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Prime Minister

I think Brian's conclusion is broadly in line with your current thinking. The most worrying thing here is the extent of the upward revision to the Treasury's M0 forecasts (p. 3) that make a mockery of what the Chancellor

PRIME MINISTER

9 September 1988

was saying to you until very recently. While I certainly agree we should give 12% interest rates a chance, these latest M0 figures suggest to me that we should not set our faces against, say, 13% in the early autumn.

THE ECONOMY: CURRENT ASSESSMENT

RAC

(This note follows the monthly monetary assessment meeting of officials chaired by Peter Middleton). 9/9

The International Background

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This has been helpful:

- real growth in the world economy, after a rapid spurt in the second half of 1987 and first quarter of 1988 appears to be moderating (draft IMF report on the world economy suggests this);
- no sign of worldwide acceleration of inflation;
- prices of metals and agricultural raw materials levelled off in August;
- a tightening of monetary policy in most countries, except Japan, last month.

Strong Demand in the UK Economy

All the recent indicators, monetary and real, confirm an economy with an excess of demand outstripping supply. This excess demand is funded by private sector money and credit and the effects of it are (i) a rise in the rate of inflation, (ii) a growth of real output greater than that of capacity growth and (iii) a rapid deterioration in the balance of payments.

The current statistics are regrettably rather gloomy.

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Three particular points, however, are worth noting:

(a) Money GDP

The Treasury has revised money GDP growth for 1988-89 from the Budget forecast of 7½% to 10%. However recent economic statistics indicate faster growth in the first half of the year than was thought last month, suggesting that the 10% figure might be too low.

Another upward revision may be necessary.

(b) Housing Prices

House prices rose by an annual 28% to the end of July.

Until now the accepted view has been that the rise in house prices has reflected an increase in demand for houses at the expense of greater demand for goods and services. In other words the house price rise reflects a change in the relative price of houses to other assets goods and services in the economy, rather than being an indicator of more general inflation in the economy.

The Treasury's argument is that this remains the case and that the excess demand is seen in the deficit on the balance of payments.

However, the Treasury failed to forecast the extent of demand - growth hence the revisions to money GDP, the RH and the balance of payments. This suggests some concern over the likely course of inflation.

The problem we could well face is in maintaining the pound at current levels, as the general statistics on inflation and the balance of payments deteriorate. While the Bank at

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present recommend intervention from time to time, to prevent both a fall in sterling or an increase in interest rates, nevertheless if the pressure proved strong enough, they would feel forced to raise interest rates further, and if the pressure continued, then sterling would have to fall.

The RPI would then be vulnerable. Such a possibility should not be ruled out.

(c) Growth of MO

MO continues to grow at 7%. More important is the current projection of future growth. The most recent revision suggests MO growth will not come within the target range until the next financial year.

Growth in MO

% change on 1 year earlier
seasonally adjusted

	Budget Projection	Current Projection	Difference
1988			
April	5.0	6.2	1.2
May	4.8	6.2	1.4
June	5.1	7.3	2.2
July	4.1	6.9	2.8
August	3.8	7.6	3.8
September	2.9	7.6	4.7
October	2.1	7.2	5.1
November	1.9	7.0	5.1
December	1.4	6.4	5.0
1989			
January	1.9	6.2	4.3
February	2.0	6.0	4.0
March	1.9	5.4	3.5

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Chart VI shows the outturn this financial year for MO, and the difference between the budget forecast and the current forecast. The bad news is the extent of the revision: the good news is that the growth of MO is forecast to start falling from September.

Conclusion

The economy is showing all the signs of a classic explosion of demand generated by easy money and credit. The Government has taken the right action in raising interest rates. From the point of view of growth and corporate profitability there is a danger in interest rates overshooting, inducing a greater slowdown than necessary.

The need to maintain confidence must be uppermost. If investors begin to have doubts and the exchange rate is vulnerable (and with it the rate of inflation) it may be necessary for interest rates to be raised. But not without a determined attempt to maximise the benefits from a 12% rate.

Brian Griffiths

BRIAN GRIFFITHS

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Chart VI MO : 1988 BUDGET FORECAST

COMPARED WITH OUTTURN & LATEST FORECAST

12 MONTH % GROWTH (s/a)

