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FROM: F N SEDGWICK
DATE: 9 JULY 1982

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Deputy Governor)
Mr Dow)
Mr George) Bank
Mr Coleby) of
Mr Fforde) England
Mr Goodhart)
Mr Plenderleith)
Mr Foot)

Professor A Walters
No. 10

INTERPRETATION OF MONETARY CONDITIONS : JULY 1982

... I attach the monthly note which reflects the discussion at
your meeting yesterday.

P.N.S
F N SEDGWICK

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INTRODUCTION AND SUMMARY

This month's note:-

(i) discusses the recent behaviour of the principal monetary aggregates and other indicators of the impact of monetary policy;

(ii) summarises the results of the most recent forecast for the financial year 1982-83;

(iii) discusses the relationship between monetary growth and certain asset prices - houses, land, tender prices for new buildings -, assesses the extent to which changes in asset prices can be a leading indicator of changes in the general price level (the RPI), and examines the implications of recent monetary growth and increases in asset prices for future RPI inflation.

2. The most recent information on the monetary aggregates and other indicators broadly confirms the impression that while monetary conditions were very tight at the end of 1981 and at the beginning of this year there are signs that the degree of tightness is now somewhat reduced. Neither the most recent statistics nor the recently completed forecast suggest that this slight relaxation is excessive and the immediate prospect is for low growth in real output and some further downward movement in inflation.

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(1) THE GROWTH OF THE MONETARY AGGREGATES AND THE EVIDENCE OF OTHER INDICATORS OF THE IMPACT OF MONETARY POLICY

3. Table 1 summarises the most recent information on the nominal financial aggregates as well as data for previous financial years.

TABLE 1 : GROWTH RATES IN THE NOMINAL MONETARY AND FINANCIAL AGGREGATES

	Composite monetary indicator	MO	Non- interest bearing M1	M1	£M3	M3	FSL2	Net financial wealth**
(a) financial years								
1979-80*	6.2	9.6	4.2	3.2	11.0	12.4	11.3	14.6
1980-81*	10.3	7.4	7.9	11.3	19.8	21.5	14.0	30.1
1981-82*	6.1	1.2	0.4	4.4	12.3	15.6	10.9	
(b) changes on same period in previous year								
1981 (1)	8.1	7.5	4.2	7.4	18.3	19.4	12.8	30.8
(2)	10.4	5.8	8.9	12.1	18.7	21.3	13.4	30.1
(3)	12.1	5.0	9.4	10.6	15.3	21.1	13.7	18.0
(4)	8.4	4.2	4.8	7.7	13.1	18.8	11.4	17.3
1982 (1)	8.5	2.8	4.2	8.5	13.9	16.1	11.8	
(2)	6.7	2.3	1.6	6.5	12.5	13.5	10.3	
(c) changes on same period in previous year								
1981								
July	12.0	6.6	10.5	10.8	14.6	19.5	13.1	
August	11.3	3.8	9.4	9.0	13.4	18.7	13.0	
September	12.1	5.0	9.4	10.6	15.3	21.1	13.7	18.0
October	9.8	4.5	7.1	8.6	14.5	21.6	12.5	
November	9.6	3.8	6.8	9.8	13.6	19.6	11.9	
December	8.4	4.2	4.8	7.7	13.1	18.8	11.4	17.3
1982								
January	10.5	6.8	7.4	11.1	14.3	17.8	12.3	
February	8.7	3.3	4.3	9.0	13.9	16.8	12.1	
March	8.5	2.8	4.1	8.5	13.9	16.1	11.8	
April	6.1	1.2	0.4	4.4	12.3	15.6	10.8	
May	5.7	0.8	0.1	4.1	11.8	14.1	10.3	
June	6.7	2.3	1.6	6.5	12.5	13.5	10.3	
(d) changes (at an annual rate) in 6 months to								
1981								
July	16.8	6.3	18.3	18.8	14.6	23.1	14.2	
August	12.0	3.4	9.9	9.7	15.8	23.3	14.7	
September	14.2	6.8	12.2	14.2	19.1	25.5	16.2	9.6
October	7.0	2.0	1.1	3.7	18.1	25.8	13.5	
November	4.9	2.0	-1.4	3.9	15.3	19.9	10.9	
December	5.4	2.3	-1.7	5.4	16.1	18.1	11.1	-0.5
1982								
January	4.5	7.2	-2.4	3.8	13.9	12.7	10.5	
February	5.5	3.3	-1.0	8.3	12.1	10.6	9.6	
March	3.0	-1.1	-3.4	3.0	8.9	7.5	7.6	
April	5.2	0.4	-0.3	5.0	6.9	6.3	8.2	
May	6.5	-0.4	1.7	4.3	8.6	8.5	9.6	
June	7.9	2.3	5.0	7.7	9.1	9.2	9.6	

