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FROM: P N SEDGWICK
DATE: 9 September 1983

SIR TERRY BURNS

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Mr George)
Mr Coleby)
Mr Fforde)
Mr Goodhart)
Mr Plenderleith)
Mr Allen)
Mr Foot)

Professor A Walters No. 10

INTERPRETATION OF MONETARY CONDITIONS : SEPTEMBER

... I attach the note for this month.

P.N.S

P N SEDGWICK

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INTERPRETATION OF MONETARY CONDITIONS

INTRODUCTION AND SUMMARY

The latest monetary data shows slight falls from their previous high levels in the six month growth rates of broad money. The six month growth rate of aggregate M1 remains high, but once again this is largely the result of strong growth in interest bearing sight deposits. The six month growth rate of non-interest bearing M1 was lower - at $10\frac{1}{2}$ per cent - than aggregate M1, but even within total NIBM1 there is a marked difference between the behaviour of notes and coin on the one hand, and non-interest bearing sight deposits on the other, with the six month growth rate of the latter significantly higher in the very recent past. In fact notes and coin (and hence the wide monetary base) is the only component of broad money that has recently been growing very slowly. While the real monetary base fell over the last six months all the other real aggregates showed significant positive growth.

2. Other indicators of monetary conditions continue, as in previous months, to indicate tighter monetary conditions, than do the monetary aggregates. The growth of money GDP continues to be fairly low, and while there has been some upturn in RPI inflation this is not true of producer output prices. Current indications are that the twelve month increase in earnings continued to edge down in recent months. The nominal exchange rate has continued to be stable and while there appears to have been a slight fall in real short term interest rates so far during 1983 this may in part reflect the use of estimates of future price inflation that are too high. In spite of falls in the very recent past IG yields are higher than in the first quarter of this year.

3. The latest monthly information (for July) on house prices shows an upturn in twelve month rate of inflation - to over 15 per cent - for prices at the mortgage approval stage. There are no signs as yet of a comparable upturn in the rate of inflation for other asset prices.

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(1) THE BEHAVIOUR OF THE MONETARY AGGREGATES

4. Table 1 and Charts I to IV summarise the most recent information on the nominal monetary and financial aggregates as well as data for previous financial years.

TABLE 1 : % GROWTH RATES IN THE NOMINAL AND FINANCIAL AGGREGATES ø

	Composite monetary indicator	MO	Non-interest bearing M1	M1	M2øø narrow definition (monetary sector)	M2øø broad definition	£M3	M3	PSL2
(a) financial years									
1980-81*	11.1	6.7	7.8	11.2			19.9	21.6	14.4
1981-82*	5.4	2.1	-0.3	3.9			12.0	15.3	10.8
1982-83*	10.9	5.1	11.3	14.9			11.5	12.8	11.4
(b) changes on same period in previous year+									
1981(1)	8.8	7.3	4.6	7.7			18.7	20.9	13.5
(2)	11.6	5.7	8.6	11.8			18.6	22.5	13.9
(3)	12.2	5.0	9.2	11.4			16.1	22.4	13.6
(4)	8.2	4.2	4.9	7.8			13.0	18.6	11.1
1982(1)	7.7	2.7	3.5	8.0			13.2	15.5	11.7
(2)	6.0	2.2	1.3	6.4			12.0	13.1	10.3
(3)	6.3	1.5	3.9	8.8			10.3	10.3	8.5
(4)	8.9	3.9	8.8	11.5	6.4	4.3	10.4	12.0	8.8
1983(1)	10.5	5.2	10.9	13.3	8.1	6.5	10.2	13.3	10.2
(2)	11.3	7.0	10.5	15.9	8.9	8.0	11.7	13.1	11.7
(c) changes on same period in previous year									
1982 Sept	6.1	1.5	3.9	8.8			10.3	10.3	8.5
Oct	7.1	3.2	5.7	8.7			9.7	9.4	8.9
Nov	8.5	3.4	7.5	10.5	4.9	3.4	10.1	10.7	8.9
Dec	8.9	3.9	8.8	11.5	6.4	4.3	10.4	12.0	8.8
1983 Jan	7.5	1.7	6.0	10.7	4.3	3.5	9.9	12.4	8.6
Feb	9.1	3.5	8.9	11.8	6.3	5.1	10.2	13.1	9.5
March	10.6	5.2	10.9	13.3	8.1	6.5	10.2	13.3	10.2
April	11.3	5.0	11.3	14.9	8.5	7.3	11.5	12.8	11.4
May	11.5	5.8	11.5	16.0	9.1	7.9	11.0	12.2	11.5
June	11.2	7.0	10.5	15.9	8.9	8.0	11.7	13.1	11.7
July	11.8	5.4	10.7	15.0	8.7	8.5	12.4	13.1	12.8
Aug	11.5	5.0	10.0	10.3	8.8	9.1	11.5	12.4	12.9
(d) changes (at an annual rate) in 6 months to									
1982 Sept	9.8	4.9	11.9	12.8	7.7	4.1	10.5	12.1	8.3
Oct	9.7	5.3	12.6	13.4	7.3	4.7	10.5	10.7	8.2
Nov	11.3	6.6	15.4	18.3	8.9	6.5	10.7	12.0	7.7
Dec	9.5	6.3	13.2	15.1	6.3	5.5	9.7	13.0	6.9
1983 Jan	9.2	4.8	8.4	16.2	3.6	4.6	11.3	12.2	9.3
Feb	10.6	5.9	10.1	13.6	6.4	7.1	10.5	13.3	11.0
March	11.4	5.6	9.9	13.9	8.4	8.9	9.9	14.7	12.2
April	13.0	4.8	10.0	15.2	9.8	9.9	12.5	14.8	14.6
May	11.8	5.1	7.7	13.8	9.3	9.4	11.2	12.4	15.4
June	12.9	7.9	8.0	16.8	11.6	10.6	13.7	13.2	16.8
July	14.5	6.2	13.2	13.8	14.1	12.5	13.6	14.0	16.4
Aug	12.4	4.1	10.5	14.3	11.3	11.1	12.5	11.5	14.9

