PREM 19/1199

PART II

SECRET

204

CONFIDENTIAL FILING

Domestic Monetary Policy

ECONOMIC POLICY

Pt I: May 1979

Pt II: November 1983

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
7.11.83		12.6.84					
25.11.83		19.6.84					
28.11.83		25.6.84					
12.12.83		6.7.84					
19.12.83		12/7/84					
23.12.83		16/7/84					
3.1.84		20.8.84					
9.1.84		14.8.84					
12/1/84		3.9.84					
19.1.84		13.9.84					
27.1.84		18.9.84					
6.2.84		20.9.84					
10.2.84		18.10.84					
16.2.84		25.10.84					
22.2.84		31/10/84					
MARCH 84		20/11/84					
11.4.84		22/11/84					
8/5/84		23/11/84					
16.5.84		26.11.84					
31.5.84							

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Bank of England Panel Of Academic Consulta
Monetary Trends in the United Kingdom.
Panel Paper No 22 Attached to this file

PART 11 ends:-

DW to AT 26/11/84

PART 12 begins:-

HMT to AT + attached 5/12

TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
CC(84) 38th Meeting, item 6	22/11/1984
CC(84) 33rd Meeting, item 6	18/10/1984
CC(84) 31st Meeting, item 4	20/09/1984
CC(84) 30th Meeting, item 5 Limited Circulation Annex	13/09/1984
CC(84) 30th Meeting, item 5	13/09/1984
CC(84) 26th Meeting, item 5	12/07/1984
CC(84) 18th Meeting, item 1	10/05/1984

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

Signed J. Gray Date 22/7/2013

PREM Records Team

Published Papers

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

Bank of England Panel of Academic Consultants – Monetary Trends in the United Kingdom: Panel Paper No 22, published by Bank of England 1983 - ISBN 0 903312 61 1

Organisation for Economic Co-operation and Development (OECD) – CES/83.59. The Longer-Term Challenges of OECD Economies: Challenges Facing Governments. Note by the Secretary-General 9 December 1983

Organisation for Economic Co-operation and Development (OECD) – SME/SAIR/SE/83.09. The Growth of Social Expenditure: Overview and Main Issues. Note by the Secretariat. 18 August 1983

Economics Progress Report No 172, October 1984. Published by the Treasury and printed by HMSO - ISSN 0262-5067

Bank of Scotland International Division – United Kingdom Taxation: offshore oil and gas. Fifth edition August 1984. Published by Bank of Scotland Oil and Energy Department

Lloyds Bank Economic Bulletin No 65, May 1984. Published by Lloyds Bank - ISSN 0261-0175

Signed J. Gray Date 22/7/2013

PREM Records Team

File

26 November 1984

MR TURNBULL

JOHNSON MATTHEY

The Chancellor commissioned a report from the Governor on the conduct of the Johnson Matthey affair, and in particular the apparent failure of their supervisory arrangements to spot trouble at an early stage. This report has now arrived at the Treasury, who regard it as grossly inadequate and do not therefore wish to show it to No.10 as it stands. There is even talk in the Treasury of taking bold steps such as putting a management consultant into the Bank's supervisory division, or hiving-off the Bank's supervisory operation - rather like the Registry of Friendly Societies.

The Chancellor is due to discuss the implications of the Johnson Matthey affair with the Governor tomorrow. After that, he should be in a position to report his views to the Prime Minister. So it might be worthwhile the Prime Minister enquiring further about Johnson Matthey at their next bilateral meeting.

David Willetts

DAVID WILLETTS

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E.R.

File

23 November 1984

MR TURNBULL

FUNDING

The meeting reported that:

1. National Savings are likely to hit the target of £3 billion this year. The Economic Secretary stressed that if a mistake was made, it should be over-funding and not under-funding.

2. There was a long discussion of possible new funding instruments in the index-linked National Savings field. It was agreed to carry on working on a new higher yielding index-linked instrument, and to consider a retirement type instrument where the capital would be fixed in nominal terms, but the income would be increased by inflation over its life.

3. Banking October was a satisfactory month gilt sales, with gross sales to the non-bank private sector estimated at nearly £1.5 billion.

4. It was agreed that some new stock may be necessary, with the possibility of a small package of tranchettes in banking December, and/or a new partly-paid stock

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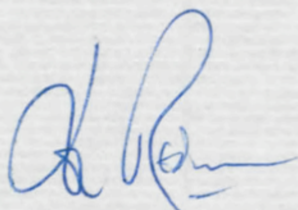
aiming to bring money in in January and February. There will also be the introduction of a new low coupon instrument.

5. The Economic Secretary urged that the forecast of more than 1 per cent growth in sterling M_3 in January was on the high side, and if possible more funding should be tied up.

Conclusion

No need to bother the Prime Minister: all seems to be proceeding well, and the market is performing satisfactorily.



JOHN REDWOOD

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10 DOWNING STREET

From the Private Secretary

20 November 1984

NATIONAL SAVINGS TERMS

The Prime Minister has seen your letter to me of 19 November and is content with the Economic Secretary's proposals for the reduction of national savings rates other than for the 29th NSC.

ANDREW TURNBULL

Adrian Ellis, Esq.,
Economic Secretary's Office,
H.M. Treasury.

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Prime Minister (1)

Content?

AT 19/11

CC/B1

Treasury Chambers, Parliament Street, SW1P 3AG

Yes mt

A Turnbill Esq
10 Downing Street
LONDON SW1

19 November 1984

Dear Andrew

NATIONAL SAVINGS TERMS

Following the recent reductions in mortgage and investment rates announced by the building societies, we have been considering the response we should make on National Savings.

The Economic Secretary intends to reduce National Savings rates to bring them into line with the new Building Society rates. This will entail reductions in the rates for the Income and Deposit Bonds (down to 12%), and for Invac (down to 11¼%). He intends to leave 29th NSC (offering 8% after 5 years) on sale since the movement by the societies has only now made this instrument competitive. The terms offered on matured Certificates ("common extension terms") will be reduce by ¼% to 8 ¼% in order to damp down possible large scale redemptions of the 19th NSC which matures in February and March. He does not, however, propose to change the rate offered on the Yearly Plan scheme. These rates will come into effect at various times across the next six weeks. We estimate that these changes should still enable National Savings to achieve its £3 billion target for 1984-85.

In our presentation we shall be indicating that we are merely responding to the building societies, bringing rates into balance, and that necessarily our rates have less far to fall than those of the societies since we did not follow them up to September.

The Economic Secretary would like to announce these rates, with which the Chancellor is content, on 20 November if possible.

Yours ever,

Adrian Ellis

A M ELLIS

OLO

From: W Gonzalez
Date: 31 October 1984

INLAND REVENUE
STATISTICS DIVISION
SOMERSET HOUSE

File

1. MR WALTON ✓ Note at end J.W.S.W. 31/10
2. MR ISAAC Note seen.
3. PRIME MINISTER

DISTRIBUTION OF PERSONAL WEALTH

1. You asked for briefing on the latest estimates of the distribution of wealth among the adult population published this week in Inland Revenue Statistics 1984.

2. The estimates cover both marketable wealth and this together with the present value of pension rights. (The tables are attached). They indicate that the long term trend towards greater equality was interrupted in 1981 and 1982 and this has caused some press comment.

3. There has been a gradual trend towards greater equality which is largely the result of increasing home ownership coupled with the accumulation of occupational and state pension rights in place of direct holdings of company shares. However changes from year to year take place because of differential movements in asset prices. Houses are predominantly held by people with moderate amounts of wealth whilst company securities tend to be held directly by the more wealthy. In the years immediately before 1980 house prices rose more rapidly than share prices, which reinforced the underlying trend towards greater equality. In 1981 and 1982 the price changes were

	Ordinary Shares %	Houses %
1981	+13.5	+5.5
1982	+11.1	+2.5

cc. Chancellor of the Exchequer
Financial Secretary
Mr Folger, Treasury
Mr G P Smith, Treasury
Mr D Ramprakash, CSO

Chairman
Mr Isaac
Mr Houghton
Mr Walton
Mr Gonzalez
Mr Morgan
Mr Brown
Mr Sullivan

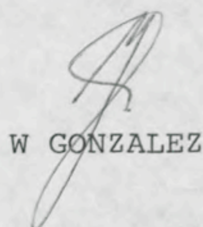
causing the movement towards greater equality to be interrupted. This no doubt over-simplifies a complex process but nevertheless represents a substantial effect.

4. There is no evidence that capital transfer tax has had any effect on recent changes in the distribution of wealth. Its yield has not exceeded 0.1 per cent of marketable wealth.

5. The levels of wealth at the different percentiles of the distribution are as follows:

	1982	
Percentage of adult population above the level shown	Marketable Wealth (Table 4.8)	Marketable wealth and occupational pension rights (Table D2: lower variant)
	£	£
1	110,000	115,000
2	75,000	80,000
5	45,000	50,000
10	28,000	32,000
25	12,500	17,500
50	3,000	7,000

6. I attach an annex dealing with press comment on changes in income distribution.



W GONZALEZ

If any reference is made to the recent change in the distribution of wealth indicated by the figures, the response could be on the following lines:-

> The distribution of wealth reflects the value of the assets held by different groups of wealth holders. The relative value of the assets changes from time to time and so does the distribution of wealth. These are simple market effects. For instance, the value of shares has recovered.

J.W.S.W
31/10

ANNEX

There are also references in a Guardian leader to changes between 1978-79 and 1981-82 in the distribution of income (taxable income plus non-taxable benefits). It quotes more or less correctly (but wrongly describes the top 1% as of taxpayers) information from the CSO article in the July issue of Economic Trends. In saying that the changes are part of a deliberate policy, the Guardian article cites reductions in income tax for those on high incomes. But the rise in the share of post tax incomes taken by the top 1% was no greater than the rise in the corresponding share of pre-tax incomes (0.7 percentage points in each case) though described by the Guardian article as "even greater". (The same is broadly true of the top 10% or top 20%; the rise in the share of pre-tax incomes at the top reflects mainly a shift in the distribution of earned income). The decline in the proportion of income taken by the bottom 50% is probably mainly a reflection of the increase in unemployment.

TABLE 4.8

Personal wealth

Distribution among the adult population of marketable wealth (Series C)
1966, 1971, 1976 and 1979-82

See notes on page 43

Percentages

		1966	1971	1976	1979	1980	1981	1982
Concentration of wealth among adult population								
Percentage of wealth owned by:								
Most wealthy 1 per cent of adult population		33	31	24	22	21	21	21
" " 2 " " " " "		42	39	32	28	28	28	28
" " 5 " " " " "		56	52	45	40	38	40	41
" " 10 " " " " "		69	65	60	54	51	53	56
" " 25 " " " " "		87	86	84	77	76	79	81
" " 50 " " " " "		97	97	95	95	95	96	96
Distribution of adult population by individual net wealth								
Percentage of adult population with								
Over (£)	Not over (£)							
	5,000	91	85	69	55	48	49	51
5,000	15,000	7	12	23	26	27	26	24
15,000	50,000	1.7	2.7	6.8	16	22	21	20
50,000	100,000	0.4	0.4	0.9	1.7	2.4	3.1	3.9
100,000			0.3	0.4	0.7	0.9	1.2	1.4
Total adult population - thousands		39,228	39,809	40,496	41,107	41,356	41,868	41,937
Gini coefficient (Series C)		81	80	76	69	69	72	74

TABLE 4.9

Personal wealth

Distribution among the adult population of marketable wealth including occupational and state pension rights (Series E) 1971, 1976 and 1979-82

See notes on page 43

Percentages

	1971	1976	1979	1980	1981	1982
Concentration of wealth among the adult population						
Percentage of wealth owned by:						
Most wealthy 1 per cent of adult population	21	14	13	12	12	11
" " 2 " " " " "	27	18	17	16	16	16
" " 5 " " " " "	37	27	25	24	24	24
" " 10 " " " " "	49	37	35	33	33	34
" " 25 " " " " "	69-72	58-61	56-59	55-58	56-59	56-59
" " 50 " " " " "	85-89	80-85	79-83	78-82	78-82	78-82
Total adult population - thousands	39,809	40,496	41,107	41,356	41,868	41,937
Gini coefficient (Series E) - lower variant	59	48	45	45	45	45
Gini coefficient (Series E) - upper variant	64	53	50	50	50	50

APPENDIX D2

Personal wealth

Distribution among the adult population of personal wealth including occupational pension rights (Series D) 1971, 1976 and 1979-82

See notes on page 44

Percentages

	1971	1976	1979	1980	1981	1982
Concentration of wealth among the adult population						
Percentage of wealth owned by:						
Most wealthy 1 per cent of adult population	27	21	19	17	17	17
" " 2 " " " " "	34	27	24	22	22	23
" " 5 " " " " "	46	40	34	33	33	34
" " 10 " " " " "	59	53	45	45	46	47
" " 25 " " " " "	78-83	75-81	70-74	68-72	69-73	71-75
" " 50 " " " " "	90-96	89-93	88-92	90-94	90-94	91-95
Total adult population - thousands	39,809	40,496	41,107	41,356	41,868	41,937
Gini coefficient (Series D) - lower variant	74	66	62	62	63	64
Gini coefficient (Series D) - upper variant	79	72	68	68	69	70

31 OCT 1984

THE RT HON DR DAVID OWEN MP

HOUSE OF COMMONS
LONDON SWIA OAA

Mr Turnbull (No 10) (IMMEDIATE)

CH/EXCHEQUER
REC. 23 OCT 1984
ACTION Mr Lankester
COPIES TO EST
Sir P. Middleton
Mr Cassell, Mr Hall,
Mr Ilett
Mr Ridley, Mr Lord,
Mr Portillo.

23 October 1984

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

Dear Nigel.

There are a number of unanswered questions about the Bank of England's decision 3 weeks ago to rescue from collapse Johnson Matthey Bankers (JMB) Ltd, a subsidiary of Johnson Matthey PLC. I recognise that the City of London needs the back-up system which the Bank of England provides, although in this case it is not clear if the Bank was aware that at least some City institutions did not believe that the gold bullion market, of which JMB Ltd is a member, was ever in danger. Nevertheless, a number of questions remain about the propriety of the Bank of England's behaviour and it is in the public interest that a full account of the Bank's role in the rescue of JMB Ltd be made by you as the person ultimately responsible for the Bank's conduct as soon as possible. I imagine you were consulted about the £10 million put up by the Bank as part of the overall deal.

The first question is why the Bank, after negotiating successfully a stand-by credit of loans and guarantees to protect depositors and preserve money market confidence in the short term, did not then proceed to wind down JMB Ltd and ensure a smooth transition to the liquidation of a failed company. Why was it necessary for the Bank itself to take-over JMB Ltd and all its subsidiaries? Such treatment has not been accorded to a number of other and much larger industrial and commercial companies which have also collapsed in recent years.

If one accepts that some of the problems incurred by JMB Ltd were because there was not sufficient money to be earned in the bullion business - owing to shrinking volumes and an excess of new competitors - and if the normal economic consequence of a reduced market is a falling number of companies in which some will go out of business, why was it right in this case to leave an uneconomic business in operation and subvert the usual market forces? All this has done is to create an artificial and now commercially supported JMB Ltd which the Bank seems to believe it can force the bullion market to accept as a 'new' member.

The most critical question, however, concerns the prospect of public money being called on in future. The scale of the losses at JMB Ltd

/2

is still uncertain, but most reliable estimates suggest a likely figure of £150 - £250 million. Although there is already some £170 million available to meet losses, the Bank itself is contributing £10 million to a £100 million safety net of guarantees being provided by a number of City banks, which can be called on as further losses are discovered. Furthermore, it is my understanding that these banks, in the initial deal with the Bank of England, agreed only to underpin any further shortfall in the JMB Ltd commercial loanbook, but have now been requested to guarantee a set of continuing businesses which have a high degree of exposure to potentially sizeable trading losses in future. Does the Bank believe that it can sell the commercial loanbook of JMB Ltd which it surely has an obligation to the indemnitors to first work off?

The Bank of England press notice for 12 October 1984 outlined the Bank's intentions towards JMB Ltd and its 14 subsidiaries very clearly: ie "... that the various businesses of Johnson Matthey Bankers Ltd should be continued and their strength developed to the point at which there can be a sale on a going concern basis into appropriate private sector hands." My impression is that the Bank does not have much grasp of the credit issues involved in these businesses and the evidence suggests that the prospects of future profitability for most of them are slim indeed. For instance, the ability to be a bullion dealer in current market conditions has a low value owing to the fact that the bullion business is at present depressed and for other participants very unprofitable. Is it the Bank's intention to stand behind all of the JMB Ltd subsidiaries in future, thereby exposing both indemnitor and taxpayer to the likely prospect of further trading and credit losses? And on whose authority has the Bank agreed to guarantee such losses should they occur?

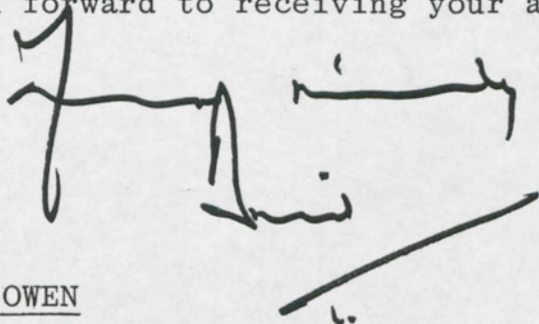
Finally, there are a set of questions concerning the role of the parent company, Johnson Matthey (JM) PLC. Did JM PLC give a guarantee of its subsidiary, JMB Ltd, and if so was that guarantee ever called by the Bank? Is one to assume that the £50 million injection by the parent company into JMB Ltd effectively bought off this liability of JM PLC's shareholders? The central question here is whether the "full and final discharge" of its liabilities, as given JM PLC by the Bank, was excessively broad and provided the parent company with unjustified relief - for example from the employment of JMB Ltd's staff, the pension fund of JMB Ltd, or certain tax obligations of JMB Ltd assured or guaranteed by JM PLC?

Although not directly comparable, the total cost to the Bank, and so indirectly to public funds (because its dividends to the Treasury were damaged) of the secondary banking crisis 10 years ago, was about £100 million. The danger is that the Bank's decision to try and 'turn around' the various businesses of JMB Ltd, operating in the difficult, risky, and at present depressed markets of commodities and precious metals, will inflict in the longer term a similar and potentially even larger toll on both the Exchequer and the taxpayer.

/3

The risk of public money being called on in this way is wholly unacceptable because it reflects a Bank of England policy decision which ignores the commercial and market realities confronting JMB Ltd.

I look forward to receiving your answers to the above questions.



DAVID OWEN

24 OCT 1984

CONFIDENTIAL

File

MR TURNBULL

23 October 1984

I attended the Funding Meeting yesterday: nothing of any importance.

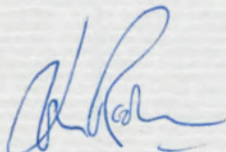
National Savings reported that it is too early to say how the 29th Issue at 8 per cent net will sell.

Money growth for September was disappointing, but October should be better. Mo and £M3 is within target range on a 6 and 12 month basis.

Indexed gilts had a flurry of popularity after a long period of disinterest in them.

The decision to cut oil prices, coupled with NACODS, has hit the gilt market quite hard, so yields are now more attractive again. Treasury and Bank have done a good job, not intervening or deliberately driving up short interest rates.

If the market becomes strong, they might sell a late 1990s medium/long (15 years). Much more likely, they will issue tranchettes against a background of the odd good day or two. They are proposing zero coupon stocks in principle. The Economic Secretary was warned of the presentational difficulty at a time when the IR are clamping down on bond washing.



JOHN REDWOOD

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SECRET (AND PERSONAL UNTIL 2.30 PM THURSDAY 18 OCTOBER 1984)

MONTHLY MONETARY REPORT: SEPTEMBER-DECEMBER

SUMMARY

The main points from this month's report are:-

- as expected MO grew by 1 per cent in banking September. Six, 12 and target period growth rates are still in the bottom of the range at around 5-5½ per cent. The year on year growth of M2 has been creeping up even after adjusting for reclassifications.

- the unexpectedly sharp rise in £M3 probably reflected some round tripping and misreporting. £M3 is now at the top of the target range but 6 and 12 month growth is still around 9 per cent. PSL2 continues to grow more rapidly.

- MO growth is forecast to remain around 5-5½ per cent. Broad monetary growth is also expected to be modest, especially in December, reflecting overfunding and the unwinding of this month's distortions.

- the forecast PSBR is low, in seasonally adjusted terms, only partly because of the BT sale. The gross gilt sales target is £1 billion for November and £½ billion for December. Funding through National Savings may total less than £½ billion but the £3 billion target still looks within reach.

- this month's large rise in bank lending to the private sector was probably erratic. But the reduction in public sector borrowing may lead to some strengthening in private sector loan demand compared with the summer.

- building societies' retail inflows recovered during the course of banking September. The better trend in retail inflows should be sustained, though the BT sale may divert some funds from the societies in December. New commitments suggest some slow-down in advances.

HF3 Division

October 1984

SECRET (AND PERSONAL UNTIL 2.30 PM THURSDAY 18 OCTOBER 1984)

MONTHLY MONETARY REPORT: SEPTEMBER-DECEMBER

Monetary Aggregates

1. The rise in the broad aggregates was much sharper than expected in banking September, even allowing for the shortfall in gross gilt sales. The figures were probably inflated by round tripping and misreporting. Annualised growth in £M3 is now right at the top of the target range, but six and twelve month growth rates remain around 9 per cent. (Three month growth is depressed by the freakishly high June base). Even faster growth in PSL2 was due to a rise in the non-bank private sector's holdings of bills as well as to a pick-up in building society inflows. The latter reflected heavy wholesale borrowing by the societies from the non bank private sector, and a recovery in the societies' retail inflows in the second half of the banking month.

2. There is no reason to suppose that the growth of the narrow aggregates was distorted. As expected, MO grew by 1 per cent, following two very low months; six, twelve and target period growth rates have been in the bottom half of the target range since early spring and are still around 5-5½ per cent. A fall in retail bank deposits kept M2 growth at a modest 0.3 per cent despite the growth in notes and coins and building society retail deposits.

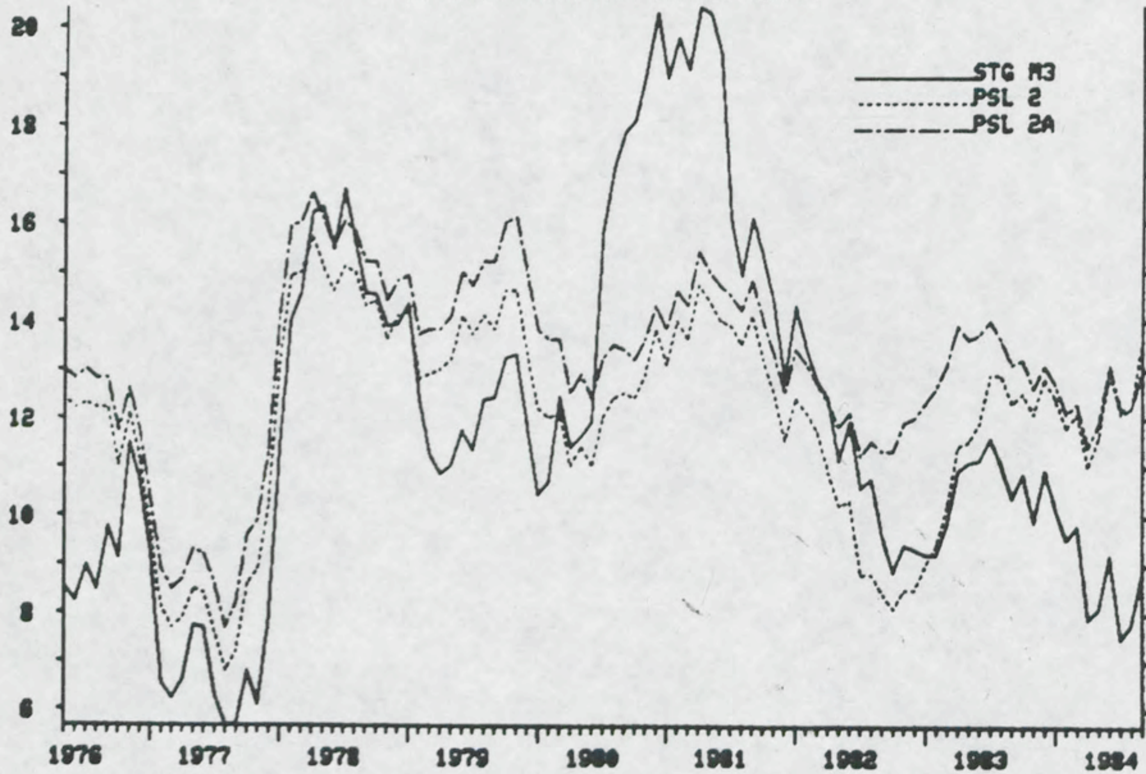
TABLE 1 MAIN AGGREGATES : RECENT EXPERIENCE

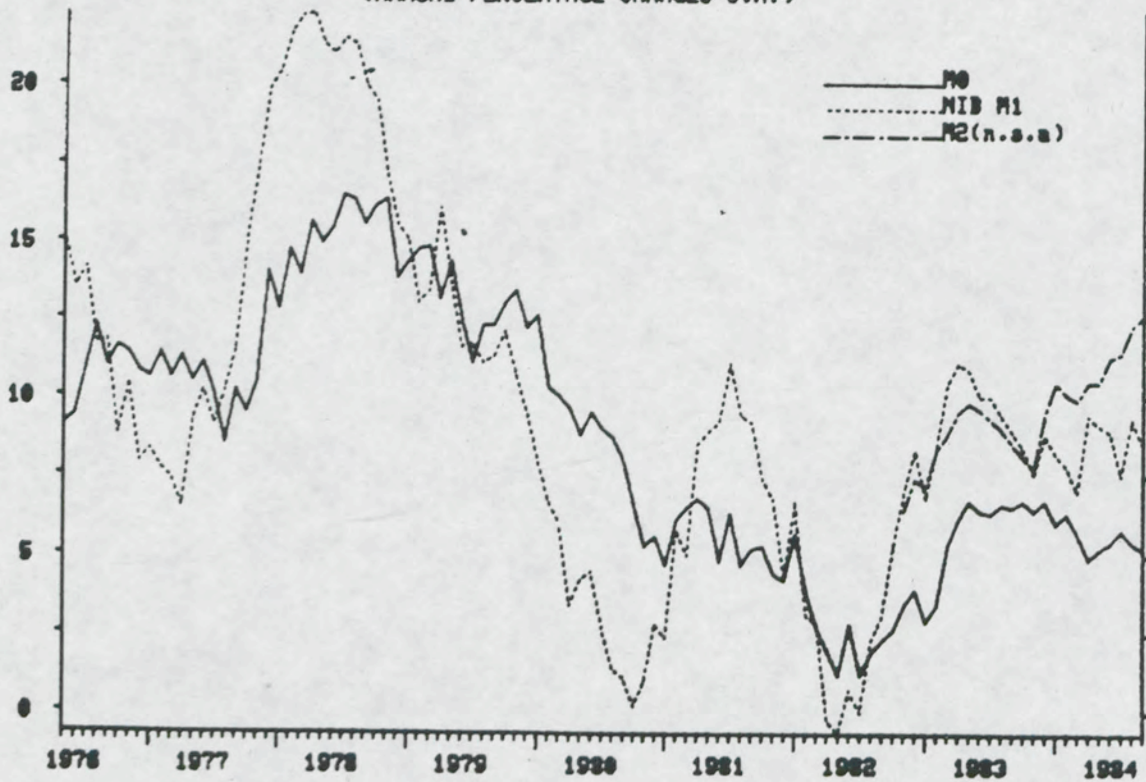
per cent, s.a

	MO	M2*	£M3	PSL2
Monthly change				
August	-0.1	0.3	0.7	1.0
September	1.0	0.3	1.3	1.6
Growth to mid-September at an annual rate				
over past :-				
3 months	4.4	*	4.1	11.5
6 months	5.3	*	8.8	15.4
12 months	5.2	12.6	8.9	13.6
Target Period	5.5	*	10.1	16.4

* not seasonally adjusted

CHART I





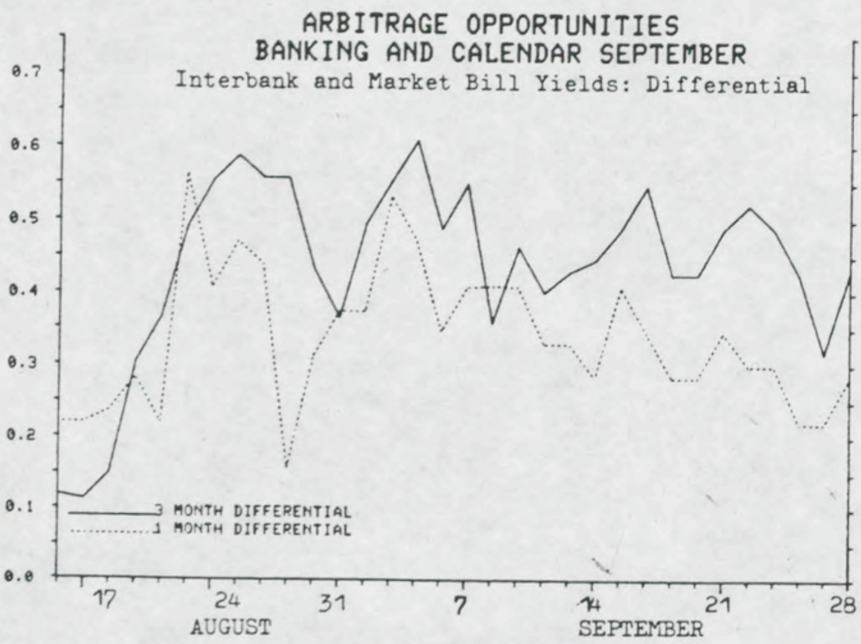
Reclassifications of building society accounts earlier in the year add about 2¾ per cent to the year on year growth rate. Even excluding reclassifications, the 12 month growth rate has been creeping steadily upwards since last winter, from about 8 per cent to about 9½ per cent now. Full details of the growth of all the main aggregates are given in the annex. Chart 1 shows the recent path of year-on-year change for both narrow and broad money.

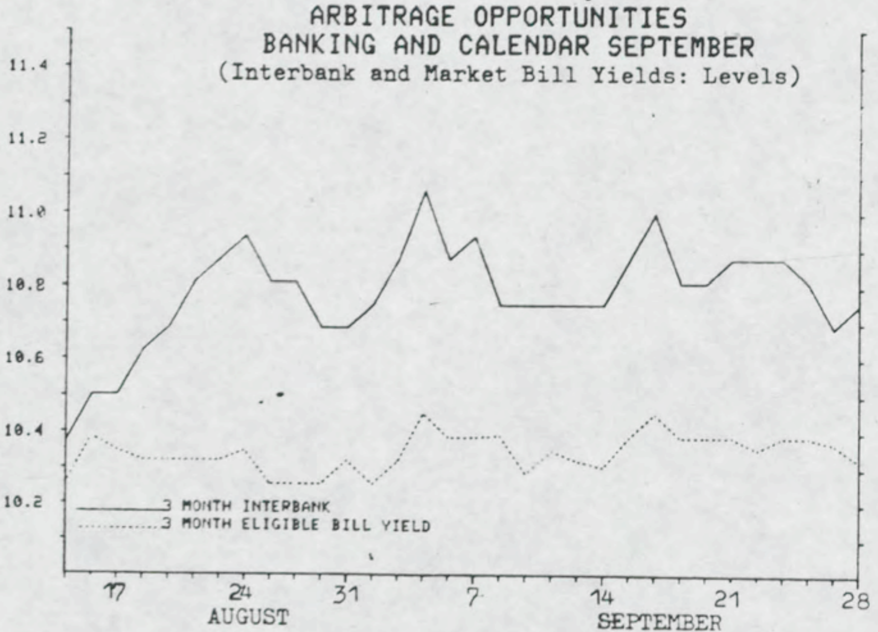
3. Estimates of the extent of any distortion to broad money are inevitably highly speculative. For working purposes, we have assumed that £M3 was inflated by something like ½ per cent, split fairly evenly between round tripping and misreporting of wholesale bank deposits. The evidence for round tripping is circumstantial. As Chart 2 shows, there certainly were times during the month when differentials between 3 month bills and comparable inter-bank rates exceeded ½ per cent, the margin at which hard arbitrage is generally thought to be profitable, after allowing for acceptance costs and an element of risk. Not all arbitrage inflates £M3: "soft arbitrage", which takes place even at fairly narrower differentials, only affects the composition of bank lending; and "hard arbitrage" by banks and overseas sectors has no effect on £M3. Failure to make these distinctions may be one reason why market estimates for round tripping (up to £1 billion) look on the high side. The detailed money figures are not inconsistent with some effect on £M3 this month. Most of the very sharp rise in bank lending to the private sector took the form of bills; and, as Annex Table C shows, wholesale deposits accounted for all the rise in £M3 (the rise in the wholesale deposits was even larger than in June when the surge in £M3 was fairly well spread).

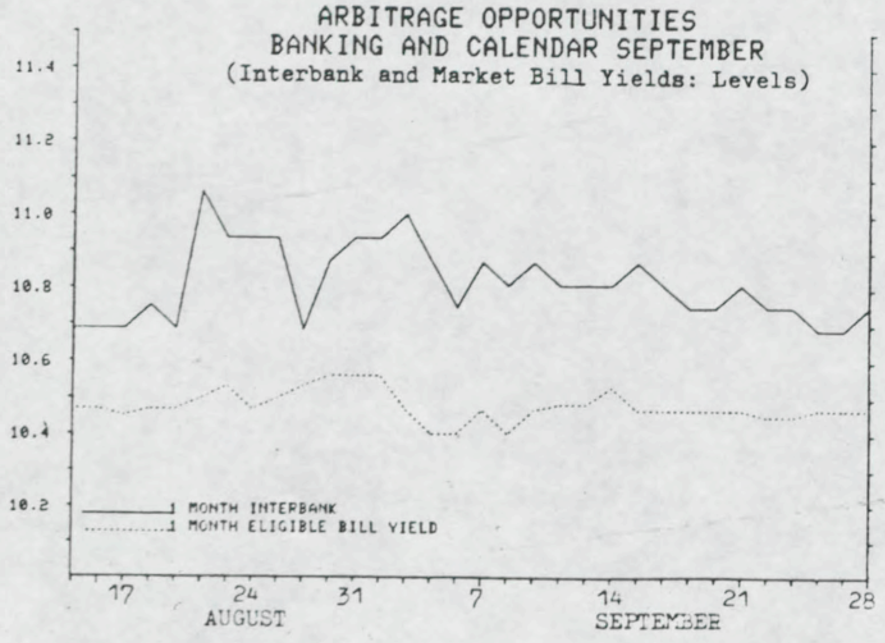
4. This month's sterling inter-bank difference implies that lending by the monthly reporting banks to other banks exceeded deposits taken from the rest of the monetary sector by about £500 million. This could reflect an erratically high sampling error: or misreporting of assets and/or liabilities. We have assumed that most of the error is on the liabilities side (which implies that £M3 was overstated) and attributed the rest to sampling error. We have discounted the possibility of misreporting on the asset side because this would imply an implausibly high underlying level of bank lending

CHART 2

SECRET (AND personal until 2.30 PM THURSDAY 18 OCTOBER 1984)







to the non-bank private sector.

5. As usual, the forecasts for the next three months assume unchanged interest rates, and take as given the targets for gross gilt sales (£1 billion in banking November and £½ billion in December), though we do allow for the fact that this month's £1 billion target has already been exceeded. The weekly figures suggest another fairly sharp rise in M0 in October, possibly around ¾ per cent. We expect this to slow down to around ¼ per cent a month as the effect of the recent rise in interest rates comes through, leaving M0 still in the bottom half of the target range by the end of the forecast period.

6. The forecasts for £M3 reflect a low PSBR over the next 3 months, not wholly explicable by receipts from the first call for British Telecom and the payment of our EEC budget refund. Even with relatively light funding, the public sector's contribution to £M3 is likely to be significantly contractionary. This may be partly offset by higher bank lending to the private sector, which we expect to grow by about £1¼ billion a month, a little above the recent trend. There is a possibility that the figures for banking October may again be inflated by round tripping (as Chart 2 shows, there seem to have been arbitrage opportunities earlier this month): but the December forecast reflects unwinding of most of the round tripping in 3 month bills which we assume took place in September. More tentatively, the £M3 forecasts for October and November are reduced by some reversal in this month's positive sterling inter-bank difference.

7. The picture, therefore, is of rather slow monetary growth over the next 3 months. The implicit assumption is that the liquidity build-up ahead of the British Telecom sale has largely taken place already and that most of the funds to pay for shares will therefore come from bank deposits. This view gets some support from quarterly data on institutional holdings of cash. But it could easily be wrong. If it is, the chances are that monetary growth in October and November will be somewhat higher than we now expect.

8. Much of the personal sector's subscription to British Telecom

(assumed to be around £0.3 billion) may be at the expense of building society deposits and National Savings. December is likely to be a poor month for the societies: but their underlying position is looking much healthier than it did over the summer. The recent recovery in retail inflows is expected to be sustained in October and November. Since new commitments are pointing to a lower level of lending over the next three months, the societies may be able to reduce their wholesale borrowing without further damage to liquidity ratios. On this scenario, PSL2 growth may be fairly moderate by recent standards, though it is still likely to exceed that of £M3. The forecast for M2 allows for a growth in bank retail deposits of around ¼ per cent a month and assumes, in line with recent experience, that about 2/3 of building society retail inflows fall within the aggregate.

TABLE 2 MAIN AGGREGATES : SUMMARY OF FORECAST

per cent, s.a

	MO	M2*	£M3	PSL2
Monthly change				
October	0.7	0.7	0.4	1.0
November	0.3	0.9	0.7	0.9
December	0.3	0.1	0.0	0.4
growth to mid-October at an annual rate				
Over Past :-				
3 months	6.4	*	10.1	15.6
6 months	6.6	*	8.9	15.5
12 months	5.4	12.7	8.2	13.8
Target Period	5.9	*	9.4	15.9
growth to mid-December at an annual rate				
Over Past :-				
3 months	5.3	*	4.8	9.5
6 months	4.8	*	4.5	10.5
12 months	4.9	10.4	7.7	13.8
Target Period	5.5	*	8.5	14.3

* not seasonally adjusted

Public Sector Borrowing

9. The seasonally adjusted "PSBR" was £1½ billion in banking September, about £100 million more than expected, largely due to a delay in corporation tax receipts. By the end of calendar August the (unadjusted) PSBR was £0.6 billion above the budget profile, principally due to higher than expected local authority borrowing. The forecasts for the next 3 banking months are consistent with the October NIF, and imply some further widening in this gap. Seasonal factors add about £1¾ billion to borrowing over the period; in adjusted terms, however, "the PSBR" is only £290 million, reflecting borrowing of around £½-¾ billion a month in October and November, and a surplus of over £1 billion in December. This compares with a total "PSBR" of £2¾ billion (S.A.) over the last 3 banking months (£2¼ billion, unadjusted).

10. Much of the reduction in borrowing can be explained by asset sales (the first call for BT, which is assumed to reduce the PSBR by £1.4 billion in December, and delayed receipts of £95 million for INMOS, in November) and payment of our EC budget refund (which is assumed to reduce the November PSBR by £¼ billion after allowing for funds already held in the Number 1 account.) Even after adjusting for these factors, however, borrowing is expected to be nearly £¾ billion lower than over the past 3 months in seasonally adjusted terms. First receipts from VAT on imports are not due until 17 December, after the end of the banking month.

11. The forecast assumes that the lower PSBR will be partly offset by increases in the foreign exchange reserves, to match the remaining payments from the EC in November and foreign currency receipts of some £0.3 billion from the overseas sale of BT. At this stage, there is some doubt about the impact of the EC refund. If, as looks possible, the EC does not need to make additional payments into the Number 1 account after all, we will need to make offsetting changes to the forecasts for both the PSBR and the externals. The net effect on money is however nil, both in the forecast, and on this alternative assumption. (The £M3 forecast would only be increased

if we were to assume that the EC makes no further payments in the Number 1 account, but the rise in the reserves goes ahead all the same).

Debt Sales

(a) Gilts

12. Table 3 compares the September outturn with performance over the target period so far, and summarises the forecast for the next three months.

TABLE 3 : GILT SALES *

monthly averages ,£m

	Actual		Forecast
	Banking Sept	mid-Sept 1983 -mid-Sept 1984	mid-Sept 1984 -mid-Dec 1984
Gross Sales	581	1145	933
Redemptions	-2	-291	-218
Next Maturities	-32	-144	0
Net Sales	547	710	715
of which : -			
Monetary Sector	76	-1	83
Public Corporations	25	2	0
Overseas	372	48	67
Non-bank private sector	74	661	565

* excluding Repos

13. In the five weeks of banking September, market activity was unusually thin. Gross sales of gilts raised £580 million, well below the target of £1¼ billion. The gross figure included just over £½ billion of calls. Sales of other stock raised well over £300 million, but buying in of stocks other than next maturities, in support of the market, largely offset this. Net sales were £547 million, there having been no significant redemptions in the month. Unusually, most of these went to the overseas sector and the non-bank private sector's take-up was only £75 million. Some of the overseas sector's purchases of gilts may have been financed out of non-resident sterling bank deposits, which fell for the first

time in over a year. But this fall was much less than the total increase in external holdings of gilts.

14. The London Clearing Banks reduced their base rates by a further ½ per cent on 17 August. However, hopes of further reductions were replaced by fears of an increase when a second dock strike was called, driving money market rates up and gilt prices down. The strength of the dollar also cast a shadow over the market. The August provisional money figures were rather above expectations and did nothing to revive interest in gilts. Sales picked up towards the end of the month, on hopes that the talks between the NCB and NUM would lead to a settlement of the miners' dispute, but when these broke up, the market fell back. The dock strike, which had only been partly effective, was called off at the end of the banking month, too late to affect gilt sales.

15. At the beginning of the month the Bank announced the issue of £950 million of 10½ per cent Treasury convertible 1992 (£200 million of which was reserved for CRND), the first new FOTRA stock since 1977. The first and second call, of 30 per cent each, took place in banking September. The second and final instalment of 11 per cent Exchequer 1989 raised £443 million. Towards the end of banking September, two tranchettes of existing low coupon stocks were issued, £150 million of 2½ per cent Exchequer 1986 and £100 million of 3 per cent Treasury 1987.

16. With a week still to go in banking October, the target of £1 billion has already been exceeded and have gone slightly over the top of the upside range identified at the last funding meeting (£1¼ billion). The final call on 10½ per cent Treasury convertible 1992 was received on 8 October. The market remains reasonably firm, but there is little stock remaining in the Issue Department. We have made the assumption that gross sales will total £1.3 billion this month, falling to £1 billion in November and £½ billion in December, in line with the lower targets agreed at last month's funding meeting. This compares with gross sales of £1.1 billion a month on average in the seven months to mid-September (and a forecast rate of about £1 billion a month for the financial year

1984-85 in the latest NIF). The low target for December reflects a short (3 week) banking month, as well as some allowance for the BT sale. Net sales will be depressed by a £650m redemption in banking October but there are no further redemptions or assumed buying in over the rest of the forecast period.

(b) National Savings

17. National Savings contributed £900 million (unadjusted) to funding during banking September (£973 million seasonally adjusted), exceeding the forecast by about £100 million. Sales of the highly competitive 28th Issue in banking September amounted to £800 million (£50 million of which had not been processed by make-up day, and was held in the Ways and Means account), about £100 million above forecast. With the exception of the Income Bond (terms on which were improved on 2 September), other DNS instruments continued to perform poorly.

18. With no conventional certificate on sale between the 11 September and the 15 October, inflows in banking October will be much lower. Total National Savings funding is forecast at £220 million, unchanged from last time, and largely attributable to the Income Bond and accrued interest.

19. The 29th Issue is not expected to attract substantial funds in banking November and December. The terms of the new issue (8 per cent) were pitched to avoid strong competition with the BT sale. On the assumption that total sales of BT shares to the personal sector reach £0.3 billion, inflows into National Savings may be depressed by around £50 million a month in both November and December compared with what might otherwise have been achieved at present rates. In addition we are expecting the usual large outflow from index-linked certificates in November, following payment of the annual supplement. In seasonally adjusted terms, National Savings is expected to contribute only £150 million to funding in banking November and a mere £35 million in banking December. If correct, this forecast implies that National Savings inflows would have to achieve an unadjusted monthly rate of £250 million (£150 million

seasonally adjusted) to reach the £3 billion target for the financial year as a whole (see final column of table 4 below). This compares with inflows of around £200 million a month (before and after seasonal adjustment) in the period up to mid-August.

TABLE 4: NATIONAL SAVINGS INFLOWS

£m

	Financial year to end August	Financial year to mid September	Financial year to end December	monthly striking rate to achieve £3bn
unadjusted	868	1766	2131	248
seasonally adjusted	1135	2108	2478	150

(c) Certificates of Tax Deposits

20. There was a net outflow of £170m from CTDs in banking September much in line with forecast. But two major payments have already produced inflows of £470m in banking October. Assuming no further payments of this unusual size (the interest differential between CTDs and interbank rates has since been cut by ¼%) we forecast that CTDs will contribute £400m to funding in banking October compared with our previous forecast of a net outflow of £225m. Thereafter the net impact of CTDs on the funding position is likely to be fairly modest.

The PSBR and Funding

21. Table 5 summarises the net funding position over the target period so far and that implied in the forecast to mid-December. Since mid-February the 'PSBR' has been slightly over-funded after taking account of the external finance of the public sector, but underfunded by £0.2 billion if this is excluded. In unadjusted terms both measures show significant underfunding. Over the forecast period we expect overfunding of over £2 billion in seasonally adjusted

terms but a much flatter position in unadjusted terms, reflecting the large negative seasonal adjustment to the PSBR over this period.

TABLE 5 THE "PSBR" AND FUNDING

£ billions sa
(figures in brackets are unadjusted)

	Actual	Forecast	
	mid-Feb 84 -mid-Sep 84	mid-Sep 84 -mid-Dec 84	mid-Feb 84 -mid-Dec 84
"PSBR"	6.7	0.3	7.0
Debt sales to nbps (-) of which :-	-6.5	-2.4	-8.9
Gilts	-4.0	-1.7	-5.7
National Savings	-2.4	-0.4	-2.8
CTDs	-0.0	-0.3	-0.4
OVER(-)/UNDERFUNDING(+)	0.2	-2.1	-1.9
Unadjusted	(2.2)	(-0.4)	(1.7)
External finance of public sector(-)	-1.1	0.3	-0.8
OVER(-)/UNDERFUNDING(+) alternative definition	-0.9	-1.8	-2.7
Unadjusted	(1.1)	(-0.2)	(0.9)

Money Market Influences

22. Daily shortages averaged £550m during banking September, implying gross assistance of £13¼ billion, mainly due to maturing bills. Market shortages were particularly large at the beginning of the banking month and again at the end of calendar August. However the total stock of assistance rose by only £300m over the month to reach £11¼ billion by mid-September. The forecast implies a rise in the stock of assistance of about £½ billion over the forecast period, entirely concentrated in December. Little net change in assistance is expected in either October or November.

