5	-.6	-.6	-.8	-.6	-.8	-.8	-.9
Goods not elsewhere classified	.3	.0	.2	.1	.3	.4	.5	.4	.5	-.4
TOTAL	-2.9	-.9	-.1	-.7	-1.9	-2.6	-2.0	-3.5	-3.6	-6.2

(1) Sitc 0,1,4
(2) Sitc 6 (Manufactured goods classified chiefly by material)
Source : OSCE.

TABLE II.5 : VISIBLE TRADE BY COUNTRY : BALANCES

(as % of GDP)

	79	80	81	82	83	84	85	86	87	88
1. Intra EEC	-1.0	.5	.3	-.3	-.7	-.8	-.6	-2.3	-2.2	-3.0
Of which : France	-.4	-.1	-.1	.1	.3	.4	.3	-.3	-.2	-.2
F.R.Germany	-.7	-.2	-.1	-.7	-1.1	-1.0	-1.0	-1.4	-1.5	-1.7
Italy	-.5	-.2	-.2	-.2	-.3	-.3	-.2	-.3	-.3	-.4
Spain	-.1	.0	.0	.0	.0	-.1	-.1	.0	.0	.1
2. Western industrialized third countries	-1.9	-1.6	-1.4	-1.5	-2.0	-2.2	-1.9	-1.9	-1.7	-3.5
Of which : USA and Canada	-1.1	-1.2	-.5	-.5	-.4	-.4	.2	.3	.4	-.3
Japon	-.5	-.5	-.7	-.8	-.9	-1.2	-.9	-1.0	-1.0	-1.1
EFTA	-.4	-.2	-.6	-.6	-1.0	-1.2	-1.3	-1.3	-1.2	-1.4
3. Developing countries	.2	.2	1.1	1.3	1.0	.6	.6	.7	.6	.3
Of which : OPEC	-.2	.0	.6	.8	.8	.8	.6	.7	.6	.5
4. Countries with state-trade	-.2	-.1	-.1	-.2	-.2	-.2	-.1	-.1	-.2	-.2
5. Others	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0
6. TOTAL	-2.9	-.9	-.1	-.7	-1.9	-2.6	-2.0	-3.5	-3.6	-6.3

Source : OSCE

TABLE II.6 : EXPORTS BY COUNTRY
(AS % OF TOTAL)

	79	80	81	82	83	84	85	86	87	88
1. Intra EEC	44.5	45.0	43.3	43.3	46.1	46.8	48.8	47.9	49.2	49.8
Of which : France	7.2	7.4	7.2	8.0	9.4	10.1	9.9	8.5	9.7	10.1
F.R.Germany	9.9	10.4	10.5	9.5	10.0	10.5	11.4	11.7	11.7	11.6
Italy	3.4	3.9	3.3	3.5	3.7	4.1	4.4	4.7	5.2	5.0
Spain	1.3	1.4	1.4	1.5	1.9	1.8	2.0	2.6	2.7	3.3
2. Western industrialized third countries	30.8	29.9	30.3	31.5	30.3	31.5	31.3	31.1	31.0	29.8
Of which : USA and Canada	11.3	11.0	13.7	15.1	15.4	16.3	17.1	16.7	16.4	15.3
Japon	1.4	1.2	1.2	1.2	1.3	.1	1.3	1.6	1.9	2.2
EFTA	12.7	12.5	10.1	9.9	9.0	9.2	8.3	8.3	8.3	7.8
3. Developing countries	21.5	22.2	23.4	23.2	21.5	19.1	17.7	17.9	17.2	17.5
Of which : OPEC	8.0	9.2	10.8	10.4	9.0	7.3	6.6	6.5	5.8	5.3
4. Countries with state-trade	2.9	2.7	2.2	1.8	1.9	2.4	2.1	2.4	2.0	2.0
5. Others	.3	.3	.2	.2	.2	.2	.2	.6	.6	.9
6. TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Total as % of GDP	21.7	21.3	20.7	20.8	20.3	22.1	22.0	19.2	19.4	18.1

Source : OSCE

TABLE II.7 : IMPORTS BY COUNTRY
(AS % OF TOTAL)

	79	80	81	82	83	84	85	86	87	88
1. Intra EEC	43.3	40.9	41.6	43.1	45.5	45.2	47.2	50.4	51.2	49.2
Of which : France	8.0	7.3	7.6	7.2	7.5	7.4	7.7	8.5	8.8	8.5
F.R.Germany	11.8	10.8	10.9	12.3	14.1	13.6	14.6	16.2	16.5	15.8
Italy	5.1	4.5	4.4	4.6	4.7	4.8	5.0	5.4	5.5	5.3
Spain	1.5	1.6	1.5	1.7	1.7	2.1	2.2	2.1	2.2	2.1
2. Western industrialized third countries	34.9	35.9	37.0	37.5	36.8	37.3	36.5	34.5	33.7	36.3
Of which : USA and Canada	14.3	16.0	16.3	16.9	15.8	16.0	14.9	12.6	12.3	12.8
Japon	3.3	3.5	4.4	4.7	5.2	4.9	5.1	6.0	6.0	6.1
EFTA	12.9	12.8	12.7	12.2	12.6	13.2	13.1	12.9	12.3	11.5
3. Developing countries	18.4	20.1	18.6	16.6	15.0	14.6	13.6	12.2	12.1	11.6
Of which : OPEC	7.7	8.9	7.8	6.5	4.5	3.4	3.6	2.2	2.1	1.8
4. Countries with state-trade	3.2	2.9	2.7	2.6	2.5	2.8	2.5	2.4	2.6	2.2
5. Others	.2	.2	.2	.2	.2	.2	.2	.5	.5	.6
6. TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
TOTAL as % of GDP	24.6	22.2	20.8	21.5	22.2	24.7	24.0	22.7	23.0	24.4

Source : OSCE

TABLE II.8 : IMPORT PENETRATION FOR MANUFACTURING

(imports/home demand)

	81	82	83	84	85	86	87
Extraction of minerals and ores other than fuels,	27	29	31	35	37	36	37
Manufacture of metals,mineral products and chemicals	25	28	31	37	39	40	42
Of which: Metal manufacturing	30	33	35	38	40	40	41
Chemical industry	59	67	70	68	71	68	66
Production of man-made fibres							
Metal goods, engineering and vehicles industries	36	38	41	43	44	45	45
Of which: Mechanical engineering	32	31	32	34	36	37	38
Manufacture of office machinery and data processing equip.	96	105	106	105	100	100	93
Electrical and electronic engineering	36	39	42	44	47	47	49
Manufactures of motor vehicles	42	47	52	51	50	51	48
Other manufacturing industries	22	22	23	25	25	25	26
Of which: Textile industry	39	39	41	44	44	45	47
Manufacture of leather and leather goods	42	42	44	44	49	46	49
TOTAL MANUFACTURING	27.8	29.0	31.1	33.4	34.3	34.3	35.2

Source: Department of Trade and Industry.

TABLE II.9 : EXPORT SALES RATIO FOR MANUFACTURING

(Exports/Sales)

	81	82	83	84	85	86	87
Extraction of minerals and ores other than fuels, Manufacture of metals,mineral products and chemicals	29	30	32	35	39	40	40
Of which: Metal manufacturing	22	23	25	32	34	36	41
Chemical industry	39	40	41	44	47	47	46
Production of man-made fibres	63	69	74	72	73	68	64
Metal goods, engineering and vehicles industries	41	41	39	41	43	42	42
Of which: Mechanical engineering	47	45	40	42	43	42	43
Manufacture of office machinery and data processing equip.	94	108	110	107	100	100	91
Electrical and electronic engineering	36	38	37	39	43	43	43
Other manufacturing industries	14	14	13	14	14	14	15
Of which: Textile industry	30	29	28	30	31	30	32
Manufacture of leather and leather goods	30	32	33	35	38	36	40
TOTAL MANUFACTURING	27.3	27.2	26.6	28.3	30.2	29.6	30.3

Source: Department of Trade and Industry.

TABLE II.10: EXPORT PERFORMANCE BY BRANCH A ND BY COUNTRY

a) By branch

	1980	1981	1982	1983	1984	1985	1986	1987
Metals	-4.0	0.2	5.1	-7.1	-6.9	-5.4	16.3	1.6
Non metal minerals	-2.4	-7.9	-6.9	-5.4	-1.6	5.2	0.6	4.9
Chemicals	0.2	-14.1	4.1	-1.4	0.2	1.9	0.3	2.0
Metal products	-7.4	-11.8	2.5	-0.6	5.8	9.9	-9.4	-20.9
Agric. and ind. machinery	1.8	-7.6	2.2	-12.3	-4.3	2.3	1.3	11.2
Office machinery	-12.0	-4.5	4.9	-2.0	9.3	14.7	-11.1	6.8
Electric appliances	-1.2	-14.5	5.3	-2.3	1.0	16.2	-1.1	8.0
Motor vehicles	-9.2	-15.3	-10.8	-9.4	-5.3	9.8	-1.0	8.4
Means of transport	-12.5	-29.5	0.8	14.1	13.1	-2.3	36.5	-11.4
Food products	-2.6	-8.6	1.1	1.2	-6.6	0.0	-3.7	-0.5
Textile, clothing	-2.7	-10.8	-1.2	-6.9	-1.7	3.6	-0.9	10.6
Leather and shoes	10.1	-20.5	-3.4	0.0	0.7	-1.2	5.3	6.8
Wood and furniture	-2.3	-15.1	6.8	-10.3	0.3	2.4	0.3	4.2
Paper and printing	-5.7	-12.2	3.4	-4.9	8.5	2.8	1.6	6.4
Rubber and plastic	1.8	-11.2	0.4	-6.4	0.9	3.1	2.5	-2.7
Other manufacturing	0.4	-13.1	-0.9	9.1	1.3	-8.2	4.1	-5.0

b) By country

	1980	1981	1982	1983	1984	1985	1986	1987
Canada	-10.8	-16.5	13.9	-13.6	-2.4	19.1	-0.4	0.8
USA	-4.1	-10.9	0.0	-0.7	-11.1	6.6	1.0	2.5
Japan	-8.6	-7.5	-4.4	2.6	-1.7	7.6	3.3	8.9
Belgium	-4.3	-9.3	6.2	1.0	0.3	2.3	0.2	0.2
Denmark	-3.6	-15.0	5.2	-7.6	0.6	0.2	-0.1	7.5
France	-3.8	-1.4	1.9	0.4	1.8	3.1	-1.5	8.9
Germany	2.3	-2.4	4.1	-0.6	10.2	5.6	1.6	6.0
Ireland	-4.2	-9.5	-0.6	0.2	-3.7	1.8	0.1	1.6
Italy	-2.6	-2.0	2.2	5.1	5.9	4.7	-0.9	-0.9
Netherlands	1.3	-2.4	-10.1	-5.6	2.5	3.7	3.7	1.5
Greece	-15.9	-2.8	1.2	41.8	1.2	-8.3	9.1	14.8
Portugal	-2.1	-27.0	16.8	-5.6	-9.4	3.3	-2.1	5.9
Spain	9.4	-5.4	5.4	8.8	-2.1	0.5	-8.7	3.5
EFTA	-0.7	-20.7	-6.0	0.3	1.1	-6.1	-0.8	7.2

(1) UK exports divided by UK export market growth.

Source: Commission Services

TABLE II.11 RELATIVE CYCLICAL POSITION, RELATIVE PRICES AND COSTS OF UNITED KINGDOM

VIS A VIS IC19 PARTNERS

YEAR	INDEX OF RELATIVE CYCLE	EFFECTIVE EXCHANGE RATE	RELATIVE GDP PRICES		RELATIVE UNIT LABOR COSTS		RELATIVE WAGE SHARE
			NATIONAL CURRENCY	COMMON CURRENCY	COMMON CURRENCY	NATIONAL CURRENCY	
			°/° CHANGE P.A.				
1971	- 1.1	- .0	2.8	2.9	- .2	- .0	- 2.9
1972	- .7	- 3.6	1.6	- 2.2	4.1	.2	2.5
1973	2.1	-10.5	- 2.2	-12.2	- 2.0	-12.1	.2
1974	- 3.0	- 3.5	3.0	- .7	5.1	1.3	2.0
1975	- .6	- 8.0	14.6	5.5	16.3	7.1	1.5
1976	- 2.4	-14.4	5.8	- 9.3	1.6	-13.0	- 4.0
1977	- 3.2	- 4.7	5.6	.7	1.7	- 3.1	- 3.6
1978	.8	.2	3.6	3.8	3.1	3.3	- .6
1979	- .4	6.1	6.4	12.8	6.6	13.2	.2
1980	- 3.9	10.0	9.9	20.9	11.2	22.4	1.2
1981	- 1.4	.2	2.6	2.8	2.1	2.3	- .5
1982	2.6	- 4.4	- .4	- 4.8	- 2.4	- 6.6	- 1.9
1983	3.0	- 7.0	- .5	- 7.5	- 1.0	- 8.0	- .5
1984	- 1.1	- 4.7	- .1	- 4.9	2.5	- 2.3	2.6
1985	- .2	- .1	1.4	1.3	1.3	1.2	- .1
1986	.2	- 7.3	- .4	- 7.7	1.1	- 6.3	1.5
1987	.9	- 1.0	1.9	1.0	2.1	1.1	.1
1988	3.8	5.8	2.9	8.7	3.3	9.2	.5
1989	.8	2.2	2.9	5.2	4.0	6.3	1.1
1990	- .9	.4	2.0	2.4	3.6	4.0	1.6

