SECRET (AND PERSONAL UNTIL 2.30PM, THURSDAY 16 SEPTEMBER 1982)

MR MIDDLETON

FROM: A TURNBULL
10 September 1982

MONETARY PROSPECTS: SEPTEMBER-NOVEMBER

I attach a copy of the report on the prospects for the monetary aggregates over the next three months.

A TURNBULL

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Summary

(i) The outturn for August revealed some acceleration for all three target aggregates, though this leaves the growth of £M3 since February in the top half of the target range and M1 and PSL2 in the bottom half. While the monetary base has fallen since February, PSL2A which includes building society term shares has grown rapidly, 13 per cent a.r. since February.

(ii) Over the next three months we expect the growth of £M3 to average just under 1 per cent which would leave the annual growth rate at around 11 per cent. However we expected the recorded figure for September to be only about ½ per cent, somewhat below the underlying trend. Much of this is due to the quirks of seasonal adjustment - see below.

(iii) We expect M1 to grow about 1 per cent a month. While the decline in interest rates will be boosting M1, the slow growth of prices and activity will reduce the element of transactions demand.

(iv) PSL2 is forecast to average ¾ per cent a month. The recovery of National Savings - see below - may reduce the growth rate of the wider measure, PSL2A.

(v) The CGBR is forecast to average £1 billion a month over the period. In September PRT receipts were £400 million higher than expected but this was partially offset by higher on-lending to the other parts of the public sector. Although higher on-lending to local authorities has been deliberately sought, ironically it took the form of fixed rate rather than variable rate lending. This higher on-lending should produce a large reduction in the bank borrowing of the rest of the public sector.

(vi) Gross sales of gilts in September are estimated at £700 million, well down from August's £1.3 billion. But with buying in and maturities much lower, net sales are expected to be higher, £700 million against £550 million in August. For October and November gross sales are projected at £1 billion in each month, though £460 million is already lined up by a call in October.

(vii) The combination of declining interest rates elsewhere and improvements to National Savings products appears to be achieving a revival of inflows to around £230 million a month. If sustained this would take the total for the year over £2 billion.

(viii) We have revised upwards the underlying growth of bank lending to around £1.3 billion. The deceleration between April and June has not been sustained. There could also be some special factors boosting recorded lending in September. Heavy money market intervention in banking September appears to have depressed bill rates relative to deposit rates. Even if this fell short of creating positive arbitrage profits, it could make it relatively cheaper to borrow and hold balances. Also in August and September there could be some effect of the abolition of HP controls and the new registration year for cars. Lending for housing is still accelerating and it may be some months before the banks' intention to slow it down is reflected in disbursements.

(ix) We are continuing to project a substantial negative contribution from the externals, around £200 million a month in October and November, but somewhat less in September when there could have been inflows to finance PRT payments.

(x) Compared with last month's forecast, the PSBR has been revised downwards and total debt sales upwards. In consequence by November overfunding in the target period could be around £2 billion.

(xi) It has not yet been necessary to run an NLF balance, though Ways and Means have been as low as £25 million. The position will remain tight and balances a possibility at least until 22 September when a large stock matures. Thereafter the position should ease.

Assumptions and forecast of £M3

The forecast of £M3 growth in the banking months September to November is summarised in tables 1 and 2. The forecast incorporates the usual assumption that there will be no further reductions in short-term interest rates and that the exchange rate remains stable without the need for official intervention.

2. Table 1 shows that we are forecasting £M3 to grow at much the same rate over the next three months on average as in recent months - just under 1 per cent a month. In the current month (September) we are forecasting growth of only ½ per cent, followed by two months of growth at 1 per cent a month. To some extent the September forecast understates the underlying growth in the month. As explained in more detail later, PRT receipts were much higher than expected and CTD surrenders much lower - both of these tending to depress £M3 growth. We would normally expect the seasonal adjustment process to smooth out PRT receipts over a six-month period, but because the current seasonals assume receipts lower than actually occurred they fail to make full allowance. If the seasonal had taken account of the PRT outturn, we would be forecasting growth of £M3 in September at about 1 per cent and growth in the previous five months would have been correspondingly lower, leaving the cumulative growth to mid-September unaffected. However, it is unlikely that the seasonals will be revised before the regular annual update next spring.

