

PREM 19/183

PM's meeting with Gordon Pepper.

- Discussions on the Budget and Monetary Policy.

Part 1

ECONOMIC
POLICY

PART 1.

May 1979

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
21.5.79							
22.5.79							
4.7.79							
18.7.79							
3.7.79							
23.7.79							
9.79.							
24.10.79							
19.11.79							
PA 24.1.80							
PA 4.3.80							
PA							
PA							
— FRIENDS —							

PREM 19/183

PART 1 **ends:-**

Greenwell
Monthly Bulletin 102 (MARCH)

PART 2 **begins:-**

Greenwell
Monthly Bulletin 103 (APRIL)

010

W. Greenwell & Co.

Bow Bells House,
Bread Street, London EC4M 9EL

Telephone: 01-236 2040 Telex: 883006

W. Greenwell Associates (Investment Adviser) 450 Park Avenue, New York, N.Y. 10022
Telephone: 212 832 7428 Telex: 710 5815122

Scan P1
N.G.



MONETARY BULLETIN

No. 102, March 1980

R

Contents

This Bulletin contains the following sections.

- (i) The monetary background on the eve of the budget.
- (ii) Monetary control - our initial reactions to the Government's Green Paper.
- (iii) A discussion of current distortions to the monetary data.
- (iv) Our regular comment on the latest monetary statistics.

The monetary background on the eve of the budget

Because inflation is still rising, many people are querying whether the Government's monetary policy is working as expected. They doubt the validity of monetary economics and question the Government's reliance upon it.

In contrast, the events of the last year or so, both at home and abroad, seem to us to confirm the correctness of monetary analysis.

Firstly, there is the behaviour of worldwide inflation. As mentioned briefly in our last Bulletin, worldwide inflation has followed worldwide excessive monetary growth.

Secondly, the behaviour of the U.S. economy during the last year or so has been very similar to that of the U.K. economy in 1976. The exchange rate fell, price inflation rose and the behaviour of financial markets has enforced policy changes on the authorities. All this followed a gross excess of the domestic supply of money over the domestic demand for it.

Thirdly, U.K. inflation has risen since the end of 1978. This followed excessive monetary growth which started to recur in September 1977. The growth of sterling M3, for example, jumped from 6% in the year to September 1977 to 14% in the year to September 1978. The initial cause was an inflow of money from abroad. Subsequently, interest rates, which had been reduced in an abortive attempt to stop the inflow, were raised insufficiently. At about the same time the PSBR started to rise again, having fallen during the previous two years. Further and most importantly, the PSBR continued to rise after economic growth resumed so that the public sector continued to require extra funds at the same time as the demand for finance from the private sector also rose.

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 should also be stressed that the amount of excessive monetary growth in the U.K. was greater than published data for sterling M3 suggest, because of distortions caused by the corset, etc. The following table shows the annualised growth of a full range of aggregates between mid-July 1978 and mid-October 1979.

Table I

Annualised Growth Rates

July 1978 to October 1979

Notes & coin	14% p.a.
Retail M1	12½% p.a.
Sterling M3	11½% p.a.
M4	15% p.a.
M4 plus local authority deposits	16½% p.a.
M5	15% p.a.

Because of the excessive monetary growth shown above, inflation should have been expected to rise from its level of about 8% in 1978 to about 15% by now. In fact, it has risen to about 20% because of additional factors. More than three years of prices and incomes policies have come to an end and VAT was raised to 15% in last June's budget. The profile of price rises was also affected by the incidence of inflation abroad, mainly the rise in oil and commodity prices, although this was mitigated by the appreciation of sterling.

It should be noted that, such was its momentum, excessive monetary growth did not stop when the Conservative Government took office in May. The watershed seems to have been nearly six months later in October. The position since then is shown in Table II (the unwinding of the distortions to sterling M3 reflected in these figures will be discussed in more detail later):

Table II

	<u>Oct. '79 to Jan. '80</u>	<u>Oct. '79 to Feb. '80</u>
Notes & coin	5% p.a.	7% p.a.
Retail M1	-5% p.a.	-5% p.a.
Sterling M3	9% p.a.	10% p.a.
M4	6% p.a.	4½% p.a.
M4 & L.A. deposits	5½% p.a.	n.a.
M5	8% p.a.	7% p.a.

The crucial question is how soon will inflation respond to this reduction in monetary growth.

Monetary time lags

Inadequate monetary growth can lead to any combination of the following:

- (a) an inflow of money from abroad,
- (b) a slowdown of real economic activity, and
- (c) a direct fall in price inflation.

If the first is dominant, the exchange rate will rise and the response of price inflation will be quick, as it was in 1977. Unfortunately, the U.K.'s present exchange rate is already so high that our export industries are finding it extremely difficult to compete. There is no scope for a further rise in sterling (if anything the reverse seems more likely). The quick, external route to reduce inflation is not open.

The reduction in inflation will, therefore, have to follow the slower, domestic route. Orthodox monetary analysis suggests that, if exchange rates stay constant, there is a time lag of about a year before a slowdown in economic activity leads to a reduction in inflation. After a lag of a further nine months or so, the growth of wage rates starts responding to the combination of falling inflation and the supply of labour exceeding the demand for it.

Relating this to the present, the current slowdown in economic activity started last summer, for example unfilled job vacancies began to fall in July. Consequently, price inflation cannot be expected to peak before the coming summer and wage settlements may not fall before next spring. Lags of this duration are not a reason to doubt the validity of monetary economics.

Monetary control

Paragraph 6.3 of "Monetary Control", Cmnd 7858 (the Green Paper), sets out the authorities' immediate decisions:

- (i) "The Supplementary Special Deposits scheme (the corset) has come virtually to the end of its useful life, and should be phased out as soon as it conveniently can be;
- (ii) the requirement to maintain the 12½ per cent Reserve Assets Ratio appears to be no longer necessary either as a means through which interest rates are influenced or as a means of affecting the rate of growth of banks' balance sheets. It is proposed that it should end;
- (iii) the Bank of England is issuing a separate consultative document on the need for holding liquid assets for prudential reasons;
- (iv) it is necessary to have some cash requirement, to act as a fulcrum for the Bank when it wishes to generate interest rate changes. It is proposed that the present requirement, which applies only to the London Clearing Banks, should be replaced by one which applies more generally. The Bank will issue a detailed discussion paper on this;
- (v) the Special Deposits scheme should be retained to guard against the possible effects of excess liquidity in the banking system as a whole."

We support all these conclusions. The Bank and the Treasury should be congratulated on their highly critical analysis of the present system of monetary control and their decision to scrap it. We also welcome the separation of prudential from monetary controls. As far as a new system of monetary control is concerned, the possibilities span a spectrum which is described below, starting with least change and finishing with greatest change.

- (i) The authorities might have chosen to have no control ratio at all. The Bank might have advocated that it should be left (a) to study the behaviour of monetary growth as data became available, (b) to decide when action to correct deviations should be taken and (c) to decide for itself the appropriate alterations in interest rates, hoping for no interference from politicians and no undue pressure from markets.
- (ii) The Bank has decided instead to have cash ratios for all banks. The Bank argues for this to increase its control over interest rates. Although the Green Paper is not explicit, it follows that the U.K. will in the future have data for the cash base of the banking system, i.e. for a monetary base. The Bank does not at present intend to control the quantity of this cash base directly but it could start to do so quickly, as the Fed did on 6th October 1979 in the U.S. In our view this is a significant step forward, even if the authorities are underplaying it, and in due course could be of major importance.
- (iii) The snag with a central bank being left to decide on appropriate changes in interest rates is that, as history shows so clearly, the changes are often too little and too late. The experience of the U.S. during the last eighteen months is a horrible example of what can happen. Chapter 5 of the Green Paper is about "Indicator systems". The Bank has devised a possible system of automatic changes in interest rates linked to the behaviour of sterling M3. Such schemes have not up to now been described in economic literature. The Bank is pioneering. This suggestion should be considered with an open mind.
- (iv) The Bank opposes the scheme, which we have advocated, of quantitative control of the monetary base with mandatory ratios.
- (v) The Bank also opposes quantitative control of the monetary base without mandatory ratios. Its case against an early change to this scheme is sound. Such a scheme should probably evolve only from a successful scheme with mandatory ratios.

Returning to quantitative control of the monetary base with mandatory ratios, at this stage we would like to make two points. Firstly, events in the U.S. since 6th October 1979, when the Fed started quantitative control of the monetary base, are strong evidence that some of the Bank's arguments in Chapter 4 of the Green Paper are incorrect. This evidence has only become available recently, presumably after Chapter 4 was completed.

Secondly, the demand for money is not necessarily the same as the supply of it and the two may not equalise quickly. For example, the supply of money exceeded demand for a long time in 1972 and 1973; in technical language the money stock was supply determined. As explained clearly in the Governor's important Mais Lecture in February 1978, the Bank considers it appropriate to seek to influence the money stock by altering the demand for money through changes in interest rates. In this way, the Bank operates on the demand side.

In contrast, the monetary base approach concentrates on the supply side. The Bank's criticism of the monetary base approach in Chapter 4 misses the point because it uses demand side analysis. Proposers and opposers are using different types of analysis and have failed so far to communicate.

Put simply, the argument is as follows. The Bank is proposing that it should continue to supply all the cash which banks want, determining only the level of interest rate at which it is supplied. But given the availability of cash, bankers will continue to do everthing they can to expand their own businesses subject only to the price restraint imposed by the Bank. Under a monetary base system, in contrast, the Bank would control the quantity of bankers' cash. Therefore, the cash base to support excessive expansion would not be available. Summing up, if the money is there, bankers will try and lend it; if it is not, they won't.

Our detailed comments on the Green Paper will be published in due course, probably following our analysis of the budget.

Distortions to monetary data

"Soft arbitraging"

Small changes in relative interest rates in the domestic wholesale markets will lead to switching between sterling M3 and close substitutes for money. Colloquially, this is often called "soft arbitraging". The main types of close money substitute are:

- (i) bank acceptances,
- (ii) Treasury bills,
- (iii) certificates of tax deposit, and
- (iv) deposits with local authorities.

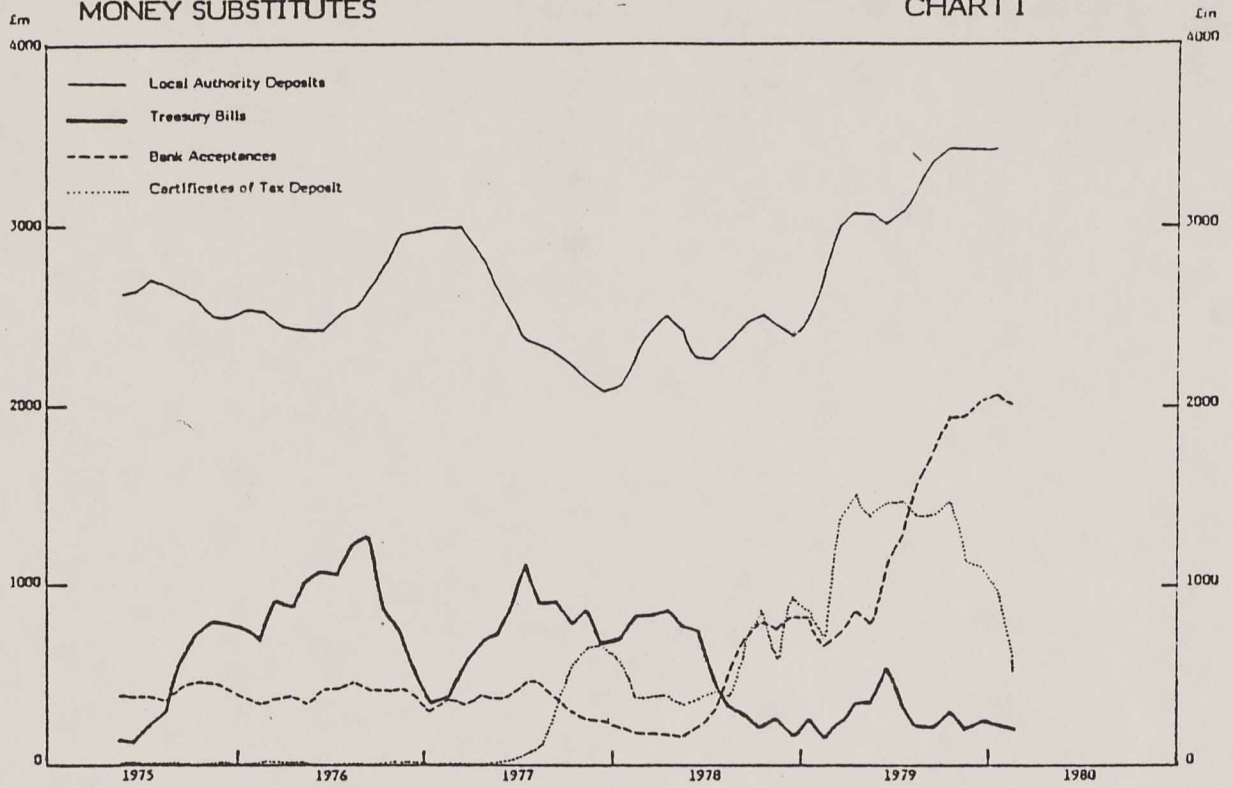
Nearly all the comment elsewhere at the moment is about bank acceptances; the other types of money substitutes are also important. Chart I, at the top of the next page, shows the levels in nominal terms of the non-bank private sector's holdings of each type. It will be seen that in the last four months certificates of tax deposits have fallen and have offset much of the previous rise in bank acceptances. Chart II, at the bottom of the page, shows the total of the first three types of money substitute expressed as a percentage of our definition of M4, and the total of all four types expressed as a percentage of M4 plus local authority deposits. Money substitutes fell in percentage terms between August 1976 and July 1978 (M4 in fact grew by 1% p.a. less than sterling M3 whilst the aggregate including local authority deposits grew by 2% p.a. less than sterling M3). Between July 1978 and October 1979, the money substitutes rose in percentage terms (relative to sterling M3, M4 rose by 4% p.a., and the broader aggregate by 5% p.a.). Since October 1979 the money substitutes have been falling in percentage terms, i.e. sterling M3 has been distorted upwards.

In spite of the money substitutes having fallen since October, substantial distortions to sterling M3 remain to be unwound and will most probably do so shortly after the corset is abolished. If the total of money substitutes returns to the average level in percentage terms that prevailed between 1975 and 1978, sterling M3 will have a once and for all rise of almost 2%. If this occurs, it will be merely an unwinding of a distortion and not something of economic significance.

A further point concerning M4 has been mentioned in recent Bulletins. Only those bank acceptances which are held by the non-bank private sector should be included in M4. Because up to date data are not available, our series includes all bank acceptances held outside the banking sector. Those held by non-residents have been increasing recently. For this reason our series for M4 is currently distorted slightly upwards.

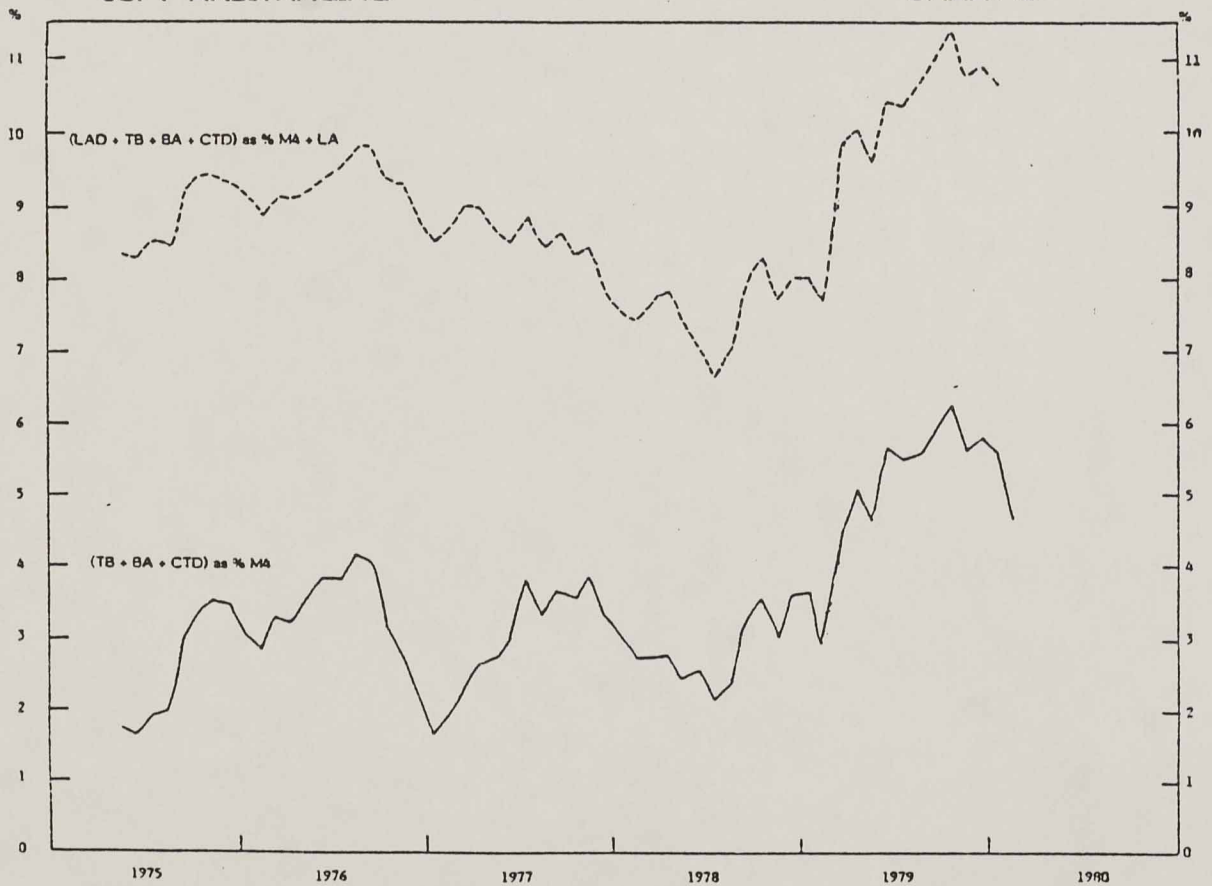
MONEY SUBSTITUTES

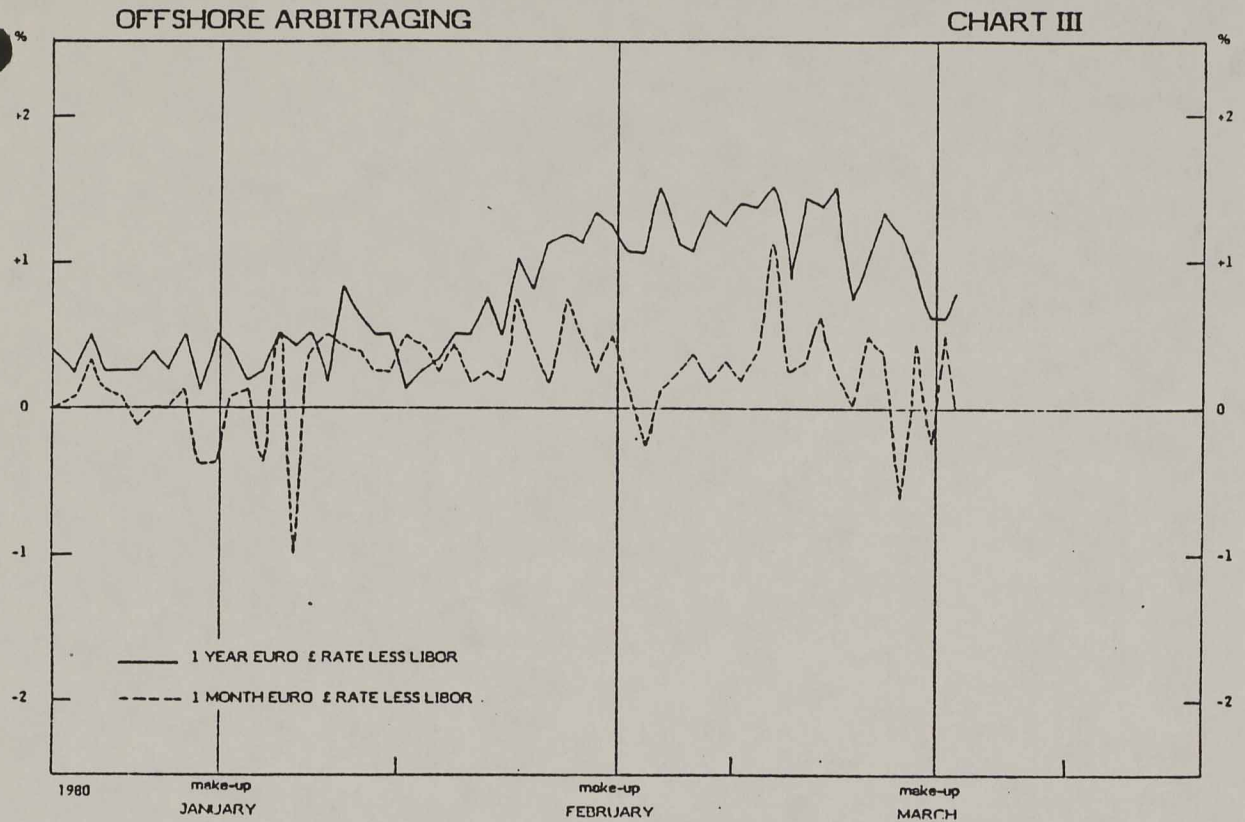
CHART I



SOFT ARBITRAGING

CHART II



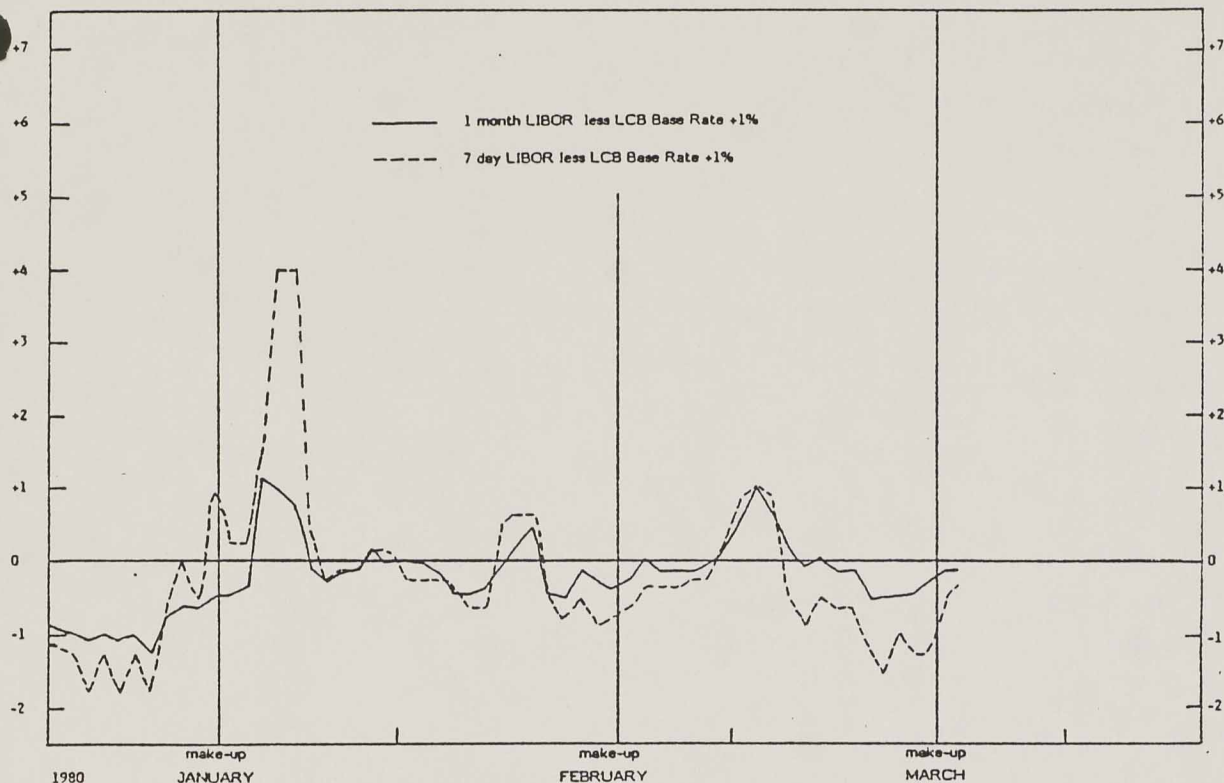


Offshore arbitraging

Following the abolition of exchange controls, U.K. residents are now permitted to borrow and lend in the euro-sterling market. The Bank of England, however, has asked banks and money brokers not to encourage their customers to use this market. If U.K. residents were to do so, domestic banking statistics would understate both the provision of credit and the growth of liquidity in the private sector.

Chart III, above, shows the differences, on both a one year and a one month basis, between euro-sterling and domestic interest rates (the latter measured by LIBOR). It will be seen that the one year differential widened about a week before the February banking make-up, giving an incentive for holders of domestic sterling to switch into euro-sterling. Some U.K. residents may have taken advantage of this, and sterling M3 will have been distorted downwards to the extent that they did. On a one month basis, however, the differential has not tended to widen. More precisely, the interest rate differential has only widened significantly for terms of three months and longer.

One of the problems with offshore arbitraging is that it is not possible, even for the authorities, to quantify its extent. One has to rely on anecdotal evidence. Our guess is that the distortion was minor at the February make-up date but increased thereafter.



Round tripping

A third type of distortion is round tripping; this involves borrowing funds from a bank which, because relative interest rates make it profitable, are then re-deposited with the same or another bank. Chart IV shows two sets of interest rate differentials - one month LIBOR less LCB base rate plus 1%, and seven day LIBOR less LCB base rate plus 1%.

It will be seen that the interest rate relatives to encourage the shorter term round tripping occurred just before the January banking make-up. However, any such transactions that were opened either then or during the first halves of the banking months of February and March would have been closed by the February and March make-up dates because they would have become unprofitable. The same is not true for the one month transactions in either banking February or March; profitable transactions effected during the banking months will have been outstanding at the end of the relevant months. We conclude, therefore, that round tripping has distorted sterling M3 upwards on all three make-up dates. It is not possible, again, to quantify the distortions.

Seasonal adjustments

The official seasonal adjustments in current use assume that there is no seasonal pattern in the non-bank private sector's holdings of bank acceptances, Treasury bills and certificates of tax deposit. This is obviously wrong as far as the last is concerned. The Bank is about to revise the seasonal adjustments now that sufficient data have become available to ascertain the pattern. The present ones assume, in effect, that the bulk of taxes is paid out of bank deposits or from new borrowing from banks. When the seasonal adjustments are altered to allow for taxes being paid out of certificates of tax deposit, etc., those for bank lending will also be changed. The seasonally adjusted series for sterling M3 during the last few months will be revised downwards but that for bank lending will be revised upwards and, with the latter, our series for M4.

Monetary statistics for the month to 20th February, 1980

In the five week banking month to mid-February the seasonally adjusted behaviour of the monetary aggregates was as follows:

Table III

	<u>£m.</u>	<u>p.a.</u>
Notes & coin	86	11%
Retail M1	-106	-5%
Sterling M3	529	11%
M4	11	-
M5	372	4%
DCE	495	
Bank lending in sterling to private sector	584	15%

In its press release, the Bank of England draws attention to the large surrenders of certificates of tax deposit during the month, associated with the seasonal payment of corporation tax, and gives an indication of the revisions to the seasonal adjustments for the month. After the revisions sterling M3 rises by some £330m. (7% p.a.) and bank lending in sterling to the private sector grows by some £780m. (20% p.a.).

The underlying picture of recent monetary growth is shown in Table IV. The amendments to the seasonal adjustments in the banking month of February have not been incorporated because those for earlier months are not available.

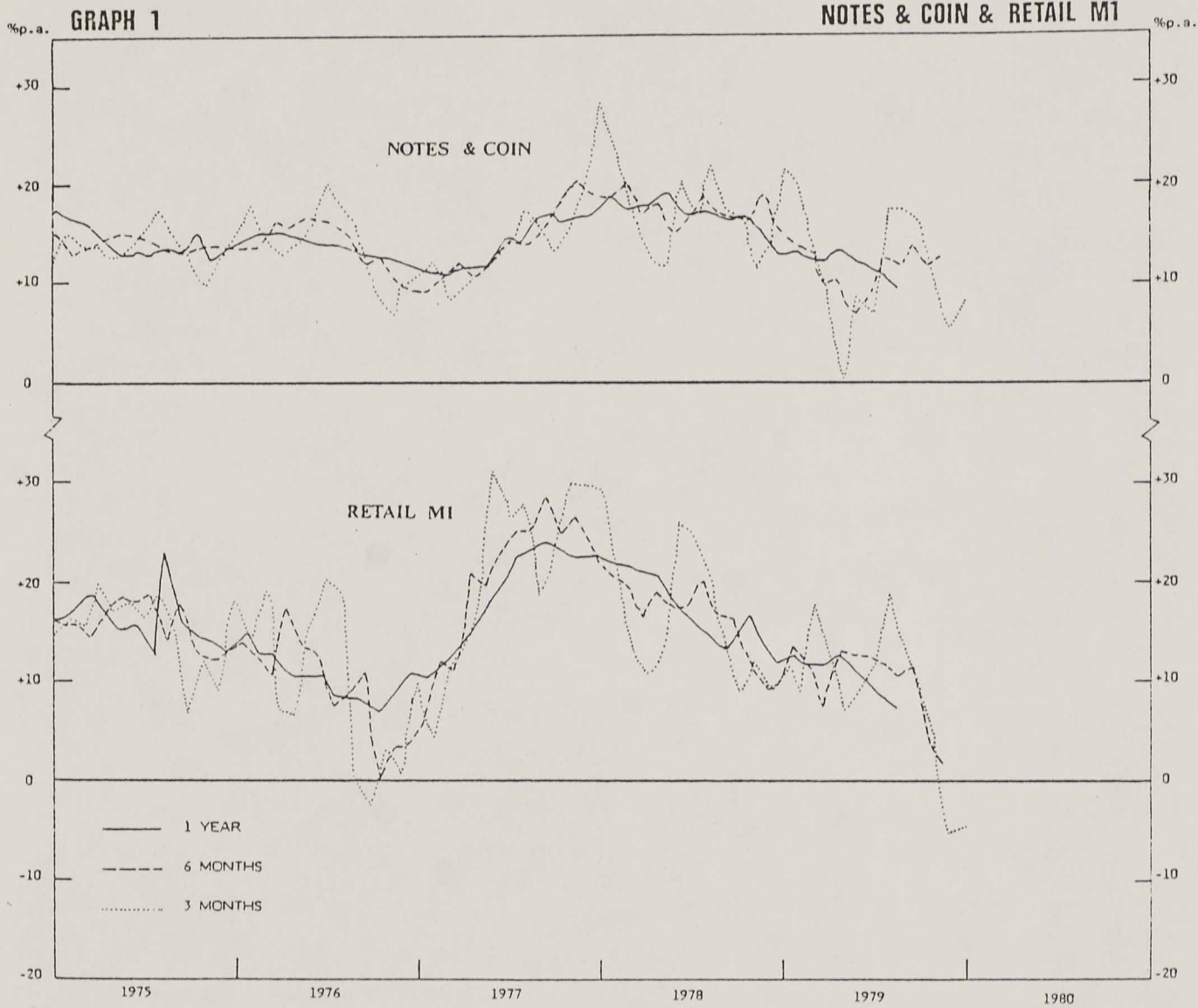
Table IV

	<u>3 months</u>	<u>4 months</u>	<u>6 months</u>	<u>8 months</u>	<u>12 months</u>
		(since mid-Oct)		(since mid-June)	
Notes & coin	8% p.a.	7% p.a.	12% p.a.	14% p.a.	9%
Retail M1	-5% p.a.	-5% p.a.	2% p.a.	6% p.a.	7%
Sterling M3	10% p.a.	10% p.a.	12% p.a.	12% p.a.	11%
M4	6% p.a.	4½% p.a.	10% p.a.	11% p.a.	13%
M5	8% p.a.	7% p.a.	12% p.a.	12% p.a.	14%

Conclusions

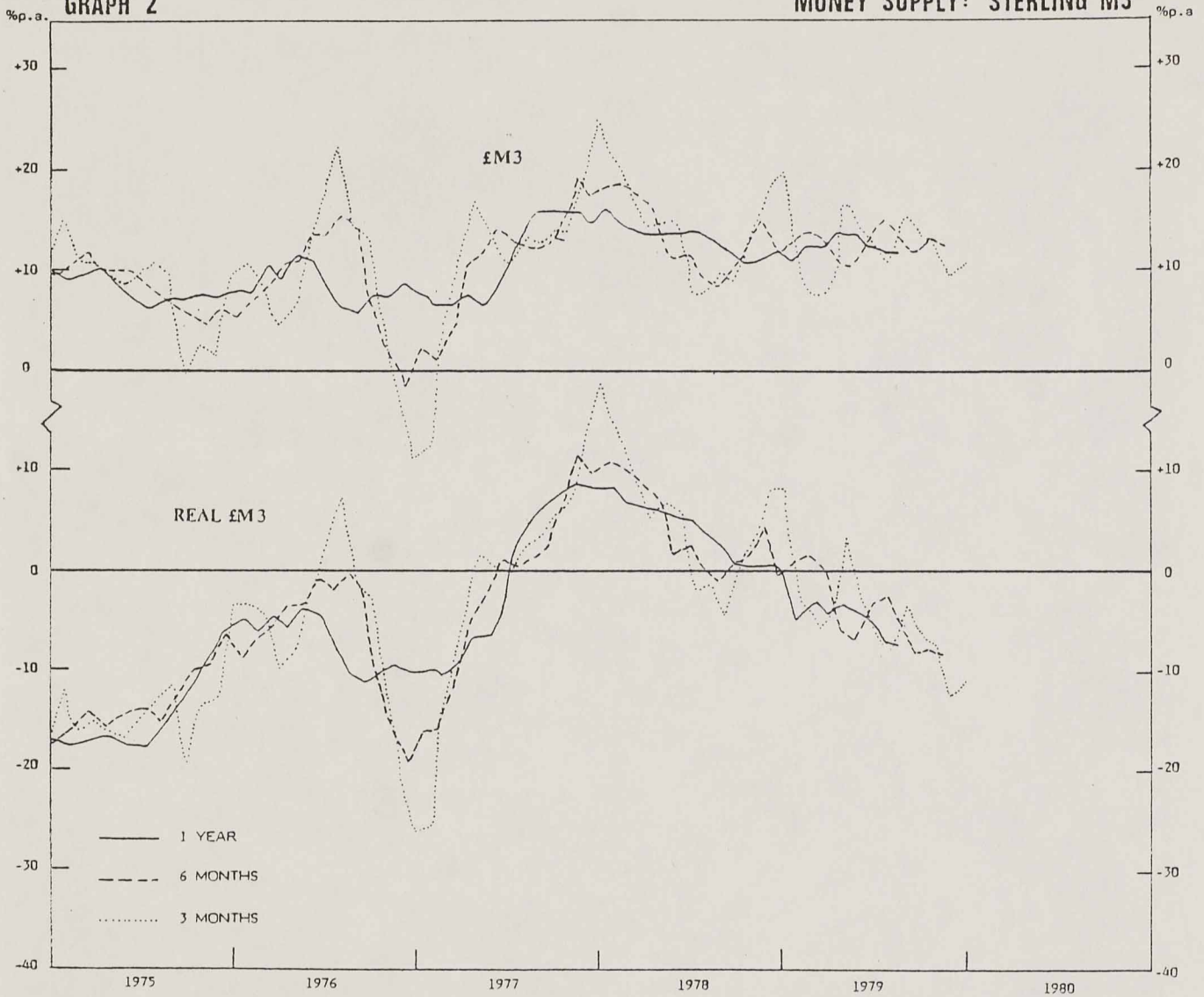
Bearing in mind all of the distortions discussed in the previous section, our conclusion following the publication of the latest data is that underlying monetary growth has declined to just within the 7-11% target range set for sterling M3. As far as the more recent months are concerned, sterling M3 is clearly distorted upwards whilst our series for M4 is distorted downwards because of incorrect seasonal adjustment. The average of the two, some 7-8% p.a., is probably about the best indicator of monetary growth during the last three or four months.

GTP/RLT/RR



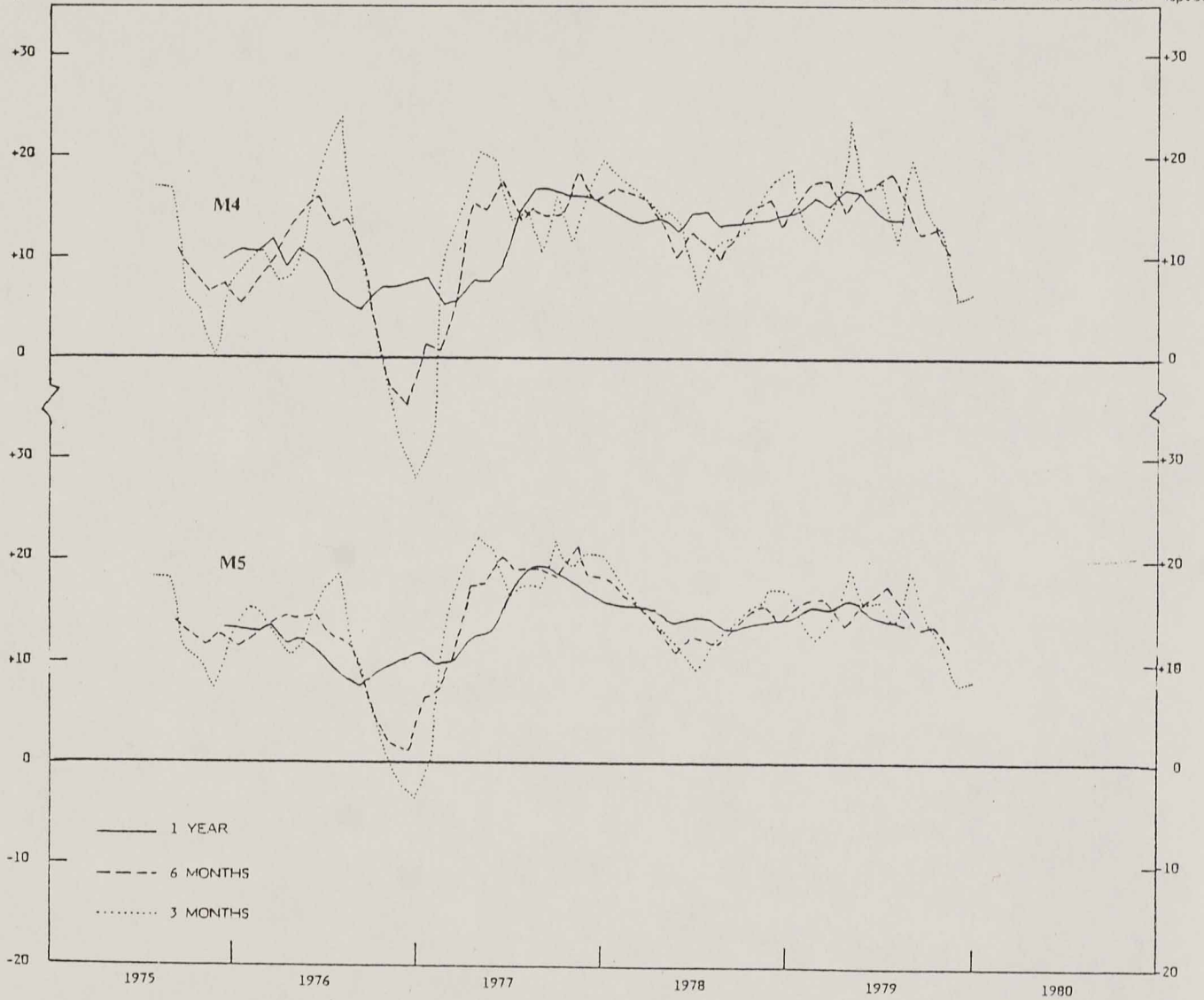
GRAPH 2

MONEY SUPPLY: STERLING M3



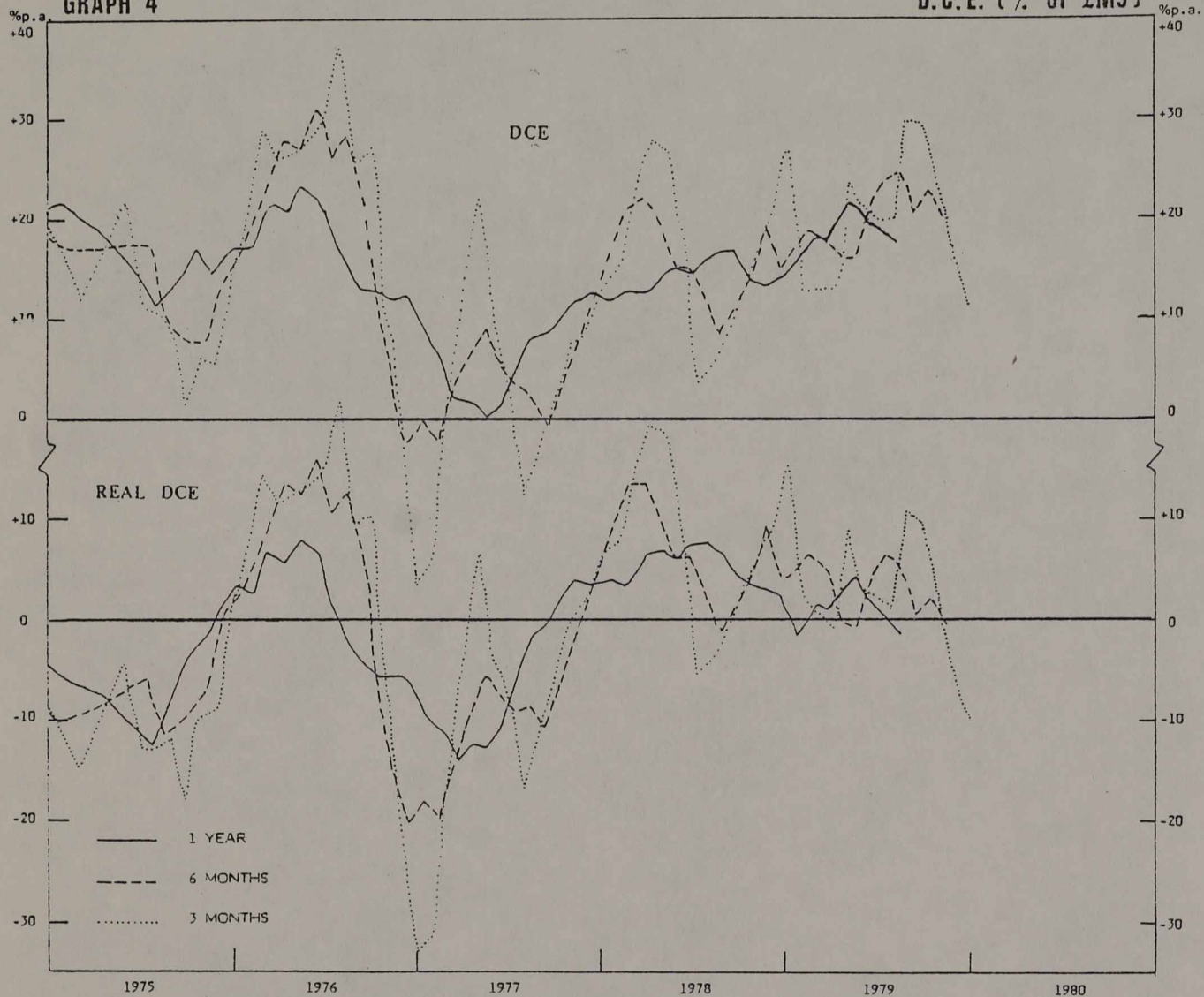
GRAPH 3

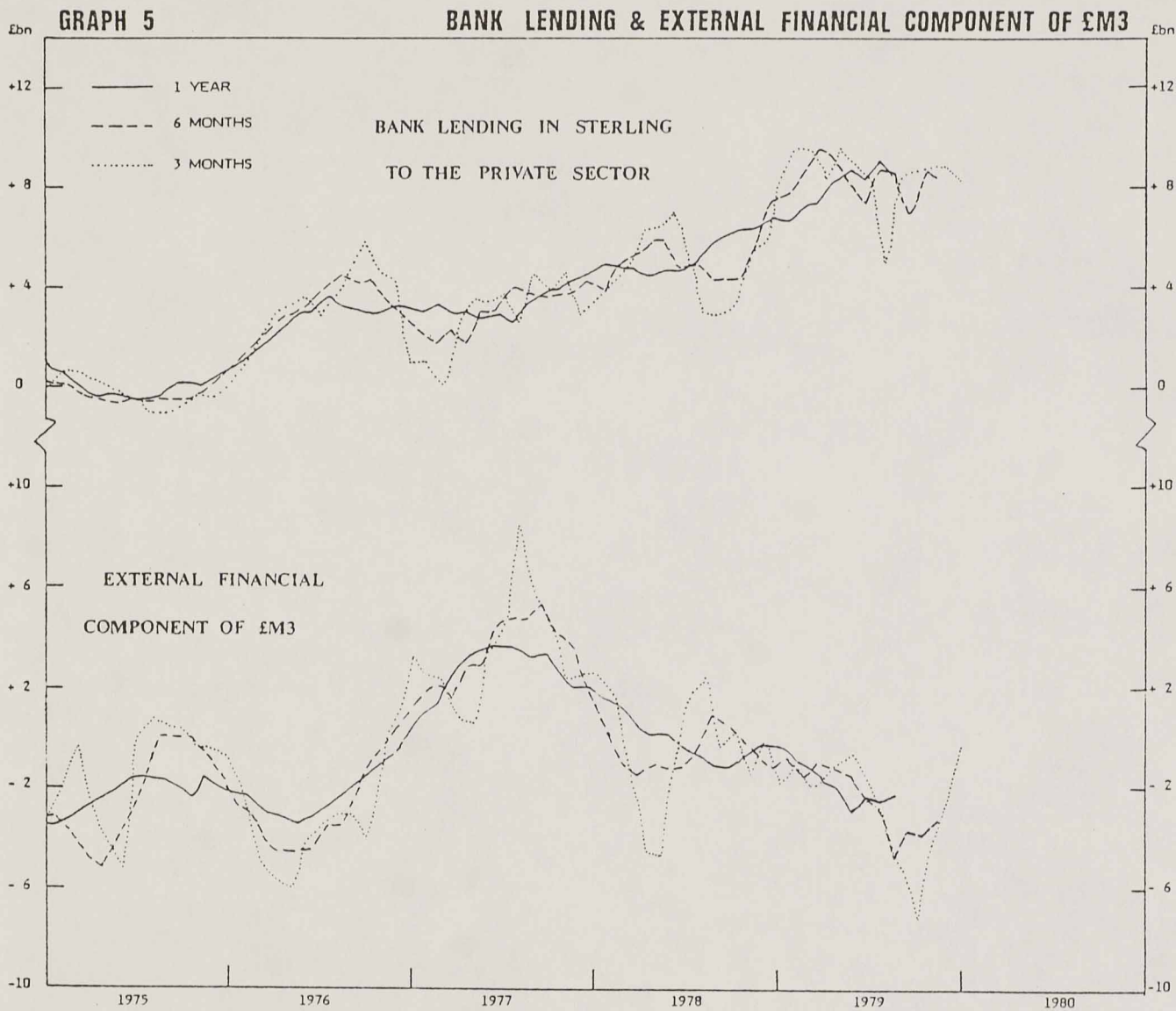
MONEY SUPPLY: M4 & M5 %p.a.



GRAPH 4

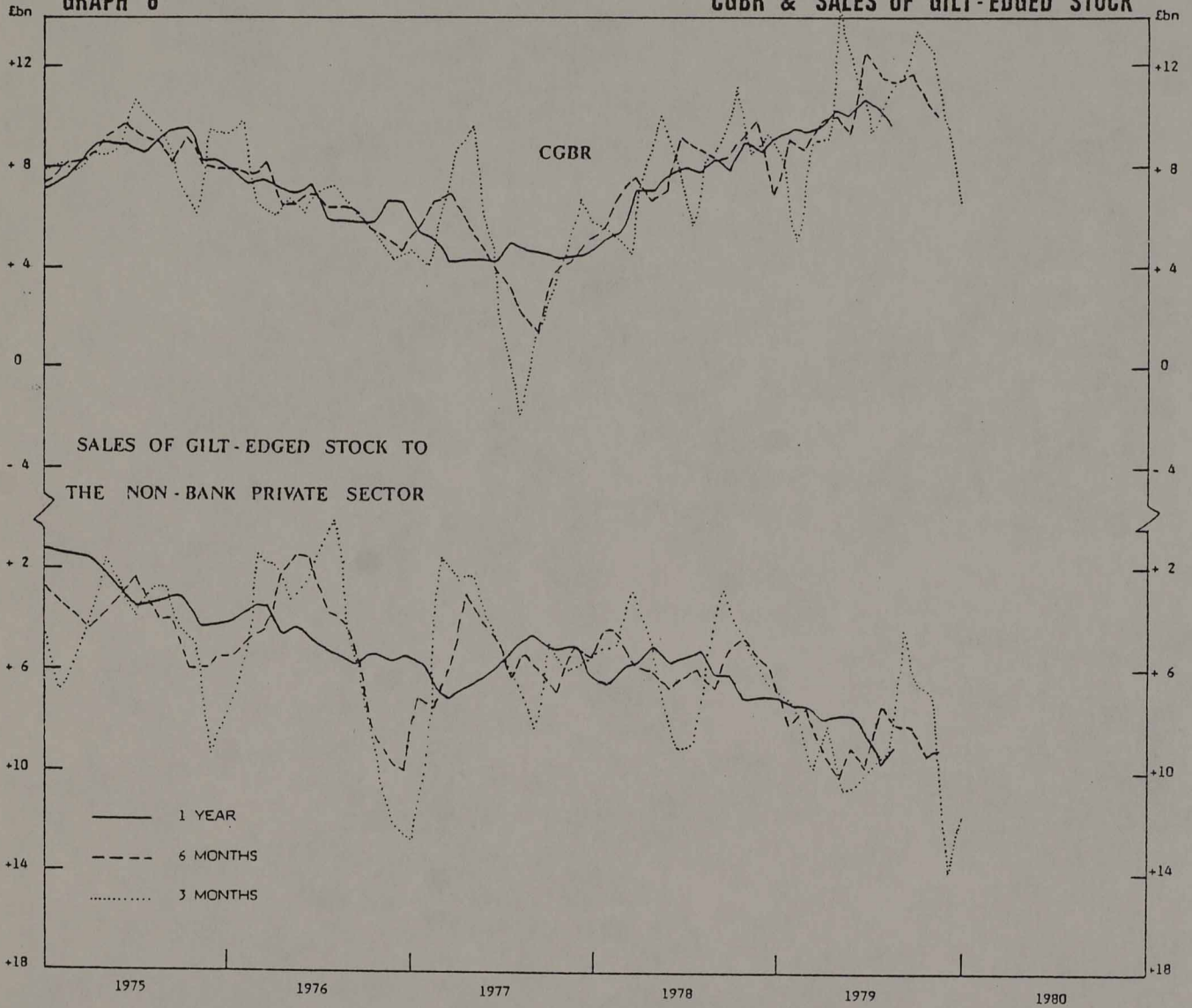
D.C.E. (% of £M3)





GRAPH 6

CGBR & SALES OF GILT-EDGED STOCK



STATISTICS

reprinted from Bank of England, *Banking Statistics*.

[Table 6 in the Quarterly Bulletin]

UK banking sector: transactions in liabilities and assets (a)

£ millions

Month ended	Liabilities													
	Total	Domestic deposits										Overseas sector deposits		Non-deposit liabilities (net)
		Total		Public sector				Private sector		Sterling	Other currencies	Sterling	Other currencies	
		Un-adjusted	Seasonally adjusted	Sterling		Other currencies	Sterling		Other currencies					
Un-adjusted	Seasonally adjusted	Un-adjusted	Seasonally adjusted	Un-adjusted	Seasonally adjusted		Un-adjusted	Seasonally adjusted		Un-adjusted	Seasonally adjusted			
1979 Feb. 21	+ 646	- 70	+ 483	+ 353	+ 265	- 4	- 598	+ 43	+ 179	- 11	+ 675	+ 52		
Mar. 21	+ 120	- 662	- 704	- 324	- 265	+ 38	- 115	- 216	- 261	+ 339	+ 467	- 24		
Apr. 18	+ 4,125	+ 1,514	+ 786	+ 42	+ 106	- 34	+ 1,393	+ 601	+ 113	+ 353	+ 2,144	+ 114		
May 16	+ 3,210	+ 710	+ 916	- 151	- 146	+ 12	+ 600	+ 801	+ 249	+ 115	+ 2,392	- 7		
June 20	+ 4,704	+ 1,026	+ 1,068	+ 187	+ 34	- 11	+ 451	+ 646	+ 399	+ 151	+ 2,962	+ 565		
July 18	+ 4,771	+ 255	+ 136	- 210	- 147	+ 18	+ 561	+ 379	- 114	+ 207	+ 4,235	+ 74		
Aug. 15	+ 1,071	+ 208	+ 361	- 103	+ 63	- 12	+ 472	+ 459	- 149	+ 275	+ 561	+ 27		
Sept. 19	+ 6,961	+ 195	+ 78	- 36	- 59	+ 35	+ 374	+ 280	- 178	+ 70	+ 6,753	- 57		
Oct. 17	+ 6,967	+ 1,335	+ 1,137	+ 67	+ 95	- 6	+ 996	+ 770	+ 278	+ 164	+ 5,204	+ 264		
Nov. 21	+ 4,714	+ 899	+ 1,080	+ 118	- 55	+ 10	+ 48	+ 402	+ 723	+ 395	+ 3,507	- 87		
Dec. 12	- 10	- 169	- 110	- 100	+ 95	+ 3	+ 190	+ 159	- 262	+ 342	- 248	+ 65		
1980 Jan. 16	+ 5,032	+ 287	+ 346	+ 173	+ 59	+ 7	+ 389	+ 457	- 282	+ 402	+ 4,159	+ 184		
Feb. 20	+ 935	+ 71	+ 723	+ 81	+ 83	+ 6	- 290	+ 360	+ 274	+ 127	+ 1,003	- 266		

Month ended	Assets											
	Total	Lending to public sector					Lending to private sector				Lending to overseas sector	
		Total		Sterling		Other currencies	Sterling		Other currencies	Sterling	Other currencies	
		Un-adjusted	Seasonally adjusted	Central government	Other		Un-adjusted	Seasonally adjusted				
Un-adjusted	Seasonally adjusted	Un-adjusted	Seasonally adjusted	Un-adjusted	Seasonally adjusted	Un-adjusted	Seasonally adjusted	Un-adjusted	Seasonally adjusted			
1979 Feb. 21	+ 646	- 742	- 57	- 768	+ 26	- 7	+ 326	+ 830	+ 19	- 146	+ 696	
Mar. 21	+ 120	- 518	- 703	- 891	+ 373	- 72	+ 639	+ 942	+ 113	+ 3	- 45	
Apr. 18	+ 4,125	+ 1,382	+ 637	+ 1,098	+ 284	- 99	+ 637	+ 629	- 4	+ 30	+ 2,179	
May 16	+ 3,210	+ 187	+ 367	+ 551	- 164	- 18	+ 166	+ 367	+ 378	+ 70	+ 2,427	
June 20	+ 4,704	+ 115	- 25	+ 69	+ 46	+ 8	+ 1,385	+ 1,315	- 50	- 75	+ 3,321	
July 18	+ 4,771	- 286	+ 138	- 480	+ 194	- 153	+ 1,098	+ 352	+ 191	- 10	+ 3,931	
Aug. 15	+ 1,071	+ 360	- 92	+ 281	+ 79	- 42	+ 341	+ 889	- 45	+ 112	+ 345	
Sept. 19	+ 6,961	+ 190	+ 173	- 99	+ 289	- 42	+ 115	+ 160	- 93	- 29	+ 6,820	
Oct. 17	+ 6,967	+ 286	+ 123	+ 305	- 19	- 14	+ 1,347	+ 1,222	+ 146	- 29	+ 5,231	
Nov. 21	+ 4,714	- 13	+ 207	- 102	+ 89	+ 12	+ 693	+ 709	- 3	+ 103	+ 3,922	
Dec. 12	- 10	+ 241	- 178	+ 411	- 170	- 60	- 453	+ 164	- 34	- 22	+ 318	
1980 Jan. 16	+ 5,032	- 1,216	- 560	- 1,545	+ 329	- 48	+ 2,065	+ 1,302	+ 437	+ 188	+ 3,606	
Feb. 20	+ 935	- 399	+ 352	- 503	+ 104	- 113	+ 558	+ 574	+ 385	+ 92	+ 412	

(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. Inter-bank items are excluded and adjustments made to allow for transit items (see additional notes to Table 6 in the Quarterly Bulletin).

Money stock: amounts outstanding

[Table 11.1 in the Quarterly Bulletin]

£ millions

	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)			
	Notes and coin in circulation with public	Non-interest-bearing (a)	Interest-bearing	Unadjusted	Seasonally adjusted			Unadjusted	Seasonally adjusted		Unadjusted	Seasonally adjusted	Unadjusted	Seasonally adjusted
Month ended														
1979 Jan. 17	8,382	13,497	3,661	25,540	25,730	23,611	1,153	50,304	50,570	4,685	54,989	55,250		
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	4,575	54,502	55,210		
Apr. 18	8,862	14,484	3,792	27,138	26,750	23,173	1,224	51,535	51,360	4,550	56,085	55,910		
May 16	8,833	14,262	3,857	26,952	26,790	23,930	1,073	51,955	52,090	4,837	56,792	56,930		
June 20	8,804	14,026	3,718	26,548	26,570	24,756	1,260	52,564	52,690	5,066	57,630	57,760		
July 18	9,230	14,335	3,755	27,320	27,210	24,971	1,050	53,341	53,110	4,655	57,996	57,770		
Aug. 15	9,143	14,532	3,632	27,307	27,200	25,369	947	53,623	53,670	4,586	58,209	58,250		
Sept. 19	9,121	14,750	3,470	27,341	27,310	25,687	911	53,939	53,990	4,633	58,572	58,610		
Oct. 17	9,267	15,143	4,038	28,448	28,210	25,722	978	55,148	55,020	4,903	60,051	59,920		
Nov. 21	9,307	14,777	3,588	27,672	27,630	26,586	1,096	55,354	55,370	5,559	60,913	60,930		
Dec. 12	9,675	15,064	3,540	28,279	27,650	26,537	996	55,812	55,620	5,263	61,075	60,780		
1980 Jan. 16	9,319	14,379	3,798	27,496	27,620	27,353	1,169	56,018	56,180	4,857	60,875	61,040		
Feb. 20	9,372	13,815	3,473	26,660	27,180	27,952	1,250	55,862	56,700	5,100	60,962	61,800		

(a) After deducting 60% of transit items (see additional notes to Table 6 of the Quarterly Bulletin).

(b) M₁ equals columns 1 + 2 + 3. Sterling M₃ equals M₁ + columns 5 + 6. M₃ equals sterling M₃ + 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

	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)	
	Notes and coin in circulation with public	Non-interest-bearing (b)	Interest-bearing					Transactions	Valuation changes (e)		
											1
Month ended (unadjusted)											
1979 Feb. 21	+ 212	- 485	+ 52	- 221	- 165	+ 353	- 33	+ 175	- 5	+ 137	
Mar. 21	+ 95	+ 434	- 225	+ 304	- 324	- 324	- 344	+ 223	- 57	+ 624	
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	+ 326	+ 187	+ 609	+ 388	- 159	+ 838	
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	+ 316	- 143	+ 190	+ 363	
Oct. 17	+ 146	+ 393	+ 568	+ 1,107	+ 35	+ 67	+ 1,209	+ 272	- 2	+ 1,479	
Nov. 21	+ 40	- 366	- 450	- 776	+ 864	+ 118	+ 206	+ 733	- 77	+ 862	
Dec. 12	+ 368	+ 287	- 48	+ 507	- 49	- 100	+ 458	- 259	- 37	+ 162	
1980 Jan. 16	- 356	- 685	+ 258	- 783	+ 816	+ 173	+ 206	- 275	- 131	- 200	
Feb. 20	+ 53	- 564	- 325	- 836	+ 599	+ 81	- 156	+ 280	- 37	+ 87	
Month ended (seasonally adjusted)											
1979 Feb. 21	+ 198	- 56	+ 52	+ 194	+ 0.8	+ 47	+ 265	+ 506 + 1.0	+ 175	- 5	+ 676 + 1.2
Mar. 21	+ 38	+ 222	- 225	+ 35	+ 0.1	- 213	- 265	+ 443 - 0.9	+ 223	- 57	+ 723 - 1.3
Apr. 18	+ 14	+ 468	+ 304	+ 786	+ 3.0	- 171	+ 106	+ 721 + 1.4	+ 79	- 104	+ 696 + 1.3
May 16	+ 74	- 100	+ 65	+ 39	+ 0.1	+ 336	- 146	+ 729 + 1.4	+ 261	+ 26	+ 1,016 + 1.8
June 20	- 79	+ 5	- 139	- 213	- 0.8	+ 780	+ 34	+ 601 + 1.2	+ 388	- 159	+ 830 + 1.5
July 18	+ 194	+ 410	+ 37	+ 641	+ 2.4	- 68	- 147	+ 426 + 0.8	- 96	- 315	+ 15 -
Aug. 15	+ 41	+ 79	- 123	- 3	-	+ 503	+ 63	+ 563 + 1.1	- 161	+ 92	+ 494 + 0.9
Sept. 19	+ 125	+ 157	- 162	+ 120	+ 0.4	+ 285	- 59	+ 346 + 0.6	- 143	+ 190	+ 393 + 0.7
Oct. 17	+ 201	+ 152	+ 568	+ 921	+ 3.4	+ 50	+ 95	+ 1,066 + 2.0	+ 272	- 2	+ 1,336 + 2.3
Nov. 21	+ 24	- 149	- 450	- 575	- 2.0	+ 1,001	- 55	+ 371 + 0.7	+ 733	- 77	+ 1,027 + 1.7
Dec. 12	+ 4	+ 70	- 48	+ 26	+ 0.1	+ 137	+ 95	+ 258 + 0.5	- 364	- 37	+ 143 - 0.2
1980 Jan. 16	+ 95	- 351	+ 258	+ 2	-	+ 550	+ 59	+ 611 + 1.1	- 170	- 131	+ 310 + 0.5
Feb. 20	+ 86	- 192	- 325	- 431	- 1.6	+ 877	+ 83	+ 529 + 0.9	+ 280	- 37	+ 772 + 1.3

(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) M₁ equals columns 1 + 2 + 3. Sterling M₃ equals M₁ + columns 5 + 6. M₃ equals sterling M₃ + columns 8 + 9.

(d) Including certificates of deposit.

(e) See additional notes to Tables 6 and 11 of the Quarterly Bulletin.

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

£ millions

Month ended (unadjusted)	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 sector (c)	Domestic credit expansion (d)	External and foreign currency finance (increase -)			Net non-deposit liabilities (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 sector sterling deposits (e)	Banks' foreign currency deposit liabilities (net) (e)		
1979 Feb. 21	- 31	+ 375	- 945	+ 1,125	-	146	+ 378	- 228	+ 11	-	- 52	- 33
Mar. 21	+ 272	+ 280	- 1,373	+ 430	+ 3	- 388	+ 607	+ 607	- 339	-	+ 24	- 344
Apr. 18	+ 2,335	+ 233	- 1,388	+ 543	+ 30	-	+ 1,753	+ 469	- 353	-	- 114	+ 1,608
May 16	+ 695	- 341	- 526	+ 607	+ 70	-	+ 505	- 111	- 115	+ 134	+ 7	+ 420
June 20	+ 1,507	+ 35	- 1,416	+ 1,099	- 75	-	+ 1,150	+ 246	- 151	+ 71	+ 565	+ 609
July 18	+ 601	+ 82	- 837	+ 1,132	- 10	-	+ 968	+ 260	- 207	- 170	- 74	+ 777
Aug. 15	+ 571	+ 216	- 229	+ 145	+ 112	-	+ 815	- 89	- 275	-	- 142	+ 282
Sept. 19	+ 1,456	+ 195	- 971	+ 112	+ 29	-	+ 763	- 509	- 70	+ 75	+ 57	+ 316
Oct. 17	+ 849	- 447	+ 53	+ 1,348	- 29	-	+ 1,774	- 24	- 164	- 113	- 264	+ 1,209
Nov. 21	+ 466	+ 52	- 466	+ 713	+ 103	-	+ 868	- 45	- 395	- 309	+ 87	+ 206
Dec. 12	+ 2,310	- 256	- 1,168	+ 454	- 22	-	+ 410	- 276	- 342	+ 731	- 65	+ 458
1980 Jan. 16	- 863	+ 433	- 1,340	+ 2,064	+ 188	-	+ 482	+ 199	- 402	+ 111	- 184	+ 206
Feb. 20	- 790	- 28	- 152	+ 568	+ 92	-	- 310	+ 614	- 127	- 599	+ 266	- 156
Month ended (seasonally adjusted)												
1979 Feb. 21	+ 648	+ 338	- 921	+ 1,129	-	146	+ 1,048	-	312	-	- 230	+ 506
Mar. 21	- 30	+ 295	- 1,322	+ 733	+ 3	-	- 321	-	86	-	- 36	- 443
Apr. 18	+ 1,464	+ 133	- 1,346	+ 535	+ 30	-	+ 816	-	87	-	- 8	+ 721
May 16	+ 833	- 215	- 521	+ 808	+ 70	-	+ 995	-	132	-	- 134	+ 729
June 20	+ 1,250	+ 133	- 1,441	+ 1,029	- 75	-	+ 896	-	16	-	- 279	+ 601
July 18	+ 786	+ 119	- 861	+ 386	- 10	-	+ 420	-	7	-	- 1	+ 426
Aug. 15	+ 231	+ 202	- 243	+ 693	+ 112	-	+ 1,045	-	354	-	- 128	+ 563
Sept. 19	+ 1,647	+ 129	- 960	+ 157	- 29	-	+ 944	-	548	-	- 50	+ 346
Oct. 17	+ 937	- 622	+ 38	+ 1,223	- 29	-	+ 1,547	-	368	-	- 113	+ 1,066
Nov. 21	+ 731	+ 13	- 482	+ 729	+ 103	-	+ 1,094	-	746	-	+ 23	+ 371
Dec. 12	+ 1,470	- 137	- 1,224	+ 163	- 22	-	+ 250	-	153	-	- 145	+ 258
1980 Jan. 16	+ 154	+ 471	- 1,322	+ 1,301	+ 188	-	+ 792	-	110	-	- 71	+ 611
Feb. 20	+ 22	- 76	- 127	+ 584	+ 92	-	+ 495	-	51	-	+ 85	+ 529

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

Month ended	Marketable debt		National savings		Tax instruments	Other (g)	Total (column 4 above)	
	Stocks	Treasury bills	Unadjusted	Seasonally adjusted			Unadjusted	Seasonally adjusted
1979 Feb. 21	- 925	+ 95	- 266	- 242	+ 148	+ 3	- 945	- 921
Mar. 21	- 513	- 80	- 131	- 30	- 653	+ 4	- 1,373	- 1,322
Apr. 18	- 997	- 113	- 145	- 103	- 124	- 9	- 1,388	- 1,346
May 16	- 578	+ 5	- 54	- 49	+ 109	- 8	- 526	- 521
June 20	- 1,108	- 175	- 24	- 49	- 79	- 30	- 1,416	- 1,441
July 18	- 907	+ 178	- 90	- 104	- 18	- 10	- 837	- 861
Aug. 15	- 439	+ 145	- 43	- 57	+ 101	+ 7	- 229	- 243
Sept. 19	- 929	- 10	- 38	- 27	- 10	+ 16	- 971	- 960
Oct. 17	+ 248	- 79	- 43	- 58	- 75	+ 2	+ 53	+ 38
Nov. 21	- 987	+ 75	- 47	- 63	+ 333	+ 160	- 466	- 482
Dec. 12	- 1,133	- 51	- 56	- 112	+ 20	+ 52	- 1,168	- 1,224
1980 Jan. 16	- 1,370	+ 33	- 136	- 118	+ 125	+ 8	- 1,340	- 1,322
Feb. 20	- 428	+ 21	- 205	- 180	+ 457	+ 3	- 152	- 127

(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 M₃ equals domestic credit expansion plus columns 8 + 9 + 10 + 11 (see also page 7).