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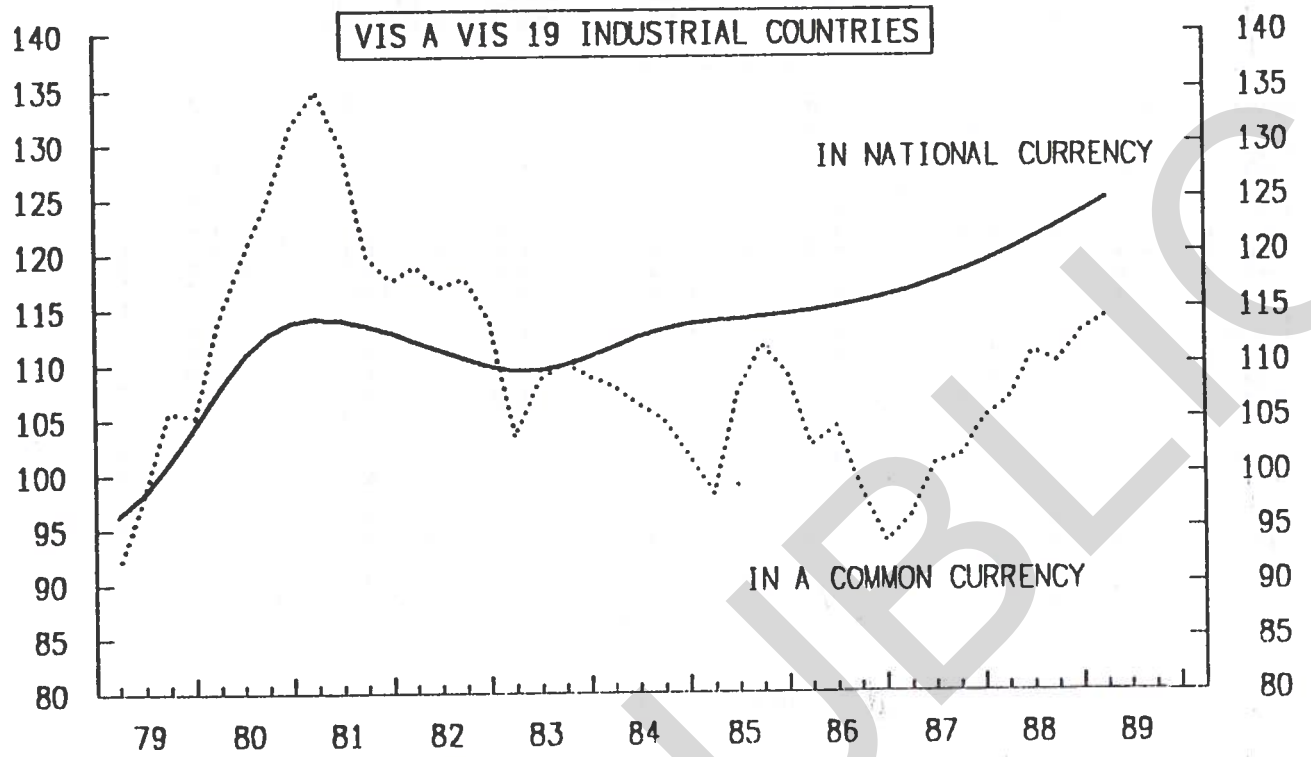
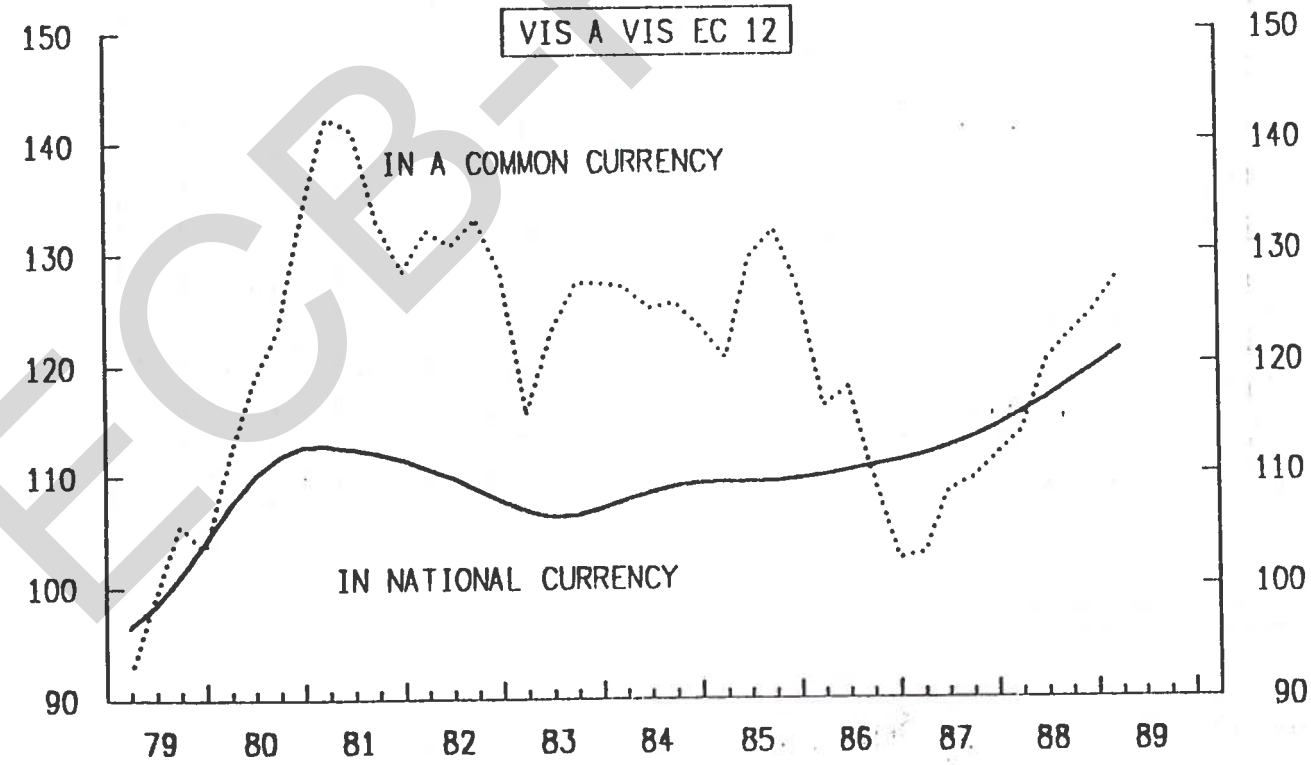
YEAR	INDEX OF RELATIVE CYCLE	EFFECTIVE EXCHANGE RATE	RELATIVE GDP PRICES		RELATIVE UNIT LABOR COSTS		RELATIVE WAGE SHARE
			NATIONAL CURRENCY	COMMON CURRENCY	COMMON CURRENCY	NATIONAL CURRENCY	
			°/° CHANGE P.A.				
1971	- 1.1	- .6	1.9	1.4	- 1.2	- 1.9	- 3.1
1972	- .1	- 5.4	1.2	- 4.2	3.7	- 1.8	2.4
1973	2.2	-13.3	- 1.8	-15.0	- 1.9	-15.0	- .1
1974	- 3.0	- 3.0	3.7	.6	5.7	2.4	1.9
1975	- .1	- 9.9	14.3	3.0	15.2	3.8	.9
1976	- 3.1	-11.2	5.1	- 6.8	1.7	- 9.6	- 3.3
1977	- 2.8	- 5.1	4.6	- .7	.8	- 4.4	- 3.6
1978	1.0	- .7	3.0	2.3	2.4	1.6	- .6
1979	- .7	3.2	6.0	9.4	6.3	9.9	.3
1980	- 4.4	10.3	9.4	20.6	10.4	21.7	.9
1981	.4	10.1	2.3	12.6	1.5	11.8	- .8
1982	2.1	- 1.1	- 1.6	- 2.6	- 2.7	- 3.8	- 1.1
1983	4.4	- 3.7	- 1.9	- 5.6	- 2.4	- 5.9	- .5
1984	.8	- .2	- 1.0	- 1.1	1.9	1.7	2.9
1985	.6	.8	.6	1.3	.8	1.5	.2
1986	.2	-13.3	- 1.0	-14.2	1.0	-12.4	2.1
1987	1.0	- 5.0	2.0	- 3.1	2.2	- 3.0	.2
1988	4.1	6.9	3.1	10.2	4.0	11.3	.9
1989	.9	4.3	3.3	7.8	5.0	9.4	1.6
1990	- 1.3	.1	2.4	2.5	4.5	4.6	2.1

DOUBLE EXPORTS WEIGHTING
SOURCE: COMMISSION SERVICES

GRAPH 1
REAL EXCHANGE RATE

RELATIVE UNIT LABOR COSTS (TOTAL ECONOMY)
(index 1979 = 100)

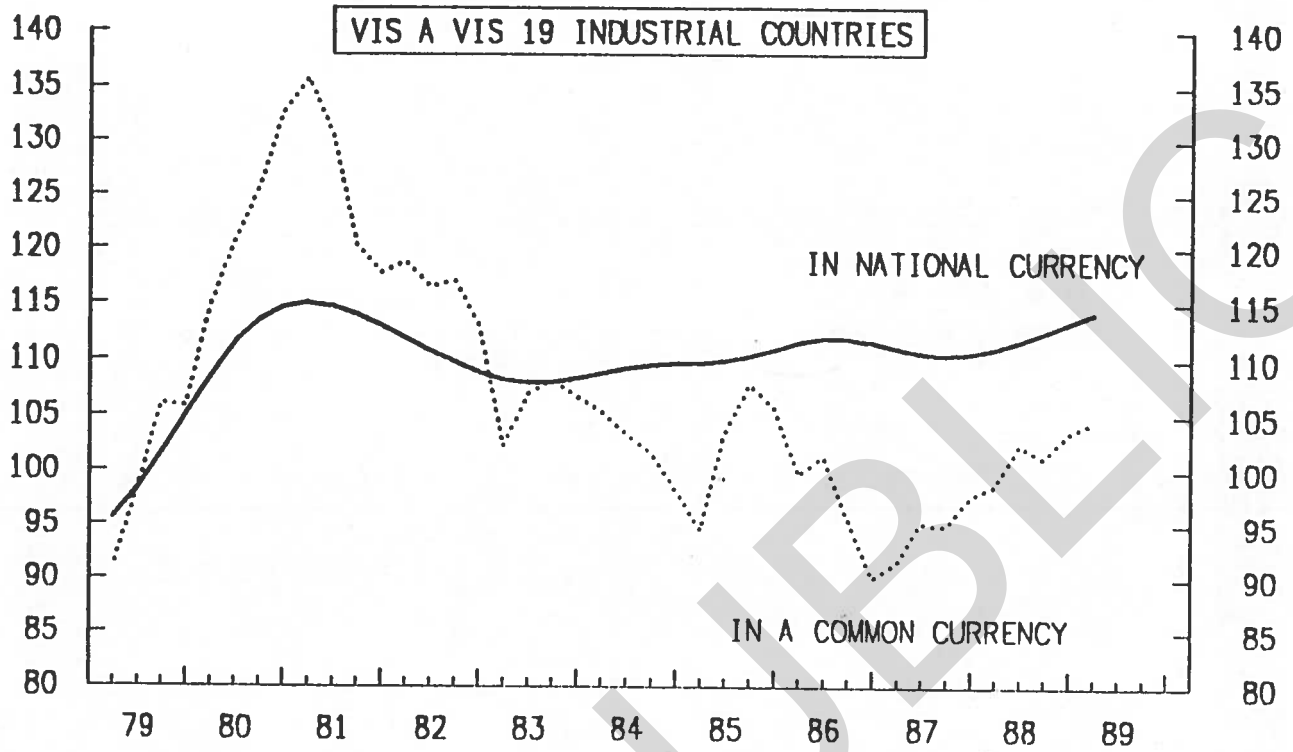


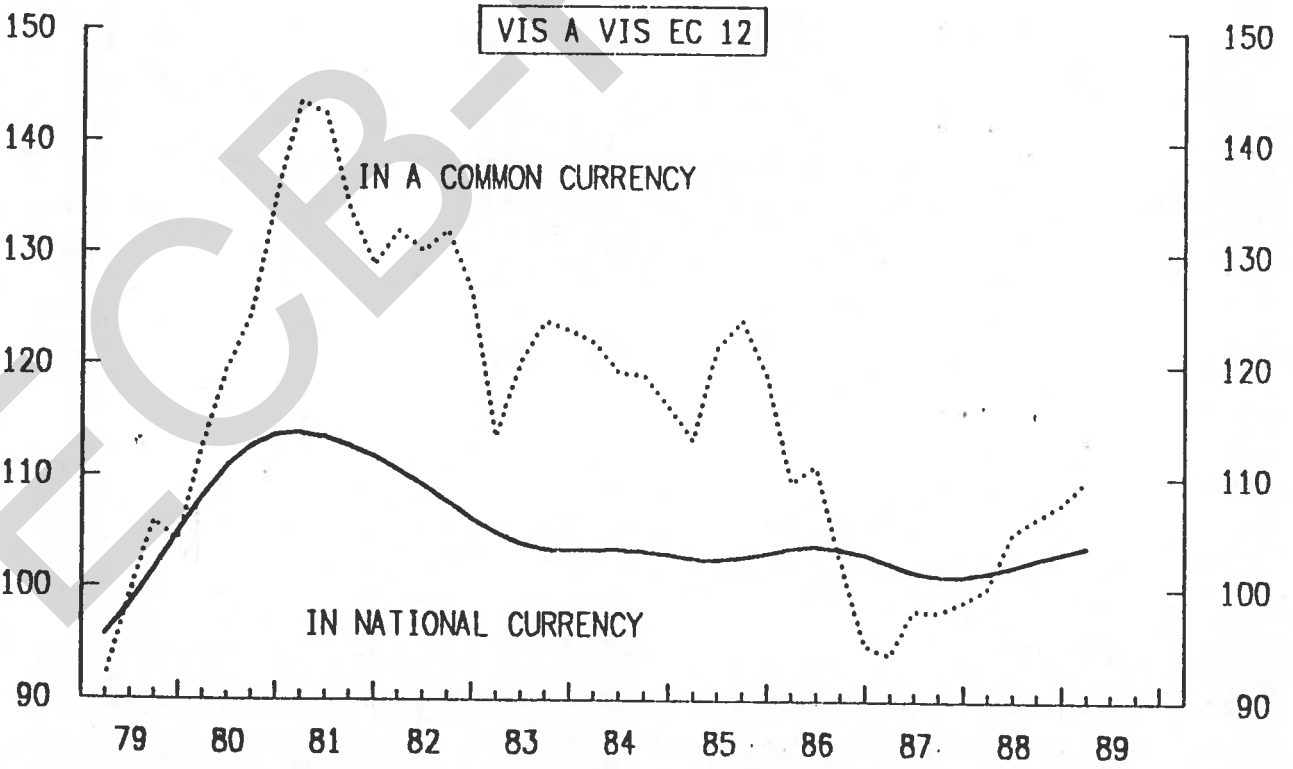


Source : Commission Services

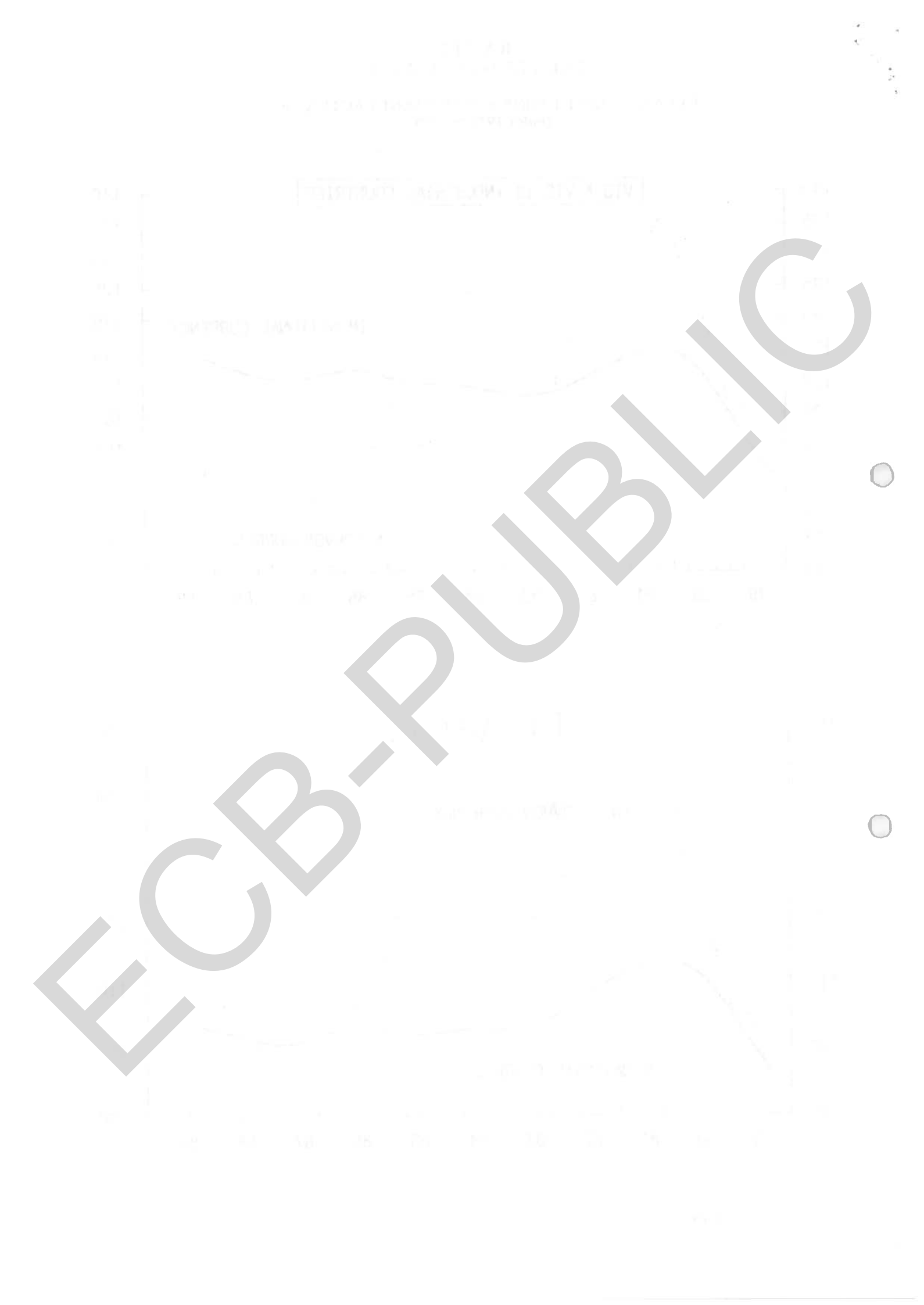
GRAPH 2
REAL EXCHANGE RATE

RELATIVE UNIT LABOR COSTS (MANUFACTURING)
(index 1979 = 100)





Source : Commission Services



COMMISSION
OF THE EUROPEAN
COMMUNITIES

Directorate-General
for Economic and Financial Affairs

Brussels 4 July 1989
II/158/89-EN

II-D-3

THE ECONOMIC AND MONETARY SITUATION IN THE UNITED KINGDOM

(Note for the attention the Monetary Committee)

Annex III

Main monetary developments and money-market techniques

1. Main monetary developments

   1.1 Monetary aggregates
   1.2 Interest rates
   1.3 Exchange rates

2. Techniques of monetary management

   2.1 The role of the Bank of England in the money markets
   2.2 The Bank's counterparties
   2.3 Instruments and techniques
   2.4 Recent trends in money-market operations

Tables

III.1 Influences on the cash position of the money market
III.2 Official offsetting operations

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1. Main monetary developments

1.1 The monetary aggregates

The broad money aggregates have grown at a rapid pace throughout the second half of the decade (Table 5.1). Twelve-month M4 growth, seasonally adjusted, (the measure now preferred by the authorities) was in a range of 12-14% during 1985. In early 1988 it accelerated, remaining in the 14-16% range throughout 1986 and 1987, then accelerated further during 1988 to reach around 18% in the autumn of that year. The most recent figure (April 1989) shows an increase of 18.1% (Graph 5.1).