3. In seasonally adjusted terms the public sector is expected to exert a contractionary influence on £M3 in September, as debt sales exceed the PSBR by over £½ billion. In the two subsequent months the PSBR is expected to be slightly underfunded. However, it appears that underlying sterling lending has recovered somewhat in the last couple of months, particularly lending to persons for house purchase and lending to ICCs. We are now forecasting recorded lending to grow by £1¼ billion a month on average.

4. £M3 growth in August has been provisionally estimated at 1.4 per cent, some 0.3 per cent higher than our forecast. The main differences between outturn and forecast were a lower other public sector contribution, stronger bank lending and less negative externals and non-deposit liabilities. This month we have applied two cross-checks to the forecast of £M3 produced by examination of the counterparts. First a naive model has been estimated based on past movements of £M3. This suggests a rather higher figure for September than the ½ per cent we have projected. Secondly, we have sought to establish a relationship between the growth of the private sector's domestic wealth (very broadly money plus Government debt plus NDL's) and the proportion held as money. Over a recent period this has averaged about 45 per cent, though there have been large month to month variations. The share of wealth going into money in September is rather low, thus also indicating that our forecast may be on the low side. However, we believe that the outcome on PRT receipts and CTD surrenders is sufficient reason to expect low growth of £M3 in this month. In October and November analysis of the counterparts suggests growth of 1 per cent a month, very much in line with the naive model and implying a more normal ratio of money to wealth. On this forecast, cumulative £M3 growth in the target period would remain in the upper half of the target range.

Forecast of the other monetary aggregates

5. Although the M1 series remains extremely erratic, we have witnessed some acceleration over recent months as nominal interest rates have fallen (though in August the increase was in interest bearing M1). Cumulative growth in the target period is now above the bottom of the target range. We are expecting further increases of about 1 per cent a month, which would take cumulative growth to mid-November to the middle of the target range. The PSL2 forecast, summarised in table 1, is for slightly slower growth than £M3, averaging ¾ per cent a month. On this forecast PSL2 would remain in the bottom half of the target range. The wider aggregate PSL2A, which includes building society term shares, is however expected to grow slightly faster than PSL2.

Forecast of £M3 counterparts

6. The main features of the counterparts to the £M3 forecast for September to November are summarised in table 2:

(i) The seasonally adjusted CGBR is forecast to be in large deficit - £¾ billion in October and £1¼ billion in both September and November. The deficit in August was in line with the forecast, despite higher on-lending to local authorities. The main area of improvement was in Customs receipts, as shortfalls in revenue from earlier months have been recovered as a result of extra manpower devoted to enforcement. It is still too early to be sure that the improvement in Customs receipts is permanent, but there is an extra £¼ billion or so of shortfall still to be recovered. The own account position in September seems likely to be about £¾ billion better than envisaged in the last forecast, with almost all the improvement accounted for by higher receipts of oil taxes. PRT receipts were nearly £½ billion better than expected, it appears because North Sea production was underestimated. Tax receipts are also anticipated to be high in October, with two PAYE dates falling in the month and large corporation taxes due; by contrast November is forecast to see a large unadjusted deficit of £1¼ billion on own account.