(g) Includes repayments (+) by the Fund for Banks for Savings (a central government fund) to the trustee savings banks.

Symbols and conventions

.. not available.

- nil or less than £¼ 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 Financial Statistics Division, Bank of England, London EC2R 3AH.

W. Greenwell & Co.

Bow Bells House,
Bread Street, London EC4M 9EL

Telephone: 01-236 2040 Telex: 883006

W. Greenwell Associates (Investment Adviser) 450 Park Avenue, New York, N.Y. 10022
Telephone: 212 832 7428 Telex: 710 5815122

Handwritten signatures and initials, including a '2' in the top right corner.



MONETARY BULLETIN

No. 101, February, 1980

Summary and conclusions

The monetary statistics for the month to mid-January contained three features of special interest - (i) large official intervention in the foreign exchange markets, (ii) a record central government surplus after sales of debt, and (iii) record bank lending. In this Bulletin these three features are discussed in turn before the routine commentary on the statistics.

The conclusions are :

- (i) The recent scale of official intervention in the foreign exchange markets, moderating sterling's rise, can have dangerous consequences for the money supply. It should cease. The ideal solution would be for the U.S. authorities to tighten their monetary policy immediately, which would remove the source of the U.K.'s problem. But if this does not happen and if sterling continues to rise, the appropriate policy response for the U.K. authorities will be to impose temporary incoming exchange controls.
- (ii) If the U.K. already had an efficient monetary base system of control and if the authorities had not intervened directly in the foreign exchange markets, the rise in money market rates of interest since the turn of the year would certainly have been less and might well have been a good deal less.
- (iii) If the monthly data are averaged, bank lending has been on a very high plateau for about a year. But if allowance is made for recent special factors, there is some indication that lending is starting to fall.
- (iv) In the seven months since mid-June, the base for the current target range, the underlying growth of sterling M3 has been between 1-2% above the top of the 7-11% range. Monetary growth in the last three months, however, has been much lower than that in the previous four months. After the disappointments of the autumn, our impression is that we are now past the turning point of monetary expansion, providing that the authorities cease large scale intervention in the foreign exchange markets.

Foreign exchange intervention

The banking statistics for the month to mid-January show that official intervention in the foreign exchange markets exceeded foreign buying of gilt-edged stock and other public sector debt by no less than £470m. Impressionistic evidence from the gilt-edged markets suggests that foreign buying of stock was substantial. The implication is that there was large official intervention in the foreign exchange markets in the banking month of January. Sources in the foreign exchange market suggest that it has continued into the banking month of February.

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

Official intervention in the foreign exchange markets that exceeds foreign buying of public sector debt increases the money supply unless the authorities are offsetting transactions undertaken by the banking sector. Fortunately, there were £323m. of such transactions in the banking month of January. Nevertheless, official intervention on the recent scale is dangerous.

Two aspects need discussing, firstly the reasons for the foreign exchange inflow and secondly the appropriate policy response.

In the early autumn there was a massive run on the dollar (the underlying reason for which was that in the U.S. the domestic supply of money continued to exceed the domestic demand). The outflow of money from the U.S. flooded the rest of the world with liquidity. Following the U.S. measures of 6th October, we hoped that money would flow back to the U.S., so reducing the surplus liquidity elsewhere, and that the Fed would control bank reserves in accordance with its new policy, so bringing the domestic supply of money in the U.S. back under control. To date, progress in both directions has been very disappointing.

Surplus liquidity worldwide is also a background explanation for the explosion in the price of gold and the rise in commodity prices (events in Iran and Afghanistan were the trigger). Another result will be that the widely expected worldwide recession will be delayed.

Surplus worldwide liquidity appears in two forms. Some of it enters the domestic financial systems of certain countries and, hence, is reflected in their money supply statistics. The remainder accumulates "offshore", mainly in euro-currency markets. Chart I, on page 3, which is reproduced from the February edition of the Bank Credit Analyst (published by Storey, Boeckh & Associates of Montreal) shows the behaviour of broad monetary growth in real terms in selected countries. It will be seen that the U.K. stands out very clearly as the only country with a substantial monetary squeeze in real terms.

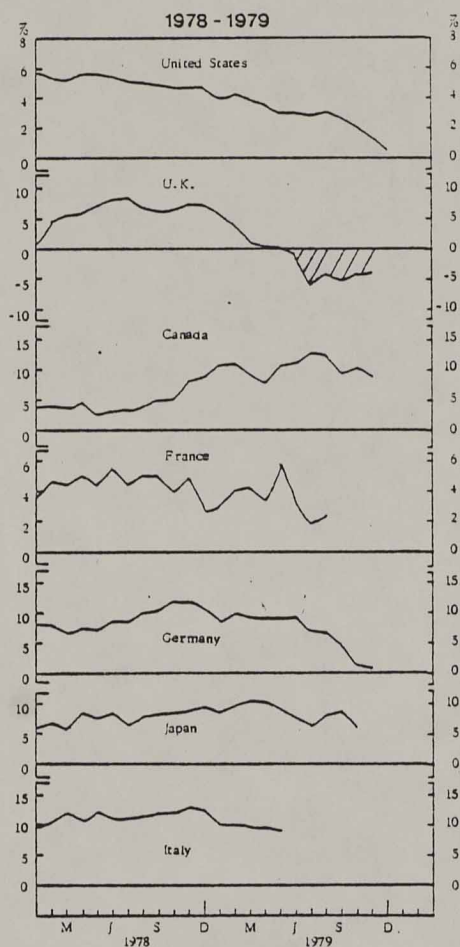
Money tends to flow from an area of high pressure to one of low pressure, from areas where there is surplus money to those where there is a shortage. This is the underlying reason for sterling's recent firmness. If the U.K. authorities continue to intervene in the foreign exchange markets to stop sterling from rising, monetary growth in the U.K. will eventually be given another upwards boost. The U.K.'s recession will then be delayed, moving into phase with the rest of the world. If this is allowed to happen, inflation will carry on rising for some time. To prevent this, the authorities must stop direct intervention in the foreign exchange markets.

The reason for the official intervention is presumably that the height of sterling is thought to be causing acute pressure in some sectors of manufacturing industry. The abolition of outgoing exchange controls was the appropriate policy response in the autumn. The appropriate response now, if sterling continues to rise, is a temporary imposition of incoming exchange controls. The last Conservative Government imposed such controls (in addition to outgoing ones) in 1971. Banks were not allowed to accept additional sterling deposits from non-residents, and non-residents were not permitted to purchase gilt-edged stock. An alternative would be for the U.K. authorities to copy the measures taken from time to time by the Swiss and German authorities, for example two-tier interest rates.

Incoming exchange controls would only need to be temporary, whilst the rest of the world is bringing monetary growth under control. This is just as well, because controls would be circumvented before very long.

INFLATION ADJUSTED BROAD MONEY SUPPLY

CHART I



The graphs show year on year changes. The data for the U.S. are M5 plus security R.P.'s & federal funds purchased, money market funds (net of C.D.'s), net euro-dollar borrowings and bank related commercial paper. The data for the U.K. are sterling M3 plus building society deposits. For the other countries the data are for various definitions of the broad money supply.

Central government surplus

In the banking month to mid-January, sales of central government debt to the non-bank private sector exceeded the central government borrowing requirement by a record £2,500m. About £1,000m. of this was the usual seasonal pattern, many taxes being payable in January. After seasonal adjustment, the £1,500m. flow of funds into the Exchequer was still a record. Conditions in the banking sector suggested that the Exchequer's surplus may well have continued into the banking month of February.

Such inflows reduce the money supply. Interest rates, therefore, can be lower than they would otherwise need to be. Under an efficient system of monetary control, funds flowing into the Exchequer would automatically reduce interest rates below the level they would otherwise be. Under the present system, in the short run at least, the opposite happens. There are two reasons for this, namely a shortage of funds in the money markets and a squeeze on banks' reserve assets.

The first can be illustrated by considering what happens when a tax demand is paid by cheque. When the cheque is cleared, the tax payer's deposit with his bank falls, as does his bank's balance at the Bank of England. Under the present system of monetary control, the bank will replenish its balance with the Bank by withdrawing funds from the discount market. Discount houses will then be short of funds. A discount house can defend itself in three ways - (i) by bidding for additional funds, (ii) by selling assets and (iii) by going to the Bank for assistance. The first two raise interest rates. Under the present system, the Bank gives whatever quantity of assistance the discount market wants, choosing only the price and method. If the Bank does not want interest rates to rise, it will buy Treasury bills from discount houses at unchanged rates. Even so, other rates of interest may rise, for example those in the inter-bank market.

The opposite happens under a monetary base system of control, because the Bank does not wait to be approached by a discount house for assistance. When the cheque for the tax is cleared, the Bank observes a decline in its liabilities as the bank's balance falls (as explained). The Bank's assets fall in line. Its holding of Treasury bills falls as the tax payment reduces the government's need for finance from the Bank. Under the monetary base method, the Bank controls the total of its assets; it goes into the market buying Treasury bills to replenish its portfolio. The Bank, rather than the discount market, takes the initiative. Further, the Bank decides on the quantity of Treasury bills to buy. If the flow of funds into the Exchequer reduces the money supply below the target path, the Bank will, in effect, give slightly more assistance than the discount market wants. The Bank will maintain the supply of reserves even though banks' demand for reserves will have fallen slightly because deposits are lower. Interest rates will fall as a consequence.

The second reason why interest rates tend to rise under the present system is that an inflow of funds to the Exchequer squeezes the supply of reserve assets. A fall in call money with discount houses reduces banks' reserve assets. The pool of available reserve assets is also reduced as the Bank buys Treasury bills. The Bank can act to relieve such pressure on reserve assets. For example, in the banking month of January £780m. special deposits were released and £95m. was lent to discount houses. But, in spite of this, the banks' and the discount market's holdings of public sector debt which qualifies as a reserve asset for a bank fell by £526m. Another example of the Bank relieving pressure is the more recent sale and repurchase agreement with the clearing banks for gilt-edged stock, there being no more special deposits to release.

When there is a shortage of reserve assets, some banks tend to bid aggressively for deposits, intending to use the money so acquired to purchase Treasury bills. This is the second reason why money market rates tend to rise under the present system. Under a monetary base system, this does not happen. The decline in the Treasury bill issue does not squeeze banks' reserve ratios because Treasury bills do not qualify as reserves.

Since the turn of the year, money market interest rates have risen substantially. One month interbank rates rose from $16\frac{1}{2}\%$ in mid-December to a peak of 19% just after the mid-January banking make-up. They have since fallen back to around $17\frac{1}{2}\%$. Shorter term rates such as the seven day inter-bank rate rose from $16\frac{1}{4}\%$ in mid-December to a peak of 22% just after the mid-January banking make-up; they also have subsequently fallen. If the U.K. already had an efficient monetary base system of control and if the authorities had not intervened directly in the foreign exchange markets, the rise in interest rates would certainly have been less and might well have been a good deal less.

Bank lending

In the month to mid-January bank lending in sterling to the private sector was a record £1,304m., seasonally adjusted. The major background reason for this buoyancy was the continued involuntary loan demand which is only to be expected given that the corporate sector's financial deficit is currently so large.

As well as distinguishing between voluntary and involuntary borrowing, previous Bulletins have divided loan demand into personal and corporate. The normal pattern in a business cycle is for the growth of personal borrowing to fall before that of corporate borrowing. This is currently happening. When discussing bank lending the latest London Clearing Banks' release states that there was "little change in the underlying position of the personal sector" in the banking month to mid-January; i.e. that there was little net lending to the personal sector.

In addition to buoyant involuntary loan demand from the corporate sector, there is another important explanation for high bank lending in January. Bank lending is usually high when the CGBR is low and sales of debt are high. The reason is that many people borrow from their banks to pay their taxes. Some also borrow to finance purchases of gilt-edged stock. For the reasons explained below, this tendency was exaggerated in the banking month to mid-January.

Many finance directors would have planned to pay taxes by running down their gross liquid assets. For example, short-term deposits would have been arranged to mature on the day of a tax payment. But on this year's tax payment date, because of the rise in money rates described earlier, the rate of interest earned by leaving the money on deposit was considerably higher than the cost of using a credit line or an overdraft tied to base rates. Some companies, therefore, will have paid their taxes by borrowing from their clearing bank rather than by running down their deposits held with other banks. This is a form of "round-tripping" which amplified the monetary data in the month to mid-January, both bank lending and sterling M3 being distorted upwards.

M Summing up, if the monthly data are averaged, bank lending has been on a very high plateau for a year. But if allowance is made for recent special factors, there is some indication that lending is starting to fall.

Monetary statistics for the month to 16th January, 1980

In the five week banking month to mid-January, the seasonally adjusted behaviour of the monetary aggregates was as follows:

Table I

	<u>£m</u>	<u>p.a.</u>
Notes & coin	95	12%
Retail M1	-256	-13%
Sterling M3	626	13%
M4	552	11%
M5	1,054	12%
DCE	522	
Bank lending in sterling to private sector	1,304	35%

Bank acceptances held outside the banking system grew only modestly, by £40m.; as in the previous month, non-residents are said to be taking up these acceptances, and to that extent our figures for M4 and M5 will be too high.

After the latest data, the underlying picture of monetary growth becomes:

Table II

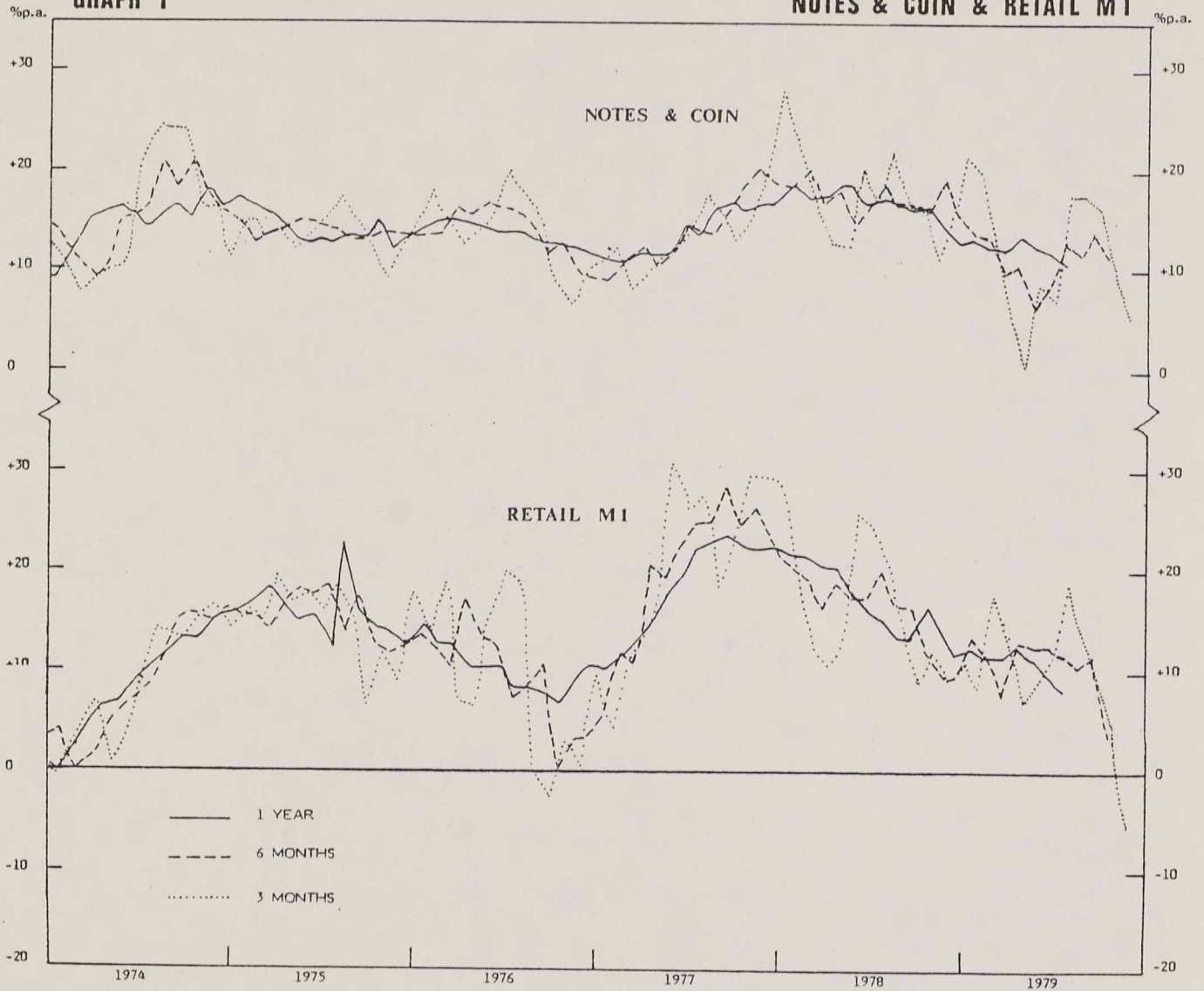
	<u>3 months</u>	<u>6 months</u>	<u>7 months</u> <u>(since mid-June)</u>	<u>12 months</u>
Notes & coin	5% p.a.	11% p.a.	14% p.a.	11%
Retail M1	-5% p.a.	4% p.a.	8% p.a.	8%
Sterling M3	9% p.a.	13% p.a.	12% p.a.	11%
M4	7% p.a.	13% p.a.	12% p.a.	14%
M5	8% p.a.	14% p.a.	13% p.a.	14%

M In the seven months since mid-June, the base for for current target range, the underlying growth of sterling M3 has been between 1-2% above the top of the 7-11% range. Monetary growth in the last three months, however, has been much lower than that in the previous four months. After the disappointments of the autumn, our impression is that we are now past the turning point of monetary expansion, providing that the authorities cease large scale intervention in the foreign exchange markets.

G.T.P.
R.L.T.
R.R.

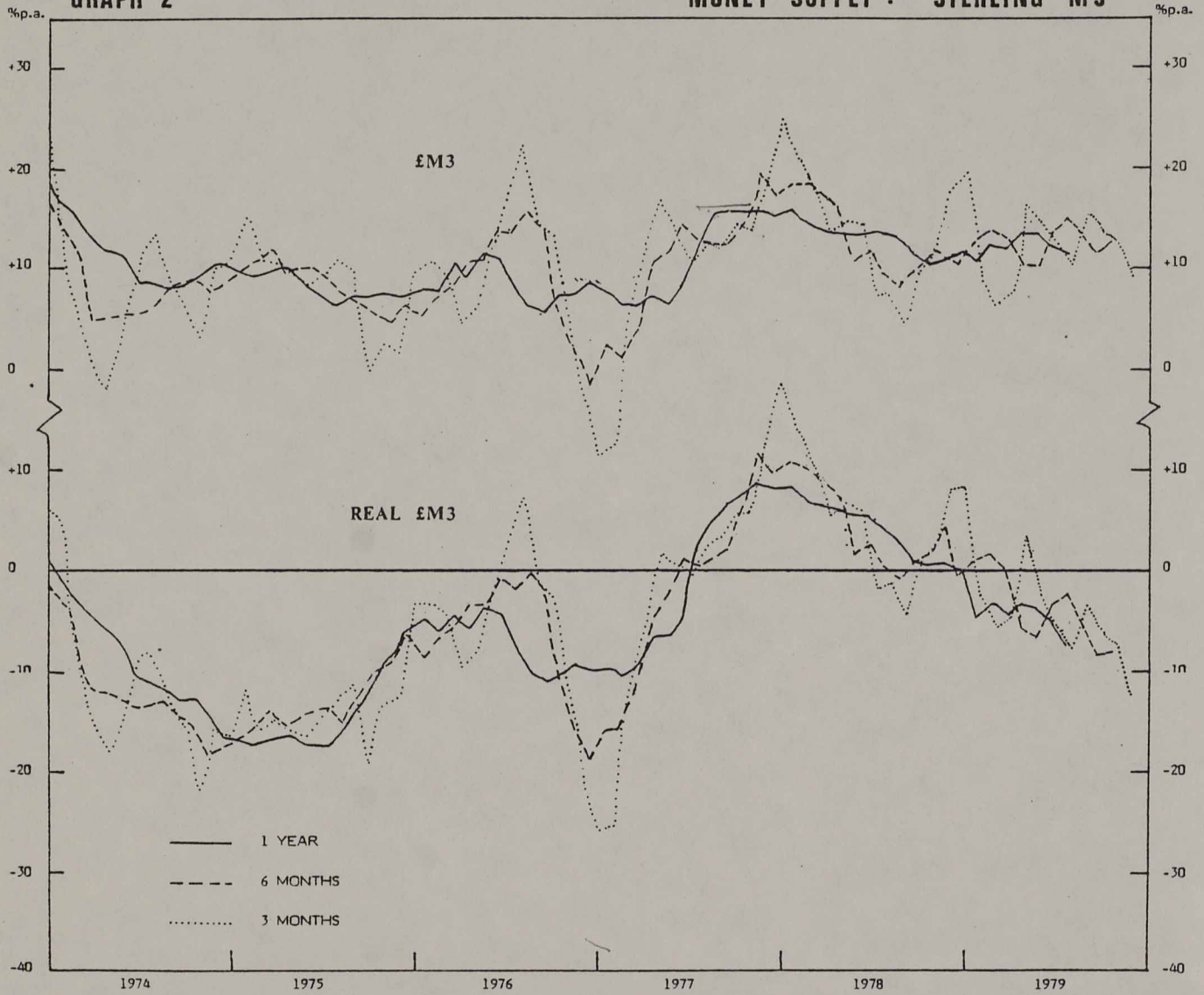
GRAPH 1

NOTES & COIN & RETAIL M1



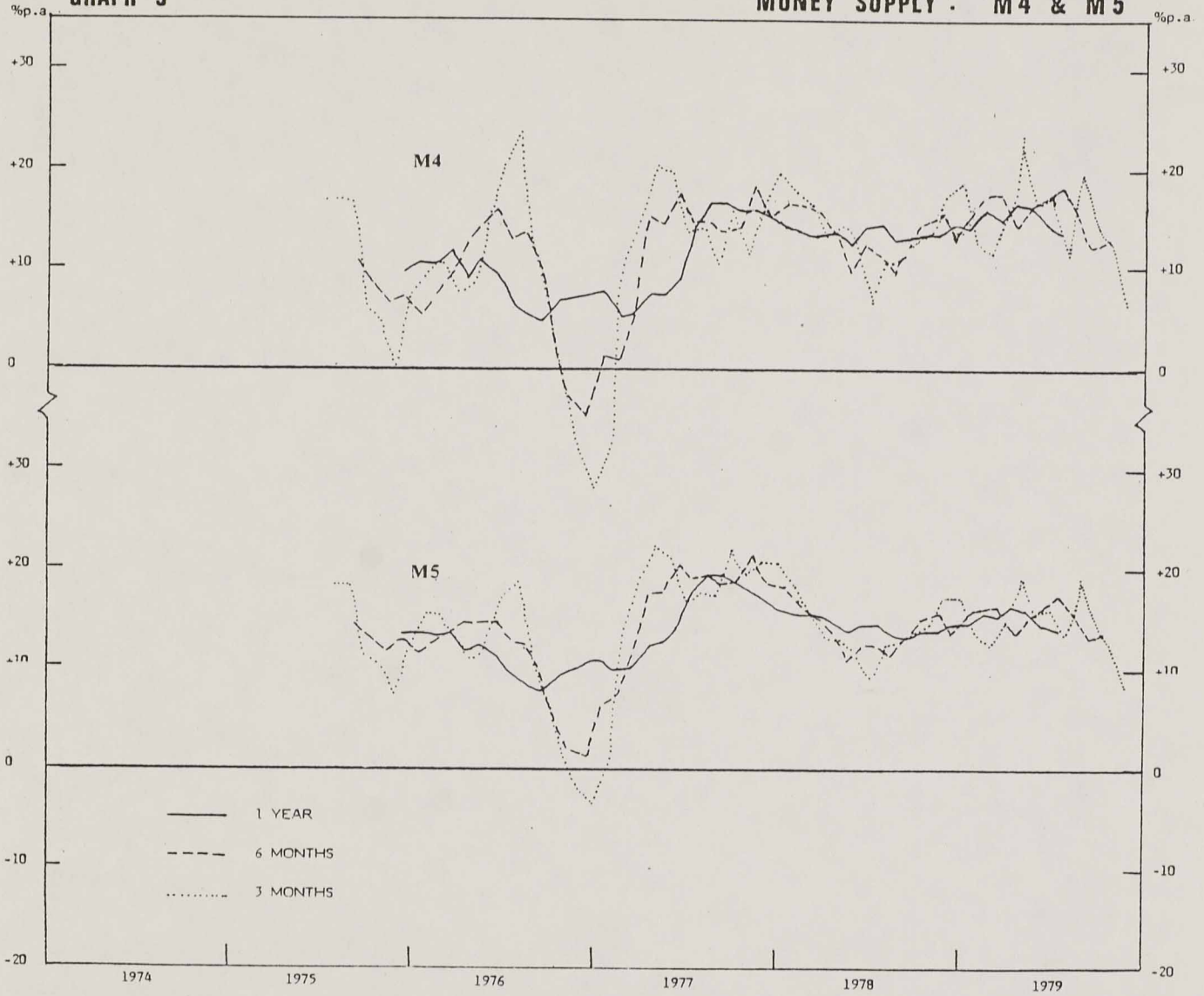
GRAPH 2

MONEY SUPPLY : STERLING M3



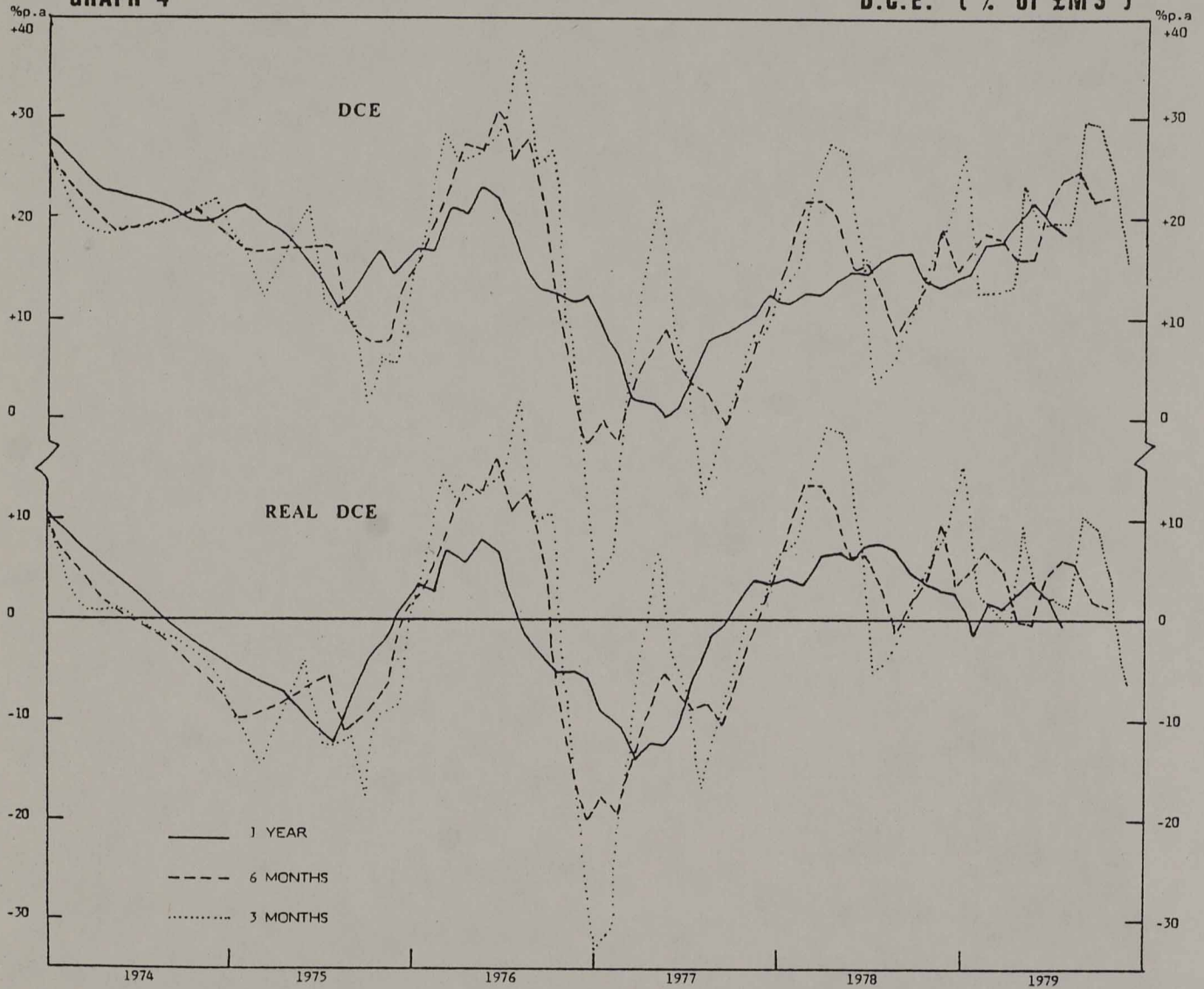
GRAPH 3

MONEY SUPPLY : M4 & M5



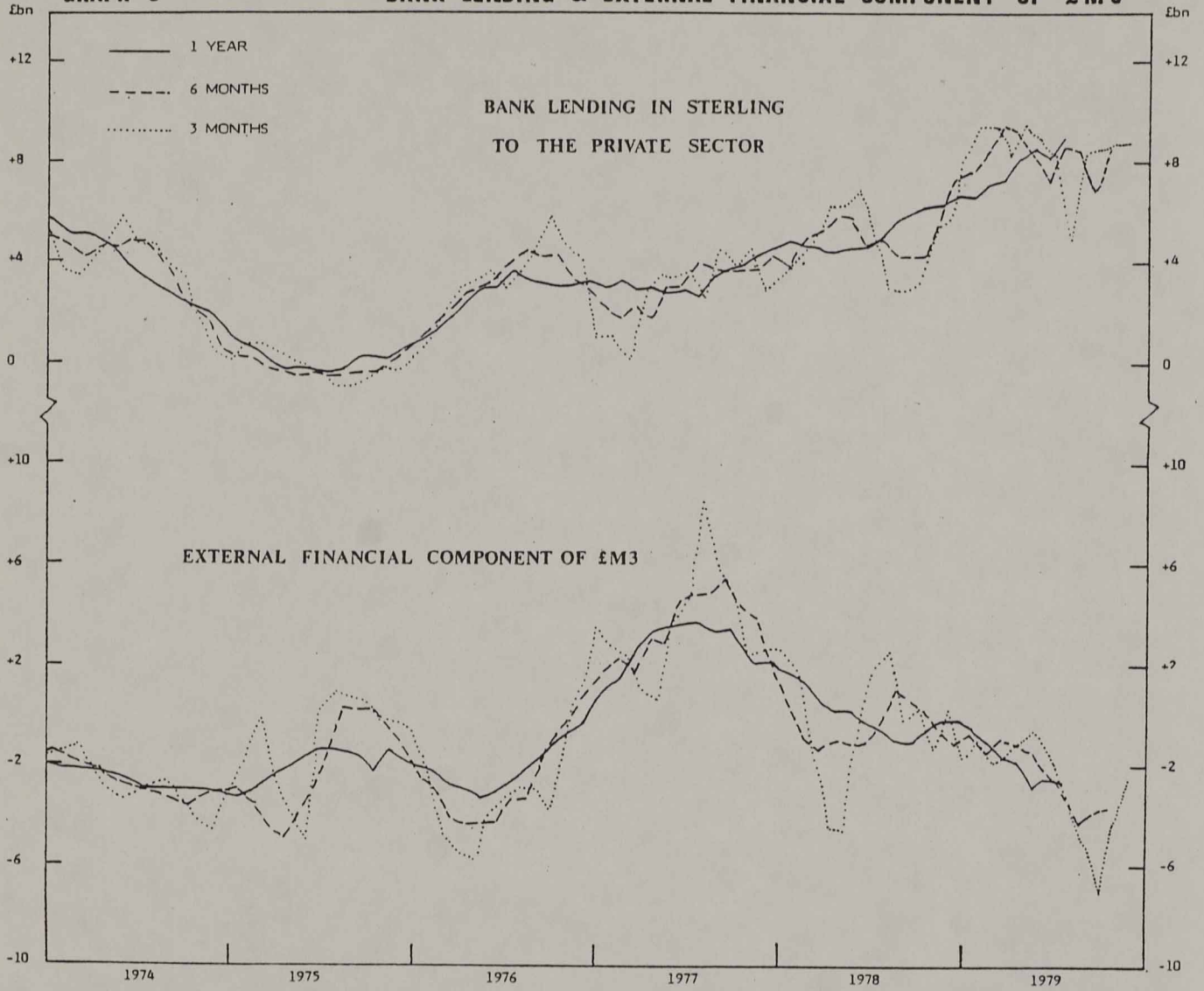
GRAPH 4

D.C.E. (% of £M3)



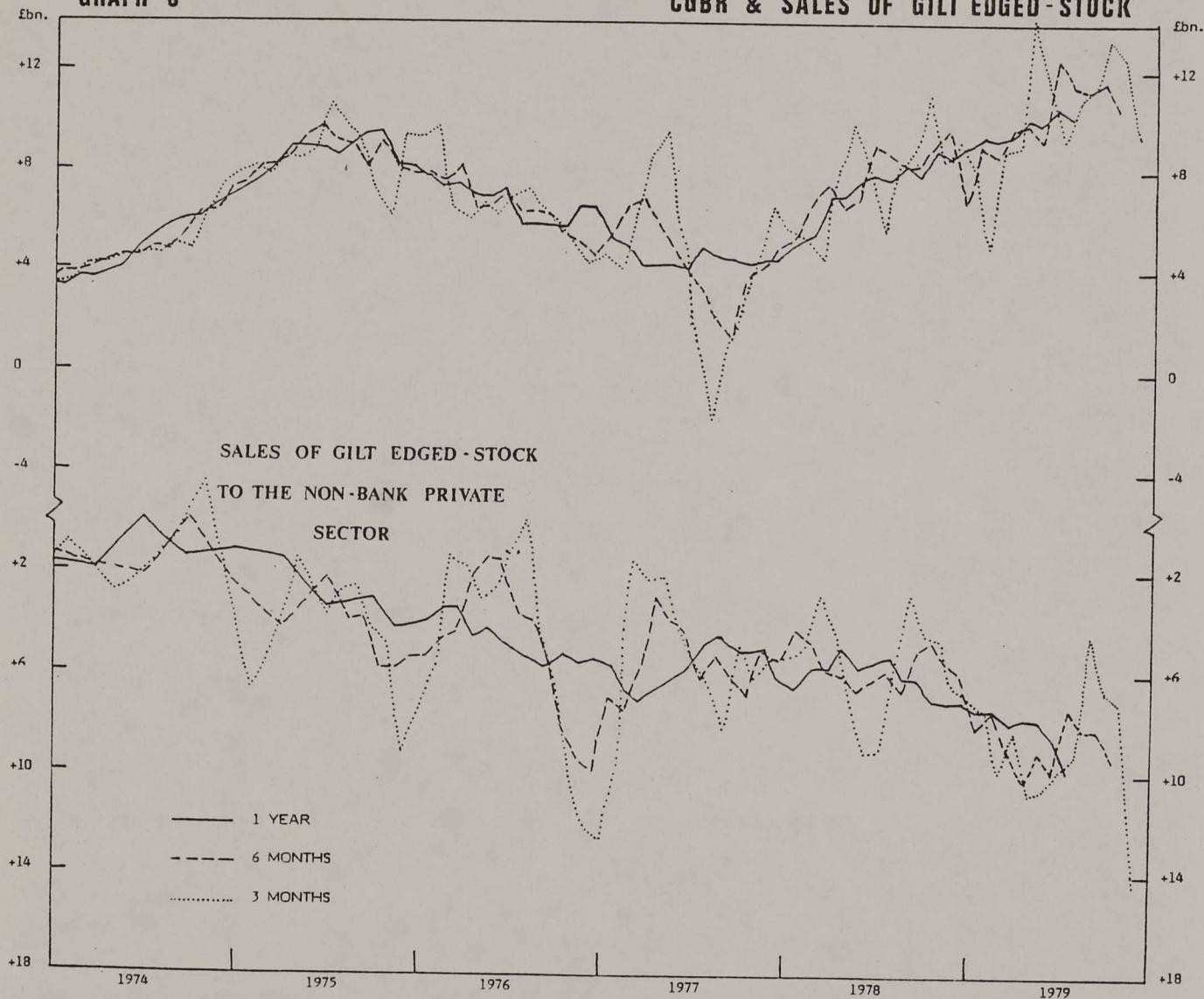
GRAPH 5

BANK LENDING & EXTERNAL FINANCIAL COMPONENT OF £M3



GRAPH 6

CGBR & SALES OF GILT EDGED-STOCK



STATISTICS

reprinted from Bank of England, *Banking Statistics*.

UK banking sector: transactions in liabilities and assets (a)

(Table 6 in the *Quarterly Bulletin*)

£ millions

Month ended	Liabilities												
	Total	Domestic deposits										Overseas sector deposits	Non-deposit liabilities (net)
		Total		Public sector				Private sector		Sterling	Other currencies		
		Un-adjusted	Seasonally adjusted	Sterling		Other currencies		Un-adjusted	Seasonally adjusted				
		Un-adjusted	Seasonally adjusted	Un-adjusted	Seasonally adjusted	Un-adjusted	Seasonally adjusted	Sterling	Other currencies				
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	- 662	- 704	- 324	- 265	+ 38	- 115	- 216	- 261	+ 339	+ 467	- 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	+ 1,026	+ 1,068	+ 187	+ 34	- 11	+ 451	+ 646	+ 399	+ 151	+ 2,962	+ 564	
July 18	+ 4,771	+ 255	+ 137	- 210	- 147	+ 18	+ 561	+ 380	- 114	+ 207	+ 4,235	+ 74	
Aug. 15	+ 1,071	+ 208	+ 361	- 103	+ 63	- 12	+ 472	+ 459	- 149	+ 275	+ 561	+ 27	
Sept. 19	+ 6,961	+ 195	+ 78	- 36	- 59	+ 35	+ 374	+ 280	- 178	+ 70	+ 6,753	- 57	
Oct. 17	+ 6,968	+ 1,335	+ 1,136	+ 67	+ 94	- 6	+ 996	+ 770	+ 278	+ 164	+ 5,204	+ 265	
Nov. 21	+ 4,714	+ 899	+ 1,080	+ 118	- 55	+ 10	+ 48	+ 402	+ 723	+ 395	+ 3,507	- 87	
Dec. 12	- 12	- 166	- 107	- 100	+ 95	+ 3	+ 190	+ 159	- 259	+ 342	- 251	+ 63	
1980 Jan. 16	+ 5,583	+ 352	+ 412	+ 173	+ 59	+ 7	+ 403	+ 472	- 231	+ 393	+ 4,699	+ 139	

Month ended	Assets											
	Total	Lending to public sector					Lending to private sector				Lending to overseas sector	
		Sterling					Other currencies	Sterling		Other currencies	Sterling	Other currencies
		Total		Central government	Other	Un-adjusted		Seasonally adjusted				
Un-adjusted	Seasonally adjusted	Un-adjusted	Seasonally adjusted				Un-adjusted		Seasonally adjusted			
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	- 164	- 18	+ 177	+ 378	+ 378	+ 61	+ 2,427	
June 20	+ 4,703	+ 115	- 25	+ 69	+ 46	+ 8	+ 1,382	+ 1,312	- 50	- 73	+ 3,321	
July 18	+ 4,771	+ 286	+ 138	- 480	+ 194	- 153	+ 1,094	+ 347	+ 191	- 6	+ 3,931	
Aug. 15	+ 1,071	+ 360	- 92	+ 281	+ 79	- 42	+ 337	+ 885	- 45	+ 116	+ 345	
Sept. 19	+ 6,961	+ 190	+ 173	- 99	+ 289	- 42	+ 113	+ 158	- 93	- 27	+ 6,820	
Oct. 17	+ 6,968	+ 286	+ 123	+ 305	- 19	- 14	+ 1,351	+ 1,227	+ 146	- 32	+ 5,231	
Nov. 21	+ 4,714	- 13	+ 207	- 102	+ 89	+ 12	+ 693	+ 709	- 3	+ 103	+ 3,922	
Dec. 12	- 12	+ 240	- 179	+ 411	- 171	- 60	- 459	+ 158	- 34	- 17	+ 318	
1980 Jan. 16	+ 5,583	- 1,218	- 562	- 1,548	+ 330	- 48	+ 2,068	+ 1,305	+ 475	+ 188	+ 4,118	

[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. Inter-bank items are excluded and adjustments made to allow for transit items (see additional notes to Table 6 in the *Quarterly Bulletin*).

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	Unadjusted	Seasonally adjusted	Unadjusted	Seasonally adjusted	Unadjusted	Seasonally adjusted		
	1	2	3													4	5
Month ended																	
1978 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	50,570	4,685	54,989	55,250					
Feb. 21	8,594	13,012	3,713	25,319	25,920	23,446	1,506	50,271	51,080	4,855	55,126	55,930					
Mar. 21	8,689	13,446	3,488	25,623	25,960	23,122	1,182	49,927	50,640	4,575	54,502	55,210					
Apr. 18	8,862	14,484	3,792	27,138	26,750	23,173	1,224	51,535	51,360	4,550	56,085	55,910					
May 16	8,833	14,262	3,857	26,952	26,780	23,930	1,073	51,955	52,090	4,837	56,792	56,920					
June 20	8,804	14,026	3,718	26,548	26,570	24,756	1,260	52,564	52,690	5,066	57,630	57,750					
July 18	9,230	14,335	3,755	27,320	27,210	24,971	1,050	53,341	53,110	4,653	57,996	57,770					
Aug. 15	9,143	14,532	3,632	27,307	27,200	25,369	947	53,623	53,670	4,586	58,209	58,250					
Sept. 19	9,121	14,750	3,470	27,341	27,310	25,687	911	53,939	53,990	4,633	58,572	58,620					
Oct. 17	9,267	15,143	4,038	28,448	28,210	25,722	978	55,148	55,020	4,903	60,051	59,930					
Nov. 21	9,307	14,777	3,588	27,672	27,630	26,586	1,096	55,354	55,380	5,559	60,913	60,940					
Dec. 12	9,675	15,064	3,540	28,279	27,650	26,537	996	55,812	55,630	5,266	61,078	60,790					
1980 Jan. 16	9,319	14,379	3,793	27,491	27,620	27,372	1,169	56,032	56,210	4,860	60,892	61,070					

(a) After deducting 60% of transit items (see additional notes to Table 6 of the Quarterly Bulletin).

(b) M₁ equals columns 1 + 2 + 3. Sterling M₃ equals M₁ + columns 5 + 6. M₃ equals sterling M₃ + 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	Unadjusted	Seasonally adjusted	Unadjusted	Seasonally adjusted	Unadjusted	Seasonally adjusted	Unadjusted	Seasonally adjusted	Unadjusted	Seasonally adjusted	Transactions	Valuation changes (e)	Unadjusted	Seasonally adjusted
	1	2	3														
Month ended (unadjusted)																	
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	- 144	+ 223	- 57	- 624							
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	+ 388	- 159	+ 838							
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	- 36	+ 316	+ 143	+ 190	+ 163							
Oct. 17	+ 146	+ 393	+ 568	+1,107	+ 35	+ 67	+ 1,209	+ 272	- 2	+ 1,479							
Nov. 21	+ 40	- 366	- 450	- 776	+ 864	+ 118	+ 206	+ 733	- 77	+ 862							
Dec. 12	+ 368	+ 287	- 48	+ 607	- 49	- 100	+ 458	- 256	- 37	+ 165							
1980 Jan. 16	- 356	- 685	+ 253	- 788	+ 835	+ 173	+ 220	- 224	- 182	- 186							
Month ended (seasonally adjusted)																	
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	- 223	- 57	- 723	-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	+ 388	- 159	+ 830	+1.5				
July 18	+ 194	+ 37	+ 642	+2.4	- 68	- 147	+ 427	+0.8	- 96	- 315	+ 16	-					
Aug. 15	+ 41	+ 79	- 123	- 3	+ 503	+ 63	+ 563	+1.1	- 161	+ 92	+ 494	+0.9					
Sept. 19	+ 125	+ 157	- 162	+ 120	+0.4	+ 285	- 59	+ 346	+0.6	- 143	+ 190	+ 393	+0.7				
Oct. 17	+ 201	+ 152	+ 568	+ 921	+3.4	+ 50	+ 94	+ 1,065	+2.0	+ 272	- 2	+ 1,335	+2.3				
Nov. 21	+ 24	- 149	- 450	- 575	-2.0	+1,001	- 55	+ 371	+0.7	+ 733	- 77	+ 1,027	+1.7				
Dec. 12	+ 4	+ 70	- 48	+ 26	+0.1	+ 137	+ 95	+ 258	+0.5	- 361	- 37	- 140	-0.2				
1980 Jan. 16	+ 95	- 351	+ 253	- 3	+ 570	+ 59	+ 626	+1.1	- 119	- 182	+ 325	+0.5					

(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) M₁ equals columns 1 + 2 + 3. Sterling M₃ equals M₁ + columns 5 + 6. M₃ equals sterling M₃ + columns 8 + 9.

(d) Including certificates of deposit.

(e) See additional notes to Tables 6 and 11 of the Quarterly Bulletin.

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

£ millions

Month ended (unadjusted)	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 sector (c)	Domestic credit expansion (d)	External and foreign currency finance (increase -)			Net non-deposit liabilities (increase -) (e)	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 sector sterling deposits (c)	Banks' foreign currency deposit liabilities (net) (e)				
													8	9
	1	2	3	4	5	6	7	8	9	10	11	12		
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	+ 280	- 1,371	+ 426	- 8	- 385	+ 605	- 339	- 248	+ 23	- 344			
Apr. 18	+ 2,335	+ 233	- 1,381	+ 543	+ 29	+ 1,759	+ 462	- 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	- 27	+ 609			
July 18	+ 601	+ 82	- 817	+ 1,128	- 6	+ 988	+ 240	- 207	- 170	- 74	+ 777			
Aug. 15	+ 571	+ 216	- 224	+ 141	+ 116	+ 820	- 94	- 275	- 142	- 27	+ 282			
Sept. 19	+ 1,456	+ 195	- 997	+ 110	- 27	+ 737	- 483	- 70	+ 75	+ 57	+ 316			
Oct. 17	+ 849	- 447	+ 69	+ 1,352	- 32	+ 1,791	- 40	- 164	- 113	- 265	+ 1,209			
Nov. 21	+ 466	+ 52	- 317	+ 713	+ 103	+ 1,017	- 194	- 395	- 309	+ 87	+ 206			
Dec. 12	+ 2,310	- 260	- 1,168	- 460	- 17	+ 405	- 273	- 342	+ 731	- 63	+ 458			
1980 Jan. 16	- 863	+ 460	- 1,640	+ 2,067	+ 188	+ 212	+ 470	- 393	+ 70	- 139	+ 220			
Month ended (seasonally adjusted)														
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	+ 295	- 1,320	+ 729	+ 8	+ 318	- 38			- 37	- 443			
Apr. 18	+ 1,464	+ 133	- 1,339	+ 535	+ 29	+ 822	- 94			- 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	+ 689	+ 116	+ 1,050	- 359			- 128	+ 563			
Sept. 19	+ 1,647	+ 129	- 986	+ 155	- 27	+ 918	- 522			- 50	+ 346			
Oct. 17	+ 937	- 622	+ 54	+ 1,228	- 32	+ 1,565	- 384			- 116	+ 1,065			
Nov. 21	+ 731	+ 13	- 333	+ 729	+ 103	+ 1,243	- 895			+ 23	+ 371			
Dec. 12	+ 1,470	- 141	- 1,224	+ 157	- 17	+ 245	+ 156			- 143	+ 258			
1980 Jan. 16	+ 154	+ 498	- 1,622	+ 1,304	+ 188	+ 522	+ 129			- 25	+ 626			

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

Month ended	Marketable debt		National savings		Tax instruments	Other (g)	Total (column 4 above)	
	Stocks	Treasury bills	Unadjusted	Seasonally adjusted			Unadjusted	Seasonally adjusted
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	- 30	- 104	- 18	- 10	- 817	- 841
Aug. 15	- 434	+ 145	- 43	- 57	+ 101	+ 7	- 224	- 238
Sept. 19	- 955	- 10	- 38	- 27	- 10	+ 16	- 997	- 986
Oct. 17	+ 264	- 79	- 43	- 58	- 75	+ 2	+ 69	+ 54
Nov. 21	- 838	+ 75	- 47	- 63	+ 333	+ 160	- 317	- 333
Dec. 12	- 1,133	- 51	- 56	- 112	+ 20	+ 52	- 1,168	- 1,224
1980 Jan. 16	- 1,626	- 11	- 136	- 118	+ 125	+ 8	- 1,640	- 1,622

(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 M₃ equals domestic credit expansion plus columns 8 + 9 + 10 + 11 (see also page 7).

(g) Includes repayments (+) by the Fund for Banks for Savings (a central government fund) to the trustee savings banks.

Symbols and conventions

.. not available.

- nil or less than £¼ 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.

W. Greenwell & Co.

Bow Bells House,
Bread Street, London EC4M 9EL

Telephone: 01-236 2040 Telex: 883006

W. Greenwell Associates (Investment Adviser) 450 Park Avenue, New York, N.Y. 10022
Telephone: 212 832 7428 Telex: 710 5815122

Econ
Pol. 2



MONETARY BULLETIN

No. 100 January, 1980

MT

Don't think

with reading.

π

Current monetary growth and the height of the targets

In the three week banking month to 12th December, the seasonally adjusted ^{22/1} behaviour of the monetary aggregates was as follows:

Table I

	<u>£m.</u>	<u>p.a.</u>
Notes & coin	4	-
Retail M1	52	3%
Sterling M3	212	5%
M4	368	8%
M5	613	7%
DCE	253	
Bank lending in sterling to private sector	212	6%

During the month, the CGBR appears to have been erratically high whilst bank lending was erratically low, the two being connected. In fact, during the banking month to mid-December the CGBR on a non-seasonally adjusted basis was £635m. greater than the average of that in the calendar months of November and December, but some of this was seasonal.

In general, the improvement in the monetary aggregates which we reported last month has continued. The underlying picture has become:

Table II

	<u>3 months</u>	<u>6 months</u> (since mid-June)	<u>12 months</u>
Notes & coin	10% p.a.	14% p.a.	12%
Retail M1	5% p.a.	12% p.a.	10%
Sterling M3	13% p.a.	12% p.a.	12%
M4	13% p.a.	12% p.a.	15%
M5	13% p.a.	13% p.a.	15%

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

Our series for M4 and M5 include bank acceptances held outside the banking sector, which rose by £90m. in banking December. Anecdotal evidence suggests, however, that non-residents have recently acquired substantial amounts of these acceptances. To the extent that this is so, the above data for M4 and M5 overstate the growth of U.K. residents' liquidity.

For many months we have reported that sterling M3 has been giving a misleadingly low impression of monetary growth. Our Bulletins have shown that both the narrower and broader aggregates have been growing faster than sterling M3. Table II suggests that this pattern is disappearing, especially if allowance is made for the above point about bank acceptances.

Last month, however, we suggested that another adjustment should be made. In assessing underlying monetary growth some allowance should be made for any growth in foreign currency deposits of U.K. residents following the abolition of exchange controls. In banking November such deposits with banks in the U.K. grew by £748m. but in banking December they fell by £375m. (ignoring valuation changes). It is also worth noting that U.K. residents can now hold deposits with banks outside the U.K., but data for these are unavailable.

Adding these points together, our conclusion is that underlying monetary growth since mid-June has not exceeded the upper limit of the 7-11% target range by more than 2%.

Turning to the future, there are the following favourable factors:

- (i) official sales of gilt-edged stock in banking January have been very substantial,
- (ii) large sales of National Savings Certificates are expected when the 19th Issue becomes available in February, and
- (iii) the central government borrowing requirement is expected to be very low in March.

In the opposite direction, apart from the possibility of one month's rogue data, particularly for bank lending, the most important danger is an inflow of money from abroad. Given the favourable factors, though, it is quite likely that the appetite of gilt-edged investors will be sufficient for the authorities to reduce monetary growth below the upper limit of its target range.

When the present target range was set, inflation was officially forecast to peak at 17½% (between November 1978 and November 1979). Currently, inflation is widely expected to peak at about 21% (between the second quarter of 1979 and that of 1980). To prevent the monetary squeeze from becoming considerably more severe in real terms than was originally intended, and than now seems wise, the authorities should, in our opinion, aim at the upper limit rather than the mid-point of the current target range.

The appendix is a note which we wrote some months ago on the problems of setting monetary targets; it explains the thinking underlying our last point. The authorities are again walking the tight rope between excessive and inadequate monetary growth. They stumbled on the excessive side in October. They are now regaining their balance. But the rise in the current rate of inflation means that the tight rope has become narrower.

G.T.P.
R.L.T.
R.R.

Appendix

Setting monetary targets

Targets for monetary growth must be expressed in nominal terms and not real terms. This is because if they are expressed in real terms they can be achieved by inflation accelerating. (This is similar to the I.M.F.'s argument for constraining DCE; an M3 target can be achieved because the balance of payments deteriorates.)

Some people argue that the target for monetary growth should be very low. In effect they argue for shock treatment. It is claimed that inflationary expectations can be reduced quickly and, after this has happened, economic growth can be resumed.

At first sight the case for shock treatment appears to be quite strong, because reducing inflation solely by gradually constraining the growth of the money supply will be a long drawn out process. The reason why shock treatment should not be administered is that it would cause a financial crisis. After the ravages of inflation, balance sheets are weak. Many companies can stand only a limited degree of financial pressure without going bankrupt. Individual bankruptcies can be tolerated but not those which lead to chain reactions and "domino effects". Therefore, the financial system as a whole must not be put under so great financial pressure that individual bankruptcies will trigger uncontrolled chain reactions.

Summarising, on the one hand the degree of shock treatment which the economy can stand is severely limited by the need to avoid a financial crisis but, on the other hand, the gradual approach should be as fast as possible. This suggests that the maximum possible financial pressure should be exerted subject to avoiding a financial crisis.*

The best measure of financial pressure is the behaviour of the money stock in real terms. This depends on what rate of inflation is actually experienced.

The vast majority of monetarists stress that there is a time lag before inflation responds to changes in monetary growth and that this can be as long as two and a half years although about twelve months may be more usual. Further, prices and incomes policies, discontinuities in exchange rates and external shocks all affect the incidence of inflation in the short run. For these reasons, the rate of inflation can rise in spite of concurrent control of the money supply. A Government can do everything in its power to reduce inflationary expectations but at the end of the day inflation may still rise. It is this inflation which determines the degree of financial pressure in the short run.

* *It should also be remembered that inflation is caused by too much money chasing too few goods. The cure has two parts - less money and more goods. The case against shock treatment on the monetary side does not apply to the other half of the cure. Shock tactics should definitely be used to increase the supply of goods, e.g. reductions in marginal rates of total taxation coupled with substantial cuts in public expenditure.*

What degree of financial pressure makes a financial crisis likely? The behaviour of sterling M3 in real terms and adjusted for unusual arbitrage transactions is probably the best measure of pressure. Adjustment should also be made for known special factors affecting the incidence of monetary growth, e.g. a tax rebate. The behaviour of security markets and any excessive monetary growth in the immediately preceding period are also relevant.

The experience of 1974 provides some guide. The exact point when financial pressure became dangerous was a matter of judgement. Our verdicts were recorded in our Bulletins at the time. In our June Bulletin (No. 25) we reported that the seasonally adjusted growth in real terms of M3 had been -13% p.a. during the latest three months, -2% p.a. during the latest six months and +8% during the latest year. We concluded that the monetary indicators were, unequivocally, signalling a recession. A month later these rates of growth had become -16% p.a., -9% p.a. and +4% and we concluded that the reduction in the growth of the money supply was too sharp for a policy of gradualism. In our next Bulletin we stated that the public sector was borrowing considerably more than it needed from the private sector. We also accused the authorities of pre-empting finance that was desperately needed by the private sector itself and argued that the Bank of England should severely ration its net sales of gilt-edged stock. (Subsequently, tax relief for stock appreciation had to be announced in November, Burmah Oil had its financial crisis in December and stockmarkets fell until the beginning of January 1975.)

A combination of the above thoughts suggests the following:

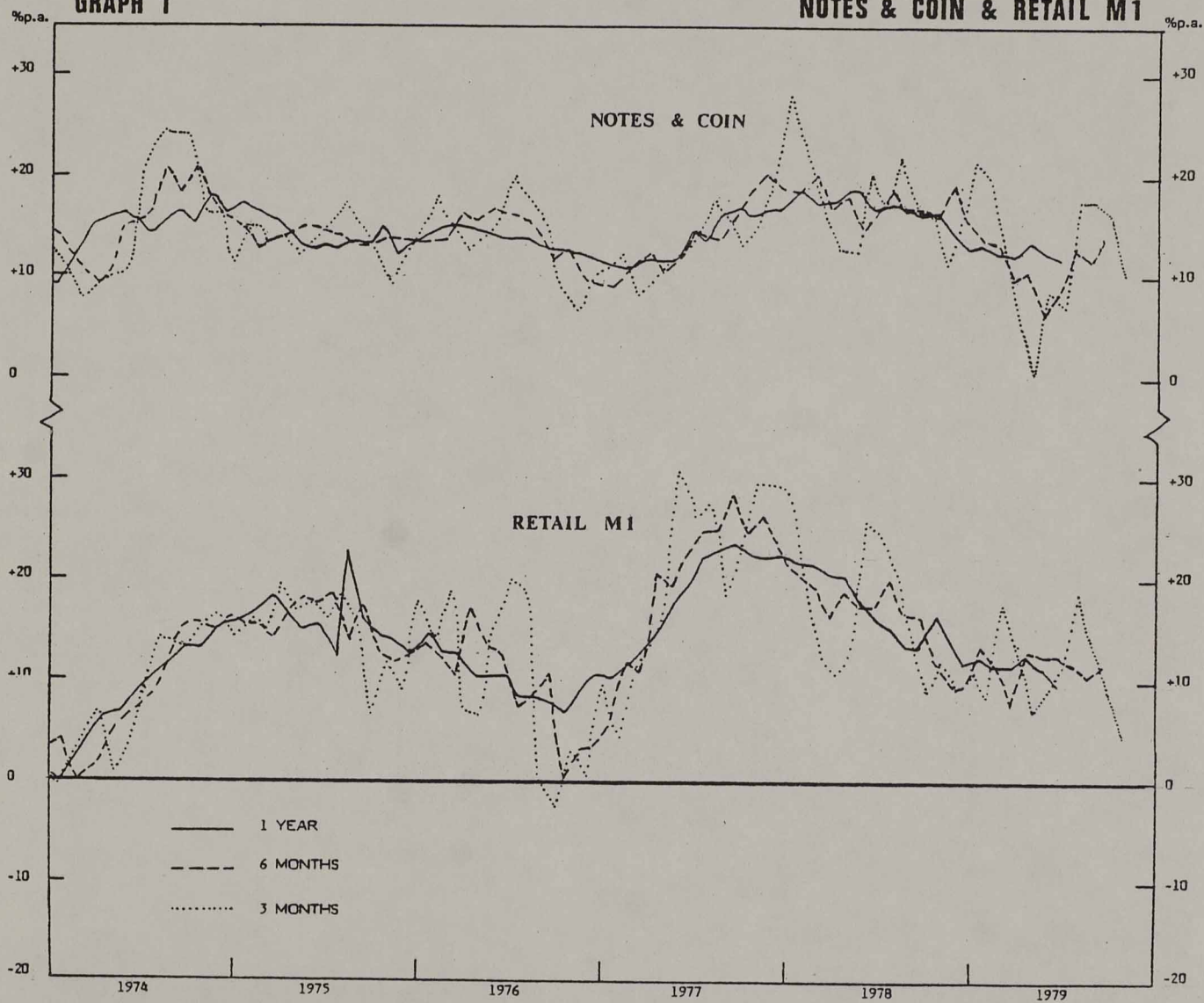
- (i) Target ranges for monetary growth should be expressed in nominal terms.
- (ii) The upper limit of a target range should be sufficiently high to allow monetary growth in real terms to be above the danger level.
- (iii) The outturn of inflation will determine the point within the range at which the authorities should aim but the higher the rate of inflation, the more intense should be the financial pressure in real terms.

Elaborating on the last point, financial pressure in real terms should be made more intense when inflation is high, for two reasons. Firstly, inflation has a greater tendency to gather dangerous momentum when it is high than when it is low; financial pressure must be sufficient to arrest the momentum. Secondly, financial pressure increasing in real terms as inflation rises increases the deterrent to high wage settlements.

As the policy is pursued, inflation will start responding to prior control of the money supply and the effects of previous prices & incomes policies and discontinuities in exchange rate policy will wear off. Inflation will both reduce and become less volatile. Therefore, the width of the target range for the money supply can be narrowed at the same time as the mid-point is lowered.

