

EBU

RA

PRIME MINISTER

MEETING WITH ALAN WALTERS

Alan is in the country on Monday, returning to the States that same afternoon. But we thought you would find it helpful to have a chat with him and have lined this up for 3.00 pm on Monday.

You will want to have your usual stocktaking discussion with Alan on the stance and execution of policy. Points to cover might include:

i. His latest thinking on whether 12 per cent interest rates are likely to be high enough to secure downward pressure on inflation as soon as possible next year. The latest monetary figures are not encouraging:

- you have already seen the revised Treasury forecast which points to no significant deceleration in M0 growth before the end of the current financial year (Flag A);
- the latest M0 weekly return (Flag B) shows the figures still very high, although there has been some slight deceleration in the last couple of weeks;
- the first guess for M3 in September (Flag C) points to a renewed sharp growth in bank lending and a two point increase in the year on year M3 figure.

ii. Market Management. Some commentators - e.g. County NatWest (Flag D) - are starting to question whether we should be looking again at introducing over-funding. It would be interesting to know how Alan reacts to this. You will recall that he strongly supported the decision in 1985 to stop over-funding. The reasons for doing so

then were very strong; we had got into the nonsensical position where the initial contractionary impact of the over-funding was being offset in the money markets by the Bank pushing out liquidity in order to keep short-term rates steady, so generating the build up of the bill mountain.

But I think there may be a case for looking again at this in today's conditions. The Chancellor continues to protest that last year's heavy foreign exchange intervention did not loosen monetary conditions because it was fully funded. Arithmetically, he may be right. But we all know that monetary conditions have been loosened and M0 has been growing far too fast. The straightforward way to tackle this is through interest rate increases along the lines already adopted. But, given that the basic problem now is too much private sector liquidity, it is worth considering reinforcing the interest rate effect by a period of over-funding - as long as we do not get back to a position where the Bank's money market operations offset its effect and create new problems of their own.

I have not discussed any of this yet with the Treasury, as I thought you would want to take Alan's mind first.

iii. Before you see Alan again you will have made your Lord Mayor's Banquet speech. You may want a brief word with him about possible angles you could take.

Paul G.

PAUL GRAY

14 October 1988

EAMACY

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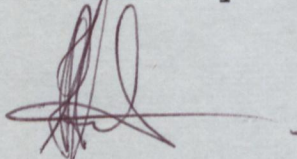
11 October 1988

P Gray Esq
10 Downing Street
London SW1

Dear Mr Gray

Sir Alan Walters has asked me to pass on, with his compliments, the September issue of our UK Financial Bulletin. In particular, he would like to draw your attention to the feature article "What Went Wrong?"

Yours sincerely



Stephen Hannah
Senior Economist

● COUNTY NATWEST

UK Financial Bulletin

September 1988

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The UK Financial Bulletin is intended primarily for sterling bond and money market clients. The key focus is therefore on events most relevant to short- and long-term interest rates.

Research is closely co-ordinated with that of County NatWest Securities/Wood Mackenzie whose economists produce related documents tailored for equity clients.

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Highlights

September 1988

- Details*
- Excessive domestic demand, which has so visibly impacted on the trade deficit, is now affecting prices. "Core" inflation is up to 5-5½% and may well edge higher. ... pp 16-17
 - The monetary base, lamentably ignored whilst the authorities played their exchange rate games, continues to accelerate. The impact of higher interest rates will take some time to work through. ... pp 12-13 & Centre Spread
 - Sterling has weakened, despite wider interest rate spreads. We continue to assume no major sterling crisis, but the downside risks have increased and should not be understated. ... pp 4-5
 - Short-term interest rates are expected to rise to 13%, the appalling trade figures necessitating a revision to our earlier 12% peak. Long gilt yields will also rise further - the bull market having to wait for the new year. ... pp 6-9
 - Recent monthly outturns suggest a substantial PSBR surplus in 1988-89, of around £9 billion. The Autumn Statement will need to continue the theme of fiscal prudence, the market's faith in sound monetary policy having been severely shaken. ... pp 14-15

WHAT WENT WRONG?

This month's special feature explores why Britain's economic "dream" has turned into a nightmare. The accusing finger is pointed at monetary policy - particularly the regrettable obsession with exchange rate targeting which diverted attention from the clear warning signals being emitted by the monetary base. Contrary to popular belief the problem has not been a shortage of monetary instruments - the Treasury is right to reject credit controls. The real difficulty has been one of misconceived implementation. The way forward is to downgrade the exchange rate as a guiding beacon and to promote M0 to its rightful place as the premier monetary indicator.

KEY FORECASTS

	1988				1989	
	Q1	Q2	Q3	Q4	H1	H2
Base rate (%)	8¾	8	11	12¼	10¾	9½
Long Gilt Yields (%)	9½	9¼	9½	9¾	9¼	9
£ index	75.4	77.6	75.9	75.9	74.1	72.6
\$/£	1.80	1.84	1.70	1.74	1.74	1.74
DM/£	3.01	3.14	3.16	3.13	3.05	2.96
Inflation (%)	3½	4¼	5½	6¼	6¼	4½
M0 (%)	6½	7¾	7½	6¾	5½	4¼
M4 (%)	16¾	16¾	19	20	17¼	14½
	1987	1988	1989			
GDP (%)	4¼	3½	2			
Current Account (£bn)	-2½	-14	-12			
	1987-88	1988-89	1989-90			
PSBR (£bn)	-3½	-9	-11¼			

Market and Policy Assessment

Runaway train: Recent economic data show Britain not to be so much a locomotive of growth, but rather a runaway train which is in danger of derailment. Consumer spending activity – and above all the appalling trade deficit for July – have underlined the excessive strength of domestic demand. For some time it had been clear that the UK was overheating, in the sense of aggregate demand growing ahead of supply potential. However, the real “surprise” in recent months has been the *scale* of the problem – which goes far beyond the markets’ earlier fears.

Although full data are not yet available, domestic demand is estimated to have been growing at around 8% in the second quarter. For 1988 as a whole, final demand growth is projected to be 6½% – faster than in 1973 (the infamous Barber boom) and probably a post-war record. With productive potential growing by, at best, 3% this spending spree is clearly unsustainable and the economic cracks are beginning to appear.

As our feature article (centre spread) argues, Britain’s current predicament is essentially a monetary phenomenon. The monetary base (MO) was giving warning signals as early as the second half of 1986. But by early 1988, interest rates had fallen to extraordinary low levels, despite monetary base growth having doubled. Effectively, the authorities were ignoring MO’s siren call, distracted by the Chancellor’s quest for exchange rate stability. The EMS shadowing experiment – which was doomed to failure from the start – played a significant role in sustaining Britain’s monetary and credit boom.

Back in 1970 Milton Friedman had neatly summarised the consequences of a monetary “shock”:

“On the average, a change in the rate of monetary growth produces a change in the rate of growth of nominal income about six to nine months later . . . [The] effect on prices comes about six to nine months after the effect on income and output, so the total delay between a change in monetary growth and a change in the rate of inflation averages something like 12-18 months. That is why it is a long road to hoe to stop an inflation that has been allowed to start. It cannot be stopped overnight.”

The Counter-Revolution in Monetary Theory
16 September 1970

Plus ça change! Following the acceleration in the monetary base in the second half of 1986, signs of overheating began to emerge – in terms of output and spending volumes – by the middle of 1987. The current account lurched into deficit, having been in broad balance in 1986, with this year’s shortfall set to be £14 billion – around 3% of GDP and broadly equivalent to the comparable US figure. The non-oil deficit in 1988 will be a post-war record, even as a % of GDP.

The inflation impact of the monetary expansion was not obvious in 1987 – but around 18 months after the MO acceleration had begun, in the early part of this year, the tell-tale signs emerged (see table below).

“Core” measures of RPI Inflation

RPI excluding . . .

		Mortgage interest payments	Mortgage interest rate, seasonal food, and Budget tax effects
1986	Sep	3.4	3.3
	Dec	3.5	3.5
1987	Mar	3.8	4.0
	Jun	3.5	4.3
	Sep	3.5	4.2
	Dec	4.0	4.5
1988	Mar	3.8	4.3
	Jun	4.7	5.2
	Latest	5.0	5.3

Sources of a slowdown: The question now facing domestic markets is no longer the simple one of “will-there-be-a-slowdown?” The answer is obvious. There *has* to be a slowdown – the economy can no longer cope with the current pace of growth. The real issue is whether the slowdown will be induced by *policy* (higher interest rates) or an *inflation* take-off (a collapse in real incomes).

The policy option offers the best chance of a “soft” landing – although it is clearly not a soft option and may well require interest rates to be nudged higher in the coming weeks. Nor is it an easy matter – history is littered with examples of actions by monetary authorities adding to market instability. Last year’s EMS shadowing experiment was one such episode. And the difficulties are not always created by mismanagement. The authorities’ recent interest rate hikes – designed to cool the economy down – resemble a blind man trying to hit a moving target. Policy judgements are based on economic data which are by nature historical, rather than current – so interest rate moves are effectively taken in the dark. To make matters worse, when the current situation does become “known” – subject to revisions, of course – the problem can turn out to be far worse than initially thought (the July trade figures being a case in point).

The “option” of an inflation take-off is hopefully one which will not be taken. Certainly it is not a scenario that is discounted in markets. Fear there is – but the current structure of interest rates, and particularly the downward slope of the yield curve, suggest that markets are interpreting the current inflation “problem” as a purely temporary phenomenon (as in 1985). Our forecasts assume this optimism is justified although there are still many doubts, which may well not be resolved until the New Year. Since a risk-averse government and investing public are also expected to share these concerns, we are likely to see higher interest rates in the weeks ahead, as prices of money market and bond instruments more closely reflect the risks now faced.

The risks ahead: In assessing the outlook for the next few months it is, of course, not all gloom. Indeed the relative calm in markets – despite some unnerving economic events – is testimony to investors’ “think positive” approach. The PSBR is set for a huge surplus – we estimate £9 billion – and the higher mortgage rates are bound to dampen consumer spending and housing investment, at some stage. Weaker oil prices, a steady exchange rate and an apparent easing of overheating pressures in the US also provide some inflation comfort.

But, on balance, we would still say the risks are on the downside and expect 13% base rates in the not too distant future. Gilt yields – which have been edging higher since the Budget – are also unlikely to have peaked. The main areas of risk, which could see inflation prospects deteriorate rather more than currently expected, are sterling and wages.

For the exchange rate, the downside risks have clearly increased following the sharp widening of Britain’s trade gap. Higher interest rate spreads have not prevented sterling from drifting down, suggesting that more bearish sentiment towards the pound now prevails. A renewed dollar freefall may yet bale Mr Lawson out – though this could hardly be regarded as good news in a wider sense. However, there is clearly a good deal resting at present on the continued confidence of the overseas investor in Mrs Thatcher’s Britain. Should that confidence be lost, then the Treasury’s war chest of reserves will certainly be needed, if interest rates are not to soar.

On the wages front, the recent stability of underlying earnings growth at 8½% has been an encouraging sign. However, beneath that calm exterior is an unhealthy rising trend in settlements. A year ago underlying earnings growth, excluding the cyclical overtime effect, was just over 7%. Now that figure is 8¼%. If the output slowdown follows normal patterns then productivity growth will falter and unit labour costs will begin to eat into margins. Sharply higher RPI inflation will also be making wage negotiators fidgetty. Whilst profit margins have plenty of room to be squeezed, this optimism on cost-push inflation is still a hope, and not yet a reality.

Sterling

- The pull of higher interest rate spreads is fading, with the huge trade gap now casting a dark shadow over sterling's future.
- The faster-than-expected dwindling of oil and invisibles surpluses has exposed the severity of Britain's trade problem.
- We continue to assume no major sterling crisis, but the downside risks have increased and should not be understated.