(See page 3 for footnotes)

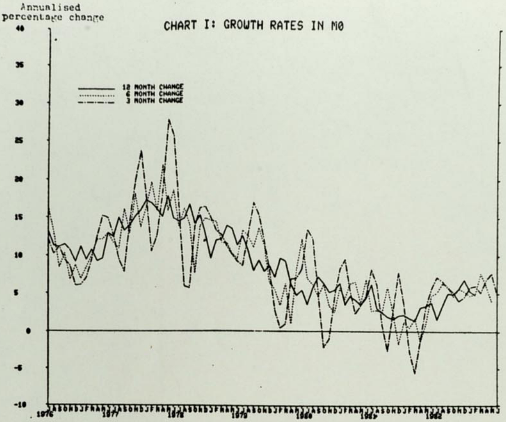
/ Footnotes to Table 1

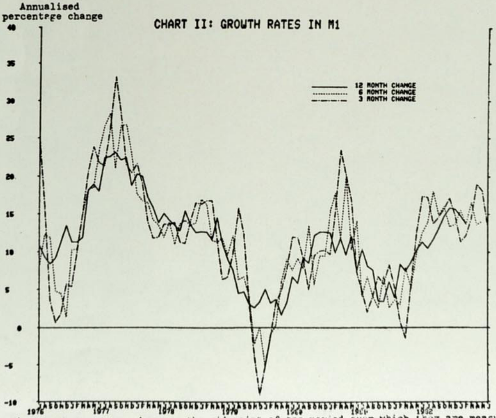
* Through the financial year (mid-April on mid-April)

ø The growth rates for all monetary aggregates, except non-interest bearing M1, are adjusted for changes to the new monetary sector. The October 1982 figures were greatly distorted by the over-subscription of the STC share issue. The figures shown here are the Bank of England/Treasury best estimates of what would have happened in the absence of the distortion.

+ The quarterly figures are for the final banking month of the quarter.

øø M2 is "seasonally adjusted" by using a seasonally adjusted series for the NIBM1 component and unadjusted series for the other components. When proper seasonal adjustment of M2 is eventually possible its within year movements will be different.





Note: The growth rates are shown as the mid-point of the period over which they are measured. Thus the growth from September 1981 to September 1982 is shown as March 1982 and the six month annualised growth rate from March 1982 to September 1982 is shown as June 1982.

CHART III: GROWTH RATES IN STERLING M3

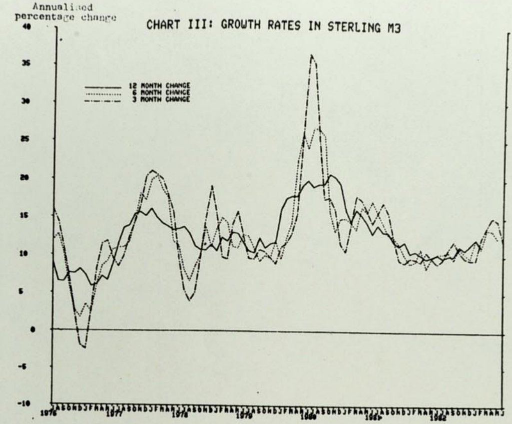
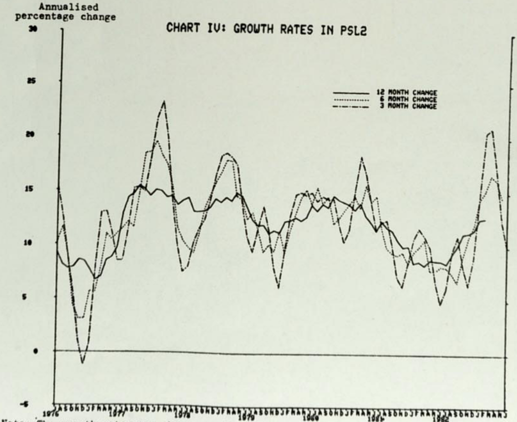


CHART IV: GROWTH RATES IN PSL2



Note: The growth rates are shown as mid-point of the period over which they are measured. Thus the growth from September 1981 to September 1982 is shown as March 1982 and the six month annualised growth rate from March 1982 to September 1982 is shown as June 1982.

5. The six month growth rates of the broad aggregates have fallen slightly from the high levels experienced in recent months. Table 1A shows the markedly different behaviour of the components of £M3.

(i) The six month growth rates of total interest bearing deposits (which will not be distorted by any switch of mainly wholesale deposits between the sight and time components) have been fairly high in recent months.

(ii) The six month growth of non-interest bearing sight deposits (which has probably been biased down in the recent past by shifts as a result of financial innovation into interest bearing sight deposits) has risen quite sharply in the last few months, having previously been low. This particular component of narrow money is generally thought to be the most sensitive to changes in nominal interest rates. It is, however, difficult to see how recent changes in interest rates - or the lagged effects of changes during 1982 - can account for the sharp rise in the six month growth rate in recent months.

(iii) Finally the six month growth rate of notes and coin (and therefore of the wide monetary base) has fallen in recent months to a very low level.