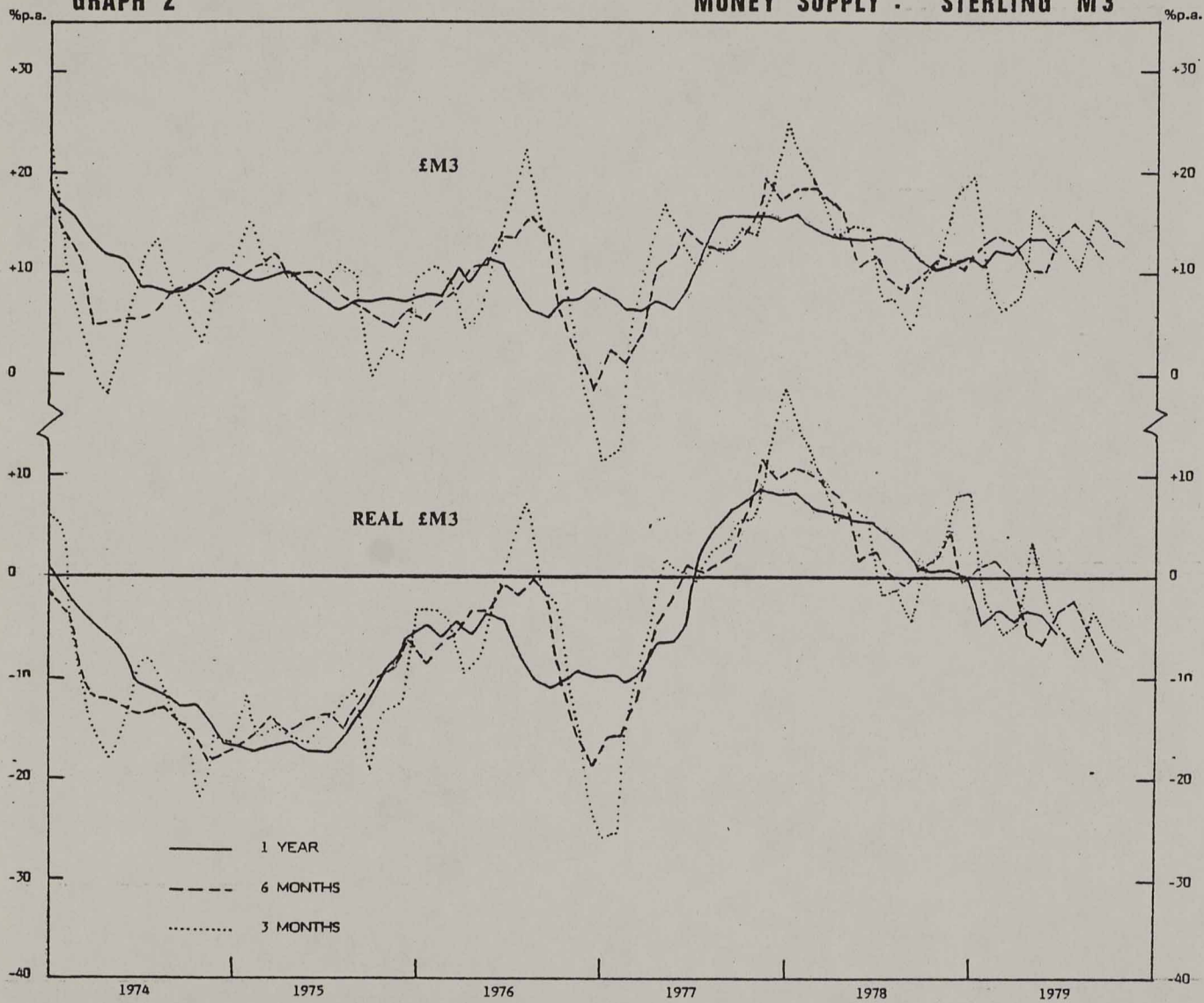
GRAPH 1

NOTES & COIN & RETAIL M1



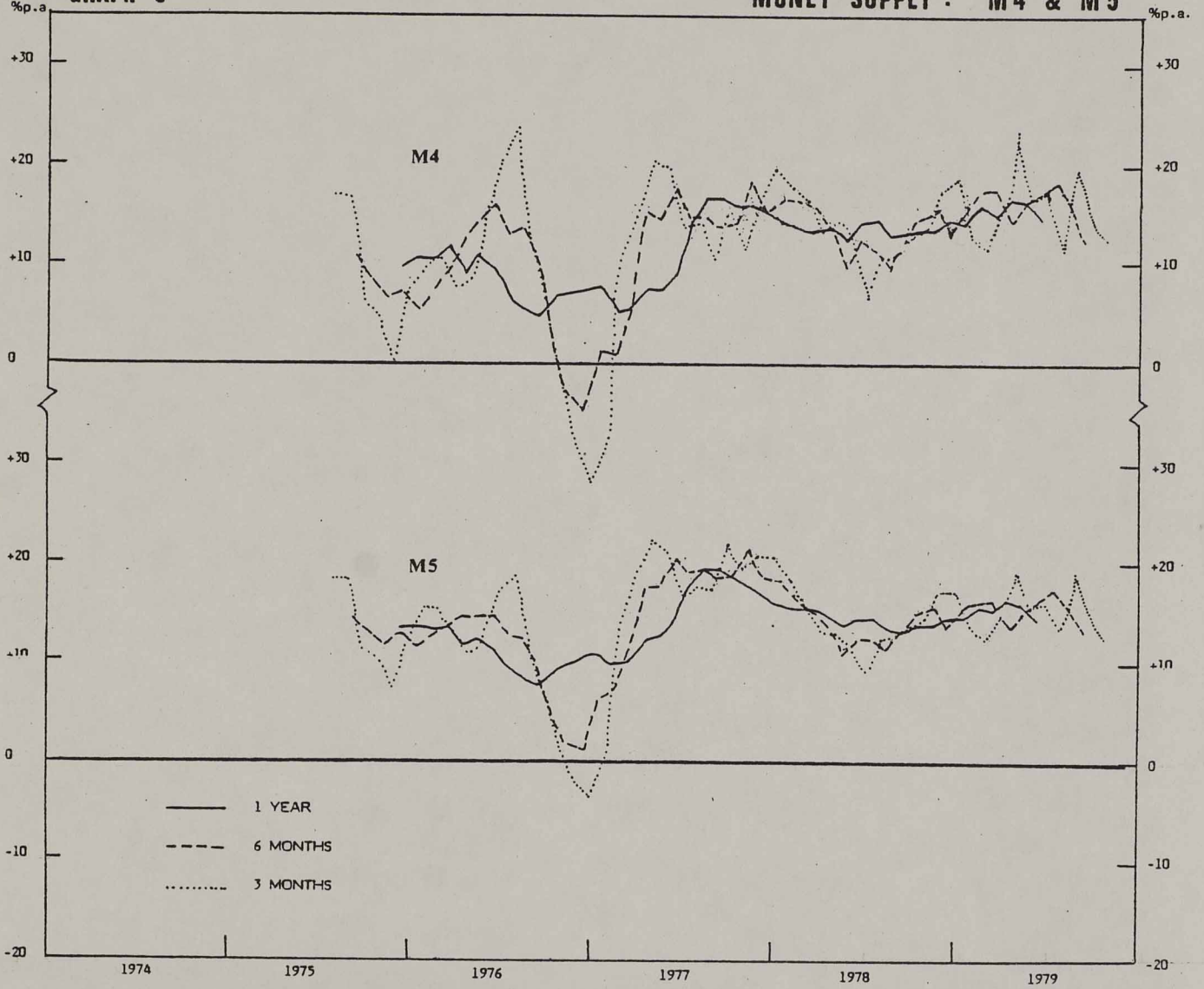
GRAPH 2

MONEY SUPPLY : STERLING M3



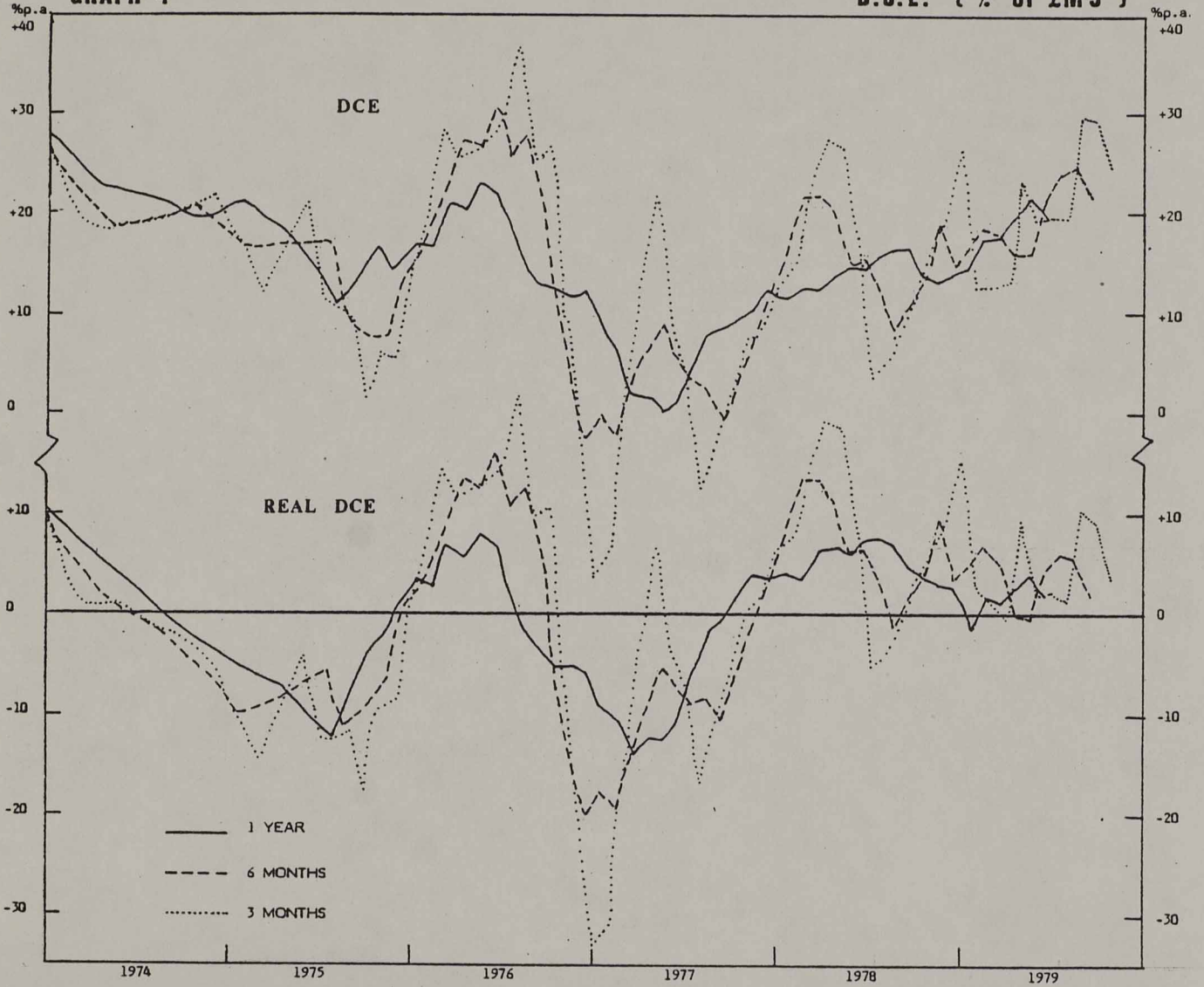
GRAPH 3

MONEY SUPPLY : M4 & M5



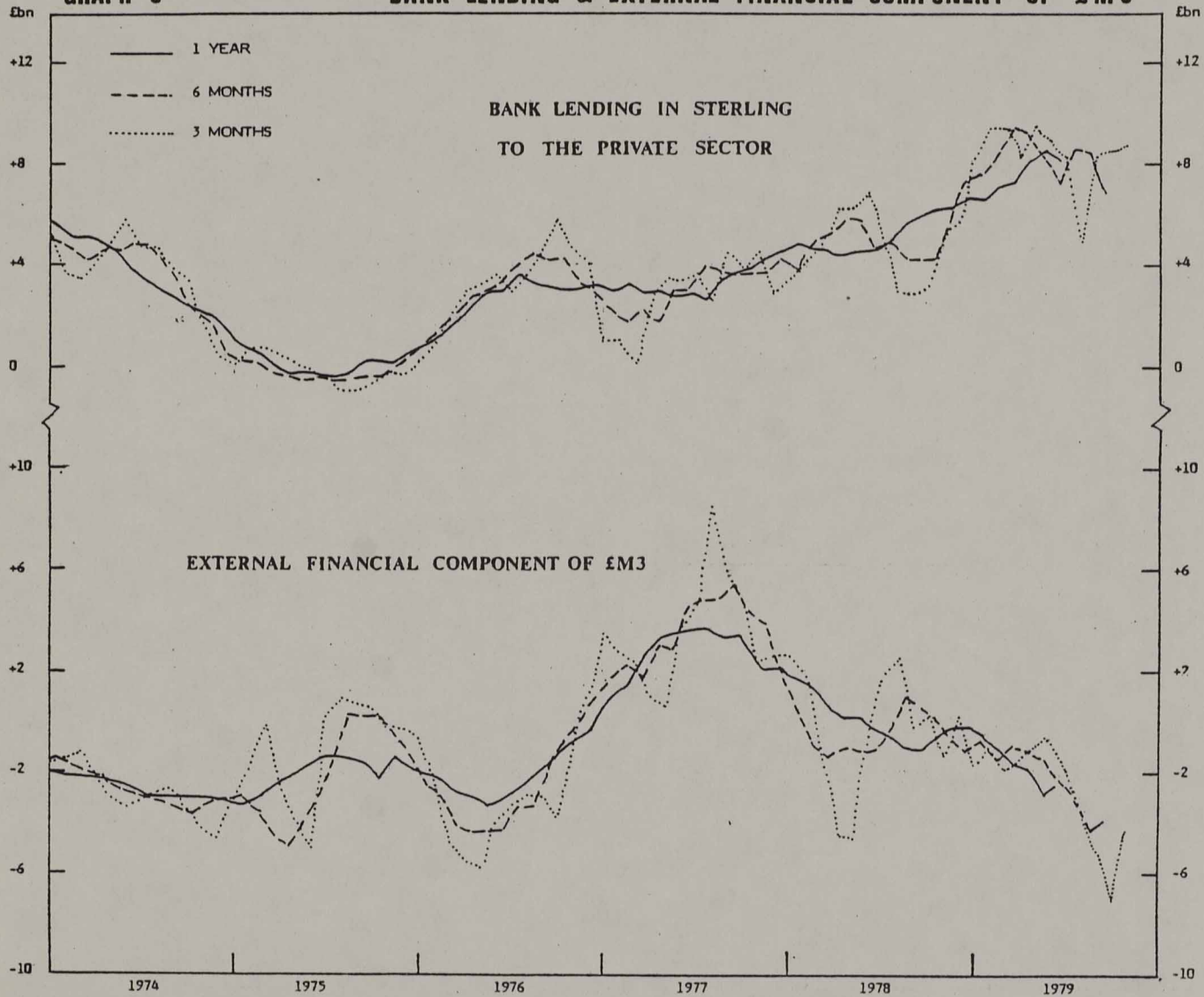
GRAPH 4

D.C.E. (% of $\Sigma M3$)



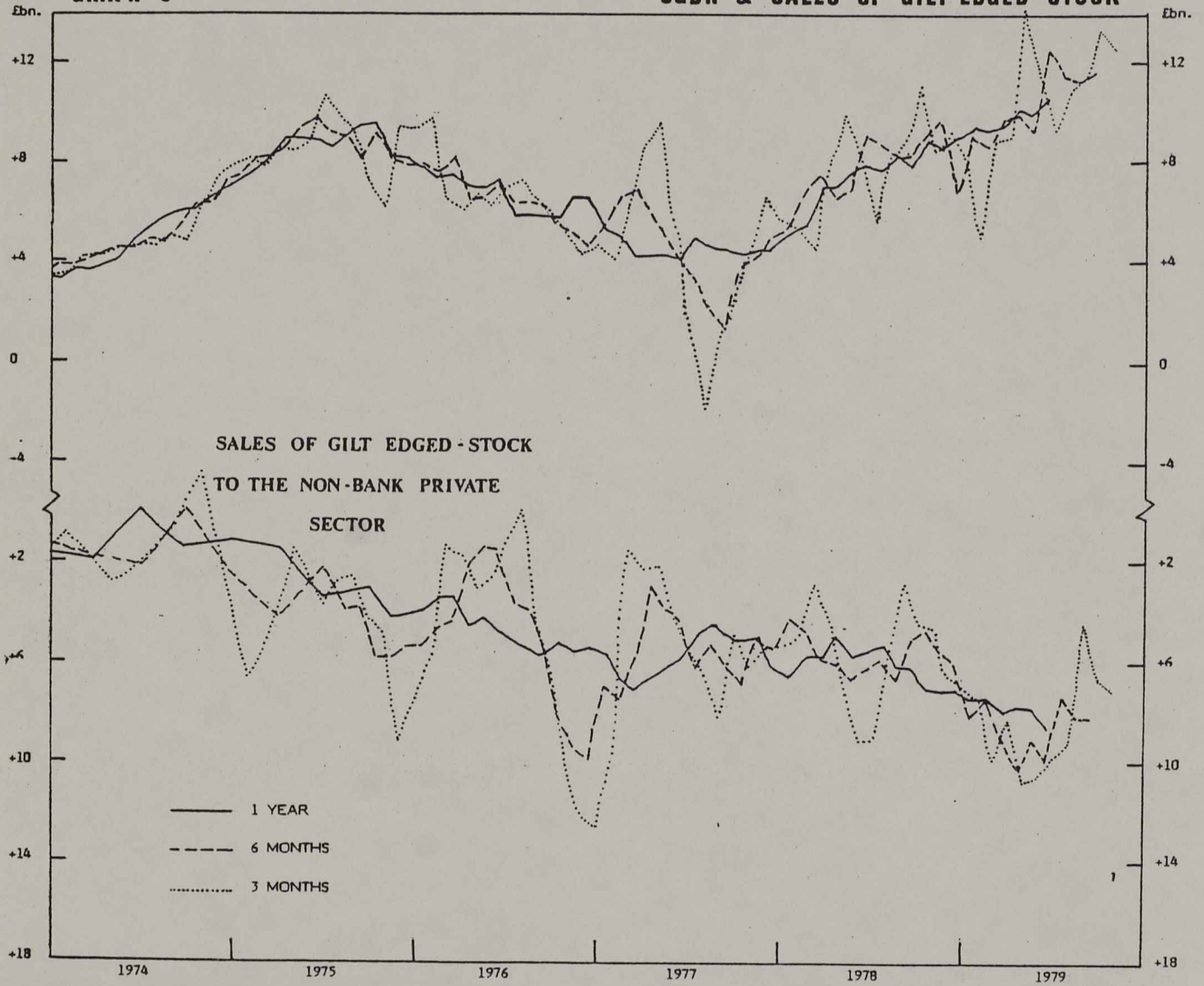
GRAPH 5

BANK LENDING & EXTERNAL FINANCIAL COMPONENT OF £M3



GRAPH 6

CGBR & SALES OF GILT EDGED-STOCK



STATISTICS

reprinted from Bank of England, *Banking Statistics*.

[Table 6 in the Quarterly Bulletin]

UK banking sector: transactions in liabilities and assets (a)

£ millions

Month ended	Liabilities												
	Total	Domestic deposits										Overseas sector deposits	Non-deposit liabilities (net)
		Total		Public sector				Private sector		Sterling	Other currencies		
		Un-adjusted	Seasonally adjusted	Sterling		Other currencies		Un-adjusted	Seasonally adjusted				
		Un-adjusted	Seasonally adjusted	Un-adjusted	Seasonally adjusted	Un-adjusted	Seasonally adjusted	Sterling	Other currencies				
1978 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	- 662	- 704	- 324	- 265	+ 38	- 115	- 216	- 261	+ 339	+ 467	- 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	+ 1,026	+ 1,068	+ 187	+ 34	- 11	+ 451	+ 646	+ 399	+ 151	+ 2,962	+ 564	
July 18	+ 4,771	+ 255	+ 137	- 210	- 147	+ 18	+ 561	+ 380	- 114	+ 207	+ 4,235	+ 74	
Aug. 15	+ 1,071	+ 208	+ 347	- 103	+ 63	- 12	+ 472	+ 445	- 149	+ 275	+ 561	+ 27	
Sept. 19	+ 6,961	+ 205	+ 75	- 36	- 59	+ 35	+ 374	+ 267	- 168	+ 70	+ 6,743	- 57	
Oct. 17	+ 6,957	+ 1,346	+ 1,145	+ 67	+ 94	- 6	+ 1,007	+ 779	+ 278	+ 164	+ 5,204	+ 243	
Nov. 21	+ 4,741	+ 908	+ 1,076	+ 118	- 55	+ 10	+ 42	+ 383	+ 738	+ 395	+ 3,499	- 61	
Dec. 12	- 88	- 192	- 167	- 100	+ 95	+ 3	+ 178	+ 113	- 273	+ 349	- 307	+ 62	

Month ended	Assets											
	Total	Lending to public sector					Lending to private sector				Lending to overseas sector	
		Total	Sterling		Other currencies		Sterling		Other currencies		Sterling	Other currencies
			Un-adjusted	Seasonally adjusted	Central government	Other	Un-adjusted	Seasonally adjusted	Un-adjusted	Seasonally adjusted		
1978 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	+ 1,382	+ 1,312	- 50	- 73	+ 3,321	
July 18	+ 4,771	- 286	+ 138	- 480	+ 194	- 153	+ 1,094	+ 347	+ 191	- 6	+ 3,931	
Aug. 15	+ 1,071	+ 360	- 92	+ 281	+ 79	- 42	+ 337	+ 892	- 45	+ 116	+ 345	
Sept. 19	+ 6,961	+ 190	+ 173	- 99	+ 289	- 42	+ 113	+ 165	- 93	- 27	+ 6,820	
Oct. 17	+ 6,957	+ 286	+ 123	+ 305	- 19	- 14	+ 1,340	+ 1,212	+ 146	- 32	+ 5,231	
Nov. 21	+ 4,741	- 13	+ 207	- 102	+ 89	+ 12	+ 707	+ 730	+ 10	+ 103	+ 3,922	
Dec. 12	- 88	+ 244	- 175	+ 411	- 167	- 60	- 465	+ 213	- 28	- 17	+ 238	

(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. Inter-bank items are excluded and adjustments made to allow for transit items (see additional notes to Table 6 in the Quarterly Bulletin).

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
Month ended												
1978 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	8,394	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	4,575	54,502	55,220
Apr. 18	8,862	14,484	3,792	27,138	26,750	23,173	1,224	51,535	51,360	4,550	56,085	55,910
May 16	8,833	14,262	3,857	26,952	26,790	23,930	1,073	51,955	52,090	4,837	56,792	56,930
June 20	8,804	14,026	3,718	26,548	26,570	24,756	1,260	52,564	52,690	5,066	57,630	57,760
July 18	9,230	14,335	3,755	27,320	27,210	24,971	1,050	53,341	53,110	4,655	57,996	57,770
Aug. 15	9,143	14,532	3,632	27,307	27,190	25,369	947	53,623	53,640	4,586	58,209	58,220
Sept. 19	9,121	14,750	3,470	27,341	27,300	25,687	911	53,939	53,950	4,643	58,582	58,590
Oct. 17	9,267	15,154	4,038	28,459	28,220	25,722	978	55,159	55,010	4,913	60,072	59,920
Nov. 21	9,307	14,778	3,588	27,673	27,610	26,590	1,096	55,359	55,310	5,582	60,941	60,890
Dec. 12	9,675	15,064	3,540	28,279	27,610	26,530	996	55,805	55,510	5,275	61,080	60,680

- (a) After deducting 60% of transit items (see additional notes to Table 6 of the Quarterly Bulletin).
 (b) M₁ equals columns 1 + 2 + 3. Sterling M₃ equals M₁ + columns 5 + 6. M₃ equals sterling M₃ + 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					Trans- actions	Valuation changes (e)				
											1	2	3
Month ended (unadjusted)													
1978 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	- 223	- 57	- 624			
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	+ 388	- 159	+ 838			
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	- 36	+ 316	- 133	+ 190	+ 373			
Oct. 17	+ 146	+ 404	+ 568	+ 1,118	+ 35	+ 67	+ 1,220	+ 272	- 2	+ 1,490			
Nov. 21	+ 40	- 376	- 450	- 786	+ 868	+ 118	+ 200	+ 748	- 79	+ 869			
Dec. 12	+ 368	+ 286	- 48	+ 606	- 60	- 100	+ 446	- 270	- 37	+ 139			
Month ended (seasonally adjusted)													
1978 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	- 223	- 57	- 723	- 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	+ 388	- 159	+ 830	+ 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	- 59	+ 333	+ 0.6	- 133	+ 190	+ 390	+ 0.7
Oct. 17	+ 201	+ 166	+ 568	+ 935	+ 3.4	+ 45	+ 94	+ 1,074	+ 2.0	+ 272	- 2	+ 1,344	+ 2.3
Nov. 21	+ 24	- 162	- 450	- 588	- 2.1	+ 995	- 55	+ 352	+ 0.6	+ 748	- 79	+ 1,021	+ 1.7
Dec. 12	+ 4	+ 48	- 48	+ 4	-	+ 113	+ 95	+ 212	+ 0.4	- 175	- 37	+ 200	- 0.3

- (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) M₁ equals columns 1 + 2 + 3. Sterling M₃ equals M₁ + columns 5 + 6. M₃ equals sterling M₃ + columns 8 + 9.
 (d) Including certificates of deposit.
 (e) See additional notes to Tables 6 and 11 of the Quarterly Bulletin.

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

£ millions

Month ended (unadjusted)	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 sector (c)	Domestic credit expansion (d)	External and foreign currency finance (increase -)			Net non-deposit liabilities (increase -) (e)	Money stock sterling M ₂ (f)		
	Central government borrowing requirement	Other public sector contribution	Other public sector debt	Central government deficit				Public sector	Overseas sector sterling deposits (c)	Banks' foreign currency deposit liabilities (net) (e)				
													8	9
	1	2	3	4	5	6	7	8	9	10	11	12		
1978 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	+ 141	+ 116	+ 820	- 94	- 275	- 142	- 27	+ 282			
Sept. 19	+ 1,456	+ 195	- 997	+ 110	- 27	+ 737	- 483	- 70	+ 75	+ 57	+ 316			
Oct. 17	+ 849	- 447	+ 69	+ 1,241	- 32	+ 1,780	- 40	- 164	- 113	- 243	+ 1,220			
Nov. 21	+ 466	+ 122	- 394	+ 727	+ 103	+ 1,024	- 187	- 395	- 303	+ 61	+ 200			
Dec. 12	+ 2,310	- 271	- 1,204	- 466	- 17	+ 352	- 222	- 349	+ 727	- 62	+ 446			
Month ended (seasonally adjusted)														
1978 Dec. 13	+ 756	+ 401	- 709	+ 474	+ 137	+ 1,059	- 289	- 186	- 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	+ 696	+ 116	+ 1,057	- 359	- 149	+ 549					
Sept. 19	+ 1,647	+ 129	- 986	+ 162	- 27	+ 925	- 522	- 70	+ 333					
Oct. 17	+ 937	- 622	+ 54	+ 1,213	- 32	+ 1,550	- 384	- 92	+ 1,074					
Nov. 21	+ 731	+ 83	- 410	+ 750	+ 103	+ 1,257	- 882	- 23	+ 352					
Dec. 12	+ 1,470	- 152	- 1,260	+ 212	- 17	+ 253	+ 196	- 237	+ 212					

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

Month ended	Marketable debt		National savings		Tax instruments	Other (g)	Total (column 4 above)	
	Stocks	Treasury bills	Unadjusted	Seasonally adjusted			Unadjusted	Seasonally adjusted
1978 Dec. 13	- 366	+ 87	- 23	- 79	- 334	- 17	- 653	- 709
1979 Jan. 17	- 411	- 38	- 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	- 387	+ 178	- 80	- 104	- 18	- 10	- 817	- 841
Aug. 15	- 434	+ 145	- 43	- 57	+ 101	+ 7	- 224	- 238
Sept. 19	- 955	- 10	- 38	- 27	- 10	+ 16	- 997	- 986
Oct. 17	+ 264	- 79	- 43	- 58	- 75	+ 2	+ 69	+ 54
Nov. 21	- 911	+ 71	- 47	- 63	+ 333	+ 160	- 394	- 410
Dec. 12	- 1,134	- 86	- 56	- 112	+ 20	+ 52	- 1,204	- 1,260

[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 M₂ equals domestic credit expansion plus columns 8 + 9 + 10 + 11 (see also page 7).

[g] Includes repayments (+) by the Fund for Banks for Savings (a central government fund) to the trustee savings banks.

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 3AH.

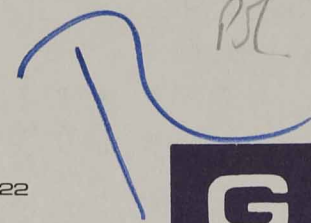
W. Greenwell & Co.

Bow Bells House,
Bread Street, London EC4M 9EL

Telephone: 01-236 2040 Telex: 883006

W. Greenwell Associates (Investment Adviser) 450 Park Avenue, New York, N.Y. 10022
Telephone: 212 832 7428 Telex: 710 5815122

Econ
PSL



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:

	<u>3 months</u>	<u>4 months</u> (since mid-June)	<u>6 months</u>	<u>12 months</u>
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 some definite 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 has been at the top, or in excess, of the target range, such room for manoeuvre does not exist. Prompt action becomes necessary.

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

There remains, however, the possibility that the data for banking October are a freak. One way of checking this is to examine past revisions to the monetary data. The seasonal adjustments for sterling M3 are revised, sometimes substantially, particularly when the authorities acquire more information about the amount of tax actually paid. Our guess is that the seasonally adjusted growth of sterling M3 in banking October will be revised downwards but that for banking September may be revised upwards. Appendix I discusses the revisions to sterling M3 in the past. It concludes that the three month moving average of the revised series is only a little different from the series as first published. Appendix II discusses distortions to sterling M3. Apart from illustrating the erratic nature of the monthly series, neither appendix provides evidence for disregarding the current excessive growth of sterling M3.

In a talk to the Society of Investment Analysts on 19th November (already circulated), Gordon Pepper suggested that current excessive monetary growth was caused by buoyant demand for finance from three sources.

Firstly, the private sector's demand for funds to finance real activity is currently acute. It always is at the peak of a business cycle as profit margins are squeezed and finished goods are left unsold on the shelves. The fall in unfilled job vacancies which was published on 20th November was further evidence that the expected downturn in the economy has started. In addition, the Treasury's mid-year forecast, which has just been published, estimates that GDP in real terms will fall by 2% between 1979 and 1980. Accordingly, the private sector's demand for funds to finance real activity will subside before long.

Secondly, the demand for finance by the public sector has also been acute. The Treasury's mid-year economic forecast and data for the PSBR in the second quarter of 1979/80, which have also just been published, confirm that the Treasury is expecting the seasonally adjusted PSBR to fall from an annual rate of £13.26bn. in the first half of the financial year to £3.34bn. in the second half, allowing for the recent policy changes. In addition, the PSBR for 1980/1 is forecast to show "little change from the 1979/80 level as a percentage of GDP." On a constant employment basis it is, therefore, forecast to fall significantly as a percentage of GDP. It is worth stressing that the Treasury could not emphasise more strongly the margins of error contained in these forecasts.

The third source of demand for finance is, however, still growing. The private sector requires funds to finance inflation, for example stock appreciation. It will be some time before this declines. But the growth of wage settlements would have to be very substantial to more than offset the expected fall in the other two sources of demand for finance. As the total demand for finance subsides, monetary growth should slow.

G.T.P.
R.L.T.
R.R.

Appendix I

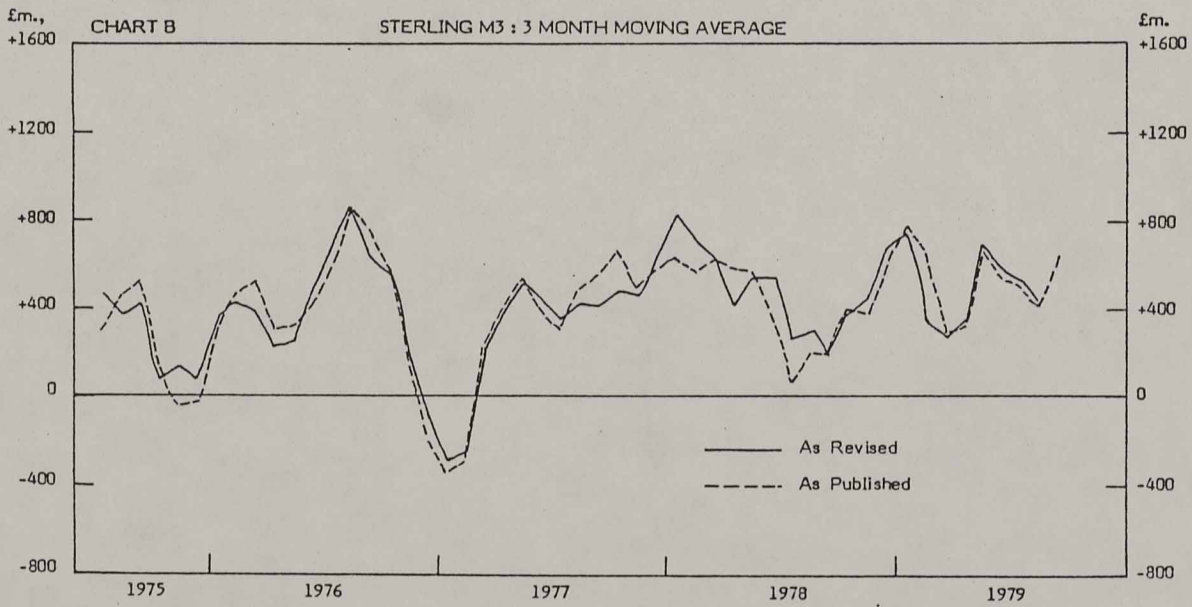
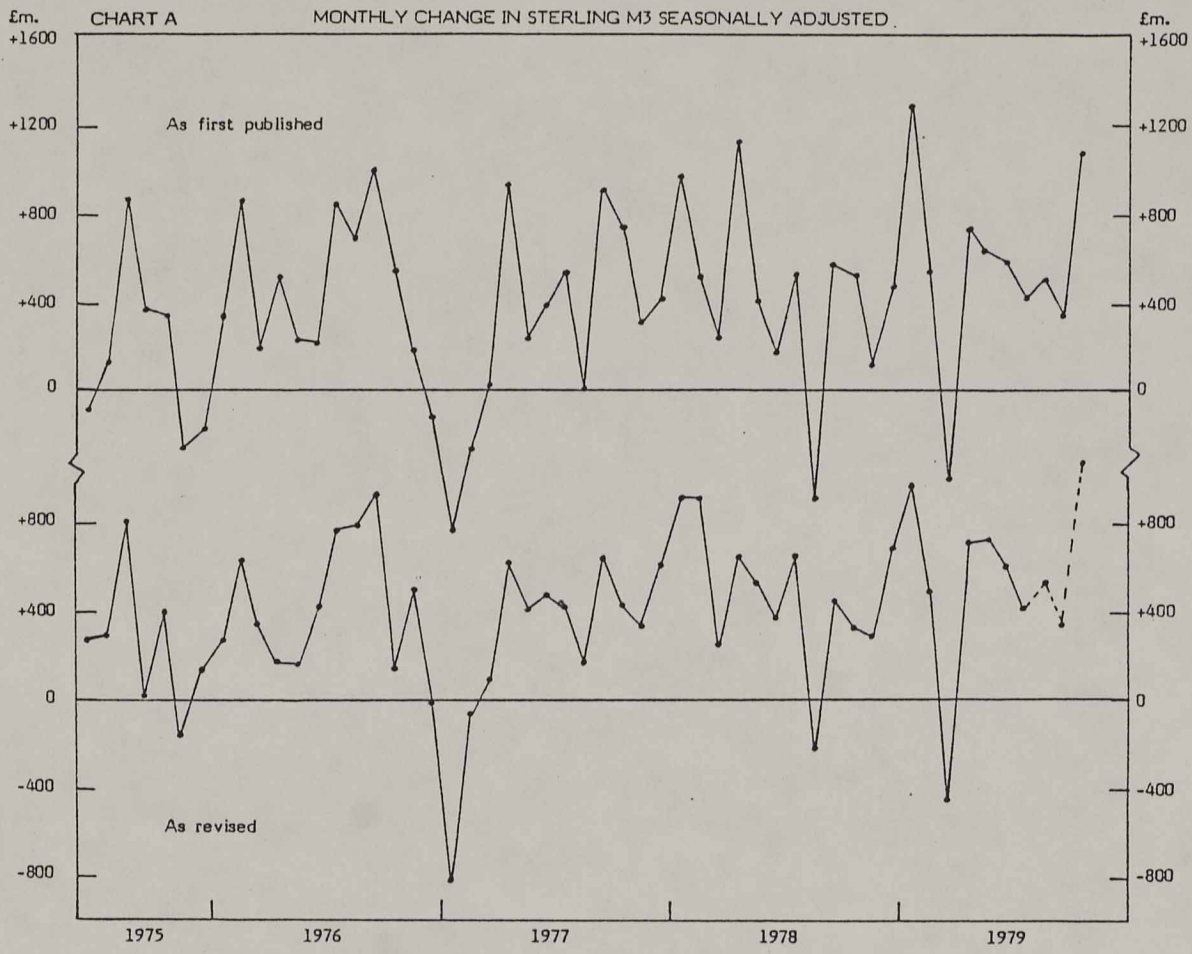
Revisions to Sterling M3

Revisions to monetary data are in the news, with the recent very large downward adjustment to U.S. data because of an error by a reporting bank. Revisions occur to U.K. data also, both to the raw data, before seasonal adjustment, and to seasonally adjusted data. Table I on the next page shows the revisions since statistics started being collected in their present form in May 1975. Before December 1976 only data for M3 were published. Subsequently, the data shown are for sterling M3. It will be seen that, apart from an aberration very early in the period, the revisions to the raw data have been small. The seasonal adjustments, however, have on occasions been revised very substantially, by almost £500m. The patterns in the seasonally adjusted data are illustrated visually in Chart A on the following page; the top graph shows the monthly changes as first published and the bottom graph shows them as subsequently revised. The revised series is a little smoother - the large fluctuations in the top series are damped but by not very much. Chart B shows the three month moving averages of the two series - it will be seen that the revised series is only little different from series as first published.

TABLE I
STERLING M3

		Unadjusted			Seasonally Adjusted		
		As first Published	Revised	Difference	As first Published	Revised	Difference
1975	June	187	202	15	-96	276	372
	July	532	661	129	121	281	160
	Aug.	549	419	-130	867	805	-62
	Sept.	264	199	-65	365	10	-355
	Oct.	379	428	49	329	400	71
	Nov.	-48	-31	17	-274	-176	98
	Dec.	333	324	-9	-177	140	317
1976	Jan.	-263	-274	-11	336	276	-60
	Feb.	326	325	-1	873	639	-234
	Mar.	416	440	24	172	338	166
	Apr.	749	773	24	514	170	-344
	May	28	31	3	236	163	-73
	June	269	338	69	206	414	208
	July	1,190	1,146	-44	845	772	-73
	Aug.	538	546	8	681	799	118
	Sept.	886	900	14	1,001	956	-45
	Oct.	426	414	-12	538	141	-397
	Nov.	418	439	21	169	511	342
	Dec.	-57	-73	-16	-133	-18	115
1977	Jan.	-945	-948	-3	-639	-814	-175
	Feb.	-635	-612	23	-277	-69	208
	Mar.	259	239	-20	12	83	71
	Apr.	1,073	1,063	-10	934	627	-307
	May	183	189	6	229	410	181
	June	470	463	-7	399	480	81
	July	666	656	-10	522	421	-101
	Aug.	-56	-54	2	5	164	159
	Sept.	809	810	1	918	651	-267
	Oct.	669	669	-	741	436	-305
	Nov.	439	438	-1	296	341	45
	Dec.	798	827	29	414	617	203
1978	Jan.	98	84	-14	982	929	-53
	Feb.	386	386	-	488	920	432
	Mar.	339	359	20	221	263	42
	Apr.	1,735	1,753	18	1,137	669	-468
	May	398	422	24	400	540	140
	June	194	209	15	159	383	224
	July	941	934	-7	520	666	146
	Aug.	-509	-486	23	-494	-223	271
	Sept.	477	478	1	568	460	-108
	Oct.	546	536	-10	520	334	-186
	Nov.	243	253	10	103	306	203
	Dec.	934	950	16	471	710	239
1979	Jan.	336	332	-4	1,287	996	-291
	Feb.	-24	-33	-9	538	507	-31
	Mar.	-339	-344	-5	-406	-443	-37
	Apr.	1,608	1,608	-	741	721	-20
	May	389	420	31	629	729	100
	June	598	609	11	582	601	19
	July	777	(777)	(-)	427	(427)	(-)
	Aug.	230	(282)	(52)	497	(549)	(52)
	Sept.	317	(317)	(-)	334	(334)	(-)
	Oct.	1,226			1,080		

* Prior to December 1976, data are for M3



Appendix II

Distortions to sterling M3

The growth of bank acceptances held outside the banking sector, which are excluded from the official series for sterling M3, has received a lot of publicity. They are included in our series for M4. The other differences between sterling M3 and our series for M4 have not received publicity. There are two of them, namely (i) Treasury bills held outside the banking sector and (ii) tax instruments. The case for including the latter is not obvious because tax instruments are not negotiable, as are C.D.'s, bank acceptances and Treasury bills.

Our reasons for including tax instruments is that we are doubtful about the official seasonal adjustments for sterling M3, which are based on the statistical patterns of the past when tax instruments were unimportant. Prior to the tax paying season, tax payers accumulate liquid assets, including bank deposits and C.D.'s; in the tax paying season these holdings are run down. As tax instruments have grown in importance, the seasonal fluctuation of bank deposits and C.D.'s has become less important. As a result, the official seasonally adjusted series for sterling M3 may understate the growth of sterling M3 prior to the tax paying season and overstate it during the tax paying season. The inclusion of tax instruments in our series for M4 allows for any such distortion. When the new seasonal pattern in sterling M3 becomes statistically discernible and is incorporated in the official seasonal adjustments, we plan to delete tax instruments from our series for M4. Table II on the next page shows the full data for the differences between sterling M3 and our series for M4. The monthly changes (as revised) in the two series are shown below in Chart C.

Another distortion may become apparent in the coming months. The abolition of exchange controls allows U.K. residents to hold money in the form of foreign currency deposits. A rapid growth in these deposits will indicate that a further adjustment to sterling M3 should be made.

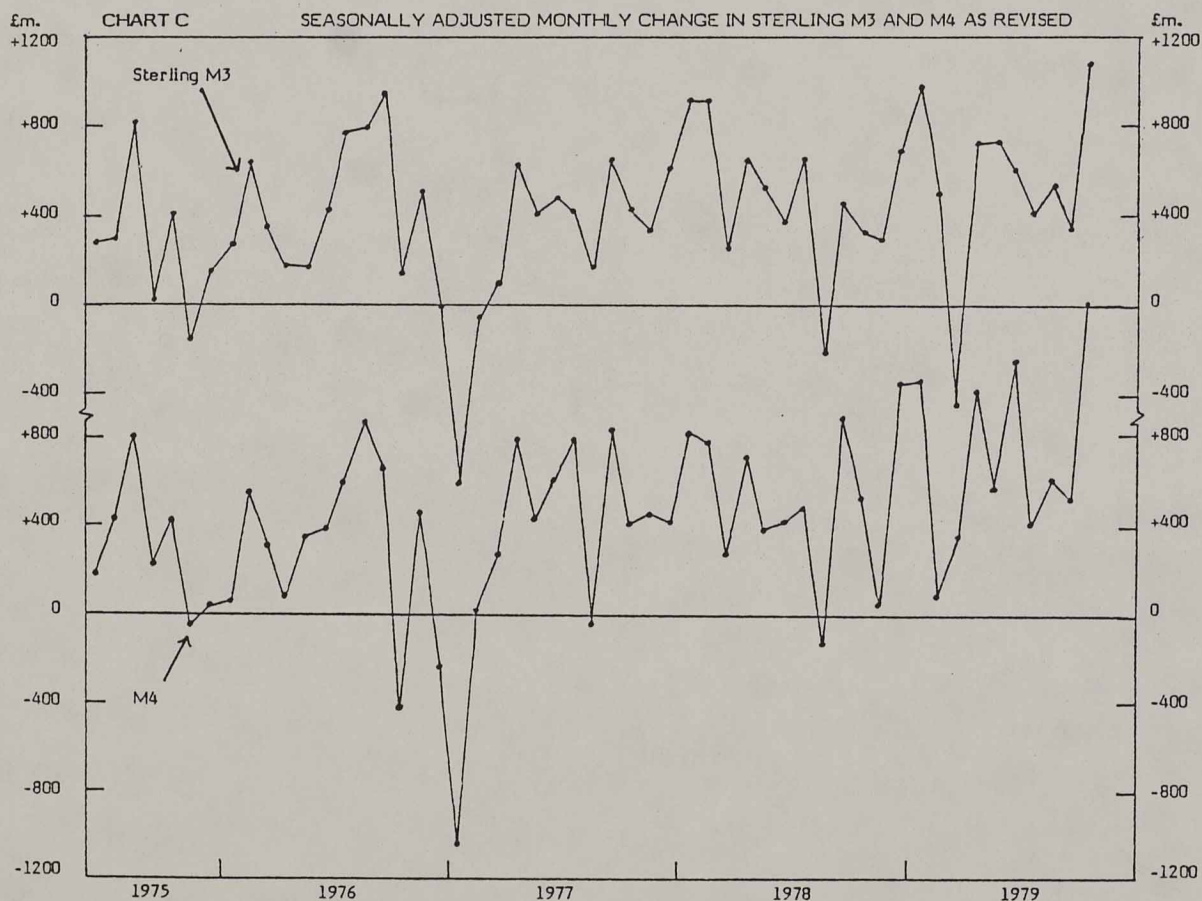


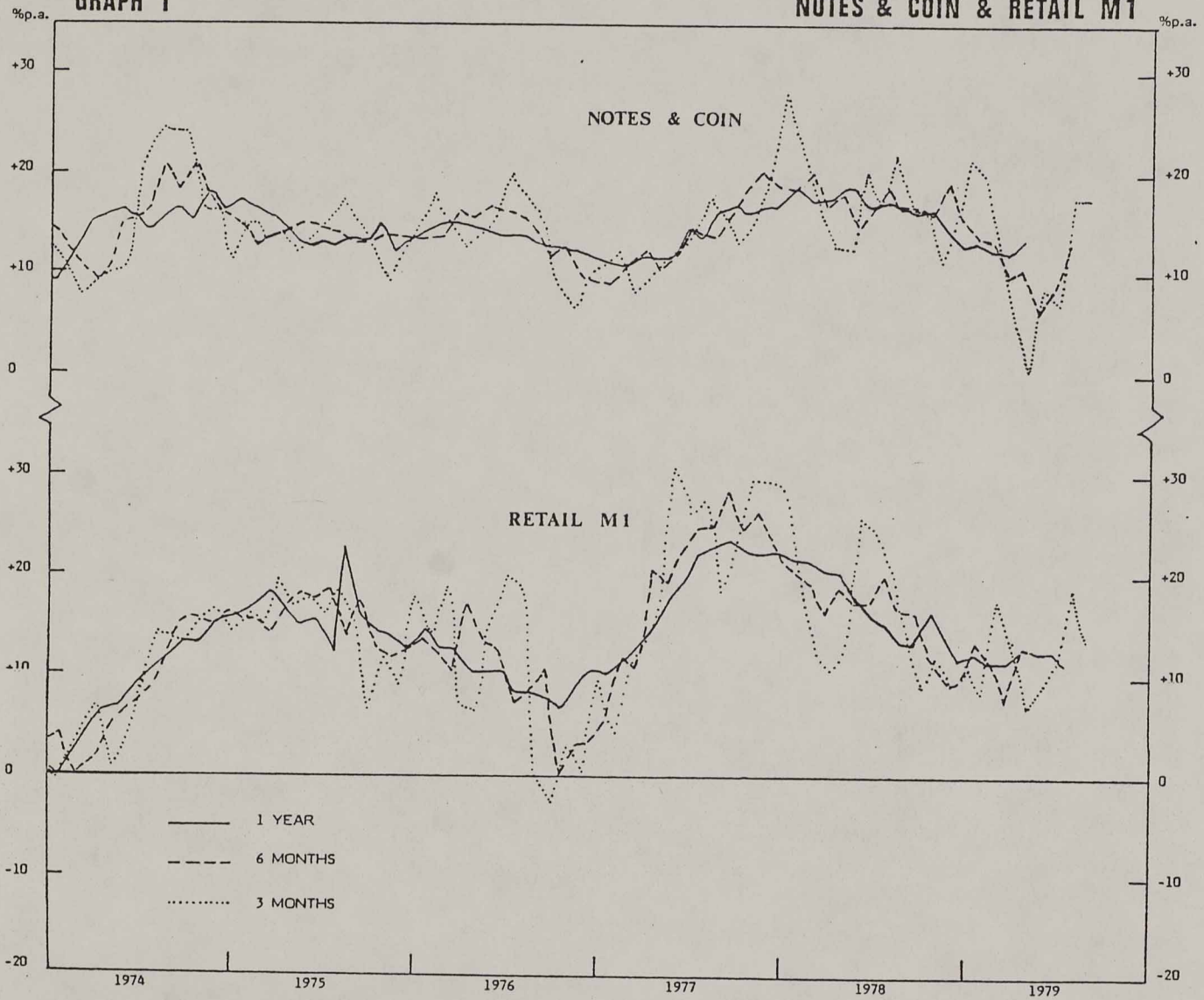
TABLE II

Differences between Sterling M3 and M4

	£M3 (Seas.Adj.)	Treasury Bills	Tax Instruments	Acceptance Credits	M4 = 1+2+3+4	M4 - £M3 = 5 - 1	
	(1)	(2)	(3)	(4)	(5)	(6)	
1975	June	184	-4	-1	-15	164	-20
	July	324	74	-2	20	416	92
	Aug.	742	97	-1	-39	799	57
	Sept.	-150	293	-2	63	204	354
	Oct.	260	131	-1	31	421	161
	Nov.	-118	56	2	-5	-65	53
	Dec.	61	-7	-	-16	38	-23
1976	Jan.	180	-41	-1	-93	45	-135
	Feb.	617	-24	4	-44	553	-64
	Mar.	134	184	-	-9	309	175
	Apr.	81	-13	2	-	70	-11
	May	201	134	-5	8	338	137
	June	277	46	-	64	387	110
	July	577	4	2	11	594	17
	Aug.	691	175	-1	-	865	174
	Sept.	659	16	-	-23	652	-7
	Oct.	-44	-382	2	-14	-438	-394
	Nov.	602	-138	1	1	466	-136
	Dec.	-18	-218	-	-5	-241	-223
1977	Jan	-814	-167	-2	-80	-1,063	-249
	Feb.	-69	15	-3	68	11	80
	Mar.	83	171	-	6	260	177
	Apr.	627	130	1	35	793	166
	May	410	42	23	-36	439	29
	June	480	112	3	15	610	130
	July	421	286	17	69	793	372
	Aug.	164	-210	63	-57	-40	-204
	Sept.	651	9	259	-83	836	185
	Oct.	436	-135	185	-78	408	-28
	Nov.	341	79	85	-42	463	122
	Dec.	617	-172	25	-40	430	-187
1978	Jan.	929	9	-98	-20	820	-109
	Feb.	920	132	-208	-61	783	-137
	Mar.	263	-6	22	-1	278	15
	Apr.	669	34	7	3	713	44
	May	540	-75	-60	-15	390	-150
	June	383	-32	31	52	434	51
	July	666	-269	33	69	499	-167
	Aug.	-223	-145	-5	242	-131	92
	Sept.	460	-40	301	163	884	424
	Oct.	334	-62	152	105	529	195
	Nov.	306	35	-250	-42	49	-257
	Dec.	710	-87	334	86	1,043	333
1979	Jan.	996	88	-71	38	1,051	55
	Feb.	507	-95	-148	-177	87	-420
	Mar.	-443	80	653	61	351	794
	Apr.	721	113	124	68	1,026	305
	May	729	-5	-109	-54	561	-168
	June	601	175	79	300	1,155	554
	July	428	-178	18	150	418	-10
	Aug.	548	-145	-101	325	627	79
	Sept.	334	10	10	180	534	200
	Oct.	1,080	79	74	170	1,403	323

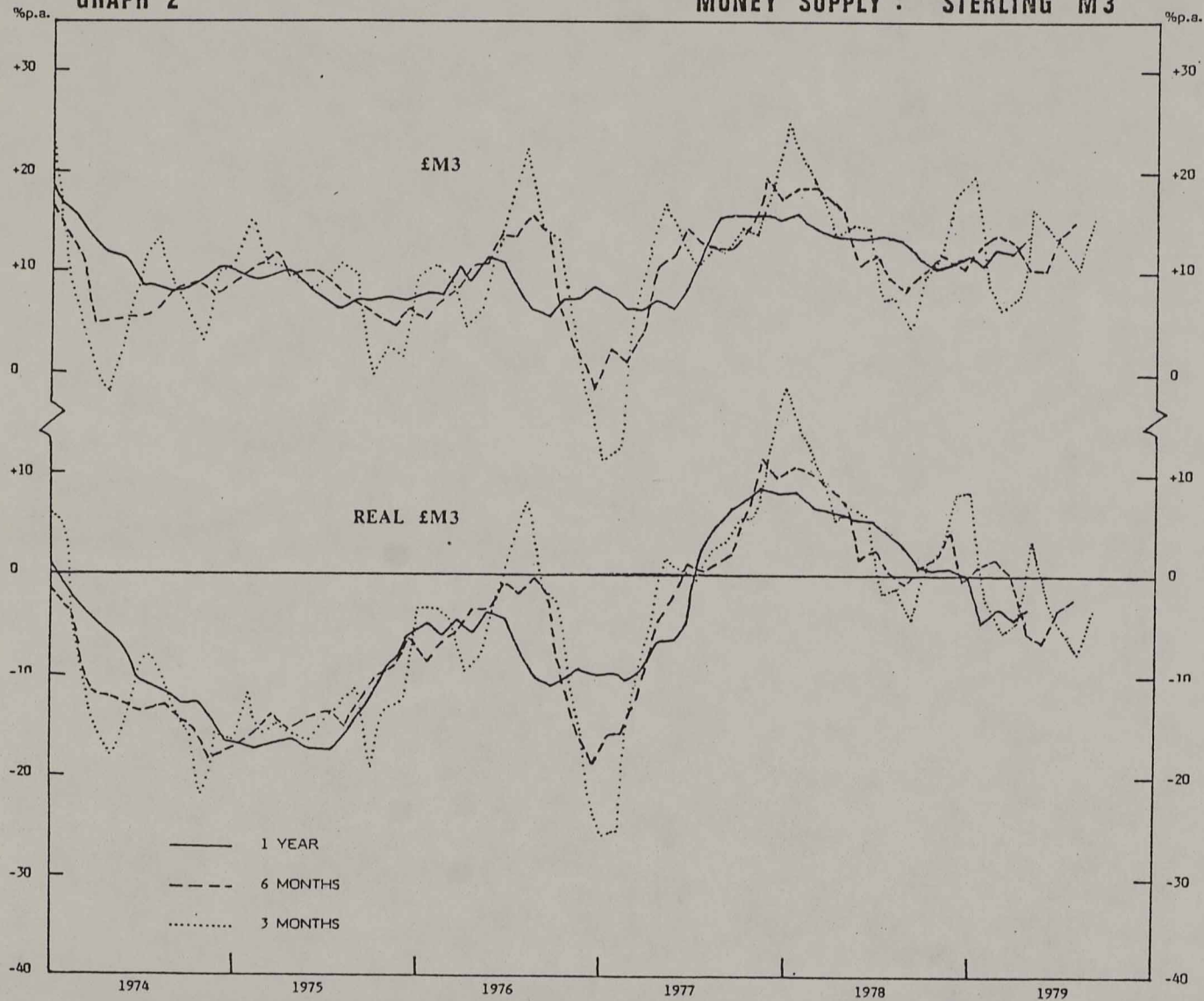
GRAPH 1

NOTES & COIN & RETAIL M1



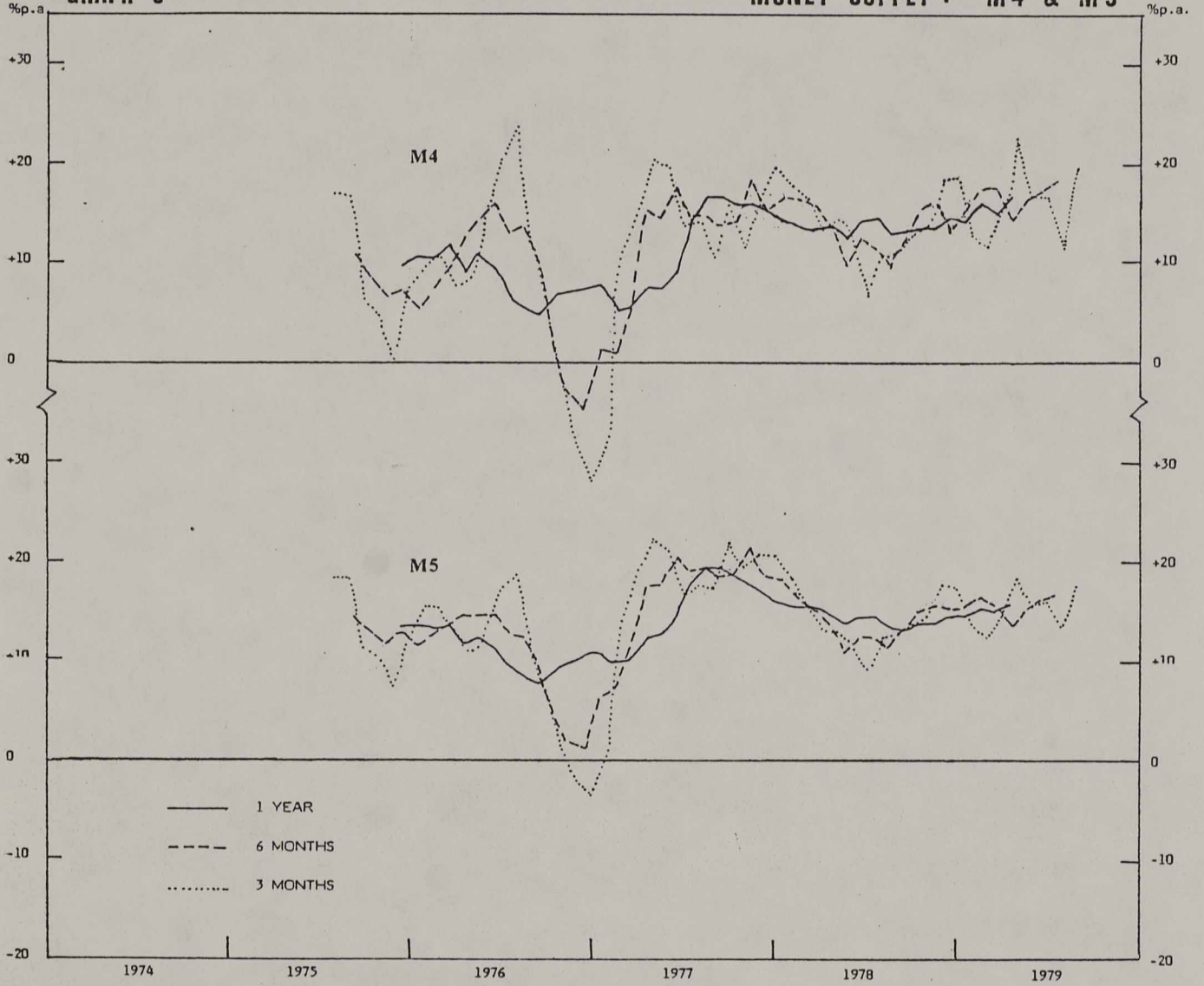
GRAPH 2

MONEY SUPPLY : STERLING M3



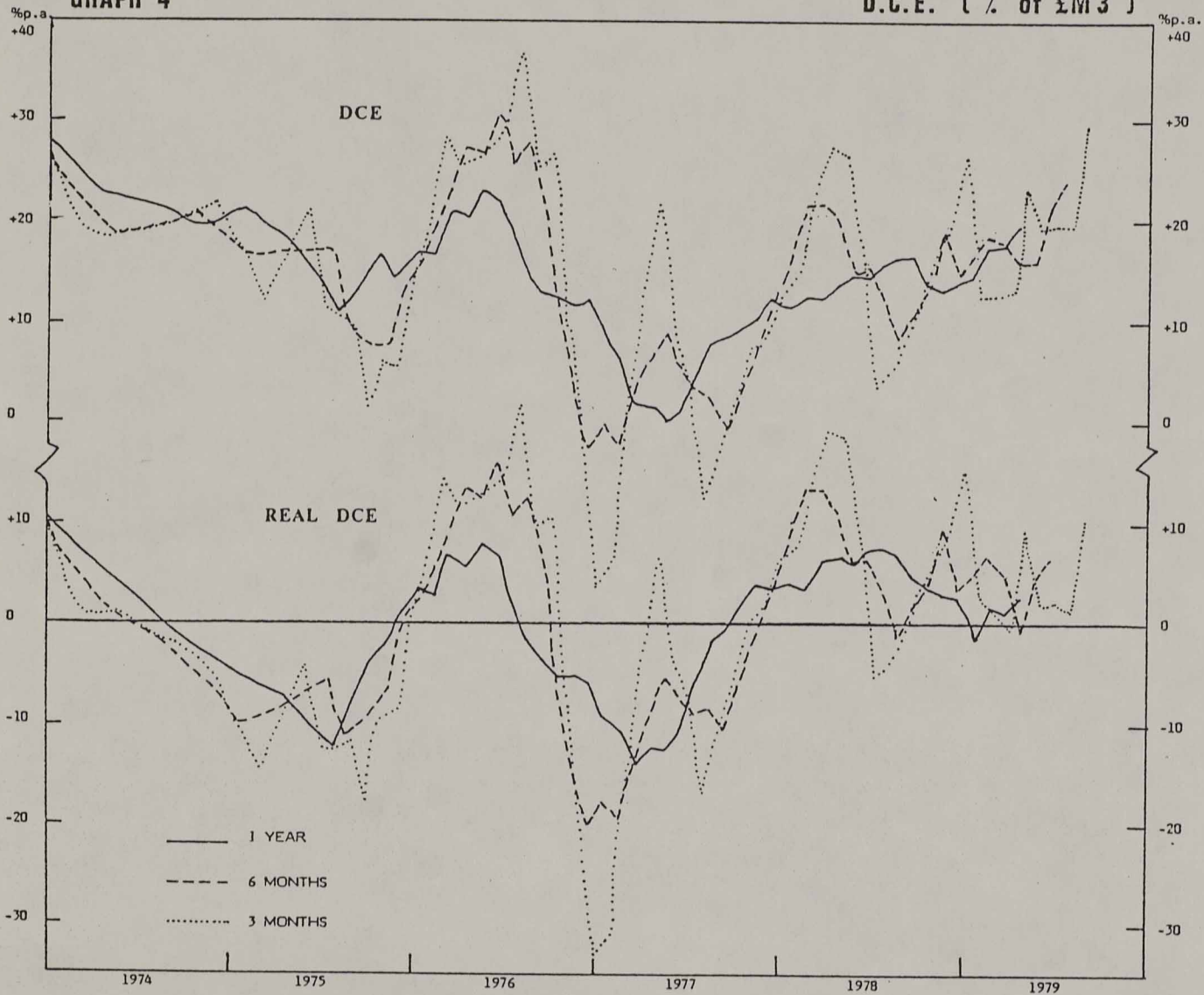
GRAPH 3

MONEY SUPPLY : M4 & M5



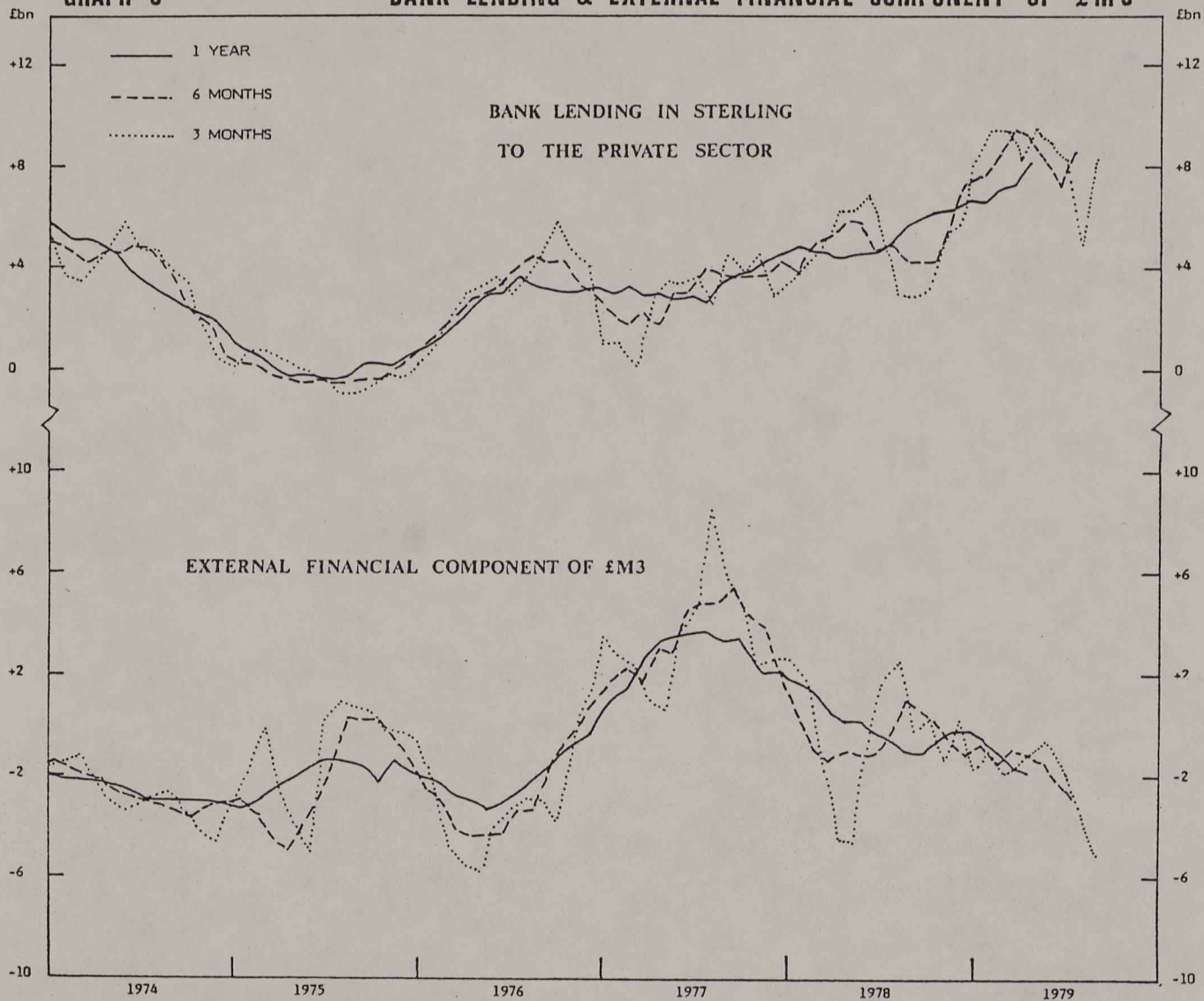
GRAPH 4

D.C.E. (% of $\pounds M3$)



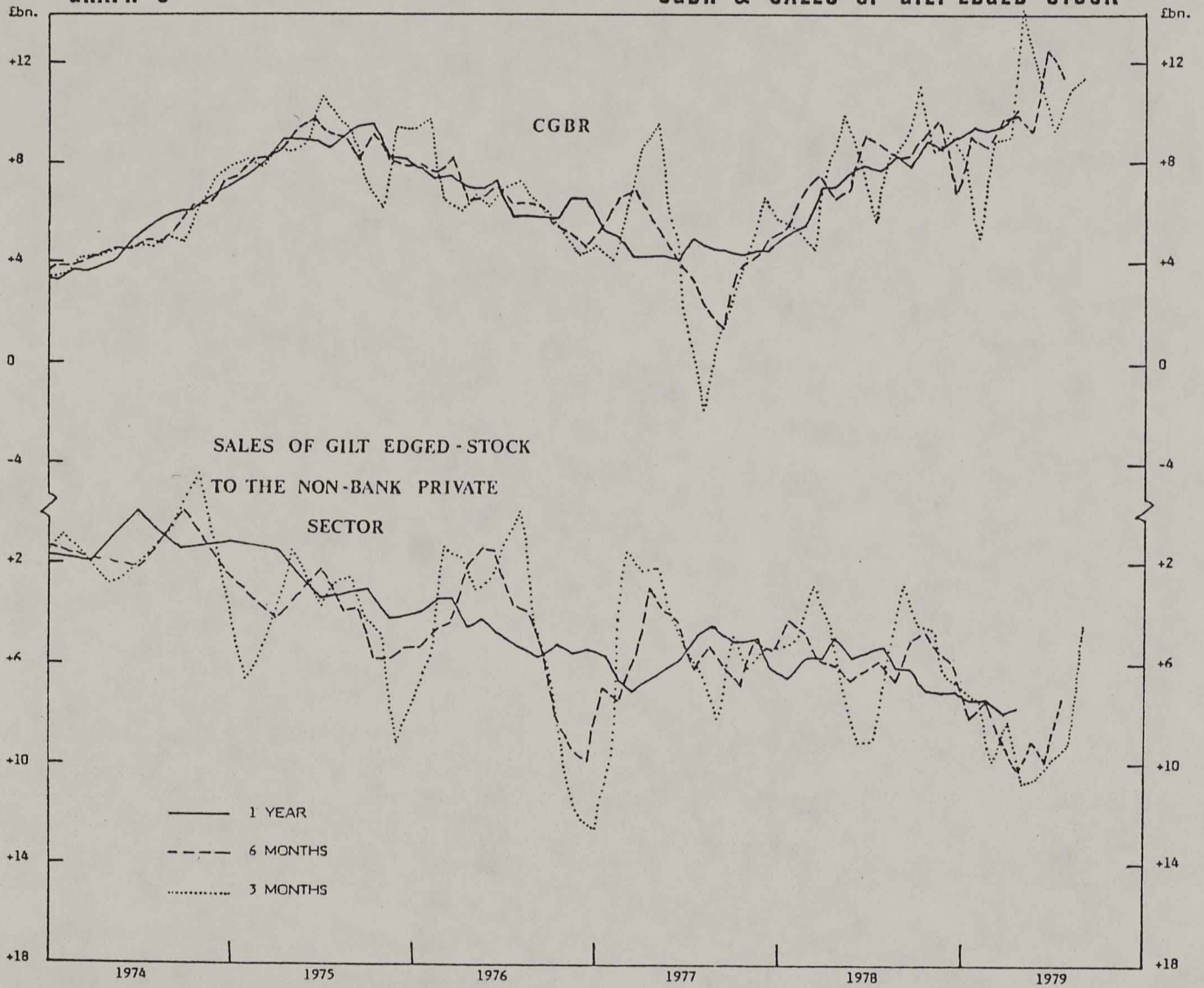
GRAPH 5

BANK LENDING & EXTERNAL FINANCIAL COMPONENT OF £M3



GRAPH 6

CGBR & SALES OF GILT EDGED-STOCK



STATISTICS

reprinted from Bank of England, *Banking Statistics*.

