SECRET

FROM: RACHEL LOMAX
DATE: 20 JANUARY 1984

1. SIR PETER MIDDLETON

2. CHANCELLOR

cc: Chief Secretary
Financial Secretary
Sir T Burns
Mr Littler
Mr Cassell
Mr Monck
Mr Battishill
Mr Lavelle
Mr Lankester
Mr Peretz
Mr Mowl
Mr Riley
Mr Sedgwick
Mr O'Donnell
Mr Willetts
Mr Willoughby
Mr Wynn Owen
Mr Lord
Mr Ridley

Mr George - B/E

Prof. Sir A Walters
UKTSD Washington

Mr Redwood - No 10

MONETARY PROSPECTS

This minute summarises our latest assessment of the monetary situation and prospects, and the discussion at Sir Peter Middleton's usual monthly meeting with the Bank to review our approach to short-term interest rates and funding.

Monetary Aggregates

2. All three target aggregates rose quite sharply last month, following a period of relatively slow growth over the Autumn, especially in £M3; however, uncertainty about seasonals for an unusual four week banking December makes interpretation particularly difficult. The profile of monetary growth since the summer means that six month growth rates of most of the aggregates have remained steady, or continued to decline, whilst three month growth rates have jumped up. Over the ten months of the target period, £M3 has now moved to the top of the range, with PSL2 and M1 still within 2 per cent of the top, (though the underlying figures for both are higher once allowance is made for known special factors - more like 1- per cent for M1 and 12½ per cent for PSL2).

Table 1: Main Aggregates : recent experience

(per cent, seasonally adjusted)

	M1	£M3	PSL2	Notes and coin*	M0	M2‡
monthly change:-						
November	+0.6	+0.6	+0.5	+0.5	+1.0	+0.5
December	+1.6	+1.3	+1.0	+0.4	-	+0.6
growth at an annual rate over past:-						
3 months	15.8	14.1	10.7	4.3	4.3	5.9
6 months	8.2	7.9	9.0	5.2	3.9	4.8
target period (10 months)	12.9	11.0	12.1	6.2	6.7	7.7
12 months	12.4	10.8	13.1	6.5	5.9	7.7

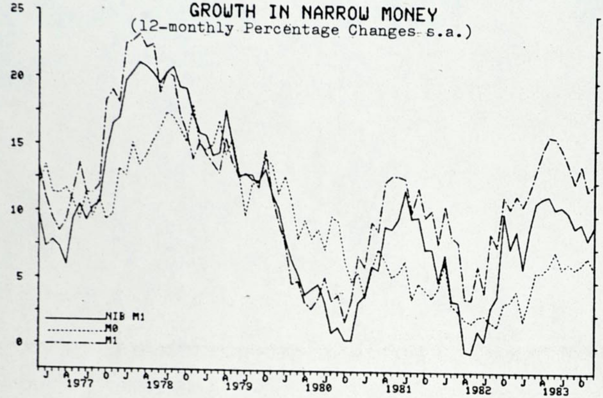
* including till money

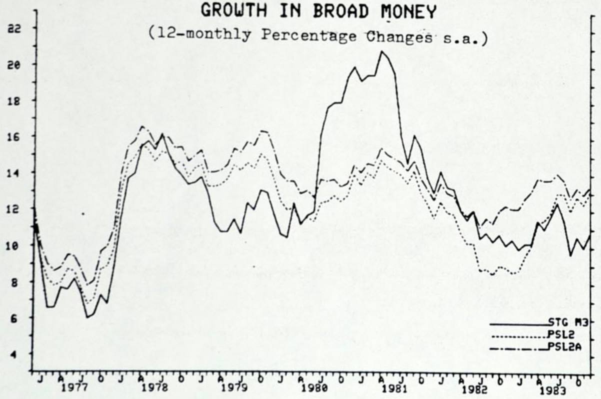
‡ M2 seasonally adjusted for its NIB M1 and building society interest credited components only. Not published in this form.