M0 (the wide monetary base) by contrast showed much more restrained growth in the 1985-87 period, remaining within its target ranges (Table 2.1) but accelerated sharply from the end of 1987, peaking at around 8% in the autumn of 1988 before subsiding thereafter to a most recent rate (April 1989) of 5.7% (12-month increase, seasonally adjusted) (Graph 5.3). Over the six months to April, annualized M0 growth, seasonally adjusted, was less than 1%.

The second half of the 1980's has been marked in Britain, as in a number of other countries, by a **fall in the velocity of circulation of broad money** (Table 5.1). The decade as a whole has broken the longer-run trend to higher velocity, a trend which was consistent with the theoretical presumption of an income elasticity of money demand of less than one. The decline in velocity in the 1980's is related to greater competition within the financial sector, innovation in the availability of monetary instruments and declines in the opportunity cost of money holdings (particularly as mesured by inflation in the first half of the decade and, until recently, by interest rates) (*). While broad money holdings of the non-financial private sector have increased during the 1980's in relation to GDP, they have been rather stable relative to gross financial wealth (Table 5.2) (partly the result of increased share prices and privatizations).

For narrow money aggregates, the position is somewhat different. In particular, **the velocity of non-interest bearing M1 is no higher than at the beginning of the decade** (reflecting the increased availability of interest-bearing monetary instruments), and the velocity of notes and coin has increased substantially, reflecting improvements in payments technology and practices.

(*) Annex I contains information on change in financial markets.

1.2 Interest rate developments

Interest rates, both long and short, followed an erratic path around a gradually declining trend from early 1985 (when short rates had risen to almost 14% in response to sterling pressure) to May 1988 (when short rates fell below 8% as the authorities attempted to restrain a rise in sterling). During this period the amplitude of fluctuations in long rates was, as always, considerably less than that in short rates. Turning points in long rates have shown some tendency to lead turning points in short rates (Graph 5.1 and Table 5.3) perhaps suggesting that policy-determined short rates have tended to react to swings in longer-term market expectations (or the factors driving them) as reflected in longer rates. The lead of long rates was also evident in the Spring of 1988, a period that seems to have marked the bottom of the cycle in interest rates. Short rates were then raised in successive steps, and 3-month interbank were above 14% by late May 1989. Medium and longer-term rates have also risen since April 1988. Until May 1989 the upward movement was very limited, but has become much more marked in recent weeks, and the benchmark long yield (2003-2007) now stands at 10.27%, more than 100 basis points higher than in April 1988.

The yield curve, which had been positively sloped in the early 1980's (probably reflecting the persistence at that time of inflationary expectations inherited from the 1970's and the 1979/80 period), became inverted towards the end of 1984. It became positive again in 1985/86 as sterling depreciated. But inversion reappeared in late 1987 and early 1988 (Graph 5.2, panel b) and the curve has remained strongly inverted ever since.

During 1987, **ex ante real medium and long-term rates** - as suggested by the yield on index-limited stock - increased noticeably until the stock market crash. But nominal rates rose by more than this, as activity in the UK economy gathered pace, suggesting that the move to a positive yield curve also involved an uptick in inflation expectations. Immediately after the crash, however, both real yields and inflation expectations appeared to subside. Index-linked yields remained at lower levels during the first half of 1988, but picked up in the second half of that year in response to policy-induced increases in short-term nominal rates - (although the response was naturally much less marked for long (18 years) index-linked stock than for 4-year or 8-year stock. During 1989, real yields have shown some tendency to decline again.

Medium-term inflation expectations (as suggested by the gap between yields on conventional gilts and index-linked gilts), also picked up noticeably during the course of 1988 (Graph 5.2, panel C), but an upward trend in longer-term inflation expectations during that year is harder to discern. These movements, in conjunction with a very marked inversion of the yield curve since mid-1988, confirm the tightness - in terms of expected real short-term interest rates - of the current monetary stance.

The trend in **short-term interest-rate differentials** vis-à-vis both Germany and the United States appeared to have been gently downward - but with marked fluctuations - from the beginning of 1987 until the first few months of 1988. Long-term differentials peaked in late 1986, as period of sterling depreciation came to an end, and after falling sharply in early 1987 had until recently become increasingly stable (at a barely positive level vis-à-vis the US by the Spring of 1988). In the last few weeks however, long-yield differentials have increased sharply, particularly vis-à-vis US rates, where the differential is now around 200 basis points) (see Graph 5.4).

1.3 Exchange-rate developments

There appear to have been four phases in nominal exchange-rate developments over the period since the last examination (*).

- During 1985, the **effective sterling exchange rate** rose by about 10% (Graph 5.5) reflecting both a tightening of UK monetary policy early in the year and the first stage of dollar depreciation.

- In 1986, however, the effective rate fell by almost 20%, despite continued dollar depreciation, as the authorities chose to maintain the "oil-price adjusted" exchange rate rather than the nominal rate. Sterling's low point was reached in the fourth quarter of 1986.

- It then began to recover somewhat against the DM and, more markedly, against the dollar. After the Louvre accords of February 1987, however, sterling was maintained in a very narrow range against the DM (between 2.92 and 2.99, see Graph 5.4) until late February 1988.

(*) Developments in real exchange rates are treated in Annex II.

Over this period, however, the effective index continued to rise, mainly as a result of the dollar's depreciation until the end of 1987. At the end of February 1988, the implicit shadowing of the DM was abandoned, and sterling rose to a high point above DM 3.25 by early 1989. With the dollar recovering, the rise in the effective rate between early 1988 and early 1989 was somewhat less marked, but nonetheless amounted to more than 6%, taking the total rise from the October 1988 low point to almost 16%.

- More recently, however, sterling has slipped back, first against a strong dollar and more recently as a result of independent weakness. The effective index is now (early June) back to its level at the time DM shadowing was abandoned.

2. Techniques of monetary management (*)

2.1 The role of the Bank of England in the money markets

As banker to the Government and to the clearing banks, the Bank of England (henceforth "the Bank") is necessarily involved in the day-to-day transactions between these parties, which can result in substantial daily net flows between the clearing banks and the Bank. In its money market operations, the Bank aims to offset these net flows. Thus although the money market arrangements in place provide a framework within which it might be possible to operate some form of monetary base control - that is, procedures for giving priority to the **amount** of official money market intervention rather than to the **interest rate** at which it is transacted - the arrangements are not used in such a way. Instead, the terms on which the Bank offers assistance (or drains liquidity) in offsetting net money-market flows have general implications for interest rates.

2.2 The Bank's counterparties

In offsetting money market flows the Bank has traditionally dealt mainly with discount houses and only to a very limited extent with commercial banks. Discount houses have traditionally been the principal market-makers in bills.

(*) This section is based on two articles in the Bank of England Quarterly Bulletin: "The Bank of England and the money market" (March 1982) and "Bank of England operations in the sterling money market, Annex 3, Bank of England dealings in the sterling money market: operational arrangements" (August 1988).

They underwrite the weekly Treasury bill issue - a function now less important than in the past - are regularly invited to offer eligible bills for sale to the Bank, can offer bills for sale to the Bank at their own initiative, and have borrowing facilities at the Bank against approved collateral up to maximum amounts related to their capital bases. As part of their function as intermediaries between the Bank and the clearing banks, they accept call money or very short-term deposits from the latter. If the clearing banks find themselves short of cash, they can call on their deposits with the discount houses. These, in turn, are able to balance their books via their money-market dealings with the Bank.

Following changes in the structure of the gilts market after Big Bang, the Bank has offered to extend its dealing relationships to gilt-edged market makers, subject to their acceptance of obligations, akin to those of discount houses, of providing sterling liquidity continuously to the commercial banks, to their meeting certain conditions in terms of capital, experience, management and resources and to their acceptance of the Bank's prudential oversight. The Bank has acted in this way to ensure continuing competition among its money-market dealing counterparties. At present, two gilt-edged market makers have accepted such a dealing relationship, bringing the total number of counterparties to ten.

2.3 Instruments and techniques

2.3.1 Instruments

Eligible Bills are the instrument in which the Bank conducts its money-market operations via the discount houses. These comprise:

- Treasury bills
- local authority bills with an original maturity of not more than 187 days
- commercial bills accepted by a bank(*), with an original maturity of not more than 187 days.

However, in periods of acute cash shortages in the banking system, such as in the main tax-paying periods, the Bank sometimes conducts sale and repurchase agreements in gilt-edged stock and certain other assets directly with the banks.

(*) The list of institutions whose acceptances are eligible for discount at the Bank comprises around 150 banks.

2.3.2 Techniques

(i) Bill operations

In order to relieve a shortage of funds in the banking system, the Bank normally invites discount houses to offer eligible bills to the Bank for outright sale. The invitation usually makes no distinction among Treasury, eligible local authority and eligible commercial bonds, but it may do so and may also be confined to certain remaining-maturity bonds. The Bank does not normally purchase bills with a remaining maturity of more than three months. In response, each discount house specifies the discount rate at which bills are being offered. The Bank decides at its discretion which offers to accept, and normally buys paper, up to the amount of the money-market shortage as estimated by the Bank, at the best acceptable rates offered. If offers exceed the estimated shortage, the Bank normally accepts offers of shorter rather than longer bills and of bills at higher rates than lower rates.

Discount houses also have the right to offer bills to the Bank at any time at their own initiative, but at a rate of the Bank's choosing. This right has rarely been exercised in recent years.

Sales and repurchase agreements in eligible bills are also conducted, with the bank responding to bids in the same way as with outright purchases. Sales and repurchase operations can be undertaken in a wider range of maturities (e.g. in bills with a remaining maturity of more than three months) than with outright purchases.

In the event of an estimated money-market surplus, the Bank may invite both discount houses and clearing-banks to bid for Treasury bills for same-day settlement.

(ii) Lending

Discount houses have borrowing facilities at the Bank against approved collateral (in the form of eligible bills due after the maturity of the loan and gilt-edged stock with a residual maturity of up to five years) up to maximum amounts related to the capital base of each house. The terms of lending are at the discretion of the Bank. More limited facilities are also available to gilt-edged market-makers and to money brokers operating in the gilt-edged market.

(iii) Treasury bill tender

A tender is held each Friday, in amounts and maturities set and announced by the Bank a week in advance. There is no restriction on who may tender for Treasury bills, subject to a minimum tender of UKL 50,000. Accepted tenders are accepted at the price bid, although the Bank can decide to allot less than the announced amount. Even if a sizeable shortage is in prospect for the following week, some Treasury bills will normally be offered so as to preserve a market in these bills. During a period of substantial surpluses, the tender may be increased in size. The tender is underwritten each week by the discount houses collectively.

(iv) Special deposits

Although this scheme has not been activated since December 1979 it remains available as a means of withdrawing cash from the banking system. Since a call for, a repayment of, special deposits requires a period of notice, the scheme is best suited to prospective periods of protracted cash surpluses. Deposits may be called from monetary sector institutions with eligible liabilities of UKL 10 million or more. They would normally earn a rate of interest close to the average rate of interest at the most recent Treasury bill tender.

2.3.3 Signalling changes in interest rates

When the Bank wishes to give a signal to the market about interest rates, it may publish an announcement that discount houses wishing to use their borrowing facilities (see 2.3.2 point (ii) above) are invited to do so; on such occasions the interest rate at which the loans are made is usually published. Or (as in January 1985), the Bank may announce a Minimum Lending Rate, which, for a short period ahead, it will apply in any lending to discount houses.

2.4 Recent trends in money-market operations

Money-market assistance increased sharply during the first half of the decade as a result of overfunding (see box to chapter 5 of analytical note): the bank bought large amounts of short-term paper, mainly eligible commercial bills, in order to provide assistance to the money market in the face of the drain of funds caused by overfunding. By July 1985, total assistance had reached UKL 17 billion (against less than UKL 1 billion in 1981), of which about UKL 14 billion was in the form of commercial bills held by the Bank.

The total of assistance has fallen since 1985 (to stand at about UKL 4 billion in March 1989). A switch to a policy of a "full fund" rather than overfunding removed the main stimulus to increases in money-market assistance. And within the finances of the public sector, heavy borrowing by local authorities from the central government, the proceeds of which were largely used to reduce net debt to the banking system, reduced the need for assistance. Such borrowing increased the central government borrowing requirement (CGBR) within a given PSBR and a given funding requirement. Since it is the CGBR that is relevant to changes in the need for money-market assistance, these switches had a positive influence on the cash position of the money market (see Annex Table III.1).

In consequence, the bank has been a net seller of commercial bills over the period since 1985 as a whole. In addition, the amount of Treasury bills outstanding (which had fallen to less than half a billion pounds in the mid-1980's) has increased somewhat (see Annex Table III.2).

Expected central government flows are likely to lead to recurrent surpluses in the money market future, requiring official draining operations to offset them.

*

* *

TABLE III.1 - INFLUENCES ON THE CASH POSITION OF THE MONEY MARKET

UKL billion, not seasonally adjusted

	1981/2	1982/3	1983/4	1984/5	1985/6	1986/7	1987/8	1988/9
Under/overfunding (+/-)	-3.8	-1.8	-4.2	-4.6	+0.3	+0.3	-0.1	-2.5
Local authority borrowing requirement (-)	+0.2	-0.1	-1.2	-2.4	-1.7	-0.2	-1.2	-0.5
Public corporation borrowing requirement (-)	-2.3	-1.1	-0.5	-1.2	+0.3	+1.3	+1.5	+2.0
Central govt. on-lending to other sectors (+)	+1.0	+5.0	+4.1	+3.7	+6.7	+6.0	+4.2	+6.0
Central govt. net debt sales to banks (-)	+1.4	+0.2	-0.7	+0.4	-0.8	-1.6	+0.3	+4.5
Local authority and public corporation net debt sales to non-banks (+)	-0.7	-0.5	-0.1	-0.8	-1.1	-3.0	-2.5	-1.5
Private sector currency	-0.4	-1.4	-0.3	-0.8	-0.7	+0.2	-0.2	-1.1
Other circulation (increase -)	-0.6	+0.5	-0.1	-	+0.7	+1.3	+0.6	-0.6
Total change in the market's cash	-5.1	+0.8	-3.0	-5.7	+3.7	+4.4	+0.6	+6.2

Source: Bank of England Quarterly Bulletin, May 1989.