(ii) The on-lending component of the CGBR is also expected to add to the central government deficit, by £1 billion in September and £½ billion in both the subsequent months. Borrowing in September has been particularly high, as local authorities have responded to falling long rates by switching out of variable rate borrowing from the market and into fixed rate PWLB borrowing; and public corporations have had to borrow heavily, with the New Towns and Housing Corporation forced to refinance maturing loans and interest payments. To date the local authorities have borrowed only very small amounts under the new variable rate facility, and conditions are unlikely to favour this type of borrowing in the immediate future. However, local authorities are still expected to be small net borrowers from PWLB in October and November as they continue to move into fixed rate borrowing. The new temporary borrowing facility for public corporations is expected to start soon, but it is uncertain how much interest it is likely to generate - we have assumed about £50 million a month. But corporations are still likely to be heavy net borrowers from the NLF in coming months.

(iii) The other public sector contribution to £M3 is expected to be negative by £¼ billion over the three forecast months. Public corporations are assumed to more than cover their borrowing requirements by borrowing from the NLF, while local authorities are expected to continue switching away from market borrowing (mainly from the banks).

(iv) The forecast for gilt sales is shown in more detail in table 3. Net sales to date in September have already reached £½ billion as 9¼% Exchequer (maturing at the beginning of banking October) cannot now be bought in, and no other stocks are due for redemption. The call due on 10½% Exchequer 1987 in October nearly cancels out the stock maturing in market hands, but we have assumed only moderate further gross sales of £550 million. Net sales are set to recover sharply in November, with £1 billion gross sales assumed and only modest buying of stock due to be redeemed in 1983. Taking the three months as a whole, net sales to the non-bank private sector are forecast to average over £½ billion a month. On this forecast about £1½-2 billion new stock would have to be created in October and November.

(v) Sales of <u>other central government debt</u> are also expected to make a significant contribution to funding. National Savings inflows are recovering, with the 24th Issue becoming more competitive and the holdings limit increase attracting funds into index-linked certificates; high rates are also encouraging inflows into Invac, and the Income Bond is exceeding expectations with nearly £100 million in the first month. We are forecasting net inflows of £200-250 million in each of the three months; if this rate were maintained for the remainder of the financial year net inflows would total £2¼-2½ billion for 1982/83 as a whole. CTDs are also assumed to continue attracting reasonable purchases. (A new prospectus is likely to be introduced next month.) Surrenders are however forecast at very low levels as companies who bought their CTDs at rates higher than current have an incentive to continue holding them. With large PRT payments made in September substantial surrenders were anticipated by the seasonal factors; in the event virtually no CTDs were surrendered, so the net unadjusted purchases of £150 million forecast for September will become a £400 million contribution to funding in seasonally adjusted terms. In October and November only small net purchases (seasonally adjusted) are forecast.

(vi) Table 4 gives details of the forecast of <u>sterling lending</u> to the private sector. Personal lending has if anything showed some upward trend in recent months, particularly in lending for house purchase; also in August lending for consumption showed some increase, probably as a result of the ending of hire-purchase controls and the new car registration year. Lending to companies has also started to show signs of recovery in recent months, perhaps giving some credence to lower levels of business confidence reported recently. Prospects for the company sector will be analysed in detail in the forthcoming main forecasting round; we have tentatively assumed the underlying level of corporate borrowing will remain at the current £½ billion or so a month. The net effect of the recent upward movement in lending is to cause us to revise our forecast of underlying lending upwards to about £1¼ billion a month, with no decline over the period. As considerable money market assistance was required when PRT fell due, bill rates fell relative to interbank rates. Even if this did not generate positive profits/ for hard arbitrage, it would have reduced the relative cost of holding balances. It may therefore have encouraged companies to borrow more to build up liquidity. We have made a nominal allowance for this in September, which pushes recorded lending to £1.4 billion in the month. As the bills mature in subsequent months recorded lending would be expected to fall off.

(vii) The forecast of <u>net externals</u> is shown in tables 5 and 6. The outturn in August suggests that the upward revisions we have made recently to capital outflows were correct - the error in the month is almost totally accounted for by an increase in the reserves which we had not anticipated. The forecast assumes the higher level of structural outflows will continue, suggesting an underlying negative contribution from the externals of about £200 million a month. In September we have assumed the large PRT payments will have generated some inflows particularly given the lack of CTD surrenders, reducing the negative contribution of the externals by perhaps £50 million.