(See page 3 for footnotes)

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4. The latest monetary statistics confirm the impression that the growth in the broad monetary and financial aggregates has been falling for some time. Although part of the deceleration in the broad aggregates is the result of the recovery from the Civil Service dispute, it is most unlikely that this accounts for all of the deceleration. The narrow aggregates and the composite monetary indicator have risen much more slowly than the broad aggregates, but these growth rates have been rising and are now very much closer to those of the broad aggregates (particularly if attention focuses on the six-month growth rates in Table 1 for the most recent months). On the evidence of the narrow aggregates and the composite indicator it is now possible to identify the last quarter of 1981 and the first quarter of 1982 as the periods when monetary conditions were at their tightest. Because the proportion of interest-bearing deposits classified in M1 has been rising, it is of some interest to examine the behaviour of non-interest bearing M1. There has been a fairly sharp rise in the six month growth rate of non-interest bearing M1 in the last few months presumably in response to earlier falls in interest rates. It is most unlikely that the process of adjustment to the most recent falls in interest rates is complete. ✓

Footnotes to Table 1

- * through the financial year (mid-April on mid-April)
- ** including revaluations (calendar quarters)
- ∅ the growth rates for all monetary aggregates, except non-interest bearing M1, are adjusted for recent changes in definition.
- + quarterly figures are for the final banking month of the quarter except for net financial wealth which are for calendar quarters.

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TABLE 2: CHANGES IN THE REAL MONEY SUPPLY (%)

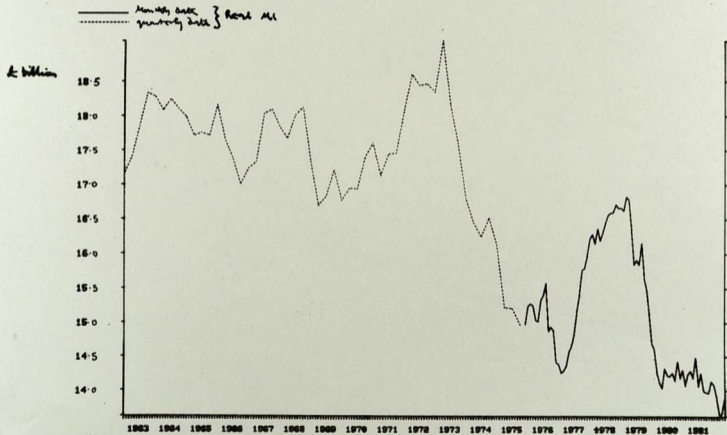
		RPI	Composite monetary indicator	MO	Non interest bearing M1	M1	£M3	PSL2
(a) Change in 12 months to								
1981	July	10.9	1.1	-4.3	-0.4	-0.1	3.7	2.2
	August	11.5	-0.2	-7.7	-2.1	-2.5	1.9	1.5
	September	11.4	0.7	-6.4	-2.0	-0.8	3.9	2.3
	October	11.7	-1.9	-7.2	-4.6	-3.1	2.8	0.8
	November	12.0	-2.4	-8.2	-5.2	-2.2	1.6	-0.1
	December	12.0	-3.6	-7.8	-7.2	-4.3	1.1	-0.5
1982	January	12.0	-1.5	-5.2	-4.6	-0.9	2.3	0.3
	February	11.0	-2.3	-7.7	-6.7	-2.0	2.9	1.1
	March	10.4	-1.9	-7.6	-6.3	-1.9	3.5	1.4
	April	9.4	-3.3	-8.2	-9.0	-5.0	2.9	1.4
	May	9.5	-3.8	-8.7	-9.4	-5.4	2.3	0.8
	June	(9.1)	-3.0	-6.8	-7.5	-2.6	3.4	1.2
(b) Change (at an annual rate) 6 months to								
1981	July	13.0(1)	3.8	-6.5	5.3	5.8	1.6	1.2
	August	13.7	-1.7	-10.3	-3.8	-4.0	2.1	1.0
	September	12.2	2.0	-5.4	0.0	2.0	6.9	4.0
	October	10.2	-3.2	-8.2	-9.1	-6.5	7.7	3.3
	November	11.6	-6.7	-9.6	-13.0	-7.7	3.7	-0.4
	December	11.7	-6.3	-9.4	-13.4	-6.3	4.5	-0.6
1982	January	11.1	-6.6	-3.9	-13.5	-7.3	2.8	-0.6
	February	8.4	-2.9	-5.1	-9.4	-0.1	3.8	1.2
	March	8.4	-5.4	-9.5	-11.8	-5.4	0.5	-0.8
	April	8.6	-3.4	-8.2	-8.9	-3.6	-1.7	-0.4
	May	7.3	-0.8	-7.7	-5.6	-3.0	1.3	2.3
	June	(6.5)	1.4	-4.2	-1.5	1.2	2.6	3.1

