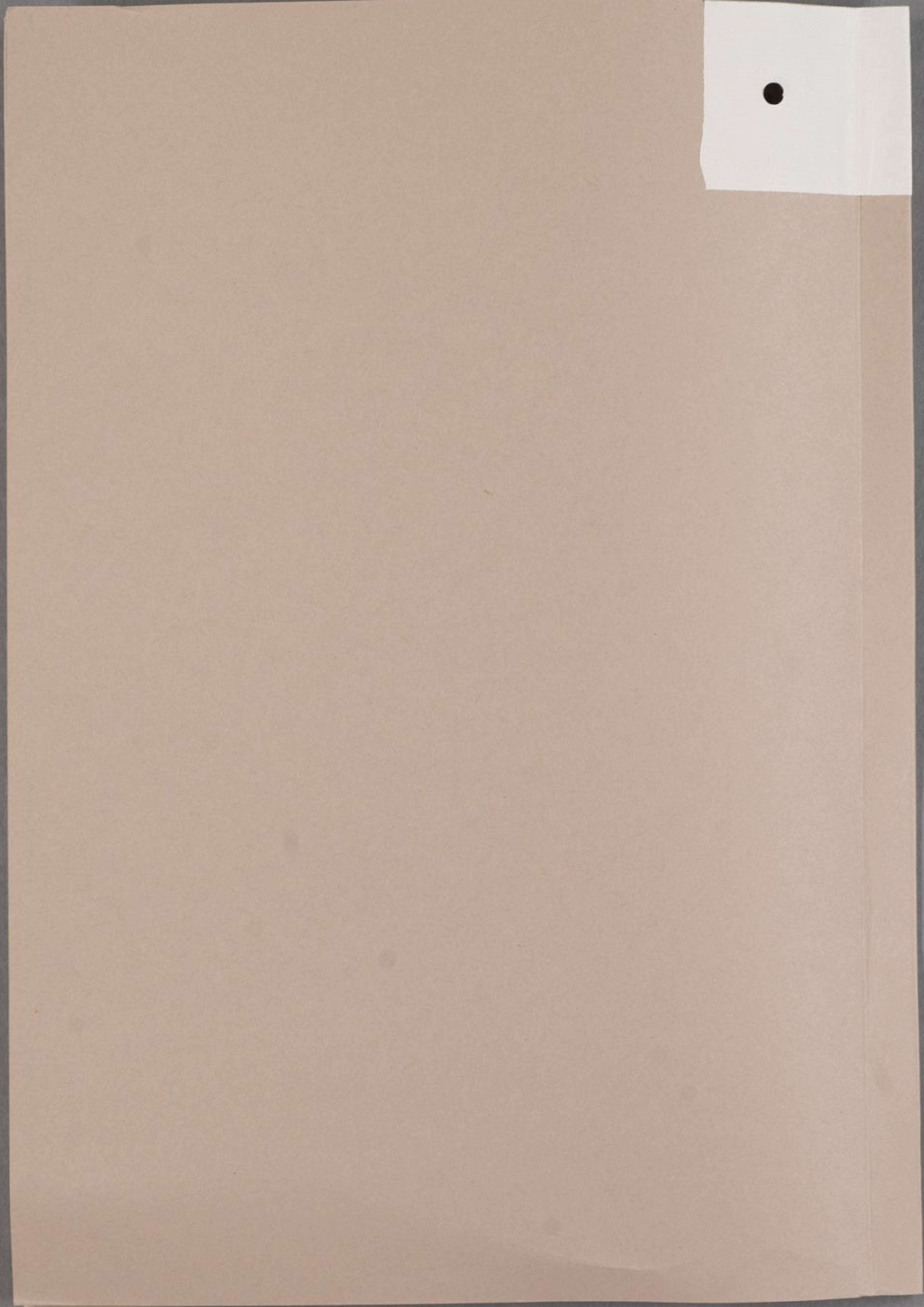
PREM19 34

ECONOMIC POLICY

(Monetary policy - domestic)

(Part 2)

PREM 19/34



PART 2 ends:-

NFR PM/ Chanc. 20.12.79

PART 3 begins:-

Chanc. to PM 7. 1. 80

SENIOR STAFF IN CONFIDENCE

Original on Euro Pol Pt 4
Future Policy towards the EEC
Community Budget.
cc Mr Whitmore

NOTE FOR THE RECORD

The Chancellor of the Exchequer called on the Prime Minister at 0845 hours today. The following are the main points which came up in discussion:

(i) EEC Budget

The Chancellor said that the Lord Privy Seal was establishing a small official group to assist him in developing our negotiating strategy on the EEC Budget issue. Four FCO officials were to be on this group, but only one Treasury official had been invited. While accepting that the FCO had to be in the lead, he felt that the Treasury had a crucial role to play; and therefore Treasury representation on the group should be on a par with the FCO. The Prime Minister agreed that Treasury representation should be stronger, and that - in addition to Sir Ken Couzens - there should be at least two other Treasury representatives. (We have since spoken to Sir Ian Gilmour's Office about this, and he is taking the necessary action.)

(ii) Treasury Appointments

The Chancellor asked the Prime Minister whether she had been able to form a view of Mr. Ryrie when she visited Washington. The Prime Minister replied that she had not been very impressed by him: in particular, she had not found his manner at all easy, and this suggested to her that he would not be very good at managing a major part of the Department. The Chancellor said that he was also having doubts about Mr. Ryrie's succeeding Sir Lawrence Airey. But he had not yet taken a final view, and would come back to the Prime Minister in the New Year.

(iii) Budget Date

The Chancellor said there were too options: either 25 March or 22 April. His own provisional preference was for 25 March mainly because the later date would involve

/a loss

a loss of about £100 million (assuming the indirect taxes were revalorized). After the late Budget this year, he also did not want a repeat. The Prime Minister said that she agreed.

(iv) Monetary Policy

The Chancellor said that the Treasury were reviewing various aspects of monetary policy, including the Bank's performance in October and also the proposals for Monetary Base Control. He would be letting the Prime Minister have a note fairly soon. Moreover, he had promised a paper on monetary policy to Cabinet.

P.

20 December 1979

SECRET

Prime Minister
Seen
12
11/12

18

Econ Policy

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

MONETARY SITUATION

You ought to know that the monetary figures for November are likely to show some improvement on the October figure.

2. The eligible liabilities figures, which will be published tomorrow, Tuesday 11th, show an increase of 1.9 per cent. However, this considerably overstates the likely growth of the money supply, which preliminary indications suggest was about 0.6 per cent. With appropriate briefing by the Bank, commentators will be able to deduce this. Domestic Credit Expansion remained high, however, probably at around £1.2 billion. Details of the components are given in the Annex, and while these may change before publication on 20th December, the change in the sterling M3 figure is unlikely to be great.

3. The rise in MLR on November 15th, and the other measures announced in my statement to the House, have had a substantially beneficial effect on confidence. We have since then secured substantial gilt sales, and the November monetary figures have been helped considerably as a result. Gilt sales outside the banking system in November were nearly £1 billion, and with resulting part payments and additional sales since then the December figure could be even higher.

4. The increase in MLR will have had little or no

/ effect

SECRET

effect on bank lending in November, and indeed the full impact will probably take some time to come through. Nevertheless the November figure, while still substantial at about £¾ billion, was considerably less than the record October figure of £1.2 billion, and there was virtually no further leakage of acceptances outside the banking system. Although we hope for some slowing down in the next few months, the trend is still worryingly high.

5. Although the overall money supply figure is mildly encouraging, the components are less so. With bank lending remaining buoyant, DCE was still high and it was only a substantially negative external adjustment - £0.8 billion - which brought the money supply figure down to a reasonably satisfactory level. We cannot rely on external adjustments of this size in the coming months, and it is important that DCE falls further.

6. I am reasonably confident that DCE <u>will</u> fall sufficiently, and the gilt sales already achieved have helped the prospect for December considerably. But bank lending remains the worrying aspect of the present monetary situation, and it will be necessary to see some falling off in this, in addition to sustained gilt sales and a satisfactory development of Central Government borrowing, before thinking in terms of a reduction in interest rates.

7. I am copying this minute to the Governor.

(G.H.)

10 December, 1979

ANNEX

	Average of 3 months July-September	£ billion Banking Months	
		Banking October	Banking November
CGBR	0.90	+0.94	+0.73
less sales of CG debt outside the banking system			
Gilts	-0.77	+0.25	-0.96
Other	+0.07	-0.21	+0.50
Bank and overseas lending to the rest of the public sector	+0.15	-0.62	+0.06
Bank lending to:			
Private sector	+0.41	+1.24	+0.75
Overseas	+0.03	-0.03	+0.10
DCE	+0.79	+1.57	+1.19
External Adjustment	-0.29	-0.40	-0.83
Other	-0.07	-0.09	-
Change in £M3	+0.43 (0.8%)	+1.08 (2.0%)	+0.35 (0.6%)

Econ Pol

Extract from a meeting with the Chancellor of the Exchequer 6.12.79

(b) The Prime Minister said that she was still concerned about the Bank's handling of monetary policy during October. She hoped that they were now moving quickly in developing specific proposals for Monetary Base Control (MBC). The Chancellor replied that he had indeed impressed upon them the need for speed with the MBC proposals. He had also asked them for a rapid appraisal of the methods of selling gilts, and a review of personal credit mechanisms.

Subject file
Iran-Situation - May 79

PRIME MINISTER

After your meeting with the Chancellor this morning, which had to be cut short, he mentioned to me three points:

(i) He hoped that you might encourage Mr. Whitelaw and Lord Carrington to make a major speech on economic policy. He felt that too much of the burden of explaining the Government's economic policies was falling upon you and himself. It was important, in his view, that other senior Ministers should be speaking out. He suggested that John Hoskyns might provide Mr. Whitelaw and Lord Carrington with suitable material. (I am sure that you will not want to burden Lord Carrington with anything more at the present; but perhaps you might have a word with Mr. Whitelaw).

(ii) The Chancellor said that he was conducting a post-mortem on how the Bank went wrong in their handling of the October funding programme. Gordon Pepper has published some trenchant criticism of the Bank (see Flag A); and although some of his criticisms are unjustified (as explained in the Treasury note at Flag B), their performance was certainly lacking - especially the failure to arrange any funding.

(iii) The Chancellor said that David Lea of the TUC had been in touch with Sir Douglas Wass after the resignation of the NEB Board. Lea had said that there was growing pressure within the TUC General Council for the TUC to withdraw from the NEDC Sector Working Parties, and that this could escalate to demands for withdrawal from the NEDC and possibly the MSC and other bodies as well. Lea explained that this would all come to a head at next Wednesday's TUC General Council meeting, where he thought there would be strong pressure on Len Murray to ask for a meeting with you. Lea thought that this would be counter-productive in that you would be unable to meet the TUC's demands, and that this would then make withdrawal from NEDC, etc. inevitable. He suggested that the position of Murray and others who wanted to maintain contact with the

/ Government

Government would be made a good deal easier if you were to take the Chair at the December meeting of NEDC.

The Chancellor does not think this would be a good idea, although he thinks that Lea is trying to be helpful. The December meeting of NEDC is, as you will recall, to review the economic outlook (in lieu of the economic forum idea); and he wants to handle this himself. But, in any case, your attendance on that day would be difficult: you have the memorial service for Betty Harvey Anderson followed by the Press Gallery Lunch at which you will be making a major speech.

I take it, therefore, that you do not want me to pursue the idea of your chairing the December meeting. That said, if Lea's prediction is correct, we may get a request from Murray next week for an early meeting. If you agreed to a meeting, I do not think it need necessarily be unproductive: I think you could help to calm the TUC down. On the other hand, to refuse a meeting would almost certainly aggravate the situation.

From the Chancellor's point of view, a meeting before the December NEDC meeting would no doubt be helpful - we could probably squeeze this in on 4 December. But, for the moment, we do nothing.

TL

22 November 1979

The UK Gilt-Edged Market

Gordon Pepper, in a seminar organised by the Society of Investment Analysts on 19 November, discussed recent events in the gilt-edged market. He made the following specific criticisms of the authorities' tactics:

(a) The Bank were in a position to realise that the CGBR was running higher than expected in banking October, but made no attempt to make additional sales of gilts in order to offset the likely impact on money supply in that month.

(b) The Government broker in fact refused a substantial bid for the long tap on the last day of the banking month.

(c) The banks' position within the SSD guidelines was relatively comfortable in banking October, although it would have been open to the Bank to squeeze them by reducing the supply of reserve assets.

(d) The authorities' apparent confidence about monetary growth in banking October, as suggested both by their tactics in the gilts market and the decision to abolish exchange controls, added to the shock of the October figures and made the market's reaction worse.

A rebuttal of some of these points has already appeared in the press. They may be met as follows:

(i) We did not know that the CGBR would be high until the very end of the banking month when it became clear that the expected VAT receipts would be dalayed. By this time it was too late to take action in the gilts market. Expectations of a low CGBR had meant we had planned no part payments in the month. The Bank did in fact sell a variety of miscellaneous stocks on 17 October (the payment for which will have been received in banking November).

(ii) A bid was also made for the long tap on 17 October, when the market strengthened a little following the BL ballot. But this came after a period of a declining market and there was insufficient reason to suppose that the market had found a level from which it could be expected to move forward. Moreover sales of the tap would have left the authorities with no tap stock, and the forthcoming announcement on exchange controls, coupled with what we were beginning to learn about the October figures, would have made it difficult to issue and price a new tap without giving the market a misleading indication of the prospect. In other words, a decision to sell out the tap might have wrongly and falsely encouraged market expectations. In fact yields continued to drift downwards after 17 October, which supports the Bank's judgement of the time.

ie - Gordon Pepper was right.

(iii) The banks' position on make-up days depends, inter alia, on money market flows on that day. These fluctuate substantially, unpredictably and the authorities have only partial information at the time. The banks' position at the end of banking October reflected the large CGBR, which as explained above was not fully apparent to us.

More generally, two criticisms can be made of Mr Pepper's analysis:

(i) He is writing with the benefit of hindsight, and additional information available to the authorities or current developments is much less, and less useful, than he implies.

Not 'holding' the Tap

(ii) Mr Pepper, like the authorities, has emphasised in the past that attention should be focussed on the trend of money supply growth rather than fluctuations from month to month, which can be substantial.

The Background to 1980

Mr Pepper goes on to discuss the monetary prospect for 1980. He chooses a number of series as indicators of the public and

private sector's demand for finance. These indicators have been rising, but since they are likely to turn down, dramatically in the case of the CGBR, monetary growth and hence inflation will start to moderate. This will provide the classic conditions for a bull market in 1980.

The indicators chosen by Mr Pepper are not the most relevant for the purposes he has in mind, and his analysis of cause and effect is suspect. But we would agree with his broad conclusion that monetary growth can be expected to slacken under the combination of the current high level of interest rates and a much lower PSBR in the second half of the year. This will in turn offer the prospect of lower interest rates, although the timing of any fall is uncertain and will depend on a number of other factors.

Some supplementaries are attached.

(This note prepared in consultation with the Bank of England)

and it [illegible] too much

Notes for Supplementaries

Bank's tactics inflated October's figures
The size of the CGBR in banking October was not apparent to us until very late in the month. Because we expected a low CGBR we had planned no receipts from part payments. In fact the Bank did sell stock on the last day of banking October.

Bank's tactics meant subsequent crisis
Different tactics might have wrongly encouraged the market. That could have led to much sharper increases in market rates. The hon member has the benefit of hindsight.

Gilt pricing policy too inflexible
Our objective is to sell a substantial volume of stock over a long period. £5 billion has been sold since mid April. Some proposals for changing tactics could put this at risk, although we are constantly reviewing this. Attention should be focussed on the trend of money supply growth; monthly fluctuations are to be expected.

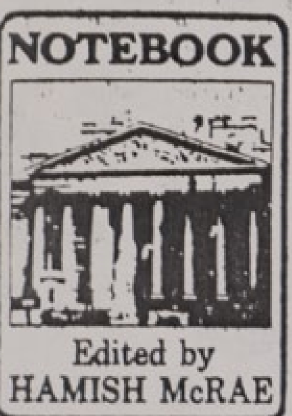
SSD Scheme not tight enough last month
The high CGBR last month meant that the banks were in a slightly more comfortable position. The banks' position will inevitably change with fluctuations in money market flows.

TUESDAY 20 NOVEMBER 1979

FINANCIAL GUARDIAN

Threadneedle Street deserves the flak it's getting from Right,

NOTEBOOK



Edited by HAMISH McRAE

YOU HAVE only to look at what happened on the markets yesterday to get a glimpse of how damaging last week's increase in Minimum Lending Rate has been. While the increase has, to be sure, achieved the immediate aim of giving the authorities control over the markets, it has been at a considerable cost, both to the Bank of England's reputation, and to Her Majesty's taxpayers' pockets.

Since the Government is under fire from a number of its own backbenchers over high interest rates, it is important to be clear that this criticism does not centre on the level of interest rates as such.

They may, now, indeed be unnecessarily high to do the job that they are required to do: to bring down the rate of growth of bank lending. Maybe a lower level of rates would have done the job, but we will not really know for some months, perhaps not even then.

But there is a quite different level of criticism which we can make right now, which centres on the way in which the Bank of England allowed the Government's funding programme to stop at a crucial time. It has got it going again now, but by the crudest possible method.

Yesterday the price of gilts continued to soar, ensuring that the new tap stock, prospectuses for which are published today, will be oversubscribed. In that sense, arguably, it will be a success. But you can always sell things if you drop the price.

The central question must be whether it was necessary to allow last week's events to happen. This question was answered yesterday by Mr Gordon Pepper, partner of brokers W. Greenwell, in a speech to the Society of Investment Analysts. He put it quite politely: "The Bank's actions after September appear, with the benefit of hindsight, to be very puzzling."

He then went on to point out how the Government broker had refused bids for stock on the last day of the banking month October at a time when it must have been clear that the monetary figures would be bad. This lulled the market into the view that all was well, and the bad figures came as a complete shock.

Mr Pepper also points out that the banking statistics chose not to make the corset bite, even though it had become clear that bank lending was buoyant. Implicit in his argument is the conclusion that, while the Bank could be forgiven for being wrong-footed by the unexpected swing in the Government's finances which turned October from a potentially easy month to a difficult one, it cannot be forgiven for failing to react to adverse information.

The result has been that instead of selling stock at around 13 per cent, it has had to do so at 15 per cent. We, the taxpayers, have to fork out for the difference.

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Bread Street, London EC4M 9EL

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THE U.K. GILT-EDGED MARKET

A talk by Gordon Pepper at a Seminar on the Economic and Investment Outlook for 1980, organised by The Society of Investment Analysts on Monday 19th November 1979

Today is a special occasion for me in two ways. It is the first one-day seminar organised by the Society of Investment Analysts - I wish the Society every success with its new venture. Secondly, it is the first time that I have spoken at the same seminar as Dr. Henry Kaufman. I have known Henry for many years. He has had a great influence on my way of thought. I am both honoured and delighted to share the platform with him.

My talk is divided into two. I will start with the extraordinary events of the last few weeks; subsequently I will describe the outlook for 1980.

Chart I shows the monthly changes in sterling M3 as of a month ago. It will be seen that in the four months prior to mid-September, monetary growth had fallen and was continuing to fall. (Allowing for distortions, the picture was not quite so encouraging, as is shown in Chart II for M4). If the data for banking October had been good, the monetary situation would have been encouraging.

It was originally expected that the data for banking October would be good. On 7th September the Bank announced issues of two new gilt-edged stocks. It arranged the calls so that none was due in banking October. The calls, on these and previous issues, in banking September were very large. Two substantial calls were arranged in banking November. But banking October was left void. The Bank would surely have done this only if it had been been confident that monetary growth in banking October would be sluggish. Such confidence at the time was not unreasonable. Indeed, we and many other commentators shared it. We were all wrong. But the Bank's actions after September appear, with the benefit of hindsight, to be very puzzling.

P. G. E. Greenwell
R. H. Lawson
C. E. Frappell
G. T. Pepper
The Lord Annaly
The Lord Renwick
J. A. Rickards
L. Gooderham
T. Quinn
A. T. Boanas
M. T. Higgins
D. G. Thomson
H. N. Seely
T. G. Wakeley
J. F. R. Hammond
J. Wigglesworth
E. J. Fenton
A. J. Bonner
N. S. King
G. P.P. Stewart
K. P. Joseph
A. G. P. Davidson
P. D. Jones
R. L. Thomas
K. C. Brown
J. C. Finch
S. J. D. Posford
K. G. Sykes
R. W. Walker
W. E. A. Bain
R. M. Harvey
R. B. Pomphrett
M. R. F. Wonfor
Associated Members
O. J. Olcay (U.S.A.)
Graham H. Greenwell

It must be remembered that the Bank has far more up to date information than do market participants. The Bank has daily data for the CGBR, total sales of central government debt and official intervention in the foreign exchange market. There are also official projections for the CGBR. Further, the Bank has weekly data for the money supply, although these data are not available immediately.

Chart III shows the monthly behaviour of the CGBR less sales of central government debt to the non-bank private sector. In banking October it made a record contribution to monetary growth of almost £1,000m. What action did the Bank take, while it was observing that development taking place?

Chart IV shows a long-dated gilt-edged index on which sales of official tap stocks have been superimposed. In banking October, the long dated official tap stock was operative on just one day, 27th September. Subsequently, although the authorities sold various unofficial tap stocks, they appeared to make no move to encourage additional sales, for example by inducing a rise in yields. Further, on the last day of the banking month, we understand that the Government Broker was bid for a substantial amount of the long-dated tap stock at a price that was in line with the market price (marked X) but some three points below the price at which the Government Broker had last supplied stock. The authorities, however, chose not to accept the bid.

As a result of authorities' inaction, official sales of gilt-edged stock in banking October were some £250m. less than redemptions and buying-in of the next maturities.

The banking statistics also indicate that the authorities chose not to make the corset bite, even though bank lending was very buoyant. The banks' IBELs on the October make-up date were lowered by £624m. market loans to the discount market. If the Bank had squeezed the supply of reserve assets, the banks would have had to designate these loans as call money (which qualifies as a reserve asset) and the corset would have been a greater constraint.

The authorities' decision not to respond to the bid for the tap stock on 17th October had a secondary effect. It suggested that the authorities remained confident about monetary growth in banking October. The abolition of exchange controls on 23rd October was interpreted by many, including us, in the same way. We did not think that the

authorities would open the euro-sterling loop-hole in the corset unless monetary growth was under control. For all these reasons the publication on 6th November of bad data for the deposits of the London Clearing Banks and the eligible liabilities of all banks came as a bolt out of the blue.

Another factor made an important contribution to the extent of the market's reaction. It is much more difficult for a market to discount adverse monetary forces than bad news. A monetary squeeze in real terms means more sellers than buyers of securities whilst the squeeze lasts. A continuing flow of transactions anticipating the end of the squeeze is needed to offset the effect of the squeeze.

Some ten years ago the gilt-edged market did not anticipate monetary forces because few people understood them. As people have learnt, the market has anticipated a reversal of monetary forces earlier and earlier, by perhaps six weeks in 1974 and three months in 1976/7. This suggested that the market might look even further ahead at the current turning point. It tried to do so but we now know that the adverse forces, which I will describe in a moment, were too large. The bargain hunters ran out of funds to commit to the market. One reason why I mention this is to indicate that there has been no buyers' strike. Another reason is that it is a vivid reminder for investment analysts that formal analysis should be combined with the intuitive approach. On this occasion the market nose warned that people were running out of money.

Having discussed the events of the last few weeks, I would now like to consider the background for 1980.

When conditions change as rapidly as they have recently, it is wise to return to fundamentals. Excessive monetary growth is caused by too much borrowing (by both the public and private sectors) from banks. In the U.S., Henry Kaufman specialises in analysing the supply and demand for credit. The concept of credit is, perhaps, not so widely appreciated in the U.K. as it is in the U.S. I tend, instead, to use the expressions the demand for finance and the supply of savings. Interest rates rise when the demand for finance in the economy as a whole exceeds the supply of savings. Conversely, they fall when the supply of savings exceeds the demand for finance.

In the U.S. it is possible to build up a comprehensive table showing the components of the supply and demand for credit. The gap in the U.S. statistics usually amounts to only about 10% of the whole. The last time I tried to build a similar table for the U.K. the gap amounted to no less than 60%. This was exceptional even by U.K. standards; the gap is usually about 40%. But the poor coverage of U.K. statistics means that we cannot use the U.S. technique in this country.

A broad-brush technique has to be used instead. The demand for finance comes from the private sector, to finance both real growth and inflation, and from the public sector. Full data are available only quarterly and a long time after the event. Proxy data, however, are available monthly and quite quickly.

The top graph in Chart V shows a proxy for the public sector's demand for finance. It shows the central government borrowing requirement (CGBR) expressed as a percentage of GDP. Running annual totals of monthly data have been plotted in the middle of the period to which they apply.

The second graph shows a proxy for the private sector's demand for funds to finance real economic activity. It shows seasonally adjusted unfilled job vacancies. When these rise, activity and the demand for finance by the private sector are both expanding.

The third graph shows a proxy for the private sector's demand for funds to finance inflation. It shows annual percentage changes in the wholesale output price index, plotted in the middle of the period to which they apply.

The bottom Graph shows the yield on twenty year gilt-edged stock.

It will be seen that when the dominant tendency is for the top three graphs to rise, the bottom graph also rises. If demand for finance from the public and private sectors rise together, yields rise. Conversely, when the top three graphs are tending to fall, so does the bottom one. If the demand for finance from the public and private sectors fall together, yields fall. I will discuss each of the sources of demand for finance in turn.

Firstly, disappointingly high inflation is, of course, an important reason for the recent financial difficulties. Because inflation is currently rising, some people are arguing that monetarism is not working. They do not seem to understand that current control of

the money supply does not control the current rate of inflation; rather it has its effect in one to two years time. The current rate of inflation is a reflection of excessive monetary growth since August 1977. If the growth of the money supply is controlled from now on, inflation will start to fall in due course.

As far as real growth is concerned, in my judgement the graph of unfilled vacancies has passed its cyclical turning point. Paul Nield has just described his economic forecast. A recent run of the London Business School's model produces similar forecasts for GDP. There are, of course, differences of detail but they can wait until the discussion.

The private sector's demand for finance is always very high at the present point of the business cycle. When the economy turns downwards involuntary loan demand rises as profit margins are squeezed and finished goods are left unsold on the shelves.

Turning to the CGBR, Chart VI shows it in more detail (but this time in absolute terms rather than as a percentage of GDP). The dashed and dotted graphs show the six and three month moving averages of seasonally adjusted data. It will be seen that the graph fell in 1976 and the first three quarters of 1977; the last part of the fall was the result of the IMF measures. A major turning point occurred in the autumn of 1977. Since then the graph has been rising, because of four factors.

Firstly, the Labour Government backslid on the IMF measures. In the year before the election, necessary but unpopular action went by default.

Secondly, decisions to curtail the growth of public expenditure take at least six months to have an effect. So the trend inherited from Labour continued after the Conservative Government was elected in May.

Thirdly, the switch in the June Budget from direct to indirect taxation delayed the receipt of revenue by about two months. PAYE is paid about a month in arrears. VAT is paid about three months in arrears.

Fourthly, strikes and other industrial action have delayed the collection of VAT and telephone bills, as the Chancellor said in his statement on Thursday.

As a result of these four factors the public sector's demand for finance has continued to rise. This is why the financial situation became acute. But the situation is forecast to improve, dramatically for the next six months and, in comparison with the recent past, significantly thereafter.

The Chancellor's statement on November 15th included an updating of the Treasury's forecast of the PSBR in 1979/80, namely £9bn. before the policy changes and £8.3bn after them. During the first half of the financial year the PSBR has been in excess of £6bn. on a seasonally adjusted basis. This implies an official forecast for the PSBR in the second half of the fiscal year of less than £3bn. before the policy changes and about £2bn. after them. In short, the seasonally adjusted PSBR in the second half of the current financial year should be about a third of that in the first half.

Turning again to Chart V, the graph of unfilled vacancies is already falling. The graph of the CGBR is forecast to fall sharply in the near future. The two graphs falling together provide the classic conditions for a bull gilt-edged market to start. The CGBR is forecast to rebound somewhat in 1980/81 but the Government will most probably ensure that it is significantly lower than in 1979/80 as a whole on a constant employment basis. The weakness of the real economy and inflation starting to fall will provide the conditions for the bull market to continue.

There are many other current factors relevant for a forecast of interest rates that I have not mentioned - the abolition of exchange controls, overseas interest rates and the situation in Iran. There is not time to discuss them, but they do not alter my main conclusion that classic conditions will exist for a bull market in 1980. The events of the last few weeks have meant the bull market is more rather than less likely, although it has started from a higher yield basis than I expected. Notice the tense. It started on Thursday afternoon.

MONTHLY CHANGE IN STERLING M3 SEASONALLY ADJUSTED : AS REVISED

CHART I

£m.

+2000
+1600
+1200
+800
+400
0
-400
-800
1200

£m.

+2000
+1600
+1200
+800
+400
0
-400
-800
-1200

SEP.

1975 1976 1977 1978 1979

MONTHLY CHANGE IN M4

CHART II

£m.

+1600
+1200
+800
+400
0
-400
-800
-1200
-1600

£m.

+1600
+1200
+800
+400
0
-400
-800
-1200
-1600

SEP.

1975 1976 1977 1978 1979

MONTHLY CHANGE IN CGBR LESS CENTRAL GOVERNMENT DEBT SALES

CHART III

£m.
+1200
+800
+400
0
-400
-800
-1200
-1600
OCT.
1975
1976
1977
1978
1979

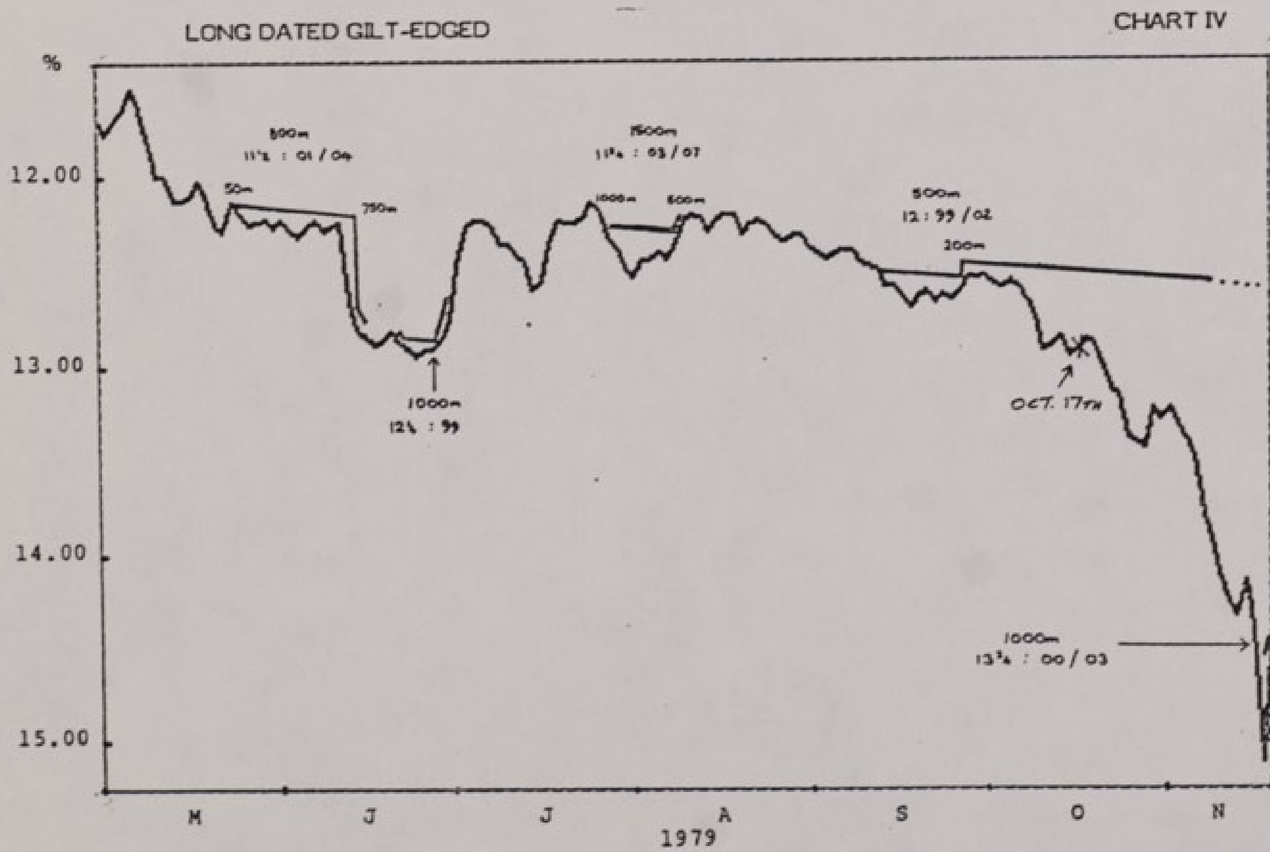


CHART V

CGBR (as % GDP)

Unfilled Vacancies

Wholesale Output Prices

20 Year Gilt-edged Yield

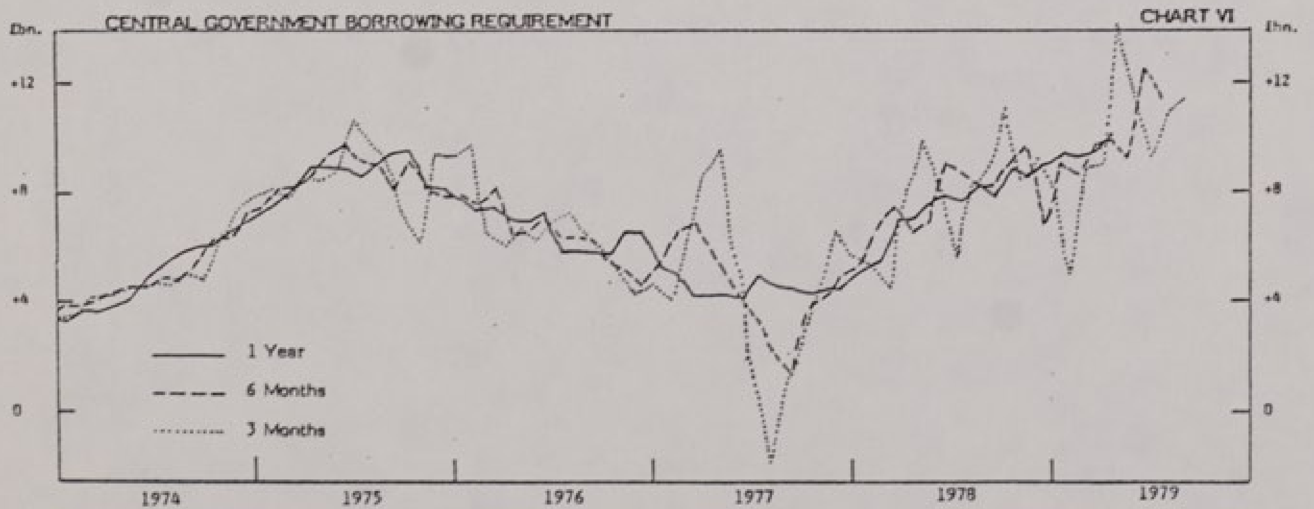
% 10 8 6 4 2 0 -2

000's 300 200 100

% 25 21 17 13 9 5 1

% 15 13 11 9 7

1969 1970 1971 1972 1973 1974 1975 1976 1977 1978 1979



DRAFT

MONETARY BULLETIN

No. 98, November, 1979

Current monetary growth

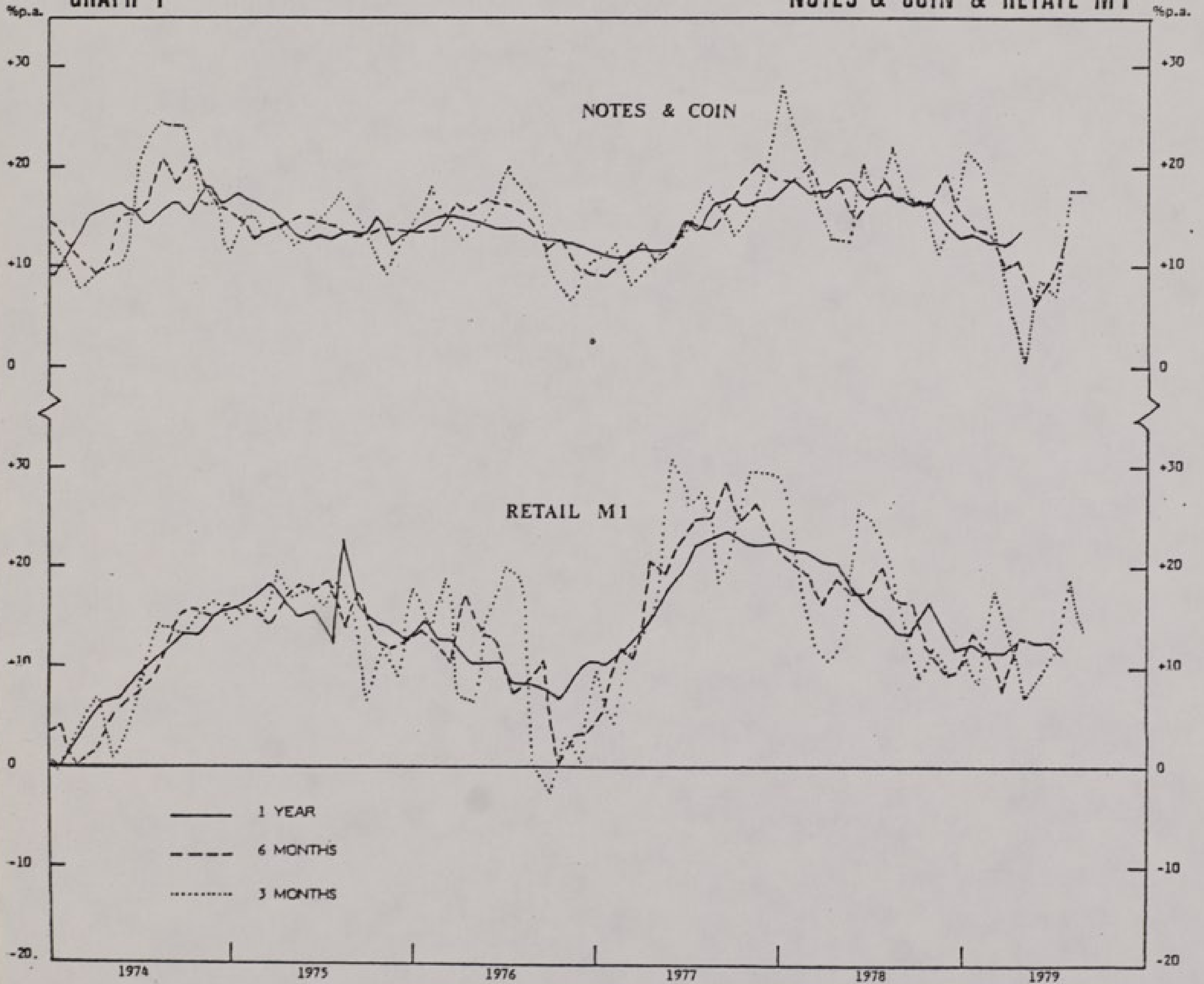
The data for the banking month to mid-October were very bad. In the four weeks to 17th October, 1979, the seasonally adjusted behaviour of the monetary aggregates was as follows:

Notes & coin	£ 202m.	(26% p.a.)
Retail M1	£ 368m.	(19% p.a.)
Sterling M3	£1,080m.	(24% p.a.)
M4	£1,403m.	(30% p.a.)
M5	£1,750m.	(21% p.a.)
DCE	£1,566m.	
Bank lending in sterling to private sector	£1,237m.	(35% p.a.)