(viii) <u>Non-deposit liabilities</u> rose again in August. The substantial fall in July remains something of a mystery. In the absence of evidence to the contrary we we have assumed NDLs to revert to their trend level of increases of about £200 million a month.

Money markets and overfunding

7. The following table shows that we are forecasting slight overfunding of the borrowing requirement in the next three months:

£ billion, seasonally adjusted

	Last 12 months to mid-Aug.	Sept.	Oct.	Nov.	Target period: mid-Feb to mid-Nov.
'PSBR' (CGBR + OPS contribution)	4.9	0.6	0.7	1.2	5.6
CG debt sales to NBPS	10.3	1.3	0.6	1.0	7.7
(of which, gilt sales)	(6.5)	(0.6)	(0.3)	(0.7)	(5.2)
OVERFUNDING (increase +)	5.4	0.7	-0.1	-0.2	2.1

This shows a rather different picture to the last forecast. Cumulative overfunding in the target period to mid-November is now put at £2 billion. Most of the revisions are to the PSBR, with both the CGBR and the other public sector component revised downwards.

8. Table 7 summarises our forecast of money market influences over the next three months. The large market surplus we were forecasting for August did materialise, but we are now forecasting a £½ billion market shortage overall in banking September despite higher than expected on-lending, mainly due to higher oil tax receipts. A further shortage in October we are expecting will be more than outweighed by a surplus of £½ billion in November. Although we can only forecast the Ways and Means position at the end of each banking month, we are expecting an easier position in October and November after the tight conditions seen in September. Between mid-September and mid-November we are expecting a rise in Ways and Means advances of over £1 billion. This assumes

that only £1½ billion of new stock (excluding the call on 10½% Exchequer 1987) is issued to meet the gross gilt sales forecast. However, September provides a cautionary example - our forecast is still for a fall in Ways and Means through September of about £¾ billion from a level of £1.3 billion at mid-August, but on 9 September Ways and Means fell to only £25 million.

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Table 1: PERCENTAGE CHANGES IN MONETARY AGGREGATES

Seasonally adjusted data

Banking month	Wide monetary base (M0)	Non-interest bearing M1	M1	£M3	M3	PSL1	PSL2
Outturn							
- March	-0.5	-0.6	-0.7	+ 0.7	+ 0.7	+ 0.5	+0.7
- April	-1.2	+0.4	+0.1	+ 0.6	+ 1.8	+ 1.3	+1.1
- May	-0.2	+0.3	+0.6	+ 1.1	+ 0.9	+ 0.8	+0.7
- June	+1.7	+1.4	+2.0	+ 0.8	+ 0.6	+ 0.5	+0.6
- July	+0.2	+2.2	+0.9	+ 0.8	+ 1.5	+ 0.4	+0.1
- August	-1.7	-	+1.2	+ 1.4	+ 1.1	+ 1.5	+1.1
Last 12 months	-0.2	+3.1	+8.3	+11.6	+12.3	+11.1	+9.3
Last 6 months (target period) at annual rate	-3.4	+7.5	+8.4	+11.2	+14.0	+10.8	+8.8
Forecast							
(i) Percentage change in month							
- September			(1 percent	+ 0.5		+ 0.9	+0.7
- October			(a month	+ 1.1		+ 1.1	+0.8
- November				+ 1.0		+ 1.0	+0.7
(ii) Percentage change since Feb '82							
- September				+ 5.9		+ 6.2	+5.0
- October				+ 7.1		+ 7.4	+5.9
- November				+ 8.1		+ 8.4	+6.7
(iii) Percentage change since Feb '82 (annual rate)							
- September				+10.4		+10.9	+8.8
- October				+10.8		+11.2	+8.9
- November			+9.8	+10.9		+11.4	+9.0

Note: All figures are on the basis of the new monetary sector.