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TABLE 1A : GROWTH RATES OF COMPONENTS OF £M3 (%)

	Notes/Coin		Non-interest bearing sight deposits		All private sector interest bearing deposits		Interest bearing sight deposits	
	12 months	6 months (annual rate)	12 months	6 months (annual rate)	12 months	6 months (annual rate)	12 months	6 months (annual rate)
Q1	6.3	5.1	-	11.7	-	17.7	-	13.7
Q2	5.8	6.8	12.5	15.9	26.6	12.6	33.7	6.8
Q3	5.5	6.4	12.6	13.6	20.4	20.6	23.9	23.8
Q4	5.3	3.7	4.7	-5.4	17.3	22.0	25.7	47.8
Q1	4.7	3.1	2.5	-7.5	18.0	15.4	32.8	42.5
Q2		3.1	-0.1	5.6	17.5	13.1	33.5	20.5
Q3	3.5	3.9	4.2	17.2	12.8	10.3	28.4	15.7
Q4	4.8	6.6	11.4	17.5	10.0	7.0	20.9	21.2
Q1	6.3	8.8	13.8	10.6	9.7	9.1	21.3	27.2
Q2	7.7	8.8	12.3	7.4	11.6	16.3	33.2	46.3
Sept	3.5	3.9	4.2	17.2	12.8	10.3	28.4	15.7
Oct	3.8	5.2	6.7	17.4	10.8	7.5	20.9	19.4
Nov	4.4	6.2	9.5	21.5	10.8	8.6	21.9	28.1
Dec	4.8	6.6	11.4	17.5	10.0	7.0	20.9	21.2
Jan	3.9	7.7	7.3	8.8	10.6	10.7	26.7	44.1
Feb	5.8	8.8	10.9	10.9	10.1	9.5	21.5	24.7
March	6.3	8.8	13.8	10.6	9.7	9.1	21.3	27.2
April	7.2	9.1	14.0	10.8	10.9	14.4	26.9	34.8
May	7.3	8.4	14.2	7.3	11.2	13.9	31.1	34.1
June	7.7	8.8	12.3	7.4	11.6	16.3	33.2	46.3
July	7.3	6.9	12.9	17.2	12.2	13.8	28.9	15.3
Aug	6.3	3.9	12.8	14.7	11.6	13.9	25.2	25.7

6. Table 2 and Charts V and VI show the latest data on the growth of real money. The very low growth of nominal MO

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

		RPI+	Composite monetary indicator	MO	Non interest bearing M1	M1	£M3	PSL2
(a) Financial years*								
1980-81		12.0	-0.9	-4.9	-2.7	0.3	7.9	2.5
1981-82		9.4	-3.6	-6.7	-8.9	-5.2	2.3	1.3
1982-83		4.1	6.6	1.0	7.0	9.9	7.3	6.4
(b) Changes in same period in previous years								
1981	(1)	12.6	-3.3	-4.6	-6.1	-3.5	6.1	1.0
	(2)	11.3	0.3	-5.0	-1.5	1.4	7.4	2.7
	(3)	11.4	0.7	-5.8	-1.4	0.5	4.3	2.5
	(4)	12.0	-3.4	-6.6	-6.3	-3.9	0.9	-0.3
1982	(1)	10.3	-2.4	-6.9	-6.2	-2.3	2.6	1.2
	(2)	9.2	-2.9	-6.4	-7.2	1.4	2.6	1.0
	(3)	7.3	-0.9	-5.4	-3.0	5.8	2.8	1.1
	(4)	5.4	3.4	-1.4	3.4	5.8	4.7	3.3
1983	(1)	4.6	5.6	0.6	6.0	8.3	5.3	4.9
	(2)	3.7	7.4	3.2	6.6	11.8	7.7	8.0
(c) Change in 12 months to								
1982	Sept	7.3	-1.1	-5.4	-3.0	1.4	2.8	1.1
	Oct	6.8	0.3	-3.4	-1.1	1.9	2.7	2.0
	Nov	6.3	2.2	-2.7	1.3	4.1	3.6	2.5
	Dec	5.4	3.3	1.4	-3.4	5.8	4.7	3.3
1983	Jan	4.9	2.5	-3.1	1.1	5.5	4.7	3.5
	Feb	5.3	3.6	-1.7	3.4	6.2	4.6	3.9
	Mar	4.6	5.7	0.6	6.0	8.3	5.3	5.4
	April	4.0	7.1	1.1	7.1	10.5	7.2	7.1
	May	3.7	7.5	2.0	7.5	11.9	7.0	7.5
	June	3.7	7.3	3.2	6.6	11.8	7.7	7.0
	July	4.2	7.3	1.2	6.3	10.3	7.9	8.2
	Aug	(4.7)	6.5	0.2	5.3	8.8	6.4	7.8
(d) Change in 6 months to								
1982	Sept	5.7	3.9	-0.7	6.0	6.8	4.6	2.6
	Oct	5.0	4.3	0.1	7.1	8.5	5.0	2.9
	Nov	5.3	5.7	1.3	9.7	12.4	5.2	2.3
	Dec	4.4	4.9	1.8	8.4	10.2	5.0	2.3
1983	Jan	3.8	5.2	1.0	4.4	12.0	7.2	5.3
	Feb	3.5	6.8	2.3	6.3	9.7	6.7	7.3
	Mar	3.5	7.6	2.0	6.1	10.0	6.2	8.4
	April	2.8	9.9	2.1	7.1	12.6	9.4	11.5
	May	2.2	9.3	2.8	5.3	11.3	8.7	12.9
	June	3.0	9.6	4.7	4.8	13.3	10.4	13.4
	July	4.7	9.4	1.4	8.2	8.7	8.6	11.2
	Aug	(5.8)	6.2	-1.7	4.4	8.0	6.3	8.4

+ The simple method of seasonal adjustment for the RPI for use in calculation of the six monthly growth rates was described in the February 1982 Interpretation of Monetary Conditions.

* Through the financial year (mid-April on mid-April)

has involved the re-emergence of negative growth of real MO. All the other real aggregates have continued to grow at significant positive rates.