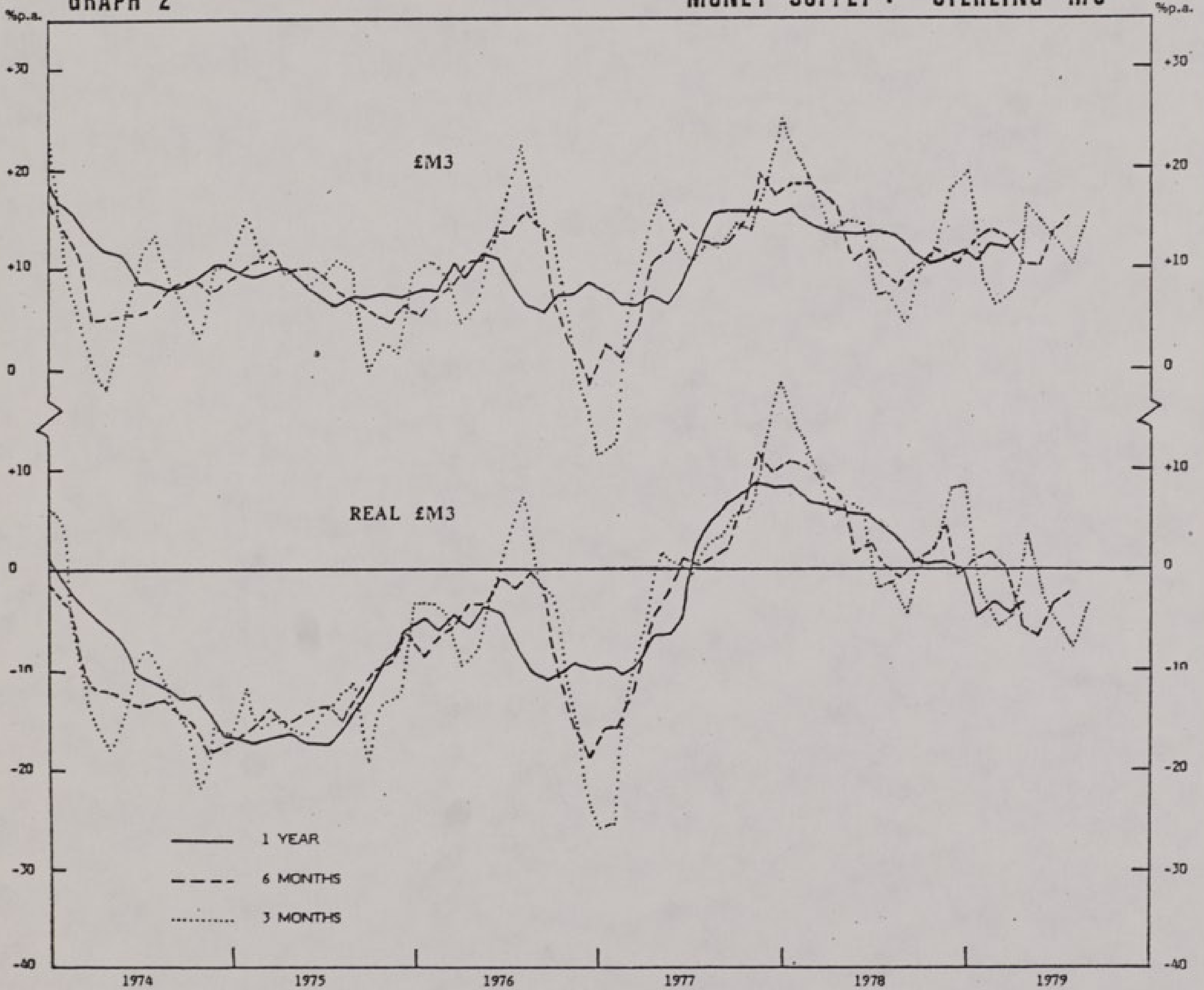
Unfortunately these bad data were not for just one month in isolation after a period of satisfactory monetary growth. We wrote last month that, although there had been a marked deceleration since June, the underlying growth of sterling M3 might not have fallen below the 11% upper limit of its target range. As a result of the latest increase, the underlying picture becomes:

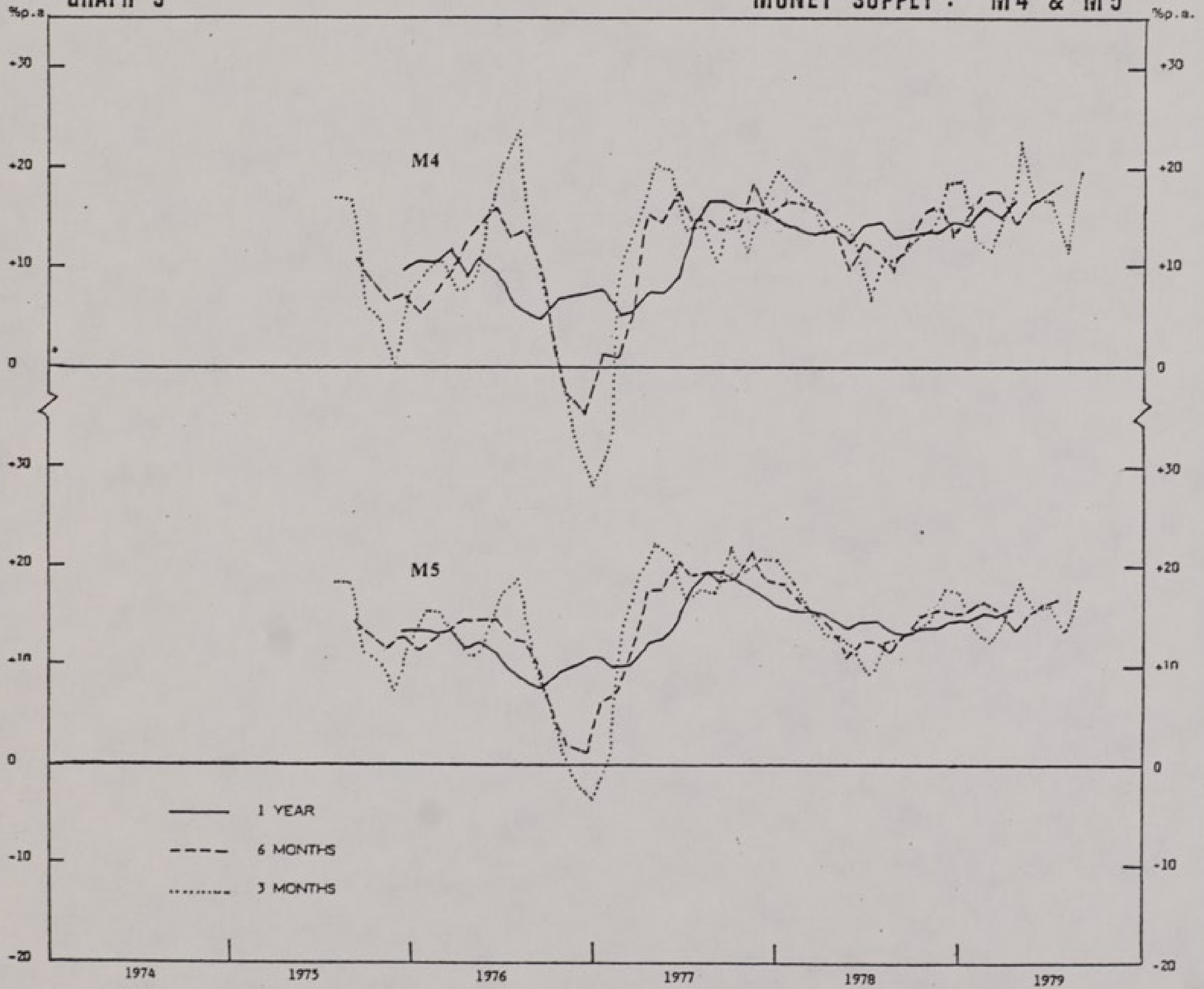
	3 months	4 months (since mid-June)	6 months	12 months
Notes & coin	17% p.a.	20% p.a.	13% p.a.	13%
Retail M1	14% p.a.	19% p.a.	11% p.a.	12%
Sterling M3	16% p.a.	14% p.a.	15% p.a.	13%
M4	20% p.a.	17% p.a.	18% p.a.	17%
M5	18% p.a.	16% p.a.	17% p.a.	16%

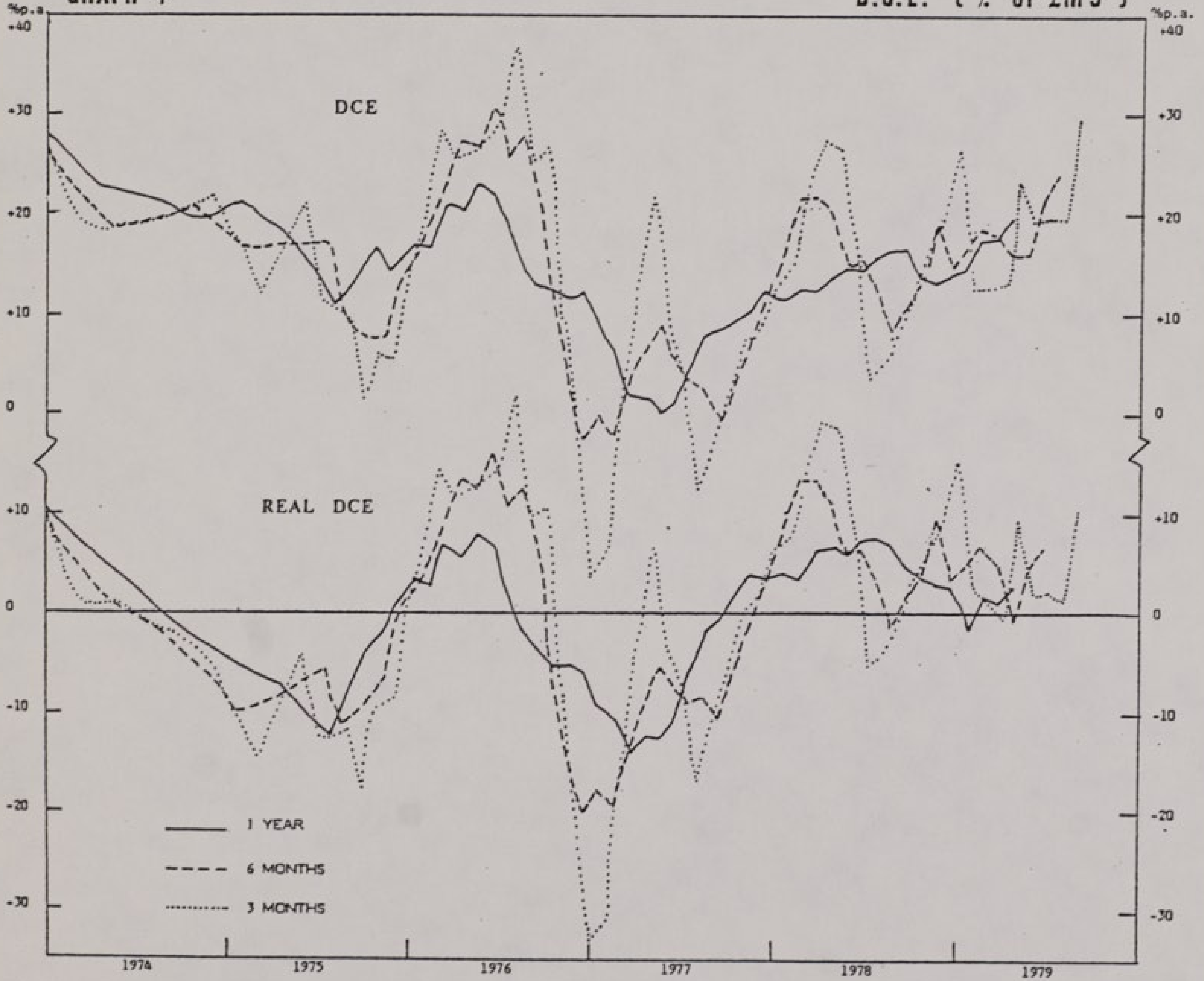
There is no doubt that the authorities were quite right to take remedial action. If monetary growth had previously been in the middle of its target range, there might have been a case for waiting for a month to see if the latest data were an erratic fluctuation. When previous growth, however, has been at the top, or in excess, of the target range, such room for manoeuvre does not exist. Prompt action becomes necessary.


GRAPH 1
NOTES & COIN & RETAIL M1
%p.a.
+30
+20
+10
0
-10
-20
NOTES & COIN
RETAIL M1
1 YEAR
6 MONTHS
3 MONTHS
1974
1975
1976
1977
1978
1979

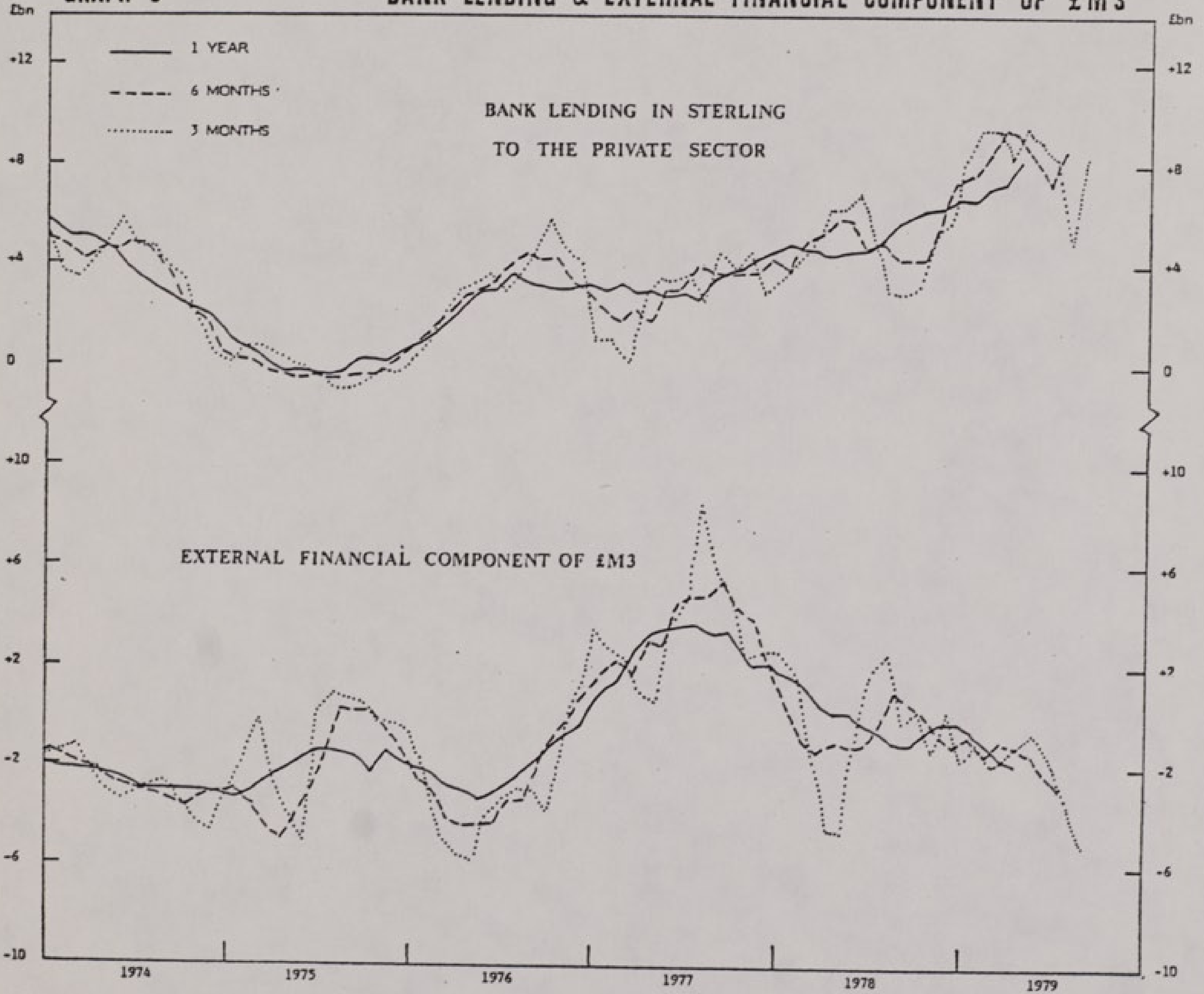
GRAPH 2 MONEY SUPPLY : STERLING M3

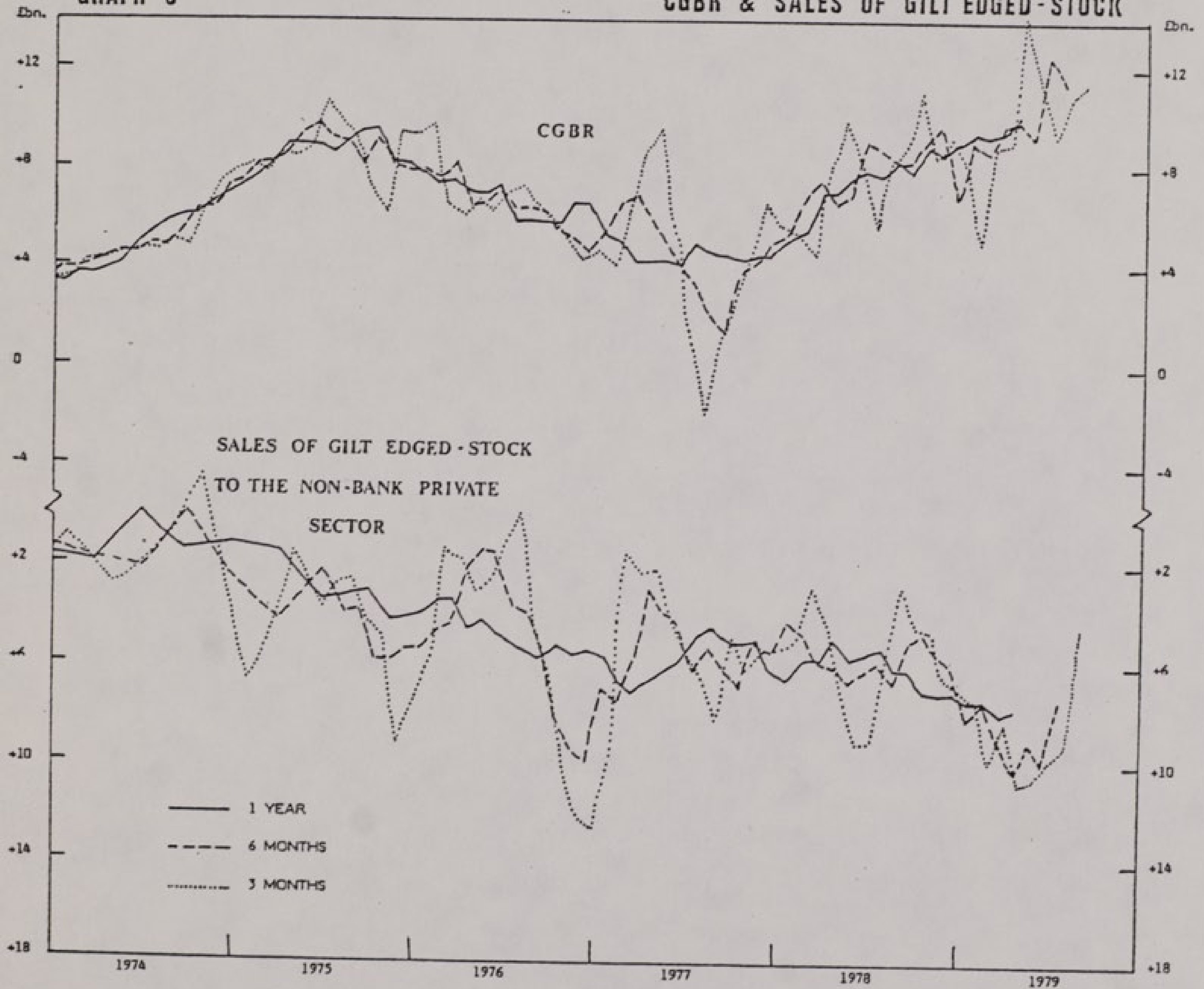



GRAPH 3
MONEY SUPPLY : M4 & M5
%p.a.
+30
+20
+10
0
-10
-20
M4
M5
1 YEAR
6 MONTHS
3 MONTHS
1974
1975
1976
1977
1978
1979


GRAPH 4
D.C.E. (% of £M3)
%p.a.
+40
+30
+20
+10
0
-10
-20
-30
DCE
REAL DCE
1 YEAR
6 MONTHS
3 MONTHS
1974
1975
1976
1977
1978
1979

GRAPH 5 BANK LENDING & EXTERNAL FINANCIAL COMPONENT OF £M3




GRAPH 6
CGBR & SALES OF GILT EDGED-STOCK
£bn.
+12
+8
+4
0
-4
+2
+6
+10
+14
+18
CGBR
SALES OF GILT EDGED-STOCK
TO THE NON-BANK PRIVATE
SECTOR
1 YEAR
6 MONTHS
3 MONTHS
1974
1975
1976
1977
1978
1979

STATISTICS

reprinted from Bank of England , *Banking Statistics*.

[Table 6 in the *Quarterly Bulletin*]

UK banking sector: transactions in liabilities and assets [a]

£ millions

Liabilities

Month ended	Total	Domestic deposits: Total: Unadjusted	Domestic deposits: Total: Seasonally adjusted	Public sector: Sterling: Unadjusted	Public sector: Sterling: Seasonally adjusted	Public sector: Other currencies	Private sector: Sterling: Unadjusted	Private sector: Sterling: Seasonally adjusted	Private sector: Other currencies	Overseas deposits: Sterling	Overseas deposits: Other currencies	Non-deposit liabilities (net)
1978 Oct. 18	+3,306	+642	+391	−116	−53	+12	+628	+314	+118	+9	+2,721	−66
Nov. 15	+4,403	+434	+484	+32	+49	−8	+147	+180	+263	+10	+3,892	+67
Dec. 13	+2,781	+546	+553	−38	+8	−4	+564	+630	+24	+84	+2,182	−31
1979 Jan. 17	+2,010	+440	+755	+85	−86	+27	+547	+928	−219	+187	+1,171	+212
Feb. 21	+645	−70	+484	+353	+265	−4	−598	+44	+179	−11	+675	+51
Mar. 21	+121	−660	−702	−324	−265	+38	−115	−216	−259	+339	+465	−23
Apr. 18	+4,124	+1,514	+786	+42	+107	−34	+1,393	+600	+113	+353	+2,144	+113
May 16	+3,212	+710	+916	−151	−146	+12	+600	+801	+249	+115	+2,392	−5
June 20	+4,703	+1,023	+1,065	+187	+34	−11	+451	+646	+396	+151	+2,965	+564
July 18	+4,771	+255	+137	−210	−147	+18	+561	+380	−114	+207	+4,235	+74
Aug. 15	+1,066	+208	+347	−103	+63	−12	+472	+445	−149	+275	+561	+22
Sept. 19	+6,969	+206	+76	−35	−58	+35	+374	+267	−168	+70	+6,743	−50
Oct. 17	+6,952	+1,477	+1,276	+66	+93	−6	+1,013	+785	+404	+163	+5,075	+237

Assets

Month ended	Total	Lending to public sector: Sterling: Total: Unadjusted	Lending to public sector: Sterling: Total: Seasonally adjusted	Lending to public sector: Sterling: Central government	Lending to public sector: Sterling: Other	Lending to public sector: Other currencies	Lending to private sector: Sterling: Unadjusted	Lending to private sector: Sterling: Seasonally adjusted	Lending to private sector: Other currencies	Lending to overseas sector: Sterling	Lending to overseas sector: Other currencies
1978 Oct. 18	+3,306	+223	+63	+29	+194	+20	+413	+395	−12	−14	+2,676
Nov. 15	+4,403	+65	−17	+267	−202	+121	+254	+425	+145	−117	+3,935
Dec. 13	+2,781	+432	+127	+370	+62	−12	+36	+505	+159	+137	+2,029
1979 Jan. 17	+2,010	−238	+525	−475	+237	−53	+1,218	+485	−45	+62	+1,066
Feb. 21	+645	−742	−67	−768	+26	−7	+826	+830	+19	−147	+696
Mar. 21	+121	−518	−703	−891	+373	−72	+635	+938	+113	+8	−45
Apr. 18	+4,124	+1,382	+637	+1,098	+284	−99	+637	+629	−4	+29	+2,179
May 16	+3,212	+187	+367	+551	−364	−18	+177	+378	+378	+61	+2,427
June 20	+4,703	+115	−25	+69	+46	+8	+1,342	+1,312	−50	−73	+3,321
July 18	+4,771	−286	+138	−480	+194	−153	+1,094	+347	+191	−6	+3,931
Aug. 15	+1,066	+360	−92	+281	+79	−42	+339	+894	−45	+109	+345
Sept. 19	+6,969	+190	+173	−95	+285	−42	+111	+163	−87	−20	+6,817
Oct. 17	+6,952	+266	+103	+296	−30	−1	+1,364	+1,236	+185	−33	+5,171

[a] The banking sector comprises all banks included in Table 3 together with the discount market and the Banking Department of the Bank of England. The National Girobank is included in the banking sector throughout, even though prior to October 1978 it was excluded from Table 3. Inter-bank items are excluded and adjustments made to allow for transit items (see additional notes to Table 6 in the *Quarterly Bulletin*).

Source – Bank of England

Money stock: amounts outstanding

[Table 11.1 in the *Quarterly Bulletin*]

£ millions

	Notes and coin in circulation with public	UK private sector sterling sight deposits		Money stock M_1[b]		UK private sector sterling time deposits [c]	UK public sector sterling deposits	Money stock Sterling M_3[b]		UK residents' deposits in other currencies [c]	Money stock M_3[b]	
		Non-interest-bearing [a]	Interest-bearing	Unadjusted	Seasonally adjusted			Unadjusted	Seasonally adjusted		Unadjusted	Seasonally adjusted
	1	*2*	*3*	*4*		*5*	*6*	*7*		*8*	*9*	
Month ended												
1978 Sept. 20	8,160	13,184	3,237	24,581	24,620	22,462	1,190	48,233	48,140	4,522	52,755	52,670
Oct. 18	8,184	13,557	3,319	25,060	24,860	22,635	1,074	48,769	48,490	4,637	53,406	53,130
Nov. 15	8,258	13,583	3,258	25,099	24,900	22,817	1,106	49,022	48,800	4,946	53,968	53,750
Dec. 13	8,682	13,906	3,500	26,088	25,490	22,816	1,068	49,972	49,520	4,953	54,925	54,370
1979 Jan. 17	8,382	13,497	3,661	25,540	25,730	23,611	1,153	50,304	50,370	4,685	54,989	55,260
Feb. 21	8,594	13,012	3,713	25,319	25,930	23,446	1,506	50,271	51,080	4,855	55,126	55,940
Mar. 21	8,689	13,446	3,488	25,623	25,960	23,122	1,182	49,927	50,640	4,577	54,504	55,220
Apr. 18	8,862	14,484	3,792	27,138	26,750	23,173	1,224	51,535	51,360	4,552	56,087	55,920
May 16	8,833	14,262	3,857	26,952	26,790	23,930	1,073	51,955	52,090	4,839	56,794	56,930
June 20	8,804	14,026	3,718	26,548	26,570	24,756	1,260	52,564	52,690	5,065	57,629	57,760
July 18	9,230	14,335	3,755	27,320	27,210	24,971	1,050	53,341	53,110	4,654	57,995	57,770
Aug. 15	9,143	14,532	3,632	27,307	27,190	25,369	947	53,623	53,640	4,585	58,208	58,220
Sept. 19	9,121	14,750	3,470	27,341	27,300	25,687	912	53,940	53,950	4,642	58,582	58,590
Oct. 17	9,268	15,154	4,038	28,460	28,220	25,728	978	55,166	55,010	5,038	60,204	60,050

[a] After deducting 60% of transit items (see additional notes to Table 6 of the *Quarterly Bulletin*).
[b] M_1 equals columns 1 + 2 + 3. Sterling M_3 equals M_1 + columns 5 + 6. M_3 equals sterling M_3 + column 8.
[c] Including UK residents' holdings of certificates of deposit.

Money stock: changes[a]

[Table 11.2 in the *Quarterly Bulletin*]

£ millions: *percentages in italics*

	Notes and coin in circulation with public	UK private sector sterling sight deposits		Money stock M_1[c]		UK private sector sterling time deposits [d]	UK public sector sterling deposits	Money stock Sterling M_3[c]		UK residents' deposits in other currencies [d]		Money stock M_3[c]	
		Non-interest-bearing [b]	Interest-bearing							Transactions	Valuation changes [e]		
	1	*2*	*3*	*4*		*5*	*6*	*7*		*8*	*9*	*10*	
Month ended (unadjusted)													
1978 Oct. 18	+ 24	+ 373	+ 82	+ 479		+ 173	− 116	+ 536		+ 130	− 15	+ 651	
Nov. 15	+ 74	+ 26	− 61	+ 39		+ 182	+ 32	+ 253		+ 255	+ 54	+ 562	
Dec. 13	+ 424	+ 323	+ 242	+ 989		− 1	− 38	+ 950		+ 20	− 13	+ 957	
1979 Jan. 17	− 300	− 409	+ 161	− 548		+ 795	+ 85	+ 332		− 192	− 76	+ 64	
Feb. 21	+ 212	− 485	+ 52	− 221		− 165	+ 353	− 33		+ 175	− 5	+ 137	
Mar. 21	+ 95	+ 434	− 225	+ 304		− 324	− 324	− 344		− 221	− 57	− 622	
Apr. 18	+ 173	+1,038	+ 304	+1,515		+ 51	+ 42	+ 1,608		+ 79	− 104	+ 1,583	
May 16	− 29	− 222	+ 65	− 186		+ 757	− 151	+ 420		+ 261	+ 26	+ 707	
June 20	− 29	− 236	− 139	− 404		+ 826	+ 187	+ 609		+ 385	− 159	+ 835	
July 18	+ 426	+ 309	+ 37	+ 772		+ 215	− 210	+ 777		− 96	− 315	+ 366	
Aug. 15	− 87	+ 197	− 123	− 13		+ 398	− 103	+ 282		− 161	+ 92	+ 213	
Sept. 19	− 22	+ 218	− 162	+ 34		+ 318	− 35	+ 317		− 133	+ 190	+ 374	
Oct. 17	+ 147	+ 404	+ 568	+1,119		+ 41	+ 66	+ 1,226		+ 398	− 2	+ 1,622	
Month ended (seasonally adjusted)													
1978 Oct. 18	+ 73	+ 81	+ 82	+ 236	*+1·0*	+ 151	− 53	+ 334	*+0·7*	+ 130	− 15	+ 449	*+0·9*
Nov. 15	+ 77	+ 27	− 61	+ 43	*+0·2*	+ 214	+ 49	+ 306	*+0·6*	+ 255	+ 54	+ 615	*+1·2*
Dec. 13	+ 72	+ 271	+ 242	+ 585	*+2·3*	+ 117	+ 8	+ 710	*+1·5*	− 85	− 13	+ 612	*+1·1*
1979 Jan. 17	+ 154	− 102	+ 161	+ 213	*+0·8*	+ 869	− 86	+ 996	*+2·0*	− 87	− 76	+ 833	*+1·5*
Feb. 21	+ 198	− 55	+ 52	+ 195	*+0·8*	+ 47	+ 265	+ 507	*+1·0*	+ 175	− 5	+ 677	*+1·2*
Mar. 21	+ 38	+ 222	− 225	+ 35	*+0·1*	− 213	− 265	− 443	*−0·9*	− 221	− 57	− 721	*−1·3*
Apr. 18	+ 14	+ 467	+ 304	+ 785	*+3·0*	− 171	+ 107	+ 721	*+1·4*	+ 79	− 104	+ 696	*+1·3*
May 16	+ 74	− 100	+ 65	+ 39	*+0·1*	+ 836	− 146	+ 729	*+1·4*	+ 261	+ 26	+ 1,016	*+1·8*
June 20	− 79	+ 5	− 139	− 213	*−0·8*	+ 780	+ 34	+ 601	*+1·2*	+ 385	− 159	+ 827	*+1·5*
July 18	+ 194	+ 411	+ 37	+ 642	*+2·4*	− 68	− 147	+ 427	*+0·8*	− 96	− 315	+ 16	—
Aug. 15	+ 41	+ 77	− 123	− 5	—	+ 491	+ 63	+ 549	*+1·0*	− 161	+ 92	+ 480	*+0·8*
Sept. 19	+ 125	+ 155	− 162	+ 118	*+0·4*	+ 274	− 58	+ 334	*+0·6*	− 133	+ 190	+ 391	*+0·7*
Oct. 17	+ 202	+ 166	+ 568	+ 936	*+3·4*	+ 51	+ 93	+ 1,080	*+2·0*	+ 398	− 2	+ 1,476	*+2·5*

[a] Changes in the money stock may differ from those which can be calculated by reference to amounts outstanding (see additional notes to Table 11 of the *Quarterly Bulletin*).
[b] After deducting 60% of transit items (see additional notes to Table 6 of the *Quarterly Bulletin*).
[c] M_1 equals columns 1 + 2 + 3. Sterling M_3 equals M_1 + columns 5 + 6. M_3 equals sterling M_3 + columns 8 + 9.
[d] Including certificates of deposit.
[e] See additional notes to Tables 6 and 11 of the *Quarterly Bulletin*.

Source—Bank of England

[Table 11.3 in the *Quarterly Bulletin*]

Public sector borrowing requirement, domestic credit expansion and changes in money stock

£ millions

	Public sector borrowing requirement (surplus –)		Purchases (–) of public sector debt by UK private sector (other than banks)		Sterling lending to UK private sector [b]	Bank lending in sterling to overseas [c]	Domestic credit expansion [d]	External and foreign currency finance (increase –)			Non-deposit liabilities (net) (increase –) [c]	Money stock sterling M_3 [f]
	Central government borrowing requirement	Other public sector contribution	Other public sector debt	Central government debt [a]				Public sector	Overseas sterling deposits [c]	Banks' foreign currency deposits (net) [e]		
	1	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*	*11*	*12*
Month ended (unadjusted)												
1978 Oct. 18	+ 293	+ 107		– 215	+ 415	– 14	+ 586	+ 60	– 9	– 167	+ 66	+ 536
Nov. 15	+ 983	– 222		– 763	+ 269	– 117	+ 150	+ 126	– 10	+ 54	– 67	+ 253
Dec. 13	+ 1,424	+ 328		– 653	– 5	+ 137	+ 1,241	– 212	– 84	– 26	+ 31	+ 950
1979 Jan. 17	– 547	+ 125		– 511	+ 1,216	+ 62	+ 345	+ 397	– 187	– 11	– 212	+ 332
Feb. 21	– 31	+ 375		– 944	+ 1,125	– 147	+ 378	– 229	+ 11	– 142	– 51	– 33
Mar. 21	+ 272	+ 279		– 1,371	+ 426	+ 8	– 386	+ 606	– 339	– 248	+ 23	– 344
Apr. 18	+ 2,335	+ 234		– 1,381	+ 543	+ 29	+ 1,760	+ 461	– 353	– 147	– 113	+ 1,608
May 16	+ 695	– 341		– 526	+ 618	+ 61	+ 507	– 111	– 115	+ 134	+ 5	+ 420
June 20	+ 1,507	+ 35		– 1,426	+ 1,096	– 73	+ 1,139	+ 256	– 151	– 71	– 564	+ 609
July 18	+ 601	+ 82		– 817	+ 1,128	– 6	+ 988	+ 240	– 207	– 170	– 74	+ 777
Aug. 15	+ 571	+ 216		– 224	+ 143	+ 109	+ 815	– 94	– 275	– 142	– 22	+ 282
Sept. 19	+ 1,456	+ 184		– 993	+ 108	– 20	+ 735	– 476	– 70	+ 78	+ 50	+ 317
Oct. 17	+ 849	– 442		+ 57	+ 1,365	– 33	+ 1,796	– 52	– 163	– 118	– 237	+ 1,226
Month ended (seasonally adjusted)												
1978 Oct. 18	+ 368	– 60		– 228	+ 397	– 14	+ 463		– 179		+ 50	+ 334
Nov. 15	+ 890	– 186		– 779	+ 443	– 117	+ 251		+ 165		– 110	+ 306
Dec. 13	+ 756	+ 401		– 709	+ 474	+ 137	+ 1,059		– 289		– 60	+ 710
1979 Jan. 17	+ 593	+ 151		– 494	+ 483	+ 62	+ 795		+ 186		+ 15	+ 996
Feb. 21	+ 648	+ 338		– 920	+ 1,129	– 147	+ 1,048		– 313		– 228	+ 507
Mar. 21	– 30	+ 294		– 1,320	+ 729	+ 8	– 319		– 87		– 37	– 443
Apr. 18	+ 1,464	+ 134		– 1,339	+ 535	+ 29	+ 823		– 95		– 7	+ 721
May 16	+ 853	– 215		– 521	+ 819	+ 61	+ 997		– 132		– 136	+ 729
June 20	+ 1,250	+ 133		– 1,451	+ 1,026	– 73	+ 885		– 6		– 278	+ 601
July 18	+ 786	+ 119		– 841	+ 381	– 6	+ 439		– 13		+ 1	+ 427
Aug. 15	+ 281	+ 202		– 238	+ 698	+ 109	+ 1,052		– 359		– 144	+ 549
Sept. 19	+ 1,647	+ 118		– 982	+ 160	– 20	+ 923		– 512		– 77	+ 334
Oct. 17	+ 937	– 617		+ 42	+ 1,237	– 33	+ 1,566		– 400		– 86	+ 1,080

[a] Net purchases (–) of central government debt by the UK private sector (other than banks) can be analysed by instrument as follows:

	Marketable debt		National savings		Tax instruments	Other	Total (column 4 above)	
	Stocks	Treasury bills	Unadjusted	Seasonally adjusted			Unadjusted	Seasonally adjusted
Month ended								
1978 Oct. 18	+ 37	+ 62	– 166	– 179	– 152	+ 4	– 215	– 228
Nov. 15	– 832	– 35	– 135	– 151	+ 250	– 11	– 763	– 779
Dec. 13	– 366	+ 87	– 23	– 79	– 334	– 17	– 653	– 709
1979 Jan. 17	– 411	– 88	– 66	– 49	+ 71	– 17	– 511	– 494
Feb. 21	– 924	+ 95	– 266	– 242	+ 148	+ 3	– 944	– 920
Mar. 21	– 511	– 80	– 131	– 80	– 653	+ 4	– 1,371	– 1,320
Apr. 18	– 990	– 113	– 145	– 103	– 124	– 9	– 1,381	– 1,339
May 16	– 578	+ 5	– 54	– 49	+ 109	– 8	– 526	– 521
June 20	– 1,118	– 175	– 24	– 49	– 79	– 30	– 1,426	– 1,451
July 18	– 887	+ 178	– 80	– 104	– 18	– 10	– 817	– 841
Aug. 15	– 434	+ 145	– 43	– 57	+ 101	+ 7	– 224	– 238
Sept. 19	– 951	– 10	– 38	– 27	– 10	+ 16	– 993	– 982
Oct. 17	+ 251	– 79	– 43	– 58	– 74	+ 2	+ 57	+ 42

[b] Bank lending in sterling to the UK private sector (see page 6) *plus* Issue Department's holdings of commercial bills.

[c] See page 6.

[d] Domestic credit expansion equals the sum of columns 1 to 6.

[e] Banks' foreign currency deposits from, *less* foreign currency lending to, UK and overseas residents (see page 6).

[f] Sterling M_3 equals domestic credit expansion *plus* columns 8 + 9 + 10 + 11 (see also page 7).

Symbols and conventions

.. not available.

– nil or less than £½ million.

Owing to rounding of figures, the sum of the separate items will sometimes differ from the total shown.

Further notes and definitions on these tables are given in the *Quarterly Bulletin*.

Issued by the Economic Intelligence Department, Bank of England, London EC2R 8AH.

Source—Bank of England

SECRET

CHANCELLOR

cc Chief Secretary
Financial Secretary
Sir D Wass
Sir L Airey
Sir F Atkinson
Sir K Couzens
Mr Barratt
Mr Littler
Mr Bridgeman
Mr Hancock
Mr Middleton
Mr Unwin
Mr P G Davies
Mr Bottrill
Mr Gill
Mrs Gilmore
Mr Hodges
Mrs Lomax
Mr Folger
Mr Williams
Mr Macrae
Mr Ridley
Mr Cardona
Mr Cropper

Mr Fforde)
Chief Cashier) Bank
Mr Goodhart)

SPEECH TO THE INSTITUTE OF BANKERS, FRIDAY 16 NOVEMBER

I attach a draft speech which concentrates on monetary policy but contains also a section prepared by Mr Hancock on exchange controls. The material may not be entirely consistent with the latest version of tomorrow's statement, and has not yet been checked in detail with the Bank. Some changes may be necessary on both accounts. Topping and tailing will, of course, also be necessary.

2. I also attach a section by Mr Brendon Sewill on the method of payment of wages which he has suggested might be included in the speech. It does not fit easily into the speech as currently drafted, and the Bank have not yet seen it, but you may wish for it to be woven in.

pp C J RILEY
15 November 1979

SECRET

14.11.79

DRAFT SPEECH TO INSTITUTE OF BANKERS, FRIDAY 16 NOVEMBER

1. Yesterday in the House of Commons I announced the Government's plans for rolling forward the monetary target and a package of measures designed to ensure that the target is met. I also discussed techniques of monetary control, and I would like to talk tonight about some of these issues in greater detail.

2. Control of the money supply is, of course, absolutely central to our economic strategy. It is now generally accepted, not only in this country but also throughout the industrialised world, that reducing inflation is the key to sustained economic growth. It is also recognised that excessive monetary growth is inconsistent with low inflation. Even our predecessors eventually came to realise this. But they put the cart before the horse; they continued to rely heavily on incomes policies, in one guise or another, in spite of the demonstrable failure of such policies over a long period of years. These years of failure show quite clearly that the Government's policy of relying mainly on monetary means of controlling inflation is right. We are committed to take whatever measures are necessary, whether monetary or fiscal, to achieve monetary objectives.

3. But tight monetary control is not a painless cure. As the Prime Minister made quite clear in her speech at the Lord Mayor's Banquet on Monday, the path to lower inflation may well be a ~~strong~~ stony one. Inflationary

/attitudes

attitudes and behaviour are deeply entrenched in our economy, and inevitably it will take time for these to be corrected. A tight monetary policy will therefore almost certainly involve some loss of output in the transitional period before inflation adjusts to lower monetary growth. This is so whether monetary control is achieved by fiscal means - cutting the PSBR - or by having high interest rates. But it is essentially a temporary phenomenon, and furthermore the extent of the temporary loss of output is something which those in industry have within their power to determine.

4. Put simply, the quicker that unions and management accept that the Government will not shrink from tight monetary control, and that inflation <u>will</u> come down if they behave responsibly, the less will be the temporary loss of output and jobs. If inflationary expectations do not adjust quickly and high wage settlements persist, this will inevitably mean a loss of jobs as the Government has either to tighten fiscal policy or raise interest rates in order to prevent monetary growth exceeding the target. So There is no escape from this, and it is quite clearly in everybody's interests to recognise it.

[Handwritten marginal note: If Govt. doesn't do it [illegible], the market [illegible] properly for them to. There will be [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] whatever.]

5. Influencing inflationary expectations is thus a critical part of the Government's strategy, ~~and~~ in this respect the commitment which I made in my Budget Speech to a progressive reduction in the rate of monetary growth has an important role to play. My decision not

/to

to allow for "base drift" when rolling forward the monetary target should further also convince both sides of industry that we will not surreptitiously allow a relaxation in our monetary stance. And the other measures which I took yesterday show how much importance I attach to ensuring that the targets are met and hence that our whole strategy carries conviction. Only then can we rely on the emergence of those favourable expectational factors which will allow us to beat inflation with a minimum cost to output and jobs.

6. But I would like to add a warning here about the ability of the authorities to control monetary growth in the very short run. The events of the last few months in particular have shown that it is not a practical possibility to achieve control on a month by month basis. In spite of the rise in MLR in the Budget, monetary growth has been well above the top end of the target range. In practice it is not feasible to control the money supply over periods of much less than about 6 months. It is important that those who operate in financial markets realise this, because if they expect more than is in practice achievable this inevitably makes the authorities' task harder. It is unlikely that deviations from a target path for the money supply which are corrected over 6 months to a year will significantly affect either output or prices. But the Government is well

/aware

aware that it is vital that such corrections are made so that a temporary deviation does not become a trend. Only by ensuring the complete credibility of the target can we hope to have the favourable impact on inflationary expectations which is so important.

7. Thus the crux of the Government's policy for controlling inflation is to provide an appropriate financial framework and to try to ensure that inflationary expectations respond as quickly as possible to the rate of inflation consistent with that framework. Our policy is not to interfere in the workings of the labour market so that the distortions associated with incomes policies are avoided.

8. It was in similar spirit that I announced on 23 October the completion of the process of abolishing exchange controls which I foreshadowed in my Budget Speech. The decision has been widely welcomed, both at home and abroad, as an important step in the resotration of health to the British economy. But the TUC have said that the removal of exchange controls is contrary to the national interest because it boosts investment overseas at the expense of investment at home. In fact, I have not created any incentive for overseas investment. What I have done is to remove an artificial barrier discriminating against overseas

/investment

investment that had the effect of preventing the price system from operating as it should.

9. In my June Budget, I allowed sterling to be used to finance direct investment overseas within very generous limits; and now I have completed the process by abolishing the requirement to obtain permission to make such investments. The great weight of the available evidence supports the Government's view that direct investment abroad encourages employment and output at home and does not substitute for it. A recent survey by the NEDC involving both sides of industry, for example, supported this conclusion by showing that overseas investment is in many cases necessary for a successful export performance. The old restrictions were particularly hard on small firms seeking outlets overseas because they lacked the resources possessed by larger firms to find ways of achieving what they needed to do consistently with the rules.

10. The controls imposed substantial administrative costs on both the public and private sectors. About 750 staff in the Treasury and the Bank of England will now be released for other work. The commercial banks, stockbroking firms and others who bore the brunt of the administrative burden are now free of these responsibilities. Individuals and firms will no longer have to contend with the rules. Everyone can now buy foreign currency without having his passport marked, and

/not

not only by those directly involved in business and finance.

11. In reaching our decision to abolish controls, the Government had to consider the possible effect on the exchange rate for sterling. We took into account the possibility that the exchange rate would be lower than it would otherwise have been over a period ahead as investors adjusted their portfolios. But this effect, will, of course, be only one of many influences on sterling. Among the other influences is the fact that rising North Sea oil production will bring an increasing benefit to the current account over the years ahead. I am therefore making no prediction about the future course of the exchange rate.

12. The Government also considered very carefully the implications of the abolition of exchange control for domestic monetary policy, and we were, of course, particularly concerned with how it would affect our ability to meet our monetary targets. Some City commentators have argued that abolition will make our task more difficult. But these arguments miss one basic point, and that is that the fundamental elements in achieving monetary control are keeping down the level of public sector borrowing and ensuring that interest rates are at the right level. There is no avoiding this, with or without exchange controls.