3. The trend growth in narrower measures of money seems to be little changed. The sharp increase in NIB M1 was partly due to a large erratic fall in transit items(which may also have distorted the bank lending figures). The year-on-year growth in M2 remains inside the 6½-8 per cent range within which it has been fluctuating since last March. The three and six month growth rates for M0 have fallen, reflecting high outturns in September and June as well as last month's low figure. Among the wider measures, total M3 grew very sharply, by 2.3 per cent, with a massive £1¼ billion increase in residents foreign currency deposits, only half of which was due to valuation adjustments resulting from sterling's fall against the dollar. The target period growth in private sector £M3 remains fractionally above £M3, at 11.2 per cent.

4. <u>Over the next three months</u>, £M3 is expected to stay at the top of the target range, averaging about 1 per cent a month over February and March, and perhaps a little less in January. We have cautiously increased our forecasts of underlying sterling lending, though we are looking for some reduction relative to December. Building society rates are assumed to remain unchanged at least until the Budget, and the prospect is still for fairly buoyant inflows and strong mortgage demand. Wider liquidity may grow a little faster than £M3, partly for seasonal

CHART 1


GROWTH IN NARROW MONEY
(12-monthly Percentage Changes s.a.)
25
20
15
10
5
0
NIB M1
M0
M1
J A J O
1977
1978
1979
1980
1981
1982
1983


GROWTH IN BROAD MONEY
(12-monthly Percentage Changes s.a.)
22
20
18
16
14
12
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8
6
4
STG M3
PSL2
PSL2A
J A J O
1977
1978
1979
1980
1981
1982
1983

reasons, moving PSL2 even further outside the target range. The projected growth in MO is closely in line with what we take to be the underlying trend over the target period so far. On the basis of the Weekly Bank Return, MO is estimated to have fallen by ¼-½ per cent in banking January; notes and coin were flat (seasonally adjusted).

Table 2: Summary of the Forecast

growth at an annual rate

	MO	M1	£M3	PSL2
mid-December - mid March	6¼-9½	16	11¼*	15¾*
mid-February 83 - mid March	6½-7¼	13½	11	13

*Forecasts for January have been shaded down since Sir P Middleton's meeting, to reflect provisional information on public sector transactions.

Public Sector Borrowing

5. The 'PSBR' was £0.6 billion in banking December, £0.3 billion higher than last month's final forecast (probably attributable to a high LABR). The forecast already took account of lower than expected central government own account borrowing. Over the next three months, the 'PSBR' may total about £1¼ billion, seasonally adjusted, which is low relative to previous three month periods this year. Calls on earlier share sales will raise £300 million in January (BP) and £175 million in March (Cable and Wireless), but the £½ billion EC refund assumed in the calendar March has little effect in this period. The projections for the eleven months to mid-March look reasonably consistent with the Autumn Statement. They are based on calendar month profiles which do not yet take account of later updates of the NIF.

6. With the start of the main revenue season, central government is forecast to be in unadjusted surplus in January and March, and close to balance in February. The seasonally adjusted profile is particularly uneven, though the size and uncertainty of seasonal influences at this time of year make it difficult to put much weight on individual monthly figures. On lending, which has shown itself very responsive to interest rate expectations, is subject to wide margins of error. The forecast

of £1 billion over the three months, while lower than over the same period last year, compares with a total of £2.9 billion for the eight months to mid-December.

7. The provisional CGBR for banking January is a surplus £35 million, (£320 million unadjusted). The own account surplus was bigger than expected.

Debt Sales

8. Gross sales reached £1 billion in banking December, but high redemptions brought net sales to only £0.3 billion. Sales to non-banks, at £0.6 billion, exceeded net sales, as the monetary sector and overseas were again net sellers. We have done slightly better than the planning ambition in banking January, with gross sales reaching £1.35 billion (net sales were £0.8 billion). The forecast assumes gross sales of £1¼ billion a month in February and March. The prospects of achieving this have been significantly improved by the success of the new convertible, and net sales in February will be helped by the absence of redemptions or buying-in; but March will be another month of heavy redemptions.