- (1) The simple method of seasonal adjustment for the RPI for use in calculation of the six monthly growth rates was described in the February Interpretation of Monetary Conditions.
- (2) The RPI for May is not yet available and a prediction of its seasonally adjusted increase is included here.

Chart I

Real MI: 1963 Q1 - JUNE 1982

SA DATA, SERIES DELETED BY RTI, 1975=1.0



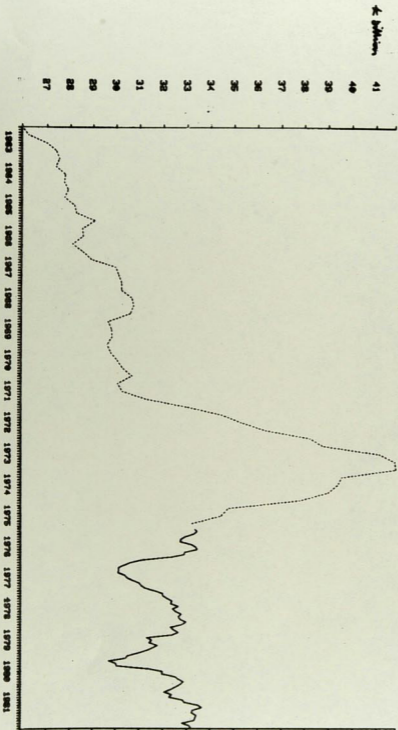
4A

Chart I

Repe 4400 1943 01 - June 1982

SA DEM. SOURCE DERIVED BY SFC 1975 = 1.0

Monthly index } Road index
 quarterly index }



4 B

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5. Table 2 shows twelve and six-month growth rates of the real money supply over the past year. The growth rates of the real narrow aggregates (M0, non-interest bearing M1, and M1) and the composite monetary indicator have tended to be negative, even for six month growth rates, so far this year, though the six-month growth rate for M1 was positive in June. (It is worth bearing in mind that there has been a downward trend in real M1 in recent years as Chart I makes clear.) The real broad aggregates have shown positive growth. The growth of all the real broad aggregates would be higher if these aggregates were adjusted for the effects of the Civil Service strike. Examination of say, real non interest-bearing M1 and real PSL2 suggest - as did the nominal data - that monetary conditions were at their tightest in the fourth quarter of 1981 and the first quarter of 1982.

6. The interpretation of the nominal and real monetary aggregates taken together depends crucially on the weight given to the broad and narrow aggregates. The performance of the narrow aggregates and the composite indicator towards the end of 1981 and so far this year suggests a very tight monetary policy, but this tightness may be in the process of disappearing. It is most unlikely that the narrow aggregates have fully adjusted to the fall in interest rates so far this year. In contrast the growth of the nominal aggregates has fallen to more acceptable levels. But because movements in the broad aggregates have not had a very close relationship with changes in prices or output in recent years, they may not be of great significance for the behaviour of the economy in the near future. (These movements in the broad aggregates may have implications for events further ahead. This possibility is discussed in Section 3.)

7. The evidence of other indicators is somewhat conflicting, but they tend to confirm the picture of tight monetary policy so far this year. The six-month growth rate of the CSO's average estimate of money GDP rose until the third quarter of 1981 and has probably fallen in each subsequent quarter.