[Table 6 in the
Quarterly Bulletin]

UK banking sector: transactions in liabilities and assets (a)

£ millions

Month ended	Liabilities												
	Total	Domestic deposits						Overseas deposits		Non-deposit liabilities (net)			
		Total		Public sector		Other currencies	Private sector		Sterling		Other currencies		
		Un-adjusted	Seasonally adjusted	Un-adjusted	Seasonally adjusted		Un-adjusted	Seasonally adjusted					
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	+ 455	- 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	

Month ended	Assets										
	Total	Lending to public sector					Lending to private sector			Lending to overseas sector	
		Total	Sterling		Other currencies	Total	Sterling		Other currencies	Sterling	Other currencies
			Un-adjusted	Seasonally adjusted			Central government	Other			
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	+ 428	+ 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	- 763	+ 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	+ 1,382	+ 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*).

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)	
	1	2	3	4	5	6			7	8		9	10
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	4,951	54,925	54,370	
1979 Jan. 17	8,382	13,497	3,661	25,540	25,730	23,611	1,153	50,304	50,570	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	8,362	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	9,250	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) M₁ equals columns 1 + 2 + 3. Sterling M₃ equals M₁ + columns 5 + 6. M₃ equals sterling M₃ + 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)		
	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) M₁ equals columns 1 + 2 + 3. Sterling M₃ equals M₁ + columns 5 + 6. M₃ equals sterling M₃ + columns 8 + 9.
 (d) Including certificates of deposit.
 (e) See additional notes to Tables 6 and 11 of 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 -) (e)	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
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	- 347	+ 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	+ 371	+ 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:

Month ended	Marketable debt		National savings		Tax instruments	Other	Total (column 4 above)	
	Stocks	Treasury bills	Unadjusted	Seasonally adjusted			Unadjusted	Seasonally adjusted
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	- 1,993	- 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 M₃ 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.

26 NOV 1959



010
W. Greenwell & Co.

Bow Bells House,
Bread Street, London EC4M 9EL

Telephone: 01-236 2040 Telex: 883006

W. Greenwell Associates (Investment Adviser) 450 Park Avenue, New York, N.Y. 10022
Telephone: 212 832 7428 Telex: 710 5815122



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 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.

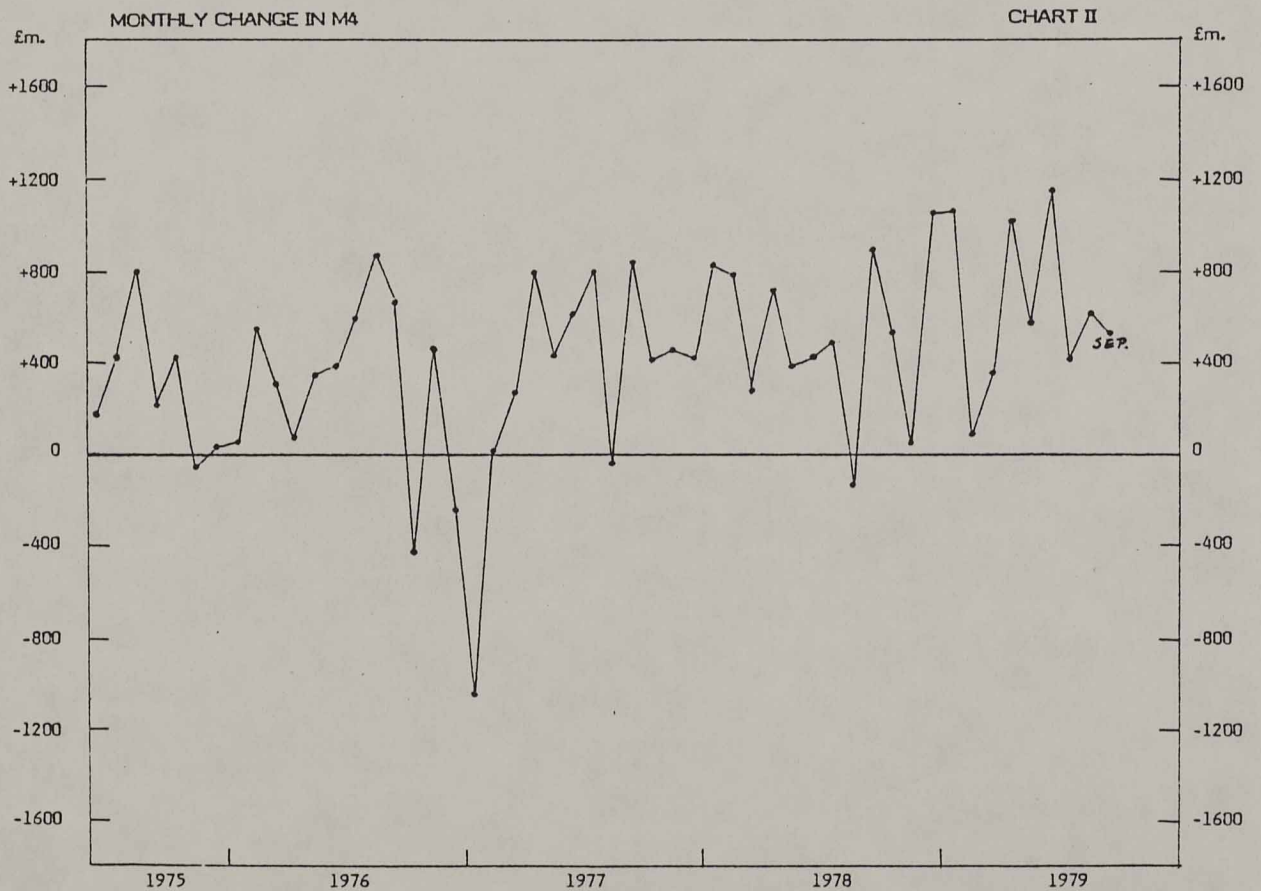
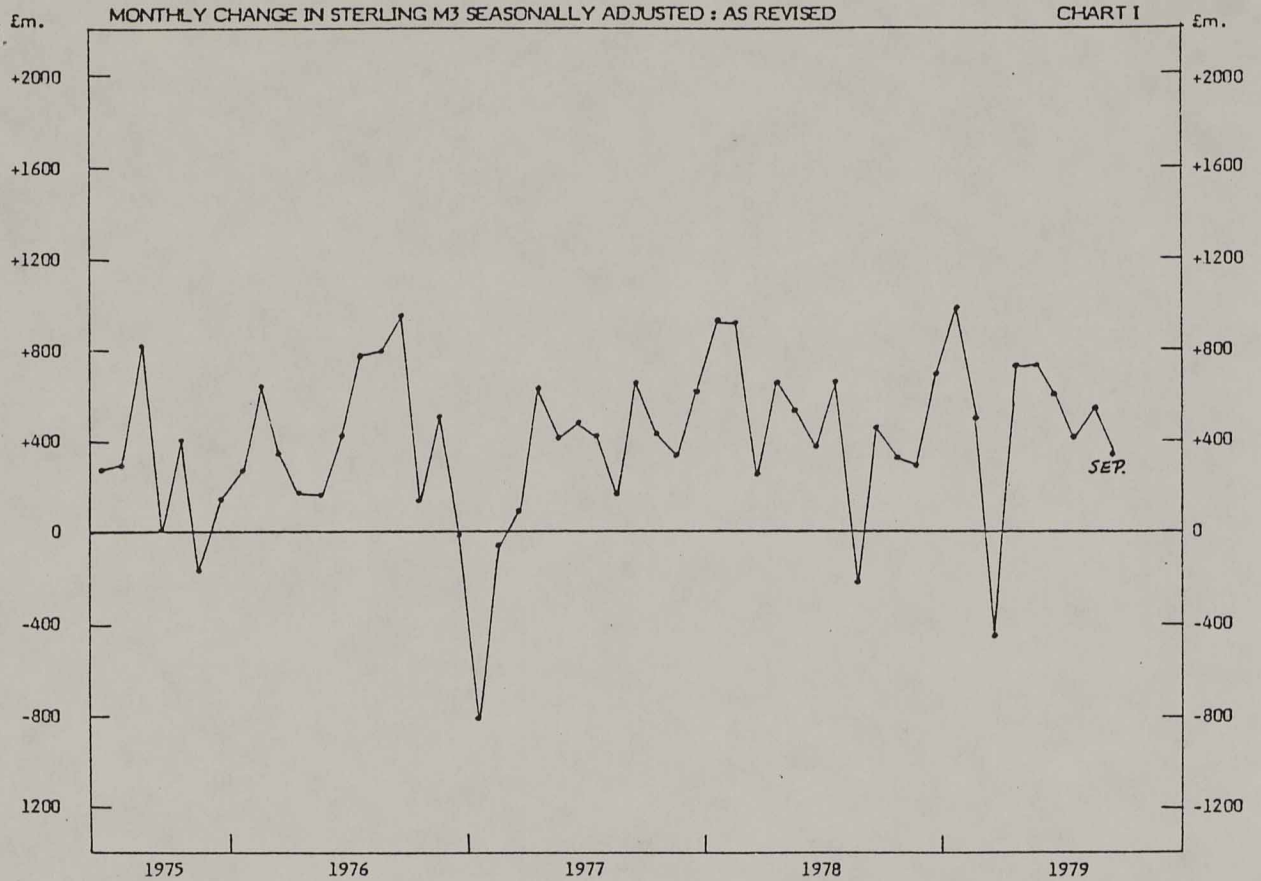
Fourthly, strikes and other industrial action have delayed the collection of VAT and telephone bills, as the Chancellor said in his statement on Thursday.

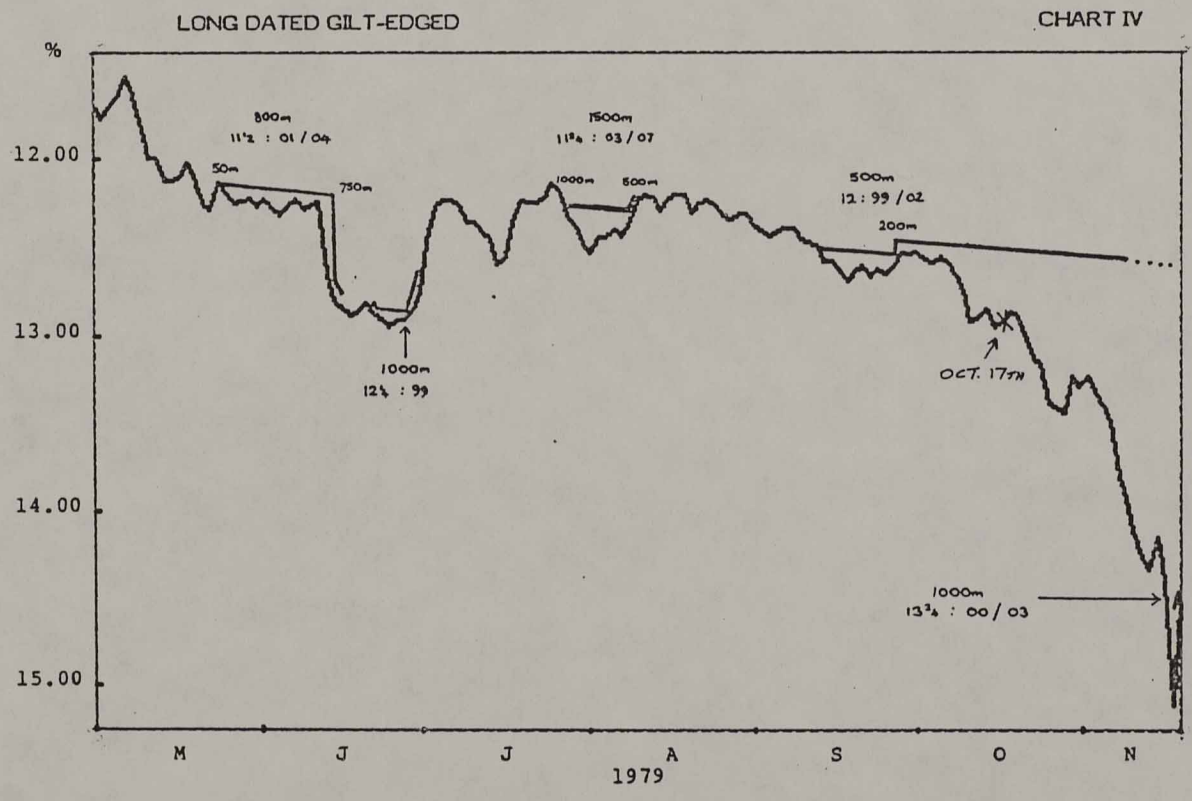
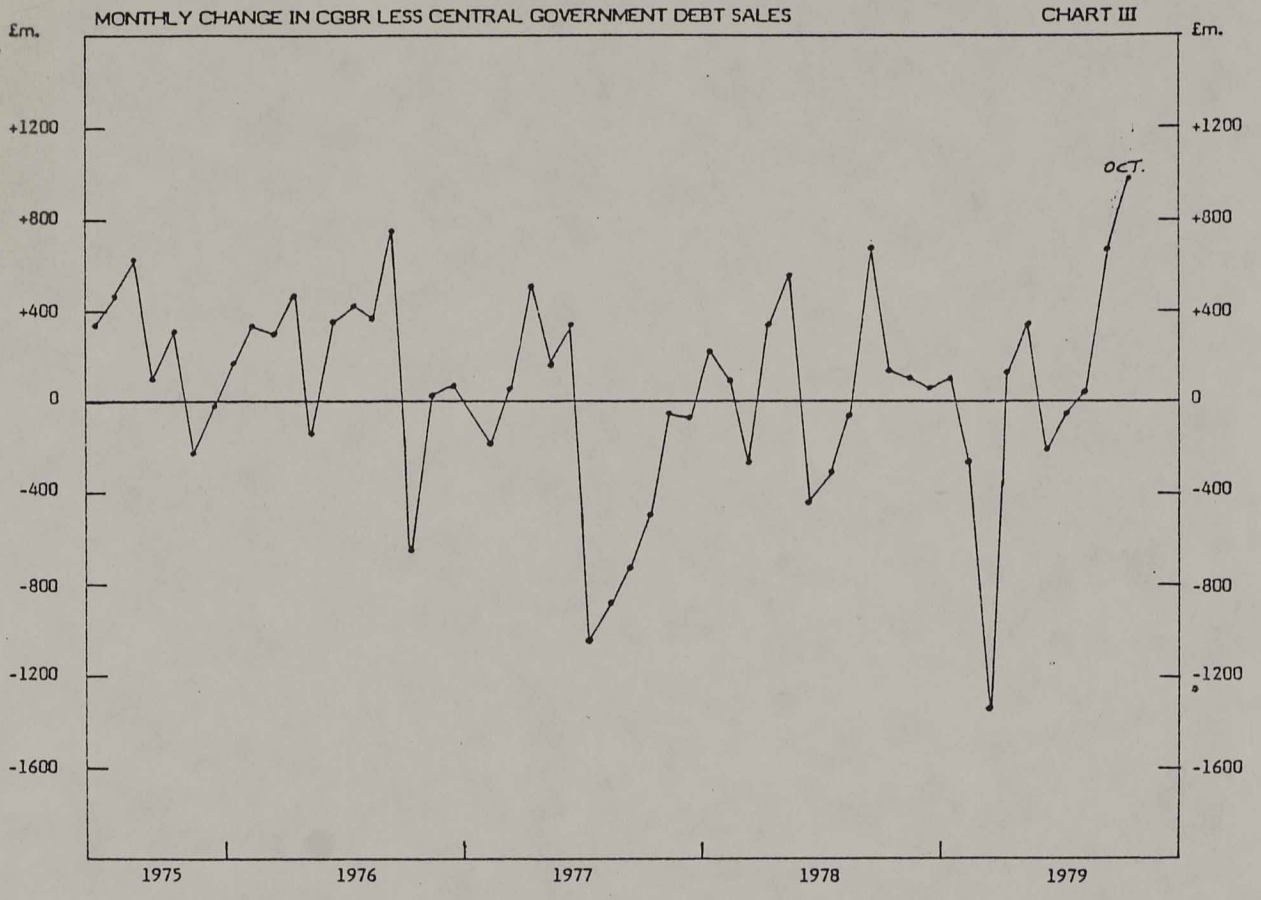
As a result of these four factors the public sector's demand for finance has continued to rise. This is why the financial situation became acute. But the situation is forecast to improve, dramatically for the next six months and, in comparison with the recent past, significantly thereafter.

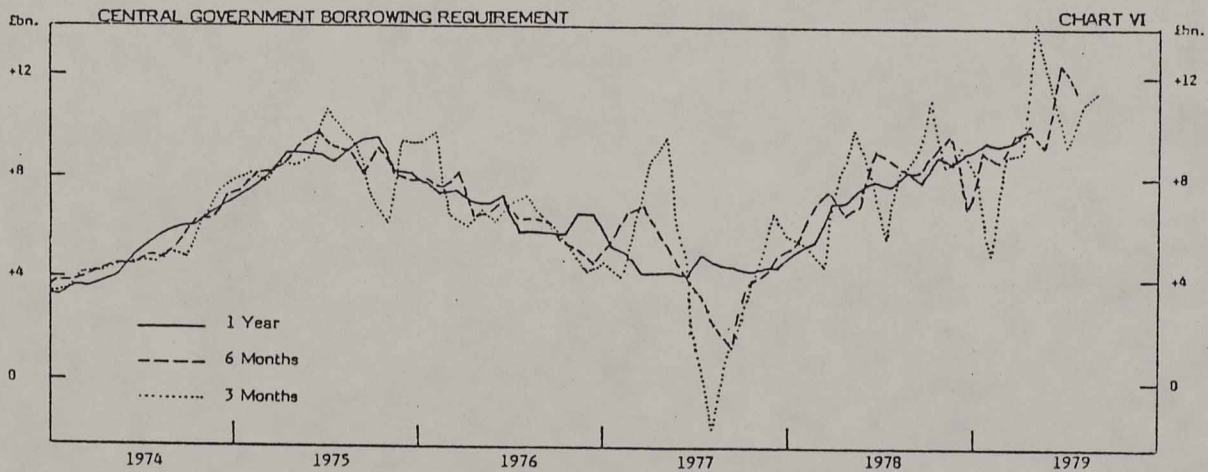
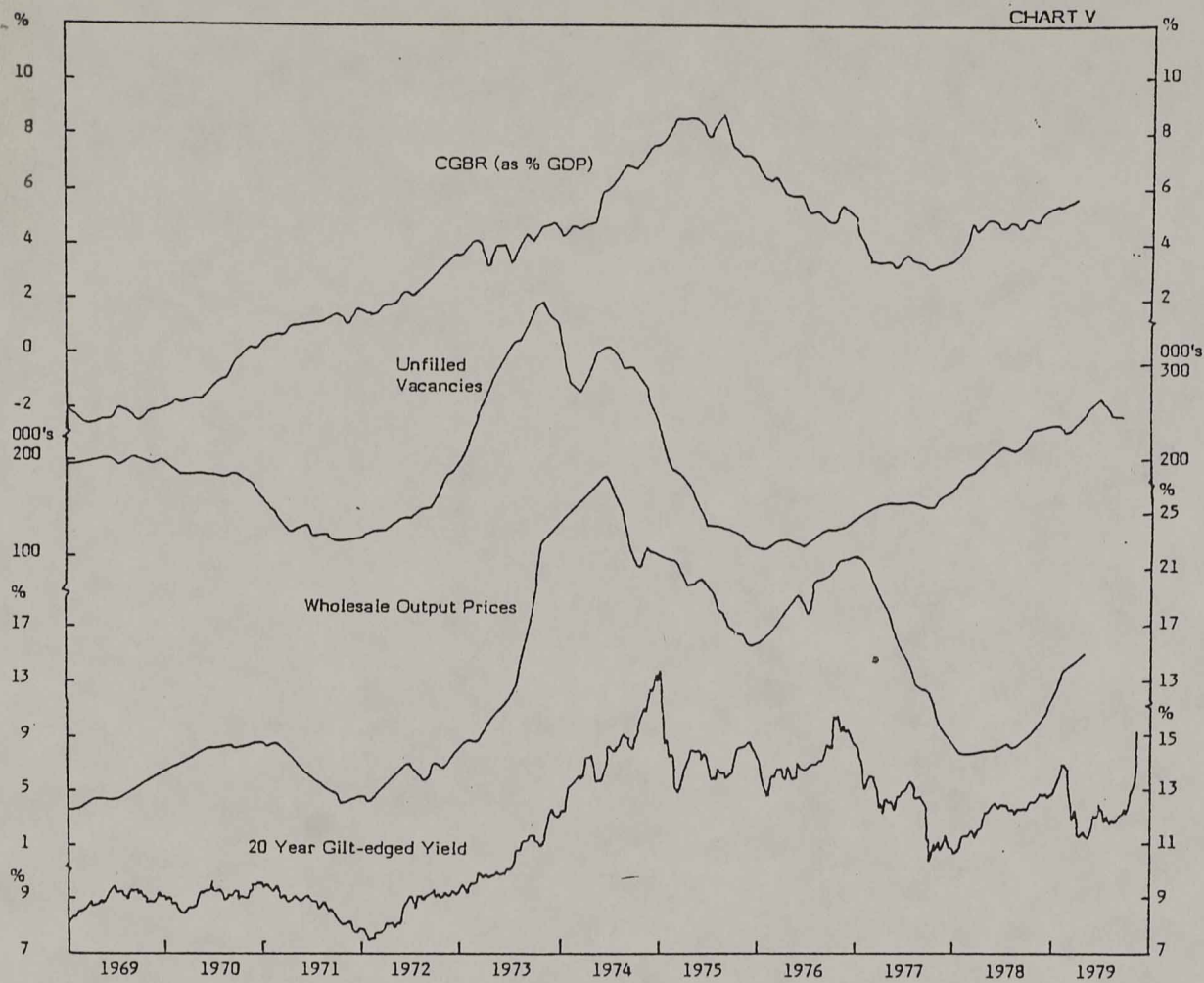
The Chancellor's statement on November 15th included an updating of the Treasury's forecast of the PSBR in 1979/80, namely £9bn. before the policy changes and £8.3bn after them. During the first half of the financial year the PSBR has been in excess of £6bn. on a seasonally adjusted basis. This implies 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.







W. Greenwell & Co.

Bow Bells House,
Bread Street, London EC4M 9EL

Telephone: 01-236 2040 Telex: 883006

W. Greenwell Associates (Investment Adviser) 450 Park Avenue, New York, N.Y. 10022
Telephone: 212 832 7428 Telex: 710 5815122

W.Bomz
R Econ. Pol
2/10


MONETARY CONTROL IN THE U.K.

*A talk by Gordon Pepper on 24th October, 1979 to the
Institute of Bankers, City of London Centre*

During the last month, there have been three important developments concerning monetary control. Firstly, two and a half weeks ago, Paul Volcker announced changes in the method of monetary control in the U.S. - the Fed is changing from interest rate control to quantitative control of the reserve base of the U.S. banking system. Secondly, last Monday the Financial Times reported that an important debate was under way within the Treasury and the Bank of England about changes in the methods of monetary control in the U.K. The third event was yesterday's abolition of exchange controls - in effect, it opens a euro-currency loop-hole in the corset - the relaxation of exchange controls comes close to making the corset ineffective. As a result, this talk is different from the one I intended a few days ago.

U.K. residents are now allowed to place deposits and borrow in the euro-sterling market. Consider the position of a foreign bank which opened a branch in London only a few years ago. The bank would have been hoping for a reasonable amount of U.K. domestic banking business. Its hopes would have been frustrated by the corset. It may have acquired customers who wanted sterling finance but it would not have been able to bid for the deposits to satisfy these customers without incurring severe penalties under the corset. As from midnight last night, the bank can suggest to its customers that its Paris or Frankfurt branches can supply euro-sterling finance. If the Paris or Frankfurt branch bids for euro-sterling deposits at rates a little higher than the London inter-bank rates, it should attract the necessary deposits to accommodate its new customers. I wonder how many money brokers telephoned their clients today pointing out that money could now be switched from a domestic deposit to a euro-sterling deposit for a gain in interest?

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

Such transactions in euro-sterling deposits and loans are outside the corset. They also escape the Bank of England's reserve asset regulations. Further, the transactions are not recorded in the domestic banking statistics. The euro-sterling deposit of the U.K. resident is not included in the data for the money supply.

One result of abolishing exchange controls is to make the corset largely ineffective. A few days ago, in our last Monetary Bulletin, we wrote that although there has been a marked deceleration in the underlying growth of sterling M3 since MLR was raised in June, it may not yet have fallen below the 11% upper limit of its current target range. There was certainly insufficient evidence of satisfactory monetary growth for the authorities to reduce MLR. Similarly, the evidence currently before me does not justify the lifting of the corset. The authorities, however, have evidence which has yet to be published.

In effect, the authorities have come close to scrapping the existing system of monetary control without announcing what will be put in its place. At the moment, there is something of a void.

My own forecast is that monetary growth will continue to decelerate. The corset may already have done its job (such as it was - which is debatable). If I am right, the absence during the next few months of an efficient system of monetary control will not matter very much. If monetary growth has already turned downwards, tight constraints will not be needed. But forecasts can be wrong. An efficient mechanism might be needed during the next few months. Although I welcome the abolition of exchange controls in its own right, the authorities are taking considerable risks with monetary control.

If monetary growth does rebound upwards, the euro-sterling loop-hole will distort the published statistics. There are already various other loop-holes, such as acceptance credits held outside the banking sector, but these, in the main, can be quantified. The disquieting thing about a euro-sterling loop-hole is that it cannot be quantified. In my opinion it would be best for the Bank to announce that the corset has been lifted. If it does so, we would at least be able to know what was happening if monetary growth again became excessive.

When I was planning this talk before the announcement about exchange controls, I intended to compare the present situation with that in 1970/71 after the last Conservative Government was elected to power. The election was in June 1970. The consultative document "Competition and Credit Control" was published in May 1971. The changes were put into effect in September 1971, i.e. fifteen months after the election. I was going to say that I thought the timing might be roughly similar this time. I am now wondering. The present void needs filling more quickly.

I had planned to say that the monetary system would be changed, if only for one reason. In 1970, both the Bank of England and the Treasury wanted change because the previous system of monetary control had resulted in intolerable distortions to the financial system. Non-clearing banks had gained at the expense of clearing banks, and deposit-taking-institutions just outside the banking sector (near-banks) had gained at the expense of banks. When distortions to the financial system reach a certain stage, a central bank wishes to change its system of monetary control.

The distortions caused by the present corset are large. In the winter and spring of 1978, before the present corset was imposed, various banks indulged in window-dressing transactions to increase the base of their interest-bearing eligible liabilities. They did this in spite of the Bank of England warning that they would not obtain a competitive advantage, because the corset would be back-dated. In the event, many bankers believe that the corset was not back-dated sufficiently and that the bankers who window-dressed their balance sheets stole a march. If the present corset is lifted and bankers subsequently think that a new one will be imposed, I hate to think of the size of the pre-emptive transactions which will then occur. Next time everyone will join in. In short, the distortions to the financial system caused by the corset have probably reached the stage at which the Bank of England again wants to change the control mechanism.

There is, however, a far more important and basic reason for wanting to change the system of monetary control. The present mechanism is insufficiently powerful to prevent excessive monetary growth. Excessive monetary growth can come from two sources. Firstly, the government can print money and, secondly, excessive private sector credit can be created. I will deal with each of these in turn.

In medieval times the most common form of money was coinage, e.g. gold sovereigns. If a medieval king wanted to finance a war, he could do so by debasing the coinage, i.e. by reducing the gold content in sovereigns. Later, the most popular form of money was paper money, e.g. pound notes. Governments could then literally print money, as happened in Weimar Germany. Nowadays the most popular form of money is bank deposits. Over 80% of sterling M3 consists of bank deposits. The modern way of printing money is government borrowing from the banking system.

Exactly what happens is this. Supposing that the government makes a payment to someone by way of cheque. When the cheque is cleared, the person concerned will be credited with an additional deposit at his bank and the balance which his bank keeps with the Bank of England will rise by the same amount. Because a balance with the Bank of England does not earn interest, the bank will probably withdraw the money from the Bank of England and place it on call with a discount house. The discount house will then have surplus funds. The Bank of England will absorb these surplus funds by selling Treasury bills to the discount market as part of its day to day operations in the money market. The result will be that the government will have borrowed from the banking system, in this example from a discount house by selling Treasury bills, and the total of bank deposits will have increased by the rise in the person's deposit with his bank, i.e. the money supply will have grown.

The above process is automatic. Under the U.K.'s present system of monetary control, if the government does not manage to raise all the finance that it needs from the general public (in the gilt-edged market for instance) the residual comes automatically from the banking sector.

There are various possible systems for financing government deficits. Extreme monetarists advocate a system in which it is impossible for a government to print money excessively. Economists who are not quite so extreme argue that, if a government prints money excessively, it should announce what it is doing and publicly justify it. More permissive economists argue that if a government prints money it should at least take a conscious decision to do so. The most permissive case is a monetary system in which the government prints money automatically without having to take a conscious decision. The last is the existing system in the U.K.

The second way in which the money supply can grow excessively is through private sector credit creation. If someone with an overdraft makes a payment by cheque, his overdraft rises and the recipient's bank deposit increases. The money supply rises with the increase in the bank deposit.

The growth of bank lending between last December and last June was an example of what can happen under the U.K.'s present system of monetary control. The background last December was that during the previous sixteen months the growth of sterling M3 had averaged more than 14% per annum, which was above the 12% upper limit of the target range. Between mid-December and mid-June, bank lending suddenly grew at a 27% annual rate. The corset had been imposed in June 1978, i.e. it had been in place for six months before bank lending became buoyant. It was exactly the sort of situation that the corset was meant to control. It did not. The upshot was that the excessive monetary growth continued until last June. The fact of the matter is that under the present system of monetary control the published growth of sterling M3 between August 1977 and June 1979 was 14% per annum but, allowing for distortions, it was about 15½% per annum. It was well in excess of the upper limit of the target range.

From my description of the present system, you may wonder why monetary growth has not been even more excessive. What happens is this.

The commercial banks first collect the monetary data, which are reported to the Bank of England which processes and aggregates them. At this stage, the Bank becomes aware of any problem of excessive monetary growth. The authorities then have to decide on appropriate action, and the decision making process may take a little while. Further, action to control monetary growth is unpopular, because it entails raising interest rates, and the politicians may want to wait for further data, to make sure that the unpopular action is really necessary. The result may be a problem of quite considerable proportion before action is taken.

I now come to a crucial point. The Prime Minister, the Chancellor and the Governor may all be determined to curb the excessive monetary growth but the authorities simply do not know what rise in interest rates is necessary. The authorities

may consult the computer for a theoretical answer, but little confidence can be placed on the result. In the U.S. the authorities decide on a hike in interest rates, followed by a pause for a month or so to see the effect. If excessive monetary growth remains, interest rates are given another hike, and so on.

The trouble with this approach has been illustrated all too clearly in the U.S. Inflation is a malignant disease. The financial system can get further and further out of equilibrium. The rise in interest rates can get further and further behind what is needed to restore equilibrium.

There is considerable evidence, for example in a speech by Lawrence Roos, President of the Federal Reserve Bank of St. Louis, at a recent seminar at the City University, that central banks rarely alter interest rates sufficiently quickly. When monetary growth is excessive, they do not raise interest rates fast enough. When monetary growth is inadequate they do not lower interest rates fast enough.

To stop this from happening, monetarists argue for a system of monetary control which produces a market clearing rate of interest. The market, itself, should establish the necessary change in interest rates.

This brings me to the design of the new monetary mechanism. I have already said that the corset will be scrapped. It is also clear that the definition of reserve assets should be changed.

Under the new definition, the total pool of reserve assets should be under the complete control of the authorities. This is in contrast to the present situation, where banks can increase the pool of reserve assets by bidding for Treasury bills held by the non-bank private sector. They can also attract money previously deposited with local authorities. Local authorities then have to borrow from the Public Works Loans Board and the Bank issues Treasury bills to banks to finance the PWLB. Under the new definition of reserve assets, banks, either individually or together, would no longer be able to enlarge the pool of reserve assets.

I should warn that, if the authorities announce a new mechanism of control under which they cannot control the reserve base of the banking system when things are going badly wrong, the reaction of the foreign exchange and gilt-edged markets will be hostile, and inflationary expectations will be affected adversely.

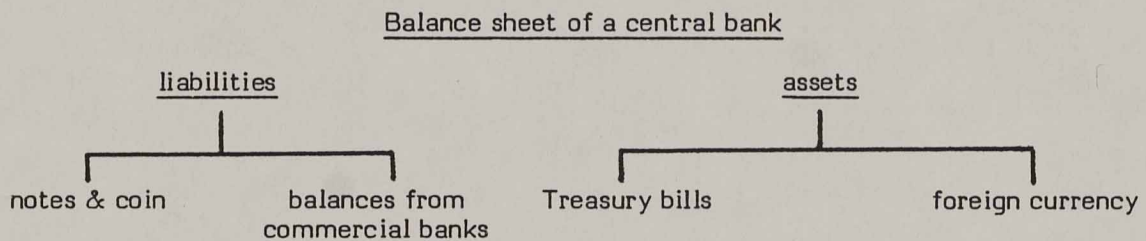
There are various possible monetary systems under which the authorities can control the reserve base of the banking system. Much of the detailed argument can be avoided if the following principle is accepted. The new control mechanism must not penalise a bank relative to a near-bank or an off-shore bank.

Current experience in the U.S. is an awful warning of the mess which can occur if the domestic banking system is penalised. Member Banks of the Federal Reserve System are required to place reserves with Federal Reserve Banks on which no interest is paid. This lack of interest becomes an increasing penalty as interest rates rise. When interest rates rose in 1974/75, non-Member Banks and near-banks realised that they had a competitive advantage over Member Banks. They were quick off the mark when interest rates rose this time. Member Banks have had to defend themselves. Suppose for example that a customer asked a Member Bank for a C.D. The Member Bank, knowing that a non-Member Bank could issue a C.D. bearing a higher rate of interest, might suggest that its customer should purchase one of its own holdings of U.S. Treasury bills on a sale and repurchase basis, the transaction circumventing the Fed's reserve requirements. In this way the Member Bank can remain competitive. There are many other examples of money substitutes - ATS and NOW accounts, money market funds and euro-dollars - being created because of the excessive penalty that the Fed imposes on Member Banks. The lesson is very clear. The new control mechanism for the U.K. must not penalise a bank compared with a near-bank or offshore bank. This lesson is doubly important now that exchange controls have been abolished.

Acceptance of the principle that the control mechanism must not penalise a bank compared with a near-bank or an off-shore bank rules out several monetary systems which have been proposed. For example, it rules out a permanent version of the corset, altered to allow one bank to buy some of another bank's quota of interest-bearing eligible liabilities. It also rules out the proposal that there should be two types of Treasury bill - Type A which would qualify as a reserve and Type B which would not. The terminology

may vary. For example, Type B bills may be called Treasury deposit receipts. Under such proposals, if there is a reserve squeeze, banks would bid for Type A bills, driving their yield down, and would sell Type B bills, which would drive their yields up. The difference between the yields on the two types of bills would penalise banks. Various similar schemes have been suggested. In each case you should ask yourself whether they penalise banks severely.

The systems which control the reserve base of the banking system without penalising banks are variations of monetary base systems. The concepts of monetary base and of high powered money are not familiar in the U.K. I will try in the simplest possible terms to explain the basic concept. The following represents the balance sheet of a central bank.



The main liabilities are notes & coins in circulation and balances kept by commercial banks with the central bank. The main assets are Treasury bills and foreign exchange. The above account will not be familiar. In effect, I have merged the accounts of the Banking Department, Issue Department and Exchange Equilisation Account.

Some people define the monetary base as notes & coin plus the balances from the commercial banks, i.e. the total of a central bank's liabilities. Others exclude notes & coin in circulation with the general public; they just include till money (or vault cash, to use the U.S. terminology) and the balances from the commercial banks. Our own proposals which we published last June focussed only on the balances from the commercial banks. We suggested that banks should be required to keep reserves with the Bank of England (the clearers could be allowed to keep them on behalf of non-clearers if the latter so wished, to leave clearing unchanged). We also suggested that the reserve ratio should be chosen so that banks' reserves would be close to the level which they would choose for prudential

reasons. Further, we suggested that interest should be paid on reserves backing interest-bearing deposits. In this way our proposals were designed not to penalise a bank compared with a near-bank or an off-shore bank.

Under the purest form of monetary base, proposed by many academics, the reserve ratio is not specified; each bank is left to decide on the level of reserves which it considers prudent (as in Switzerland). This form of monetary base does not penalise banks compared with near-banks or off-shore banks.

Tonight is not a suitable time to discuss the technical details of monetary bases. The important point is that under these schemes banks' reserves are liabilities of the Bank of England.

A central bank, like any bank, knows the size of its liabilities and assets continuously. Therefore, a central bank would know daily the size of the monetary base. Further, a central bank can control the size of its liabilities by buying or selling assets, either Treasury bills or foreign exchange. In the U.S., the Fed tends to buy or sell Treasury bills in its domestic money markets. In Switzerland, the National Bank tends to deal in foreign currencies on the foreign exchange markets. In principle, a central bank can control its assets, and therefore its liabilities, on a daily basis.

Suppose that the Bank of England announced that the reserve base of the banking system would rise at a 10% annual rate. Banks would then know that the total assets of the banking system could not grow at a faster rate than 10%. If they started growing faster, and if banks forecast that this would continue, action to constrain the growth of assets would have to be taken. Base rates could be raised to discourage the demand for loans. A start could be made on revising overdraft limits. Alternatively, assets could be sold, for example Treasury bills, gilt-edged stock or commercial bills.

Similarly, discount houses could watch the Bank's Weekly Return to see if bank reserves were growing faster than 10%. If they were, it would be a warning that the discount market might at some time in the near future be given less assistance by the Bank than it wanted. Under the present system, the Bank gives the discount market

whatever quantity of assistance it wants, choosing only the price (i.e. the rate of interest) and the method of giving assistance. Under a monetary base system, the discount market might ask for £100m., say, and be given only £95m. Discount houses would have to raise the remaining £5m. by selling assets, e.g. Treasury bills.

The well known equation setting out the main factors governing the supply of money is shown below. I have divided the last factor, sales of public sector debt to the non-bank private sector, into three components: firstly, non-marketable government debt, e.g. national savings, on which interest rates cannot be altered quickly for administrative reasons, and other public sector debt. Secondly, sales of marketable long-dated central government debt, e.g. medium and long-dated gilts. Thirdly, sales of marketable short-dated central government debt - this being the important issue.

Factors influencing the money supply

	Increase in sterling M3
	equals
	(i) public sector borrowing requirement
plus	(ii) bank lending in sterling to the private sector
less	(iii) external and foreign currency finance raised by the public and banking sectors
less	(iv) sales of public sector debt to the non-bank private sector. This debt can be subdivided as follows:
	(a) non-marketable central government debt, e.g. national savings, and other public sector debt,
	(b) marketable long-dated central government debt, e.g. long-dated gilts
and	(c) marketable short-dated central government debt, e.g. Treasury bills

At present U.K. money markets are primarily designed to enable the Government to sell short-dated central government debt to the banking sector. They should be widened to enable the Government to sell such debt to non-banks as well as banks. Further, if Treasury bills and under-one-year gilts no longer qualify as reserve assets, the way would be clear for the Bank to issue six and twelve month Treasury bills, as happens in the U.S. The Bank could also issue one and two year gilt-edged stock, instead of buying

them in as it does at present - again, this happens in the U.S. The discount market would be given the important task of widening money markets to include the non-banking sector. Discount houses have already proved that they can do so, viz the large quantity of bankers acceptances currently held outside the banking sector. About two years ago, when the corset produced the right yield differentials, discount houses showed that they could also sell large quantities of Treasury bills to non-banks.

Why, if it is as good and as simple an idea as I have described, have central banks not adopted monetary base schemes and quantitative control of the reserve base of commercial banks? Their most important objection is the fear that interest rates will not be just volatile but unstable in the short run. As I described earlier, under the present system of monetary control there is a lag of maybe two or three months before a rise in interest rates has a powerful impact on monetary growth. If there is a substantial lag before interest rates work, they might continue to rise during the lag. Further, there might be a perverse effect on the monetary aggregates in the short run. Involuntary loan demand could rise and yield differentials could cause arbitrage transactions which would add to monetary growth, as occurred in 1972/3. If this happens, interest rates could become unstable under a monetary base system of control, i.e. changes could feed on themselves.

The key to preventing interest rates being either unstable or extremely volatile is those sales of short-dated central government marketable debt to non-banks that I mentioned earlier. If they occur, the money supply will react quickly to the system coming under pressure.

Earlier I discussed how banks and the discount market as a group would react to their assets growing faster than the permitted rate. I considered the position from the viewpoint of the banking sector as a whole. But how would an individual bank react?

Suppose that you are a treasurer of a bank which is short of £10m. reserves at the Bank, what would you do? You could do two things - you could either bid for deposits or sell assets. In practice you would do both. Bidding for money would raise interest rates. This is how market clearing rates of interest would rise - how the market itself would

establish the necessary rise in interest rates which I described earlier. And the sales of assets would have a quick effect on the money supply.

Under Competition and Credit Control, banks found that pressure on the system as a whole was relieved if they bid for deposits, because this increased the pool of reserve assets, as explained earlier. Under a monetary base system, pressure on the system as a whole could not be relieved by such action. Bank A could pinch the reserves of Bank B, but the total would not increase. Banks would find that their desired objective would be achieved more often by sales of assets, which would relieve pressure on the system as a whole.

Sales of short-dated central government debt to non-banks would be an important buffer which would be needed to make interest rates stable. But it would not be the only buffer. I do not know one responsible monetarist who advocates very short term control of the money supply. Unless conditions are extreme, fluctuations in the money supply which reverse within about six months have no relevance for the real economy. This cannot be stressed too often. Accordingly, various timing buffers can be built into a monetary base system to guard against instability in the very short run, for example reserves can be based on average weekly data instead of on data at a single point of time. Again, I will not go into detail tonight.

Finally, I come to consultation. Competition and Credit Control in May 1971 was described as a consultative document, but the authorities had already made up their minds about the new design. I am hoping that a genuine consultative document will be published by the authorities within a month or so. There should then be a gap of, say, six months before implementation, whilst the new proposals are running the gauntlet of scrutiny not only by academics but also, and more importantly, by practical bankers. Treasurers, general managers and officials of discount houses should be given every opportunity to criticise the new proposals. Ideally, the authorities' consultative document should contain two or three different proposals. If this happens, I hope that practical bankers will describe how they will react to difficult conditions under each proposal. If they do, there is every chance that a monetary base system can be designed under which interest rates will not be unstable or extremely volatile.

In the U.S. the Fed has introduced quantitative control of the reserve base in the worst possible way - during a crisis when the financial system is badly out of equilibrium and when the new mechanism has not been explained clearly and is not understood by many people in the money market. Further, I am not sure whether the buffers to make interest rates stable have been included in the U.S.

People I talk to in the U.K. want evolution and not revolution. One possibility is that the present $12\frac{1}{2}\%$ reserve asset ratio will remain, but 6%, say, of these reserves must be placed with the Bank. A two tier system could be introduced under which the authorities could gradually place more and more emphasis on the 6% reserve ratio and less on the $12\frac{1}{2}\%$ reserve asset ratio. In this way, they might blend the new system with the old.

In finishing, I repeat my plea for a genuine consultative document. Unfortunately, the Bank of England has an instinct for secrecy, especially when something may become operational. I hope that the bankers here tonight will support my plea for full discussion this time before the authorities make up their minds about the general design of the new system of monetary control. In this way we can avoid the pitfalls of Competition and Credit Control.

W. Greenwell & Co.

Bow Bells House,
Bread Street, London EC4M 9EL

Telephone: 01-236 2040 Telex: 883006

W. Greenwell Associates (Investment Adviser) 450 Park Avenue, New York, N.Y. 10022
Telephone: 212 832 7428 Telex: 710 5815122



MONETARY BULLETIN

No. 97, October, 1979

Current monetary growth

In the five week banking month to 19th September, 1979, the seasonally adjusted behaviour of the monetary aggregates was as follows:

Notes & coin	£ 125m.	(17% p.a.)
Retail M1	£ 280m.	(14% p.a.)
Sterling M3	£ 334m.	(8% p.a.)
M4	£ 534m.	(11% p.a.)
M5	£1,111m.	(14% p.a.)
DCE	£ 923m.	
- Bank lending in sterling to private sector	£ 160m.	(5% p.a.)

The main features of the month were:

- (i) The CGBR was exceptionally large at £1,647m., seasonally adjusted. This reflected the tax rebates from increased personal allowances.
- (ii) Net purchases of central government debt by the non-bank private sector were large, at £983m., seasonally adjusted. This was lower than some market forecasts because of substantial official purchases of the next maturities, as well as the redemption of 3% Treasury 1979.
- (iii) Bank lending in sterling to the private sector was low because of special factors. Firstly, bank acceptances held outside the banking system rose by some £180m. (circumventing the corset). Secondly, corporate liquidity will have benefited from the exceptionally high borrowing requirement of the government, as mentioned by the Bank in its press release.
- (iv) External and foreign currency finance reduced sterling M3 by £499m., seasonally adjusted. As in August, the recent relaxation of exchange controls was a cause of both this and high DCE.

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

Prime Minister ECMA 2
To glance - especially page 2.
TL
23/10

R22
Aut

The behaviour of the monetary aggregates in recent months is shown in the following table:

	<u>3 months</u>	<u>6 months</u>	<u>12 months</u>
Notes & coin	17% p.a.	9% p.a.	12%
Retail M1	19% p.a.	13% p.a.	11%
Sterling M3	10% p.a.	14% p.a.	12%
M4	12% p.a.	17% p.a.	15%
M5	14% p.a.	16% p.a.	15%

In our last Bulletin we suggested that there had been a change in the trend of monetary growth starting in mid-June, following the increase in MLR to 14%. The three month averages in the above table show the data for this period; they should be compared with those for the previous six months:-

	<u>mid-June to mid-September</u>	<u>mid-December to mid-June</u>
Notes & coin	17% p.a.	10% p.a.
Retail M1	19% p.a.	8% p.a.
Sterling M3	10% p.a.	13% p.a.
M4	12% p.a.	17% p.a.
M5	14% p.a.	16% p.a.

There has been a clear deceleration in the broader aggregates (i.e. sterling M3, M4 and M5). However, the two narrow aggregates have increased very sharply. Special and temporary factors explain some of this buoyancy. Our last Bulletin mentioned the spending spree prior to the increase in VAT. The recent tax rebate is another. Nevertheless, the buoyancy is somewhat disturbing.

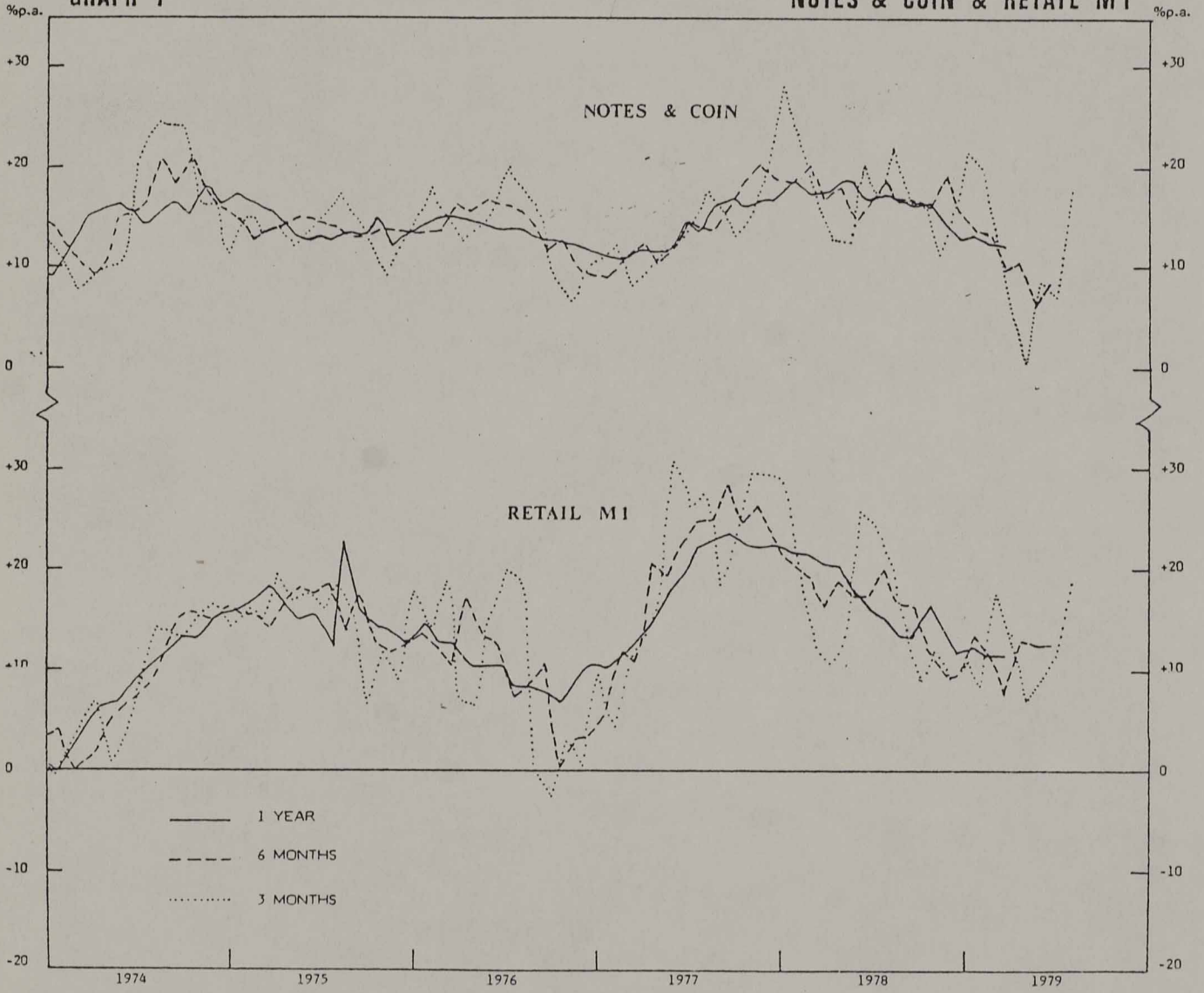
The data for the latest three months have a second worrying feature. The growth of sterling M3 is lower than that of all the other aggregates, both broader and narrower, even allowing for the probable influence of the special factors mentioned above.

Our conclusion is that there has been a marked deceleration in the underlying growth of sterling M3 but that it may not yet have fallen below the 11% upper limit of the current target range.

G.T.P.
R.L.T.
R.R.

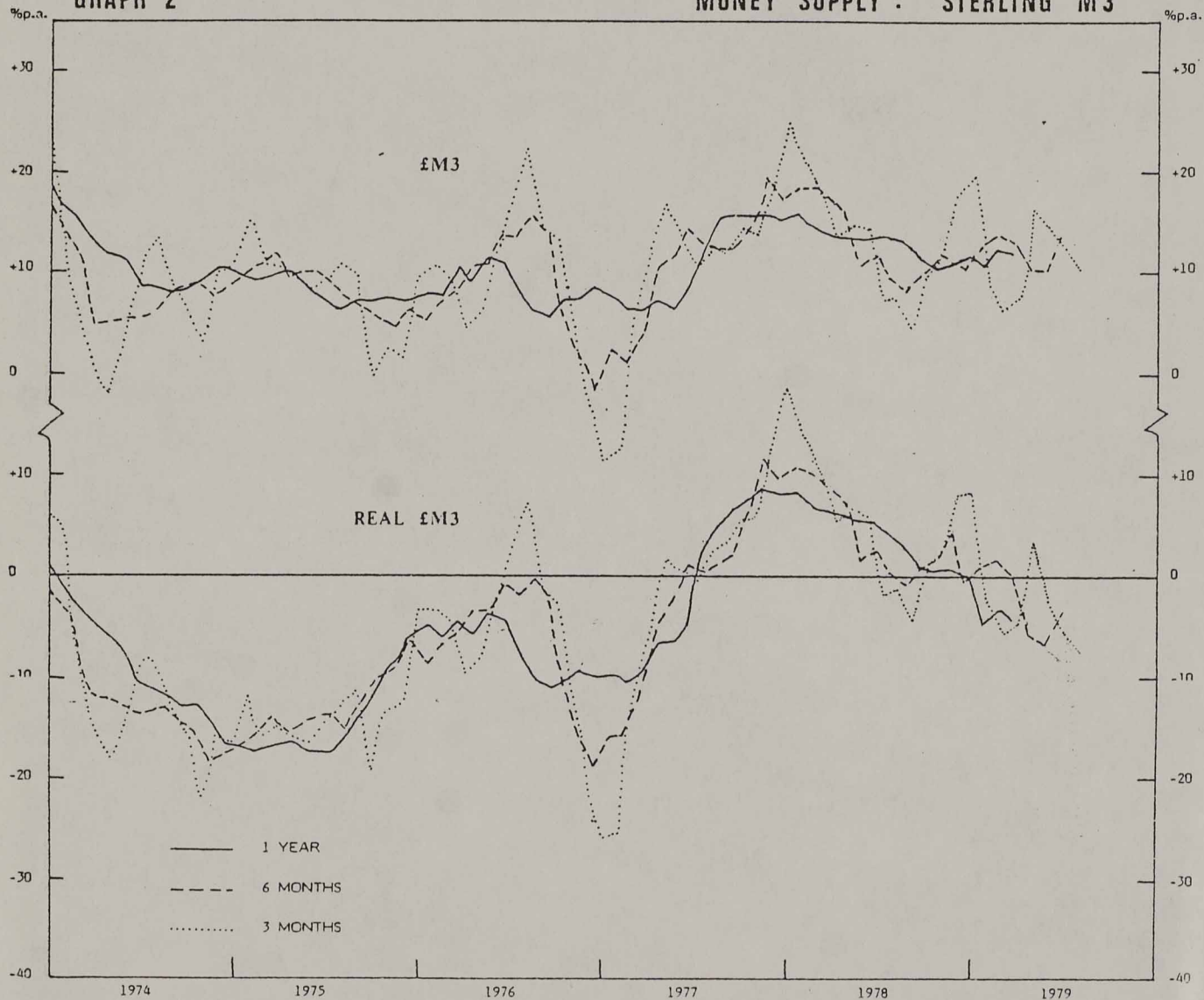
GRAPH 1

NOTES & COIN & RETAIL M1



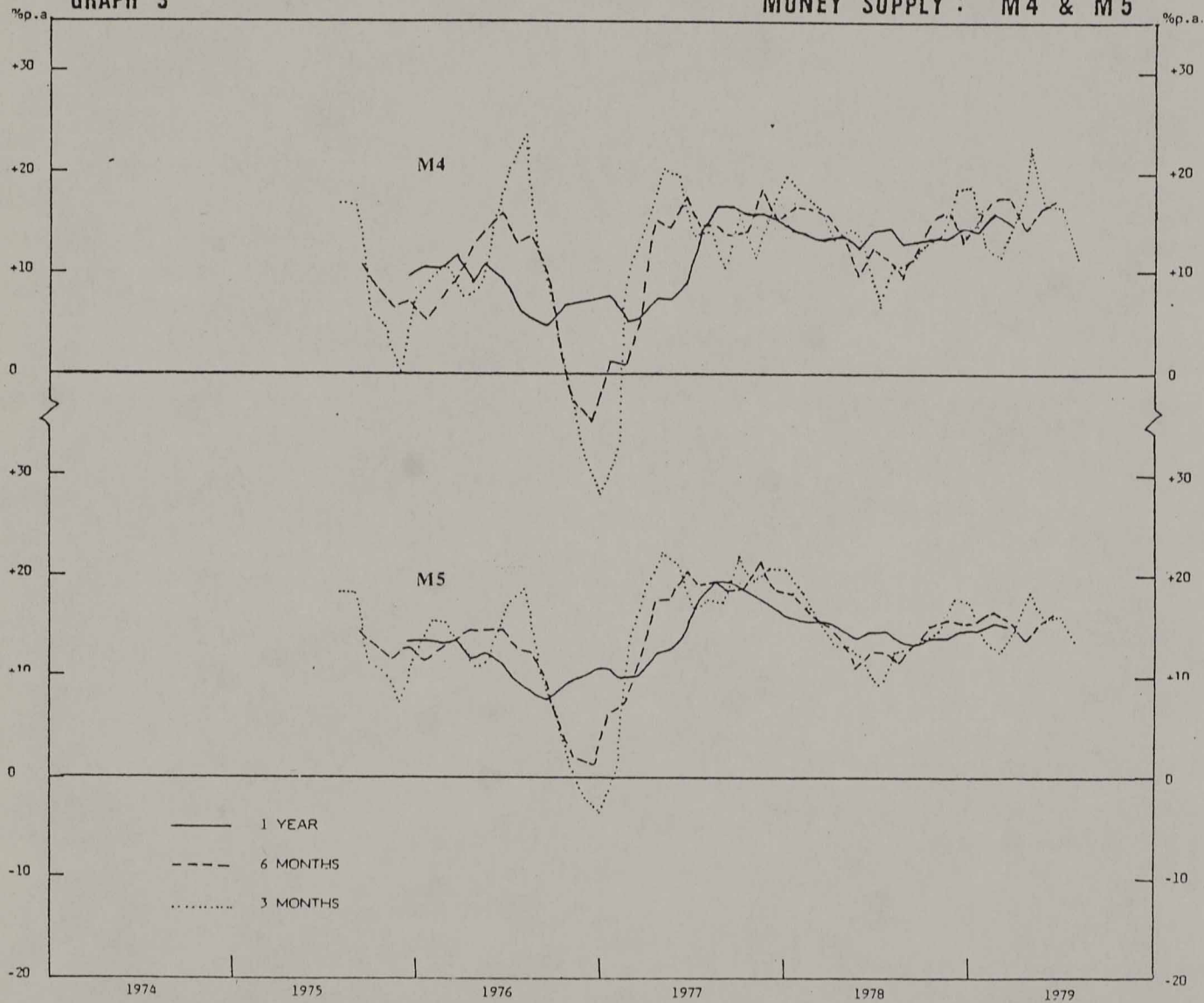
GRAPH 2

MONEY SUPPLY : STERLING M3



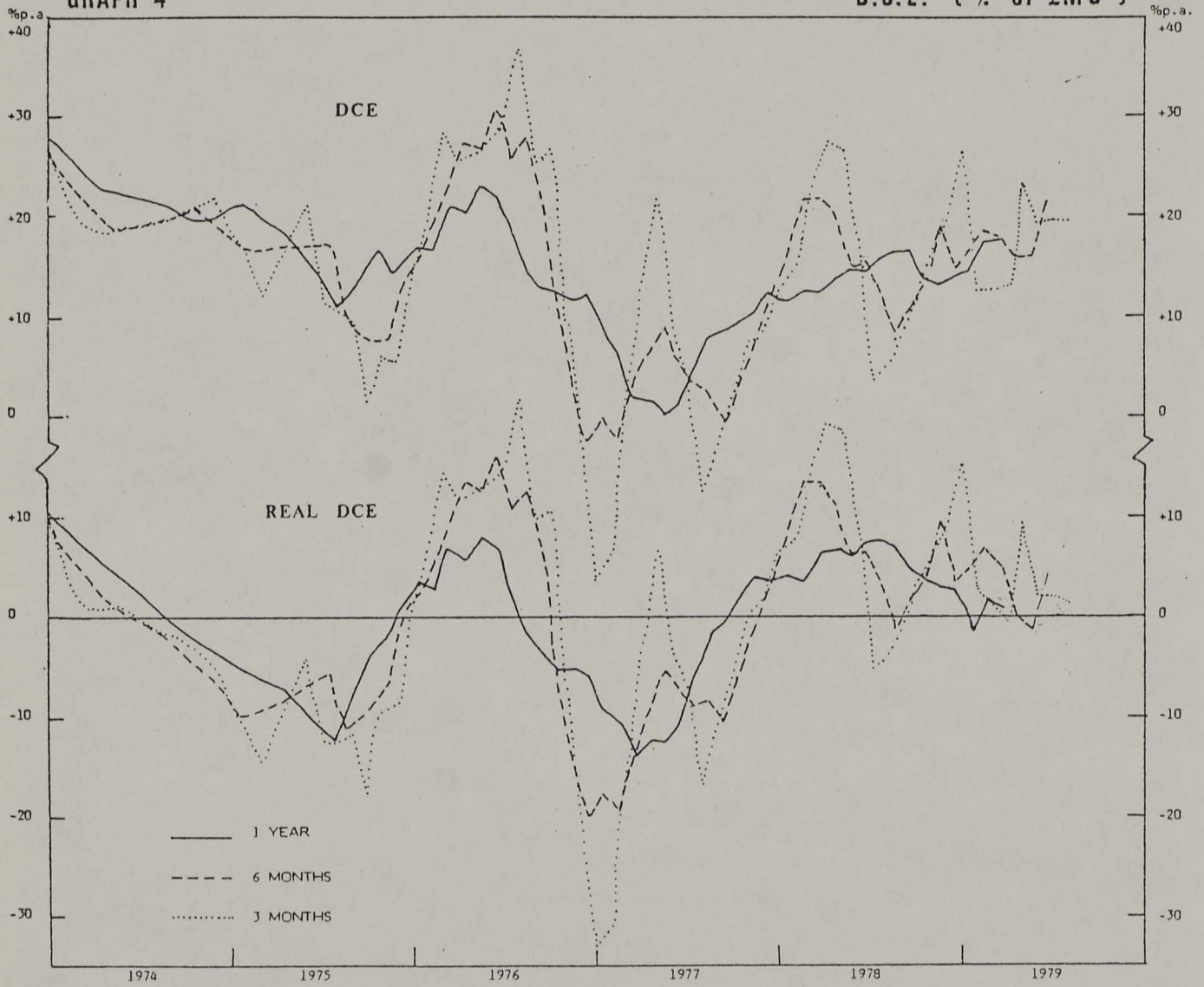
GRAPH 3

MONEY SUPPLY : M4 & M5



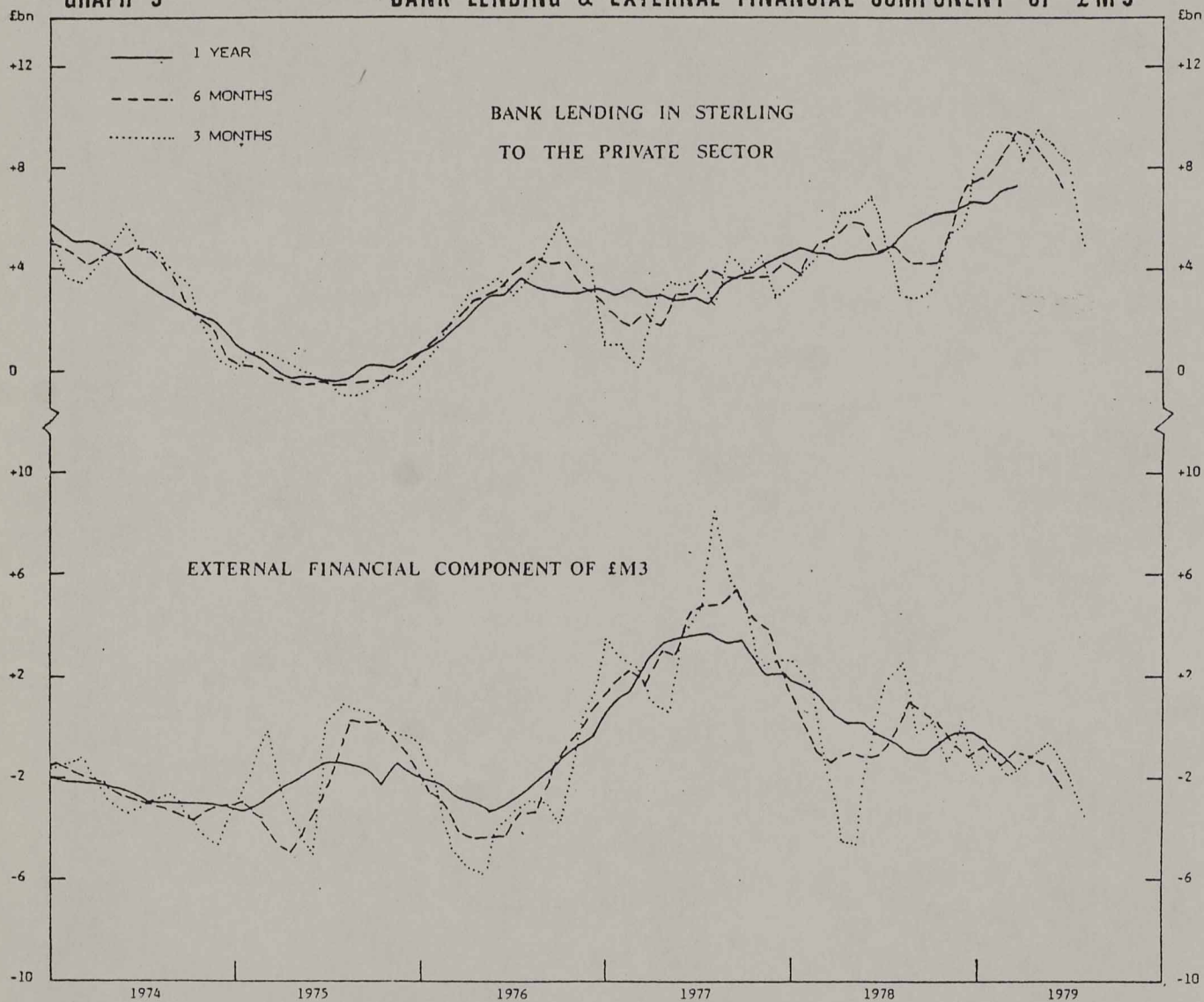
GRAPH 4

D.C.E. (% of EM3)



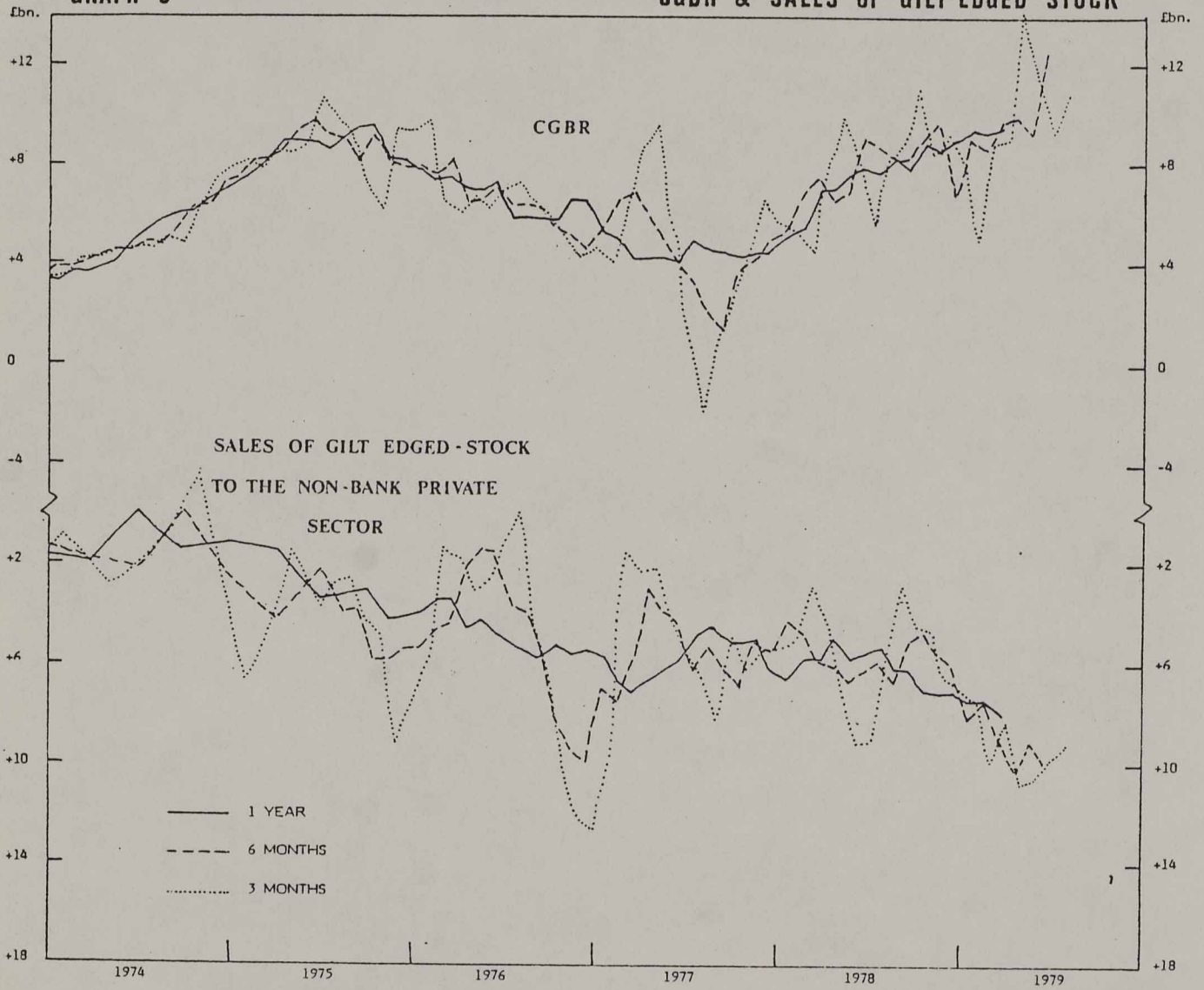
GRAPH 5

BANK LENDING & EXTERNAL FINANCIAL COMPONENT OF £M3



GRAPH 6

CGBR & SALES OF GILT EDGED-STOCK



STATISTICS

reprinted from Bank of England, *Banking Statistics*.