TABLE III.2 - OFFICIAL OFFSETTING OPERATIONS

UKL billion, not seasonally adjusted

	1981/2	1982/3	1983/4	1984/5	1985/6	1986/7	1987/8	1988/9
Net increase (+) in bank's [1] commercial bills	+4.7	-0.3	+3.8	+1.5	-2.0	-3.3	+2.5	-5.7
Net increase (-) in treasury bills in market	+0.1	-0.2	-0.1	+0.2	-0.1	-0.7	-0.8	-0.5
Securities acquired (+) under sale and repurchase agreements	-	+0.6	-0.6	+3.4	-1.1	-1.2	-1.1	-
Other	+0.3	-0.6	-0.1	+0.7	-0.4	+0.9	-1.5	+0.1
Total	+5.1	-0.5	+3.0	+5.8	-3.7	-4.2	-0.9	-6.1
Change in bankers' operational balances at the bank	-	+0.3	-	+0.1	-	+0.1	-0.3	+0.2

(1) Issue and Banking Departments of the Bank of England

Source: Bank of England Quarterly Bulletin, May 1989.

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Brussels 31 May 1989
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THE ECONOMIC AND MONETARY SITUATION IN THE UNITED KINGDOM

(Note for the attention of the members of the Monetary Committee)

STATISTICAL ANNEX

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TABLE 1.1 : MAIN ECONOMIC INDICATORS

	80	81	82	83	84	85	86	87	88	89 (1)	90 (1)
GDP, % p.a., (1980 prices)											
UK	-2.0	-1.1	1.2	3.8	1.8	3.6	3.1	3.8	3.7	2.4	2.1
EC-12	1.3	.2	.8	1.6	2.3	2.5	2.6	2.8	3.6	3.2	2.9
Total employment, % p.a.											
UK	-.3	-3.9	-1.8	-1.2	1.9	1.6	.4	1.7	3.1	1.6	.9
EC-12	.2	-1.2	-.8	-.5	.1	.6	.8	.9	1.5	1.2	1.0
Unemployment rate, as % of civilian labour force (2)											
UK	6.0	9.1	10.6	11.6	11.8	12.0	12.0	10.7	8.7	6.8	6.5
EC-12	6.1	7.8	9.4	10.6	11.4	11.8	11.9	11.4	11.0	10.2	9.9
GDP deflator, % p.a.											
UK	19.6	11.4	7.6	5.2	4.7	5.6	3.6	4.9	6.6	7.6	5.8
EC-12	13.0	10.9	10.4	8.5	6.9	6.1	5.5	4.0	4.3	4.9	4.7
Current balance of payments position as % of GDP											
UK	1.6	2.6	1.5	.9	-.2	.7	-.9	-0.7	-3.2	-3.3	-2.9
EC-12	-1.2	-.9	-.9	.0	.3	.7	1.2	.9	.4	.0	.0

(1) Forecasts of the Commssion services, June 1989
(2) SOEC definition
Source : Commission Services

TABLE 1.2: CHANGE IN DEMAND COMPONENTS AT CONSTANT PRICES AND CONTRIBUTION TO GDP GROWTH

	80	81	82	83	84	85	86	87	88	89 (1)	90 (1)
Change on preceding year (%)											
Private consumption	.0	.0	.9	4.5	1.8	3.5	5.7	5.4	6.5	3.6	1.9
Government consumption	1.6	.3	.8	2.0	.9	.0	2.0	1.1	.5	.9	.7
Gross fixed capital formation	-5.4	-9.6	5.4	5.0	8.6	3.8	1.7	8.3	11.8	6.3	3.1
Domestic demand including stockbuilding	-2.9	-1.6	2.2	4.9	2.6	2.7	4.2	5.1	6.5	3.3	1.7
Exports of goods and services	.0	-1.0	1.0	2.3	6.6	5.8	3.7	5.4	-1.0	2.7	5.9
Imports of goods and services	-3.6	-2.9	5.2	6.3	9.8	2.5	6.4	7.4	11.9	6.4	4.0
GDP	-2.0	-1.1	1.2	3.8	1.8	3.6	3.2	4.6	3.7	2.4	2.1
Contribution to change in GDP (a) (%)											
Final national uses (excl. net stockbuilding)	-.7	-1.6	1.6	4.0	2.8	2.8	3.8	5.0	6.2	3.7	2.0
Stockbuilding	-2.2	.1	.6	.9	-.1	-.2	.0	.1	0.3	-.3	-.2
Balance of goods and services	1.0	.5	-1.0	-1.0	-.8	.9	-.7	-.6	-3.8	-1.3	.3

(1) forecasts of the Commission services, June 1989
(a) change as % of GDP of preceding year.

Source : Commission Services

Table 1.3

United Kingdom : saving and investment by sector

(% of GDP)

	1980	1985	1986	1987	1988
Gross saving (1)					
Households	9,3	6,4	5,0	3,6	2,6
Enterprises	9,0	12,4	12,5	13,5	13,2
General government	-0,5	-0,4	-0,5	-0,0	1,8
Total	17,8	18,4	17,0	17,1	17,5
Capital transfers (net receipts)					
Households	0,1	0,1	-0,0	-0,1	-0,3
Enterprises	0,2	0,0	0,0	-0,1	-0,1
General government	-0,4	-0,3	-0,1	0,1	0,3
Gross investment (1)					
Households	3,9	4,4	4,9	5,2	5,6
Enterprises	10,6	10,8	10,4	11,2	12,6
General government	2,4	2,0	1,8	1,5	1,2
Total	16,9	17,2	17,1	17,9	19,4
Net lending (+) or net borrowing (-)					
Households	5,5	2,2	0,2	-1,6	-3,8
Enterprises	-1,2	1,8	2,1	2,3	1,1
General government	-3,4	-2,7	-2,4	-1,5	0,9
Total domestic	0,9	1,3	-0,1	-0,8	-1,8
Counterpart :					
. Balance of current transactions with rest of world	1,4	0,9	0,0	-0,7	-3,2
. Unexplained residual	-0,5	-0,3	0,2	0,1	-1,4

1 Excluding stock appreciation

Table 1.4 : Gross fixed investment
(percentage per annum change)

	1982/1979	1985/1982	1986	1987	1988	1989(1)	1990(1)
Private dwellings	-3,5	2,7	8,4	6,3	11,2	-5,4	1,3
Business - manufacturing	-14,4	11,2	-2,9	8,0	14,9	4,7	5,7
- other non-oil	2,4	5,0	1,2	14,1	17,0	11,3	3,0
- oil	2,9	-5,0	-12,1	-22,3	-8,8	8,3	2,5
Public dwellings	-14,2	3,6	3,4	1,7	1,1	7,2	2,2
Public non-dwellings	-18,4	25,8	7,0	-4,7	-20,5	-2,5	4,0
Total	-3,4	5,8	1,7	8,3	11,8	6,3	3,1

(1) Forecasts of the Commission services, June 1989

Source : Commission services.

Table 1.5 : Employment, unemployment and trade union membership

	1981	1982	1983	1984	1985	1986	1987	1988
Changes in civilian employment[1] (millions)								
Total	-0,99	-0,43	-0,30	0,45	0,38	0,09	0,54	0,81
Employees in employment	-1,10	-0,48	-0,35	0,17	0,27	0,08	0,31	0,68
- men	-0,76	-0,36	-0,27	-0,05	0,08	-0,07	0,04	0,31
- women	-0,34	-0,12	-0,08	0,22	0,19	0,15	0,27	0,37
- agriculture, forestry and fishing[2]	-0,01	0,00	-0,01	-0,01	0,00	-0,01	-0,01	-0,01
- production and constr. industries[2]	-0,85	-0,45	-0,38	-0,16	-0,08	-0,20	-0,09	0,08
of which : manufacturing	-0,72	-0,36	-0,33	-0,12	-0,04	-0,13	-0,07	0,07
- services[2]	-0,24	0,03	0,05	0,33	0,35	0,30	0,40	0,61
Self-employed	0,11	0,05	0,05	0,28	0,11	0,02	0,23	0,13
Part-time employment[2]				0,22	0,17	0,15	0,25	0,10
- men				0,06	0,04	0,02	0,08	0,04
- women				0,16	0,13	0,13	0,17	0,05
Unemployment rate (% of labour force)[3]	9,1	10,6	11,6	11,6	11,8	12,0	10,7	8,6
Trade union membership (millions)[4]	12,1	11,6	11,2	11,0	10,8	10,5	10,5	

[1] June to June. Defined here as the sum of changes in employees in employment and of changes in self-employment (the national definition also includes among the employed participants in work-related government training programmes)
[2] Great Britain
[3] Annual average
[4] At end-year

Source : UK official statistics, Eurostat (unemployment rate).

TABLE 1.6: WAGES, PRODUCTIVITY AND TERMS OF TRADE

(growth rate)

	80	81	82	83	84	85	86	87	88	89 (1)	90 (1)
Nominal wages / wage and salary earner	19.6	14.0	8.4	8.6	5.3	6.7	7.3	6.9	8.0	9.2	8.2
Real wages (price of private consumption)	2.9	2.4	-.3	3.6	.2	1.4	2.8	3.0	2.9	3.3	2.9
Productivity (whole economy) (real GDP/person employed)	-1.7	2.9	3.1	5.2	-.1	2.0	2.7	2.0	2.2	1.7	1.3
Unit wage costs (whole economy)	21.1	9.9	4.8	3.0	4.3	4.3	4.5	4.8	7.4	8.1	6.9
Terms of trade (goods and services)	4.2	.6	-.2	.1	-1.1	1.1	-3.9	.7	2.2	2.0	-1.0
Wage share (whole economy)	1.8	-.6	-2.2	-1.7	.7	-.9	.9	-.1	.8	.7	.9

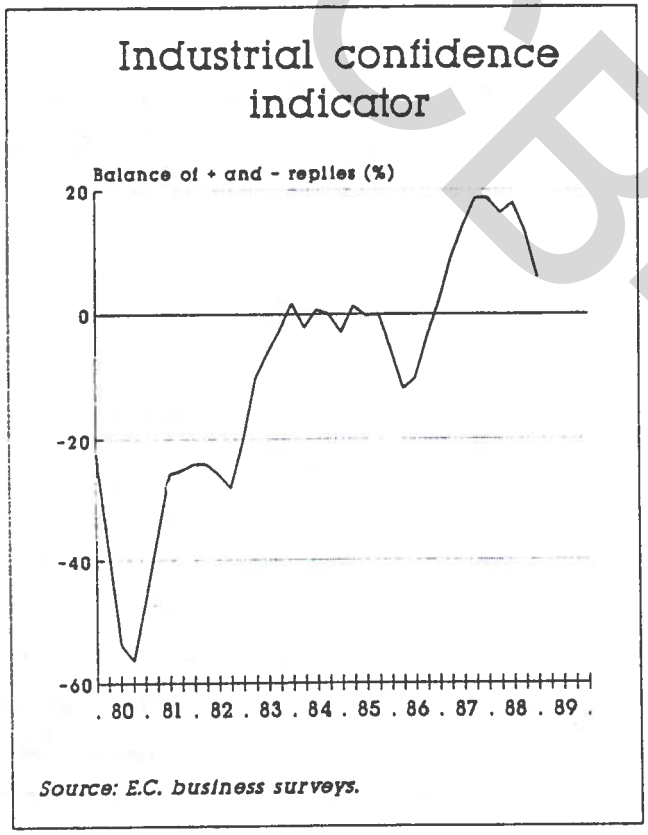
(1) Forecasts of the Commission services, June 1989
Source : Commission Services

TABLE 1.7 : BALANCE OF PAYMENTS
(TRANSACTIONS BASIS - % GDP)

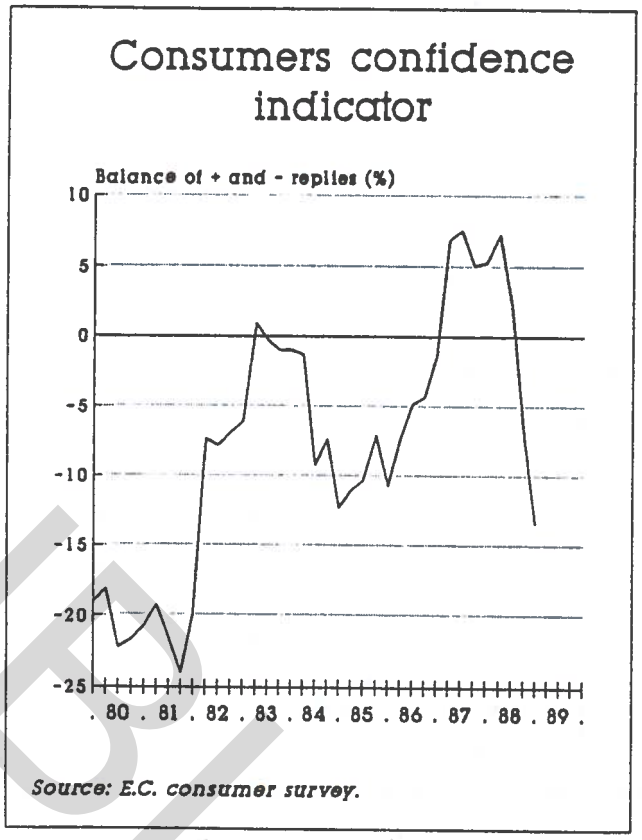
	79	80	81	82	83	84	85	86	87	88	89 (1)	90 (1)
1. Current account	-.3	1.4	2.7	1.7	1.3	.6	1.0	.0	-.7	-3.2	-3.3	-2.9
1.1 Visibles	-1.7	.6	1.3	.8	-.4	-1.4	-.7	-2.3	-2.5	-4.5	-4.3	-3.8
Of which : non-oil	-1.4	.5	.1	-.9	-2.7	-3.6	-3.0	-3.4	-3.5	-5.1		
1.2 Invisibles	1.5	.8	1.4	.9	1.6	2.1	1.6	2.4	1.8	1.3	1.0	.9
Of which : Services (2)	2.0	1.7	1.5	1.0	1.2	1.2	1.7	1.5	1.3	.8		
Int. , prof. & div.	.6	-.1	.5	.5	.9	1.4	.8	1.4	1.3	1.3		
Transfers	-1.1	-.9	-.6	-.6	-.5	-.5	-.9	-.6	-.8	-.8		
2 Non bank capital flows (net)	-1.7	-2.0	-3.6	-2.7	-2.6	-5.9	-4.4	-5.5	.0	-2.8		
2.1 Direct invest.	-1.5	-.2	-1.2	-.4	-.7	-1.9	-1.4	-1.7	-2.6	-1.7		
2.2 Portfolio invest.	.3	-.8	-1.6	-2.7	-1.8	-2.6	-3.5	-4.7	2.7	-1.5		
2.3 Other net trans. of non pub. sec.	-.4	-.8	-.7	.2	.2	-1.1	.8	.9	-.3	.6		
2.4 Net transactions of general govnt	-.2	-.1	.0	.1	-.4	-.2	-.2	-.1	.2	-.2		
3. Net overseas transfers of UK banks	1.9	.4	-.3	1.4	.9	3.2	2.2	2.6	.6	3.2		
4. Subtotal	-.1	-.2	-1.1	.3	-.4	-2.0	-1.2	-2.9	-.1	-2.9		
Financed by:												
5. Change in official reserves (3)	-.5	-.1	1.0	.5	.2	.3	-.5	-.8	-2.9	-.6		
6. Balancing item (4)	.7	.4	.2	-.8	.2	1.8	1.7	3.6	3.0	3.4		

(1) Economic forecasts of the Commission Services, June 1989
(2) Includes net labour income from abroad.
(3) Increase in reserves : (-).
(4) Including allocations of SDR.
Source : CSO.