/13.

13. But the abolition of controls will certainly affect the environment in which monetary control operates and the usefulness of certain forms of control will clearly be affected. In my statement yesterday I made it plain that the Supplementary Special Deposits scheme - the corset - is nearing the end of its useful life, and exchange control/. But it is not the only one. This year already there has been increasing evidence that certain transactions which might normally have been undertaken by the banks have been pushed outside the banking system as pressure under the corset increased. To the extent that this has occurred sterling M3, our target variable, has tended to understate underlying monetary growth. And the abolition of exchange controls adds further to the possibilities for evading the control without affecting underlying monetary conditions by switching transactions outside the domestic banking sector.

/abolition is one factor which leads me to that conclusion

14. The corset has only been used as a complement to the main weapons of monetary control - fiscal policy and interest rates - and the fact that its usefulness has diminished does not significantly affect our ability to get these fundamentals right. But I have decided that it would be unwise abruptly to abolish any control, even if it has only a limited effect, at a time when particularly strenuous efforts are needed to get monetary growth under control. As I said in my statement, the Treasury and the Bank are to start consultations on possible

/alternative

alternative forms of control, and in particular various types of monetary base control which have been suggested, and I believe it would be right to retain the corset until those consultations are complete.

15. The second reason for not ending the corset immediately is that once the control is removed most of the transactions pushed outside the banking system which I mentioned earlier will once again be taken onto their books and this will inflate the recorded money supply. The Governor and I believe that it is important that this process of "reintermediation" should not be allowed to occur so abruptly that there is a substantial surge in recorded monetary growth which would be quite misleading as an indicator of underlying monetary conditions.

16. It is for these two reasons, therefore, that I decided on an extension of the scheme for a further six months. But the permitted rate of increase of interest bearing eligible liabilities of 1% per month is some way above the rate of growth of sterling M3 which must be achieved in the next twelve months if our target is to be met. The relationship between the growth in sterling M3 and IBELs is extremely complex, but it is my hope that the growth of bank lending will moderate sufficiently to allow some unwiding of existing distortions. I must stress, however, that the extension is a temporary measure pending abolition of the scheme.

/17.

17. The extension of the 7-11% target which I announced yesterday means that monetary growth will have to be quite a bit lower over the next twelve months than it has been in the last twelve. I could have set an easier target by allowing "base drift" and starting the low target from October for example, but I do not believe this would have carried conviction and we would almost certainly have forfeited the chance of any beneficial effect on inflationary expectations.

18. However, although a significant deceleration will be necessary I do not doubt that the target can be achieved. If bank lending were to continue to increase over the next year at anything like the same rate as in the last year this would imply a quite unprecedented cumulative increase in the amount of loans outstanding. I do not believe that the current rate of increase will go on indefinitely and I am confident that the rate will fall off in due course, particularly in view of the high rates of interest which borrowers must now pay. I have also taken steps to ensure that the PSBR will be about £8½ billion this year which means a substantial slowing down from now on. And in my next Budget I will take whatever steps are necessary to ensure that the PSBR next year is consistent with meeting the target at an acceptable level of interest rates.

19. The measures I announced yesterday, and in particular the rise in MLR, will undoubtedly hurt some sections of the economy in the short run. But the Government cannot evade its responsibilities. We are determined not to relax our monetary stance and we aim to convince people that this is so. Inflation <u>will</u> come down, and if this is accepted and acted upon in both financial and labour markets the sooner we can return to a high employment, low interest rate economy.

Cabinet / Cabinet Committee Document

The following document, which was enclosed on this file, has been removed and destroyed. Such documents are the responsibility of the Cabinet Office. When released they are available in the appropriate **CAB** (CABINET OFFICE) CLASSES.

Reference: CC(79) 21st Conclusions, Minutes 1 and 4

Date: 15 November 1979

Signed AWayland Date 14 October 2009

PREM Records Team

Published Papers

The following published paper(s) enclosed on this file have been removed and destroyed. Copies may be found elsewhere in The National Archives.

House of Commons Hansard,
15 November 1979, columns 1513-1529
"Monetary Policy"

Signed [signature] Wayland Date 14 October 2009

PREM Records Team

Statement by the Chancellor

With the Compliments

of the

Chancellor of the Exchequer.

PA

Treasury Chambers,
Great George Street,
S.W.1.

With the permission of the House, Mr Speaker, I should like to make a statement on monetary policy.

2. The figures for October, just published, show that £M3 grew by 2 per cent in that banking month. The growth since mid-June, the beginning of the target period, has been equivalent to just over 14 per cent a year. Although the figure for banking October was erratically high, it is clear that the underlying growth of £M3 is still significantly above the target of 7-11 per cent.

3. There have been two principal causes of this excess: a higher than expected Public Sector Borrowing Requirement in the first half of the year and the persistently high level of bank lending.

4. Because of the timing of the Budget measures - in particular receipts from VAT and reductions in public spending - the PSBR was always expected to be higher in the first half of the year than in the second. In the event, the PSBR in the first half year has been further increased by strikes and other industrial action, which have delayed the collection of VAT and telephone bills. At the peak arrears on telephone bills are expected to reach £1 billion.

5. A large part of these arrears will be made good in the second half-year. Even so, the best estimate which

could now be made of the PSBR for the year as a whole if no action is taken is that it would be about £9 billion, compared with the £8.3 billion Budget estimate.

6. The monthly growth of bank lending has averaged about £700 million over the last quarter. Although the timing is difficult to predict, its growth can be expected to fall in due course.

7. Nevertheless it is necessary to take action now to bring the growth of the money supply within the target range. The Bank of England accordingly announced this morning with my approval that Minimum Lending Rate would be increased to 17 per cent. This goes beyond the rise in market interest rates at home and demonstrates the Government's determination to act with the firmness foreshadowed by my Rt Hon Friend the Prime Minister earlier this week.

8. The House will realise that interest rates overseas have risen sharply as other countries have moved to fight inflation by limiting monetary growth. In the United States, for example, prime rates have risen from 11½ to 15½ per cent since the summer.

9. In addition to sales of gilts, we intend to secure further funding of the PSBR through National Savings. The limit on holdings of the index-linked National Savings Certificates Retirement Issue will be increased next month from £700 to £1,200. A new ordinary National

Savings Certificate will be introduced early next year. The interest rate on the National Savings Bank Investment Account will be raised to 15 per cent from 1 January next.

10. Although much of the increase in the estimate of this year's PSBR is due to the timing of receipts, further action is required to bring the PSBR down. In the light of this we shall require oil companies to make a payment on account of Petroleum Revenue Tax at the time when they make their returns. This will have the effect from now on of advancing the due date for collection by 2 months, thus bringing the arrangements for PRT into line with those for collecting royalties. This will ensure that PRT reaches the Exchequer with the minimum of delay at a time when oil prices are rising.

11. The Bill to achieve this will be introduced shortly. It will reduce this year's PSBR by £700 million and thus bring the estimated level back to the original Budget figure of £8.3 billion. It will also yield an extra £300 million next year, in addition to £400 million or so from the deferred payment of telephone bills.

12. I set in hand some months ago a review of methods of controlling the growth of the money supply. The main instruments must continue to be our public expenditure and tax policies, which together determine both the size and the composition of the PSBR, and interest rate policies. Recently the Supplementary

Special Deposits scheme, or corset, has also played a part in monetary control. I am well aware of the limitations of this scheme and do not believe that it has a permanent role to play. Nevertheless, the Governor and I have agreed that it is right that it should continue for a further six months. The Bank announced the arrangements this morning.

13. In the future, other techniques, including one of the variants of monetary base control, could play a useful role, without the disadvantages of the SSD scheme. The Bank and Treasury will therefore shortly issue a discussion paper for consultation. I must, however, stress that no such scheme can avoid the need for the right fiscal and interest rate policies. Indeed, one of the possible advantages would be to improve the response of interest rates to monetary conditions.

14. Finally, I am extending the period covered by the present target range for £M3 of 7 to 11 per cent per annum. That target at present applies to the 10 months from mid-June 1979 to mid-April 1980. It will now cover the 16 months from mid-June to mid-October 1980. The effect will be to avoid building into the target for the new period the excess growth of the money supply in the recent past, while allowing a reasonable period in which to offset that excess.

15. Mr Speaker, Britain's future depends above all on mastering inflation. This can only be done if we bring the money supply under firm control, progressively

reduce the rate of monetary growth over the years, and pursue the most rigorous restraint on public spending. The supposed alternatives to these policies are a delusion. None of them would be responsible and none of them would be sustainable. The action I have taken today underlines the Government's total and continuing commitment to getting inflation down.

15 NOV 1979

COVERING SECRET UNTIL 4.00 THEN UNCLASSIFIED

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

15th November, 1979

Dear John,

I enclose a copy of a statement which the Chancellor of the Exchequer will deliver in the House this afternoon.

I am copying this letter to all the Private Secretaries to all the Cabinet members and Martin Vile.

(M.A. HALL)
Private Secretary

J.A. Chilcot, Esq.,
Private Secretary
Home Office

With the permission of the House, Mr Speaker, I should like to make a statement on monetary policy.

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could now be made of the PSBR for the year as a whole if no action is taken is that it would be about £9 billion, compared with the £8.3 billion Budget estimate.

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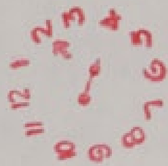
reduce the rate of monetary growth over the years, and pursue the most rigorous restraint on public spending. The supposed alternatives to these policies are a delusion. None of them would be responsible and none of them would be sustainable. The action I have taken today underlines the Government's total and continuing commitment to getting inflation down.

15 NOV 1979



S E C R E T
(until 12.30pm 15 November)

POINTS FOR PRIME MINISTER'S QUESTIONS

The Government is determined to counter inflation by doing whatever is necessary to control the money supply.

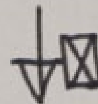
It is clear that the rate of monetary expansion, and in particular private sector demand for short term credit, remains excessive although the money and banking figures for the single month of October exaggerate the underlying trend.

In recent weeks market rates of interest have risen by about 2%. A further rise is requires at the present time to achieve slower monetary growth. Minimum Lending Rate has accordingly been raised to 17%.

The Supplementary Special Deposit scheme has been continued for a further 6 months. Tigher or additional direct controls would merely distort the system, and not affect underlying monetary conditions. There is no substitute for getting right the fundamentals - public spending and borrowing and interest rates.

My r.h.f. the Chancellor of the Exchequer will be making a fuller statement later this afternoon.

The rise in UK interest rates has to be seen in relation to the rest of the world. United States' prime rates have risen by 4% since the summer.



SECRET AND PERSONAL UNTIL
4 pm 15th NOVEMBER THEN
UNCLASSIFIED

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CHANCELLOR

copy addressees
as on attached list

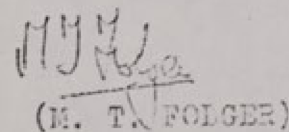
R

MONETARY STATEMENT: BRIEFING

I attach briefing for your use in presenting the monetary statement this afternoon. This has been prepared by CU and HF with the help of the other divisions concerned.

2. The briefing is organised as follows:-

Brief	Subject
A	1. Recent monetary developments 2. Monetary target 3. Interest rates (including implications for Building Societies) 4. SSD scheme and monetary control techniques
B	National Savings
C	Advancing collections of PRT
D	PSBR for 1979-80
E	PSBR and public expenditure for 1980-81
F	Effects on industry, GDP and employment
G	Prospects for tax cuts
H	Public Expenditure White Paper on the later years
J	Medium term financial plan
K	Exchange control and the monetary position



(M. T. FOLGER)

15th November, 1979.

COPY RECIPIENTS OF BRIEFING FOR CHANCELLOR'S MONETARY STATEMENT, 15 NOVEMBER

Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
PCC (inc Mr Ryric UKTSD)
Mr Bridgeman HF
Miss Brown GEA
Mr Butler GEP
Mr Cassell MP
Mr Hancock EF
Mr Lovell FP
Mr Middleton FEU
Mr Monck PE
Mr Shepherd SD
Mr Bottrill EB
Mr Williams HF3
Mr Broadbent CU

Mr Ridley
Mr Cropper
Mr Cardona

Mr Lankester No 10

PS/Governor
PS/Inland Revenue

A1 RECENT MONETARY DEVELOPMENTS

factual

1. £M3 grew by 2% in banking October (figures published 2.30 pm today). Bank lending was main expansionary factor (increased by £1½ billion).

2. In four months since mid-June, £M3 grown at annual rate of just over 14% (14.2%), ie above 7-11% target range. If allowance made for take-up of acceptancesoutside banking sector, underlying growth somewhat higher.

3. Details of recent developments in Annex.

positive

1. Latest figures suggest taking longer than hoped to bring down money supply growth from rate inherited but Government determined to bring back within target range.

2. Excess growth largely due to even higher PSBR than expected in first half of year and sustained growth of bank lending.

3. Can expect some slowing in £M3 growth. Budget measures reducing the PSBR will take effect in second half of the year. Further reduction from bringing forward PRT due date. Bank lending growth should moderate with lower activity, and interest rate increases.

defensive

1. Banking October:

(i) Banking October figures swollen by a number of distortions to normal financial flows.

(ii) CGBR in banking October affected by delays to some receipts from higher rate of VAT; expected low CGBR meant no receipts from part paid gilts were planned.

(iii) High demand for credit in banking October following small rise in banking September. Special factors operating

other way and tending to increase lending in October, eg ending of engineering strike; also impact of tax rebates on companies' cash flow.

(iv) Outflows across exchanges from non-bank private sector, as in other recent months. Probably associated with exchange control relaxations.

(v) M1 growth substantial (3.4%) but rise in interest bearing sight deposits accounted for much of it; possibly associated with funds awaiting longer term investment.

2. Government borrowing: PSBR expected to be higher in first half of year; and swollen further by PO strike (peak effect about £1 billion) and delays in VAT collection. Greater part of short fall made good in second half, when also expect receipts from higher rate VAT/public expenditure reductions and benefit from bringing forward PRT due date.

3. Bank lending: Remained strong, since beginning of year (increased about £700 million in last 3 months). Affected in some months by special factors, but expect increases to moderate not least as a result of higher interest rates and lower activity. But timing difficult to predict.

4. Acceptances: Recognise underlying growth in bank-type credit understated by published figures. Substantial take-up of acceptances outside banking sector(£1.1 bn in last 5 months). A side effect of SSD scheme (see separate brief). Action to prevent leakage would be counterproductive - force credit into more damaging and hidden channels.

5. Debt sales: Substantial sales until September. Sales affected by market uncertainties. Receipts in banking October affected by lack of part payments in anticipation of low CGBR and substantial redemptions and buying in of next maturities.

6. Exchange control abolition: Net effect on monetary growth difficult to assess but likely to be small this year (see separate brief).

RECENT MONETARY DEVELOPMENTS

I. Monetary Growth

	Banking October	£bn seasonally adjusted Banking July - Banking October (4 months)
CGBR	0.94	3.65
Purchases of central government debt by non bank private sector (increase:-)	+0.04	-2.02
Other public sector	-0.62	-0.18
Sterling bank lending to:		
private sector	1.24	2.48
overseas	-0.03	0.05
DCE	1.57	3.98
External and foreign currency finance adjustment	-0.40	-1.28
Net non deposit liabilities etc.	-0.09	-0.31
£M3	1.08	2.39
%	2.0	4.5

II. Cumulative £M3 growth (at an annual rate in target period)

banking months %

Target	August	September	October
7-11% (annual rate)	11.6	10.3	14.2

III. Bank lending and acceptances

£bn

	July	August	September	October
Bank lending	0.4	0.7	0.2	1.2
Acceptances	0.1	0.3	0.2	0.2
Total	0.5	1.0	0.4	1.4

	last 6 months	last 3 months
Average bank lending to private sector, adjusted for bill leak	£900m	£920m

A2 MONETARY TARGET

Factual

1. Objective remains to reduce monetary growth as key factor in reducing inflation with progressive reduction of target range.

2. Present target period extended: £M3 target now 7-11% (at annual rate) to apply from mid June 1979 to mid October 1980 (16 months).

3. Growth of 7-11% for whole period implies substantially lower rate over next 12 months - 7.4%

4. Target to be rolled forward again in Budget.

Positive

1. Keeping £M3 growth within target vital to improving inflation and prospect for revitalisation of industry.

2. Keeping same base avoids building-in recent excess growth (ie avoids 'base drift': to rebase on October 1979 would be less restrictive since £M3 growth to mid October above target range).

3. Target allows us to offset recent rapid growth over reasonable period. Growth at middle of range (9%) over whole 16 months implies 7.4% mid October 1979 - mid October 1980.

4. Provided private sector exercises restraint in pay bargaining, expect room within target for necessary finance for industry.

Defensive

1. Lower target: To reduce target now would be unnecessarily restrictive; new target implies sharp deceleration. Still intend to reduce target in longer term.

2. Higher target: To be less restrictive would be contrary to commitment to progressive deceleration of monetary growth. An increase in inflation would be much more damaging to investment and growth.

3. Turnaround excessive: Much sharper switch achieved in 1976-77 [£M3 growth in 6 months to mid November 1976 was 15% at an annual rate; in following 6 months just 1%].

4. Medium term targets: Chancellor considering whether to formulate more precisely longer term objectives (see separate brief on medium term financial plans).

5. Too complicated: No, simply applies to longer period. Necessary to avoid base drift.

6. Other aggregates: We monitor and take account of movements in other measures of money supply and liquidity. Additional targets would overconstrain the system. £M3 has a number of advantages as a target and is well understood by markets.

7. Exchange control makes £M3 less relevant: Not necessarily, but will monitor developments and reconsider appropriate definitions if and when necessary.

A3 INTEREST RATES (including implications for building societies)

factual

1. Bank announced at 12.30 today increase in MLR by 3% to 17% from today.

2. Bank statement also gave details of roll forward of SSD scheme and foreshadowed statement this afternoon (see separate briefs).

3. Recent interest rates developments in Annex.

positive

1. Increase demonstrates Government's determination to bring money supply under control. Recent increases in market rates reflect both developments in wage negotiations, and general increase in interest rates overseas.

2. High nominal rates of interest essential, given present rate of inflation, to slow demand for credit.

3. Increase will help bring down recent rapid growth in bank lending. Reflects Government's determination to meet monetary objectives.

4. Future interest rates crucially dependent on future inflation and earnings growth. If progress in reducing inflation is slower than expected then would not hesitate to take further fiscal or monetary action required.

defensive

1. Building societies: Recent rises in market rates will inevitably put some strain on societies. Impact will depend on societies' reactions to effects of package. (Money market rates now some 3% above societies' grossed up share rate of 12½%). See separate brief for impact of national savings measures.

2. Future mortgage rates: Matter for the societies. The decisions will doubtless depend on how long higher interest rates

last, which in turn depends on progress in restraining £M3 growth and reducing inflation.

3. Lower rates: As factors boosting monetary growth fall away, should be possible to see lower interest rates. Timing of fall will depend on external and internal developments, and we will want to be sure monetary growth is under control.

4. Still higher rates: MLR rise is sufficient to meet present situation.

5. Exchange rate: Increase in interest rates needed on internal grounds. Overseas interest rates also risen, therefore may be little net impact on exchange rates. But unchecked expansion of domestic credit would have put pressure on exchange rate in longer term.

6. Industry and investment: Higher interest rates may have some impact on activity, and will add to companies' costs. But surge in rate of inflation would be more damaging to output and employment (see separate brief).

7. High interest rates inflationary: No, high rates restrain demand for credit and reduce monetary growth. This helps to reduce inflation. [For reference: increase of 1% in mortgage rate adds ¼% to RPI.]

8. U-turn: No, Government remains determined to bring money supply under control. In time, as inflation comes down and public expenditure is restrained, this should be possible with lower interest rates. 'Consistency and continuity' about policy.

A3 Annex

INTEREST RATES: RECENT DEVELOPMENTS

1. Sterling Rates

1979	MLR	Clearing Banks' Base Rate	3 month Interbank	Gilt Yields* 5 years	10 years	20 years
25 May	12	12	11 13/16	11.4	11.9	12.2
29 June	14	14	14 1/16	12.3	12.8	12.9
27 July	14	14	14	12.4	12.3	12.3
31 Aug	14	14	14 5/16	12.1	12.3	12.4
28 Sept	14	14	14 1/8	12.2	12.3	12.6
19 Oct	14	14	14	12.6	12.9	13.0
26 Oct	14	14	14 3/4	13.5	13.6	13.5
2 Nov	14	14	14 3/4	13.3	13.5	13.4
9 Nov	14	14	15 5/8	14.8	14.5	14.3
14 Nov	14	14 +	16 1/16	15.4	14.9	14.6

*on nearest convenient date
(for 14 November, on that day)
+ except for Nat West, at 15½%

2. U.S. Rates

	3 month Eurodollar	3 month Interbank	Covered* differential
28 Sept	12 7/8	14 1/8	-
19 Oct	14 7/8	14	-7/16
26 Oct	15 13/16	14 3/4	-5/16
2 Nov	15 11/16	14 3/4	-1/4
9 Nov	15 11/16	15 5/8	+1/8
14 Nov	15	16 1/16	+ 1/16

* - indicates differential against sterling

1. Foreign US rates

2. Bank lending

3. Borrowing

A4 SSD SCHEME AND MONETARY CONTROL TECHNIQUES

Factual

1. SSD scheme (the 'corset') continued for further 6 months.

2. Government aware of SSD scheme's limitations, and do not see it as permanent.

3. Current guideline extended to mid June 1980; allows for further growth of 1% per month in banks' interest bearing eligible liabilities (IBELs). Details announced in Bank press release at 12.30 pm.

4. Bank and Treasury to undertake issue discussion paper and consultations with those most concerned on monetary base schemes.

Positive

1. Whatever the control system, main methods of control must be policies on PSBR and interest rates. Other controls no substitute for this.

2. SSD scheme despite its defects still some role to play.

3. Consultations on monetary base control to assess whether it could help smooth monetary growth or bring about better response of interest rates to changes in monetary conditions.

4. Directional guidance remains in force: asks banks to give priority to finance for industry and exports and, in order to ensure they can meet priority requirements, to exercise strict restraint on lending to persons, property companies, and for purely financial requirements.

Defensive

1. Distortions: Recognise SSD scheme and other direct controls encourage development of alternative channels of liquidity and credit - SSD scheme particularly encouraged take-up of acceptances outside bank sector. Also has damaging structural impact on financial sector. But, even allowing for this, has effects on credit conditions.

2. Adjust figures: Can only estimate total impact of distortions; preferable to remove cause.

3. Other controls distort: Depends on form of control and how they are used. No substitute for getting PSBR and interest rates right.

4. Monetary base now: Highly technical subject with wide ranging institutional implications. Hence need for consultations. Not sensible to introduce before new system fully understood and widely accepted.

5. Exchange control: Transactions abroad potentially a further loophole of SSD scheme. But high sterling interest rates bite on demand for sterling credit whatever its source. Ability to get the fundamentals right not significantly affected by abolition of exchange controls (see separate brief).

6. Guideline still too tight: Relationship between IBELs and £M3 very complex. Tightness depends, inter alia, on money market developments. But guideline growth somewhat greater than targeted £M3 growth rate. Would hope that bank lending moderates sufficiently to allow some reversal of distortions.

7. Industry squeezed: Availability of finance to industry depends on pay bargains agreed. Providing these are reasonable, room within guidelines for necessary finance to industry.

8. Restrict personal lending: Directional guidance remains in force. More direct controls would only increase distortions. Lending to persons relatively small part of total.

9. Increase HP controls: HP controls have a discriminatory impact between industries and between forms of credit; and the net effect on credit growth would be small.

B NATIONAL SAVINGS

i) factual

i. The National Savings Bank Investment Account rate will be increased on 1 January 1980 from 12½% to 15%.

ii. The maximum holdings limit on the Retirement (15th) Issue of National Savings Certificates will be increased on 3 December from £700 to £1200. The ~~National~~ Retirement Issue is index-linked and is only available to those of national retirement age.

iii. A new (19th) Issue of National Savings Certificates will be introduced in February in place of the current 18th Issue. The new Issue will be sold in units of £10 with a minimum purchase of £10 and maximum individual holdings of £1500 (the same as the 18th issue). A £10 certificate will increase in value to £16.35 over 5 years (equivalent to overall compound interest rate of 10.33% tax free). The grossed up yield to the standard rate taxpayer is 14.75%. This compares with 8.45% or 12.07% gross for the 18th Issue. The incremental structure for a £10 certificate is as follows:-

	Interest P	Total £	Annual Yield %	Cumulated Yield %
End of Year 1:	50	10.50	5	5
Year 2:	90	11.40	8.57	6.79
Year 3:	115	12.45	9.21	7.59
Year 4:	165	14.10	13.25	9.01
Year 5:	225	16.35	15.96	10.33

ii) positive

These changes are intended to ensure that these savings media remain an attractive form of investment for the personal saver thereby ensuring that National Savings plays a full part in financing the Public Sector Borrowing Requirement from outside the banking system. This will enable the Government to achieve its money supply targets at a generally lower level of interest rates than would otherwise be the case.

ii. The substantial increase in the holdings limit for the Retirement Issue will provide a considerably greater measure of protection against the effects of inflation for the savings of the section of the population least able to protect themselves.

iii) defensive

i. The higher rates of interest offered on the Investment Account and the new certificate reflect the rise in the general level of market interest rates in recent weeks. Prompt action was required to ensure that the competitive position of National Savings was not eroded thus making it more difficult for the Government to achieve its monetary targets.

ii. It is impossible to say how much additional investment the changes will generate. The savings media concerned have generallyproved to be attractive forms of investment for savers and we would therefore expect quite a substantial response.

iii. The exact impact on competing savings institutions will depend on how they react to the movement in the market rates. The National Savings changes are, however, likely to result in some reduction in their inflows.

C ADVANCING COLLECTIONS OF PRT

i) factual

At present PRT is normally paid four months after the end of the 6-monthly chargeable periods. The proposal is to require, by legislation, that companies should make their payment with the return they already submit two months after the end of each chargeable period. These payments would be received at the beginning of March and September. Assessed tax is, and continues to be, due at the beginning of May and November.

ii) defensive

The proposal will bring the payments arrangements for PRT into line with those which already operate for the collection of royalties by the Department of Energy.

The proposal does not conflict with the assurances about stability of the North Sea fiscal regime. There is no change in the rate of tax, only in the arrangements for collection.

The problem on the PSBR has arisen in large part from late payment of telephone bills or of tax. It is appropriate to correct this by a measure that brings forward the timing of tax collections.

[If questioned on IMPLICATIONS FOR RECENT BP SHARE SALE: This is a general measure affecting all oil companies paying PRT.]

iii) positive

The effect of the change, which will be permanent, will be to increase the PRT receipts in 1979-80 by £700 million and to raise receipts for 1980-81 by £300 million. The beneficial effects will continue so long as taxable profits from the North Sea are on a rising trend.

D PSBR for 1979-80

i) factual

The Budget forecast for the PSBR was £8.3billion. The first estimate for the first half of the financial year will be published on 22 November. The material is not yet complete but the main component - the central government borrowing requirement has already been published. It was about £6 billion, after allowing for seasonal factors (the actual figure was about £6½ billion). The total PSBR in the half year was probably close to £6½ billion (seasonally adjusted) with an actual total near £7 billion. It was always to be expected that the bulk of the year's PSBR would lie in the first six months. But the latest evaluation is for a PSBR for the year of about £9 billion before allowing for the acceleration of PRT collection. This means about £8.3 billion after taking PRT into account.

IMPORTANT NOTE THESE FIGURES ARE NOT PRECISE AND THE SEASONAL ADJUSTMENT IS SUBJECT TO CORRECTION BEFORE 22 NOVEMBER

Factors pointing to an excess if some action were not taken included the Post Office telephone billing excess. Though bills are now going out again, recovery will not be completed in this financial year: a net excess of about £400 million is now expected this year. Secondly, local authorities have been borrowing more than was expected in June; and this is now expected to continue.

ii) defensive

The wide margins of error in any forecast of the PSBR are well known, but it would have been unsafe not to heed the evidence so far. We seemed to be heading for a figure of about £9 billion.

The acceleration of PRT collection will improve the prospective public sector cash flow by about £700 million and so lessen the borrowing needed in the remainder of this year. After taking account of this, the 1979-80 PSBR is estimated at about £8.3 billion, in line with the Budget forecast.

D

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The programme of gilt sales and the improvements to the terms of National Savings will help to finance the PSBR in a non-inflationary way.

iii) positive

The extra receipts from the change in the PRT collection arrangements will help to ensure that the PSBR for the year as a whole is in line with the Budget forecast of £8.3 billion. We have demonstrated therefore our determination to take steps to keep borrowing under control.

E PSBR AND PUBLIC EXPENDITURE FOR 1980-81

i) factual

Government expenditure plans for 1980-81 were given in Cmnd 7746 on 1 November. They provide for stabilisation of the volume of public expenditure at the 1979-80 level. Treasury Ministers will not wish to say anything which rules out categorically a possible further review of 1980-81 spending plans, in time for the Budget say.

It is intended to publish a forecast figure for the 1980-81 PSBR in the Industry Act forecast to be published in the next ten days or so. The proposal to accelerate collection of PRT will itself benefit next year's PSBR to the tune of some £300 million. Telephone bills not collected this hear will benefit it by a further £400m.

ii) defensive

As demonstrated by the statement today the Government will be ready to adjust the fiscal balance as necessary to help secure observance of the monetary target. We will be considering the PSBR for 1980-81 on this basis.

Apart from relatively minor adjustments, such as further savings as a consequence of the Lord President's exercise on Civil Service staff costs, there are no plans at present for further reductions in planned public spending.

A final view on the PSBR and fiscal plans for 1980-81 will be taken in next spring's Budget.

iii) positive

The 1980 Budget will be framed in the light of the monetary target, which is paramount.

As the Prime Minister has said, the Government is embarking on a sustained programme of trying to get public expenditure down as a proportion of national income. We cannot go on spending money which the nation does not earn.

E

A <u>forecast</u> figure for the <u>1980-81 PSBR</u> will be given in the <u>Industry Act</u> forecast to be published shortly. [IF PRESSED ON TIMING OF PUBLICATION: I must ask the House to be patient - the forecast will be published soon.] But <u>decisions</u> on the PSBR and the fiscal balance will be taken later.

The proposal to accelerate collection of PRT will itself ease the PSBR position for 1980-81 by about £300 million. In addition the telephone bills not collected this year will benefit the 1980-81 PSBR by some £400 million.

F

EFFECTS ON INDUSTRY, GDP AND EMPLOYMENT

i) factual

1. Impossible to give reliable figures for impact on GDP of recent upward trend in interest rates.

2. Interest rates not necessarily the most important determinant of investment; prospect for economy generally much more important.

3. The Industry Act forecast will probably be published in the ~~next~~ few days or so but not by 20 November, which on one interpretation is the deadline implied by the Act. It will take account of the monetary package, and will contain a figure for the 1980-81 PSBR. A garbled story about the alleged content of the draft forecast appeared in the Financial Times on 14 November. It stressed the alleged pessimism on the outlook, especially for the path of GDP.

ii) positive

1. Reduction in monetary growth and hence inflation crucial to give the right conditions for investment and revitalisation of industry.

2. The acceleration of PRT collections will benefit public sector cash flow and hence reduce need for public sector borrowing.

3. As inflation and money supply brought under control it should be possible to meet objectives with lower interest rates.

4. Financial prospects for industry depend crucially on moderation in pay negotiations. Interest rate rises should help by confirming government's unwavering commitment to reduce monetary growth.

iii) defensive

1. The Industry Act forecast will be published shortly. Meanwhile it would not be right to give a detailed account of the economic outlook. However, nearly all forecasters are expecting some fall in GDP next year. This is a cost that we must be ready to bear if inflation is to be brought under control. [IF PRESSED

ON THE PUBLICATION DATE: I must ask the House to be patient - the forecast will be published soon.]

2. Higher interest rates damaging to Investment, Output and Jobs: Higher inflation would be much more damaging to investment, output and employment over the longer term.

3. Monetary target too tight: Provided private sector exercises restraint in pay bargaining, expect room within target for necessary finance for industry. (See brief A2 on new target.)

4. Impact on liquidity: Recognise that higher interest rates will add to burden on many companies, and liquidity already depleted following strikes, bad weather last winter, and recent cost pressures. But Government no intention of financing inflationary wage increases; companies will benefit in longer term from reduction in inflation.

5. Two Tier Interest Rates: There are objections of practice and principle to such schemes. Financial system too sophisticated; and protective for one sector would require greater restraint on others.

G PROSPECTS FOR TAX CUTS

i) factual

i. Main tax points in Chancellor's speech to Tax Reform Conference

- chances of economic and industrial recovery will certainly be improved by further pruning and re-shaping of the damaging tax structure that was inherited; but even that important task cannot be allowed to blunt the determination to keep borrowing down and the money supply under control

- certainly hope to be able in the years ahead to make further cuts in the basic rate of income tax

- also want to bring further relief to those at the bottom of the income tax scale, by raising the thresholds

- and to make improvements in company taxation

- but must have regard to the constraints imposed by the combination of low growth and in-built public spending.

ii. Chancellor's intentions for the next (and subsequent) Budgets

We recommend against being drawn into any discussion of prospects for tax adjustments in 1980 and the medium term, or of timing and form of specific tax changes that might be introduced. Budget fiscal policy will have to be consistent with the overriding need to contain monetary growth.

iii. Tax reductions expensive - for example:
- 1p off basic rate: over £500m (full year)
- £100 on basic personal allowances: over £700m (full year)

ii) positive

i. Much already achieved.

3p off basic rate. Allowances increased by double the amount needed to keep up with inflation. Substantial cuts in higher rates - threshold up from £8,000 to £10,000, 60% maximum on earned income. Aim has been to improve incentives, reward hard work, responsibility and success. Dire[ct] tax reduced by £4,300m in full year.

G

ii. Long-term objectives unchanged

Budget cuts in income tax only a first step. Objective remains 25% basic rate and to raise thresholds as high as possible. Need for a simpler and less oppressive system of capital taxation.

iii) defensive

i. Burden of tax to be increased in next Budget?

Determined to cut burden of income tax further. Too early to be specific about scope for action. Tax Reform speech said: "No Chancellor at this time could encourage over-generous expectations."

ii. Thresholds?

As outlined in Tax Reform speech, there is a strong case for raising thresholds - best way of widening gap between those in and those out of work and improving incentive to work.

iii. 1977 Finance Act indexation?

Action on thresholds will naturally be a major priority. [Recommend - avoid specific commitment to raise thresholds in line with 1979 price inflation (ie 17% plus).]

iv. Specific duties

To be considered in usual way in framing Budget.

v. VAT

No intention of going back on commitment not to raise 15% rate ceiling.

vi. Why consider cuts in capital taxes, when no more being done on income tax?

Income tax was given priority this year - bulk of the benefit went to helping those liable at basic or reduced rate. Right to review capital taxes as the second stage.

vii. Reliefs/exemptions/mortgage interest relief ceilings etc

Will all be considered in usual way in framing Budget judgement. No question of withdrawing mortgage interest relief.

H

H PUBLIC EXPENDITURE WHITE PAPER ON THE LATER YEARS

i) Factual

(a) Date of publication

It has been the general practice recently to publish a White Paper in January giving details of public expenditure plans for a five year period. In the Press Conference held on publication of Cmnd 7746 on 1 November Treasury Ministers said that a White Paper on the years to 1983-84 would be published at around "the turn of the year". In his statement to the House the Chief Secretary said simply that plans for later years would appear in a "subsequent" White Paper. The intention to publish in January, or indeed whether to publish at all, is being reviewed by Treasury Ministers. Therefore for the moment as little as possible should be said publicly about the publication date: neither to give a stronger commitment on January nor to give rise to speculation about delay or cancellation.

(b) Economic content

Treasury Ministers warned at the Press Conference on 1 November that the White Paper on the later years might not contain all the detailed "futurology" that was in recent White Papers. Treasury Ministers are reviewing the economic content of the next White Paper. Therefore little should be said, neither to imply that there will be a detailed forecast of revenue etc nor to suggest that decisions on expenditure are proving difficult for Cabinet to reach.

ii) defensive

By presenting Cmnd 7746 on public expenditure for 1980-81 the Government has already provided a basis for planning for next year. Plans for later years will be announced later. [IF PRESSED ON PRECISE PUBLICATION DATE: There is nothing to add at this stage to what the Chief Secretary said in his statement to the House on Cmnd 7746.] [IF PRESSED ON ECONOMIC CONTENT: We shall be considering the details of the next White Paper in due course.]

H

iii) <u>positive</u>

Spending plans for the years after 1980-81 will be announced later. Public expenditure in the years ahead will be consistent with the observance of monetary targets. As the Prime Minister has said, we must try to get public expenditure down as a proportion of national income. We cannot go on spending money which the nation does not earn.

J MEDIUM TERM FINANCIAL PLAN

i) factual

The Chancellor has said in the House that he is considering whether there would be advantage in adopting and publishing a medium term financial plan. Such a plan would contain specific medium term commitments on the progressive reduction of the rate of growth of the money supply. It could also contain supporting data, such as revenue and expenditure projections.

ii) defensive

A medium term financial plan could be helpful in further demonstrating that the government is absolutely determined to control inflation. But, as the Chancellor said in the House on 8 November, this is not the only argument to be taken into account. It would not be right to rush a decision on this important matter.

iii) positive

The government has already given a firm commitment to reduction of the rate of growth of the money supply. The announcement of a tight monetary target for next year and the measures adopted to help meet it are further moves in discharging that commitment. The Government will remain ready to adopt whatever measures prove necessary to secure observance of the monetary target.

K

EXCHANGE CONTROL AND THE MONETARY POSITION

i) factual/positive

1. Abolition of controls removed an artificial distortion of capital markets which discriminated against private investment overseas.

2. Domestic monetary implications complex, and have been somewhat overplayed. An outflow from the UK private sector would put downward pressure on money supply whereas our present problem is excessive monetary growth.

3. Net effect likely to be spread over months or even years. Net effect this year likely to be small, and could go either way.

ii) defensive

1. Detailed effects: Contractionary impact as private sector seeks investment opportunities abroad. But offset if bank borrowing increased to finance overseas investment or repayment of foreign currency debt; and foreign assets may be purchased at expense of gilts. Net impact will also depend on size and nature of offsetting inflows.

2. Domestic economy exposed: Abolition does mean we are more sensitive to developments overseas. But recent increases in overseas interest rates, especially in US, have been so dramatic that a UK response would have been necessary regardless.

3. Domestic Monetary Control: Abolition weakens SSD scheme (see separate brief). But as always the key things are an appropriate fiscal policy and the right level of interest rates. We remain determined to get these fundamentals right and our ability to do so not significantly affected by abolition. Higher sterling interest rates bite on demand for sterling credit whatever its source.

SECRET

16

Ref. A0664

PRIME MINISTER

Financial Statement

We have rung round to reinstate the 11 o'clock start for tomorrow's Cabinet (and MISC 22 at 10.15 am).

2. The Bank of England's announcement will not be made until later in the morning. I therefore suggest that it would be convenient to get the three routine items out of the way, before you ask the Chancellor of the Exchequer to tell his colleagues about the measures proposed and about the statement which he intends to make in the afternoon.

3. I daresay that, after the Chancellor has made his statement to his colleagues, you will want to make the general point that this situation underlines the implications of the fact that, painful as the process of reducing the growth of public expenditure has been, we still face in 1980-81 a figure which is no less than (on present published figures a little higher than) the figure for 1979-80 in constant terms. That will increase the importance of getting a satisfactory outcome at Dublin, which could take the 1980-81 figure below the 1979-80 figure.

4. I suggest that you should not suggest or even hint at the possibility of a further review of public expenditure for 1980-81: that could lead to defensive counter-briefing by Ministers who saw their programmes as threatened. But perhaps we do need to begin to prepare for the possibility of having to make further cuts in expenditure for 1980-81, if over the coming few months it is not possible to regain control of the monetary targets by the measures now proposed. I believe that it would be useful for you privately to ask the Chancellor and the Chief Secretary, strictly within the Treasury, to review the programmes for 1980-81 with a view to identifying options for further cuts, if further cuts had to be made. It would be useful if they could report on the results of such an exercise by Friday, 7th December, so that it would be available if needed in the following week - the week before you go to the United States.

ROBERT ARMSTRONG

14th November, 1979

PM seen. SECRET Econ Pol 15

PRIME MINISTER

MONETARY POLICY

Following our meeting last Friday and my minute to you of 9 November I have been discussing further with the Governor and with officials the proposals I shall need to announce tomorrow in the light of the latest monetary and other developments.

2. We are faced with an exceedingly difficult situation. It is widely known that the PSBR for this year is out of line (and, even if we were to volunteer nothing further on this ourselves tomorrow, it will be apparent from the PSBR figures for the first 6 months due to be published next week); market rates have already moved upward in anticipation of a significant increase in MLR; and the publication of a revised (and very tight) monetary target for the next 12 months is bound to create strong adverse expectations about interest rates. This is especially true if it becomes thought - as it is already in some quarters - that the corset is a piece of self delusion on the part of the authorities.

3. If we are to hold confidence and create the atmosphere in which there is a reasonable prospect of achieving the large gilt sales that are needed quickly (£1.5 to £2 billion over the next 3 months), we must announce proposals that do not disappoint market expectations. This entails - as you have recognised - an increase, unwelcome though it is, in interest rates. But it is also essential, as I think we are both agreed, to be seen to be taking action to correct the overshoot in this year's PSBR that is now apparent. To a substantial degree the overshoot is due to adventitious factors (notably the Post Office strike and delayed VAT payments) which can and will be explained. But - particularly given the other bad news that the markets will have to absorb, such as today's trade figures - I do not believe explanation alone is enough and that we need to supplement an increase in MLR with specific fiscal action.

4. This is easier said than done and the range of choice is a narrow one. It is too late to make any significant changes in public expenditure this year; and, although I have gone into this in detail with Customs and Excise, I do not think we can announce any steps to

accelerate VAT payments which would not risk being counterproductive (most of the big firms pay promptly already; and there would have to be a de minimis limit that would exclude most of the little ones).

5. The only major proposal that I consider feasible is an advancement of PRT receipts by 2 months into 1979-80. This would require immediate legislation (a short Bill) and would yield an extra £700 million or so this year and around a further £300 million next year. Although in one sense an accounting transaction it would nevertheless bring forward a stream of payments with continuous benefit to the PSBR for some years to come and would, I believe, be the only effective response to the PSBR problems now facing us.

6. In view of the instability of the world oil situation it would not in itself be an attractive proposal. There could be accusations of bad faith and perhaps even law suits in relation to the BP issue, although this would depend on what happens to the BP share price (BP will pay about two-thirds of the £700m on top of their share of the BNOC forward oil sales). Any row that might ensue could to some extent offset the beneficial effects of our overall proposals. But I am satisfied that there is no viable fiscal alternative; and I am convinced that without the inclusion of a measure of this magnitude there is a serious risk that the statement will prove inadequate and that we should be faced with the prospect of even higher interest rates and a further deterioration in the prospects for gilt sales and confidence in the Government generally. The fact is that a new situation has arisen since the BP issue and the action we must unavoidably take is one answer to any criticisms of the kind referred to above.