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TABLE 3 : GROSS DOMESTIC PRODUCT AT CURRENT PRICES

	GDP at factor cost (income based)		GDP at factor cost (expenditure based)		GDP at market prices (CSO's average estimate)		
	£b	% change on a year earlier	£b	% change on a year earlier	£b	% change on a year earlier	% change over six month annual rate
1981 Q1	50.43	8.0	50.7	11.0	60.0	11.1	9.7
Q2	51.5	6.7	(51.9)	(9.9)	(61.4)	(11.3)	(10.2)
Q3	53.7	8.6	(53.5)	(8.7)	(53.2)	(10.3)	(11.0)
Q4	54.7	8.5	54.5	9.0	64.6	10.5	10.7
1982 Q1	55.4	9.9	55.2	8.6	65.9	9.7	8.7
Q2	(56.7)	(10.1)	(57.0)	(9.8)	(67.3)	(9.6)	(8.5)

Recent data for the RPI and wholesale prices show a continuation of deceleration, though at a more modest rate in the last month or so. (See Table 4.)

TABLE 4 : RETAIL AND WHOLESALE PRICES
(% change on same period a year before)

	Retail prices		Wholesale output prices (home sales)	Wholesale input prices
	Recorded	Under- lying \neq		
1981 Q1	12.7	12.2	10.9	8.5 (22.3)*
Q2	11.7	11.2	10.3	12.2 (24.4)*
Q3	11.3	12.3	10.1	16.8 (19.1)*
Q4	11.9	12.7	11.2	16.7 (2.3)*
1982				
January	12.0	11.5	11.0	13.9 (1.2) \neq
February	11.0	10.0	10.6	12.1 (5.2) \neq
March	10.4	9.0	9.7	8.0(-2.7) \neq
April	9.4	8.0	8.8	7.7(-0.3) \neq
May	9.5	9.0	8.7	4.8(-4.4) \neq
June	9.1		8.2	5.6(13.4) \neq

\neq The underlying rate of inflation is based on recent movements in the RPI which have been purged of influences which make difficult the assessment of the trend. More precisely, increases in rents, rates, Nationalised Industry prices and seasonal food are computed on a twelve month basis whilst changes in the remaining items that comprise retail prices are calculated in a fashion that gives more weight to (annualised) one month changes than to twelve month changes.

*Increase over previous quarter at an annual rate

\neq Increase over past three months at an annual rate

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It is very likely that after adjustment for cyclical variations in productivity trend profit margins fell again in the second quarter of 1982, thus continuing an uninterrupted fall since the beginning of 1980. The average level of short term interest rates (as measured by the three month interbank rate) fell slightly between May and June and has remained close to the June average in early July. Banks' base rates fell by rather more (see table 5). The pre-tax real short-term interest rate has been close to 4 per cent so far during 1982 (see Table 6). The falls in nominal interest rates engineered so far during this year have done no more than match the fall in expected inflation.

TABLE 5: NOMINAL INTEREST RATES (period averages)

		Three month Interbank	Three month Eurodollar	Base Rate	Long Rate (20 year gilts)	Yield gap
1981	Q1	13.3	16.5	13.6	13.8	0.5
	Q2	12.5	17.7	12	14.2	1.7
	Q3	14.2	18.4	12.3	15.2	1.0
	Q4	15.6	14.3	15.1	15.7	0.1
1982	January	15.0	14.5	14.4	15.6	0.6
	February	14.4	15.8	13.9	14.7	0.3
	March	13.5	15.0	13.9	13.8	0.3
	April	13.7	15.3	13.0	13.9	0.1
	May	13.3	14.6	13.0	13.7	0.4
	June	13.0	15.4	12.5	13.6	0.6
	July 8	12.7	15.5	12.5	13.3	0.6

TABLE 6: REAL INTEREST RATES

		Expected inflation over next 12 months**	3 month Interbank rate less expected inflation	Real post-tax deposit rate	Yield on 1996 indexed gilt
1981	Q1	10.7	2.6	- 3.0	2.1
	Q2	10.0	2.5	- 3.7	2.4
	Q3	10.3	3.9	- 3.5	3.1
	Q4	10.1	5.5	-1.1	3.2
1982	January	10.5	4.5	- 1.8	3.2
	February	10.4	4.0	- 2.6	3.2
	March	10.1	3.5	- 3.1	2.8
	April	9.3	4.4	- 2.3	2.9
	May	9.3	4.0	- 2.3	3.0
	June	9.0	4.0	- 2.4	3.1
	July 8	(9.0)	3.7	- 2.4	3.1

* Period average

** Unweighted average of forecasts by Phillips & Drew, National Institute and the London Business School

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The effective exchange rate has remained fairly stable, in spite of a movement in the uncovered differential against the dollar which has been in the dollar's favour. The change in the uncovered differential against the DM has been much less.