Table 2 : £M3 COUNTERPARTS

	August		Forecast			New Target Period: mid Feb 82 to mid-Nov 82
	Forecast	Outturn	Sept.	Oct.	Nov.	
(CGBR, n.s.a., surplus -)	(+1590)	(+1608)	(+ 490)	(+ 450)	(+1650)	(+6905)
1 CGBR, s.a.	+1475	+1492	+1190	+ 620	+1295	+6254
(o/w, on-lending)	(+150)	(+294)	(+980)	(+475)	(+310)	(+2844)
2 Net purchases of CG debt by NBPS						
a Gilts	- 600	- 474	- 615	- 325	- 700	-5157
b Treasury bills	-	- 3	-	-	-	- 26
c National Savings	- 140	- 99	- 230	- 250	- 215	-1951
d CTDs, etc	- 230	- 287	- 415	- 30	- 35	- 561
TOTAL	- 970	- 863	-1260	- 605	- 950	-7695
3 Other public sector						
a Local authorities	- 50	- 285	- 435	+ 90	- 175	- 166
b Public corporations	+ 100	- 120	- 150	- 50	+ 40	- 456
TOTAL	+ 50	- 405	- 585	+ 40	- 135	- 622
4 £ lending to private sector	+ 970	+1324	+1415	+1295	+1100	+12918
(adjusted lending)	(+1100)	(+1410)	(+1300)	(+1300)	(+1300)	(+13100)
5 Net externals	- 335	- 208	- 135	- 190	- 240	-2450
6 Net non-deposit liabilities	- 280	- 141	- 200	- 200	- 200	-1545
TOTAL £M3	+ 910	+1199	+ 425	+ 960	+ 870	+6860
% change in period	+1.0	+1.4	+0.5	+1.1	+1.0	(+10.9 annual rate)

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Table 3: GILTS FORECAST

£ million

	Actual	Forecast		
	Aug.	Sept.	Oct.	Nov.
TRANSACTIONS TO 9 SEPT AND KNOWN FUTURE TRANSACTIONS				
Redemptions	- 2			
Buying-in next maturities	- 760	- 5		
Sales	+1315	+555		
Calls			+460	
FORECAST				
Assumed buying-in of next maturities				
- 9¼% Exchequer 1982 (22/9)			-500(R)	
- 8¾% Exchequer 1983 (5/1)			-100	- 200
Further gross sales		+165	+540	+1000
TOTAL NET SALES	+ 553	+715	+400	+ 800
Overseas purchases (-)	+ 22	- 50	- 25	- 50
Banks (-)	- 53	- 50	- 50	- 50
LDMA (-)	- 48			
PCs (-)	-	-	-	-
NET SALES TO NBPS	+ 474	+615	+325	+ 700

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Table 4: STERLING LENDING TO THE PRIVATE SECTOR

£ million
Seasonally adjusted

	Actual			Forecast		
	June	July	August	Sept.	Oct.	Nov.
Adjusted lending	+ 930	+1353	+1407	+1300	+1300	+1300
Bills held by NBPS	+ 145	+ 148	+ 17	- 30	- 30	- 30
PSBR offset	+ 55	- 10	- 100	+ 45	+ 25	- 120
Round-tripping	- 50	-	-	-	-	-
Liquidity effect	-	-	-	+ 100	-	- 50
Actual/forecast recorded lending	+1080	+1491	+1324	+1415	+1295	+1100
Centred 3-month moving average of adjusted lending	+1190	+1230	+1350	+1335	+1300	