Graph 1.1



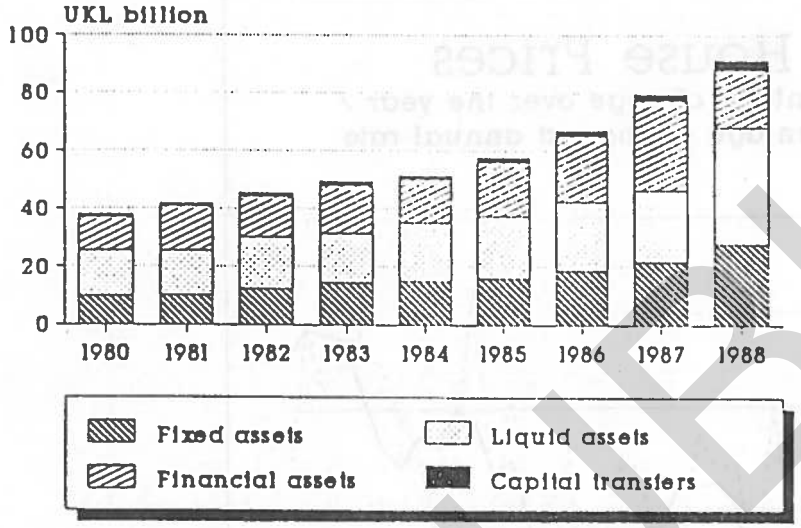
Graph 1.2



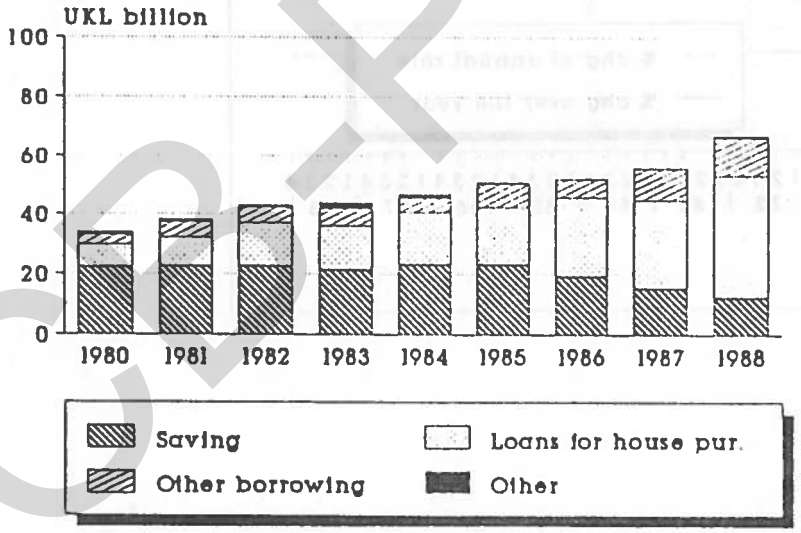
Graph 1.3

Personal sector : sources and uses of funds

Identified uses of funds

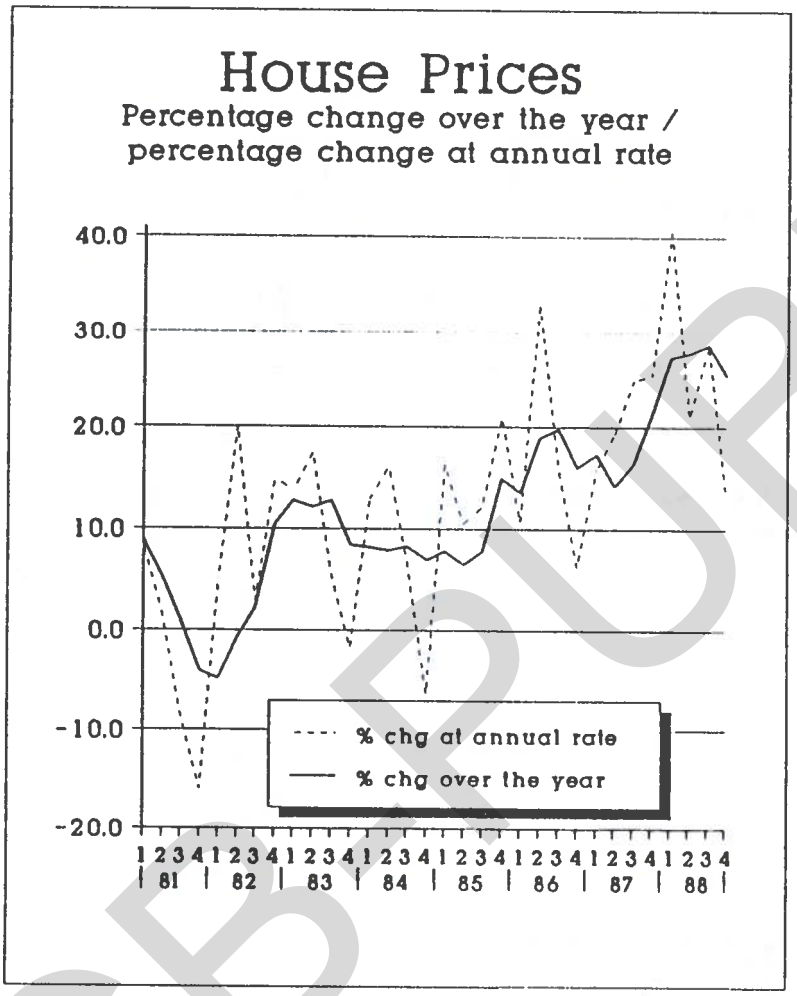


Identified sources of funds

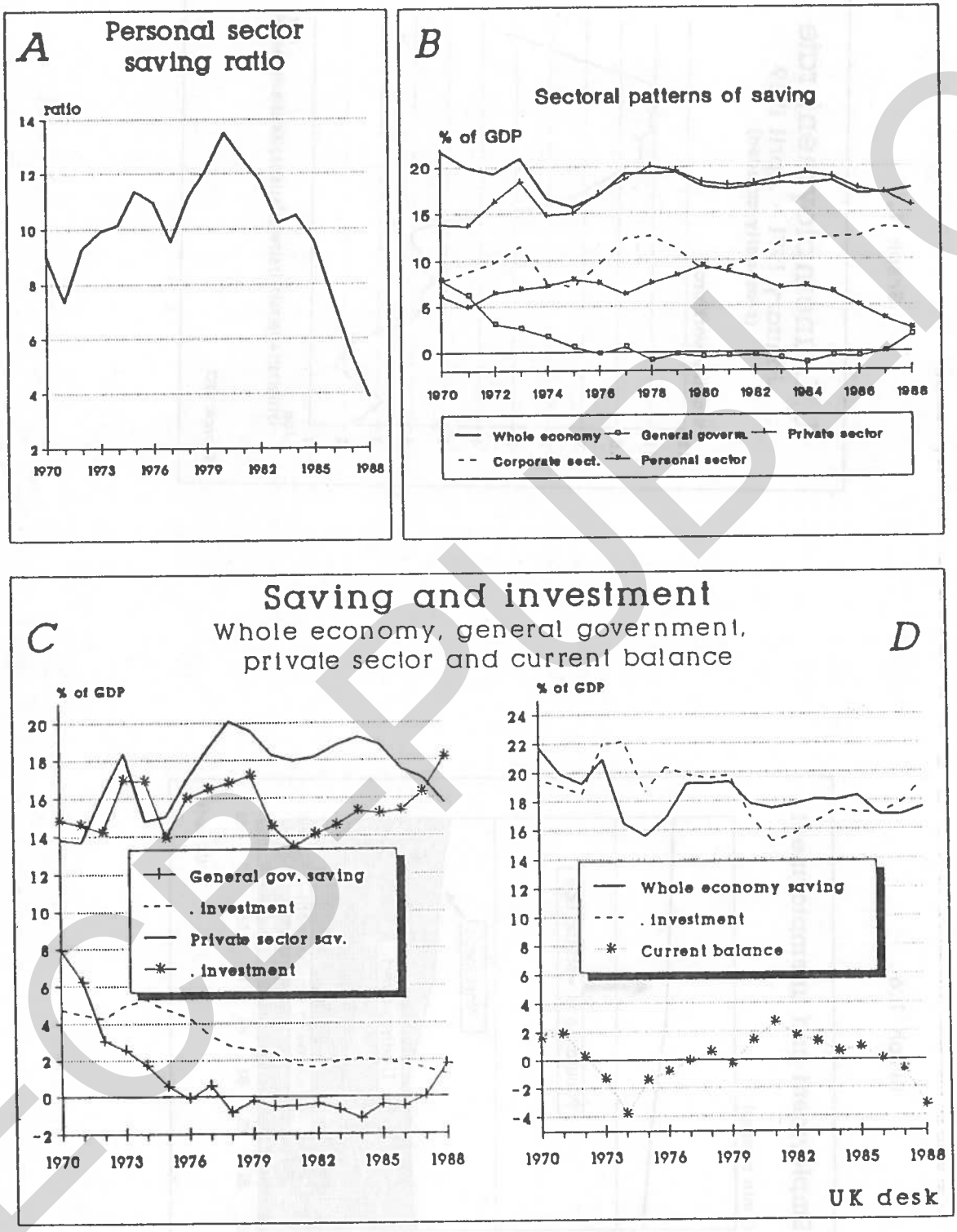


Note: difference between identified uses and sources of funds in the personal sector balancing item.

