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Excellent inflation news ahead - part 2

Has the Bank of England exaggerated the inflation risks?

Bank of England's *Inflation Report* projects annual RPIX inflation above 2 1/2% until end of 1997,

As usual, the Bank of England's latest *Inflation Report* contained a mass of interesting and useful analysis. But, also as usual, it will turn out too pessimistic about inflation prospects. The projection on p. 44 points to an annual change in the retail price index excluding mortgage interest payments (the so-called RPIX measure) consistently above 2 1/2% until the end of 1997. The argument (on p. 46) is that "there will be a temporary rise of RPIX inflation - as higher input prices feed through to domestic inflation, and the very low price rises of a year ago drop out of the twelve-month measure - followed by a fall towards, but remaining just above, 2 1/2%". Elsewhere in the *Report* (on p. 7) the peak in RPIX inflation is identified as being in November this year.

which is more pessimistic than this *Review*

The Bank of England's analysis appears to be quite different from that set out on p. 1 of the October issue of this *Review*, where it was suggested that the headline annual rate of inflation could collapse to zero or 1/2% in the spring of 1995 and implied that the underlying annual rate could be under 1%. But there is an obvious explanation for the difference, namely that the Bank has decided to exclude "next year's electricity rebates" from its assessment, presumably because "their treatment...in the RPI has yet to be determined" (p. 44). As the rebate might take 1 1/2% off the RPIX for a few months, the Bank's view may not conflict with the position taken in the October *Review*. (The proposed dip to 1/2% in the headline RPI reflects the timing of mortgage rate changes, which seem not to bother the Bank all that much.)

But is the Bank still being too cautious? It is not only the electricity rebate and the mortgage rate changes which matter here. Also important are the large increase in indirect taxation between November 1994 and April 1995 (which will be followed by a much smaller increase in indirect taxation between November 1995 and April 1996, reducing the annual RPI change), and a variety of price cuts and rebates in the utilities *apart from electricity*. In any case the exclusion of the electricity rebate from the analysis is debatable. The electricity industry has a choice between a rebate and a price cut, and - as the price cut would undoubtedly be regarded as affecting "the inflation rate" - it is unclear that a rebate should not be so regarded. (Electricity prices are in fact already falling because of the Littlechild Review.) More fundamentally, the rebates reflect *genuine* gains in productivity and *permanent* cost reductions. A case can therefore be made that it would be anomalous to ignore them. The Bank of England's failure to discuss these points in more detail, and to recognise that RPI inflation may tumble in the next few months, could prove an embarrassment. In particular, the credibility of its continuing opposition to lower interest rates may be undermined.

Should the electricity rebate be included or excluded from RPIX?

Professor Tim Congdon

15th November, 1995

Summary of paper on

'1996 and 1997 will be good years for the economy'

Purpose of the paper

The Treasury Panel of Independent Forecasters presents the Chancellor of the Exchequer with forecasts of the British economy, so that these can be compared with the Treasury's own forecasts. Professor Congdon's latest *Submission* to the Panel argued that the current slowdown in activity would not lead to a recession, and that 1996 and 1997 would see a favourable mix of low inflation and trend or above-trend growth.

Main points

* **As the level of national output remains beneath trend, inflation pressures will remain subdued, and - like the last three years - 1996 and 1997 should enjoy low inflation and satisfactory growth.**

* **Inflation could be particularly low in early 1996, because of a bunching of special positive influences. It is even possible that the annual rate of headline retail inflation could drop to almost zero, although this depends on the statistical treatment of the £50 electricity rebate.**

* **Exports in 1995 have been disappointing, although the official figures may understate the growth of export volumes. At any rate, the balance of payments is not a major issue for policy-makers.**

* **Faster growth in the money supply (on the broad measures), combined with a fall in inflation, imply much higher growth of real money. As real money is quite a good leading indicator of activity, the message is that the slowdown will not become a recession.**

* **As public sector finances are only on the margin of sustainability, tax cuts need to be accompanied by genuine and permanent reductions in public expenditure. A small interest rate cut at around Budget time may also be appropriate, to fend off any recessionary forces.**

This paper was written by Professor Tim Congdon. Much of the work was done at Lombard Street Research Ltd., Gerrard & National's research subsidiary.