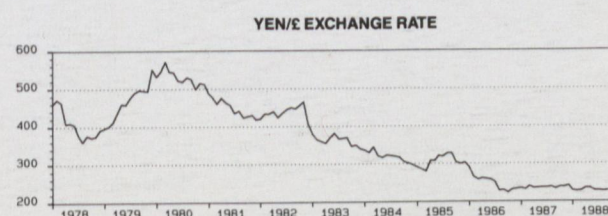
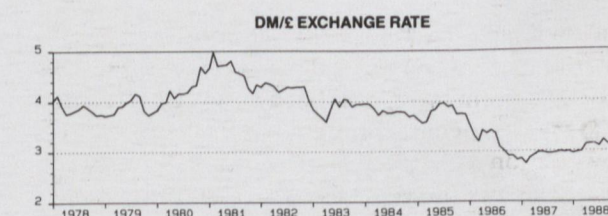
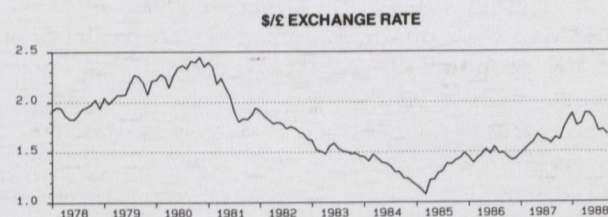
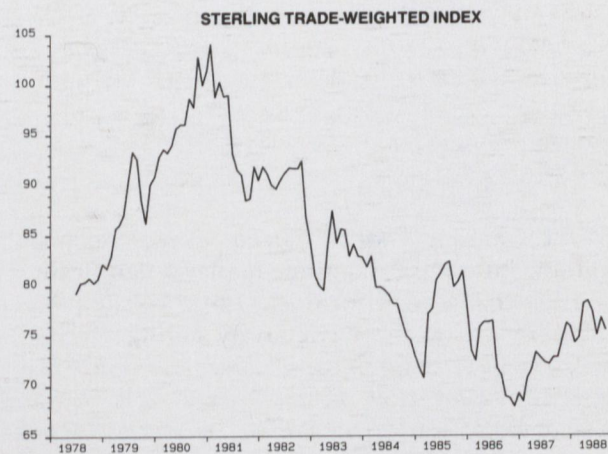
Recent trends: Sterling has had mixed fortunes over the past couple of months in the face of conflicting factors.

The sharp rise in UK interest rates has given support to the currency but working against this has been a wave of bullish sentiment for the dollar (with US interest rates also rising), and, of course, Britain's yawning trade deficit.

Latterly, central bank intervention together with rises in European interest rates has helped to dampen dollar enthusiasm. A key factor was the hike in the German discount rate (from 3% to 3½%) on 25th August coupled with a Bundesbank statement making clear the German's opposition to further mark weakness. Tentative signs of a moderate slowdown in the US economy have also dampened speculation about higher US interest rates and this has seen the dollar lose further ground.

However, it is a reflection of the more bearish sentiment for sterling that the weakness of the dollar appears to have benefited the deutschemark more significantly. This is despite the spread of UK over German money rates having widened by around 175 basis points since the beginning of August (sterling falling from DM3.21 to DM3.13 over that period). The explanation lies principally with the sharply widening UK trade gap (the record £2¼ billion deficit in July was twice as bad as expected) which threatens to erode significantly Britain's stockpile of external assets. With the non-oil deficit (as a % of GDP) now well in excess of that recorded in the mid-70's, the market is increasingly aware of the need for a sharp correction in the exchange rate in order to secure a sustainable external balance. Britain no longer has the prospect of substantial oil surpluses to bale it out – the Piper Alpha disaster and the weakness of oil prices exacerbating the situation – and the erosion of its external assets is also threatening its previously healthy invisibles surplus.

Interest rate differentials: As indicated earlier the sharp rise in UK interest rates has seen a widening of spreads against other currencies. However, whether



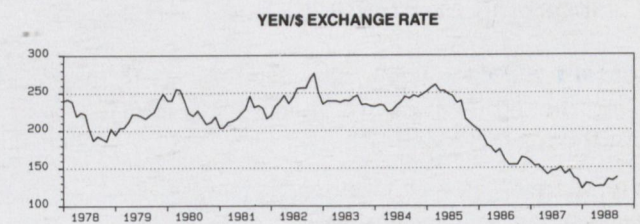
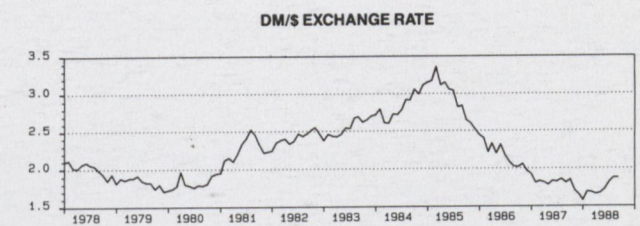
sterling will derive much protection from these more attractive differentials remains in doubt.

Against the dollar the current money market spread is just under 4%. Whilst this is certainly well above the zero spread seen earlier in the year, and above the average seen in the '80s, it does not stand out as particularly "abnormal". In earlier bear markets for the pound – notably 1985–86 the differential has been as wide as 5%. In the 1976–77 "IMF crises" the spread rose as high as 10%.

Against the deutschemark the current interest rate spread of around 7½% is towards the top end of the range seen this decade. However, similar spreads during 1985–86 were not enough to prevent a 14% depreciation in DM/£ between 1985Q2 and 1986Q1.

Current account impact: Recent events suggest that trade imbalances continue to play a significant role in exchange rate fortunes. Large UK deficits imply that foreigners are effectively adding sterling assets to their portfolios. Whilst this may be acceptable for a period of time, there is bound to be a limit to the process particularly if, as with sterling, the currency concerned is not central to international trade and financial transactions. The risks of a sharp depreciation in sterling – which add to the "required" interest rate premium over other currencies – is highlighted by recent simulation work on the National Institute model of the UK economy. To achieve a current account balance with a seven year period the model suggests that the sterling index has to depreciate by an average 5% per annum. This leads to interest rates averaging 11% over the period with inflation at 7¾%. Whilst this may well be an unduly pessimistic scenario for the future it illustrates quite starkly the seriousness of the trade position which Britain now faces.

Our own view of short-term currency prospects is that the trade-weighted index should end the year close to current levels but that a 4–5% depreciation is likely to occur through 1989. Most of this depreciation is expected to be against European currencies and the yen. Despite recent firmness, we retain our negative stance on the dollar.



Exchange rates

Period averages	DM/\$	Yen/\$	\$/£	DM/£	Yen/£	£ index
1985	2.92	237	1.30	3.78	307	78.3
1986	2.17	168	1.47	3.18	247	72.8
1987 Q1	1.84	153	1.54	2.83	236	69.9
Q2	1.81	143	1.64	2.97	234	72.7
Q3	1.84	147	1.62	2.97	238	72.7
Q4	1.70	135	1.75	2.99	238	74.9
1988 Q1	1.68	128	1.80	3.01	230	75.4
Q2	1.71	126	1.84	3.14	231	77.6
Q3	1.86	134	1.70	3.16	228	75.9
Q4	1.80	130	1.74	3.13	226	75.9
1989 H1	1.75	125	1.74	3.05	218	74.1
H2	1.70	120	1.74	2.96	209	72.6

Interest rate differentials

3 month euro-rates Period averages	US-Ger	US-Jap	UK-US	UK-Ger	UK-Jap
1985	3.0	1.8	3.8	6.8	5.6
1986	2.2	1.8	4.2	6.4	6.0
1987 Q1	2.2	2.2	4.2	6.4	6.4
Q2	3.4	3.2	2.0	5.4	5.2
Q3	3.3	2.9	2.6	5.9	5.5
Q4	3.9	3.6	1.2	5.1	4.8
1988 Q1	3.6	2.8	2.0	5.6	4.8
Q2	3.9	3.3	0.9	4.8	4.2
Q3	3.3	3.5	3.1	6.4	6.6
Q4	3.4	3.5	3.9	7.3	7.4
1989 H1	3.4	3.5	1.9	5.3	5.4
H2	3.7	3.3	1.4	5.0	4.5

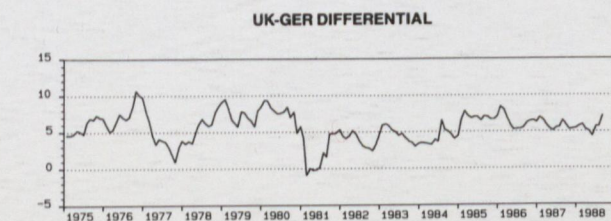
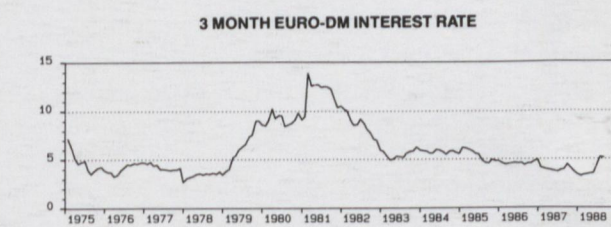
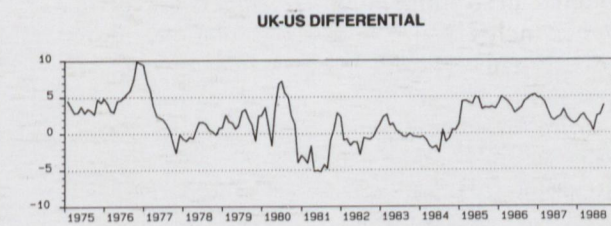
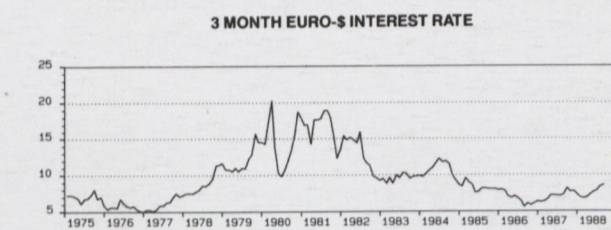
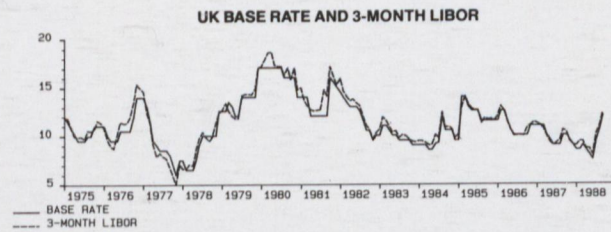
Money Rates

- Inflation pressures have turned out worse than expected, necessitating a sharp rise in interest rates.
- The interest rate peak is projected at 13%, assuming no major sterling crisis, and it may be fairly short-lived.
- The momentum of domestic demand pressures, together with higher world interest rates, will keep base rates in double figures for some time yet.

Recent trends: Domestic interest rates have continued to rise, partly in response to external pressures – the rise in world interest rates and weaker levels of sterling – but also in the face of internal inflationary pressures, notably the above-target growth of M0, strong consumer spending and the surge in imports. The sharp change in personal sector behaviour – from net saver to net dissaver – has been a key driving force behind the unsustainable surge in domestic demand. High earnings growth, substantial tax cuts and the easy availability of credit have all been responsible. But the strength of the house price boom – and its consequent impact on debt acquisition – has also played a key role. For this reason the authorities have been anxious to ensure that rises in base rates are converted into mortgage rate increases so that the impact on discretionary income is quickly and effectively felt.