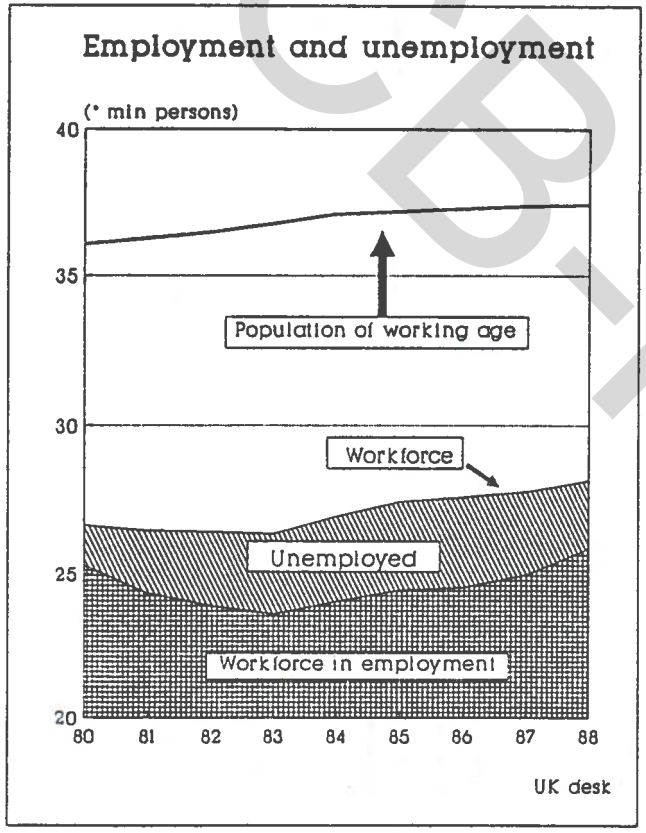
Graph 1.4



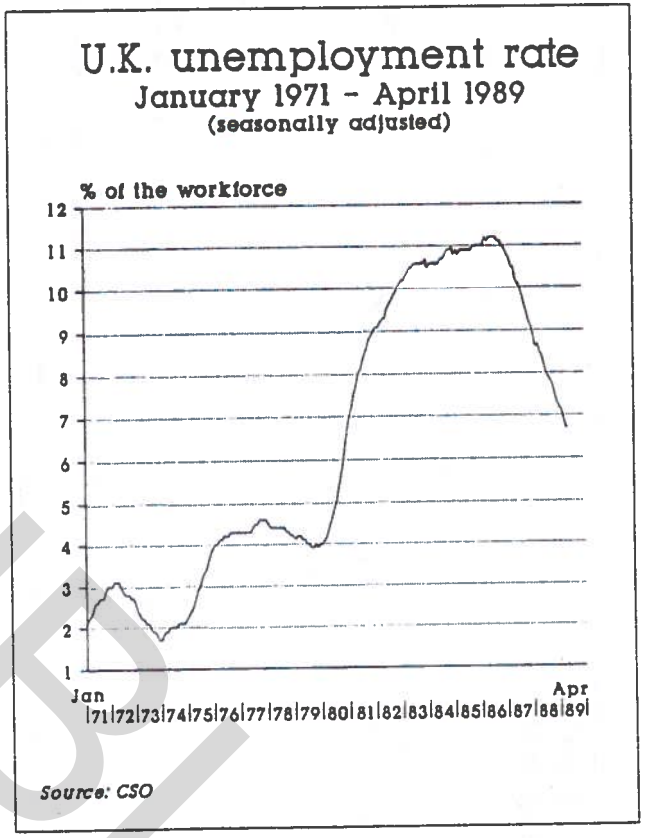
Graph 1.5



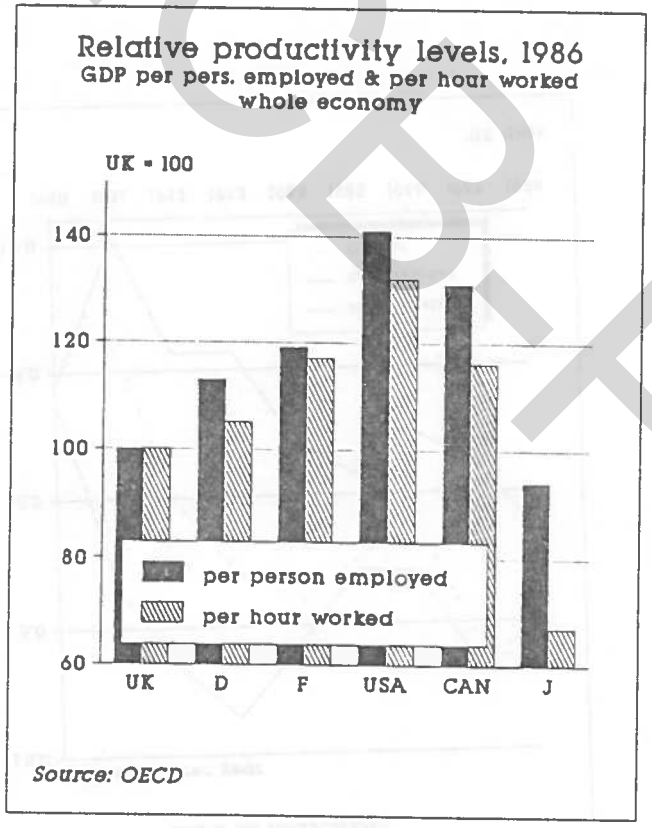
Graph 1.6



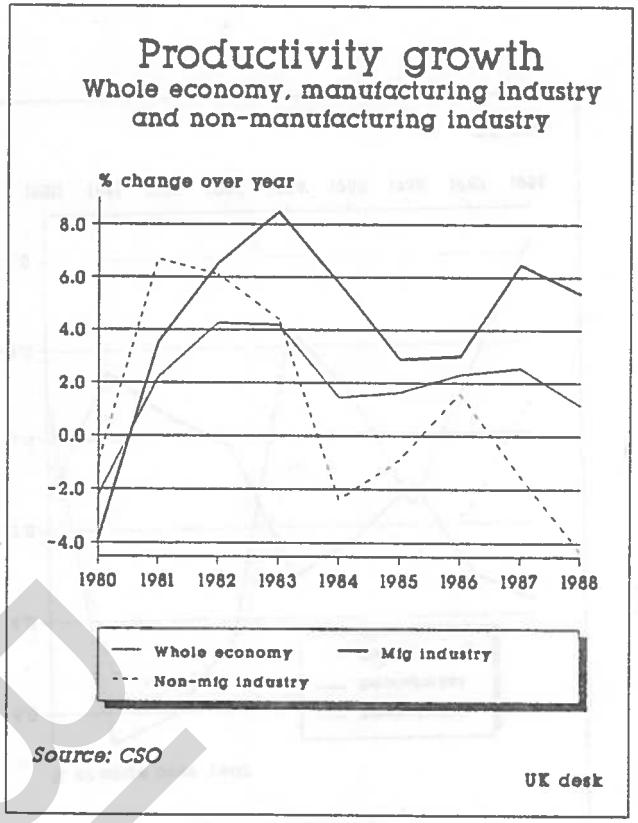
Graph 1.7



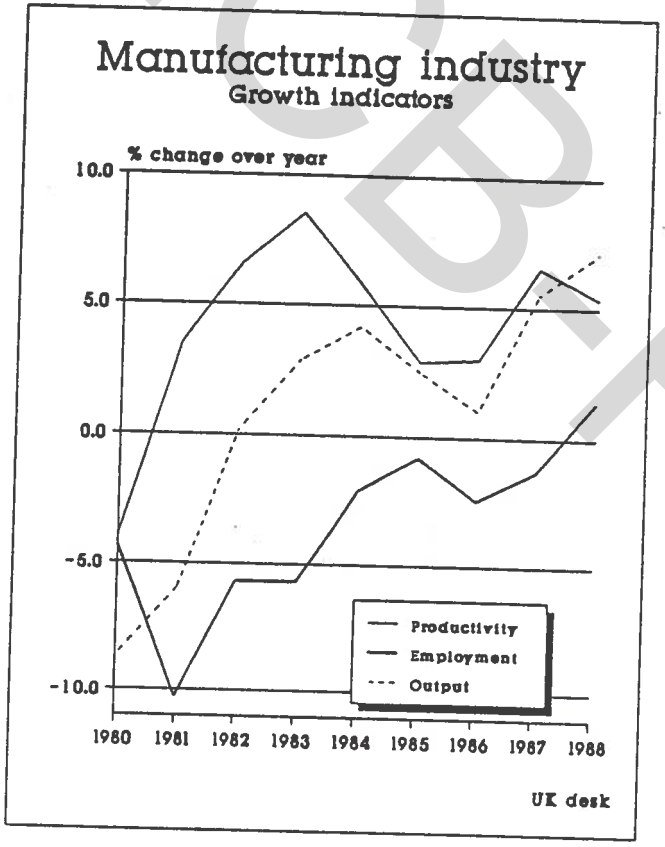
Graph 1.8



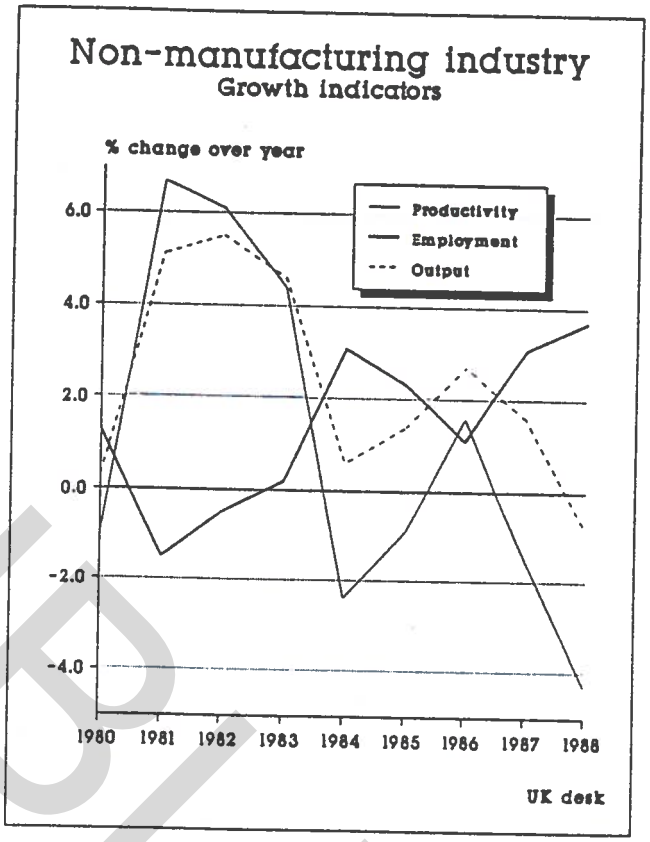
Graph 1.9



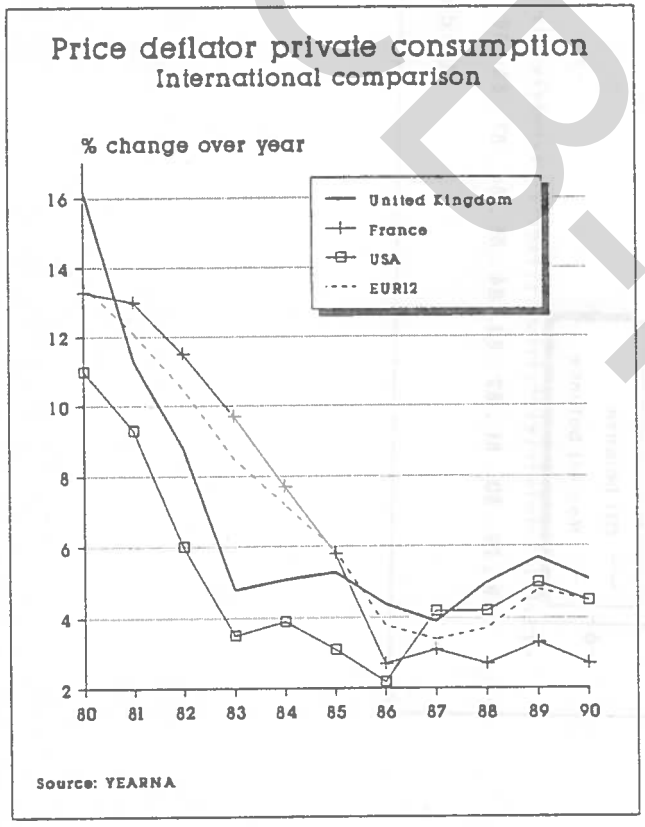
Graph 1.10



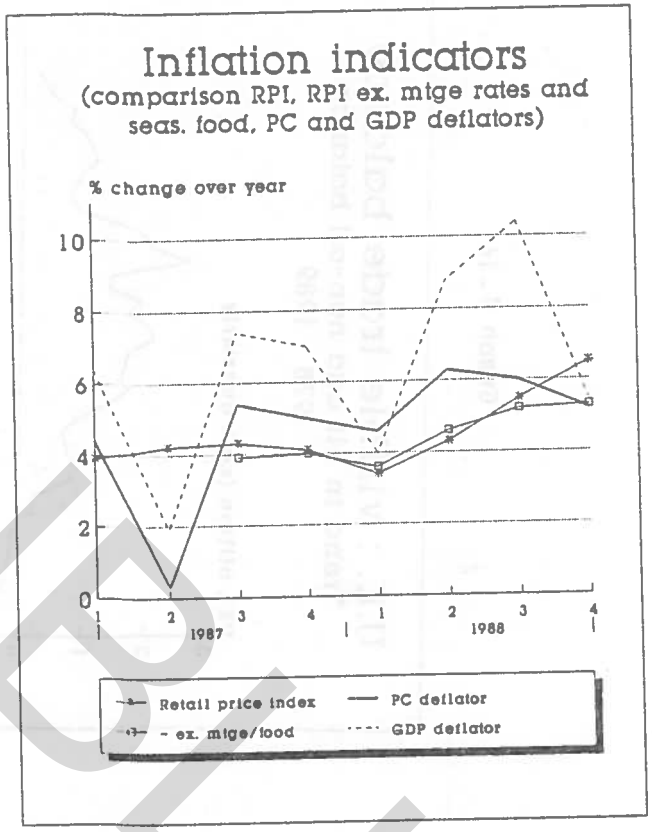
Graph 1.11



Graph 1.12



Graph 1.13



Graph 1.14

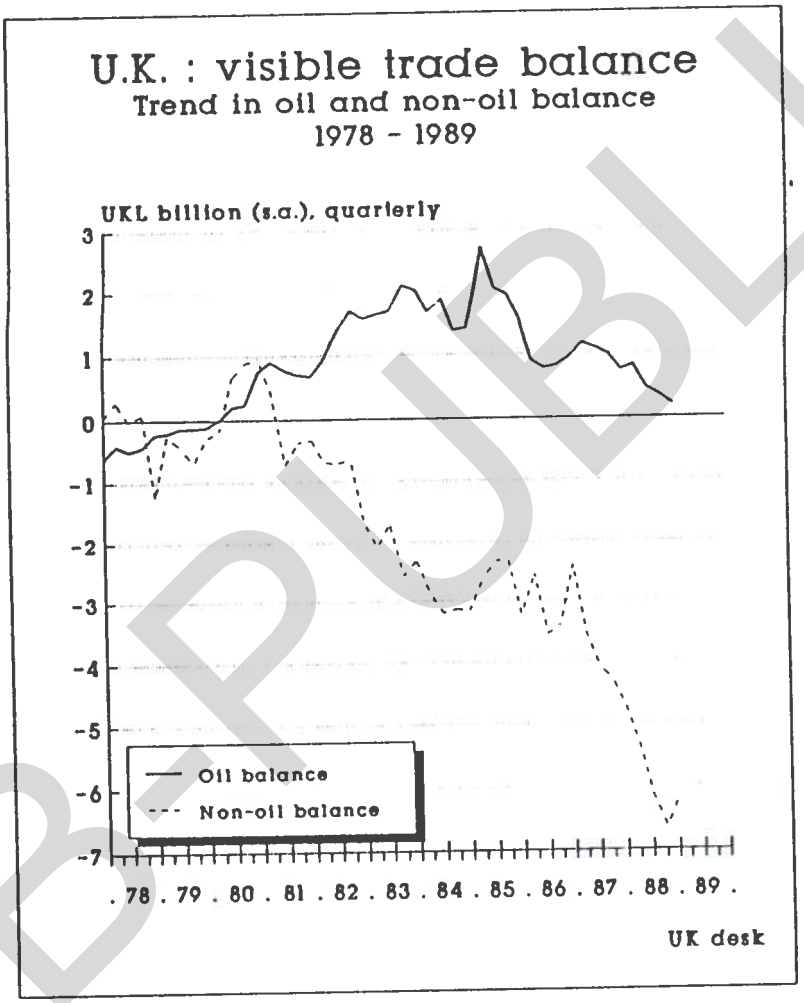


Table 2.1 Monetary aggregates: MTFS targets(1) and outturns(2)

% change

For:	£ M3		M1		PSL2		MO	
MTFS of:	Target	Outturn	Target	Outturn	Target	Outturn	Target	Outturn
1980/81	7–11	19 1/2						
1981/82	6–10	12 3/4						
1982/83	8–12	11 1/4	8–12	12 1/4	8–12	11 1/2		
1983/84	7–11	9 3/4	7–11	14	7–11	12 1/2		
1984/85	6–10	12					4–8	5 1/2
1985/86	5– 9	16 1/2					3–7	3 1/2
1986/87	11–15	14 1/2					2–6	4
1987/88							2–6	5 3/4
1988/89							1–5	6 1/4
1989/90							1–5	

(1) Fourteen months from February for 1980/81 to 1984/85; over period of financial year from 1985/86 onwards.
(2) Latest available outturn, annual growth rates (seasonally adjusted)as at end of target period.

Source: Financial Statement and Budget Report, successive years.

Table 2.2 PSBR: MTFS Projections and outturns

	Projected in										Out-turns
	80	81	82	83	84	85	86	87	88	89	
1980/81	3 3/4	6									5.3
1981/82	3	4 1/4	4 1/4								3.3
1982/83	2 1/4	3 1/4	3 1/2	2 3/4							3.1
1983/84	1 1/2	2	2 3/4	2 3/4	3 1/4						3.1
1984/85			2	2 1/2	2 1/4	3 1/4					3.1
1985/86				2	2	2	2				1.6
1986/87					2	2	1 3/4	1			0.9
1987/88					1 3/4	1 3/4	1 3/4	1	- 3/4		-0.9
1988/89					1 3/4	1 3/4	1 1/2	1	- 3/4	-3	-2.1
1989/90							1 1/2	1	0	-2 3/4	
1990/91								1	0	-1 3/4	
1991/92									0	-1	
1992/93										- 1/2	

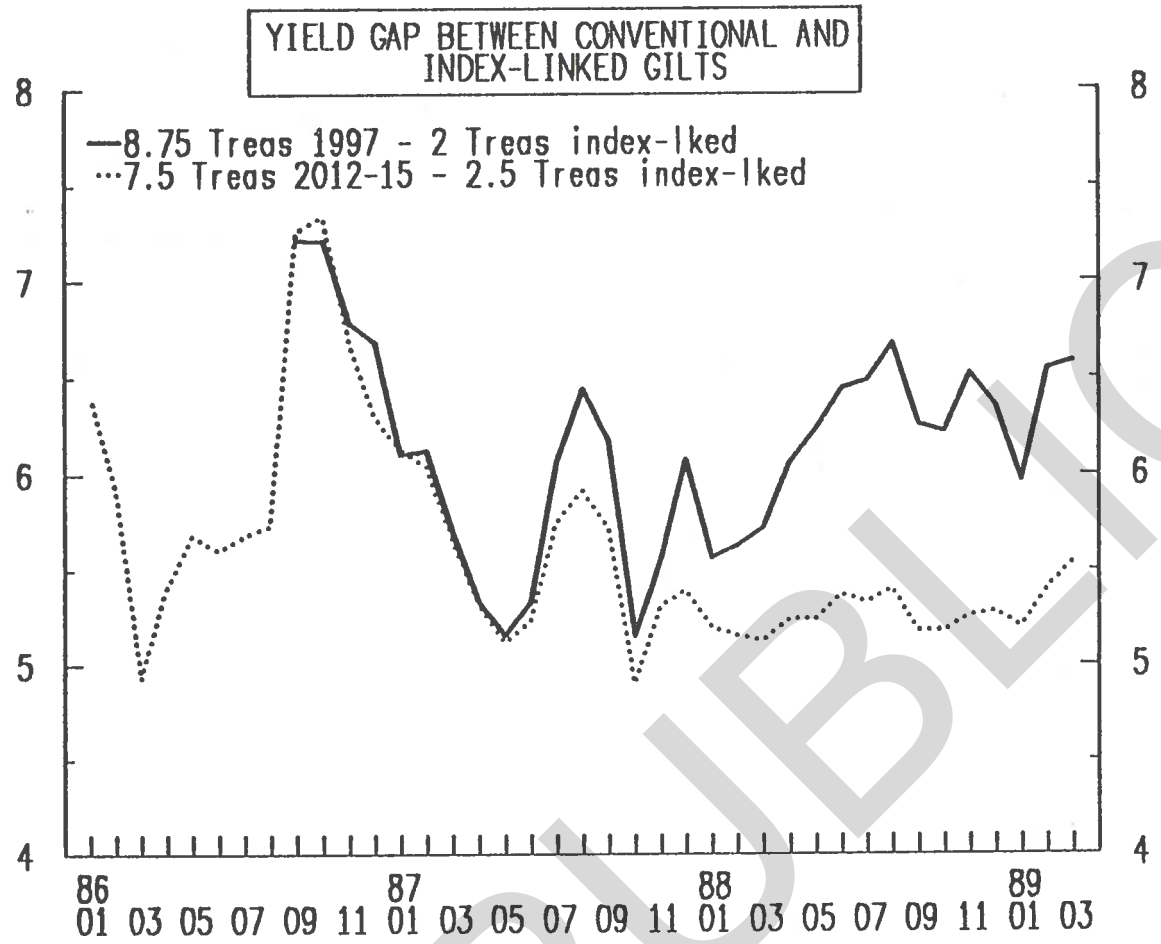
Source: Financial Statement and Budget Report, successive years.