Sterling Lending to the Private Sector

23. Sterling bank lending increased by £1½ billion in banking September, about £½ billion above forecast. At the same time, the "bill leak" rose by about £150m and foreign currency lending by UK banks to the UK private sector went up by around £100m. Monetary sector lending to the building societies was £120m, lower than in August, but high by earlier standards. Some of the increase in

total sterling bank lending may have reflected round tripping (possibly as much as £¼ billion). This month's figure was particularly surprising in view of the high PSBR; however, there is increasing evidence that variations in the PSBR only affect lending with a lag, so it may be that we shall see some offset this month.

TABLE 6 THREE AND SIX MONTH MOVING AVERAGES OF RECORDED AND UNDERLYING STERLING LENDING

£ millions

	Three Month Average		Six Month Average	
	Recorded Lending	Underlying Lending	Recorded Lending	Underlying Lending
Oct	1348	1258	1227	1165
Nov	1284	1215	1163	1190
Dec	1428	1202	1252	1214
Jan	1214	993	1281	1126
Feb	1290	1028	1287	1121
March	1286	1095	1357	1149
April	1445	1628	1330	1310
May	1322	1393	1306	1211
June	1304	1540	1295	1318
July	939	852	1192	1240
August	882	1098	1102	1246
September	837	933	1071	1237

24. The three and six month moving averages of recorded and "underlying" bank lending over the last year are shown in table 6 . The "underlying" series is adjusted to allow for the offsetting effects of high PSBRs and the leasing adjustments paid by two clearers in July and August, and an assumed £¼ billion of round tripping in September. The figures suggest some deceleration in the trend of bank lending to the private sector over the summer, a conclusion which is supported by anecdotal evidence from the banks, especially the clearers, who are reporting rather slack loan demand. There is no useful up-to-date information about the composition of lending.

25. For the forecast we have projected underlying lending at around

£1.15 billion a month. Recorded lending is expected to be somewhat higher at around £1.3 billion a month due to more round tripping in October, and the effect of low forecast PSBRs, particularly in December. We have also allowed for £200m extra bank lending to the building societies in December to make up for lower retail inflows resulting from the sale of BT. This is largely offset, however, by the unwinding of much of September's round tripping, three-quarters of which may be repaid in banking December.

26.As table 7 shows, net issues by UK listed companies rose again in banking September. The gross issues queue (excluding privatisations) is still around the £1 billion mark. The major new issue in banking October was Barclay's 'perpetual floater' which raised $600m on 8 October. This should not affect £M3; it is likely to be reflected in an increase in net non-deposit liabilities matched by a rise in the banks net currency liabilities (included within the externals).

Table 7 Net Issues by Listed UK Companies

(Calendar month averages, £M)

	Net Issues	Gross Issues Queue* (Equities)
1984 Q1	51	850
Q2	199	1510
Q3	218	1030
July	132	1105
August	216	1010
September	305	978+

* Excluding privatisations

+ As of 5 October

SECRET (AND PERSONAL UNTIL 2.30 PM THURSDAY 18 OCTOBER 1984)

Building Societies

27. After a disastrous start to the banking month, retail inflows recovered sharply at the beginning of calendar September, reflecting seasonal factors and increases in the premium rates offered by the societies. But even recent weekly inflows are still some way below levels reached in the Spring. Despite extremely heavy wholesale borrowing by the societies in both August and September there was a further rundown in liquidity as net advances continued to grow strongly. But there are clear signs that the growth in net commitments has moderated over the summer, from a peak monthly rate of about £2.4 billion in June and July to around £1.8 billion in calendar August.

Table 3: Building Society Inflows

monthly rate, £M, seasonally adjusted

	mid-April to mid-September	Forecast: mid-September to mid-December
1. Total retail inflows (incl. interest credited)	+ 880	+1005
2. of which term shares	- 80	- 130
3. Net issues of CDs and time deposits to NBPS	+ 145	+ 90
4. BS acquisition of liquid assets. excl. gilts (inc -)	+ 198	- 320
5. Building Societies' contribution to:		
PSL2 (1-2+3+4)	+1303	+ 900
M2	+ 790	+ 820
Memo item		
Building Society net mortgage advances	+1300	+1230

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28. We expect the recent weekly rate of inflow to be broadly sustained in October and November, allowing the societies to reduce their wholesale borrowing to a monthly rate of perhaps only £100m a month. The BT sale is expected to reduce retail building society inflows by some £50m in banking November and perhaps £150m in banking December. As the slowdown in new commitments feeds through to advances, this forecast should be consistent with a broadly constant liquidity ratio for the societies (currently around 17½%) implying some increase in their holdings of liquid assets. We assume that this will largely take the form of higher building societies holdings of cash.

SECRET(AND PERSONAL UNTIL 2.30PM, THURSDAY 18TH OCTOBER 1984)

TABLE A : PERCENTAGE CHANGES IN MONETARY AGGREGATES

per cent, s.a

Banking months	MO	NIB M1	M1	M2*	£M3	M3	PSL2	PSL2A
(1) In month								
Sept	1.0	-0.8	1.1	0.3	1.3	2.3	1.6	1.4
Oct	0.7			0.7	0.4		1.0	0.9
Nov	0.3			0.9	0.7		0.9	0.9
Dec	0.3			0.1	0.0		0.4	0.4
(2) latest 3 months (a.r)								
Sept	4.4	0.0	7.7	*	4.1	11.3	11.5	9.6
Oct	6.4			*	10.1		15.6	13.5
Nov	8.2			*	10.3		15.2	13.6
Dec	5.3			*	4.8		9.5	9.3
(3) latest 6 months (a.r)								
Sept	5.3	6.4	14.6	*	8.8	8.6	15.4	13.2
Oct	6.6			*	8.9		15.5	13.4
Nov	6.4			*	8.7		14.7	12.8
Dec	4.8			*	4.5		10.5	9.5
(4) latest 12 months (a.r)								
Sept	5.2	7.6	15.4	12.6(9.5)**	8.9	11.5	13.6	12.8
Oct	5.4			12.7(9.7)**	8.2		13.8	12.8
Nov	5.2			13.4(10.6)**	8.9		14.4	13.1
Dec	4.9			10.4(10.5)**	7.7		13.8	12.4
(5) target period (a.r)								
Sept	5.5	8.3	17.9	*	10.1	10.0	16.4	14.2
Oct	5.9			*	9.4		15.9	13.9
Nov	5.7			*	9.4		15.4	13.6
Dec	5.5			*	8.5		14.3	12.7

* not seasonally adjusted

** excluding reclassifications

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TABLE B: £M3 COUNTERPARTS

£ millions

	SEPTEMBER		FORECAST			TARGET PERIOD	
	FORECAST	OUTTURN	OCT	NOV	DEC	MID-FEB 84 TO MID-DEC 84	MID-APRIL 84 TO MID-DEC 84
1. CGBR							
Own-account (u.a)	900	1036	275	640	35	8742	5467
On-lending (u.a)	250	145	610	395	485	2324	2065
Total (u.a)	1150	1181	840	720	850	11036	7502
TOTAL CGBR (s.a)	1300	1329	760	830	-1110	7082	4906
2. NET PURCHASES OF CG DEBT BY NBPS							
Gilts	-675	-74	-500	-800	-375	-5704	-4535
Treasury bills	0	14	0	0	0	-97	-144
National Savings	-860	-971	-220	-115	-35	-2810	-2300
CTDs,etc	250	170	-400	-15	85	-364	-112
TOTAL DEBT	-1285	-861	-1120	-930	-325	-8975	-7091
3. OTHER PUBLIC SECTOR							
Local Authorities	-190	104	80	-175	-315	-33	-323
Public Corps.	345	127	-295	40	475	-39	179
TOTAL OPS	155	231	-215	-135	160	-72	-144
4. £ LENDING TO PRIVATE SECTOR	965	1457	1345	1190	1355	11959	8879
5.NET EXTERNALS	-140	-543	240	325	360	-306	514
6.NET NON-DEPOSIT LIABILITIES	-500	-226	-600	-500	-400	-2692	-1828
CHANGE IN £M3 £m	495	1387	410	790	40	7006	5246
(%)	(0.5)	(1.3)	(0.7)	(0.9)	(0.1)	(8.5)*	(7.9)*
"PSBR"	1455	1560	545	695	-950	7010	4762
OVER(-)/UNDERFUNDING(+)	170	699	-575	-235	-1275	-1965	-2329

* at an annual rate

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SECRET

TABLE C: The Components of £M3 and PSL2

£ million, Seasonally adjusted

	Banking September	Cumulative total since mid-February	Monthly rate
Notes and coin in circulation	+ 82	+ 467	+ 67
Bank deposits:			
Retail			
(a) interest bearing	+195	+ 905	+ 129
(b) non-intrest bearing	-348	+1010	+ 144
Wholesale	+1575	+3283	+ 469
£ Certificates of Deposit	- 35	+ 102	+ 15
Change in £M3	+1387	+5766	+ 824
Bills and other adjustments	+ 60	+ 841	+ 120
Building Society inflows:			
(a) retail (and interest credited)	+1038	+7012	+1002
(b) wholesale	+ 300	+ 711	+ 102
Other	+ 160	+1236	+ 177
Change in PSL2	2945	15566	+2225

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Table D: Gilts

£ million

	Outturn SEPT	OCT to date	Remainder of OCT	Forecast OCT	Forecast NOV	Forecast DEC
Calls*	-	251	5	256	-	-
Other 'gross' sales	581	1034	10	1044	1000	500
'GROSS' SALES	581	1285	15	1300	1000	500
Buying-in next maturities$^{\phi}$	- 32	- 1	0	- 1	-	-
Redemptions	- 2	-650	- 4	-654	-	-
TOTAL NET SALES	547	634		645	1000	500
Purchases (-) by:						
Overseas	-372			- 50	-100	-50
Banks	- 48			- 85	- 50	
LDMA	- 28			- 10	- 50	-75
Public Corporations	- 25			-	-	-
NET SALES TO NBPS (+)	74			500	800	375

* of which calls on:

- Final call on 10½% Treasury Convertible 1992 (35.3%)
-
-

ϕ of which, buying in of:

-
-

SECRET (AND PERSONAL UNTIL 2.30 PM, THURSDAY 18 OCTOBER)

Table E: Sterling lending to the private sector

£ million
Seasonally adjusted

	Actual			Forecast		
	July	Aug	Sept	Oct	Nov	Dec
Adjusted lending	- -89	+1337	+1550	+1150	+1150	+1150
Bills held by NBPS(-)	+286	- 1	- 135	-	-	-
PSBR offset	+430	- 170	- 208	+ 145	+ 40	+_205
Leasing effect	-290	- 450	-	-	-	--
Round tripping	-	-	+ 250	+ 50	-	- 200
B.T.	-	-	-	-	-	+ 200
Actual/forecast recorded lending	337	716	1457	1345	1190	1355
3-month moving average of adjusted lending	852	1098	933	1346	1283	1150

SECRET (AND PERSONAL UNTIL 2.30 PM, THURSDAY 18 OCTOBER)

Table F: Money Market Influences

£ million
not seasonally adjusted

	Actual	Forecast		
	SEP	OCT	NOV	DEC
A. Money market influences				
CGBR (increase +)	+1211	+885	+1035	+520
Reserves etc (+)	- 178	- 5	+ 270	+205
Notes and coin (-)	+ 72	+193	- 110	-715
National Savings (-)	- 898	-160	- 175	- 29
CTDs (-)	+ 142	-455	+ 20	+ 40
Gilts (-)	- 547	-455	-1000	-500
Other Exchequer items etc	+ 6	- 45	- 315	+330
TOTAL MONEY MARKET INFLUENCES (Market surplus + / shortage -)	- 192	+ 2	+ 40	-479
B. Money market operations				
Commercial bills (purchase +)				
- Issue Department	+ 120			
- Banking Department	+ 179			
LA bills (purchase +)				
- Issue Department	+ 7			
- Banking Department	- 5			
Treasury bills (purchase +)	+ 73			
Market advances	- 74			
Other	-			
TOTAL MONEY MARKET OPERATIONS	+ 300	- 2	- 40	+479
Change in bankers' balances	+ 108	-	-	-
TOTAL ASSISTANCE OUTSTANDING*	11222	11220	11180	11659

* excluding Treasury bills

1984-85 KEY AGGREGATES **Table G**

TARGET AGGREGATES

		JAN	FEB	MAR	APR	MAY	JUNE	JULY	AUG	SEP
£M3	(Exc. Public sector deposits)									
	Monthly change (£ millions)	+655	+84	+1,401	+374	+759	+2,091	-1,048	+727	+1,387
	Monthly % change	+0.7	+0.1	+1.4	+0.4	+0.7	+2.0	-1.0	+0.7	+1.3
	Three-monthly % change a.r.	+7.7	+7.6	+8.9	+7.7	+10.9	+13.4	+7.3	+7.1	+4.1
	Six-monthly % change a.r.	+7.6	+6.7	+9.1	+7.7	+9.1	+11.1	+7.5	+9.0	+8.8
	12 Monthly % change	+10.2	+9.5	+9.9	+8.0	+8.1	+9.2	+7.5	+7.8	+8.9
	% Change since Feb-83 a.r.	+10.3	+9.5	+10.2	+9.8					
	% Change since Feb-84 a.r.			+18.2	+11.2	+10.9	+14.8	+9.0	+9.0	+10.1
MO	Averaged weekly									
	Monthly change (£ millions)	+23	+20	+74	+11	+53	+137	+30	-17	+133
	Monthly % change	+0.2	+0.2	+0.6	+0.1	+0.4	+1.0	+0.2	-0.1	+1.0
	Three-monthly % change a.r.	+5.1	+3.7	+3.6	+3.2	+4.3	+6.2	+6.8	+4.6	+4.4
	Six-monthly % change a.r.	+6.6	+6.3	+5.1	+4.1	+4.0	+4.9	+5.0	+4.4	+5.3
	12-monthly % change	+6.0	+6.3	+5.7	+4.9	+5.2	+5.4	+5.8	+5.4	+5.2
	% Change since Feb-83 a.r.	+6.7	+6.3	+6.3	+5.9					
	% Change since Feb-84 a.r.			+7.0	+3.9	+4.3	+6.4	+5.7	+4.4	+5.5

CROSS CHECKS

		JAN	FEB	MAR	APR	MAY	JUNE	JULY	AUG	SEP
PSL2	Monthly change (£ millions)	+1,828	+1,065	+2,894	+1,615	+2,160	+3,956	172	+1,824	+2,945
	Monthly % change	+1.2	+0.6	+1.8	+0.9	+1.2	+2.3	0.1	+1.0	+1.6
	Three-monthly % change a.r.	+10.4	+11.2	+15.0	+14.1	+16.8	+19.1	+15.1	+14.3	+11.5
	Six-monthly % change a.r.	+9.6	+9.0	+11.9	+12.2	+14.0	+17.0	+14.6	+15.6	+15.4
	12-monthly % change	+12.3	+11.6	+12.1	+11.0	+11.6	+13.0	+12.1	+12.2	+13.5
	% Change since Feb-83 a.r.	+12.0	+11.6	+12.5	+12.4					
	% Change since Feb-84 a.r.			+23.5	+17.6	+16.8	+20.2	+16.1	+15.6	+16.4
M2 unadjusted	Monthly change (£ millions)	+1,223	+63	+1,595	+2,3178	+615	+2,110	+1,431	+378	+452
	Monthly % change	+1.0	+0.1	+1.3	+1.9	+0.5	+1.7	+1.1	+0.3	+0.3
	12-monthly % change	+10.5	+10.1	+9.9	+10.5	+10.5	+11.3	+11.4	+12.3	+12.6
	(exc re-classifications)	(+8.2)	(+7.8)	(+7.5)	(+8.0)	(+7.9)	(+8.5)	+8.7	+9.5	+9.8
Levels :	£M3 (Exc. Pub Sec Deps)	99,725	99,781	101,203	101,537	102,270	104,306	103,346	104,061	105,418
	MO (Averaged weekly)	13,137	13,157	13,231	13,242	13,295	13,432	13,462	13,445	13,578
	PSL 2	167,139	168,170	171,063	172,623	174,754	178,727	178,907	180,688	183,598
	M2 (unadjusted)	121,006	121,238	122,885	125,202	125,857	128,017	129,448	129,826	130,278

Table H

OTHER WIDE AGGREGATES

		JAN	FEB	MAR	APR	MAY	JUNE	JULY	AUG	SEP
PSL1	Monthly change (£ millions)	+381	-176	+1,687	+369	+901	+2,631	-1,183	+755	+1,447
	Monthly % change	+0.4	-0.2	+1.7	+0.4	+0.8	+2.5	-1.1	+0.7	+1.3
	Three-monthly % change a.r.	+6.8	+4.7	+7.9	+7.6	+12.0	+15.4	+8.9	+8.6	+3.8
	Six-monthly % change a.r.	+7.1	+5.3	+8.6	+7.2	+8.3	+11.6	+8.2	+10.3	+9.6
	12-monthly % change	+9.8	+8.7	+9.2	+7.2	+7.8	+9.4	+7.6	+7.8	+9.0
	% Change since Feb-83 a.r.	+9.8	+8.7	+9.7	+9.3					
	% Change since Feb-84 a.r.			+22.8	+13.2	+12.0	+17.2	+10.6	+10.3	+11.2
PSL2A	Monthly change (£ milions)	+2,132	+1,165	+3,021	+1,678	+2,023	+3,968	+103	+1,759	+2,759
	Monthly % change	+1.2	+0.6	+1.6	+0.9	+1.0	+2.0	+0.1	+0.9	+1.4
	Three-monthly % change a.r.	+11.6	+11.5	+14.3	+13.1	+15.2	+17.0	+13.2	+12.5	+9.6
	Six-monthly % change a.r.	+11.2	+10.6	+12.7	+12.3	+13.4	+15.7	+13.2	+13.8	+13.3
	12-monthly % change	+12.5	+11.9	+12.4	+11.4	+11.9	+13.1	+12.2	+12.2	+13.0
	% Change since Feb-83 a.r.	+12.3	+11.9	+12.6	+12.5					
	% Change since Feb-84 a.r.			+21.6	+16.2	+15.2	+18.1	+14.4	+13.8	+14.4
M3	(Exc. Public Sector Deposits)									
	Monthly change (£ millions)	+827	+726	+1,739	+664	+1,097	+2,088	+204	+256	+2,779
	Monthly % change	+0.7	+0.6	+1.5	+0.6	-0.9	+1.8	+0.2	+0.2	+2.3
	Three-monthly % change a.r.	+14.2	+14.9	+12.0	+11.3	+4.6	+5.7	+4.1	+8.9	+11.3
	Six-monthly % change a.r.	+11.5	+11.9	+14.7	+12.8	+9.6	+8.8	+7.5	+6.7	+8.6
	12-monthly % change	+12.4	+11.6	+11.9	+10.7	+9.2	+10.0	+9.5	+9.3	+11.5
	% Change since Feb-83 a.r.	+11.9	+11.6	+12.2	+11.8	-				
	% Change since Feb-84 a.r.			+19.5	+13.0	+4.6	+9.0	+7.6	+6.7	+10.0
Levels :										
	PSL1	103,119	102,909	104,605	104,920	105,792	108,440	107,265	107,977	109,389
	PSL2A	187,415	188,550	191,559	193,178	195,262	199,247	199,358	201,074	203,798
	M3 (ex. Pub. Sec. Deps)	115,761	116,462	118,250	118,873	117,747	119,888	120,112	120,340	123,102

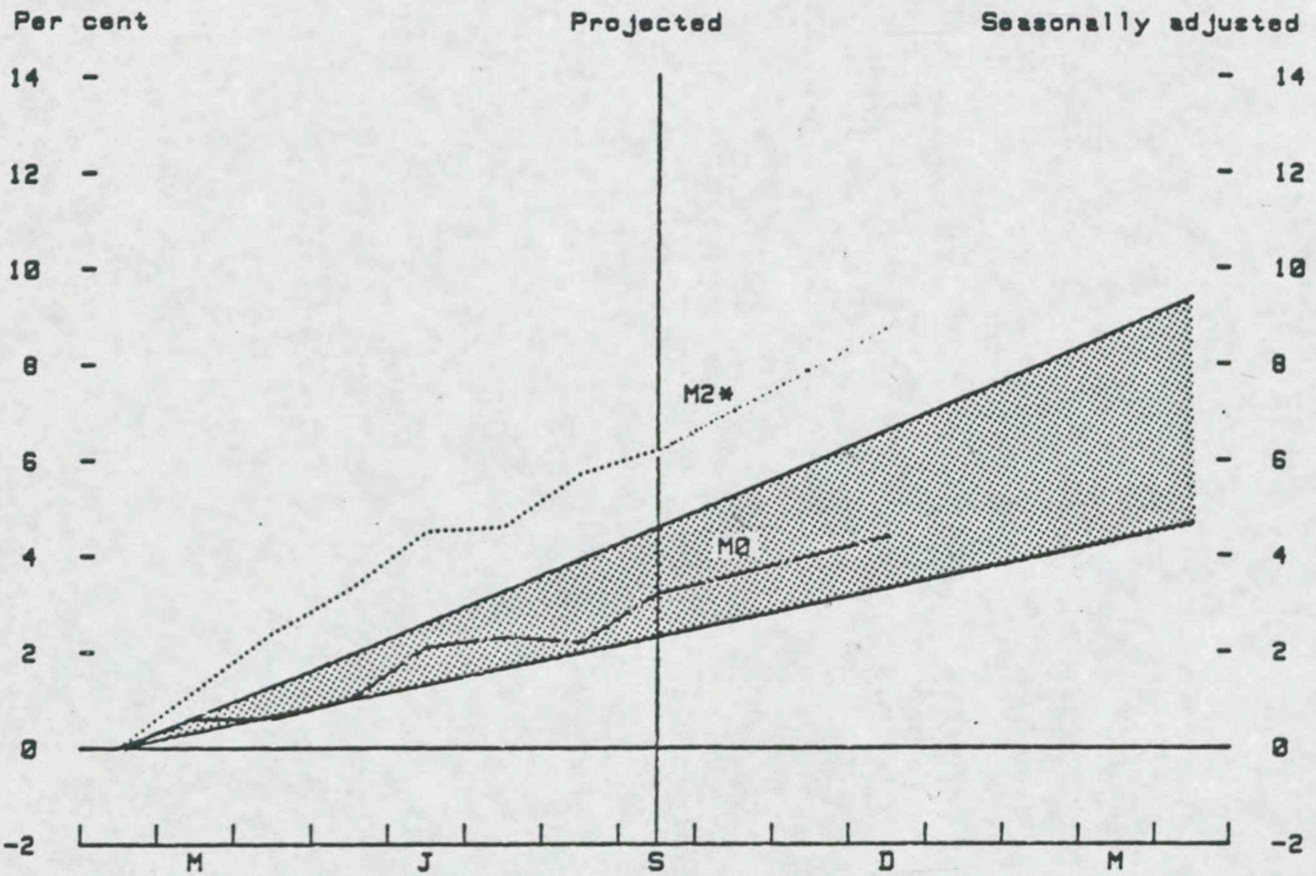
Table I

OTHER NARROW AGGREGATES

		JAN	FEB	MAR	APR	MAY	JUNE	JULY	AUG	SEP
NIB M1	Monthly change (£ millions)	-91	+56	+474	+581	+140	+281	-401	+668	-266
	Monthly % change	-0.3	+0.2	+1.5	+1.8	+0.4	+0.9	-1.2	+2.1	-0.8
	Three-monthly % change a.r.	+6.4	+5.3	+5.7	+15.0	+16.2	+13.3	+0.2	+6.9	-
	Six-monthly % change a.r.	+7.2	+7.1	+8.7	+10.7	+10.6	+9.4	+7.4	+11.5	+6.4
	12-monthly % change	+8.2	+7.8	+7.9	+9.3	+9.2	+9.4	+7.3	+9.3	+7.6
	% Change since Feb-83 a.r.	+8.3	+7.8	+8.7	+9.7					
	% Change since Feb-84 a.r.			+19.8	+22.1	+16.2	+14.9	+8.5	+11.5	+8.3
M1	Monthly change (£ millions)	+299	+158	+1,285	+778	+687	+857	-318	+685	+507
	Monthly % change	+0.7	+0.4	+3.0	+1.8	+1.5	+1.9	-0.7	+1.5	+1.1
	Three-monthly % change a.r.	+10.5	+9.1	+17.4	+22.3	+28.0	+22.6	+11.3	+11.1	+7.7
	Six-monthly % change a.r.	+10.5	+9.5	+16.4	+16.3	+18.2	+20.0	+16.7	+19.3	+14.9
	12-monthly % change	+10.7	+11.1	+13.4	+13.6	+13.7	+13.7	+13.5	+14.3	+15.6
	% change since Feb-83 a.r.	+11.8	+11.1	+13.3	+14.0					
	% change since Feb-84 a.r.			+42.2	+32.3	+28.0	+27.2	+19.3	+19.3	+18.5
M2	Partially seasonally adjusted									
	Monthly change (£ millions)	+1,932	+749	+1,661	+1,513	+1,268	+1,804	+142	+1,326	+574
	Monthly % change	+1.6	+0.6	+1.4	+1.2	+1.0	+1.4	+0.1	+1.0	+0.4
	Three-monthly % change a.r.	+16.2	+15.9	+15.4	+13.6	+15.4	+15.7	+10.7	+10.7	+6.5
	Six-monthly % change a.r.	+10.4	+11.4	+13.5	+14.9	+15.7	+15.6	+12.1	+13.0	+11.0
	12-monthly % change	+10.4	+10.1	+10.1	+10.4	+10.4	+11.3	+11.3	+12.3	+12.3
	% Change since Feb-83 a.r.	+10.3	+10.1	+10.7	+11.0					
	% Change since Feb-84 a.r.			+17.6	+16.6	+15.4	+16.1	+13.0	+13.0	+11.9
Levels :	NIBM1	31,151	31,207	31,686	32,267	32,406	32,689	32,288	32,986	32,704
	M1	42,980	43,140	44,440	45,220	45,910	46,770	46,460	47,170	47,660
	M2 (Partially S/A)	121,210	122,128	123,841	125,354	126,661	128,517	128,659	129,949	130,504

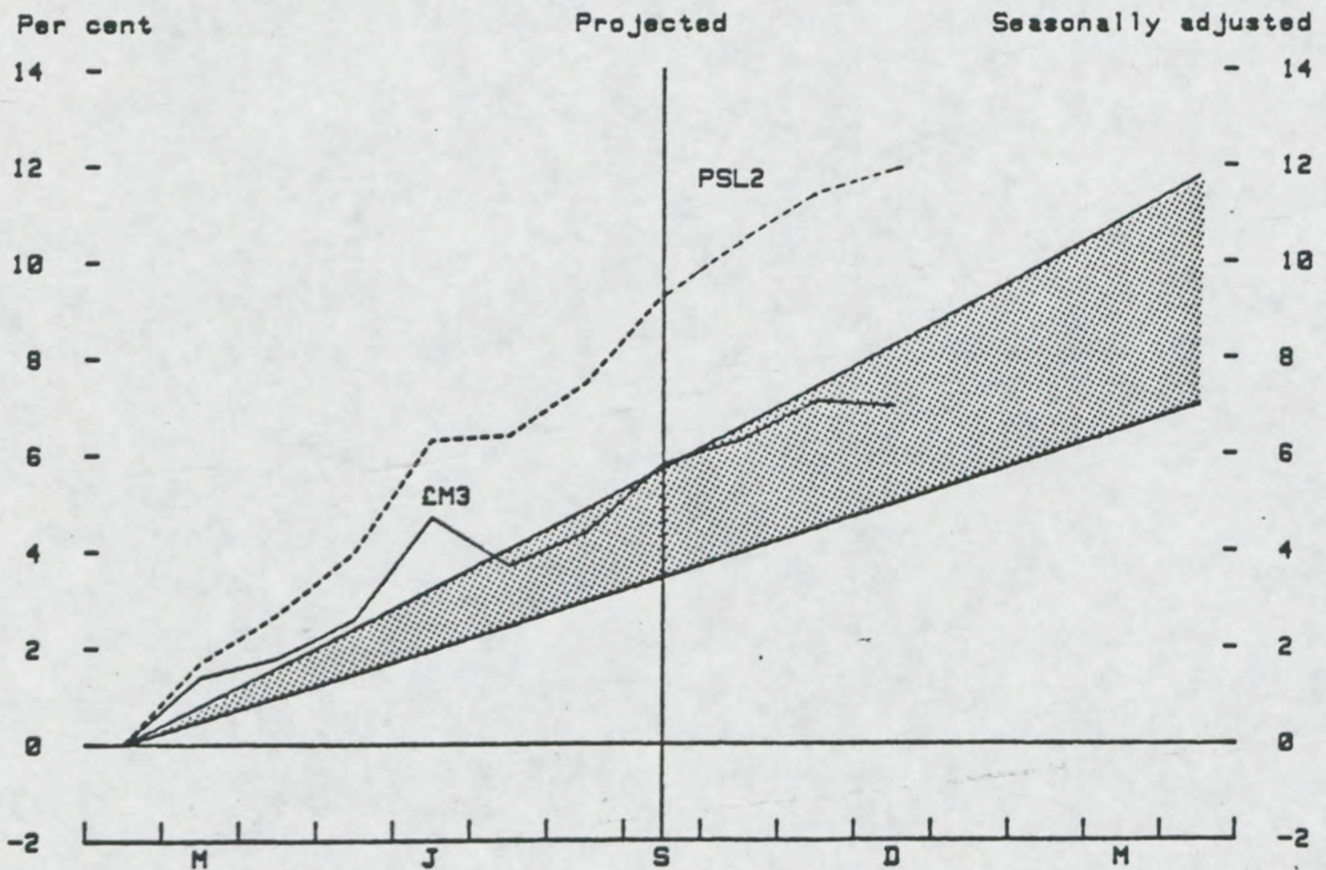
Narrow Money(Target 4-8%)

Chart A



*excluding reclassifications

Broad Money(Target 6-10%)



10 DOWNING STREET

AT has kept
Sir A Walters
Drafts on
Fiscal and
Monetary Policy
from attached
folder.

Added to main file
G. Gray
22/7/2013

Robin Butler

Could you 'revise' this (or me please?) AW

Monetary Policy

The Background 1950-79

In many ways the discussion of monetary pollicy and particularly monetary instruments has followed a course similar to that of fiscal policy. But over the years there has been a substantial change in the relative importance attributed to monetary and fiscal policy. In the years after World Wat II, money virtually never entered into the discussion of macro-economic policy. The attempts to bring back so-called monetary measures (they were actually credit restrictions and controls) as part of a package in 1955-58 were seem to be an unredeemed failure and led to the establishment of the Radcliffe Committee and its Report of 1959._/

_/ Committee on the Workings of the Monetary System, the cahirman of which was Lord Radcliffe, a prominent judge; the committee was dominated by Richard Sayers, professor of economics at the London School of Economics. In 1968 or 9, Lord Radcliffe told me He thought that he had made a mistake in allowing the 'academics' so much influence in shaping the Report. That he was already pursuaded that there were serious flaws in the approach.

The Radcliffe Report was thought to show that monetary policy was ineffective._/ It argued that the financial effects of policy were exerted by a concept which it could never define called "liquidity". The quantity of money was thought to be relevant only in so far as it was a component or affected the 'liquidity' of the financial system. The Radcliffe Committee believed that, since credit markets were not perfect, direct controls on bank lending and hire purchase were the most powerful and quick acting financial instruments to be properly employed in adjusting the economy to its full-employment state, or to reduce any unsupportable pressure on the pseudo-fixed sterling exchange rate.

MP(2)

~~Monetary policy had sunk so low in the~~

In the early 1960's the government did not even prepare any statistics on the quantity of money. But there were elaborate data on bank lending, hire purchase credit, and the like. _/

_/ It is of some interest to note that when in 1961/2 Noel Kavanagh and I applied for a Houblon Norman research grant from the Bank of England in order to develop statistics of the quantity of money in the UK, the application was rejected, partly, I was told, on the grounds that the quantity of money was of little interest in formulating financial policy. The Bank accurately reflected the opinion of the profession and Radcliffe.

The first imitations of monetarism came soon after the Labour Party won power in 1964. Because of the intial expansionary policy associated with the 1964 National Plan, and with the government refusal to devalue sterling in 1964-6 the balance of payments absorbed large quantitites of foreign exchange reserves, and the government was forced to ask for assistance from the IMF. The IMF had some considerable experience of other monetary systems and had developed its own particular medicine for overheated economies, Ceilings were imposed on <u>domestic credit expansion</u> (DCE) in the letter of intent to the IMF in 1968. Even so the mechanisms of credit rationaing went on substantially as before.

Like any other system of controls, the allocation of credit caused considerable distortions and inefficiency. Banks and particularly the clearing banks bore the brunt of the regulation - but this merely resulted in the normal banking business leaking out to the unregulated non-bank sector. For example comapnies lent directly to one another rather than allow their money to be caught up in the web of controls in the banking system.

Competition and xxxixx Credit Control (CCC), introduced by the Heath government in 1971, intended to sweep away the quantitative and qualtitative controls on credit markets. The Governor of the Bank said..."Basically what we have in mind is a system undee which the allocation of credit is determined by its cost..." The CCC regime

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_/ "Key Issues in Monetary and Credit Sontrol Policy", Bank of England Quarterly Bulletin,, Vol 11 (2) June 1971.

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lasted but two years. Yet in that period there was the most rapid monetary expansion in the history of Britain.- xxxxxxxxxxxxx1973x ixxxxxxxxxxxxxxxxx1971 CCC had clearly failed, and the evidence of the extent of the failure accumulated rapidly as inflation accelerated (to 14% in 1974) successive funding crises developed, and the current account balance of payments degenerated into a record deficit (of £3.3 Bn). The reasons for the failure are many. Xxxxxxxxx Perhpas the main reason was the fact that the authorities were unwilling to xxxxx impose the rates of interest which would contain the monetary aggregates. A secondary reasonx was that the government, believing that monetary and fiscal policy could be xregarded as largely independent, had embarked on a massive prggram of fiscal stimulus in an attempt to xxxxxx avoid an iminent increase in unemployment to the magic figure of one million.

The CCC period left many long-lasting impressions on xxxxxxx monetary management. The first was that rapid increases in monetary aggregates xxx should be avoided; and the system should be changed to prevent such explosions. The sednnd lesson was that monetary policy must be considered in conjunction with fiscal policy; they sbould not be planned as thoughx they were indepnndent instruments.

Although these two lessons were long-lasting and remain as central principles of monetary policy today, the immediate reaction in 1973 was the reintroduction of controls. True they were imposed on the liability side of the banks' accounts, rather than on bank credit, but that was only a matter of form. The quantitive constraint took the form of a control over the 'interest bearing eligible laibilities' (IBELs) with suitable penalties if these were exceeded. Like most controls, it was initially seemingly successful; but as time wore on the financial community found many ways of circumventing the mechanism. Like its nickname "the corset", it squeezed the controlled sector of the financial body but redistributed the fat into the uncorsetted areas; it made the financial system seem trimmer and fitter than it really was. But appearances matter - particularly in political discussion - and the corset remained girdling the financial markets until it was abolished in mid 1980.

The introduction of the first explicit monetary targets in Britain was in the April budget of 1976. This followed a period from the first election of 1974 to the sterling crisis of July 1975 of reckless expansion, particularly in public spending.

Contrary to many accounts, the monetary targets were not imposed by the IMF, although they were much influenced by the troubled state of sterling. Perhaps the main reason for monetary targets was the burgeoning belief that monetary control was necessary to avoid inflation. The lessons of 1971/4 had been heeded.

The choice of M3 as the only target variable seemed eminently sensible, in spite of the fact that more than half of the total consisted of interest bearing deposits. The M3 aggregate had the

singular advantage of being closely related to the fiscal variables, and particularly to the PSBR. Treasury and Bank officials could readily translate a constraint on M3 into a maximum PSBR and thus into limits on public spending. True, there were many slips between cup and lip, but the general flow of the argument was unmistakeable.

Yet there was another reason for embracing M3 ~~which was probably even more~~ important institutionally. ~~Credi~~ The rationing of credit had been the form of financial control for many decades, and ~~xxxxxxxxxx~~ statistics of lending particularly by banks had been the main triggers of the regulatory system. And the definitions were such that the increase in M3 could be easily translated into its components on the ~~lending~~ credit side:

PSBR less sales of debt to the domestic non-bank sector	plus	Sterling lending to the private sector	plus	External and foreign currency transactions [including sales of government debt to foreigners]
	minus	Increase in non-deposit liabilities		

These are the credit counterparts of sterling M3._/ It

_/ Sterling M3 differs from the traditional M3 in excluding sterling balances held by foreigners and the foreign currency deposits of residents.

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was natural to interpret the main task of monetary control in its M3 context as simply another version of the control of credit. Granted the PSBR was substantially funded, the major item was the extension of credit to the private sector. Cynically speaking we were still securely entrenched in the business of credit control — it had merely been relabled "money."

The first experiences with ~~monetarism~~ monetary targets was entirely favourable, parti-cularly after the signing of the IMF letter of intent in December 1976. Yet confusion over the ultimate ~~ins~~ objectives of financial policy, and particularly the desire to keep the exchange rate from appreciating, ~~qui~~ soon led to sterling M3 booming well in excess of the target limit._./ The political

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_/ In the financial year 1977/8 sterling M3 grew by more than 16 per cen compared with ~~the upper limit of~~ the target fange of 9 to 13.

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paralysis of the winter of discontent, as well as the increasing acrimony in the Labour Party, gave little encouragement for the continuation of ~~th~~ a resolute financial policy.

(Certainly the rapid expansion of the money supply was absurdly inconsistent with the final phase IV of incomes policy - a 5 per cent norm for the rise in wages. In the event ~~wages~~ average earnings increased about 13 per cent in the last year of the Labour government - but that left much pent-up wage inflation ready and waiting for the Thatcher government)

The Evidence

The accumulation of evidence on the effects of the monetary mechanism in the U.K. really dates only from the first half of the 1960s. Many of the early ideas were borrowed directly from the United States and particularly from the Chicago School. The first issue was clear: could one identify a stable and largely predictable function for the demand for money ? If the demand for money were random and could not be forecast with any consistency or certainty, then we could all stop ~~talking~~ going on about it and turn our minds to more important matters.

In this monograph, however, I cannot give anything like a complete survey and evaluation of the evidence. All I can do is to give a broad summary of the state of debate, and indicate where I believe the balance of evidence falls. _/

_/ A thoughtful discussion of the present state of knowledge is to be found in David Laidler, Monetarist Perspectives.,Harvard, Cambrideg, 1982, Chapter 2.

Empirical studies of the dmenand for money in the 1960s suggested that, contrary to what had been asserted by generations of economists and by the Radcliffe REport (1959), there was convincing evidence that the demand for money was a stable relationship. The precise form of the relationship and the dynamics of causation were still open issues of much dispute. But it seemed clear that, whatever the outcome of such arguments, money, money income and interest rates were not unrelated. In fact it was

convenient frequently to carry out such analyses in terms of such tradtional concepts as the velocity of circulation or its reciprocal, the so-called Cambridge 'k", which is the quantity of money divided by National Income, or GDP or GNP. The results of the work in the 1960s showed that, for the long run relationship, the income elasticity of demand for money was nearly unity and the elasticity with respect to the consol rate was about 0.5 to 0.6. _/ With this long-run relationship seemingly secure, analysts

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_/ In Kavenagh N.J. and Walters AA (1966) "The Demand for Money in the United Kingdom, 1877-1961" Bulletin of the Oxford University Institute of Economics and Statistics, vol 28, p- 93-166, for the more reliable data in the period post World War I, 1923-1961 the elasticity withrespect to income was +o.96 and with respect to the consol rate -- 0.55. There was also considerable support from the analysis of short-run (usually quarterly) functions - see Laidler and Parkin (1970) and Goodhart and Crockett (1970).

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turned much of their attention to the more difficult problems of the dynamics and the nature of the transmission mechanism._/

_/ For my own attempt see Monetary Multipliers of the United Kingdom Oxford Economic Papers 1966.

The mid-1970s experience, however, appeared to provide convincing evidence to contradict the notion that stability was a characteristic the demand for money in the UK ~~was a stable function~~. The period after the introcution of CCC saw a sustained increase in the ratio of money to GNP (i.e. a decline in velocity) and a sharp increase in the yield on

consols. This ran counter to the normal movement that had been observed xxxx over the previous xxxxxxxxxx half a centruy.

This effect can be seen most readily by plotting the data divided by GNP for the "old M2" against the yield on consols (both averaged over the year). The data produced in figure..... have been adapted directly from Artis and Lewis (1983)._/ The years 1973,4 and 5

_/ Michael Artis and KXM.K. Lewis How Stable is the Demand for Money in the United Kingdom ?, mimeographed, University of Manchester, 1983. Artis and Lewis use the "old M2" which comprises currency outside of bank holdings and the sterling deposits of London Clearing Banks, and they report that this amounted to about 86 per cent of M3 in June 1982. This definition of "old M2" xxxxxxxmakes it easy to get long series of comparable money supply figures from 1920 onwards. Essentially the Artis Lewis analysis is an extension of the work that Kavanagh and I did in 1966.

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xxxx appear as a marked aberation from the fifty years or so which preceeded them. There is simply no other period like it.

This x deviation from the historical relationship had a considerable effect on monetary analysts and eroded some of the faith in monetary control which had been built on the stable results for the last fifty (or even one hundred) years._/ It seemed that

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_/ See David Laidler, "Monetarism: An Interpretation and an Assessment", Economic Journal, 91, No. 361 1981.

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yet another great stable relationship of macro-economics had become unhinged _/

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xxxxxxxxxxxxxxxxxxx

_/ Readers will recall that the stability of the (Keynesian) Consumption function also disappeared in the maelstrom of the early 1970's

Yex

The AL graph however shows that the abandonment of monetarisms claim for demand stability was a little premature. The deviations of the early 1970s proved to be transitory. From 1977 through to 1982 the observations were so uncannily close to the predicted values from the AL fit from 1920-1957 that 1977-82, as AL point out, the forecast values have a much smaller xxxnd deviation from the true values than thexforecastxhavexfrom the average deviation for the sample 1920-57. To forecast so accurately the outcome 20 years hence is a remarkable performance - perhaps even a unique performance - in prediction with economic time series.

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The picture of stability that emerges from the AL figure pertains of course to the long run. We are not able to adduce any such stability for short-run, month by month or quarter by quarter periods. Little or nothing can be learned about the dynamics of adjustment. But, in any progressive program of research, it is important to establish the long run constraints that obtain. If long run velocities conform to a stable pattern, then those who make monetary policy will ignore these relationship at their, or rather the country's peril.

The most detailed analysis of the long run velocities has been carried out by Firedman and Schwartz (1982) for the United Kingdom and the United States. _/ The methodology they use

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is directed towards averaging out, through taking business cycle phase averages, the variability in the short and medium run in order to highlight the long run underlying relationships. Friedman and Schwartz analysed the data from 1871 to 1977. Thus their analysis finished with the great aberation of the early and mid 1970s, Nor did they take into account the 'return to the monetarist fold' of 1977-82. Nevertheless FM claim to have found some remarkable stability in the velocity over the previous 100 years or so. The Fm claim is supported by sholarship of the highest possible kind in which the data have been checked and exhaustively analysed for alternative hypotheses. It is a comfort that they tell broadly the same story as the crude data plotted by AL in figure..... But there are some differences – probably the most important is that FM ascribe less importance to the interest rate variable than appears in my analyses (Kavanagh & Walters (1966) or the AL figure.

The FM results, however, have been subject to stringent and sweeping criticisms, primarily because of their statistical

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or econometric statistical properties by D.F. Hendry and N. R. Ericsson (HE). HE argued that contrary to what FM assert, velocity is better described as a "will-o-the-whisp" and is not distinguishable from a 'random walk'. Essentially HE argues that the observations of velocity contain less information than Friedmand and Swhwartp believe they encompass. This is because the particular observations of velocity are not like 'independent drawings' from a system which produced the velocity curve like that of AL. On the contrary the velocities are systematically related to history, as HE demonstrate elegantly and exhaustively in his equations (20) to (29) and Table II p. 73. This can be seen by simple inspection of the observations in the AL figure. Generally the progression is from low velocities (high M/Y) to high velocities (low M/Y), and correspondingly from low to high interest rates - and from low inflation in the interwar years to the increasing inflations of the years after World War II. But around this general time trend there are many 'loops' which betray some underlying dynamic process not captured by the long-term relationship. The most striking is the long loop during and after World War II. In 1939 to 47 the money supply, relative to income, expanded rapidly at yields on consols which were all rather below the value forcast by the fitted equation. After the war, the monetary stock/ relative to income/ steadily declined at interest rates which were all somewhat above thee expected values. This is merely one example of the distinct patterns in the residual deviations of the observations from the line.

(HE) Monetary trends in the UK "Assertion without empirical basis: An econometric appraisal of Friedman & Schwartz" Bank of England London Oct 1983

Nevertheless, notwithstanding the great weight of sophisticated econometric testing that HE has brought to bear, it is difficult - to accept that the observations in figure.... as a will-o-the-wisp. Is it a mere accident of history that we have wandered on our random walk from the low velocities of pre-World War II to the high ones of the post war years? We might, according to the random walk explanation, have wandered in

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the other direction to even lower velocities. Like Dr Johnson, when told that he could not refute Bishop Berkeley'ss proposition that reality, in the form of a large boulder, did not exist ,promptly hit the boulder with his stick saying "I refute it thus...", one feels inclined to believe the graphical evidence rather than be pursuaded that one is being deluded by optical illusions.

But even more clinching is the evidence of 1977 onwards. The Friedmand and Schwartz analysis refer to the period up to and including 1977.[1] From 1977-82, however, there is an uncannily close relationship between forecast and observiced velocities... Obviously the astonishingly tight fit is something of a fluke. But if one relied on the systematic relationship calculated from the 1920-57 data, one would have done much better in predicting the outcome of the late 70s and early 80s than if one had projected it as a random walk. The pritical test of a proposition lies in the accuracy of its predictions outside the period-of-fit rather than the extent of correspondence of predicted and true value within the sample period. Visual inspedtion shows that the model passed with flying colours.[/]

[1] HE however extended their analysis to include 1978-82.