Since May, base rates have risen 4½% and mortgage rates look likely to rise to 12½% or more in October having been 9¾% only a few months ago. With the dual mortgage relief deadline also having passed (early August) the stage now seems set for a housing-led slowdown. Indeed, there are tentative signs of a slump in new mortgage demand during August and a stabilisation of house prices in the South East. For this reason – and the government's natural desire to avoid stifling the welcome boom in capacity and efficiency enhancing investment – there is some official resistance to raising interest rates above 12% on domestic grounds alone. The next trigger for higher base rates – we expect the peak to be 13% – is therefore likely to be renewed downward pressure on sterling although further bad news on the domestic economy cannot be ruled out. Certainly the authorities cannot afford to stoke up further the already worrying inflationary pressures in the system by allowing a drop in the currency.

Monetary conditions: The current exchange rate-interest rate mix represents significantly tighter monetary conditions than have generally prevailed over the past 18 months. This is welcome, although the tightening has come later than it should (and

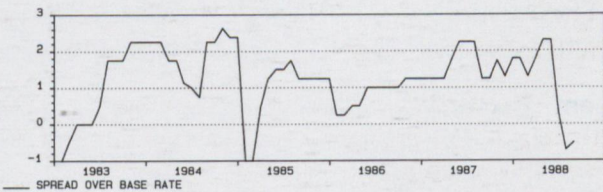
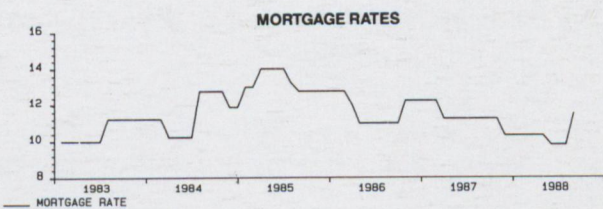


with an intermediate period of excessively loose conditions) and against the background of inflationary pressures which are proving more severe than previously realised.

Ignoring the impact of higher mortgage rates on the recorded RPI, "core" inflation is currently around 5-5½%, representing a sharp acceleration from the 4½% "norm" seen for most of 1987. When underlying inflation was last at these levels – mid-1985 – interest rates were just over 12½% and the sterling index around 79. The current policy mix is therefore not unusually tight by recent historical standards, once the inflation background is taken into account.

Clearly with the exchange rate already 4½% lower than in 1985, the authorities cannot afford to allow much of a depreciation in the short term for fear of adding to inflation expectations. Only when a slowdown in the economy has been established can the exchange rate be safely allowed to fall, helping redress the trade imbalance.

Interest rate outlook: The strength of domestic demand growth – as revealed in the sharp acceleration of imports – has taken most commentators by surprise. As a result of inflation pressures being more troublesome than expected we have raised our estimate of the interest rate peak from 12% to 13%. This assumes no major crisis of confidence in sterling. Potential triggers for further base rate increases include hikes in international interest rates and occasional market disappointments with the pace of slowdown in the UK economy. Unless inflation pressures ease off quickly, double-digit interest rates may have to persist well into 1989.



Interest rate forecasts

Period averages	Base rate	3 month interbank	3 month euros		
			\$	DM	Yen
1985	12.3	12.2	8.4	5.4	6.6
1986	10.9	11.0	6.8	4.6	5.0
1987 Q1	10.8	10.6	6.4	4.2	4.2
Q2	9.4	9.2	7.2	3.8	4.0
Q3	9.6	9.8	7.2	3.9	4.3
Q4	9.2	9.2	8.0	4.1	4.4
1988 Q1	8.8	9.0	7.0	3.4	4.2
Q2	8.1	8.4	7.5	3.6	4.2
Q3	11.1	11.5	8.4	5.1	4.9
Q4	12.2	12.5	8.6	5.2	5.1
1989 H1	10.8	10.6	8.6	5.2	5.1
H2	9.5	9.5	8.2	4.5	5.0

Monetary Conditions

	6 months ago	3 months ago	Latest
M0	4.8%	5.9%	7.0%
M4	22.5%	19.4%	20.6%
Sterling	76.8	76.2	75.9
FT All-Share Index	928	955	904
House Price Inflation	14.3%	22.0%	30.7%
Short rates	8.9%	8.4%	12.2%
Long yields	9.1%	9.3%	9.6%

Bond Yields

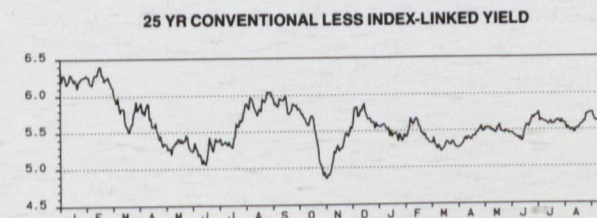
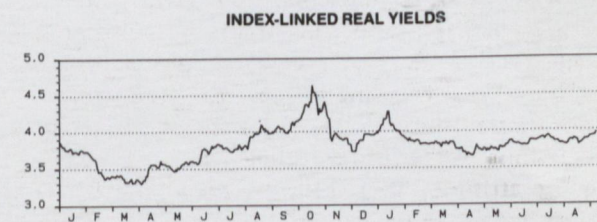
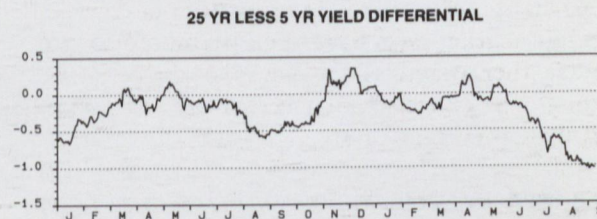
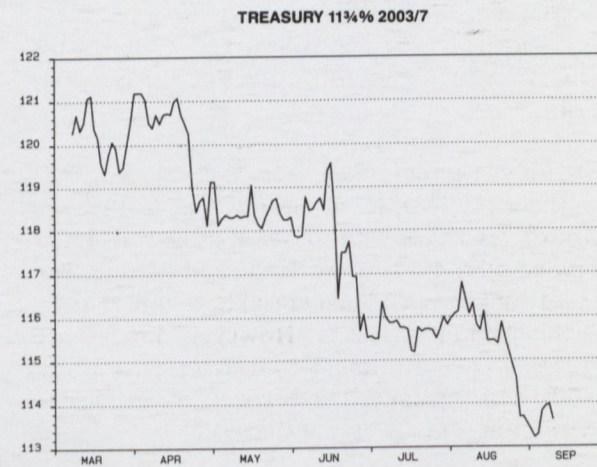
- The bear market continues and has not yet completed its course.
- Inflation worries and currency nerves have not fully reflected themselves in prices – but are expected to do so before the end of the year.
- 1989 will be the bull market when glimmers of an economic slowdown will combine with the “stock shortage” to make a powerful double-act.

Recent trends: As predicted in previous Bulletins the gilt market has finally succumbed to inflation worries with long-dated stock over 7 points down from Budget peaks. Having traded in a relatively narrow range for much of July and August the market dipped sharply towards the end of the month with the main catalyst being the appalling current account data (released 25th August) and the authorities reaction in the form of a 1 point hike in base rates.

The post-Budget bear market has had the following characteristics:

- **Long yields** have risen around 60 basis points. Meanwhile index-linked yields have risen only around 10 basis points suggesting that inflation expectations have deteriorated by around ½%. Since “core” inflation has risen by more than this since the Budget (and there can, as yet, be no assurance that it has peaked) then the market is still displaying some optimism about the future. As the chart opposite shows, the spread of long conventional over index-linked yields does not suggest that expectations have deteriorated to the degree seen at the end of 1986 (which followed a sharp dip in sterling).
- **Short yields** have risen more sharply, around 150 basis points, reflecting the pull of money market rates. However, as with longs, the sector is hardly displaying a particularly pessimistic streak. Money rates are currently 200 basis points above 5 year yields. In similar periods of monetary squeezes – early 1985 and early 1986 – the spread has generally been only 130–150 basis points.

One factor that differentiates the current period from previous bear markets – and so may be responsible for “uncharacteristic” yield relationships – is the so-called “stock shortage”. Whilst the scarcity of stock has not prevented a fall in prices it has probably avoided a more extensive rout than would otherwise have been the case.

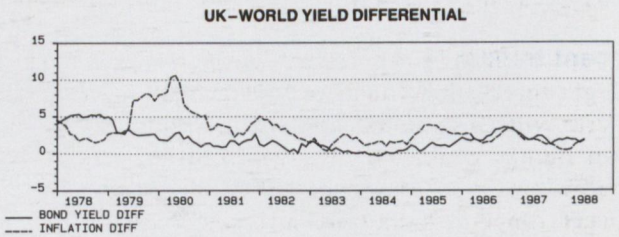
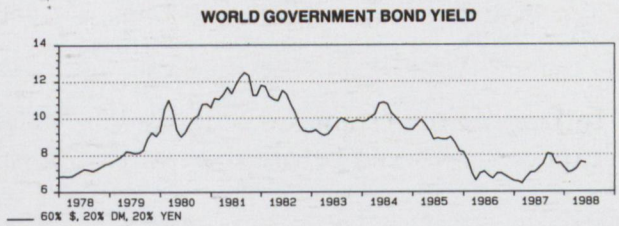


International comparisons: The US bond market saw some weakness during August with long yields rising towards 9½%. The strength of the US economy – as signalled by the labour market data released on 5th August – heightened inflation fears and this prompted the Fed to raise its discount rate from 6% to 6½% on 9th August. More recently, evidence of less tight labour market conditions together with weaker oil prices has encouraged a sharp rally in bonds, with yields falling back towards the bottom end of their 8¾%–9½% Q3 trading range. Our forecasts continue to project a bout of dollar weakness towards end 1988 so this recent strength in Treasuries is not expected to persist.

German short-term interest rates have risen sharply over the past couple of months with the key securities repurchase rate now standing at 4¼% compared with 3½% towards the end of June. The discount rate has also been raised in two ½% steps over this period, to 3½%. However, Bunds have only seen modest weakness with yields generally in a 6.7%–6.9% range. We expect little change between now and the end of the year.

Japanese bond yields have risen around ½% on the back of weakness in the yen and strong domestic growth. There has been no overt tightening of monetary conditions by the Japanese authorities although market rates have been permitted to rise. Some further weakness is projected in the near term although the expected recovery in the yen should help allay inflation worries.

Gilt-edged outlook: As noted earlier the sharp reduction in the net supply of stock has provided a cushion to the market in the face of adverse economic conditions. However, sentiment remains poor and there is particular uncertainty about sterling's outlook and the extent of inflation damage that is likely to unfold. Whilst investors have become increasingly used to “bad news”, recent trade data have far exceeded worst expectations and this has jolted their previously sanguine attitude. With 10% yields on the 03/07 bellweather already having been breached we believe that further weakness is likely in the near term – the peak in yields projected to be in the 4th quarter. Only when world interest rates have peaked and domestic inflationary conditions are more clearly under control can yields move confidently back down towards 9%.



Gilt Yields forecast

Period average, %	Long		Conventional
	Conventional*	Index-Linked	Less Index-Linked
1982–86 average	11.0	3.3	7.7
1987 Q1	9.7	3.6	6.1
Q2	9.0	3.8	5.2
Q3	9.7	4.1	5.6
Q4	9.6	4.0	5.4
1988 Q1	9.4	3.9	5.5
Q2	9.2	3.9	5.3
Q3	9.6	3.9	5.7
Q4	9.8	3.9	5.9
1989 H1	9.3	3.7	5.6
H2	9.1	3.5	5.6

*20 year par stock

International Bond Yields

10 years, annual basis, period average	US	Germany	Japan	France
1985	10.9	6.9	6.8	11.5
1986	7.9	6.0	5.5	8.8
1987 Q1	7.3	5.9	4.9	8.8
Q2	8.6	5.7	3.4	8.8
Q3	9.0	6.4	4.9	9.8
Q4	9.3	6.6	5.2	10.2
1988 Q1	8.6	6.3	4.7	9.4
Q2	9.1	6.5	4.6	9.2
Q3	9.2	6.7	5.2	9.0
Q4	9.5	6.8	5.3	9.1
1989 H1	9.0	6.6	5.1	8.9
H2	8.8	6.4	4.8	8.8

Bond Supply

- There is tentative evidence of substantial buying-in of stock during the 2nd quarter.
- The authorities have no need to issue, but may see a good case for overfunding this year.
- Eurosterling supply has been plentiful, helping to offset the gilt shortage.