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1996 and 1997 will be good years for the economy

Professor Congdon's *Submission* to the Treasury Panel of Independent Forecasters, October/November 1995

Overview and discussion of the current situation

Concern about excessive growth at the start of the year

1994 was a year of hope for the British economy, with output growth of 4% accompanied by the lowest inflation for over 30 years. 1995 is proving more difficult. Growth has slowed down, unemployment is no longer falling quickly, inflation has deteriorated a little and companies are becoming increasingly nervous about the prospects for 1996. But a case can be argued that 1995 is better interpreted as a pause that refreshes than as a year of hope deferred. At the start of the year widespread concern was expressed that the period of above-trend growth since mid-1993 had eliminated the "negative output gap". According to many influential commentators (notably Mr. Gavyn Davies of Goldman Sachs), above-trend growth was likely to continue, the level of output would go above trend and inflation would accelerate. This prospect appeared to justify further increases in interest rates. The Bank of England seems to have endorsed a large part of the argument, as its Governor pressed for higher interest rates in his monthly meetings with the Chancellor of the Exchequer. (An economy has a negative output gap if actual output is beneath its trend level. The UK undoubtedly had a wide negative output gap, amounting probably to 4% of trend output, in early 1993.)

This concern now seems misplaced,

It is now clear that this pessimistic appraisal was wrong. Although inflationary pressures did strengthen in late 1994 and early 1995 in manufacturing, which was particularly exposed to commodity price increases, inflation elsewhere in the economy has remained well under control. The increases in the GDP deflator in the years to the first quarter (Q1) and Q2 1995 were 0.9% and 1.0% respectively, while the increase in unit wage and salary costs for the whole economy in the year to Q2 1995 was only 0.7%. Meanwhile the growth of pay has been modest and the last few months have seen a slight decline in the underlying annual rate of increase. This evidence is consistent with the output gap remaining negative, perhaps by more than 2% of trend output.

as inflation prospects for 1996 are bright,

If so, the prospects for inflation in 1996 are bright. In fact, a combination of favourable underlying performance and various helpful special influences could result in the headline retail price increase (i.e., including mortgage interest payments) showing an annual increase of under 1%, or even of little more than zero, by the spring of next year. The annual increases in the underlying RPI, measured on both the RPI-X and RPI-Y formulas, are also likely to reach the lowest levels so far seen in the 1990s. As inflation numbers of this kind are startlingly better than the consensus forecasts for 1996 that prevailed a few months ago, the subject deserves a more detailed explanation.

partly because of exceptional influences

The prospective decline in the headline RPI is partly the result of the timing of mortgage rate changes. (If short-term interest rates are cut by 1/2% in the Budget, the favourable impact on the annual rate of headline RPI increase

between September 1995 and April/May 1996 will be about 1%.) The fall in the underlying RPI increase will also reflect exceptional, non-recurring items, notably the disappearance from the index of the indirect tax increases and mortgage tax changes that took effect between January and April 1995. Further, the utilities have announced several price cuts and/or rebates timed in late 1995 and early 1996. The most important of these is the £50 electricity rebate that will be paid to consumers if the National Grid is floated, as planned, in December. Newspaper reports suggest that the precise statistical treatment of this rebate is still being debated. Nevertheless, an advantageous and possibly large effect on the RPI seems likely. (According to a story in the *Financial Times* on 30th September, the rebate could take 1 1/2% off the RPI in the quarter when it is paid. This dip is removed over the following three months. A year later the annual RPI increase rises by 1 1/2% more than would have been the case without the rebate.)