[/] Except of course fo r the early 1970s to which we return

~~It will be interesting to see whather this period causes Professor Hendry to revise his view that velocity is a random walk.~~

The early 1970s however remain to be explained away. The rationalisation that comes readily is to suggest that it was due to a dramatic change in monetary policy starting in 1971 and running

MP 14

through to 1976. The unprecented size of the increase in the rate of growth of the money supply over these years, and particularly from the fall of 1971 through to the end of 72 associated with unprecedented deficits was a 'shock' to which the financial system had to adjust in the ensuing years. Expectations of very rapid inflation, large demand for credit (to finance the deficits of both public and corporate sectors) and far higher interest rates than would historically pertain to monetary conditions of this kind - all suggests that the economy was driven off its long run demand for money as it adjusted to the inflationary policies of the 1970s. _/

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z_/ The early 1970s, with decreasing velocity were a little like the war time years when velocity similarly decreased, and then, as in the mid 1970s, after 1947 it decreased. But in the 1940s interest rates remained low; this probably represented the widespread belief in the long run stability of the price level. This was eroded in the 1950s and 60s and shattered in the 70s.

This is a superficially attractive explanation and has been embraced amd developed._/ But it is also unsatisfactory. If sharp and sustained changes in monetary growth cause large deviations from the long-term stable relationships then the forecasts of monetary conditions will be wanting in accuracty just when one most needs them.

Ironically the monetary model did in fact forecast the inflationary consequences of the early 1970s far better than any other model. Poor though its performance may have been, alternative models performed even worse. Towrds the end of 1971 and in early 1972, I forecasst that on the basis of the increase in the rate of growth of the money supply (M3) (from circa 9 per cent to over 20 per cent per annum), the rate of inflation in 1974 would be 'over 10 per cent and perhaps as high as 15 per

MP 15

per cent". In fact it was 14.7 per cent. _/ Other forecasters

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_/ "Inflation, inflation, devluation, and more Inflation" Sebag Gilt edged REview, May-June, 1982. This article followed quite closely a memorandum I had submitted as a part time employee of the Central Policy REview Staff to ~~the~~ Lord Rothschild for the attention of the Prime Minister. The article also forecast that there would be a current balance of payments deficit of 'as much as one billion pounds' in 1974 (it turned out to be more than 3 billion) and that in ~~in~~ a year's time (from May-June) the government ~~would~~, in spite of their protestations to the contrary. would ~~imp~~ be driven to impose price-incomes controls, (this actually occured in July 1973,)

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had suggested that the rates of inflation would increase little from the 1971 value (some even thought a fall was likely). _/ Thus

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_/ For a post mortem, see Michael Intrilligator (ed) Frontiers of Econometrics, ~~x197~~ NorthHolland 1976. The main explanation advanced by the principal critic, Mr David Worswick (then Director of the National Institute of Economic and Social Research), was that I had been lucky since the incareassed rate of growth of the money stock had just preceeded the great increases in the price of imported raw materials and, later, oil. Perhaps so. I hope I continue to retain my lucky star.

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in spite of the deviations recorded in the AL figure, The simplest version of the monetarist model performed relatively very well during the great monetary explosion of the early 1970s.

The long run relationship xxxxxxh between velocity and the consol yield, although giving a framework for monetary analysis, does not tell us anything about the relationship between money, real income and the price level. Nor does it say much, if anything, about the chain of causation.

Thexgxx classical argument, as old as economics, is that an increase in the supply of money which exceeds the demand for money at current prices and real income levels, willxhaxx xil merely increase prices in the long run; there will be no effect on output. This result ~~xxmxx~~ emerges clearly from the Friedman Schwartz analysis (pages 7 and 8)- and indeed more dramatically from the history of the last fifteen years of the great inflation. This is of course a long run result. In the short run, for sylcial effects, the evidence is less clear cut. Friedman and Swhartz find that the quantity theory approximation is a good one; monetary vatiation has little or no effect on output, the effect being entirely initially absorbed in the variation in velocity (and ~~presumably~~ the variation in ~~yields~~ interest rates). Finally FS find that there is a negative relationship between the phase average Growth of ouput and the rate of change of pricesin the United Kingdom - a result which appears less surprising today than it would some decade ago. Inflation, whatever its cause, is not 'good for growth' over the phases of the cycle

/ In Lord Kaldor trenchant illustration: if his waist expands, he lets out the seams in his trousers - he does not go on a diet

The 'chain of causation' is perhaps the maxx issue that generates most differences of opinion and emphasis. At one extreme is the Kaldorean or Cambridge view that the money supply is ixxgxix virtually entriely an endogenous factor. The money supply simply responds to the needs of trade. If the private sector want more money they can easily 'manufacture' it for themselves, by mutually gxxx extending credit./ The causation is entirely from income and activity to money. This stands in stark contrast to the Friedmand and Schwartz paradigm, where their analysis is dominantly in terms of the government (or authorities) determining the quantity of money, and income and prices are the consequence of adjustments by agents in the conomy.

Both extreme versions are caracatures of reality. But the FS version approaches more nearly the messy process of monetary control. Through all recent history, the Authorities in the United Kingdom have had neither the instruments nor the will to control directly the quantity of money - however that concept is defined. The authorities have normally used as their main instrument the short term interest rate (variously labelled Bank Rate, Minimum Lending Rate, and currently the dealing rate for bills). The market is supplied with whatever quantity of money it wants at this interest rate._/ The authorities, xxx over the years, have

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_/ This case has been most cogently put by Tim Congdon "Has Friedman Got it Wrong ?" The Banker July 1983 p 117-125

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had different, and often muturally exclusive, objectives in fixing interest rates - and it is only in recent years that the quantity of money has been among that list of desiderata.

There will be some considerable impulses which flow from income to money demand and supply at these controlled interest rates, a fact which Friedmand has frequently acknowledged. _/

_/

He argues however thta the main movements of the money supply have been exogenously by the authorities determined by processes such as that employed in the early 1970s of pegging the interest rate too low. There is no doubt historically that the great expansion of 1971-3 was not due toaccidental effects transmitted on the demand for money through transitorily high incomes.

The Kaldor argument of course goes much further than this. Essentially it says that money is a private credit arrangement over which government can have little if any control. Then indeed government policy with respect to monetary control would not matter - and so it is difficult to see why there is such debate over what is regarded as harmless.

Monetary changes are an incidental result rather than a contributory cause

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There is no doubt, however, that if the main effects of money are exerted and best measured in terms of the quantity of money, then control of that magnitude through the manipulation of short term interest rates seems hardly an efficient way of managing policy. The relationship between money and interest rates is ver precise, and there is bound to be many aslip between cup and lip. The appropriate interest rates are rarely obvious. Yet, as Congdon points out, the mechanism of supplying the market with liquidity has many advantages - particularly in times of

liquidity crises that it should not lightly be set aside. (We return to this problem in the next section.)

The conclusion is that there is a usefully stable demand xnxxnxfxnm functionx for money balances, which seems to fail only when there is a drastic change of regime. Secondly the main effect of monetary growth xignxfixxntixxgrxxtxrxxthx is on prices and not on output. On the contrary there is some weak evidence that inflation and output growth are negatively related.

Money - Wide and Narrow

One of the crucial distinctions made by monetarists and many monetary economists is thxxdi between credit and money. The essential point about money is that it is used in transactions. You pay your bus fare with money; you do not offer the fare collector a promissory note. A transfer of money discharges obligations; a
n extension
xxxnxfxx of credit delays the discharge of obligations. Money is used to pay bills, credit is used nxxxxxxpxyxbill to dexlay paying them. Sinee, however, most money in modern economies is also credit - usually extended by the holder to the govfrnment (e.g. bxnknnx paper currency) - it is easy to confuse the two._/ Mxxtxnxn

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_/ The exception to this general rule is coins of precious metals where the intrinsic value is near to its exchange value

Money is that limited class of credit instruments which are customarily and widely used in the buying and selling of goods and services. Thus one would clearly not count 50,000 negotiable CDs as money; so far as I am aware no-one would ever accept such an instrument to pay an outstanding bill. Money is then naturally defined in terms of currency (notes and coin) and checkable accounts held in financial institutions such as banks and building societies.

Obviously there is no way in which one can define instruments are used as money. Over time they change. For example, it is only recently that building societies have offered checkable deposits; hithertoo deopits in such institutions were not functioning as money. And on the other hand not all checkable deposits should be counted as money; some are wholesale deposits and can only be encashed in terms of large denominations. Although the boundary does shift, the criterion for deciding what is and what is not money is fairly straightforward and causes difficulty only when the categories are passing through some metamorphisis. Over the years the UK approximation to transactions money has been M1 - currency plus sight deposits of the banks. But recently the changes in the financial system have induced the authorities to develop a "new M2". _/ This counts

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_/ In the Bank and Treasury documents this is referred to as merely as M2 - but we need to distinguish it from the old M2 which consisted of currency plus the deposits of London Clearing Banks.

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in the checking accounts of building societies but nets out the wholesale interest bearing sight deposits. It approaches much more closely the concept of transactions balances.-

It is money in this transactions sense that plays the central role in the theoretical structure and the propositions of monetarism. Credit has but a minor role. Yet for much of the empirical analysis, many of the studies have used indicators for 'money' which have included substantial credit instruments which are never or very rarely used for transactions purposes. _/

_/ In FS, for example, money includes the time deposits of commercial banks.

Indeed the definition that was adopted in the MTFS was for sterling M3 - about ~~2/3rds~~ 60% of which ~~was~~ is interest bearing credit instruments which are not used for transactions purposes. True much of this credit was highly liquid and could be rapidly and almost costlessly transformed into checking account balances or cash. ~~But~~ It was, in the IMF phrase, quasi-money and not transactions money.

But some other person or agency had to supply the cash or checking account balance

~~The~~ There were many reasons for embracing a wider definition of money . First, and of dominant importance for the comparable studies of FS, it was easier to get long runs of ~~reliable~~ comparable data on somewhat wider definitions of money. Secondly, and particularly important in the case of the United Kingdom, it was possible to relate the wide M3 to the markets for credit, and the impact of the demand for credit by the public sector. This provided a degree of continuity with the regime of credit monitoring and rationing ~~which~~.... plus ca change.. Thirdly, and most important for monetary analysts, up to the early 1970s all the monetary measures moved in ~~very~~ close harmony. When Kavanagh and I investigated the data from the 1870s to 1961, we found that the definition of money, whether wide or broad, had largely only

scaling effects in the equations._/ Consequently it did not

_/ This was not discredited by the more detailed work of David Sheppard The Growth and Role of UK Financial Institutions 1880-1962 Methuen, and the exploration of adjustment hypotheses in Laidler D. and Parkin J.M. The Demand for money in the United Kingdom 1956-67; preliminary estimates, Manchester School, 38, sept 1970.

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much matter which definition of money was used, the statistical results when suitably rescaled were more or less the same. The choice of M3 therefore encountered little or no resistance from monetary analysts.

The wide M3 measure received an additional fillip with the analysis of the genesis of the great inflation of the mid-1970s. The M3 measure had been a somewhat better predictor of the inflation than any of the narrow measures, particularly M1._/

_/ [In the course of discussions about monetary policy in 1981 Sir Geoffrey Howe and Mr Nigel Lawson pointed out that] I had accurately predicted the 15 per cent inflation of 1974 by using M3 statistics in 1971/2. [It was also reported that] Mr Barber and Mr. Heath, at that time, argued that, from the data on M1, there was little if any monetary laxity. However, any rational review of the record will [both discredit the Heath/Barber position, and show] that, although M3 performed somewhat better during this period, both M1 and the monetary base Mo also predicted with fair accuracy the arrival of the increase in inflation. of about 7 per centage points.

(footnote to be completed)

Thus the arguments in favour of adopting one £M3 target appeared quite cogent if not overwhelming.

In retrospect this appears as remarkable capitulation of monetarist principle to institutional continuity. True the harmony of the statistics provided a good excuse and, so far as I know, no monetarist put up a fight for a money as opposed to a credit measure. Thus the MTFS and political reputations were based on the volatile credit base of £M3.

A parable will illustrate the problem. Consider an economy which consists of two sectors Household (H) and Corporate (C) - each of which is substantially self financing, so that there is no flow of credit between them. Now consider some event occuring that makes the H sector rich and the C sector equivalently poor for a specific period (say one year), after which the situations are reversed for the same period and we get back to the status quo (in year 3). Clearly there will be an increase in savings of H and the accumulation of financial assets - and a decrease in savings and an increase in the liabilities of C. The banks, acting as intermediaries will take interest bearing deposits from H and lend them out to C. Bank deposits and credit will expand. But there is no reason why this expansion of credit and interest bearing deposits should be associated with an increase in nominal income and an increase in the price level. Transactions and narrow (transactions) money balances remain what they were before - only the quantity of credit has changed._/ Thus the quantity of credit can change without having any effect on aggregate demand.

_/ In principle there is no reason why the rate of interest should change since the additional demand and supply of credit are equal.

[Margin note: A necessary condition of the expansion of credit and deposits is that the banks can acquire reserves at non-penal rates which makes intermediation profitable]

This description serves as a useful caracature of 1979/81 in the United Kingdom. Because of the mixture of high real wage

increases, the appreciation of sterling and the begining of the international recession, the corporate sector was in dire financial straights._/Correspondingly the Household sector was enjoying higher real incomes, Personal savings increased from 10.8 per cent of disposable income in 1977 to 15.6 per cent in 1980.

_/ The normal financial surplu of industrial and commerical companies became a £1.6 bn deficit in 1979 and a mere £558 mn surplus in 1980.

The natural corrollary was an expansion of bank credit and interest bearing deposits, which largely found their way into the M3 aggregate._/

_/ There were at times many other factors also working to increase the degree of abnk intermediation; the elimination of the "corset" with effect from July 1980, the virtual extinction by inflation of the corporate debt market, and the reluctance to engage in rights issues with the equity market so 'low', inter alia.

The attempt by the authorities to contain the burgeoning £M3 statistics took the form of raising short term interest rates through the MLR mechanism in and effort to sell more government debt.to offset the additional bank lending. But as an inadvertent outcome, the MLR increases induced a severe squeeze on transactions money M1 and the monetary base._/ No doubt the increases in interest

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_/ From a growth rate of almost 17 per cent from the end of III/77 to the end of III/78, M1 growth fell to virtually zero fro IV/79 to III/80

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rates contained and curtailed to some extent the growth of bank credit, but this effect appeared to be small compared with the severity of the effects on transactions balances.

~~xRexhapxxthexmainxlessonxtoxbexn~~

One of the main lessons to be absorbed from this experience is the primacy of the transactions definition of money for monitoring and control purposes. Money matters much more than credit. This does not mean, however, that there is no knowledge of monetary conditions to be gained ~~frxm~~ by monitoring such credit magnitudes as M3 etc. Clearly there is much to be gained from keeping a weather eye on ~~burgeoning~~ bank credit, ~~for example~~. Nor can anyone doubt that if bank credit to the industrial and commercial companies had been curtailed by effective rationing devices or yet higher interest rates, there would have been considerable repercussions on real output and the level of prices. A credit crunch can be effective but at fearful cost. ~~Monitoring bank credit conditions~~ Similarly one can use other ~~mmmmxxxx~~ indicators of monetary and credit conditions, such as the excahnge rates, interest rates, inflationary expectations, etc, to check consistency. Although, as we shall see, they are often very difficult to interpret - and this has to be borne in mind when using such data.

Monetary Policy and the MTFS

The role of monetary policy varies according to the time period considered. It is clear, however, from all the empirical evidence accumulated over these many years, that our knowledge of long run effects is far more secure than for short run consequences. In the long run a persistent increase in the rate of growth of the money supply is transmitted into an increase in the rate of inflation. But how long is the run ? Alas there is no precise answer. It seems however that an increase in the monetary growth which occurs for some six months and is then reversed in the following six months will have little or no effect on the rate of inflation. On the other hand we are virtually certain that if the higher monetary growth is maintained for three years, then higher inflation will result.

For control of inflation therefore we need to plan low increases in the monetary aggregates over a period of at least three years - and we had best try to ensure that growth of money does not get substantially off course in any rolling period of more than one year. For practical planning purposes we might regard the long run as four to five years - the socalled medium term.

In the period covered by the business cycle, the main role for monetary policy is to avoid exacerbating the cyclical swings. The combination of the unpredicatable timing of the cycle and the fact that monetary effects are slow and uncertain in the lags means that monetary variations are unsuitable for countercyclical policy. All that can be done is to ensure that monetary policy does not become pro-cylical and make the swings wider than they otherwise would have been.

In the short run - that is to say in the day-to-day operation of monetary policy the main objective ~~is~~ is to ensure the liquidity of the financial system. The authorities will be called upon daily to relieve 'shortages' or to syphon off ~~excesses~~ 'surpluses' on the money markets. But more important if there is a liquidity crisis and a run on the banking system (or on a large bank), then the authorities should be ready to supply liquidity - or if there is a run on deposits to supply currency - to restore the public's belief in the integrity of deposit liabilities. _/

_/ This is a sort of lender-of-last-resort function of monetary policy, and in its banking crisis manifestation, it is often called Bagehot' Rule. There are many problems of moral hazard with these arrangements, but they cannot be discussed in this monograph.

The MTFS was primarily concerned with the problem of eliminating inflation (and budgetary imbalance) and restoring a low and stable rate of inflation. It was a medium term program in the monetary sense that it anticipated a permanent reduction in the rate of inflation. As for the cyclical effects, it was never part of the policy to design to vary the money supply targets ~~with respect to~~ to counter expected cyclical oscillations. _/

_/ This is distinct from the PSBRs in the MTFS where it was thought that some modest overshooting should be allowed if the economy were in a recession. In combination with the monetary targets this implied additional sales of gilts in a recession to cover the increased deficit.

This rejected 'fine tuning' 'touches on the tiller' etc as likely to be xxxxxxx pro-cyclical and uitimately inflationary. However the MTFS regognised the essential day-to-day requirements of maintaining the liquidity of the financial system. But if there was a need to expandxiixxi the money supply/to ensure the liquidity nor even to counter a run on the banking system, then any increase could be readily offset before it had a chance of promoting inflation.

Since the monetary targets of the MTFS were set in terms of M3 (for broadly the reasons discussed above), there was a crying need to show that they were compatible with the planned budgetary policy./ In addition to the extension of bank lending to the private sector, One of the main demands xxxx for credit comes from the goverments PSBR, which in turn arises/mainly from expected public spending and tax revenues. Thus the M3 target had to be consistent with the targets for public spending and revenues._/

_/ There are other/volatile elements in the equation. The overseas contribution - for example by residents switching from sterling to foreign currency deposits - may have a considerable effect on sterling M3 in a particular period. But over the longer run these elements will tend to cancel out. Similarly the net addition of non-deposit liabilities may exhibit volatility in the short run, but little in the longer time span. Perhpas the most volatile element - and the one most difficult to forecast - is bank lending/in sterling to the private sector, as discussed above.

Such consistency is however in its turn entirely consistent with considerable year to year variations in the PSBR and the growth of M3. One would not expect them to march in step - slthough with controlled and 'sticky' interest rates one might induce some

some contrived annual correlation. But in the long or even medium run there must be some consistency, since, if the government runs higher and higher PSBRs, then it must continue reducing the price of its gilts in order to fund the deficit and maintain its M3 targets. But there is a limit to the extent to which the private sector will absorb gilts. And as has been repeatedly demonstrated, the attempt to force large sales of gilts down the throats of unwilling portfolio managers gives rise to very damaging oscillations in interest rates and the price of government debt. Funding strikes and financial crises are the consequence of high PSBRs and low M3 targes. _/ The MTFS sought to, and from

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_/ See House of Commons, Treasury and Civil Service Committee, memorandum on Monetary Policy (July 1980), where both Lord Kaldor and Milton Friedman gave evidence from somewhat different points of view.

1981 onwards through to 1984 did avoid any sustained funding strike and financial crisis.

This consistency provided a necessary but not sufficient condition for the <u>credibility</u> of the policy. Another precondition for credibility was that the authorities had or were willing and able to acauire and wield the instruments to bring this policy into being. Apart from the fiscal instruments, the main control on the monetary side was the manipulation of the short run interest rate. Although monetarists had long argued that interest rate controls were a most inefficient and difficult way of controlling monetary aggregates, this had been the main form of control in Britain for, literally, centuries. During most of that period there had been no persistent inflation - and over long periods there had been pervasive but gentle deflation. But in view of the

of the recent experience following CCC (in 1971-3) when the government deliberately pegged interest rates, from political motives, and allowed the inflation to explode, there was initially considerable doubt about the performance likely from the Thatcher government. The cynics sighed... plus ça change.

In some extreme versions of the theory of expectations (socalled rational expectations), the announcement of a policy by government would have wonderful effects. People would quickly adjust their behaviour to the new parameters of policy, including the low inflation rates to be achieved by the MTFS. But such theories should be regarded as parables or ideals; they should not be taken as recipes for reality. It is indeed more rational not to believe a government's will implement its protestations on policy if one judges only by the historical record._/ The paths of politicsseem inevitably

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_/ Readers will recall that a certain indicator of the imminence of devaluation was the frequency and vehemence with whichthe Chancellor denied that he had any such thoughts in mind.

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to be one long painful path of U turns.

And there were good technical as well as political reasons for doubt if not cynicism. In addition to the optimistic targets for public spending, discussed above, not only the Bank but also many monetary economists were doubtful about the ability of the Authorities to control the growth rate of sterling M3.

As the views of the Bank filtered out to the journalists, it seemed, as is natural, the Bank was not xxxxx in favour of a limit on its discretion in the form of a meeting a target monetary aggregate. The Bank was ~~generally infavour of~~ well disposed towards an exchange rate target and supported the case for the entry of the U.K. into the European Monetary System (EMS), at a suitable partiy of course. Moreover there was considerable (and ultimately justified) trepidation of the effects on Sterling M3 of the abolition of the corset in mid 1980.

The opposition to the MTFS by those economists and commentators who still believed in substantial discretionary policy and taggets xxxxxx in terms of real variables, such as growth of GDP, level of unemployment or employment, etc was entriely understandable; their opinions had a Bourbon predicaability, What was more surprising however was the opposition, albeit on technical grounds, from many monetarists._/ While these critics usually embraced the

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_/ Economists such as Brian Griffiths, Roy Batchelor at The City University Centre for Banking and International Fiance were the most prominent critics - and they were joined by many of the most distinguished monetarists in the United States, such as Alan Meltzer.

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targetting of sterling M3, largely on the empirical grounds that it was marginally better than other aggregages in the recent past, they believed that the use of interest rates as an instrument was clumsy, inefficient and perhaps ultimately ineffective. They argued that the best method xxxxxx was monetary base control(MBC) _/

_/ See, for example, Alan Meltzer, Central Bank Policy; Some First Principles, Annual Monetary Review, No.2 (1980), City University, London.

There was, however, some ambivalence, perhaps inconsistency, in the position taken by the monetarist critics. A monetary base control method combined with a sterling M3 target would only be efficient if there was a close and predicatable relationship between the monetary base and sterling M3. While the relationship was valid for long runs - say more than/three years (or so) - the/variation monthly and yearly in the ratio of the monetary base to sterling M3 was consierable._/

_/ In fact, the monetary base was very well contained during the all the years of the Thatcher government. But the ratio of sterling M3 to the monetary base expanded probably faster than any period in recent history.

There is little or no point in trying to use the MBC system to control M3. There is however a logically consistent argument for MBC if the monetary base is used as the target as well as the control. Then the argument is that, provided the monetary base is held at a suitably low rate of growth (say 0 to 2 per cent), it is very unlikely that there will be any substantial persistent inflationary pressure. _/ This was, however, a far cry from the MTFS, but

_/ This was a fair representation of the positions taken by many distinguished monetarists such as Karl Brunner and Alan Meltzer as well as the late William Fellner.

the issue of Mo will be taken up later in this narrative.

Monetary Policy and the EMS

There have long been aspirations to form some monetary union of the European Community, which would correspond to the trade and fiscal harmonisation implicit in the Treaty of Rome. The breakdown of the Bretton Woods system of more or less fixed exchange rates and the erosion of confidence in the stability of the dollar,added to theEuropean view that there should be some substitute for the role of reserve currency. The initial 'snake' , introduced from early 1972, was modelled on the late lamented Bretton Woods, with exchange rates 'fixed but adjustable'._?/

_/ The snake had a checkered history, with the early defection of three of the four major currencies, leving only the German mark and its satellite currencies. However by the time of the introduction of the EMS, the snake had become very permissive indeed and had few pretentions to be a fixed rate system - adjustments were large and frequent.

The EMs was introduced in early 1979 and included all the major currencies of Europe except sterling.

The essebce of the EMS consists of agreeing central rates with respect to the European Currency Unit which obtain until the next 'realignment'. The member countries then use policies of intervention and monetary control in order to keep their rates within a band ± 2½ per cent, expept Italy where the band is ± 6 per cent. In practice however the rates are usually maintained fairly close to the central value.

Although the system has many of the features of a mini-Bretton Woods, there is no systematic relationship of any currency, including the Dmark, to the US dollar. The most important exchange rate in the trading world, the Dmark/dollar rate, was excluded from the EMS.

In assessing the effect on monetary policy of membership of the EMS one must initially draw a sharp but essential distinction, between the ideal system and the real system. First the ideal. If the objectives meant anything, then they required the exchange rates to be virtually fixed with respect to one another for a specific period (say one year) before the next realignment. If this is the case, and assuming there are no oscilations around the central values, the markets can expect periods of up to one year when the exchange rate between the Italian lira and the Dmark are fixed.

But if the excahgne rate is fixed for an average of six months, then this will imply that the rates of interest on financial assets with those maturities will also be roughly the same. If, after six months, I can exchange my lira for Dmarks at the same rate at which I bought them, I will find it profitable to switch into lira deposits if the interest rate in Italy is a tithe above that in Frankfurt. Thus nominal interest rates for those maturities must be approximately equal; portfoliao arbitrage will ensure that outcome._/ — run on

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_/ There will be some transmission of this effect to other maturities so the level of the yield curve will be largely determined by this arbitrage ~~- but we leave that aside for this argument.~~

It follows that by joining the EMS, as in any fixed exchange rate system, Britain would have to forgo a substantial degree of sovereignty over here monetary policy*./

/ The government would have a number of other monetary instruments - such ass reserve ratios/- and varying the maturity sfructure of public debt which could be used, but there is no doubt that interest ratex policy is the primary weapon.

This ix interest rate equality illustrates one of the main difficulties - an inherent controadiction no less - with the EMS. One of the objectives of the EMS was to produce 'convergence' of the / rates of inflation of/ member countries - and in these terms it meant converging on the inflation rate of Germany. Thus it was hoped that Italy, with an infltion rate of about 15 per cent, would eventually converge to the German inflation rate of about 3x p per cent. But the requirement that, under a fixed exchange rate, German and Italy have the same nominal interest rate - say 9 per cent - means that the real interest rate in Germany is high and positive (6 per cent) whereas the real rate in Italy is negative at minus 6 per cent, If the monetary authorities operate an interest rate regime in controlling their domestic money supply, there will be a great pressure to expand money and credit in the Italy, whereas in Germany there will be a substantial financial squeeze.

This is precisely the opposite mmonetary policy to that which would move towards 'convergence'. Monetary policy has not been merely neutralised by the ~~EMS (consider~~ fixed exchange rate system, it has been made perverse. If countries still seek convergence, then this must be achieved mainly through fiscal policy - and indeed

fiscal policy will have to offset the malignant effects of the EMS monetary policy. It is often claimed that the EMS has had a substantial effect in inducing member countries to take stringent fiscal action which they would not have entertained had they not been members of the EMS. This is true. But it is odd to credit the EMS with discipline that arises from it distortions. _/

_/ Am I alone in finding it odd that exhange rate fixity and the conoom itant equality of interest rates is described as 'closer monetary cooperation ...in Europe' ? (Five Years of Monetary Cooperation in Europe, EEC, COM(84) 125 final, March 1984.) Fixing exchange rates and interest rates will produce divergent monetary policies.

In reality, however, the EMS diverges substantially from the fixed exchange rates with free capital markets that we have outline above. First there are substantial restraints on the free flow of capital - particularly by France and Italy, so that arbitrage is nowhere near perfect. Indeed in the case of France [and to a lesser extent in the case of Italy] the capital constraints have become sondierably more stringent since France has been a member of the EMS. One must be wary of post hoc ergo propter hoc but this evidence is not inconsistent with the fact that France would not have needed such controls if she had not been constrained by the psuedo fixity of exchange rates. Willy nilly, regulation of capital flows has enabled considerable deviations in interest rates between member countries, so the countries have been able to pursue mor appropriate monetary policies than those which were implied by a strict EMS.

Secondly, even over quite short time horizons, the exchange rates have not been fixed. This is partly because of the width of the band within which currencies can move - up to 5 per cent for all expept Italy which caan move as much as 12 per cent._/ But the main reason is that changes in the parity have been frequent and sometimes quite sudden.

_/ It must be noted that the practice of countires was to attempt to keep their exchange rate on the average close to the central value and not to bump against ceilings and floors.

The forward markets reflect all these uncertainties about future rates of exchange. And it is noticeable that the forward discounts for France (and Italy) in the EMS group, with respect to the Dmark, were and are usually larger than the ones pertaining to the UK.*/ Being inside the EMS idd not seem to reduce the insurance premium one had to pay to avoid exghange rate risk. On the contrary insuring against exchange risk cost more if you were Italy, France or Eire, than if you were outside like the UK or USA

*/ The average percentage change (ignoring sign) from month to month(end) in the exchange rate of the Frech france and th Italian lira from 1979 to 1983 was 0.8 per cent._/ If the movemnet is all one way, as it was substantially in the case of Italy, this represents about a 10 per cent depreciation of the lira during a year. Although currencies outside the EMS exhibited greater month to month variability, on this measure, there were many more negatives cancelling out positives, rather than the more or less steady downward drift of Italy and France.

_/ See 'Five Years of Monetary Cooperation in Europe', Table 1.

for more on p. MP(38)

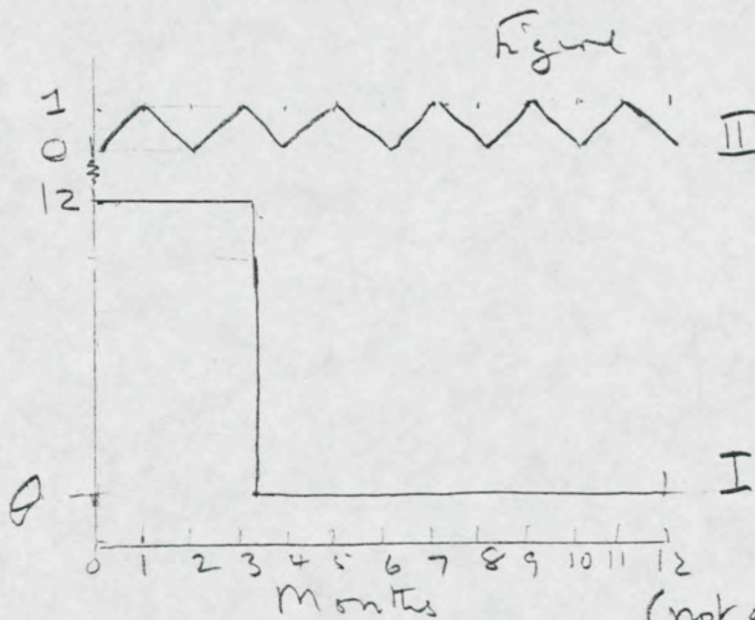
MP (38)

_/ Thus on March 27th, 3 month forward dollars commanded a 5 percent premium in DM, and a 6% discount in Lira. This corresponds to the annual 10% drift of the lira against the DM in 1983. Sterling however was at a premium ~~discount~~ of only 1.74 per cent. And of course three month interbank reflected these at 5.85 in Germany, 17.4 in Italy and 9 in London

Although the EMS has removed some of the short term, month-by-month (unsystematic) "random" variations in exchange rates, it has not reduced significantly the systematic variation which can be forecast by the market._/

_/ The ECE Study "Five Years of Monetary Cooperation in Europe" measures exchange rate instability by the size of the average monthly absolute change in per centage terms. It is worth noting therefore that the same measure of variability (i.e. 1 per cent a month) would apply to the following two series. In series

Figure



I there is one big 12 per cent fall (not atypical of the EMS realignments), whereas in the other series (II) there is a plus one, minus one pattern for each month. Thus the same measured result masks a very distinct and different reality.

This variation in EMS exchange rates together with capital controls has enabled the countries to pursue monetary policies - as manifest in their interest rates which were not entirely counterproductive in indusing 'convergence'. The basic inconsistency between fixed exchange rates and convergence remains.

In the rather messy EMS system, there has been no evidence of convergence. As the ECE paper admits, the mean absolute deviation beetween anual price inflation increased slightly from 4.2 per cent in 1979 to 4.4 per cent in 1983 - although as always great things are expected for the years to come. The record on convergence so far is rather dismal, but more important is the fact that the EMS has butressed the latent argument for greater capital controls and reductions in the degree of convertibility.

The EMS was also presented as a step on the grand process of monetary integration of Europe - perhaps ultimately towards one central bank, one currency, and one economic policy. If one entertains such ultimate goals, then the EMS seems to me to be a step backwards. Fixing prices (like exchange rates or indeed agricultural prices) creates centrefugal and divergence not centrepetal forces and convergence. The road to convergence is to harmonise the great quantity determinants of monetary conditions - namely the rate of growth of money, and the budget deficit. If the members each pursued policies of similar low monetary growth then there would be

the basis for eventual convergence. A medium term financial strategy is the right approach.

It has been claimed that the EMS is one way in which member states will accept the ~~disciplines of~~ fiscal and monetary disciplinerequired for convergence. The ~~example~~ policies of France in the period of the socialist government 1981-84 ~~is~~ are presented as an example of such discipline. And it is true that the expansionary program of the Mitterand government from ~~1981~~ the assumption of powerin 1981 ran only until March 1983. Then/after successive devaluations in October 1981, June 82, and March 83 the government instituted and austerity program, ~~ix~~ aimed at reducing the budget deficit to 3 per cent of GNP and monetary growth to 9 per cent. Of course one cannot be sure that policy the French government would have pursued if they had not been members of the EMS. But we do know that the behaviour of the British ~~socialist~~Labour government in the period 1974-76 was quite similar._/ Unbridled expansionism

---

_/ The main exception is that Britain did not devalue until 1977.

---

in 1974-5 was followed by ssubstantial squeeze in 1976. Ironically in spite of the fact that Britain was not in the snake, the exchange rate against the dollar was pegged over this period !

Thus protestations that the French government were largely or even signficantly induced to the austerity of 1983 by membership of the EMS must be viewed with skepticism. It is entirely understandable that the supporters of the EMS should claim such credit as falls their way.

The conclusion is that it is ~~diffcult~~ difficult to see what The United Kingdom would gain from joining the EMS. Certainly under the Thatcher government, and conceivable under alternative governments, there ~~would~~ is no need to bolster the anti-inflationary policies with psuedo fixed parities.of the kind practiced in the EMS. At most the EMS might reduce the very short term/variations
weekly, or monthly
in the exchange rate against the ~~Europe~~ EMS currencies. But research suggests that/such short term movements have little
because of thick and almost perfrect forward markets
if any/inhibiting of trade._/ ~~Anyxxxxdxxxxxx~~ On the other
effect ~~in~~in

_/ Seethe research carried out by the British North American Association...........

A survey of firms showed little concern with the short term variability of exchange rates - and firms were apparently well versed in buying ~~k~~forward cover. Under floating conditions the firms could either buy certainty in the forward market or take their chances on the spot market. With a/fixed rate
real
system that choice is deined them.

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hand those who seek eventual monetary union of Europe had best pursue it through quantitative convergence rather than exchange rate fixity. Britain will best serve monetary union in Europe by urging the right policies rather than embracing the wrong ones.

6/2b

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FMR (84)9
October 1984

FINANCIAL MARKETS REPORT

Prepared by HF3 and EF(1)

The attached note reports on developments in the foreign exchange and domestic financial markets during the period banking and calendar September.

R N G BLOWER
D McSHARRY

6/2b

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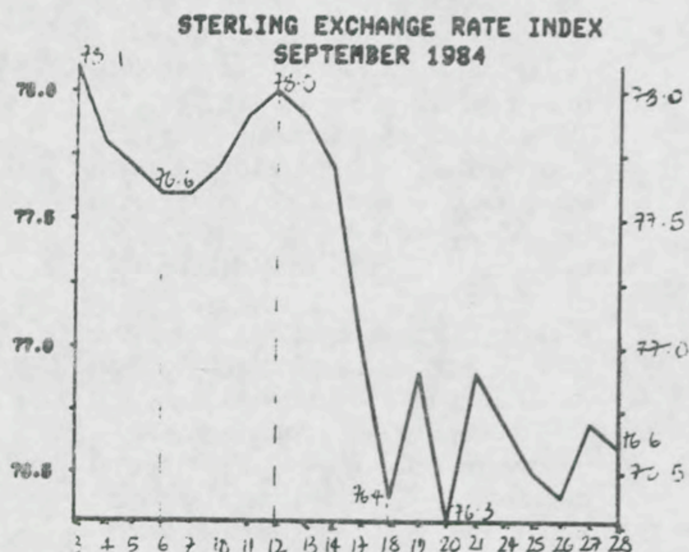
Introduction

On the foreign exchange market the dollar hit new all-time highs which caused sterlings ERI to fall to 76.0 (its lowest level since November 1976). Interbank rates were basically steady though the undertone was nervous. Gilt yields declined marginally in quiet trading.

FOREIGN EXCHANGE MARKETS

Spot Sterling



- Following the ½ per cent cut in base rates to 10½ per cent on 17 August, sterling's ERI eased by 0.2 to 78.5. Concern about the possibility of a second national dock strike in 2 month pushed sterling to a low of 77.8 at noon on the 23rd. After closing at $1.3085 DM 3.7580 and ERI 77.8 on the 24th, mixed responses to the strike call at some of the major ports helped the pound to end at around $1.31, DM 3.78 and ERI 78.2.

  Sterling began September generally steady. A sharp surge in the dollar caused the pound to fall to a series of lows ($1.2735 on the 7th), but it suffered no more than other major currencies, despite developments at the TUC conference. The 0.5 fall in the ERI to 77.6 was largely a reflection of the dollar's strength.

- The pound gained ground against European currencies and held up relatively well against the stronger dollar in the week beginning 10 September, helped by some good commercial demand in the face of cautious optimism about the NCB/NUM talks. Sterling closed at an ERI of 78.0 on the 12th and the dollar touched a new high of $1.2664 on the 13th. News of the breakdown of the miners' talks late on the 14th was absorbed relatively well.

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The dollar

- The dollar traded erratically during the second half of August, falling from a high of DM 2.93 reached earlier in the month to DM 2.86$^{7}/_{8}$ on the 29th after inconclusive economic data led to uncertainty over future dollar direction.

- The dollar began September with renewed vigour, breaking through the key DM 3.0 evel on the 10th as sentiment became increasingly bullish, reflecting belief that

  President Reagan would be re-elected and that US interest rates would remain high in the near-term. Apart from the occasional bout of profit-taking, the dollar continued its surge, reaching a new 11½ year high of DM 3.1760 and new all-time highs against most other European currencies on the 21st . However, aggressive Bundesbank intervention the same day and signs of renewed inflationary pressure (US consumer prices +0.5 per cent in August), sparked a sharp 8 pfennig decline.

- With the mood extremely nervous, further Bundesbank intervention on the 24th forced the dollar down to DM 2.9750. The US currency cautiously recovered to DM 3.0790 on the 26th in the absence of heavy central bank intervention, but eased to DM 3.0245 the following day after several major US banks cut their prime rates in line with Morgan Guaranty's ¼ per cent reduction to 12¾ per cent on 21 September. The dollar ended the month on a rising note helped by data showing stronger than expected US economic activity.

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OTHER RELATED DEVELOPMENTS

	EMS Top	EMS Bottom	Spread %	Yen	Gold
15 August (close)	Dfln	Bfr	1	242.15	350.90
3 September (close)	DM	Bfr	5/8	242.60	344.50
5 September (close)	I£	Bfr	5/8	244.46	338.25
21 September (close)	I£	Bfr	1 7/16	244.30	343.50
28 September (close)	I£	Bfr	1 7/16	246.80	343.75

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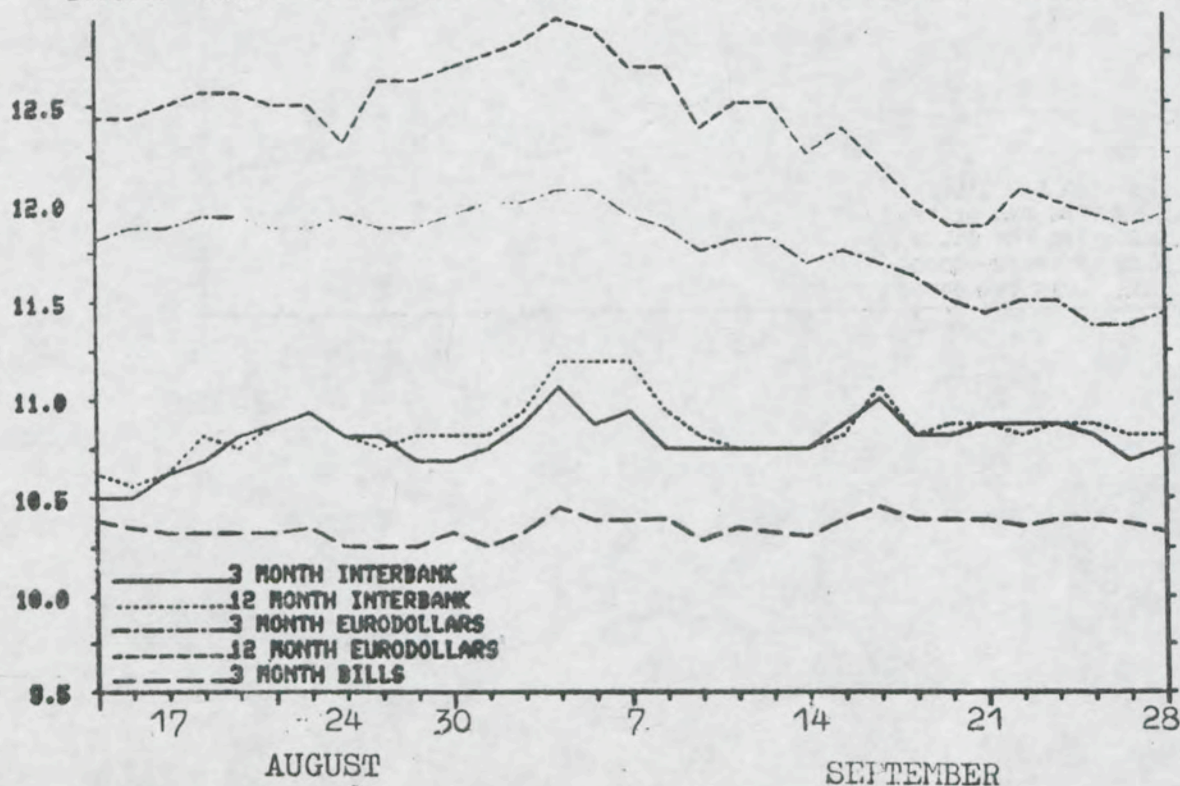
Money Markets

Interbank interest rates traded in a fairly narrow range during banking and calendar September, though industrial disputes and the weakening exchange rate caused the market to be nervous throughout.

The clearers announced cuts in their base rates by ½ per cent to 10½ per cent on 17 August. But shortly afterwards the calling of a second national dock strike and the strength of the dollar caused rates to harden. They peaked after sterling's fall below $1.30 on 4 September, which prompted some precautionary marking up in interest rates. But this was unwound after a few days when sterling improved, peace moves in the mining dispute giving some hope and when it became clear that the authorities would not support any general upwards move in interest rates.

Another factor reducing pressure on UK interest rates was the perception that US short-term interest rates had peaked early in September. The settlement of the Dock strike in the middle of the month was also helpful. The yield curve flattened as expectations for interest rates were revised downwards Rates remained pretty steady for the rest of the period, with the 3 month rate about ½ per cent higher than at the time of the August base rate cut.

Average daily money market assistance was over £½ billion in banking September. There appear to have been a number of opportunities when so called "hard arbitrage" was profitable, when companies could issue bills and deposit the proceeds in the interbank market. Such opportunities can open up when interbank rates rise, while bill rates are held down by the weight of the Bank's operations at its fixed dealing rates.



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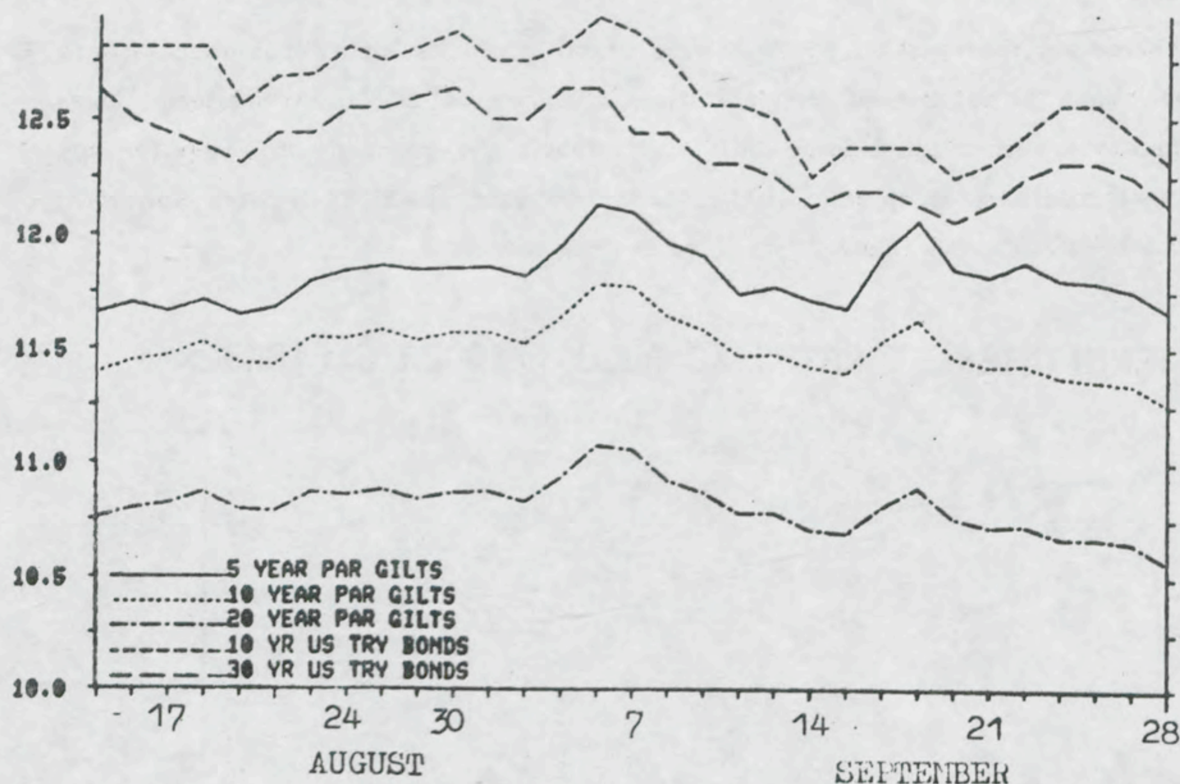
The Gilt-Edged Market

Gross gilt sales in banking September, struck after buying-in of over £300 million of stock other than next maturities, totalled £580 million. Buying-in of next maturities reduced the net total to £535 million. Just over £500 million came from calls on part-paid stock issued in earlier months.