"Gross" gilt sales in the second quarter were much less than we estimated suggesting that the Bank had been actively buying-in stocks with over one year to maturity. In the table opposite, gross sales are defined on the official basis – that is, net sales of stock with over one year to maturity. In other words, the "buying-in" column (the only buying-in data made available by the Bank) only covers official purchases of stock within a year of maturity. Since actual gross issues (including receipts of calls already secured) were around £1¼ billion in the second quarter, the Bank's data suggests that around £¾ billion of buying-in of one year plus maturities took place.

The low level of "gross" sales in the second quarter led to net redemptions of £1.4 billion – the sharpest contraction in the market seen in modern times. In July and August estimated net redemptions have been £1¼ billion. An auction of short-dated stock – £¾ billion of 8½% 1994 – took place on 10th August and was relatively well received.

For the financial year as a whole we now estimate that the gilt market would contract by a net £8½ billion if the authorities stuck rigidly to their full fund policy. This assumes intervention activity remains modest, that the National Savings programme maintains its recent pace, and that the monetary sector and building societies are net buyers of gilts in the second half of the financial year. However, the recent strength of monetary growth – which is likely to be maintained if the yield curve remains sharply inverse – might encourage the authorities to overfund this year (the funding rule does not constrain the Bank to achieve a neutral fund within a given financial year).

Helping to offset the shortage of gilt-edged supply was a further spate of eurosterling and other fixed interest sterling debt in the second quarter. Gross issues of non-gilt sterling fixed income debt have amounted to £7½ billion in the 1st half of 1988, which compares to only £3½ billion in the previous six months. In July and August eurosterling issues have fallen back sharply, as interest rates have risen and sterling has looked less secure on the foreign exchanges.

Gilt-edged Sales

£bn	Gross Sales†	Redemptions	Buying-in*	Net sales
1985-86	11.7	-4.0	-2.5	5.7
1986-87	14.7	-5.8	-3.0	6.1
1987-88	13.5	-5.5	-1.0	7.1
1987 1	2.7	-2.2	-1.1	-0.8
2	4.0	-2.1	-0.5	1.5
3	2.6	-1.0	-0.2	1.4
4	3.8	-1.1	-0.2	2.5
1988 1	3.1	-1.3	-0.1	1.7
2	0.9	-1.8	-0.4	-1.4

† Includes some buying-in. * Up to one year only.

Gilt-Edged Funding Arithmetic

£bn	1987-88	1988-89	1989-90
PSBR	-3.5	-8.9	-10.2
+ Redemptions/buying-in	6.5	9.5	11.5
+ Debt sales to monetary sector*	-0.4	0.5	1.1
- Intervention	11.8	1.0	0.0
- National Savings	-2.0	-1.6	-1.4
- Other public sector debt	1.0	0.5	0.0
= Required gross gilts	13.4	1.0	1.0

*Including building societies after '87-88.

Gilt-Edged Funding Projections

£bn	Gross	Net
1984-85	15.3	10.2
1985-86	11.7	5.7
1986-87	14.7	6.1
1987-88	13.5	7.1
1988-89	1	-8.5
1989-90	1	-10.5

Non-gilt sterling debt*

Gross issues, fixed rate £bn	Domestic			Eurobonds			Total
	Domestic	Eurobonds	Total	Domestic	Eurobonds	Total	
1987 Q1	0.2	3.2	3.4				
Q2	1.1	2.4	3.5				
Q3	0.5	1.1	1.6				
Q4	0.5	1.2	1.7				
1988 Q1	0.4	3.2	3.6				
Q2	0.8	2.9	3.7				

*Including equity-related.

What Went Wrong?

Inflation looks set to top 6½% at the turn of the year, the current account has lurched into massive deficit, interest rates have soared and may go higher. Britain's macro scene, which only a few months ago the Chancellor paraded as a checklist of success, is now described by many as a disaster area.

For several years the government has prided itself on its commitment to defeat inflation and its promotion of steady growth. The old "stop-go" cycle was supposedly dead. And yet now it is clear that an almighty "go" was already in full motion last year and that it is having to be followed by an abrupt "stop". What went wrong?

Fiscal policy is unlikely to have been the main source of the problem. Certainly the tax cuts made were excessive, as we argued at Budget time. But these merely exacerbated an overheating problem that was already there. In all other respects fiscal policy has been impressively tight.

Rather it is in the conduct of monetary policy where an explanation can be found. After all, inflation is a monetary phenomenon. Our basic theme throughout the following analysis is the importance of the monetary base, and its superiority over the exchange rate as a monetary indicator. The shadowing of the EMS in 1987-88 is argued to have been a misguided monetary experiment – diverting the authorities, particularly in the latter stages, from the clear warning signals being emitted by the monetary base. A policy which had taken the M0 target more seriously might have helped better contain the overheating problem and avoid the sharp volatility of interest rates in recent months.

Monetary basics: Before assessing recent events it is worth going back to basics. The box insert overleaf illustrates the key monetary identities in an open economy such as Britain's. A simple balance sheet approach is taken – but, whilst many rough edges are smoothed, the essential ingredients are all there. The key points to digest are:

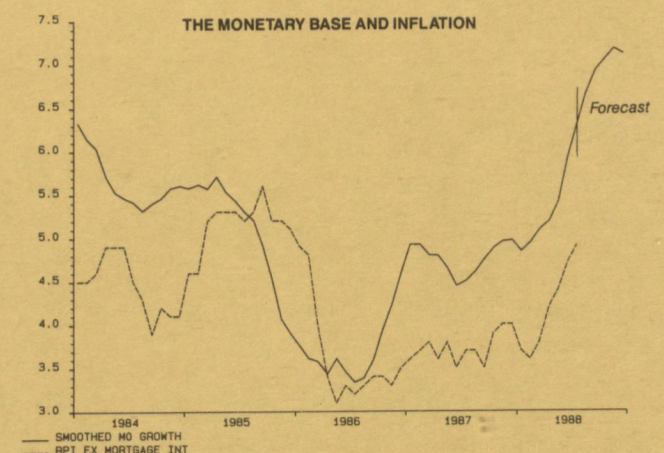
- The **monetary base** (M0) is as valid a starting point for assessing monetary conditions as overall money supply (M). Indeed, in practice, the monetary base is superior since it bears a closer and more predictable relationship with inflation than broad money.
- **Intervention**, such as the heavy dollar purchases made in 1987-88, adds to monetary growth unless the impact is "sterilised" by additional sales of gilts. Capping sterling can therefore add to inflation pressures if the monetary base effects are ignored.

- **Overfunding**, and thus an engineered rise in long yields, has a role to play in dampening monetary growth and reducing inflationary pressures. Since Autumn 1985, the authorities have rejected this open market operations approach to monetary control.

- A **fiscal surplus** only helps cool monetary and inflation pressures if the opportunity is taken to scale down the central bank's balance sheet (ie control the monetary base) rather than to concentrate efforts, as seems to be the case at present, on retiring the National Debt. Again, therefore, it makes sense to focus on monetary base trends for purposes of assessing inflationary conditions.

Assessing monetary conditions: Our balance sheet analysis confirms M0's central role, in theory, in assessing monetary conditions. This proposition can also be given strong empirical substance. The details appeared in our June Bulletin, "The Monetary Base and Inflation", but the main conclusions are worth recapping here.

- There is a stable, and statistically significant link, between the monetary base, money GDP and inflation. The correlation between current M0 growth and inflation 6 months to a year later is around 75%. The chart below illustrates the lead-lag relationship between the monetary base and prices in the current inflationary cycle.



- M0 is far superior to the exchange rate as a monetary indicator. Analysing data from 1973 Q3-1987 Q4 shows that the monetary base is a statistically significant predictor of inflation whereas the exchange rate is not. This evidence is rather damning for the pro-EMS lobby and helps explain why the experimental shadowing of the D-mark in 1987-88 proved such a failure in inflation control.

Monetary Balance Sheet

Assets		Liabilities		
Central Bank	FX Reserves Lending	R C1	Monetary Base (BB+NC)	M0
Commercial Banks	Bankers' balances Lending	BB C2	Deposits	D
Consolidated Balance Sheet	FX Reserves Lending (C1+C2)	R C	Notes and Coin (M0-BB) Deposits	NC D
Total=Money Supply M		Total=Money Supply M		
M=R+C=NC+D				

Central Bank holds foreign exchange reserves (R) as assets together with a collection of securities issued by the government and private sector (C1). The latter can be thought of as central bank lending where the IOU's held would include gilts, commercial bills, etc. The matching liability is the monetary base (M0) which comprises bankers' balances (BB - see below) and cash in circulation with the public (NC).

Commercial Banks hold reserve assets at the central bank (BB) and these, of course, will form part of the monetary base liabilities (M0) of the central bank. In addition, the commercial banks make loans to the private sector (C2). The matching liability comprises the deposits placed with the banks by the private sector.

Consolidated balance sheet. Since bankers' balances with the central bank (BB) are both an asset and a liability for the combined monetary sector then BB does not appear explicitly in the consolidated balance sheet. However, cash in circulation (NC) does, since this represents a liability of the combined monetary sector to the non-bank public.

Key monetary identity. Focusing on the liabilities side of the consolidated balance sheet provides the familiar monetary identity $M = NC + D$ (ie money supply = cash + deposits). However, the other key identity to highlight is given by the aggregate of matching assets. This shows that $M = R + C$ (ie money supply = foreign exchange reserves + domestic credit). An implication is that, other things being equal, intervention purchases of currencies will add to monetary growth. "Sterilised" intervention is where a change in R is matched by an opposite change in C1.

Credit growth and Gilt-edged funding. The central bank can control domestic credit (C) in our simplified example by adjusting their funding programme. If the central bank sells large amounts of gilts from its portfolio then C1 falls. Commercial banks also find that deposits (D) are falling as the

public writes cheques to the central bank to purchase additional gilts. This forces the banks to reduce their lending activities since their reserves at the central bank (BB) cannot be run down below prudential requirements. In our schematic balance sheet, therefore, both C1 and C2 (and thus domestic credit, C) falls back.

Overfunding and the bill mountain. The balance sheet analysis implies that overfunding (issuing gilts and other government securities in excess of the PSBR) would be appropriate in a period of excess monetary growth. The basic economic process at work is that the subsequent rise in long term interest rates dampens activity by (a) signalling to the consumer that rises in short rates are not a purely temporary affair (b) encourages the private sector to switch from money to bonds, by flattening the yield curve (from its typical inverse sloping shape) (c) squeezes commercial bank deposits, and hence the system's ability to supply credit.

In previous episodes of overfunding (which was abandoned by the Chancellor in 1985) the authorities were not prepared to accept the necessary rise in short-term interest rates. So overfunding went alongside a sharp rise in the bill mountain which, in our schematic framework, meant that central bank lending (C1) did not fall (sales of gilts were offset by purchases of commercial bills). For overfunding to be effective commercial bank reserves have to be squeezed. If the government subsidise credit by keeping bill rates down then the monetary impact of higher long term yields is lost.

Fiscal Policy and the National Debt. The government's balance sheet identity implies that the fiscal deficit or surplus will be financed either by money or bonds. Specifically, the government is currently running a fiscal surplus which can be used either to dampen growth in the monetary base or to retire government debt (gilts), or a combination of the two (for simplicity, we ignore the impact of equity finance, ie privatisation). Of course, at present, the government is largely intent on securing a reduction in the national debt and hence foregoing the opportunity of dampening monetary growth and thus inflationary pressure. By retiring the national debt the authorities are also reducing the future stream of interest payments, and thus signalling to the private sector the prospect of further reduction in taxes. In other words, government spending is being financed rather more by the inflation tax (monetary growth), and less by conventional taxes, than is appropriate.