[Table 6 in the *Quarterly Bulletin*]

UK banking sector: transactions in liabilities and assets (a)

£ millions

Month ended	Liabilities											Non-deposit liabilities (net)
	Total	Domestic deposits								Overseas deposits		
		Total		Public sector				Private sector		Sterling	Other currencies	
		Un-adjusted	Seasonally adjusted	Sterling		Other currencies	Sterling		Other currencies			
	Un-adjusted	Seasonally adjusted	Un-adjusted	Seasonally adjusted		Un-adjusted	Seasonally adjusted		Other currencies			
1978 Sept. 20	+ 2,458	+ 480	+ 334	+ 182	+ 119	- 26	+ 266	+ 183	+ 58	+ 121	+ 1,651	+ 206
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	- 661	- 703	- 324	- 265	+ 38	- 115	- 216	- 260	+ 339	+ 466	- 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	+ 1,040	+ 1,082	+ 187	+ 34	- 11	+ 451	+ 646	+ 413	+ 151	+ 2,948	+ 564
July 18	+ 4,771	+ 257	+ 139	- 209	- 146	+ 18	+ 561	+ 380	- 113	+ 207	+ 4,234	+ 73
Aug. 15	+ 1,054	+ 206	+ 345	- 103	+ 63	- 12	+ 471	+ 444	- 150	+ 275	+ 562	+ 11
Sept. 19	+ 6,857	+ 203	+ 73	- 36	- 59	+ 35	+ 375	+ 268	- 171	+ 70	+ 6,621	- 37

Month ended	Assets											
	Total	Lending to public sector					Lending to private sector				Lending to overseas sector	
		Total		Sterling		Other currencies	Sterling		Other currencies	Sterling	Other currencies	
		Un-adjusted	Seasonally adjusted	Central government	Other		Un-adjusted	Seasonally adjusted				
1978 Sept. 20	+ 2,458	+ 518	+ 481	+ 509	+ 9	- 9	+ 149	+ 154	- 28	- 10	+ 1,838	
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	+ 428	+ 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	+ 1,382	+ 1,312	- 50	- 73	+ 3,321	
July 18	+ 4,771	- 286	+ 138	- 480	+ 194	- 153	+ 1,094	+ 347	+ 191	- 6	+ 3,931	
Aug. 15	+ 1,054	+ 359	- 93	+ 281	+ 78	- 42	+ 340	+ 895	- 45	+ 109	+ 333	
Sept. 19	+ 6,857	+ 191	+ 174	- 95	+ 286	- 42	+ 111	+ 163	- 87	- 20	+ 6,704	

(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*).

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
Month ended												
1978 Aug. 16	8,130	13,112	3,202	24,444	24,370	22,303	1,008	47,755	47,670	4,496	52,251	52,170
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	50,570	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	4,355	55,126	55,940
Mar. 21	8,689	13,446	3,488	25,623	25,960	23,122	1,182	49,927	50,640	4,576	54,503	55,220
Apr. 18	8,862	14,484	3,792	27,138	26,750	23,173	1,224	51,535	51,360	4,551	56,086	55,910
May 16	8,833	14,262	3,857	26,952	26,790	23,930	1,073	51,955	52,090	4,838	56,793	56,930
June 20	8,804	14,026	3,718	26,548	26,570	24,756	1,260	52,564	52,690	5,081	57,645	57,770
July 18	9,230	14,335	3,755	27,320	27,210	24,971	1,051	53,342	53,110	4,670	58,012	57,780
Aug. 15	9,143	14,532	3,631	27,306	27,190	25,369	948	53,623	53,640	4,601	58,224	58,240
Sept. 19	9,121	14,750	3,470	27,341	27,300	25,687	912	53,940	53,950	4,655	58,595	58,610

- (a) After deducting 60% of transit items (see additional notes to Table 6 of the Quarterly Bulletin).
 (b) M₁ equals columns 1 + 2 + 3. Sterling M₃ equals M₁ + columns 5 + 6. M₃ equals sterling M₃ + 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)		
											2
Month ended (unadjusted)											
1978 Sept. 20	+ 30	+ 72	+ 35	+ 137	+ 159	+ 182	+ 478	+ 32	- 6	+ 504	
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	- 222	- 57	- 623	
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	+ 402	- 159	+ 852	
July 18	+ 426	+ 309	+ 37	+ 772	+ 215	- 209	+ 778	- 95	- 316	+ 367	
Aug. 15	- 87	+ 197	- 124	- 14	+ 398	- 103	+ 281	- 162	+ 93	+ 212	
Sept. 19	- 22	+ 218	- 161	+ 35	+ 318	- 36	+ 317	- 136	+ 190	+ 371	
Month ended (seasonally adjusted)											
1978 Sept. 20	+ 158	+ 56	+ 35	+ 249	+ 1.0	+ 92	+ 119	+ 460	+ 1.0	+ 486	+ 0.9
Oct. 18	+ 73	+ 81	+ 82	+ 236	+ 1.0	+ 151	- 53	+ 334	+ 0.7	+ 449	+ 0.9
Nov. 15	+ 77	+ 27	- 61	+ 43	+ 0.2	+ 214	+ 49	+ 306	+ 0.6	+ 615	+ 1.2
Dec. 13	+ 72	+ 271	+ 242	+ 585	+ 2.3	+ 117	+ 8	+ 710	+ 1.5	+ 612	+ 1.1
1979 Jan. 17	+ 154	- 102	+ 161	+ 213	+ 0.8	+ 869	- 86	+ 996	+ 2.0	+ 833	+ 1.5
Feb. 21	+ 198	- 55	+ 52	+ 195	+ 0.8	+ 47	+ 265	+ 507	+ 1.0	+ 677	+ 1.2
Mar. 21	+ 38	+ 222	- 225	+ 35	+ 0.1	- 213	- 265	- 443	- 0.9	- 222	- 1.3
Apr. 18	+ 14	+ 467	+ 304	+ 785	+ 3.0	- 171	+ 107	+ 721	+ 1.4	+ 696	+ 1.3
May 16	+ 74	- 100	+ 65	+ 39	+ 0.1	+ 836	- 146	+ 729	+ 1.4	+ 1,016	+ 1.8
June 20	- 79	+ 5	- 139	- 213	- 0.8	+ 780	+ 34	+ 601	+ 1.2	+ 844	+ 1.5
July 18	+ 194	+ 411	+ 37	+ 642	+ 2.4	- 68	- 146	+ 428	+ 0.8	+ 17	-
Aug. 15	+ 41	+ 77	- 124	- 6	-	+ 491	+ 63	+ 548	+ 1.0	+ 479	+ 0.8
Sept. 19	+ 125	+ 155	- 161	+ 119	+ 0.4	+ 274	- 59	+ 334	+ 0.6	+ 388	+ 0.7

- (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) M₁ equals columns 1 + 2 + 3. Sterling M₃ equals M₁ + columns 5 + 6. M₃ equals sterling M₃ + columns 8 + 9.
 (d) Including certificates of deposit.
 (e) See additional notes to Tables 6 and 11 of 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 -) (e)	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
Month ended (unadjusted)													
1978 Sept. 20	+ 1,247	+ 47	- 746	+ 11	- 10	+ 549	+ 138	- 121	+ 118	- 206	+ 478		
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	- 34	- 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	- 73	+ 778		
Aug. 15	+ 571	+ 214	- 224	+ 144	+ 109	+ 814	- 93	- 275	- 154	- 11	+ 281		
Sept. 19	+ 1,456	+ 185	- 994	+ 108	- 20	+ 735	- 475	- 70	+ 90	+ 37	+ 317		
Month ended (seasonally adjusted)													
1978 Sept. 20	+ 1,403	- 24	- 734	+ 16	- 10	+ 651	+ 103	- 294	+ 460				
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	+ 2	+ 428				
Aug. 15	+ 281	+ 200	- 238	+ 699	+ 109	+ 1,051	- 370	- 133	+ 548				
Sept. 19	+ 1,647	+ 119	- 983	+ 160	- 20	+ 923	- 499	- 90	+ 334				

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

Month ended	Marketable debt		National savings		Tax instruments	Other	Total (column 4 above)	
	Stocks	Treasury bills	Unadjusted	Seasonally adjusted			Unadjusted	Seasonally adjusted
1978 Sept. 20	- 335	+ 40	- 140	- 128	- 301	- 10	- 746	- 734
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	- 952	- 10	- 38	- 27	- 10	+ 16	- 994	- 983

[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 M₃ 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.

W. Greenwell & Co.

Bow Bells House,
Bread Street, London EC4M 9EL

Telephone: 01-236 2040 Telex: 883006

W. Greenwell Associates (Investment Adviser) 450 Park Avenue, New York, N.Y. 10022
Telephone: 212 832 7428 Telex: 710 5815122

W. Greenwell & Co.


INTEREST RATES AND THE GILT-EDGED MARKET

The outlook in the changing economic scene

The transcript of a talk by Gordon Pepper at a Building Society Seminar on Investment and Liquidity Management organised by Fulton Packshaw Limited on 4th October, 1979.

I will start with an outline of the structure of my talk. I will begin by discussing the economic outlook in 1980 and I will forecast that interest rates will then be falling rapidly. The question that everyone will ask is when will this fall start? I will explain that our knowledge of monetary economics is inadequate to be precise about the timing but, having started with the medium term outlook, I will discuss shorter and shorter term factors.

It seems clear that the U.K. is heading for a recession in 1980. It does not matter what method of economic forecasting is used, whether it is Keynesian, flow of funds or monetarist, the answer is the same. Consumer spending is expected to be the most buoyant component of demand. The most contractionary factor is predictions of a very large financial deficit for the corporate sector. Businesses will probably react more quickly to this than they did in 1974. Lines of production which are unprofitable will be closed down and redundancies will be declared. A critical question is how the consumer will react when this happens. In 1974/75 a combination of rising unemployment and rising inflation made the consumer scared. Fear is an extremely powerful motive for saving. If in 1980 the savings function rises as it did in 1974/75, the recession will start feeding on itself.

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

The economy is a dynamic system in the genuine mathematical sense of the word. One person's expenditure is on goods produced by someone else, from which income is earned, which is subsequently spent. Expenditure, production and incomes chase each other round in a circle. The system can either accelerate or decelerate. Keynesians refer to multipliers and accelerators. Suppose that the Government injects £100m. into the economy and the savings function is 20%. The first time this money goes round the circle of expenditure, production and incomes, £80m. will be spent. The second time it goes round, 80% of £80m. will be spent, i.e. £64m. Each time it goes round the effect is less, the total effect being greater than the original £100m. - hence the term multiplier. Further, as the economy picks up, industry will start to invest. Producers of capital goods will start earning additional income which they in turn will spend. This is the accelerator. Summarising, if an economy is left to its own devices it may accelerate into a boom or, conversely, a recession may start feeding on itself.

An economy needs stabilisers to stop a recession feeding on itself. One such stabiliser is the external one, i.e. exports can increase. It is unlikely, however, that this stabiliser will be working in 1980, for two reasons. Firstly, the world is faced with a recession and so world trade is likely to be sluggish. Secondly, in spite of its recent fall, sterling is still high and, therefore, our exports may not be competitively priced.

Another important stabiliser is the use of discretionary fiscal policy, i.e. boosts to public expenditure and cuts in taxation. Such measures, however, are against the Conservative Government's declared policy.

There is also an automatic fiscal stabiliser. In a recession, the public sector loses revenue because taxes on both incomes and expenditure bring in a smaller amount. Further, there is the additional cost to the Exchequer of higher unemployment benefits etc. As a result, the budget deficit tends to rise in a recession and fall in a boom. This is known as the automatic fiscal stabiliser. There are doubts, however, about whether the Government will allow even this to work.

What then will stabilise the economy and stop the coming recession feeding on itself? The answer is action to stop the money supply from undershooting its target range. The money supply is like a pressure gauge. The rate of growth of the money stock tells us the pressure within the economy. That pressure is a mix, partially of external influences

from government policy or from abroad, and partially of internal pressures. When a recession starts feeding on itself, internal pressure is inadequate. Monetary growth always falls, reflecting the inadequate pressure.

Summarising, if the private sector savings function jumps upwards in 1980, as it did in 1974/75, the coming recession will start feeding on itself. Monetary growth will then undershoot its target range. The Bank of England will then act to stop the money supply from undershooting its target range. It will do so by rationing its sales of gilt-edged stock.

There have been two minor examples of the Bank of England rationing sales of gilt-edged stock. The first was in September 1977, which was the famous North Sea oil bull market, but the question you have to ask yourselves is why the City had not thought of North Sea oil in July and August 1977 when markets were falling. The second example was in late February and March 1979, the Margaret Thatcher bull market, but again the question you have to ask yourself is why the City had not thought of Margaret Thatcher in January and early February when markets were falling. Those two are comparatively minor examples of the money supply tending to undershoot. (In fact in the last one the authorities made a mistake, the money supply was not undershooting.) If in 1980 the money supply tends to undershoot by the amount that it did in 1974/75 or 1969/70, both recessionary years, the effect of the Bank of England rationing its sales of gilts will be much more dramatic than it was in September 1977 or March 1979. In short, if the personal sector savings function jumps up as it did in 1974/75 we could be in for a bull market in gilts (and also in equities), the power of which people cannot at the moment envisage.

What about the timing? When will the fall in interest rates start? First, I must stress that our knowledge of monetary economics is inadequate. It is impossible to be precise about the timing. Although I find it difficult to be constructive, I do know what arguments in vogue at the moment are wrong.

Bankers' instincts at the moment give a wrong answer; they always do at this stage of the business cycle. A clear illustration is what happened at the opposite phase of the business cycle in the autumn of 1977.

In October 1977, in one of our Bulletins, we became alarmed about the amount of excessive monetary growth and stated that the Bank rate should be increased. It was, from 5 to 7%. Some bankers and members of the discount market were extremely cross. They saw no reason whatsoever for an increase in interest rates. Some of them were on the loan side of their business. Loan demand was still extremely sluggish and they saw no reason for any rise in interest rates as long as loan demand was not recovering. Others in the banking sector had a viewpoint of both their assets and their liabilities. These people saw no reason for a rise in interest rates as long as money was coming in faster than it was going out. Monetarists, however, pay attention only to the speed with which money is coming in.

If money is coming in at an excessive rate, interest rates should be increased. This is the opposite of market forces. Raising interest rates when there is an excessive supply of money is like raising the price of a commodity when that commodity is in surplus supply. I repeat, it is the exact opposite of market forces. In retrospect, there is no question whatsoever that the Bank was right to raise MLR in October 1977. Side tracking for a moment, the period of excessive monetary growth, when the money supply overshot its target range, was August 1977 to, hopefully, June 1979. The first mistake the authorities made was to intervene in the foreign exchange markets, the result of which was a £5bn. increase in the money supply. The second mistake was leaving interest rates too low after sterling had started to float. MLR had been reduced from 15% to 5% in a vain attempt to stop money flowing in from abroad. After sterling floated, MLR was increased from 5% to 7%. In retrospect, it should have been increased further, to about 10%, which would not have been high in real terms with inflation running at about 9%. The reason why excessive monetary growth became a continuing problem was domestic interest rates remaining too low. So much for my diversion.

The point I want to make is that control of the money supply in the autumn of 1977 advanced the natural turning point of interest rates by about six months. As far as the present phase of the business cycle is concerned, I referred earlier to the huge financial deficit facing the corporate sector. As a result, the amount of money that businessmen will need in the coming months from their bankers will be very large. Further, as the economy enters a recession, monetary growth will slow down, as it always does. The situation facing bankers at the moment is strong loan demand and the rate of inflow of

money starting to taper off. We are at the phase of the business cycle when banks have a shortfall in their cash flow. I have no doubt that you in the building society movement will recognise the swings and the roundabouts of the flow of funds which I have been describing, because, in many ways, your flow of funds is similar to those of the banking sector. Summarising, market forces are still tending to increase interest rates. If market forces were the sole factor, I would forecast that the peak of interest rates would be about next March. However, in the same way as control of the money supply advanced the turning point of interest rates by some six months in the autumn of 1977, it should advance the current turning point - by roughly the same amount.

Rates of change of the money supply leading rates of change of national income is the best known monetarist relationship, but the lead time is unfortunately long and variable. It averages about nine months. For reasons which I will not go into at the moment, I expect the lead time this cycle to be about six months. Therefore, if the recession starts in the first quarter of 1980, the money supply should now be starting to decelerate.

An early indicator is the behaviour of the narrow monetary aggregates, i.e. notes & coins and M1. At the turning points of the business cycle, there is some evidence that the narrower aggregates tend to turn before the broader aggregates, i.e. the M3's, 4's and 5's etc. An examination of the current behaviour of the narrower aggregates suggests that they have already turned downwards. I do not want to over emphasise this point. It is dangerous to base a forecast on just the behaviour of the narrow aggregates. A wiser approach is to monitor the broader aggregates and, if they have a downturn, the behaviour of the narrower aggregates is some guide as to whether the downturn in the broader ones is just a fluctuation or a turning point. But as I said, the narrower ones appear to have turned already.

Summarising, what I think has been happening is this: between August 1977 and June 1979 the money supply overshot its target range. Between June 1979 and December 1979 my guess is that the money supply has fallen back within its target range. I must stress that there is not much hard evidence as yet for this assertion. In our last Bulletin I described the evidence as fragile. If the anecdotal evidence about the monetary growth during these last few weeks is correct, I am expecting to report in our next Bulletin that

the evidence is becoming substantial, but the case will not be proven. Only as we enter 1980 am I expecting a tendency for the money supply to drop below the lower limit of its target range.

The most critical factor determining short term timing will be the behaviour of the savings function which I mentioned earlier. Being more specific, the way the consumer reacts when the coming tax rebates are paid will be very important. People's first instinct when inflation rises is to think what goods they want to buy in the next few months - whether they want a washing machine or something. They buy it straight away to avoid a price increase. In other words, they bring forward their expenditure, which reduces their savings function. A little later, rising inflation and rising unemployment make people scared, as I also described earlier. The savings function then jumps upwards. In which of the two ways will the consumer react in the next month or so?

Supposing someone gets £100 tax rebate, will he decide to buy a new colour television for £300 and borrow the remaining £200 on hire purchase, from Barclaycard or from Access; or will he decide that he overspent in the pre-VAT spending spree and use the £100 to repay debt? The position is also complicated by the delay in the Post Office sending out telephone bills. If the consumer decides to go on a last spending spree, the recession will be delayed a month or so, personal loan demand will remain high and the downturn in the money supply will also be delayed a month or so. To avoid confusion, let me stress that business loan demand lags the business cycle but personal loan demand is a coincidental indicator. Although I am not very interested in the behaviour of business loan demand, because it is a lagging indicator, I am very interested in what is happening to personal loan demand. As far as the timing of the turning point of interest rates is concerned, each of you can make up his own mind about the way in which you think the consumer will react. Building societies may be well placed to decide because what is happening to your deposits may indicate whether people are spending or saving. You have an important clue from your own business.

Let me now turn to the components of $M3$, i.e. the public sector borrowing requirement (PSBR), sales of public sector debt (mainly gilts) to the non-bank private sector, bank lending to the private sector and the external component. You will notice

that I have not so far mentioned these. Quite a lot of people try to predict the money supply by forecasting the behaviour of these components. But this method of forecasting has no record of reliable results. I think we have tried as hard as anyone to make the method work - we did so internally without publishing the results - but it appears to be unreliable. All I will say about the components is that it is important not to consider one in isolation. The other day a banker talking to me became very gloomy because businesses were borrowing a lot to pay VAT. But that same VAT payment reduces the PSBR; the net impact of the payment of VAT on the money supply is downward and not upward. Another example is that recently some investment trusts have been repaying back-to-back foreign currency loans and borrowing in sterling instead. This again makes some bankers gloomy, because loan demand is rising but, as the Bank of England intervenes in the foreign exchange market, the external component of the money supply turns negative and there is no net effect on sterling M3. Another example occurred a few days ago when there was a rumour that a merchant bank had put all its pension fund liquidity into Deutsche mark bonds. If this was correct, sales of gilt-edged stock will be reduced but, as the Bank of England intervenes in the foreign exchange market, the external component of the money supply will be negative again and there will be no net effect on M3. So I repeat, it is important not to look at one component in isolation.

Finally, I come to technical factors. First the long market. The situation last August was the existence of extremely large calls on new issues which the authorities had already sold. It was clear at the time that, unless foreign buying continued, there would be severe technical indigestion. We now know that the foreign buying did not continue. It is not surprising, therefore, that the gilt-edged market went soggy for four to five weeks.

Let me side track again, but this time about foreign buying. The first point to make is that whenever there is unexplained buying or selling in the gilt-edged market, it is nearly always blamed on the foreigner and nine times out of ten the reports are wrong. It is rare for foreign interest to be of really major importance. For major buying to occur there have to be three factors. Firstly, foreigners must be satisfied that interest rates are likely to fall in the U.K. Secondly, they must consider that there is a reasonable chance of a foreign exchange profit. Thirdly, their own domestic bond market must not be

rising because, if it is, most of their attention will be focussed at home and they will not have time to look at foreign markets. In September and October 1977, all three conditions were present for the U.S. and we saw substantial U.S. buying of gilts. In February and March this year the conditions were not right in the U.S. but they were on the Continent and we saw a lot of continental buying of gilts. Summarising, when you hear reports of foreign buying, or forecasts of foreign buying, it is worthwhile asking yourselves whether my three conditions are present.

Returning to the gilt-edged market in early August and September, as I explained it was soggy for technical reasons and, as a result, all the gloomy arguments started receiving publicity. But the technical situation has now altered. During the last few weeks new money has accrued to life offices and pension funds so that their liquidity is now back to normal. As far as the short dated market is concerned, there is no doubt that the flows of funds of banks and near-banks, including building societies, are adverse at present, as I described earlier. So in this sense, the technical situation for shorts is weak. However, at the moment there are some large redemptions. Money is being rolled over and this gives a market technical strength. So I would suggest that the technical situation in both longs and shorts is now very different from what it was at the start of August.

My final point of detail concerns the way the authorities operate the official "tap" stocks. I don't want to say much about this but there have been some representations to the authorities that the way they operate "tap" stocks can encourage a buyers' strike. A good example occurred on Friday, ten days ago. The Government Broker was bid for a large amount of the short dated "tap" and dropped his "tap" price. He also led the jobbers to believe that he was prepared to sell more stock at the same price. Various institutional investors, who had started to bargain hunt in the long market because their liquidity was accumulating, as I described earlier, immediately stopped doing so. What was the incentive to bargain hunt, taking the risks which that involved, if the Government Broker was going to supply subsequent investors with stock at exactly the same price?

The situation in December 1978 was a good example of what can happen. Financial institutions were accumulating a considerable amount of liquidity which was awaiting investment. The main threat overhanging the market was high wage settlements about which there was considerable doubt. Some institutions were optimistic but others were

pessimistic. It might be thought that the optimists would invest their liquidity but that the pessimists would not. In fact many of the optimists also delayed investment. The reason was the existence of a "tap" only a little above the current level of the market and expectations that it would not be raised rapidly. If the optimists had invested their liquidity as it accrued, they would have gained little relative to the pessimists if the wages' outturn had been good and would have lost considerably if the wages' outturn had been bad. It was assumed that if wage settlements had turned out low investors would be able to buy at, or close to, the current "tap" price. If wage settlements had turned out high, it was assumed that the gilt-edged market would fall. Allowing for uncertainty, the best strategy for the optimists as well as the pessimists was to refrain from investment until the wages' outlook was clearer.

In our opinion when there is good news the authorities should raise a "tap" price by an amount sufficient to provide a reasonable reward for any investor who has correctly anticipated the news. The aim should be to encourage investors to anticipate good news instead of waiting for the outlook to become clearer.

Returning to the events that occurred on Friday a week ago, they appeared to be a good illustration of the way in which the authorities can encourage a buyers' strike; some representations to the authorities were made. A sequel occurred on the following Tuesday. The Government Broker appeared to undo some of the damage done on the previous Friday. We are not quite sure what happened but the Government Broker appears to have surprised at least one jobber by raising his "tap" price without allowing the jobber to buy as much stock as that jobber wanted at the old price. As I said, confusion still surrounds the incident but there is talk of the Government Broker's action being unprecedented. I have mentioned the incident because there is a chance that at some time in the future the authorities may be prepared to raise their "tap" prices much faster than they have done in the past. In the past they have never raised a tap price rapidly. The big upward movements in the gilt-edged market have always occurred in between "tap" stocks. I am suggesting that it is no longer safe to rely on the market not rising quickly whilst a "tap" stock is still in existence.

Let me be quite specific about the gilt-edged strategy that I recommend at the moment. We are approaching a major turning point. I do not know of any analytical way of ringing the bell at the turning point. The "market nose" may ring the bell at the right time but the probability of buying at exactly the bottom of the market is not high.

I think that more money will be lost buying after the turning point than before the turning point. Therefore, I recommend a strategy of bargain hunting on a falling market. Do not buy on the days when the news is good and the market is rising. Wait for the days when the market is falling and all the gloom, despair and despondency is trotted out. There was a classic bargain hunting opportunity on the day after the budget. There was another one about a week ago. I think that there will be another before the market finally turns upward but my guess is that prices will be higher than a week ago. I would add that the day before the market turns I am almost bound to be forecasting that there will be yet another bargain hunting opportunity!

In conclusion, I started with the medium term, with the economic forecast in 1980 and worked backwards to the short term. I leave you with a final longer term thought. I described how in 1980 we could have a business cycle bull market. It could be more than this. If Margaret Thatcher succeeds in her declared policies, as I personally believe she will, the secular rise in interest rates since the war will definitely have reversed.

W. Greenwell & Co.

Bow Bells House,
Bread Street, London EC4M 9EL

Telephone: 01-236 2040 Telex: 883006

W. Greenwell Associates (Investment Adviser) 450 Park Avenue, New York, N.Y. 10022
Telephone: 212 832 7428 Telex: 710 5815122

Econ P07,


MONETARY BULLETIN

No. 96, September, 1979

Current monetary growth

In the month to 15th August, 1979, the seasonally adjusted behaviour of the monetary aggregates was as follows:

Notes & coin	£ 41m.	(6% p.a.)
Retail M1	£ 117m.	(6% p.a.)
Sterling M3	£ 497m.	(12% p.a.)
M4	£ 576m.	(13% p.a.)
M5	£1,076m.	(14% p.a.)
DCE	£1,065m.	
Bank lending in sterling to private sector	£ 677m.	(21% p.a.)

The main feature was the buoyancy of bank lending after the previous month's lull; the private sector not only obtained £677m. from the banking sector but also raised over £300m. through bank acceptances held outside the banking system and the Issue Department of the Bank of England. The total of almost £1bn. is considerably higher than might be expected from the corporate sector's growing financial deficit. Part of the excess is due to precautionary transactions, i.e. loans being taken now because of fears that they may not be available in the future. Further some of the buoyancy is due to the relaxation of Exchange Controls.

There are reports of U.K. companies and financial institutions replacing some of their borrowing in foreign currency with sterling loans. A company may, for example, obtain sterling by borrowing from its bank, switch the sterling into dollars, and repay a dollar loan. If the Bank of England intervenes in the foreign exchange market, buying the sterling and selling the dollars, the money supply will not on balance be affected (a positive item in Column 5 of Table 11.3 on the last page of the Bulletin will be offset by a negative item in Column 8 of the Table). During the month to mid-August external and foreign currency finance accruing to the public and banking sectors reduced sterling M3 by no less than £446m., seasonally adjusted. Some of this and the buoyancy of bank lending are offsetting items. Further, the transactions taking advantage of the relaxation of Exchange Controls help to explain why DCE was so large at £1,065m.

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

The £300m. increase in bank acceptances held outside the banking system is included in our series for M4, which also includes the non-bank private sector's holdings of Treasury bills and tax instruments which fell by almost £250m. This is why M4 grew only a little faster than sterling M3.

The behaviour of the monetary aggregates in recent months is shown in the following table:

	<u>3 months</u>	<u>6 months</u>	<u>12 months</u>
Notes & coin	7% p.a.	7% p.a.	13%
Retail M1	12% p.a.	13% p.a.	11%
Sterling M3	12% p.a.	10% p.a.	12%
M4	17% p.a.	16% p.a.	16%
M5	15% p.a.	15% p.a.	15%

From this table there is no evidence that monetary growth has decelerated. But for the period following the rise in MLR to 14%, i.e. since mid-June, the picture is somewhat different:

	<u>2 months</u>
Notes & coin	17% p.a.
Retail M1	20% p.a.
Sterling M3	11% p.a.
M4	11% p.a.
M5	13% p.a.

The 17% p.a. and 20% p.a. growth of the two narrow aggregates suggest that the trend has not changed downwards, but these high rates were caused by the spending spree prior to the increase in VAT, a purely temporary factor. The behaviour of the broader aggregates is reasonably encouraging, bearing in mind that there is a lag before a rise in interest rates has its full effect on them. But the evidence that monetary growth is becoming satisfactory is very fragile; it is certainly insufficient for the authorities to reduce MLR.

It is worth repeating a paragraph from a column by Gordon Pepper in The Observer of 12th August:

"I should stress that inadequate monetary growth is not our problem at the moment. On the contrary, monetary growth in the recent past has been excessive and appears only now to be coming back under control, but inadequate growth will be a danger by next year".

We elaborated slightly on this in our last Bulletin when we commented that monetary growth would become inadequate when the coming recession starts feeding on itself. Given the accuracy of existing techniques, whether monetary or Keynesian, it is unfortunately not possible at present to be precise about timing, For example, exactly when the recession starts will depend on consumer psychology, which will have an important influence on the level of savings. Forecast of savings are notoriously unreliable; the sophisticated theories explaining the exact patterns of the past were

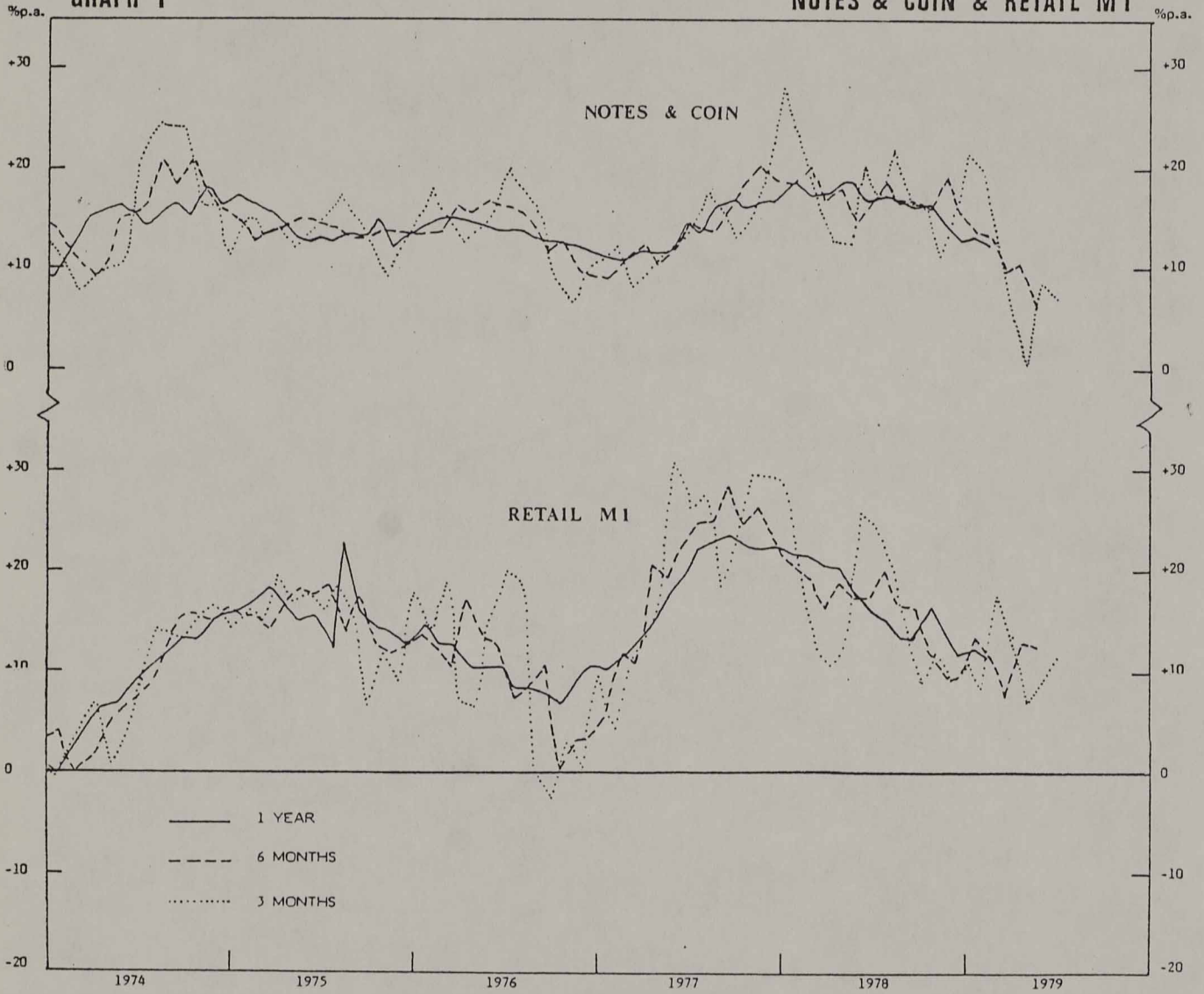
developed after the event. We have little doubt, however, that before long the rise in inflation and the coming rise in unemployment will make people cautious, and that savings will then rise; but the consumer could in the meantime bring expenditure forward to beat future price increases. If this happens, savings will temporarily fall, personal loan demand will remain buoyant and the downturn in the money supply, and the recession, will be delayed slightly.

Finally, and in contrast to some misleading press comments on our position, we stress that we are not suggesting that the Government should relax its declared policy of gradually reducing the growth of the money supply. Previous Bulletins have explained that the money supply tends to depart from the gradualist path because of pressures generated internally within the private sector of the economy, and that these departures vary according to the phase of the business cycle and inflation. In the twenty two months between August 1977 and June 1979, these internal pressures caused the monetary aggregates to overshoot the gradualist path (notes & coin rose by 15% p.a., retail M1 by 16% p.a., sterling M3 by a distorted 14% p.a., M4 15% p.a. and M5 by 16% p.a.) We are now pointing out that in 1980 the internally generated pressures will be in the opposite direction, and that the money supply will tend to undershoot the gradualist path. We have argued that the authorities should then act to stop the money supply from falling below the gradualist path (for example, by rationing sales of gilt-edged stock). We have not argued that the target range for the money supply should be raised. Further, in no way does the coming recession reduce the need for cuts in public expenditure. Indeed, such cuts are the key to a sustainable and early recovery in business activity.

G.T.P.
R.R.

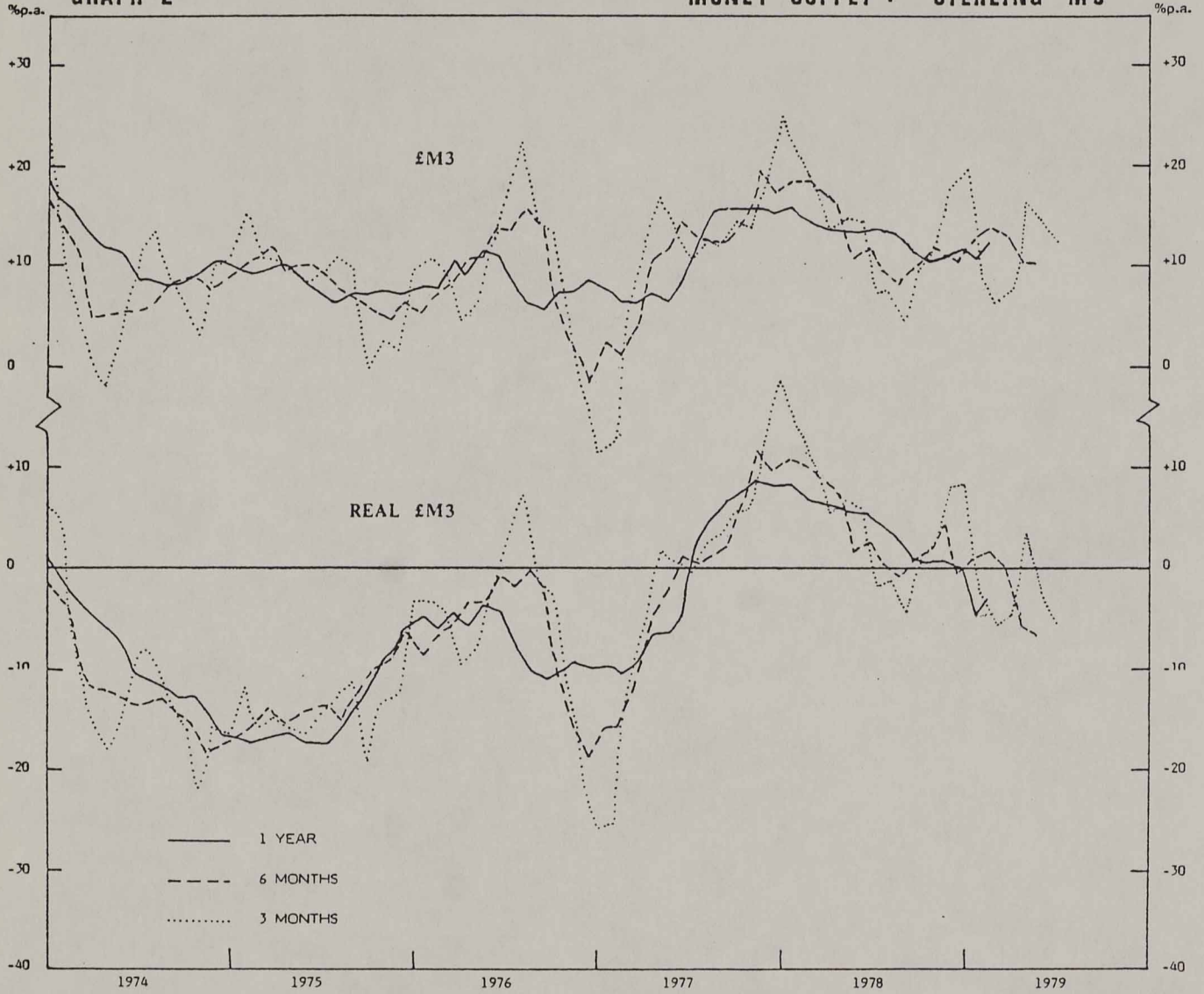
GRAPH 1

NOTES & COIN & RETAIL M1



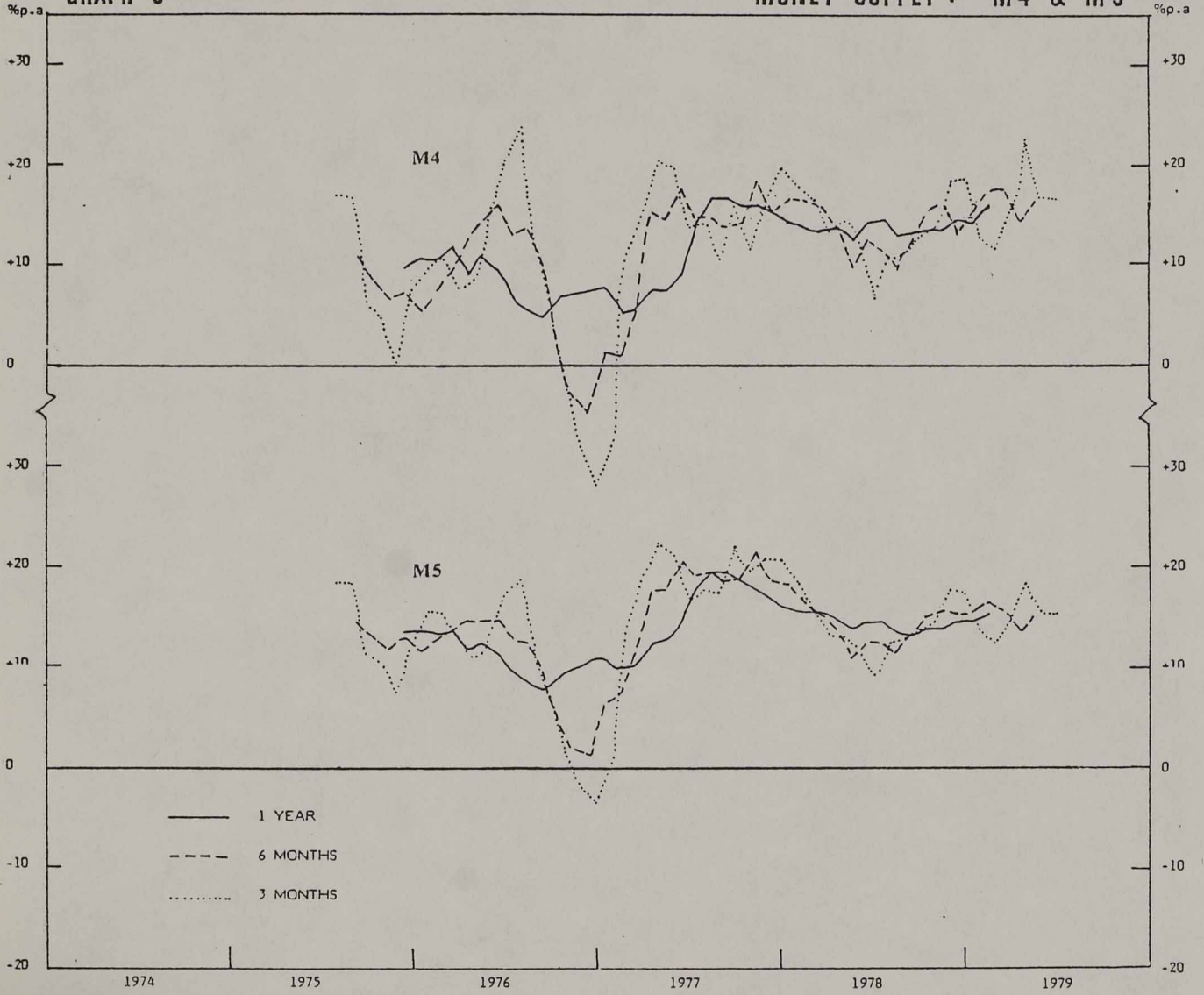
GRAPH 2

MONEY SUPPLY : STERLING M3



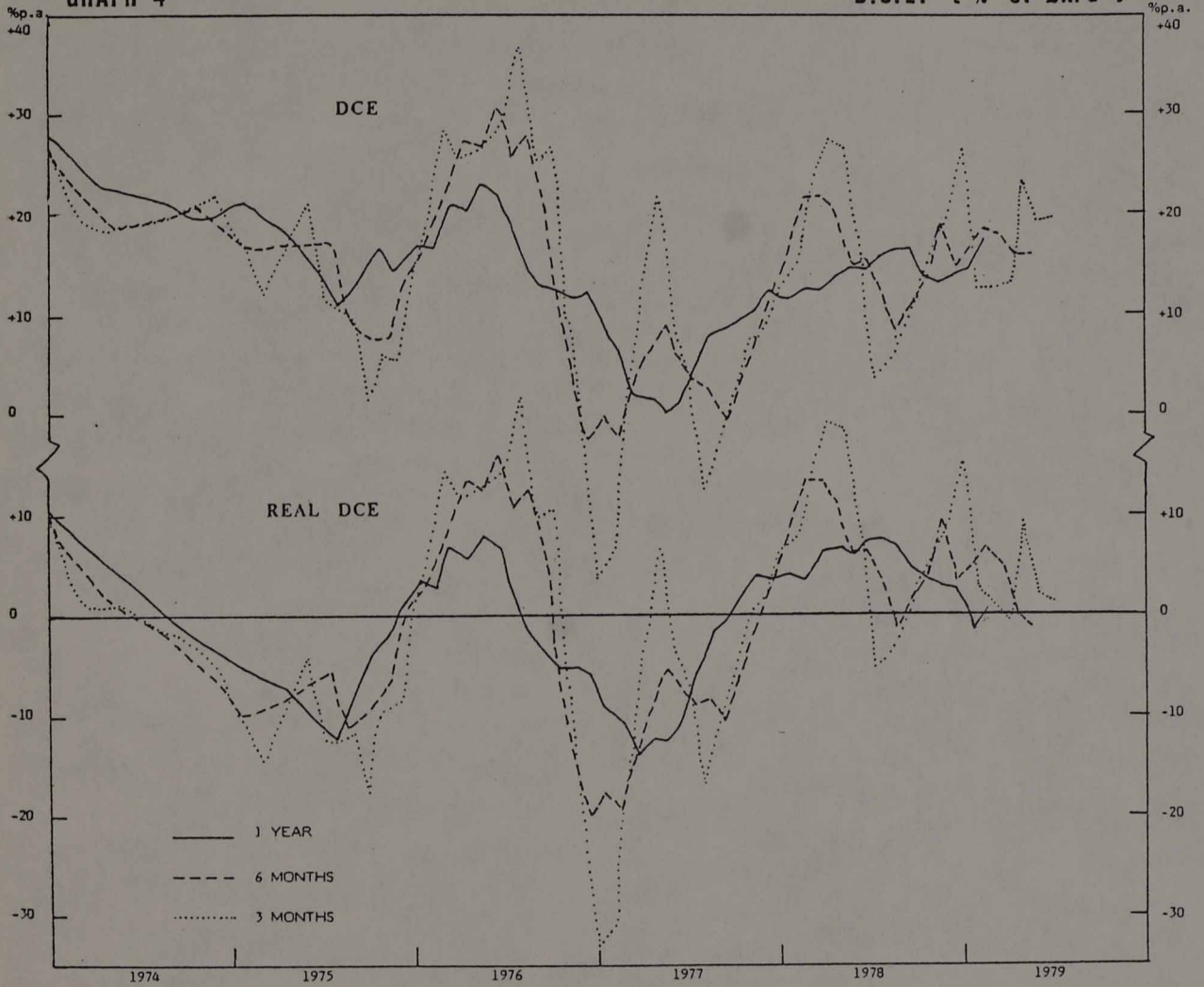
GRAPH 3

MONEY SUPPLY : M4 & M5



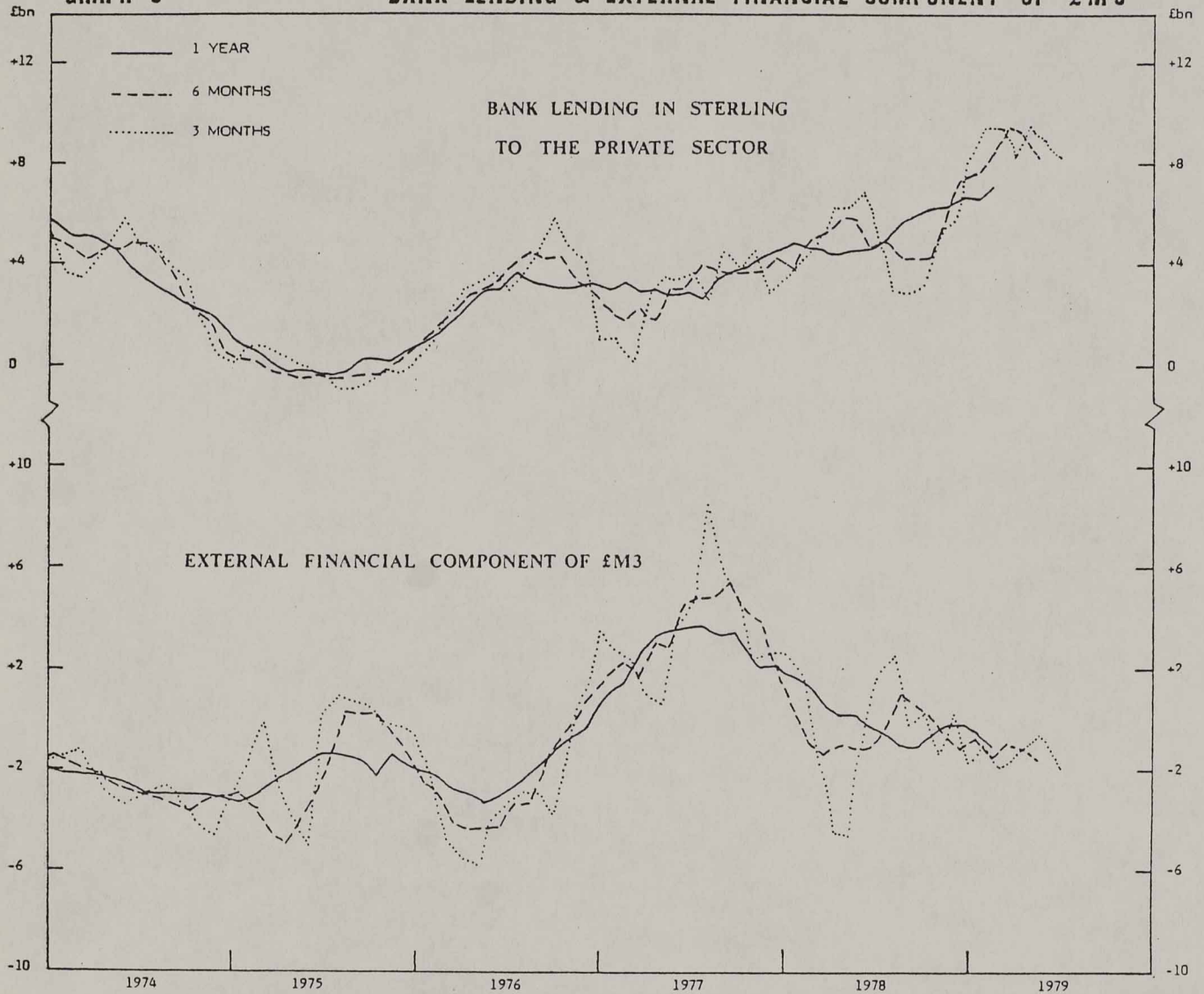
GRAPH 4

D.C.E. (% of $\pounds M3$)



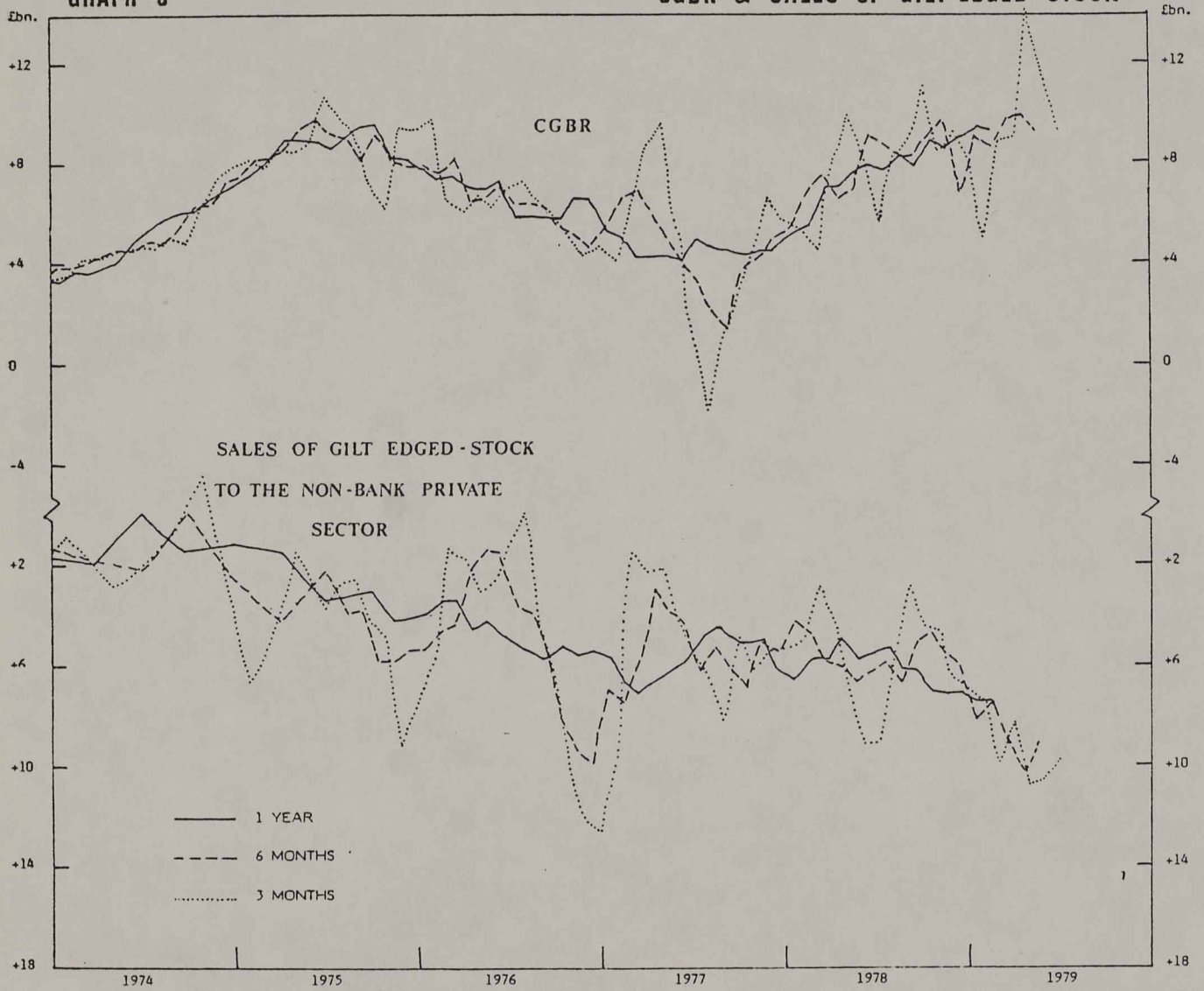
GRAPH 5

BANK LENDING & EXTERNAL FINANCIAL COMPONENT OF £M3



GRAPH 6

CGBR & SALES OF GILT EDGED-STOCK



STATISTICS

reprinted from Bank of England, *Banking Statistics*.

[Table 6 in the *Quarterly Bulletin*]

UK banking sector: transactions in liabilities and assets (a)

£ millions

Month ended	Total	Liabilities										Non-deposit liabilities (net)		
		Domestic deposits												
		Total		Public sector				Private sector					Overseas deposits	
		Un-adjusted	Seasonally adjusted	Sterling		Other currencies	Sterling		Other currencies	Sterling	Other currencies			
1978 Aug. 16	+ 2,337	- 665	- 535	- 434	- 257	+ 10	+ 4	- 43	- 245	- 24	+ 3,024	+ 2		
Sept. 20	+ 2,458	+ 480	+ 334	+ 182	+ 119	- 26	+ 266	+ 183	+ 58	+ 121	+ 1,651	+ 206		
Oct. 18	+ 3,306	+ 642	+ 391	- 116	- 53	+ 12	+ 628	+ 314	+ 118	+ 9	+ 2,721	- 66		
Nov. 15	+ 4,402	+ 434	+ 484	+ 32	+ 49	- 8	+ 147	+ 180	+ 263	+ 10	+ 3,892	+ 66		
Dec. 13	+ 2,783	+ 546	+ 553	- 38	+ 8	- 4	+ 564	+ 630	+ 24	+ 84	+ 2,182	- 29		
1979 Jan. 17	+ 2,009	+ 440	+ 755	+ 85	- 86	+ 27	+ 547	+ 928	- 219	+ 187	+ 1,171	+ 211		
Feb. 21	+ 645	- 70	+ 484	+ 353	+ 265	- 4	- 598	+ 44	+ 179	- 11	+ 675	+ 51		
Mar. 21	+ 118	- 662	- 704	- 324	- 265	+ 38	- 117	+ 218	+ 259	+ 337	+ 464	- 21		
Apr. 18	+ 4,126	+ 1,515	+ 787	+ 42	+ 107	- 34	+ 1,395	+ 602	+ 112	+ 355	+ 2,146	+ 110		
May 16	+ 3,211	+ 710	+ 916	- 151	- 146	+ 12	+ 600	+ 801	+ 249	+ 115	+ 2,392	- 6		
June 20	+ 4,705	+ 1,040	+ 1,082	+ 187	+ 34	- 11	+ 451	+ 646	+ 413	+ 151	+ 2,948	+ 566		
July 18	+ 4,774	+ 257	+ 139	- 209	- 146	+ 18	+ 561	+ 380	- 113	+ 207	+ 4,234	+ 76		
Aug. 15	+ 1,046	+ 131	+ 270	- 103	+ 63	- 12	+ 420	+ 393	- 174	+ 328	+ 587	-		

Month ended	Total	Assets											
		Lending to public sector					Lending to private sector					Lending to overseas sector	
		Total		Sterling		Other currencies	Sterling		Other currencies	Sterling		Other currencies	
		Un-adjusted	Seasonally adjusted	Central government	Other		Un-adjusted	Seasonally adjusted		Sterling	Other currencies		
1978 Aug. 16	+ 2,337	- 462	- 875	- 291	- 171	- 81	- 99	+ 375	+ 149	+ 20	+ 2,810		
Sept. 20	+ 2,458	+ 518	+ 481	+ 509	+ 9	- 9	+ 149	+ 154	- 28	- 10	+ 1,338		
Oct. 18	+ 3,306	+ 223	+ 63	+ 29	+ 194	+ 20	+ 413	+ 395	- 12	- 14	+ 2,676		
Nov. 15	+ 4,402	+ 65	- 17	+ 267	- 202	+ 121	+ 253	+ 427	+ 145	- 117	+ 3,935		
Dec. 13	+ 2,783	+ 432	+ 127	+ 370	+ 62	- 12	+ 37	+ 506	+ 159	+ 138	+ 2,029		
1979 Jan. 17	+ 2,009	- 238	+ 525	- 475	+ 237	- 53	+ 1,218	+ 485	- 45	+ 61	+ 1,066		
Feb. 21	+ 645	- 742	- 67	- 768	+ 26	- 7	+ 825	+ 829	+ 19	- 146	+ 696		
Mar. 21	+ 118	- 517	- 702	- 890	+ 373	- 72	+ 635	+ 938	+ 113	+ 5	- 46		
Apr. 18	+ 4,126	+ 1,381	+ 636	+ 1,097	+ 284	- 99	+ 638	+ 630	- 4	+ 31	+ 2,179		
May 16	+ 3,211	+ 187	+ 367	+ 551	- 364	- 18	+ 176	+ 377	+ 394	+ 61	+ 2,411		
June 20	+ 4,705	+ 115	- 25	+ 69	+ 46	+ 8	+ 1,383	+ 1,313	- 66	- 72	+ 3,337		
July 18	+ 4,774	- 286	+ 138	- 480	+ 194	- 153	+ 1,094	+ 347	+ 191	- 3	+ 3,931		
Aug. 15	+ 1,046	+ 363	- 89	+ 281	+ 82	- 42	+ 318	+ 873	- 47	+ 123	+ 331		

(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*).

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)	
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
Month ended																
1978 July 19	8,186	12,752	3,370	24,308	24,210	22,491	1,442	48,241	47,880	4,911	53,152	52,790				
Aug. 16	8,130	13,112	3,202	24,444	24,370	22,303	1,008	47,755	47,670	4,496	52,251	52,170				
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	50,570	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	13,445	3,488	25,622	25,960	23,121	1,182	49,925	50,640	4,577	54,502	55,220				
Apr. 18	8,862	14,484	3,792	27,138	26,750	23,173	1,224	51,535	51,360	4,551	56,086	55,910				
May 16	8,833	14,262	3,857	26,952	26,790	23,930	1,073	51,955	52,090	4,838	56,793	56,300				
June 20	8,304	14,026	3,718	26,548	26,570	24,756	1,260	52,564	52,690	5,081	57,645	57,770				
July 18	9,230	14,335	3,755	27,320	27,210	24,971	1,051	53,342	53,110	4,670	58,012	57,780				
Aug. 15	9,143	14,531	3,620	27,294	27,180	25,330	948	53,572	53,590	4,576	58,148	58,160				

(a) After deducting 60% of transit items (see additional notes to Table 6 of the Quarterly Bulletin).

(b) M₁ equals columns 1 + 2 + 3. Sterling M₃ equals M₁ + columns 5 + 6. M₃ equals sterling M₃ + 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)	
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
Month ended (unadjusted)																
1978 Aug. 16	+ 56	+ 360	- 168	+ 136	- 188	- 434	- 486	- 235	- 180	- 901						
Sept. 20	+ 30	+ 72	+ 35	+ 137	+ 159	+ 182	+ 478	+ 32	- 6	+ 504						
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	+ 433	- 225	+ 303	- 325	- 324	- 346	- 221	- 57	- 624						
Apr. 18	+ 173	+ 1,039	+ 304	+ 1,516	+ 52	+ 42	+ 1,610	+ 78	- 104	+ 1,584						
May 16	- 29	- 222	+ 65	- 186	+ 757	- 151	+ 420	+ 261	+ 26	+ 707						
June 20	- 29	- 236	- 139	- 404	+ 826	+ 187	+ 609	+ 402	- 159	+ 852						
July 18	+ 426	+ 309	+ 37	+ 772	+ 215	- 209	+ 778	- 95	- 316	+ 367						
Aug. 15	- 87	+ 196	- 135	- 26	+ 359	- 103	+ 230	- 186	+ 92	+ 136						
Month ended (seasonally adjusted)																
1978 Aug. 16	+ 77	+ 242	- 168	+ 151	+ 0.6	- 117	- 257	- 223	- 180	- 638	- 1.2					
Sept. 20	+ 158	+ 56	+ 35	+ 249	+ 1.0	+ 92	+ 119	+ 460	+ 1.0	+ 486	+ 0.9					
Oct. 18	+ 73	+ 81	+ 82	+ 236	+ 1.0	+ 151	- 53	+ 334	+ 0.7	+ 449	+ 0.9					
Nov. 15	+ 77	+ 27	- 61	+ 43	+ 0.2	+ 214	+ 49	+ 306	+ 0.6	+ 615	+ 1.2					
Dec. 13	+ 72	+ 271	+ 242	+ 585	+ 2.3	+ 117	+ 8	+ 710	+ 1.5	+ 612	+ 1.1					
1979 Jan. 17	+ 154	- 102	+ 161	+ 213	+ 0.8	+ 869	- 86	+ 996	+ 2.0	+ 833	+ 1.5					
Feb. 21	+ 198	- 55	+ 52	+ 195	+ 0.8	+ 47	+ 265	+ 507	+ 1.0	+ 617	+ 1.2					
Mar. 21	+ 38	+ 221	- 225	+ 34	+ 0.1	- 214	- 265	- 445	- 0.9	- 723	- 1.3					
Apr. 18	+ 14	+ 468	+ 304	+ 786	+ 3.0	- 170	+ 107	+ 723	+ 1.4	+ 697	+ 1.3					
May 16	+ 74	- 100	+ 65	+ 39	+ 0.1	+ 836	- 146	+ 729	+ 1.4	+ 1,016	+ 1.8					
June 20	- 79	+ 5	- 139	- 213	- 0.8	+ 780	+ 34	+ 601	+ 1.2	+ 844	+ 1.5					
July 18	+ 194	+ 411	+ 37	+ 642	+ 2.4	- 68	- 146	+ 428	+ 0.8	+ 17	-					
Aug. 15	+ 41	+ 76	- 135	- 18	- 0.1	+ 452	+ 63	+ 497	+ 0.9	+ 403	+ 0.7					

(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) M₁ equals columns 1 + 2 + 3. Sterling M₃ equals M₁ + columns 5 + 6. M₃ equals sterling M₃ + columns 8 + 9.