TABLE 7 : EXCHANGE RATES*

	Effective rates	£/₡ rate	uncovered differential	
			£/₡	£/DM
1981 Q1	101.8	2.31	-3.1	1.0
Q2	97.8	2.08	-5.0	-0.7
Q3	90.6	1.84	-4.2	1.6
Q4	89.7	1.88	1.3	4.4
1982 January	91.1	1.88	0.5	4.8
February	91.5	1.85	-1.4	4.3
March	90.8	1.81	-1.5	3.7
April	90.1	1.78	-1.6	4.5
May	89.9	1.81	-1.3	4.3
June	91.0	1.76	-2.5	3.8
July 9	91.1	1.72	-2.9	3.5

* Period averages

** Between 3-month UK Interbank rate and 3-month Eurodollar rate

8. There are signs of a deceleration in bank lending, though the extent to which the recorded deceleration (and previous acceleration) are of significance for the performance of the economy will depend on the view taken on the size of possible distortions to the data (if any) as a result of commercial bill round tripping.

TABLE 8 : BANK LENDING

(monetary sector, banking months, seasonally adjusted)

	Increase in Total sterling lending £mn	Percentage change in stock of lending over	
		12 months	6 months (at annual rate)
1981 August	1510	13.9	12.5
September	1242	14.6	12.9
October	715	14.0	13.9
November	2540	17.9	23.1
December	1317	19.3	27.9
1982 January	1336	19.9	31.1
February	1914	21.8	32.0
March	2173	23.3	34.7
April	1991	25.9	39.1
May	949	27.4	31.8
June	1023	29.0	30.1

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9. Bank lending for house purchase appears to have flattened off, at a high level, in recent months, but lending by building societies rose again in May by a substantial amount. There are indications that building societies' commitments to future lending fell in May and this may signal the end of the rapid rise in their monthly lending.

TABLE 9 : LENDING FOR HOUSE PURCHASE (£m)⁽¹⁾
(change on previous period (£m.),
seasonally adjusted)

	<u>Building Societies</u>	<u>Banks (excl. TSBs) Estimated</u>	<u>Total Banks & Building Societies</u>
1979	5271	590	5860
1980	5822	490	6210
1981	6207	2200	8410
1981 1	1634	250	1880
2	1841	370	2210
3	1475	730	2210
4	1257	840	2100
1982 1	1271	800	2070
October	397	280	680
November	431	290	720
December	429	270	710
January	387	230	620
February	411	220	630
March	473	350	820
April	620	350	970
May	688	340	1030

(1) All data is for calendar quarters and months

(2) THE SHORT TERM FORECAST FOR 1982-83

10. The most recent short term forecast foresees a continuation of the monetary trends experienced in the recent past. The growth of M1 continues to rise (to just under 10 per cent by the end of the year) whereas the growth of £M3 continues to fall slightly. Growth of money GDP falls further (from a higher level than the CSO are projecting; see Table 3 above) and then rises slightly at the beginning of 1983. RPI inflation falls to 7½ per cent by the second half of the financial year. The growth of real GDP edges slightly upwards in the course of the year. The forecast assumes some further fall in short term interest rates and a smaller fall in long rates. These falls are consistent with a reasonably stable effective exchange rate, though the forecast assumes some slight fall.

TABLE 10 : THE SHORT TERM FORECAST FOR 1982-83

(a) The monetary and financial aggregates (% change over same period a year earlier)

	<u>MO</u>	<u>Non-interest bearing M1</u>	<u>M1</u>	<u>£M3</u>	<u>PSL2</u>	<u>Net financial wealth</u>
1982 2	5.7		5.3	12.8	9.9	8.8
3	7.4		6.8	11.0	9.1	14.2
4	4.6		9.9	10.9	10.3	18.6
1983 1	5.7	7.5	9.9	10.1	9.7	15.1

(b) Output and prices (% change on same period a year earlier)

	<u>Money GDP (at market prices)</u>	<u>RPI</u>	<u>GDP volume</u>
1982 2	10.1	9.4	0.9
3	9.5	8.9	1.3
4	8.4	7.7	1.5
1983 1	9.0	7.7	1.7

(c) Interest rates and the exchange rate (levels)

	<u>3 month inter-bank rate</u>	<u>20 year gilt rate</u>	<u>Effective exchange rate</u>
1982 2	13.4	13.7	90.3
3	12.0	13.1	89.3
4	12.0	12.9	88.9
1983 1	12.0	12.7	88.2

(3) MONETARY GROWTH, ASSET PRICES, AND GENERAL INFLATION

11. It has often been argued that high monetary growth - particularly of the broad aggregates - has an effect on certain asset prices, such as those for houses and land, some time before its effects are recorded in the more conventional measures of inflation. If this were true movements in asset prices could act not only as a leading indicator of future inflation, but as a check on the ultimate inflationary consequences, if any, of high monetary growth.