9. National Savings inflows have remained buoyant, and banking January should be another good month. Despite some recent upturn in withdrawals of index-linked certificates, inflows have been stronger than expected. The building societies have also had high inflows in the last few weeks, and it is possible that both benefitted (along with low coupon gilts) from switching out of offshore roll-up funds before the end of the year. On the basis of a forecast which assumes that monthly inflows continue to exceed £200 million a month on average, we should get very close to the £3 billion target for the financial year.

10. The private sector has been surrendering Series 5 CTD's as expected, and the stock has approximately halved since early September. The policy of setting CTD rates rather more aggressively has generated an unusually large volume of new purchases. Even so, we

are expecting CTD's to make a modest negative contribution to funding over the next three months.

11. The implications for funding are summarised in table 3, before and after allowing for the external finance of the public sector. Figures in brackets are unadjusted.

Table 3: Funding and the 'PSBR'

£billions, seasonally adjusted

	mid-Feb - mid-Dec (target period)	mid-April - mid-Dec	mid-Dec - mid-Mar	mid-April - mid-Mar
'PSBR'	+11.3	+8.4	+1.3	+ 9.7
Debt sales to NBPS(-)	-10.0	-9.3	-2.5	-11.8
Over(-)Underfunding(+)	+ 1.3 (+3.1)	-0.9(+0.3)	-1.2(-4.2)	-2.1(-3.9)
External finance of public sector (-)	- 0.9	-0.6	-0.3	- 0.9
Over(-)Underfunding(+) (alternative definition)	+ 0.4	-1.5	-1.5	- 3.0

Money Market Assistance

12. The forecasts imply overfunding on a substantial scale relative to the unadjusted 'PSBR' (and to a lesser extent, even on a seasonally adjusted basis). Money market influences are expected to be even more sharply contractionary than they were over the same period last year, reflecting both a lower CGBR and a higher assumed level of gilt sales. The stock of money market assistance may rise by something like £3½ billion over the three months to mid-March (compared with about £1¼ billion last year) to reach nearly £12 billion by the end of the period. The seasonal peak, probably at the beginning of calendar March, might be a little higher (compared with a peak of £10¾ billion last year). The Bank may, at some stage, need to supplement their normal bill operations with special repurchase arrangements based on gilts or export credit paper (as happened last year). The NLF may

also run a surplus, on occasion, for related reasons.* This would be deposited with the Banking Department as provided for under the 1982 Finance Act. (The relationship between funding, money market ... assistance and NLF surpluses is explained in the attached Annex.)

Lending to the Private Sector

13. Total lending seems to have accelerated in the last three months following a period of slackening growth, particularly in lending to companies, earlier in the year. But the very high seasonally adjusted December figure is a little suspect, and there is no reliable sectoral breakdown for banking months. What evidence there is suggests that lending for consumption has been growing particularly strongly, though bank lending for house purchase has been increasing a fairly steady rate. As expected, company sector borrowing in sterling has clearly recovered from the low levels earlier in 1983, but it is not possible to separately identify industrial and commercial companies. Foreign currency borrowing from UK banks has been rising strongly since early Summer, and while new capital issues were sharply down towards the end of the year, they were running at record levels in the second and third quarters. The forecasts assume an underlying growth in sterling lending of around the average rate in the past three months.

Building Societies

14. The prospect of a cut in mortgage rates looks increasingly remote. The higher level of new commitments in November and December points to further increases in the rate of lending, following strong growth in advances in recent months. The increase in mortgage rates announced by two of the clearers does not suggest a serious desire by the banks to compete business away from the societies. Retail inflows fell in banking December, partly for seasonal reasons, but inflows so far this month have been high, and the societies have continued to tap the wholesale market. We are only expecting a slight slackening in the rate of inflows over the next three months.