But the distinction between "exceptional" and "underlying" influences is far from clear-cut

Cynics might say that the excellent inflation prospect over the next few months is misleading, because it reflects the bunching of exceptional items. However, the distinction between "exceptional" and "underlying" influences is not precise. It needs to be recognised that the price cuts and rebates in the utilities sector are the consequence of substantial and very genuine gains in efficiency since privatisation, and that they are as much part of the underlying story as any other kind of productivity improvement. Moreover, a marked change in the inflationary climate is now underway across the economy and would be curbing inflation even aside from the allegedly "exceptional" factors. In the September CBI survey the positive balance of companies planning to raise prices was down to 7%, which on past form would imply an annual rate of producer price inflation of between 1% and 2%, sharply less than the 4% - 5% rate recorded in early 1995.

Encouraging inflation prospect is consistent with benign macroeconomic outcomes overall

There are many uncertainties about the growth of demand and output in 1996 and 1997. But the encouraging inflation news, which is fairly definite, suggests that the combinations of growth and inflation in these two years will remain good by the standards of the 1970s and 1980s. This is in line with a remark made in the July 1993 *Submission* from Lombard Street Research, that "the improvement" in growth/inflation combinations "will continue into the mid-1990s, which ought to be excellent years for the British economy". A marked worsening in growth/inflation combinations may occur in the late 1990s, but only if the level of output goes far above trend because of a misguided boom. The ideal outcome over the next few years would be the growth of demand to be fairly stable at a slightly-above-trend rate until the level of output returns to trend in, say, late 1997 or 1998. By then inflation expectations ought to be at their weakest since the 1950s. Thereafter stable and moderate monetary growth, buttressed by sound budgetary policies, might be consistent - indefinitely into the future - with approximate price stability, steady growth of demand and output at about the trend rate, and the highest levels of employment that can be sustained without inflationary trouble.

The outlook over the next 18 months to two years

National accounts data for Q2 1995 look a little odd,

The latest national accounts indicate a marked slowdown in growth from a relatively buoyant period in late 1993 and early 1994. Whereas GDP at factor cost in real terms rose at an annualised rate of 5.0% in the first half of 1994, it went up at an annualised rate of 2.3% in the first half of 1995. The slowdown has been more marked for domestic demand than for total demand (i.e., including net exports). Between Q4 1994 and Q2 1995 domestic demand increased at an annualised rate of less than 1 1/2%. Even so it has been boosted in recent quarters by fairly high levels of stockbuilding. In the year to Q2 1995 the value of the physical increase in stocks and work in progress (in 1990 prices) was £4.0b., sharply higher than £0.6b. in the preceding year. While this broad pattern of demand and output over the last year is uncontroversial, some doubts can be expressed about the GDP statistics for the second quarter by itself. According to CSO press release (95) 206, published on 22nd September, real domestic demand fell by 1/2% in Q1, but then rose by over 1% (i.e., at an annualised rate of almost 5%) in Q2. The discrepancy between the two quarters and the vigour of domestic demand in Q2 look a bit odd. Further, the mix of domestic demand growth and the contribution of net exports is difficult to reconcile with most survey evidence.

with low export volumes being difficult to reconcile with survey evidence

The CBI survey and information from companies point to continued satisfactory growth of exports in early 1995, although not at the spectacular rate seen in 1994. But the national accounts give a lower figure for exports in Q2 1995 than in Q4 1994. The latest balance-of-payments press release (95) 207, also published on 22nd September, gives more detailed background. The unit value index for exports of non-oil goods is estimated to have risen by 9.5% (i.e., at an annualised rate of 20.0%) between Q4 1994 and Q2 1995. This would be remarkable enough it is own right, but it is particularly so in comparison with manufacturers' views on what was actually happening to their export prices.