CHART V: GROWTH RATES IN REAL M1

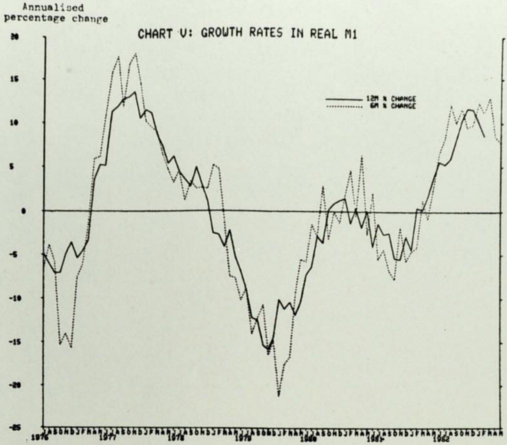
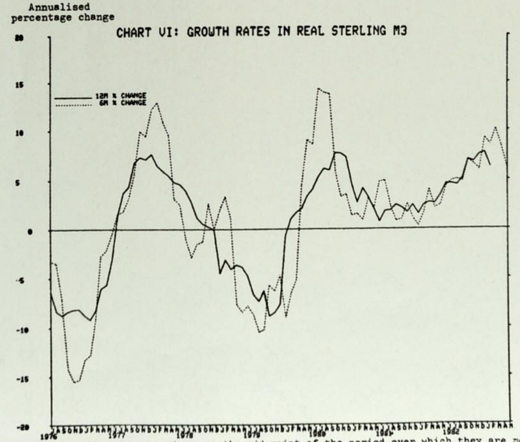
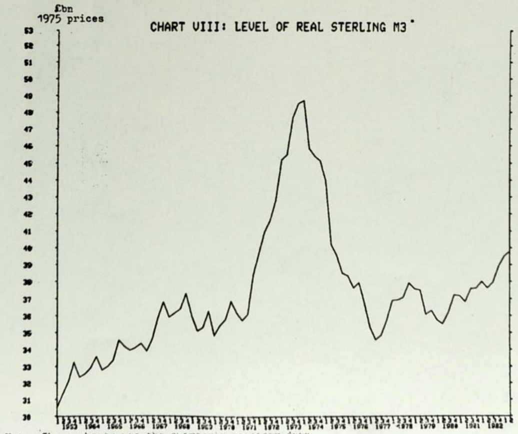


CHART VI: GROWTH RATES IN REAL STERLING M3



Note: The growth rates are shown as the mid-point of the period over which they are measured. Thus the growth from September 1981 to September 1982 is shown as March 1982 and the six month annualised growth rate from March 1982 to September 1982 is shown as June 1982.



Note: These charts use the quarterly monetary data

*1983 Q2 estimated

CHART IX: LEVEL OF REAL PSL2

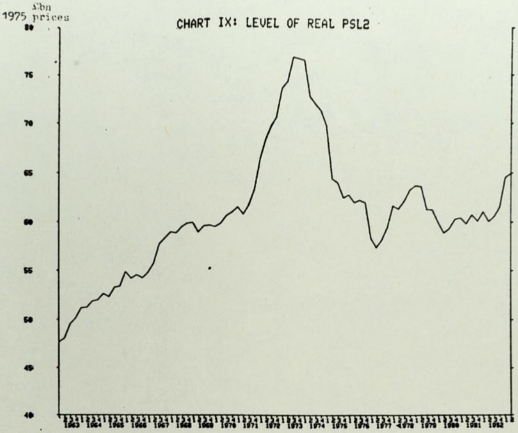
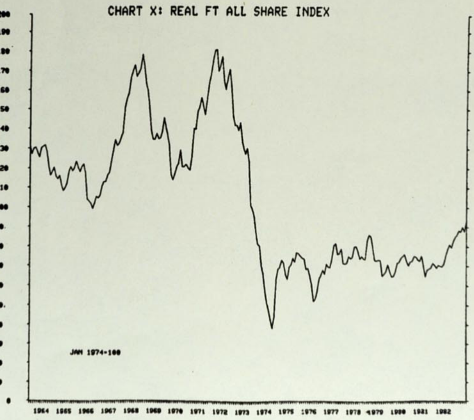


CHART X: REAL FT ALL SHARE INDEX



7. Table 3 shows that there has been a continuation of the decline in the growth in bank lending which has been underway since the beginning of the year.

TABLE 3 : BANK LENDING
(monetary sector, banking months, seasonally adjusted)

		Percentage change in stock of lending over	
		12 months	6 months (at annual rate)
1981	October	12.8	11.6
	November	16.3	20.2
	December	17.3	24.3
1982	January	18.9	31.7
	February	20.9	31.5
	March	21.7	35.3
	April	24.2	38.2
	May	25.6	31.3
	June	26.5	28.6
	July	28.8	25.9
	August	27.6	23.8
	September	28.6	22.3
	October	29.5	21.4
	November	26.9	22.8
	December	25.5	22.5
1983	January	23.6	21.3
	February	21.7	19.7
	March	19.5	16.8
	April	17.3	13.3
	May	16.9	11.4
	June	17.2	12.2
	July	15.7	10.3
	August	15.1	10.6

(2) OTHER INDICATORS OF MONETARY CONDITIONS

8. Although the numbers for particular quarters have continued to be erratic, Table 4 shows that the growth rate for money GDP appears to have been at a fairly low level in the recent past. Taken together with the information in Tables 1 and 1A on the nominal monetary aggregates this information implies a continuation of the fall in velocity for the monetary aggregates other than notes and coin (or M0).

TABLE 4 : GROSS DOMESTIC PRODUCT AT CURRENT PRICES

	GDP at market prices (CSO's average estimate)	
	% change on a year earlier	% change over six months (annual rate)
1981 Q2	9.3	8.7
Q3	9.4	9.2
Q4	9.0	9.3
1982 Q1	9.4	9.4
Q2	9.5	10.1
Q3	8.5	7.7
Q4	8.7	7.3
1983 Q1	8.6	9.5
Q2	(6.6)*	(6.0)*

*CSO projections

9. Table 5 shows the most recent behaviour of the RPI and the new series for producers' input and output prices. The most important change to the producer price series (compared with the former series for wholesale prices) is that mineral oil refining no longer forms part of manufacturing, so that prices of petroleum products are now a component of the input price index and no longer appear in the output price index. This has produced lower figures for output price inflation during the recent past.