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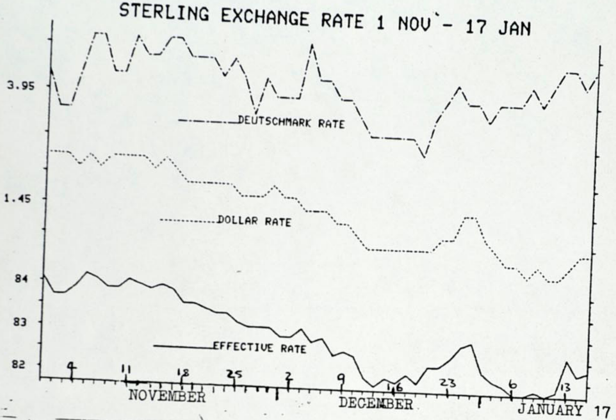
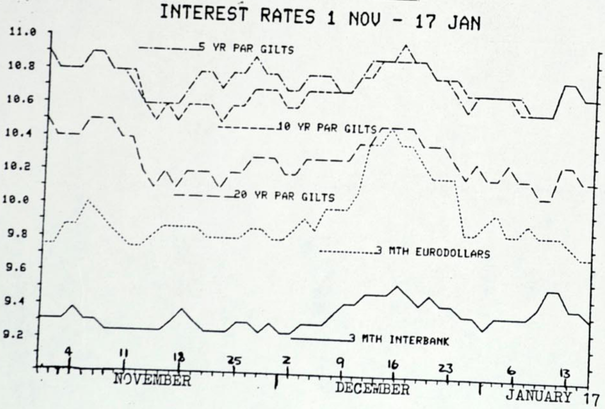
* The first dates on which this is likely to occur are January 25 and 27, (and there is an outside chance of one tonight, 20 January). If there is an NLF surplus next Wednesday, it will be apparent from the published Weekly Bank Return.

CHART 2


STERLING EXCHANGE RATE 1 NOV - 17 JAN
3.95
1.45
84
83
82
DEUTSCHMARK RATE
DOLLAR RATE
EFFECTIVE RATE
4
11
18
25
2
9
16
23
6
13
NOVEMBER
DECEMBER
JANUARY 17


INTEREST RATES 1 NOV - 17 JAN
11.0
10.8
10.6
10.4
10.2
10.0
9.8
9.6
9.4
9.2
5 YR PAR GILTS
10 YR PAR GILTS
20 YR PAR GILTS
3 MTH EURODOLLARS
3 MTH INTERBANK
4
11
18
25
2
9
16
23
6
13
NOVEMBER
DECEMBER
JANUARY 17

Other Indicators of Monetary Conditions

15. The dollar eased back around Christmas, but has since risen strongly against European currencies, including the pound. Sterling's effective rate is now at much the same level as a month ago (see ... chart 2), reflecting a stronger £/DM rate as well as some recent recovery against the dollar. Money markets have remained generally featureless, though, as in the gilts markets, the provisional December money figures caused some nervousness. Real short rates and tax yields on index-linked stock seem to be little changed.

16. There is little new information on asset prices. Monthly data for house prices (which are not mix-adjusted) provide tentative evidence that the rate of house price inflation may be coming down. While the ratio of house prices to the consumer expenditure deflator has risen significantly from the 1981 trough, the ratio to average wages and salaries has increased more slowly, and is still well below the 1979 peak.

Policy

17. The meeting agreed that there was no case for the authorities to take the initiative in raising short term interest rates. But the Bank argued that sustained official resistance to market pressure for higher rates would risk damaging the credibility of policy. Markets had become more concerned about domestic monetary developments, and it would be difficult to mount a convincing case for allowing the aggregates to overshoot the target. Unlike the early part of last year, when rapid growth was associated with the public sector's contribution to £M3, the main worry now is bank lending to the private sector: the appropriate policy response could be different. The exchange rate was a continuing source of uncertainty; while the rate was now more settled, it could be vulnerable to overseas developments, in the US and Germany and, possibly, the oil market. As always, however, the response to market pressures would have to be reviewed in the light of circumstances. There was general agreement that it would be desirable to see further evidence before acquiescing in an increase in rates.

18. The significance of the recent strength of bank lending was not

easy to assess. The upturn in consumer borrowing has added to the Bank's long standing concern about mortgage credit, though they are not yet convinced that corporate lending has taken off. Sir Terence Burns suggested that concern about the growth of personal borrowing is not easy to reconcile with the view expressed by some commentators that the consumer boom is about to collapse, unless there is a real prospect of a sharp upturn in inflation. Neither the outside forecasts nor the current indicators pointed in that direction. The Bank were less sanguine about the immediate inflation outlook, but accepted that there was a puzzle. Sir Peter Middleton said further work was needed to reach an agreed analysis of recent trends in personal borrowing, and the implications for policy.