Eventually export volume growth may be revised upwards

In an appendix to this *Submission* (available from Mr. Stewart Robertson of Lombard Street Research, tel. no. 0171 337 2979) the official unit export value is compared with the CBI survey's answer to its export prices question. From Q3 1977 to Q4 1991 the CBI export prices questions and the official unit value index moved together, as logically they ought to have done. But since Q4 1991 the previous relationship has broken down. A possible message is that export volumes have tended to be under-stated, which certainly looks plausible in Q2 1995. When "all the figures are in", export volume in Q2 may be revised up and domestic demand revised down. The corresponding change to the industrial composition of output would be an addition to the initial estimates of manufacturing production and a reduction in services ouput. At any rate the pattern of growth since mid-1994 has a rather discouraging implication for the second half of 1995, since it seems unlikely that stocks will continue to be built up at their recent rate. Attempts "to move goods off the shelves" ought further to dampen inflationary forces.

and the balance of payments is not a policy problem

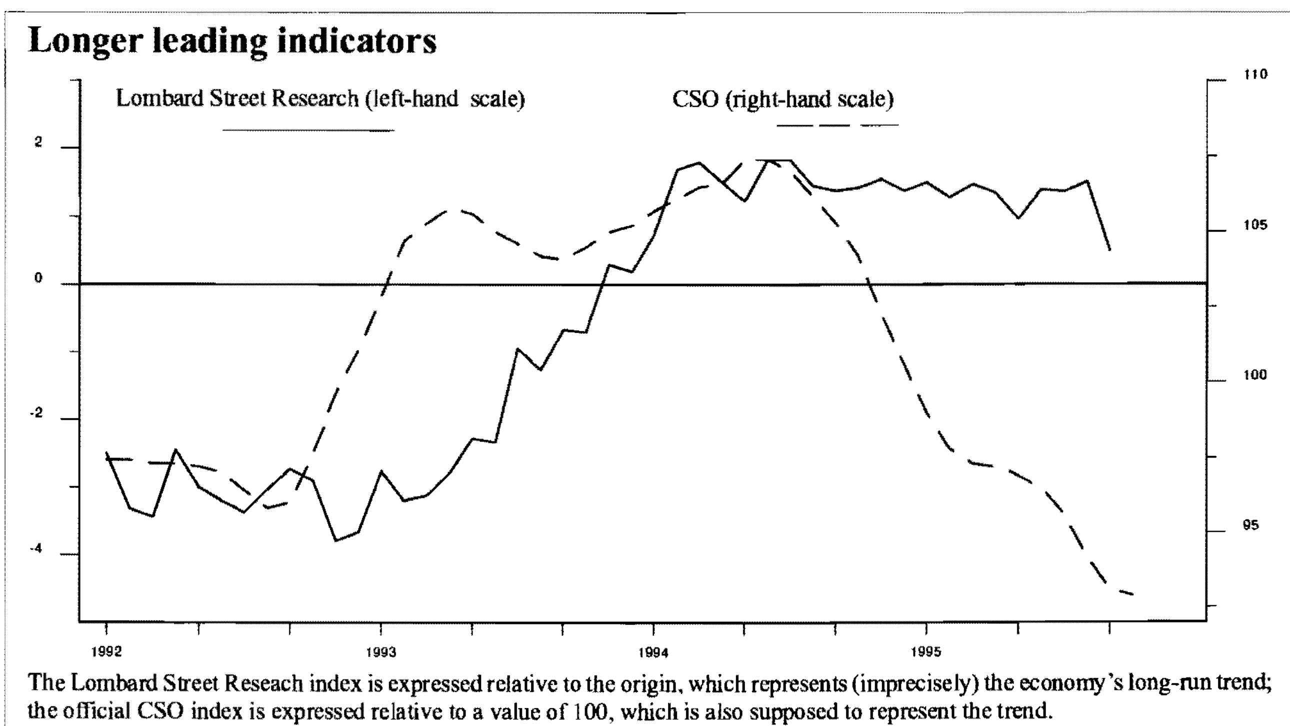
If the current official estimates of export volumes are correct, 1995 has been a disappointment compared with 1994. Official statistics show that the current account of the balance of payments has also slipped from the black in late 1994

into the red in early 1995. The UK is still a large positive creditor overall and the small current account deficit has no message for policy. (It certainly does not justify a large devaluation, import restrictions, targetted industrial subsidies or anything of that sort.) However, questions need to be raised about the accuracy - and indeed the precise conceptual status - of some of the estimates of the UK's invisible transactions, and its cross- border payments of interest, profits and dividends.