TABLE 5 : RETAIL AND PRODUCER PRICES
(% change on same period a year before)

	Retail Prices	Producer Price Index (All manufactured products)	
		Output prices (home sales)	Input prices
1981 Q1	12.7	10.3	3.7 (14.5)*
Q2	11.7	9.3	9.8 (15.6)*
Q3	11.3	9.0	13.4 (12.1)*
Q4	11.9	9.7	15.0 (14.5)*
1982 Q1	10.4	8.7	11.8 (11.5)*
Q2		7.2	5.7 (-2.6)*
Sept	7.3	7.3	3.8 (-3.4)ø
Oct	6.8	6.8	3.6 (0.6)ø
Nov	6.3	6.4	3.6 (5.5)ø
Dec	5.4	6.3	4.9 (12.8)ø
1983 Jan	4.9	5.6	5.2 (14.9)ø
Feb	5.3	5.2	5.7 (18.8)ø
Mar	4.6	5.1	5.8 (15.6)ø
April	4.0	5.4	5.9 (11.7)ø
May	3.7	5.6	6.8 (8.2)ø
June	3.7	6.0	7.3 (2.0)ø
July	4.2	5.5	6.4 (-1.4)ø
Aug	(4.7)	5.4	8.0 (-1.8)ø

*Increase over two quarters before at an annual rate.
øIncrease over past six months (at an annual rate).

10. This revision to the output price series has reduced the gap between retail and producer (previously wholesale) price inflation during 1983, a process that has been assisted by the albeit modest rise in retail price inflation that began in July and is likely to continue in August. The underlying twelve month growth of average earnings had come down to 7 per cent by June and could fall still further in the subsequent months. Taken as a whole the information on retail prices,both output and input producer prices, and on pay does not suggest that any marked change in inflation is as yet under way or likely in the immediate future.

11. Table 6 shows the most recent information on nominal interest rates. In spite of the mid-year rise in US short rates the UK's three month interbank rate has been steady at just under 10 per cent. The short term yield curve is, however, still sloping upwards.

TABLE 6 : 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	12.0	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	Q1	14.3	15.1	14.1	14.7	0.4
	Q2	13.4	15.1	12.8	13.7	0.3
	July	12.4	14.2	12.3	13.2	0.8
	Aug	11.2	11.7	11.3	12.1	1.9
	Sept	11.0	12.0	10.5	11.4	1.4
	Oct	9.8	10.4	9.8	10.5	0.7
	Nov	9.4	9.8	9.2	10.6	1.2
	Dec	10.5	9.5	10.1	11.4	0.9
1983	Jan	11.2	9.0	10.7	11.9	0.7
	Feb	11.3	9.1	11.0	11.5	0.2
	March	10.8	9.4	10.7	11.2	0.4
	April	10.3	9.3	10.2	10.6	0.3
	May	10.3	9.0	10.0	10.6	0.3
	June	9.9	9.8	9.7	10.4	0.5
	July	9.8	10.0	9.5	10.9	1.0
	Aug	9.8	10.3	9.5	11.0	1.2
	Sept 8	9.8	10.0	9.5	10.9	1.1

There has been a slight rise in the 20 year gilt rate (and the yield gap) over recent months.

12. Table 7 shows that the real pre-tax three month interbank rate is lower than at the beginning of the year. It is still possible, however, that the price expectations based on outside

TABLE 7 : REAL INTEREST RATES (period average)

	Expected inflation over 12 months*	Real 3 month Interbank Rate	Yield on indexed gilts	
			1988	1996
1981 Q1	10.7	2.6	-	2.1
Q2	10.0	2.6	-	2.4
Q3	10.3	3.9	-	3.1
Q4	10.1	5.5	-	3.2
1982 Q1	10.3	4.0	-	3.1
Q2	9.2	4.1	2.8	3.0
1982 July	8.2	4.2	2.9	3.2
Aug	8.1	2.9	3.1	2.9
Sept	7.7	3.0	3.3	2.9
Oct	7.5	2.3	3.2	2.7
Nov	5.4	3.9	2.8	2.7
Dec	5.9	4.6	2.7	2.8
1983 Jan	6.1	5.1	2.8	2.5
Feb	6.4	4.9	2.9	2.5
March	6.5	4.3	2.9	2.5
April	6.5	3.8	3.0	2.5
May	5.9	4.4	3.4	2.9
June	6.2	3.7	3.9	3.2
July	6.4	3.4	4.3	3.5
Aug	6.2	3.6	4.2	3.5
Sept 8	6.2	3.6	3.7	3.3

*Unweighted average of forecasts by Phillips & Drew, National Institute and the London Business School; the expected rate of inflation for a given month is the change in the price level between six months earlier and six months ahead. This is assumed to approximate roughly to average inflation expectations over the 3 months immediately ahead.

forecasts are higher than those of most operators in financial and other markets so that the real short term interest rate is lower than the figures in Table 7 suggest. The yields on indexed gilts, which had risen significantly in recent months have dropped slightly, but still remain at high levels.

13. Table 8 shows that the effective exchange has continued

TABLE 8 : EXCHANGE RATES (period averaged)

	Effective rate	£/$ rate	uncovered differential* £/$	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 Q1	91.1	1.85	-0.8	4.3
Q2	90.3	1.78	-1.7	4.2
1982 July	91.2	1.72	-1.8	3.0
Aug	91.3	1.72	-0.5	2.4
Sept	91.7	1.72	-1.0	2.9
Oct	92.5	1.70	-0.6	2.6
Nov	89.3	1.63	-0.4	2.3
Dec	85.4	1.62	1.0	4.2
1983 Jan	82.0	1.57	0.1	4.5
Feb	80.8	1.53	2.2	5.8
March	79.1	1.49	1.4	5.8
April	82.1	1.53	1.0	5.3
May	85.0	1.58	1.3	5.3
June	85.2	1.55	0.1	4.5
July	84.7	1.53	-0.2	4.7
Aug	85.0	1.50	-0.5	4.4
Sept 8	84.8	1.49	-0.2	4.0

*Between 3 month UK Interbank rate and 3 month Eurodollar rate and the 3 month Euro DM rate.

at the level that has prevailed since May, notwithstanding changes in the uncovered differential against both the $ and DM.