12. The May Interpretation of monetary conditions discussed in some detail the sharp rise in activity in the linked markets for mortgages and house building. There are already signs that house prices have begun to rise, though not by a large amount so far. These developments could be interpreted as the results of the high growth in the broad aggregates in recent years which, together, with the rise in money market assistance, have made possible a very sharp rise in bank and building society lending for house purchase. It is of some interest therefore to examine whether past changes in monetary growth have been followed by changes in the prices of other assets and whether these in turn are leading indicators of changes in the RPI.

13. Chart III shows twelve month changes for the period since 1971 in agricultural land prices, tender prices for new buildings, and house prices. These are compared with movements in the RPI, £M3 and M1.

(a) Asset prices and the monetary aggregates

14. The very sharp rise in asset prices (particularly land prices) in the early 1970's is not well correlated with M1 and appears to coincide with the rise and then fall in the growth rate of £M3. The correlation between £M3 and asset prices is much less marked in the period of rising inflation at the end of the 1970's, though this may in part be the result of distortions to £M3 as a result of the corset. For this period the high growth in M1 in 1977 and 1978 appears to be more closely synchronised with the rise in the growth of asset prices. Since 1980 the growth in asset prices has fallen sharply, with the level of all of them falling at some time during 1981 or early 1982. The only information yet available of a rise in

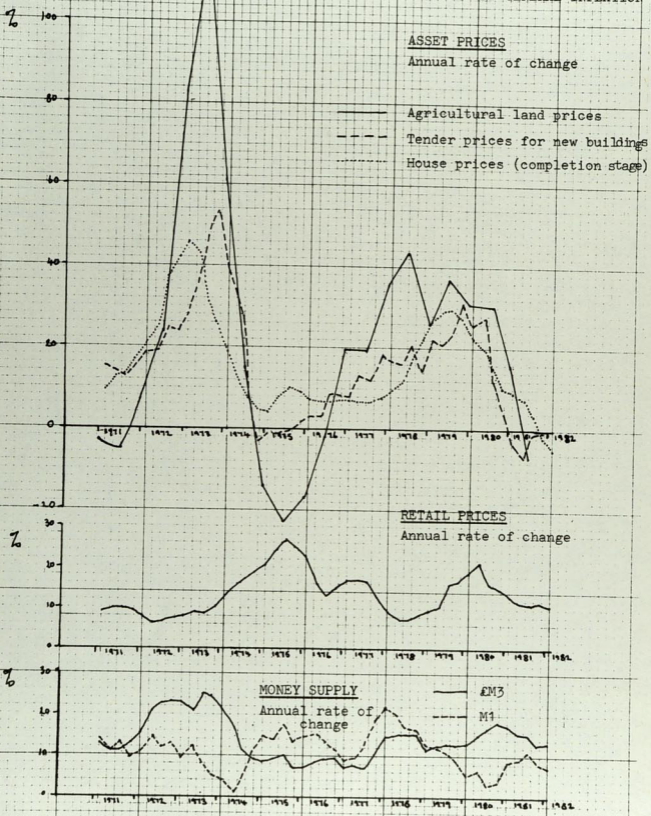
the level of prices during 1982 is for houses, but the rise is not great and the twelve month growth rate is still falling.

15. On the basis of this evidence there does not seem a strong argument for the proposition that the high growth of the broad aggregates in the last few years will lead to a very sharp rise in the growth of asset prices in the near future. On the other hand the experience of the late 1970's could suggest that any sharp rise in the growth rate of the narrow aggregates - should this occur - in response to the falls in nominal interest rates could set off a sharp inflation of asset prices.

(b) Asset prices as leading indicators of the RFI

16. Chart II does suggest that while asset price inflation (particularly for land) varies by much greater amounts than does RFI inflation it does precede major changes in RFI/^{inflation} by a year or more. If this relationship holds in the future the prospects for the RFI in the next year or so should be satisfactory.