The net IPD position in 1994 was apparently affected by a sharp change in the profitability of foreign-owned financial institutions in the UK. This is interesting and important, and it might have been more clearly identified in official statistics. The latest Bank of England survey showed that the average daily turnover in foreign exchange turnover in London climbed by 60% between 1992 and 1995. As the City Research Project showed foreign exchange trading to be almost the largest industry in the City in the early 1990s and that much of the trading was with overseas counterparties, this 60% growth probably has some significance for the UK's "true" GDP and balance of payments, i.e., both GDP and net international credits on the current account were higher. But the measurement of the "value added" in this activity is bedevilled by problems with international accounting conventions.

Most surveys and orders data point to a slow end to 1995 and start to 1996

Most survey and orders information suggests that growth will remain weak until the end of the year and into early 1996. The classic leading indicators of "real" activity - such as construction orders, housing starts, mortgage commitments and car registrations - are all neutral or negative. (The chart below compares the Lombard Street Research longer leading index with the official longer leading index.) On this basis late 1995 will see beneath- trend growth and early 1996 will be lucky to enjoy any improvement. One aspect of the rather drab



The Lombard Street Reseach index is expressed relative to the origin, which represents (imprecisely) the economy's long-run trend; the official CSO index is expressed relative to a value of 100, which is also supposed to represent the trend.

short-term outlook merits further discussion. The January 1995 publication *Forecasts of the UK Economy* compiled by the Treasury showed that on average 42 forecasters expected fixed investment to rise by 5.8% in 1995. But in the first half of 1995 gross domestic fixed capital formation was in fact only 1.5% higher than a year earlier and it now seems most unlikely that GDFCF will be more than 3% up in 1995 as a whole. What went wrong?

Investment has been more sluggish than expected,

The over-prediction of investment may be partly related to the misinterpretation of the extent of the output gap, which has already discussed. If it were true that the level of output had returned to trend by early 1995, there would be a need for higher investment to accommodate rising demand. But, if output were in fact still beneath trend, the case for higher investment would not be so compelling. A further misunderstanding is that some economists appear to have taken evidence of a sharp rise in expenditure on plant and equipment in manufacturing as presaging, or even as being equivalent to, a similar increase in aggregate GDFCF. But last year expenditure on plant and equipment was only slightly more than a third of all GDFCF. (Expenditure on plant and equipment in manufacturing alone was barely more than 10% of GDFCF. See table on p.8.) The principal element in GDFCF is spending on buildings and structures, not on plant and equipment, while the ratio of manufacturing investment to GDFCF is lower than the ratio of manufacturing output to GDP.

with the weakness in construction activity being particularly marked

Construction orders are therefore a much more important guide to future investment than, for example, the CBI survey respondents' capital spending intentions. Construction orders, expressed in terms of constant 1990 prices, were 11% lower in Q2 1995 than the 1994 quarterly average. Over the next few quarters the resulting adverse effect of GDFCF will outweigh the effects of quite strong growth in plant and equipment investment. The July CBI survey reported a positive balance of 17% of firms planning to spend more on plant and machinery over the next 12 months, the highest figure since April 1989, while investment in computers, telecommunications and multi-media remains buoyant.

Housing market ordeal is still curbing the demand for mortgages, but credit growth has increased

The disheartening prospects for the construction sector are partly due to the continued ordeal of the British housing market. According to the Halifax and Nationwide building societies, house prices have fallen again in recent months. The ratio of mortgage debt to the value of the housing stock has continued to rise and is now at its highest-ever level, indicating severe strain in this pivotal aspect of the personal sector's balance sheet. Net mortgage lending will be lower in 1995 than in 1994 and seems likely to remain subdued in 1996. However, overall credit growth has strengthened in 1995, partly because the personal sector (including small unincorporated businesses) is borrowing much more for non-mortgage reasons and partly because of a recovery in corporate loan demand. Companies are borrowing largely to finance take-overs, not to support organic expansion. The most notable transactions have been the Glaxo/Wellcome deal and the take-overs in the electricity sector.