THE MARKETS FOR MORTGAGES AND HOUSES

Mortgage lending

14. The increase in building society interest rates from July led, as expected, to a dramatic improvement in building society inflows. The net increase in shares and deposits in calendar July (seasonally adjusted) was £1,080 million, the highest figure since November 1982 and £390 million higher than the figure for June. Gross mortgage advances at £1449 million and net advances at £809 million were both down on June reflecting the lower level of commitments made by societies at the time when they were rationing lending. Consequently, the seasonally adjusted liquidity ratio rose from 17.2 per cent in June to 17.7 per cent in July. In spite of the improved liquidity position, net new commitments unexpectedly declined further in July (£1343 million against £1442 million in June), suggesting that the societies were still imposing some lending restrictions.

15. Building societies raised also £200 million net from the wholesale money markets in July. Most building society CDs have a maturity of one month or three months, so that increasing quantities of gross issues will soon be required to maintain the same level of net issues. It is probable that the rate of net issues will decline from the levels recorded in June and July. On the other hand, building societies will be able to take wholesale time deposits from October, while the introduction on 1 September by the largest societies of a new 2-year premium term share aimed at raising £1 billion by the end of the year is likely to improve retail inflows. As the liquidity ratio continues to improve, mortgage rationing is likely to be reduced so that lending commitments and eventually actual lending should begin to approach the levels recorded earlier in 1983.

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TABLE 9 : BUILDING SOCIETY FINANCIAL FLOWS (calendar months and quarters, seasonally adjusted)

	Liquidity Ratio (end period)	Net increase in shares & deposits	Net advances	Gross advances	Net new commitments
1982 Q1		£m	£m	£m	£m
1982 Q1	19.0	2311	1275	2754	3323
Q2	19.5	2499	1922	3768	4031
Q3	20.0	2623	1984	3897	4077
Q4	20.1	2842	2674	4717	5273
1983 Q1	18.0	2390	2933	5196	5284
Q2	17.2	1983	2816	4922	4565
October	20.2	1049	838	1490	1592
November	20.2	1148	882	1552	1760
December	20.1	645	954	1675	1922
January	19.4	725	955	1728	1706
February	18.7	795	918	1637	1772
March	18.0	870	1060	1831	1806
April	17.8	719	900	1620	1572
May	17.2	574	1036	1708	1551
June	17.2	690	880	1594	1442
July	17.7	1080	809	1449	1343

16. Table 10 indicates that the flow of bank lending for house purchase has not yet declined significantly compared with the early months of 1983, in spite of additional lending restrictions announced by some banks, notably National Westminster and Lloyds. The rate of growth of bank lending, however, whether measured over 6 or 12 months, has continued to decline. The 12-month growth of building society lending remains at about 20 per cent, while the estimated growth of bank and building society lending combined has declined slightly from a peak of 24.7 per cent in March and April and remained at the very high level of 23.8 per cent in July.

TABLE 10 : NET LENDING FOR HOUSE PURCHASE
(£m., seasonally adjusted, calendar months)

		Building Societies	Banks (Est)	Total
	July	651	450	1101
	August	638	470	1108
	September	695	420	1115
	October	838	410	1248
	November	882	390	1272
	December	954	360	1314
1983	January	955	260	1215
	February	918	320	1238
	March	1060	280	1340
	April	900	250	1150
	May	1036	270	1306
	June	880	310	1190
	July	809	290	1099

Percentage change in stock of lending

		Building Societies		Banks (excl. TSBs Estimated)		Total Banks and Building Societies	
		12 months	6 months	12 months	6 months	12 months	6 months
1982	Dec	15.9	18.6	83.1	71.3	23.1	25.1
1983	Jan	17.0	19.6	78.6	61.3	23.8	25.1
	Feb	18.0	20.5	73.9	53.6	24.4	25.1
	Mar	18.9	21.8	67.3	47.4	24.7	25.4
	April	19.3	21.7	62.2	41.3	24.7	24.5
	May	19.7	21.9	57.2	36.9	24.6	24.2
	June	19.9	21.2	51.7	34.3	24.2	23.3
	July	20.0	20.3	47.1	34.2	23.5	22.5

17. Table 11 and charts XI and XII show the latest available information on house price inflation based on quarterly and monthly house price data. The quarterly figures based on building society approvals and completions do not indicate any acceleration in house prices in the second quarter. The DOE mix-adjusted index for the second quarter confirms this conclusion.

18. The monthly house price figures for July do, however, indicate some acceleration compared with recent months. The annual rate of inflation based on approvals rose to 15.5 per cent, the highest figure for two years. This latest increase is difficult to explain. Mortgage rationing and the partial withdrawal of the banks may account for the halt in the upward trend

TABLE 11 : HOUSE PRICES
(% change on a year earlier)

	Based on mortgage approvals	Based on mortgage completions	Mix-adjusted (based on completions)	Nationwide (based on approvals)
1982 Q1	-4.0	-4.9	0	2
Q2	-0.7	-3.0	1	2
Q3	4.0	0.5	2	3
Q4	12.2	6.8	6	8
1983 Q1	13.0	11.3	11	9
Q2	12.8	10.4	9	11
1982 October	9.9	3.1		
November	12.9	6.9		
December	14.2	10.4		
1983 January	13.8	9.6		
February	13.7	10.8		
March	12.4	11.8		
April	12.6	10.9		
May	12.4	9.5		
June	13.3	10.9		
July	15.5	11.7		

in house price inflation in the first half of 1983, but there is no evidence that rationing ceased suddenly in July and, as has been noted above, the flow of net new commitments to advances declined further. The increased lending as a result of the recent higher inflows - together with any effect this will have on house prices - is still to occur.