- M0 growth much above 3½ % should be taken as a warning signal of inflation problems ahead (assuming that trend inflation above 4% is regarded as a "problem"). The well known "quantity equation" is $MV = PY$ where velocity (V) is defined as money GDP (PY, price times output) divided by money, M. The sustainable trend in output (Y) is at best 3%, and velocity (V) grows by an average 4¼ %. Taking into account "normal" variations around the velocity trend suggests that - given an inflation objective of 4% - monetary base growth of much more than 3½ % should ring alarm bells.

The table below shows what has actually happened to cash circulation over the past couple of years, and the authorities' interest rate response. As is clear from the table, the monetary base was signalling inflationary pressures as early as the second half of 1986. Yet, with the exception of temporary "blips", the authorities responded inadequately to the warning signs and interest rates fell by 4% over the period against the background of a doubling in monetary base growth.

Monetary Base and Interest Rates

End Period	Notes and Coins 12 mth %, sa	Base rate
1986 Q1	3.4	11.5
Q2	3.3	10.0
Q3	4.4	10.0
Q4	5.2	11.0
1987 Q1	3.8	10.0
Q2	4.6	9.0
Q3	5.1	10.0
Q4	4.8	8.5
1988 Q1	6.4	8.5
Q2	7.1	7.5

The October equity crash was, of course, one reason why the 1987 Q3 rise in interest rates was quickly reversed. However, by early 1988 it was becoming clear from the M0 data that monetary conditions remained excessively loose. Despite this, interest rates were cut further reaching an extraordinary low 7½ % in May of this year.

The key reason M0 was effectively ignored was, of course, the authorities obsession with exchange rate stability. This misguided experiment in monetary policy, with the "underlying" strength in the currency giving the authorities a false sense of security, lies at the heart of the UK's current predicament.

The exchange rate muddle: Spring 1987 marked a key watershed in monetary policy when the Chancellor embarked on his policy of shadowing the Deutschemark. Hitherto, exchange rate policy

had effectively been a free float. Several factors were behind the U-turn:

- The old-style MTFs, based on broad money targeting and devised by Lawson in his Financial Secretary days, was in disarray. Financial innovations had made a nonsense of M3 as an inflation signalling device.
- The Chancellor's pro-EMS stance made good political sense, as an approach which clearly distanced him from the Prime Minister. It was a calculated gamble, in anticipation of a post-Thatcher world.
- In international circles, currency fixing was fashionable. The sharp drop in the dollar in 1985 and 1986 was thought by the G5 authorities to have gone far enough. The Louvre Accord was agreed in early 1987 and gave an air of "respectability" to Mr Lawson's personal mission.

During the first half of 1987 sterling came into heavy demand - the general election undoubtedly contributing to speculative pressures. However, instead of dampening such pressures at an early stage by allowing the exchange rate to jump - thus inducing expectations of a future depreciation and discouraging further capital inflows - the authorities tried to avoid the inevitable by intervening heavily. Over \$20 billion of spot currency purchases were undertaken in 1987, with an untold amount of forward intervention on top. Since the monetary base continued to accelerate it suggested that full "sterilisation" was not taking place (see the box insert for details).

These delaying intervention tactics simply added to speculative buying of the currency. Domestic inflation pressures were building up and it was clear that a Thatcher government, committed to price stability, would eventually have to remove the "cap". In the event, the speculators won their "bet" against the central bank and the ceiling was removed at the Prime Minister's insistence, just before the Budget.

Following the Lawson-Thatcher "row", sterling surged as pent-up demand scrambled to take advantage of a short-term one way bet. However, even after this political "catharsis", monetary errors were still committed - the desire for exchange rate stability still clouding the authorities' monetary judgement. Despite clear evidence at Budget time of an overheating economy - exacerbated by the granting of excessive tax cuts - interest rates continued to be cut, reaching a low of 7½ %. The monetary base was accelerating throughout this period but this was effectively ignored as the exchange rate continued to hog the policy limelight.

That the exchange rate was giving the wrong message about monetary conditions in 1987-88 is now obvious. The upward pressure on sterling was clearly not because of excessively tight monetary conditions. Rather, monetary conditions were actually getting looser and the heavy speculative capital inflows were simply the counterpart of a burgeoning current account deficit. By intervening to peg the currency, the authorities made matters worse since the resultant expansion in the central bank's assets helped sustain the acceleration in the monetary base. The myth that linking sterling with the D-mark would see a straight-line and trouble free convergence of British and German inflation rates has now been well and truly blown.

Policy implications: Our analysis shows that the adoption of an exchange rate target in 1987 was misguided and diverted attention from the clear warning signals being emitted by the monetary base. As such the DM "peg" experiment failed and contributed to the current upturn in inflation. If the M0 message had been heeded at an earlier stage then the severity of the economic problems now faced could have been much reduced.

The recent rise in interest rates to 12% is in belated recognition of overheating pressures. However, the momentum of excess demand has been allowed to get dangerously strong and it will be some time before a sufficiently strong slowdown becomes

evident. Our forecasts suggest that double-digit base rates into summer 1989 should help secure M0 growth of around 4-4½% in the second half of next year. This is a move in the right direction although, as we argued earlier, 3½% growth would be a more comfortable level to live with. Certainly if retail spending does not ease off soon - and unfortunately there is no confirmation of that yet - then interest rates could well have to edge up higher still.

There has been much debate recently about whether there is excessive reliance on interest rates as a policy tool. There is something in this - we would argue, for instance, that overfunding might be re-examined as a means of controlling monetary growth (see box insert). However, the Treasury is certainly right to reject credit controls as an ineffective means of tackling the problem. What the analysis above implies is that the problem has not been a lack of indicators and instruments, but rather a period of misconceived implementation of monetary policy.

The experience of the last 18 months shows that the exchange rate should be downgraded as a guiding beacon and that M0 should be promoted to its rightful place as the premier monetary indicator. The recent sharp rise in interest rates - in apparent disregard for the DM/£ exchange rate - is an encouraging sign that the Chancellor is at last being persuaded of this view.

Bond Demand

- Domestic funds have shown greater willingness to shed long-dated stock.
- The monetary sector has trimmed its gilt portfolio, partly reflecting the bear market in shorts.
- Building societies continue to replenish their holdings reversing the trend set in the past couple of years.
- Overseas buyers were still in evidence in July but have latterly become more cautious.

With the exception of revisions to earlier data, little new information has emerged on the pattern of gilt demand.

The April-June quarter was marked by heavy redemptions so it is not surprising to see the monetary sector having run down its gilt portfolio by around £1½ billion. Nevertheless, little effort appears to have been taken to replenish holdings since then, reflecting the bear trend in short gilts since the Spring.

The building societies - major players in the short gilt market - appear to have reversed their earlier pattern of net selling, established over the past couple of years. In the 4 months to July the societies have made net purchases of £0.6 billion, despite the uptrend in yields. However, this still leaves the share of gilts in the societies' asset portfolio at a relatively low 6%. In 1983 the share stood at 12%, with the sharp fall since then largely reflecting less favourable tax treatment.

Overseas purchases of gilts have picked up since the first quarter although the buying rate remains well below the levels seen around the time of last year's election. The latest full money figures show that foreigners bought just over £¼ billion of gilts in July, against the background of relatively weaker US Treasury and Bund markets.

In the latter part of August - particularly following the UK trade figures - domestic institutions have shown greater readiness to sell long-dated stock. Against the background of currency fragility and heightened inflation worries the "scarcity" of supply has attracted a much smaller premium than hitherto. With little evidence of substantial buying-in by the authorities in the 3rd quarter, prices have subsequently had to fall in order for the stock to be willingly held.

Domestic Institutions' Cash Flow

£bn	1987				1988
	Q1	Q2	Q3	Q4	Q1
Pension Funds	2.8	2.6	2.2	2.4	2.3
Life Assurance	2.5	2.7	3.5	2.5	3.2
General Insurance	0.5	0.6	0.5	0.5	0.3
Investment and Unit Trusts*	1.0	0.3	1.9	0.4	-0.1
Total	6.7	6.2	8.1	5.8	5.7

*Net of other institutional investment.

Domestic Institutions' Quarterly Investment Patterns

£bn	1987				1988
	Q1	Q2	Q3	Q4	Q1
Gilts	-0.1	-0.5	-0.1	1.1	2.4
UK Equities/debentures	2.0	5.6	5.4	4.7	1.6
Overseas securities	2.6	0.6	0.8	-5.3	0.0
Property	0.0	0.1	0.1	0.7	0.2
Liquid assets	3.2	1.1	0.9	4.2	0.3
Other	-1.0	-0.7	1.0	0.4	1.2
Total	6.7	6.2	8.1	5.8	5.7

Analysis of Gilt Purchases

£bn	Monetary Sector	Non-bank domestic				Personal sector	Overseas sales	Total net
		LAPFs	Other financial	Companies	Other			
1983	0.2	5.3	1.7	0.4	0.9	0.9	9.5	
1984	0.2	5.5	0.8	-0.1	1.2	1.0	8.6	
1985	0.3	4.7	0.4	-0.4	1.7	2.9	9.6	
1986	1.3	2.1	-0.6	-0.2	-2.1	2.1	6.9	
1987	-0.9	-0.9	0.0	-0.4	1.4	5.4	4.6	
1987 1	0.2	-0.4	-0.7	-0.3	-0.2	0.7	-0.8	
2	-1.3	-0.8	0.4	-0.1	1.6	1.8	1.5	
3	0.2	-0.3	0.4	0.0	-1.3	2.4	1.4	
4	0.0	0.6	0.0	0.1	1.3	0.5	2.5	
1988 1	0.8	2.5	-0.3	-0.2	-1.4	0.3	1.7	

Monetary Aggregates

- The monetary base is still accelerating, but NIBM1 holds out some hope for the future.
- A slowdown in M0 will eventually come through. But higher interest rates take time to work and are battling against the strong wave of excess demand unleashed over the past year.
- Higher interest rates are likely to maintain the attractiveness of interest-bearing money and hence the growth of M4. Credit demand will show few signs of slowing down in the near term.

Narrow money: The underlying growth of the monetary base has continued to rise in recent months, despite sharply higher interest rates. Whilst our research confirms that higher interest rates will eventually dampen M0 growth, the short-term path is dominated by the acceleration in prices and the continued strength of retail spending.

The latest official data – for July – showed a deceleration in M0 growth from 7.7% to 7.0%. However, this was entirely explained by erratic movements in bankers' balances. The underlying trend – as measured by seasonally adjusted notes and coin – actually deteriorated with growth picking up from 7.1% in June to 7.3% in July.

The initial indications for August are disappointing. The underlying cash base continues to accelerate and the recorded figures are likely to register another 7.7% increase in M0, despite relatively low bankers' balances. Given the Chancellor's commitment to bringing the aggregate back within its 1%–5% target range (consistent with keeping trend inflation centred at around 4–4½%) then the August data are likely to maintain a degree of interest rate nervousness.

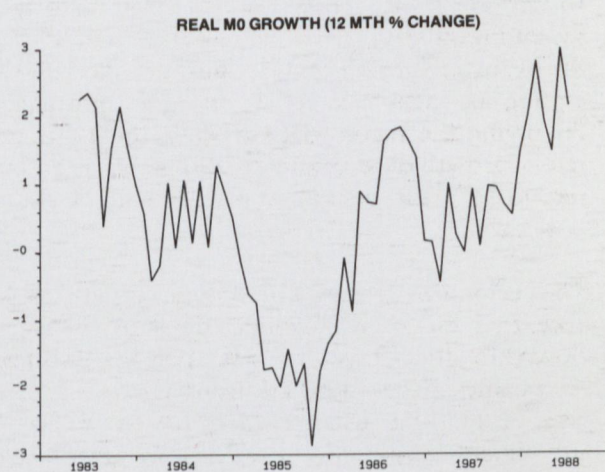
Looking further ahead the persistence of double-digit interest rates into 1989 is expected to see a deceleration in M0. The year-on-year growth figures should be back within their target range in the second half of next year, with the 6-month annualised measure of M0 below 5% by Spring 1989.