(d) Including certificates of deposit.

(e) See additional notes to Tables 6 and 11 of 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 -) (e)	Money stock sterling M ₃ (f)							
	Central government borrowing requirement	Other public sector contribution	Other public sector debt	Central government debt				Public sector	Overseas sterling deposits (c)	Banks' foreign currency deposits (net) (e)									
													1	2	3	4	5	6	7
Month ended (unadjusted)																			
1978 Aug. 16	+ 636	-	452	-	437	-	163	+ 20	-	396	-	201	+ 24	+ 89	-	2	-	486	
Sept. 20	+ 1,247	+ 47	-	746	+ 11	-	10	-	10	+ 549	+ 138	-	121	+ 118	-	206	+ 478		
Oct. 18	+ 293	+ 107	-	215	+ 415	-	14	-	14	+ 586	+ 60	-	9	+ 167	+ 66	+ 536			
Nov. 15	+ 983	-	222	-	763	+ 268	-	117	-	149	+ 126	-	10	+ 54	-	66	+ 253		
Dec. 13	+ 1,424	+ 328	-	653	+ 6	-	138	-	138	+ 1,243	-	212	-	84	+ 26	+ 29	+ 950		
1979 Jan. 17	- 547	+ 125	-	511	+ 1,216	-	61	-	61	+ 344	+ 397	-	187	-	11	-	211	+ 332	
Feb. 21	- 31	+ 375	-	944	+ 1,124	-	146	-	146	+ 378	-	229	+ 11	-	142	-	51	-	33
Mar. 21	+ 272	+ 279	-	1,370	+ 426	-	5	-	5	+ 388	+ 606	-	337	-	248	-	21	-	346
Apr. 18	+ 2,335	+ 234	-	1,382	+ 544	-	31	-	31	+ 1,762	+ 461	-	355	-	148	-	110	+ 1,610	
May 16	+ 695	-	341	-	526	+ 617	-	61	-	506	-	111	-	115	+ 134	+ 6	+ 420		
June 20	+ 1,507	+ 35	-	1,426	+ 1,097	-	72	-	72	+ 1,141	+ 256	-	151	-	71	-	566	+ 609	
July 18	+ 601	+ 82	-	817	+ 1,128	-	3	-	3	+ 991	+ 240	-	207	-	170	-	76	+ 778	
Aug. 15	+ 571	+ 219	-	207	+ 122	-	123	-	123	+ 828	-	111	-	328	-	159	-	+ 230	
Month ended (seasonally adjusted)																			
1978 Aug. 16	+ 391	-	468	-	450	+ 311	-	20	-	196	-	54	-	-	81	-	223		
Sept. 20	+ 1,403	-	24	-	734	+ 16	-	10	-	651	+ 103	-	103	-	294	+ 460			
Oct. 18	+ 368	-	60	-	228	+ 397	-	14	-	463	-	179	-	50	+ 334				
Nov. 15	+ 890	-	186	-	779	+ 442	-	117	-	250	-	165	-	109	+ 306				
Dec. 13	+ 756	+ 401	-	709	+ 475	-	138	-	138	+ 1,061	-	289	-	62	+ 710				
1979 Jan. 17	+ 593	+ 151	-	494	+ 483	-	61	-	61	+ 794	-	186	-	16	+ 996				
Feb. 21	+ 648	+ 338	-	920	+ 1,128	-	146	-	146	+ 1,048	-	313	-	228	+ 507				
Mar. 21	- 30	+ 294	-	1,319	+ 729	-	5	-	5	+ 321	-	85	-	39	-	445			
Apr. 18	+ 1,464	+ 134	-	1,340	+ 536	-	31	-	31	+ 825	-	98	-	4	+ 723				
May 16	+ 853	-	215	-	521	+ 818	-	61	-	996	-	132	-	135	+ 729				
June 20	+ 1,250	+ 133	-	1,451	+ 1,027	-	72	-	72	+ 887	-	6	-	280	+ 601				
July 18	+ 786	+ 119	-	841	+ 381	-	3	-	3	+ 442	-	13	-	1	+ 428				
Aug. 15	+ 281	+ 205	-	221	+ 677	-	123	-	123	+ 1,065	-	446	-	122	+ 497				

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

Month ended	Marketable debt		National savings		Tax instruments	Other	Total (column 4 above)	
	Stocks	Treasury bills	Unadjusted	Seasonally adjusted			Unadjusted	Seasonally adjusted
1978 Aug. 16	- 417	+ 145	- 170	- 183	+ 5	-	- 437	- 450
Sept. 20	- 335	+ 40	- 140	- 128	- 301	- 10	- 746	- 734
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	- 510	- 80	- 131	- 80	- 653	+ 4	- 1,370	- 1,319
Apr. 18	- 991	- 113	- 145	- 103	- 124	- 9	- 1,382	- 1,340
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	- 417	+ 145	- 43	- 57	+ 101	+ 7	- 207	- 221

[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 M₃ 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.

W. Greenwell & Co.

Bow Bells House,
Bread Street, London EC4M 9EL

Telephone: 01-236 2040 Telex: 883006

W. Greenwell Associates (Investment Adviser) 450 Park Avenue, New York, N.Y. 10022
Telephone: 212 832 7428 Telex: 710 5815122

Gen Z PE
PRIME MINISTER

To see -
much food for thought MS

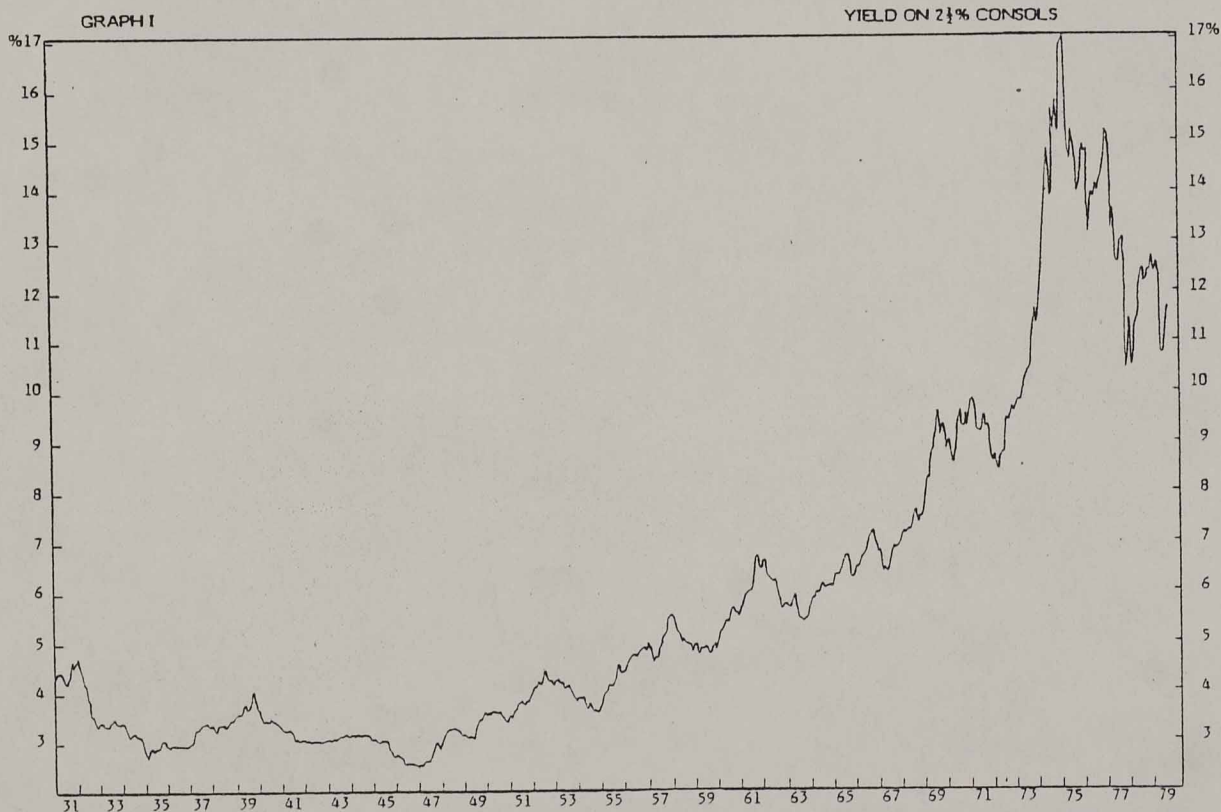


Money Supply and Interest Rates after the 1979 Budget

A speech by Gordon Pepper on 23rd July, 1979 at a conference "Budget 1979 - New Directions for the British Economy" organised by the Financial Times.

ms

The Budget, the money supply and interest rates. Let me start with interest rates. Graph I shows the yield on Consols 2½% since 1930. It will be seen that yields rose from the beginning of 1935 to the end of 1974. This long-run trend may well have reversed in 1975; the peak of interest rates in 1976 was lower than that at the end of 1974 and the one earlier this year was lower still. It is not yet certain that the trend has reversed. It is possible that the period 1974 to 1976 was an aberration and the upward trend prior to 1973 will be resumed. But in my judgement, the trend has reversed. Forty year trends do not reverse without something happening of major importance. What was it?



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

The discovery of North Sea oil is one factor. The worldwide energy shortage is another. But in my view the most important is that the U.K. has learnt a vital lesson. If unemployment is temporarily reduced at the cost of higher inflation, that rise in inflation causes even more unemployment in the medium term. Therefore, the battle against inflation must be waged not only in its own right but also to stop jobs being destroyed in the future. (This lesson has still to be learnt in the U.S.) Mr. Callaghan described the lesson vividly in his speech to the Labour Party Conference in 1976. Sir Geoffrey quoted part of it in his Budget Speech. The full quotation is:

"We used to think that you could just spend your way out of a recession and increase employment by cutting taxes and boosting Government spending. I tell you in all candour that that option no longer exists and that insofar as it ever did exist, it worked by injecting inflation into the economy. And each time that happened the average level of unemployment has risen. Higher inflation, followed by higher unemployment. That is the history of the last twenty years."

Stripped to basics, inflation is caused by too much money chasing too few goods. Inflation is reduced by decreasing the supply of money and increasing the supply of goods. Control of the money supply is the harsh and negative part of the solution. Increasing the supply of goods is the attractive and positive part.

One way of judging a Budget is to consider how it affects control of the money supply and whether it encourages or discourages the supply of goods. The snag is that many of the measures which encourage the supply of goods increase the money supply by a greater percentage amount, for example rises in public expenditure. During the last year or so I have often suggested to economists that they should think of increasing the supply of goods in ways which have the minimum impact on the money supply, productivity increases are a very obvious example. However, those economists who really understand the supply of goods frequently do not know what affects the money supply and financial economists, such as myself, are often naive about the supply of goods.

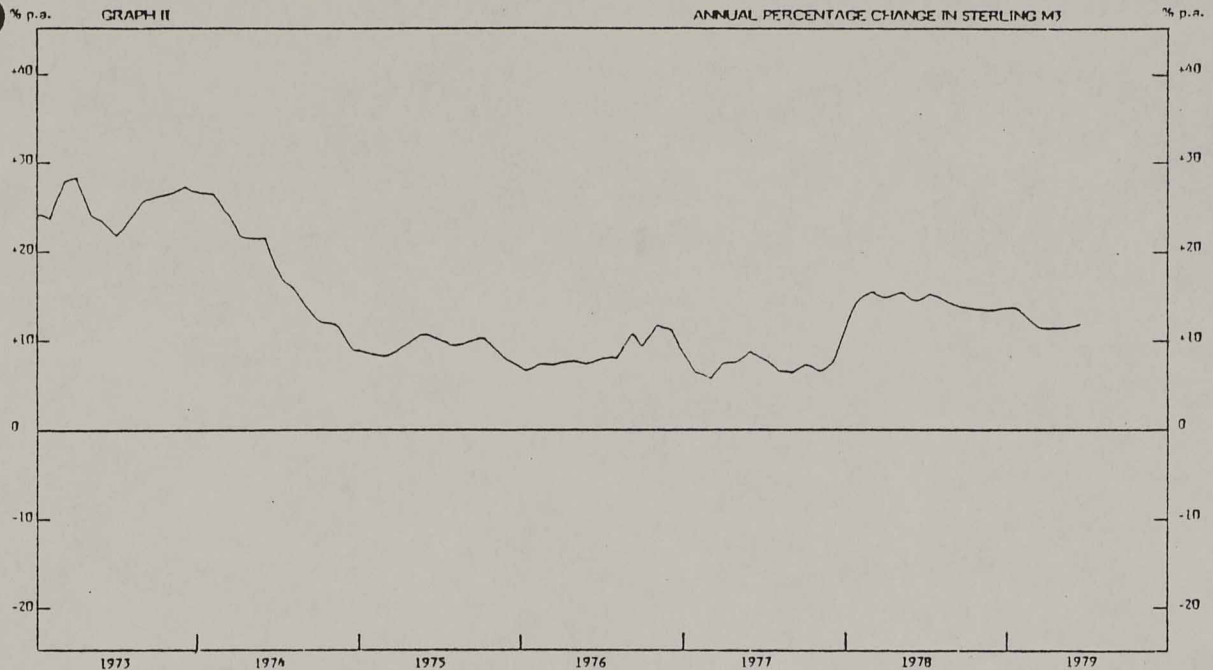
Neo-Keynesians will have difficulty in understanding the point which I have just tried to make. They are trying to judge Sir Geoffrey's first Budget by its impact on demand; they are using traditional Keynesian techniques, because this is the way they

have assessed budgets in the past. But Keynesian analysis is no longer fruitful, at least in the conditions in which we are now operating. This Budget reflects those new conditions much more clearly than do all the available macro-economic models. Before the Budget, people kept on asking me what injection of demand I thought the economy could "afford". When the money supply is being controlled this question has no clear meaning. The old analytical framework has lost relevance.

If fiscal policy is eased, the budget deficit rises and tends to boost monetary growth. If the growth of the money supply is to stay unchanged, financial policy must be tightened, in that bank lending must be reduced and/or sales of gilt-edged stock must be increased. Budgetary policy plus financial policy equals money supply policy. Keynesians argue, of course, that easier budgetary policy has a greater impact on economic activity than tighter financial policy. My reply is that I have researched into the U.K.'s past dividing changes in monetary growth into those which have been caused by budgetary policy and those which have been caused by financial policy. True to my Keynesian upbringing at Cambridge, I expected budgetary policy to have a more powerful and quicker effect on the real economy than financial policy. As a stockbroker I could have made a lot of money if I had been able to use my Keynesian training to explain some of the notoriously variable time lags between changes in the money supply and changes in the economy. But try as I might, I have not managed to detect budgetary policy being more powerful than financial policy. Therefore, my first important point is that control of the money supply is, in fact, demand management; it is an automatic way of fine tuning demand in contrast to the Keynesian discretionary way. Demand is boosted in real terms if monetary growth is faster than the rate of inflation. Demand is contracted in real terms if monetary growth falls relative to inflation.

The level of demand

Currently, demand is falling in real terms. Monetary growth can fall relative to inflation because either monetary growth falls in nominal terms or inflation rises. As far as the first is concerned, the Chancellor appeared in the Budget to reduce the target for sterling M3 but in fact he has not done so. The range was lowered from 8-12% to 7-11% but the base was raised when it was altered from mid-April to mid-June. The net effect is that the mid-point of the target has been left unchanged although the range has been narrowed slightly. Monetary growth in real terms will, nevertheless, fall because three factors are raising prices:



Firstly, inflation is rising following an increase in the growth of the money supply. The year-on-year data shown in Graph II illustrate how the growth of sterling M3 fell abruptly in 1974, after which it fell slowly until the autumn of 1977 when it jumped upwards from about 6% to 15%. Since then, although the graph falls slightly, the underlying growth of the money supply has remained at almost 15% if allowance is made for distortions caused by the corset on the banks. The result has been as predicted by monetary theory - inflation has stopped falling and is once again rising.

The second factor raising prices is OPEC's recent increases in the price of oil.

The third factor is the increases in indirect taxes which were included in the Budget, mainly the increase in VAT to 15%. Only in this last sense can the Budget be described as reducing the real level of demand in the economy.

Supply side

The revolution in budget-thinking is far more than just automatic fine tuning of demand through control of the money supply. Keynes was one of the first economists to grapple with dynamic analysis applied to the economic system as a whole. Because he saw

the main problem in the 1930's to be one of deficiency in demand, Keynes concentrated on the demand side of the economic system. Neo-Keynesians have consistently failed to apply similar dynamic analysis to the supply side of the economy. The Budget introduces supply side measures. With the level of demand being fine tuned automatically by control of the money supply, these measures must be judged according to their impact on the supply side of the economy. It is wrong to judge them as demand side measures.

Before I come to the specific measures in the Budget, I must mention one important supply side factor. OPEC's increase in the price of oil is not only demand deflationary, in the way described earlier, but also it disrupts supply. The result will be world-wide recessionary pressure.

The budget measures

I wholeheartedly welcome the Budget's £3bn. cuts in public expenditure in 1979/80, which are important both for monetary control and to leave room for the growth of more productive parts of the economy. However, I must highlight the disappointing fact that, in spite of these cuts, general government expenditure is still forecast to increase as a percentage of GDP. It is forecast to rise from a provisional outturn of $43\frac{1}{2}\%$ in 1978/9 to 45% in 1979/80. Before the Budget changes it was forecast to rise to no less than $46\frac{1}{2}\%$, which would have completely reversed the fall since the IMF measures in December 1976. This, together with recent trends in monetary growth, which I mentioned earlier, illustrate only too clearly the back-sliding of the Labour Government towards the end of its period in office. Between 1971 and 1976 general government expenditure rose as a percentage of GDP by more than 8% . Although I accept that it is administratively impossible to reverse this quickly, it is surely possible given time.

Secondly, I most certainly welcome the Budget's cuts in marginal rates of taxation, not because they boost demand but because they are an important supply side measure. There was an overwhelming case for the cuts in higher rates of income tax. There was an equally strong case for the increases in income tax allowances which reduced the extraordinarily high marginal rates of tax for people at the other end of the range of incomes who are caught in the "poverty trap". Allowing for loss of Social Security benefits, the marginal rates of tax on some low incomes had been exceeding 100%.

The Conservatives describe the argument for lower taxation in terms of incentives. Supply-side-fiscalists in the U.S. refer to the "wedge" between the marginal gross cost to an employer of additional labour and the marginal net take-home pay of the worker. As Professor Art Laffer has said, we have consistently taxed work, effort and employment and have subsidised leisure, lack of effort and unemployment. Exactly in accordance with the basic laws of economics, the outcome has been less work, less effort and less employment. This is a most important reason why productivity is currently low and unemployment is high.

The Laffer Theory emphasises the importance of marginal and not average rates of tax. Further, it refers to all taxes, not just income tax. The Budget includes as a third measure the switch from direct to indirect taxes. The basic rate of income tax was reduced by 3% to 30% whilst VAT was increased to 15% from the previous two rates of 8% and 12½%. I am wary of such changes from income to expenditure tax because the rates of tax have to be higher if the same amount of revenue is to be obtained. This is because the base for expenditure taxes is, in general, lower than that for income taxes because people do not spend all their incomes. A switch from income to expenditure taxes discourages people from working in order to spend; however, people who wish to save more are encouraged to work. The net effect on the supply side of the economy is uncertain. In short, the switch from income tax to expenditure tax increased the price level, without having a clear benefit for the supply side of the economy. It runs the risk of triggering high wage settlements. It also makes monetary control more difficult; interest rates have had to rise. In my view it was mistaken.

A fourth measure in the Budget, which I welcomed, was the relaxation of Exchange Controls, and a further relaxation was announced last week. I welcome these relaxations not just because the removal of controls will end distortions. I am one of those economists who argue for a strong currency, who hope that sterling will enter the virtuous circle enjoyed by the Deutschmark and Swiss franc. Nevertheless, sterling is currently too high. The present pressure on export industries and on domestic profit margins is too acute. Monetarists argue for gradualism, because the real economy reacts slowly to financial pressure. We argue for controlled pressure in the desired direction. If pressure is allowed to become too acute, the real economy can become disrupted. I do not, however, expect the relaxation of Exchange Controls to have a rapid effect on the level of sterling. It will probably take several months before people take advantage of the relaxation and invest abroad.

The money supplyCurrent Monetary Growth

	<u>3 months</u>	<u>6 months</u>	<u>8 months</u> (since mid-Oct '78)	<u>12 months</u>
Notes & coin	0% p.a.	10% p.a.	10% p.a.	13%
Retail M1	7% p.a.	8% p.a.	9% p.a.	12%
Sterling M3	-17% p.a.	13% p.a.	13% p.a.	12%
M4	22% p.a.	18% p.a.	17% p.a.	14%
M5	-17% p.a.	16% p.a.	16% p.a.	15%
Bank lending	26% p.a.	27% p.a.	25% p.a.	19%

Turning to the recent behaviour of the money supply, the above table shows the performance of sterling M3, together with that of the narrower and broader aggregates, in the months prior to mid-June, for which data were released on Thursday. It will be seen that in the last three months sterling M3 grew at an annual rate of 17%, M4 at 22% and M5 (which includes building society deposits) at 17%. During the last six months the rates were 13% p.a., 18% p.a. and 16% p.a., respectively. There is no doubt that the behaviour of the broader aggregates is currently worrying. The authorities have taken remedial action. MLR was raised by 2% to 14% on 12th June (make-up date was on 20th June) and the corset is now exerting pressure on the banks. Time will tell whether the action was sufficient. My guess is that it will be sufficient providing the authorities maintain the pressure of the corset.

What are the prospects for monetary growth in the coming months? As inflation rises the demand for money will rise. The official forecast for inflation is 16% between the third quarter of 1979 and the third quarter of 1978, $17\frac{1}{2}\%$ between November 1979 and November 1978 and $13\frac{1}{2}\%$ between the third quarter of 1980 and the third quarter of 1979. Monetary growth being constrained to the 11% upper limit of its target range implies a large jump in the velocity of circulation. Normally, this does not occur without a substantial rise in interest rates. This was, presumably, another reason why MLR was raised by 2% in the Budget, and why the Government Broker reduced the price of his long-dated gilt-edged tap stock by $5\frac{1}{2}$ points on the day after the Budget.

An important point is that the velocity of circulation always rises as an economy approaches a recession. I have already indicated that real economic growth in the U.K. is likely to fall. If inflation falls in 1980, as officially forecast, the overall picture will then be one of national income in nominal terms decelerating quite rapidly. Rates of change of

the money supply usually precede rates of change of national income. This is likely to be an important factor reducing monetary growth in the coming months. My own hunch is that monetary growth will fall back within its target range sooner than many people are forecasting.

The normal method of forecasting monetary growth in the short run is to try to forecast its components, i.e. the public sector borrowing requirement, bank lending, gilt-edged sales and the external flows. You will notice that I have not adopted this approach. The reason is that at present there is too much uncertainty about the components, so I have little confidence in the result. The above technique worked in somewhat similar circumstances to the present in November 1976.

Interest rates

Finally, I come to the outlook for interest rates, As far as the immediate prospects are concerned, I do not expect MLR to be reduced from its present high level of 14% until the authorities are sure that monetary growth has dropped within its target range. Some people are, however, arguing that MLR will not be reduced until bank lending, which has been extremely buoyant in recent months, becomes sluggish. We will probably not have to wait so long. Changes in the growth of the money supply usually lead the business cycle, as I described earlier. Corporate loan demand usually lags. If the normal pattern occurs, monetary growth will turn down before bank lending does. Therefore, I think that MLR will fall sooner than some people are suggesting.

Moving ahead to 1980, interest rates are likely to be lower than they are now and falling rapidly. Firstly, there will be world-wide recessionary pressures. Not only will economic growth be declining in the U.K. but also the U.S. and Europe will be in a similar phase. I envisage recessionary pressures of the order of 1974/5 but probably not so great. As recessionary pressure builds up, interest rates will fall as they always do when this happens.

Secondly, the Conservative Government is committed to reducing the budget deficit. If budgetary policy is tightened in the face of recessionary pressure, financial policy will have to be further eased. So interest rates will fall faster.

Thirdly, as the recessionary pressure gathers momentum, the money supply will become sluggish or fall as it did in 1974/5, 1969/70 and in all previous recessions. The Bank of England will ration its sales of gilt-edged stock to stop the money supply from undershooting its target range. When this happens, the gilt-edged and equity markets rise rapidly, as occurred in September 1977 and, to a lesser extent, last March.

Fourthly, there is just a possibility that within a year the present system of controlling the banking sector, by reserve ratio and corset, will be altered to a monetary base method. If this happens, the authorities will be able to rely more on sales of short dated public sector debt and less on sales of long dated gilt-edged stock, in which case the long end of the gilt-edged market will rise further. Adding these four factors together, the rise in stockmarkets could be very large.

The gilt-edged market is already trying very hard to anticipate favourable events in 1980. But we are not out of the wood yet. Adverse monetary pressure is likely to continue for several months. The corset may force the banking sector to sell some assets. The main threat, though, will be high wage settlements.

If the average of wage settlements is in the very high teens or larger, the gilt-edged market is almost bound to fall between now and the favourable events in 1980. But I am not so pessimistic. Wage settlements in manufacturing industry will be moderated by the squeeze on profit margins, liquidity and credit, and by recessionary pressure. It should be noted, though, that these factors are adverse for ordinary share prices in the short run.

Conclusion

Returning to the graph of the yield on 2½% Consols which I discussed at the start and whether or not the 40 year trend has reversed, the key to it being reversed is cuts in public expenditure. I am confident that it will be reversed if the Conservative Government can reduce public expenditure substantially as a percentage of GDP. They must also control the money supply. I stress that I am arguing for policies which will not only reduce interest rates and inflation but also will create additional employment and encourage a faster rate of economic growth.

In contrast, the opposition has argued that the economic philosophy of the Conservative Government is a return to the 1930's, which conjures up the impression of slump and dole queues. As far as the supply side of the economy is concerned, it is in many ways a return towards the 1930's. The great difference is on the demand side.

Keynes was right that the problem of the 1930's was one of deficient demand. Monetary growth was much too inadequate in 1929 and the 1930's. In the coming months and years the Bank of England must ensure that the money supply does not undershoot its target range. This will prevent a deficiency of demand. In short, although I very much hope that neo-Keynesian economics is dead, the lesson that Lord Keynes himself taught us has not been forgotten. That is the crucial difference with the 1930's.

W. Greenwell & Co.

Bow Bells House,
Bread Street, London EC4M 9EL

Telephone: 01-236 2040 Telex: 883006

W. Greenwell Associates (Investment Adviser) 450 Park Avenue, New York, N.Y. 10022
Telephone: 212 832 7428 Telex: 710 5815122

W
G

MONETARY BULLETIN

No. 94, July, 1979

Monetary Statistics for the month to 20th June 1979

The seasonally adjusted data for the five week banking month to mid-June are as follows:

Notes & coin	-£ 78m	(-10% p.a.)
Retail M1	-£ 41m	(- 2% p.a.)
Sterling M3	£ 582m	(13% p.a.)
M4	£1,175m	(26% p.a.)
M5	£1,372m	(18% p.a.)
DCE	£ 816m	
Bank lending in sterling to the private sector	£ 937m	(28% p.a.)

Allowing for these figures the pattern of monetary growth in recent month is as follows:

	<u>3 months</u>	<u>6 months</u>	<u>8 months</u> (since mid-Oct '78)	<u>12 months</u>
Notes & coin	0% p.a.	10% p.a.	10% p.a.	13%
Retail M1	7% p.a.	8% p.a.	9% p.a.	12%
Sterling M3	17% p.a.	13% p.a.	13% p.a.	12%
M4	22% p.a.	18% p.a.	17% p.a.	14%
M5	17% p.a.	16% p.a.	16% p.a.	15%
Bank lending	26% p.a.	27% p.a.	25% p.a.	19%

There is no doubt that the behaviour of the broader aggregates is worrying. However, the authorities raised MLR to 14% on 12th June and the corset is now exerting pressure on the banks. But for these two factors, the tone of this Bulletin would be highly critical. As it is, neither we nor, probably, the authorities can yet be confident that the remedial action will prove to be adequate. Our guess is that the 2% rise in MLR will be sufficient providing the authorities maintain the pressure of the corset.

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

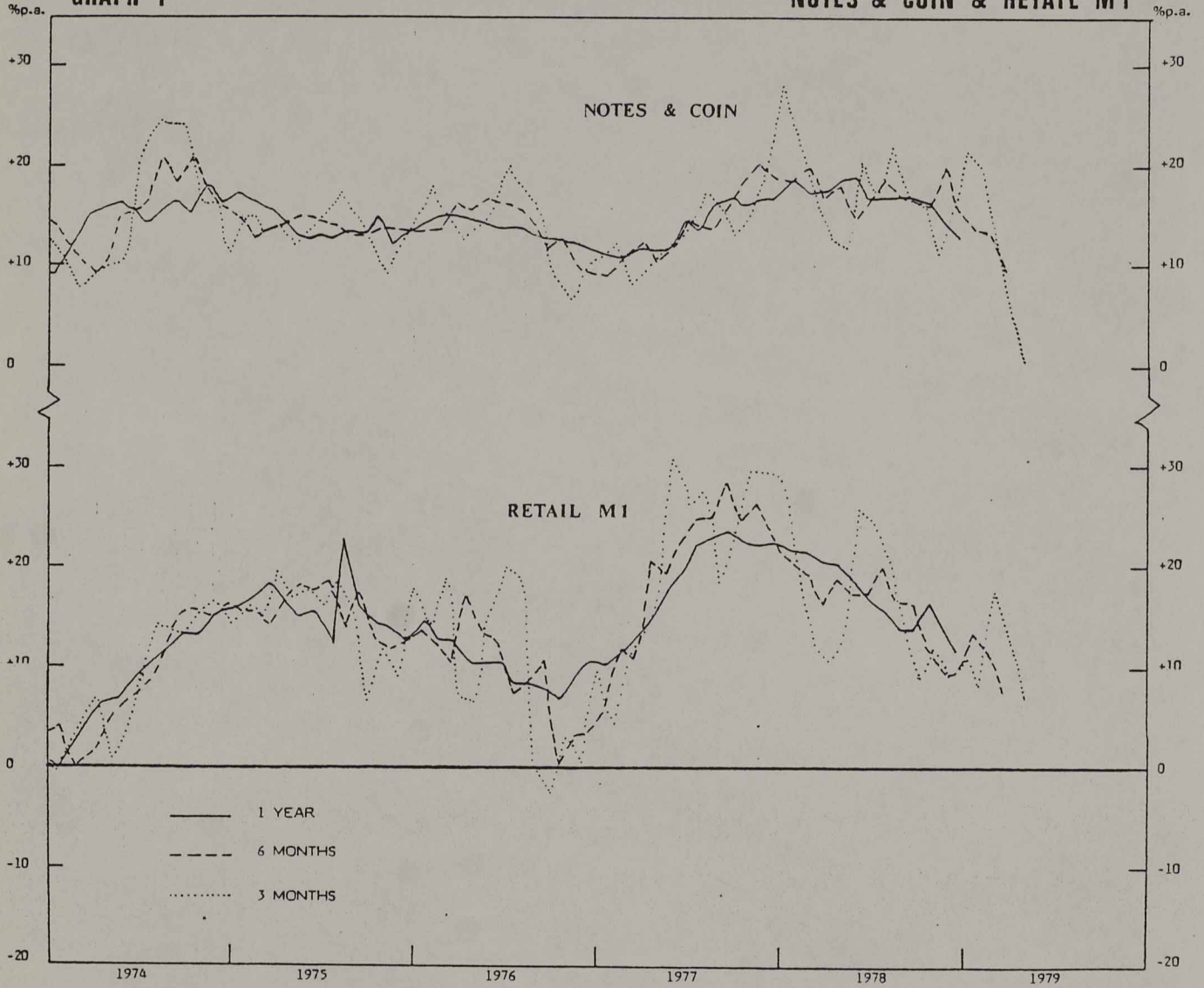
The target range for sterling M3

If the Budget had not been delayed, the target range for sterling M3 for the period until mid-April 1980 would have been based on data for mid-April 1979 and the 8-12% range set last October might have continued. In the event, the range was lowered to 7-11% but the base was raised because it was altered to mid-June. If the new range is expressed relative to the mid-April data it becomes 8.3-11.7%, i.e. the mid-point has not been lowered, the range has just been narrowed.

G.T.P.
R.L.T.
R.R.

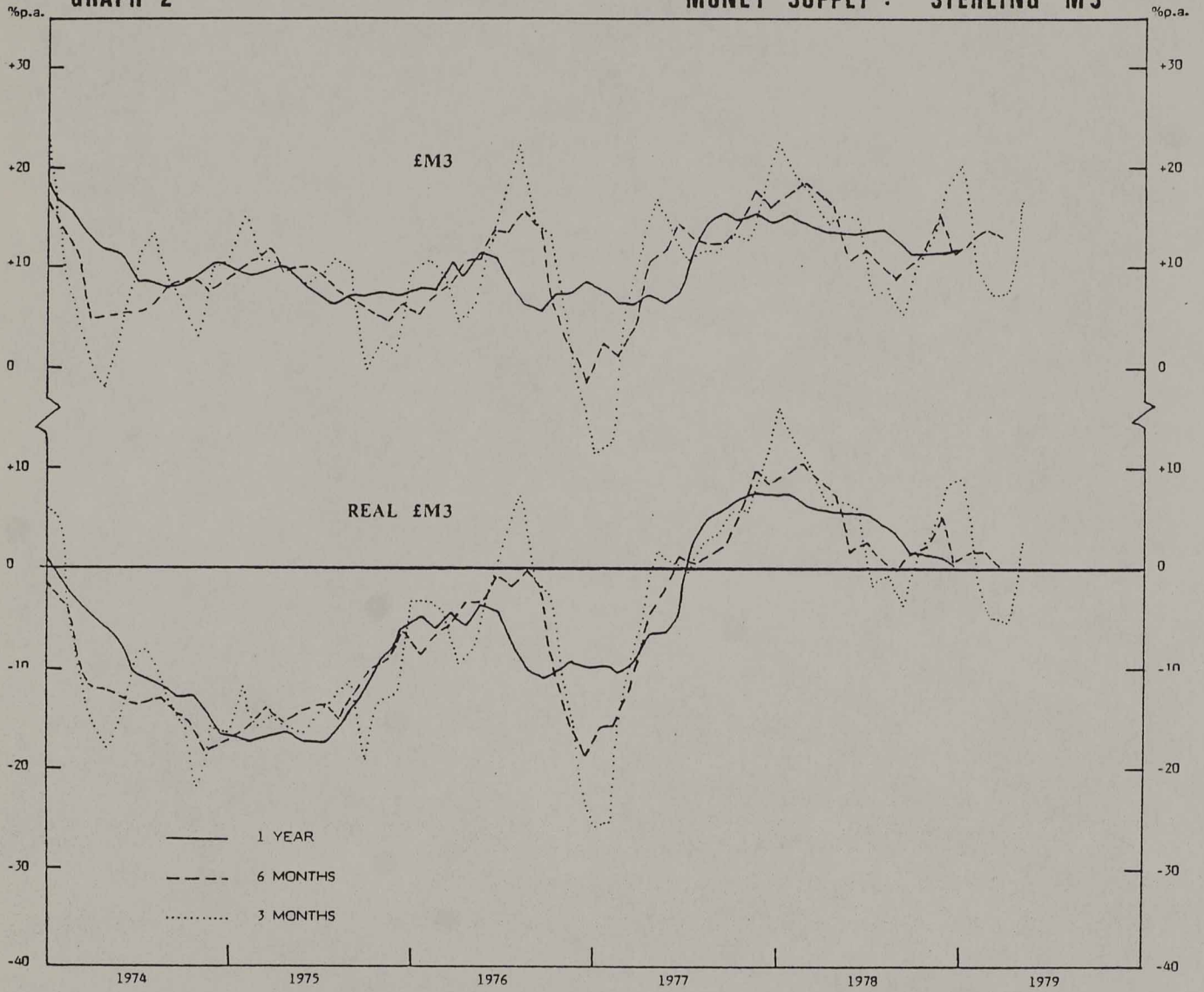
GRAPH 1

NOTES & COIN & RETAIL M1



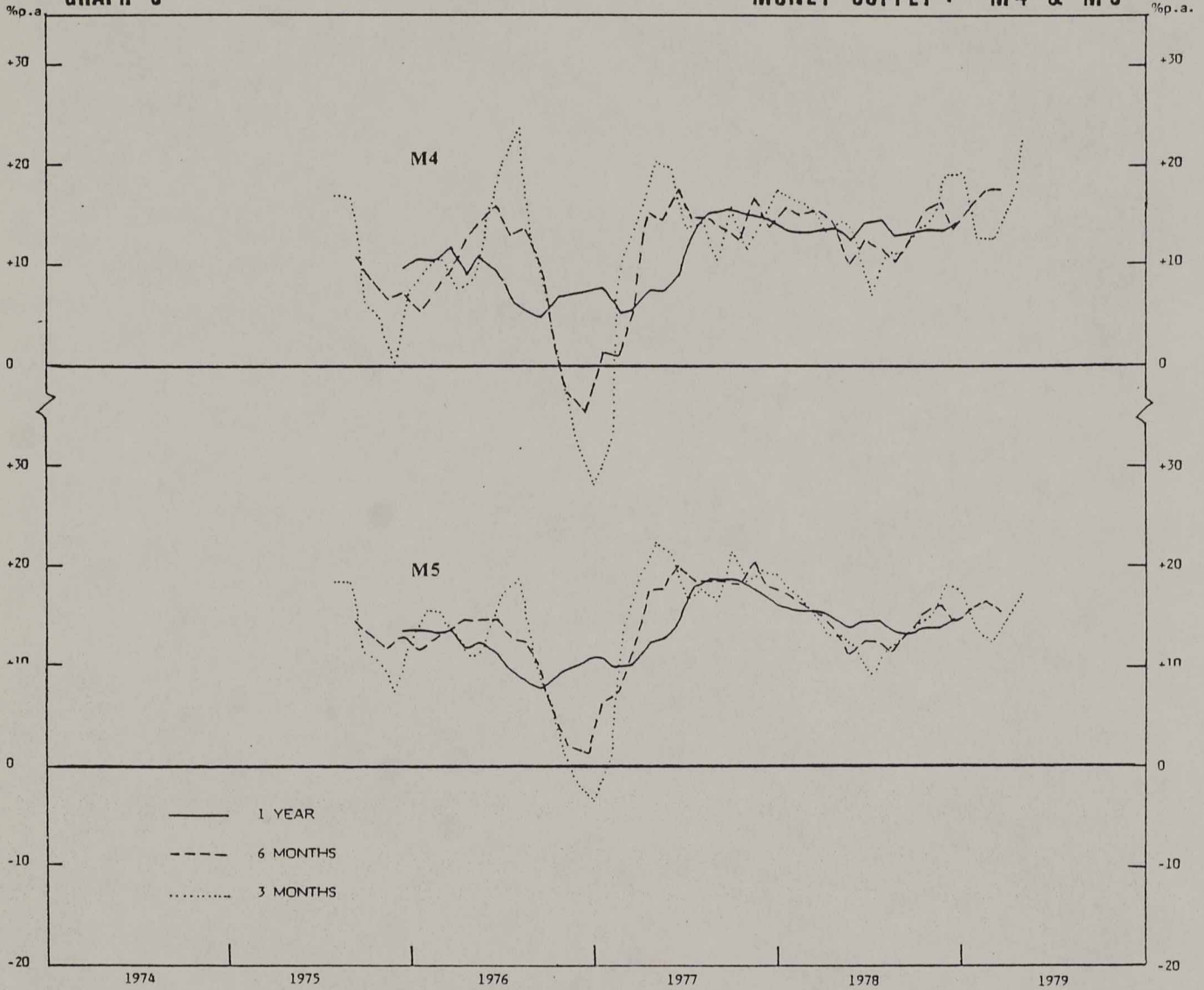
GRAPH 2

MONEY SUPPLY : STERLING M3



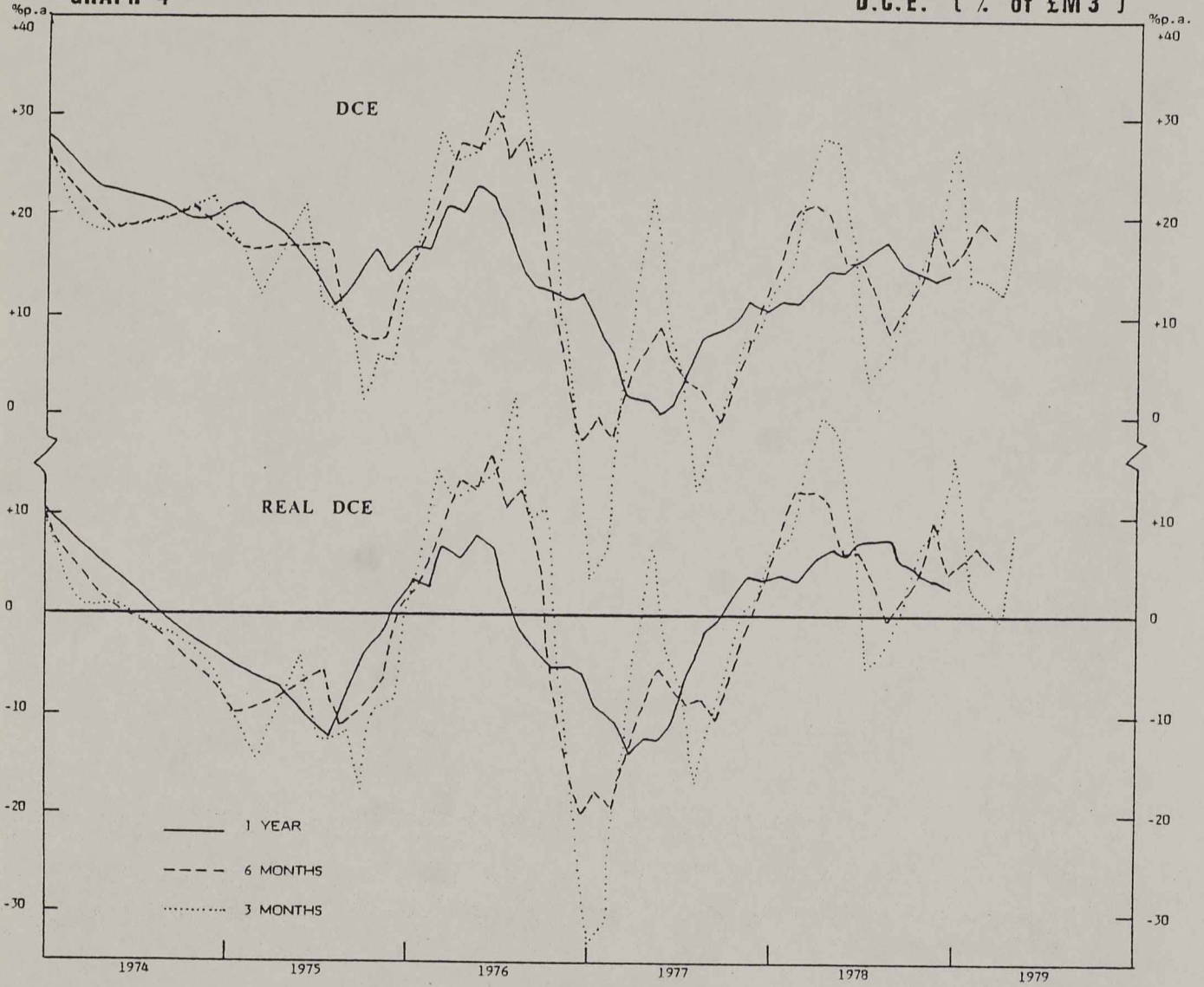
GRAPH 3

MONEY SUPPLY : M4 & M5



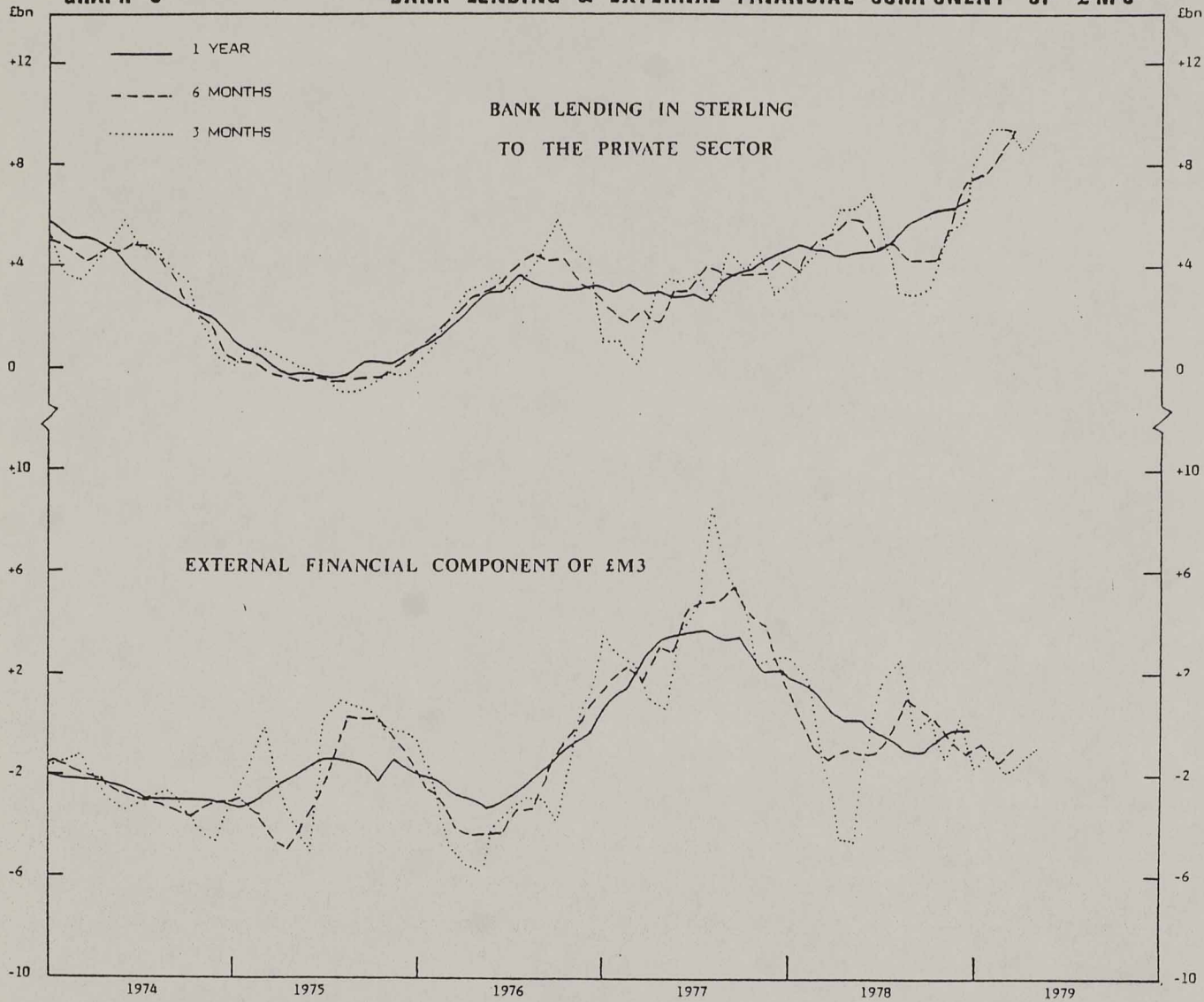
GRAPH 4

D.C.E. (% of £M3)



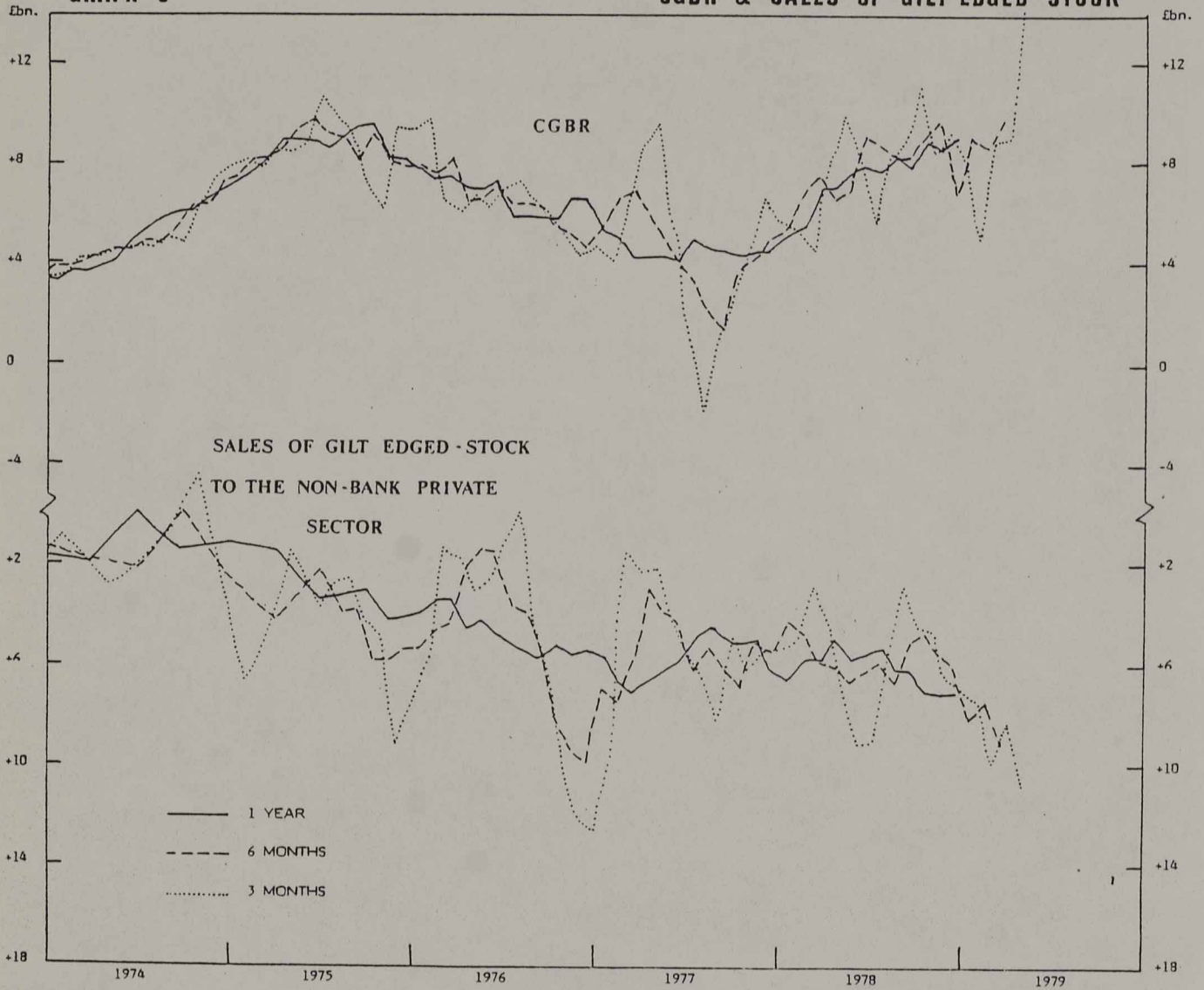
GRAPH 5

BANK LENDING & EXTERNAL FINANCIAL COMPONENT OF £ M 3



GRAPH 6

CGBR & SALES OF GILT EDGED-STOCK



STATISTICS

reprinted from Bank of England, *Banking Statistics*.

(Table 6 in the *Quarterly Bulletin*)

UK banking sector: transactions in liabilities and assets (a)

£ millions

Month ended	Liabilities												
	Total	Domestic deposits							Overseas deposits		Non-deposit liabilities (net)		
		Total		Public sector		Other currencies	Private sector		Sterling	Other currencies			
		Un-adjusted	Seasonally adjusted	Un-adjusted	Seasonally adjusted		Un-adjusted	Seasonally adjusted					
1978 June 21	+ 3,216	+ 263	+ 504	+ 280	+ 102	- 40	- 192	+ 227	+ 215	- 1	+ 2,681	+ 273	
July 19	+ 1,412	+ 494	+ 445	- 22	+ 69	-	+ 585	+ 445	- 69	+ 77	+ 769	+ 72	
Aug. 16	+ 2,354	- 666	- 537	- 434	- 257	+ 10	+ 3	- 45	- 245	- 34	+ 3,024	+ 20	
Sept. 20	+ 2,441	+ 481	+ 352	+ 182	+ 119	- 26	+ 266	+ 200	+ 59	+ 121	+ 1,650	+ 139	
Oct. 18	+ 3,307	+ 641	+ 422	- 116	- 53	+ 12	- 627	+ 345	+ 118	+ 9	+ 2,720	- 63	
Nov. 15	+ 4,403	+ 435	+ 521	+ 32	+ 49	- 8	+ 148	+ 217	+ 263	+ 10	+ 3,892	+ 66	
Dec. 13	+ 2,781	+ 565	+ 605	- 38	+ 3	- 4	+ 564	+ 663	+ 43	+ 84	+ 2,166	- 34	
1979 Jan. 17	+ 2,010	+ 441	+ 762	+ 35	- 83	+ 27	+ 547	+ 931	- 218	+ 187	+ 1,169	+ 213	
Feb. 21	+ 661	- 70	+ 508	+ 353	+ 231	- 4	- 598	+ 102	+ 179	- 11	+ 675	+ 67	
Mar. 21	+ 102	- 656	- 640	- 324	- 243	+ 38	- 117	- 182	- 253	+ 337	+ 459	- 38	
Apr. 18	+ 4,124	+ 1,515	+ 307	+ 42	+ 113	- 34	+ 1,395	+ 616	+ 112	- 355	+ 2,145	+ 109	
May 16	+ 3,216	+ 710	+ 347	- 151	- 156	+ 12	+ 600	+ 742	+ 249	- 115	- 2,391	-	
June 20	+ 4,692	+ 1,029	+ 1,065	+ 187	+ 30	- 11	+ 439	+ 630	+ 414	+ 151	+ 2,950	+ 562	

Month ended	Assets										
	Total	Lending to public sector					Lending to private sector			Lending to overseas sector	
		Sterling		Other currencies	Sterling		Other currencies	Sterling	Other currencies		
		Un-adjusted	Seasonally adjusted		Central government	Other					
1978 June 21	+ 3,216	- 639	- 458	- 628	- 11	- 21	+ 643	+ 507	+ 232	+ 140	+ 2,361
July 19	+ 1,412	- 14	+ 240	+ 102	- 116	- 25	+ 790	+ 213	+ 114	- 21	+ 568
Aug. 16	+ 2,354	- 462	- 376	- 291	- 171	- 81	- 99	+ 375	+ 158	+ 23	+ 2,810
Sept. 20	+ 2,441	+ 518	+ 498	+ 509	+ 9	- 9	+ 149	+ 154	- 36	- 19	+ 1,838
Oct. 18	+ 3,307	+ 223	+ 95	+ 29	+ 194	+ 20	+ 413	+ 395	- 12	- 13	+ 2,676
Nov. 15	+ 4,403	+ 65	+ 19	+ 267	- 202	+ 121	+ 254	+ 428	+ 145	- 117	+ 3,935
Dec. 13	+ 2,781	+ 432	+ 160	+ 370	+ 52	- 12	+ 36	+ 505	+ 159	+ 137	+ 2,029
1979 Jan. 17	+ 2,010	- 238	+ 520	- 475	+ 237	- 53	+ 1,218	+ 497	- 44	+ 62	+ 1,065
Feb. 21	+ 661	- 742	- 3	- 768	+ 26	- 7	- 325	- 799	+ 27	- 138	+ 696
Mar. 21	+ 102	- 517	- 567	- 890	+ 373	- 72	+ 636	+ 969	+ 104	- 3	+ 46
Apr. 18	+ 4,124	+ 1,381	+ 666	- 1,097	- 284	- 99	+ 637	+ 622	- 4	- 30	+ 2,179
May 16	+ 3,216	+ 188	+ 262	+ 552	- 364	+ 18	+ 179	+ 426	+ 395	- 51	+ 2,411
June 20	+ 4,692	+ 114	+ 16	+ 69	+ 45	+ 8	+ 1,368	+ 1,223	- 75	- 72	+ 3,349

(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*).

Money stock: amounts outstanding

(Table 11.1 in the Quarterly Bulletin)

Month ended	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)	
	1	2	3	4	5	6			7	8		9	10
1978 May 17	7,693	12,509	3,656	23,858	23,690	22,056	1,184	47,098	46,530	5,014	52,112	51,550	
June 21	7,314	12,464	3,268	23,546	23,660	22,297	1,464	47,307	46,930	5,086	52,393	52,020	
July 19	8,186	12,752	3,371	24,309	24,210	22,491	1,442	48,242	47,600	4,911	53,153	52,520	
Aug. 16	8,130	13,112	3,202	24,444	24,370	22,303	1,008	47,755	47,390	4,496	52,251	51,890	
Sept. 20	8,160	13,184	3,237	24,581	24,620	22,462	1,190	48,233	47,880	4,523	52,756	52,410	
Oct. 18	8,184	13,556	3,319	25,059	24,860	22,635	1,074	48,768	48,270	4,638	53,406	52,900	
Nov. 15	8,258	13,583	3,258	25,099	24,910	22,817	1,106	49,022	48,620	4,947	53,969	53,560	
Dec. 13	8,682	13,906	3,500	26,088	25,500	22,816	1,068	49,972	49,370	4,973	54,945	54,240	
1979 Jan. 17	8,382	13,497	3,661	25,540	25,720	23,611	1,153	50,304	50,410	4,705	55,009	55,120	
Feb. 21	8,594	13,012	3,713	25,319	25,940	23,446	1,506	50,271	50,950	4,875	55,146	55,830	
Mar. 21	8,689	13,445	3,488	25,622	25,950	23,121	1,182	49,925	50,570	4,602	54,527	55,170	
Apr. 18	8,862	14,484	3,792	27,138	26,740	23,173	1,224	51,535	51,320	4,576	56,111	55,390	
May 16	8,832	14,262	3,857	26,951	26,740	23,930	1,073	51,954	51,980	4,863	56,817	56,340	
June 20	8,804	14,026	3,718	26,548	26,560	24,744	1,260	52,552	52,560	5,107	57,659	57,670	

(a) After deducting 60% of transit items (see additional notes to Table 6 of the Quarterly Bulletin).

(b) M₁ equals columns 1 + 2 + 3. Sterling M₃ equals M₁ + columns 5 + 6. M₃ equals sterling M₃ + 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

Month ended (unadjusted)	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
1978 June 21	+ 121	- 45	- 388	- 312	+ 241	+ 280	+ 209	+ 175	- 103	+ 281	
July 19	+ 372	+ 288	+ 103	+ 763	+ 194	- 22	+ 935	- 69	- 106	+ 760	
Aug. 16	- 56	+ 360	- 169	+ 135	- 188	- 434	- 487	- 235	- 180	- 902	
Sept. 20	+ 30	+ 72	+ 35	+ 137	+ 159	+ 182	+ 478	+ 33	- 6	+ 505	
Oct. 18	+ 24	+ 372	+ 82	+ 478	+ 173	- 116	+ 535	+ 130	- 15	+ 650	
Nov. 15	+ 74	+ 27	- 61	+ 40	+ 182	+ 32	+ 254	+ 255	+ 54	+ 563	
Dec. 13	+ 424	+ 323	+ 242	+ 989	- 1	- 38	+ 950	+ 39	- 13	+ 976	
1979 Jan. 17	- 300	- 409	+ 161	- 548	+ 795	+ 85	+ 332	- 191	- 77	+ 64	
Feb. 21	+ 212	- 485	+ 52	- 221	- 165	+ 353	- 33	+ 175	- 5	+ 137	
Mar. 21	+ 95	+ 433	- 225	+ 303	- 325	- 324	- 346	+ 215	- 58	+ 619	
Apr. 18	+ 173	+ 1,039	+ 304	+ 1,516	+ 52	+ 42	+ 1,610	+ 78	- 104	+ 1,584	
May 16	- 30	- 222	+ 65	- 187	+ 757	- 151	+ 419	+ 261	+ 26	+ 706	
June 20	- 28	- 236	- 139	- 403	+ 814	+ 187	+ 598	+ 403	- 159	+ 342	
1978 June 21	+ 73	+ 287	- 388	- 28	- 0.1	+ 328	+ 102	+ 402 + 0.9	+ 175	- 103	+ 474 + 0.9
July 19	+ 156	+ 290	+ 103	+ 549	+ 2.3	+ 52	+ 69	+ 670 + 1.4	- 69	- 106	+ 495 + 1.0
Aug. 16	+ 77	+ 242	- 169	+ 150	+ 0.6	- 118	- 257	- 225 - 0.5	- 235	- 180	- 640 - 1.2
Sept. 20	+ 158	+ 56	+ 35	+ 249	+ 1.0	+ 109	+ 119	+ 477 + 1.0	+ 33	- 6	+ 504 + 1.0
Oct. 18	+ 73	+ 80	+ 82	+ 235	+ 1.0	+ 183	- 53	+ 365 + 0.8	+ 130	- 15	+ 480 + 0.9
Nov. 15	+ 77	+ 28	- 61	+ 44	+ 0.2	+ 250	+ 49	+ 343 + 0.7	+ 255	+ 54	+ 652 + 1.2
Dec. 13	+ 72	+ 271	+ 242	+ 585	+ 2.3	+ 150	+ 8	+ 743 + 1.5	- 86	- 13	+ 664 + 1.2
1979 Jan. 17	+ 154	- 112	+ 161	+ 203	+ 0.8	+ 882	- 83	+ 1,002 + 2.0	- 86	- 77	+ 839 + 1.5
Feb. 21	+ 198	- 27	+ 52	+ 223	+ 0.9	+ 77	+ 231	+ 531 + 1.1	+ 175	- 5	+ 701 + 1.3
Mar. 21	+ 38	+ 192	- 225	+ 5	-	- 149	- 243	+ 387 - 0.8	- 215	- 58	- 660 - 1.2
Apr. 18	+ 14	+ 470	+ 304	+ 788	+ 3.0	- 158	+ 113	+ 743 + 1.5	+ 78	- 104	+ 717 + 1.3
May 16	+ 73	- 133	+ 65	+ 5	-	+ 810	- 156	+ 639 + 1.3	+ 261	+ 26	+ 946 + 1.7
June 20	- 78	+ 37	- 139	- 180	- 0.7	+ 732	+ 30	+ 582 + 1.1	+ 403	- 159	+ 826 + 1.5

(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) M₁ equals columns 1 + 2 + 3. Sterling M₃ equals M₁ + columns 5 + 6. M₃ equals sterling M₃ + columns 8 + 9.

(d) Including certificates of deposit.

(e) See additional notes to Tables 6 and 11 of the Quarterly Bulletin.

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

£ millions

Month ended (unadjusted)	Public sector borrowing requirement (surplus -)		Purchases (-) of public sector debt by private sector (other than banks)		Sterling lending to the 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 -) (e)	Money stock sterling M ₃ (f)
	Central government borrowing requirement	Other public sector contribution	Other public sector debt	Central government debt				Public sector	Overseas sterling deposits (c)	Banks' foreign currency deposits (net) (e)		
1978 June 21	+ 655	+ 250	- 1,168	+ 637	+ 140	+ 514	- 249	+ 77	+ 216	- 273	+ 209	
July 19	+ 244	+ 39	- 535	+ 1,005	+ 21	+ 654	+ 473	- 77	+ 43	- 72	+ 935	
Aug. 16	+ 636	+ 452	- 437	+ 163	+ 28	+ 388	- 201	+ 24	+ 98	- 20	+ 487	
Sept. 20	+ 1,247	+ 47	- 746	+ 11	+ 19	+ 540	- 138	+ 121	+ 110	- 189	+ 478	
Oct. 18	+ 293	+ 107	- 215	+ 415	+ 13	+ 587	+ 60	+ 9	+ 166	+ 63	+ 535	
Nov. 15	+ 983	+ 222	- 763	+ 269	+ 117	+ 150	- 126	+ 10	+ 54	- 66	+ 254	
Dec. 13	+ 1,424	+ 328	- 653	+ 5	+ 137	+ 1,241	- 212	+ 34	+ 29	+ 34	+ 950	
1979 Jan. 17	+ 547	+ 125	- 511	+ 1,216	+ 62	+ 345	+ 397	+ 187	+ 10	- 213	+ 332	
Feb. 21	+ 31	+ 375	- 944	+ 1,124	+ 138	+ 386	+ 229	+ 11	+ 134	- 67	+ 33	
Mar. 21	+ 272	+ 279	- 1,370	+ 427	+ 3	+ 395	+ 606	+ 337	+ 258	+ 38	+ 346	
Apr. 18	+ 2,335	+ 234	- 1,382	+ 543	+ 30	+ 1,760	+ 461	+ 355	+ 147	- 109	+ 1,610	
May 16	+ 695	+ 348	- 526	+ 620	+ 61	+ 502	+ 104	+ 115	+ 136	-	+ 419	
June 20	+ 1,507	+ 11	- 1,425	+ 1,082	+ 72	+ 1,103	+ 279	+ 151	+ 71	- 562	+ 598	
Month ended (seasonally adjusted)												
1978 June 21	+ 767	+ 302	- 1,193	+ 501	+ 140	+ 517	-	+ 74	-	+ 41	+ 402	
July 19	+ 243	+ 30	- 559	+ 428	+ 21	+ 121	+ 463	-	+ 86	+ 670		
Aug. 16	+ 390	+ 468	- 450	+ 311	+ 28	+ 189	+ 63	-	+ 39	- 225		
Sept. 20	+ 1,420	+ 24	- 734	+ 16	+ 19	+ 659	+ 95	-	+ 277	+ 477		
Oct. 18	+ 400	+ 60	- 228	+ 397	+ 13	+ 496	+ 178	-	+ 47	+ 365		
Nov. 15	+ 926	+ 186	- 779	+ 443	+ 117	+ 287	+ 165	-	+ 109	+ 343		
Dec. 13	+ 789	+ 401	- 709	+ 474	+ 137	+ 1,092	+ 292	-	+ 57	+ 743		
1979 Jan. 17	+ 583	+ 156	- 494	+ 495	+ 62	+ 802	+ 187	-	+ 13	+ 1,002		
Feb. 21	+ 719	+ 331	- 920	+ 1,098	+ 138	+ 1,090	+ 305	-	+ 254	+ 531		
Mar. 21	+ 7	+ 306	- 1,319	+ 760	+ 3	+ 263	+ 95	-	+ 29	+ 387		
Apr. 18	+ 1,494	+ 134	- 1,340	+ 528	+ 30	+ 846	+ 97	-	+ 6	+ 743		
May 16	+ 733	+ 208	- 521	+ 867	+ 61	+ 932	+ 123	-	+ 150	+ 659		
June 20	+ 1,297	+ 104	- 1,450	+ 937	+ 72	+ 816	+ 17	-	+ 251	+ 582		

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

Month ended	Marketable debt		National savings		Tax instruments	Other	Total (column 4 above)	
	Stocks	Treasury bills	Unadjusted	Seasonally adjusted			Unadjusted	Seasonally adjusted
1978 June 21	- 1,163	+ 32	- 17	- 42	- 31	+ 11	- 1,168	- 1,193
July 19	- 629	+ 269	- 142	- 166	- 33	-	- 535	- 559
Aug. 16	- 417	+ 145	- 170	- 183	+ 5	-	- 437	- 450
Sept. 20	- 335	+ 40	- 140	- 128	- 301	- 10	- 746	- 734
Oct. 18	+ 37	+ 62	- 166	- 179	- 152	+ 4	- 215	- 228
Nov. 15	- 832	+ 35	- 135	- 151	+ 250	-	- 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	- 510	+ 80	- 131	- 80	- 653	+ 4	- 1,370	- 1,319
Apr. 18	- 991	+ 113	- 145	- 103	- 124	+ 9	- 1,382	- 1,340
May 16	- 578	+ 5	- 54	- 49	+ 109	- 8	- 526	- 521
June 20	- 1,118	+ 175	- 24	- 49	- 78	- 30	- 1,425	- 1,450

(b) Bank lending in sterling to the 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 M₃ equals domestic credit expansion plus columns 8 + 9 + 10 + 11 (see also page 7).