CHART III
MONETARY GROWTH ASSET PRICES AND GENERAL INFLATION



NS See glossary for definition

DEFINITIONS

1. Agricultural land prices. These figures are derived from the particulars delivered to the Controller of Stamps whenever an interest in real property in England and Wales is transferred. The figures are half yearly and come from Inland Revenue Statistics.
2. Tender prices for new buildings. These consist of an index of the level of pricing in tenders accepted by central and local government for various types of new building (excluding housing). The figures are quarterly and come from the Department of Environment Housing and Construction Statistics.
3. House prices. These are an average of all houses (new and secondhand) at the completion stage. The figures are quarterly and come from the Building Society Association Bulletin.
4. Retail prices. This refers to the Retail Price Index. The figures are quarterly.
5. Money Supply. The figures for £M3 and M1 are quarterly.

Chart IV

12 MONTH % AGE CHANGE IN MI AND MP

MAY 1976 - JUNE 1982

SA DATA

MI } % growth over 12 months
MP } % growth over 12 months

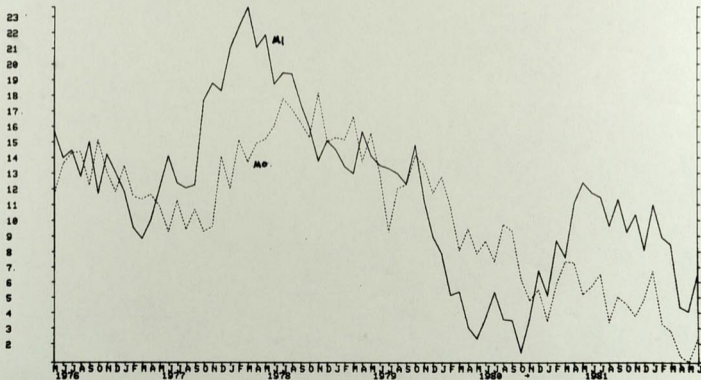


Chart V

12 MONTH % AGE CHANGE IN EMS AND MI