Non-interest bearing M1 is giving a slightly more encouraging message with the 12-month growth rate down to 10¾% from a 15¼% peak in March. The 3-month annualised measure is growing by only 7¾% and, if this deceleration persists, should help allay fears of excess liquidity feeding through into inflation.

Broad money: M4 growth accelerated further in July with the year-on-year rise now 17½% compared with a 12%–14% "norm" for most of the 1980s. The boost to this wide liquidity measure came despite a £3½ billion overfund in the year to

Narrow Money

End period	Notes and Coin	M0	NIBM1
12 mth % change			
1987 Q1	3.2	3.5	10.2
Q2	4.6	4.2	13.3
Q3	5.3	5.2	5.5
Q4	4.7	4.2	10.2
1988 Q1	6.9	6.4	15.2
Q2	7.5	7.7	10.7
May	6.0	5.7	13.4
Jun	7.5	7.7	10.7
Jul	7.5	7.0	10.7



Broad Money

End period	M2	M3	M4
12 mth % change			
1987 Q1	12.2	18.9	13.9
Q2	12.0	19.3	13.9
Q3	10.0	19.7	15.0
Q4	10.5	22.9	16.3
1988 Q1	13.5	20.9	16.8
Q2	15.0	20.2	16.8
May	13.8	18.6	16.1
Jun	15.0	20.2	16.8
Jul	15.7	20.6	17.4

July, with the record increase in credit the main driving force. The 3-month annualised increase in M4 was 21½% on a seasonally adjusted basis with high money rates (particularly when compared with gilt yields) likely to see strong growth in interest-bearing liquidity being maintained.

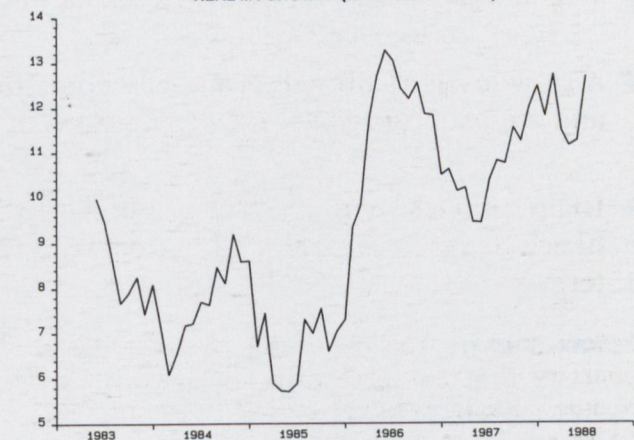
Both June and July have seen sharp rises in retail and wholesale interest-bearing deposits with banks. This is partly explained by the rise in interest rates and is a counterpart to the observed deceleration in NIBM1. However, the sharp rise in wholesale deposits may also be partly reflecting the continued preference for liquidity by life insurance and pension funds.

The deceleration in non-interest bearing bank deposits has not coincided with a slowdown in overall personal sector liquidity. M2 – the widest measure of the transactions demand for money – is now growing at 15¾% having been around 10% last Autumn. Over the past 3 months liquidity has expanded at an annualised 21½%, partly reflecting the impact of tax rebates and the personal sector's preference for cash over equities in the wake of last October's crash.

Credit growth: M4 lending has picked up sharply in recent months, partly swelled by takeover bids and the distorting impact of the August deadline for the ending of dual tax relief on new mortgages. Following the record data for July, the 12-month rate of growth of bank and building society lending rose to 23½% – compared with 19% at the end of last year.

The sectoral analyses of borrowing suggest that the recent acceleration in credit demand is largely down to the corporate and personal sectors. Companies have switched from equity to bank finance in order to carry forward the boom in investment spending (particularly in manufacturing). The housing bubble has also seen a sharp increase in lending to property companies and the construction industry. In the personal sector, mortgage lending has continued to accelerate with the building societies having won back some of their earlier losses in market share.

REAL M4 GROWTH (12 MTH % CHANGE)



Credit Growth

End period	Bank Lending	Bank & Building Society Lending
12 mth % change		
1987 Q1	20.7	19.1
Q2	21.6	19.3
Q3	23.6	20.1
Q4	22.8	19.0
1988 Q1	25.2	20.8
Q2	27.8	23.0
May	27.0	22.3
Jun	27.8	23.0
Jul	27.9	23.6

Money Forecasts

End period	M0	M4
12 mth % change		
1987 Q1	3.5	13.9
Q2	4.2	13.9
Q3	5.2	15.0
Q4	4.2	16.3
1988 Q1	6.4	16.8
Q2	7.7	16.8
Q3	7.5	19.0
Q4	6.8	20.1
1989 H1	5.6	17.2
H2	4.2	14.5

Fiscal Trends

- This year's debt repayment is expected to be £9 billion, well in excess of the Treasury's Budget forecast of £3¼ billion.
- Revenue growth is running well ahead of Budget projections – testimony to the strength of the economy – with non-oil taxes up 15% on a year ago.
- Expenditure remains subdued and asset sales are likely to overshoot the £5 billion target.

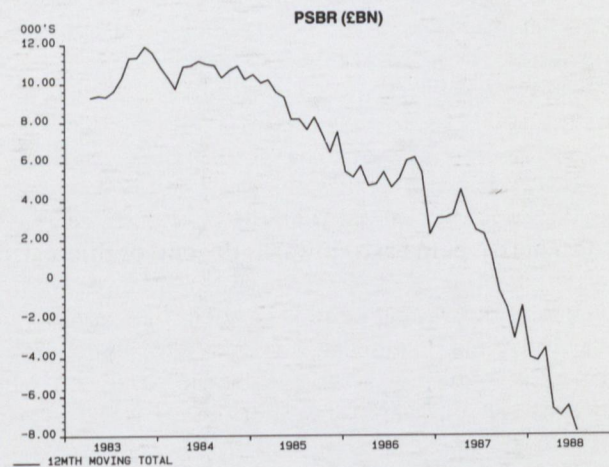
Recent signals: Recent PSBR outturns have continued to emerge better than expected. Excluding asset sales, the cumulative PSBR so far this financial year is a surplus of around £400 million compared with a £4.0 billion deficit at the same stage in 1987-88. The comparison with last year improved sharply in July despite the substantial tax rebates paid over.

Central government spending (slightly wider in coverage than supply expenditure alone) has remained remarkably subdued with cumulative expenditure up only 1½% on a year ago; a reduction in real terms. Whilst some acceleration is expected in the second half of the year the overall 1988-89 outturn is expected to be only 3% – slightly down on last year's 4%. The main items of spending which have been showing below-trend growth in recent quarters are debt interest payments and subsidies.

Even with the income tax rebates now having been paid – the Treasury appear confident that their impact is now fully reflected in the PSBR data – central government revenues are showing substantial growth on a year ago. In the 4 months to July, non-oil revenues are up 15% on a year ago – compared with Budget estimates of around 5½%. Income taxes appear to be running well ahead of Budget projections and expenditure taxes are up a cumulative 10½% so far this year (the Treasury projected growth of only 7%). Although only very limited information is available at this stage, corporation tax appears, if anything, to be running below Budget projections.

Local authority borrowing began the financial year well ahead of expectations. However, the latest figures have seen a substantial improvement – testimony to the notorious volatility of the monthly data. Using official seasonal adjustments, the LABR in the 4 months to July is around £400 million which compares with the Treasury's projections of around £1½ billion for the year as a whole.

Public corporations' debt repayments are running at a slightly lower level than last year although this



Recent fiscal indicators

	PSBR, ex asset sales, £bn		Non-oil central government revenues*	Supply expenditure*
	This year	(last year)	% change	% change
Jan	-6.3	(-3.7)	12.2	3.6
Feb	-0.5	(0.0)	11.9	3.9
Mar	3.8	(3.9)	11.1	4.0
Apr	0.7	(2.2)	11.9	-8.9
May	0.4	(0.3)	13.0	-0.9
Jun	0.1	(1.3)	10.2	-1.6
Jul	-1.7	(0.1)	14.9	+0.7

* Cumulative position in relevant fiscal year compared to year earlier.

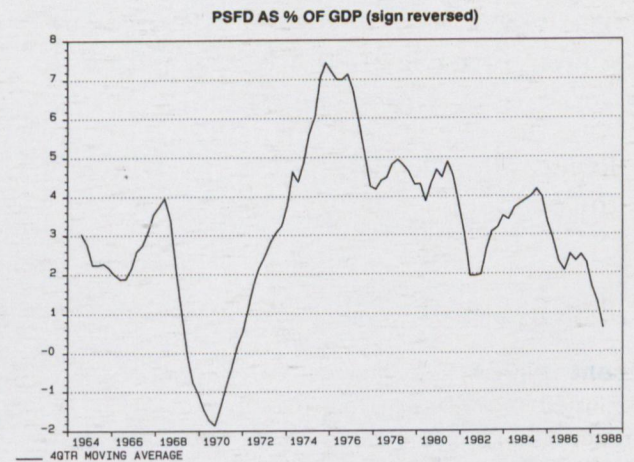
PSBR forecasts

£bn	1987-88	1988-89	1989-90	1990-91
General Government expenditure	171.9	181.9	194.1	207.1
General Government receipts	173.8	189.6	205.1	220.1
Public corporation market borrowing	-1.6	-1.2	-1.2	-1.2
Cumulative tax cuts	—	—	1	4
PSBR	-3.5	-8.9	-11.2	-10.2

is in line with the implied budget projection of a £¾ billion debt repayment for the year as a whole (this assumes that the unallocated reserve is assigned to central government and local authority borrowing).

Fiscal outlook: The full year PSBR surplus now looks as if it will be close to £9 billion which compares with the Treasury's Budget forecast of £3.2 billion. Growth so far this year has emerged well in excess of expectations and this is seeing another broadly based overrun in government revenues. The strength of the economy is also restraining demand-led spending and tending to offset policy measures which have worked in the opposite direction. Privatisation receipts also look set to overshoot plans by around £1 billion on the assumption that the sale of British Steel goes ahead (on a partly-paid basis) towards the end of the year.

The next major staging post in fiscal policy will be the Autumn Statement – expected in early November. Despite widespread concerns about the strength of the economy and the role that excessive tax cuts may have played, the Chancellor has clearly set his face against an Autumn mini-Budget. This would suggest that the focus of the November Statement will, as usual, be on the public expenditure plans, for 1989-90. In this regard the government's key objective is to secure a declining path for the ratio of general government expenditure to money GDP. Since activity has turned out stronger than expected this year the spending ratio may well be as low as 39¼% in 1988-89 (compared with the 40¾% ratio set out in the January Public Expenditure White Paper). The Treasury will therefore be probably looking for a ratio of at most 39¼% for 1989-90 which, given plausible money GDP growth assumptions, would imply an expenditure total of just over £194 billion. The planning total may therefore be allowed to rise by around £1-2 billion for 1989-90 (last November the plans were for a year ahead were raised by £2½ billion). Certainly an increase in spending plans substantially above this level would risk sending the wrong message to financial markets about the government's anti-inflation resolve.