7. I also propose to announce three National Savings measures designed to produce a net inflow of some £700m in the present financial year. This will produce a valuable contribution to funding the PSBR at a slightly lower average interest rate and help to reassure the gilts market. The additional funding of the PSBR will come at a time when the gilts market may be very uncertain. In the judgement of the Governor and myself this addition will significantly increase the chance of the package succeeding. However, much of the inflow (perhaps a half) would be at the expense of the building societies and consequently at the expense of mortgage lending early next year.

Their immediate reaction might be to slash any new mortgage commitments for the period February to April. It could also bring forward the date of a further mortgage rate increase. But the alternative is running a greater risk that the general level of interest rates will have to increase even further.

8. I propose, therefore, that my statement tomorrow should in addition to the MLR change which the Bank will have announced at 12.30 pm, include:-

(i) The PRT advancement described above;

(ii) a roll-forward of the £M3 target at the present 7-11% target range for the 16 months from mid-June to mid-October 1980 (thus avoiding any "base drift" arising from the excessive rate of growth in recent months);

(iii) extension of the "corset" at the present rate for a further 6 months, although announcing that it will be phased out in due course and that there will be early consultations on monetary base control;

(iv) The National Savings measures referred to above.

9. I attach a draft of the statement I have in mind. As you will see I have left open the crucial figure for the MLR increase. I fear that the movement in market rates has been such that 16% would no longer be sufficient. But I think we must leave this open until tomorrow morning. It would be fatal to undershoot; but I shall be reviewing the position with the Governor and with officials further this afternoon before I see you.

10. I thought it would be helpful to set out my conclusions, and to let you see a draft of my statement, before our discussion this afternoon. Among other things I should like to take your view on how we might present the proposals to our colleagues at Cabinet tomorrow morning when final decisions will have had to be taken.

G. H.

Geoffrey Howe
14 November 1979

DRAFT STATEMENT.

Mr Speaker with the permission of the House I would like to make a statement on monetary policy.

The figures for banking October, published earlier this afternoon, show that £M3 grew by £1,080 million, or 2% in that month. The rate of growth over the 4 months since mid-June, the beginning of the present target period, has therefore been equivalent to just over 14%. Although a number of factors point to the figure for banking October being erratically high, just as that for the previous month was erratically low, it is clear that the underlying growth of £M3 is still significantly above the top of the target range which I set, namely 7-11% per annum for the 10 months from mid-June 1979 to mid-June 1980.

The excess has been largely due to the sustained rapid growth of bank lending and the high PSBR in the first half of the year.

It had always been expected that the PSBR would be higher in the first half of the year than the second, because many of the effects of the Budget - notably the receipts from the higher rate of VAT, and reductions in public expenditure, would mainly affect the second half. But the PSBR was further increased in the first half year by the effects of industrial action, notably on telephone bills and VAT collection. The greater part of ~~both~~ this shortfall will be made good in the second half year. But the best estimate which can now be made for the PSBR for the year as a whole is that it would be £9¼ billion, if no action were taken. This compares with the estimate of £8¼ billion at the time of the Budget. The Public Sector Borrowing Requirement

will be significantly lower in the second half of the financial year not only because of the factors originally envisaged but because of the partial recovery of the receipts in the first half year. Thus monetary conditions will be tighter on this account in the second half than in the first.

The other main factor contributing to the high rate of monetary growth has been the growth of bank lending to the private sector. This has fluctuated markedly from month to month but over the last 3 months has averaged about £700 million a month. This level can be expected to fall in due course from the changes in interest rates earlier in the year [and with the decline in the level of economic activity], although its timing is difficult to predict.

Some of the causes of the recent high rate of growth of the money supply are essentially matters of timing; and there are good reasons to expect it to decline somewhat in the future. But the

~~Whilst there are good reasons to expect that the rate of growth of the money supply will decline somewhat in the future, the~~ Government consider that it is necessary to take action now in order to bring the growth of the money supply back within the target range. Accordingly, we will be seeking to reduce the PSBR by bringing forward by [2] months (in place of the present 4) the due date for payment of petroleum revenue tax. The Bill to achieve this will be introduced shortly. This change will yield £700 million this year, and a further £300 million next. Next year's PSBR will also benefit from some £400 million of telephone bills not collected this year.

Take in new paragraphs at end →

The Bank of England announced this morning, with my approval, that Minimum Lending Rate would be increased to [17%]. This

both confirms the recent rise in market interest rates which have been generated by reactions both to the domestic monetary situation, and to the general rise in interest rates in other countries, notably the United States and shows the Government's determination to act in the way which my r.h.f. the Prime Minister foreshadowed on Monday.

In addition to operations in the markets, we will be taking steps to secure a further funding of the PSBR through National Savings. The limit on holdings of the National Savings Certificates Retirement Issue - the Granny Bonds - will be increased next month from £700 to £1,200. A new ordinary National Savings Certificate will be introduced early next year. The Interest Rate on National Savings Bank Investment Account will be raised to 14½% from 1 January next.

The Government have been reviewing the methods which are available to the authorities for controlling the growth of the money supply. The main methods must continue to be the policies on public expenditure and tax, which together determine both the size and the composition of the PSBR, and interest rate policies, both at the short end and in the gilts market. However, successive governments have supported these methods by some more direct method of control of the banking system such as the ceilings on lending used in the 1960s or the supplementary special deposits scheme, usually referred to as the corset, which has been applied at various times since December 1973. The efficacy of the SSD scheme has diminished

over time with the development of alternative channels of liquidity and credit outside the control, and it has nearly outlived its usefulness.

It would be inappropriate in present circumstances to dismantle the scheme completely. I have therefore agreed with The Governor that the scheme should be phased out over a period rather than brought to an abrupt end: the Bank of England announced, with my approval, this morning the basis on which it would be extended for a further 6 months.

It is possible that other techniques of control, possibly one of the variants of monetary base control, might have a useful role to play in the future, without having the disadvantages of the SSD scheme. The Bank and Treasury will accordingly shortly be starting technical consultations on the basis of a discussion paper with those most concerned to establish whether such a scheme is technically feasible, and whether it would have the desired effects of either smoothing the growth of the money supply, or of bringing about more readily the interest rate changes which may be necessary for monetary control. But I must stress to the House that any such scheme of monetary base control is not a substitute for the appropriate fiscal policy and interest rates: indeed one of the possible advantages is that they improve the response of interest rates to changes in monetary conditions.

Finally I intend to extend by 6 months, to mid-October next year, the period for which the present target range of 7-11%

per annum for the rate of growth of £M3. That target at present applies to the 10 months from mid-June to mid-April next,and it will now apply to the 16 months from mid-June to mid-October. I am extending it in this way, because to adopt the more normal procedure of setting the target for the 12 months from mid-October this year to mid-October next year would involve building into the new target the excess growth of the money supply in the recent past. It would be totally at variance with this Government's philosophy of controlling the money supply to allow that, and to do what the experts call "base drift". Instead, we are allowing a reasonable period over which we can offset the more rapid growth which has already taken place.

Mr Speaker, this Government is committed to bringing the money supply under control, and thereafter to reduce progressively the rate of monetary growth over the years. The measures which I have announced today show that we are ready to take the action which appears necessary to achieve that objective.

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ANNOUNCEMENT

[Additional paragraphs for insertion on page 2.]

w I am not satisfied that the present arrangements for collecting petroleum revenue tax are entirely satisfactory as regards the speed with which this tax, as distinct from royalties, reaches the Exchequer. This is not a criticism of the oil industry but, rather, of the tax collection rules themselves in the Oil Taxation Act 1975. The House will appreciate that very large sums are involved and that we must ensure that PRT reaches the Exchequer with the minimum delay consistent with collection arrangements that are workable in practice. I therefore intend to bring before the House a short Bill, before the recess, containing the Government's proposals for changing the present PRT collection rules.

x Further details are given in a Press Notice being issued by the Board of Inland Revenue.

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Ree 14 DS

bc: David Wolfson.
cc: John Beverly
cc: Master set

10 DOWNING STREET

From the Private Secretary

14 November 1979

The Prime Minister held a meeting this evening at 1700 hours to discuss the measures which the Chancellor of the Exchequer proposes to announce tomorrow. The Home Secretary, the Chancellor, the Chief Secretary, the Financial Secretary, the Attorney General and the Governor were present. The meeting had before it the Chancellor's minute of today's date together with the draft of his Statement. The following are the main points which came up in discussion.

The Prime Minister first outlined the problems on the monetary front with which the Government had to deal. In view of the very bad money supply figures for October, it was essential that there be a sharp improvement in the figures for November; and this meant the need for heavy sales of gilts in the next few days. Against this background, an increase in MLR was inevitable. In addition, measures needed to be taken to reduce the PSBR for 1979/80, since it was now forecast to be significantly higher than at the time of the Budget.

MLR

The Governor said that it was essential to sell £500 million of gilts by the close of next Tuesday. The only way of being sure of achieving this was to raise MLR to 17%. The three-month rate was now standing at over 16%, and all the advice he had had was that anything less than 17% would carry with it the risk of failure. He found it very unpleasant to have to recommend such a large increase, and there was the added difficulty that we might be accused of aggravating the problems of the Dollar arising from the Iranian situation. But there was no alternative if the Government's monetary strategy was to remain in tact. The Governor went on to say that there was £350 million still available from the 1989 tap; the Bank intended to issue a new long tap amounting to £1 billion, and this would be part-paid with £150 million planned for receipt before the end of the banking month.

The Chief Secretary added that it would be fatal to undershoot on the MLR increase. If Ministers did not accept the advice of their professional advisers and went for say 16½%, there was a real risk that the increase would not have the desired effect; if that happened, there would be a real crises and no doubt a full fiscal package would be required. Having adopted a strategy of firm monetary control, the Government must stick to it.

/The Prime Minister

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The Prime Minister said that she was very disturbed that it was now thought necessary to raise MLR to 17%. With the measure to bring forward payment of PRT (see below), she felt that 16½% might be sufficient. Before taking a final decision, she asked Treasury Ministers to make a fine judgement balancing the political problems of raising MLR to 17% against the market risks of going to 16½%. (At a reconvened meeting later in the evening, the Prime Minister agreed reluctantly that the increase should be to 17%.)

The Home Secretary commented that an increase to 17% would indeed be a political shock both for Ministerial colleagues and for the country. He wondered whether more reliance could not be placed on measures other than MLR to control the creation of credit. The Chancellor responded that other possible measures to control credit to the private sector had been fully examined; there were none which would provide an answer to the current difficulties. One possibility which he was looking at was to reduce the tax relief available on borrowings; but no changes could be made on this front before the next Finance Bill and they would involve complex legislation.

PRT

The Chancellor said that advance payment of PRT could bring in £700 million in 1979/80 and a further £300 million in 1980/81. This would require legislation, and there were legal risks. But on balance he was convinced that this would be a useful additional measure. It would go a long way to bringing the PSBR back into line with the Budget forecast.

The Attorney General commented that an announcement tomorrow to oblige the oil companies to make advance payments of PRT was much too close to the recent BP share sale for comfort. Some of the contracts relating to this sale were still not complete. Moreover, the Securities and Exchange Commission document relating to the sale gave specific dates of payment of PRT. If the BP share price were to fall significantly following the announcement, and if a shareholder were then to start proceedings against the Government for not having made its intentions clear at the time of the sale, it seemed quite likely that the judgement of the Court would go in his favour. At the very least, the Government would have great difficulty in proving that it had not intended to proceed with the PRT decision when the share sale was announced.

The Chancellor, however, pointed out that the extra financial burden on BP would not be all that great. In terms of the interest which they would have to forego, the extra net cost to the private shareholders was likely to be only about £6 million. The Home Secretary added that, politically, there would be great advantage in including the PRT measure in the Chancellor's announcement. It was generally understood that oil companies were making large profits following the recent oil price increases, and there was a general feeling that the Government ought to be taking a larger slice.

The Governor commented that, if it were decided to go ahead with the PRT measure, it should be presented in a low key manner. It could be presented as a means of counteracting the delay in the payment of VAT and Post Office bills. It would be a mistake to give the impression that it was a major new fiscal initiative since it clearly was not.

/The Prime Minister

The Prime Minister said that, despite the risks of a row and even possible law suits, it would be right to include this measure in the Chancellor's announcement.

Other possible measures to reduce the PSBR

The Chancellor said that he had examined the possibilities for speeding up VAT demands. He had concluded that there was little that could be done. He had ruled out the use of the regulator because of its effect on the RPI, while its effect on the PSBR would be relatively small.

On the other hand, there was scope for a further £100 million from forward sales of oil; and the contingency reserve could probably be trimmed by £150 million because that amount had been set aside for assistance to Rhodesian refugees - and it seemed very unlikely that it would now be needed this financial year.

The Prime Minister said that the Treasury should be looking at the possibility of increasing the tax on bank profits. (I wrote to Tony Battishill earlier today about this.)

The Prime Minister also wondered whether there were possibilities for reducing public expenditure in the short run. The only significant option appeared to be to reduce the UK's EEC contribution, and she would have to say at Dublin that - against the current economic background - the UK had no alternative to eliminating its net payment. Another possibility might be to slow down capital spending.

The Financial Secretary said that it would be right to reconsider the public expenditure figures for 1980/81; but this must be done in an orderly fashion. It would be a mistake to give any indication in the Chancellor's Statement tomorrow that the recently published figures were going to be changed.

National Savings Measures

The Chancellor said that these should produce a net inflow of £700 million in the present financial year. This would be a substantial help in funding the PSBR.

The Prime Minister said that she was not altogether happy with the measures in so far as they would take funds away from the building societies. But she agreed they should be included in the Chancellor's Statement as he proposed.

Roll-forward of the M3 Target

It was agreed that the present 7-11% target should be rolled-forward for the 16 months from mid-June 1979 to mid October 1980.

Extension of the "Corset"

The Prime Minister said that it was an unnecessary hostage to fortune to announce that the "corset" would be phased out

/after

after 6 months. It might, in the event, be needed for more than 6 months. It was agreed that the Statement should be redrafted so as to leave open the possibility of its continuation beyond 6 months.

Iran and the Dollar

Finally, the Chancellor reported on a conversation he had had on the telephone during the course of the meeting with Secretary Miller. Miller had explained the background to President Carter's order freezing official Iranian assets held in the USA and in US banks abroad, and had asked for HMG's co-operation in making the order effective. He had responded sympathetically, and had said that HMG would certainly be willing to consider any proposals from the US authorities.

I am sending copies of this letter to John Chilcot (Home Office), Bill Beckett (Attorney General's Office) and Sir Robert Armstrong (Cabinet Office).

T. P. LANKESTER

KRR

Martin Hall, Esq., M.V.O.,
HM Treasury.

Top Copy Econ Pol, May 79,
Correspondence with John Sparrow on Econ Matters

Econ Policy

Note for the record

c.c. Mr. Wolfson
Mr. Hoskyns

Mr. John Sparrow called on the Prime Minister at 1015 hours today.

Mr. Sparrow said that nobody had expected the October banking figures to be anything like as bad as they had turned out to be. Nor was there any clear reason for the bad figures. One possible explanation was that interest rates were now debited quarterly; if this was not taken account of in the seasonal adjustment, it would tend to push up the figures for October. His own experience was that companies were not increasing their overdrafts.

Mr. Sparrow went on to say that the City were expecting MLR to be increased to 16% on Thursday. Gilts prices had fallen in response to this expectation. But brokers generally felt that today or Wednesday would be the last time to buy gilts cheaply. In other words, they expected the interest rates to come down once the MLR increase was announced.

Besides the MLR increase, many people in the City were expecting additional spending cuts and the use of the regulator; these, combined with the hope of renegotiation of the UK's EEC budget contribution, would help to bring down the PSBR.

The Prime Minister asked whether companies were not borrowing to finance big pay settlements. Mr. Sparrow replied that the current level of settlements was not as high as it might appear. It was the big settlements which got all the publicity. Small settlements did not get publicity because it was not in the interests of managements to publicise them. He cited the example of Mather and Platt which had settled for 12½%, and also the Talbot settlement. It would be a mistake for the Government to try and give such settlements publicity - even though the publicity given to the big settlements

/did have

did have an influence on the general tenor of the pay round.

After the meeting, Mr. Sparrow told me that a general question running through the City was whether the Government were going to embark on a 'U' turn. His own clear impression from what the Prime Minister had said to him, and what she had said at the Lord Mayor's Dinner, was that the Government had no such intention.

R.

13 November 1979

c/ Wolfson Hoskyns

File

COVERING SECRET

10 DOWNING STREET

From the Private Secretary 12 November 1979

Dear Tony,

I enclose my note of the meeting on monetary policy which followed the Prime Minister's lunch last Friday with Treasury Ministers, the Secretary of State for Trade, the Governor of the Bank of England and senior officials.

I am sending a copy of this letter and enclosure to Stuart Hampson (Department of Trade), John Beverly (Bank of England), Sir Robert Armstrong and Sir Kenneth Berrill.

Yours ever,

Tim Lankester.

A.M.W. Battishill, Esq.,
HM Treasury.

cc Master set

13

NOTE OF A MEETING HELD AT 10 DOWNING STREET AT 1400 HOURS ON FRIDAY 9 NOVEMBER 1979

Present: The Prime Minister
The Chancellor of the Exchequer
The Secretary of State for Trade
The Chief Secretary
The Financial Secretary
The Governor of the Bank of England
The Chief Cashier
Mr. Fforde
Mr. Goodhart
Sir Douglas Wass
Sir Kenneth Berrill
Mr. Bridgeman
Mr. Middleton
Mr. David Wolfson
Mr. Adam Ridley
Mr. Tim Lankester

The meeting had before it the Chancellor's minute of 9 November.

The Chancellor said that an increase in MLR up to 16%, or possibly over, next Thursday was inescapable. Against the background of the very bad money supply figures for October and rising market interest rates, failure to raise MLR would precipitate a crisis of confidence. It was essential to get gilt sales under way again on a substantial scale, and a sizeable increase in MLR was an essential pre-requisite for this. In addition, higher interest rates would moderate the expansion of lending to the private sector, though they could not be expected to have a big impact immediately. Ideally, interest rates ought to be accompanied by action to bring down the PSBR. The PSBR was running at a higher rate than had been forecast, and it was making the achievement of the Government's monetary targets that much more difficult. However, there could be no question of a fiscal package. The Government had only just announced its public expenditure decisions for 1980/81, and use of the regulator had to be ruled out on counter-inflationary grounds. But there were still certain possibilities for increasing revenue before the end of the financial year. One such option was to oblige the oil companies to make advance payments of PRT. Although this would require legislation, it could bring in £700 million; and it was worth considering. Speeding up the payment of VAT should also be looked at.

The Chancellor went on to say that he would need to make a statement next Thursday. Besides announcing the MLR increase, he

/ proposed

proposed to announce the roll forward of the monetary target; on this, he would be bringing forward separately a specific proposal next week. He would also announce the intention to phase out the "corset", and he would also say that the Treasury and the Bank intended to begin consultations shortly on possible forms of monetary base control.

The Prime Minister said that the October money supply figures were far worse than she had been advised they were likely to be when she had discussed monetary developments with the Chancellor and the Governor in September and early October. This appeared to be partly due to the fact that the borrowing requirement in October had been forecast at a much lower level than had transpired, and as a consequence the authorities had not planned on any substantial receipts from gilt sales. It was a pity that the forecast had been so badly wrong. As regards lending to the private sector, it seemed that the existing policy levers were having no effect. High interest rates seemed to be having little effect on loan demand, and existing controls on the supply of credit had proved ineffective. It was disappointing that the Treasury had been unable to come forward with any new proposals for controlling credit on the supply side.

In discussion, it was generally agreed that there was no alternative to increasing MLR to at least 16% if the money supply was to be brought under control. It was suggested that an additional measure might be to intervene in the exchange market so as to push sterling up. Against the background of bad trade figures next week, intervention in support of sterling might be necessary in any case. On the other hand, it was pointed out that supporting sterling would not necessarily improve the figures for M3. In recent months, there had been counter-balancing factors on the external side and it could not be assumed that these would not continue.

As regards lending to the private sector, it was pointed out that it was very hard for the authorities, and even the banks themselves, to bring this under control as long as the demand for credit remained high. Since industrial customers were normally borrowing within existing lines of credit, it was hard - even if they wanted to - for the banks to cut back their lending. As for

the authorities, measures to control bank lending other than by moving interest rates simply did not work. Schemes such as the "corset", while they might have some effect on bank lending, all too easily led to credit creation outside the banking system. And with the abolition of exchange controls, the opportunities for evasion were now all the greater.

The Prime Minister asked whether there was nonetheless scope for putting pressure on the banks to reduce their lending. The Governor said that he saw the Chairmen of the Clearers every month, and he was ready to use what influence he had. But there was a risk in putting too much overt pressure upon them: if this happened, borrowers might well draw down their overdrafts against the expectation of a worsening credit situation and thus aggravate the position. The Chancellor commented that, while applauding the Government's strategy in principle, the banks did not seem to be taking the message of tight money to heart and putting it into practice.

It was further pointed out that the demand for credit was inelastic in the short run. But consideration should be given to ways of making demand more responsive to interest rate changes. One such approach would be to change the provisions for tax relief on interest payments. The Chancellor said that although changes of this kind could not be introduced until the next Finance Bill, he would consider the possibilities. The Prime Minister suggested that borrowing on credit cards would be lower if people were better aware of the high cost of interest which they were paying on them. More generally, it was argued that the demand for credit would only fall significantly when the economy moved into recession.

As regards measures to reduce the PSBR, the Prime Minister asked about the possibilities of holding back our contributions to the EEC budget. The Chancellor replied that he had had this fully examined, and it was possible to introduce some delay. There had been the possibility, for example, of delaying payment of £50 million earlier that week; but he had decided that in the

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run-up to the European Council that would be unwise. However, this should not be ruled out for the future.

Other possibilities for action on the PSBR were mentioned. First, the Rate Support Grant for 1980/81 was still to be announced. Could it not be reduced below 61%? The Prime Minister said that she did not think it would be possible to re-open the decision which Cabinet had taken on this. Second, additional forward sales of oil - possibly £100 million - might be contemplated for 1979/80. Third, asset sales for the current financial year might be increased somewhat: for example, BGC could be directed to sell Wytch Farm. On the other hand, there was no possibility of selling further BP shares at least for another 18 months: this was effectively ruled out by the prospectus for the recent 5% sale.

The Prime Minister said that she was worried that MLR might be increased to 16%, and gilts sales would still not get under way. She was also concerned about the general psychological effect of raising interest rates still further. She thought the Treasury might be showing excessive zeal in their effort to demonstrate that they were sticking to a policy of monetary discipline. The Financial Secretary commented that, on the contrary, the MLR increase proposed was absolutely essential if the Government's monetary strategy was to have any continued credibility. The Chancellor added that the Government's attitude to interest rates was regarded as an area of weakness. The reports that we were trying to prevent the mortgage rate increase in July had been damaging. It was essential to avoid any further impression that the Government would resist interest rate increases where they were necessary. The Governor said that he was reasonably confident that, following the increase in MLR, gilts sales would start moving again. If they did not, there would indeed be a real crisis; and a fiscal package might then be unavoidable.

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As regards the Chancellor's statement on Thursday, it was argued that it was important to avoid the impression of a crisis. On the other hand, latest developments showed that the Government's decisions on public expenditure were, if anything, insufficiently tough; and it might well be necessary to reconsider the spending plans for 1980/81 in the run-up to the Budget. Reducing public expenditure was much the most effective way of bringing the money supply under control.

As for the announcement of consultations on MBC, it was pointed out that an MBC scheme would not obviate the need for interest rate increases when the demand for credit was excessive. On the contrary, such increases would be more automatic, and possibly larger, than under the present system. It was possible with MBC that interest rates would move in the wrong direction. For example, a large inflow of foreign exchange, by pushing up M3, would tend to push interest rates up automatically. By contrast, under the present system the authorities at least had some discretion to prevent this from happening. It was essential to have adequate time for consultations before any decision to introduce an MBC scheme.

In conclusion, the Prime Minister said that she reluctantly agreed that MLR should be increased to 16% next Thursday. She also agreed that the Chancellor's statement should cover the roll-forward of the monetary target, the phasing out of the "corset", and the intention to start consultations on MBC. The statement should not suggest that further expenditure cuts would now have to be considered. However, the Treasury should pursue the options for reducing the PSBR which had come up in discussion.

T.L.

12 November 1979

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Seen

PRIME MINISTER

As you suggested, Adam Ridley has seen Brian Griffiths, Harold Rose, Terry Burns and John Flemming. Their views are very much one of a kind. Briefly:

(1) It is essential to move fast and increase MLR to at least 16%. M3 for November must be "good", and the only way of being certain of achieving this is to sell a large quantity of gilts. There is a general feeling that there is a "gilts strike" at present. No one will buy unless MLR goes up.

(2) It is almost impossible to control Bank lending to the private sector ~~and~~ on the supply side - i.e. direct controls such as tightening reserve asset ratios, the SSD scheme and "moral suasion" won't work. Bank lending will only be certain to come down when activity weakens and we have high interest rates - though interest rates will not have an immediate effect.

(3) Nonetheless, the Governor should call the clearers in and try to get them to reduce lending. This could reduce the published figures for lending, though other ways of getting finance (e.g. acceptances and borrowing from branches abroad or from American banks) are likely to take its place.

(4) There is no point in having a medium-term financial plan when the Markets are dubious about our ability to stay within the existing target.

(5) If we were to change to monetary based control, there should be plenty of time for consultation. Only four months consultation was allowed for Competition and Credit, and this was not enough.

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(6) To be sure of selling sufficient gilts over the next month, there should be a tender - i.e. no minimum price.

(7) More generally, the credibility of the Government for years is at risk if adequate action is not taken now. There is a feeling that we are dithering, and unwilling to take unpleasant consequences of sticking to tight monetary targets. (Apparently this stems partly from the feeling that we were prepared to interfere with the mortgate rate: there needs to be a positive affirmation that we are not going to - though we virtually said this in the House the other day.) Terry Burns says that our fiscal stance is too lax, and in theory would like a fiscal package but he understands the political difficulties.

R.

9 November 1979

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PM has seen

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Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

MONETARY POLICY

I attach a very preliminary Treasury note on possible forms of direct control over bank lending (as distinct from Monetary Base Control, which I discuss later in this minute). We have not had time to discuss it with the Bank. You may find it useful if I set it in context.

2. I think that we are faced with three issues:-

(i) How can we best develop the system of monetary control?

(ii) What can we do immediately to regain control over the money supply, as quickly as possible; can we, in the short run, reduce bank lending or sell more gilts?

(iii) How can (ii) be best presented as part of a coherent package including the roll forward of the target in the next week or so?

The system of monetary control

3. This is the most important issue in the longer term. It is not the most pressing, though we may need to make some reference to the development of our thinking on this - a point which I return to below. But I should stress one key point, which came out in the earlier discussions on monetary base control. In an economy and monetary system which are as sophisticated as ours, and ones which are now open with the relaxation of exchange control, the main methods available to the Government to affect

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monetary conditions are what it does to public expenditure, taxation policy, and so the PSBR; what it does through interest rates and gilt sales; and how it intervenes in the foreign exchange markets. Any attempt at more direct control just stimulates evasion, either elsewhere in the uncontrolled sector of the domestic financial markets or through offshore routes. At present changes in interest rates are partly brought about by the markets, and partly by the discretionary actions of the authorities. A monetary base system, if it were found practicable, would generate changes in interest rates more automatically and with less direct political involvement on the part of the authorities. But most people would consider that it would induce wider swings in interest rates. If such a system had been operating in the last few months, it would almost certainly have led to higher interest rates than today's.

4. The attached note on alternative methods of controlling bank lending suggests that almost any method of direct controls open to us is likely to encounter a basic difficulty. It would further stimulate the channelling of credit through other routes outside the banking system, in ways analogous to those which have already brought the SSD scheme into disrepute; all the more so because there is now the obvious additional avenue of avoidance through the Euro-sterling markets. Moreover, forcing the credit into alternative routes is apparently unlikely to alter the present upward pressure on interest rates.

<u>What should be done in the short run?</u>

5. It is possible that something might be gained if one could change the present general impression that credit is fairly freely available. The Governor might ask the banks to be more severe in the granting or renewal of facilities. I would welcome the Governor's view on this, although particularly at the outset I would expect the effect mainly to be on the atmosphere in markets, rather than on the monetary statistics.

6. It seems pretty clear that the only way we are going significantly to affect the money supply figures for banking November and December is through getting the gilts market moving again. One element in this has to be the Government reasserting its determination to control the money supply, and being seen to take the necessary action to achieve this, whatever it may cost in other respects. The other has to be the Bank following this through in it gilts market oparations. On the first, if we rule out fiscal action, as I think we must, then it still seems difficult to avoid action on interest rates, at the very least moving MLR to confirm the move which has already taken place in market rates. I am strongly advised that anything less than a move to 16 per cent now would be seen as the action of Canute, and call in question our resolve to adhere to our monetary targets. The second is a matter for the Governor.

7. These are, of course, two of the key questions for discussion at our meeting later today.

The announcement next Thursday.

8. As I indicated in my minute last night, the other main elements in an announcement next Thursday ought to be the roll forward of the target, and the future of the SSD scheme.

/ The

The decision on what the amount of the roll forward should be is, I think, separable from the decision on interest rates and the SSD scheme. I would therefore suggest that we should deal with it separately later. I will put something to you on it early next week.

9. But, I think that it would be useful if we discussed the SSD scheme today. There is a good case in logic for bringing it to an end. Ways round it have now become so developed that it is having little, if any, effect on either liquidity or credit. This is obvious to all informed commentators. Moreover, there is a distinct risk that if it is continued, it will encourage disintermediation into offshore banking - the Euro-sterling market. However, the Governor and I consider that there would be an adverse reaction, particularly abroad, if we were seen to take it off tout court. We therefore recommend announcing that it is intended to phase out the SSD scheme. We would justify that domestically by explaining that, while we accepted the scheme was no longer having a significant effect on liquidity of credit, its ending would lead to the inflation of a sterling M3 statistic, by as much as 3 per cent over a period, as some of the flows which had avoided the corset came back into the banking system. We were therefore retaining it to control the speed at which these flows returned.

10. The presentation would also be helped by including in the Thursday statement our intention to begin consultations shortly on possible forms of the Monetary Base control scheme. The cognoscenti would realize that the SSD scheme, and any monetary base scheme practicable in the absence of exchange control,were not really alternatives. The latter is less a system of direct control, and more a method of generating the necessary changes in interest rates.

Conclusion

11. The conclusion to which one is driven by the best advice so far available is that controls on bank lending, or other changes in control systems, are not going to produce the immediate improvement in monetary conditions which we need. From this there follows the need to achieve substantial gilt sales, particularly before the end of banking November (21st), if at all possible, and to sustain them thereafter. This requires the Government to do what is necessary to maintain confidence in our determination to carry our policies through: that in turn means we must accept MLR of at least 16 per cent. It must then be followed by successful operations by the Bank in the gilts market to secure the maximum sales. Clearly these are the issues on which we both want to concentrate today.

12. I am sending a copy of this to the Governor.

Approved by the Chancellor
and signed in his absence

(G.H.)

9 November 1979

cc: Sir K. Berrill

ANNEX

S E C R E T

ALTERNATIVE METHODS OF DIRECT CONTROL OVER BANK LENDING

In assessing ways of controlling bank lending one must separate the effect on the banks and their ability and willingness to control their advances to private sector customers, and the effects on the customers' demand for bank credit.

Banks' Ability to Control Lending

2. The ability of banks to control lending is circumscribed particularly in the short run. The first reason for this is the general practice of granting facilities, which are then used at the customer's discretion. The overdraft system is the classic example of this, where a bank normally agrees with a customer an overdraft ceiling, which is subject to review, usually annually: the customer then has a virtual contractual right to use that facility at his discretion until the time of the next review. The average utilisation of such facilities normally varies between 50% and 60%, and at present is at the top end of that range. Hence there is considerable scope for an uncheckable increase in bank lending due to increased utilisation of facilities, which the banks can nothing to prevent in the short term. In recent years, there has been a progressive switch from overdraft to term loans, but here again the normal practice is to negotiate facilities, which can then be drawn down at the customer's discretion.

3. The main opportunity for banks to vary the scale of their lending is therefore at the time when facilities are either requested from them or renewed. As a rule these reviews are, say, once a year, which means that the opportunities they offer for changing facilities are very limited, particularly over a period of a few weeks. The scope for change is further limited in practice, because a bank may not be able to reduce its overdraft facility to most industrial customers sharply without putting them out of business. The ability to cut back on lending is probably greater in the personal sector, where there are more personal loans for particular purposes which are being runn off in accordance with a pre-determined schedule.

4. Banks can influence the use which is made of facilities already granted in only two ways, short of reneging on a contractual

obligation. The first is through the interest rate which it charges. The second is to offer an alternative source of finance, and to pursuade the customer to use it rather than to draw on the facility: this may well have been happening to some extent in the recent past with the growth of acceptances, and could obviously happen in the future by offering a loan in the euro-sterling market from an overseas associate.

The Demand for Credit

5. In the longer term, the authorities can affect the demand for bank credit by the whole range of their economic policies with their effects on the level of activity, prices, or on company profits and liquidity. For example the increase in VAT will have had a once-for-all effect on company liquidity, which should have reduced the demand for bank lending. More specifically, the authorities can affect the demand through interest rates, although it is clear that certain types of lending at least are not very sensitive, particularly in the short run. For example a company facing a turn down in demand for its products may have little alternative but to build up stocks in the short run, financing it from its bank facility, although its decision about whether to maintain those stocks thereafter or cut back on production may turn on the rate of interest. The effect of interest rates on company decisions may also be muted to the extent that interest payments are a charge against profits before tax.

6. The amount of credit which is taken by the borrower may be affected by the ease with which he can obtain facilities. But, given the sophistication of the British financial system, to the extent that some channels of credit are closed, it will usually be possible to find others - here again acceptances are a clear example at present, and euro-sterling loans could be in future. It may be harder for personal sector borrowers than for companies to find alternative sources of credit.

Methods of Control by the Authorities

a. Existing

7. The present monetary methods for controlling bank lending, as one of the counterparts of the money supply, are interest rates, the Supplementary Special Deposits Scheme and directional guidance. Interest rates, which are essentially the price of credit, tend to have their effect after a substantial lag as already mentioned. The extent of the effect varies between types of customer, and with the financial situation in which the customer finds himself.

8. The Supplementary Special Deposits Scheme (the corset) may initially have had some effect on the willingness of banks to grant facilities. In those cases where it has bitten it has also had an effect on interest rates, because of provisions in some medium term loan agreements which enable banks to pass on part of any penalties which they incur under the SSD scheme. However, it would appear that the banks have now found sufficient ways round the SSD scheme, eg through acceptances, for it to be having little effect on their willingness to grant credit, although in some cases that credit has been channelled into acceptances. So it probably affects only individual interest rates rather than their general level.

9. The directional guidance requires the banks to exercise such restraint in their lending to low priority categories (persons, property companies and loans to finance purely financial transactions), as may be necessary to ensure that the banks have sufficient funds for priority lending, such as to meet the needs for working capital of manufacturing industry. The directional guidance seems to have restrained banks' lending to persons somewhat when the corset has been on on previous occasions. However, it would appear to have had less effect this time, presumably because the banks were confident that they could channel sufficient of the demand for credit from their other customers through the acceptances and other loopholes. The banks have recently been taking some measures to constrain personal lending. But the increase in personal lending in recent months since the post-Budget

spending boom, has been significantly less than one tenth of the total increase in bank lending outstanding. The increases in personal credit in recent months have probably been more important in fostering a general impression that there is not a squeeze on credit, than in adding greatly to the figures.

b. Other Methods of Control

i. Controls on Banks

10. There are a range of methods of control which would seek to constrain more directly than the SSD scheme the growth of bank lending within banks' balance sheets. These include:

a. ceilings on bank lending, as used in the 1960s;

b. penalties on lending over a guideline - eg a tax on the excess: this would in effect be a switch of the SSD scheme from banks' liabilities to a block of their assets;

c. a reserve or liquidity ratio system, which would require bank lending to be matched by the holding of a proportion of the amount lent in specified assets, the total of which could be controlled by the authorities.

The problem with them all is that they would cause the banks to channel business outside the control, without affecting underlying liquidity and credit conditions, in the same way that has already happened with the SSD scheme. If the scope of the control were widened to cover one loophole, for example acceptances, other channels would develop, notably the inter-company market and offshore banking. These by their very nature cannot be controlled and moreover they are potentially more dangerous than acceptances, both because their extent cannot be monitored and because of the distortions they create in the domestic financial system.

ii. Moral Suasion

11. It might be possible for the Governor to reinforce his directional guidance, by specifically asking all British banks to exercise restraint in granting or renewing facilities. The main banks would undoubtedly comply with the letter of the request. But it would not stop disintermediation: the demand for credit would not be affected and the supply would undoubtedly be forthcoming for most customers from other sources, eg the inter-company market and offshore.

ie. stokes borrowing from abroad

iii. Hire Purchase and Other Terms Controls

12. At present hire purchase terms controls still apply to cars and certain electrical goods, and banks are asked to match those terms when giving personal loans or overdrafts for the purchase of such goods. The controls probably still have some effect in relation to

expensive goods. Finance houses prefer hire purchase contracts for them because their security is better, and since banks usually know when a facility is being used for that purpose. But, particularly since the Consumer Credit Act, the range of forms of credit for smaller purchases has become so great - overdrafts, personal loans, bank credit cards, departmental credit cards, charge accounts and retailers credit generally - that any attempt to reimpose hire purchase terms controls on smaller goods could be readily evaded. Moreover the Department of Trade no longer have enforcement staff.

13. The amount of consumer credit, other than bank lending, has been growing at about £100 million a month recently - much the same as last year. This is roughly 20% pa. However, given the extent to which the banks finance house subsidiaries have been financed by acceptances recently, it is doubtful whether the tightening or extension of terms controls would have much effect on the bank lending or money supply statistics.

iv. Credit Cards

14. The money advanced on bank credit cards is within the total of bank lending to persons. It would be possible to ask them again to tighten the repayment requirements - and to abstain from further increases in credit ceilings. But it would be difficult to justify singling out this one form of personal credit (which is already relatively expensive) for special treatment.

v. Tax

15. A theoretical option for making interest rates more effective as a means of regulating demand for credit would be to tax the borrower. This could take the form of either:

a. disallowing interest - presumably above some base level - as a charge against profit in computing corporation tax liability;

or b. levying a tax on financing charges (interest etc) for consumer credit.

But both would almost certainly be complex, if they were practicable at all. It is difficult to see either being introduced very quickly, if they were thought desirable.

SECRET

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cc Financial Secretary
PS/Secretary (No.10) (2)
Sir D Wass
Mr Bridgeman
Mr Middleton

CHANCELLOR

GRIFFITHS, BURNS, ROSE AND FLEMMING

I attach a series of notes on the conversations I was instructed to arrange. That with John Flemming was of necessity very short, but the others were fairly exhaustive. In each case I managed to cover most of the chief issues but not all, partly because to have raised too many questions on my side would have been indelicate.

2. There is a clear unanimity about almost all issues, apart from gauging what has happened to money supply and why and where it will go hereafter. These are matters about which people are understandably very cautious. But this caution does not diminish the firmness of views about the need for action or the general agreement about the form it should take.

AR

ADAM RIDLEY
9 November 1979

SECRET

BRIAN GRIFFITHS

The determinants of and prospects for Bank lending

It is not surprising that money supply and bank lending should be so volatile in the short term, given the many factors which affect them. But one can expect stable relationships over periods of 6 months to a year.

2. Bank lending itself, or rather its trend, will reflect the recession and high interest rates. But one cannot know precisely when.

Interest rates

3. A sharp and substantial increase now a fundamental pre-requisite of monetary policy, and possibly the only thing one can do. It is all the more necessary now that Euro-sterling has become, with the abolition of exchange controls, part of the *de facto* money supply, since interest rates are the only way one can control it. One must err on the side of caution by acting early and boldly. To do the opposite would threaten a crisis in monetary policy.

4. An MLR increase would probably set off the gilts market, and the rate could be brought down a bit before long. Once recession had set in firmly, rates could be expected to tumble very sharply over a short period - say roughly 6 months hence.

Financial Plan

5. To take an initiative over it *before* the short term anxieties over trends in and policies for money supply were resolved would be doubly dangerous. It would be deemed a foolish attempt to mask those short-term difficulties. And the plan itself would be thought to be worthless since the existence of unresolved short-term difficulties would make it appear unattainable.

Monetary Base Control

6. It is vital not to have a repetition of the Competition and Credit Control fiasco. C&C took 4 months between announcement and introduction, and that process was too hasty. MBC would require more. In particular, if one were considering introducing it now, one would need to consider very carefully the role of Euro-sterling, which might otherwise cause broadly analogous problems to the discount houses in 1972/73.

Conventional Controls

7. Special deposits, Reserve Ratios, Quantitative controls and the like would all be useless, since there is an easy foreign escape route from each. All a bank need do is discreetly ask its customers to steer transactions to an overseas branch.

Gilts

8. The present system is necessarily gilt-strike prone and spasmodic in operation. Since the Bank of England cannot in the short-run know a great deal about demand, they will periodically choose to sell stock at what turns out to be the wrong price.

9. The system is wrong. Tap prices are kept still far too long, and should be changed more quickly. There is a very strong case for an open rather than minimum price tender when selling long-dated stock.

10. At the short end of the money markets, more assets are needed; and interest rates should change more frequently and by smaller amounts, though not of course passively. They could still be used to lead the market. This is essential to keep fund managers on their toes, create a measure of uncertainty and thus a two way market. If one decided to do this, it would be vital to warn the market in advance.

Attitudes

11. No one has woken up to the nature of the authorities' monetary

policy till very recently if at all. Both the banking system and the company sector expect or at least feel that they will be "bailed out" if things get difficult.

Exchange rate

12. If Iran or other factors promote an inflow, this could be tricky and one should consider now how one would mop it up. To the extent one cannot do so, it would be far better to endure a temporary rise in the exchange rate than take in a lot of foreign money.

TERRY BURNS

Recent trends in bank lending and money supply

1. On the prospects in the Summer, and assuming no unexpected surprises, the Government's policy had seemed a little risky but not unacceptably so. An £8.4 billion PSBR and 14% MLR should have been enough to bring down the money supply growth within the target range. Now, after the event, it is not difficult to see some reasons why things have gone wrong:

- output has, up till now, been more buoyant than expected; price inflation, and expectations of its future have, too. Both will have bolstered the demand for money and boosted bank lending.

- interest rates have risen unexpectedly high and quickly overseas, thus reducing the incentive to borrow overseas and, by the same token, increasing the incentive to borrow at home;

- exchange control abolition has probably meant that domestic interest rates have to be raised by more relative to overseas to achieve a given degree of monetary stringency.

Sentiment

2. There have recently been sudden but quite unambiguous signs of a gilts strike. In the short-run this is at least in part because an increase in MLR is seen as inevitable, and no one in his right mind would buy gilts till it has happened. But in part this is because there is a growing anxiety about the incompatibility between the PSBR and the monetary targets.

PSBR

3. Published date on the CGBR cause much anxiety, and imply a 79/80 PSBR well above the FSBR projection. Burns' own anxieties on this front are now very marked too, and he suspects action is needed.

Controls?

4. Direct intervention of any kind would be undesirable, since they would just hide the problem, and would be seen to. People know exchange controls have made a nonsense of them. If there is an imbalance between revenue/expenditure and money supply, it must be dealt with directly.