and so also has the growth of the money supply

The result of the upturn in credit has been faster growth of the money stock. In the six months to August M4 rose at an annualised rate of over 11%. This represents a clear break from the preceding three-and-a-half years. From mid-1991 to the end of 1994 the six-month annualised growth of M4 was consistently between 3% and 6%. A basic principle in Lombard Street Research's approach to economic forecasting is that significant changes in the rate of real broad money growth are nearly always important for economic activity, with a variable lag of between six and 15 months. At present inflation is falling and nominal broad money growth is rising, so that real broad money growth is accelerating quite markedly. In the five years to the end of 1994 real broad money typically increased by 1% or 2% a year; in the first eight months of 1995 it increased at an annualised rate of about 7 1/2%. The key message here is that the current slowdown will not become a recession. On the contrary, a resumption of trend or above-trend growth is likely in 1996, probably in the spring. (This may require a drop in interest rates, but almost certainly not a large one. See below in the section on "Policy recommendations" for further discussion.)

Higher monetary growth may be due partly to strong capital position of banks and building societies

In any assessment of the growth outlook in 1996 and 1997 the future path of monetary growth needs to be considered. The sluggishness of mortgage demand argues that the M4 growth upturn in early 1995 was merely a blip. If so, monetary growth ought now to slow down. However, the persistence of take-over activity and the lively demand for consumer credit suggest that more systematic influences lie behind faster monetary growth. The most obvious such influence is the better profitability and strong capital position of banks and building societies. They are trying to put excess capital to work by expanding their balance sheets, which is boosting both their loan portfolios and the money stock. Building societies are finding this more difficult than the banks, because they are constrained by weak mortgage demand. The response of some of the

The composition of investment

Figures relate to gross domestic fixed capital formation in 1994, expressed in current market prices

i. analysis by industry

	£m.	Share of total %
Agriculture	943	0.9
Mining (inc. oil and gas extraction)	3,839	3.8
Manufacturing	13,353	13.3
Electricity, gas and water supply	5,372	5.4
Construction	727	0.7
Wholesale and retail and catering	7,924	7.9
Transport and comm.	11,410	11.4
Financial sector	14,312	14.3
Other services	17,469	17.5
Dwellings	20,950	20.9
Transfer costs of land & buildings	3,776	3.8
Total	100,075	100.0

ii. analysis by type of asset

	£m.	Share of total %
Buses and coaches	138	0.1
Other road vehicles	7,960	8.0
Railway stock	523	0.5
Ships	500	0.5
Aircraft	1,734	1.7
Plant and machinery	37,836	37.8
Dwellings	20,950	20.9
Other new buildings and works	26,658	26.6
Transfer cost of land & buildings	3,776	3.8
Total	100,075	100.0

Source: 1995 Blue Book

large societies has been to de-mutualise (Halifax/Leeds Permanent) or to sell out to banks (Cheltenham & Gloucester). As a result they can redeploy their reserves outside the mortgage business, which is perceived to have gone ex-growth.

If so, money growth may remain in the top half of the official monitoring range

A fair surmise is that monetary growth will moderate from its recent high rate, but remain in the top half of the 3% to 9% monitoring range over the next year or two. So the monetary environment will be rather different from that in the 1991 - 94 period. The higher rate of real money growth will help output to grow at an above-trend rate and so to return to its trend level in 1997 or 1998. The assumptions behind this surmise are, first, that the monetary authorities are concerned to keep monetary growth inside the monitoring range and, secondly, that will take the necessary action - in terms of interest rates, budgetary policy and debt management - to ensure that the monetary range is indeed met. This seems a reasonable interpretation of the concern expressed about recent high M4 growth in the minutes of the monthly meetings between the Chancellor and the Governor.

Policy recommendations

The PSBR misleads on the true state of the UK's public finances

The public sector borrowing requirement has been above initial projections in 1995/6, mainly because the level of economic activity has been weaker than expected. Although the slippage on the PSBR can be explained in cyclical terms, the ratio of public debt to GDP is still rising. The effects on future debt servicing costs are just the same as if the rise in the PSBR were due to a more deep-seated deterioration in public finances. Moreover, evidence presented in a second appendix shows that the PSBR, which is only one measure of the budgetary position, gives a misleadingly favourable impression of the UK's public finances at present. The Government is right to want to put public finances on a sustainable path over the medium term. (This second appendix consisted of the final five pages of the August 1995 *Gerrard & National Monthly Economic Review*. It is not reproduced here.)