MAY 1976 - JUNE 1982

SA DATA

— EMS } 1/2 yr. growth over 12 mths
 - - - MI

2

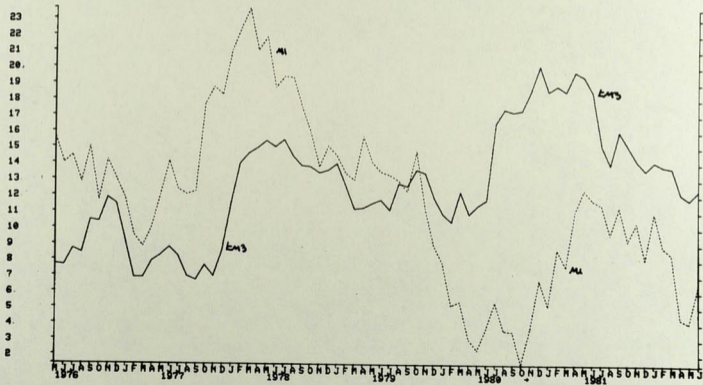


Chart II

6 MONTH %AGE CHANGE IN EMB AND AI, AT ANNUAL RATE

MAY 1976 - JUNE 1981

SA DATA

%

—— EMB } % growth over 6 mths, at annual rate
 AI }

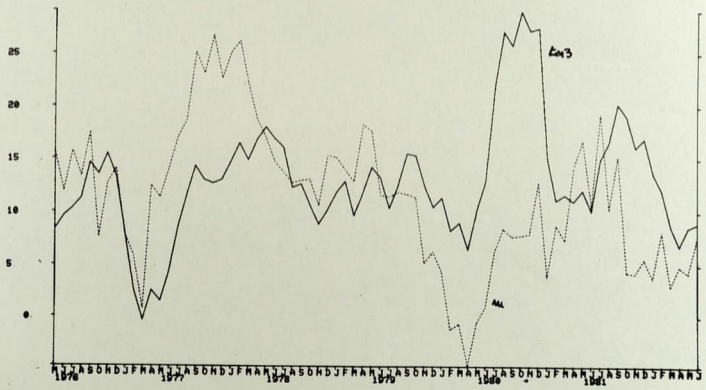


Chart VII

3 MONTH % AGE CHANGE IN EMS AND MI, AT ANNUAL RATE

MAY 1976 - JUNE 1982

2

— EMS } 2 month over 3 mos. at annual rate
 MI }

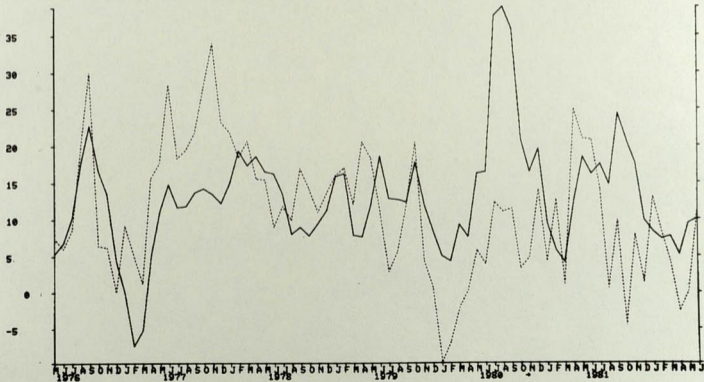


Chart VIII

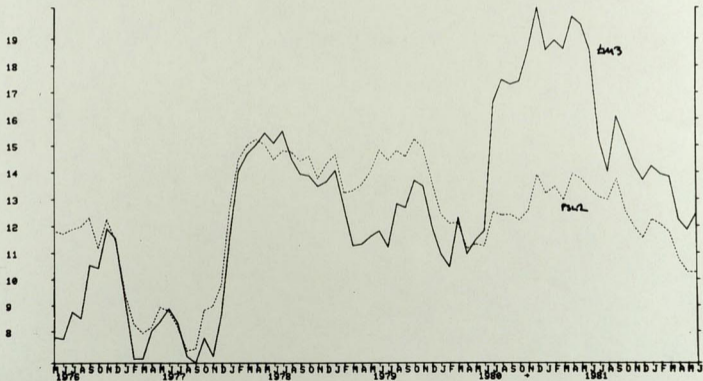
12 MTH % AGE CHANGE IN EMS AND PSLZ

MAY 1976 - JUNE 1982

SA DATA

EMS } % age growth over 12 mths
PSLZ }

2



Curve IX

6 MTH % CHANGE IN KMS AND PSL2, AT ANNUAL RATE

MAY 1976 - JUNE 1982

SA DATA

2

— KMS } % yr. growth over 6 months, at annual rate
 - - - PSL2 }



Chart X

3 MTH % AGE CHANGE IN EMS AND PSL2 AT ANNUAL RATE

MAY 1976 - JUNE 1982

— EMS } % age growth over 3 months, at annual rate
..... PSL2 }

2

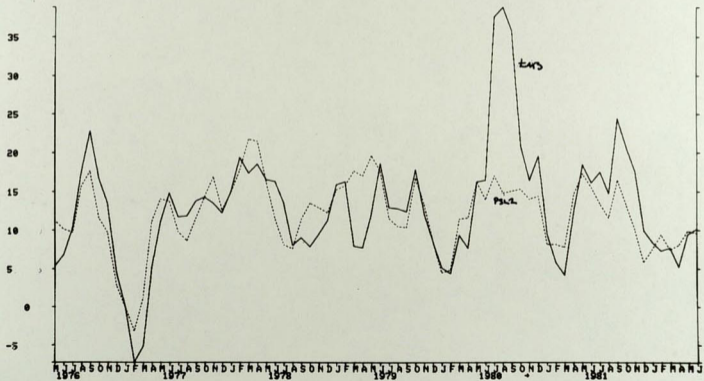


Chart XI

REPL. M/P 1963 Q1 - JUNE 1982

SERIES DEFLATED BY RPI, 1975 = 1.0

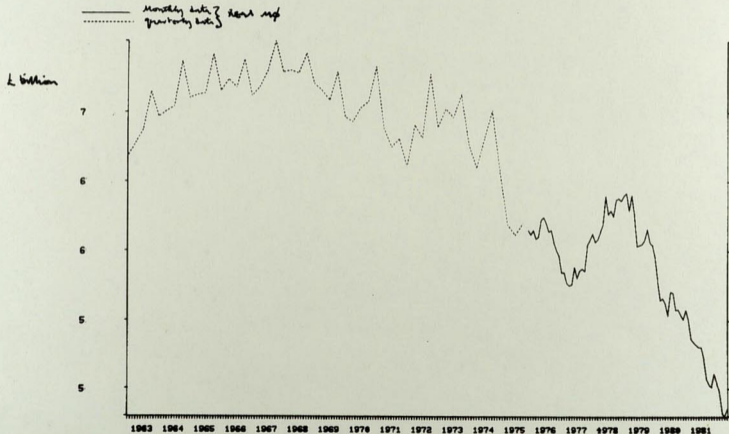


Chart XII

RPM PSL2 1963 Q1 - JUNE 1982

SERIES DEFLATED BY RPI 1975 = 1.0