Symbols and conventions

.. not available.

- nil or less than £10 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 3AH.

Econ Pol.

cc Mather
Econ. Pol. May 79
Domestic Monetary Policy

NOTE FOR THE RECORD

Mr. Gordon Pepper called on the Prime Minister at 1030 hours on Wednesday, 18 July. Most of the discussion turned on the argument about issuing long gilts as opposed to short and medium gilts. This is recorded separately in my note of 18 July. Other points which came up were:

- (i) Mr. Pepper said that the banks were likely to make very high profits this year, and this was likely to result in high pay settlements in the banking sector. This could have an impact on Civil Service pay next year because of the P.R.U. comparability arrangements.
- (ii) The Prime Minister said that local authority three-month bonds appeared to be taking money away from the building societies. These bonds were secured, as she understood it, on the local authority rates. Would it not be a good idea to take away this security? Mr. Pepper said that the problem of diverting funds from the building societies was basically about high interest rates generally. If local authority bonds were no longer available, the building society money would be going somewhere else. And interest rates would stay high as long as inflation stayed high.
- (iii) Mr. Pepper said that he hoped the Government would seriously consider proposals for Monetary Base Control (MBC). A serious study was now needed of different detailed options. But before coming to any final decisions, it would be important for the Government and the Bank to consult widely with bankers and market operators. The Prime Minister told Mr. Pepper that she was chairing a seminar later that day which would be looking at MBC.

R

25 July 1979

CONFIDENTIAL

Evan B.S.

NOTE OF A MEETING BETWEEN THE PRIME MINISTER AND MR. GORDON PEPPER
at 11.45 A.M. ON WEDNESDAY 4 JULY

The following are the main points which came up in discussion.

I. Asset Disposals

The Prime Minister asked Mr. Pepper for his views on the sale of BP shares. She was particularly worried about the timing of the sale, and whether it would be right to sell any shares outside the United Kingdom. She had earlier taken the view that all of the sale should be in the United Kingdom in order to mop up liquidity and thus have the greater impact on the money supply. But the Treasury were arguing that some sales would be desirable abroad because this would allow a higher overall price, and in any case domestic sales would to some extent be a substitute for sales of gilts. Mr. Pepper said that there was likely to be some substitution between gilts and BP share purchases. But there was a trade-off between higher interest rates and selling these shares in the United Kingdom: the larger the share sale, the smaller the amount of gilts that would have to be sold, and therefore the lower the yield. It would be a mistake, in his view, to flood the London market with, say, £1 billion of BP shares - this would only depress the price. There were various methods of undertaking the sale - for example the market could be "tapped" continuously over an 18 month period rather than in one or two tranches. However, this was a highly technical matter and in any case an extension of the sale over 18 months would not meet the Government's funding requirement. The Prime Minister commented that from a political standpoint it would be better to sell the shares in the United Kingdom, and she still felt it would be better on money supply grounds. However, she understood that, even if the sale did take place entirely in the London market, foreigners would still be able to make purchases. Perhaps a preference should be given in the first place to United Kingdom nationals. Mr. Pepper said that this would not stop foreigners from buying the shares, because a secondary market would quickly develop. He cited the example of the BP sale in 1976: many of the shares which had been sold in

/New York

CONFIDENTIAL

New York had subsequently been bought by United Kingdom institutions. Mr. Pepper went on to say that Mr. Tom Quinn would be a good person to advise the Government on the details of the sale, although he was sure that the Government was already taking advice from the Merchant Banks.

II. Gilt-edge Funding

Mr. Pepper said that the Bank should have been concentrating to a greater extent on shorter dated stock. Their failure to announce a new short tap immediately after the Budget had been a great mistake. Following the announcement of the MLR increase, they had dropped the price of the long tap by 5½ points. This had caused a shambles amongst the Jobbers and Brokers, and with the shortage of short dated stock it had resulted in a very unsatisfactory yield curve - with yields at the shorter end far below yields at the long end. Both the existing tap stocks were now exhausted and the question arose as to what new stocks should be announced. Mr. Pepper's own view was that it would be right to issue both a new long and a new short stock - perhaps £1 billion of each. But the Bank should try to sell the short stock more vigorously than the long stock and establish a smoother yield curve. The institutions were currently rather short of liquidity, while the corporate sector was reasonably liquid: so this concentration of the shorter end should be feasible. It might also be a good idea for the Governor to indicate in a forthcoming speech that the Bank were going to concentrate more on the shorter end.

III. Money Supply

Mr. Pepper said that it was very difficult to estimate at this stage what the June banking figures would look like. There was a good deal of anecdotal evidence that bank lending to the private sector was continuing at a high level but this was not necessarily conclusive because of the window dressing by the banks for their half-yearly make-up. Nonetheless, he continued to be very worried about the money supply figures. The recent heavy sales of gilts were likely to have been offset by continued private sector lending at a high rate. The latter was suggested by high

CONFIDENTIAL

- 3 -

retail sales, for example, of cars. The main element in this was likely to be personal lending; corporate loan demand by contrast, which always lagged at this stage of the cycle, was likely to be running at a reasonable level.

IV. Mortgage Rate

The Prime Minister said that it would be disastrous if the mortgage rate rose. If necessary a solution on the lines of the loan scheme devised by Mr. Harold Lever in 1974 should be implemented. But this would only work if interest rates were going to fall before the end of the financial year so that the loans to the Societies would be repaid. Mr. Pepper said that he was certain that interest rates would tumble fast in 1980 because of recession in the USA, the United Kingdom and other major economies. But he was less sure about the next six months. United Kingdom interest rates would fall soon if MLR were reduced. But it would be a mistake to reduce MLR while private sector lending remained high; to do so would be seen as a failure to stick to a policy of monetary discipline. Interest rates ought to fall soon enough to ensure that any loans to the Building Societies would be repaid this financial year; but the timing was still uncertain. Everything depended upon how soon private sector lending came back within reasonable bounds (the latter was currently running at around £800 million per month; it would need to come back to £4-500 million.) The Prime Minister asked if there were other ways of holding back private sector lending other than relying simply on higher interest rates. Mr. Pepper replied that for technical reasons the "corset" was not effective. In fact, the Bank faced a dilemma. Because of the recent heavy sales of gilts, there was pressure on the Bank's liquidity and this was pushing up money market rates. They would, therefore, need to release some special deposits in the near future in order to relieve the squeeze; but if they went too far, the "corset" would become ineffective and private sector lending would not fall. It was very difficult to strike the right balance here: the amount of the special deposit release

/was crucial.

CONFIDENTIAL

was crucial. Mr. Pepper went on to say that if and when MLR were dropped, it would be better to reduce it by a substantial amount: to reduce it by small amounts and in stages, would add to the foreign exchange inflow.

V. Sterling

Mr. Pepper said the continued upward pressure on sterling was a real worry: the sterling dollar rate above \$2.20 would make it impossible for many industries to stay competitive. However, because of money supply worries, it would not be possible to hold sterling back by reducing interest rates in the near future. This must be achieved by a further early relaxation of exchange controls. The latter might have a perverse effect in the short run, but in due course it would take some of the pressure off sterling.

R..

c.c. Mr. Wolfson

5 July 1979

✓ Housing (M.A.), May 79.

Erasmus Pal.

MY LUNCH WITH GORDON PEPPER

Gordon Pepper and I went over some of the ground which we covered at the meeting this morning. The following points are particularly relevant to the decision on mortgage rates:

- (i) Gordon repeated that he was confident that interest rates would tumble in 1980 because of recession both here and in other major economies. In the shorter term - i.e. the next three months - he believes that interest rates will fall if we reduce MLR. However, he thinks it would be unwise to move MLR before August. This is because of his worries about lending to the private sector which - as he told you - seems likely to be running at a high rate still. A drop in MLR now, and the consequent drop in interest rates would - in his view - put in jeopardy our commitment to controlling the monetary aggregates. (External considerations, of course, none the less, argue for a fall in interest rates. The pound rose to \$2.23 this morning - an effective rate of 71: Gordon, however, would say that sterling must be reduced by a further relaxation of exchange controls rather than an early reduction in MLR.)
- (ii) Gordon argued this morning that we should be prepared to lend the building societies sufficient (for example £200 million per month) to see them through their short-term difficulties, but that this should be repaid before the end of the financial year. The object of the pay-back condition would be to ensure that there was no net addition to public expenditure. I questioned him further about the likely market reaction to this - given that in the short run it would mean an increase in the money supply, even though it would be offset later in the

/year.

year. Gordon in fact admitted that commentators such as himself would react adversely, and would comment that the Government was moving away from its firm intentions on monetary discipline. Such comments could obviously have a bad effect on the market, and if so, would put off the fall in interest rates. So, there are clearly considerable risks in going down the ~~loan~~ road. These have to be set against the effect on family outgoings if people have to pay higher mortgages.

- (iii) Gordon repeated that if the societies are to be assisted, it should be a loan to be repaid a la Harold Lever, and not a subsidy on their interest rates.

12

4 July 1979

W. Greenwell & Co.

Bow Bells House,
Bread Street, London EC4M 9EL

Telephone: 01-236 2040 Telex: 883006

W. Greenwell Associates (Investment Adviser) 450 Park Avenue, New York, N.Y. 10022
Telephone: 212 832 7428 Telex: 710 5815122

Ecan BL



A MONETARY BASE FOR THE U.K.

A PRACTICAL PROPOSAL

*A supplement to our Special Bulletin of 2nd March
proposing changes to the present monetary system*

*Practical
The Chancellor
will send you
a paper on this
shortly.*

We welcome the publication of the special article on "Monetary base control" in the latest Bank of England Quarterly Bulletin.

The authors of the article, M.D.K.W. Foot, C.A.E. Goodhart and A.C. Hotson, start by explaining that the various proponents of monetary base control often have widely differing proposals in mind. Most of their subsequent criticisms are about the more extreme and impractical proposals. What follows is, we believe, a middle-of-road and workable proposal.

The broad features of our proposed scheme are that the present control system of reserve asset ratio supported by the corset should be abolished and, in its place, banks should be required to hold deposits with the Bank of England. A clearing bank should be allowed to hold the deposit on behalf of a non-clearing bank if the latter so wishes.

The monetary base is the name given to the total of these bankers' deposits with the Bank of England. Foot, Goodhart and Hotson appear to argue that an undesirable feature of monetary base control would be that only the authorities could determine the size of the monetary base. For example, banks would not be able to increase their reserves by selling Treasury bills unless the Bank agreed to buy them. It is not clear to us why this might be thought undesirable; it seems a positive advantage for a control mechanism.

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

Monetary control

There is general agreement that the money supply should be controlled. If the authorities succeed in doing this, they cannot simultaneously control either interest rates or the level of sterling by direct intervention in the markets. Fluctuations of these in the short term (but not in the longer term) will inevitably be larger than under a regime where the money supply is not controlled. Foot, Goodhart and Hotson point out this disadvantage, but it applies to all methods of controlling the money supply, i.e. whether monetary base control is used or not. In our opinion, however, the short term fluctuations in interest rates will probably be smaller under our proposed system than is the case under the present system, because of the artificialities of the latter.

Firm foundation

Our objective in advocating a monetary base method of control for the U.K. is not to replace the published target for sterling M3 by one for the monetary base (M0). Instead, it is to replace the present quagmire with a firm foundation on which to build monetary policy. With M0 controlled, relative interest rates should be altered and other weapons used (e.g. fiscal policy, bank lending policy, gilt-edged policy) so that retail M1, sterling M3 and the broader definitions of the money supply all grow at rates which are consistent with the desired behaviour of national income in nominal terms. For example, if sterling M3 is behaving appropriately but the non-bank private sector's holdings of Treasury bills are growing rapidly to produce an excessive M4, then relative interest rates should be adjusted to persuade holders of Treasury bills to switch into gilt-edged stock. Both liquidity, in the Radcliffe Committee's sense, and the narrower definitions of the money supply ought to be controlled.

Our aim is to improve the authorities' control over the whole financial system. This is in contrast to the intention of those commentators who are in favour of publishing monetary targets only because it helps to reduce inflationary expectations. Whilst it is certainly desirable to reduce inflationary expectations, it is also essential to secure financial discipline. Further, if a central bank tries to control just one monetary aggregate, that aggregate very often becomes distorted; as Goodhart's Law states, the previous relationships between the aggregate and other variables break down. Paradoxically, the behaviour of the monetary aggregates which the central bank is not trying to control is often a better measure of the underlying stance of monetary policy than the behaviour of the aggregate which it is trying to control. Our focus, therefore, is the control of the whole system and not something which may become cosmetic. We repeat that retail M1, sterling M3 and the broader aggregates should all grow at rates which are consistent with the desired behaviour of national income.

The details of a monetary base system should be chosen so as not to penalise the domestic banking system relative to near-banks and off-shore banks. A horrible example of what can happen is currently occurring in the U.S., where no interest is paid on the reserves which banks who are Members of the System must deposit with Federal Reserve Banks. This prevents Member Banks from competing with near banks, non-Member Banks and off-shore banks when interest rates are very high. Member Banks have started to defend themselves aggressively. The result is a proliferation of money substitutes. The growth of these substitutes is swamping the growth of the money supply as officially defined. Currently, the official monetary indicators in the U.S. are not merely distorted; the monetary barometer is broken.

To stop a similar occurrence in the U.K. the level of reserves which banks should be obliged to place on deposit with the Bank of England ought to be close to the appropriate prudential level, and the Bank ought to pay a commercial rate of interest on most of them. If this were done, the market clearing rate of interest would affect the profit margins of banks, near-banks and off-shore banks equally.

The level of reserves

To prevent banks managing their liabilities to circumvent the control mechanism, there is a strong case for a common reserve ratio for all deposits, whether they are sight or time, large or small. The exclusion of vault cash (till-money) from the official definition of reserves means that sight deposits would in practice need larger reserves (reserves with the Bank plus vault cash) than time deposits. To secure equity between different types of banks, it would be inappropriate to pay the full commercial rate of interest on reserves backing non-interest bearing deposits. Although the amount of reserves ought to be the same irrespective of the type of deposit, the rate of interest could be different.

Information only

A central bank has up-to-the-minute and accurate information about the behaviour of the monetary base, it does not have to rely on reports from banks. But the central bank should not only use this information when deciding on the appropriate level of interest rates. In certain circumstances it should control the size of the monetary base and allow interest rates to clear at whatever level is necessary. This is one of the main objectives of introducing a monetary base method of control.

U.S. experience

In a speech on 10th May at a seminar organised by the City University, Lawrence K. Roos, President of the Federal Reserve Bank of St. Louis, described the way in which interest rates in the U.S. have not been allowed to alter sufficiently rapidly to control the money supply:

"Let's examine the published history of the behaviour of interest rates and the monetary aggregates in the period since long-term monetary aggregate growth ranges were first announced in 1975. In the 47 months in which short-term policy ranges have been set, the Federal funds interest rate has fallen outside of its target ranges only 5 times; in the same 47 periods, M1 growth has fallen outside of its ranges 23 times essentially 50% of the time.

The monetary aggregates (M1) have tended to exceed their targets during periods of rising Federal funds rates, to fall short of their targets during periods of falling Federal funds rates, while usually remaining within their targets during periods of stable Federal funds rates. For example, from June 1976 to December 1976 Federal funds rate fell from 5.6 percent to 4.5 percent and monetary aggregates fell short of their target ranges 3 out of 7 months. From April 1977 to October 1977, when the Federal funds rate rose from 4.7 percent to 6.5 percent, the monetary aggregates exceeded their targets 5 out of 7 months."

When the money supply is exceeding its target range, a central bank can blame politicians for being reluctant to allow rates of interest to rise sufficiently quickly; neo-Keynesians also frequently argue against such a rise. These excuses cannot be used when the money supply is falling short of its target range, because politicians and neo-Keynesians do not object to interest rates falling. The central bank is then to blame for not altering interest rates sufficiently quickly. The explanation is central bankers' innate caution and hankering after orderly markets. A most important objective in introducing a monetary base method of control is to ensure that the central bank alters interest rates sufficiently quickly to control the money supply.

Practical operation

Short term fluctuations in the money supply have no significance for the real economy. There is no need for day-to-day control of the monetary base.

Suppose for simplicity that the desired growth of M0 is 10% p.a. The banking system would then know that the total of banks' assets could not grow for long faster than 10% p.a. If their assets persisted in growing too quickly, banks would have to act to constrain the excessive growth. There are various possible courses of action. For example, banks might sell assets, e.g. Treasury bills, gilt-edged stock or local authority debt. Alternatively, banks could start to curtail the growth of their lending to the private sector, e.g. overdrafts. A bank knows better than anyone else the behaviour of its own assets. It is also best able to make forecasts about them. Aggregate data are already published monthly and could be published weekly. If bankers understand the monetary base method of control they should not have difficulty in adjusting reasonably smoothly to undesirable trends in the growth of their assets.

As far as discount houses are concerned, they too should be able to react reasonably smoothly if the new system is fully understood. The total of banks' reserves with the Bank of England could be published daily, if necessary. At times when the total is showing a persistent tendency to grow too fast, discount houses would have advance warning that the Bank might give them less "assistance" than they want sometime in the near future. In normal circumstances the Bank would continue to give whatever quantity of assistance the discount market wants, choosing only the method and the price, as it does at present. But if banks' reserves are growing too quickly, the Bank, and not the discount market, would decide on the quantity of assistance. After due warning, the Bank might give slightly less assistance than discount houses want. The houses would have to raise the missing funds by selling assets. They have a proven record of being able to do so. For example, between mid-July and mid-October 1975 the Treasury bill holdings of the non-bank private sector rose by more than £500m., most of which were sold by discount houses to financial institutions and industrial companies. Under the proposed system, the published data for bank reserves would give discount houses plenty of advanced warning of the need to run down their books.

(Under the proposed system, call money which banks place with discount houses would no longer qualify as a reserve asset and, therefore, discount houses would lose their present privileged position. However, the discount market would retain its historic role of buffer between the banks and the Bank of England, with the ebb and flow of funds into and out of the Exchequer passing through it. Further, discount houses would have the job of widening the market in those assets which at present qualify as reserves for banks.)

Penalties

As with the corset at present, penalties could be set out in advance for any bank whose reserve ratio fell below the minimum. The penalties should be trivial for an occasional offence but should be severe for persistent offenders.

Free reserves and precision of control

To protect itself from an unexpected fall in its reserves, each bank would want to keep a cushion of reserves slightly in excess of the minimum. A modest level of free reserves in the banking system would be desirable because it would help banks to react smoothly to day-to-day events which are unexpected. However, fluctuations in the aggregate level of these free reserves would upset the precision of the relationship between M0 and sterling M3. If the money supply were tending to grow excessively, control of M0 would not provide complete control of sterling M3 in the short run whilst free reserves were falling; afterwards the control mechanism would become tight. In the opposite case of monetary growth tending to be too sluggish, sterling M3 would respond slowly* to control of M0 if banks continued to build up free reserves. A measure which would help to stabilise free reserves would be for the Bank not to pay any interest on free reserves, i.e. on any reserves which exceed the mandatory minimum.

* Interest rates would fall more quickly than under the present system and this would help to avoid substantial downward momentum. A clear signal of monetary policy needing help from easier fiscal policy, e.g. tax cuts, would be sterling M3 continuing to grow too sluggishly in spite of adequate growth of M0.

Lifeboats

It is important to distinguish between the Bank's two roles of lender-of-last-resort. The first, giving "assistance" to the discount market, has already been mentioned. The second is lifeboat operations. There is no question of monetary base control preventing the Bank from organising a lifeboat when an individual bank has an asset deficiency or runs out of liquidity because other banks are reluctant to grant it credit. Any lifeboat would certainly have priority in the short run. Whilst one was being launched, the monetary base might exceed its target range. After the banking failure had been contained, the Bank would act to bring the monetary base back under control. (Another circumstance in which the Bank would modify its target for the monetary base would be a substantial exogenous shock to the system.)

The authors of the article in the Bank's Bulletin warn about one feature of monetary base control which could cause difficulties for banks, but only if it were allowed to occur. In the event of a sudden and unexpected reduction in the monetary base, banks would be able to restore their reserve ratios only by reducing their assets and liabilities by a multiple of the initial shortage of reserves. But such sharp reductions in the monetary base would not occur because the Bank would be controlling it.

Conclusion

Our proposed method of monetary base control has been discussed with various bankers and officials of discount houses; many of them appear to be attracted by the clear cut environment which it would provide. There appears to be a general desire to move away from the present system of doubt about whether the Bank will act or not - with bankers being kept on tenterhooks wondering if the Bank will supply a deficiency in the quantity of reserve assets before a banking make-up, discount houses being forced night after night to go to the Bank for huge quantities of assistance, and both having to indulge in transactions which manufacture reserve assets or destroy IBELs. Many people in the banking sector express a strong desire to be rid of the present highly artificial system and to be left to get on with practical banking.

2nd July, 1979

GTP
RLT
RR

W. Greenwell & Co.

Bow Bells House,
Bread Street, London EC4M 9EL

Telephone: 01-236 2040 Telex: 883006

W. Greenwell Associates (Investment Adviser) 450 Park Avenue, New York, N.Y. 10022
Telephone: 212 832 7428 Telex: 710 5815122

Econ. Pol
CF → Mr. Mr.
0- Pepper fish



MONETARY BULLETIN

No. 92 May 1979

Gilt-edged Tactics in a Bear Market

The Past

Our Special Bulletin on 2nd March contained two assertions. The first was that on average it has not paid long term investors to bargain hunt on a falling gilt-edged market. Instead, it has paid an investment manager to delay buying stock until he has felt reasonably sure that the market has turned upwards. In the equity market, in contrast, it is usually impossible to invest large sums of money after the market has turned upwards and is still reasonably close to the bottom. The reason for this difference is that the authorities have always (with the exception of January 1975) supplied a tap stock. In colloquial language, in the equity market the bears can't get back in, but in the gilt-edged market the Bank has allowed them to do so.

The second assertion was that it has not typically paid short term investors to buy gilt-edged stock when the market has been at, or just below, the level at which a tap stock is being supplied by the Government Broker (GB), unless the tap has been about to finish. The authorities have not raised their tap prices very rapidly and this has stopped the gilt-market from rising sharply. However, sharp falls can and have occurred. In other words, the upside potential has not balanced the downside risk. In colloquial language the risk/reward ratio has been wrong when the market has been up against a tap.

The evidence for these assertions is contained in the charts on the next few pages. We keep daily charts for the first six months of every issue. Chart I on page 2 shows an example of a tap stock in a rising market. In this chart, the lower of the two graphs shows the market price (inclusive of accrued interest) of 13 $\frac{1}{4}$ % Exchequer 1996; the upper one shows the price at which the GB sold this stock during the first half of the period when it was on tap; the numbers are our own estimates of size of sales.

The other chart (Chart II) on page 2 shows an example of a tap stock in a falling market. When there is more attempted selling than buying, the jobbers do not bid the GB for stock and so the market price of a tap stock falls below the last price at which the GB has supplied it. In practice, the GB does not lower a tap price continuously as the market falls but reduces it in one step when he considers the timing is appropriate. Chart II shows the behaviour of 10 $\frac{1}{4}$ % Exchequer 1995. It will be seen that the GB reduced his tap price twice (by 4 points on 9th February and by 4 $\frac{7}{8}$ points on 19th April 1978).

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

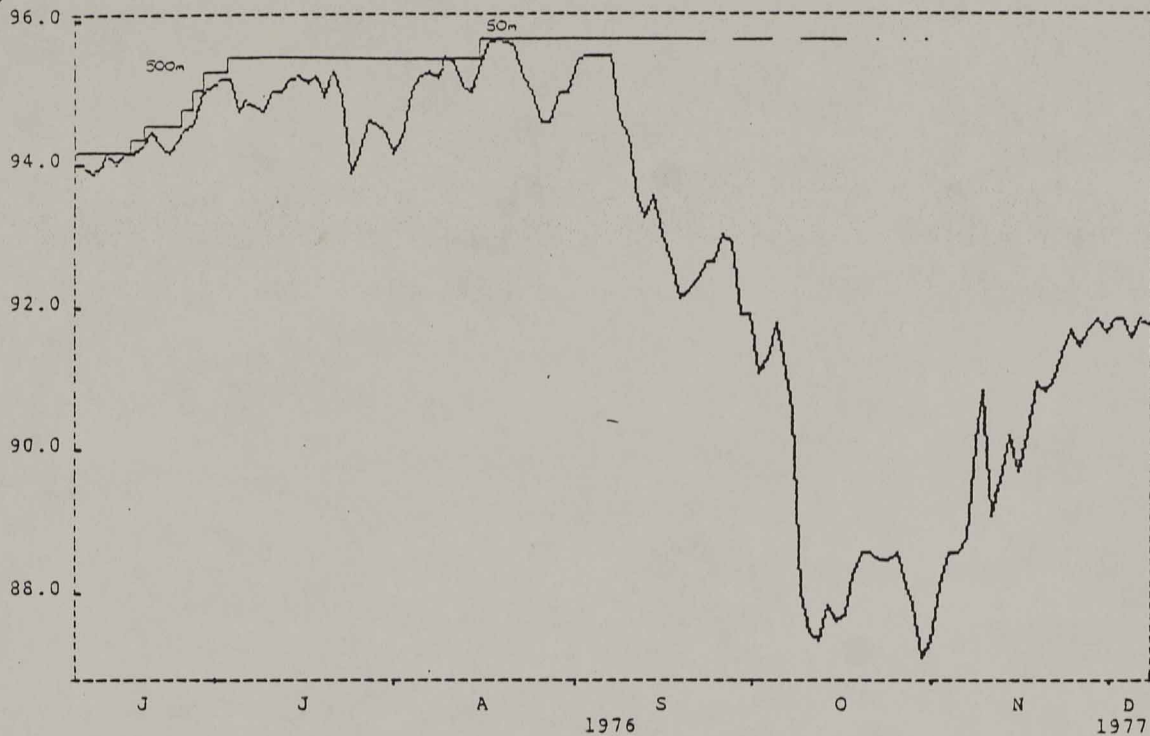
A. G. P. Davidson
P. D. Jones
R. L. Thomas
K. C. Brown
J. C. Finch
S. J. D. Posford
K. G. Sykes

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

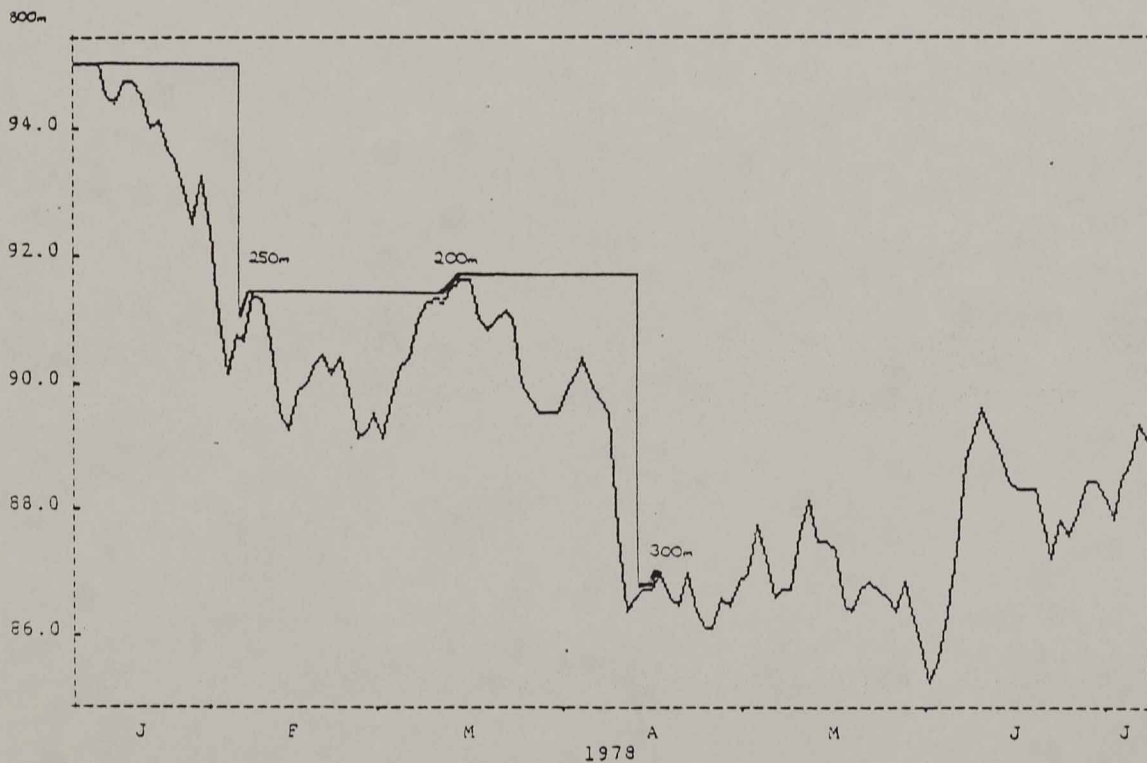
EXCHEQUER 13 1/4% 7/6/76 TO 8/12/76
1996

CHART I



EXCHEQUER 10 1/4% 1995 9/1/1978 TO 8/7/1978

CHART II



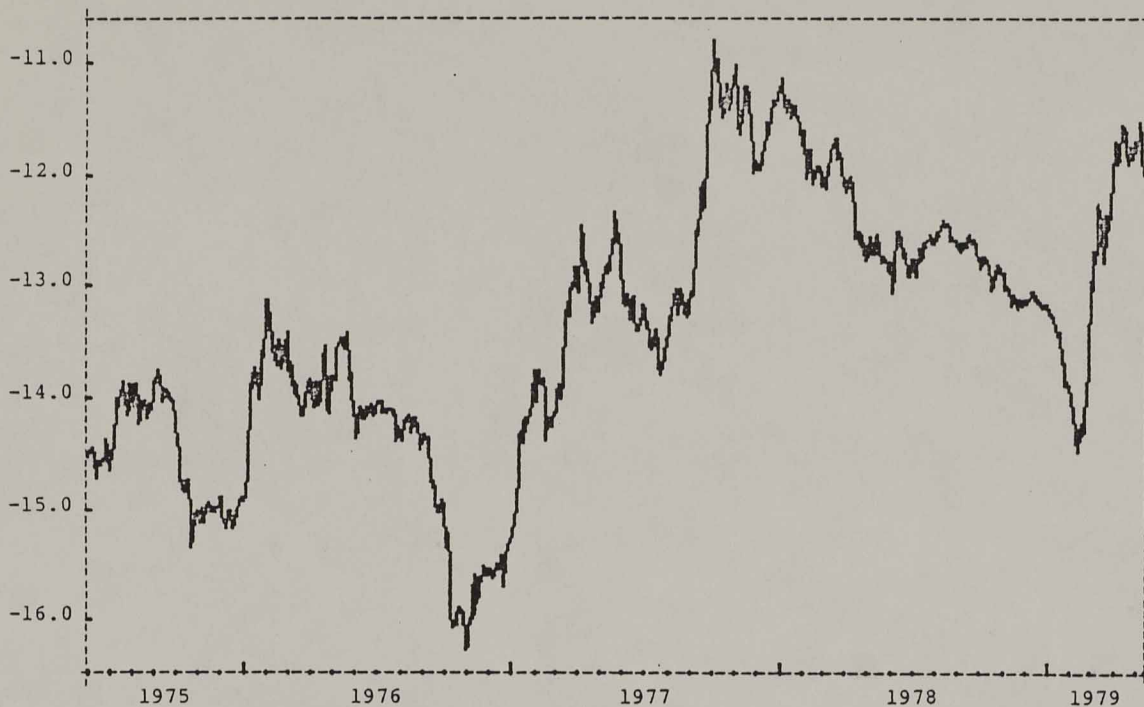


Chart III, above, shows the behaviour during the last four years of an index of long dated gilt-edged prices. It will be seen that during this period there were four troughs - late 1975, late 1976, the middle of 1977 and early in 1979.

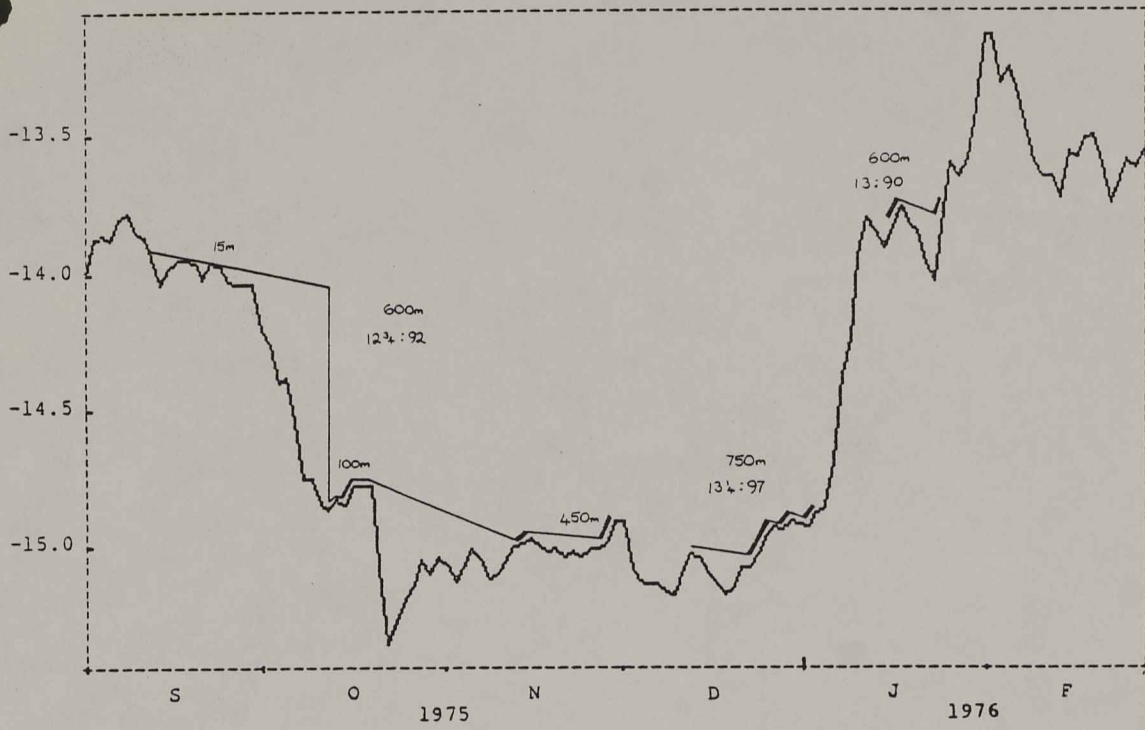
In Charts IV to VII on pages 4 & 5 the behaviour of the gilt-edged index around each trough is shown on a larger scale, together with the patterns from the charts of each tap stock. The result is an accurate indication of where the authorities sold stock during each trough. (The index excludes accrued interest, unlike the prices in Charts I & II; this is why periods of unchanged tap prices are shown as horizontal lines in Charts I & II but lines sloping downwards to the right in Charts IV to VII. The gradient of these lines varies because individual stocks do not behave exactly the same as the index, and because partly-paid issues accrue at different rates from fully-paid stocks. In some cases our estimates of the amount of stock sold at different dates do not add up to the total of an issue because official bodies, such as the National Insurance Fund, take up some stock.)

If Charts IV to VII are examined carefully it will be seen that the authorities have always supplied tap stocks after each trough and close to the bottom of the trough and, further, that on average it paid investors to purchase these taps rather than to bargain hunt as the market fell towards the bottom of a trough.

Charts IV to VII also provide evidence for the second assertion, i.e. about the unbalanced risk/reward ratio. The authorities have never raised their tap prices rapidly and by large amounts during the periods covered by these graphs. The same applied to the remainder of the four year period. (In fact, the most rapid increase in a tap price during the period was shown in Chart I.)

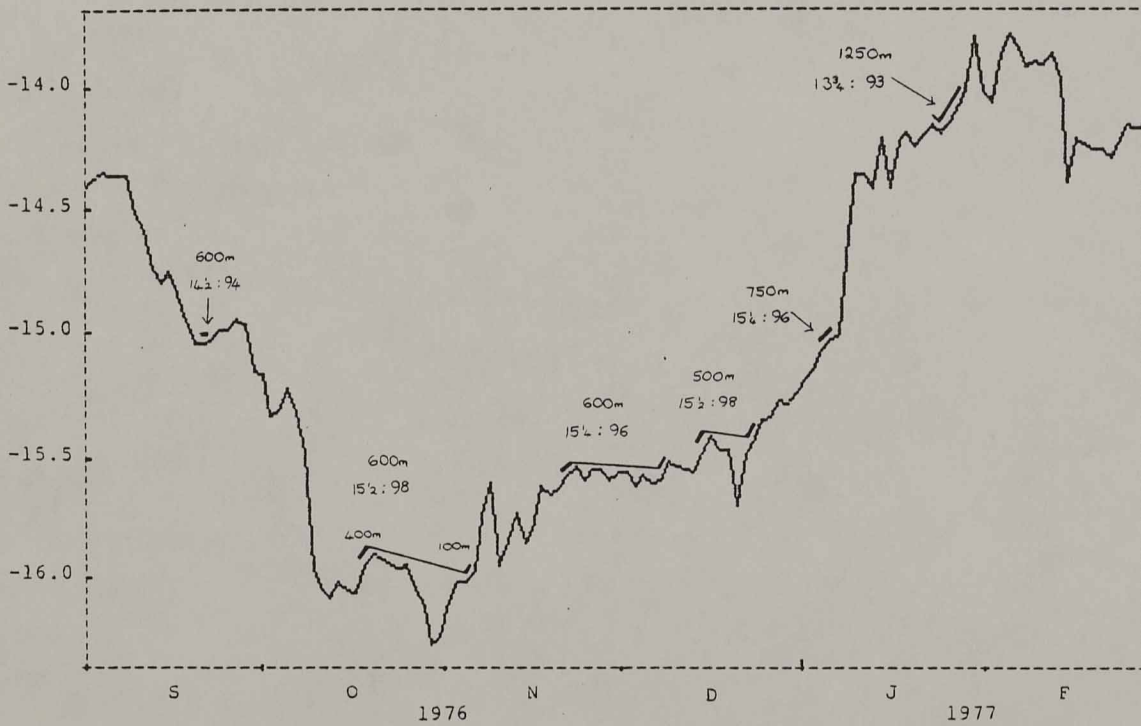
LONG DATED GILT EDGED 1/9/75 TO 28/2/76

CHART IV



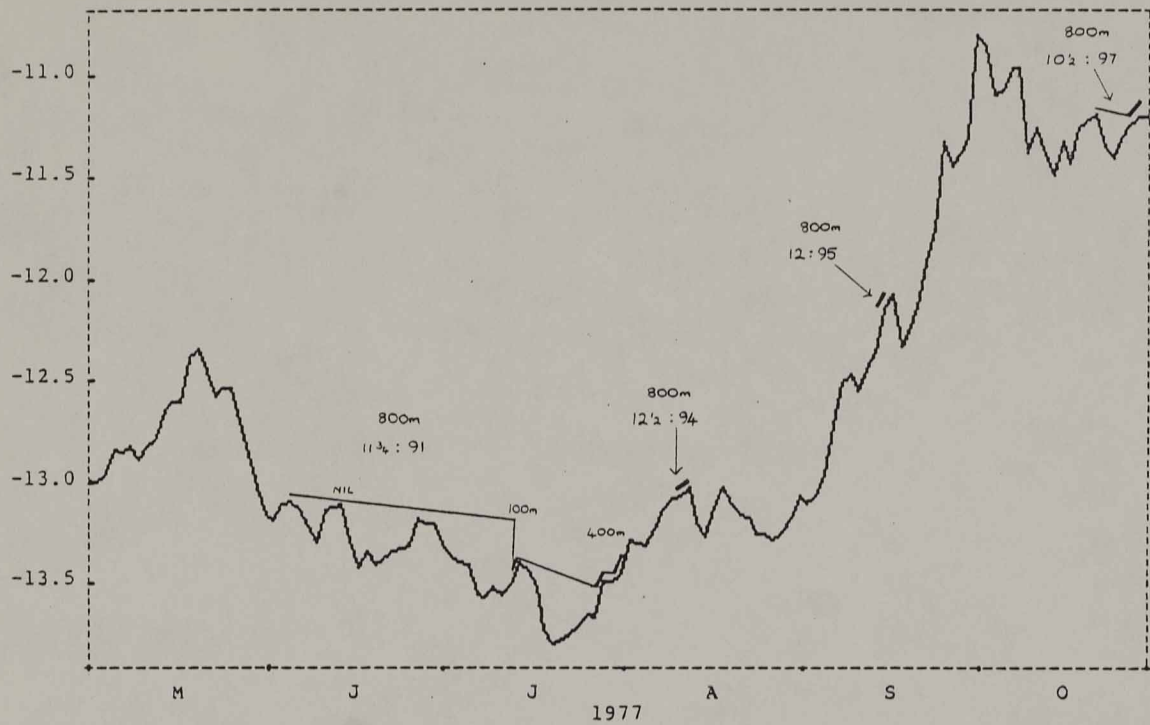
LONG DATED GILT EDGED 1/9/76 TO 28/2/77

CHART V



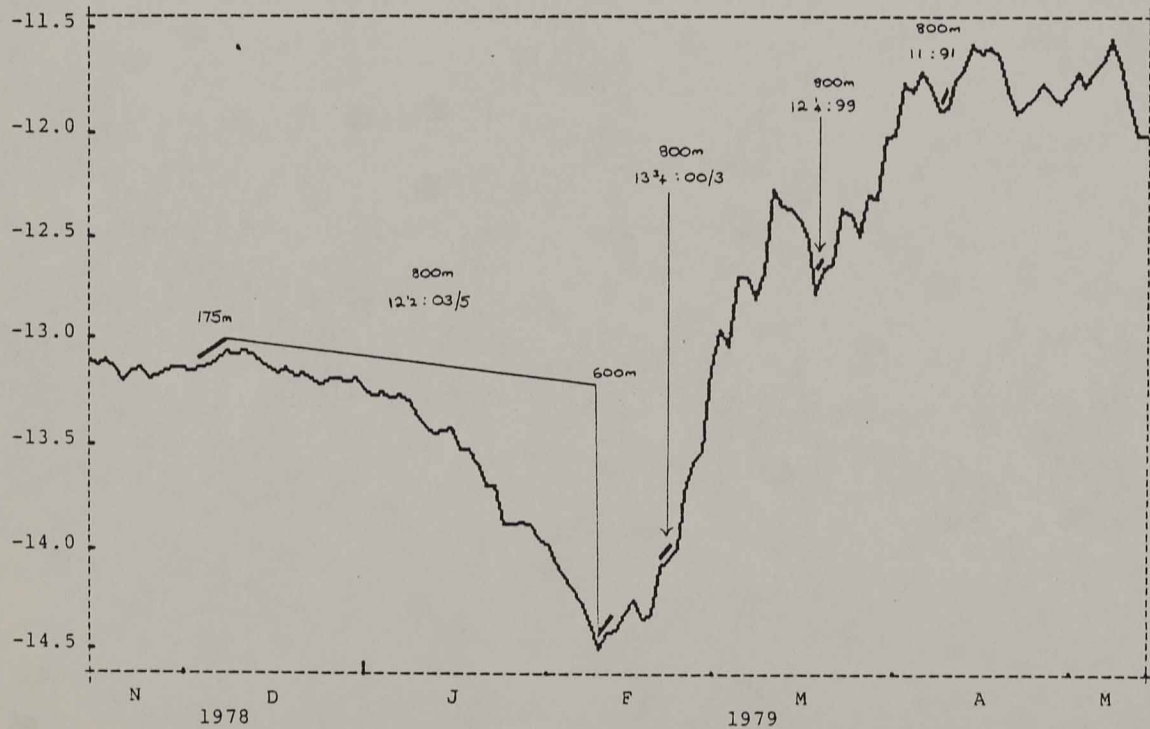
LONG DATED GILT EDGED 1/5/77 TO 30/10/77

CHART VI



LONG DATED GILT EDGED MARKET 15/11/78 TO 14/5/79

CHART VII



The Future

In the past, investors could rely on obtaining a new issue close to the bottom of the market so there was no hurry to buy stock when prices were falling. However, the position has been changing quite rapidly.

Gilt-edged stock used always to be issued by an offer for sale at a fixed price, the whole of which was payable on application. Being fully-paid, a huge amount of money had to be put up for an issue to be fully subscribed. This happened occasionally, but between June 1950 and September 1976 not one issue was oversubscribed; applications were always allotted in full. Investors used to think that there was only an extremely small risk of not obtaining as much of an issue as they wanted.

The first change occurred with the issue of 14½% Treasury 1994 on 24th September 1976. Although this issue was in fully-paid form it was oversubscribed about 1½ times and large applicants were allotted only about 60% of the amount for which they applied.

The second change was in March 1977 when for the first time a stock (12¼% Exchequer 1992) was issued in partly-paid form, only £15% being payable on application. Because less money is involved, a partly-paid issue can be oversubscribed much more easily than a fully-paid issue. Nevertheless, oversubscription was not a major problem for the well-informed investor who could gear-up his application when he knew it was occurring.

The third and most important change was the introduction on 22nd March 1979 of the partial tender method of issue, partial in the sense that the minimum price is the same as what the price would be if the issue were an offer for sale at a fixed price (a full tender issue would have a much lower minimum price). The authorities may still announce a new issue when gilt-edged prices are close to a cyclical trough but there is no guarantee that the striking price of the tender will not be considerably above the minimum price. Therefore, investors can no longer rely on being able to obtain a new issue at a price which is close to the bottom of the market.

There remains the second point about the risk/reward ratio being wrong when the market is up against a tap. The optimum tactic in the past was usually to purchase a tap stock as soon as it was thought that the GB's supply of stock might be exhausted, i.e. that a tap might run dry. The result has been an increasing scramble for the last of a tap and even the bulk of an issue being sold at 10 a.m. on the day that the tap ceases. Following the advent of tender issues, it is more important than it was before to obtain the desired amount of a tap stock which is about to expire. This raises the possibility of the GB being bid at some time in the future for a much greater amount of a tap stock than remains. If this happens, not only will investors obtain considerably less stock than they want but also the GB might raise his price substantially. With the precedent of tender issues established, the GB might price the last of a tap as if it were a tender.

Finally, during the last few years there have been various representations to the authorities to be bolder with their tap tactics and there is a possibility that the authorities will respond.

Conclusion

In the past it has often paid not to buy gilt-edged stock when prices are falling but to wait until prices have started to rise. The circumstances making this profitable have already changed considerably and are likely to alter further. Gilt-edged tactics in a bear market should be changed accordingly.

The latest monetary statistics

Two new items of information are available following our last Bulletin. Firstly, the seasonally adjusted figures for past months have been revised following the Bank's regular annual recalculation of seasonal adjustments to take account of new information. As a result the broad pattern reported in last month's Bulletin has changed as follows:

% p.a. seasonally adjusted	5 months		11 months	
	mid-Oct. to mid-Mar.		mid-Apr. to mid-Mar.	
	old series	revised series	old series	revised series
Notes & coin	16	17	17	18
Retail M1	12	10	15	15
Sterling M3	10	11½	9	11
M4	12	13½	11	12
M5	14	14½	12	13

It will be seen that the only reduction is for retail M1 in the five months between mid-October and mid-March (from 12% p.a. to 10% p.a.). All but one of the others have been revised upwards, so the general picture was more buoyant than we reported last month.

Secondly, the seasonally adjusted data for the latest month, i.e. the four weeks to 18th April, are as follows:

Notes & coin	£ 14m	(2% p.a.)
Retail M1	£ 484m	(26% p.a.)
Sterling M3	£ 741m	(18% p.a.)
M4	£1,047m	(24% p.a.)
M5	£1,400m	(18% p.a.)
DCE	£ 814m	
Bank lending in sterling to private sector	£ 519m	(16% p.a.)

There are two special factors worthy of comment. Firstly, and explaining some of the buoyancy of the aggregates, the central government borrowing requirement at £1,494m., seasonally adjusted, was exceptionally large, in part reflecting delays in government transactions resulting from the civil service industrial dispute. The dispute has also caused additional bank lending to the private sector, as some people have had to borrow because VAT has not been refunded. Further, cheques issued in payment of VAT have been held up, causing some additional increase in U.K. private sector sight deposits and sterling M3.

The second special factor works in the opposite direction. The authorities continued to intervene in the foreign exchange market in order to limit sterling's appreciation. Following £612m. in the month to mid-March, the public sector borrowed a further £500m. to finance external and foreign currency flows in the month to mid-April. So far, this has been more than offset by the growth of overseas sterling deposits and banks' net foreign currency deposits - the net effect of external & foreign currency finance has been to reduce sterling M3 by £154m., seasonally adjusted, in the last two months. However, in the coming months some of the inflow of funds from abroad can be expected to percolate through to the money supply.

Including the month to mid-April, the broad picture of monetary expansion is as follows:-

	<u>3 months</u>	<u>6 months</u>	<u>12 months</u>
Notes & coin	12%p.a.	14%p.a.	16%
Retail M1	17%p.a.	13%p.a.	16%
Sterling M3	7%p.a. <i>11</i>	13%p.a. <i>14</i>	11% <i>13</i> →
M4	12%p.a. <i>10</i>	15%p.a. <i>16</i>	13%
M5	13%p.a. <i>12</i>	15%p.a.	14%

In the Appendix we discuss how our series for M4 (and therefore M5) is distorted upwards somewhat by round tripping transactions into certificates of tax deposit. Nevertheless, sterling M3 is definitely giving a misleadingly low impression of monetary growth. The overall impression is of monetary growth just above the 12% upper limit of the target range.

G.T.P.
R.L.T.
R.R.

APPENDIX

Certificates of Tax Deposit, Soft Arbitraging & Round Tripping

The monetary data are sometimes distorted by various kinds of arbitrage transactions. Recent transactions involving certificates of tax deposit (CTD's) have become important. The term soft arbitraging is used when someone switches between two short-term assets, one of which is within a definition of the money supply while the other is not. Recently an important example of soft arbitrage has developed between bank deposits and CTD's. When holders switch from bank deposits to CTD's sterling M3 is reduced but M4 is unchanged. This is because CTD's are public sector debt and are excluded from sterling M3 but included in our definition of M4.

A second important type of arbitrage is round tripping. This can occur when someone borrows from a bank to invest in a financial asset. In the early 1970's people borrowed from banks at interest rates tied to Base Rate and invested in certificates of deposit and other bank deposits which received interest at market rates. Such transactions increased both M3 and bank lending to the private sector. Recent round tripping has been from market rate related bank borrowing into CTD's. This increases bank lending to the private sector, does not affect sterling M3 (which excludes CTD's) and increases M4 (which on our definition includes CTD's).

The Chart overleaf compares net sales of CTD's by banking month with soft arbitrage and round tripping possibilities since the month to mid-September 1978. The soft arbitrage graphs compare the yield obtainable on a CTD (if it is applied for the payment of tax) with three month, six month and one year LIBOR plus $\frac{1}{4}\%$ (on the assumption that a minimum improvement in yield is required to persuade a holder to switch into a CTD).

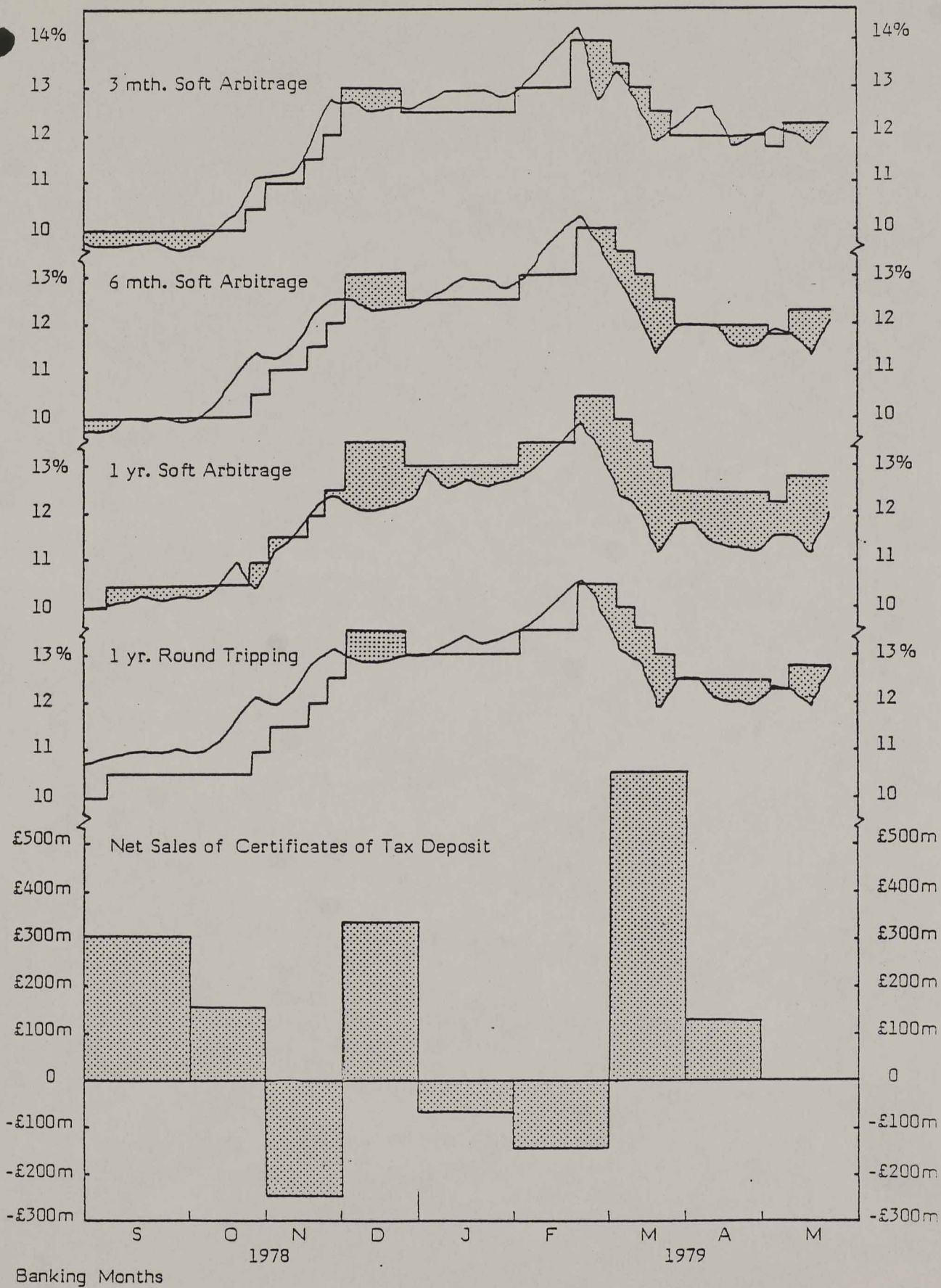
The round tripping graph compares the yield on a CTD if it is held for a year (and applied for the payment of tax) with one year LIBOR plus 1%. One year LIBOR is chosen because income tax (excluding PAYE), corporation tax (both mainstream and ACT) and petroleum revenue tax are the main taxes to which CTD's can be applied, and many of the holders of the CTD's which were issued in banking months to mid-March and mid-April probably intended to apply them for the payment of tax nine to twelve months later. The mark up of 1% over one year LIBOR has been chosen because prime borrowers probably pay $\frac{1}{2}\%$ over one year LIBOR and it is assumed that they require a profit of at least a $\frac{1}{2}\%$.

The dotted areas on the Chart overleaf show that in the months when round tripping was profitable soft arbitraging was also profitable. It is, therefore, difficult to isolate the extent of round tripping.

Two further factors make it difficult to quantify the distortions. The first tended to increase round tripping. When interest rates were falling rapidly earlier this year some companies probably bought CTD's, temporarily financing them by very short term borrowings. They hoped, quite correctly, that interest rates would fall further and that they would be able to refinance the CTD's a week or so later at significantly lower interest rates by fixed term bank loans.

A second special factor may have boosted sales of CTD's in the banking month to 18th April. Usually, a change in the interest rate payable on CTD's has been announced on a Friday to be effective the following Monday. But on Tuesday 17th April a reduction from $12\frac{1}{2}\%$ to $11\frac{3}{4}\%$ was announced which was not to take effect until Thursday 19th April. As a result sales of CTD's on 18th April would have been at $12\frac{1}{2}\%$. Some companies may have brought forward their purchases of CTD's into the banking month to mid-April.

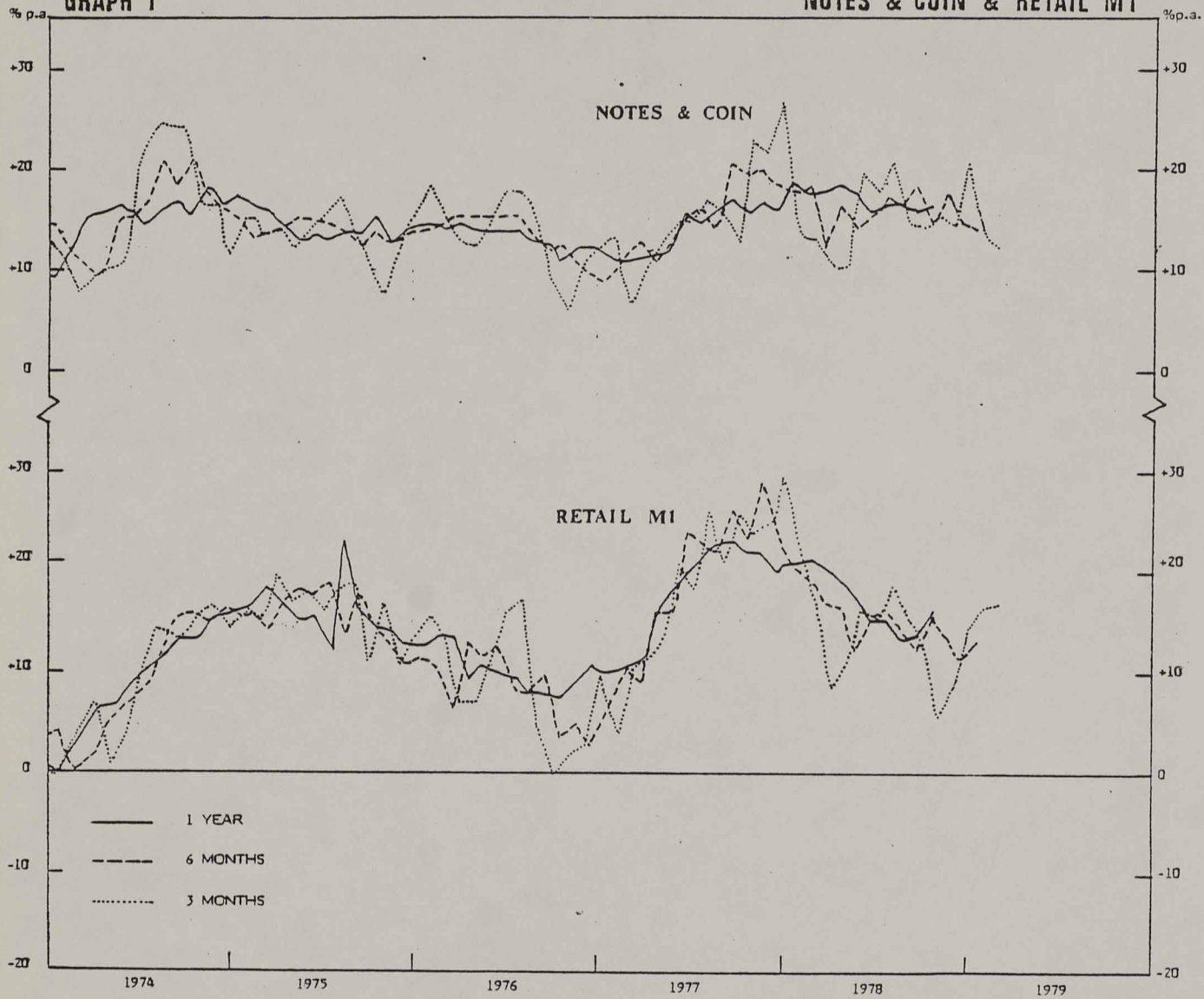
In conclusion, it is not possible to quantify the extent of distortions in recent months at all precisely. Bank lending to the private sector has been distorted upwards by round tripping. Sterling M3 has been distorted downwards by soft arbitraging but not affected by round tripping. M4 has been unaffected by soft arbitraging but has been distorted upwards by round tripping.