19. The meeting noted that the forecast implied large seasonal shortages in money markets, which could be difficult to cope with through normal bill operations, and might sometimes be associated with a build-up of NLF surpluses at the Banking Department. These developments were quite legal under the 1982 Finance Act, and entirely defensible during the revenue season, but they could attract criticism from opponents of the 1982 clauses. Given the risks on the monetary aggregates, there was no case at all for deliberately easing back on funding. But it might be worth reviewing current arrangements for PWLB and NLF lending, since higher on-lending would help to reduce the scale of shortages, other things being equal.

RL

RACHEL LOMAX

Table A: Percentage Changes in Monetary Aggregates
Seasonally adjusted data

Banking month	Wide monetary base (MO)	NIB M1	M1	M2*	Priv £M3	£M3	M3	PSL2	PSL2A
Outturn									
- July	-0.9	+1.2	-0.4	-0.6	+0.7	+0.8	+0.9	+0.9	+0.8
- August	+0.7	-	+0.8	-0.1	+0.5	+0.2	+0.1	+0.8	+0.8
- September	+1.0	+0.9	-0.2	+0.3	-0.1	-0.5	-0.4	+0.2	+0.4
- October	-	+0.5	+1.5	+0.4	+1.3	+1.4	+1.8	+1.0	+1.3
- November	+1.0	+0.4	+0.6	+0.5	+0.2	+0.6	+0.9	+0.5	+0.6
- December	-	+2.0	+1.6	+0.6	+1.4	+1.3	+2.4	+1.0	+1.1
Last 3 months at annual rate	+4.3	+12.2	+15.8	+5.9	+12.3	+14.1	+22.4	+10.7	+12.5
Last 10 months (target period) at annual rate	+6.7	+11.0	+12.9	+7.7	+11.2	+11.0	+12.8	+12.1	+12.4
Last 12 months	+5.9	+9.2	+12.4	+7.7	+10.9	+10.8	+12.7	+13.1	+13.4
Forecast									
(i) Percentage change in month									
- January	½ - ¾ per cent a month		1¼ per cent a month		+0.6	+0.6		+1.1	+1.2
- February					+1.1	+1.1		+1.3	+1.3
- March					+1.0	+1.0		+1.2	+1.2
(ii) Percentage change since Feb 1983 (annual rate)									
- January	+6.8		+13.1		+10.9	+10.7		+12.4	+12.6
- February	+6.8		+13.4		+11.1	+11.0		+12.7	+13.0
- March	+6.9		+13.6		+11.2	+11.1		+13.0	+13.2

* Seasonally adjusted for NIB M1 and building society interest credited components only.

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TABLE 2: £M3 COUNTERPARTS

£ millions
seasonally adjusted

Banking months	Outturns OCT	NOV	DEC	Forecast JAN	FEB	MAR	Target period to mid-March
. CGBR	+1210	+1500	+ 555	- 35	+2325	- 230	+15385
(CGBR n.s.a.)	(+ 960)	(+1010)	(+1765)	(-1320)	(+ 115)	(- 270)	(+14040)
. Debt sales to NBPS	- 810	-1665	- 700	-1110	- 985	- 420	-12455
. Other public sector	- 620	+ 265	+ 60	- 215	- 415	- 150	- 2825
Over (-)/Underfunding(+)	- 220	+ 100	- 85	-1360	+ 925	- 800	+ 105
. Sterling lending to private sector	+1560	+1195	+1710	+2025	+ 700	+2040	+15095
. Externals	- 470	- 245	+ 235	- 60	- 260	+ 10	- 1090
. NNDLs	+ 545	- 440	- 590	-	- 250	- 250	- 2930
Change in £M3	+1415	+ 610	+1270	+ 605	+1115	+1000	+11180

Memo:

	OCT	NOV	DEC	JAN	FEB	MAR
"PSBR" (1+3)	+ 590	+1765	+ 615	- 250	+1910	- 380
"Underlying" bank lending	+1420	+1610	+1500	+1350	+1300	+1300