Throughout banking September, the strength of the dollar cast a shadow over the market, as did the miners' and dock strikes. The end of the dock strike in mid September came too late to affect sales in the banking month, but sales picked up strongly at the end of the calender month, yields having been coming down over the previous week, despite concern that NACODS might call a strike whch would shut down the working pits. Indexed gilts did particularly well, and the authorities were able to include two indexed stocks in the substantial package of tranchettes announced at the end of the calendar month.



KJ

New stocks issued during the review period totalled £2050 million of which £300 million was for CRND.

Stocks issued in Banking and Calendar September

Stock	Date Issued	Amount	Price	Exhausted
10½% Treasury Convertible* 1992	16.8.84	950*	95.25	27.9.84
2½% Exchequer 1986	14.9.84	150	87.00	—
3% Exchequer 1987	14.9.84	100	84.00	—
10½% Exchequer 1988	28.9.84	200	96.625	4.10.84
8¾% Treasury 1997	28.9.84	200	85.875	5.10.84
12½% Treasury 2003/05	28.9.84	150	120.125	2.10.84
2% Index-Linked Treasury 1990	28.9.84	100	88.50	5.10.84
2½% Index-Linked Treasury 2009	28.9.84	100	93.00	4.10.84
10% Treasury 1987**	28.9.84	100**	96.375	-

* £200 m of the total of £950 m was for CRND.

** Entirely for CRND.

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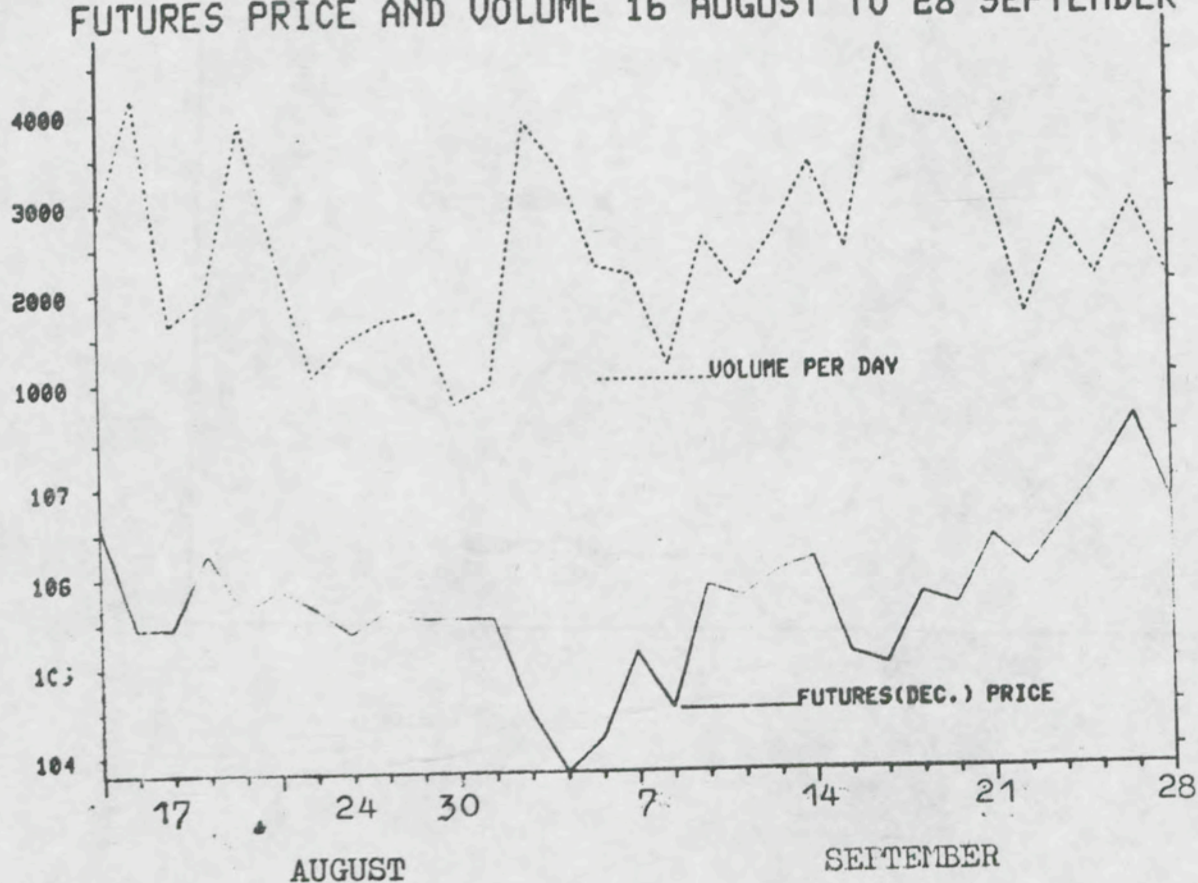
Gilt-Edged Futures

The December contract began banking September at 105.16. The contract traded steadily until early in calendar September when the dollar's growing strength against sterling weakened the cash market in gilts and the future price fell to a low for the period of 103.25 on 5 September. As gilt yields eased back the contract price recovered in line with the cash market and ended September at 106.23.

	September Price (£1/32s	Total Volume (no. of Contracts)
High	107.22 (27/9)	4618 (18/9)
Low	103.25 (5/9)	740 (30/8)
Average	105.22	2743



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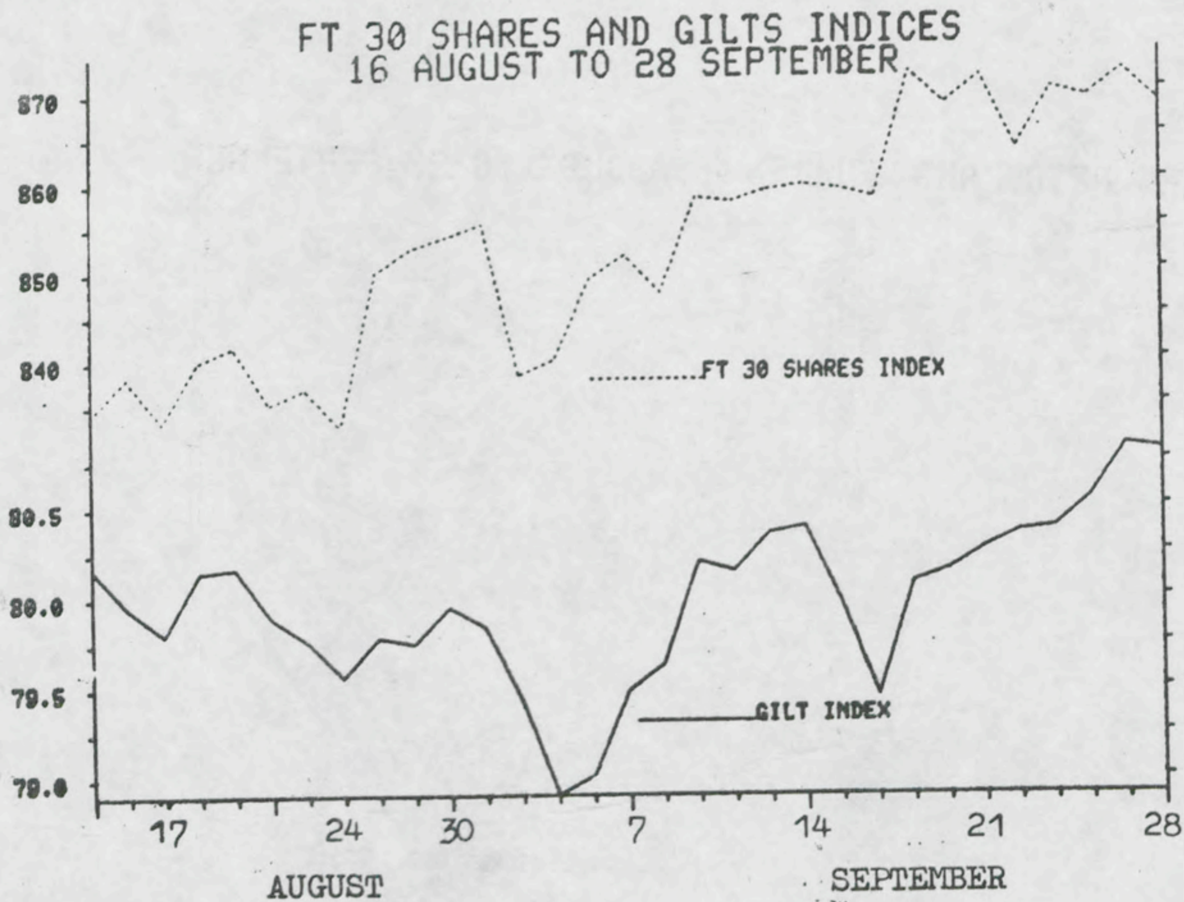
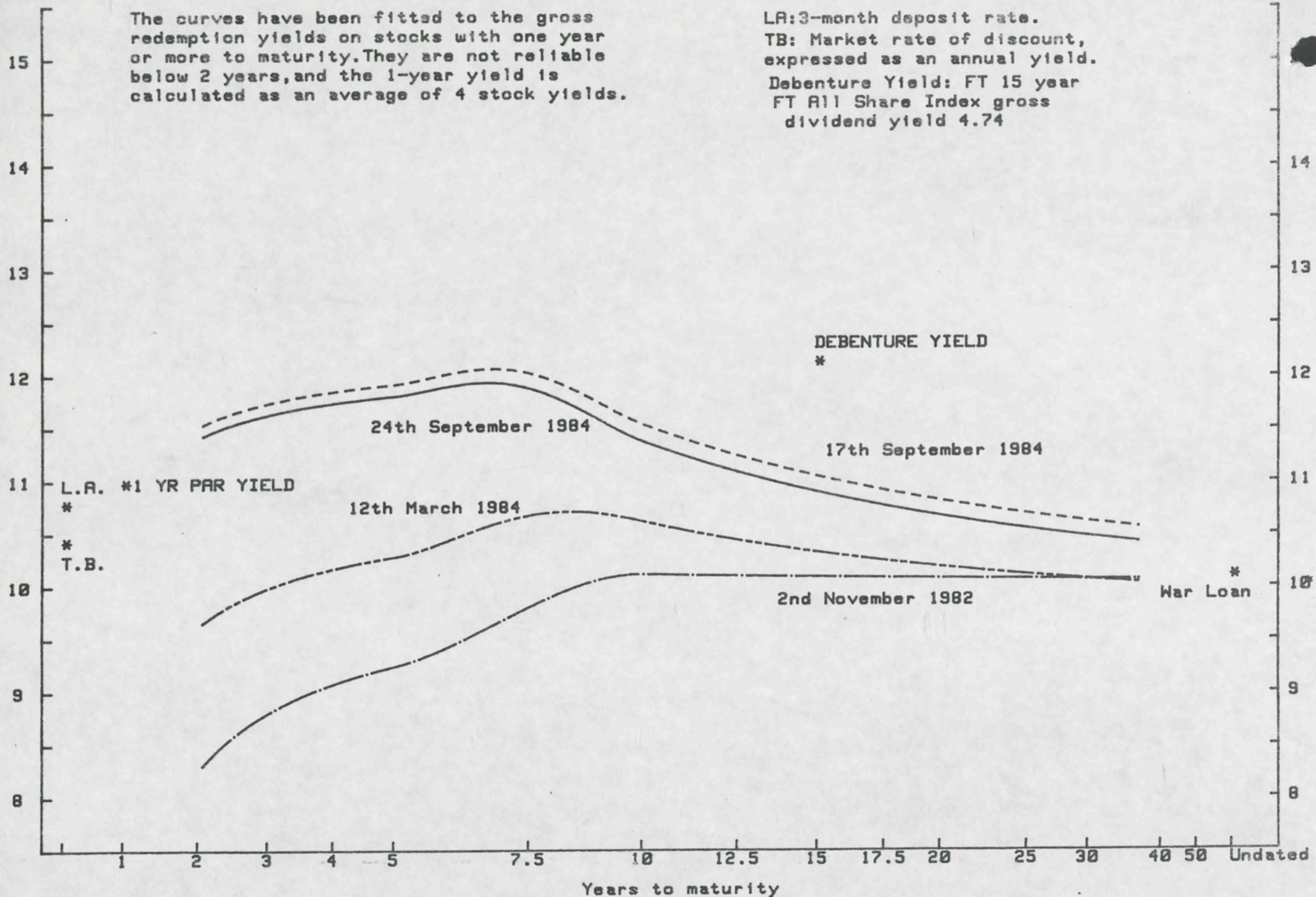
Equity Market

The FT 30 Share index began the review period of 16 August at 834.1, near the period low of 832.4 (reached on 28 August). Optimism over the miners' and docks strikes helped the market to rise, brief interruptions on sterling's we kness being quickly overcome. Trading was generally light, and the rise was gentle. On 28 September the FT 30 Share index stood at 868.4, only just below the period high of 872.0. The FTSE 100 ended calendar September 1140.3 after being at 1075.6 on 16 August.




Per cent
Time / Yield Curves of British Government Stocks
26th September 1984
The curves have been fitted to the gross redemption yields on stocks with one year or more to maturity. They are not reliable below 2 years, and the 1-year yield is calculated as an average of 4 stock yields.
LA: 3-month deposit rate.
TB: Market rate of discount, expressed as an annual yield.
Debenture Yield: FT 15 year
FT All Share Index gross dividend yield 4.74
DEBENTURE YIELD
24th September 1984
17th September 1984
L.A.
*1 YR PAR YIELD
12th March 1984
T.B.
2nd November 1982
War Loan
15
14
13
12
11
10
9
8
1
2
3
4
5
7.5
10
12.5
15
17.5
20
25
30
40
50
Undated
Years to maturity

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Pile SLHAEK

10 DOWNING STREET

From the Private Secretary

26 September 1984

NATIONAL SAVINGS

The Prime Minister saw your letter to me of 24 September. Her initial reaction was that a rate of 8 per cent for the new National Savings Certificate looked rather low. She is grateful to the Economic Secretary for having reconsidered the arguments. She has noted that, having done so, he remains of the view that 8 per cent is the most appropriate rate given the factors involved. She is, therefore, content for him to proceed as originally proposed.

Andrew Turnbull

CST

A M Ellis Esq
H M Treasury

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①

PRIME MINISTER

NATIONAL SAVINGS CERTIFICATES

I went back to the Treasury to ask them to reconsider whether setting the new certificate at 8 per cent was too low. It was clear from my enquiries that a range of options between 8 and 8 and a half per cent had been considered but the bottom end of the range was chosen because the damage done by undermining the BT issue or fuelling the building societies' spiral was thought to be greater than the damage done if inflows were disappointing (given the fact that NSC inflows are now ahead of schedule). The Treasury have put forward an additional argument, to which I believe the Chancellor attaches some importance. By aiming low the Government will be seen as supporting the optimism emerging from the Finance meetings about lower US interest rates (though I would take anything coming from Mr Regan with a pinch of salt).

The Economic Secretary reviewed the arguments again this afternoon and still feels that 8 per cent is the best choice.

Now that this has been considered carefully, agree to go along with the Treasury's judgement?

Yes m

AT

Andrew Turnbull

25 September 1984

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230/48

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Prime Minister (1)

Neither John Redwood nor I believe the Treasury will achieve even the modest inflows they seek. Agree ask Treasury to reconsider, possibly 8¼ per cent.

AT 24/9

Treasury Chambers, Parliament Street, SWIP 3AG

Yes mt

Andrew Turnbull Esq
Prime Minister's Office
10 Downing Street
LONDON
SW1

24 September 1984

Dear Andrew,

NATIONAL SAVINGS

Since 11 September, when the 28th National Savings Certificate was taken off sale, no fixed interest NSC has been available to the public. Subject to the Prime Minister's views, it is the intention to announce a replacement as soon as possible.

The 28th Certificate was, as you know, extremely successful. In the 5 weeks it was on sale it grossed over £1 billion. In doing so it made up for a rather sluggish National Savings performance in the earlier months of this financial year and put us back on course to achieve the £3 billion target. We had always intended that the rate on the 28th should be an attractive one, but part of its success was undoubtedly due to the fall in banks' base rates soon after it was announced and the general anticipation in mid-August that interest rate generally, including those of building societies, would decline. In fact rates have firmed from mid-August levels; indeed building societies' premium rates have increased to extremely aggressive levels. Given this, we cannot afford to take National Savings rates down too far.

The Economic Secretary has therefore decided that we should go a little slowly in funding from National Savings over the next 3 months because the monetary prospects, so far

as we can judge, do not require aggressive funding; we do not want National Savings to undermine, or even appear to undermine, the BT issue; and the building societies are in a nervous state after their August experience and are fearful of the BT issue.

Nevertheless out of the range of National Savings products only the fixed interest certificate has done well and a new issue must serve to contain any deficit that may arise over the next couple of months. Too low an intake over the next few months will pose the risk of National Savings falling a long way behind again and leaving a lot to catch up early in 1985 in very difficult circumstances.

Against this difficult background it has been decided to set the interest rate over the five year life of the 29th NSC at 8 per cent. This should not give the building societies genuine cause for complaint; and should not jeopardise the BT sale. At present interest rate levels some modest National Savings funding should result and, of course, it is right that the public should have an NSC available.

The Economic Secretary would therefore be grateful for the Prime Minister's approval to announce as soon as possible that the 29th NSC will be launched on 15 October with a coupon of 8 per cent. No other changes to National Savings products are being made.

Yours ever,

Adrian Ellis

A M ELLIS
Private Secretary

Monetary policy file

Comparative Rates

			%
NSC	27	28	29
Grossed up compound and held for 5 years.	10.4	12.9	11.4
Guaranteed. (Tax Free)	(7.25)	(9.0)	(8.0)

Building Society Majors

Ordinary Share (net)	11.1 (7.75)	wef 1 August 1984
7 day money (net)	13.2 (9.25)	wef September 1984
1 month money (net)	13.5 (9.35)	wef September 1984
3 month money (net)	14.3 (10.0)	wef September 1984

Bank 7 day deposit

5¾ - 6	6½ - 6¾	8¾ - 9.0	8¼	7¾ - 8.0	7¼ - 7½
9 May	6 July	12 July	8 August	11 August	17 August

Forecast National Savings Contribution to funding PSBR (£m)

	April - September	October - November	
NSC conventional*	+821	-83	
Index-Linked	-221	-155	
Invac	-178	-20	
Income Bond	+375	+135	
Yearly Plan	+1	+3	
Other	+17	+30	
Total Net Cash flow	+815	-90	
Total including accrued Interest	+1690	+325	= about £2,000m end November, or ⅔ of £3bn target. December results are problematic but will probably leave the contribution below target.

*Assumes 8% 29th Issue

These (calendar monthly) results are consistent with those in the monetary forecast which assumes that we do not need heavy NS funding in the short term.

25 SEP 1991

SECRET

10

18 September 1984

MR TURNBULL

FUNDING MEETING, 18 SEPTEMBER

I attended the Funding Meeting today.

National Savings. The 28th Issue has now been withdrawn. It was such a success that National Savings are now well ahead of their target. They will launch the 29th Issue soon at a lower interest rate.

The Bank in its Review drew attention to the upward movement in money market rates. Eddie George agreed that the domestic monetary situation was not worrying, but the strength of the dollar, combined with worries about the industrial situation in the UK, was putting pressure on markets.

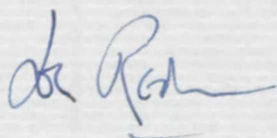
The Economic Secretary said that a rise in base rates now would be unhelpful, and urged the Bank to finesse their gilt sales programme and their approach to markets to try and avoid it. I backed him up, pointing out that the markets have taken the rise in the dollar quite well so far. The success of funding in August - when £1.9 billion of gross sales of gilts were achieved - coupled with the seasonal reduction in the PSBR, greatly strengthened the Bank of England's hand against this renewed pressure on the pound.

SECRET

There was general agreement that the approach to funding should remain opportunistic, attempting to sell stock whenever possible, and using tranchettes unless the market is very strong.

The institutions currently have considerable quantities of cash, which is a good prelude to the BT issue. There was inconclusive debate about tactics for handling the market in late November and December, to give the BT issue the best send off possible.

Monetary growth is now reasonable, with M0 at 4.4 per cent for the target period, and sterling M3 at 9 per cent. Banking September ends today: gilt sales were only around £570 million. This will be offset by sales of the 28th Issue which brought in £1 billion in banking August and banking September together, the bulk of it taking place in banking September.



JOHN REDWOOD

Monetary Policy file

9

3 September 1984

MR REDWOOD

c Mr Turnbull

RESISTING A RISE IN INTEREST RATES

You might be interested in the attached Treasury paper assessing our power to control interest rates in the light of July's events. It is good exposition of standard Treasury doctrine, which Andrew Turnbull and I remember from our days in HF.

The key argument is that if you really pull out all the stops and take on the markets to resist a rise in interest rates, then although you might succeed at the very short end, you will be signalling clearly that you care less about overall domestic monetary conditions and bringing down inflation than you do about the level of interest rates. Even if you start by saying that existing interest rates are compatible with your financial objectives, the measures taken to defend interest rates will themselves tend to loosen financial conditions. The market's expectations of future inflation will change as a result of their new view of the Government's policy objectives. This in turn will lead to:

- A fall in the exchange rate so sharp that the Government's nerve may fail.

- An upward adjustment in all but the shortest interest rates, reflecting a more pessimistic view of inflation. Base rates might well be caught in this upward adjustment, given that we do not have total control over them.

There is one important point, however, which the paper does not emphasise enough. The 1981 arrangements were not only intended to depoliticise interest rate movements, but also - connected with this - to make interest rates more flexible. The Authorities, by becoming so obviously upset about the - admittedly unjustified - upward pressure on interest rates in July, may have contributed to the atmosphere of crisis, and so increased the political damage done by higher rates. It would be better to have accepted that interest rates will move up and down as a result of market pressure, and the Government doesn't want them to change only as a result of a major political decision. If the market drives up interest rates because of a temporary panic, then they are likely to come down again pretty soon. We should be looking for frequent modest changes in interest rates, with which we need not be associated. It is only the underlying trend we should care about.

David Willetts

DAVID WILLETTS

PRIME MINISTER

MONEY MARKETS

REASONABLY GOOD NEWS. STERLING HAS TAKEN LAST WEEK'S INTEREST RATE FALLS IN ITS STRIDE AND HAS GONE UP MARGINALLY. THE THREE MONTH RATE IS NOW DOWN TO 10 AND A HALF PER CENT AND THERE SEEMS EVERY LIKELIHOOD OF A FURTHER CUT IN BASE RATES THIS WEEK OR NEXT.

TF

MESSAGE ENDS
14 AUGUST 1984

PERSONAL

Andrew

Your Ref

We spoke.

The attached papers should give you what you need:

with compliments

the message is that, with only limited weaponry at their disposal, the authorities have to be cautious in choosing where to make a stand.

Steven.

Treasury Chambers
Parliament Street
London SW1P 3AG
Tel: Direct Line 01-233
Switchboard 01-233-3000

Monetary Policy file

FROM: RACHEL LOMAX
DATE: 26 JULY 1984

CHANCELLOR

cc: Economic Secretary
Sir P Middleton o.r.
Sir T Burns
Mr Cassell
Mr Lavelle
Mr Wood

GREENWELL'S BULLETIN: POST MORTEM

Greenwell's July Bulletin contains Gordon Pepper's reflections on the latest round of base rate rises. Pepper has always been sceptical of the argument that there are times when the authorities cannot resist market pressures. This article reflects some of that scepticism, but argues that the authorities were right to acquiesce "to some extent this time" though wrong to ratify a rise as large as 3 per cent.

2. The discussion of the role of the exchange rate in official thinking is rather helpful. The point that the fall in the effective rate prior to 26 June was primarily a reflection of the strength of the dollar is well illustrated by charts showing the dollar's effective rate and sterling's effective rate against currencies other than the dollar (attached). Greenwell's argue that there is no exchange rate target, but that movements in the exchange rate are an important trigger for changes in interest rates. Worries about monetary growth are acted on quickly only if they are confirmed by the exchange rate. Conversely, the case for benign neglect of the exchange rate depends on monetary growth being under control. Although narrow money is clearly behaving itself, worries about broad money justified some rise in interest rates when sterling weakened more generally at end June and early July.

3. That strikes me as a reasonable summary of past official behaviour, and a defensible description of the thinking behind the first rise in base rates to 10 per cent. Greenwell's do not say whether they would have wanted to go beyond 10 per cent on these grounds. But the authorities certainly did not want to.

The second rise in base rates, to 12 per cent, was forced. By implication, it is this forced element that Greenwell's think could have been avoided.

4. Their reasons for arguing that market pressures could have been resisted are not very fully spelt out and, as stated, do not address the central issue at all squarely. There is no great dispute about what Greenwell's call "the true position", ie. that the authorities cannot control the term structure, or distort interest rate relativities for any length of time, but they can peg the level of any one particular short term money rate. We might be more sceptical about our ability to hold the 3-month rate than Greenwell's, because it is more heavily influenced by expectations, but we would certainly agree that 7-day and 1-month money market rates are susceptible to considerable official influence.

5. Greenwell's are also quite correct to say that the change in the Bank's dealing rates on 26 June was an attempt to bring the structure of dealing rates more in line with the market. But is does not strike me as a particularly good example of the Bank's inability to control the term structure - except as an instance of how the market yield curve can change without there being any alteration in the Bank's dealing rates. Nor is the reference to "overwhelming arbitrage transactions" particularly apposite in this context.

6. To digress a little, prior to 26 June the market yield curve had steepened, while the Bank's dealing rates had stayed flat, reflecting an earlier structure of market rates. As a result, the Bank had found itself dealing only in longer term paper (Band 4). While daily shortages were small, the situation was manageable. But, with larger shortages in prospect, the Bank were worried that they might have to engage at shorter maturities. The risk was that by doing so at existing dealing rates they might have put upward pressure on very short market rates. To avoid this, they wanted to move Band I and II rates down, and Bands III and IV rates up; but they also wanted to make it clear that, by steepening the yield curve at a time when Lloyds had raised base rates by

¼ per cent, they were not validating the market's implicit expectation that short term rates were set to rise. Hence the attempt to back up a delicate operation with a statement which, as Greenwell's argue, probably misfired.

7. Coming back to the central argument, no-one disputes the authorities' ability to peg some very short term rate, if they are so minded. What is missing from Greenwell's exposition is any recognition of the quantitative implications of holding rates down, and any discussion of the effect of large money market operations on expectations, and hence on shape of the yield curve, the exchange rate, and ultimately base rates.

8. Greenwell's argue cryptically that "abitrage transactions would cancel out" and criticise officials who "argue there would be a huge demand for cheap funds from the Bank if the authorities were to peg, say, the 7 day rate when there were engrained expectations that it would rise". One interpretation of this passage is that Greenwell's think that money market rates can be pegged, in the face of engrained expectations to the contrary, without the Bank needing to supply additional cash to the market. It is difficult to believe that this is really their view. Gordon Pepper is, after all, a long time advocate of monetary base control, and critic of the Bank's activities as "lender of first resort". And if rates are not held down by varying the amount of cash supplied, it is not clear what other mechanism they have in mind.

9. Another possibility is that Pepper believes that only a modest liquidity operation would have been needed in practice. He may be right, but there was no way of being sure before the event. The argument against trying to peg short term rates on 12 July was not that it would definitely have failed, but that it was very risky, because market expectations had hardened to the point where it might well have required more than a modest intervention to produce the desired results, and because the consequences of large scale money market operations, in such circumstances, are highly unpredictable and potentially counter-productive.

10. Greenwell's failure to explain clearly why they think the authorities could successfully have resisted pressure for higher interest rates undermines the value of their policy prescriptions. In the circumstances, they postulate - a weak exchange rate, but low growth in narrow money and broad money growth high due to funding difficulties - a policy of benign neglect towards the exchange rate would have considerable appeal. But the real problem that may have to be faced is how to put it into practice. As Greenwell's point out "The belief that the authorities will concede to market pressure and will alter interest rates in accordance with sterling's behaviour is reinforced each time they do so. It is now more firmly engrained than ever". Rhetoric may not be enough. To quote Greenwell's again "Experience has taught the market to ignore what the authorities say and to pay attention to what they do". A convincing demonstration of benign neglect may well be needed - but there is little doubt in my mind that it will be easier to mount if £M3 is coming back on target. (That was part of the argument for the element of overkill involved in going to 12 per cent).

11. Happily, these problems are looking less immediate. Volcker's statement has had a very cheering effect on the markets; we have sold a lot of stock this morning, the exchange rate is strong, and the money market yield curve is sloping down to 11 13/16 at 12 months (with the 3-month rate only just above 12 per cent).

RACHEL LOMAX

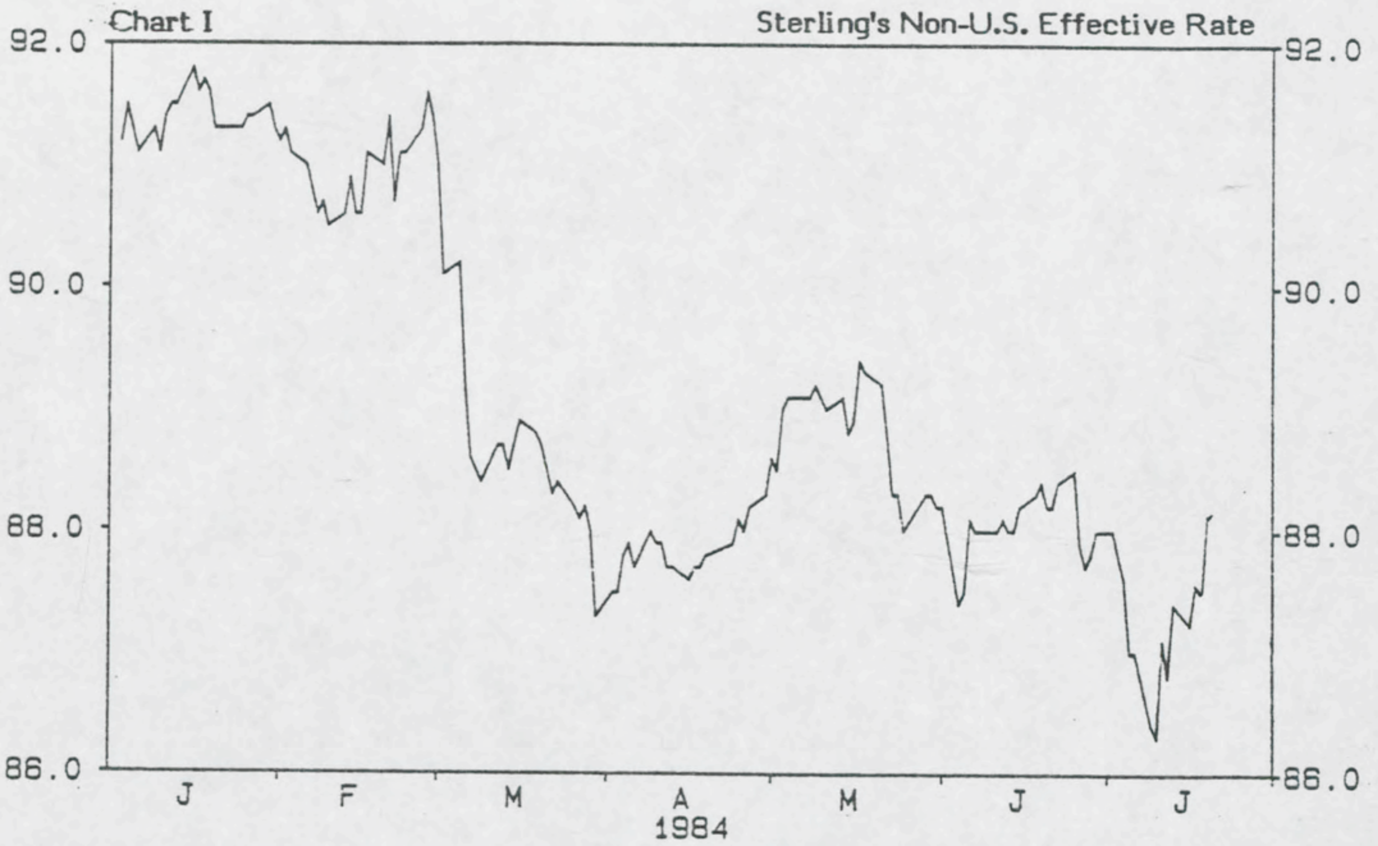


Chart I
Sterling's Non-U.S. Effective Rate
92.0
90.0
88.0
86.0
J
F
M
A
M
J
J
1984

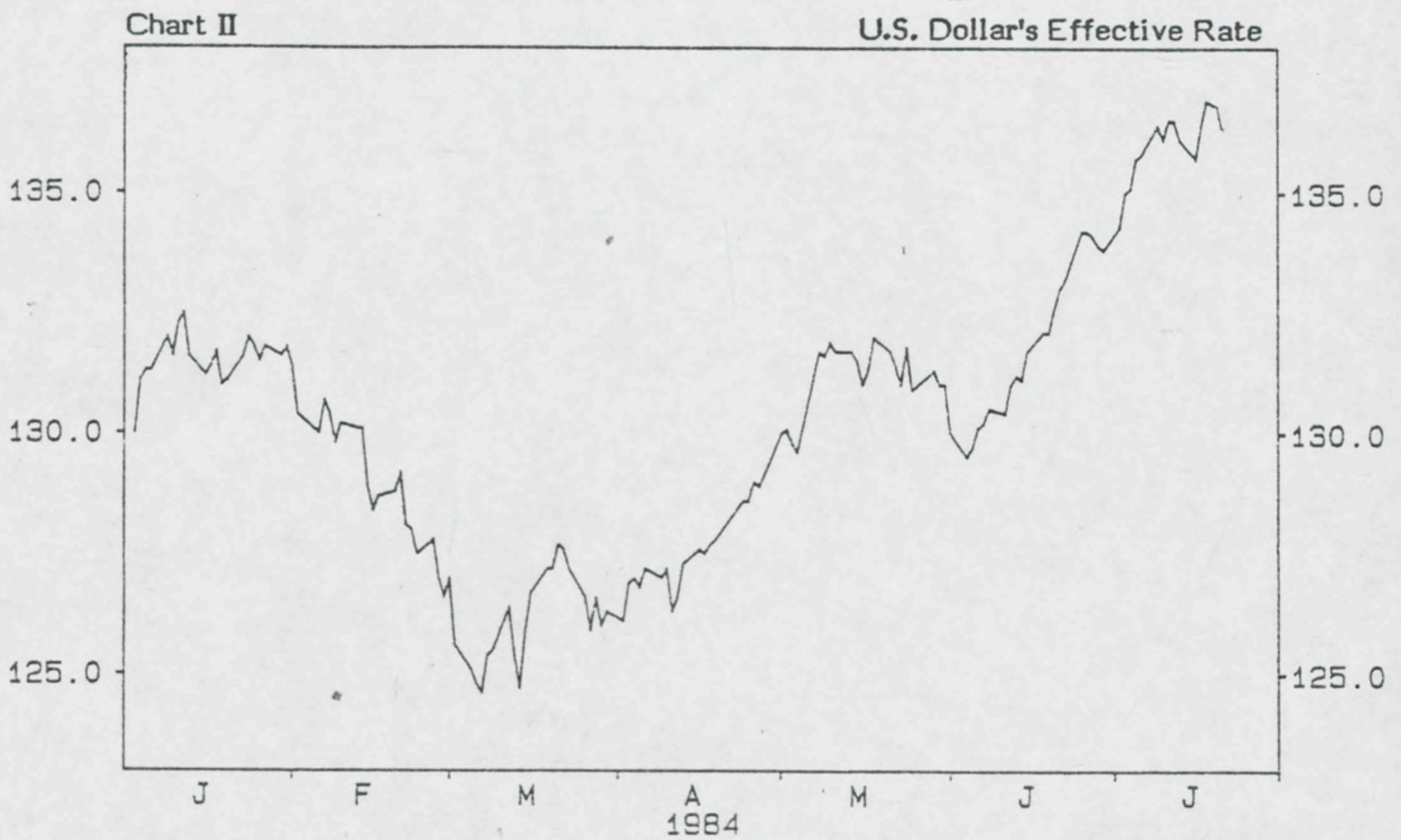


Chart II
U.S. Dollar's Effective Rate
135.0
130.0
125.0
J
F
M
A
M
J
J
1984

RESISTING A RISE IN INTEREST RATES

Introduction

The scope for official influence over the level of short term interest rates was discussed in some detail in a series of papers by Andrew Turnbull just over a year ago (influencing interest rates, January 1983, and Monetary Control Revisited, April 1983). He concluded that present control arrangements were at their most effective in exerting upward pressure on short term interest rates, ie. initiating a rise, or moderating market pressures for a fall. Putting downward pressure on rates is more difficult, whether the authorities want to initiate a fall or resist an upward move. Holding rates down in the face of strong upward pressure was identified as the most difficult operation of all. The January paper argued that techniques for operating in the money markets are less important than whether the authorities' actions succeed in shifting market expectations. It pointed to the danger that massive open market operations, to hold rates down by making the system more liquid, may not only fail, but may adversely affect expectations.

2. This asymmetry in the authorities' ability to influence short term interest rates was foreshadowed in the Bank's paper on the new arrangements, prepared for the Prime Minister's seminar in July 1981. This said:

> "In general, the Bank feel more confident about their ability to achieve an upward movement through money market operations than they do about leading the market downwards."

3. This paper tests these propositions in the light of the experience of the past 2 weeks. It analyses the nature of the problems that arose and considers how we might have set about holding base rates at 10 per cent, and the possible consequences of such an attempt. The concluding sections offer some general thoughts on the implications for our approach to monetary policy, and monetary

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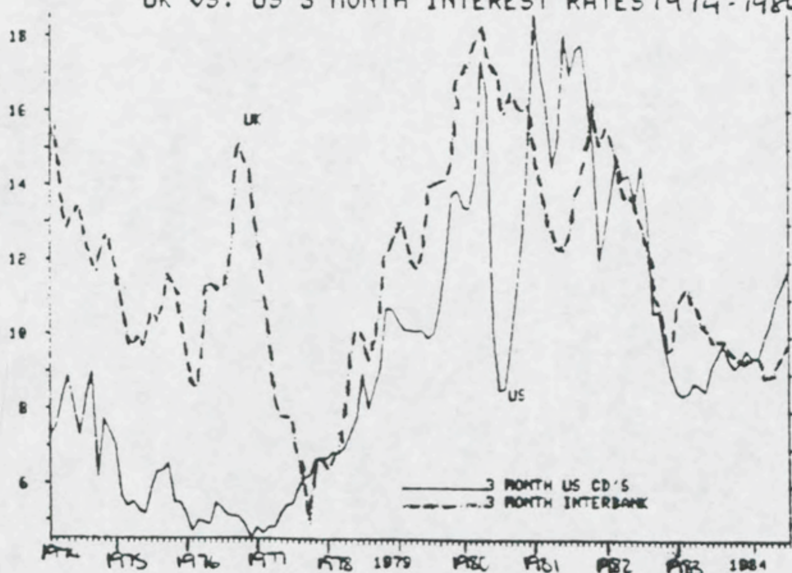

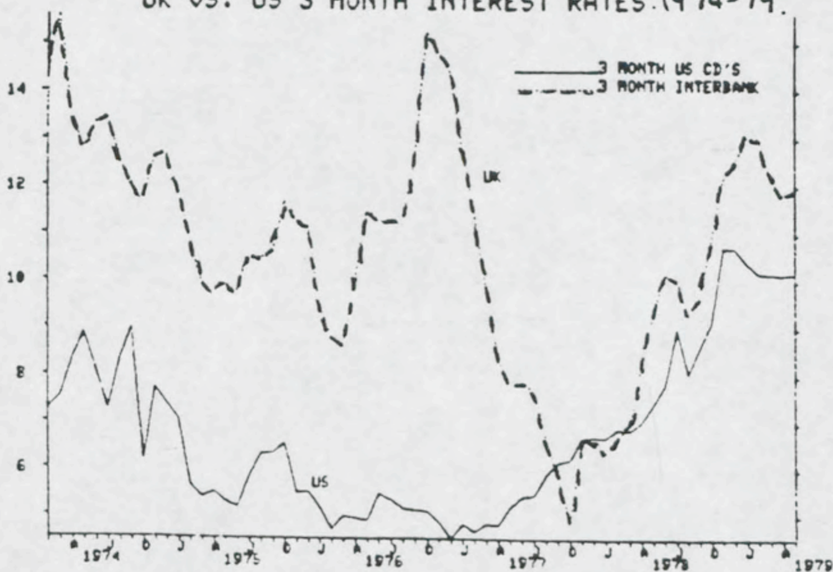

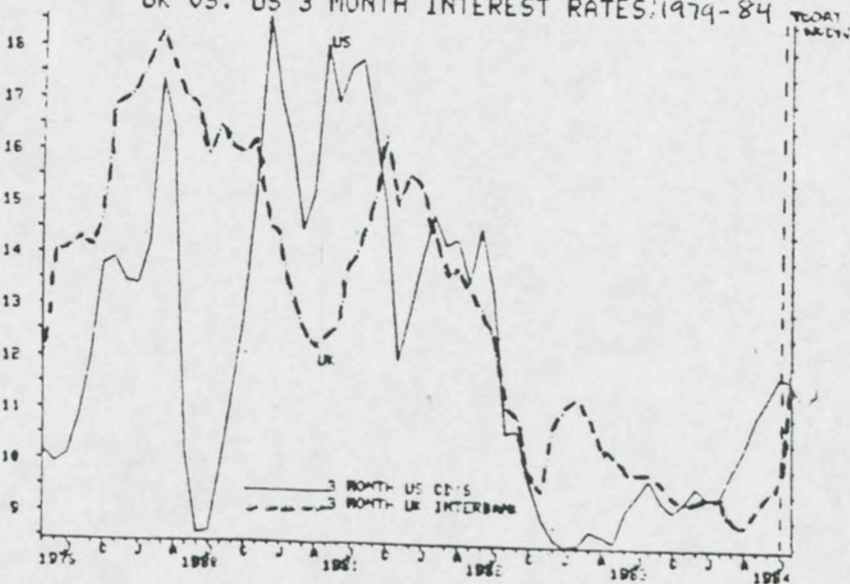

control in particular. The Annex sets out technical aspects of our present system of control and compares them with MBC, and the pre-1981 arrangements.

Market Developments

4. The longer term background to the pressure on market rates that developed at the beginning of July included:-

(i) a generally satisfactory performance of the UK real economy, and actual and prospective inflation;

(ii) a very unsettled situation in the US, with worries about the US banking system and international debt problems alternating with concern about the strength of the US recovery and credit demand, against the background of the forthcoming Presidential election;

(iii) the opening up of a significant differential between £ and $ interest rates during the first half of the year, as US rates moved up. Rates in other major countries remained fairly steady. In January £ rates were ¼-½ per cent below eurodollar rates, and on a par with the weighted world basket; By late June, with little net change in £ rates, the differential was 2¾ per cent against the dollar, and ¾ per cent against the world basket - a fairly unusual situation by past standards (see chart);

(iv) a gradual decline in the £ effective exchange rate - about 1 per cent between January and the Budget, as sterling tended to follow the dollar down against other currencies, and about 2½ per cent between then and late June, as the dollar strengthened against all major currencies;

(v) periodic market anxiety about the UK domestic monetary situation, largely focussed on bank lending and PSL2 and, latterly, the validity of our claim that the PSBR was unusually front-end loaded. But the target aggregates performed well, and unexpectedly good May money figures were reassuring. The

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INTEREST RATES AND EXCHANGE RATES: SINCE LAST CUT IN UK BASE RATES IN MARCH 1984

Closing Rates	Exchange Rates			Short Term Interest Rates					Long Term Interest Rates	
	£ effective	£/$	DM/£	UK Base Rate	US Prime Rate	3 month £ inter-bank	3 month Eurodollar	Uncovered Differ-ential	UK 10 year Gilt	US long T-bond
14 March (UK base rate cut)	81.1	1.47	3.76	8½-8¾	11	8 13/16	10 3/8	-1 9/16	10.28	12.29
19 March (US prime rates up)	80.8	1.44	3.79		11½	8 13/16	10 9/16	-1 3/4	10.32	12.42
6 April (US prime rates up)	79.8	1.43	3.74		12	8 7/8	10 15/16	-2 1/16	10.43	12.5
4 May	80.5	1.41	3.83		12	9 1/4	11 1/16	-1 13/16	10.85	13.02
8 May (US prime rates up)	80.0	1.38	3.85		12½	9 3/4	11 1/2	-2 1/8	11.23	13.05
9 May (UK base rates up)	80.0	1.38	3.84	9-9½		9 7/16	11 5/8	-2 3/16	11.33	13.14
10 May	80.1	1.38	3.85			9 9/16	11 7/8	-2 5/16	11.33	13.25
1 June	79.5	1.40	3.76			9 15/16	11 11/16	-1 3/4	11.94	13.53
Mon 4 June	79.5	1.40	3.74			9 5/8	11 7/16	-1 13/16	11.77	13.27
Mon 11 June	79.6	1.40	3.76			9 7/16	11 9/16	-2 1/8	11.73	13.45
Mon 18 June	79.5	1.38	3.75			9 1/4	11 9/16	-2 5/16	11.83	13.15
Wed 20 June	79.4	1.37	3.79			9 5/16	11 5/8	-2 5/16	11.84	13.46
Mon 25 June } (UK base rate realigned)	79.2	1.35	3.79	9-9½*	13	9 7/16	12 3/16	-2 3/4	11.93	13.55
Tues 26 June }	79.0	1.35	3.78	9½**		9 1/2	12 1/16	-2 9/16	11.98	13.41
Mon 2 July	79.0	1.35	3.77	9½		9 9/16	12 1/4	-2 11/16	11.98	13.64
Tues 3 July	78.6	1.34	3.77			9 11/16	12 3/8	-2 11/16	11.94	13.59
Wed 4 July	78.6	1.34	3.77			9 5/8	12 1/4	-2 5/8	11.98	PH
Thurs 5 July	78.3	1.33	3.75			9 3/4	12 5/16	-2 9/16	11.92	13.74
Fri 6 July (UK base rates up)	77.9	1.32	3.74	10		10 11/16	12 1/4	-1 15/16	12.00	13.66
Mon 9 July	77.6	1.31	3.72			11 1/16	12 1/4	-1 3/16	12.04	13.38
Tues 10 July	77.2	1.31	3.70			11 3/8	12 1/8	-3/4	12.19	13.30
Wed 11 July (UK base rates up)	77.6	1.31	3.72	12		11 15/16	12 1/16	-1/8	12.40	N.A
Thurs 12 July	77.7	1.31	3.73	12		12 1/8	12 1/8	0	N.A.	N.A

*Lloyds base rate up

**National Westminster base rate up

gilts market has been unsettled for some months, in the shadow of a volatile US bond market, but adroit tactics allowed us to achieve a satisfactory level of gross sales in most months;

(vi) industrial and political problems, though the miners' strike was taken calmly by domestic markets until well into June, the Budget was well received, and the public expenditure Cabinet went the Treasury's way;

(vii) A weakening trend in spot oil prices, and growing fears of an OPEC price cut in July; but PRT forecasts for this year have been revised up.