Any tax cuts must be financed by genuine and permanent reductions in government expenditure

The message is stark, that there is no scope for any action in the Budget which would increase public sector borrowing in 1996/7 and 1997/8. This is not to say that the unsatisfactory state of the public finances precludes cuts in taxes. But it is to insist that any tax cuts must be financed by genuine and permanent reductions in public expenditure. If there are to be tax cuts, they should be intended to improve economic efficiency, not to appeal to headline-writers or the baser instincts of Conservative (or formerly Conservative) voters. Tax cuts at "the low end", where marginal tax rates are often 80% or above for the low paid or the unemployed (if they re-enter employment), are more worthwhile than 1p. off the standard rate. Large reductions in capital gains tax and inheritance tax would be welcome if they were affordable, but they are certainly not a priority in the present state of the UK's public finances and the rich have anyway done very well over the last 15 years.

The scope for reductions in public expenditure is a political matter. However, in one respect the structure of public expenditure in recent quarters has been disturbing. Public sector construction activity has been cut back, while current

expenditure has tended to move ahead of the planned levels. The retrenchment in public sector construction has been partly the result of the Private Finance Initiative, where contractors have found that schemes are being held up because of uncertainty about the rules. The PFI is an imaginative new departure, and it may over time both curb public borrowing and lead to greater efficiency in large projects as risk is transferred to the private sector.

Need to galvanise the Private Finance Initiative

But so far it must be judged, in its practical operation, to have been limited and disappointing. It might be discussed in the Budget, with one possibility being greater government willingness to offer guarantees and assume contingent liabilities in order to "get things moving". (For example, the Treasury might agree to pay a proportion of excess costs, above a certain figure, on a large project, with contractors required to pay money to the Government for the protection this would give them.) The guarantees and contingent liabilities would have no immediate PSBR implications (unless public sector accountants are very fussy), but a government decision to grant them might stimulate construction activity. Admittedly, there are reasons for resisting this kind of financial creativity, as the Treasury hardly has the expertise to judge the risks in large projects. But the PFI needs a push if it is to flourish.

Cut in interest rates may be sensible

As the scope for tax cuts is so limited, a cut in interest rates in the Budget (or around Budget time) may be sensible. The recent upturn in monetary growth argues that the cut should be only 1/2% and that policy-makers must be prepared to retract it if economic activity starts to rebound in early 1996. But - given that the level of output remains 2% or so beneath trend - a small fall in interest rates would not take much risk with inflation. (In Lombard Street Research's forecast interest rates are assumed to be higher in 1997 than in 1996.)

and gilt sales should be geared towards index-linked sector

It is well-known that official gilt sales have run behind schedule in recent months. A more active approach towards funding, and a tilt in the gilt selling programme towards more issues of long-dated stock, seem advisable. This would go some way towards dampening monetary growth. Further, the Government should step up its sales of index-linked stock in order to reduce the interest cost on the national debt. With inflation dropping to under 2%, and perhaps under 1%, in 1996, the cost to the Exchequer of servicing the conventional gilt-edged debt sold in the early 1990s will be much higher next year than if index-linked debt had been sold instead.