ANNEX

FUNDING MONEY MARKET ASSISTANCE AND THE NLF'S BALANCE SHEET

An increase in the volume of funding feeds through one-for one into the volume of money market assistance and into the NLF's liabilities, other things being equal. But other influences also affect the stock of money market assistance. The main accounting differences between overfunding (defined as the 'PSBR' less sales of Government debt to the non-bank private sector) and changes in the stock of money market assistance are:-

i) Definition of public sector borrowing: money market shortages are determined by the CGBR, not the 'PSBR' (because they are measured as the net inflow or outflow from the Exchequer). Central Government onlending to nationalised industries and local authorities reduces market shortages, by raising the CGBR; but, providing there are compensating adjustments in la & pc bank finance, has no effect on the 'PSBR' and hence on overfunding as defined above.

ii) Debt sales: money market conditions are affected by all sales of non-monetary debt, not just those to UK non-banks.

iii) Official intervention in the foreign exchange market: changes in the reserves are matched by flows of sterling to or from the private sector.

iv) Changes in the demand for cash affect money market conditions: an increase in cash, for example, needs to be paid for by the banking system - a negative money market influence.

Also, overfunding is conventionally quoted in seasonally adjusted terms, whilst money market assistance is an unadjusted concept.

2. The table below shows these influences in the financial year so far and forecast to mid-March 1984:-

ANNEX

Funding and the Money Markets

	£ billions		
	mid-April '83 - mid-Dec '83	mid-Dec '83 -mid Mar '84	mid-April '83 - mid-Mar '83
Over(-)/Underfunding(+)sa	-0.9	-1.2	-2.1
Over(-)/Underfunding(+)ua	+0.3	-4.2	-3.9
Public sector component of 'PSBR' (borrowing -)	+1.5	+0.5	+2.0
Add			
Other money market influences:			
Fall in reserves (-)	+0.2	-	+0.2
Increase in notes and coin (-)	-1.2	+0.6	-0.6
Gilt sales (other than NBPS) (-)	-1.1	-0.6	-1.7
Other	-0.3	+0.2	-0.1
Equals: Money market influences	-0.6	-3.5	-4.1

If money market influences are consistently negative two things may happen:

i) the stock of money market assistance reaches the maximum feasible;

ii) the NLF runs a surplus.

The first will importantly affect the nature of our money market operations. The second is an accounting curiosity.

4. The volume of money market assistance which the Authorities have acquired to relieve shortages may reach the limit of the market's capacity to generate eligible bills at anything like prevailing prices. We cannot continue to conduct money market operations by buying eligible bills from the discount houses and may need to buy different sorts of assets from different institutions. Last year gilts and export credit paper (public

sector liabilities) were bought off the banks to be resold later. Because forecasts of money market influences are very uncertain it is difficult to assess whether it will be possible to avoid such operations this year.

5. The point at which the NLF accumulates a surplus is an accounting curiosity of no significance for monetary policy generally. The total size of the Issue Department's balance sheet is fixed by its liability, the note issue. Its assets consist principally of unsold gilts, eligible bills acquired in money market operations, and ways and means advances to the NLF. As the stock of assistance rises so the Issue Department runs down its ways and means advances to the point where it no longer has the capacity to buy bills from the market (independent of the market's actual capacity to generate them). The composition of the NLF's liabilities has meanwhile been changing in line with changes in the Issue Department's assets. In the simplest case of high gilt sales, the NLF's gilt liabilities rise and its liabilities to the Issue Department fall, whilst its total assets (lending to the nationalised industries, local authorities and the Consolidated Fund) remain unaffected. When it has repaid its ways and means advances from the Issue Department it begins to run surplus. It acquires a new asset (deposits with the Banking Department) to match the continuing increase in gilt liabilities. It is this increase in total NLF liabilities, unmatched by any lending to finance the public sector but incurred for purposes of monetary policy, which was ratified in the 1982 Finance Act. This deposit is used by the Banking Department to buy the eligible bills which the Issue Department is no longer able to absorb.

HF3 Division
20 January 1984