5. Factors precipitating last week's events seem to have included:-

(i) the Bank's statement about monetary conditions, in the context of the technical change in its dealing rates towards the end of June. In conjunction with recent Ministerial statements, this may have dampened hopes of higher UK rates;

(ii) a growing belief that US rates would not peak in July, as expected, but could rise much further, inspired by evidence of continued rapid growth in the US economy. There was, however, little movement in eurodollar rates during the first week of July;

(iii) fading hopes of an early settlement of the miners' dispute;

(iv) signs of a general move out of sterling during the week beginning 2 July, with the rate falling against other currencies as well as the dollar, from an effective of 79 on Monday, to touch a new low (on the new index) of 77.4 on Thursday night;

(v) a rise in base rates to 10 per cent on Friday, rapidly endorsed by the Bank in an attempt to pre-empt the money figures

(vi) a sharp deterioration in the industrial situation following the announcement of a National Docks strike, which pushed £ market rates up to around 11 per cent and above on Tuesday, and caused sterling to weaken further;

(vii) poorer than expected June money figures on July 10, which, according to one report, were received with a "sigh of relief" because, in the market view, they removed any doubt about the authorities' ability to resist a further rise in interest rates. Evidence for this view came from sterling, which had dipped below $1.29 in overnight Far East trading, but opened steadier on Wednesday, in anticipation of an imminent move in UK rates.

Tuesday 10 July and Wednesday morning, 11 July

6. Closing rates on Monday were:

	7days	1 mth	3 mths	12 mths
£ interbank	9 7/16	10 3/8	11 1/16	11½
Change on day	+ 1/4	+3/16	+ 3/4	+ 7/16

At the Chancellor's meeting on Tuesday, there was considerable reluctance to contemplate a further rise in base rates. But it was accepted that the banks could not be prevailed on to hold their base rates at 10 per cent for more than a few days, if the current structure of market rates was maintained. The Bank suggested that it might be possible to give the market a lead by doing an early (10 o'clock) dealing round on Wednesday morning. By convention, this is only done when an unusually large shortage (over £500m) is expected. With an anticipated shortage of only £300m on Wednesday, the market would have recognised early dealing as a clear signal of the Bank's views. The hope was that this would modify expectations and, in that way, take some of the pressure off market rates.

7. The early dealing round proposal was abandoned on Wednesday because, by then, market rates, in both bill and interbank markets,

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MARKET DEVELOPMENTS JULY 2-12

	Assistance		£ Interbank			US Interest Rates		Bill Market Differential* (Market-dealing)		Exchange Rates		
	Expected Shortage	Help	O'night	1 mth	3mths	3 mth Euro$	Differ-tial	Band 1	Band 4	£/$	£/DM	Effec-tive
	£millions											
July 2	550	597	9	9 1/16	9 9/16	12 1/4	-2 11/16	-1/32	-1/32	1.3495	3.7697	79.0
3	400	433	4	9 3/16	9 11/16	12 3/8	-2 11/16	-	+1/16	1.3360	3.7665	78.6
4	400	317	10	9 5/16	9 5/8	12 1/4	-2 5/8	-	+3/32	1.3360	3.7635	78.6
5	600	522	7	9 5/16	9 3/4	12 5/16	-2 9/16	-	+1/4	1.3260	3.7527	78.3
6 (Base rates to 10)	550	564	10	10 3/16	10 5/16	12 1/4	-1 15/16	-1/8	-1/16	1.3190	3.7347	77.9
9	300	409	3	10 3/8	11 1/16	12 1/4	-1 3/16	-	+3/16	1.3095	3.7216	77.6
10	300	324	2	10 15/16	11 3/8	12 1/8	- 3/4	+3/4	+3/4 to 1/4	1.3090	3.7018	77.2
11 (Base rates to 12)	150	142	6	11 7/8	11 7/8	11 7/8	-	+7/8 to -1/2	+1/4 to -	1.3092	3.7207	77.6
12	500	426	12 1/2	12 1/16	12 1/8	12	-1/8	-1/16	-1/16	1.3091	3.7313	77.7

* discount rates

Source: Daily Market Reports; closing rates.

had risen further, substantially reducing the chances of successfully holding base rates to 10 per cent. At 10.30 am on Wednesday the structure of rates in the interbank market was as follows:-

	7 days	1 mth	3 mths	12mths
£ interbank	10¾	11¼	11 3/16	11 7/8

The firmness of shorter period rates limited the clearers' scope to fund themselves for a time by borrowing from wholesale markets at 7 days or 1 month - a technique which, on other occasions, has enabled them to postpone a rise in base rates.

8. One technical consequence of the rise in market rates was that it would not have been possible, in the Bank's judgement, to demonstrate convincingly a "stop" rate of 10 per cent without, in effect, declaring posted dealing rates. Even by close on Tuesday, market bills were standing well above the Bank's dealing rates in all 4 bands (11-10¾ per cent across the board). A technical complication was that the expected shortage had been revised down to £150m, as a result of buying-in of next maturities in the gilts market on Tuesday afternoon.* This reduced the scale of official operations which the market would have anticipated.

9. If the 10 o'clock round had gone ahead in this situation the chances are that the Bank would have been flooded with offers of bills, vastly in excess of the expected shortage. Individual houses, convinced that rates were set to rise, and looking at the rates available in the market, would have been anxious to clear their books at the best price possible. By convention, the Bank acts commercially - ie. it buys cheaper/higher rate bills first, and either rejects or scales down more expensive/lower rate bills to take out the remainder of the shortage. Especially with rather

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* The Bank accepts the obligation to make a price for gilts maturing within 3 months. This is usually done by reference to the Bank's bill dealing rates. Where these are well below market rates, investors have a clear incentive to off-load next maturities on to the authorities, if they can.

a small shortage in view, houses offering bills at 10 per cent would therefore run a high risk of getting their offer rejected, and having to clear their books at the higher rates prevailing in the market. With a margin of nearly 1 per cent between dealing and market rates, and knowing how other houses would react, an individual institution would be likely to pitch its bid just far enough above 10 per cent to be reasonably confident of getting a good alotment.

10. The flatness of the short term yield curve was rather unusual. Typically when the markets expect interest rates to rise shorter period money rates soften as the 3 and 12 month rates rise, producing a steeply upward sloping yield curve. Lenders want to place funds at short maturities, whilst borrowers look for longer term money, possibly bringing forward future borrowing, to take advantage of low rates while they last. The supply of funds at short maturities increases, while the demand for funds may increase in total and is concentrated in the longer maturities. The structure of rates on Tuesday evening may have reflected a view that a rise in base rates was imminent.

The Options

11. By Wednesday morning, therefore, it looked as if both domestic and external markets were convinced that the authorities would accept an immediate further rise in interest rates. At the Chancellor's meeting there was general agreement that:-

(i) neither the underlying performance of the economy nor the domestic monetary situation justified a further rise in base rates;

(ii) the exchange rate had not reached a level where it posed a real threat to domestic inflation objectives. But the Bank warned that if hopes of a rise in interest rates were dashed, the exchange rate could easily fall to levels that might be worrying. No-one attempted to put a figure on this rate;

(iii) market pressures were a response to external and domestic problems which might be temporary but were unlikely to be short-lived, and could well get worse before they got better;

12. At that stage, the options considered were:-

(i) acquiescing in a decisive move in rates to 12 per cent, in the hope that this would settle the markets, and set up expectations that the next move would be downwards;

(ii) accepting a limited rise to 11 or 11½ per cent, avoiding overkill, but accepting the risk that the market would remain unsettled for a time;

(iii) digging-in at 10 per cent.

No-one felt convinced that (i) would definitely succeed. It was chosen because:

(i) the second option was thought to combine the worst of both worlds - a politically damaging and economically unnecessary rise in rates that could well fail to settle the markets;

(ii) there seemed to be a high probability that all-out resistance would fail and, by so doing, create conditions in which an even larger rise in rates would be needed to restore orderly markets.

However, considerable scepticism was expressed about the validity of the last proposition. The rest of this paper therefore discusses the form that all-out resistance might have taken, and some of the possible consequences.

The Scope for Influencing Base Rates

13. The clearing banks are still open to a degree of moral suasion from the authorities. But they have also become increasingly dependent on wholesale money to fund their lending activities. The wholesale money markets are not a new development, but they

Table 1: Sterling inter-bank deposits (£ billions)

As at mid June	
1975	14.9
1976	13.8
1977	15.8
1978	20.1
1979	23.6
1980	27.5
1981	27.8
1982	38.1
1983	46.5
1984	53.6

The table shows the size of the sterling inter-bank market over the last 10 years, as measured by deposits taken by banking/monetary sector institutions from other members of the sector

Table 2: London Clearing Bank Groups
(amounts outstanding £ billions)

Mid-December (unless stated)	Inter-bank Borrowing (+)	Inter-bank Lending (-)	Net
1975 (November)	+4.2	-6.2	-2.0
1976	+4.6	-6.6	-2.0
1977	+7.0	-8.5	-1.5
1978 (November)	+7.6	-9.9	-2.3
1979	+10.4	-15.7	-5.3
1980	+7.9	-13.7	-5.8
1981 (November)	+10.4	-13.5	-3.1
1982 (November)	+20.7	-19.2	+1.5
1983	+21.8	-19.5	+2.3
1984 (June)	+24.8	-20.8	+4.0

SOURCE: Monthly Statement of the Clearing Banks (Banking Information Service)

have grown rapidly in recent years. The M2 statistics imply that about £40 billion of the monetary sector's deposits from other sectors are now on wholesale terms. In addition, there is a large interbank market in sterling wholesale deposits and CD's which, at mid-June 1984, amounted to about £54 billion. Table 1 shows the size of the sterling interbank market over the past 10 years, as measured by deposits taken by banking/monetary sector institutions from other members of the sector.

14. The clearers have always been active in these markets, originally (prior to 1971) through special subsidiaries. In recent years, however, they have become increasingly dependent on wholesale money, as their retail lending has expanded and their retail deposit base has been eroded. The position varies from bank to bank; according to its last annual Report, Barclays, the clearer thought to be most dependent on wholesale funds, took 53 per cent of its domestic deposits on wholesale terms last year, compared with 45 per cent in 1981, and only 36 per cent in 1979.

15. Another significant development has been a change in the LCB's position in the more narrowly defined interbank market, from being traditionally a net supplier of funds to the rest of the system, to being large scale net borrowers. Table 2 traces this development over the past decade. In 1981, LCB Groups were net lenders, by just over £3 billion; at June this year, their net £ borrowing from other banks was £4 billion. Even LCB parents, traditionally less dependent on wholesale money, were net borrowers (by £¼ billion) on the interbank market at mid-August last year (the latest date for which figures are available); in 1981, their net lending to the rest of the system was £4½ billion.

16. These developments have understandably made the clearers more sensitive to fluctuations in money market rates. The only surprising feature of Barclay's decision earlier this year to move to something akin to a market related formula for setting base rates is that it did not come earlier. Sooner or later the other clearers are likely to follow suit.

17. This greater sensitivity of bank base rates to market rates

is entirely in the spirit of the 1981 arrangements. One objective in abolishing MLR was to break the remaining link between base rates and an official posted rate (though market forces were anyway working in that direction). The result has been, however, to produce:

> "a significant switch of emphasis away from a structure of interest rates centred around a central bank rate, set and controlled by the government of the day, to a situation where bank base rates and most conspiculously clearing bank base rates appear to have become almost the fulcrum of the system."*

18. Preventing a rise in interest rates presents itself nowadays in terms of forestalling a rise in bank base rates. And that in turn depends, to a significant extent, on bringing about a structure of wholesale money market rates with which the banks can live without unacceptable damage to their profitability. Despite Barclay's decision to attach particular significance to the 3 month interbank rate, it is not clear that this is necessarily the crucial rate for all the clearers. In the Bank's view, the one month interbank rate may often be the best indicator of the marginal cost of funds. Nor is there any fixed formula for computing a tolerable margin between base rates and money market rates; that will vary according to an individual bank's overheads, its desired return to capital, its provision for bad debts and so on.

19 The Turnbull paper suggested that banks are likely to be under pressure once 3 month interbank rates exceed base rates by about ½-¾ per cent. Judging by recent experience the market takes a similar view. But it also clear that a margin of this size is more tolerable the lower the shorter period money rates. (Relatively low 7 day and 1 month rates enabled Lloyds and NatWest to hold their base rates at 9 per cent for over a month when 3 month interbank rates were usually above 9½ per cent).

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* Peter Dunkley manager group funds, NatWest <u>Banker</u> Feb 1984.

Techniques for Influencing Market Rates

20. How, on Wednesday morning, could we have set about achieving a reduction of 1 per cent in 3 month rates (and probably more than that in the shorter maturities)? It is useful to distinguish between two sorts of operations:-

(i) those primarily designed to influence expectations;

(ii) those which have a significant effect on the overall liquidity of the system.

In practice, the distinction is not hard and fast, since operations of the first sort may be helped by modest 'overdoing of the help". But there is a conceptual difference which has parallels in foreign exchange market intervention. In that context, we draw a line between tactical "smoothing" intervention, which is primarily intended to establish an official presence and give the market a lead, and sustained intervention, which attempts to prevent the nominal exchange rate rising by techniques that affect monetary conditions. The latter operation involves an open ended commitment to supply sterling on whatever scale is necessary to establish the target exchange rate. The same sort of commitment may be required in money market operations that rely on influencing rates by varying the supply of funds to the market. The risk in both cases is that the market's perception of the Government's monetary objectives may be affected, with damaging consequences for inflationary expectations.

Giving the market a lead

(a) Techniques

21. In the circumstances of Wednesday morning, the Bank could have maintained its dealing rates, but only, in the Bank's judgement, by high profile action. Rejecting offers of bills at rates above 10 per cent would certainly have come into that category. That would have been tantamount to reverting to the old system of posted dealing rates, and it would have been more straightforward to do

just that. A similar strong signal could have been given by rejecting all offers of bills, and announcng a rate at which it would be prepared to lend through the discount window. In effect, reinstating MLR. Another high profile technique is to over-assist on a significant scale. This last option is considered in detail in the above section.

(b) Would it work?

22. There is no technical problem about giving a signal of whatever strength is deemed necessary. The issue is whether holding the Bank's dealing rates would succeed in bringing down market rates. As long as the Bank's operations are confined to relieving the expected system shortage (based on the difference between the forecast net Exchequer position and target operational balances at the Bank of England), the answer is that such a tactic can only work if it succeeds in changing the expectations of at least some participants in the market.

23. The fact that, by convention, the Bank only buys bills that have been in existence for 7 days and have changed hands at least once means that significant differences can open up between market bills rates, and the Bank's dealing rates. (This was why the convention was established, so there would be a degree of market risk in writing bills). No-one is going to take the risk of accepting or buying a bill at 10 per cent, if he is convinced that the Bank is about to raise its dealing rates, or if he sees a significant chance that he will have to dispose of his holdings at higher market rates. By Wednesday morning, market bill rates were well above the Bank's dealing rates, offering no scope for arbitrage between market bills and the interbank market. Bank dealing rates of 10 per cent would have provided arbitrage opportunites, but as long as the Bank was only supplying a few hundred million a day to relieve the shortage, the sums involved would not have been enough to produce a significant impact on the vastly much greater wholesale money markets.

24. Large scale arbitrage can only take place, in these circumstances, if there are other institutions besides the Bank prepared to buy bills at high prices. The most likely candidates

are the discount houses. But even if they are quite convinced that the Bank intends to maintain unchanged dealing rates, they have every incentive to limit their purchases to amounts they can confidently dispose of to the Bank within a short period - unless they can be persuaded that market rates will fall back. For this reason, the 7 day rule is not crucial - and indeed it could be suspended if necessary; more important is the likely scale of the Bank's operations in bill markets, and the effect of official action on expectations.

25. A high profile signal might have encouraged the clearers to delay putting up their base rates, and this could possibly have had a useful effect on market expectations. But in terms of the flow of funds in the market, the consequences are not necessarily helpful. Relatively low base rates give companies an incentive to switch borrowing on to overdraft terms, and increase total borrowing, redepositing the proceeds on the interbank market. "Round - tripping" can inflate £M3 - as it has in the past; by increasing the supply of wholesale funds it may also help to depress market rates, probably in the shorter maturities. But the effect on the banks' liquidity may have an offsetting effect on rates by forcing them to bid more heavily for funds, possibly at longer maturities where funding is more expensive. The yield curve may steepen, and there may be downward pressure on shorter term rates, but there is no obvious reason why the whole structure of rates should move down, or why the banks' immediate funding problems should be significantly eased.

26. In a situation where the market is uncertain whether a rise in rates is needed, or how large it ought to be, and where the exchange rate is firm, a clear lead from the Bank can have a helpful effect in steadying the market, or limiting the rise in rates that takes place. The effect is largely psychological, and the tactic is most likely to work if the authorities have prior knowledge of news to come, which will help to validate their stand, in the market's eyes. That was not the situation last week. One immediate consequence of a firm lead by the Bank would probably have been a sharp fall in the exchange rate. While the rate might not have fallen to levels which we found worrying, it could well have

reinforced the market's view that rates would indeed have to rise. Outsiders have generally taken a more pessimistic view of the inflation prospect than the Treasury, and the market could well have reasoned that we would be forced to step in to stop a slide. The fact that, in the public perception, that is precisely what we had done the previous Friday could have added to this conviction.

27. Would an attitude of hardened official indifference to a falling exchange rate have helped to bring market rates down, in this situation? Just conceivably, if it succeeded in convincing the market that there was, in reality,no threat to inflation from a lower rate, and/or if the rate did not in fact fall all that far. But there were two risks:-

(i) that the fall in the exchange rate would be so sharp as to worry us about its implications for inflation (though even so, we might have argued that a large fall was likely to be temporary);

(ii) that the market would misinterpret our indifference to what it regarded as an alarming fall, and conclude (as some brokers have been arguing) that the Government's priorities have changed, and that it is more interested in keeping interest rates down than in reducing inflation

If the gamble had not come off, inflationary expectations would have deteriorated, pushing up period money market and longer term rates and, in the worst case, requiring an even larger rise in interest rates to undo the damage (to the exchange rate, or to credibility, or both).

Operations that Influence Liquidity

(a) Techniques for varying the supply of cash

28. None of the discussion so far should be taken as implying that the Bank is powerless to hold down short term interest rates, if that is the overriding priority. Providing the authorities are prepared to supply liquidity to the system on whatever scale

is necessary, they can always effectively determine very short term money market rates. Nor is there any technical difficulty about increasing the supply of cash. Under present arrangements, the Bank could announce itself willing to buy bills at below market rates. There would be no shortage of offers, and it could accept them all. If the supply of bills proved inadequate it could announce itself ready to buy in public sector paper (eg Treasury bills, gilts close to maturity, even longer term assets), monetising the entire National Debt if necessary. Offers of next maturity gilts would certainly be forthcoming without prompting if the Bank was prepared to offer prices in line with its bill dealing rates. Supportive as this would be of money market operation, however, it would involve de-funding if non-bank private sector sellers were involved, thus adding to £M3. Sales by overseas holders would tend to push down the exchange rate.

29. Depositing funds in the interbank market would achieve the same end result. (So would putting money into the LA short term deposit market - a tactic which has been used in the past). While the Bank have always been reluctant to deal directly in the interbank market - because they think it would, in practice, mean dealing with the big clearers - there is no technical problem about doing so. The Bank would simply place funds though its money brokers, in the same way as other market participants. In the circumstances envisaged, the Bank would probably want the operation to be visible; but it is difficult to believe that even an anonymous large scale operation could go undetected for any length of time.

30. In the rather extreme circumstances in which we found ourselves last week, at least, there is, however, no obvious reason why depositing funds with the interbank market should be a technically superior way of operating to conventional dealings through the Discount Houses. There can be other occasions when it might be helpful; if, for example, the system shortage does not get positioned in the discount market, or if purely technical factors are raising interbank rates in a way that is threatening to unsettle the market. In practice, however, this is unlikely to be the problem if there is strong upward pressure on rates; market participants

will be only too anxious to offload bills, to avoid future capital loss; and the Discount Houses are likely to find themselves offered too much paper rather than too little.

31. If expectations of higher rates are firmly held - as they were last week - significant differentials between market bill rates and interbank rates are unlikely to open up. Funds can move very freely between different parts of the London money markets - between bills and wholesale deposits, and between the interbank market and the discount market - and the participants in these markets overlap. What may cause market rates to diverge is uncertainty - for example, the possibility of a difference of view about future rates between the discount market, on the one hand, and the rest of the market on the other, as suggested earlier. Official operations in the interbank market would then reinforce arbitrage activity that is likely to take place anyhow in such circumstances.

32. If the Bank has already taken a high profile stand, and has announced itself ready to buy bills or other paper at posted rates without limit and for an indefinite period, it is effectively supplying funds for arbitrage anyhow. There should be no need to take the further step of acting in both markets simultaneously. The investors from whom it has bought paper can be relied upon to deposit cash in the interbank market for as long as there is any interest advantage in doing so, forcing interbank rates down in the process.

(b) Possible Consequences

33. The significant feature of a liquidity operation is not the paper in which the Bank deals, nor its maturity, but the fact that the supply of funds to the market is increased. Providing funds are supplied on a sufficient scale, market forces will ensure that all very short term interest rates will be depressed. The overnight rate would approach zero. If the market believes that a rise in interest rates is imminent, investors will be prepared to sell their assets and hold the proceeds overnight even at the risk of being stuck with non-interest bearing balances at the Bank. Longer term deposits even at low interest rates will also be acceptable, espeially if the Bank makes it clear that it is prepared to go on operating in this way indefinitely.

34. It is, however, debatable how far, if at all, this tactic would reduce 3 month rates, and beyond that probability is that period money rates would rise sharply. Liquidity operations on any significant scale would not go unnoticed. Details of the Bank's daily operations, relative to the expected shortage, are shown on the Reuter's screen. Even if they were not, they would be evident to the market and, unless rapidly reversed, would show up in the published monetary statistics, most obviously for MO. They would certainly be perceived as a significant change of stance by the authorities.

35. Even if the market sees the Bank pursuing a deliberate policy which, in a technical sense, can be sustained almost indefinitely, the belief that, in practice, they will have to call a halt may still force up rates at maturities as short as 3 months. The most immediate constraint is likely to be the exchange rate which would probably fall sharply, for two reasons:

(i) if the market concluded that the authorites had abandoned monetary discipline, there could be a "fundamental reappraisal" of sterling;

(ii) low short term money rates would make it cheap to sell sterling short, (after all, flooding the market with cash is precisely what is involved in "unsterilised" foreign exchange market intervention to depress the exchange rate).

The market would no doubt be influenced by the fact that few Governments have had the stomach to weather a really severe exchange rate crisis without reacting - partly for political reasons, but also because the UK is a very open economy, and exchange rate movements do have a significant effect on prices even in the short term. Even if the Bank persisted, and allowed the exchange rate to find its own level, this would probably affect inflationary expectations, raising long term money rates and still more gilt prices. In time, the effect on inflationary expectations might be reinforced by the behaviour of the broader monetary aggregates which, as a result of funding difficulties, a highly liquid banking

system and possible round-tripping would almost certainly be inflated like MO.

36. How bank base rates would be affected is a matter for conjecture. But the chances of them being depressed, along with shorter period interest rates may be less than they would have been five or ten years ago, if only because the banks' response may be conditioned by past experience of inflation and more volatile interest rates. Their interest rates, like market rates, may now be more sensitive to inflationary expectations.

37. Clearly an operation of this kind would need very careful handling if it was not to backfire. Arguably, in the present situation, where MO is well within target, there is some scope for expanding liquidity without unduly damaging credibility. But there is no guarantee that a limited liquidity operation would succeed in holding down interest rates to the required extent, and the more sustained market expectations of a rise in rates are, the larger and more prolonged a rearguard liquidity operation would need to be.

Why was it so difficult?

38. This paper has suggested that it would have been extremely difficult to resist an upward move in interest rates last week, without running significant risks of making matters still worse. Nonetheless, on an objective appraisal of the situation, none of us could see any economic justification for higher base rates. The decision to acquiesce was a tactical one, and there can be no assurance that it was correct. There seemed a high probability that the sourcess of pressure would persist, possibly for several months. This meant that the chances of influencing expectations by esssentially holding operations (leaning on the clearers, "showing" an official rate) seemed small. But equally, there was a real risk that the external and industrial situation would deteriorate further. By giving in to pressure so quickly, we may have made it more difficult to resist next time, succeeding only in ratcheting interest rates up by two points.

39. The episode is a revealing example of how our present system of monetary control works. It is an over-simplification to regard short-term interest rates as an instrument of policy. The authorities rely heavily on telling the market what they are trying to achieve, (eg. via the MTFS), and trusting it to produce an appropriate level and structure of rates. We have deliberately aimed at a very light touch both in money market operations and in the gilts market. At a technical level, the scale of the Bank's liquidity operations is closely related to the size of the expected daily shortage, and this is not sensitive to short term changes in the market's demand for liquidity. The Bank seeks to influence interest rates by varying the terms on which it is prepared to relieve the shortage. It does not automatically repond to unwanted pressure on short term rates by varying the supply of liquidity - or, at least, not to any significant extent. This sets limits on the degree of influence that can be exerted over even very short term market interest rates.

40. The difficulty of resisting a rise in interest rates is, however, much more than a matter of technique. There is a lot of truth in the argument that a commitment to monetary rather than interest rate targets severely constrains the authorities' freedom to determine interest rates. If the market becomes convinced that interest rates must rise for the authorites to achieve their stated objectives (even fairly broadly defined), there will always be a risk that a refusal to acquiesce in higher rates will damage the credibility of policy, with unwelcome consequences both for inflationary expectations and those longer term interest rates that are less susceptible to immediate official influence. The problem exists whatever the scale of the Bank's liquidity operations. Successful resistance will depend critically on changing the market's perception of what level of interest rates is consistent with its avowed policy aim.

41. Last week's decision essentially reflected a view that this would not be possible, even though we ourselves did not think there was a real threat either to monetary conditions, or inflation. Was the market simply being irrational, or were we deluding ourselves?

The case for going even to 10 per cent was debatable, though many people in the markets probably felt it was justified by the underlying monetary situation. But it is difficult to believe that many seriously thought that 12 per cent was necessary, in these terms. If they did, there is an alarming gap in thinking, which suggests either a wilfull refusal to listen on our part, or some serious misconceptions on the market's.

42. The critical factors were probably worries about the effect of higher US interest rates on the £ exchange rate, and about the effect of industrial disputes on the Government's ability to sustain its policies. It is never easy to protect domestic interest rates from exchange rate pressures in a highly open economy; but our public stance may have added to the problems. On the monetary policy side, we have acknowledged that the exchange rate is a factor to be taken into account in determining short term interest rates; and, on the external side, our reluctance to engage in visible intervention in the foreign exchange markets, coupled with the relatively small size of our liquid foreign currency reserves, has been practical evidence of a belief that interest rates are the most appropriate and effective means of influencing the nominal exchange rate. There is much to be said for both lines of argument. But, against this background, it is not entirely surprising that the market's instinctive reaction to downward pressure on the exchange rate is to mark up domestic interest rates.

43. In the circumstances of last week, it was not at all clear that higher interest rates were the appropriate response to the weakness in the exchange rate; but we have been pretty vague about what we mean by "taking account of the exchange rate", and the exact circumstances in which it is or is not appropriate to respond to sharp movements in the rate. Last week's events may, in part, be the price of that vagueness.

44. The response to industrial unrest is more difficult, but industrial problems have thrown previous UK Governments off course, and it is not surprising if the market requires some risk premium to compensate for the uncertainties created by the present situation.

If the Government could be fully confident of a successful outcome, there might be a good case for taking the strain on the exchange rate (as there was before the election). If not, there may be something to be said for buying orderly markets; if the miners' strike ends badly for the Government, there may be a price to be paid on interest rates anyhow, since the objectives in the MTFS may be that much more difficult to achieve. But, at bottom, the immediate judgement is a political one. Is it easier to convey the message that the Government is not to be deflected against the background of a crisis rise in interest rates, than it would be in the face of another wave of headlines about the sinking pound?

45. **Implications for Monetary Control**

Even if the central problems are not technical, it is still worth asking whether the 1981 arrangements have made monetary management unnecessarily difficult. As the Bank warned at the time, it is fairly clear that they have not made it any easier to resist upward pressure on interest rates. There was always a tension between allowing market forces a greater influence over the structure of rates, and maintaining an adequate degree of control. It is worth asking if we have got the balance right.

(i) High profile techniques are still available if the authorities want to give the market a lead. But the fact that they have fallen into disuse makes it more of an event to employ them. On the other hand, in the face of strongly entrenched expectations, simply posting an official rate might not have been worth much. A 1½ per cent rise in rates would still have been politically damaging and under an MLR system it would have been even more difficult to distance Ministers from responsibility for it.

(ii) If expectations are strongly held, however, the terms of limited intervention will not be crucial; scale will also matter (as it does in the foreign exchange market). A more important question is whether the Bank should conduct liquidity operations so as to underwrite some particular level of short term rates; precisely how it seeks to do this is secondary.

(iii) it is worth noting that if we did succeed in reducing the bill mountain, the scale of the Bank's daily operations would be much reduced. If, in the circumstances of last week, we had wanted to show a rate and there had been no shortage, the Bank would have needed to artificially create one first (by selling domestic bills, or by intervening in the foreign exchange market to support sterling - ie. selling foreign currency assets). But whether that would have significantly added to the disadvantages of posting a rate - the option on offer - is debatable.

(iv) The ending of MLR and the rhetoric surrounding the 1981 arrangements have accelerated the effective severing of the link between base rates and officially determined interest rates. But the clearers growing reliance on wholesale funds goes back much further than 1981, and the erosion of their retail deposit base has pushed them in the direction of more flexible market related base rates anyhow. Inconvenient as this may be at times, this greater sensitivity has been seen as the necessary price for attempting to depoliticise interest rate movements (though, ultimately, depolitisation may depend on the clearers adopting an even more flexible pricing structure, less dependent on base rates. This still seems some way off). But Barclay's decision to focus on 3 rather than 1 month interbank rates may have added to the problems. The degree of official influence at this maturity is less, and expectations are relatively more important. Even a Government committed to an avowedly expansionist monetary policy might find its influence over base rates rather restricted in practice - at least in the absence of a panapoly of controls.

46. A serious deficiency of present control arrangements is their lack of clarity. Even informed observers find it difficult to decide what current control arrangements amount to. If short term interest rates are the main operational instrument, how can we argue that market forces have a key influence and that pressures on the most politically sensitive short term rates are sometimes

irresistible? If control over short term rates is so imperfect, what monetary policy instruments are available for meeting the monetary targets? Sceptics may recall the 1980 Green Paper which argued: "The short term interest rates generated by the markets are not necessarily those needed to achieve the monetary target."

47. There is a general problem in devising a means of monetary control likely to be effective in a highly developed and relatively unregulated financial system. Influencing expectations is certainly likely to be important - hence the need for clearly formulated monetary policy objectives (and the problem caused by our lack of clarity about the role of the exchange rate). But influencing expectations may depend ultimately on the market believing that the authorities have the means - and the will - to achieve their objectives. A completely "hands off" approach to monetary control may simply not be credible.

48. Both MBC and the old MLR system are certainly easier to understand. There is much truth in the observation that our behaviour last week would not have been very different under MBC (MO was on track, and there would have been no reason to expand liquidity to resist a rise in interest rates). If our freedom to influence interest rates is as restricted as last week's experience seems to suggest, would it not be better to go the whole way, and formally espouse MBC?

49. There are two counter arguments. First, as argued in the Annex, there would be more difference between MBC and present arrangements in other situations. Monetary base control implies a willingness to allow interest rates to fluctuate in order to keep MO on track, irrespective of what other indicators suggest. We are not yet powerless to control interest rates - notwithstanding last week's events - and the present framework of policy does allow us to exercise that freedom on wider grounds than the behaviour of MO. It was precisely because the market was worried on wider grounds that the pressures on interest rates was so difficult to resist.

50. Under a credible MBC system these worries might well not have mattered. The fact that they did points to another difficulty with moving further in the direction of MBC. It would not enhance credibility. The main issue is not the authorities' ability to control the monetary base - though some commentators would question that too. The main worry has been whether controlling the base would give the authorities an adequate degree of influence over monetary conditions and inflation. For most commentators, MO still has some way to go before it proves itself in these terms.

51. Unless and until it does, it may be unwise to downplay the degree of official influence over short term rates. The Bank's influence over, say, 3-month rates is certainly not what it was in the days of Bank Rate and the clearers' cartel, when the "traditional" money markets were dominant. But the 1981 arrangements involved deliberately de-emphasising some of the techniques still available for influencing interest rates. There have been some important gains to set against the loss of control that has, on occasion, been involved. There is a greater understanding that interest rates are not solely the result of official decisions. But these gains may not be seriously jeopardised if the authorities do, on well chosen occasions, sometimes show themselves ready to take a clear line on interest rates, and back that up with more extensive operations in the money markets - preferably before the market has made up its mind.

HF3
July 1984

SECRET

Table The London Sterling Money Markets, 1957-1979

(end-year, £ million)

	1957	1962	1967	1972	1977	1978 **	1979
Money at call with discount market	903	1,186	1,662	2,530	3,513	4,004	4,435
Treasury bills	3,388	3,042	3,156	1,719	3,950	2,813	2,480
Commercial bills*	250	400	725	1,188	2,169	3,393	5,588
Local authority bills	-	-	-	240	443	499	599
Other local authority temporary debt	450	1,071	1,750	2,145	2,896	3,788	5,135
Deposits with finance houses	99	337	591	437	921	967	1,117
Inter-bank deposits	..	508	1,309	5,068	11,407	13,205	16,433
Sterling certificates deposit	-	-	-	4,934	4,546	3,678	3,692
Other market loans by the banking sector	..	..	..	..	4,296	4,581	5,314
Total	5,090	6,544	9,193	18,261	34,141	36,928	44,793

*This excludes acceptances held outside the banking sector:

**A sectoral breakdown ^f these holdings at end 1978 is shown in table 4.

Source: Wilson (1980) Appendix 3, p 510

ANNEX

MONETARY CONTROL: NEW ARRANGEMENTS, MBC and MLR

The Radcliffe Report draws attention to:

"the principle that, except in so far as its views influence market expectations (an important exception) the Bank cannot choose both a rate of interest and a quantity of debt to be held at that rate.... An important technical manifestation of this principle appears in relation to the control of the liquid assets "credit base" of the clearing banks. Because the Bank wants reasonable stability in the Treasury Bill rate.... It follows that the Bank cannot restrain the lending operations of the clearing banks by limiting the creation of cash, without losing its assurance of the stability of the rate on Treasury bills...."

2. Any form of monetary base control involves directing official money market operations at regulating the supply of cash (or the banking system's reserve assets). It is the antithesis of the approach described in the Radcliffe Report, under which the Bank stood ready to vary the supply of cash to whatever extent was necessary to sustain a particular level and structure of short term interest rates. The Bank's methods of operation have clearly changed very substantially since the Radcliffe Report; but nor would we usually regard them as a version of monetary base control. The Annex briefly summarises present control arrangements,and compares them with the arrangements under which the Bank operated prior to 1981, and with a "fully fledged" MBC system.

The 1981 Arrangements

3. Present methods of operation are described in some detail in a BEQB article on "The role of the Bank of England in the money market" (March 1982). Key features include the following:-

(i) The Bank's operations in the market are conducted chiefly through transactions in bills with the discount houses, with the objective of "keeping very short term rates within an

TABLE I

The Bank's money market operations

The figures are illustrative of a typical day on which, prior to any operations by the Bank, there is a market shortage.

The daily arithmetic

The items listed are explained in the main text, in particular in the section 'Daily procedures'.

	£ millions	
1 Morning estimate of the day's position (before taking account of any official operations that may be in prospect during the day):		
Clearing banks' operational balances at Bank, above (+) or below (−) assumed target last night	+ 30	Not usually disclosed
Exchequer receipts (−) net of disbursements (+)	−210	
Proceeds of net official sales (−) of gilt-edged stocks	− 20	−220
Net receipts (−) of sterling on Exchange Equalisation Account (EEA)	+ 10	
Increase (−) or decrease (+) in note issue	+ 30	+ 30
Take-up (−) of Treasury bills by market, less maturities in market hands	− 20	
Local authority and commercial bills maturing in the Bank's hands	−120	−140
Bills being resold by the Bank to the market	—	—
Repayment (−) to Bank of earlier lending by it	—	—
Other, including other Bank customers	− 10	Not disclosed
	−310	
2 At about noon the Exchequer figure is revised to −190, and that for the note issue to +40. The revised total is	−280	
3 Soon after midday the Bank purchases bills from the market (see opposite) totalling	+260	
4 At about 2 pm the Exchequer figure has again been revised, to −160; and the figure for 'other' items has been revised to +10. The revised total, before taking account of the operations in (3), is now	−230	

5 If the estimate of −230 is correct, the bill purchases of 260 will leave the market with a net surplus of 30 on the day. The Bank decides to undertake no further operations.

6 When the town clearing has been settled it becomes apparent that the actual Exchequer figure was −170. Thus the true position for the day was:

Total market shortage	−240
Bank's operations	+260
	+ 20

The clearing banks' operational balances will be 20 above the assumed target overnight.

What is published

The Bank releases information in the course of the day to the main press agencies and by direct input to the Reuter Monitor service.

1 The following announcement is made at about 9.45 am:

'A shortage of around £300 million is expected today. Among the main factors are:

Exchequer transactions	−220
Decrease in note issue	+ 30
Bills maturing and take-up of Treasury bills	−140'

The overall figure is rounded to the nearest 50. The position of bankers' balances is only exceptionally disclosed, while that of other customers is never revealed. 'Exchequer transactions' include in this context the effect of gilt-edged and EEA settlements. Bills being resold to the market would usually be disclosed if significant, as would the repayment of any published lending.

2 The revision is not large enough to warrant publication.

3 Details of these operations are published. Thus, when the operations are complete. the following announcement is made:

'The Bank has undertaken operations, making the following purchases totalling £260 million:

Band 1	Bank bills, £75 million at $13\frac{1}{4}$%
Band 2	Treasury bills, £12 million at $13\frac{5}{16}$%
Band 2	Local authority bills, £18 million at $13\frac{5}{16}$–$\frac{3}{8}$%
Band 2	Bank bills, £155 million at $13\frac{5}{16}$–$\frac{7}{16}$%.'

The rates shown for bill purchases are rates of discount.

4 The revision is now large enough to justify publication, so the following announcement is made:

'The shortage of around £300 million published this morning has been revised to one of around £250 million, before taking account of today's operations.'

5 The following announcement is made, at approximately 2.30 pm:

'The Bank has not operated in the money market this afternoon.'

6 No further announcements are made.

unpublished band which would be determined by the authorities with a view to the achievement of their monetary objectives".

(ii) Daily operations are intended to broadly offset the daily cashflows between the Bank and the money markets. The calculation of the system shortage allows for the monetary base to be demand determined: what this means in practice is that the Bank automatically supplies cash to finance the rise in the note issue, and to allow bankers' operational balances to return to the "target" level agreed with the banks themselves (currently £169m). Errors in estimating the shortage result in fairly small day-to-day divergences in operational balances from target; when these arise, the calculation of the next day's shortage allows for balances to return to target levels (see table).

(iii) Other than through bill operations, the Bank may supply or withdraw cash from the market by late lending to the discount market; by sale and repurchase operations (repos) in gilts or export credit paper; by placing funds directly in the LA short term deposit market; or - at least in principle - by releasing or calling Special Deposits. While the Special Deposit Scheme remains available, Special Deposits have not been called since 1979, and they have been zero since August 1981. (Unlike Supplementary Special Deposits, which were non-interest bearing, Special Deposits earn interest at a rate close to Treasury bill rate).

(iv) The Bank deals in bills in 4 maturity bands, at rates that lie within an unpublished (but readily detectable) band. The bands are:-

Band 1: 1-14 days
Band 2: 15-33 days
Band 3: 34-63 days
Band 4: 64-91 days

where maturity refers to residual, not original, maturity. The Bank does not usually buy bills with a residual maturity of more than 3 months.

(v) Lending through the discount window (in exceptional circumstances) is at rate of the Bank's choosing. Both the amount and the terms of 2:30 lending are published. Late (2:45) lending is usually on penal terms, but these are not published (though the amount is).

(vi) After 20 August 1981, the Bank ceased to post a minimum lending rate continuously. But it reserved the right to announce in advance the minimum rate which, for a short period ahead, it would apply in any lending to the discount houses.

Comparison with Pre-1981 Arrangements

4. The system of monetary control prior to August 1981 was described in the Green Paper on Monetary Control (Cmnd 7858, March 1980). The main instrument for influencing short term interest rates was discretionary variations in MLR, "made effective through money market operations conducted through the discount market". The process of making changes in MLR effective depended on the deliberate over-issue of Treasury bills at the weekly tender to create artificial money market shortages which were subsequently relieved by the discount market borrowing or selling assets to the Bank. The Special Deposit Scheme (first introduced in 1960) offered a means of regulating the liquidity of the banking system. The Reserve Asset Ratio was originally introduced in 1971 as a monetary control that would have the same effect, but it had ceased to serve this function long before 1981; by the end of 1973 it had become apparent that the banks' main response to reserve asset pressure was to bid for wholesale funds, resulting in interest rate differentials that provided incentives for round-tripping.

5. Information on how the Bank conducted its daily operations at times of unwanted interest rate pressure is sparse. Prior to 1971, at least, the Bank's position as jobber of last resort to the gilts market did sometimes put it in the position of supplying additional cash to the market in exchange for gilts, at times of falling prices, thus effectively taking some of the pressure off prices. But it is not easy to say how far, in practice, the Bank

bought in Treasury bills at such times, at posted dealing rates, to reinforce its view on MLR. The 1980 Green Paper implies that liquidity operations of this sort might be employed, though it puts most emphasis on the expectational impact of published official rates. For example:

"Market interest rates beyond the very short term are often heavily influenced by expectations about the future movement of MLR... If there is a strong expectation of any early cut in MLR, it may take persistent penal lending to stem a fall in say 1-3 month rates in relation to MLR: or, if an early rise in MLR is expected, even generous help by the Bank to relieve any shortage of funds, or the deliberate creation of easy conditions, may not be enough to induce the houses to hold on to longer term, say 1-3 month assets, and therefore to prevent the comparable money market rates from rising. Thus, in practice, the Bank's money market operations are intended to influence expectations in a much broader way rather than supply to influence the immmediate cost of money to the discount market."

6. The major changes made in 1981 were the ending of posted dealing rates and a continuously published MLR, both of which gave the Bank's dealing rates a much lower profile. The switch from discount window lending to operations in the bill market was intended to have the same effect and, even at the time, was regarded as being mainly of presentational significance. The ending of the practice of over-issuing Treasury bills has, in the event, been of no real significance, given the growth of the bill mountain. Maturing bills have ensured large and almost continuous market shortages, requiring regular operations even in longer maturity paper (Bands 3 and 4). With a substantially smaller bill mountain, however, the 1981 arrangements would have much reduced the scale of the Bank's daily intervention in the money markets, probably confining it, as originally intended, to Bands 1 and 2.

7. Whatever the practice prior to 1981, or the intention at the time the new arrangements were announced, it is clear that substantial variations in the supply of liquidity are not a

significant part of the Bank's current armoury of techniques for influencing short term rates. Special Deposits may be available in theory, but in practice releasing Special Deposits was not an option in early July (unless we could have contemplated creating negative Special Deposits). Official operations closely matched the ex post system shortage (as they have in previous periods of pressure) and daily deviations of bankers' balances relative to target rarely approached even £100m.

Comparison with Monetary Base Control

8. Does the fact that the Bank would typically scale down offers of bills in excess of the expected system shortage, even at times of unwanted and sharp upward pressure on interest rates, imply that, in practice, our present system is closer to monetary base control, than to a system where short term interest rates are the main operational instrument? Only up to a point. It is true that the Bank's operations in early July might have been very little different had we been operating an MBC system. MO was on target and the Bank's operational aim would have been to keep it there; there would have been no reason to vary the supply of cash to the banking system to damp the rise in interest rates.

9. In other circumstances, however, there could be more significant differences. Compared with our present system, MBC could imply - depending on how strictly it is operating in the short term -

(i) a willingness to move the Bank's dealing rates up or down in response to deviations in MO from target, irrespective of what other indicators were suggesting about monetary conditions. This rather weak form of MBC is what we have tended to regard as the most practical operational option. There is no necessary reason why this should lead to greater interest rate volatility than we have at present. That would depend on the volatility of MO, and the degree of short term control over it that was sought;

(ii) a deliberate attempt to over or under do assistance to the money markets on a daily basis, depending on whether MO is below or above target. If this meant large deviations in bankers' balances from desired levels, it would certainly generate larger fluctuations in rates, at the very short end of the market, at least in the short run. But whether it would mean more volatility in 3-month rates, or in banks' base rates, is conjectural. On the whole, we have tended to think that this is a real risk - partly on the basis of US experience (difficult as it is to interpret). What is clear, however, is that such a system would only be practical if the banks held much larger operational cash balances than they do now; no doubt brief experience of such a system would rapidly encourage them to do so.