Appendix: Short-term forecasts of the UK economy

Forecast of the macroeconomic variables

All figures are % changes on a year earlier, unless otherwise stated

	Outturn	Forecast	
	1994	1995	1996
Core variables			
GDP	3.9	2.8	2.5
Domestic demand	3.3	1.8	2.4
Net trade (contribution to GDP growth, per cent)	0.5	1.0	0.1
Unemployment, (UK, millions, Q4)	2.5	2.3	2.1
Current account (£b.)	-1.7	-2.9	1.5
RPI - Q4	2.6	3.0	1.7
RPI excluding MIPs - Q4	2.3	2.9	1.8
Short-term interest rate (Bank base rates, Q4)	6.1	6.5	6.25
PSBR (£b., financial year)	35.9	28.5	22.0
Other variables			
Consumers' expenditure	3.0	1.7	2.1
GG consumption	2.0	1.5	1.7
Gross fixed investment	3.7	2.7	3.9
Stockbuilding (£b.)	2.8	2.8	3.5
Exports of goods and services	8.2	6.5	4.8
Imports of goods and services	5.1	2.7	4.6
Non-oil GDP	3.4	2.7	2.7
GDP deflator (financial year)	1.8	1.7	2.7
Export prices (goods)	0.7	5.7	4.0
Import prices (goods)	2.3	6.0	3.8
Underlying average earnings	3.8	3.6	4.0
RPDI	0.8	1.7	2.4
Employment	0.4	1.0	0.6
Sterling index (1990 = 100, Q4)	89.1	85.9	87.5
Oil price ($pb)	15.8	17.0	17.5
M4 - Q4	4.2	7.5	6.5
Money GDP (financial year)	5.8	4.7	5.4
Saving ratio	9.4	9.4	9.7
Visible trade balance	-10.6	-8.2	-5.1

Forecast of key money and credit flows in 1995 and 1996

1. Determination of the money stock (i.e., "the money supply")

i. Mortgage advances (net) - institutional composition

£b.	Building societies	Banks	Other	Total
1995	10.0	6.7	-1.2	15.5
1996	10.4	7.0	0.0	17.4
1997	10.8	7.5	0.5	18.8

ii. Sectoral composition of M4 lending

£b.	To personal sector: For mortgages	For other purposes	To ICCs	To OFIs	Total M4 lending
1995	15.5	10.0	8.5	14.0	48.0
1996	17.4	13.5	9.0	13.0	52.9
1997	18.8	15.1	9.4	15.0	58.3

iii. Public sector contribution to M4 growth

£b.	PSBR	Ext. and f.c. finance of the public sector	Debt sales to non-banks	Public sector contribution
1994	+37.9	+1.3	-21.6	+17.6
1995	+31.5	+1.0	-23.3	+9.2
1996	+23.0	+1.0	-20.0	+4.0
1997	+18.0	+1.0	-16.0	+3.0

iv. Credit counterparts to M4 growth

£b.	Public sector contributions (see above, iii.)	Lending to private sector (see above, ii.)	Banks, etc. external transactions	Change in non-deposit liabilities	Change in M4
1994	17.6	31.2	-8.1	-14.6	24.7
1995	9.2	48.0	-6.0	-12.7	40.2
1996	4.0	52.9	-3.0	-11.0	42.9
1997	3.0	58.3	-3.0	-11.0	47.3

v. Growth of M4

£b.	M4 total	Change in M4	Growth rate of M4, %
1994	568.3		
1995	608.6	40.2	7.0
1996	651.5	42.9	7.0
1997	698.8	47.3	7.3

2. Analysis of demand to hold the money stock

i. Sectoral composition of M4 holdings

£b.	Total M4	Personal sector M4	Non-personal sector M4
End-			
1994	568.3	392.3	176.0
1995	608.6	416.4	192.2
1996	651.5	439.3	212.2
1997	698.8	463.5	235.3

ii. Split of non-personal M4 holdings

	Non-personal M4 - total	ICCs £b.	ICCs % growth	OFIs £b.	OFIs % growth
1994	176.0	81.5		94.5	
1995	192.2	82.5	+11.2	109.7	+16.1
1996	212.2	90.4	+19.6	121.8	+11.0
1997	235.3	103.8	+14.8	131.5	+8.0

iii. Corporate liquidity ratio

£b., not seasonally adjusted

	ICCs' M4 holdings	ICCs' M4 borrowings	Liquidity ratio - %
End-			
1994	81.5	140.5	0.62
1995	82.5	149.0	0.55
1996	90.4	158.0	0.57
1997	103.8	167.4	0.62