TABLE 5 : FACTORS CONTRIBUTING TO EXTERNALS £million

Ex ante demand for £ by sector	Sept.	Oct.	Nov.
1. Non-bank private sector			
a. Current balance	+150	+150	+150
b. Ex ante exchange control outflow	-400	-400	-400
c. Underlying outflows	-250	-250	-250
d. PRT	+150	-	-
	-350	-500	-500
2. Banks	-	-	-
3. Overseas			
a. Overseas £ deposits	+250	+250	+250
b. Sterling lending overseas	-200	-200	-200
	+ 50	+ 50	+ 50
4. TOTAL EX ANTE DEMAND FOR £ (1 + 2 + 3)	-300	-450	-450
5. a. Intervention (increase in reserves -)	-	-	-
b. NBPS equilibrating flow	+200	+300	+300
6. PSBR offset	+ 15	+ 10	- 40
7. EXTERNALS (1 + 5(b) + 6)	-135	-190	-240

Table 6: FINANCING OF NET EXTERNALS £ million

	Sept.	Oct.	Nov.
Sterling deposits net from banks abroad	- 50	- 70	- 30
Sterling deposits net from non-banks abroad	- 50	- 50	- 50
Bank's net foreign currency liabilities	+ 62	+ 38	+ 9
Overseas holdings of gilts	- 50	- 25	- 50
Overseas holdings of Treasury bills and local authority sterling debt	-	-	-
Reserves net of official borrowing	-	-	-
TOTAL NET EXTERNALS (n.s.a.)	- 88	-107	-121
Seasonal adjustment	- 47	- 83	-119
TOTAL NET EXTERNALS (s.a.)	-135	-190	-240

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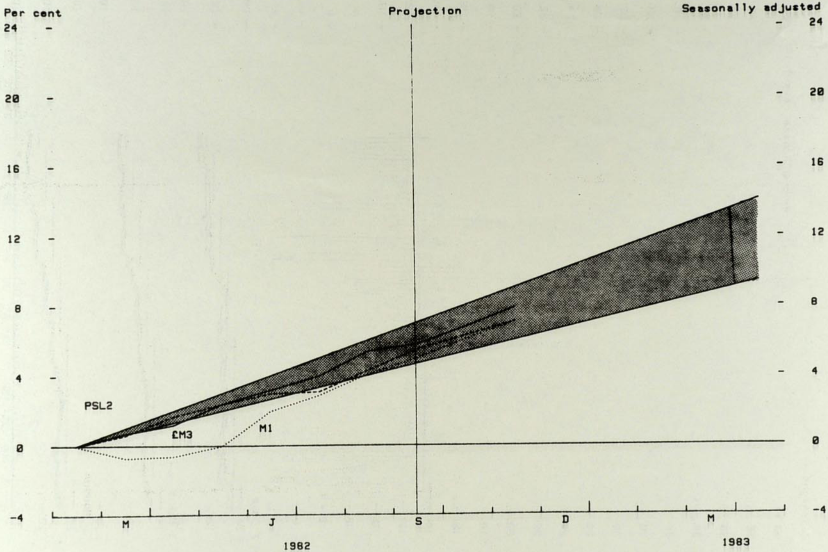
Table 7: MONEY MARKET INFLUENCES