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Introduction

During the last nine months we have been relatively relaxed about the behaviour of the monetary aggregates. In the light of the latest data this position must obviously be thoroughly scrutinised; this is done in some detail below but it may be helpful to begin with a broad summary.

The most striking feature of the monetary statistics at present is the marked acceleration in all of the broader aggregates. The growth of PSL2 has been high for some time but its six month rate of growth has continued to rise since the turn of the year. PSL1 and, now, sterling M3 are also growing at rates clearly greater than the target range.

The picture is rather different for the narrower aggregates. Mo remains well within its target range. Currency, on a properly calculated basis, is not too different. The growth of retail M1 looks to be slowing down after a temporary acceleration in March and April, while M2 is trending very slowly upwards in a way that is consistent with reasonable economic growth.

There is, therefore, a striking contrast between the behaviour of the two sets of monetary aggregates. With inflation relatively low and stable and with real interest rates at the height they are now, it is obviously true that a growing portion of genuine savings are being held in the form of interest-bearing money, e.g. with building societies and in bank deposit accounts. It is also true that such savings can subsequently be spent, thereby raising inflationary pressures, but there are no signs yet of a strong spending boom. If anything, retail sales seem to be losing their momentum, and the rise in interest rates must make a further slowdown more probable.

Monetary Growth in the Month to Mid-June

The seasonally adjusted data for the five weeks to 20th June were as follows:-

	£m.	p.a.
Mo	144	13%
Currency	118	12%
Retail M1	279	10%
M1	853	22%
Sterling M3	2,064	24%
PSL1	2,589	29%
PSL2	3,874	27%
Bank lending in sterling to private sector	1,549	17%

R.H. Lawson, G.T. Pepper, C.E. Frappell, The Lord Annaly, J.A. Rickards, L. Gooderham, T. Quinn
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, R.W. Walker, W.E.A. Bain, R.M. Harvey, R.B. Pomphrett
M.R.F. Wonfor, A.L. Bucknall, M.S. Jaskel, P.B. Lilley, A.J.E. O'Sullivan, G.R. Addison, K.M. Feeny
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The longer-term picture of monetary growth at mid-June becomes:

% p.a.		3 months	4 months**	6 months	1 year
Narrow money:	Mo	6	7	5	5
	Currency	10	9	5	5
	Retail M1	13	15	9	9
	M1	23	27	20	14
	M2	n.a.	n.a.	n.a.	11*
Broad money:	Sterling M3	14	15	11	9
	PSL1	16	17	12	10
	PSL2	19	20	17	13

* 8% after allowing for reclassification of building society deposits
** Target period so far

The growth of Mo continues to be reassuringly in the middle of its 4-8% p.a. target range. We estimate that it will have risen by less than ½% in banking July, bringing its three, six and twelve month growth rates to 7½% p.a., 5½% p.a., and 6% respectively.

Currency has grown at a similar rate to Mo over the last six and twelve months, but has been more buoyant over the last three. About half of this more rapid growth arises from the fact that the currency series is based on a single, relatively volatile mid-month calculation rather than on an average of weekly data within a banking month. The latter basis produces a three month growth rate for currency of 8% pa.

The growth rate of retail M1 was again not very high in the month to mid-June. As we pointed out last month, the growth of retail M1 in real terms was lower after mid-1983 than would have been expected given the trend in interest rates; its acceleration in March and April is no cause for alarm if all that was happening was a return of retail M1 to a normal relationship with interest rates. The last two months' figures suggest that this might be happening. Further, the recent rise in interest rates should cause retail M1 to decelerate sharply, starting in the banking month to mid-August.

As the Chancellor stated in his Financial Statement last March "the increasing share of interest bearing deposits within the total has complicated interpretation and made M1 an increasingly inadequate measure of transactions balances". The reclassification of certain deposits late last summer is still boosting the twelve month growth rate of M1 but not the three and six month rates. More recently, however, M1 has been increased by the introduction of high interest checking accounts by Midland and Barclays. Even after making allowance for these accounts, we estimate that M1's three, four and six month growth rates remain high at about 19% pa, 23% pa and 17%pa respectively.

M2 will no doubt become the authorities' preferred indicator of narrow money but, as a seasonally adjusted series is not yet available, only its annual growth rate is relevant. After adjusting for the reclassification of certain building society deposits, its annual growth rate continues at a very reasonable 8.3%.

The very rapid growth in sterling M3 in the month to mid-June reflects an above average PSBR (at twice the rate of the Budget forecast for the year) coinciding with high bank lending, low sales of gilt-edged stock and unfavourable external finance and non-deposit liabilities. This extreme combination of every counterpart is exceptional. Turning to future growth, it should be noted that the recent rise in interest rates has

altered the structure of rates. In particular, banks' deposit rates have risen relative to building society share rates. This should encourage a faster growth of bank deposits and, therefore, of sterling M3. To the extent this merely reflects a change in the form which people hold their savings, this rise in sterling M3 would not be especially worrying.

PSL1 & PSL2 are growing even more rapidly than sterling M3. The growth of PSL1 has been boosted by non-bank holdings of eligible bills having risen by more than £1bn in the four months to mid-June. The rapid growth of PSL2 reflects a 22% p.a. increase in its building society component over the same four months.

Counterparts to Monetary Growth

Sterling M3 was also giving cause for concern a year ago. An obvious approach is to compare this year's overshoot with that of last year, which is done in Table I.

TABLE I
Counterparts to Monetary Growth

£bn	4 months to June '83	4 months to Oct '83	4 months to Feb '84	4 months to June '84
PSBR*	4.9	4.1	3.1	4.0
less CG Debt sales	-2.4	-5.5	-4.3	-3.3
Bank Lending	3.3	4.8	4.9	5.5
External Finance and banks' non-deposit liabilities	-1.3	-1.3	-1.8	-1.6
Sterling M3	4.5	2.2	1.9	4.6
Deviation of sterling M3 from:				
mid-point of target range	+1.8	-0.5	-0.8	+2.0
top of target range	+1.2	-1.1	-1.4	+1.3

* plus purchase of local authority & public corporation debt from non-bank private sector.

Remembering the mini-Budget last July, the surprising factor about the above table is that the most important cause of excessive monetary growth last June was very low debt sales rather than an especially high PSBR. The main cause this year is high bank lending. We discuss the PSBR and bank lending in turn.

The Profile of the PSBR

Ever since the Budget, the profile of the PSBR has been expected to be skewed this year. On a seasonally adjusted basis, the borrowing requirement is expected to be more than £2bn greater in the first half than in the second half of the year.

This is mainly because the tax changes and the asset sales announced in the Budget will have a very uneven impact. Additional VAT receipts, proceeds from asset sales and EEC rebates will be heavily concentrated in the second half of the year. Table II shows the impact of the Budget changes on the PSBR's expected profile.

TABLE II

Influences on PSBR Profile in 1984/5

£m	First Half	Second Half
EEC rebate	-400	-650
Asset sales	-600	-1,300
Extra VAT	-50	-1,500
End of N.I.S.	-	+350
	-1,050	-3,100

It should be noted that on a non-seasonally adjusted basis almost the whole of the PSBR is expected to occur in the first half of the year, £6¾bn compared with £½bn. The published figure of £4.7bn (£3.4bn seasonally adjusted) for the first quarter of the fiscal year is quite consistent with this estimate.

The miners' dispute is likely to have a further impact on the PSBR profile, as well as putting the total under some pressure if it is not settled fairly soon. Our estimate of the weekly rate of loss for the NCB and the rest of the public sector is shown in Table III.

TABLE III
Weekly Accounting Losses

			£m
NCB:	reduced revenue from lower sales	65	
	reduced expenditure	-35	
			30
CEGB:	increased expenditure on oil	43	
	reduced expenditure on coal	-26	
			17
British Rail			4
British Steel			4
Police			4
Income tax lost and benefits paid			7
			66

The impact of the dispute on the PSBR will be different from the accounting losses shown above because it will lead to a fall in the NCB's stocks of coal and the CEGB's stocks of coal and oil, which will release finance. The NCB's coal stocks were virtually unchanged in April but the CEGB's coal and oil stocks fell by £130m and £50m respectively. Data for May and June have not yet been published but reductions in stocks are likely to be lower because the CEGB increased its purchases of fuel oil and because the seasonal reduction in the demand for electricity enabled coal stocks to be conserved.

Allowing for the finance released by the fall in stocks, our estimates of the effect of the miners' dispute on the PSBR during April, May and June are £115m, £240m and £200m respectively. If the dispute were to end by the beginning of August, which does not now look likely, there would be a PSBR increase of some £230m in July. The rebuilding of coal stocks by the NCB and CEGB and the continuation, for a few months, of a higher than normal oil burn by the CEGB would continue to raise the PSBR in subsequent months. These additional effects could amount to some £300m, of which £100m would increase the 1985/6 PSBR.

On the assumption that the miners' dispute ends within a month, its total impact on the PSBR this fiscal year will be less than £1,000m, as compared with a contingency reserve of £2¾bn for the year as a whole.

There are further identified claims on the contingency reserve. First, public sector pay increases are running above the 3% assumption made in the Public Expenditure White Paper. The outcome is likely to be an overrun of about 1½% which would increase expenditure for 1984/5 by £550m, before any offsetting manpower reductions. The increase in the PSBR will be lower at £325m, as almost 40% of the extra wage costs will be offset by higher receipts of income tax and national insurance contributions.

Secondly, unemployment is continuing to rise slowly, compared with the Budget assumption of an unchanged level. Social security costs are likely to be £200m higher than planned.

There is one important factor which will reduce the PSBR this year. According to the Budget estimates, receipts of petroleum revenue tax (PRT) and oil royalties will be £8bn in 1984/5. As receipts in a fiscal year are determined by production in a calendar year, information for half of the current year is already available. Not only has the volume of oil production risen by 13% in the first half but the sterling oil price has also risen with the fall in the sterling/dollar exchange rate. The Budget assumed that "oil prices do not change much from current levels". At that time sterling was above $1.46. In the first half of the year it averaged $1.41. If the average is, say, $1.33 in the second half, and dollar oil prices are maintained, the sterling oil price will be 6% above the Budget assumption. If these assumptions are correct, receipts from PRT and oil royalties will exceed the Budget estimate by some £500m.

All these factors suggest that the PSBR will be close to the Budget forecast of £7¼bn. The PSBR is, however, likely to be under real pressure if the miners' dispute extends very far into the autumn.

Bank Lending

As Table I shows, high bank lending is an important factor behind the rapid monetary growth in the last four months. Indeed, compared with the same period a year ago, bank lending is more than £2bn higher. A full breakdown is not available but partial data clearly indicate that lending to persons is no higher than a year ago (group data for the London Clearing Banks show that lending to persons was about £1.2bn in the four months to mid-June, some £50m lower than last year). The increase of £2bn, therefore, arises from lending to companies and unincorporated businesses.

The quarterly analysis of bank lending to mid-May confirms that the lending is to companies rather than persons. Further, it is widespread across different industries rather than confined to merely a few.

The other source of information is data for industrial and commercial companies' net borrowing in the first calendar quarter, which have recently been published. In spite of a record financial surplus of £3.6bn, bank lending was still high at £2.6bn. This was not because of a strong build-up of liquid assets, which at only £1.1bn were less than a third of the previous quarter's increase. Rather, there was a record level of "unidentified" items, at £5.2bn. These include errors and omissions as well as trade credit and unrecorded transactions, e.g. foreign currency flows and changes in leads and lags of trade. The first quarter accounts, therefore, suggest that corporate bank borrowing in the four months to mid-June may reflect lower remittances to the UK and more rapid transfers abroad, presumably responding to the continued rise in the US dollar.

A Post-mortem

Before coming to overall conclusions, there are some important lessons to be learned from a post-mortem into the recent rise in short term interest rates. To begin with, we focus on the contrast between three firmly held impressions and reality.

Impressions

First, it is very widely believed that sterling has been weak since March. Confidence in the foreign exchange market is determined to a very large extent by sterling's exchange rate against the US dollar, because the US dollar is involved in the majority of sterling's foreign exchange transactions. Almost invariably, the press concentrates on the sterling/dollar exchange rate. Throughout the period since March there have been continual headlines of sterling falling to new all-time lows.

Secondly, most participants in the money and gilt-edged markets believe that sterling weakness is the single most important cause of increases in short term interest rates. They do so because they have observed that there has nearly always been a foreign exchange explanation when the Bank of England has altered its dealing rates in the bill market or, in the old days, when it altered MLR.

Thirdly, many officials believe that the authorities have to accede to market pressure when expectations of an increase in interest rates become really engrained.

Reality

Reality was certainly different from the first of the above impressions. If the behaviour of the US dollar is excluded, sterling was not weak during April, May and June. The Bank's index of sterling's "effective exchange rate" measures sterling against a basket of currencies weighted according to their importance in our overseas trade. It is possible to calculate an index leaving out the US dollar. Chart I, at the top of page 7, shows that this index actually rose by some 1½% between 30th March and 25th June. During the same period, the dollar's own effective exchange rate rose by no less than 6¼%, as shown in Chart II, at the bottom of page 7. The sterling/US dollar exchange rate fell because sterling rose by substantially less than the US dollar. Despite the newspaper headlines, sterling was not weak before 26th June - the US dollar was strong.

On 26th June the Bank, in a most unusual statement, claimed that "there is no need on monetary policy grounds for any general increase in the level of domestic interest rates". On the 28th June, the West German discount rate was raised from 4% to 4½%. An interpretation of these events was that Germany was following the rise in US interest rates but the UK was not. Sterling's weakness became general. Between 25th June and 10th July its effective rate, excluding the US dollar, fell by some 2½%. The first report of substantial selling occurred on the afternoon of Thursday 5th July and this continued into the morning of Friday 6th July. The Bank reacted at once; base rates rose by ¾% at midday on the Friday and the Bank's dealing rates in the bill market were raised by 1%. The crisis, such as it was, broke extremely quickly.

Sterling continued to be weak in spite of this rise in interest rates. The provisional data for the money supply for the month to mid-June, which were published on Tuesday 10th July, were poor and base rates rose by another 2% on Wednesday 11th July. Sterling's effective rate, excluding the US dollar, has subsequently recovered over three-quarters its post-25th June losses.

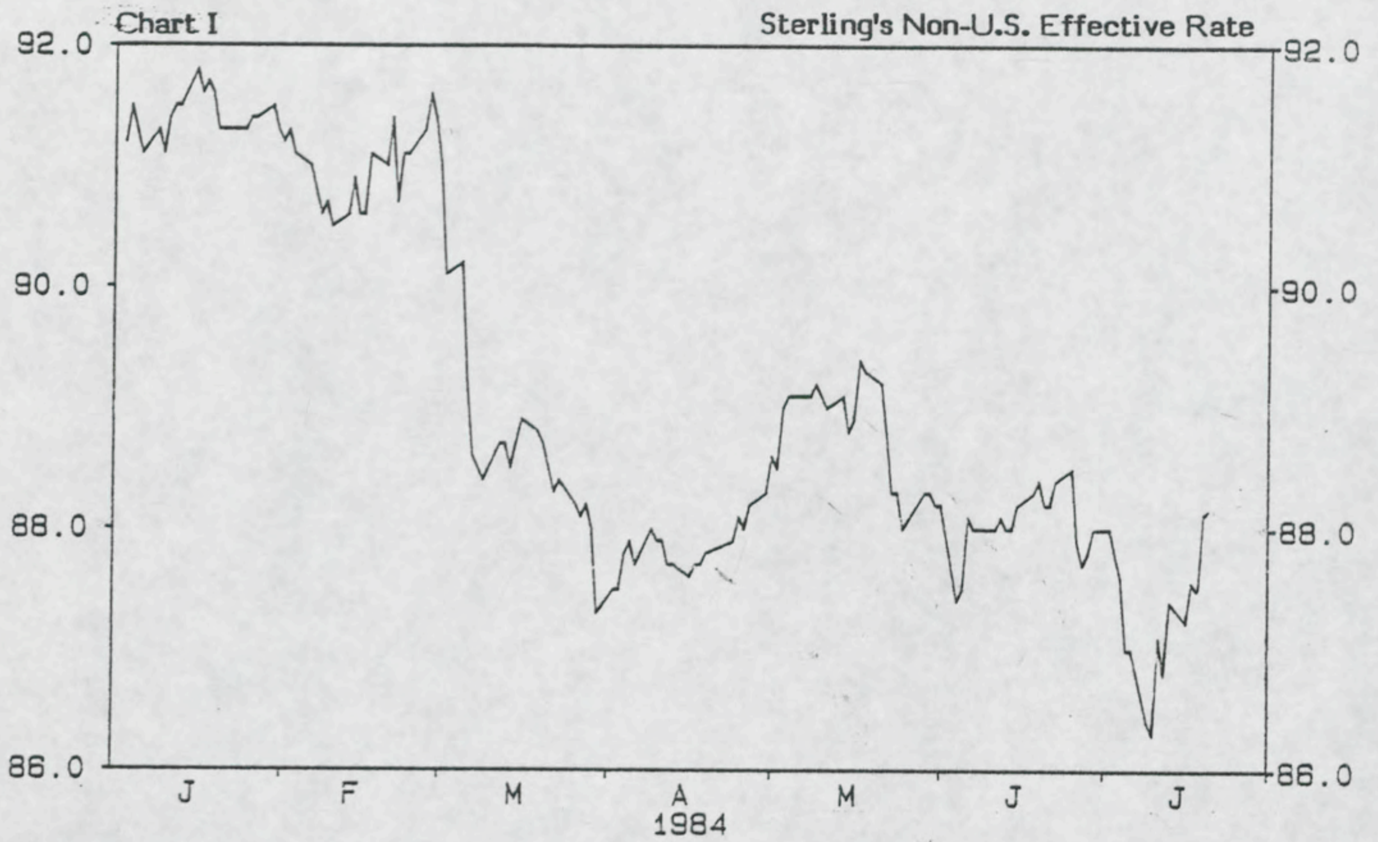
Chart I
Sterling's Non-U.S. Effective Rate
92.0
90.0
88.0
86.0
J
F
M
A
M
J
J
1984

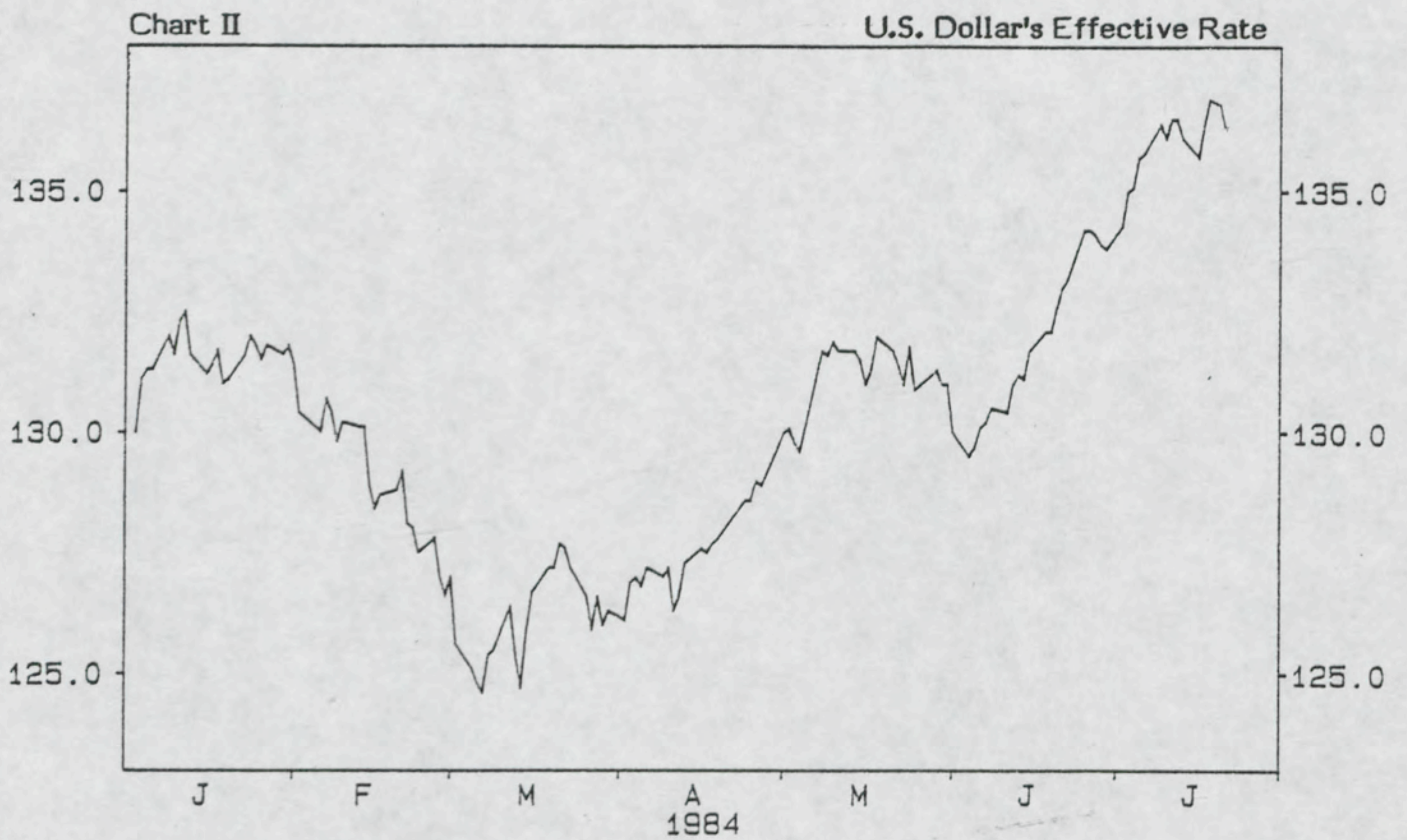
Chart II
U.S. Dollar's Effective Rate
135.0
130.0
125.0
J
F
M
A
M
J
J
1984

Turning now to the belief that the behaviour of sterling is the dominant cause of changes in short term interest rates, the authorities continue to claim that they are following a domestic money supply policy and have no target for the exchange rate. The Chancellor has explained the policy on two recent occasions, in his Mansion House Speech last October and in his Mais Lecture in June.

The message has not yet got through. This is not because market participants are simple-minded or do not want to understand. Experience has taught the market to ignore what the authorities say and to pay attention to what they do. The simple fact is that the authorities react to foreign exchange pressure and concede to persistent market expectations of a change in interest rates that are based on sterling's behaviour.

The policy which the authorities are trying to follow is quite subtle. The monthly data for the money supply are volatile. When the data are published, it is often far from clear whether a deviation which appears in the monetary aggregates is a random fluctuation or the start of a trend, and the authorities are right to pay attention to all available information. The behaviour of sterling is an important confirming indicator. Put simply, if sterling's behaviour confirms the latest deviation in the money supply, the authorities tend to act quickly. If it does not, they tend to delay.

There is no doubt that the behaviour of sterling has been a most important factor determining the timing of increases in short term interest rates. Many market participants fail to distinguish between the trigger for a change and the underlying reason for it. The distinction should be important on those occasions when sterling and the money supply persist in giving opposite signals, as they did, for example, during February and March 1983 when sterling was weak but the money supply was under control. Such periods are unusual because domestic monetary pressures have an important influence (although with a lag) on the short term capital account (and balancing item) of the balance of payments and, therefore, on sterling. If such a period of divergence occurs, non-monetary reasons for sterling's behaviour (eg the current miners' and dockers' strikes) should be assessed and the data for the money supply should be examined to make quite certain that they have been correctly interpreted. If the inconsistency persists, history in the UK shows that it has been right to focus policy on the behaviour of the money supply and adopt a foreign exchange policy of benign neglect. March 1983 was an excellent example.

We now consider the third impression, the belief on the part of many officials that the authorities have to accede to engrained market expectations of a change in interest rates. The true position is as follows:

(i) The authorities cannot control the term structure of money rates, eg they cannot peg the seven day rate and the three month rate at levels at which the difference between them is contrary to market expectations of a change in their levels.

(ii) The authorities cannot for long distort interest rate relatives, in particular they cannot hold down bank base rates relative to LIBOR.

(iii) The authorities definitely have the ability to peg the level of one particular money rate, eg either the seven day rate or the three month rate but not both.

If the authorities were to attempt either of the first two courses of action, arbitrage transactions would soon become overwhelming. The situation on 26th June, when the Bank issued its statement on interest rates, was quite a good example. The term structure of money rates was wrong. The Bank had been dealing in seven day and three month bills at the same yield, which was not in accordance with market expectations. The statement was issued to reassure the market about the general level of rates when the Bank changed the term structure.

The authorities should definitely be able, however, to peg any one particular money rate, because arbitrage transactions will cancel out. Some officials argue there would be a huge demand for cheap funds from the Bank if the authorities were to peg, say, the seven day rate when there were engrained expectations that it would rise. This argument is fallacious; people would not borrow for seven days and invest for, say, three months if the gradient of the yield curve were allowed to reflect expectations accurately.

There is no doubt that officials who argue that the authorities must react to engrained market expectations have a powerful voice. In practice, they tend to win the argument unless it is clear that the change in interest rates is inconsistent with controlling the money supply.

The belief that the authorities will concede to market pressure and will alter interest rates in accordance with sterling's behaviour is reinforced each time they do so. It is now more firmly engrained than ever.

The Provisional Money Supply Data

The authorities' statement on the 26th June seemed to be inconsistent with the publication on 10th July of poor provisional data for sterling M3 in banking June. We suspect that the authorities were very surprised by these data. They have up-to-date daily information about the majority of the counterparts to sterling M3, namely the CGBR, sales of central government debt and the government's external transactions; these were satisfactory. Up-to-date data for bank lending and banks' external transactions are not, however, available, and early indications for a banking month have to be obtained by survey. We, ourselves, discuss what has been happening widely within the banking sector. The indications we obtain are usually reasonably accurate providing that proper allowance is made for variation in holdings of commercial bills, in particular in the Bank's own holdings. Our discussions for the banking month of June suggested that lending would be about £1,000m lower than it actually was; the error was our largest ever. The Bank was probably surprised in the same way.

The vital practical point is that there was a waning in the belief that monetary growth was satisfactory at the same time as the start of substantial selling of sterling. Arguments for a foreign exchange policy of benign neglect were undermined by poor data for the money supply.

Conclusions

The behaviour of sterling is a very important factor determining the timing of changes in interest rates. When sterling is weak and monetary growth is satisfactory, however, the authorities should not readily acquiesce in a rise in interest rates. Given the conflicting signals from the broader and narrower money aggregates, the authorities were right to acquiesce to some extent this time. They were wrong, however, to ratify a rise as large as nearly 3%.

Looking through the behaviour of sterling, the reason for the substantial rise in UK interest rates was, of course, the upward trend of those in the US. We are most concerned that US rates may rise still further. Dr Henry Kaufman, amongst others, is forecasting that this will happen. More specifically, his current view is that "the peak in interest rates is not near - both in terms of level and when it will occur . . . much higher interest rates loom ahead".

In America, the contractionary effect of high interest rates is offset by grossly easy fiscal policy. In developed countries other than the US, high interest rates are not generally offset by easy fiscal policy to anything like the same extent as they are in the US. The UK is, in particular, at the opposite end of the spectrum to the US. It can be argued that UK fiscal policy is tight rather than easy. Without the offsetting factor of clearly easy fiscal policy, there is a distinct danger that the economic recovery in the UK will collapse if we follow US rates up again.

Such a collapse is not yet in sight. It will be preceded, if it occurs, by a slowdown in the growth of the narrower monetary aggregates in the UK. Historically, the money supply has declined in real terms, i.e. after allowing for inflation, prior to every recession. The slowdown does not, however, necessarily occur in the broader aggregates.

The experience of the second half of 1980 illustrates this. There was at that time a loss of confidence, a rise in the savings ratio (from 11½% to 15½%) and buoyant growth of the broader aggregates, as genuine savings were invested in bank deposits. Something somewhat similar could happen in the coming months. The possibility of another rise in US rates is a dark cloud overhanging the gilt-edged market. We have recently had a dreadful demonstration of what can happen to our market when the US bond market is in disarray. In these circumstances it would be no surprise at all if sales of government debt in the UK did not respond as they should to the current height of UK interest rates. Investors may easily prefer to hold bank deposits rather than gilt-edged stock.

In his recent Mais Lecture, the Chancellor stressed that Mo and sterling M3 have equal weight in guiding policy decisions. In our view he should modify this rule in the coming months and place greater weight on the narrower monetary aggregates. If these start to decline in real terms, the authorities should act as they did in the second half of 1980 and reduce short term interest rates, even if the broader aggregates are still buoyant.

There remains the question about how sterling would react. Ideally, the UK should strive for international agreement, particularly with Germany and Japan, not to follow US interest rates upwards. If such an agreement cannot be achieved and sterling comes under pressure, the UK authorities should adopt a foreign exchange policy of benign neglect and resist those who argue that they must accede to engrained market expectations of a rise in interest rates.

GTP
RLT
RR

MONETARY GROWTH

In Nominal Terms

Percentage annual rates		Mo	Currency	Retail M1	M1	M2	Sterling M3	PSL1	PSL2
Changes in year to:									
1983	July	6	8	10	14	9	12	11	13
	Aug.	7	8	9	13	8	11	10	13
	Sept.	6	8	8	12	8	10	9	12
	Oct.	7	8	7	13	7	11	10	13
	Nov.	6	8	8	12	7	10	9	12
	Dec.	7	8	8	12	9	10	10	13
1984	Jan.	6	7	9	11	10	10	10	13
	Feb.	6	5	8	11	10	9	9	12
	Mar.	6	5	8	13	10	10	9	12
	Apr.	5	6	9	14	10	8	7	11
	May	5	5	9	14	10	8	8	12
	June	6	5	9	14	11	9	10	13
Changes in 6 months to:									
1984	Jan.	7	5	7	10		8	7	10
	Feb.	6	4	7	10		7	6	9
	Mar.	5	4	9	16		9	9	12
	Apr.	4	7	11	16		8	7	12
	May	4	4	11	18		9	9	14
	June	5	5	9	20		11	12	17
Changes in 3 months to:									
1984	Apr.	3	10	15	22		8	8	14
	May	4	7	16	28		11	12	17
	June	6	10	13	23		14	16	19

In Real Terms

Percentage annual rates		Mo	Currency	Retail M1	M1	M2	Sterling M3	PSL1	PSL2
Changes in year to:									
1984	July	2	4	5	10	4	7	7	9
	Aug.	2	3	5	9	4	6	6	8
	Sept.	1	2	3	7	3	5	4	7
	Oct.	2	3	2	8	2	6	5	8
	Nov.	2	3	3	7	3	5	5	7
	Dec.	1	3	3	6	4	5	5	8
1984	Jan.	1	2	4	6	5	5	5	8
	Feb.	1	0	3	6	5	4	4	7
	Mar.	0	0	3	8	5	5	4	7
	Apr.	0	1	4	8	5	3	2	6
	May	0	0	4	9	5	3	3	7
	June	0	0	4	9	6	4	4	8
Changes in 6 months to:									
1984	Jan.	2	0	2	5		3	2	5
	Feb.	1	-1	2	5		2	1	4
	Mar.	0	-1	4	12		4	4	7
	Apr.	-1	1	5	11		2	2	7
	May	-1	-1	5	13		4	3	9
	June	0	0	4	15		6	7	12
Changes in 3 months to:									
1984	Apr.	-2	5	10	17		2	2	9
	May	-1	2	11	23		6	7	12
	June	1	4	8	17		8	10	14

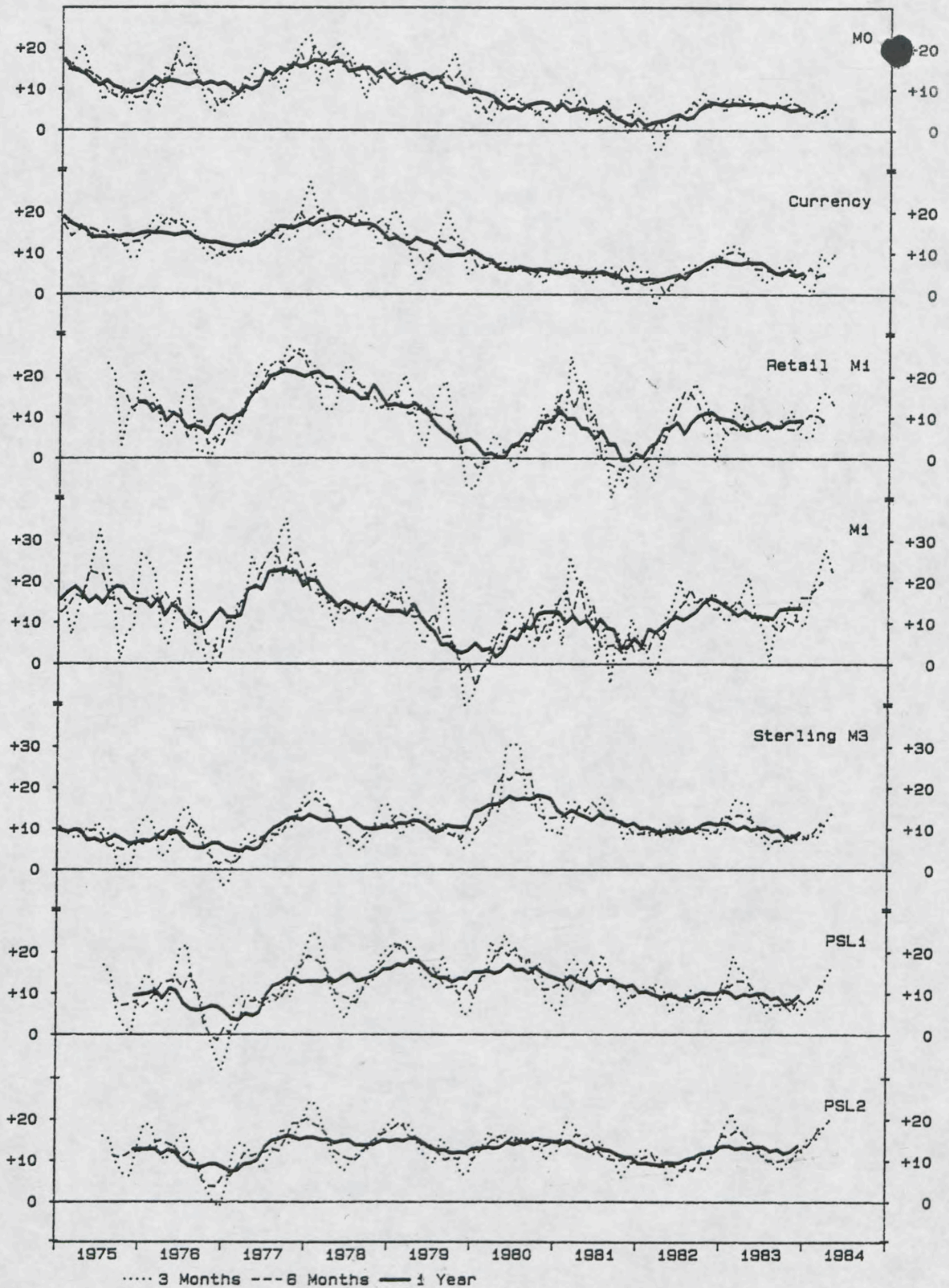
Chart 1 - Monetary Growth in NOMINAL Terms (% p.a.)
M0
Currency
Retail M1
M1
Sterling M3
PSL1
PSL2
+30
+20
+10
0
1975
1976
1977
1978
1979
1980
1981
1982
1983
1984
3 Months
6 Months
1 Year

Chart 2 - Monetary Growth in REAL Terms (% p.a.)

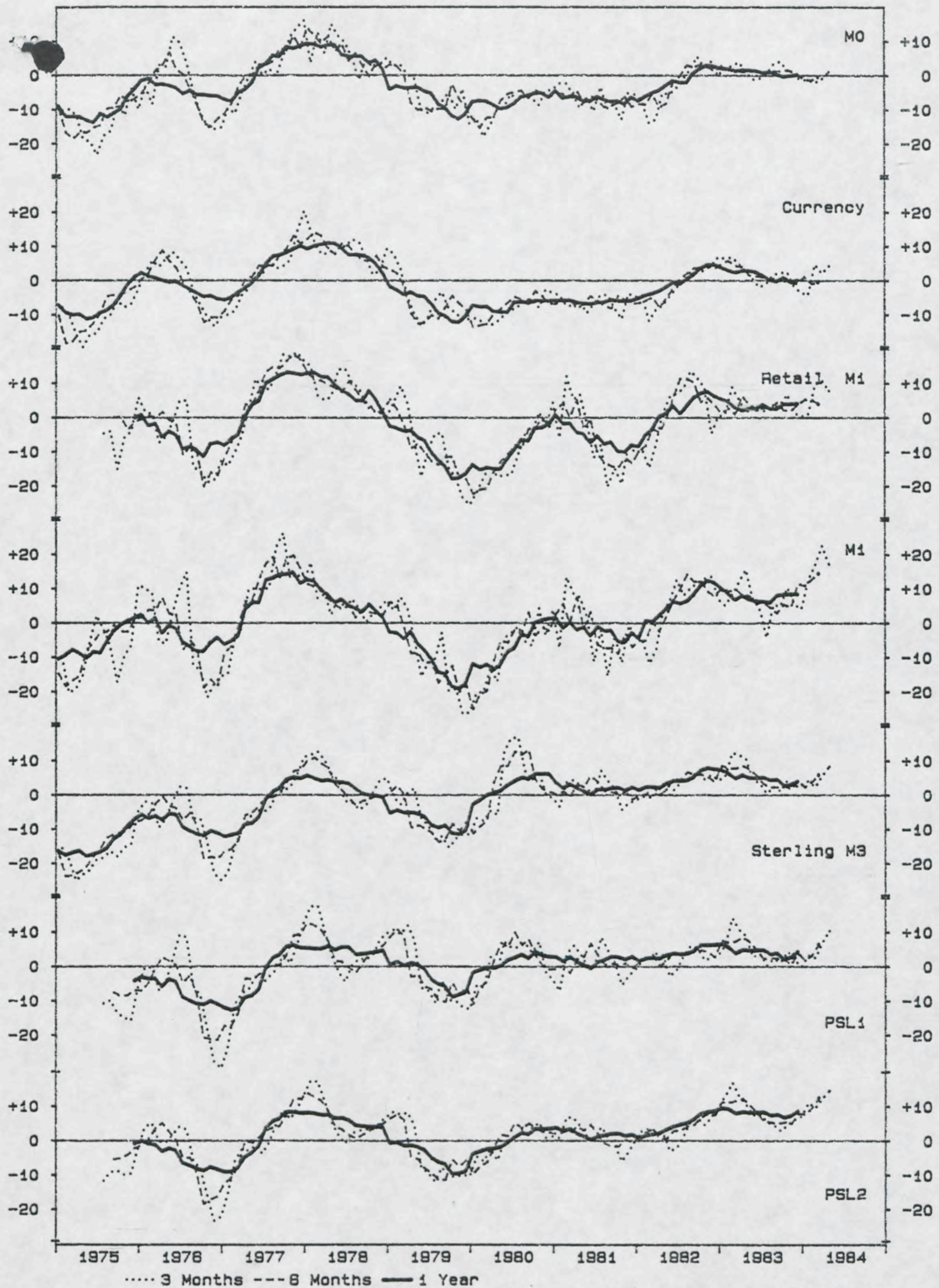

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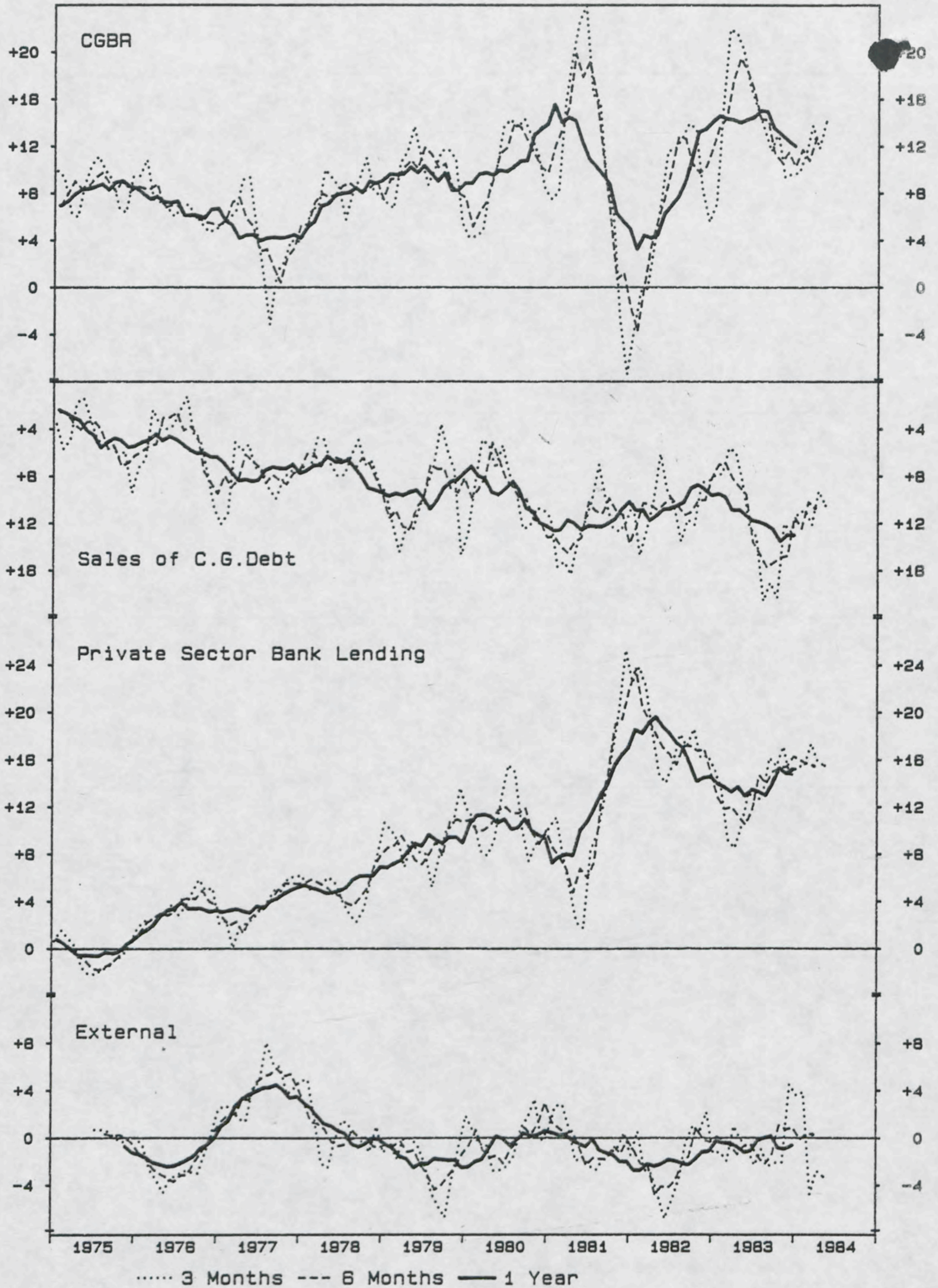
Chart 3 - Components of Monetary Growth (bns)



STATISTICS

reprinted from Bank of England *Banking Statistics*

[**Table 11.1** in the *Quarterly Bulletin*]

Money stock: amounts outstanding

£ millions

Month ended	Notes and coin in circulation with public	UK private sector sterling sight deposits		Money stock M1[b]		UK private sector sterling time deposits[c]	Money stock £M3[b] [d]		UK private sector deposits in other currencies [c]	Money stock M3[b] [d]	
		Non-interest-bearing[a]	Interest-bearing	Unadjusted	Seasonally adjusted		Unadjusted	Seasonally adjusted		Unadjusted	Seasonally adjusted
	1	*2*	*3*	*4*		*5*	*6*		*7*	*8*	
1983 May 18	11,263	18,415	10,656	40,334	40,300	53,261	93,595	94,460	13,095	106,690	107,560
June 15	11,328	18,564	11,102	40,994	41,060	53,803	94,797	95,430	13,274	108,071	108,700
July 20	11,601	18,978	10,714	41,293	40,860	55,029	96,322	95,930	13,497	109,819	109,430
Aug. 17	11,507	18,785	10,902	41,194	41,180	55,579	96,773	96,380	13,489	110,262	109,870
Sept. 21[e]	11,477	18,876	10,601	40,954	41,170	55,952	96,906	96,740	13,545	110,451	100,290
Oct. 19	11,473	19,369	11,172	42,014	41,910	56,135	98,149	97,750	14,086	112,235	111,830
Nov. 16	11,531	19,264	11,352	42,147	42,190	55,757	97,904	97,850	14,523	112,427	112,380
Dec. 14[e]	12,119	19,990	11,466	43,575	42,680	56,238	99,813	99,100	15,865	115,678	114,960
1984 Jan. 18	11,467	19,320	11,914	42,701	42,980	56,619	99,320	99,740	16,036	115,356	115,770
Feb. 15	11,531	19,018	11,951	42,500	43,140	56,119	98,619	99,810	16,754	115,373	116,560
Mar. 21[e]	11,641	19,467	12,637	43,745	44,440	55,735	99,480	101,220	17,047	116,527	118,270
Apr. 18	12,044	20,572	13,038	45,654	45,220	55,449	101,103	101,550	17,329	118,432	118,870
May 16	11,834	20,593	13,485	45,912	45,910	55,925	101,837	102,550	15,474	117,311	118,020
June 21[e]	11,941	20,646	13,962	46,549	46,770	57,501	104,050	104,620	15,528	119,578	120,150

[**Table 11.2** in the *Quarterly Bulletin*]

Money stock: changes[f]

£ millions: *percentages in italics*

Month ended	Notes and coin in circulation with public	UK private sector sterling sight deposits		Money stock		UK private sector sterling time deposits[c]	Money stock		UK private sector deposits in other currencies [c]		Money stock	
		Non-interest-bearing[a]	Interest-bearing	M1[b]			£M3[b] [d]		Trans-actions	Valuation changes[g]	M3[b] [d]	
	1	*2*	*3*	*4*		*5*	*6*		*7*		*8*	
Month ended (unadjusted)												
1983 June 15	+ 65	+ 149	+ 446	+ 660		+ 542	+ 1,202		− 102	+ 281	+ 1,381	
July 30	+ 273	+ 414	− 388	+ 299		+ 1,226	+ 1,525		+ 285	− 62	+ 1,748	
Aug. 17	− 94	− 193	+ 188	− 99		+ 550	+ 451		− 87	+ 79	+ 443	
Sept. 21	− 30	+ 71	− 306	− 265		+ 323	+ 58		− 66	+ 87	+ 79	
Oct. 19	− 4	+ 493	+ 571	+ 1,060		+ 183	+ 1,243		+ 460	+ 81	+ 1,784	
Nov. 16	+ 58	− 105	+ 180	+ 133		− 378	− 245		+ 357	+ 80	+ 192	
Dec. 14	+ 588	+ 716	+ 109	+ 1,413		+ 291	+ 1,704		+ 670	+ 682	+ 3,056	
1984 Jan. 18	− 652	− 670	+ 448	− 874		+ 381	− 493		+ 73	+ 98	− 322	
Feb. 15	+ 64	− 302	+ 37	− 201		− 500	− 701		+ 1,005	− 287	+ 17	
Mar. 21	+ 110	+ 444	+ 671	+ 1,225		− 424	+ 801		+ 190	+ 73	+ 1,064	
Apr. 18	+ 403	+ 1,105	+ 401	+ 1,909		− 286	+ 1,623		+ 130	+ 152	+ 1,905	
May 16	− 210	+ 21	+ 447	+ 258		+ 315	+ 573		− 2,133	+ 278	− 1,282	
June 21	+ 107	+ 53	+ 467	+ 627		+ 1,561	+ 2,188		− 226	+ 255	+ 2,217	
Month ended (seasonally adjusted)												
1983 June 15	+ 48	+ 154	+ 554	+ 756	+ *1.9*	+ 179	+ 935	+ *1.0*	− 102	+ 281	+ 1,114	+ *1.0*
July 20	− 14	+ 236	− 434	− 212	− *0.5*	+ 704	+ 492	+ *0.5*	+ 285	− 62	+ 715	+ *0.7*
Aug. 17	+ 46	+ 17	+ 266	+ 329	+ *0.8*	+ 130	+ 459	+ *0.5*	− 87	+ 79	+ 451	+ *0.4*
Sept. 21	+ 82	+ 146	− 269	− 41	− *0.1*	+ 337	+ 296	+ *0.3*	− 66	+ 87	+ 317	+ *0.3*
Oct. 19	+ 56	+ 228	+ 454	+ 738	+ *1.8*	+ 260	+ 998	+ *1.0*	+ 460	+ 81	+ 1,539	+ *1.4*
Nov. 16	+ 62	+ 73	+ 148	+ 283	+ *0.7*	− 173	+ 110	+ *0.1*	+ 357	+ 80	+ 547	+ *0.5*
Dec. 14	+ 86	+ 352	+ 38	+ 476	+ *1.1*	+ 576	+ 1,052	+ *1.1*	+ 670	+ 682	+ 2,404	+ *2.1*
1984 Jan. 18	− 59	− 32	+ 389	+ 298	+ *0.7*	+ 351	+ 649	+ *0.7*	+ 73	+ 98	+ 320	+ *0.7*
Feb. 15	+ 16	+ 40	+ 103	+ 159	+ *0.4*	− 57	+ 102	+ *0.1*	+ 1,005	− 287	+ 820	+ *0.7*
Mar. 21	+ 58	+ 416	+ 811	+ 1,285	+ *3.0*	+ 114	+ 1,399	+ *1.4*	+ 190	+ 73	+ 1,662	+ *1.4*
Apr. 18	+ 206	+ 375	+ 197	+ 778	+ *1.8*	− 405	+ 373	+ *0.4*	+ 130	+ 152	+ 655	+ *0.6*
May 16	− 54	+ 194	+ 547	+ 687	+ *1.5*	+ 179	+ 366	+ *0.9*	− 2,133	+ 278	− 989	− *0.8*
June 21	+ 118	+ 161	+ 574	+ 853	+ *1.9*	+ 1,211	+ 2,064	+ *2.0*	− 226	+ 255	+ 2,093	+ *1.8*

[a] After deducting 60% of net debit transit items (see additional notes to Table 6 of the *Quarterly Bulletin*).
[b] M1 equals columns 1 + 2 + 3. £M3 equals M1 + column 5. M3 equals £M3 + column 7.
[c] Including certificates of deposit.
[d] Excluding public sector deposits.
[e] Changes in the monthly-reporting population occurred in these months. See also the additional notes to Table 3 in the *Quarterly Bulletin*, and, for December 1983, footnote [b] to Table 3 on page 5.
[f] 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*.)
[g] See additional notes to Tables 6 and 11 of the *Quarterly Bulletin*.