5. Furthermore, anxieties about the Government's possible willingness to intensify controls are already a serious problem, and have aggravated the authorities' problems. The stories indicating a desire to restrain mortgage interest are the chief problem. The PM's recent statement at Question Time (Thursday 6) ? accepting that interest rates might have to rise after all in the New Year had not been noted generally. People are saying that just as petrol prices were the Americans' Achilles heel, mortgages were the British Governments. A positive affirmation that the Building Societies would not be interfered with is urgently needed.

Monetary Base?

6. Not desirable in a hurry whatever its merits. Memories of Competition and Credit control have become obsessive. But the issue is more fundamental. Monetary control, gilt selling and so on are only operable effectively and reliably when monetary policy is right and create very high interest rates, rationing, and distortion when they are wrong.

7. This is not to say that it would be foolish to announce some moves or other on consultation over monetary base. But that, though sensible, is no substitute for the central measures needed, particularly an early increase in interest rates.

Gilts

8. It is not easy to be objective about selling methods when respected observers and commentators - most, however, with axes to grind - bend one's ear this way and that. However, it would

seem sensible to sell gilts by tender and ensure one mopped up one's target of liquidity, month by month. To hit targets for the quantity of money you must be able to control pretty directly the PSBR and gilt sales, its two principal determinants. The present system is one in which the authorities are often fighting with one hand tied behind their backs, and in which it is thus possible for some parts of the markets to make large and easy profits out of that disability.

Interest rates

9. There is no avoiding a sharp increase. The longer one waits the bigger the gilts strike and the larger the jump needed. One should nip the crisis in the bud hard and as fast as possible.

What is to be done?

10. The ideal response would be:

- a sharp and early MLR hike;

- action to reduce the PSBR, ie expenditure cuts or tax increases;

- new gilts sales tactics;

- on the negative front the avoidance of evasions, in particular an unfrank Bray forecast, and the continuation of anxieties about intervention in the mortgage interest levels.

Reducing the PSBR

11. To achieve much this year would evidently be very difficult. To make firm suggestions about how would require a proper examine of the technical and political possibilities on both expenditure and revenue.

12. But in principal one can say something about the orders of magnitude one would be aiming at. One would wish at least to get

the PSBR back to £8.4 bn this year, and may be more to allow for the fact that, if one standardised the PSBR projection for deviations between projected and actual levels of output and prices, the £8.4 bn figure would be equivalent to less in today's conditions.

13. There is a very strong case for overkill now. Timing considerations are becoming very awkward. There is a risk, if one under-reacted now, that one would be driven to an excessively violent package in, say 6 months time, just when the economy is turning down anyway. The case for "quick and hard" is reinforced by the need to be influencing wage bargaining. The present deteriorating prospect on that front is only to be expected given the effective lack of awareness of the intended tightness of monetary policy.

Retrospect

14. Present problems stem from Healey's errors, from late 1977 onwards. But even if they are largely his fault, the need to err on the side of caution is none the less.

HAROLD ROSE

Money and lending trends since May

A slow-down in either never seemed probable before early 1980. The Bank of England read far too much optimism into the September money supply figures. The Banks have seen no clear signs of higher Vat payments in October, which strongly implies companies are short of money, only in limited measure because of funding income tax rebates, important though that is. Of course the tax position is of little comfort, as the more that is paid back, the lower the PSBR and Government created liquidity, but the higher is demand for Bank lending ceteris paribus.

2. Barclays - and other clearers - expect lending to remain strong for months and not to slacken before 1980 Q1 or possibly even QII.

3. The determinants of the money supply are not that easy to interpret. One factor leading to high demand for money may be that industry now operates with and wants high stock levels in relation to output, since to do so is very cheap with stock-relief plus tax deductible interest (if you have profits); and industrial disruption - now chronic - dictates higher levels for obvious reasons. The surveys suggest recession is only just beginning.

Policy

4. Interest rates must clearly go up immediately. On the one hand arbitraging is already happening and will get much worse if they don't. On the other, a feeling of gilts-striking is growing fast and that demands an increase. With short interest rates so high the authorities simply look silly if they delay.

5. The PSBR is looking too high. Direct controls are no use if there is unsatisfied demand for credit. It will go offshore immediately, and while it could leave the £M3 statistic looking better, people would not be fooled for long.

 Harold Rose

6 . The Bank of England should certainly take a tougher line in its guidance. No one has any feeling of monetary policy being tough. The Bank looked like being so only briefly in the Summer, when it failed to repay special deposits in August. But it soon changed its tune. One would have expected it to take a tougher line in a variety of ways, particularly over personal credit.

7. Barclays only issued a circular to branch managers about restricting the net total of personal credit last month. Since the branches always put up excellent "special case" pleas, this guidance will not be fearfully effective in all probability.

8. The increase in house prices is as telling a sign as any of the relative slackness of credit conditions.

JOHN FLEMMING

Bank lending and money supply

The underlying determinants are very difficult to disentangle. The exchange control relaxation will, for various technical reasons, make it very attractive to borrow at home and run down overseas loans while dollar interest rates are so high relative of ours, all the more so since US inflation is less than here and their exchange rate is more competitive.

Role of interest rates

2. They will certainly have a dampening effect on credit expansion. But the lags and scale will vary a lot depending on a multitude of factors. Even Milton Friedman, who used to deny they restricted credit, has now recanted and admitted they do. They should be raised immediately.

3. Ruthless pursuit of monetary targets requires ruthlessness over interest rate policy.

Gilts strategy

4. This, too, demands higher interest rates.

SECRET

File D5 9
so Vile Cab Office
cc Masters So

10 DOWNING STREET

From the Private Secretary

8 November 1979

Dear Tom,

When they met this morning, the Prime Minister and the Chancellor of the Exchequer discussed latest monetary developments. They had before them the Chancellor's minute of 7 November.

The Prime Minister said that she was not convinced that a further increase in MLR next week would bring the money supply under control. It would also, of course, create political problems. It seemed to her that existing policy levers were no longer working; in particular, an increase in interest rates of even several percentage points was unlikely to choke off lending to the private sector. Her own impression was that the demand for credit was continuing at a very high level, and that the banks were all too willing to provide it. There was the further difficulty that any increase in interest rates would tend to put upward pressure on the exchange rate; and with its worsening liquidity position, this could cause problems for industry.

The Prime Minister went on to say that alternative ways of bringing credit creation to the private sector under control should be examined with the utmost urgency. She understood that the work on monetary base control was still proceeding; this should be speeded up. Other possibilities, such as putting direct pressure on the banks, tightening their reserve asset ratios and even imposing higher taxes on their profits, should be examined. It was essential, in her view, to devise new measures of control - preferably as a substitute for a further rise in interest rates.

The Chancellor said that he too was most unhappy at the prospect of having to raise MLR. But he did not think there was any alternative. On the other hand, he shared the Prime Minister's concern about the inadequacy of the existing policy levers, and had asked that alternatives should be examined. If there were to be any changes on the existing set up, it was important that decisions should be reached in a considered manner; otherwise, there was the risk that we would move in the wrong direction. Logically, there was a case for abolishing the "corset" forthwith since it was now largely ineffective; but there were practical and political arguments for keeping it in place until an alternative system had been devised. The Chancellor went on to say that the major priority must be to make sure that next month's figures were much improved, and he agreed therefore that urgency was of the essence.

/ Turning

SECRET

Turning to the borrowing requirement for this year, the Prime Minister said that renewed efforts must be made to reduce it. She agreed with the Chancellor that a new fiscal package should be ruled out; but there was a case for going harder on sales of assets, and also for reducing the borrowing of the nationalised industries. As regards the latter, she wondered whether new steps could not be taken to recover some of the lost revenue caused by the telephone billing dispute: could not subscribers be given a small discount on their bills if they paid early? The Chancellor commented that on practical grounds, he did not think assets sales could be pursued much further during the current financial year; and in any case, any further sales would not be all that helpful for the money supply because they would be - to some extent - substitutes for sales of gilts.

In conclusion, the Prime Minister re-emphasised that alternative options to a further increase in MLR should be examined very urgently. She would meet the Chancellor, the Chief Secretary, the Financial Secretary, the Secretary of State for Trade, the Governor and senior officials tomorrow to discuss the position further.

I am sending a copy of this letter to John Beverly (Bank of England). I will also be giving a copy of this letter personally to the Secretary of State for Trade.

Yours ever,

Tim Lankester

A.M.W. Battishill, Esq.,
H.M. Treasury.

GB

1

PRIME MINISTER

MONETARY POLICY

The Chancellor will be sending over a paper by 1030 tomorrow morning as background for the discussion at the lunch which is arranged for 1 o'clock.

I imagine you will want to keep the lunch quite brief, and then continue afterwards in the Cabinet Room.

The following will be attending:

The Chancellor
Chief Secretary
Financial Secretary
Secretary of State for Trade
Sir Douglas Wass
Peter Middleton
Michael Bridgeman
The Governor
John Fforde, Director for Home Finance at the Bank
John Page, Chief Cashier
Charles Goodhart, Chief Adviser on the Domestic Finance side

Would you like me also to invite Sir Kenneth Berrill? He put in a good questioning brief for the Monetary Seminar in July, and would - I think - make a useful contribution.

R

8 November 1979

T.L.
Pa Kenneth is ringing you direct for details.
CL.

SECRET AND PERSONAL

8b

MR LITTLER

cc Mr Barratt
Mr Hancock
Mr Middleton
Mr Unwin
Mrs Gilmore
Mr Riley Mr Ridley

Mr Fforde
Chief Cashier
Mr Goodhart

copies attached for:

Chancellor Financial Secretary
Chief Secretary
Sir Douglas Wass
Sir Lawrence Airey
Sir Fred Atkinson
Sir Ken Couzens

PS/Governor

MONETARY POLICY

This submission is primarily directed to the two issues - the roll forward of the monetary target and the future of the SSD scheme - on which decisions might best be announced on 15 November. It also deals with some of the factors affecting a decision on MLR, although that decision will be affected significantly by what happens in the markets in response to yesterday's eligible liability figures, and this submission therefore does not reach any recommendation on that.

2. The submission has been discussed in draft with the Chief Cashier. But it is not agreed with the Bank and on one issue - the SSD scheme - we understand that the Governor takes a different view.

<u>The Prospect</u>

3. The submission should be read with Mr Middleton's parallel submission on the prospect as it has been reassessed following the October figures.

4. Events have meant that it is necessary to deal with the roll forward and the future of the SSD scheme at the same time as it has become clear that the monetary situation requires immediate corrective action. The problem with the present situation is that:-

i. the PSBR this year is now much more likely to be in excess of £8¼ billion than below it - the central estimate probably now lies between £9-9½ billion;

ii. the CGBR figures already published, are already causing the City commentators concern: the cumulative figures will soon confirm this unease, even if a higher figure were not published in the Industry Act forecast;

iii. the risesin world interest rates, and in inflationary expectations here, have meant that UK domestic interest rates are not a severe deterent to borrowing: it is difficult to argue that monetary and credit conditions are tight in present circumstances;

iv. bank lending is still high, and while there will almost certainly be a fall due to the recession, we may not yet have passed the peak - since Mr Middleton's note was prepared we have heard that the clearing bank economists variously expect the peak to be in Q4 1979 or Q1 1980;

v. these, and other factors - notably the prospect on pay and market fears about the PSBR and/or taxation next year following the Public Expenditure White Paper - have contributed first to hesitancy, and now to gloom in the gilts market which has meant that we have not achieved significant gilt sales since September, and there is little prospect of that situation changing of its own accord;

vi. the cumulative effect of these factors has been to leave the growth of £M3 at much the same level as was inherited, and to cause market rates to move up to a level at which MLR at 14% has been left behind.

5. The time lags are such that most of any immediate relief can only be achieved by creating conditions in the gilt edged market in which substantial sales can be resumed. The successful sale of two tap

stocks beyond those allowed for in the forecasts (say £1 billion long, £800 million short) could affect the growth of the money supply by 2% or more in the next few months. Such a turn round is partly a question of gilt tactics and pricing. But it also requires some action to dealwith the underlying concerns in the market: this certainly means raising short term rates so that they are again a deterent to borrowing and create tight conditions. The latest estimates on the PSBR may cause the Bank to re-open the question, which was touched on on Monday, of action on it through the regulator - although that raises issues which go much wider than this submission. The problem with the regulator from our side is that the effect of prices and inflationary expectations on interest rates will offset, largely if not even more, the effect of the lower PSBR on interest rates.

The Roll Forward System

6. The last Government adopted a system of rolling targets, similar to the then American practice, although not identical to it as the periods were longer in our case. A 6 monthly roll forward of a target set for 12 months forward was thought to have a number of advantages over a sequence of targets for each financial year, set in the Budget of that year, namely:-

i. in the second half of the financial year it gave the market some reassurance about the Government's intentions for the beginning of the next year - there is always a target for at least 6 months ahead;

ii. on the other hand, it meant that if there was a perturbation in the money supply in the second half of the financial year, the authorities had longer to get back on track - it is totally impracticable to reverse, before the end of the financial year, a significant change in trend which becomes apparent in January;

iii. the authorities had the option as to whether to "base drift", or not, but had to give an explanation of their decision;

iv. there was an occasion, between Budgets, for the Chancellor to reassess monetary policy, to decide on whether any corrective fiscal or monetary action was required, and to make a public exposition of his policies.

7. Some of these arguments will be affected if there is a medium term financial plan. It would be appropriate to look again at the form of the roll forward system at the same time as we look at the way in which the monetary objectives are specified in the medium term financial plan, if Ministers decided in principle to have one. But we would recommend that in the meantime the Chancellor should continue the roll forward system: given the October figures, a restatement and extension now of the Government's monetary targets would seem to be most desirable.

The Choice of Target Range

8. The existing target range is 7-11% pa for the 10 months, mid-June 1979 to mid-April 1980: the centre is equivalent, given the higher rate of growth in banking May and June, to 10.2% in the 12 months to mid-April 1980. The October figure brings the increase in £M3 in the first 4 months to 4.5% equivalent to 14.2% pa, rather than the 2.9% which would be equivalent to the centre of the target range.

9. The choice now is:-

i. whether the range should again be 7-11%, or something lower, say 6%-10%;

ii. whether the period should run 12 months from mid-October (which would "base drift" by including

the high figures so far in the base) or for 16 months from the original date of mid-June, so avoiding base drift.

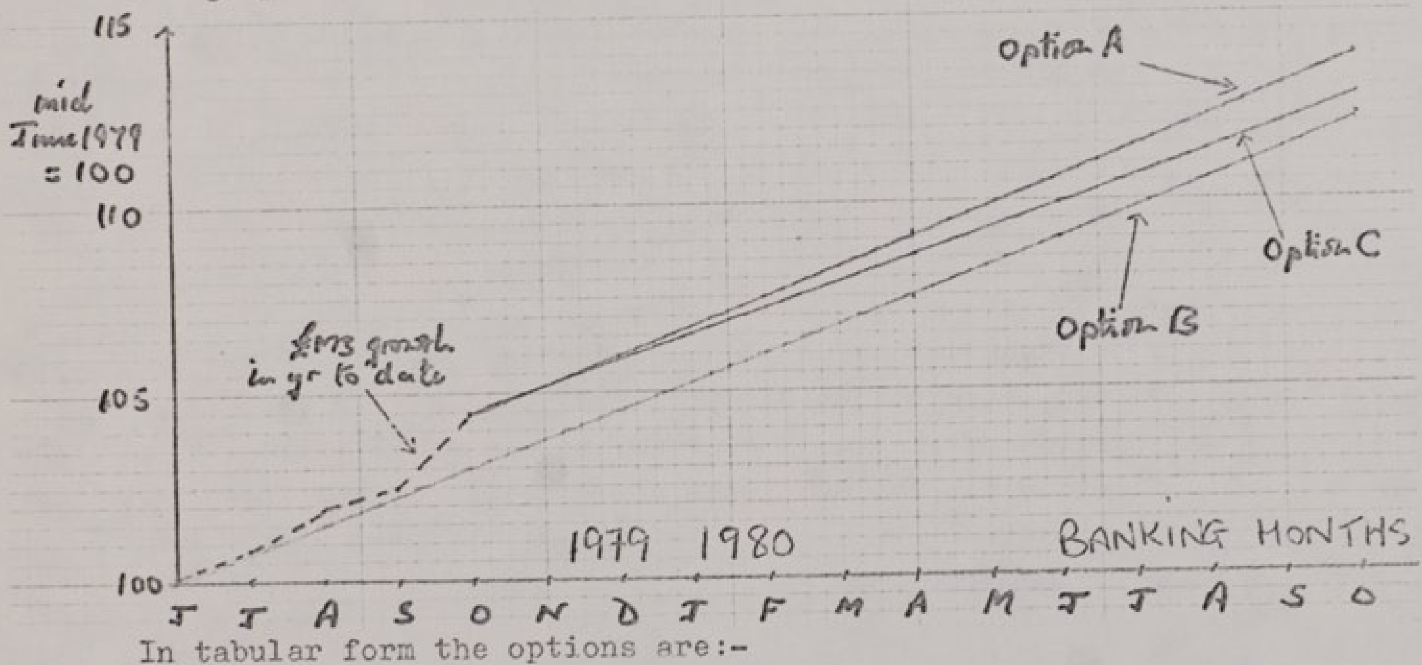
This gives the main options:-

a. 7-11% to apply for 12 months from mid-October 1979;

b. 7-11% to apply for 16 months from mid-June 1979;

c. 6-10% (or 6½% to 10½%) to apply for 12 months from mid-October 1979.

The graph below shows the choice in somewhat exaggerated form:



In tabular form the options are:-

mid-June 1979=100

Level of money supply if growth is in middle of range

Option	(a) at mid-April 1980	(b) at mid-October 1980
A	109.1	113.9
B	107.4	112.2
C	108.6	112.9

10. The respective pros and cons (some of which tend to be two-edged) are:-

A Pro:

i. probably requires lower interest rates than others;

ii. even this could be presented as a significant tightening; if the SSD scheme were ended since, after allowing for reintermediation, a substantial fall in the underlying rate of growth would be required.

Con:

i. the extent of base drift (some 1.7%) over 4 months would cast severe doubt on the Government's resolve - it could be interpreted as following an accommodating monetary policy.

B Pro:

i. avoids accusations of base drift, by eliminating it;

ii. although it keeps the same number for the range, can be seen as a tightening of policy - it only allows 7.3% growth over the remaining 12 months to mid-October 1980; (the converse effect would apply in a year's time).

Con:

i. it is tight and will require a deceleration of growth to a rate below that which an MTFP might envisage for another year or more;

ii. there must be a severe danger that it will not be met if there was doubt about it being achieved.

C Pro:

i. can be seen as a progressive reduction in the figures for the ranges;

ii. is not so tight as B in the coming year.

Con:

i. will be criticised as "base drifting" and to some extent as a spurious tightening;

ii. sets a precedent for downward shifts in the numberical range of each roll forward, a precedent which may not be sustainable;

iii. in practice requires a lower rate of growth in 1980-81 than the other options, because it would be politically impracticable to raise the target range again.

11. The arguments against C are conclusive. But the choice between A and B is not an easy one at the present juncture given that monetary growth is still above the top of the existing target range, that some increase in interest rates now seems inevitable, and that subject to what is said below, room has to be found for the growth of the £M3 statistic as the SSD scheme is phased out or ended.

12. The most critical issue is which is most likely to sustain confidence in the Government's monetary policies. A clearly runs a risk in this respect because of its acceptance of base drift - that might be attributed to the "inheritance", but that excuse would run thin, given the earlier decision to start the previous target in June. B also runs a risk since the market could fairly soon come to the view that the sharp deceleration in underlying monetary growth could not be achieved without further fiscal action. (We could get a repetition of the situation after the 1978 Budget.) On the other hand, if it were achieved it might be at the cost of driving the economy further into

recession. (This depends in part on how far the recession already in train will of itself lead to a deceleration in monetary growth.)

13. This can only be a matter of judgement, and there are differing views among us in HF and FEU. On balance, mine is reluctantly in favour of B because I doubt whether the markets would accept A.

The SSD Scheme

14. The present guideline for the SSD scheme ends with the 3 month average for the make-up days in October, November and December. It is therefore necessary to announce soon whether it is to be extended or ended: this can be most logically done in the context of the roll forward of the target.

15. The paper "Direct Monetary Controls" attached to my submission of 1 October made the point that, with the ending of exchange controls, disintermediation through offshore banking would be added to the existing ways round the SSD control. This point has not unexpectedly been seized on by outside commentators. The SSD scheme has therefore now lost much of its remaining credibility (and so its ability to reassure the markets) in the eyes of most, but probably not quite all, commentators. But it may not yet have done so with the markets. It does seem to have lost its efficacy in exerting a squeeze on the banking system as the banks have discovered how easy it is to get round it eg through acceptances: from outside at least, it appears that on this, its third appearance, it has had less effect in causing the clearing banks to constrain low priority lending in accordance with the directional guidance - eg to persons.

16. Because of the risks of the ending of the SSD scheme being misinterpreted as a weakening of the authorities' stance - particularly by overseas exchange market operators, the Governor will probably propose continuation of the SSD scheme at its present guideline of 1% per month. This would be coupled with a request to banks not to facilitate offshore disintermediation. But in our view the arguments against this are very strong indeed:-

i. given that domestic avoidance would continue, it would not affect underlying monetary conditions;

ii. it is doubtful how far such an appeal to banks would stop disintermediation offshore, particularly by multinational companies, and we would not have the statistics monitor it;

iii. it would cause the Government to be accused of having its head in the sand, believing that it was controlling monetary conditions when it controlled the £M3 statistic through the SSD scheme;

iv. alternatively it would be accused of its monetary policy being merely a front, controlling a statistic rather than the reality;

v. while there will be problems about the unwinding of disintermediation due to avoidance, referred to below, whenever the scheme is ended, and events of the last month make us less sanguine about dealing with them than we were at the time of the exchange control decision, the fact remains that the next 6 months appear likely to be as good as any for the foreseeable future for absorbing the effects as far as the PSBR is concerned: even after the increased estimate it is likely to be lower in the second half of 1979-80 than it has been so far, or is likely to be for some time to come. (The position on bank lending might on the other hand be somewhat easier later);

vi. moreover the amount to be re-absorbed would probably grow over time if the SSD scheme were continued, even relatively loosely (eg 1% per month).

17. Some of the criticism might be met, if it were announced that this would definitely be the last 6 months of the scheme. The authorities

would not be accused of ignoring completely the defects of the SSD scheme. But even if the guideline were somewhat eased, it would lead to the continuance of much of the existing stock of disintermediation: as that stock was rolled forward it might take less desirable forms of disintermediation - notably offshore banking, notwithstanding the request to banks. The stock of outstanding disintermediation at the end of the 6 months, would then have to be reabsorbed into the statistic, at a time which would be even more difficult than the next 6 months.

18. It has to be accepted that there would be problems with an abrupt ending of the SSD scheme. It has been estimated that disintermediation amounts to about 3% of the money supply. If the SSD scheme were just abolished, that disintermediation might come back into banking channels, and so the £M3 statistic, over the coming months at a rate which is not predictable, but could be rapid. If monetary growth, after allowing for this, was allowed to be at the top end of the target range, it could be explained that this was merely the working into the statistic of an increase in "money" which had already taken place. This explanation would - or ought to - satisfy those critics of the SSD scheme who have pointed to the present distortions resulting from it. But it would not necessarily be apparent to observers further removed from the United Kingdom - such as foreign exchange dealers overseas. But even achieving growth at the top end of the range would require the underlying growth to be near or below the bottom end of the range - a tight stance on any of the options above, but especially so for option B.

19. Indeed, it might be possible to justify option A on the target on the grounds that it was not allowing "base drift", but including provision for reintermediation, and so bringing within the statistic monetary growth which had not been recorded as such. The SSD scheme has led to three main identifiable forms of avoidance which increase liquidity and credit without affecting the £M3 statistic:-

i. bank acceptances held outside the banking system. (These increased by £290 million in the 6 months

to mid-June, and by a further £820 million in the 4 months since then);

ii. Treasury Bills held outside the banking system (the respective changes were £360 million and minus £230 million);

iii. local authority short term debt held outside the banking system. (These increased by £770 million in the 6 months to end-June: we do not have figures for a more recent period).

The main unquantified form hitherto has probably been sale and repurchase agreements in respect of other bank assets (eg short term gilts) over make-up day. We will be able to monitor i. and ii. and to comment on it when the £M3 statistics are announced month by month. But we can only obtain local authority statistics quarterly and 3 months in arrears. (Indeed, if it had not been for this last point it might have been worth adopting temporarily a £M3½ statistic incorporating those 3 forms of disintermediation and setting the target for it for the period mid-June 1979 to mid-October 1980.)

20. The balance of argument would seemto point to ending the SSD scheme now, recognising that it will allow reintermediation which will bring liquidity at present outside the £M3 statistic within it, explaining this in advance and monitoring it as it happens. It will probably require aiming for underlying growth at about the bottom of the target range in order to keep the growth of the statistic at the top. If it is felt that this is too restrictive, my preference would be to have option A on the target and ending the SSD scheme, rather than the tighter option on the target and retaining the SSD scheme.

Other Methods of Control

21. An alternative method of monetary control, such as one of the variants of monetary base, would not get over this problem of having to

allow this reintermediation following the end of the SSD scheme. It is common ground between those who have been working on possible schemes in the Bank and the Treasury and outside advocates, such as Pepper and Griffiths, that any continuing scheme should not impose a significant penalty on the UK banks in relation to their competitors, domestic or foreign - to do so would only cause similar disintermediation problems to the SSD scheme, with the added complications now of disintermediation through offshore banking.

22. The ending of the SSD scheme, without having a monetary base system to put in its place, would not represent a lacuna. Any monetary base system, which did not impose a penalty on the UK banking system, would work by generating changes in market interest rates generally and to at least some extent automatically, rather than leaving so much of the determination of the timing and amount of the changes in interest rates to the authorities. In other words, if a monetary base system had been in operation in recent months, the increase in interest rates discussed in the next section might already have taken place - it would not have provided any alternative to that change.

23. I should perhaps add that considerable work has been done in the Bank and the Treasury on alternative schemes and a submission should be ready shortly. We have severally had discussions on detailed points with Messrs Pepper and Griffiths. It is far from clear that there will at the end emerge a scheme which is workable, which will have the desired effects and will be acceptable to all concerned. But this will only be conclusively established when one or two of the schemes, which look most promising, have been put out for technical consultation, particularlly with market operators, eg the discount market and the clearing banks. (Mr Pepper seems to have stolen our clothes on this.) Such consultations might be conveniently timed in relation to the papers on reserve asset ratios and on future prudential liquidity requirements which the Bank will probably want to issue about the turn of the year. If a particular monetary base scheme then proved justified, it would have to be refined and introduced over a period of 6 months or a year.

MLR

a. Timing

24. There would be considerable advantage in being able to announce a decision next week:-

i. it would enable a more considered assessment to be made of the amount of the move necessary, and in particular give longer to observe the domestic market reaction to the eligible liability figures;

ii. it would enable the change to be presented as part of a monetary policy package;

iii. in particular it would enable the market to assess the implications of the MLR change and the ending of the SSD scheme together, and avoid the risk of an adverse reaction to the latter if it were announced separately a week after the MLR change;

iv. it would avoid the change coinciding with a Building Societies Association council meeting, although this time there is probably little risk of a "snap" move.

25. There is one argument for acting this week rather than next, namely it would give an opportunity for greater gilt sales in banking November, and so produce an earlier improvement in the statistics. But I do not consider that this argument outweighs those above.

26. I understand that at present - thanks partly to good briefing by the Bank Press Office - neither domestic nor external markets are expecting a move this week. So, unless there is an unexpected change in the exchange market in the next few hours, it should be possible to

defer a decision until then without undue cost in terms of either intervention or the exchange rate. But clearly the Chancellor will want to consider the Governor's and OF's latest assessment of this at the meeting this afternoon.

b. Amount

27. A final decision on this should clearly wait until next week. But at present the signs are pointing to 16% rather than 15%:-

i. a move to 15% would barely validate existing changes in market rates, and so would not have much effect on confidence;

ii. indeed the prospect for reducing monetary growth in the next few months depends critically on achieving substantial gilt sales, and so on restoring confidence in the markets; there is therefore a need to establish the authorities' determination to deal with the continuing high growth;

iii. the upward drift since the Budget in inflationary expectations means that the effective real rates of interest have fallen: the prime borrowing rate (base rate + 1% = 15% at present) is below the current inflation rate;

iv. the ending of exchange control, and the resultant pressures on sterling, have meant that we have had to pay more attention to movements in international rates. These rates have been rising recently and, if allowance is made for differing rates of inflation, our short term rates may be lower than most others;

v. it will be necessary to offset the ending, or phasing out, of the SSD scheme in two respects;

a. fears by <u>some</u> that it represents a relaxation of control;

b. reintermediation leading to an increase in the £M3 statistic.

(Even if it is accepted that £M3 should grow at the upper end of the target range, it will be necessary to have PSBR/interest rate such as to keep the "underlying rate" at near the bottom end of the range.)

28. The factors pointing to keeping to 15%, if market rates next week are not still above it, are:-

i. there are good reasons for expecting a downturn in bank lending and the PSBR in due course;

ii. any increase will probably need to be sustained for several months - an increase next week may not affect the outturn for banking November very much, so at best it would be early February before there could be two months good figures sufficient to justify any relaxation;

iii. building society receipts have been bouyed up recently by investment of tax rebates: but their rates (other than term shares) are already badly uncompetitive, and they will be concerned about their inflows in the early months of 1980s. (This could be turned into an argument for a sharper increase now, as giving a better chance of rates being lower by February/March next year);

iv. a further rise in interest rates could affect industrial confidence at this juncture to an extent which is disproportionate to the effect on companies' cash flow.

The Gilts Market

29. As mentioned above, one of the main aims of the monetary package must be to re-establish confidence in the gilts market: this is as much a question of dealing with the markets' fears, so far as possible at the present juncture, on the Government's resolve in relation to the other determinants of monetary conditions - the PSBR and bank lending - as bringing about a "Duke of York" style upward shift in the yield curve. But it will be necessary to consider with the Bank how any move in MLR can best be exploited in relation to:-

a. repricing existing taps (we have just under £400 million of the medium tap left) and

b. the timing and terms of new taps - we will probably need both a long tap and a short one.

30. We will face a familiar dilemma over long stocks. It is often argued that the downward sloping yield curve encourages institutions to hold funds short, and that we should therefore be ready to see long rates rise substantially. But stimulating a rise in long rates means that the real cost of borrowing becomes formidable, if inflation comes down on anything like the path hoped for by the Government. In present circumstances we can probably do little but accept that potential cost. (The option of borrowing more for medium term periods is not there - experience with the last taps suggests that that is a limited market.)

Conclusion

31. To sum up, I recommend that:-

i. the new target range should be 7-11% for the 16 months to mid-October 1980;

ii. the SSD scheme should be ended, rather than continued or phased out;

iii. the MLR change should be deferred until next week, if exchange market conditions permit.

If the combined effect of i. and ii. is thought to require too tight a squeeze on the underlying rate of monetary growth, then I would opt for starting the target from the mid-October base, rather than for retaining the SSD scheme.

32. While it would be premature to reach a final decision on the size of an MLR change now, the balance of argument does at present seem to point to a change to 16%, rather than one to 15% which would merely validate the change that had already taken place in the market.

J.M.B.

J M BRIDGEMAN
7 November 1979

8a

Mr Littler

copies attached for:

Chancellor of the Exchequer
Financial Secretary
Chief Secretary
Sir Douglas Wass
Sir Lawrence Airey
Sir Fred Atkinson
Sir Kenneth Couzens

PS/Governor (B/Eng)

cc Mr Barratt
Mr Hancock
Mr Bridgeman
Mr Unwin
Mrs Gilmore
Mr Riley ✓
Mr Ridley

Mr Fforde)
Chief Cashier) B/Eng
Mr Goodhart)

MONETARY POLICY

The attached note on the prospect, which has been agreed with the Bank, should be read alongside Mr Bridgeman's submission of today's date.

E. K. Clarke

pp P E MIDDLETON
7 November 1979

Enc

THE MONETARY PROSPECT

1. The Chancellor is familiar with the factors which we take into account in assessing the financial prospect. The following is the latest assessment of these factors by the Treasury and the Bank.

The Present Target

2. The Government's announced target for the growth in the stock of £M3 is 7-11% from June to April with a centre point of 9%. This is equivalent to 10% for the full financial year 1979-80.

3. So far this financial year up to October:

a. the money supply has increased by 15% at an annual rate. During the first 4 months of the target period the money stock has increased at a rate of 14% - well above the upper end of the range.

b. If we allow for the distortions caused by the SSD scheme, underlying monetary growth has been even higher. The effect is difficult to quantify but it seems that near-money substitutes of £1 billion or more have been created since April.

c. Some £7 bn of the forecast £8½ bn borrowing requirement has already taken place.

d. Bank lending has remained obstinately high - at an underlying rate of over £800 million a month. (See Table IV attached).

e. Externals have been negative by £240 million a month. Some of this has been the result of the outward movement from the private sector resulting from the relaxation of exchange controls. This has offset DCE of nearly £980 million a month.

f. Market sentiment has noticeably deteriorated recently. Markets, unsettled by the removal of exchange controls, were disappointed with the Public Expenditure White Paper. There is no longer any expectation of an early fall in interest rates.

Factors Affecting the Prospect for the Remainder of the Financial Year

4. In looking at the prospect for the remainder of the year the following factors have to be taken into account in addition to the currently very high rate of monetary growth:

a. The PSBR. When discussing the short term forecasts with Ministers we said that the PSBR for 1979-80 was being reconsidered in the light of recent information. The PSBR for the financial year is now expected to be around £9¼ bn compared with the estimate of £8.3 bn at the time of the Budget. A good deal of uncertainty surrounds this figure: in particular, it assumes that all of the current shortfall in VAT receipts is recouped by the end of the year, which is at the optimistic end of the range of possibilities. The PSBR is however still likely to be much lower in the second half of the year than in the first.

There is likely to be an increasingly difficult problem in dealing with market expectations. The cumulative unadjusted Central Government Borrowing Requirement at the end of December could itself be as much as £9 bn, on the above conservative assumptions about the payment of VAT. This is likely to cause concern in the markets about the size of the PSBR for the year as a whole.

b. Bank Lending may be expected to abate in due course, not least because of the recession we forecast. But there are no signs of this yet and the timing of any reduction is very difficult to predict. Indeed, in the initial stages of the recession there could be upward pressure on lending.

c. Overseas Interest Rates. These have risen sharply recently as other countries have tightened their monetary policies in the wake of rising international inflation (see Chart II and III). The extent of the change can be guaged by the fact that looking at current interest rates and inflation rates, US real interest rates are now positive, and UK real rates negative: this is a significant reversal of the position earlier in the year. This puts some upward pressure on UK rates.

d. Exchange Control Relaxation. In the various submissions preceding the decision to relax exchange controls we pointed out that interest rates might need to rise to keep monetary growth within the target range. UK interest rates are no longer insulated as they were to some extent in the past from the movements in international rates referred to above.

e. The SSD Scheme. The artificial reduction in recorded £M3 since the imposition of the corset may now be around 3% though we have no way of knowing precisely. And the abolition of exchange controls opens up the potentially important new channels of offshore disintermediation; it has also concentrated attention on the disintermediation which has already taken place.

If the corset is removed, the recorded money stock could increase quite rapidly - by perhaps 3% as reintermediation takes place. The effect on market confidence if the corset is removed also has to take into account that it will appear to some as though we have relaxed a control. To others however retention of the corset, causing continuing large disintermediation - some of it overseas - might itself be seen as a sign of weakness and cast doubt on the strength of the Government's commitment to genuine monetary control.

5. Interest rates in the market have already moved upwards; they are currently over 13½% at the long end and over 15% at the short end. We would not attribute this solely to special factors; there seems to have been some deterioration in inflationary expectations, and growing concern about the coming wage round.

The Next Three Months

6. We have looked in detail at the prospects for the next three months on the assumption that changes in MLR do no more than accommodate recent movements in market rates. On this basis, as the table below shows, we expect monetary growth since mid-June to remain above the top end of the target range even if the corset remains in place. If, on the other hand, the corset were to be removed we would expect a substantial acceleration in recorded monetary growth as the figures increasingly start to

reflect the underlying monetary position.

Table I
1979-80

Monthly Averages
£m

	OUTTURN	FORECAST	
		Corset On	Corset Off
	JUNE-OCT	NOV-JAN	NOV-JAN
CGBR	900	450	450
CG Debt Sales (-)	- 500	- 50	- 100
Other Public Sector	- 50	- 50	- 50
Bank Lending	650	650	1000
DCE	1000	1000	1300
Externals	- 350	- 400	- 400
Other	- 50	- 100	- 100
£M3	600	500	800
Percentage increase in £M3 since mid-June (at annual rate)	14%	13%	17%
£M3 adjusted roughly for disintermediation	19%	17%	17%

7. The main points are:

a. The CGBR comes down, as VAT receipts increase. The assumption is that the current VAT shortfall is entirely recouped during this period - and this could be optimistic.

b. With MLR doing no more than following market rates up, gilts and other public sector debt sales are low, against a background of continued weak domestic confidence.

c. The underlying growth in bank lending remains strong. We expect some reduction to occur eventually but we are extremely unsure about the timing. So the most we feel able

to say is that there might be some slight deceleration compared with recent months.

d. Although there has been significant official intervention to support the exchange rate recently, a somewhat smaller presence in the market is assumed in future. The direct effect of capital outflows is to reduce £M3 to some extent.

The Remainder of the Present Financial Year

8. The credibility of policy in the final quarter of the financial year depends critically on the behaviour of the PSBR. Though PSBR changes do not have a once for one effect on the money supply, confidence is bound to be adversely affected if it looks as though the PSBR is likely to substantially exceed the £8.3 bn set out by the Chancellor in his Budget. Figures of the order of £9-9½ bn are likely to be greeted with concern in both domestic and overseas markets.

9. It is of course still possible to imagine more favourable circumstances - especially if the PSBR does fall rapidly and tighten up monetary conditions or if bank lending falls sharply or if external markets remain buoyant because of fears of further changes in the world oil price - in which the current level of interest rates is satisfactory or even too high. But the balance of risks points in the other direction though it is impossible to be precise about the change in interest rates which might be necessary to bring monetary growth to the centre of the target range.

10. Interest rate changes do however operate after uncertain time lags. To give the best chance for the changes to affect monetary conditions in the rest of 1979-80 the sooner the authorities move the better.

The Prospect for 1980-81

11. The prospect for inflation in 1980-81 is relatively poor, unless the current pay round turns out to be much better than now seems likely and the exchange rate holds up extremely well. The PSBR prospect, even if it is held constant as a proportion of GDP, is for a substantially higher nominal figure than in

1979-80. With target monetary growth well below both the likely rate of accumulation of financial assets by the private sector and the growth of nominal incomes, it is difficult to see much change in interest rates from current levels. If rates are raised sharply in response to the deterioration in the immediate outlook some falling back may be possible but even this is far from certain.

12. There might indeed be some further upward movement in interest rates. This could happen, for example, if any of the PSBR increase which we now foresee for the present year has to be carried forward into next. And of course the interest rate outlook next year depends critically on the target for monetary growth which is adopted as well as the accompanying fiscal stance. Looking at it crudely the tighter the monetary target the higher interest rates will have to be unless there is an accompanying tightening of fiscal policy. Some forms of fiscal tightening - for example increases in indirect taxes - may not even help much. But the relation between the monetary target and the interest rate outlook is not quite as simple as this suggests. Much depends on how the markets interpret any change in the target. For example, to the extent that a reduction in monetary tightness is foreshadowed - say by allowing some degree of base drift - inflationary expectations are likely to be adversely affected and this itself would have some adverse impact on interest rates. This is not to say that a losser monetary stance would imply higher interest rates than a tighter one, but simply that the gain in terms of interest rates from a loosening may not be very great.

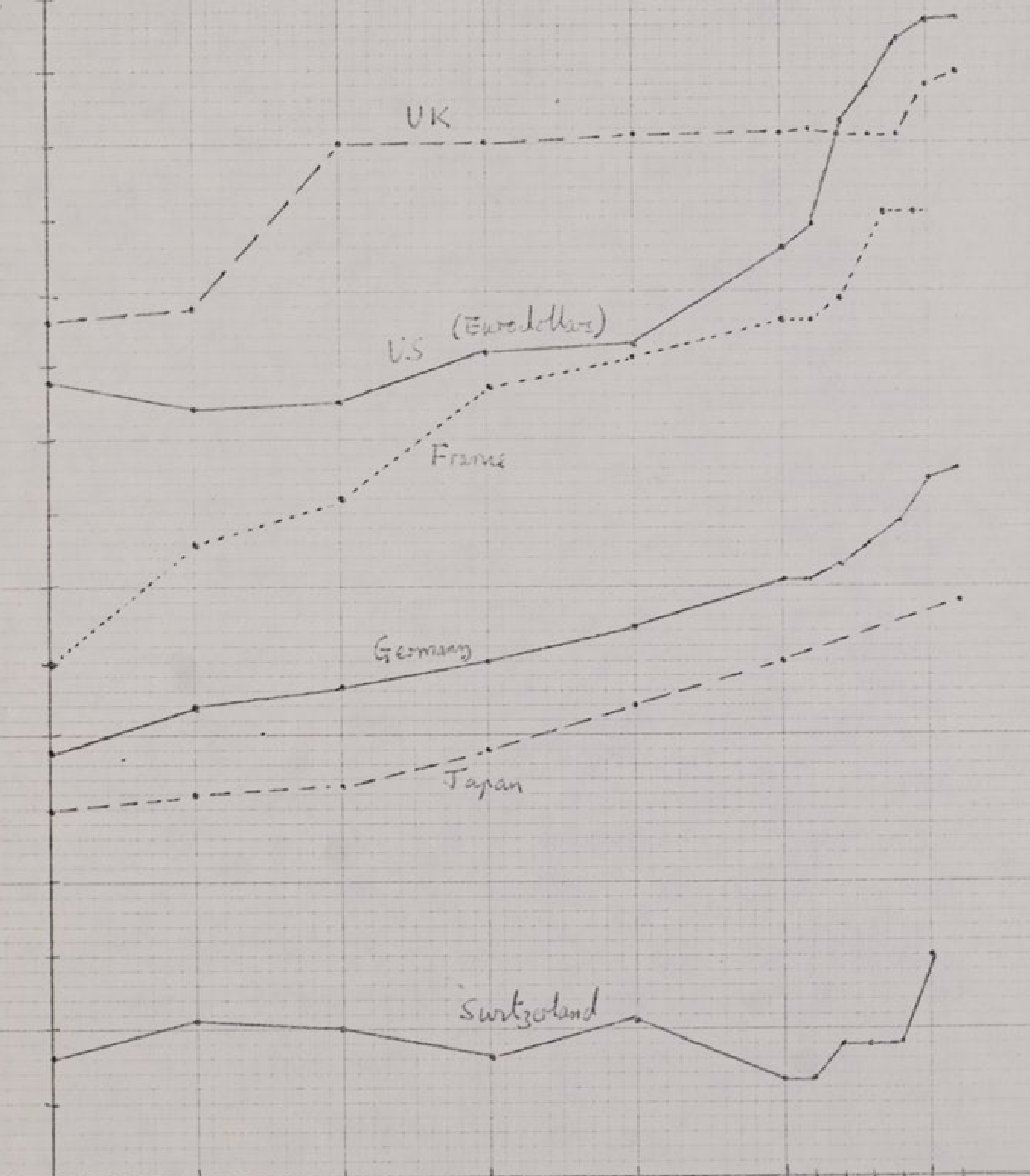
13. These judgements are all subject to large margins of error; in particular the recession may produce much lower bank lending than we have suggested. Some commentators have suggested this, though none of them are confident about the timing. On the other hand, if it becomes the view that the PSBR over the next 3 years was on a strongly rising trend, interest rates might be carried still higher.