Tax Analysis

£bn	1986-87	1987-88	1988-89	1989-90	1990-91
Non-oil taxes	115¼	127½	141¾	154	168
Oil taxes	4¾	4¾	3	3	3
National insurance, etc	26½	29	32½	35	37
Interest and other receipts	14	12¼	12¼	13	12
Total General Government receipts	160	173¾	189½	205	220
(% increase on year earlier)		(8½%)	(9%)	(8¼%)	(7¼%)

Public sector deficits

% of GDP	PSBR	PSFD	GGFD
1970s average	5	4	2½
1984-85	3	4	3½
1985-86	1½	2¼	2½
1986-87	1	2½	2½
1987-88	-¾	½	¾
1988-89	-2	-¾	-½
1989-90	-2	-1	-1
1990-91	-2	-1	-¾

PSFD = Public Sector Financial Deficit
GGFD = General Government Financial Deficit

Public Expenditure Trends

	Planning Total (£bn)		General Government Expenditure (£bn)		Forecast % of GDP*
	HMT	Forecast	HMT	Forecast	
1986-87	139.4	139.4	165.1	165.1	42.7 (43.9)
1987-88	146.1	146.1	171.9	171.9	40.5 (41.7)
1988-89	156.8	155.8	182.9	181.9	39.3 (40.6)
1989-90	167.1	168.5	193.0	194.1	39.2 (40.2)
1990-91	176.1	182.0	202.0	207.1	39.1 (40.0)

* Figures in brackets exclude privatisation receipts.

Inflation

- Inflation is moving up sharply towards 6½ % and above.
- The recorded measure is distorted by mortgage rate changes but even "core" inflation is up to 5-5½ %.
- Wage inflation is unlikely to fall back soon – with obvious risks of a further rise.
- Clear signs of a fall in "core" inflation are unlikely to emerge before the middle of next year.

Short-term signals: RPI inflation has risen sharply in recent months, even after taking account of special one-off factors. "Core" inflation has increased by around 1% over the past year and is currently around 5-5½ % (depending on the specific measure chosen). Clearly, the excess demand pressures which have so visibly impacted on the trade deficit are also now affecting inflation. Underlying inflation was last at these levels in 1985.

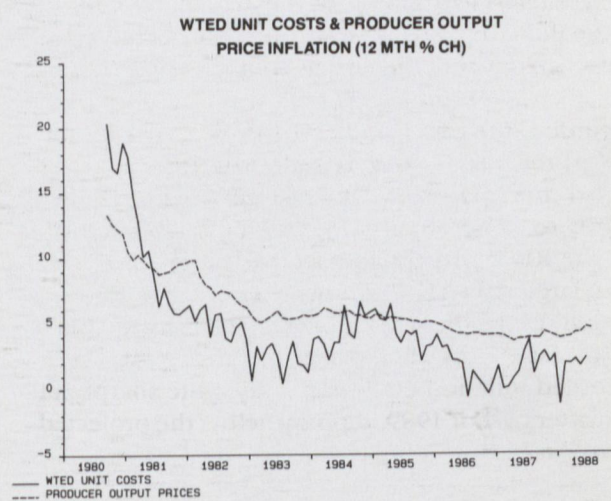
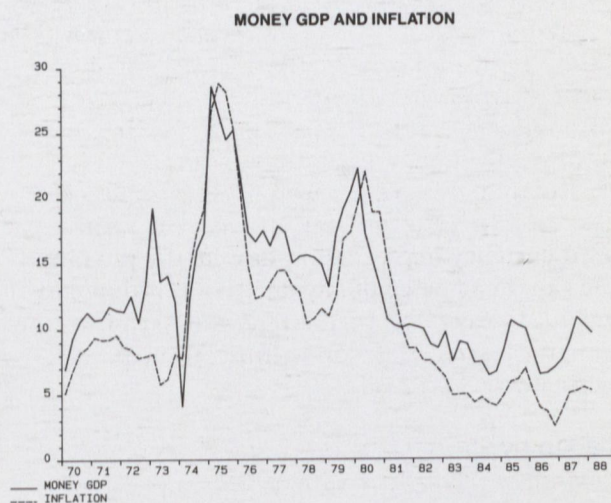
One difference between this inflationary cycle and that peaking in 1985 is that manufacturing prices have, as yet, shown few signs of acceleration. Excluding the volatile food, drink and tobacco sector, producer price inflation has been a steady 4¾ % since last October (compared with around 5¾-6% in 1985). Profit margins still appear to be comfortable with weighted unit costs up only 2-2½ % on a year ago – unit wage cost inflation remains low and the sharp rise in commodity prices has not seen any major acceleration in import costs.

Labour market pressure: A key question for future inflation is the behaviour of wages in the coming year. Already settlements have edged up, with the current high underlying growth in earnings owing less to the cyclical overtime boom than in previous quarters.

Whole economy earnings

	Recorded underlying	Overtime contribution	Adjusted underlying
1985 Q4	7½	—	7½
1986 Q4	7¾	—	7¾
1987			
Q2	7½	¼-½	7-7¼
Q3	7¾	½-¾	7-7¼
Q4	8¼	¾	7½
1988			
Q1	8½	¾	7¾
Q2	8½	¼	8¼

High productivity growth is keeping unit wage cost inflation relatively subdued in the manufacturing sector at about 1½ %. However, the trend is probably around 3-3½ % once cyclical factors are taken into account. At the whole economy level unit wage cost growth is less impressive. The latest



data – for 1988 Q1 – show cost inflation at almost 6% with the productivity trend probably around 2½ %. This would suggest that wage inflation should ease back to around 7-7½ if "core" inflation is not to level out above its 4½ % "norm".

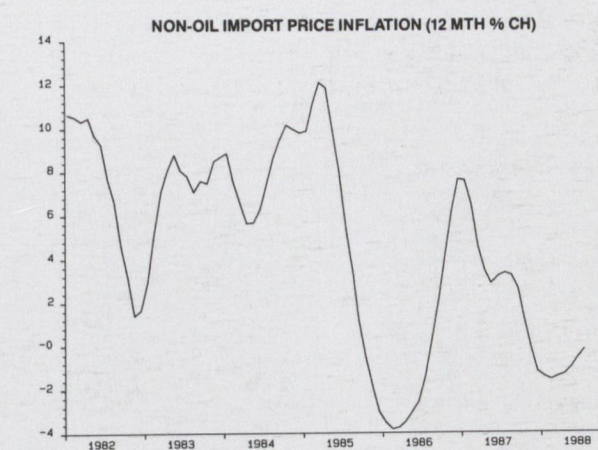
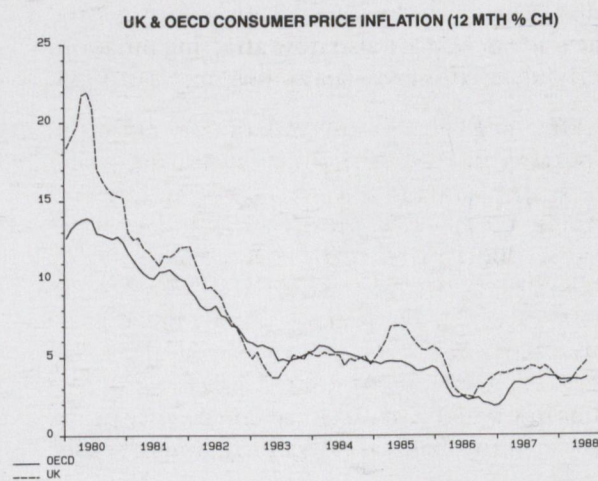
In the near term, a deceleration of earnings growth seems unlikely. Activity remains strong and unemployment is still falling quite rapidly (monthly falls currently averaging around 45 thousand – not significantly different from the 50 thousand average seen in the second half of last year). Recorded inflation is also set to increase sharply – from its present 4.8% to over 6½ % in the early part of 1989. Against this background there are few chances of earnings growth slowing down – with clear risks that it could rise further. This emphasises the limited scope at present for the authorities to permit currency depreciation, despite the yawning trade gap. In advance of any decisive slowdown in demand, a weaker level of sterling would remove an important constraint on firms from ceding excessive wage claims.

Inflation outlook: The momentum and strength of excess demand will probably see a further edging up of underlying inflation over the next few months. However, the sharp rise in interest rates so far – and the possibility of further increases – should help contain any further build-up of inflationary pressures. Any fall in "core" inflation may take some time to work through if previous experience is anything to go by (see our analysis "The Interest Rate Lever" in the July/August edition of the Bulletin) and this we would not expect to see clear signs of until the middle of next year.

Recorded inflation is expected to be 6½ % by the end of the year – largely reflecting the impact of higher mortgage rates. The rise in rates from 9¾ % in July to 12½ % by October is worth just over 1% on the RPI (with the impact on the inflation rate even larger given that mortgage rates fell at the end of 1987). On the assumption that mortgage rates begin falling in the second half of next year, recorded inflation could fall away quite sharply in the latter part of 1989, dipping below the projected "core" rate.

Inflation Forecasts

% change on year earlier	RPI	Producer Prices Output	Input	Unit Wage Costs (manuf.)	Import prices (non-oil)
1987	4.2	3.8	3.1	1.1	2.8
1988	4.8	4.4	3.8	1.8	1.0
1989	5.5	4.6	6.5	4.9	4.6
1988 Q1	3.4	3.8	1.7	0.5	-1.8
Q2	4.2	4.4	3.8	1.4	1.1
Q3	5.4	4.6	3.9	2.4	1.7
Q4	6.3	4.7	5.7	3.1	2.3
1989 Q1	6.6	4.6	7.7	4.0	2.5
Q2	6.1	4.6	6.0	4.8	4.9
Q3	5.2	4.5	5.4	5.6	5.1
Q4	4.0	4.5	6.6	5.0	5.8



Output and Demand

- There are no convincing signs of a slowdown.
- Domestic demand growth is excessive and is taking its toll on the trade balance. It is too early to assess with confidence the effectiveness of interest rates in cooling the economy.
- The current account is set for a £14 billion deficit this year, with little improvement in 1989.
- Growth is expected to fall back to 2% next year.

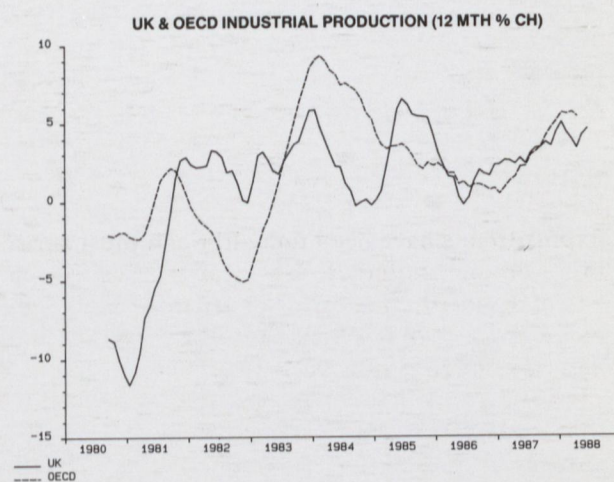
Output trends: The preliminary output measure of GDP showed a stronger than expected 1¼% increase in the second quarter – leaving activity over 5% up on a year ago. Non-oil GDP growth was over 5½%. Services output remains strong and, if anything, has shown a slight acceleration. There are, nevertheless tentative signs of a slowdown – onshore GDP in the first half of the year was up only 4% in annualised terms on 1987 H2. However, the data remain provisional and revisions experience suggest that growth may well be underestimated. For example, back in May, the CSO estimated that Q1 manufacturing output had fallen 0.1% – it now thinks output rose 1.2%. As a recent CBI analysis has shown, the latest official data appear to be underestimating once more the pace of manufacturing growth, raising the prospect of further substantial revisions to Q2 data.

Few indicators are available for the third quarter although CBI Surveys suggest that the near term outlook is for manufacturing output to remain on a strong uptrend. Oil production, meanwhile, is sharply down on a year ago reflecting the Piper Alpha disaster.