CHART XII: MONTHLY HOUSE PRICES

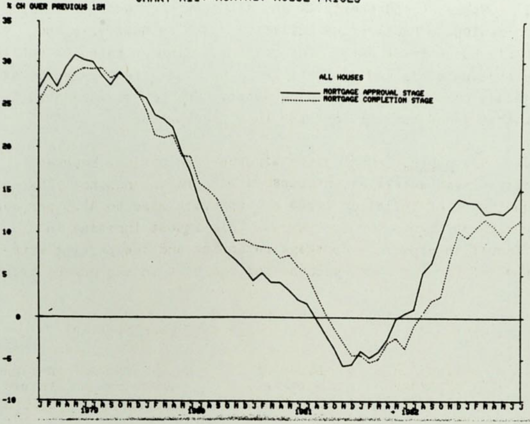
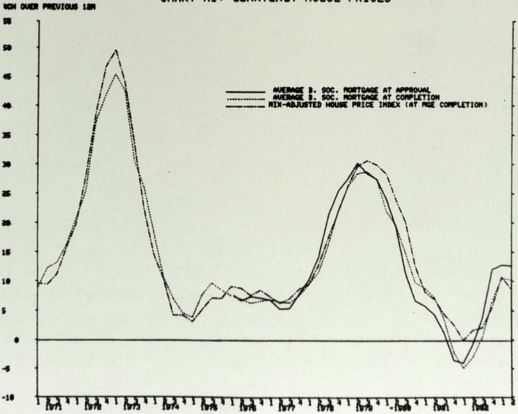
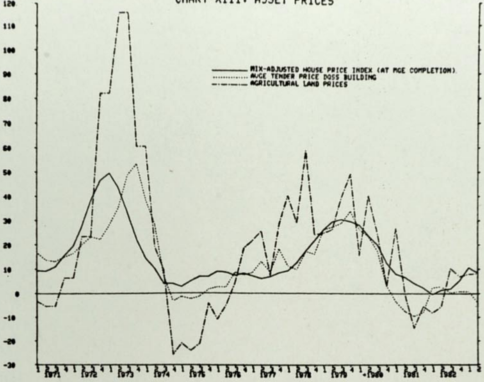


CHART XI: QUARTERLY HOUSE PRICES

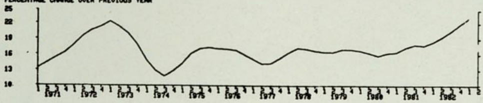


19. Chart XIII shows movements up to the second quarter of this year in the twelve month inflation rates for average tender prices for public sector buildings and agricultural land prices, as well as for the mix-adjusted house price index. Agricultural land prices show an annual percentage change of just over 8½ per cent in the second quarter; very little different from the figures for the previous two quarters. Tender prices for public sector buildings actually fell over the year to the second quarter of 1983. There is therefore no indication as yet of an acceleration in asset prices other than for house prices.

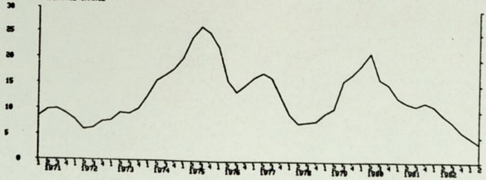
CHART XIII: ASSET PRICES



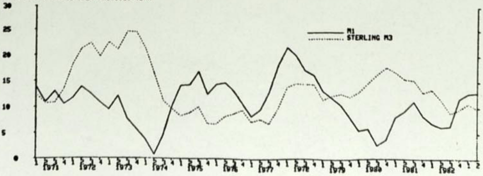
STOCK OF MORTGAGES OUTSTANDING



RETAIL PRICE INDEX



GROWTH RATE* OF M1 AND STERLING M3



*1983 Q2 Estimated

Bank of England

With the compliments of

E.A.J.George

COVERING SECRET

BANK OF ENGLAND
Threadneedle Street
London
EC2R 8AH

9 September 1983

P E Middleton Esq
H M Treasury
Parliament Street
London
SW1P 3AG

Dear Peter,

I enclose our regular monthly note on interest rates over the next few weeks for our meeting on Tuesday afternoon.

Yours ever,

Eddie

INTEREST RATES OVER THE NEXT FEW WEEKS £ millions

1 The unpublished band for interest rates on bills with up to 14 days to maturity stands at 9-11%, where it has been since last October. Within this band our operations have been conducted at a rate of 9 9/16% since just after the General Election.

Market conditions

2 US financial developments - and particularly money supply growth there - have continued to be the main influence on world financial markets over the last few weeks, but their effect on the UK has been muted. Sterling has remained for the most part fairly steady since late August at around $1.50 against the dollar and 85-85 1/2 in effective terms, though it dropped back to 84.6, partly on some speculation in the foreign exchange market about lower UK interest rates in the wake of the better-than-expected August money figures. In the money market, earlier anxieties about monetary conditions both here and in the US have been diminished by the unexpected fall in M1 announced on 2 September and, more important, by the money supply figures published here on 6 September; but nevertheless the yield curve from a month out to a year remains upward sloping, and there has been no market pressure on us to lower our dealing rates.

3 The gilt-edged market has been influenced by the vagaries of the US bond market, but the underlying tone has been firm and we have been able to sell substantial quantities of stock. Gross sales so far secured for banking September total 1,570 but as yet we have no calls secured for future months.

4 To judge from such stockbrokers' circulars as have been published over the holiday season, inflationary expectations may have moderated somewhat further. The consensus is that the 12-month increase in the RPI will rise to around 5% at the end of this year and 6 1/2% by mid-1984. The one-year inter-bank rate is now around 10 1/2%; on this basis pre-tax real interest rates are around 4%.

Monetary conditions

5 Sterling M3 rose by only 0.2% in banking August; PSL2 went up by 0.8% and M1 by 0.9%. The annualised growth rates of these aggregates over the first six months of the target period are 12.4%, 15.0% and 14.3% respectively.