P E MIDDLETON
7 November 1979

CHART II

THREE MONTH INTEREST RATES

(Source Morgan Guaranty & Bank of England)



(end-period)

CHART III

UNCOVERED 3 MONTH INTEREST DIFFERENTIALS

COMPARED WITH STERLING (+ in favour of sterling)
(− against sterling)

(Source Morgan Guaranty & Bank of England).

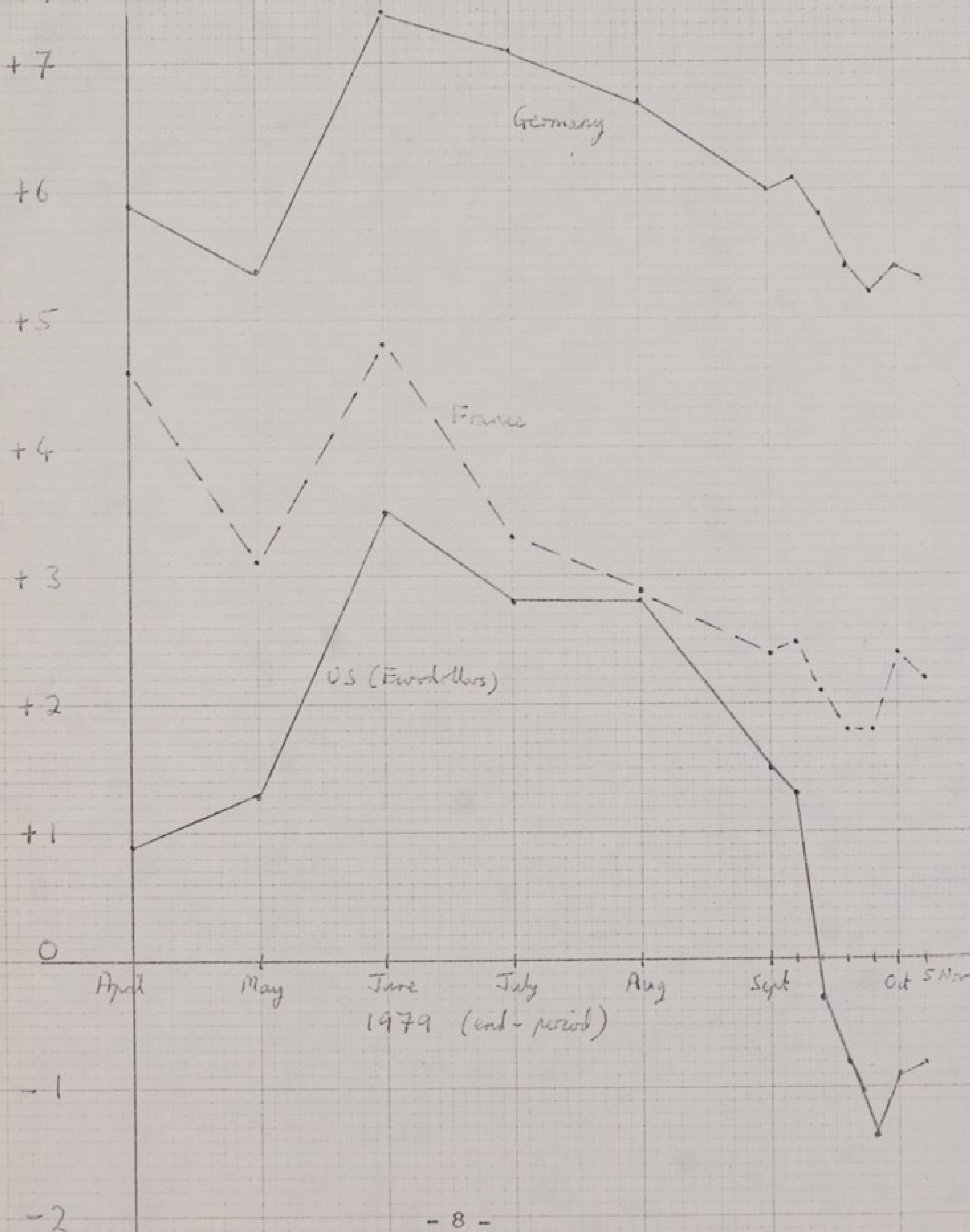


Table IV: Bank Lending: Recent History

monthly average increase (£m)
months preceding October:

	1	3	6	12
Recorded increase in lending	1,237	699	720	676
Effect of:				
bill leak	174	223	178	95
special factors	- 535	- 98	- 19*	- 10*
Underlying increase in lending	876	824	879	761

*special factors were not quantified in monthly forecasts prior to that for July

8

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

MONETARY DEVELOPMENTS

The monetary situation remains as bleak as when we talked on Monday. Indeed, there is now growing concern about the size of the PSBR for this year. Nevertheless, the Governor and I have considered the market situation this evening, and concluded that we should delay the change in MLR until next week. There would be difficulties in reaching a considered decision by 11 a.m. tomorrow, and there would also be a cost in terms of piecemeal presentation.

2. As expected the eligible liability figures depressed the domestic market - the 3 months inter-bank rate is now over 15¼ per cent, the yields on short gilts are about 14½ per cent, and on long stocks a little under 14 per cent. However, developments elsewhere, notably in Iran and Arabia, have so far outweighed the effect on the exchange markets, and sterling has risen: the effective rate is now 67.2 per cent. While the market regards an increase in MLR as almost inevitable, it does not seem to be expecting it this week.

3. The Bank's assessment therefore is that postponement of the decision from this week would of itself be unlikely to represent a significant risk. But there is of course bound to be some risk of other unforeseen developments affecting markets adverseley during the coming week, and therefore that the delay could mean

/that

that the change in MLR had to be greater when it came. Because of this latter risk, if MLR were the only change which had to be announced, the Governor and I would have no hesitation in recommending a change to 16 per cent this week - the movement in market rates has been such that this would be the minimum necessary to reassert the authorities' position in the market.

4. However, there is a strong presentational case for delaying the change until next Thursday, 15th November, when the full money supply figures will be published. A change then could be explained as part of a general statement to the House on monetary policy. This would put the change in MLR and the October figures in context, reaffirm our determination to keep to the targets, and also include:-

(i) the announcement of the roll forward of the monetary target;

(ii) the announcement of the extension of the SSD scheme, or more probably its phasing out; and

(iii) the statement of the intention to have technical discussions on a monetary base scheme, so that, if it proved appropriate, it could be brought in as the SSD scheme was phased out.

The impact on markets of a comprehensive statement would be much greater than that of an announcement on MLR this week and an announcement on the other points a week or two later. This advantage to my mind outweighs the risk of needing a higher change in MLR: that risk is not substantial, since the movement in market interest rates

/has

only just passed the point at which the move in MLR has to be to 16 per cent rather than 15 per cent, and there is therefore some leeway for a further move in market rates before the change would have to be one to 17 per cent.

5. If you agree that we should wait in this way, I will come back to you about the constituents of next week's package when I have had a further opportunity to discuss it with the Governor and others. I am sending a copy of this minute to the Governor.

(G.H.)
7 November, 1979

Econ Pol

PRIME MINISTER

Meeting with the Chancellor - Thursday 8 November at 9 a.m.

I understand that the Chancellor and the Governor decided this evening not to propose an increase in MLR tomorrow. They decided, instead, to put off the increase, which they regard as inevitable, until next week. The disadvantage of postponing is that we will lose another week before gilt sales start moving again. On the other hand, there are substantial advantages of waiting. These are that the increase - and I do not think a figure has yet been decided - would be accompanied by the announcement of the new six month, monetary target and possibly the ending of the "corset". We are committed to announcing a new target very soon; moreover, as you know, the "corset" has been ineffective for some time in controlling the money supply broadly defined and is less effective still now that exchange controls have been abolished. The draw-back of getting rid of the "corset" is that it will bring into M3 money which is currently not recorded as part of it; and this will give a once and for all boost to M3. On the other hand, we are interested in controlling the money supply properly measured, and most commentators are now well aware that M3 - while the "corset" continues - does not provide an adequate measure.

The Chancellor will be sending over a note later tonight. Subject to whatever that says, you might ask him:-

i) How big an increase in MLR he envisages next week? And what effect will the increase have on sterling? (sterling was very strong today).

ii) What are the real causes for the surge in the money supply in October? The Treasury tell me that VAT receipts were probably postponed because of industry's worsening financial position - in turn, partly due to the engineering strike, partly to the PAYE refunds. These latter factors no doubt go to explain the very high level of bank lending to the private sector. High bank lending does not necessary imply that the recession is being postponed: it could be that firms are borrowing to finance stocks they cannot

/sell

sell. A further bizarre reason for the surge in M3 is that, because the Treasury were not forecasting a high borrowing requirement in October, they did not plan on having part payments on gilts this month; hence, gilt sales were actually negative. But it is notoriously difficult to forecast the borrowing requirement, since it is the balance of two very large quantities. (You should be aware, in this connection, that my internal sources in the Treasury tell me that they are now in fact forecasting a PSBR of £9¾b. for 1979/80 rather than £8.3b. at the time of the Budget.)

iii) What monetary target does the Chancellor have in mind? If the Chancellor decides to adopt a new target of say 7-11% starting from the June base, monetary growth over the next six months will have to be very tight indeed given that we are now overshooting considerably (i.e. 14% at an annual rate since June). He could adopt a new target starting from October, but then he would be accused of starting from a more favourable base.

iv) What does the Chancellor have in mind to replace the "corset"? The answer may be nothing for the time-being until the work on Monetary Base Control (MBC) has been completed. One thing is clear - the introduction of MBC would not obviate the need for interest rates to rise if the demand for credit is excessive.

TL

7 November 1979

SECRET

Subject file Econ Pol - Strategy - Pt4 7

Econ Pol.

NOTE FOR THE RECORD

My letter of today's date to Battishill records the conclusions of the Prime Minister's meeting with the Chancellor this afternoon. The following additional points came up in discussion.

(i) The Prime Minister noted that the monetary prospect was now a great deal worse - as recorded in the Chancellor's minute of today's date, and that it might be necessary to raise MLR either this Thursday or next. The Chancellor said that the reasons for the deterioration in banking October were far from clear except that VAT receipts were coming in much more slowly than had been expected. Added to this, sales of gilts had been negligible. A further fiscal package was unthinkable (the Prime Minister agreed) and therefore the only option for bringing the money supply back within the target seemed likely to be a further increase in MLR. The Prime Minister said that she was most disturbed by this, and said that she was not sure that a further MLR increase would do the trick. So much depended upon psychology, and it was not clear to her that increasing MLR again would have the necessary effect. The Chancellor said that he and the Governor might need to see the Prime Minister on Wednesday to reach a decision on whether or not MLR should be moved this week; if not this week, it would almost certainly have to be considered very seriously next. Hearing that the Governor was planning a trip to China starting on 15 November, the Prime Minister said that - if MLR were to be increased - he ought to cancel this visit. The Chancellor pointed out that if the monetary prospect did not improve in the next month or two it might well be necessary to consider a further "cut" in next year's public spending plans.

(ii) On the issue of what figure to publish for the RPI forecast, the Chancellor pointed out that Phillips and Drew were forecasting a figure of 15% for the coming year in their latest report. This was higher than the forecast published in the FSBR at the time of the Budget because energy prices had increased and because the earnings out-turn for 1978/79

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/ and also

and also earnings assumptions for the current year were higher than then assumed. He had decided to shade the Treasury forecast down to 14 or 15%, but he did not believe it was possible to go lower than this. To do so simply would not be credible - and it would also make it difficult to justify an increase in the National Insurance contribution rates which was needed to help finance the PSBR. The Prime Minister said that she was most unhappy to find that the Treasury were still assuming that inflation would be in the mid-teens at the end of 1980. How could this be so if the Government were pursuing a tight monetary policy and when the underlying rate of inflation at present was only 12-13%? She thought that insufficient emphasis was being given to the beneficial effect of the monetarist approach. The Chancellor replied that, in the short term, the crucial factors determining inflation were the earnings assumption and the exchange rate. Monetary stringency would no doubt influence earnings in due course, but the short term effect would be primarily on output. If earnings continued to grow, as seemed likely, over the next 12 months, by 14% plus, then it was hard to see how inflation could be lower than 14%. The Prime Minister reluctantly agreed that 14% should be used for the Bray forecast and the Government Actuary's Report.

(iii) The Chancellor raised the question again of Mr. Christopher Macmahon's appointment as Deputy Governor of the Bank of England. He had a solid international reputation, and would - in his view - make an excellent appointment. The Prime Minister said that she was still not happy with this proposal. The Chancellor then said that the Governor would want to go back to her on it.

(iv) The Chancellor said that he was disappointed that the Government strategy was not being adequately put across by Ministers. He felt that he was carrying too much of the burden himself. The Paymaster General had circulated some good material in September, but Ministers were not making enough use of it. This material also needed to be up-dated continuously. The

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Paymaster General had had it in mind to appoint an Assistant Secretary from the Department of Industry to expedite this work; so far no-one had been appointed. (After the meeting the Chancellor told me that he did not wish this to be minuted between No. 10 and Departments; I undertook to take the matter up with Sir Douglas Wass and then with the Paymaster General himself.)

R.

5 November 1979

Distribution: Sir Robert Armstrong, Cabinet Office.
Mr. David Wolfson, No. 10

SECRET

010

S E C R E T

cc Mr Wolfson

PM has seen
JRH 5/11/79

6

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

MONETARY PROSPECT

I am afraid that the October monetary figures are going to be worse than disappointing, and not encouraging as we had originally hoped.

2. The eligible liabilities figures, to be published tomorrow, Tuesday 6th, will show an increase of 2.4 per cent. The market will deduce from this that the money supply grew by about 2 per cent - correctly. The preliminary figures show that £M3 grew by 2.0 per cent and that Domestic Credit Expansion was £1.6 billion. (The components shown in the Annex, and the DCE figure, may change somewhat before they are published on Thursday 15th, but it is unlikely that there will be much change in £M3.)

3. The main change from expectation was in the Central Government's Borrowing Requirement which was nearly £1 billion rather than virtually nothing. This was due to the estimates of a number of components all going the wrong way. The largest single factor was that VAT receipts, which included the first significant payments at the higher rate, were £500 million less than expected: some of this was clearly a matter of timing (possibly due to the after effects of the computer strike) and has already been partly made good.

/4. Net

4. Net debt sales were negligible, partly because the authorities were wrong-footed by the CGBR forecast: the calls on the part-paid stocks issued in banking September were timed for banking November, in expectation of a negligible borrowing requirement in banking October.

5. Perhaps more disturbing, the bank lending figure of £1.2 billion is a record. It is reasonable to look at this with last month's figure of £0.2 billion - bank lending, after allowing for acceptances taken up outside the banking system, still seems to be running at about £0.9 billion a month, as it has since the beginning of the year.

6. It is clear that monetary policy since June has not been as tight as we had intended. The rate of growth of the £M3 statistic has been about 14 per cent pa. If allowance is made for avoidance of the SSD scheme, for example through acceptances, the underlying growth is higher still.

7. While there are good grounds for thinking that the October figure was a "hump", and will be followed by lower figures, there are a number of further factors which have convinced the Governor and myself that we must consider whether we should act to tighten policy further. Market uncertainties have halted debt sales, which had been good until September. The borrowing requirement has been running at a level which is casting considerable doubt on whether it will be as low as the Budget estimate of £8¼ billion for the year as a whole. Other countries' interest rates have moved higher - most notably in the United States, but more recently in Germany and Japan.

/8. The

8. The market reactions to our policies, including exchange control relaxation, had generally been good, until the Public Expenditure White Paper last week.

9. Any immediate reaction to the monetary developments would have to be on MLR. Domestic market rates have already shifted upward in the last few weeks as a result of some of the factors I have just mentioned: the 3 month inter-bank rate is now over 14¾ per cent, leaving MLR out of line. Market rates are likely to move upward on the announcement of the eligible liability figures tomorrow, possibly with some further movement on Thursday week when the money supply figures confirm the worst. There could also be a further adjustment then, if we decide to announce the ending of the SSD scheme at the same time as the roll forward of the monetary target. It will certainly be necessary to move MLR by at least sufficient to validate these changes in market rates. The Governor and I will be considering whether a move may be needed to achieve our monetary targets.

10. We might discuss this briefly when we meet later this afternoon. But any decision should depend on the market reaction to Tuesday's figures, and on the further analysis by the Bank and Treasury of the implications of those figures. If there were a marked adverse reaction in the foreign exchange market, it might be necessary to decide at very short notice on Wednesday to move MLR this week. But I would hope that we could make the change the following week, when it could be presented in context with the roll forward of the target, and the full set of figures.

11. I have, of course, discussed these disagreeable developments with the Governor, who receives a copy of this minute.

(G.H.)
November, 1979

- 5 NOV 1979

5a

SECRET
+ PERSONAL

cc Mr Bridgeman
Mr Middleton
Mr Riley
Mr Sheridan

Preliminary Monetary Aggregates for October 1979
seasonally adjusted

As usual at this stage all figures are subject to revision, particularly those affected by overseas holdings of gilts and others shown in brackets on the attached table.

£ millions

1. Preliminary figures for all banks in banking October confirm the picture given by the 'first guess'. Sterling M3 is estimated to have risen by 1,080 or 2% making a rise of 4.5% since mid-June or 14.2% at an annual rate. The bulk of this rise was reflected in M1 which rose by a record 937 (3.4%) but much of it was in interest-bearing sight deposits which rose by 570. M1 has risen by 1,050 (3.9%) over the latest three months. Non-interest-bearing M1 rose by 370 (1.5%) - of which notes and coin accounted for 200 - and has risen by 13.9% at an annual rate in the three months since mid-July.

2. The main features of the counterparts were a high level of bank lending, which in the absence of gilt sales led to high DCE, together with further substantial external outflows. The CGBR was large at 940 but the central government's own account borrowing was only 60 (although this was very much bigger than forecast). The bulk of the CGBR was offset by the large negative contribution (-620) of the rest of the public sector so that the PSBR (net of purchases of other public sector debt by the non-bank private sector) was only 320. Significant redemptions and buying-in of gilts were largely offs[et] by non-bank purchases of Treasury bills and other forms of debt to give non-bank sales of CG debt of 70 (an expansionary influence on DCE).

to give non-bank sales of CG debt of 70 (an expansionary influence on DCE).

3. Bank lending to the private sector was at a record monthly level of 1,240, of which advances accounted for 1,040 (LCB 610 and their subsidiaries 90, both unadjusted; the analysis of these advances is not yet available). Acceptances continued to rise strongly, by 310, with 140 being taken up within the banking system to leave a 'leak' of 170. The overall demand for credit then was about 1,400 and has been running at an average of 900 a month fairly consistently since the beginning of the year.

4. Within the net external and foreign currency finance of -430 there was an increase in the reserves net of official borrowing (140) but overseas residents acquired sterling deposits (160) and public sector debt (220) and banks switched into sterling (120). Non-deposit liabilities rose by 85.

SECRET

£ millions
seasonally adjusted

Preliminary DCE, sterling M3 etc. in banking October 1979

	Preliminary[ø]		Forecast*	
CGBR: own account	+ 64		- 700	
on-lending to LAs	+ 85		+ 20	
on-lending to PCs	+ 788		+ 760	
		+ 937		+ 80
Net purchases of CG debt by non-bank private sector: (inc. -)				
Gilts	(+ 282)		+ 275	
Treasury bills	(- 81)		- 25	
National Savings	- 58		- 25	
Certificates of tax deposit etc.	- 72		- 80	
		(+ 71)		+ 145
Other public sector: Local authorities	(- 324)		+ 20	
Public corporations	(- 293)		- 590	
		(- 617)		- 570
Sterling lending:				
Bank lending to private sector	+1,236		+ 645	
Issue Department commercial bills	+ 1			
Bank lending to overseas	- 33		+ 50	
		+1,204		+ 695
DCE		(+1,595)		+ 350
External and foreign currency:				
Increase in reserves (inc. +)	+ 69		+ 40	
Official borrowing (inc. -)	+ 71		+ 60	
Overseas public sector £ debt (inc. -)	(- 221)		- 225	
Overseas sterling deposits (inc. -)	- 163		- 85	
Banks' net currency deposits (inc. -)	- 118		-	
Seasonal adjustment	- 67		- 65	
		(- 429)		- 275
Non-deposit liabilities (inc. -)		- 85		- 100
Sterling M3		+1,081		- 25
		(2.0%)		(0.0%)

ø Figures in brackets are more uncertain than other figures.

*As revised after the Monetary Review Committee meeting on 11th October.

2/3(a), A20

SECRET

Prime Minister ②

Econ Pol. ⑤

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

8th October, 1979

Dear Tim,

MONEY SUPPLY AND ELIGIBLE LIABILITY FIGURES

The eligible liability figures and the clearing bank figures to be published tomorrow will give the market a first indication of the likely money supply figure for banking September, and also of the bank lending figures. The Chancellor thought that the Prime Minister might like to be aware of the provisional full figures, which will be published on Thursday week, 18th October, since it is possible that the market will read more into them than is justified.

As the attached note brings out, it would be risky to conclude that this is the first sign of a turndown in the bank lending figures. It may be, but it is risky to conclude this on the strength of one month's figures alone. First, the underlying reduction is probably not as much as the published figures suggest. Second, there have been monthly fluctuations in the underlying figures - in both directions - of at least as much as this in the recent past. The Chancellor will let the Prime Minister know what implications he draws for monetary policy when he has had a chance of considering these figures and the new financial forecasts with the Governor.

I am sending a copy of this letter to John Beverly at the Bank.

Yours ever,

Tony Battishill

(A.M.W. BATTISHILL)

T. Lankester, Esq.,
Private Secretary,
10, Downing Street

SECRET

DOMESTIC MONETARY PROSPECT

Banking September

The provisional figures for banking September show that the money supply grew by just over ½% - bringing the rate of growth in the first three months of the target period to 10% p.a.

2. The analysis so far available shows its composition to have been broadly:-

	£bn	
CGBR	1.65	
less sales of c.g. debt outside banking system		
gilts	- 0.99	
other	- 0.03	
Bank and overseas lending to rest of public sector	+ 0.12	
Bank lending to private sector	+ 0.17	
Overseas	- 0.02	
DCE	0.89	
External (net)	- 0.49	
Other adjustments	- 0.10	
Change in £M3	+ 0.30	(0.6%)

The pattern was broadly as expected with a high CGBR being only two thirds covered by gilt sales. External factors were contractionary - for once fairly closely matching the fall in the reserves.

3. The most significant feature was the sharp drop in the growth of bank lending to the private sector. But this is overstated by the above figures. Allowing for the growth of acceptances outstanding outside the banking system, and other special factors, the underlying figure was probably in the

£600m - £700m range, compared with the underlying figures of about £1 bn in the recent past. It would be tempting to conclude that this is the long awaited turndown in the growth of bank lending, but the underlying figures have fluctuated recently from month to month by at least this amount, so that it would be risky to reach this conclusion on one month's figures.

Prospect

4. Unless there is some totally unexpected development the money supply should fall in banking October (which ends on Wednesday 17th) because the Central Government would be nearly in balance. However, the various factors distorting the monthly bank lending figures recently, including the timing of the various Budget tax changes, are such that the published bank lending figures next month may be significantly higher - a figure of £500m would be consistent with a continued fall in the underlying figure. So just as the market may be over-encouraged in the next few days by the September figures, so it may be set back in a month's time by this item in the October ones. It will be necessary to emphasise the need to take the two month's figures together.

5. Thereafter, there would seem to be a reasonable prospect of being able to keep monetary growth in banking November and December in about the middle of the target range. The CGBR will be relatively low but we may only secure modest gilt sales, given the disposals and the possibility of uncertainties about how the prospect on wages will develop.

Financial Times extract 9/10/79

LOMBARD

The urgency of a monetary plan

BY SAMUEL BRITTAN

THE FIASCO of the Engineering Employers' defeat underlines the urgency of a medium term monetary plan as the only hope of preventing both inflation and unemployment from getting out of hand. The issue can be postponed no longer. Monetary targets, the Public Expenditure White Paper and the choice of a new Chief Economic Adviser (who ought in my view to be Prof. Terry Burns) are all coming to a head.

Yet a new argument has been found by the obstructionists. This is, as Peter Riddell reported from Belgrade last Wednesday, that medium term targets should be "sustainable over a period and not have to be adjusted." Thus the very understandable scepticism of ministers against official numerical projections is being cunningly twisted into an argument against the centrepiece of any monetarist strategy worth the name.

The objection misses the point. Monetary targets should be not forecasts but statements of Government intention. If unforeseen changes occur, adjustments to other elements such as public spending, taxation and interest rates would have to be made to ensure that these targets are kept.

Overliteral

The chief weapon of the anti-monetarists is now overliteralness. The case for a medium-term plan does not depend on there being exact fulfilment of the figures for later years. What would one think of a major company that refused to formulate objectives for more than 12 months because later plans might have to be revised?

The point of a monetary plan is to indicate for all to see that monetary growth will be on a declining path. Attempts by the banking system to get round the official definitions might actually call for lower targets; and any worthwhile plan would have to contain a strong preamble saying that the spirit as well as the letter would be observed and that a large variety of monetary indicators, apart from the usual "M3" would be monitored.

Paradoxically enough the crucial argument for a medium term approach is the very one raised by the anti-monetarists: how do we prevent monetary restriction from squeezing output rather than inflation? One year monetary targets of the Healey hand-to-mouth kind indeed risk landing us with the worst of all worlds. As they do not stretch nearly far enough ahead to lower people's inflationary expectations, the main effect is all too likely to be on output and employment.

Borrowing

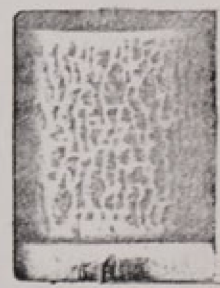
If the money supply is to grow at a relatively non-inflationary rate in four years' time, public sector borrowing will have to fall to a very modest proportion of the national product—Professor Patrick Minford in a fascinating paper (in The Taming of Government, published today by the Institute of Economic Affairs) makes a case for zero.

If there were a medium term plan for declining monetary growth and a declining PSBR proportion, it would not matter so much whether the PSBR proportion were reduced on an actual or cyclically adjusted basis. A temporary rise in the PSBR in a recession would have less inflationary effect in the context of declining monetary growth, and of medium term spending and tax plans geared to reduce borrowing in a normal year. If on the other hand the PSBR is reduced on an actual rather than constant employment basis, the restrictive effect on output would be less

Another line of attack is to ask what effect a monetary plan will have on the inflationary expectations of shop floor leaders. This is a very *simpliste* approach. Wage demands, and still less actual earnings, are not drawn like numbers out of a hat. Fifteen years ago a wage settlement of 9 per cent seemed as outrageous and provocative as one of 25 per cent today; and the jump has much more to do with the intervening monetary explosion than any increase in militancy.

Monetary policy cannot be expected to take away any power that strong arm groups have to depress the relative pay of their weaker brethren or force them on to the dole. But it is absurd of the anti monetarists to assume that strong-arm groups are also stupid and can be tricked by monetary expansion or inflation into accepting lower real settlements than under the framework of a monetary plan.

The greatest absurdity of all would be for Mrs. Thatcher to pass over potential chief economic advisers of a free market anti-incomes policy approach in favour of an estabilshment candidate who had never irritated her because he had kept a discreet silence on controversial matters. Finally no worthwhile appointment will avoid ruffling the feathers of the economic forecasters; and it is incredible that one hears this mentioned as a factor in the choice



Econ Pol
Domestic Monetary

Meeting extract PM/Chancellor 4.10.79 at 9.00am

vii. The Chancellor said that he would be putting proposals to the Prime Minister shortly on a further exchange control package; he was also discussing within the Treasury the idea of medium term monetary targets, and would be reporting back to the Prime Minister on that too.

Subject file Econ Pol
Consultation with IMF

SECRET

Econ Pol

Copies on Euro Pol (EMS) Master

4

NOTE FOR THE RECORD

c.c. Mr. Alexander

The Prime Minister had a brief discussion with the Chancellor and the Governor about recent intervention tactics and the EMS before the lunch yesterday. (Other main points discussed are recorded in my letter of today's date.)

Intervention Tactics and the EMS

The Governor explained the background to the Bank's substantial intervention between 13 and 17 September. The present agreed policy was not to "dig in" at any particular level but rather to "lean on" the rate to moderate marked changes in the rate one way or the other. But it had been thought right to intervene fairly heavily in order to moderate sterling's weakness. To have stayed out of the market would have risked a much sharper fall. While sterling had been too high when it reached $2.30, it was important - in his view - that sterling should stay relatively high. This was on counter-inflation grounds and because a weak pound would make it more difficult to sell gilts and therefore to meet the Government's monetary objectives.

The Chancellor said that the recent instability of the pound - both up and down - was worrying. At some point, joining the EMS might help.

The Prime Minister said she agreed with the present policy of intervention, and that the Bank had been right to moderate sterling's fall. She also agreed that it was important to keep the pound strong if it could be achieved at reasonable cost. But she did not think our joining the EMS exchange rate regime was a starter until the Government's stabilisation policies began to see fruit.

R.

25 September 1979

SECRET

~~CONFIDENTIAL~~ SECRET

Econ Pol. JFH
cc M. Vile C.O.
Copied to Master set + Econ Pol: Exch Control

10 DOWNING STREET

From the Private Secretary

25 September 1979

Dear Martin.

The Prime Minister gave a lunch yesterday for Treasury Ministers and the Governor. They had a wide-ranging discussion. The following is a summary of some of the points covered.

The Domestic Monetary Situation

The Governor said that the monetary prospect was now a little more encouraging. This was for three reasons. First, the Government's funding requirements would be rather lower over the next few months. Secondly, while lending to the private sector was still strong, there were signs that it might begin to edge down soon. Some of the recent lending had been to finance early repayment of foreign currency loans, and this had increased the level of total lending over what it otherwise would have been. Thirdly, the August figures for lending to persons suggested that this category of lending was beginning to moderate.

On the other hand, there were several anxieties. In the first place, there was the engineering dispute, which was causing uncertainty in the market. Secondly, it was still possible that lending to the private sector would continue at a high level - especially if corporate liquidity worsened in response to big pay settlements. Thirdly, there was concern that sterling might fall further. Insofar as this would worsen the inflationary outlook, this would make gilt sales that much more difficult. Finally, there was pressure from rising interest rates overseas.

The Prime Minister asked whether, against this background, interest rates were likely to fall in time to avoid the increase in the mortgage rate in January. The Governor responded that, although the outlook was very uncertain, it seemed more likely that interest rates would stay up than that they would turn down soon enough.

The Prime Minister then asked whether it would not be possible to tighten the "corset" in order to hold back bank lending. The Chancellor explained that, while the "corset" arrangements could in principle be changed so as to eliminate the existing leakages, the banks and borrowers would almost certainly find new ways of evading the controls. For example, inter-company lending would probably increase. There might also be increased borrowing from abroad. Ultimately, the authorities had to rely on interest rates to bring the level of credit creation to the private sector within the desired limits.

SECRET

~~CONFIDENTIAL~~

/Exchange Controls

Exchange Controls

The Chancellor said that a decision would have to be taken within the next few weeks on the further dismantling of exchange controls. A firm decision one way or the other was needed partly in connection with the sale of BP shares. His own preliminary view was that the remaining controls should be dismantled.

The Prime Minister said that she would be glad to discuss this after the Chancellor returned from the IMF/Bank meetings: but her initial view was that there should be no further relaxation for the time being. She felt that it would be a mistake to relax the controls further until the Government's market philosophy was being seen to work. To move any further now could all too easily lead to a large outflow of funds.

I am sending a copy of this letter to John Beverly (Bank of England).

T. P. LANKESTER

M.A. Hall, Esq.,
HM Treasury.

3

Econ Pol.

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

21st September, 1979

Prime Minister
I have also included in this folder the latest Treasury note on the monetary situation (which you discussed with the Chancellor last week).
TL 21/9

Dear Tim,

The Prime Minister has invited Treasury Ministers and the Governor to lunch with her on Monday before the Chancellor leaves for meetings of the Commonwealth Finance Ministers and the IMF and World Bank.

By way of background to their discussion the Chancellor thought the Prime Minister might find it helpful to have the enclosed short notes on the UK economy and on the economic assessment which appeared in the Bank of England Quarterly Bulletin earlier this week. He has also suggested she might like to see the latest Treasury comparison of selected short-term forecasts.

I should perhaps add for completeness that the note on the economy and the remarks about company liquidity in the note on the Bank assessment are not to be taken as a preview of the next short-term forecast, which is not yet completed.

Yours ever,

Tony Battishill

(A.M.W. BATTISHILL)

T. Lankester, Esq.,
Private Secretary,
10, Downing Street

21 SEP 1979

UK ECONOMY

GDP recovered in the second quarter from the earlier severe whether and industrial disputes, but underlying growth since last summer has been modest. Industrial production in the three months to July was some 3% higher than in the previous three months. Some of the rise is still attributable to recovery from the effects of the strikes and severe weather at the beginning of the year, and the underlying rise in production is probably slight. Consumer spending rose substantially in the second quarter partly in anticipation of Budget indirect tax increases, but in July and August, taken together, retail sales have fallen back to the first quarter level. Investment and stockbuilding both show signs of cyclical downturn. Export volumes in recent months have been well above the depressed levels of the first quarter of 1979; so far this year they have been much the same as for the second half of 1978. Import volumes have risen substantially, and are running at a level about 15% higher than in the second half of 1978.

2. Average earnings increased by 16.4% in the year to July. Retail prices in July were 15.8% higher than a year earlier. Contributory factors to the rise were the lagged effects of past wage cost increases and the Budget indirect tax increases.

3. Sterling M3 increased in the early summer at an annual rate above the previous Government's 8-12% target range. The increase in July and August, taken together, the first two months of the new 7-11% target period, was 1.8%, close to the top of the new range, but figures for so short a period should be treated with caution.

4. The current balance of payments was in deficit by £2.4 billion in the first eight months of 1979, compared with a surplus of £0.9 billion in the second half of 1978. The deterioration is due both to adverse trends in volumes and to a worsening on invisibles. The current deficit, however, has been more than offset by capital inflows. The reserves have risen by $7½ billion since the end of 1978 (of which $4½ billion was due to the revaluation of gold etc in March). Sterling's effective exchange rate has been on a downward trend since its peak in July; it is still some 7% higher than at the end of last year.

5. There has been some improvement in the current balance in the latest few months but there seems little reason to expect much further progress. Growth in world trade is likely to slacken and this, coupled with poor price and cost competitiveness, will hold down the growth in exports. A slackening of domestic activity will have some dampening effect on the growth of imports, but poor price and non-price competitiveness are likely to lead to a continuation of current trends of import penetration. Invisibles will be adversely affected by higher oil company profits in the North Sea and by the UK's rising contributions to the EEC Budget. Taking all these influences together it appears that the current account may well remain in deficit next year.

L AIDE MEMOIRE ON THE UK ECONOMY — 20 September 1979

PRESENT SITUATION

GDP Output Estimate 3% higher Q2 1979 than Q1 (production recovering from adverse weather and industrial disputes); 1979 H1 ½% higher than 1978 H2. Industrial production down 0.6% in July; level in latest 3 months 2.9% up compared with previous 3 months: manufacturing production down 1.5% in July; latest 3 months 1.9% above previous 3 months. (Production showing small underlying rise.)

Consumers' expenditure rose 3.8% in Q2 1979, following strong rise during previous 5 quarters. Retail sales (volume) up 2.3% in latest 3 months (to July) (Export and import volume figures have been affected by the road haulage dispute and distortions to the flow of information). Manufacturing investment (1975 prices) fell 2% in Q2 1979, below the 1978 level. Latest DI manufacturing investment intentions survey suggests 2-5% rise in 1979, followed by a small decrease in 1980.

Stockbuilding by manufacturers and distributors has continued in 1979 H1 at a similar rate to 1978. Lower stockbuilding by manufacturers has been offset by higher stockbuilding by wholesalers.

August unemployment (UK, seasonally adjusted excluding school-leavers) was around 1,265,000 (5.2%). The September 1977 peak was 1,418,000 (5.9%).

August RPI (all items) up 0.8% on July. Change over 12 months to August 15.8%. August TPI up 1.0% on July.

Wholesale input prices (fuel and materials) rose 0.6% in August Wholesale output prices ("factory gate") rose 0.9% In last 6 months input prices have risen 19.5% (at an annual rate); wholesale output prices have risen 18.9% Average earnings index for July up 16.4% compared with the same month 1978. RPDI little changed in Q1 1979 but up 7.5% on Q1 1978.

PSBR in financial year 1978/79 £9.3 billion. 1979/80 Q1 £2.8 billion. Post-Budget forecast for 1979-80 is £8¼ billion.

Sterling M3 rose 1.8% in July and August, taken together, close to top of target 7-11% growth at annual rate over period to April 1980. MLR raised to 14% on 12 June.

Balance of payments current account recorded a deficit of £400m in 3 months to August; total deficit first 8 months 1979 of £2400m. Reserves at end-August $23.305 billion. Exchange rate closed at $2.1440 on 19 September with effective exchange rate index standing at 68.2.

BANK OF ENGLAND QUARTERLY BULLETIN : SEPTEMBER 1979

The Bank of England's economic assessment (contained in the Quarterly Bulletin published on 19 September) describes the deterioration in the world prospect following the recent oil price rises. It suggests that as the trend of inflation worsens, Governments will consider that they have less room for manoeuvre in economic policy than in the past and will thus be less likely to expand demand in an attempt to stimulate growth. The Bank criticise the rigidity of the relative price and wage structure in industrial countries and conclude that unless this can be softened, there can be little hope of world growth returning to a satisfactory rate.

2. Within the UK, the Bank foresee a period of negative growth and high unemployment. They point in particular to the weakness of the supply side of the economy. They discuss the recent strength of sterling and while acknowledging that a higher exchange rate will bring benefits to the price level, they draw attention to the corresponding loss in competitiveness. The picture they paint of the prospects for the company sector is especially gloomy.

3. In discussing the appropriate policy response to this situation, the Bank agree that the Government's first priority must be to reduce inflation. They caution against any stimulus to demand until the Government's monetary policy has contained the inflationary pressures in the economy and the supply side has begun to respond. But they stress that an improvement in the economic prospect does not depend solely on Government action but also on the reaction of both sides of industry to our current difficulties: lower pay settlements and higher productivity will help to bring inflation down faster at a lower cost in terms of lost output and employment.

Comment

4. We would accept much of the Bank's analysis of our present predicament and their broad policy prescriptions. Their assessment is helpful in highlighting the need for a change of attitude throughout the country and such statements as "the future of some individual firms, and thus of the jobs they provide, could well depend on the willingness of all who work in them to co-operate in keeping down wage costs and getting better results as regards efficiency and competitiveness" accords well with the general message the Government has been seeking to put across. But the overall tone of the Bulletin is very pessimistic and has led the Financial Times to conclude that the latest edition is "one of the gloomiest ever produced". Although the Bank stress at several points that the outlook could improve if the country would only rise to the challenge, there is little sign that they themselves are expecting such a response or that they have made any allowance for the effect of the recent major changes in policy on confidence and expectations.

5. The press have seized upon one element in the Bank's Bulletin in particular. They have picked up the reference in the economic commentary to the possibility that the financial deficit for industrial companies in 1979-80 could be about the same size in real terms as in the "crisis" year of 1974-75, with little prospect of an improvement next year. Forecasts of the financial deficit of the company sector are notoriously unreliable but while we agree that the outlook for companies looks fairly bleak, we believe the Bank have exaggerated the problem. Firms will come under increasing pressures in the coming months but, as the Bank themselves acknowledge, they now have much more experience of living with high rates of inflation and are thus unlikely to run into the same difficulties as five years ago. Moreover, with the change of Government, the confidence of the company sector is now much higher than in 1974-75 and this in itself should make the task of financing deficits rather easier. The Bank's comments are therefore

probably unduly alarmist but are not necessarily wholly unhelpful since they reinforce the warnings which the Government itself has been giving about the dangers if companies fail to adjust in time to the new monetary climate.

Comparison of Selected short-term Forecasts for the UK

Background Economic Briefing
compiled by EB Division
HM Treasury (Tel 01-233 4524)

September 1979

Summary

Since the last edition, NIESR and Phillips and Drew have issued full forecasts, while Cambridge Econometrics have put out a special report. The comparison also takes a brief look at the latest comments by the LBS, and at forecasts by Wood-Mackenzie and by the Sunday Telegraph team. New material is sidelined as usual. With the exception of the CEPG, all the forecasts now take into account the June Budget.

A broad consensus is beginning to emerge concerning the main economic variables (see also graphs). GDP is generally expected to grow by only ½-1½% this year, to fall in 1980 as a whole, but to pick up very slightly towards the end of 1980. The path of consumers' expenditure is distorted by the timing of direct tax cuts, but growth for 1979 as a whole is 3-4%, slowing to 1-2% next year. Public authorities' current expenditure is generally flat or falling throughout the forecast period. The outlook for investment is universally gloomy, though the extent of falls forecast for 1980 varies over a range of 0-5½%. Most forecasters expect exports to grow by 3-4% next year, after little or no growth in 1979, but the outlook for growth in imports varies from 3¾% to 8% in 1979, and from ¼% to 3½% next year. Unemployment rises to reach 1.6-1.7 million by the fourth quarter of 1980.

Price inflation is expected to peak at 16-17% in the first quarter of 1980, and then to drop back to 11-12% by the end of the year. Assumptions for the growth in average earnings vary from under 14% to 16%.

There is less consensus over the balance of payments current account, where forecasts range from a small deficit to a small surplus, but the CBI forecast a deficit of £2¼ billion.

The forecasts also disagree on likely financial developments. LBS and NIESR expect that the PSBR be over £10 billion in 1980-81, that the growth of the money supply will remain within the target range, but that interest rates will have to remain high. Phillips and Drew, on the other hand, forecast a reduction in the PSBR to £6.9 billion, and a reduction in interest rates to around 8½% in 1980-81; the money supply growth by about 9%.