Table 3.1 Contributions to price increases[1], UK

	Percentage points				
	1986	1987	1988	1989(2)	1990(2)
Import prices(3)	-3.0	0.1	1.2	1.0	0.6
Nominal effective exchange rate	2.2	0.5	-1.2	-0.6	0
Unit labour costs	2.2	2.4	2.7	3.3	3.2
Profits	-0.6	0.8	1.3	1.1	0.7
Net indirect taxes	1.2	0.7	0.7	0.7	0.6

(1) Deflator of final uses.
(2) Forecast of Commission services, May 1989.
(3) Excluding impact of nominal exchange rate movements.

GRAPH 3.1



Source : Central Statistical Office

TABLE 4.1 : RECEIPTS AND EXPENDITURE OF GENERAL GOVERNMENT AS % OF GDP

	79	80	81	82	83	84	85	86	87	88	89 (1)	90 (1)
Indirect taxes	15.0	15.8	16.7	16.7	16.3	16.2	16.0	16.5	16.4	16.4	16.0	15.7
Direct taxes	12.8	13.4	14.3	14.5	14.4	14.4	14.6	13.8	13.4	13.3	13.4	13.9
Social security contributions	5.8	6.0	6.3	6.5	6.9	6.9	6.8	6.9	6.8	6.9	6.9	6.7
Other current receipts	4.2	4.5	4.5	4.5	4.0	3.9	4.1	3.4	3.2	2.9	2.5	2.2
Total current receipts	37.8	39.8	41.8	42.3	41.6	41.5	41.5	40.5	39.8	39.5	38.9	38.5
Current transfers	14.0	14.3	15.4	15.9	15.9	16.2	16.2	15.6	14.8	13.8	13.3	13.1
To enterprises	2.4	2.5	2.5	2.1	2.1	2.3	2.0	1.6	1.4	1.3	1.1	1.0
To households	10.6	11.1	12.3	13.2	13.2	13.3	13.2	13.4	12.6	11.8	11.4	11.3
To the rest of the world	1.0	.8	.6	.6	.6	.6	.9	.6	.8	.7	.8	.7
Actual interest payments	4.4	4.7	5.0	5.0	4.7	4.9	4.9	4.5	4.3	4.0	3.4	3.0
Government consumption	19.7	21.3	21.8	21.7	21.7	21.6	20.9	21.0	20.6	20.0	19.5	19.6
Compensation of employees	11.8	12.8	13.2	12.9	12.9	12.7	12.3	12.3	12.4	12.3	12.2	12.2
Purch of goods and serv	7.2	7.7	7.9	8.2	8.2	8.2	7.9	8.0	7.6	7.1	6.7	6.9
Total current expenditure	38.1	40.3	42.3	42.7	42.3	42.7	42.0	41.1	39.7	37.8	36.3	35.7
Gross saving	-.2	-.5	-.5	-.4	-.7	-1.2	-.5	-.6	.0	1.8	2.6	2.8
Net capital transfers	.4	.4	.4	.5	.6	.6	.3	.0	-.1	-.3	-.2	-.3
Gross fixed capital formation	2.6	2.4	1.8	1.6	2.0	2.1	2.0	1.8	1.5	1.2	1.2	1.2
Total expenditure	41.1	43.1	44.4	44.7	44.9	45.4	44.3	42.9	41.2	38.6	37.1	36.6
Financial balance	-3.3	-3.4	-2.6	-2.5	-3.3	-3.9	-2.7	-2.4	-1.4	.8	1.7	1.8

(1) Forecasts of the Commission services , June 1989
Source : Central Statistical Office,Commission services

TABLE 4.2 : BUDGET BALANCES AS % OF GDP

	79	80	81	82	83	84	85	86	87	88	89 (1)	90 (1)
General government												
Financial balance (2)	-3.3	-3.4	-2.6	-2.5	-3.3	-3.9	-2.7	-2.4	-1.4	.8	1.7	1.8
Adjustments,of which :												
Net lending	-1.8	-1.5	-1.1	-1.0	-.3	.5	.5	1.1	1.6	1.1		
Company sec. (3)	-.1	.1	.7	.0	-.2	-.8	-.7	1.0	1.5	1.4		
Accruals adj. (bal.)	1.5	.6	1.2	-.6	.4	-.1	.3	-.4	.1	.0		
Borrowing requirement (-)			-4.5	-2.1	-4.0	-3.0	-2.4	-.9	.2	1.9	3.0	2.9
Public sector												
Financial balance (2)	-4.4	-4.5	-3.1	-2.7	-3.4	-4.0	-2.7	-2.1	-1.2	1.2	2.2	2.2
Borrowing requirement (-)	-6.4	-5.1	-4.1	-1.8	-3.8	-3.2	-2.1	-.6	.4	2.5	3.4	3.3

(1) Forecasts of Commission Services, June 1989
(2) Excluding privatisation proceeds
(3) Includes privatisation proceeds
Source : Central Statistical Office

TABLE 4.3 : CENTRAL GOVERNMENT CURRENT EXPENDITURE AS % OF GDP

	79	80	81	82	83	84	85	86	87	88
1. Final consumption	11.9	13.0	13.3	13.4	13.5	13.4	13.0	13.0	12.6	12.2
1.1 Defence	4.5	4.9	4.9	5.2	5.2	5.2	5.1	5.0	4.6	4.3
1.2 Health	4.4	4.9	5.1	4.9	5.1	5.0	4.9	4.9	5.0	4.9
1.3 Other	3.0	3.2	3.3	3.3	3.2	3.1	3.1	3.1	3.1	3.0
2. Subsidies	2.0	2.0	2.0	1.6	1.6	1.9	1.7	1.3	1.3	1.1
3.Grants to the personal sector										
3.1 Social security benefits	9.2	9.5	10.6	11.4	10.7	10.7	10.7	10.9	10.3	9.6
3.2 Other	1.0	1.1	1.2	1.3	1.4	1.5	1.5	1.5	1.4	1.3
4. Other grants	6.8	6.5	6.6	6.5	6.8	6.9	6.8	6.4	6.5	5.9
5. Debt interest	3.4	3.6	4.0	4.1	4.1	4.4	4.5	4.2	4.2	3.8
Total current expenditure	34.2	35.7	37.8	38.3	38.0	38.8	38.1	37.3	36.3	33.9

Source : Central Statistical Office

Table 4.4. General government gross fixed capital formation (percent of GDP)

	1970	1975	1980	1985	1986	1987	1988
United Kingdom(1)	4.7	4.7	2.7	2.4	2.2	1.8	1.7
Germany	4.6	3.9	3.6	2.3	2.4	2.4	2.4
France	3.9	3.9	3.4	3.2	3.2	3.4	3.4
Italy	2.7	3.1	3.2	3.8	3.6	3.5	3.6
Eur. 10(2)	4.0	3.8	3.1	2.9	2.8	2.7	2.7

(1) Figures for the UK exclude council houses sales. Correction for 1988 is based on figures of council houses sales in 1987.
(2) EUR 12 excluding Spain and Portugal

Source: Commission services.

TABLE 4.5 : PUBLIC EXPENDITURE
REAL GROWTH RATES

	80	81	82	83	84	85	86	87	88
1. Final consumption (1)	3.3	.2	1.0	2.9	1.0	.6	.7	-.8	.5
Of which 1.1 defence	3.1	-1.8	5.4	2.2	3.0	.2	-1.5	-6.2	-2.1
1.2 health	4.1	2.0	-3.4	6.1	-.1	.7	3.0	3.3	3.5
2. Subsidies and grants (2)	3.0	6.7	3.6	3.7	4.3	3.3	-1.2	.9	-3.4
Of which Soc sector benefits	3.6	11.2	7.9	-2.3	1.1	3.6	4.0	-.9	-2.1
3. Gross fixed capial formation (2)									
Of which 3.1 general govnt	-8.0	-25.2	-13.3	26.2	8.2	-3.7	2.0	-5.0	-2.0
3.2 Public corp.	1.5	-8.4	-3.5	5.7	-11.9	-26.4	-5.9	-20.9	-3.3

(1) Public consumption deflator
(2) Private consumption deflator
Source : Central Statistical Office, Commission Services

TABLE 4.6 : PUBLIC CORPORATIONS AS % OF GDP

	79	80	81	82	83	84	85	86	87	88
1. Gross trading surplus	2.8	2.7	3.1	3.4	3.3	2.6	2.0	2.1	1.6	1.6
Of which subsidies	.7	.6	.8	.8	.9	1.1	.9	.6	.4	.3
2. Other income	.5	.4	.5	.5	.5	.5	.6	.4	.4	.4
3. Interest,dividends	1.4	1.3	1.4	1.4	1.2	1.1	1.1	.9	.8	.7
Of which : to general government	1.0	.9	1.0	.9	.9	.7	.7	.6	.5	.5
4. Taxes	.0	.0	.1	.2	.1	.1	.0	.1	.0	.0
5. Net capital transfers	-.1	.0	.1	-.1	.1	.3	.2	.2	.2	.1
6. Gross fixed capital formation	2.9	2.9	2.7	2.6	2.6	2.3	1.6	1.5	1.1	.1
7. Financial balance	-1.1	-1.1	-.5	-.3	-.1	-.1	.0	.3	.3	.4

Source : Central Statistical Office

TABLE 4.7 PUBLIC EXPENDITURE PLANS
1989-90 TO 1991-92

	89 -90	90 -91	91 -92
Planning total (1)			
% p.a. in real terms (2)	.9	1.7	1.9
Of which defence	.0	1.1	1.6
Health	2.3	1.8	.9
Education & science	.5	.0	-.5
Social security	1.9	4.7	3.0
General govern. expend. excluding priv. proceeds as % of GDP	39.3	39.0	38.8
Privatisation proceeds as % of GDP	1.0	.9	.9

(1) lanning total less the reserve, privatisation proceeds and verall adjustment item
(2) Nominal change deflated by change in GDP deflator
Source : The Government's Expenditure Plans.

TABLE 4.8 MEDIUM TERM PROJECTIONS AS % OF GDP

	88 -89	89 -90	90 -91	91 -92	92 -93
General government receipts	40.5	40.5	39.7	39.4	38.6
General government expenditure	37.9	38.1	38.0	37.8	37.1
Fiscal adjustements	.0	.0	.2	.5	1.0
G G D R	2.5	2.4	1.1	1.4	.5
P S D R	3.0	2.8	1.9	1.1	.5

Source : Financial Statement and Budget Report, March 1989

Table 4.9. Public sector debt(1)

	1980	1985	1988
Gross debt as % of GDP nominal value, 31 March	56.5	57.3	50.4
Net debt as % of GDP nominal value, 31 March	49.2	48.6	40.3
Gross debt hold overseas as a % of GDP	7.2	6.3	6.6
Foreign currency debt as % of debt hold outside the public sector	7.4	4.7	4.0

(1) General government and public corporations.

Source: Bank of England, Quarterly Bulletin, Nov. 1988; CSO, Financial Statistics, Feb. 1989.

Table 4.10. Characteristics of national debt(1)

A. Composition of market holdings of national debt

	1979	1985	1988
Government and government guaranteed securities	73.7	77.2	75.6
Treasury bills	3.2	0.8	1.6
National savings	10.2	15.2	16.0
Interest free notes due to the IMF	4.5	2.2	2.2
Certificates of tax deposit	2.3	2.2	1.6
Other	-	0.4	0.3
Foreign currency debt	6.1	2.0	2.7
Total market holdings of national debt	100.0	100.0	100.0

B. Distribution of sterling national debt(1)

	1979	1985	1988
1. Market holdings	78.7	92.5	89.9
of which:			
Public corporations and local authorities	0.3	0.6	0.5
Monetary sector(2)	6.0	5.1	4.7
Other financial institutions	36.9	45.8	40.4
Overseas residents	8.4	8.5	11.5
Individual and private trusts	18.6	22.3	21.0
Other	8.5	10.2	11.8
2. Official holdings	21.3	7.5	10.1
3. Total sterling debt	100.0	100.0	100.0

(1) The national debt consists of the liabilities of the National Loans Fund, which is responsible for raising most of the central government debt. In 1988 these liabilities represented 94 % of the general government debt and 92 % of the public sector debt. Market holdings of national debt represented in 1988 more than 90 % of total national debt, or 83 % of public sector debt.

(2) Excludes the Bank of England Issue Department which is part of the Central Government.

Source: Bank of England, Quarterly Bulletin, Nov. 1988.

TABLE 5.1 : MONETARY AGGREGATES 1979 - 1988
(YEAR-END RATE OF GROWTH)

	70 -79	80	81	82	83	84	85	86	87	88
Wide monetary base M0 (sa)	11.0	5.7	2.6	3.9	6.0	5.7	4.2	3.4	4.3	9.7
Money stock M3 (nsa)	13.9	18.6	13.9	8.9	10.3	9.7	13.4	19.2	22.8	20.4
Money stock M4 (nsa)	13.1	17.1	13.7	12.0	12.3	13.3	13.0	15.4	16.3	17.6

Source : Central Statistical Office

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TABLE 5.2 : VELOCITY OF MONETARY AGGREGATES

	Wide monetary base M0	Money stock M3	Money stock M4
70-79	15.8	3.2	1.9
80	20.2	3.8	2.1
81	21.3	3.5	2.0
82	23.1	3.2	1.9
83	23.8	3.2	1.8
84	24.1	3.1	1.7
85	25.2	3.0	1.7
86	25.9	2.7	1.6
87	27.1	2.5	1.5
88	28.1	2.3	1.4
87Q1	26.5	2.6	1.5
87Q2	26.9	2.5	1.5
87Q3	27.5	2.5	1.5
87Q4	27.5	2.4	1.5
88Q1	27.9	2.4	1.4
88Q2	28.1	2.3	1.4
88Q3	28.1	2.2	1.4
88Q4	28.1	2.2	1.4

Source: Central Statistical Office

TABLE 5.3 : RATIOS OF PRIVATE SECTOR MONEY HOLDINGS TO GROSS FINANCIAL ASSETS

	77	78	79	80	81	82	83	84	85	86	87	88q3
(1)	11396	12714	12524	14763	17867	19568	23969	27527	31142	40320	50223	# 54313
(2)	84257	95872	112887	125593	150115	170673	195439	236996	246532	281689	321093	359477
(3)	.14	.13	.11	.12	.12	.11	.12	.12	.13	.14	.16	.15
(4)	62870	72421	87412	102176	111922	125654	139877	156499	175061	195567	217828	248153
(5)	190176	211508	247238	300052	334839	407017	479054	555857	628958	745447	833675	921463
(6)	.33	.34	.35	.34	.33	.31	.29	.28	.28	.26	.26	.27
(7)	74266	85135	99936	116939	129789	145222	163846	184026	206203	235887	268051	302466
(8)	274433	307380	360125	425645	484954	577690	674493	792853	875490	1027136	1154768	1280940
(9)	.27	.28	.28	.27	.27	.25	.24	.23	.24	.23	.23	.24