An alternative presentation of counterparts to changes in £M3

£ millions

[See page 529 in the December 1983 *Quarterly B[illegible]n*]

	Public sector borrowing requirement (surplus–)[a]: Central government borrowing requirement	Public sector borrowing requirement: Other public sector contribution	Purchases (–) of public sector debt by UK private sector (other than banks): Other public sector debt	Purchases (–): Central government debt: British government stocks	Purchases (–): Central government debt: Other	External and foreign currency finance of public sector (increase–): Purchases of British government stocks by overseas sector	External and foreign currency finance of public sector: Other [b]	Banks' sterling lending to UK private sector [c]	External and foreign currency transactions of UK banks [d]: Sterling deposits from, net of market loans to, banks abroad (increase–)	External and foreign currency transactions of UK banks: Other overseas sterling deposits	External and foreign currency transactions of UK banks: Other sterling lending to overseas sector[e]	External and foreign currency transactions of UK banks: Banks' net foreign currency deposits liabilities (increase–)	Net non-deposit liabilities (increase–)	M[illegible] stoc[illegible] £M3[a] (columns 1-13)
	1	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*	*11*	*12*	*13*	*14*
Month ended (unadjusted)														
1983 June 15	+ 2,188	– 960		– 748	– 156	– 13	+ 89	+ 1,173	– 561	– 36	+ 224	+ 25	– 23	+ 1,202
July 20	+ 1,169	– 429		– 1,018	– 159	– 209	– 81	+ 2,036	+ 237	+ 149	– 37	– 108	– 25	+ 1,525
Aug. 17	+ 1,603	+ 55		– 1,082	– 21	– 102	+ 83	+ 299	– 237	– 401	+ 146	+ 133	– 25	+ 451
Sept. 21	+ 764	+ 645		– 1,747	– 442	– 55	– 113	+ 1,401	+ 64	– 46	+ 229	+ 193	– 835	+ 58
Oct. 19	+ 1,021	– 375		– 394	– 434	– 5	+ 71	+ 2,017	– 506	– 151	+ 277	– 104	– 174	+ 1,243
Nov. 16	+ 959	– 32		– 1,143	– 428	+ 46	– 40	+ 816	– 118	– 472	+ 67	+ 282	– 182	– 245
Dec. 14	+ 1,786	– 132		– 572	– 180	+ 86	– 204	+ 601	– 15	– 194	+ 270	+ 283	– 25	+ 1,704
1984 Jan. 18	– 1,362	– 491		– 738	– 239	– 164	+ 6	+ 1,798	+ 526	– 233	+ 890	+ 199	– 685	– 493
Feb. 15	– 67	+ 92		– 1,051	– 6	– 69	– 89	+ 1,230	– 226	– 328	+ 280	– 52	– 415	– 701
Mar. 21	+ 127	– 65		– 121	– 450	– 105	+ 42	+ 1,461	+ 110	– 448	+ 357	+ 545	– 652	+ 801
Apr. 18	+ 3,392	+ 360		– 1,048	– 346	– 283	– 94	+ 1,589	– 645	– 423	+ 354	– 146	– 1,087	+ 1,623
May 16	+ 766	– 299		– 279	– 114	+ 10	– 117	+ 506	– 69	+ 292	+ 85	– 300	+ 92	+ 573
June 20	+ 2243	– 114		– 374	– 543	+ 179		+ 1,541	+ 179	– 571	+ 152	+ 20	– 524	+ 2,188
Month ended (seasonally adjusted)														
1983 June 15	+ 1,710	– 831		– 748	– 155	– 13	+ 83	+ 1,125		– 260			+ 24	+ 935
July 20	+ 1,244	– 387		– 1,018	– 182	– 209	– 87	+ 784		+ 223			+ 124	+ 492
Aug. 17	+ 851	+ 191		– 1,082	– 104	– 102	+ 77	+ 1,219		– 294			– 297	+ 459
Sept. 21	+ 1,249	+ 583		– 1,747	– 514	– 55	– 119	+ 1,223		+ 325			– 649	+ 296
Oct. 19	+ 789	– 395		– 394	– 415	– 5	+ 65	+ 1,601		– 487			+ 239	+ 998
Nov. 16	+ 1,260	+ 29		– 1,143	– 367	+ 46	– 46	+ 1,041		– 249			– 461	+ 110
Dec. 14	+ 284	+ 161		– 572	– 118	+ 86	– 210	+ 1,643		+ 284			– 506	+ 1,052
1984 Jan. 18	+ 867	– 807		– 738	– 253	– 164	+ 48	+ 943		+ 1,332			– 579	+ 649
Feb. 15	+ 1,276	+ 23		– 1,051	– 51	– 69	– 95	+ 1,280		– 320			– 891	+ 102
Mar. 21	+ 659	– 103		– 121	– 508	– 105	+ 37	+ 1,637		+ 299			– 396	+ 1,399
Apr. 18	+ 1,502	+ 175		– 1,048	– 251	– 283	– 75	+ 1,425		– 582			– 490	+ 373
May 16	+ 782	– 343		– 279	– 111	+ 10	– 123	+ 898		+ 129			– 97	+ 866
June 20	+ 1,236	+ 106		– 374	– 562	+ 173		+ 1,549		– 73			+ 9	+ 2,064

[a] Excluding public sector bank deposits.
[b] Including public sector foreign currency bank deposits.
[c] Including net purchases of commercial bills by the Issue Department, and holdings of sterling certificates of deposit issued by building societies.
[d] A seasonally-adjusted breakdown of these transactions is not available.
[e] Including net purchases of ECGD-backed promissory notes by the Issue Department

M0, the wide monetary base

£ millions: *percentages in italics*

[Table 2 in the *Quarterly Bulletin*]

End-banking-month series

	Notes and coin in circulation outside the Bank of England: In circulation with public: Unadjusted	In circulation with public: Seasonally adjusted	Held by banks (till money): Unadjusted	Held by banks (till money): Seasonally adjusted	Bankers' deposits with the Banking Department: Operational deposits: Unadjusted	Bankers' deposits: Cash ratio deposits: Unadjusted
	1		*2*		*3*	*4*
Amount outstanding at						
1983 May 18	11,263	11,325	1,113	1,135	96	468
June 15	11,328	11,374	1,137	1,155	223	468
July 20	11,501	11,362	1,250	1,164	118	468
Aug. 17	11,507	11,407	1,207	1,167	148	468
Sept. 21	11,477	11,489	1,196	1,207	149	468
Oct. 19	11,473	11,545	1,177	1,191	135	468
Nov. 16	11,531	11,607	1,157	1,175	199	500
Dec. 14	12,119	11,694	1,365	1,249	150	500
1984 Jan. 18	11,467	11,636	1,221	1,230	111	500
Feb. 15	11,531	11,653	1,170	1,227	278	500
Mar. 21	11,641	11,711	1,167	1,247	232	500
Apr. 18	12,044	11,917	1,236	1,161	154	500
May 16	11,834	11,863	1,201	1,208	159	533
June 20	11,941	11,982	1,222	1,238	204	533
Change in month ended						
1983 May 18	+ 89	+ 104	+ 29	+ 50	– 41	+ 33
June 15	+ 65	+ 48	+ 24	+ 20	+ 127	–
July 20	+ 273	– 14	+ 113	+ 8	– 105	–
Aug. 17	– 94	+ 46	– 43	+ 3	+ 30	–
Sept. 21	– 30	+ 82	– 11	+ 40	+ 1	–
Oct. 19	– 4	+ 56	– 19	– 15	– 14	–
Nov. 16	+ 58	+ 62	– 20	– 16	+ 64	+ 32
Dec. 14	+ 588	+ 86	+ 208	+ 74	– 49	–
1984 Jan. 18	– 652	– 59	– 144	– 20	– 39	–
Feb. 15	+ 64	+ 16	– 51	– 3	+ 167	–
Mar. 21	+ 110	+ 58	– 3	+ 20	– 46	–
Apr. 18	+ 403	+ 206	+ 69	– 86	– 78	–
May 16	– 210	– 54	– 35	+ 47	+ 5	+ 33
June 20	+ 107	+ 118	+ 21	+ 30	+ 45	–

Monthly-average series

	Notes and coin in circulation outside the Bank of England: Unadjusted	Notes and coin: Seasonally adjusted	Bankers' operational deposits with the Banking Department: Unadjusted	M0 (wide monetary base) (columns 5 + 6): Unadjusted	M0: Seasonally adjusted	
	5		*6*	*7*		
Average amount outstanding in month ended						
1983 May 18	12,411	12,510	131	12,542	12,641	
June 15	12,556	12,589	149	12,705	12,738	
July 20	12,669	12,619	105	12,774	12,724	
Aug. 17	12,772	12,599	162	12,934	12,761	
Sept. 21	12,773	12,749	154	12,927	12,903	
Oct. 19	12,685	12,810	166	12,851	12,976	
Nov. 16	12,689	12,867	171	12,860	13,038	
Dec. 14	13,106	12,959	155	13,261	13,114	
1984 Jan. 18	13,345	12,915	222	13,567	13,137	
Feb. 15	12,686	12,955	202	12,888	13,157	
Mar. 21	12,791	13,027	204	12,995	13,231	
Apr. 18	13,023	13,085	157	13,180	13,242	
May 16	13,157	13,157	138	13,295	13,295	
June 20	13,202	13,260	179	13,381	13,439	
Change						
1983 May 18	+ 7	+ 94	– 74	– 67	+ 20	*+0.2*
June 15	+ 145	+ 79	+ 18	+ 163	+ 97	*+0.8*
July 20	+ 113	+ 30	– 44	+ 69	– 14	*–0.1*
Aug. 17	+ 103	– 20	+ 57	+ 160	+ 37	*+0.3*
Sept. 21	+ 1	+ 150	– 8	– 7	+ 142	*+1.1*
Oct. 19	– 88	+ 61	+ 12	– 76	+ 73	*+0.6*
Nov. 16	+ 4	+ 57	+ 5	+ 9	+ 62	*+0.5*
Dec. 14	+ 417	+ 92	– 16	+ 401	+ 76	*+0.6*
1984 Jan. 18	+ 239	– 44	+ 67	+ 306	+ 23	*+0.2*
Feb. 15	– 659	+ 40	– 20	– 679	+ 20	*+0.2*
Mar. 21	+ 105	+ 72	+ 2	+ 107	+ 74	*+0.6*
Apr. 18	+ 232	+ 58	– 47	+ 185	+ 11	*+0.1*
May 16	+ 134	+ 72	– 19	+ 115	+ 53	*+0.4*
June 20	+ 45	+ 103	+ 41	+ 86	+ 144	*+1.1*

Transactions balances and components of M2

[Table 11.1 in the *Quarterly Bulletin*]

£ millions: *not seasonally adjusted*

	Notes and coin in circulation with public	UK private sector sterling non-interest-bearing sight deposits with banks[a]	Non-interest-bearing M1[b]	Other UK private sector sterling retail deposits with banks	UK private sector retail shares and deposits with building societies	National Savings Bank ordinary account	M2[b]	Public sector retail deposits with banks	Overseas retail deposits with banks
	1	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*
Amounts outstanding									
1983 June 15	11,328	18,564	29,892	30,259	51,822	1,751	113,724	1,160	2,637
July 20	11,601	18,978	30,579	30,512	52,018	1,749	114,858	1,193	2,741
Aug. 17	11,507	18,785	30,292	30,360	51,952	1,729	114,333	949	2,721
Sept. 21[c]	11,477	18,876	30,353	30,176	52,193	1,742	114,464	864	2,732
Oct. 19	11,473	19,369	30,842	30,086	52,562	1,742	115,232	935	2,794
Nov. 16[d]	11,531	19,264	30,795	30,089	52,811	1,745	115,440	1,045	2,669
	11,531	19,264	30,795	30,847	52,811	1,745	116,198	1,045	2,996
Dec. 14[c]	12,119	19,990	32,109	30,218	55,673	1,750	119,750	899	2,999
1984 Jan. 18	11,467	19,320	30,787	30,340	58,280	1,765	121,172	1,072	3,124
Feb. 15	11,531	19,018	30,549	30,057	58,969	1,777	121,352	962	3,083
Mar. 21[c]	11,641	19,467	31,108	29,953	60,121	1,778	122,960	1,124	3,106
Apr. 18	12,044	20,572	32,616	29,896	60,944	1,788	125,244	995	3,116
May 16	11,834	20,593	32,427	29,879	61,777	1,775	125,858	1,073	3,187
June 20	11,941	20,646	32,587	30,455	62,980	1,743	127,765	1,079	3,193
Changes in month ended									
1983 June 15	+ 65	+ 149	+ 214	+ 356	+ 585	− 18	+1,137	+ 162	− 99
July 20	+ 273	+ 414	+ 687	+ 253	+ 196	− 2	+1,134	+ 33	+ 104
Aug. 17	− 94	− 193	− 287	− 152	− 66	− 20	− 525	− 244	− 20
Sept. 21	− 30	+ 71	+ 41	− 184	+ 241	+ 13	+ 111	− 85	+ 11
Oct. 19	− 4	+ 493	+ 489	− 90	+ 369	—	+ 768	+ 71	+ 62
Nov. 16	+ 58	− 105	− 47	+ 3	+ 249	+ 3	+ 208	+ 110	− 125
Dec. 14	+ 588	+ 716	+1,304	− 629	+2,586	+ 5	+3,266	− 146	+ 3
1984 Jan. 18	− 652	− 670	−1,322	+ 122	+2,405	+ 15	+1,220	+ 173	+ 125
Feb. 15	+ 64	− 302	− 238	− 283	+ 520	+ 12	+ 11	− 110	− 41
Mar. 21	+ 110	+ 444	+ 554	− 104	+1,104	+ 1	+1,555	+ 162	+ 23
Apr. 18	+ 403	+1,105	+1,508	− 57	+ 823	+ 10	+2,284	− 129	+ 10
May 16	− 210	+ 21	− 189	− 17	+ 792	− 13	+ 573	+ 78	+ 71
June 20	+ 107	+ 53	+ 160	+ 576	+1,203	− 32	+1,907	+ 6	+ 6

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

[b] Non-interest-bearing M1 equals columns 1+2. M2 equals non-interest-bearing M1+columns 4+5+6.

[c] See footnote [f] to Table 11.1 on page 3.

[d] In November 1983 twenty contributors joined the population providing figures in columns 4, 8 and 9, and seven contributors left the series. All monthly-reporting monetary sector institutions contribute to column 2. (See article in June 1982 *Bulletin*, page 225.)

Private sector liquidity, and other deposits

[Summary of Table 12 in the *Quarterly Bulletin*]

£ millions

Month ended	'Money'	Other money-market instruments	Savings institution deposits and securities		Certificates of tax deposit		PSL1 (columns 1+2+5)	PSL2 (columns 1+2+3+6)	PSL1		PSL2		Other shares and deposits with building societies	
	Seasonally adjusted	Seasonally adjusted	Seasonally adjusted		Seasonally adjusted		Seasonally adjusted	Seasonally adjusted	Seasonally adjusted change in month [b]		Seasonally adjusted change in month [b]		Unadjusted	
			Total (net)	*of which shares and deposits with building societies* [a]	Issues net of surrenders	Column 5 less building society holdings							Amount outstanding	Change in month
	1	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*		*10*		*11*	*12*
1983 June 15	93,997	2,842	59,355	*55,000*	2,136	1,954	98,975	158,148	+ 949	*+1.0*	+1,572	*+1.0*	16,519	+ 14
July 20	94,479	3,040	60,342	*56,058*	2,000	1,818	99,519	159,679	+ 529	*+0.5*	+1,518	*+1.0*	16,632	+113
Aug. 17	94,912	3,265	61,171	*56,950*	1,905	1,723	100,082	161,071	+ 563	*+0.6*	+1,392	*+0.9*	16,712	+ 80
Sept. 21	95,272	3,081	61,786	*57,508*	1,975	1,774	100,328	161,913	+ 168	*+0.2*	+ 764	*+0.5*	17,242	+530
Oct. 19	96,237	3,064	62,037	*58,098*	2,070	1,852	101,371	163,190	+1,043	*+1.0*	+1,276	*+0.8*	17,802	+560
Nov. 16	96,369	3,153	62,477	*58,952*	2,116	1,884	101,638	163,883	+ 275	*+0.3*	+ 699	*+0.4*	18,241	+439
Dec. 14	97,603	3,124	63,073	*59,841*	2,048	1,795	102,775	165,595	+ 948	*+0.9*	+1,522	*+0.9*	18,557	+316
1984 Jan. 18	98,170	2,954	64,409	*61,149*	2,077	1,955	103,201	167,488	+ 451	*+0.4*	+1,918	*+1.2*	18,720	+163
Feb. 15	98,249	2,890	65,673	*62,522*	1,869	1,726	103,008	168,538	− 159	*−0.2*	+1,084	*+0.6*	18,823	+103
Mar. 21	99,684	2,984	66,916	*63,742*	2,077	1,891	104,745	171,475	+1,728	*+1.7*	+2,938	*+1.7*	18,957	+134
Apr. 18	99,999	2,975	68,178	*64,734*	2,105	1,917	105,079	173,069	+ 391	*+0.4*	+1,652	*+1.0*	19,002	+ 45
May 16	101,052	3,095	69,453	*65,690*	1,982	1,794	106,129	175,394	+ 929	*+0.9*	+2,204	*+1.3*	19,002	—
June 20	103,091	3,420	70,753	*66,852*	2,206	2,003	108,717	179,267	+2,589	*+2.4*	+3,874	*+2.2*	19,002	—

[a] Including UK non-bank private sector's holdings of certificates of deposit and time deposits issued by building societies.

[b] Percentage changes are shown in italics.

de vbl

10 DOWNING STREET

From the Private Secretary 16 July 1984

VAT Recommendations of Keith Report

The Prime Minister has seen and noted without comment the Chancellor's minute of 10 July.

ANDREW TURNBULL

Miss Judith Simpson,
H.M. Treasury.

SECRET

Fil

8

11 July 1984

PRIME MINISTER

INTEREST RATES

The Bank of England is busily unravelling many months of patient work of putting clarity into our economic policy.

We have laboured the point that we do not have an exchange rate target. And we do not have one for the following good reasons:

1. Only the market can fix a true rate for the pound.

2. No chosen rate can be defended in footloose and fast-moving international markets. Governments no longer have control of enough money, compared to other people, to manage the rate (this is good news in the broader scheme of things).

3. We have money targets. You cannot target money and the exchange rate at the same time and be sure of success. It is inevitable that you will choose a money target that will not work naturally with your exchange rate target, and you will not know which one is the important one to manage.

SECRET

The position is still the same as that 2½ weeks ago when the sterling problem first became apparent and we set out three options. You can cut public spending, you can do nothing, or you can raise interest rates.

At that juncture, it was rightly decided to do nothing. Unfortunately, the Bank then went off and did something. They made an absurd statement to markets to "reassure". **Nothing undermines a market more quickly than soothing words from rattled authorities.** And when the Bank said there was no **domestic** reason for raising interest rates, they naturally invited the response: "well, what about an external reason?"

That external reason soon became pressing, and so the Bank persuaded the Chancellor to allow them to increase interest rates modestly.

Now that interest rates have been raised in panic, a new dimension has been added to our troubles. There are enormous speculative money flows. Everyone now knows that sterling is a loser. There is plenty of knocking copy about - low interest rates compared to the US, industrial disruption, feeling the Government is losing its touch, etc. Speculators will go on selling with the Bank on the run. The final irony was the publication of the money supply figures. These were known roughly by the Bank at the time they made their statement. They demonstrated that there was

a domestic reason for raising rates, and that the Bank had been lying.

Even Houdini would find it difficult to get out of this. Defending the pound with higher rates would take further rate increases. Not defending the pound would now look odd, given that the Bank has tried once, and is probably going to fail.

The best option now, therefore, unlike 2 weeks ago, is to cut public spending. The Government could respond to the heavy front-end loading of the Public Sector Borrowing Requirement, and to excess money growth, by reducing public spending. The option of benign neglect is still better than putting rates up, but it will leave open the criticism that the Government and the Bank are drifting, blowing hot one day and cold the next, and not quite sure how to behave.

The option of putting rates up is not working, is damaging to the rest of the strategy, and will be seen as a major defeat.

Linda Leavitt

JOHN REDWOOD

6.27

Prime Minister (2)
To note that Chancellor proposes to implement VAT part of Keith report in 1985 Finance Bill
AT 11/7

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

PRIME MINISTER

VAT RECOMMENDATIONS OF KEITH REPORT

At the beginning of this year, the Inland Revenue and Customs and Excise reported to me on the outcome of their extensive consultations with interested trade and professional bodies on the recommendations contained in Volumes 1 and 2 of the Keith Report on the Enforcement Powers of the Revenue Departments. Although the reaction to individual proposals was predictably mixed, the majority view was that taken as a whole the Report was a fair and balanced one, and that if the Government decided to implement it, we should treat it as an integrated package of measure designed both to improve tax compliance and to provide enhanced safeguards for taxpayers.

2. It has subsequently become clear that the Keith recommendations affecting the Inland Revenue require fairly lengthy further consultation with the legal and accountancy professions, and that it would be unrealistic to think in terms of implementing legislation before the 1986 Finance Bill at the earliest. On the Customs side, however, the recommendations on VAT enforcement are more straightforward, and the Department are confident that implementing legislation could be ready in time for next year's Finance Bill. There are substantial benefits in early and separate action on the VAT front, where the low level of compliance has long been a source of concern and has led to repeated criticism by the Public Accounts Committee. Customs estimate that over a three to four year period, implementation of the main Keith proposals for default interest and civil penalties should halve the average outstanding VAT debt of £1.5 billion, bring in over £40 million a year in penalty and interest charges, and enable them to make very substantial savings in the enforcement staff who at present have to be diverted from the more productive day-to-day control of the tax.

3. From the taxpayers' point of view the main advantage of implementing Keith would be that breaches of the regulatory provisions of the VAT law would

no longer be treated as criminal offences. Instead, there would be the certainty that specified defaults would involve particular consequences with the present, very wide, degree of official discretion being reduced to a minimum. The further controls proposed by the Committee on the use of powers of search should also do much to meet the disquiet which has sometimes been expressed about this.

4. I have accordingly decided that any VAT legislation on Keith should be included in the 1985 Finance Bill, with any Inland Revenue legislation being deferred to the 1986 Bill. This decision was announced on 18 May in response to an arranged Question (OR Vol. 60 No. 158, Col. 270 to 271).

5. I believe that - with the exception of those proposals affected by the Police and Criminal Evidence Bill or concerned with the treatment of professional privilege, where wider considerations are involved - implementation of the VAT proposals as a well-balanced package would lead to very substantial improvements in the effectiveness and fairness of the VAT system, and would go a long way to meet the anxieties of the Public Accounts Committee. I have therefore authorised Customs to continue with preparations for implementing legislation in the 1985 Finance Bill. I have asked them to consult other interested Departments on individual recommendations, and to prepare for my consideration a draft White Paper and draft clauses for publication in the autumn.

(N.L.)

10 July 1984

1984

NOTE FOR THE RECORD

Funding Policy

I spoke to Tim Lankester in the Treasury to follow up progress on Sir Alan Walters' minute of 9 May. Work in the Treasury is proceeding under two heads:-

i) market structures of selling techniques
The Bank are currently consulting 40 potential primary dealers who will operate under the new system for selling gilts. Following these discussions they will draft a document for issue in October. The change in market structure will open the way for selling techniques e.g. auctions, which were ruled out by the existing jobbing system.

ii) new instruments
The Treasury are preparing a paper for the Chancellor to discuss a number of new instruments e.g. a call option on a long gilt, a short bond to be issued by the corporate sector, a subscription certificate convertible into a gilt (this arose out of discussion of a subscription certificate convertible into BT shares), and a modified variable gilt. A short corporate bond faces a number of problems, partly arising from how it would be taxed and partly from the constraints of the Banking Act which restricts the activities of deposit takers. Such a bond could be used

/to

to establish whether there is a market outside the banking system for short dated paper. If there were it could open the way for a very short gilt. The Treasury are also examining under what circumstances and in what form the authorities could re-enter the market for long dated gilts.

AT

9 July 1984

010

NBPM
AT 10/7

ENO.

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET
Telephone (Direct dialling) 01-215) 5422
GTN 215)
(Switchboard) 215 7877

JU705
Secretary of State for Trade and Industry

9 July 1984

RESTRICTED

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Whitehall SW1

D Nigel.

FINANCIAL SERVICES: A NEW POLICY

You and I are to meet the Governor of the Bank of England on 11 July to discuss a number of subjects, including the financial services sector. In the Commons debate on financial services arranged for 16 July I shall want to give the House an indication of our approach. The enclosed note sets out in paragraph 6 what I consider to be our policy objectives, as announced in my speech at Touche, Remnant on 26 June. It also suggests the policy which I should outline to the House.

2 The policy approach which best fits in with our philosophy is, in summary, more vigorous enforcement of the law against fraud, and fuller disclosure of information to permit the freer operation of market forces and competition. In addition we need measures which are largely administered by the securities industry itself through self-regulation to prevent fraud.

3 I am copying this letter and the note to the Prime Minister, the Governor, the Lord Chancellor, the Attorney General and Sir Robert Armstrong. I also intend to let our other colleagues know of the line I propose to take in the debate after the meeting on 11 July.

Yours
Norman

NORMAN TEBBIT

RESTRICTED

(ii) more than 100 commentaries have been received on Gower's proposals, the great majority agreeing on the need for reform of the present legislation and method of enforcement;

(iii) the Governor of the Bank of England has set up a group of senior City practitioners to advise him by the end of August on the structure and operations of selfregulatory groupings which could be set up in the near future. Neither the Governor nor the Government is bound by the Group's advice, but it will show whether the City can itself deliver a practical system of self-regulation to cope with current challenges; and

(iv) to parallel the Government's initiative, Mr Fletcher has invited the insurance sector to consider making its own proposals for self-regulation, also by the end of August.

Policy Objectives

6 I see the following as our main policy objectives (in order of importance);

(i) a financial services sector able to provide services to UK industry and commerce, private investors and the Government in the most efficient and cheapest way and which is internationally competitive;

(ii) freedom for market forces to stimulate competition and encourage innovation;

(iii) the regulatory framework must provide effective protection for the investor; it should not, however, be allowed to become a screen behind which the forces of protectionism go about their business undisturbed;

(iv) the regulatory framework must inspire investor confidence by ensuring that the UK financial services sector both is and is clearly seen as, a competitive and "clean" place in which to do business; and

(v) the regulatory framework must be both predictable enough to shape structural change in the City but sufficiently flexible neither to cramp this process not be overrun by it, and adaptable enough to meet the requirements of business between professionals.

In addition there are general Government targets:

(vi) the Government should not appear to take responsibility for the activities of City practitioners;

(vii) the minimum number of civil servants; and

(viii) the minimum number of quangos.

A New Policy

7 There is a spectrum of policy ranging from "caveat emptor" on one end to close and detailed regulation of the financial services sector by Government at the other.

8 Philosophically I favour standing as close to reliance on market forces as we can defend politically. So I see a need for:

(i) maximum disclosure of information;

(ii) exposure of practitioners and their institutions to the full force of our competition policy; and

(iii) tougher enforcement of a simplified and clear investment law to deter fraud and malpractice.

9 These three ingredients would go a long way towards meeting the policy objectives set out in paragraph 6 above. But alone they will not do enough to reinforce investor confidence. We need not only measures to detect fraud, and to punish it severely when it occurs, but also measures to make fraud less likely to occur; I see a small number of functional SRAs as providing this ingredient of prevention. This would also enable us to take advantage of the Governor's initiative to enlist the support of the providers of financial services themselves in making the market clean and competitive.

10 The Government would lay down a broad statutory framework. Within this, the SRAs would be voluntary, and we would look to practitioners to set up a small number of SRAs organised on a functional basis. Within the statutory framework they would set out and administer at arms-length from Government such detailed rules as are judged by them to be appropriate to the markets they are serving and the investors whose money they are handling. The SRAs would be made subject to existing competition policy so that they do not become "cosy" clubs. I believe that such an approach should be compatible with the European Community's approach to investor protection.

11 We may or may not have a co-ordinating body to assist the Government in its dealing with the SRAs. I leave that question open at the moment until I hear what the Governor's Group may have to say; the final number of SRAs established will have a

bearing on this. Similarly I await the views of the Insurance Group but I consider that we need to treat life assurance marketing in a manner substantially equivalent to the marketing of other competing investments.

12 Developments over the next few months, including advice from the Governor's Group and the Insurance Group, will help us to refine the broad approach set out in paragraphs 7-10. I think it is practicable and that it meets the policy objectives I have set out.

Department of Trade and Industry

9 July 1984

ANNEX A

SELF-REGULATORY AGENCIES

A self-regulatory agency ("SRA") would have the following main characteristics:

(i) Registration requirements ensuring that those carrying on investment business are fit and proper persons (by virtue of checks on possible criminal records, training, financial resources, etc.).

(ii) Rules relating to the conduct of business by those it supervises which afford adequate protection for investors including provision for separate client accounts,where relevant, compensation, disclosure of commissions, disclosure of interest in transactions for clients, and the provision that in any conflict of interest the client's interest shall be paramount.

(iii) Effective procedures to monitor and enforce observance of those rules and to investigate complaints.

(iv) A governing body adequately independent of the sectional interests of the SRA's members.

2 It would be an offence to carry on investment business unless registered - either through membership of a self-regulatory agency ("SRA") recognised by Government or, if necessary, directly with Government.

Current Position

3 The PF(I) Act already provides for some delegation of prior authorisation by the Secretary of State to "recognised bodies" admission to which makes it unnecessary to be licensed by the DTI.

4 At present there are nine "recognised bodies", of which the following have many of the characteristics of SRAs: The Stock Exchange, The National Association of Security Dealers and Investment Managers (NASDIM), The London International Financial Futures Exchange (LIFFE). The SRA concept has thus been shown to be viable in practice. Several respondents to Gower have expressed their readiness to form or become SRAs.

Future Policy

5 If the self-regulatory route is adopted, the following basic principles commend themselves (and have emerged from many of the commentaries on Gower):

- the number of SRAs should be limited (otherwise they are unlikely to be effective or comprehensible to the investing public);

- the coverage of SRAs should be "functional", and not necessarily derive from existing trade associations (to emphasise their supervisory role and prevent capture by sectional trade interests);

- the rules of each SRA should be consistent in ensuring an appropriate level of investor protection;

- their rule-books and constitutions need to be scrutinised by the DTI and opened to the full effect of competition policy.

6 Given that SRAs are voluntarily set up by practitioners, there can be no guarantee that SRAs can or will be set up readily in all the areas where they do not at present exist. But we would expect there to be a need for not less than four SRAs. The simplest groupings could be as follows:

	Possible SRAs:	Existing bodies:
1	Dealing and market-making in securities	The Stock Exchange Merchant Banks Clearing Banks The security dealers in NASDIM
2	Investment management and advice	Unit trusts, and other portfolio managers
3	Dealing in and marketing of commodities and financial futures	Dealers and brokers in commodities and financial futures LIFFE
4	Marketing of collective investments and insurance	Insurance and unit trust salesmen, brokers and dealers

7 It would be for the DTI to supervise the SRAs unless an umbrella body was set up to monitor and co-ordinate their activities.

9 JUL 1984

SECRET

7

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

PRIME MINISTER

The financial markets are very unsettled this morning. The effective exchange rate opened at 77.4, the lowest since 1976, and money market rates have shifted sharply upwards.

2. I have discussed the situation with the Governor and we are agreed that in these circumstances it is necessary for our short-term interest rates to rise immediately - to 10 per cent.

3. A clearing bank is expected to raise its base rate to that level by mid-day and the Bank will then confirm that rate in its market dealings.

4. The presentation of this move, ahead of the rather poor money figures to be published on Tuesday, requires very careful handling. I think the best line to take is the one attached below.

N.L.

6 July 1984

Covering SECRET

FROM: M L WILLIAMS
DATE: 3 JULY 1984

Questions? NO

PS/CHANCELLOR

cc PS/Chief Secretary
Sir P Middleton
Mr Bailey
Mr Anson
Mr Scholar
Mr Pirie
Mr Gray
Mr Mortimer
Miss Barber

6A

PM's QUESTIONS: STATE OF THE RESERVE

I attach the additional briefing that you requested today for No 10.

M L WILLIAMS

→ Mr Turnbull

SECRET

Reserve under pressure: need for "July measures"

Line to Take

The government intends to stick to its spending plans. I see no need for any general package of measures.

Background

1. Reserve is £2¾ billion; so far just £½ billion formally charged and announced [major items are to meet part of cost of health service review body pay decision (7 June £233 million) and for summer supplementary Estimates (14 June, £226 million)].

Secret

2. Potential claims (not announced): EC contribution (£425 million) nationalised industries EFLs (£300 million), LA current (£1,800 m), LA capital (£250-£1250 million), unemployment benefit etc £300m. [Miners' strike relatively modest, mostly included in EFL figures].

Secret

3. EC contribution:

£ million

	1984-85	1985-86	1986-87	1987-88
Public Expenditure White Paper	375	550	600	-
Settlement	800	850	725	800

Extra (£425 million) in 1984-85 will be charged to Reserve.

Defensive

1. If pressed on the Reserve: Accept the position is potentially tight. But it is early in the year, there are inevitable uncertainties and we can expect downs as well as ups. Situation quite unlike that obtaining this time last year.

2. <u>If pressed on need for offsetting action</u>: If increased demands arise on particular expenditure programmmes, offsetting savings will be found, in the normal way, wherever possible.

3. <u>If pressed on local authorities:</u>

i. <u>LA current</u>: Yes, regrettably indications are for another current overspend by local authorities. That is why the Government is bringing forward its rate capping proposals and abolishing GLC and metropolitan counties;

ii. <u>LA capital</u> /figures published yesterday imply an overspend of £0.3 billion in 1983-84/. Yes, provisional outturn figures suggest there was an overspend last year. /On implications for our position this year/. The figures are still being analysed and implications being considered.

4. <u>If pressed on EC contribution</u>

The likely outturn this year will be higher than the stylised figure in our published plans. But if we had reached no agreement at Fontainebleau we would have received no refunds at all this year and our net contribution would have been very much higher still.

/See also line in Mr Peretz's letter to Mr Powell of 2 July (copy attached)/

010

Deputy Secretary to the Treasury

Mr Turnbull

You may like to have this as background. NatWest have not moved this morning, so the Bank has held its dealing rates.

It is likely that NatWest will move into line shortly — and that (subject to market conditions at the time) the Bank will make the technical adjustment described in the note.

[signature]

25/6

file

cc B Leeng (Wallace
(NatWest move and adjustment in Bank's dealing rate likely tomorrow)

AT 25/6

CONFIDENTIAL

FROM: F CASSELL

25 June 1984

CHANCELLOR

cc - Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Littler
Mr Lankester
Mrs Lomax

BASE RATES

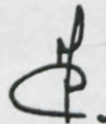
Lloyds have informed the Bank that they are moving their base rate up by $\frac{1}{4}$ this morning.

If, as seems likely, NatWest follow - bringing all the four clearers into line at $9\frac{1}{4}$ - the Bank propose to make a minor change in the structure of their dealing rates to bring it closer to the pattern in the market.

The present structure is a falling profile, from $9^{1}/16$ in Band 1 to $8\frac{7}{8}$ in Band 4. They propose to cut the Band 1 rate by about $^{3}/16$ and raise the Band 4 rate to 9. The general <u>level</u> of rates would be unchanged but the shape would be close to the actual pattern of market rates.

The Bank argue that if they do not make this sort of adjustment there is a real risk that their rates will become completely detached from market rates. The change in dealing rates would be presented as a purely technical one (see attached text), Eddie George is confident that the market would see it as part of the consolidation of rates around a $9\frac{1}{4}$ base rate.

Inter-bank rates have hardened further this morning - by about $^{1}/16$ at the 3-months maturity. There is no sign yet that Barclays or Midland are getting uneasy about their own base rates. The Bank are very conscious of the need to prevent any unhinging of those rates.



F CASSELL

CONFIDENTIAL

CONFIDENTIAL

PROPOSED STATEMENT BY BANK OF ENGLAND IF DEALING RATES CHANGE

The clearing banks have now consolidated on 9¼ per cent base rate. We see no need for further increase in the general level of rates on domestic monetary policy grounds and have taken the opportunity to make a technical adjustment to the pattern of our own dealing rates to bring it more closely into line with the pattern of market rates, while leaving the general level of those rates unchanged.

CONFIDENTIAL

1984

CONFIDENTIAL

AS 19/6

MR TURNBULL 19 June 1984

FUNDING MEETING

I attended the Funding Meeting today.

The policy of keeping cool nerves under pressure last month in the markets and refusing to put interest rates up again has paid off. Since then funding has picked up quite nicely and the month has ended with an estimated £1,575 million of gross sales.

However, the heavy levels of expenditure compared with revenue in the first 6 months continues to be a problem and June was also afflicted by major redemptions. This means that net funding in the month was only around £100 million and the monetary figures will suffer in consequence.

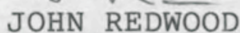
Against this background the meeting decided that:

1. There should be a modest package of measures to encourage national savings which have been dropping below target. This package will include the announcement of 3 more years of bonuses to holders of index-linked savings as an inducement for them to maintain their investments and will include a new yearly plan to be launched on 2 July giving a return of 7½% pa over the 4 year life of the certificate.

2. There will be a series of tranchettes issued to the market soon. This will probably comprise £200 million each of a 1989, a 1992 and a 2002 stock and in addition around £250 million of low coupon short stocks to attract high taxpayers who seem to be back in the market.

3. The meeting also agreed to investigate the possibility of new short instruments in the corporate sector which would help reduce companies' requirements for bank lending.

4. The bank returned to the attack on the subject of a long stock. They argued for the issue of a major new long tap if the tranchettes are successful. I argued that this could again upset the market as it did last time they tried it: it would be better to carry on with more sensitive funding techniques over a range of maturities using smaller amounts of stock each time to try and tempt the market back to health. The matter will be decided later in the month between the Economic Secretary and the Bank, as there was no agreement at the meeting.



JOHN REDWOOD

DAUAAO

CONFIDENTIAL

6/2b

CONFIDENTIAL

File

FMR (84)5

13 June 1984

FINANCIAL MARKETS REPORT

Prepared by HF3 and EF(1)

The attached note reports on developments in the foreign exchange and domestic financial markets during the period banking and calendar May.

P WYNN OWEN
R BLOWER
D McSHARRY

6/2b

CONFIDENTIAL

SUMMARY OF THE MARKETS IN BANKING AND CALENDAR MAY

(18 April to 31 May 1984 inclusive)

- The dollar fluctuated sharply as concerns about the stability of US banks and LDC debts reduced the Fed's scope for tightening monetary policy. Although sterling eased to a new record low against the dollar ($1.3707), it traded firmer against Continental currencies and broadly steady in effective terms.

- Following the base rate rise on 9 May the short-term yield curve pointed sharply upwards and by the end of calendar May a further increase in base rates was widely expected.

- Gilt Yields moved up sharply in line with short-term interest rates, seriously reducing the level of activity in the market.

- Equities fell by more than 90 points on the FT 30 Index over the period.

- Capital issues were the highest in 1984 to date, but still well down on last year's record levels.

HF3/EF1 Divisions
13 June 1984

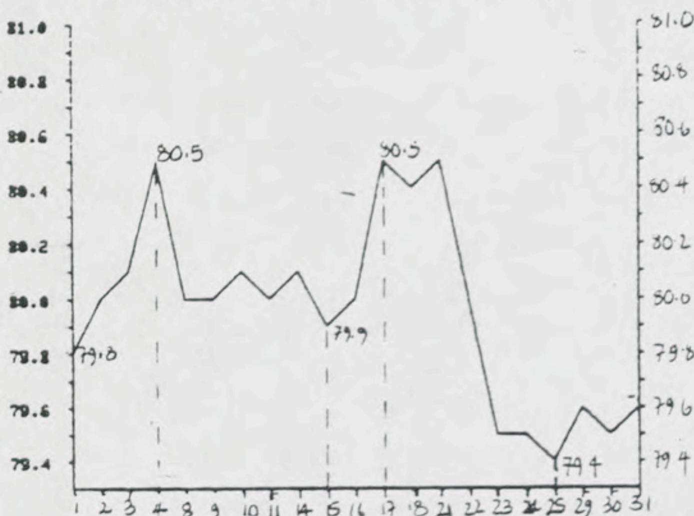
CONFIDENTIAL

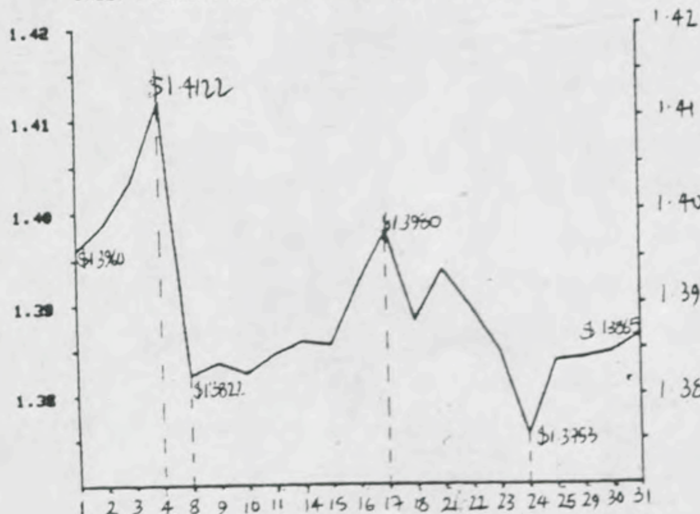
Introduction

1. On the foreign exchange market the dollar traded erratically in May and although sterling drifted lower against the dollar it traded firmly against European currencies and remained broadly steady in effective terms. Short-term interest rates finished the period pointing to a further rise in base rates, which had earlier risen on 9 May. Gilts were reluctant to make a start, with a low level of sales and rising yields. The equity market lost over 90 points on the FT 30 Index over the period. Capital issues were the highest so far in 1984.