The NIF broadly fits into the consensus outlined above, but generally lies at the pessimistic end of the spectrum

SUMMARY TABLES: 1979

Except where specified figures are % changes on previous year)	NIESR (Aug 1979)	LBS (Jul 1979)	P & D (Sep 1979)	CBI (Aug 1979)	OECD (Jul 1979)	GOVERNMENT (Jun 1979)	CEPG (Apr 1979)	Cambridge Econometrics (Jul 1979)	NIF (Jun 1979)
					1979				
GDP	0.5	1.6	0.9	1.3	0	0.4	3.0	1.5	0.2
Consumers' Expenditure	4.2	3.0	3.9	4.8	-2½H2	2.9	4.7	1.7	2.6
RPDI	4.1	4.3	1.7						3.8
Investment	-1.7	-4.0	-1.9	-0.7		-0.7	-1.5	4.7	-1.2
Public authorities' Expenditure	1.2	1.7	1.2	1.2		1.5	2.5	1.8	1.7
Prices ≠	12.7	12.6	12.9		16½ H2	16Q3	9.1	12.7	12.7
Current Account (£b)	-1.7	-0.2	-1.6	-2½	0	-0.4			-0.5
Unemployment (m) (Q4)	1.4	1.4	1.3				1.4		1.5
Exchange Rate (effective)	67.9	66	68.6				58.0		65.2
World Trade	6	7.1	5.5	5½-6		5-6	5		4
Average Earnings	13.3	14.3	14.0		14	14	14.3	14.5	
					1979/80				
£M3 growth	11	12.2*	10.9	7-11		9 ≠≠	13.4*		
DCE (£b)	6.7	9.3*	4.8						8.3
PSBR (£b)	8.8	8.5	8.2						
Interest rates (MLR)	12	12.6*	12.4				12.3	13	12¼

* Calendar Year
≠≠ June to April 1980 (annualised)

SUMMARY TABLES: 1980

Except where specified figures are % changes on previous year)

	1980								
	NIESR (Aug 1979)	LBS (Jul 1979)	P & D (Sep 1979)	CBI (Aug 1979)	OECD (Jul 1979)	GOVERNMENT (Jun 1979)	CEPG (Apr 1979)++	Cambridge Econometrics (Jul 1979)	NIF (Jun 1979)
GDP	0.5	-0.4	-0.2	-0.4	-2½ H1		1.6	-0.9	-0.8
Consumers' Expenditure	1.9	2.0	0.8	1.2	1.5 H1		1.9	-1.8	0.3
RPDI	2.7	2.0	1.5						-0.3
Investment	-0.1	-4.6	-2.9	-5.5			0.0	-1.7	-3.5
Public Authorities' expenditure	-1.3	-1.3	0.2	-1.0			2.0	1.1	-0.6
Prices	13.8	14.1	13.4		15 H1		12.3	17.2	15.1
Current Account (£b)	-0.4	-0.2	0.4	-2¼	0 H1				0.2
Unemployment (m) (Q4)	1.7	1.7	1.55		1.5 H1		1.5		1.8
Exchange rate (effective)	70.1	65	70				54.8		62.3
World Trade	5	1.8	2.4	4-5			6		6
Average earnings	15.9	13.8	15.0				17.2	15.5	
	1980/81								
£M3 growth		9.5*	8.9	7-11			12.0*		9.7
DCE (£b)		4.5*	3.8						
PSBR (£b)	10.3	10.9	6.9						
Interest rates (MLR)		11.1*	8.3				12.0	12	12¾

* Calendar year

++ June to April 1980 (annualised)

NIESR

The National Institute's September forecast is the first since the Budget. Assumptions include: unchanged policies; public expenditure cuts of some £5 billion for 1980-81 and the indexation of (only) tax allowances in the 1980 Budget; an exchange rate projected to remain at its recent high level, and that world trade rises by about 6% in 1979 and 5% in 1980.

Negligible growth (½%) is expected both this year and next. Consumers' expenditure grows by over 4% this year and by nearly 2% in 1980 as average earnings, with increases of 13½% in 1979 and 16% in 1980, continue to rise faster than prices (12.7% and 13.8% respectively). RPDI grows by over 4% this year and by 2¾% next year. Public expenditure falls from now on through 1980, and gross fixed investment falls by 1.7 in 1979 and 0.1% in 1980. The volume of exports is forecast to rise by less than 1% this year, but by about 3% next year. NIESR have assumed that the surge in imports in the first half of 1979 was a temporary aberration, and they expect the growth in the volume of imports to drop from 7¾% in 1979 to about 1% in 1980. Unemployment (GB) is expected to rise only slowly until the end of 1979, but to accelerate to over 1.6 million next year. The current account of the balance of payments is expected to be in deficit by some £1¾ billion in 1979, and by nearly £½ billion in 1980.

The PSBR is forecast at £8.8 billion, and £10.3 billion for 1980/81. The Institute expect that the growth of £M3 can be kept within the target range while at the same time permitting a limited reduction in interest rates.

In their appraisal, NIESR claim that the rise in the price of oil does not necessarily make a recession inevitable, and warn of the dangers for the OECD countries of reacting with contactionary policy stances. The Institute consider that the correct response to the rise in oil prices is for the OECD to accept the emergence of balance of payments deficits, and to refrain from deflationary action. The gloomy outlook in the forecast is attributed to the Government's present economic policies given the international background. The Review also contains a chapter on pay bargaining, and articles on monetary targets and on structural charges in the economy.

London Business School (LBS)

The LBS' August Forecast Release (which did not update their July forecast below), comprised an article by Alan Budd and Terry Burns entitled "Should the PSBR be cut next year?" In this they contend that a recession-induced rise in the PSBR has little effect on the growth in the money supply, and conclude that the combination of recession and high inflation expected next year provides favourable conditions for financing a larger PSBR; with the LBS' forecast

for output in 1980/81, a PSBR of £3¾ billion more than the target for 1979/80 would be consistent with the same monetary stance as 1979/80. A PSBR of £10½ billion in 1980/81 would then represent a significant tightening of financial policy. The LBS have however subsequently explained that they consider the present PSBR level too high.

LBS' July forecast took the Budget measures in to account and assumed that: for future years specific indirect taxes are raised in line with inflation and tax allowances with Rooker-Wise; the cash limits squeeze continues to restrain public expenditure growth rates to the White Paper rates (applied to the new lower base for 1979/80); world trade grows by 7% this year, but by only 2% in 1980; the exchange rate weakens in the fourth quarter of 1979 and in 1980; the growth of the money supply is within the new target range and decelerates sharply in the second half of 1980. The forecast was prepared before the June OPEC meeting, but it was assumed that oil prices would rise, to $19 in the first quarter of 1980.

LBS expect no further growth in output this year, and a fall next year; GDP grows by 1½% in 1979 as a whole and falls by ½% in 1980. Both inflation and recession are seen as temporary problems however, and growth resumes in 1981, to reach 3½% p.a. in 1982. RPDI is forecast to grow significantly this year, by 4½%, but by only 2% next year as consumer prices rise to an average rate of 14% in 1980, the same rate as average earnings. Price inflation for the fourth quarter of 1980 is however down to 12%. The increase in the rate of inflation is expected to cause a rise in the savings ratio, and private consumption growth is down to 2% in 1980. The level of investment is particularly hit by difficulties in the company sector and is forecast to fall steeply in 1980, though there is some recovery during 1981. Export volume increases by less than 2% between the second quarter of 1979 and the end of 1980. Contributing factors are a weak competitive position and the slowdown in world trade. With the exchange rate expected to fall and UK productions and consumption to stagnate, imports are forecast to grow extremely slowly after the third quarter 1979. Unemployment rises steadily to 1.7 million (UK) in the fourth quarter 1980 and to over 1.9 million in 1982. The current account of the balance of payments is expected to be in deficit throughout the forecast period: by £600 million this year, £800 million next year, £1.2 billion in 1981 and £2 billion in 1982.

The PSBR is forecast at £8.5 billion in the current financial year and £10.9 billion in 1980-81. It is expected that growth in the money supply will be within the new target range throughout 1979-80 and will decelerate sharply in the second half on 1980. Interest rates (MLR) decline gradually to about 10% in 1982. Domestic credit expansion is forecast to fall rapidly in 1979, to reach £4.4 billion in 1980.

On policy, the LBS considered it essential that the Government should publish a longer-term monetary and fiscal framework.

OECD

The OECD's July 'Economic Outlook' contained a forecast for the UK which was produced before the June Budget and before the end-June oil price rises, and which is not therefore covered in this comparison. The OECD did, however, include additional notes on the UK's post-Budget prospects, and it is from these notes that the figures in the summary table were taken, and to which the following paragraph refers.

GDP in 1979 is now expected to remain at roughly the 1978 level, and to decline by about 2½ per cent (annual rate) in the first half of 1978. The rate of inflation is forecast at about 16½ per cent (annual rate) in the second half of 1979, and some 15 per cent in the first half of 1980. The impact of the faster rise of prices than forecast previously will be partly offset by the reduction in income tax and somewhat higher pay increases in the public sector than had been assumed in the pre-Budget forecast. Private consumption may decline by about 2½ per cent (annual rate) in the second half of 1979, and probably a little further in the first half of 1980. Reflecting the public expenditure cuts, government consumption is expected to decline by about 1 per cent between the first halves of 1979 and 1980. In addition, it is estimated that government investment will fall by almost 2 per cent between the first halves of 1979 and 1980. Sluggish consumption and public sector investment are seen as likely to affect adversely other private investment. Weaker domestic demand is expected to lead to a slower rise in the volume of imports, but partly reflecting a further deterioration in competitiveness, this should be roughly offset by a somewhat lower rise in the volume of exports than had been forecast before the Budget. On the basis of the GDP forecast, the rise in unemployment is expected to strengthen during the next twelve months, with the rate exceeding 6 per cent in the first half of 1980. (This implies a figure of around 1½ million). The current external account may be in approximate balance in 1979 and in the first half of next year.

Phillips and Drew

Phillips and Drew's September forecast assumes a neutral 1980 Budget which merely indexes personal tax allowances and excise duties; further expenditure cuts as necessary to achieve the rigid observance of cash limits and public consumption rises of less than 1% in the current year and in 1980/81; 5½% growth in world trade this year slowing to 2½% in 1980; a 7%pa rise in non-oil commodity prices (in $ terms); an average oil price of $21½ p.b. in 1980; world inflation rates of 9-10% in 1979, and much the same in 1980; strict adherence of the £M3 target, possibly with a tightening in successive review periods; and no re-introduction of formal wage or price controls.

GDP growth is forecast at only 1% in 1979, and virtually nil in 1980 though the first half of 1981 may see some upturn. Retail price inflation is expected to rise to 17-18% by end 1979, but with a 15% growth in earnings for the new pay round, and 10% in 1980/81, the rise in retail price inflation may be down to about 11-12% end 1980 on end 1979. This profile for earnings and prices leads to virtually nil RPDI growth both this year and next. The first half of 1981 may see RPDI about 1% higher than a year earlier. A sharp slowdown is expected in the growth of personal consumption from 4% in 1979 to perhaps ½-1% in 1980; with possibly an improvement in first half 1981. Investment is expected to decline by 1½-2% this year, and 2½%-3½% next year. The negligible growth in economic activity and increased North Sea oil flow are expected to result in a surplus of £½ billion on the balance of payments current account in 1980. The lack of growth forecast for GDP combines with the expanding labour force so that unemployment rises to over 1½ million by end 1980 and continues to rise in 1981. The (trade-weighted) exchange rate index is expected to be in the region of 70 next year.

Phillips and Drew expect a PSBR of about £8½ billion in 1979-80. By 1980-81, the Government's fiscal measures, combined with a build-up of public asset sales and the expansion of North Sea oil revenues, leaD to a PSBR of £6.9 billion. Sterling M3 is forecast to grow by 12% in 1979 and by about 9% in 1980. Domestic credit expansion slows from £6 billion in 1979 to just over £3½ billion in 1980. Phillips and Drew expect a modest fall in short-term interest rates by the end of the year, and that the declining trend will continue into 1980.

Phillips and Drew have little to add to the remarks in their August forecast on Government policy, when they commented that the Government policy was worthy of support, but stressed the necessity for it to succeed as soon as possible. In the current 'Economic Outlook', they stress the dependence of Government policy upon the reaction of the labour force, but are fairly optimistic, on balance, for the prospects for the 1980/81 pay round.

Government Forecast

The Government's Industry Act forecast, published in the Financial Statement and Budget Report, (FSBR) covers the period to first half 1980. Monetary and fiscal policy assumptions for 1979-80 were determined by the Budget proposals, and money supply growth assumed to be in the middle of the 7-11% target range. Other assumptions are that specific duties and income tax allowances are adjusted in line with inflation in 1980; that the exchange rate is determined primarily by market forces, and the present level of public expenditure is extrapolated into 1980-81.

The prospect is for economic activity to decline slightly - by 1 per cent in the year to first half 1980. Retail price inflation rises to 16 per cent by the third quarter of 1979, but falls again to 13½ per cent by third quarter 1980. Consumers expenditure is expected to fall by

one per cent in the year to first half 1980. Total private sector investment is forecast to be roughly constant over the forecast period. Exports rise by some 5½ per cent by first half 1980, and the rise in imports tails off to 1 per cent over the coming year. The balance of payments current account is expected to be in deficit by some £¾ billion in the first half of 1979, but in approximate balance thereafter. The forecast for the PSBR in 1979-80 is £8¾ billion, and the money supply grows at an annual rate of 9 per cent between mid-June and mid-April 1980.

The FSBR forecast gives some consideration to a lower savings variant. Whereas in the main forecast the savings ratio was expected to remain around 15 per cent, in the variant forecast it is assumed to be some two per cent lower. The lower ratio could add some 1½ per cent to GDP, 2 per cent to consumers' expenditure and 1½ per cent to private investment by the first half of 1980, but the balance of payments outlook worsens.

Cambridge Econometrics (Cambridge Growth Project)

As a preliminary to their forthcoming Autumn forecast, Cambridge Econometrics has issued a special supplement which takes into account views expressed by subscribers at a recent Conference held for them. Cambridge Econometrics use a disaggregated macroeconomic model which produces detailed forecasts for forty industries, and their forecast is essentially medium-term in nature, in both of which respects it differs from the other, short-term forecasts in this comparison. Assumptions in the Supplement include:- further cuts in public expenditure; that the basic rate of direct tax is further reduced, to a rate of 28% next year, and 24% in 1981, but that a poor balance of payments position necessitates a return to 30% by 1990; sterling M3 is expected to rise by nearly 12% this year, and by 14% next year; the exchange rate depreciates against the dollar, quite quickly by the late 1980's, to reach 1.68 by 1986-90; average earnings rise by 15½% next year, 12% in 1981 but 8½-8% thereafter.

GDP is forecast to grow by 1½% in 1979, and to fall by 1% in 1980. Thereafter the picture improves gradually until 1984 but deteriorates again in 1985-90. Price inflation reaches 18.2%pa in 1980, but falls to some 6% by 1984. Consumers' expenditure rises by just over 1½% in 1979 as a whole, but this is with a noticeable fall in the second half of the year. The fall continues in 1980, when a decline of 1.8% is expected. After 1979 stocks fall throughout the forecast period. Some continued expansion of investment is expected in 1979, with a growth rate of 4.7%, but a fall of 1.7% is predicted for 1980. The volume of exports is expected to increase by 4.3% in 1979, and 3.4% in 1980, but all the increase is accounted for by the build-up of North Sea oil. Growth in import volumes falls from 8% in 1979 to a drop of 1% in 1980 as the economy slumps, and stocks are run down. Thereafter the UK's high propensity to import reasserts itself. Employment drops slightly in 1979, and continues to

drop throughout the next decade. Using the Department of Employment's forecasts from the working population, the model would predict 3.8 million unemployed in 1985, and 4.7 million in 1990. With lower growth in the working population, which Cambridge Econometrics feel to be more realistic, unemployment is expected to be over the two million mark for most of the forecast period. It is not, however, at all clear from their Report - and it is difficult to surmise - what policy assumptions lie behind the forecast is general, and the unemployment projections in particular. After a deficit of £1.4 billion this year, the balance of payments is expected to reach a surplus of £3-3½ billion by 1982, but return to a deficit by the mid-1980's.

Cambridge Economic Policy Group

The CEPG's annual review was published at the beginning of April. The forecast is essentially a medium-term one, and consists of three projections: a base projection, a projection with import controls, and a projection with devaluation. The base projection is intended to show up the scale of the problems which would occur if avoiding action such as import controls or devaluation is not taken. All three projections were based on the same underlying assumptions: world trade grows by 5% in 1979 and 6% pa thereafter; world oil prices rise by 7% in 1979 and 9% pa thereafter (in weighted average foreign currency terms); a zero target for the basic balance of payments (current account plus long-term capital and net trade credit); public expenditure based on White Paper Plans until 1981 and adjusted according to GDP growth thereafter; pay settlements which achieve growth in real post-tax wage rates of 5.3% in 1979, 1.7% in 1980 and ¾% pa thereafter (no new form of pay restraint is enforced), and maintenance of the cost competitiveness of UK producers at 1978 level. The forecast period divides roughly into three - 1978-80, 1980-85 and 1985-90. The base projection shows the recession intensifying - GDP growth is restrained constantly throughout the 1980's in order to meet balance of payments constraints. From an annual rate of 2.2% in 1978-80, GDP growth slows to an average 0.5% in 1980-85 and 0.1% in 1985-90. This is despite large projected benefits from North Sea oil. Consumer price inflation accelerates to over 15% pa by 1981 and remains in the 15-20% range throughout the decade. Real, post-tax earnings rise by 3.8% pa in 1978-80, and by just over 2% pa thereafter. However, because the growth in real earnings is forecast to take place at the expense of the living standards of the growing number of unemployed (also at the expense of profits and investment), consumers' expenditure grows by somewhat less than real earnings - 3.3% pa on average in 1978-80 and around 1% pa for the rest of the period. Private investment declines by 1½% pa in 1978-80, by just over 2% pa in 1980-85, and by 2¾% pa in 1985-90. The increase in the volume of exports slows from 5.8% pa in 1978-80 to 4.1% in 1980-85, and 3.8% in 1985-90, while that of imports slows from 5.4% to 4.4% and 4.3% in the corresponding periods. Unemployment is forecast to rise to 1.7 million in 1981, 2.7 million by 1985 and 3.7 million in 1990.

The CEPG illustrated their policy prescriptions by comparing their base projection with projections which incorporate either devaluation or a strategy of import controls. GDP under

a strategy of import controls, for example, was projected to grow by over 3½% in 1978-80, by 4% in 1980-85 and by 3% in 1985-90, and unemployment drops to 860,000. The CEPG's conclusions are: that although tight fiscal and monetary policy would marginally reduce inflation in the short-term, it would, after a few years, meet the impasse of "stagflation"; that incomes policy is a weak instrument for reducing inflation in the long term; and that with import controls and fiscal expansion the UK would achieve faster growth and a gradual return to full employment while import controls with fiscal expansion would not harm other countries.

CBI

The CBI's July forecast was based as usual on assumptions of unchanged policies. Specifically this is interpreted to include: the indexation of personal income tax allowances; Government spending at the levels is the FSBR forecast and subsequent Government announcements, and monetary growth within the new target range. World trade is expected to grow by 5½-6% this year and by 4-5% next year, while oil prices are assumed constant in real terms.

The CBI expects GDP to rise by around 1-1½% this year, but to fall by about ½% next year. The growth in RPDI is expected to slow this year, and because no further tax cuts are expected (beyond indexation of allowances) and earnings are not expected to rise faster than prices, very little RPDI growth is forecast for 1980. Inflation is expected to peak at 16-17% in early 1980. The savings ratio is forecast to increase in the second half of this year to about the same level as in the second half of 1978, and thereafter to change little. Consequently, consumers' expenditure grows by some 5% this year but only 1% next year. Manufacturing investment growth is expected to halt, and falls are forecast in most other components of private investment. Public capital expenditure falls by around 3½% this year and by some 7% in 1980. The recent worsening in the UK's competitiveness is expected to make itself felt in the next 12-18 months, and, together with cutbacks in exports to Iran and Nigeria, this will lead to a small fall in non-oil exports this year, and a rather larger fall next year, around 2½%. The CBI staff consider that the boost in imports in the first half of 1979 was a temporary aberration caused by disputes, and assuming a return to the more usual relationship between demand and imports, they expect non-oil imports to be about 7% higher this year but 2-2½% lower next year. An upward trend in unemployment is predicted. The balance of payments current account is expected to be in deficit by some £2½ billion this year and £2¾ billion next year, but it is stressed that the margin of error is likely to be larger than usual because of the distortion to the figures (then) available for the first half of this year.

Other Forecasts covered by the Press

Wood Mackenzie's September forecast gives zero growth for GDP in 1979, but a modest recovery next year to 0.7% growth. The exchange rate is expected to decline to about 62 by

the end of 1980, delaying the easing of inflation. Retail price inflation reaches 17% in the first half of 1990, but moves back towards single figures by end-1980. The balance of payments current account is expected to improve from a deficit of £1.2 billion in 1979 to one of £½ billion in 1980, despite an underlying position of serious deterioration in non-oil trade. The Sunday Telegraph business forecast also expects the pound to depreciate, because of an apparent easing of the oil market and rising interest rates in the US and Europe. Inflation reaches 17.2% in the first half of 1970, but drops back to under 13% in the second half; wages and salaries increase by 14% in the new pay round. The Sunday Telegraph team contend that current monetary policy can only be sustained at such rates of inflation at the cost of a fall in company profits and high unemployment; profits will be "squeezed savagely" so that the forecast 32½% increase for the second half of 1979 becomes a 1% decrease by the second half of 1980, while unemployment rises to 6% by the second half of 1980. James Capel and Co claim to have confirmed the Chancellor's warning of "almost frighteningly bad" prospects by running the Treasury model on the basis of their own assumptions. The result was a serious deterioration in output, unemployment and the balance of payments.

NIF

The post-Budget NIF is a fuller version of the FSBR forecast outlined above, covering a longer period of the first quarter 1981. The FSBR forecast is based on the NIF but rounding and other minor differences in presentation mean that there are some slight numerical discrepancies between the two forecasts. Recipients are reminded that details of the NIF are for their personal use only. In particular the following aspects are not being quoted publicly: the overall effect of the Budget is to reduce output and employment in the first year or two; unemployment rises to 1.9 million by first quarter 1981; the effective exchange rate falls to 60.2 by first quarter 1981; the PSBR for 1980/81 is £9.7 billion; short-term interest rates average 12¼% this financial year and 12¾% next; the rise in average earnings over the next pay round is forecast at 15.2%.

Indices (based on 1978 H1 = 100); Percentage Changes from preceding year

(a)

Table 1

GROSS DOMESTIC PRODUCT (b)
(1975 prices)

FORECASTER		CBI	NIESR REVIEW	LONDON BUSINESS SCHOOL	PHILLIPS & DREW	GOVERNMENT FORECAST	NIF
Percentage Changes	1979	1.3	0.5	1.6	0.9	0.4	0.2
	1980	-0.5	0.5	-0.4	-0.2		-0.8
1979	Q1 HI	100.6	100.2	100.7	100.6	101.2	100.3
	Q2	101.4	102.2	103.8	103.6		101.9
	Q3 HII	102.9	101.1	103.0	100 9	101.2	100.9
	Q4	103.3	102.4	102.2	101.8		100.9
1980	Q1 HI	102.2	101.7	101.9	101.6	100.2	100.1
	Q2	102.2	101 8	101.8	101.8		100.1
	Q3 HII	101.2	102.3	102.1	101.2		100.2
	Q4	100.9	102.5	102.1	101.4		100.4
1981	Q1 HI				102.4		100.3
	Q2				102.8		
	Q3 HII						
	Q4						

Table 2

MANUFACTURING PRODUCTION (c)

FORECASTER		CBI	NIESR REVIEW	LONDON BUSINESS SCHOOL	PHILLIPS & DREW	GOVERNMENT FORECAST	NIF
Percentage Change	1979			1.6	1.5	–	
	1980			-1.3	-0.3	-2½ (HI on HI)	
1979	Q1 HI	NO PUBLISHED FORECAST	NO PUBLISHED FORECAST	100.0	98.7		
	Q2			104.6	102.6		
	Q3 HII			103.7	103.0		
	Q4			101.8	102.6		
1980	HI			100.9	102.1		
	Q2			100.9	101.6		
	Q3 HII			100.9	101.1		
	Q4 HI			100.9	101.1		
1981	Q1 HI				101.6		
	Q2				102.1		
	Q3						
	Q4						

CONSUMER PRICES (% Change on same period a year earlier) (d)

FORECASTER		CBI	NIESR REVIEW	LONDON BUSINESS SCHOOL	PHILLIPS & DREW	GOVERNMENT FORECAST	NIF
1979	Q1 HI	NO PUBLISHED FORECAST	8.6	8.7	8.6		8.5
	Q2		10.3	10.9	10.5		10.3
	Q3 HII		15.2	14.8	15.3		15.4
	Q4		16.3	15.6	16.9	16	16.2
1980	Q1 HI		17.2	16.6	16.2		16.8
	Q2		16.4	15.6	15.3		17.8
	Q3 HII		10.7	12.2	11.5	13½	13.3
	Q4		11.7	12.2	11.0		13.0
1981	Q1 HI				10.5		13.3
	Q2				9.7		
	Q3 HII						
	Q4 HII						

a Index numbers should not be considered accurate to the last digit
b Compromise estimate used by HMT, OECD and NIESR: output estimate used by P & D and CBI, Expenditure estimate by LBS
c Index of industrial production forecast by LBS, BE
d Government publish retail prices: OECD publish figures for percentage changes from previous half year at an annual rate, and so are not strictly comparable with others
i OECD and GOVT forecast figures are half-yearly, as opposed to quarterly

BACKGROUND ECONOMIC BREIFING

COMPARISON OF SELECTED FORECASTS

Indices (based on 1978 H1 = 100) and Percentage Changes from preceding year

Table 4

REAL PERSONAL DISPOSABLE INCOME

				CBI	NIESR REVIEW	LONDON BUSINESS SCHOOL	PHILLIPS & DREW	GOVERN-MENT FORECAST	NIF
Percentage	1979 -				4.1	4.3	1.7	-	3.8
Changes	1980 -				2.7	2.0	1.5	-	-0.3
Index	1979	Q1	HI	NO PUBLISHED FORECAST	105.4	105.1	105.5	NO PUBLISHED FORECAST	108.8
		Q2			105.5	105.2	104.6		109.6
		Q3	HII		105.1	105.1	100.6		106.9
		Q4			109.6	110.6	105.5		109.8
	1980	Q1	HI		106 7	108.9	105.1		108.4
		Q2			107.7	108.9	105.4		108.8
		Q3	HII		112.0	108.5	105.9		107.6
		Q4			110.6	108.3	105.9		107.6
	1981	Q1	HI				106.5		109.3
		Q2					106.1		
		Q3	HII						
		Q4							

Table 5

CONSUMERS' EXPENDITURE

				CBI	NIESR REVIEW	LONDON BUSINESS SCHOOL	PHILLIPS & DREW	GOVERN-MENT FORECAST	NIF
Percentage	1979			4.8	4.2	3.7	3 9	2.9	2.6
Changes	1980			1.2	1.9	2.0	0.8		0.3
	1979	Q1	HI	103.8	103.8	103.8	103.8	104.7	103.4
		Q2		107.3	107.4	106.6	107 8		105.7
		Q3	HII	105.8	104.1	103.1	104.0	103.7	102.8
		Q4		107.7	106.9	104.1	105.1		103.9
	1980	Q1	HI	106.9	106.7	106.8	105.0	103.8	104.1
		Q2		107.4	106.7	105.6	105.6		104.0
		Q3	HII	107.6	108.1	106.6	106.0		104.2
		Q4		108.1	108.8	107.1	107.4		104.5
	1981	Q1	HI				107.6		104.7
		Q2					108.[illegible]		
		Q3	HII						
		Q4							

Table 6

PUBLIC AUTHORITIES CURRENT EXPENDITURE

				CBI	NIESR REVIEW	LONDON BUSINESS SCHOOL	PHILLIPS & DREW	GOVERN-MENT FORECAST	NIF
Percentage	1979			1.2	1.2	1.7	1.2	1.5	1.7
Changes	1980			-1.0	-1.3	-1.3	0.2		-0.6
Index	1979	Q1	HI	101.7	101.7	101.7	101.7	101.7	101.3
		Q2		101.7	102.0	103.0	101.8		102.4
		Q3	HII	101.7	101.8	102.5	101.8	101.7	102.0
		Q4		101.7	101 6	106.4	101.8		101.0
	1980	Q1	HI	101.0	101.3	101.1	101.8	100.8	100.1
		Q2		101.0	100.5	100.3	102.0		101.2
		Q3	HII	100.7	100.1	100.1	102.2		101.4
		Q4		100.2	99.9	101 1	102.2		101.5
	1981	Q1	HI				102.2		101.7
		Q2					102 2		
		Q3	HII						
		Q4							

[COM]PARISON OF SELECTED FORECASTS

Indices (based on 1978 HI = 100) and Percentage Changes from preceding year

Table 7

CURRENT BALANCE OF PAYMENTS (£ million) (e)

FORECASTER		CBI	NIESR REVIEW	LONDON BUSINESS SCHOOL	PHILLIPS & DREW	GOVERNMENT FORECAST	NIF
1979	Q1 HI	NO PUBLISHED FORECAST	-1184	-797	-1200	-750	-783
	Q2		-735	-316	-700	-	86
	Q3 HII		189	312	200	0	65
	Q4		43	193	100	-	164
1980	Q1 HI		-190	-229	300	0	91
	Q2		-116	-61	-100	-	-32
	Q3 HII		57	-277	200	-	72
	Q4		-151	-260	300	-	49
1981	Q1 HI	-	-	-	400	-	-67
	Q2	-	-	-	100	-	
	Q3 HII		-	-	-	-	
	Q4		-	-	-	-	

Table 8

EXPORT VOLUME (f)

FORECASTER		CBI	NIESR REVIEW	LONDON BUSINESS SCHOOL	PHILLIPS & DREW	GOVERNMENT FORECAST	NIF
Percentage	1979	0.5	0.7	1.3	1.2	-0.5	-0.8
Changes	1980	-1.6	3.0	3.8	3.7	-	3.8
Index 1979	Q1 HI	93.4	93.3	93.3	93.3	98.7	93.3
	Q2	109.9	108.6	105.6	108.3	-	104.0
	Q3 HII	102.8	103.9	106.1	105 0	103.1	103.3
	Q4	102.4	103.6	106.5	104.6	-	102.5
1980	Q1 HI	101.9	104.7	106.1	105.4	104.4	103.8
	Q2	101.3	104.8	106.6	106.2	-	104.3
	Q3 HII	99.7	105.8	106.7	106.9	-	104.9
	Q4	99.1	106.4	107.6	107.7	-	105.4
1981	Q1 HI		-	-	108.7	-	105.9
	Q2		-	-	109.5	-	
	Q3 HII		-	-	-	-	
	Q4		-	-	-	-	

Table 9

IMPORT VOLUME (f)

FORECASTER		CBI	NIESR REVIEW	LONDON BUSINESS SCHOOL	PHILLIPS & DREW	GOVERNMENT FORECAST	NIF
Percentage	1979	5.4	7.8	4.4	7.4	4.3	3.7
Changes	1980	-3.7	1.0	0.5	3.3	-	1.4
Index 1979	Q1 HI	104.5	98.8	101.1	101.1	104.4	101.2
	Q2	112.9	116.8	110.2	111.6	-	107.1
	Q3 HII	103.3	107.1	104.8	109.7	105.1	105.5
	Q4	103.5	105.8	104.3	109.8	-	103.7
	Q1 HI	103.5	109.3	106.1	110.8	105.4	105.2
	Q2	102.8	108.6	104.6	111.4	-	105.6
	Q3 HII	101.6	109.5	106.0	111.8	-	106.0
	Q4	100.9	110.9	105.9	112:6	-	106.4
1981	Q1 HI		-	-	115.1	-	107.0
	Q2		-	-	116.4	-	
	Q3 HII		-	-	-	-	
	Q4		-	-	-	-	

(e) OECD figures were originally published in dollars, table converts at
(f) Includes both goods and services

SECRET

BACKGROUND ECONOMIC BRIEFING

COMPARISON OF SELECTED FORECASTS

Indices (based on 1978 HI = 100) and Percentage Changes from preceding year

Table 10

GROSS DOMESTIC FIXED CAPITAL FORMATION

FORECASTER		CBI	NIESR REVIEW	LONDON BUSINESS SCHOOL	PHILLIPS & DREW	GOVERNMENT FORECAST	NIF
Percentage	1979	-0.7	-1.7	-4.0	-1.9	-0.7	-1.2
Changes	1980	-5.5	-0.1	-4.6	-2.9		-3.5
Index 1979	Q1 HI	95.7	95.7	95.6	95.7	99.0	97.9
	Q2	101.6	99.1	97.4	98.7		99.6
	Q3 HII	99.8	98.0	94.7	98.9	98.1	98.5
	Q4	97.5	97.9	93.6	96.5		97.2
1980	Q1 HI	95.5	96.6	92.1	94.1	96.1	95.1
	Q2	95.5	97.4	90.9	96.0		95.4
	Q3 HII	92.0	97.9	90.2	95.7		94.8
	Q4	89.9	98.1	90.2	92.8		94.0
1981	Q1 HI				93.4		92.4
	Q2				95.7		
	Q3 HII						
	Q4						

Table 11

PRIVATE FIXED INVESTMENT (g)

FORECASTER		CBI	NIESR REVIEW	LONDON BUSINESS SCHOOL	PHILLIPS & DREW	GOVERNMENT FORECAST	NIF
Percentage	1979		-2.4	-2.2	-1.2	-0.6	0.1
Changes	1980		0.7	-4.1	-0.3	-	-2.8
Index 1979	Q1 HI	NO PUBLISHED FORECAST	94.8	96.3	95.0	99.4	98.6
	Q2		98.0	99.0	98.3	-	100.3
	Q3 HII		97.7	98.2	100.9	99.4	100.1
	Q4		98.0	96.6	99.3	-	101.1
1980	Q1 HI		96.4	94.9	96.4	98.2	100.1
	Q2		98.5	93.8	98.1	-	97.5
	Q3 HII		98.5	93.9	99.2	-	96.4
	Q4		98.8	92.1	96.9	-	95.2
1981	Q1 HI		-	-	95.4	-	92.6
	Q2		-	-	97.1	-	
	Q3 HII		-	-	-	-	
	Q4		-	-	-	-	

Table 12

PUBLIC FIXED INVESTMENT

FORECASTER		CBI	NIESR REVIEW	LONDON BUSINESS SCHOOL	PHILLIPS & DREW	GOVERNMENT FORECAST	NIF
Percentage	1979		-0.4	8.3	-3.4	-1.5	-4.0
Changes	1980		-1.8	-5.6	-7.3	-	-5.0
Index 1979	Q1 HI	NO PUBLISHED FORECAST	97.3	93.9	97.0	97.1	96.6
	Q2		101.0	93.7	99.4	-	98.1
	Q3 HII		98.5	87.1	94.7	91.4	95.1
	Q4		97.6	87.1	90.8	-	89.3
1980	Q1 HI		97.1	86.0	89.4	85.7	85.3
	Q2		96.8	84.7	91.8	-	91.1
	Q3 HII		96.8	84.9	88.6	-	91.4
	Q4		96.8	86.0	84.5	-	91.8
1981	Q1 HI		-	-	89.4	-	91.9
	Q2		-	-	93.0	-	
	Q3 HII		-	-		-	
	Q4		-	-	-	-	

(g) NIESR include steel investment; OECD exclude residential investment

BACKGROUND ECONOMIC BRIEFING

COMPARISON OF SELECTED FORECASTS

FORECASTER		CBI	NIESR REVIEW	LONDON BUSINESS SCHOOL	PHILLIPS & DREW	GOVERNMENT FORECAST	NIF

STOCKBUILDING (£ million) 1975 prices

Table 13

		CBI	NIESR REVIEW	LONDON BUSINESS SCHOOL	PHILLIPS & DREW	GOVERNMENT FORECAST	NIF
1979	Q1 HI	650	682	432	378	250	243
	Q2	-300	184	400	50		- 16
	Q3 HII	80	77	356	100	200	127
	Q4	100	-80	57	100		35
1980	Q1 HI	70	38	-93	50	-150	- 38
	Q2	-10	-12	-9	20		- 98
	Q3 HII	-40	-92	0	20		- 75
	Q4	-80	-83	-135	0		- 67
1981	Q1 HI				-20		- 47
	Q2				-20		
	Q3 HII						
	Q4						

PUBLIC SECTOR BORROWING REQUIREMENT (£bn)

Table 14

		CBI	NIESR REVIEW	LONDON BUSINESS SCHOOL	PHILLIPS & DREW	GOVERNMENT FORECAST	NIF
Financial year	1979/80	NO	8.8	8.5	8.2	8¼	8.3
	1980/81	PUBLISHED	10.3	10.9	6.9		9.7
	1981/82	FORECAST		12.3			

UK UNEMPLOYMENT (000s) (h)

Table 15

		CBI	NIESR REVIEW	LONDON BUSINESS SCHOOL	PHILLIPS & DREW	GOVERNMENT FORECAST	NIF
1979	Q1 HI	NO		1362	1351	NO	1351
	Q2	PUBLISHED		1429	1304	PUBLISHED	1312
	Q3 HII	FORECAST		1437	1300	FORECAST	1344
	Q4		1395	1451	1320		1471
1980	Q1 HI			1462	1360		1567
	Q2			1464	1440		1611
	Q3 HII			1465	1500		1721
	Q4		1675	1478	1550		1827
1981	Q1 HI			1885 (Q1–Q4)	1600		1928
	Q2				1630		
	Q3 HII						
	Q4						

(h) NIESR, LBS publish GB unemployment figures and OECD only a percentage figure: these have been adjusted approximately

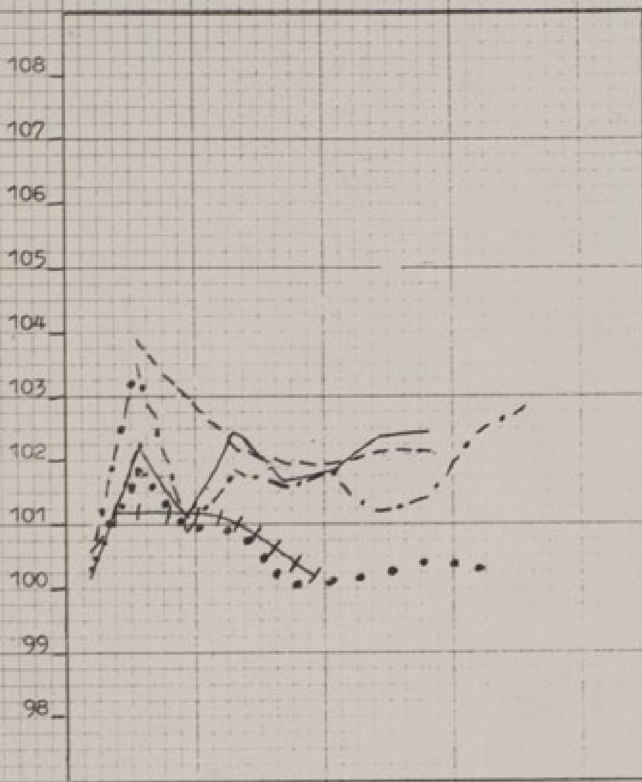
SECRET

FORECAST CHARTS

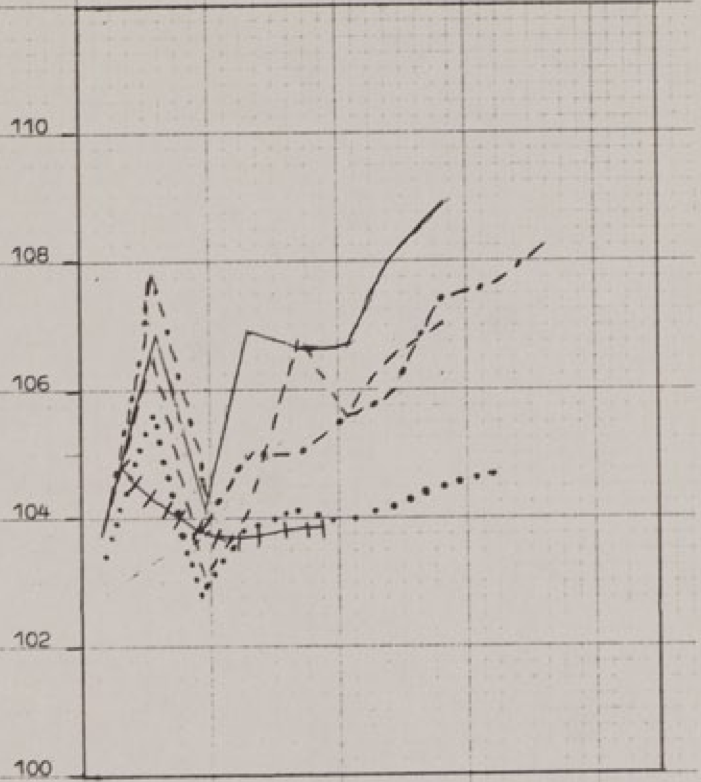
Where graphs are based on an index, 1978 H1 = 100