(1) Money holdings, non-financial companies
(2) Gross financial wealth, non-financial compagnies
(3) Ratio of 1 to 2
(4) Money holdings, personal sector
(5) Gross financial wealth, personal sector
(6) Ratio of 4 to 5
(7) Money holdings, non-financial private sector
(8) Gross financial wealth, non-financial private sector
(9) Ratio of 7 to 8

figure for 1988

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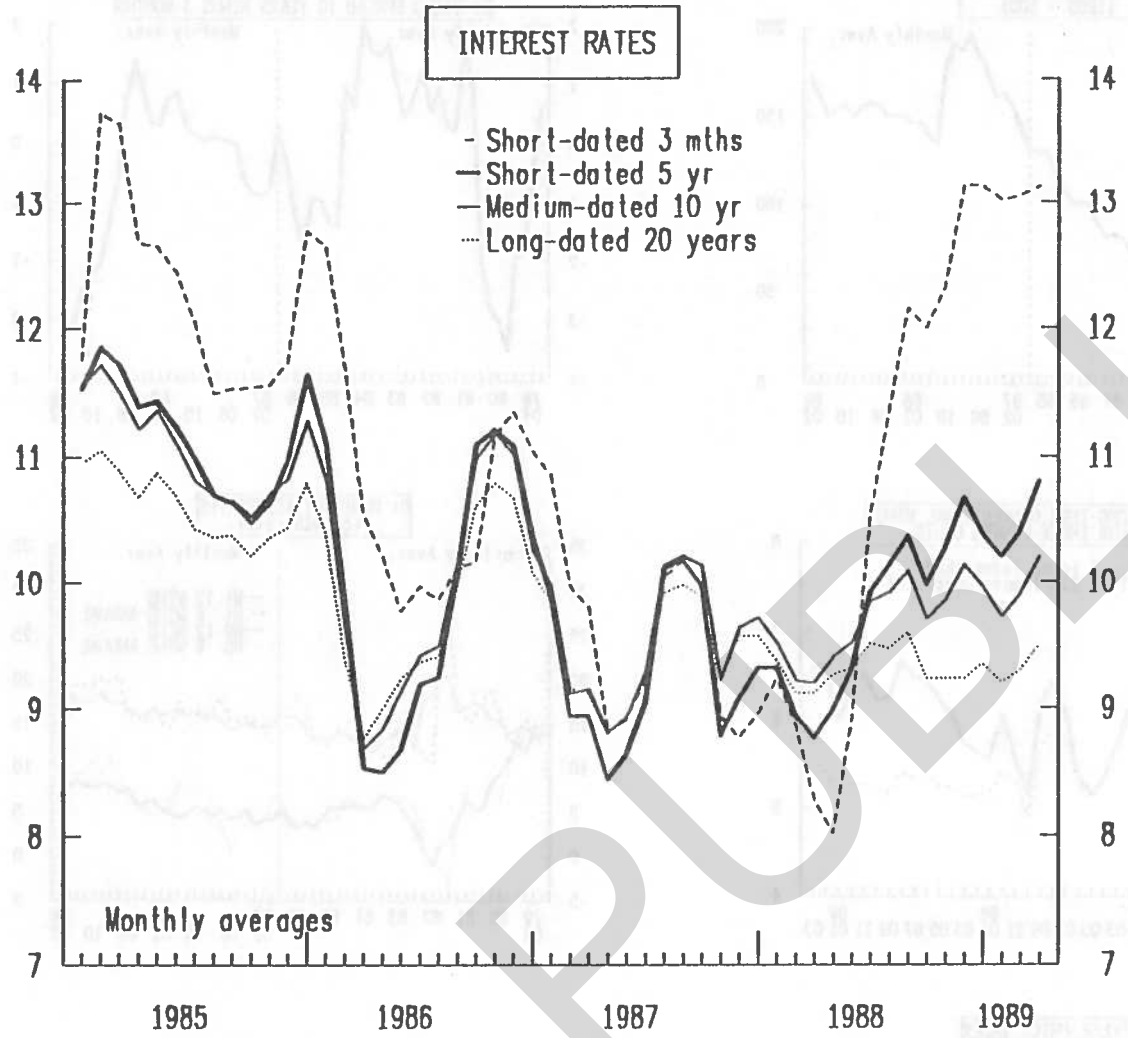
TABLE 5.4 : INTEREST RATE DEVELOPMENTS 1979-1988

	Short-dated 3 mths	Short-dated 5 yr	Medium-dated 10 yr	Long-date 20 years
70-79	9.9	10.3	11.4	11.9
80	16.6	13.8	13.9	13.8
81	13.9	14.7	14.9	14.7
82	12.2	12.8	13.1	12.9
83	10.1	11.2	11.3	10.8
84	10.0	11.3	11.3	10.7
85	12.2	11.1	11.1	10.6
86	10.9	10.0	10.1	9.9
87Q1	10.6	9.7	9.8	9.7
87Q2	9.2	8.7	9.0	9.0
87Q3	9.8	9.8	9.9	9.7
87Q4	9.2	9.3	9.7	9.6
88Q1	9.0	9.2	9.5	9.4
88Q2	8.4	9.0	9.4	9.2
88Q3	11.4	10.1	9.9	9.5
88Q4	12.5	10.3	9.9	9.3

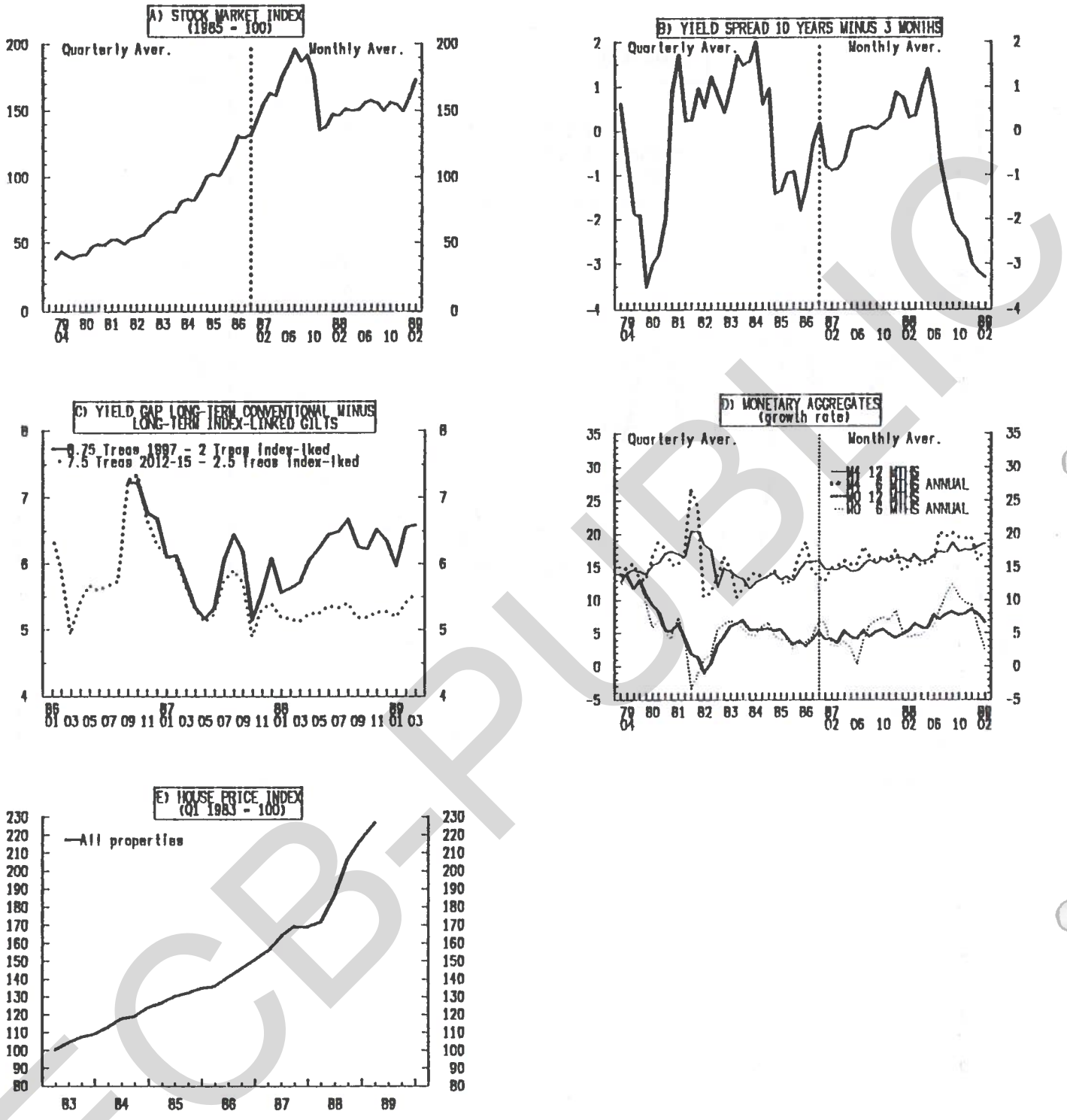
Source : Central Statistical Office and Commission Services

GRAPH 5.1



GRAPH 5.2

INDICATORS OF MONETARY CONDITIONS



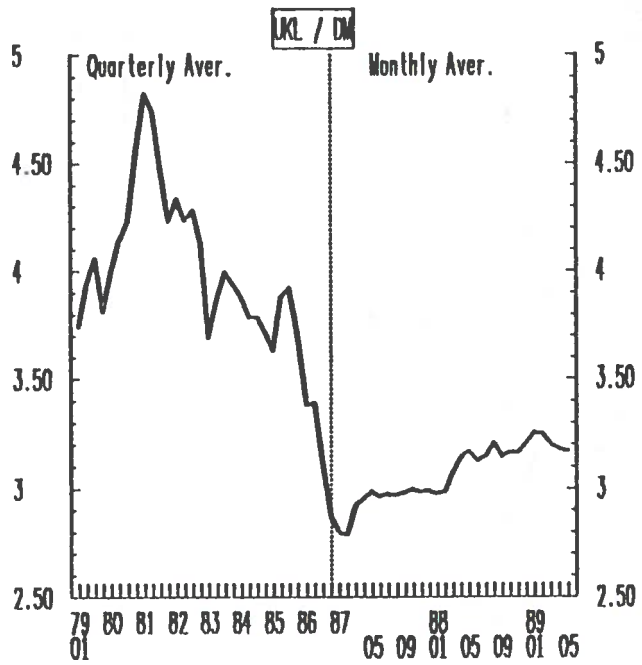
Source : Central Statistical Office and Commission Services

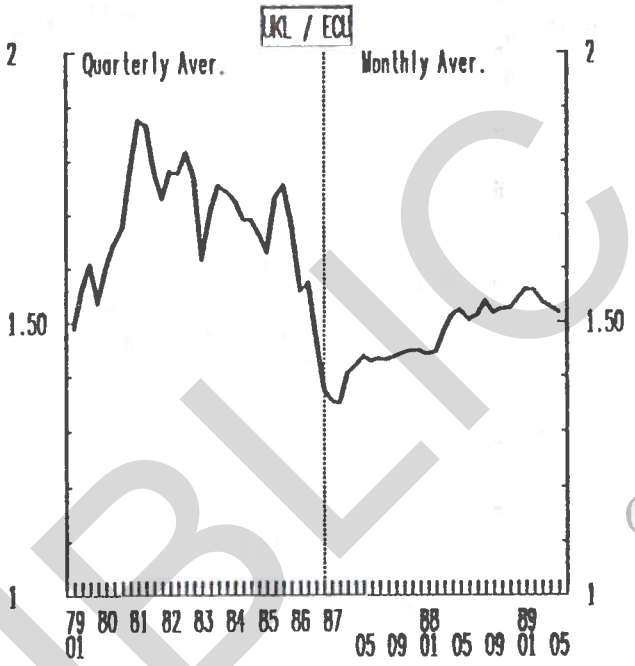
GRAPH 5.3

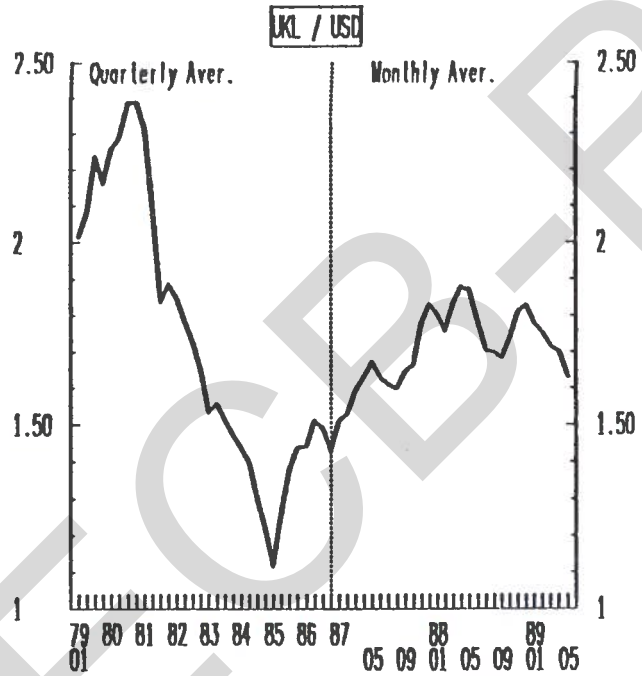
Source : Commission Services

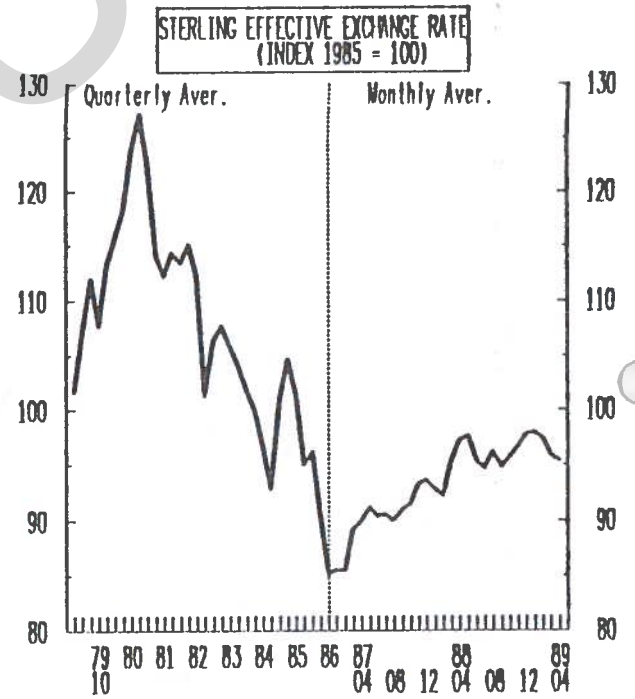
GRAPH 5.4

EXCHANGE RATE INDICATORS

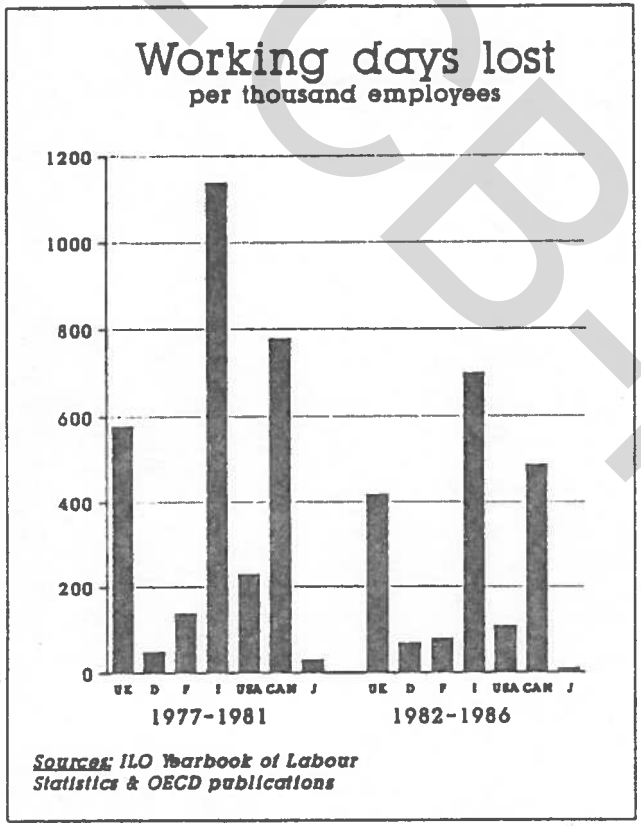








Graph 6.1



Graph 6.2