Banking Months

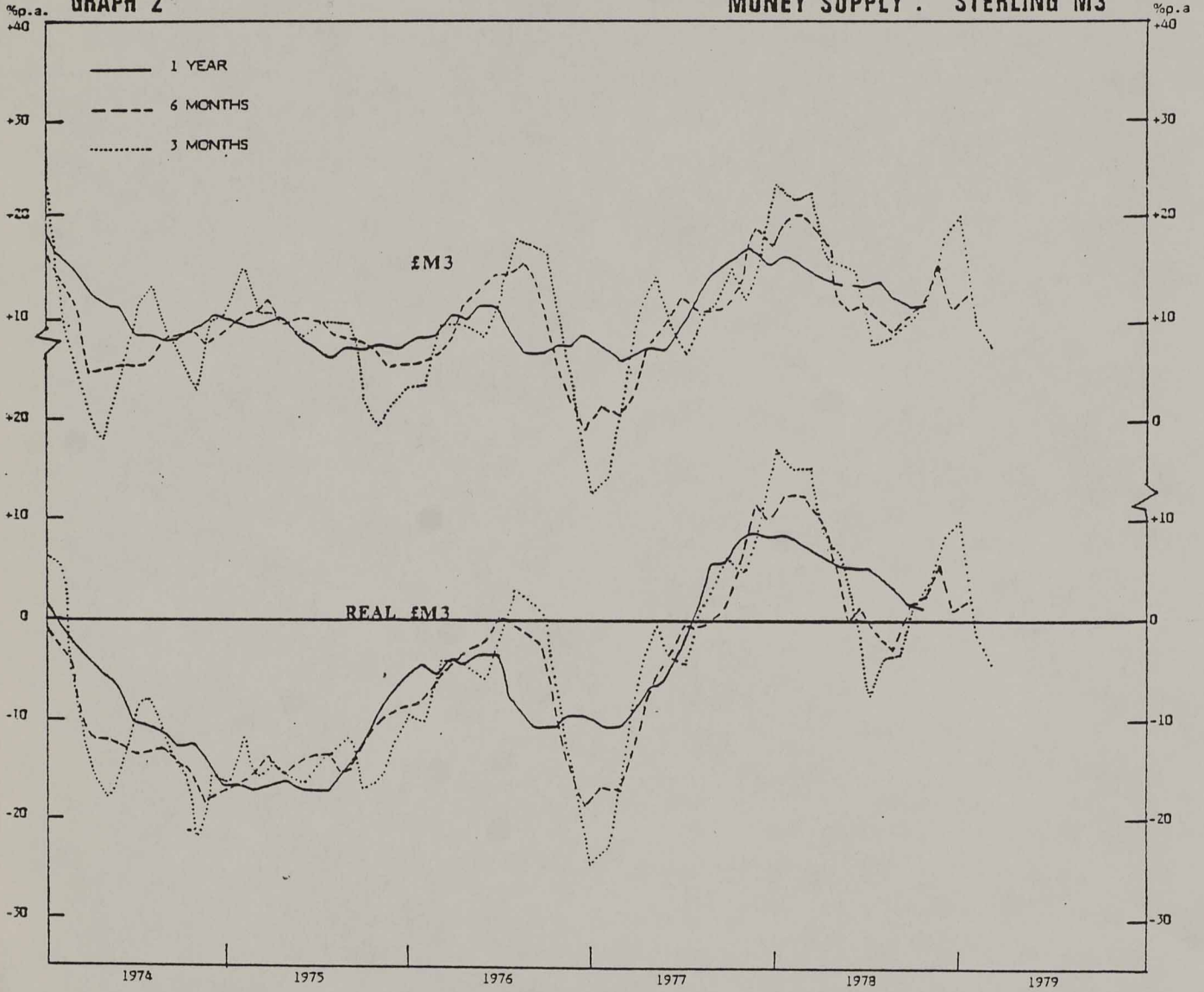
GRAPH 1

NOTES & COIN & RETAIL M1



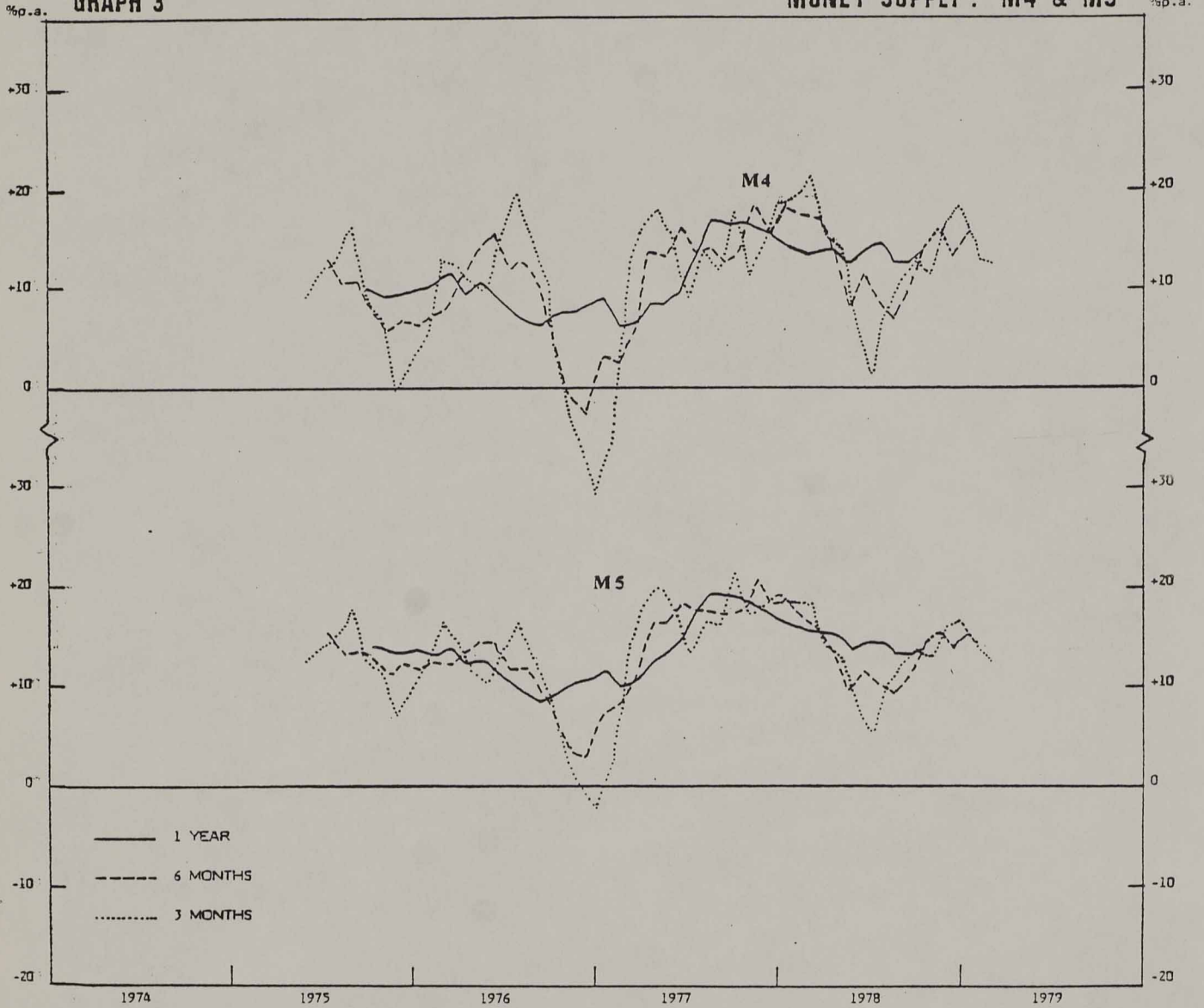
GRAPH 2

MONEY SUPPLY : STERLING M3



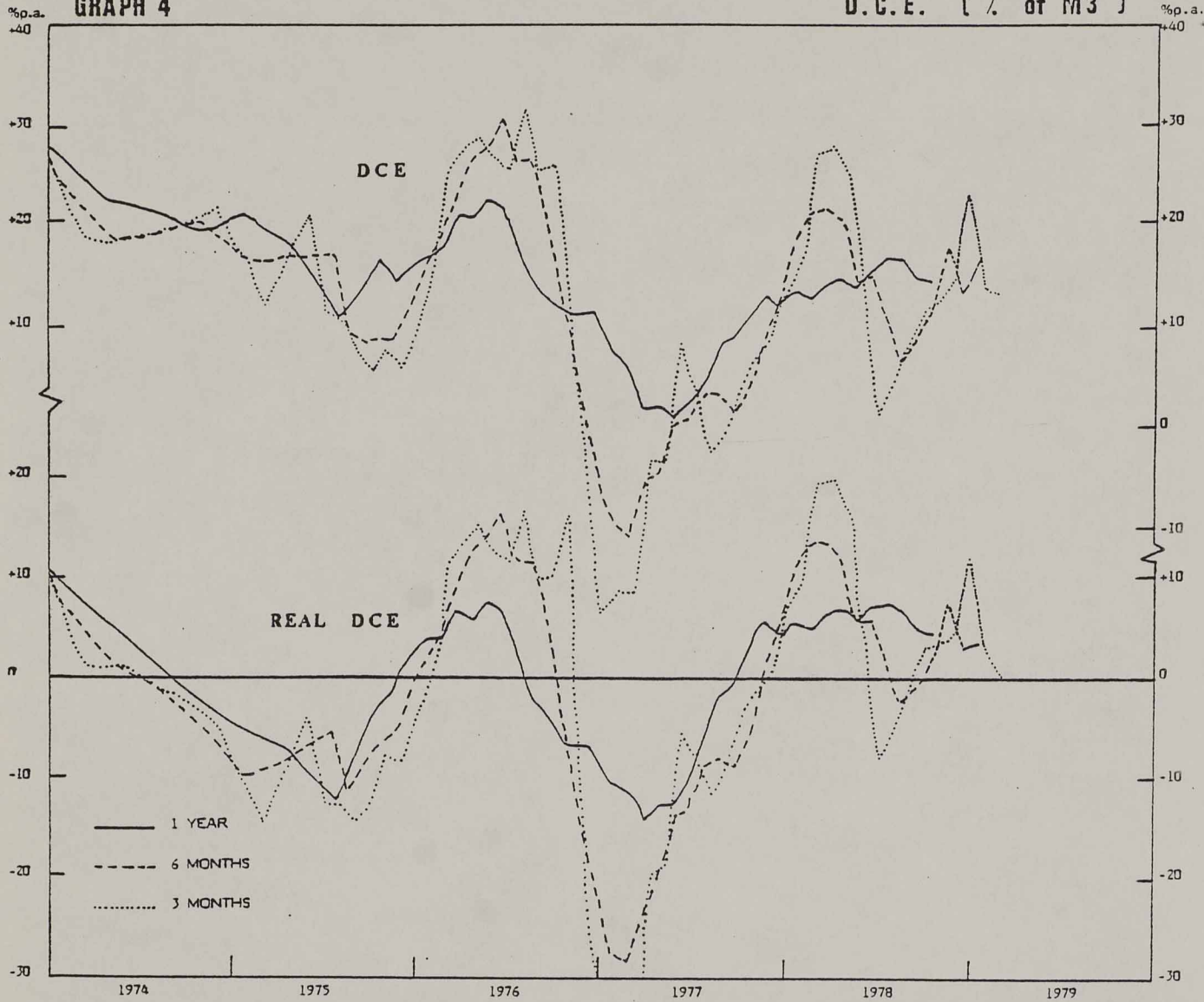
GRAPH 3

MONEY SUPPLY : M4 & M5



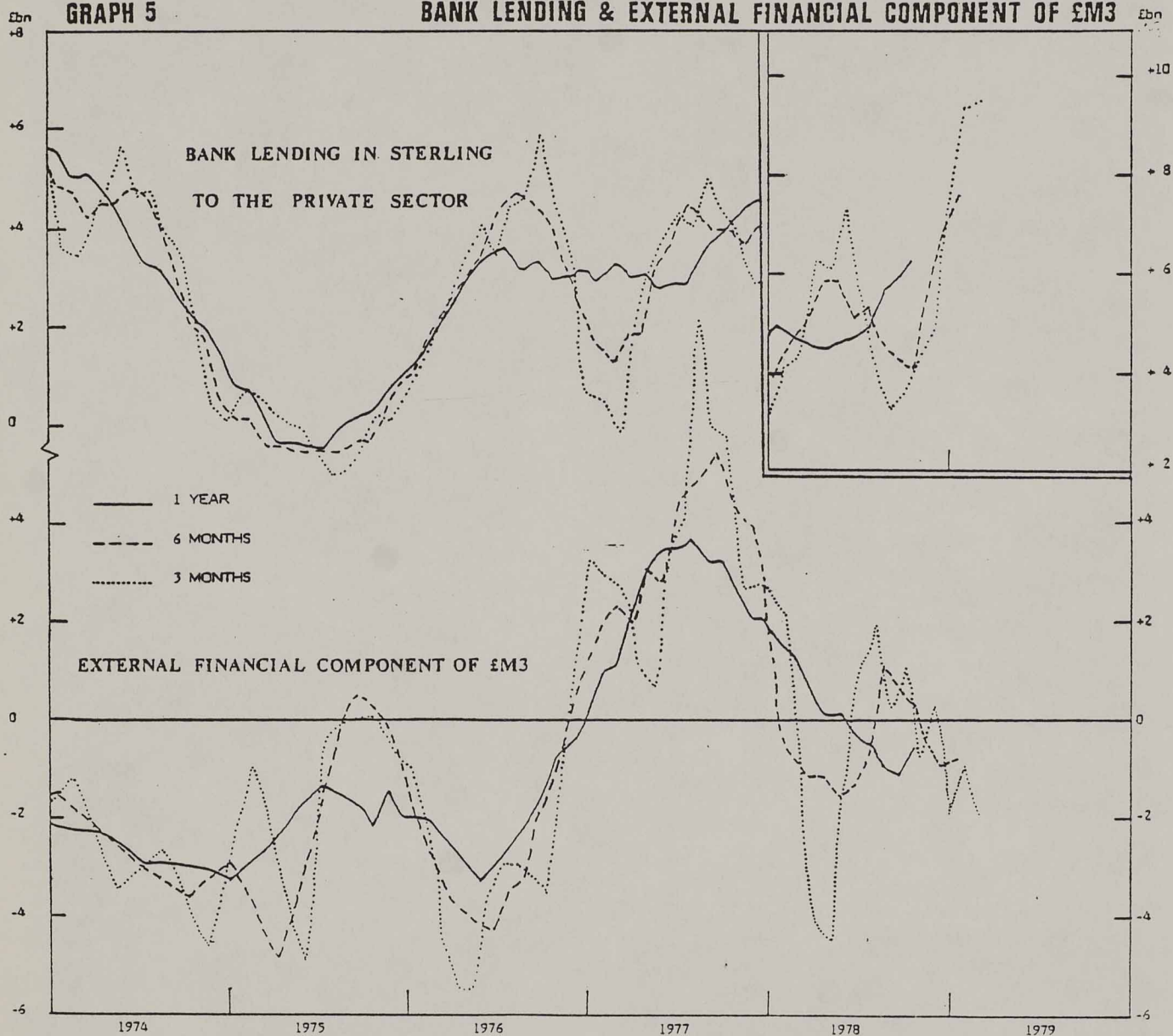
GRAPH 4

D.C.E. (% of M3)



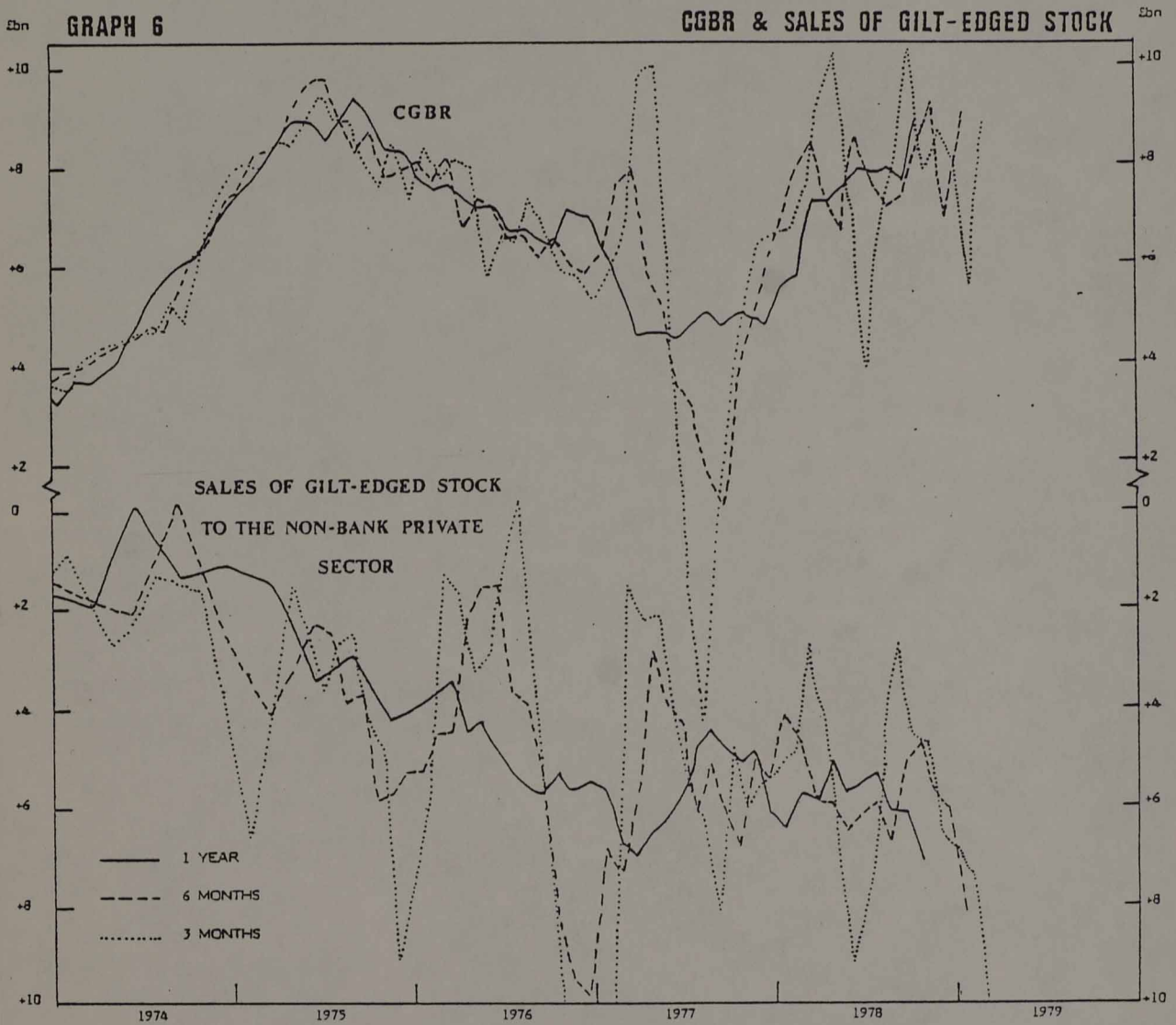
GRAPH 5

BANK LENDING & EXTERNAL FINANCIAL COMPONENT OF £M3



GRAPH 6

CGBR & SALES OF GILT-EDGED STOCK



STATISTICS

reprinted from Bank of England, *Banking Statistics*.

(Table 6 in the Quarterly Bulletin)

UK banking sector: transactions in liabilities and assets (a)

£ millions

Month ended	Liabilities												
	Total	Domestic deposits									Overseas deposits		Non-deposit liabilities (net) (b)
		Total		Public sector				Private sector			Sterling	Other currencies	
		Un-adjusted	Seasonally adjusted	Sterling (b)		Other currencies	Sterling		Other currencies				
		Un-adjusted	Seasonally adjusted		Un-adjusted		Seasonally adjusted						
1978 Apr. 19	+ 21	+ 2,126	+ 1,056	+ 196	+ 84	+ 46	+ 1,513	+ 555	+ 371	- 30	- 1,357	- 168	
May 17	+ 1,759	+ 540	+ 706	- 106	- 147	+ 10	+ 367	+ 574	+ 269	- 198	+ 1,393	+ 24	
June 21	+ 3,216	+ 263	+ 504	+ 230	+ 102	- 40	+ 192	+ 227	+ 215	- 1	+ 2,681	+ 273	
July 19	+ 1,413	+ 494	+ 445	- 22	+ 69	-	+ 385	+ 445	- 59	+ 77	+ 769	+ 73	
Aug. 16	+ 2,353	- 666	- 537	- 434	- 257	+ 10	+ 3	- 45	- 245	- 24	+ 3,024	+ 19	
Sept. 20	+ 2,441	+ 486	+ 357	+ 182	+ 119	- 26	+ 266	+ 200	+ 64	+ 121	+ 1,543	+ 189	
Oct. 18	+ 3,307	+ 641	+ 422	- 116	- 53	+ 12	+ 627	+ 345	+ 118	+ 9	+ 2,719	- 62	
Nov. 15	+ 4,411	+ 435	+ 521	+ 32	+ 49	- 8	+ 148	+ 217	+ 263	+ 10	+ 3,902	+ 64	
Dec. 13	+ 2,773	+ 565	+ 603	- 38	+ 8	- 4	+ 364	+ 663	+ 43	+ 84	+ 2,155	- 31	
1979 Jan. 17	+ 2,010	+ 441	+ 762	+ 85	- 83	+ 27	+ 547	+ 931	- 218	+ 187	+ 1,170	+ 212	
Feb. 21	+ 660	- 71	+ 507	+ 353	+ 231	- 4	- 599	+ 101	+ 179	- 11	+ 675	+ 67	
Mar. 21	+ 84	- 656	- 640	- 324	- 243	+ 38	- 117	- 182	- 253	+ 336	+ 461	- 57	
Apr. 18	+ 4,158	+ 1,509	+ 801	+ 42	+ 113	- 34	+ 1,393	+ 614	+ 108	+ 360	+ 2,159	+ 130	

Month ended	Assets										
	Total	Lending to public sector				Lending to private sector			Lending to overseas sector		
		Sterling		Other currencies	Total	Sterling		Other currencies	Sterling	Other currencies	
		Un-adjusted	Seasonally adjusted			Un-adjusted	Seasonally adjusted				
			Central government	Other							
1978 Apr. 19	+ 21	+ 322	- 42	+ 356	+ 466	- 111	+ 390	+ 296	+ 56	+ 135	- 1,271
May 17	+ 1,759	- 491	- 454	- 269	- 222	- 105	+ 551	+ 316	+ 278	+ 39	+ 1,487
June 21	+ 3,216	- 638	- 457	- 628	- 10	- 21	+ 642	+ 506	+ 232	+ 140	+ 2,361
July 19	+ 1,413	- 14	+ 240	+ 102	- 116	- 25	+ 791	+ 214	+ 114	- 21	+ 568
Aug. 16	+ 2,353	- 463	- 377	- 291	- 172	- 81	- 99	+ 375	+ 158	+ 28	+ 2,310
Sept. 20	+ 2,441	+ 518	+ 498	+ 509	+ 9	- 9	+ 149	+ 154	- 36	- 19	+ 1,338
Oct. 18	+ 3,307	+ 224	+ 96	+ 29	+ 195	+ 20	+ 412	+ 394	- 12	- 13	+ 2,676
Nov. 15	+ 4,411	+ 55	+ 9	+ 267	+ 212	+ 121	+ 264	+ 438	+ 166	- 117	+ 3,922
Dec. 13	+ 2,773	+ 431	+ 159	+ 370	+ 51	- 12	+ 37	+ 306	+ 137	+ 137	+ 2,043
1979 Jan. 17	+ 2,010	- 238	+ 520	- 475	+ 237	- 53	+ 1,217	- 496	- 44	+ 62	+ 1,066
Feb. 21	+ 660	- 744	- 5	- 758	+ 24	- 7	+ 326	+ 300	+ 27	- 138	+ 696
Mar. 21	+ 84	- 519	- 569	- 389	+ 370	- 72	+ 637	+ 970	+ 103	- 2	- 63
Apr. 18	+ 4,158	+ 1,395	+ 680	+ 1,096	+ 299	- 100	+ 623	+ 613	- 3	+ 32	+ 2,206

(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).

(b) Up to mid-April 1978 certain public sector funds placed temporarily with banking institutions through the inter-bank money market, which have been included here within public sector deposits, were excluded from the money stock. This has given rise to differences between this table and Tables 11.2 and 11.3 up to the month ended mid-May 1978. In Table 11.2 these amounts are excluded from column 6 and in Table 11.3 they have been treated as internal to the banking sector and included in column 11.

Money stock: amounts outstanding

(Table 11.1 in the Quarterly Bulletin)

£ millions

Month ended	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)	
	1	2	3	4	5	6			7	8		9	10
1978 Mar. 13	7,513	11,988	3,339	22,340	23,100	21,014	1,069	44,923	45,320	4,092	49,015	49,410	
Apr. 19	7,543	12,453	3,638	23,654	23,340	21,743	1,230	46,677	45,980	4,656	51,333	50,630	
May 17	7,593	12,509	3,656	23,858	23,690	22,056	1,184	47,098	46,530	5,014	52,112	51,550	
June 21	7,314	12,464	3,268	23,546	23,660	22,257	1,464	47,307	46,930	5,086	52,393	52,020	
July 19	8,186	12,752	3,371	24,309	24,210	22,491	1,442	48,242	47,600	4,911	53,153	52,520	
Aug. 16	8,130	13,112	3,202	24,444	24,370	22,303	1,008	47,755	47,390	4,496	52,251	51,890	
Sept. 20	8,160	13,184	3,237	24,581	24,620	22,462	1,190	48,233	47,880	4,523	52,761	52,410	
Oct. 18	8,184	13,556	3,319	25,059	24,860	22,635	1,074	48,768	48,270	4,643	53,411	52,970	
Nov. 15	8,238	13,583	3,258	25,099	24,910	22,817	1,106	49,022	48,620	4,952	53,974	53,570	
Dec. 13	8,642	13,906	3,500	26,088	25,500	22,316	1,068	49,972	49,370	4,978	54,950	54,240	
1979 Jan. 17	8,382	13,497	3,661	25,540	25,720	23,611	1,153	50,304	50,410	4,710	55,014	55,120	
Feb. 21	8,594	13,011	3,713	25,318	25,940	23,446	1,506	50,270	50,950	4,880	55,150	55,830	
Mar. 21	8,689	13,445	3,488	25,622	25,950	23,120	1,182	49,924	50,570	4,607	54,531	55,180	
Apr. 18	8,862	14,484	3,792	27,138	26,740	23,170	1,224	51,532	51,310	4,577	56,109	55,890	

(a) After deducting 60% of transit items (see additional notes to Table 6 of the Quarterly Bulletin).

(b) M₁ equals columns 1 + 2 + 3. Sterling M₃ equals M₁ + columns 5 + 6. M₃ equals sterling M₃ + 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*

Month ended (unadjusted)	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 (e)	Money stock Sterling M ₃ (c)	UK residents' deposits in other currencies (d)		Money stock M ₃ (c)			
	1	2	3	4					5	6		7	8	9
1978 Apr. 19	+ 30	+ 465	+ 319	+ 814	+ 729	+ 211	+ 1,754	+ 417	+ 147	+ 2,318				
May 17	+ 150	+ 56	- 2	+ 204	+ 313	- 96	+ 421	+ 279	+ 79	+ 779				
June 21	+ 121	- 45	- 388	- 312	+ 241	+ 280	+ 209	+ 175	- 103	+ 281				
July 19	+ 372	+ 288	+ 103	+ 763	+ 194	- 22	+ 935	- 69	- 106	+ 760				
Aug. 16	- 56	+ 360	- 169	+ 135	- 188	- 434	- 487	- 235	- 180	- 902				
Sept. 20	+ 30	+ 72	+ 35	+ 137	+ 159	+ 182	+ 478	+ 38	- 6	+ 510				
Oct. 18	+ 24	+ 372	+ 82	+ 478	+ 173	- 116	+ 535	+ 130	- 15	+ 650				
Nov. 15	+ 74	+ 27	- 61	+ 40	+ 182	+ 32	+ 254	+ 255	+ 54	+ 563				
Dec. 13	+ 424	+ 323	+ 242	+ 989	- 1	- 38	+ 950	+ 39	- 13	+ 976				
1979 Jan. 17	- 300	- 409	+ 161	- 548	+ 795	+ 85	+ 132	- 191	- 77	+ 64				
Feb. 21	+ 212	- 486	+ 52	- 222	- 165	+ 353	- 34	+ 175	- 5	+ 136				
Mar. 21	+ 95	+ 434	- 225	+ 304	- 325	- 324	- 346	+ 215	- 58	- 619				
Apr. 18	+ 173	+ 1,039	+ 304	+ 1,516	+ 50	+ 42	+ 1,608	+ 74	- 104	+ 1,578				
Month ended (seasonally adjusted)														
1978 Apr. 19	+ 16	- 98	+ 319	+ 237	+1.0	+ 334	+ 99	+ 670	+1.5	+ 417	+ 147	+ 1,234	+2.5	
May 17	+ 129	+ 237	- 2	+ 364	+1.6	+ 339	- 137	+ 566	+1.2	+ 279	+ 79	+ 924	+1.8	
June 21	+ 73	+ 287	- 388	- 28	-0.1	+ 328	+ 102	+ 402	+0.9	+ 175	- 103	+ 474	+0.9	
July 19	+ 156	+ 290	+ 103	+ 549	+2.3	+ 52	+ 69	+ 670	+1.4	- 69	- 106	+ 495	+1.0	
Aug. 16	+ 77	+ 342	- 169	+ 150	+0.6	- 118	- 257	- 225	-0.5	- 235	- 180	- 640	-1.2	
Sept. 20	+ 158	+ 56	+ 35	+ 249	+1.0	+ 109	+ 119	+ 477	+1.0	+ 38	- 6	+ 509	+1.0	
Oct. 18	+ 73	+ 30	+ 82	+ 235	+1.0	- 183	- 53	+ 365	+0.8	+ 130	- 15	+ 480	+0.9	
Nov. 15	+ 77	+ 28	- 61	+ 44	+0.2	+ 250	+ 49	+ 143	+0.7	+ 255	+ 54	+ 652	+1.2	
Dec. 13	+ 72	+ 371	+ 242	+ 585	+2.3	+ 150	+ 3	+ 743	+1.5	- 56	- 13	+ 664	+1.2	
1979 Jan. 17	+ 154	- 112	+ 161	+ 203	+0.8	+ 382	- 33	+ 1,002	+2.0	- 36	- 77	+ 839	+1.5	
Feb. 21	+ 198	- 28	+ 52	+ 222	+0.9	+ 77	+ 231	+ 530	+1.1	+ 175	- 5	+ 700	+1.3	
Mar. 21	+ 38	+ 193	- 225	+ 5	-	+ 150	+ 343	+ 387	+0.8	- 215	- 58	+ 660	+1.2	
Apr. 18	+ 14	+ 470	+ 304	+ 738	+3.0	+ 160	+ 113	+ 741	+1.5	+ 74	- 104	+ 711	+1.3	

(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) M₁ equals columns 1 + 2 + 3. Sterling M₃ equals M₁ + columns 5 + 6. M₃ equals sterling M₃ + columns 8 + 9.

(d) Including certificates of deposit.

(e) See footnote (c) on page 6.

(f) See additional notes to Tables 6 and 11 in the Quarterly Bulletin.

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

Month ended (unadjusted)	Public sector borrowing requirement (surplus -)		Purchases (-) of public sector debt by private sector (other than banks)		Sterling lending to the 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 -) (e)	Money stock sterling M ₃ (f)
	Central government borrowing requirement	Other public sector contribution	Other public sector debt	Central government deficit				Public sector	Overseas sterling deposits (c)	Banks' foreign currency deposits (net) (e)		
1978 Apr. 19	+ 1,399	+ 432	- 311	+ 388	+ 135	+ 2,043	- 666	+ 30	+ 114	+ 183	+ 1,754	
May 17	+ 1,235	- 341	- 515	+ 532	+ 39	+ 950	- 701	+ 198	- 12	- 14	+ 421	
June 21	+ 635	+ 251	- 1,168	+ 636	+ 140	+ 514	- 249	+ 1	+ 216	- 273	+ 209	
July 19	+ 244	+ 39	- 535	+ 1,006	+ 21	+ 655	+ 473	- 77	- 43	- 73	+ 935	
Aug. 16	+ 636	- 453	- 437	- 163	+ 28	- 389	- 201	+ 24	+ 98	- 19	- 487	
Sept. 20	+ 1,247	+ 47	- 746	+ 11	- 19	+ 540	+ 138	- 121	+ 110	- 189	+ 478	
Oct. 18	+ 293	+ 108	- 215	+ 414	- 13	+ 587	+ 60	- 9	- 165	+ 62	+ 535	
Nov. 15	+ 983	- 232	- 763	+ 279	- 117	+ 150	+ 126	- 10	+ 52	- 64	+ 254	
Dec. 13	+ 1,424	+ 327	- 653	+ 6	+ 137	+ 1,241	- 212	- 84	- 26	+ 31	+ 950	
1979 Jan. 17	- 547	+ 125	- 511	+ 1,215	+ 62	+ 344	+ 397	- 187	- 10	- 212	+ 332	
Feb. 21	- 31	+ 373	- 944	+ 1,125	- 138	+ 385	- 229	+ 11	- 134	- 67	- 34	
Mar. 21	+ 272	+ 270	- 1,369	+ 428	- 2	+ 401	+ 612	- 336	- 278	+ 57	- 146	
Apr. 18	+ 2,335	+ 246	- 1,419	+ 534	+ 32	+ 1,723	+ 500	- 360	- 130	- 130	+ 1,608	
Month ended (seasonally adjusted)												
1978 Apr. 19	+ 613	+ 274	- 270	+ 294	+ 135	+ 1,046	- 511			+ 135	+ 670	
May 17	+ 1,088	- 177	- 510	+ 797	+ 39	+ 1,237	- 546			- 125	+ 566	
June 21	+ 767	+ 303	- 1,193	+ 500	+ 140	+ 517	- 74			- 41	+ 402	
July 19	+ 243	+ 30	- 559	+ 429	+ 21	+ 122	+ 463			+ 85	+ 670	
Aug. 16	+ 390	- 469	- 450	+ 311	+ 28	- 190	+ 63			- 98	- 225	
Sept. 20	+ 1,420	- 24	- 734	+ 16	- 19	+ 659	+ 95			- 277	+ 477	
Oct. 18	+ 400	- 59	- 228	+ 396	- 13	+ 496	- 177			+ 46	+ 365	
Nov. 15	+ 926	- 196	- 779	+ 453	- 117	+ 287	+ 163			- 107	+ 343	
Dec. 13	+ 789	+ 400	- 709	+ 475	+ 137	+ 1,092	- 289			- 60	+ 743	
1979 Jan. 17	+ 583	+ 156	- 494	+ 494	+ 62	+ 801	+ 187			+ 14	+ 1,002	
Feb. 21	+ 719	+ 329	- 920	+ 1,099	- 138	+ 1,089	- 305			- 254	+ 530	
Mar. 21	- 7	+ 297	- 1,318	+ 761	- 2	- 259	- 108			- 10	- 387	
Apr. 18	+ 1,494	+ 146	- 1,377	+ 519	+ 32	+ 814	- 46			- 27	+ 741	

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

Month ended	Marketable debt		National savings		Tax instruments	Other	Total (column 4 above)	
	Stocks	Treasury bills	Unadjusted	Seasonally adjusted			Unadjusted	Seasonally adjusted
1978 Apr. 19	- 92	- 34	- 183	- 142	- 7	+ 5	- 311	- 270
May 17	- 488	+ 75	- 154	- 149	+ 60	- 8	- 515	- 510
June 21	- 1,163	+ 32	- 17	- 42	- 31	+ 11	- 1,168	- 1,193
July 19	- 629	+ 269	- 142	- 166	- 33	-	- 535	- 559
Aug. 16	- 417	+ 145	- 170	- 183	+ 5	-	- 437	- 450
Sept. 20	- 335	+ 40	- 140	- 128	- 301	- 10	- 746	- 734
Oct. 18	+ 37	+ 62	- 166	- 179	- 152	+ 4	- 215	- 228
Nov. 15	- 332	- 35	- 135	- 151	+ 250	- 11	- 763	- 779
Dec. 13	- 366	+ 87	- 23	- 79	- 334	- 17	- 653	- 709
1979 Jan. 17	- 411	- 38	- 66	- 49	+ 71	- 17	- 511	- 494
Feb. 21	- 924	+ 95	- 266	- 242	+ 148	+ 1	- 944	- 920
Mar. 21	- 510	- 80	- 131	- 30	- 653	+ 5	- 1,369	- 1,318
Apr. 18	- 1,026	- 114	- 145	- 103	- 124	- 10	- 1,419	- 1,377

[b] Bank lending in sterling to the 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 M₃ equals domestic credit expansion plus columns 8 + 9 + 10 + 11 (see also page 7).

Symbols and conventions

.. not available.

- nil or less than £1A 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 3AH.

CONFIDENTIAL



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

See
Minister to
to note
R271

2nd July 1979

cc Mr Holt
Econ Rd (June 79) 'Disposal of
Public Sector Assets'

Dear Tim,

DISPOSAL OF NEW TOWN ASSETS

In your letter of 18 May reporting the Prime Minister's conversation with Mr. Gordon Pepper, you mentioned, inter alia, Mr. Pepper's ideas for the disposal of new town industrial and commercial assets and the idea of a disposals organisation. This letter is simply to record that the point has certainly not been overlooked (we regard the monetary base idea as sub judice).

2. For 1979-80, the Secretary of State for the Environment offered £20 million towards the disposal of new town assets and this was taken into account in the Budget arithmetic. £20 million was thought to be the maximum that could be offered within the limitations of existing legislation, which permit the proceeds from the disposal of new town assets to be used only for the benefit of the new town which has disposed of them.

3. For the longer term, new town industrial and commercial assets will be dealt with by E(DL) Committee in the course of their survey of the prospects for disposal of public sector land and buildings. The question of new legislation will be covered in the same context, as will the case for a disposals organisation.

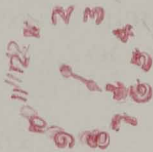
4. I am copying this letter to the recipients of yours.

Yours ever,
Mx
M. A. HALL

T. Lankester, Esq.,

CONFIDENTIAL

- 2 JUL 19 1979



CONFIDENTIAL



10 DOWNING STREET

From the Private Secretary

BC Mr. Wilson
CC DOE
D/I
CO

22 May 1979

Economic Policy VCB

Even Poi (June 79)
Disposal of public
Sector Assets?

Dear Tony.

I wrote to you on 18 May requesting that the possibility of selling off property owned by the new town development corporations should be looked at with a view to securing extra revenue for the Budget. I now enclose a paper which Mr. David Young, who has worked with the Centre for Policy Studies on this subject, has sent to us here at No. 10. I would be grateful if Mr. Young's paper could be considered as part of the general consideration of this question.

I also enclose a further paper by Mr. Young on the possibility of disposing of property owned by the English Industrial Estates Corporation.

I am sending a copy of this letter and enclosure to David Edmonds (Department of the Environment), Andrew Duguid (Department of Industry) and Martin Vile (Cabinet Office).

Im

evv.

Tim Lambert

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

CONFIDENTIAL

VCB



10 DOWNING STREET

MR. STOWE

I attach a note which you
might send to the Prime Minister
on Gordon Pepper - we discussed
on Friday.

21 May 1979

Mr. Lamberton
I spoke to
the P.M., who was
grateful for the
info. KAS
287.

PRIME MINISTER

cc. Mr. Wolfson
Mr. Ryder
Mr. James

I understand that you had a very general discussion with Gordon Pepper last week about the Budget prospects. I am not sure whether you intend to see him again before the Budget. But at the risk of appearing to say the obvious, may I put in a word of caution?

There are two points. The first, which is almost self-evident, is that - if you are to see Pepper again in the run-up to the Budget - you will need to take care not to divulge information which he could conceivably take advantage of as a stockbroker and investment adviser. Although Mr. Pepper has always been very discreet in his dealings with you, and however well-intentioned he may be, it might be difficult for him not to make use of certain information - even very indirectly. This applies not only to specific tax changes which the Chancellor may introduce, but also of course to the overall fiscal and monetary stance.

Second, you will need to avoid any impression that Mr. Pepper may be privy to the Government's thinking on the Budget. It is of course reasonably well known that he advised you in opposition, and I suspect there are those in the Press who, if given the chance, will exploit this to their own ends. If you do decide to see Mr. Pepper again before the Budget, we will ensure - just as with last Friday's visit - that this gets no publicity.

One way of keeping visits completely private is to ask the visitor in question to come through the Cabinet Office rather than the front door. If you wanted to see Gordon Pepper again before the Budget, we could ask him to come in that way.

21 May 1979

ENGLISH INDUSTRIAL ESTATES CORPORATION

1.0 Assumptions

- 1.1 The English Industrial Estates Corporation ("EIEC") has either created or owns some 35 million square feet of industrial accommodation of which some 90% is let.
- 1.2 All the leases granted are similar to the specimen lease handed to me.
- 1.3 The factories are situated in the North East and North West Regions with a number of projects in Devon and Cornwall.
- 1.4 The primary purpose of EIEC was and remains to create employment opportunities rather than industrial investments.
- 1.5 There is often a continuing obligation on EIEC to erect and finance extensions to existing factories and the retention of this facility is important for regional employment policy.
- 1.6 In adopting this programme, time is of the essence and therefore no new legislation should be contemplated.

2.0 Character of the Investments

2.1 Situation:

The investment criteria adopted by the institutional market place great emphasis on rental growth and to a lesser extent upon the age of the buildings. Past discussions with Investment Fund Managers lead me to the view that it would be difficult to sell these investments on the investment market.

2.2 Rent Reviews:

Although there are Rent Reviews in the Standard Lease:

- (a) The provisions (Clause 6) are unorthodox in that although they provide for the current annual market rental to be payable on review, it further provides that in the event of dispute the rent level will be assessed by the District Valuer. It is generally accepted that the District Valuer tends to operate on an historical basis and the end result of the negotiation and arbitration provisions under this Clause would provide a lower rental than the procedures more usually adopted. This factor alone would operate as a substantial deterrent to the investment market.

(b) In any event these provisions do not provide that any revision of rent is 'upwards only'. In these circumstances the District Valuer or arbitration proceedings could conceivably reduce the rent levels. This is an unorthodox provision (which may have been deliberately introduced for social or employment reasons) and which by itself would make these properties difficult if not impossible to dispose of for investment purposes.

2.3 In the light of all the above, my conclusions are that it would be impossible to dispose of individual holdings to the investment market.

3.0 Sale to the Occupier

3.1 Since the present intention is to enable the EIEC to sell its investments, the only remaining possibility is to sell to the occupier and there may be other reasons why occupiers should be given the first opportunity.

Much of what follows will depend on a detailed examination of individual holdings but this note seeks only to provide a procedural basis.

4.0 Incentives

4.1 In order to sell to an occupier, we shall have to:

- (a) provide an incentive to persuade the occupier to purchase;
- (b) provide a source of finance; and
- (c) ensure that the cost of financing the purchase will be kept as low as possible without introducing an element of subsidy. This is important in order to obtain full values for the properties.

5.0 Assessment of Selling Price

5.1 Without a detailed examination of the portfolio, it is difficult to give an estimate of the values involved but some general rules may be drawn.

5.2 As a result of the lack of growth in the area, normal industrial investment properties would sell on a ten to twelve per cent yield calculated on the rack rental value after allowing for the period to review.

5.3 Adopting this theoretical Investment Value as a general basis (which would ignore the deterrent in the character of the leases actually granted), we would arrive at a selling value of, say, nine times the current rack rental market value for individual properties. This should be above the historical cost for all factories built up to 1975 (and indeed could show a surplus) but there might be a shortfall for later buildings.

- 5.4 I do not know if there is a case for giving a discount to an occupier analagous to a sitting tenant of council houses. In the cases under review the occupier has protection under the Landlord and Tenant Acts but only for security of tenure and not for rental level.
- 5.5 If this formula were adopted, a general review of all rental levels would have to take place but presumably machinery exists for this purpose within EIEC if only to assess the present rental review patterns. If the District Valuer's office was used to assess these levels, then we might have to look again at the general formula.
- 5.6 The cost of servicing the mortgage would, under this formula, be little different from the current rack rental value payable by the tenant on a rent review. The tenant would have the advantage of Industrial Building Allowances which would enable him to make the capital element repayment under the mortgage.
- 5.7 I am not sure if any cash grants would arise under prevailing legislation but if so then the mortgage should be limited to the net cost of the factory to the purchaser.
- 6.0 Offer for Sale
- 6.1 EIEC should offer all its factories for immediate sale to the occupiers at a price as above.
- 6.2 As part of the offer for sale, it should offer full finance. It has been suggested that EIEC could offer its guarantee to the occupier's Bank but I do not believe this to be practicable since the amount of legal time and work involved will considerably impede the programme and introduce too many novel factors.
- 6.3 EIEC could offer a 100% mortgage at a highly competitive interest rate which should only cover its cost of finance (see 7.2 below) and the terms of the mortgage could be such that one-third of the capital could be repayable over a 15 year period. The interest rate should be fixed and the repayments calculated on a Building Society basis (i.e. a fixed monthly or quarterly payment consisting of a mixture of interest and capital, being largely weighted towards interest in the first year and capital in the last). The mortgage could have an option exercisable by the purchaser to renew for a further 15 years at the expiration of the mortgage.
- 6.4 A decision would have to be made as to whether these mortgages were assignable. If not, then they would become repayable in full on a sale of the property.

7.0 Method of Refinance

7.1 As soon as substantial sales had taken place, EIEC would find itself with no further property interest in the sold factories but holding a substantial quantity of 15 year mortgages. It should then seek to refinance these mortgages.

7.2 This could be accomplished by either of the following methods:

(a) It could offer to sell blocks of mortgages to the institutional market and as part of the package it could add its own guarantee. I am told that an EIEC guarantee is equivalent to a full Government guarantee and thus effectively we would be selling 15 year Government paper at an interest margin under 1% over LIBOR.

(b) Alternatively EIEC could sell a 15 year Debenture Stock secured on these mortgages. This would have the advantage of marketability and perhaps a fixed interest rate and should also result in a slightly lower coupon but as against this there would be the increased costs of creating the stock.

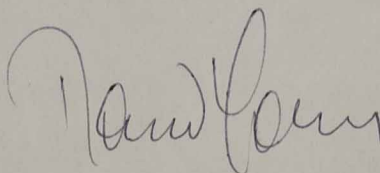
7.3 EIEC could continue to dispose of factories and either sell the mortgages from time to time or issue further tranches of stock.

7.4 The mortgages should contain an option to be renewed for a further 15 year term during which period further capital repayments amounting to one-third of the original advance would be made. EIEC could either re-sell the new mortgages to the institution or issue further tranches of Debenture Stock.

7.5 There would be no further obligations of finance at the end of the second period.

8.0 Future of EIEC

EIEC would continue to operate as an Industrial Development Agency and would also have the residual obligation to construct extensions to factories where this was provided for in the original leases. It would no longer have the obligations of property management but would still have to collect mortgage interest and repayments. If any purchasers fell into arrears and the mortgage was foreclosed, EIEC would have the obligation to re-sell the property.



May 1979

David I. Young

PROPERTY DISPOSALS

1. Introduction
2. U.K. Civil Estate
3. Investments
4. Value of the Portfolio
5. Problems of Disposals
6. Policy
7. Selection
8. Method of Disposals
9. Logistics
10. Proceeds of Realisations

1. In accordance with declared policy, one of the first steps of the new Administration will be to realise property assets now held by HMG in those instances where no substantive case can be made for retention.

Broadly speaking, these property assets fall into two categories:

1. Those properties occupied by various government departments and agencies (the U.K. Civil Estate); and
2. Those properties created by government agencies and not occupied principally by any department of HMG (Investments).

2.0 U.K. Civil Estate

As at the end of the financial year 1977/78, the U.K. Civil Estate managed by PSA comprised 10,700 holdings of which 6.8 million square metres were offices, 1.7 million square metres were storage, workshops and factories and 2.1 million square metres were specialised accommodations. About 48% of the space was freehold.

2.1

In London itself there is some 2 million square metres of Office accommodation of which about 30% is freehold and restrictions on public expenditure since the last war have ensured that the bulk of new accommodation has been leasehold at market rents with a 5/7 year review pattern. The declared policy is to increase the proportion of freehold property.

2.2

The balance of the Office accommodation is outside London and here over 40% is freehold. The long term aim is to increase the proportion of freehold property.

2.3

These are additional areas of government expenditure and whilst at first sight it may be thought preferable to occupy Freehold property than pay market rentals, the cost effectiveness of this decision is measured over decades and the short term effect can only be to increase expenditure. A reduction in the size of the establishment could take place by disposals of leasehold properties first but this whole area is outside the scope of this note.

3.0 Investments

Since the war, the Treasury has funded large scale development throughout the country, principally through the agency of New Town Development Corporations and latterly also through the English Estates Corporation and the Welsh Development Agency.

3.1

It is within this area that no logical argument can be made for the retention of completed investments particularly where in the earlier generations of New Towns the investments have been transferred to the New Towns Commission and continue to be funded by long term Treasury Loans.

4.0 Value of the Portfolio

4.1 Offices and Shops

At 31st December, 1977, the London Ring of the New Towns contained 4.7 million square feet of completed offices and over 2,500 shops containing 5.2 million square feet with approximately similar areas of offices and shops in the rest of England.

4.2 Industrial

At the same date the London Ring contained 32 million square feet of factories and warehouses with .6 million square feet under construction whilst in the rest of England there were nearly 35 million square feet completed with a further 4 million square feet under construction.

4.3 Values

4.3 (a) Shops and Offices

If we assume an average rack rental market value of £5 per square foot per annum for shops and offices in the London Ring and a capitalised rate of 14, the value of the investments is close to £700 million. The assumption of a rack rental market value of £3.50 per square foot per annum and a capitalised rate of 12.5 would add a further £400 million for those investments outside the London Ring. No account has been taken of investments held in Scotland, Wales or Northern Ireland.

4.3 (b) Factories and Warehouses

If we assume an average rack rental market value of £1.75 per square foot per annum for the London Ring and £1 elsewhere in England and a capitalised rate of 11, the value produced is in excess of £1000 million. In this instance, the investments in Scotland could add a further £200 million with a smaller addition for Wales. I do not consider that investments in Northern Ireland are disposable unless to occupiers.

4.3 (c)

Thus the gross value of the Investment Portfolio could be in excess of £2300 million but this could be reduced substantially as the information at my disposal does not reveal the amount of ground or building leases granted and this factor alone could have a substantial effect on values.

These preliminary estimates of value should be reduced by at least 30% to allow for this and marriage values (see 5.3 below).

4.4 Costs

It is difficult to identify the cost of these investments since the information available to me discloses only the Net Capital Advances to the New Towns as at 31st March, 1977, and these advances would of course include both housing and infra-structure costs. Of the total of £1.65 billion advanced at that date, the General Revenue deficit before tax was running at £44.7 million. The cumulative average rate of interest ranged from 5.05% per annum for the earliest New Towns and reached 13% per annum for some of the latest Towns.

4.5

A side benefit of any substantial disposals would be to bring the General Revenue account into surplus as a whole although there would be substantial variations with some of the later Towns still possibly running at a deficit.

5.0 Problems of Disposals

The problems involved in making substantial disposals are complex.

5.1

Undoubtedly the largest capital surpluses would be made on a disposal of the commercial and industrial assets of the first generation New Towns since not only would the current market rental value of the individual properties have appreciated substantially since construction but the whole areas are more mature and would excite greater institutional interest.

5.2

Generally speaking it would be difficult to dispose of the commercial and industrial assets in the latest New Towns since in many cases the infra-structure and development works still remain to be completed and these would invoke little institutional or other interest unless at yields which would make the realisations unattractive.

5.3

However the earlier generations of New Towns comprise investments which were created and originally let prior to 1965/66 and at this time it was common practice to grant leases with rents reviewed at intervals between 21 and 25 years. Indeed it may well be that some of the leases granted in the 'fifties may have had no reviews at all.

These investments excite little or no institutional support but they are by no means valueless. It would be necessary to renegotiate terms with the occupiers and to substitute a more modern rent review pattern after which they would become of interest. These are the so called "marriage value" negotiations and it has been current practice that the increase in value thrown up as a result of the rearrangement of the diverse property interests be shared in some way between landlord and tenant, the proportions being determined in individual cases by the relative value of these separate interests.

5.4

I have not dealt separately with the English Estates Corporation or the Welsh Development Agency as all the above remarks apply with the caveat that although the investments are unlikely to suffer from the disadvantages of a poor rent review pattern (since in the main they were created after 1966), they were often built for political reasons in areas of little demand and are therefore unlikely to be particularly attractive to an institutional investor.

6.0 Policy

In order to initiate disposals on a substantial scale, there are some matters of policy which would have to be determined.

6.1

Should occupiers have an automatic right to acquire the head interest or at least a right of first refusal?

6.2

If so, should this be restricted to occupiers of separate premises? For example, it is possible to make a case for an occupier of a Factory or the sole tenant of an Office building to acquire their superior interest but more difficult for the right also to be extended to the major tenant of an office or factory building where there are other occupiers sharing the same curtilage.

6.3

Whilst a case could be made to allow the tenant of a department store to acquire the headlease or freehold, should the same right be extended to occupiers of individual shops?

6.4

In any event, many of the possible sales outlined above would have to be subject to detailed "marriage value" negotiations.

7.0 Selection

Once the decision as to prior rights, if any, has been determined, we will then be left with the necessity of disposing of possibly the vast bulk of investments and here again these will fall into two distinct categories.

7.1 (a)

Those investments probably negotiated and let before 1966 where the rent review pattern is either non-existent or such that it will require renegotiation. These properties will have to be scheduled for sale in 1980/81 onwards but a start can be made at once on the negotiations for there may be some properties which can be sold immediately to the occupiers on terms which reflect "marriage values".

7.1 (b)

Those investments probably completed and let after 1965 in which the rent review pattern makes them of immediate interest to institutional and other investors.

7.2 Freehold or Leasehold

The decision will have to be made as to whether investments are to be sold Freehold or on a long Lease at a nominal ground rent.

7.3

It has long been accepted practice that the disposal of property on a long lease better promotes good Estate Management since restrictive covenants, obligations to maintain the structure, appearance of properties and any residual obligations to support and pay for common parts can better be enforced. If long leases are to be granted, then they should be for a period of at least 125 years since many of the major institutions refuse to invest in Leasehold properties of a shorter duration.

7.4

On the other hand disposals by way of the sale of the Freehold would parallel the sales of residential accommodation and would ultimately dispose of any residual obligations of the New Towns Commission.

7.5

At the present time the institutional market is very strong and such is the shortage of sound property investments that yields have been forced down to an historically low point. There is evidence that the income of the Pension Funds and Whole Life Insurance Funds are still increasing and all signs indicate a continually strong investment market. The disposal of substantial blocks of these assets would take the steam out of the present market and probably allow yields to increase slightly to a more normal level.

8.0 Method of Disposals

There are a number of accepted methods of disposal of completed investments:

8.1 Sale by Auction

The lead in time to arranging a Sale or a series of Sales by Public Auction is often great and measured in months rather than weeks. Brochures and Sale Particulars have to be prepared and reasonable time allowed to enable intending purchasers to make their enquiries and legal investigations. The Auction has to be advertised and there is always a danger that short term market fluctuations or political occurrences can diminish the Sale's potential on the day of sale as well as a slightly more remote possibility of purchasers combining. Whilst it is perfectly possible to arrange a short series of substantial Auctions, it would be more difficult to do this effectively on a larger scale.

8.2 Sale by Tender

There are in the main two types of Tender - Private and Public. A Private Tender is open only to a limited class or number of Purchasers whilst a Public Tender is advertised in a similar fashion to that of an Auction.

It may well be decided that as this is a disposal of public assets, the degree of selectivity involved in a Private Tender would render this course politically inadvisable. This is a policy decision.

8.3 Sale by Private Treaty

The easiest method to effect substantial sales of assets would be to enter into sales by way of Private Treaty. The difficulty of selecting an individual purchaser may well present political problems but this could be overcome by advertising the individual properties generally at agreed prices and accepting the first purchaser.

8.4 Property Bonds

There is one other more esoteric solution. Substantial blocks of property investments could be put together and sold directly to the public by way of a Property Bond or Property Unit Trust or a series of such Bonds or Unit Trusts. This would have the great advantage of dispersing ownership on the widest possible scale and may be a vehicle which would attract private as opposed to institutional investors. This is not a method which could be adopted quickly as the legalities and marketing involved would take some time to arrange and there would also be the residual problem of arranging for the management of the properties and the running of the Unit Trust or Bond. However, since the decline of the property companies, there have been few opportunities for members of the public to make small Real Estate investments and this could be seen as an attractive alternative. We should also have to consider the impact on the existing Property Bonds.

Payment could be effected through the agency of National Savings or the Giro and thus stimulate savings.

9.0 Logistics

The first task will be to review the portfolios of investments and to determine which are ready for immediate sale (see 7.1 b). My discussions with Sir John Cuckney lead me to believe that the necessary personnel and skills may not exist within the PSA and indeed may not exist within Government at all. I would suggest that we establish a Property Disposals Unit to which could be seconded such appropriate personnel as exist to enable this task to be undertaken.

9.1

I believe that it would be necessary to secure the help and advice of outside Estate Agents and a decision will have to be made as to the basis of their selection. Their skills and expertise will certainly be required in the negotiation of "marriage deals" and would probably be required if a series of Auctions or Sales by Tender were to be arranged.

9.2

The Property Disposals Unit would have the task of co-ordinating and supervising the activities of outside Estate Agents and work with, or be part of, the New Towns Commission.

9.3

A separate review body should be established to give independent and speedy confirmation of values and sale prices and whose authority should be obtained to agree Auction reserves, acceptances of Tenders and agreement of price levels for Sales by Private Tender.

10.0 Proceeds of Realisations

It is difficult to give an estimate as to the size of the programme on the rudimentary information I have to hand but I would not have thought it impossible to contemplate sales of £500 million for each of the first two years of the operations of this Unit. In my view there would be sufficient institutional and outside interest to support a programme of this scale.

April 1979

David I. Young



10 DOWNING STREET

From the Private Secretary

18 May 1979

copy on: Econ. Pol., May 79,
Monetary Policy

1 JS
cc DGE
Bgt
co

In the course of a conversation which the Prime Minister had this morning with Mr. Gordon Pepper, two points came up which the Prime Minister has asked me to pass on to the Treasury for consideration.

First, Mr. Pepper suggested that one important source of revenue in the coming Budget might be the sale of commercial property currently owned by the New Town Development Corporations. In his view, the institutions would readily take up the purchase of such properties, and it would also help dampen the current property boom. He went on to suggest that a Government company might be formed to take over commercial property from the Development Corporations, and this company would then sell it off to the institutions. The Prime Minister is aware that legislation would almost certainly be required for this, but she would like this idea looked into.

Second, Mr. Pepper referred to the possibility of moving to a monetary base method of controlling the money supply. In his view, this would be an important improvement on the present system. He said that the Bank had been studying this approach for some time and were planning an article for a forthcoming Bank of England bulletin. The Prime Minister has asked me to say that she hopes the Treasury will consider the studies which the Bank has undertaken urgently; and while she is fully conscious of the need for the Chancellor to concentrate primarily on the Budget in the next few weeks, she would like to have the Chancellor's views in due course on the possibility of moving to a monetary base method.

BF reviewed
on Monetary
file

I am sending a copy of this letter to David Edmonds (Department of the Environment), John Beverly (Bank of England) and Martin Vile (Cabinet Office).

TPH

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

Handwritten signature or initials in the bottom right corner.

NOTE FOR THE RECORD

cc Mr. Wolfson

✓ Mr. Ryder

✓ Mr. Hoskyn

The Prime Minister met Mr. Gordon Pepper here at No. 10 at 1030 this morning. Mr. Pepper had earlier sent the Prime Minister the attached note on the budget, and the discussion centred around it. The main points to emerge were as follows:

(i) The Prime Minister questioned Mr. Pepper's assessment that the Government could concentrate on getting the public sector balance right in year two, doing relatively little in year one. Sophisticated people might understand this approach, but there was a widespread expectation - and she thought this included many people in the City - of major action in the present financial year. But she well understood that this would require some very tough decisions - particularly on the public expenditure side.

(ii) Mr. Pepper said that he fully accepted the Prime Minister's approach provided it were politically feasible. The prospects as he saw them and the difficulties in making major public expenditure cuts this year made him doubtful whether it was possible to go quite as far in the first year as the Prime Minister was hoping for. The money supply was already growing well above the existing 8-12% target - the latest published figure for M3 showed growth at 12½% on an annual basis, but taking into account distortions in the system he thought the real figure was higher; and on a more narrow definition (M1) money supply was growing at nearer 16%. The money supply would continue to be under pressure in his view. Even without any indirect tax increases in the budget, the RPI would rise about 12% by the end of the year, and real growth in the economy was not slowing as fast as forecasters had anticipated. Hence, the growth of GDP in nominal terms would be higher than 12%, and higher still to the extent that it included indirect tax increases. Accordingly, the demand for money was likely to remain very buoyant. In addition, he was forecasting a substantial inflow across the exchanges from abroad (perhaps to the order of £1b over the next 12 months), and this was likely to fuel the money supply. Against this background, the City would be looking closely at the public sector financial deficit (as opposed to the PSBR); and therefore it was essential not to rely too much on sales of assets as a budgetary panacea. It was essential to get the growth of money supply down, and to achieve this the budget arithmetic must look right. To the extent

/ that it was

that it was not possible to get the PSBR and the PSFD down, it was all the more important that there should be a clear statement on the Government's intentions for cutting public expenditure in subsequent years.

(iii) There was some discussion of Mr. Pepper's view that it would be unwise to put more than 2% on the RPI in the budget (this effectively meant that indirect tax increases would have to be confined to VAT at 12½%, or some combination of a lower VAT increase and some increases in excise duties). Mr. Pepper said that this was essentially a political judgement: his own feeling was that anything more than 2% on the RPI would result in reopening the existing pay settlements and cause great difficulty in the next pay round.

(iv) Mr. Pepper pointed out that sales of assets, if they were to affect the money supply, would have to be to UK residents. Therefore, there should not be a repeat of the BP offer in New York. In addition, it was important to select assets which the City would have no difficulty in valuing. One idea which he would like to see considered was the sale of commercial properties currently owned by the new town development corporations. One or more property company could be formed to take over this property, and then sell it to the institutions. The institutions would readily take up property offered in this way, and it would help dampen the property boom. The Prime Minister asked that this be looked into, but pointed out that legislation would be needed.

(v) The Prime Minister asked Mr. Pepper about his ideas on the monetary base method of controlling the money supply. Mr. Pepper said that the bank had been studying this approach, but had been very slow to produce anything. They had planned to have an article on it in the June Bulletin, but this had been held up because of the election. The monetary base method was in his view a far better system than the present one, and he hoped it would be looked at quickly by the Treasury. The Prime Minister asked me to pursue this, though she also said that the Chancellor would be too busy to give it his full consideration until after the budget. She also expressed concern that, notwithstanding the possible merits of the monetary base method, the Government might be criticised for introducing sudden changes in the banking system. She remembered too well the introduction of Competition and Credit in 1971 and the aftermath.



10 DOWNING STREET

From the Private Secretary

16 May 1979

Many thanks for your note and your
paper on the Budget which I shall
ensure goes into the Prime Minister's
box this evening.

G.T. Pepper, Esq.

ABY

BOW BELLS HOUSE (6th FLOOR),
BREAD STREET, LONDON, EC4M 9EL
Telephone: 01-236 2040

Prime Minister 2
To see
AJ
Duty Clerk
16.5.

16th May, 1979

Miss Caroline Stephens,
10, Downing Street,
London S.W.1.

Dear Caroline

Having spent an hour or so with Mrs Thatcher before the last four Budgets, I have jotted down on paper some of the points I would be making if she had time to see me before this Budget and about which I feel strongly. I am also sending a copy to Adam Ridley. I am available for any comment until Monday afternoon; at present I am planning to spend the remainder of next week in the U.S.

Yours
Gordon.

G.T. Pepper

enc.

ASSESSING THE BUDGET

English Sickness

In order to have a realistic chance of curing English Sickness the new Conservative Government must act quickly and decisively, for at least four reasons:

- (i) Increasing benefits from North Sea oil provide some of the "give" needed to turn the vicious circle from which the U.K. has been suffering into a virtuous circle. The benefits from North Sea oil will increase rapidly for only a few years.
- (ii) Reducing inflation now has high priority. The lesson that rising inflation destroys employment has been learnt. Inflation is caused by too much money chasing too few goods. Reducing the supply of money is the technically easy part of the solution. Increasing the supply of goods is the more difficult part.
Action on the supply side of the economy must be taken quickly if there is to be a clear response before the next election. The real economy has many rigidities and, because of these, supply side measures will probably take at least three years to work. Therefore, such measures are urgent.
Cuts in direct taxation are an important supply side measure. Accordingly, significant cuts should be included in the coming budget and more substantial ones should be promised later.
- (iii) The longer the private sector of the economy is throttled, the less will be its powers of recuperation.
- (iv) Many people fear that the longer the new Government waits, the greater will be the chance that it will become overwhelmed with the problems of day-to-day government.

Public Expenditure (excluding financial items of a capital nature)

It is administratively very difficult to effect cuts in public expenditure quickly. For example, the private sector needs time to offer the services being withdrawn by the public sector. However, substantial cuts in public expenditure can certainly be achieved starting in 1980/1. Within four years it should definitely be possible to reduce public expenditure by at least 5% of GDP, but the decisions need to be taken in the next six months.

P.S.B.R.

The forecast for the PSBR in 1979/80 before the budget changes is now one of at least £10bn. This is some £2bn. higher than had been hoped. An important reason for the increase is public sector pay rising relative to private sector pay. Another reason is that, with the Budget in June, some three months of additional revenue from higher indirect taxation have been lost.

The PSBR in 1979/80 will be further increased if direct taxes are cut at once but public expenditure cannot be cut substantially until 1980/1.

The PSBR in 1979/80 can be reduced by only a small amount through higher indirect taxes without risking a big increase in inflation. Inflation is already rising from its current rate of 10% and will be increased further by the removal of subsidies and price restraints. If the retail price index is raised by more than 2% by increases in indirect taxes which are announced by the Budget, there will be a serious risk of wage settlements being reopened and of much higher inflation. In short, the budget must not increase the retail price index by more than 2% and even this may be too much. (Note - the higher inflation, the more difficult it will be to achieve the monetary targets and the less the room for real growth).

The second way of reducing the PSBR is by financial transactions of a capital nature - e.g. the sale of B.P. and less money for the National Enterprise Board. However, there is a serious danger that commentators will consider these financial transactions to be cosmetic.

Although the PSBR receives more publicity between budgets, most serious commentators, e.g. Samuel Brittan, concentrate on the PSFD when assessing the main budget. The PSFD includes the current account of the public sector and real capital spending, i.e. capital formation and stock building, but excludes capital transactions of a financial nature. Similarly, commentators such as Peter Jay and Wynne Godley have always adjusted public expenditure for financial items, e.g. the sale of B.P. in 1977, export & shipbuilding credits and investment grants.

Commentators are bound to pay considerable attention to a PSFD running at a substantially higher rate in 1979/80 than 1978/79. Given what happened in 1972 and 1973 during the last Conservative Government, reaction could be hostile if the underlying strategy is not clearly explained and justified.

A Solution

In the Budget we will be looking for guarantees of :-

- (i) really substantial reductions in public expenditure within two years
- and (ii) strict control of the money supply in the interim period.

Subject to being completely satisfied about these two factors, the PSBR/PSFD in the short run is of only minor importance. There is a short term cash flow problem which needs financing.

The Financing Problem

Labour has already issued too many long-dated fixed-rate gilt-edged stock. Therefore, other types of debt must also be sold. It is too dangerous to issue a lot of short-dated debt in the absence of a monetary base system of control, which probably cannot be introduced in time. Therefore, some equity type debt should be sold.

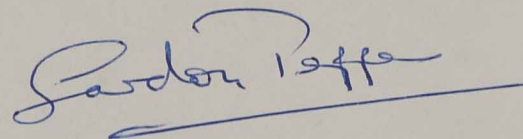
Sales of B.P. etc. are entirely appropriate in the circumstances (and accord with the philosophy of reducing the public sector). However, they must be sold to the non-bank private sector if the money supply is to be controlled. This is in contrast to 1977 when one of the objectives was to increase the U.K.'s foreign currency reserves and, therefore, half of the underwriting of the sale of B.P. at that time took place in New York. The London market will probably be capable of absorbing only part of B.P. in one go and at a realistic price. Publicly owned assets ought not to be sold at knock down prices (the Financial Times for one has promised criticism if this occurs). A substantial financing problem will probably remain. A solution of last resort would be a one-off issue of an index-linked gilt-edged stock. It might be the only way of getting the sums to add up in 1979/80.

The Guarantees

There remains the crucial question of the two guarantees. Is it possible to give them and, if so, how?

The Budget date of 12th June is too soon for the details of the cuts in public expenditure to be available. It is just possible that sufficient information about the outline of the cuts can be given which, together with a most categorical political commitment, would satisfy people. The other and less risky approach is to announce the cuts in direct taxation in the June Budget but not to legislate for them until the details of public expenditure have been worked out and announced in the late summer.

As far as a guarantee of strict monetary control is concerned, words (i.e. targets) will not be enough. The first rule of all watchers of Central Banks is to ignore what a Central Banker says but watch what the Bank does. During the latter part of Mr. Healey's Chancellorship, financial measures to control excessive monetary growth may have been delayed but when they were taken they were reasonably decisive, viz the increases in MLR to 12½% in November 1978 and 14% in February 1979. Sir Geoffrey may, unfortunately, have to demonstrate early on that he, too, is capable of tough action, i.e. that he is not a William Miller. An announcement that the Government is urgently investigating the possibility of moving to a monetary base method of control would also help. Further, the one-off issue of an index-linked gilt-edged stock would convince many people that the money supply will indeed be controlled.



Gordon Pepper
16th May, 1979

The American Problem

6
7
8
9
10
11
12
1
2
3
4
5

...the ... of ...

16 MAY 1979

...the ... of ...

The Question

...the ... of ...

...the ... of ...

...the ... of ...

[Handwritten signature]

...the ... of ...