Domestic demand: Although supply growth is well above its sustainable levels, the pace of demand is even more excessive. Consumer spending was up a preliminary 5.8% in the second quarter on a year ago. Whilst this was down from the 7% recorded in the first quarter, the data may have been distorted downwards by abnormally low spending on energy. Retail spending in Q2 was up 6½% on a year ago with the data for July showing a sharp acceleration as the tax rebates came through.

Investment is also booming. Overall fixed capital spending was up 10¼% in the year to 1988 Q1 and this strong trend looks set to continue in the near term with DTI estimates showing Q2 manufacturing investment up 12½% on a year ago. Provisional figures are also pointing to a sizeable increase in stockbuilding in the second quarter.

Overall domestic demand is probably up around 8% on a year ago – a position which is clearly



Output and Demand

% change on year earlier	1986	1987	1988	1989
Consumers' expenditure	6.0	5.2	5.5	2.6
Investment	-0.2	3.9	10.5	3.4
Public consumption	1.1	0.4	0.7	1.2
Stockbuilding (£bn)	0.6	0.8	0.7	1.2
Exports	3.2	5.7	1.1	6.0
Imports	6.3	7.6	9.5	5.5
GDP (E)	2.6	3.3	2.6	2.3
GDP (A)	2.9	4.2	3.5	2.1
Domestic Final Demand*	3.9	4.8	6.5	2.2

* Comparable with GDP(A).

Personal Income and Expenditure

% change on year earlier	1986	1987	1988	1989
Personal Disposable Income	7.3	6.9	9.5	8.8
Consumers' Expenditure Deflator	3.8	3.5	4.5	5.3
Real Personal Disposable Income	3.4	3.3	4.8	3.3
Consumers' Expenditure	6.0	5.2	5.5	2.6
Savings ratio (%)	7.2	5.4	4.8	5.4

unsustainable and which the rise in interest rates is designed to correct.

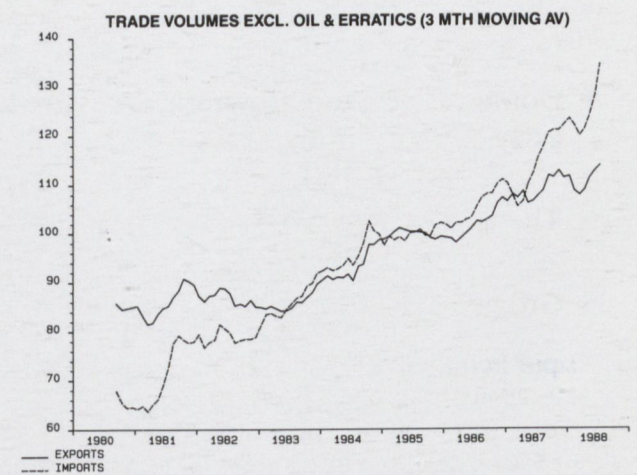
External trade: The excessive pace of demand growth – and industry's inability to meet it – has had its inevitable consequences for the current account. The deficit is now emerging much worse than expected with July's record shortfall of £2.2 billion underlining the stark reality of the problem.

With dwindling contributions from the oil and invisible surpluses the current account now looks set to register a £14 billion deficit this year (around 3% of GDP) compared with broad balance only two years ago. As a proportion of GDP the non-oil deficit is larger than it was at the height of the balance of payments "crises" in the mid-1970s.

Export trends have been dull although the 4% rise in non-oil volumes in July gave some encouragement that market shares are being maintained. Looking further ahead the omens are not particularly inspiring with recent CBI Surveys suggesting a slowdown in export orders. For the year as whole, export volumes are projected to grow by only 1% – compared with 5¼% in 1987.

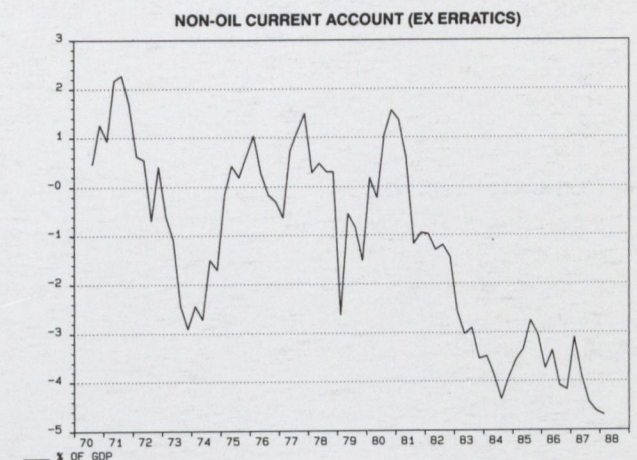
However, the surge in imports has been the main factor behind the current account deterioration. Non-oil volumes rose a dramatic 13½% in July – with the underlying trend similarly at high levels. The increase has been widely spread amongst both consumer and capital goods and reflects the combination of strong domestic demand and a rise in import penetration.

Growth outlook: The monetary squeeze is expected to see some slowdown in domestic demand during the course of next year with consumers' expenditure growth down to 2½% compared with 5½% this year. Overall domestic demand growth is expected to be 2¼%, slightly below that of productive potential, and this should help to contain inflation pressures and permit a small improvement in the current account.



Balance of Payments

£bn	1986	1987	1988	1989
Visibles	- 8.7	-10.2	-19.0	-19.0
Non-oil	-12.8	-14.3	-21.5	-21.5
Oil	+ 4.1	+ 4.2	+ 2.5	+ 2.5
Invisibles	+ 8.5	+ 7.7	+ 5.0	+ 7.0
Services	+ 5.6	+ 5.6	+ 3.8	+ 5.5
IPD	+ 5.1	+ 5.5	+ 4.7	+ 5.5
Transfers	- 2.2	- 3.5	- 3.5	- 3.5
Current Account	+ 0.2	- 2.5	-14.0	-12.0



Financial Databank

	Interest rates				Exchange rate			Inflation	US		
	3 mth interbank	5 yr gilt	20 yr gilt	Index-linked	Index	\$/£	DM/£	RPI(%)	3 mth euro \$	30 yr bond	Inflation
1983	10.1	11.2	10.8	2.9	83.2	1.52	3.87	4.6	9.7	11.2	3.6
1984	10.0	11.3	10.7	3.4	78.6	1.34	3.79	5.0	10.9	12.4	4.3
1985	12.2	11.1	10.6	3.5	78.3	1.30	3.78	6.1	8.4	10.8	3.5
1986	11.0	10.0	9.9	3.7	72.8	1.47	3.18	3.4	6.8	7.8	1.9
1987	9.7	9.4	9.5	3.9	72.7	1.64	2.94	4.2	7.2	8.6	3.7
1985 1	13.0	11.7	11.0	3.3	72.1	1.11	3.63	5.5	9.0	11.6	3.6
2	12.6	11.4	10.8	3.5	78.9	1.26	3.88	6.9	8.3	11.0	3.7
3	11.7	10.8	10.4	3.6	82.1	1.38	3.92	6.3	8.1	10.6	3.3
4	11.6	10.7	10.4	3.7	79.9	1.44	3.71	5.5	8.1	10.0	3.5
1986 1	12.4	10.9	10.2	3.9	75.2	1.44	3.38	4.9	7.9	8.8	3.1
2	10.2	8.6	9.0	3.5	76.1	1.51	3.39	2.8	7.0	7.5	1.6
3	10.0	9.5	9.6	3.6	72.0	1.49	3.11	2.7	6.3	7.4	1.6
4	11.2	11.1	10.7	3.9	68.2	1.43	2.87	3.4	6.2	7.5	1.3
1987 1	10.6	9.7	9.7	3.6	69.9	1.54	2.83	3.9	6.4	7.5	2.3
2	9.2	8.7	9.0	3.8	72.8	1.64	2.96	4.2	7.2	8.5	3.8
3	9.8	9.8	9.7	4.1	72.7	1.62	2.97	4.3	7.2	9.1	4.2
4	9.2	9.3	9.6	4.0	74.9	1.75	2.99	4.1	8.0	9.2	4.5
1988 1	9.0	9.2	9.4	3.9	75.4	1.80	3.01	3.4	7.0	8.6	4.0
2	8.2	9.0	9.2	3.9	77.6	1.84	3.14	4.2	7.5	9.1	4.0
1986 J	12.8	11.6	10.8	4.0	76.6	1.42	3.47	5.5	8.1	9.4	3.9
F	12.7	11.1	10.4	3.9	74.2	1.43	3.34	5.1	8.0	8.9	3.1
M	11.8	9.8	9.4	3.8	74.6	1.47	3.33	4.2	7.6	8.0	2.2
A	10.6	8.5	8.8	3.6	76.2	1.50	3.40	3.0	6.9	7.4	1.6
M	10.2	8.5	9.0	3.4	76.1	1.52	3.39	2.8	7.0	7.5	1.5
J	9.8	8.7	9.2	3.4	75.9	1.51	3.37	2.5	7.1	7.6	1.8
J	10.0	9.2	9.4	3.6	74.0	1.51	3.25	2.4	6.7	7.3	1.6
A	9.9	9.2	9.4	3.6	71.4	1.49	3.07	2.4	6.2	7.3	1.5
S	10.1	10.1	10.0	3.7	70.4	1.47	3.00	3.0	6.0	7.6	1.8
O	11.1	11.1	10.6	3.9	67.8	1.43	2.86	3.0	6.0	7.7	1.5
N	11.2	11.2	10.8	4.0	68.5	1.43	2.88	3.5	6.1	7.5	1.3
D	11.4	11.1	10.7	3.9	68.5	1.44	2.86	3.7	6.4	7.4	1.1
1987 J	11.1	10.4	10.1	3.8	68.8	1.51	2.80	3.9	6.2	7.4	1.6
F	10.9	9.9	9.8	3.5	69.0	1.53	2.79	3.9	6.4	7.5	2.2
M	10.0	8.9	9.2	3.4	71.9	1.59	2.92	4.0	6.5	7.5	3.1
A	9.8	8.9	9.1	3.6	72.3	1.63	2.95	4.2	6.9	8.3	3.8
M	8.8	8.4	8.8	3.8	73.3	1.67	2.98	4.1	7.4	8.8	4.0
J	8.9	8.6	8.9	4.0	72.6	1.63	2.96	4.2	7.2	8.6	3.8
J	9.2	9.0	9.2	3.9	72.8	1.61	2.97	4.4	7.0	8.6	4.1
A	10.0	10.1	9.9	4.2	72.3	1.60	2.97	4.4	7.1	8.9	4.4
S	10.2	10.2	10.0	4.2	73.1	1.65	2.98	4.2	7.6	9.6	4.3
O	9.9	10.0	9.9	4.0	73.6	1.66	2.99	4.5	8.4	9.6	4.5
N	9.0	8.8	9.2	3.9	75.4	1.78	2.99	4.1	7.5	9.0	4.5
D	8.8	9.1	9.6	4.0	75.8	1.83	2.99	3.7	8.0	9.1	4.4
1988 J	8.9	9.3	9.6	4.0	75.0	1.80	2.98	3.3	7.2	8.8	4.1
F	9.2	9.3	9.4	3.9	74.3	1.76	2.98	3.3	6.8	8.4	3.9
M	8.9	8.9	9.1	3.9	76.8	1.83	3.07	3.5	6.9	8.6	3.9
A	8.3	8.8	9.1	3.9	78.2	1.88	3.14	3.9	7.2	9.0	3.9
M	8.0	9.0	9.3	3.9	78.4	1.87	3.17	4.2	7.5	9.2	3.9
J	8.4	9.3	9.3	3.9	76.2	1.78	3.12	4.6	7.7	9.0	4.1
J	10.5	9.9	9.5	3.9	75.6	1.70	3.14	4.8	8.2	9.1	4.1
Latest	12.2	10.5	9.7	4.0	75.6	1.70	3.14	4.8	8.5	9.1	4.1

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