6 Taking the last three months together, there has been a clear slowdown in monetary growth, concentrated in private sector holdings of interest bearing bank deposits, both sight and time. PSL2 decelerated much more sharply than sterling M3, mainly because the building societies began to rebuild their liquidity (largely bank deposits which increase sterling M3 but not PSL2) and because the local authorities made net repayments of short-term debt (included in PSL2) to the non-bank private sector.

TABLE 1

Growth of the monetary aggregates

Percentage increases (annual rates); seasonally adjusted

	First six months of current target period	Mar 83 - May 83	June 83 - Aug 83	Forecast Sep 83 - Nov 83
M1	14.3	16.5	12.1	12 3/4
Sterling M3	12.4	13.8	11.1	12 1/2
PSL2	15.0	18.4	11.7	12 3/4
Wide monetary base (MO)	4.1	4.7	3.6	
Non-interest-bearing M1	10.5	10.6	10.5	
M2 (a)	11.1 (b)		8.8 (c)	
PSL1	12.8	17.2	8.6	
PSL2A	14.2	17.0	11.5	
M3	11.4	11.4	11.4	

(a) On the new definition including building society shares and deposits.

(b) Seasonally adjusted using adjustments to nib M1 and building society interest credited only.

(c) Change over 12 months to mid-August 1983.

7 Among the counterparts to the growth in sterling M3 in banking August, the PSBR[1] was down to 530, by far the lowest figure for any banking month in this target period. This brings the monthly average since mid-April (after the end-1982/83 surge in public spending) down to 990. Sale of central government debt to the non-bank private sector raised 1,100 in banking August, nearly all in the form of gilt-edged. This means that the PSBR has been fully funded over the period since mid-April. Gross sales of gilt-edged in banking August were 1,210, bringing the total since mid-March to £6 3/4 billion - an annual rate of over £16 billion.

8 Bank lending in sterling to the private sector rebounded to 1,230 in banking August, suggesting that the increase in banking July was erratically small. Comparing the most recent three months with the preceding three, the increase in this category of lending has gone up from £1.9 to £3.1 billion. If foreign currency lending and bills held outside the banking system are included, the increase was from £1.7 to £4.4 billion. In part, this increase in lending will have been a natural consequence of fluctuation in the PSBR, so that the underlying increase in the rate of lending will have been smaller than the figures suggest. The rate of personal lending does not appear to have risen much.

9 Building society lending, which had been going up at a rate of nearly £1 billion a month in the first five calendar months of 1983, moderated to 880 in June as the societies increasingly resorted to mortgage rationing in response to growing pressure on their liquidity ratios. After the first issues of building society certificates of deposit in June, and more especially after the increase in share and mortgage rates on 1 July, inflows into the societies recovered sharply, but the societies made it their first priority to reconstitute their depleted liquidity, and the rate of mortgage lending fell back further in July, to 810.

---

(1) Strictly, the PSBR minus net purchases of local authorities' and public corporations' debt by the non-bank private sector.

10 The three-month forecast is for growth in the target aggregates at around 1% a month. This would leave the annualised growth rate of sterling M3 over the target range roughly unchanged at about 12 1/2% by mid-November; but it would bring PSL2 and M1 a small way back towards the target range (14 1/4% and 13 3/4% respectively by mid-November). The modified PSBR is expected to remain high, averaging 1,210 a month, and bank lending in sterling to the private sector is put at 1,020 a month. The forecast incorporates the assumption that the rate of gross gilt-edged sales will be 1,500 this month; and 1,250 is assumed for each of the next two months; and National Savings inflows are projected at an average of 290 a month, compared with 160 a month over the most recent three months. Even on this basis the PSBR is projected to be underfunded by 925 over the three months.

11 Looking further ahead, if the post-package PSBR forecast of £10.7 billion is right, there would need to be a substantial reduction in the PSBR to a monthly rate of about 700 from mid-November 1983 to mid-April 1984. Even taking this as given, the weight of gilt-edged maturities over the winter combined with the prospect - if nothing is done - of some £1 billion of CTDs running off, will require exceptionally large funding through gilts and National Savings to be sustained throughout this period if the public sector's contribution to monetary growth is to be contained. There must be some doubts as to how far this can be achieved.

12 Moreover the building societies are likely to increase their rate of mortgage lending over the next few months, as reconstituting their liquidity becomes a less urgent pre-occupation. When this happens, the gap between the growth rates of PSL2 and sterling M3, which is already 2 1/2% at an annualised rate over the target period so far, may widen further.

Conclusion

13 The monetary situation has improved over the last month. The exchange rate has remained remarkably stable over the past few months of turbulence in the world financial markets and the US

financial situation has recently seemed a little better; the recent and prospective retail price statistics remain satisfactory, and the monetary aggregates have moved back towards the target range. On the other hand, the recovery of the real economy continues to be hesitant. Against this background there is beginning to be talk that the next move in interest rates could be downwards, though no sign as yet in the money market of expectations of any early move.

14 At the same time, the growth of all three target aggregates remains substantially above the top of the target range, and the prospects of being able to bring them back over the rest of the target period do not at this stage seem encouraging (even though £M3 in September will be helped by the recent heavy funding). And there is the constant threat from the US where the markets are fearful of a renewed acceleration of monetary growth over the next few weeks.

15 Against this background we would be cautious about any early move to reduce short-term interest rates. It is possible that if US monetary developments are more favourable in September than the markets now expect, pressure for lower rates could begin to build up. It would be important, not least in relation to the exchange market's perception of official attitudes to the exchange rate, that we should not appear to be snatching at the first opportunity to bring interest rates down, but rather that we should be seen in the first instance to be resisting such pressure if it were to emerge. But if the pressure were strong, and if we had by then evidence of a favourable monetary outcome here for banking September, we would not necessarily wish ultimately to stand out against a modest decline.