KEY
——— NIESR
- - - LBS
-·- P&D
+++ GOVT
··· NIF

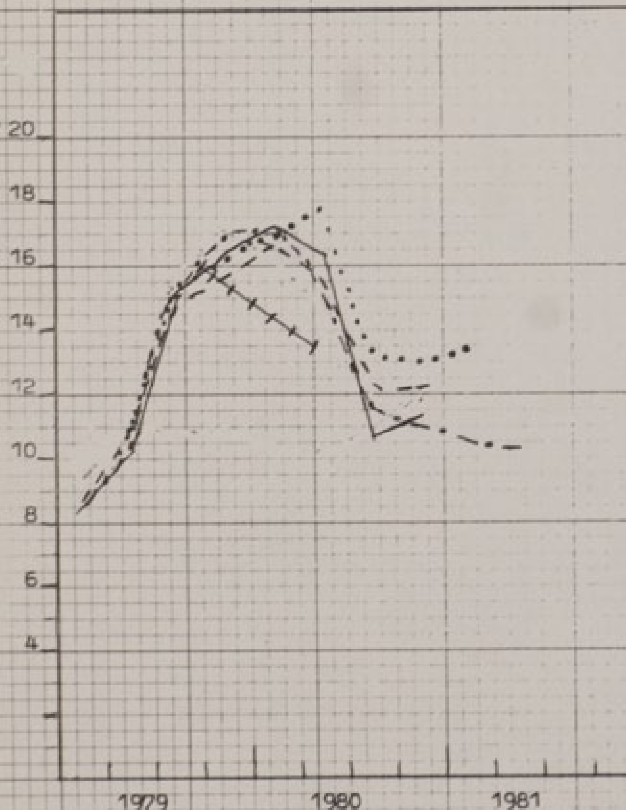
GROSS DOMESTIC PRODUCT



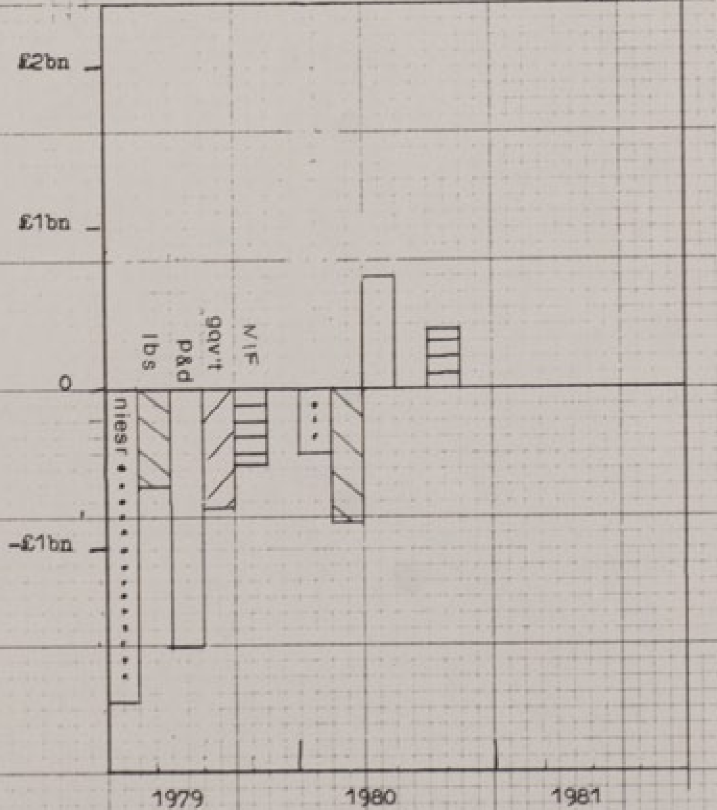
CONSUMERS' EXPENDITURE



CONSUMER PRICES : % change on yr earlier

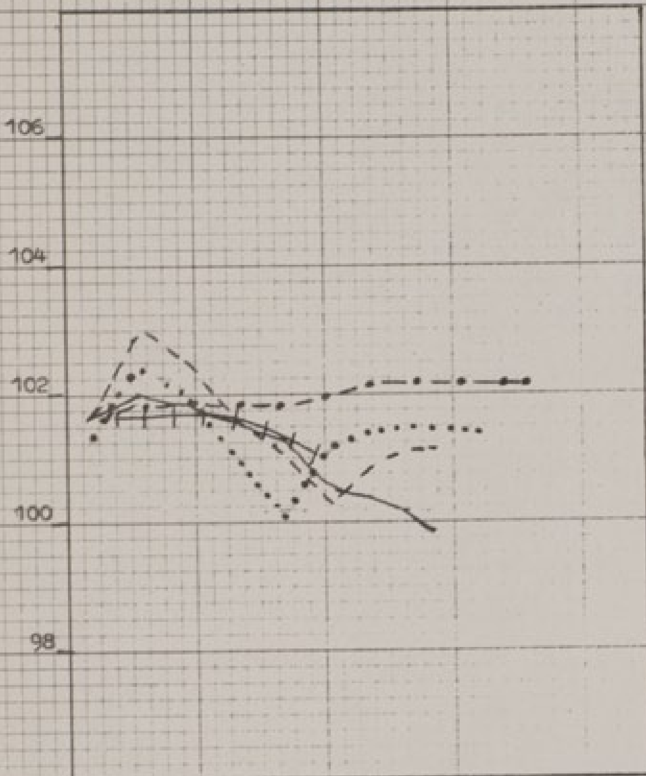


CURRENT ACCOUNT OF THE BALANCE OF PAYMENTS

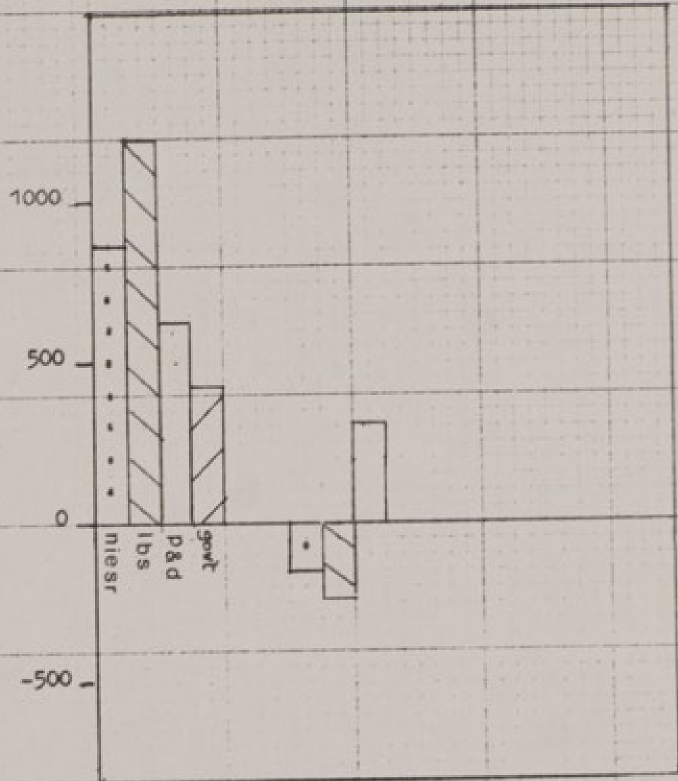


NB Graphs in index number form show the progression of series for each forecast, but bases are not necessarily equivalent in absolute levels

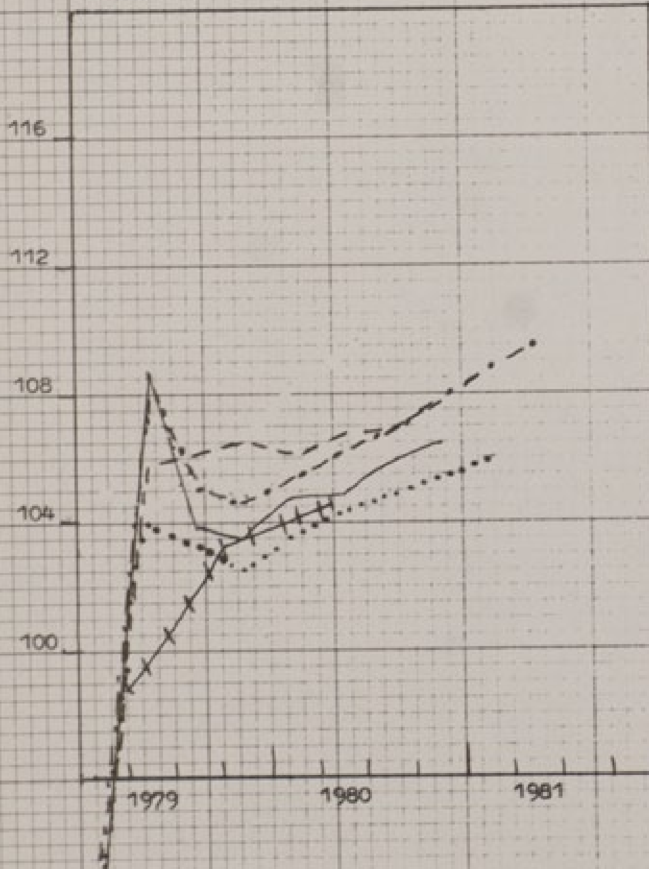
PUBLIC AUTHORITIES CURRENT EXPENDITURE



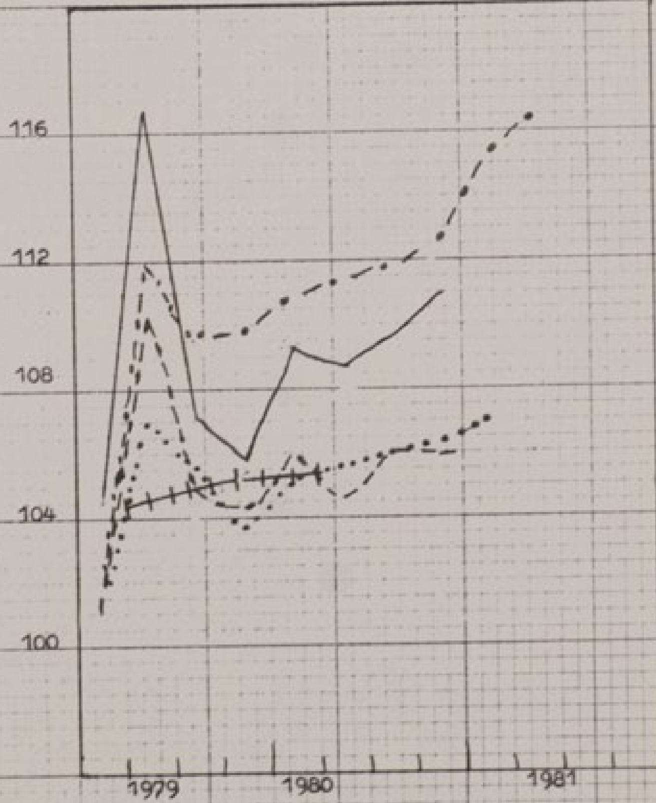
STOCKBUILDING (1975 prices)



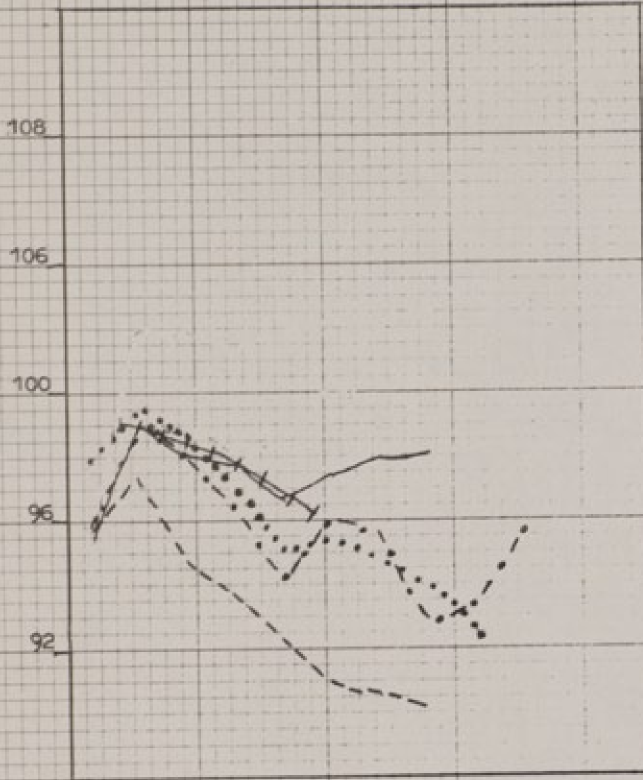
EXPORT VOLUME



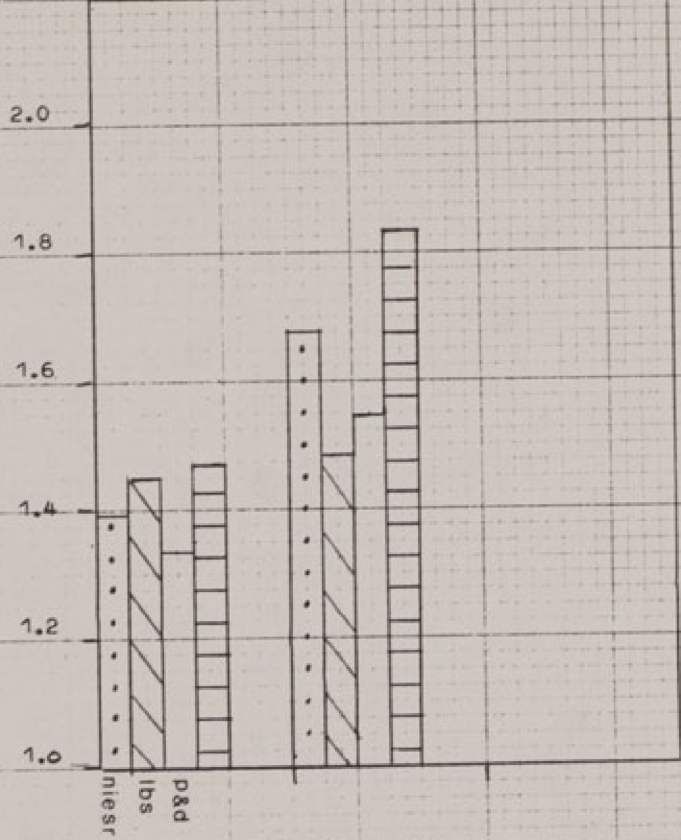
IMPORT VOLUME



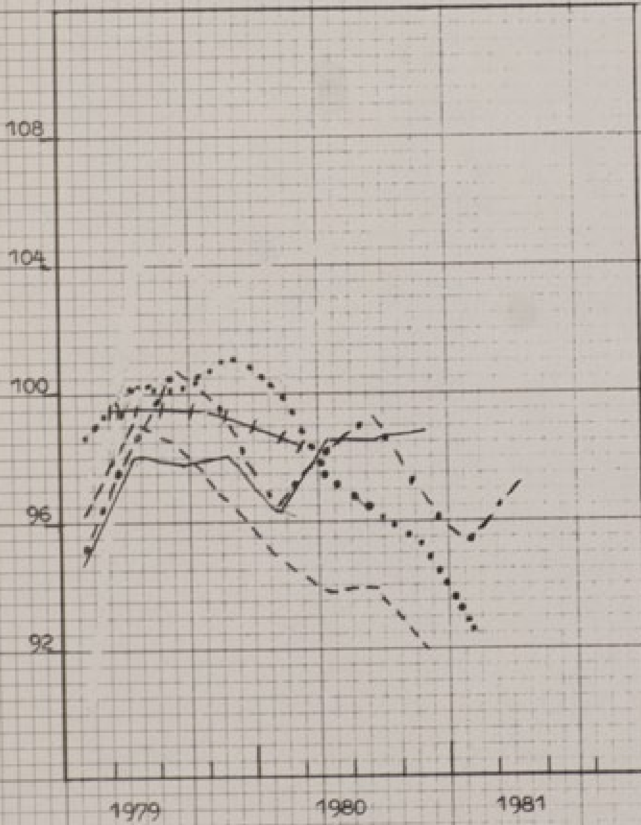
GROSS DOMESTIC FIXED CAPITAL FORMATION



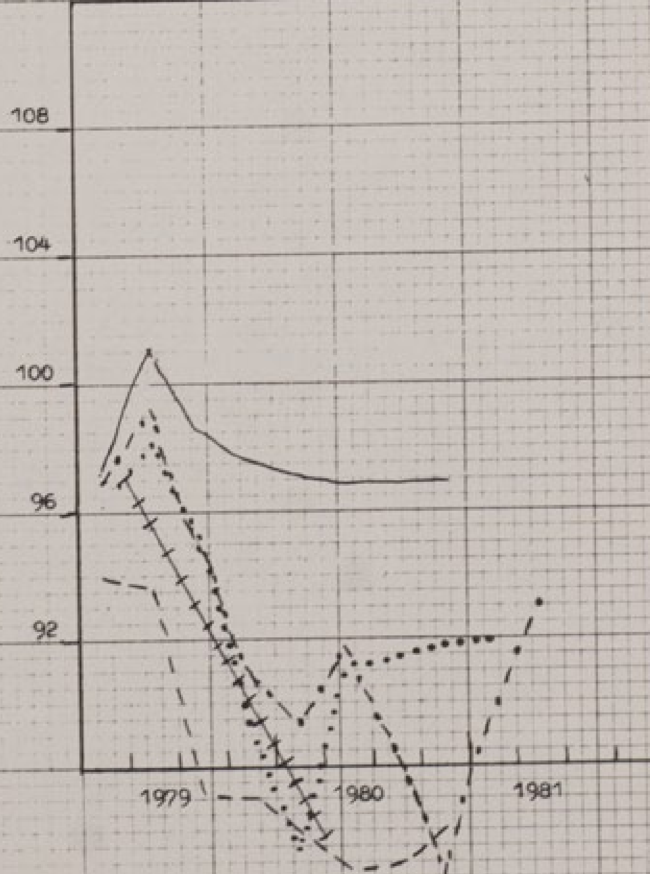
UNEMPLOYMENT (4th QTR) Millions



PRIVATE FIXED INVESTMENT



PUBLIC FIXED INVESTMENT



Text: Summary

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Summary Tables

1. 1979
2. 1980

Text: Detail

Detailed Tables

1. Gross Domestic Product
2. Manufacturing Production
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4. Real Personal Disposable Income
5. Consumers' Expenditure
6. Public Authorities' Current Expenditure
7. Current Balance of Payments
8. Export Volume
9. Import Volume
10. Gross Domestic Fixed Capital Formation
11. Private Fixed Investment
12. Public Fixed Investment
13. Stockbuilding
14. PSBR
15. Unemployment

Graphs

Sources

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Ech. M cc Master
Civil Service: Manpower
Pt 2

NOTE FOR THE RECORD

The Chancellor of the Exchequer called on the Prime Minister at 0845 this morning.

They discussed the Treasury note on "Domestic Monetary Prospect and Bank Borrowing" enclosed with Martin Hall's letter of 12 September. The Prime Minister expressed concern at the fact that bank lending to the private sector appeared to be continuing at a high level. She asked whether anything could be done to bring the figures down.

The Chancellor explained that the recent high level of lending had surprised most analysts. The reasons for it were by no means clear. For the reasons set out in the note, it was likely that there would be a turn-down before very long; but this could not be guaranteed. The current strikes were aggravating the financial position of the company sector, and if they continued this would tend to add to bank lending. It was true that the "corset" control was not working very effectively: the banks could get round it by manufacturing reserve assets. But there was no reason to believe that closing that loophole would in itself prevent bank lending from rising. Banks would find some other way. Lending to the personal sector, although it had risen fast, only represented 17% of total lending.

The Prime Minister said that she hoped that Bank lending would turn down. One idea might be to call in the Chairmen of the clearing banks to discuss the reasons for the continued high lending levels, and anything which they might do to bring them down. She urged the Chancellor to keep in close touch with Gordon Pepper and other market analysts.

The Prime Minister then raised the question of the Treasury Departments' contribution to the Civil Service cuts exercise. She said that she was very disappointed by the Chancellor's response

/ to

to Lord Soames' options exercise. In particular, the Chancellor was only proposing a reduction of 6.6% for the Inland Revenue. The Revenue staff had increased by more than 10,000 since 1970 and she could not believe that a more substantial reduction was not possible. She intended to support Lord Soames in Cabinet in urging for a greater reduction.

The Chancellor explained his difficulties: in particular, he said that 6.6% was the maximum that could be achieved by cutting back functions. He would, of course, be trying to improve efficiency as well, but this did not appear to be part of the exercise and no staff cuts had been scored against this aspect. The Prime Minister replied that she could not agree: she did not mind how the Chancellor found the savings, but they must be found.

13 September 1979

Your Ref

with compliments

Michael Portillo

Treasury Chambers
Parliament Street
London SW1P 3AG
Tel: Direct Line 01-233
Switchboard 01-233-3000

(Adam Ridley suggested you might like to see this).

12/9

CHANCELLOR OF THE EXCHEQUER

cc Financial Secretary
Sir Douglas Wass
Sir Lawrence Airey
Mr Littler
Mr Middleton
Mrs Gilmore
Mr Riley
Mr Williams
Mr Ridley
Mr Cropper

Chief Cashier

MEETING WITH THE PRIME MINISTER: 13 SEPTEMBER
MONETARY PROSPECT

R 13/9

You may like some briefing on the particular points which the Prime Minister may raise when she discusses the note with which you have provided her.

General situation

2. The Prime Minister will presumably be concerned that there has not yet been an opportunity to bring down interest rates, and there is no certainty that it will be possible to do so in the next month or two. It would certainly be premature to think of bringing them down now - indeed it is far from certain that if we brought down MLR at this juncture market interest rates, which is what really matters in relation both to bank base rates and building societies, would follow. We may be in a better position to make a judgement in a month's time, when the new forecasting round will have enabled us to make a comprehensive reassessment of the prospect for the rest of this financial year.

3. It is just possible that developments in the financial markets and the forecasts may be such that it would be justifiable to reduce MLR on Thursday 11 October, to coincide with the next meeting of the BSA Council. But the chance is small. More generally, the BSA recommended share rate (12.5%)* is so far below the present level of market interest rates (local authority three month rate is currently 14⅛%) that it seems extremely unlikely that market rates will fall sufficiently in time for the building societies to be ready to move down their share rate, which is what would be necessary if the increase in mortgage rates on 1 January

* grossed-up

w[illegible]e not to take effect. (Financial markets are so unpredictable, that it is not impossible, just unlikely.)

Bank lending

(a) Credit cards

4. The Prime Minister's Private Secretary has said that she has expressed concern about the extent to which credit cards may have led to increases in bank lending. Credit given through Access and Barclaycard is included in the bank lending to persons figures of the respective banks: the amount outstanding is about one-fifth of total lending to persons, other than for house purchase - about £1 billion - and so under 3% of the total bank advances outstanding. (We do not have precise figures for reasons of commercial confidence.) Credit in respect of such cards may have formed a higher proportion, of course, of the increase in particular months - particularly in June and July last. You may like to draw on the following points in discussion:-

(i) Personal lending as a whole has tailed off. The monthly figures for the clearers, not seasonally adjusted, are:-

	£ million
June	276
July	130
August	62

The August figure is slightly below the average level for the previous three months, March to May.

(ii) Personal lending is therefore, probably, not the main problem.

(iii) The existence of credit cards has almostly certainly made it easier for some people to get bank credit: but to a very significant extent it has replaced other forms of bank lending, notably personal loans for the purchase of durable goods. It has probably also to some extent replaced an element of trade credit which would, in the past, have been financed by the bank lending to the retailer providing the credit.

(iv) The credit card companies agreed, in late 1973, to raise the minimum monthly repayment to 15%, at the same time as there was a sharp tightening of hire purchase controls. The request to do this was removed some 18 months ago, on the grounds that

other forms of credit control had been relaxed, and its continuance presented a discrimination against one form of consumer credit. (The diversification of forms of consumer credit, particularly following the Consumer Credit Act, means that hire purchase controls would no longer be effective over the greater part of the field; the possible exception relates to large items, such as cars and caravans.)

(v) Given the relative scope of credit card credit in relation to total bank lending, there would seem to be no case for introducing a discriminatory control in relation to them.

(b) <u>The corset</u>

5. The fact that a number of banks have been in, or near, the penalty zone for the SSD scheme will have caused a number of banks to be more careful about granting facilities to non-priority borrowers. (The directional guidance from the Bank to banks is in terms of restraining lending to the low priority sectors sufficiently to enable the necessary finance to be available to the priority sectors, notably manufacturing, exports etc.) It will also have had an interest rate effect for some borrowers, since many medium term loan agreements provide for the margin over market rates to be widened if the lending bank enters into the penalty zone under the SSD scheme - this therefore reinforces the effect of the general rise in interest rates in deterring borrowers from making full use of their facilities. These two effects should taken together have a progressive effect on bank lending.

6. But, as explained in the paper on monetary control for the July seminar, the SSD scheme has to be regarded very much as a "safety-net" - it is not by itself sufficient to act as a control for sterling M3.

7. It will be necessary to roll-forward the guideline under the SSD scheme within the next two months or so. It will then be for consideration whether the rate of growth allowed for should be reduced. But it would be premature to reach a judgement on this until we have the new forecasts next month.

(c) Acceptances

8. The Prime Minister may seize on the references to the take up of bank acceptances outside the banking system mentioned in the note, and ask whether they should not be brought under control, by for example requiring them to be included within the SSD scheme levels. The simple answer is that any system of direct controls over the banking system, such as the SSD scheme or even a monetary base system, will encourage the development of alternative channels outside the control system when that control system begins to impinge on the financial institutions concerned. The existence of these alternative channels will mean that to that extent the sterling M3 statistic will be understating the growth of liquidity and credit. But over time the alternative channels will also be influenced by the more general factors affecting bank lending, notably interest rates, so that the disparity between the statistic and the effect on the economy will reduce. Acceptances are really the banking system's safety-valve at present. If they were brought within the control, then other forms of disintermediation would develop, and they would almost certainly be less desirable. A great advantage of acceptances is that they are reported, so we know the scale of the problem, and they do not appear to lead to problems on prudential grounds, at least at present. But the alternative routes to acceptances, such as greater trade credit, and bills not accepted by the banks, could not be monitored, and might cause potential problems. It therefore seems preferable to have the avoidance device that we know, than one which we do not.

Other forms of direct control

9. It is presumably possible that the Prime Minister may raise the question of the alternative of other forms of direct control over bank lending. The main points on this were made in your letter to Mr Prior of 25 July last. I attach a copy for ease of reference. (Top copy only.)

J.M.B.

J M BRIDGEMAN
12 September 1979

COVERING SECRET

Econ Pol. 2

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

12th September, 1979

Dear Tim,

THE MONETARY SITUATION

..... I enclose a note on the present domestic monetary situation as a basis for discussion of this when the Prime Minister sees the Chancellor tomorrow. The Chancellor has seen and approved it.

Yours ever,

MH

(M.A. HALL)
Private Secretary

T. Lankester, Esq.,
Private Secretary,
10, Downing Street

COVERING SECRET

DOMESTIC MONETARY PROSPECT AND BANK BORROWING

Note by the Treasury

General Prospect

Since the Monetary seminar in July, we have had figures for two more months - banking July and August, the latter to be published on Thursday.

2. £M3 grew by just under 1 per cent in both months - about the top of the target range. Because of monthly fluctuations two months is too short a period on which to base statements about the underlying trend. Looking backwards, in the financial year so far £M3 grew at about 14 per cent pa.

	£ billion (seasonally adjusted)	
	May/June	July/August
CGBR	2.10	1.07
less sales of cg debt outside banking system		
gilts	-1.70	-1.30
other	-0.27	+0.24
Bank and overseas lending to other public sector	-0.08	+0.32
Bank lending to private sector	+1.84	+1.06
In £ overseas	-0.01	+0.12
DCE	1.88	1.51
External (net)	-0.13	-0.46
Other adjustments	-0.42	-0.12
Change in £M3	+1.33	+0.93
Equivalent Annual Rate (%)	16.6%	11.0%
Memorandum		
Increase in acceptances held outside the banking system	+0.27	+0.45

3. In broad terms, bank lending to the private sector and overseas has continued to be at a much higher rate, and with an exceptionally high figure in banking June, than was allowed for over the year as a whole in the post-Budget forecast (referred to in the note for the Prime Minister's July seminar): £3.0 billion in 4 months compared with £7 billion for the year. But this has been significantly offset by higher gilt sales than this allowed for: £3.0 billion in 4 months, plus payments due on part-paid stocks of £0.6 billion, compared with just over £6 billion estimated for the year. For the rest, the lower growth of the money stock in the second two months compared with the first has been due to the monthly incidence of the CGBR, and other fluctuations, notably the contractionary effect of external items in banking August - there was little overall change in the reserves, but the deficit of the private sector, on capital and current account, with overseas was largely offset by an increase in non-resident bank deposits.

4. Looking forward, the Treasury and Bank's best guess is that the growth of the money supply in banking September will be about the same as in the preceding months, but that thanks to the central government actually being in surplus, money supply may fall in banking October, before growing again in November. The net effect may be to bring the rate of growth of the money supply over the first five months of the target period (i.e. mid-June to mid-November) to the middle of the target range. This assumes only a slight fall in the underlying rate of increase of bank lending to the private (there will be monthly fluctuations in the recorded figures due to the timing of tax payments and reliefs). But there are many other uncertainties: in particular

i. we cannot be certain about the effect of external factors - the high bank lending may have been due in part to a switch from foreign borrowing, and the external adjustment between DCE and M3 in August may have been unique, and could be reversed in part (the Bank and we are

seeking to establish more clearly the factors underlying these external effects);

ii. although we do not need significant net gilt receipts until banking November, we are faced with another substantial maturity then and will need substantial sales to finance it. This could pose problems. Sentiment in the gilts market may be affected in the next two months by the fact that it will not be apparent to the market that the money supply is coming within the range until the October figures are published - first for the CGBR and then for the money supply. Sentiment could also be affected by industrial disputes, and by any high pay settlements.

Bank Lending to the Private Sector: Recent Trends

5. The monthly increase in bank lending in nominal terms started to accelerate towards the end of last year, from a level of £300-400 million a month to about £500 million a month: it rose sharply in February and since then has averaged nearly £1 billion a month - if banks acceptances held outside the banking system are included. These figures for the monthly changes conceal the fact that the acceleration had started somewhat earlier when looked at in real terms.

Changes in Lending Outstanding

	Year to mid-Feb 1978	Year to mid-Feb 1979	6 months to mid-August 1979 (Annual Rate)
1. £ bank lending to the private sector			
% increase in nominal terms	12.2%	18.1%	23.5%
% increase in "real" terms	1.1%	8.3%	2.2%
2. £ bank lending to the private sector, plus non-bank holdings of banks acceptances			
% increase in nominal terms	11.3%	19.6%	28.4%
% increase in "real" terms	0.3%	9.7%	6.3%
Memo item			
Increase in real GDP (at factor cost)	1.3%	1.6%	na

Thus there was little change in the real level of bank credit outstanding in the year to mid-February 1978, inspite of the sharp fall in interest rates. But there was an 8 per cent or 9 per cent increase in the following year, despite rising interest rates. Since February that real increase continued until it was offset by the sharp "once-for-all" increase in prices in the Budget: the level of lending may not yet have fully adjusted to that changes.

6. It is difficult to discern yet a downward trend, if the June figure is regarded as a "freak". Allowing for acceptances, and in the last two months very crudely for such exceptional factors, e.g. the Post Office strike and the incidence of tax payments, as we can identify, the sequence for the underlying growth is:-

	£bn
March	.8
April	.7
May	.75
June	1.4
July	.7
August	.95

The Recipients of Bank Lending

7. We have only partial information about the recipients of bank lending - and none about its purpose. The annex, which summarises the available information, shows that in the last eighteen months the rate of growth has been fairly evenly spread between sectors, the exception being the more rapid growth of lending to the services sector in 1978: the latter includes the financing of leasing to other sectors. In 1978 advances to persons grew about 13 per cent in real terms. In the last 6 months however the growth of personal lending (which includes lending through Access and Barclaycard) has been 17 per cent in money terms, some 7 per cent in real terms. (These figures are not seasonally adjusted and so should not be converted into annual rates.) However, personal sector lending is not a large element in the total - accounting for 17 per cent of the stock in mid-August.

Bank Lending: the Prospect

8. The increase in bank lending over the last 18 months has been much greater than we would have expected on the basis of past experience, especially given the increase in interest rates over that period. Clearing bank base rates were 6½ per cent in the first quarter of 1978 and are now 14 per cent. Past experience has suggested that the growth in lending outstanding is reasonably stably related to the growth in prices and real incomes, subject only to some time lags. The recent break with past experience makes it very difficult to predict when lending will turn down: in the early months of 1979 we thought that it might only be a temporary break due to factors such as the disruption following the road haulage dispute, but it has now persisted too long for such temporary factors to be the main cause.

9. There are a number of reasons to expect a turndown in the rate of increase in lending at some stage and possibly even a reversal:-

i. continuation of present rates of increase would involve the ratio of lending outstanding to nominal GDP to continue to rise. It would mean a rate of growth of lending outstanding some 10 per cent p.a. faster than the rate of growth of nominal GDP in the coming months, which is implausible since it has already been increasing faster for the last 18 months, the step change in nominal GDP due to VAT apart;

ii. interest rates should be progressively affecting the demand for lending: though they tend to take effect after a lag, base rates have now been over 12 per cent for nearly 10 months, and they should now be having an effect;

iii. similarly, attempts by the banks to restrict lending by tightening their criteria for granting facilities takes time to take effect. The clearers and some other banks

have only been under pressure in relation to the SSD scheme or "corset" for a few months and they can generally only "ration" credit when new facilities are granted, or existing facilities renewed. The clearers have been tightening the criteria for personal and other low priority lending recently and this should begin to have an effect soon. (Banks can do little to influence the use of existing facilities, except encourage switching into acceptances.)

iv. some of the recent lending to persons may well have been in anticipation of the tax rebates which are due in November, and so may be repaid then.

10. On the other hand, there are two reasons for thinking that the turndown may not come quickly or sharply:

i. borrowers may not have adjusted fully yet to the step-change in prices following the Budget e.g. retailers to the higher rates of VAT on their stocks;

ii. the company sector will be facing cash flow problems, for example from the slow-down in activity leading to involuntary increases in stocks, the higher exchange rate reducing the sterling value of export receipts, and increases in pay before they are passed on in prices. These factors can be expected to add to some companies' demand for bank finance at least until they have been able to adjust to the lower level of activity and higher level of prices.

11. While therefore we are reasonably confident that the rate of growth of bank lending will fall eventually, we cannot be confident about the timing.

Conclusion

12. It is possible that the growth of £M3 in the first half of the target period from mid-June to mid-April next may be about in the middle of the target range, notwithstanding the growth in bank lending. The growth of the £M3 statistic will, however,

understate somewhat the changes in liquidity and credit because of disintermediation through banks acceptances held outside the banking system, and so overstate the potential effect of monetary policy on inflation.

13. There is no case at present for an increase in interest rates. But it is too soon to tell whether there will be scope for a reduction in either long or short term rates: while there is a reasonable chance that, thanks partly to the fluctuations in the CGBR, the rate of growth in the first 5 months after the Budget will be about the middle of the target range, we do not yet know whether that will continue. We may be in a better position to judge in mid-October by when:-

i. we will have the forecasters reassessment of the prospect for the rest of the financial year;

ii. in particular, we will have the reassessment of the PSBR for the rest of this year, taking account of any decisions on disposals;

iii. in particular we will know whether the expected central government surplus in banking October has occurred;

iv. we may have a somewhat better understanding of what has been happening on the external side, and what may result from the relaxations of exchange control;

v. we will know the gilt-edged markets reaction to the continuing relatively high money supply figures;

vi. we will have one months further bank lending figures.

ANNEX: SECTORAL ANALYSIS OF BANK ADVANCES

Unadjusted, percentage increase

	12 months to mid-Feb 78	12 months to mid-Feb 79	6 months to mid-Aug 79 (provisional - not at annual rate)
1. All banks: advances and acceptances in sterling to UK residents			
Manufacturing	12	20	14
Other Production	13	17	17
Financial	1	12	11
Services	17	29	16
Persons	16	23	17
Total	12	21	15
2. Clearers: advances in sterling to UK residents			
Manufacturing	6	21	13
Other Production	15	18	18
Financial	-3	6	-1
Services	15	27	12
Persons	16	24	17
Total	13	18	12
Clearers' facilities, percentage utilisation, end period	(53.7)	(53.9)	(55.9)

Tim — we spoke — for your personal use.

With the Compliments
of the
Chancellor of the Exchequer's
Private Secretary

[signature]

Treasury Chambers,
Parliament Street,
S.W.1

10/9.

MR. BATTISHILL

cc Financial Secretary
Sir Douglas Wass
Sir Kenneth Couzens
Sir Lawrence Airey
Mr. Middleton
Mr. Byatt
Mr. Barratt
Mr. Bridgeman
Mr. Hancock
Mr. Riley
Mrs. Lomax
Mr. M. Williams
Mr. Grice
Mr. Bell
Mr. A. Ridley
Mrs. Gilmore

CF
Back-up for mtg with Chancellor tomorrow.
TL

TARGET VARIABLES

I am replying to the enquiry in your minute of 3 September to Mr. Middleton, because I held a meeting with the Bank of England on Friday evening to take stock of the work being done to follow up discussion at the Prime Minister's seminar in July.

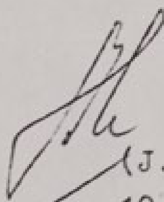
The main area to be covered is that of "monetary base control". The Bank of England have agreed to take the lead in preparing the joint papers, because we very much need for this stage of discussion to get the analysis right in terms of institutional and operational features of the banking system, etc. We identified three specifications of monetary base schemes, which we think adequate to give coverage of the spectrum of what might be prima facie practicable or at least worth positive examination (i.e. ruling out some of the naive extreme versions). We shall of course go over the Bank of England work and produce joint papers, whether fully agreed or reflecting differences of view.

A parallel exercise, which I think was not discussed at the Prime Minister's seminar in July but would need to be mentioned in the context of further discussion of the monetary base, is work which the Bank are initiating on the abolition of the banking "reserve assets ratio", and the substitution of some more appropriate liquidity norm for prudential purposes. They see this as something which should be done in the early stages of application of the new Banking Act, which certainly seems sensible. We are examining papers they have written on this subject, and on its relationship with

possible forms of monetary base control.

For the present, we are not re-examining arguments about the choice of monetary target, although there may be some implications for this in the paper on monetary base control, and of course the separate work which Mr. Bridgeman is doing on wider monetary aggregates will continue.

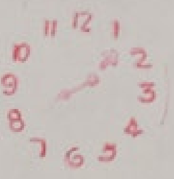
We are aiming to have papers to put to the Chancellor and Financial Secretary early in October, on the basis that the Prime Minister might wish to return to this subject fairly soon after the Party Conference is over. On the reserve assets ratio, and we think also on monetary base control, we shall want to build on the papers produced for the seminar documents which can be published to elicit comments from the banking system on the ratio question and the proposed substitute, and to contribute more widely to public debate on the monetary base, but this of course will be a point for consideration when Ministers have seen the papers.



(J.G.LITTLER)

10 September, 1979

10 SEP 1979



SECRET

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

Prime Minister
Money supply figures looking slightly better because of lower borrowing by government. The Chancellor will be sending you a further note on monetary developments before your mtg with him on Thursday.
TL
10/9

PRIME MINISTER

GILT EDGED MARKET

I thought that you might like to know a little of the background to the decision to announce the new tap stocks on Friday, of which you have already heard.

2. The growth of the money supply in banking August was less than we had expected - a little below 1 per cent - largely because it was reduced by a net switch of overseas residents holdings of sterling from the non-bank private sector to bank deposits. Domestic credit expansion was still disturbingly high - about £1 billion for the third month running.

3. The Treasury and Bank's best guess is that the growth of the money supply in banking September will be about the same, but that thanks to the Central Government actually being in surplus, money supply may fall in banking October, before growing again in November. The net effect may be to bring the rate of growth of the money supply over the first five months of the target period to the middle of the target range. But there are so many uncertainties that we cannot rely on this happening; we may feel more confident in a month or so when we know what is happening to the CGBR. More important it will not be apparent to the market that the money supply is coming within the range until the October figure is published in mid-November: until then the rate of growth will not appear much different from that which we inherited.

/4. While

SECRET

4. While there is not therefore an absolute necessity for further gilt sales until November, the Governor and I would feel considerably happier if we could achieve some more before then, given the uncertainties and the one sided risk for the Government if events do not turn out as expected. The sooner we can be seen to be bringing down the rate of growth of the money supply, the greater confidence in our policies and their effect on inflationary expectations, and the sooner we may be in a position to allow some fall in short and long term interest rates.

5. We have been without either a medium or long tap for nearly a month now. But the gilts market has been such that the announcement of a new tap would only have depressed it further. However the market, somewhat unexpectedly, revived sufficiently on Wednesday for the Bank to conclude yesterday that it would be possible to announce a further issue without adverse effects, with a prospect of achieving sales as soon as the market was heartened by further good news. I concluded that it was right to take the opportunity to get a new tap stock into place: it had to be announced on Friday, if at all, as we cannot for technical reasons announce one next week.

6. One stock is a medium - maturing in 1988-89 - as envisaged in Nigel Lawson's minute to you of 19th July: there will be £600 million, £400 million for the market and the balance for the National Debt Office. But I decided that it was also necessary to issue a long tap, since the Bank considered that to issue a medium alone would be interpreted as a signal that we were ready for long term rates to fall - which we are not yet. For this purpose a modest amount, £500 million, of an existing stock, 12 per cent Exchequer 1999-02, should suffice. Both Stocks will be part paid, with the greater part payable in banking November.

/7. The

7. The intention is to get the stocks in place, so that they are there to be sold whenever the market strengthens further. This may not be in the next few weeks, although it would be very useful if there were some sales before banking September ends on 19th September, so that the initial payments reduce the rate of monetary growth this month.

8. I am sending a copy of this minute to the Governor.

(G.H.)
10 September, 1979

PRIME MINISTER

New Gilts Issue

The Chancellor and the Governor want to announce two new issues at 3.30 p.m. this afternoon:

(i) £400 million of medium stock

(ii) £500 million of long term stock

The previous medium and long taps have been exhausted. The Chancellor and the Governor want to issue new taps because the market appears to be picking up a little, they argue - rightly - that if there is an opportunity to sell stock we should take it. This is all the more important now that the money supply figures for August are likely to be not very good.

At the Monetary Seminar at the end of July you said that you would be prepared to give the Chancellor and the Governor discretion in deciding the balance between short and longer term borrowing. However, I thought you should be aware of what they are proposing. The £500 million of longer tap is in fact a rather smaller amount than they have been issuing recently: the long tap is normally issued in trenches of between £800 - £1200 million.

T.

7 September 1979

PM - yes

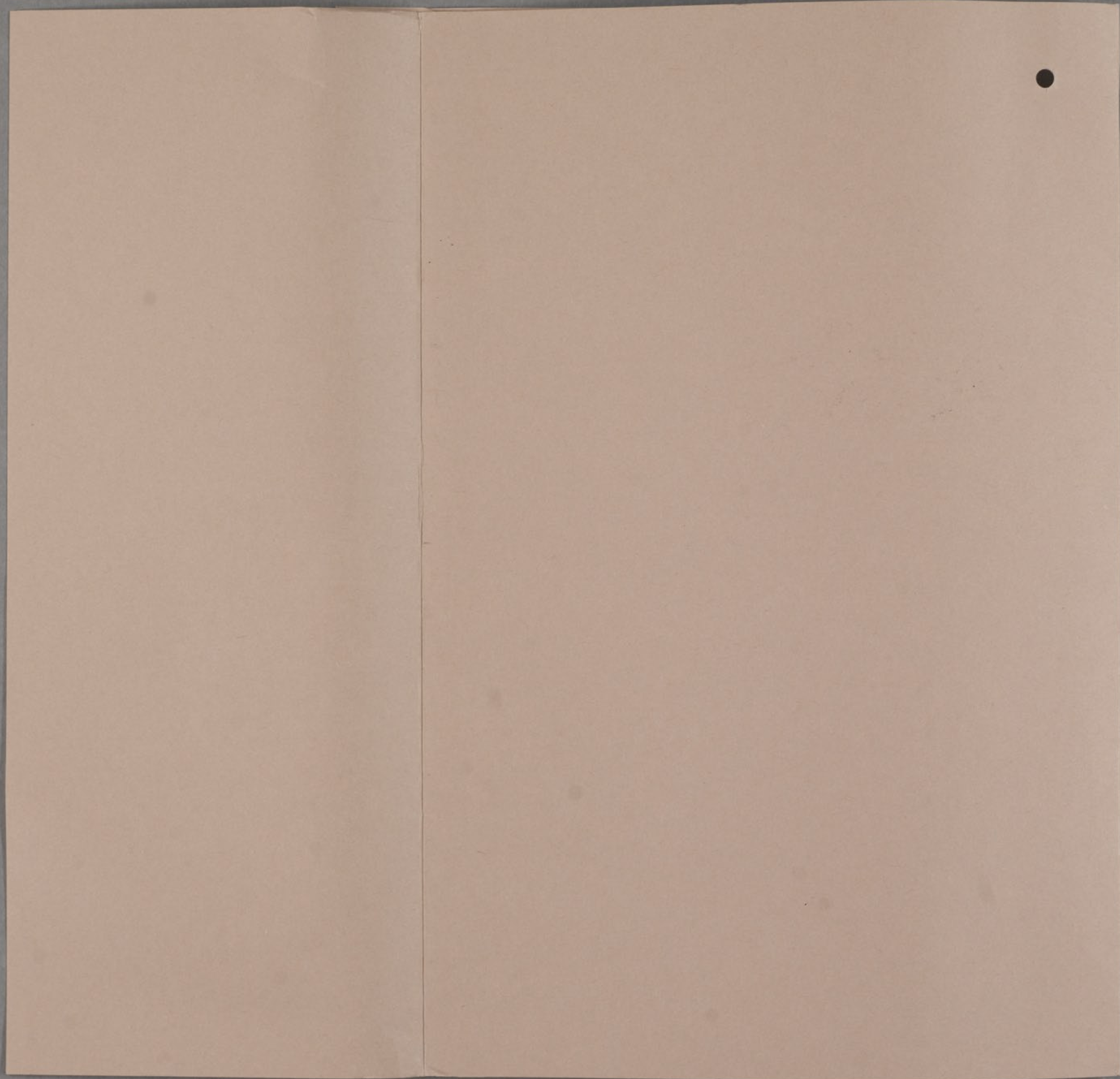
T.

PART 1 ends:-

Ch Ex to S/S Emp 25.7.79

PART 2 begins:-

TL to PM 7.9.79



END

Filmed at the National Archives (TNA) in London

February 2010