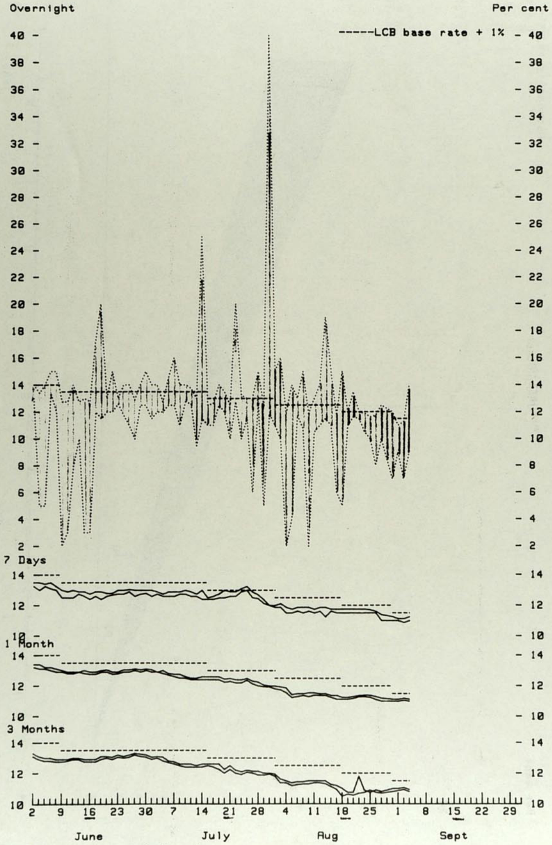
£ million
not seasonally adjusted

	Actual	Forecast		
	Aug.	Sept.	Oct.	Nov.
CGBR (increase +)	+1608	+490	+450	+1650
Reserves etc (+)	+ 186	-	-	-
Notes and coin (-)	+ 160	+171	+ 5	- 21
National Savings (-)	- 100	-232	-249	- 201
CTDs (-)	- 364	-151	-108	- 113
Gilts (-)	- 553	-715	-400	- 800
Other Exchequer items etc	+ 4	-	-	-
TOTAL MONEY MARKET INFLUENCES (Market surplus + / shortage -)	+ 941	-437	-302	+ 515
Change in bankers' balances	- 93	+ 10	+ 10	+ 10
MONEY MARKET OPERATIONS REQUIRED	-1034	+447	+312	- 505

Percentage growth in monetary aggregates since mid-February 1982(monetary sector data) CHART A



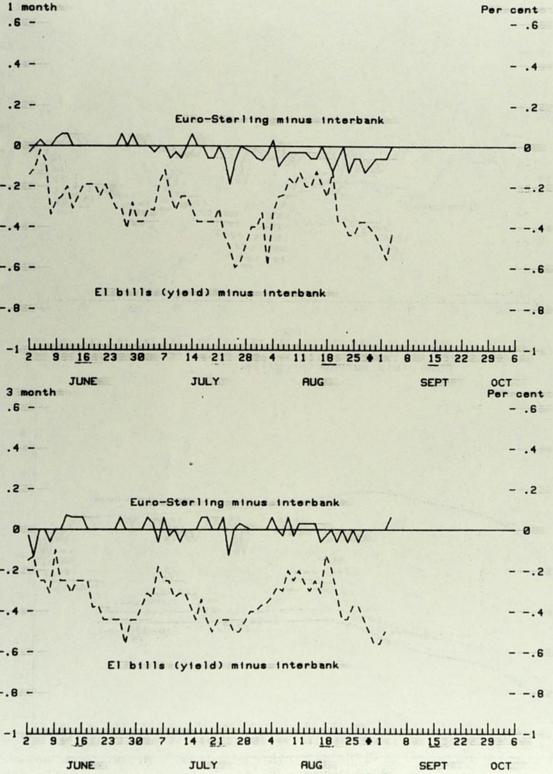
Daily range of rates in the interbank market Chart B



Make-up days underlined.

Chart C

Daily differentials between rates in the interbank market and Euro£ rates/rates on eligible bills*



* Rates taken at noon each day ♦Bank holidays (make-up days underlined)

3 MONTH INTERBANK £, EURO $ & EURO £ RATES

CHART D

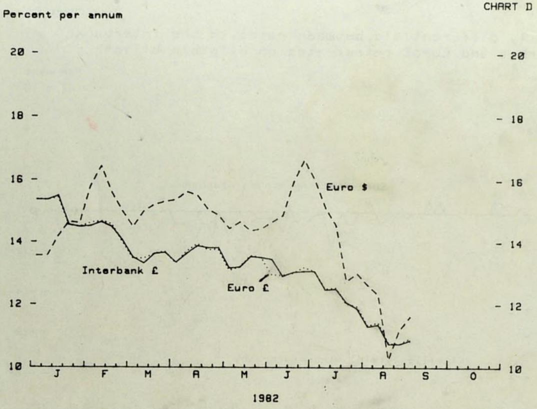


CHART E

Time yield curves for gilts