FOREIGN EXCHANGE MARKETS

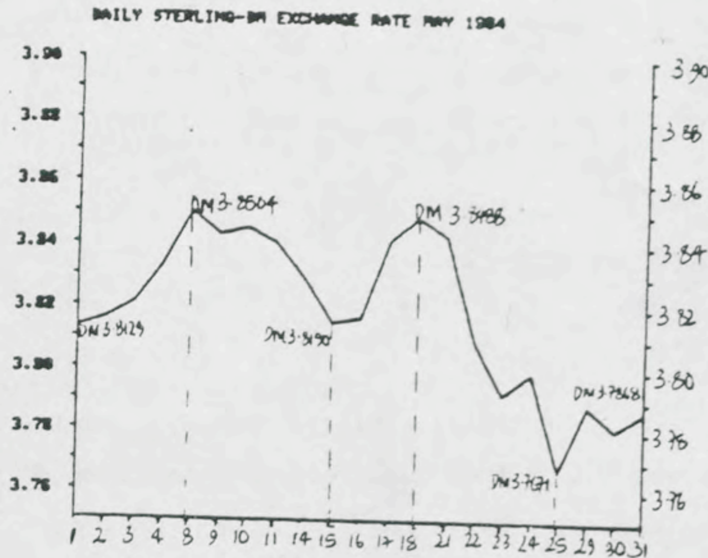
Spot Sterling





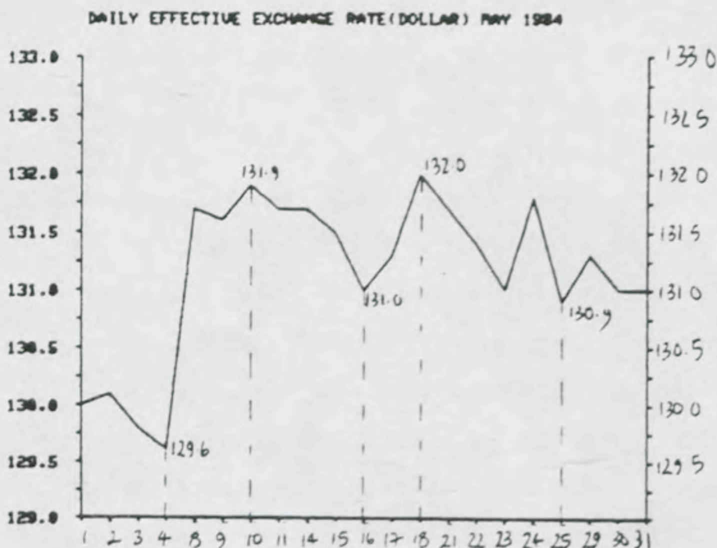
2. A sharp firming of the dollar in the second half of April on expectations of higher US interest rates caused sterling to move quietly lower, although it strengthened against European currencies and remained steady in effective terms.

3. A gradual firming of interbank sterling rates early on in May focussed attention on the possibility of an increase in base rates and the pound rose to $1.42 in New York on the 3rd. However, a late surge in the dollar on the 4th, reflecting interest rate considerations, caused sterling to fall sharply, though by less than Continental currencies, in New York on the 7th (when London was closed). With interbank rates continuing to edge higher on the 8th sterling showed a firmer tone, but unexpectedly good April money supply figures (£M3: +½%) followed by news of a rise in US prime rates led to a burst of selling and the pound fell quickly to a new all-time low of $1.3785. News of the base rate increases (½ - ¾%) on the 9th was followed by some profit-taking, but the selling was short-lived. Concerns about a possible disruption to Gulf oil supplies and a sharp stengthening in spot oil prices led to some good demand for



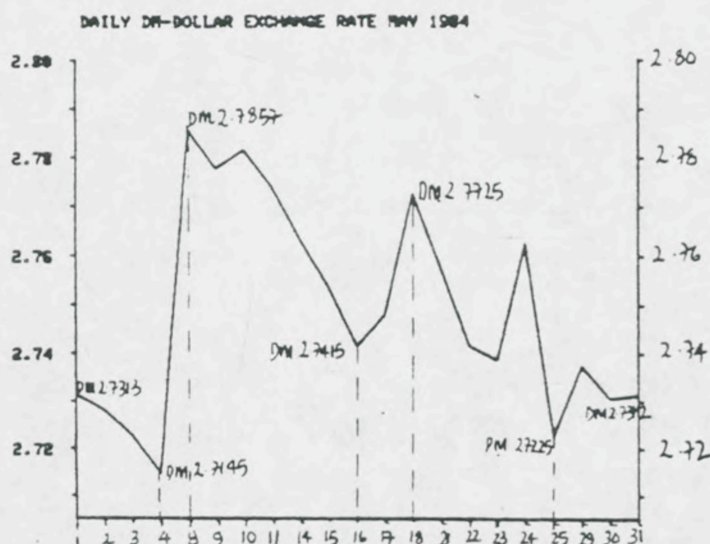
sterling around the middle part of the month. But the absence of further news from the Gulf together with a change in sentiment towards sterling after news of the failure of the NCB's talks with the miners' led to a steady decline in the rate. These factors, which coincided with a general strengthening of the dollar, caused sterling to open on the 24th at a new 13 month low of 79.4 in effective terms with the rate against the dollar falling to an all-time low of S1.3707 in New York later that day. The pound recovered from its lower levels, as the dollar fell sharply, to trade within a relatively narrow range. Publication of the April trade figures on the 29th had very little effect as did the gradual firming of interbank rates and the resulting speculation of a rise in base rates.

The dollar



4. The dollar firmed quiet in the latter part of April supported by expectations of higher US interest rates following stronger than expected US economic data, and concerns about industrial disputes in parts of Europe, particularly in West Germany.

5. After a fairly quiet start to May a forecast by Kaufman predicting "spectacularly higher US interest rates", together with news of a strong rise in US manufacturing employment, triggered a spectacular rise in the dollar in New York on the 7th which was subsequently fuelled by a ½ per cent increase to 12½ per cent in US prime rates. But nervousness over concerted intervention by central banks, coupled with rumours about the liquidity problems of a major US bank caused the dollar to move erratically lower. The



dollar was further depressed by an easing of US interest rates, despite further strong US economic data, as rumours about the financial difficulties of Continental Illinois Bank diminished the likelihood of the Fed tightening policy. The dollar began to recover cautiously around the middle part off the month in response to renewed tensions in the Gulf War. A sharp $4.9 billion rise in US M1 and news that US GNP grew by 8.8 per cent in the first quarter, compared to an earlier estimate of 8.3%, also provided support. Thereafter the dollar traded erratically as concerns about the stability of major US banks and LDC debts - Bolivia's decisions to temporarily suspend repayments - limited the Fed's scope for action. The dollar fell by six pfennigs at one point in New York on the 24th before subsequent assurances by the Fed to provide financial support to US banks in difficulties led to more settled trading. News of a record $12.2 billion US trade deficit in April was absorbed calmly by the markets.

OTHER RELATED DEVELOPMENTS

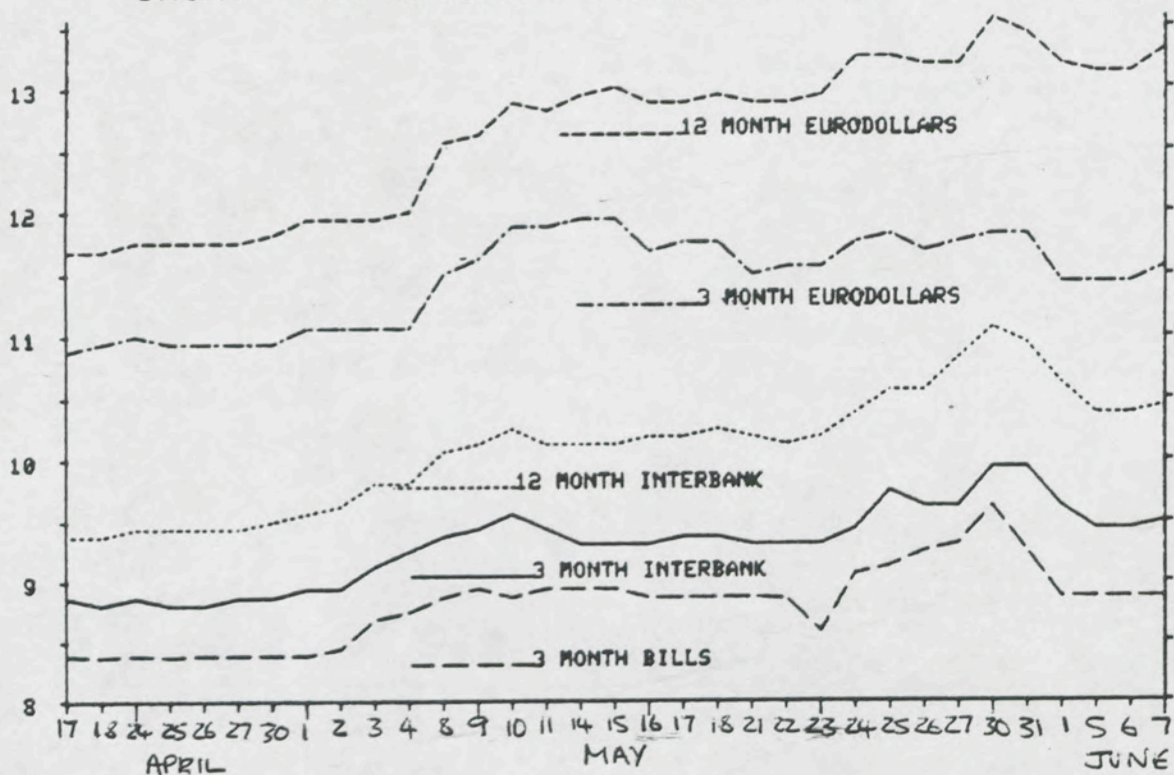
	EMS			Yen	Gold
	Top	Bottom	Spread %		
18 April (close)	DM	Bfr	1 7/8	224.63	380 ½
1 May (close)	DM	Bfr	1 5/8	227.16	376 ½
11May (close)	Dfln	Bfr	1 5/8	230.25	372 ½
21 May (Close)	Dfln	Bfr	1 5/8	233.05	380 ¾
31 May (Close)	DM	Bfr	1 13/16	231.50	384 ¼

The Domestic Markets

Money markets

6. Money market rates were quiet in the early part of the banking month but towards the beginning of calendar May pressure developed for a rise in base rates as the differential between UK and US 3 month rate grew to over 2 per cent. Base rate rose from 8½ per cent to 9 per cent (and 9¼ per cent for Barclays and Midland) on 7 May and for a while rates settled.

7. However concern about the future course of US rates, the troubles of Continental Illinois and domestic monetary worries (following the announcement of an April PSBR of £2.4 billion) began to force rates upwards again with 3 month interbank touching 10 per cent by end-month and the propsect of a further base rate increase looming on the horizon.



CONFIDENTIAL

Bank's dealing rates	**Band 1** (0-14 days)	**Band 2** (15-33 days)	**Band 3** (34-63 days)	**Band 4** (64-91 days)
April 19	$8\frac{9}{16}$	$8\frac{1}{2}$	$8\frac{7}{16}$	$8\frac{3}{8}$
May 10	$9\frac{1}{16}$	9	$8\frac{15}{16}$	$8\frac{7}{8}-\frac{15}{16}$
May 17	$9\frac{1}{16}$	9	$8\frac{15}{16}$	$8\frac{7}{8}$

Interbank rates (X)

	7 days	1 month	3 months	12 months
April 18	8.56	8.63	8.81	9.38
April 27	8.63	8.63	8.88	9.44
May 4	8.44	8.88	9.25	9.81
May 11	8.13	8.88	9.44	10.13
May 18	8.00	8.94	9.38	10.25
May 25	7.31	8.56	9.75	10.56
May 31	8.13	9.06	9.94	11.06
Eurodollar rates (Y)				
April 18	10.63	10.63	10.94	10.69
April 27	10.56	10.63	10.94	11.75
May 4	10.44	10.75	11.06	12.00
May 11	11.19	11.31	11.88	12.81
May 18	10.50	10.88	11.75	12.94
May 25	10.38	10.88	11.81	13.25
May 31	10.81	11.00	11.69	13.56
Uncovered Differential (X-Y)				
April 18	-2.07	-2.00	-2.13	-1.31
April 27	-1.93	-2.00	-2.06	-2.31
May 4	-2.00	-1.87	-1.81	-2.19
May 11	-3.06	-2.43	-2.44	-2.68
May 18	-2.50	-1.94	-2.37	-2.69
May 25	-3.07	-2.32	-2.06	-2.69
May 31	-2.68	-1.94	-1.75	-2.50

International Comparisons Closest analogies to 3 month interbank rates:

Week ended	USA	Germany	World Basket*	World/UK Differential
April 21	10.35	5.83	9.72	−0.84
April 28	10.50	5.83	9.75	−0.37
May 5	10.55	5.83	9.76	−0.51
May 12	10.95	5.83	9.91	−0.47
May 19	11.50	6.23	10.11	−0.73
May 26	11.05	6.15	9.93	−0.18
June 2	11.30	6.28	10.07	−0.13

* ROSHT World Basket, using US CD rate.

The Gilts Market

8. Gross sales in banking May only amounted to £550 million, well short of the target of £1¼ billion and net sales only came to £300 million. The first two weeks of banking June (up to the end of calendar May) saw a continued poor performance in the gilts market, with gross sales amounting to only £150 million and heavy redemptions leaving the net position minus £700 million, with three weeks of the banking month still to go.

9. The primary reason for this sluggishness in the gilts market was uncertainty about US developments, which caused gilt prices to fall to their lowest levels since September 1983, with daily turnover in banking May down to 880. Only one new stock was issued in the entire period:-

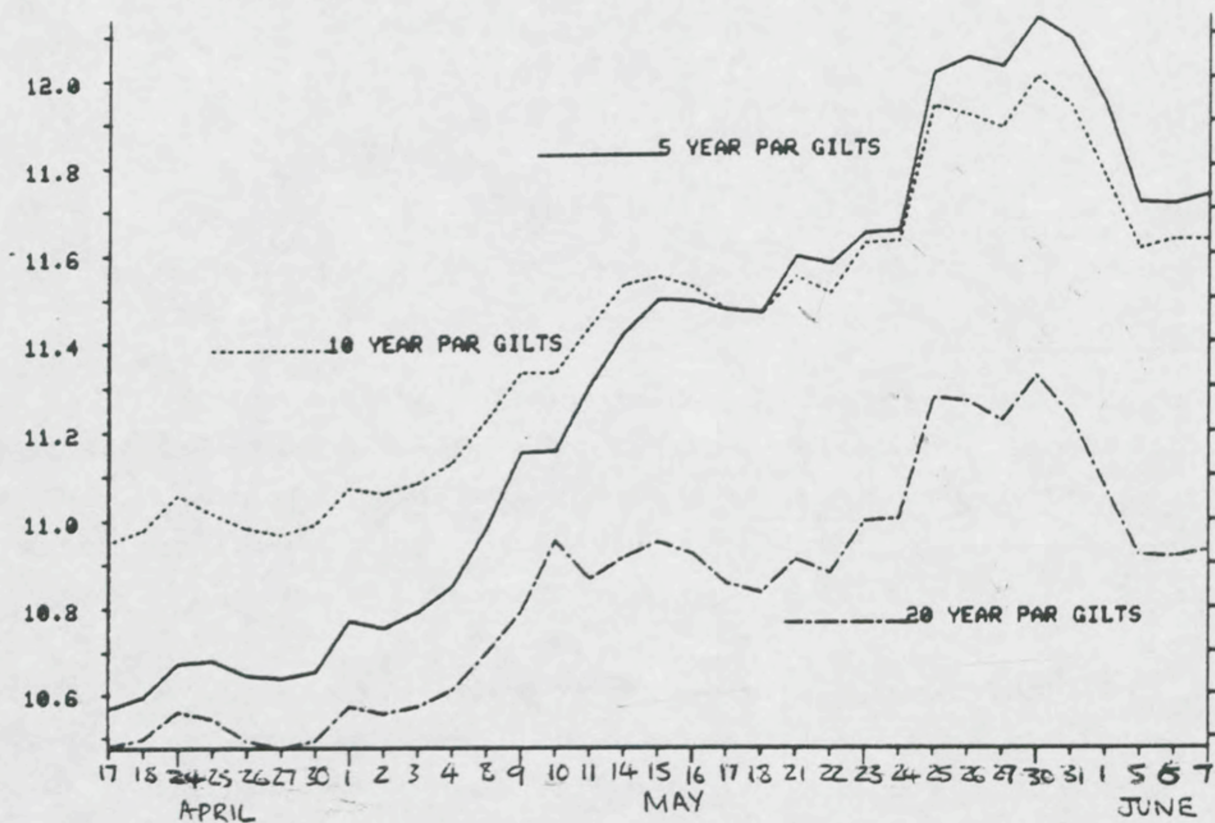
Gilts Issues in Banking and Calendar May

Stock	Date Issued	Issue Price	Gross Yield to Redemption	£m Total amount
9½% Treasury Convertible 1989 (convertible to 9½ Conversion 2005)	2/5	95½	10.70	1100*

* £100 million allotted to NILO

10. This was undersubscribed at tender on 2 May with £100 million taken up and only another £220 million nominal was sold in a price-cutting sale two weeks later. By the end of the period domestic worries about the miners strike and the next money supply figures were also beginning to adversely affect the market, in addition to US pressures and the international debt crisis.

11. As prices fell gilt yields rose dramatically in the period by anything between one and two per cent, with sharper rises at the short end:-

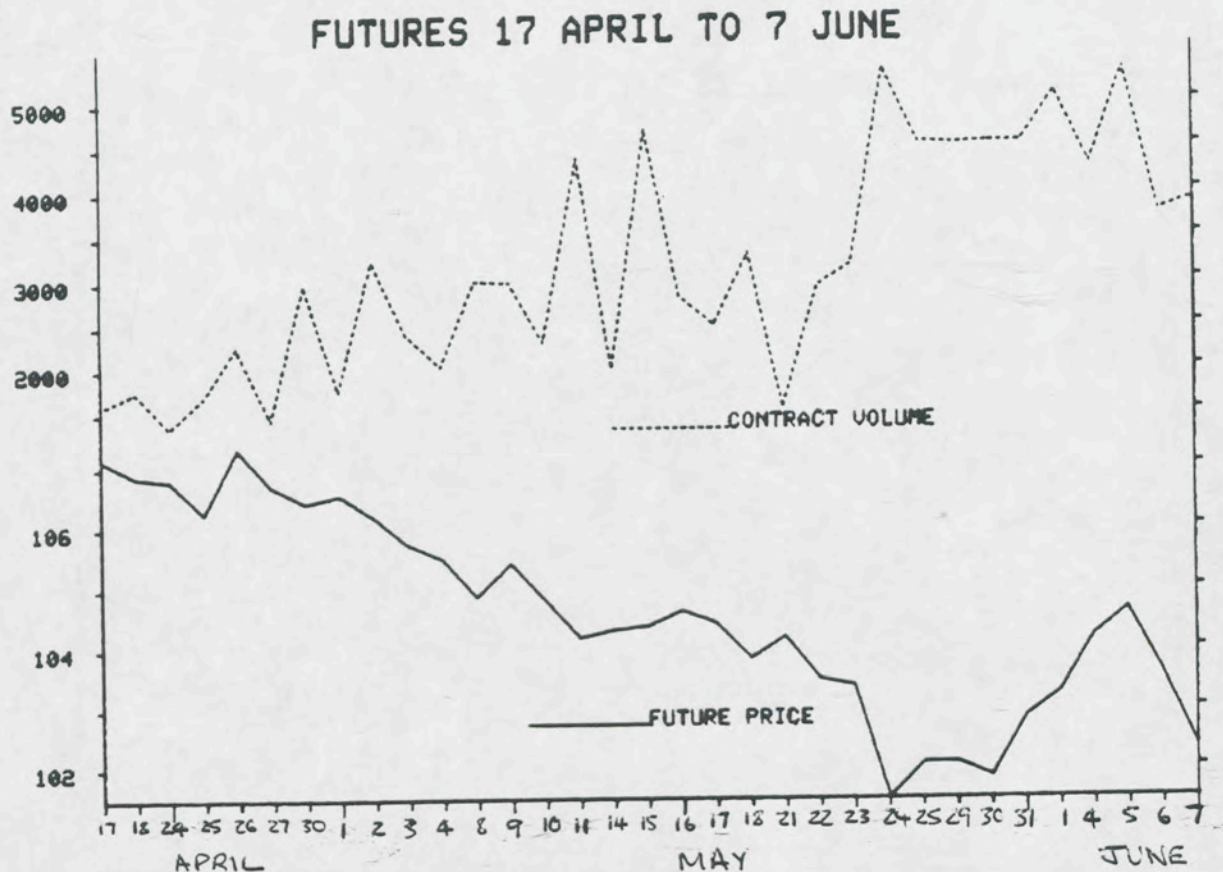


Gilt Yield curves	5 year	10 year	20 year	IG Yields 2% 1988	IG Yields 2½% 2011
April 18	10.594	10.978	10.496	4.40	3.21
April 27	10.637	10.967	10.472	4.50	3.22
May 4	10.849	11.128	10.608	4.42	3.21
May 11	11.302	11.435	10.867	4.14	3.18
May 18	11.468	11.467	10.834	4.63	3.28
May 25	12.010	11.935	11.275	5.01	3.42
May 31	12.136	12.002	11.322	4.97	3.45

Index-linked yields also rose sharply suggesting that inflationary worries were not uppermost.

12. Gilt futures contract volume averaged just over 2,900 during the period under review with trading generally very quiet except for small bursts of activity where volume reached over 500 per day. Contract price followed the cash market closely with the September

contract finishing calendar May only a point above the months lows at 102¾ after dipping at one point to 101½. The June contract had started the month at nearly 107.

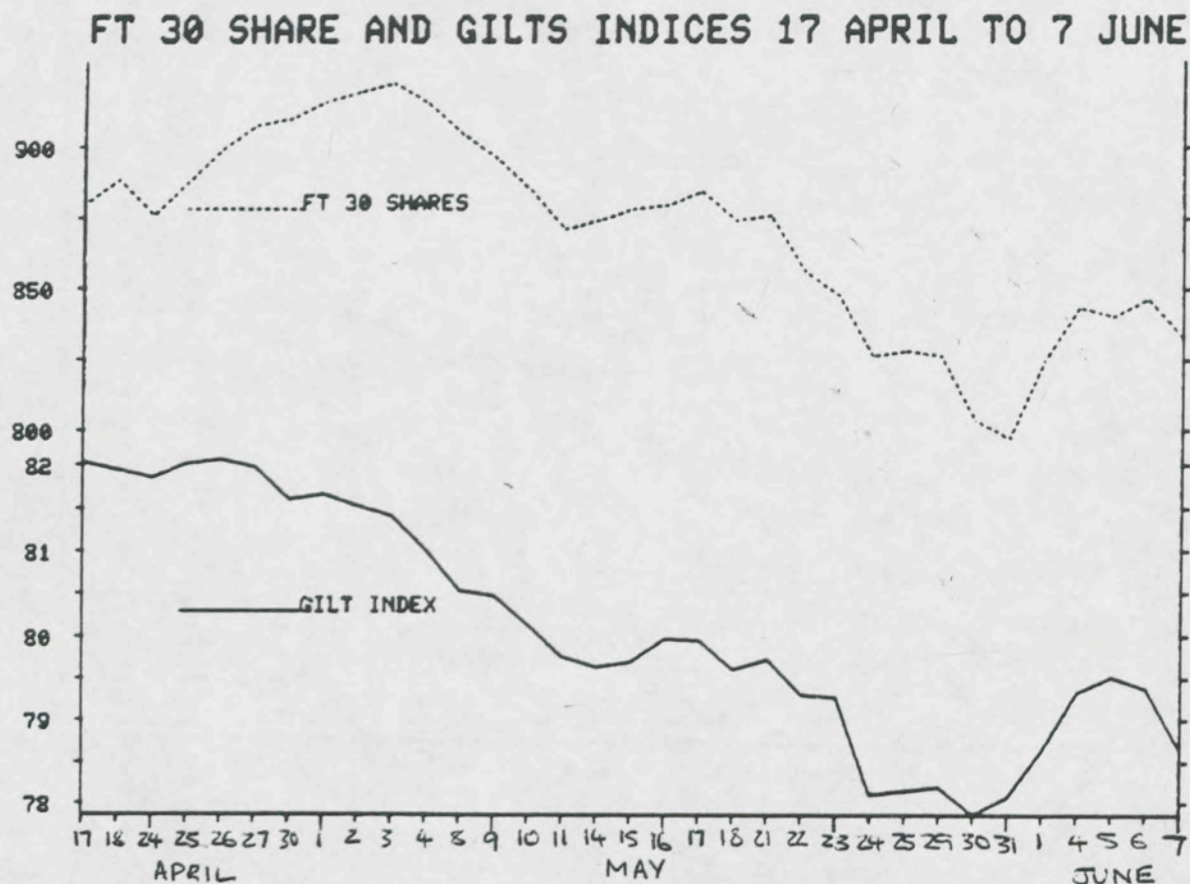


The Equity Market

13. Equities experienced their first sizeable bear market for many months with the FT 30 share index losing 91.7 points between close on 18 April and close on 31 May. Nonetheless, the early weeks of the period saw the market buoyant and the 30 share index closed at all-time high of 922.8 on Thursday, 3 May, helped by an optimistic statement at BP's AGM. But the local elections results the following day began to produce the first signs of faltering in the market. US prime rates increases early in the second week of May then began the serious fall in equity prices, on both sides of the Atlantic. By Friday 11 May the index had lost 51.8 points in the last five trading sessions.

14. There was a slight rally in mid-May, led by news of Mercantile's acquisition of Jessel and Toynbee Discount House and news of British Aerospace's merger discussions with Thorn EMI. But on Thursday 17 May the bear market went ahead again following the Continental Illinois announcement. The final May Bank Holiday did nothing to put fears to

rest and the last few days of the May saw further heavy selling, with greater acrimony in the miners' strike and news of the Bolivian default adding fuel to the flames. On Thursday 31 May the 30 share index closed below 800 at 796.9.



Capital Issues

15. Total new issues by UK listed companies in calendar May were £244 million, the highest monthly return in 1984 to date. Gross issues by industrial and commercial companies were £132 million, which included the final £50 million instalment of a £70 million loan stock placing by MEPC. Gross issues by financial companies were £118 million, including a £30 million package from Save and Prosper Return of Assets Trust, a £43 million rights issue by the Bank of Scotland and a £30 million convertible loan stock placing by Britannia Arrow Holdings. There were no local authority stock issues, but Liverpool Corporation redeemed £10 million stock. Overseas issues saw an £18 million first instalment of a £75 million loan stock placing by Electricite de France and a £15 million first instalement of a £50 million similar issue by the Republic of Trinidad and Tobago.

16. Future prospects continued to look heathy despite the prevailing bear market, with twelve UK companies announcing issues amounting to £127 million, including an offer for sale by tender of £54 million by Reuters Holdings. The Unlisted Securities Market saw new issues totalling £15 million and announcements of future issues of £22 million.

File on Stock Exchange

JR talk to Policy Unit

11 JUNE 1984

TILTING AT CASTLES

ONCE UPON A TIME - OR ABOUT A YEAR AGO, TO BE MORE PRECISE - THERE LIVED A NOBLE AND CHIVALROUS GROUP OF KNIGHTS IN A GREAT BIG CASTLE CALLED THE STOCK EXCHANGE.

NOW THOSE KNIGHTS HAD MANY VIRTUES. THEY WERE VERY HONEST - AT LEAST TO EACH OTHER - AND IT WAS TRULY THE CASE THAT THEY NEVER, NEVER LIED WHEN THEY WERE EXECUTING ORDERS. THEY ALWAYS WORKED VERY HARD AND COMPETED WITH EACH OTHER WITH HIGH SPIRITS. AND OF COURSE THEY LOVED FEASTING AND JOUSTING AND PILLAGING AND - WELL, PERHAPS WE'D BETTER NOT BE TOO EXPLICIT.

OUTSIDE THE STOCK EXCHANGE CASTLE LIVED A GREAT POPULATION OF SUBJECT PEOPLES AND PEASANTS. THEY WERE ALL FORCED TO SEND THEIR SAVINGS, THE RESULTS OF THEIR LABOURS, TO THE INSTITUTIONAL BARONS. NOW THE INSTITUTIONAL BARONS WEREN'T NEARLY SUCH A JOLLY LOT AS THE STOCK EXCHANGE KNIGHTS. WHEN THEY FOUGHT EACH OTHER, THEY DIDN'T USE THE SOFT RUBBER LANCES THAT THE STOCK EXCHANGE MEMBERS ALWAYS USED WHEN JOUSTING: THEY USED PROPER LANCES. AND ALTHOUGH THEY GOT INVITED TO SOME QUITE GOOD JOUSTS AND FEASTS, IT WASN'T THE SAME THING AS THE FEASTING AND JOUSTING AND PILLAGING THAT WENT ON IN THE STOCK EXCHANGE. AND EVERY TIME THEY TRIED TO INVEST ALL THE MONIES THEY'D COLLECTED FROM THEIR SUBJECT PEOPLES, THEY HAD TO SEND THEM ALL UP TO THE STOCK

Exchange castle, where they were taxed and pillaged. The Stock Exchange knights had a very good rule which said that they were never allowed to cut their prices and taxes on all the people outside the Stock Exchange. This made everybody inside the Stock Exchange very happy.

Now this country had been very badly governed for many years. But it fell under a wise ruler. A siege train of great OFT guns had long been threatening the Stock Exchange castle, because Governments never like to see people feasting and jousting and enjoying themselves for too long. But the wise ruler decided to send her boldest champion over to the Stock Exchange castle and sort it all out.

Now this bold man was also very wise. He decided to go forth to the castle alone and parley unarmed. But of course he kept the big siege guns loaded and trained on the castle. And when he arrived beneath the battlements, he spake thus:

> "Excuse me, but would you mind very much just lowering your drawbridge a little so that a few other people can get into your castle and enjoy some of the feasting and jousting? And do you think it would be at all possible if you could just lower a few of your taxes and not do quite as much pillaging?"

There was a long pause from within. And then the knights inside the castle fell to arguing amongst themselves, and one of their leaders bellowed down from the ramparts the following forthright message:

"Not likely mate, we're having a good time."

So the bold champion said: "I'm very sorry, but I do hope you'll reconsider and perhaps you'd let me know if you could do anything to help".

All the peasants outside became very worried, lest their bold and strong Government was in cahoots with the feasting and jousting knights inside the Stock Exchange castle after all. And all the nasty peasants who wrote for the newspapers wrote lots and lots of articles saying how rotten the Government was, and it was just like all the other bad Governments they'd ever had before. But really the bold champion had been very wise, because inside Stock Exchange castle, all the knights fell out with each other and started to revolt.

Some of the oldest - and many wrongly thought the wisest - of the Stock Exchange knights fell to arguing along the following lines:

"Those guns out there could make a big hole even in our castle strong castle walls, and then it would be

VERY DIFFICULT TO GO ON ENJOYING FEASTING AND JOUSTING AND SUCH LIKE WITH CANNON SHOT IN OUR MIDST: AND THE INSTITUTIONAL BARONS AND THE PEASANTS COULD ALL SWARM IN."

AND OTHERS STARTED SAYING:

"WE LIKE FEASTING AND JOUSTING, AND IN ORDER TO GO ON FEASTING AND JOUSTING WE NEED TO GO ON PILLAGING AND TAXING. MAYBE WE COULD DO A DEAL WITH THAT NICE BOLD CHAMPION WHO CAME TO SEE US, SO THAT WE COULD PILLAGE AND TAX ALMOST AS MUCH AS WE USED TO, WHILST EVERYBODY THOUGHT WE WERE BEING WELL-BEHAVED."

SO THE STOCK EXCHANGE SENT ITS MOST PARFAIT KNIGHT, CALLED SIR NICHOLAS, BACK TO SEE THE GOVERNMENT. AND HE SPAKE THUS:

"WE HAVE THOUGHT IT THROUGH, AND WE THINK THERE IS SOME MERIT IN WHAT YOU SAY. SO WE WOULD LIKE YOU TO TAKE YOUR SIEGE GUNS AWAY. AND WE PROMISE TO LOWER OUR TAXES AND REDUCE OUR PILLAGING ON BOTH THE PEASANTS AND THE INSTITUTIONAL BARONS. AND THEN WE HOPE THAT YOU WILL ALLOW US, AS LONG AS WE'RE DISCREET, TO GO ON FEASTING AND JOUSTING."

NOW THE WISE GOVERNMENT THOUGHT ABOUT THIS, AND SAID "YES, WE WILL REMOVE OUR SIEGE GUNS, AND WE WILL THEN WATCH AND

SEE WHAT HAPPENS".

AND VERY SOON IT BECAME APPARENT - EVEN TO SOME OF THE PRESS AND PEASANTS - THAT THERE WAS GOING TO BE A REVOLUTION AFTER ALL. EVERY DAY AND EVERY NIGHT, CRIES OF ANGUISH AND SHOUTS OF RAGE COULD BE HEARD FROM STOCK EXCHANGE CASTLE. AND ALL THE STOCK EXCHANGE KNIGHTS FORGOT THAT THE GOVERNMENT HAD EVER SUGGESTED THEY CHANGE THEIR WAYS, SO BUSY WERE THEY FIGHTING EACH OTHER.

NOW THE GOVERNMENT WAS DOING TO MANY WHAT IT HAD DONE TO THE STOCK EXCHANGE. AND SOME OF THE GREAT AND GOOD KNIGHTS OF THE OTHER ORDERS WERE WORRIED LEST THE PEASANTS GOT TOO MUCH POWER. SO THEY SAID:

> "YOU ARE DISGRACEFUL AUTHORITARIAN PEOPLE, GIVING US THE FREEDOM TO CHOOSE WHAT WE SHOULD DO AND MAKING US RESPONSIBLE FOR OUR OWN ACTIONS. WE WANT TO BE TOLD WHAT WE'VE GOT TO DO, JUST AS WE ALWAYS HAVE BEEN IN THE PAST, SO THAT WE CAN MOAN ABOUT IT."

THEY WERE WORRIED IN CASE THEIR CASTLES WERE KNOCKED DOWN AS WELL. BUT THE GOVERNMENT POINTED OUT THAT IT HADN'T FIRED A SINGLE SHOT IN ANGER AT THE STOCK EXCHANGE CASTLE. SO THE GOVERNMENT WAS A WISE GOVERNMENT AND IT WAS UNMOVED. AND THE PEOPLE BECAME HAPPIER.

NOW IN THE STOCK EXCHANGE CASTLE, THE KNIGHTS HAD ALWAYS BEEN ORGANISED IN TWO DIFFERENT ORDERS - THE ORDER OF THE

Brokers and the Order of the Jobbers. And one of their most important rules was that no broker could do what a jobber did, and no jobber could do what a broker did. And they lived together in fraternal enmity, always bickering and fighting and scrapping amongst themselves unless somebody from outside said it was very silly, in which case they turned round and defended each other to the death. But as soon as they realised that they couldn't go pillaging so much, they started fighting each other with real lances.

Now the wicked old institutional barons who'd been sitting outside in the cold for so many years saw they had a great chance. But they weren't very bright. They thought it would be joyous to feast and joust and pillage like everybody else had always done in the Stock Exchange. So when they saw the drawbridge was coming down just a little, they decided to rush inside and buy a piece of the castle so they could join in the fun. And some of the sly old Stock Exchange knights saw they were onto a winner. So they went to see the institutional barons and said:

> "You want to come inside and - well - we're getting a little old and tired, so we'll sell you our place inside the castle, as long as you pay us lots of money. And then we can go on feasting and jousting up to the day we die; but we promise we won't do it in the place in the castle that we're selling to you."

The silly old institutional barons fell for this, and they started buying their places in the castle for the most enormous sums of money. And the Stock exchange knights who sold out went on round-the-world cruises and could hardly stop laughing, because they had so much money that they could go on feasting forever. And some of them could even come back and become Stock Exchange knights all over again.

But there were a few people outside the castle who saw that the best thing to do was to lead the peasants. Everybody had tended to forget about the peasants because, after all, they were only there to do the work and provide the money for everybody else. But a lot of the peasants were fed up with the institutional barons and the Stock Exchange knights, and they were looking for new and better ways of investing their money; and some of them wanted to be able to feast and joust like everybody else. And slowly it began to dawn on all those who were Stock Exchange knights that not only might they have to lower their drawbridge to let in foreigners and institutional barons and all the rabble they'd kept out for so many years, and let them join in; but even perhaps the peasants - who'd gone on paying for the feasting and jousting for so long - would refuse to send any money to Stock Exchange castle ever again.

The narrative of the chronicle now becomes frayed and torn. Several textual commentators have supplied different endings

TO THE STORY. THE ONE I FAVOUR IS THE FOLLOWING SHORT HAPPY ENDING:

"AND SO IT BECAME APPARENT TO ALL THE PEASANTS THAT THEY HAD INDEED BEEN WISELY GOVERNED. BY CALLING OFF THE SIEGE, BY NOT INTERVENING, BY ASKING PEOPLE TO DO WHAT THEY THOUGHT WAS BEST AND REASONABLE, AND BY BEING NICE TO EVERYONE, THE GOVERNMENT HAD WROUGHT A GREAT REVOLUTION. SOME PEOPLE COULD REMEMBER PICTURES OF THE STOCK EXCHANGE CASTLE; SOME EVEN CLAIMED TO HAVE SEEN SOME OF THE LAST STONES BEING CARRIED AWAY TO MAKE NICE HOUSES FOR PEASANTS. BUT ALL AGREED THAT IT WAS MUCH BETTER TO LIVE IN A WORLD WHERE THE INSTITUTIONAL BARONS NOW HAD TO BEHAVE THEMSELVES AND DO WHAT THE PEASANTS TOLD THEM; AND WHERE THE STOCK EXCHANGE KNIGHTS NO LONGER BELONGED TO A SPECIAL ORDER; NO LONGER JOUSTED AND PILLAGED AND WENT TO TOO MANY FEASTS; BUT WHERE PEOPLE COULD CHOOSE FOR THEMSELVES WHAT TO DO WITH THEIR WEALTH; AND WHERE THE STOCK EXCHANGE MARKET WAS ORGANISED LIKE ANY OTHER MARKET FOR BUYING GROCERIES OR THEATRE TICKETS OR EVEN TICKETS TO GO AND SEE A GOOD OLD-FASHIONED MEDIAEVAL JOUST - JUST FOR FUN, OF COURSE."

NBPM

AT 1/6

May Days in the Gilt Market

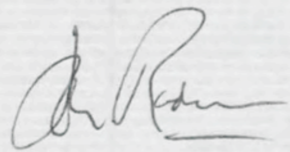
There are three options for proceeding:

1. Cut Public Expenditure. The PSBR has been too high. Cutting it would restore confidence in the counter-inflation strategy.

2. Raise Interest Rates far enough and recommence funding. The Duke of York would then be restored with a vengeance.

3. Do Nothing. Await the Fed's support for US banks to calm US markets down. Sell any type of stock as and when, issuing tranchettes of existing gilts to avoid clumsiness.

1 is the best, but the most difficult politically. 3 is the next best, with a review at the end of next week. 2 gives all the market bears good profits, and reinforces people's cynicism about Government strategy.



JOHN REDWOOD

1) Mr Flesher
2) PA.

DMS 4/6

1) Mr Turnbull
2) Prime Minister (4)
To note.

DMS 1/6

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000
Direct line 01-233 4749

T Flesher Esq
10 Downing Street
LONDON
SW1

31 May 1984

Dear Tim,

BANK OF ENGLAND 1984 REPORT AND ACCOUNTS

You will wish to know that the Bank of England will be publishing its 1984 Report and Accounts at 4pm on Monday 4 June. As ususal we shall present the Report and Accounts, by Command, to both Houses of Parliament at 3pm on the day of publication.

2. As in previous years, the Report and Accounts will include, as an annexe, the Annual Report that the Bank is required to make to the Chancellor on its activities under the Banking Act. In accordance with the provisions of that Act, we shall also present this Report separately to both Houses at the same time as the 1984 Report and Accounts.

3. Unlike last year, there is no need for the Bank to make available to the press at the same time as its own Report, the 1984 Report of the Deposit Protection Board since the Board has already published its Report. Under the Act, the Board is responsible for publishing its Report and Statement of Accounts as it thinks appropriate.

4. The Bank of England has made arrangements for thirty copies of the 1984 Report and Account (with annexe) to be delivered to the Vote Office and twenty-five copies to the Printed Paper Office, House of Lords, at approximately 3pm on 4 June for distribution at 4 pm. In addition, six copies will be sent to the Library of each House.

5. I am copying this letter to Murdo Maclean, David Morris and Janet Lewis-Jones.

Yours ever

A J SALVESON
Parliamentary Clerk

31 May 1984

PRIME MINISTER

BAD DEBTS AND BANKS

You raised the question this morning of how the banks accounted for bad debts in the UK, and the related question of the amount of tax they have to pay.

I have the accounts of Lloyds Bank to hand. Against their operating income of £1.8 billion in 1983, they made specific provisions of £143 million (related to identified advances that are going wrong) and a further £76 million pounds against general bad debts (part of a process of building up a reserve against bad advances that have not yet been identified).

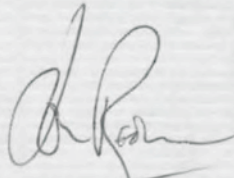
After knocking off £219 million of provisions, they were left with an income of £1.57 billion. Their total operating expenses (staff, premises, equipment, etc) was £1.2 billion, leaving a profit before tax of £387 million. Lloyds also shared in the profits of associated companies, representing an additional £32 million.

On total pre-tax profits of £419 million, Lloyds had a tax bill that year of only £135 million - this represents, as always, a very low charge because of all the different ways of tax shelter.

Conclusion

UK banks do make provisions against specific and general bad debts. They write an advance down to its estimated realisable value as and when the normal banking relationship with the customer has stopped. Until breakdown, they credit interest on the advance to the profit and loss account, but make provision if they are worried about the possible breakdown in the customer relationship.

All banks have taken advantage of the facility to up their specific and general provisions, given the international uncertainties, and I can see no case for making the tax regime even more favourable towards them.



JOHN REDWOOD

LATAAX

The Financial Times

File

8 May 1984

Lloyds Bank economist criticises tax changes

BY OUR FINANCIAL STAFF

LLOYDS BANK, one of the UK's big four clearers, today accuses the Government of pursuing a Labour-inspired corporation tax policy.

In its monthly bulletin for May, the bank says recent Budget proposals which aim for radical changes in company taxation, are based largely on Labour's 1982 Economic Programme, and are being implemented even though the previous Conservative Government pointed out their drawbacks in a Green Paper published the same year.

"The impression given by the Green Paper that corporation tax reform has been given a decent burial is now shown to have been false," writes Mr Christopher Johnson, the bank's economic adviser.

The bulletin says that there are three defects in the existing corporation tax system, but doubts that the Budget measures will correct them.

It is based, the bulletin explains, on historic cost rather than inflation-adjusted accounts. Generous tax allowances which compensated companies for inflation are to be cut even though some companies still face steep rises in costs.

The bulletin adds that the present system is a poor revenue raiser, yielding only 5 per cent of total tax revenues. The Chancellor promised that his changes would lower companies' tax bills, but if they are successful, they may have the opposite effect by giving companies incentives to make bigger profits which will then be taxed. In which case the Government may have to cut corporation tax even more.

Finally, capital allowances have encouraged wasteful investment. By abolishing them, the Chancellor will improve rates of return but will not cure the failings which produced low rates of return in the first place.

Of the changes as a whole, Lloyds says they "will not in themselves be a major determinant of sound investment decisions, but they will avoid some of the unsound decisions that the present system has encouraged." Lloyds, in common with other big British banks, faces an enormous tax payment as a result of the Chancellor's decision to phase-out capital allowances.

FILE

SIR ALAN WALTERS

Thank you for showing me your monograph on Monetary Policy.

There are only two passages which cause me any worry in this. One is the reference to the views of the Bank of England about the MTFS in the bottom paragraph of Page 30 and the top of Page 31. At the bottom of Page 30, I suggest deleting the words "not only the Bank but". And I suggest that the top paragraph on Page 31 could be omitted without seriously detracting from the argument.

The second passage is the reference to the views of Sir Geoffrey Howe and Mr. Lawson at the bottom of Page 22. I suggest that you delete the first words of the last paragraph on Page 22, so that it starts "I have predicted"; that you delete the words "It was also reported that" at the beginning of the second sentence; and that you delete the words "both discredit the Heath/Barber position, and". Again I do not believe that the deletion of these words detracts from the argument.

I should prefer that this and other monographs are not published until after August when your paid consultancy for the Government comes to an end; and you tell me that you do not propose to publish them until after that point. I look forward to reading the revised version of your piece on fiscal policy.

E. E. R. BUTLER

8 May, 1984

6.22

SECRET

Prime Minister

To note. Alan Walters is here on Tuesday and Wednesday morning. I will arrange a meeting to discuss this.

AT 4/5

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

4 May 1984

A Turnbull Esq
10 Downing Street
LONDON
SW1

Dear Andrew,

BASE RATES

Money market rates have been edging up this week to a point that puts pressure on the clearers' base rates. In particular the 3-month inter-bank rate is now above 9 per cent.

This hardening is scarcely surprising given the rise in US rates. Since the clearers' base rates were reduced after the Budget US short-term rates have risen by around 1 per cent. But the current nervousness in the money markets probably also reflects some worries about domestic monetary growth.

If the present level of money market rates persists the clearing banks will almost certainly seek to restore their margins by raising base rates (at the moment Barclay's rate is $8\frac{3}{4}$ and the others $8\frac{1}{2}$).

The April money figures, to be published on Tuesday, should help to relieve the market's immediate fears - £M3 up by $\frac{1}{2}$ per cent and MO unchanged - though the high bank lending figure will be unwelcome. The recent firmer tone in sterling will also be helpful. But we cannot be sure how the markets, in their present nervous state will react. Next week could therefore be a rather difficult time, and the Chancellor feels that the Prime Minister ought to be aware of this.

Yours ever,
David.

D L C PERETZ
Principal Private Secretary

4 MAY 1984

SECRET

NBPM AT 4/5 5

4 May 1984

MR TURNBULL

I saw Eddie George at the Bank of England yesterday, and discussed the following items.

1. The future of the gilt-edged market.

The Bank's proposals are:

(a) To extend the number of people making a market in gilts by approving a new group of market-makers. They would need adequate capital, would have access to the Government broker for the supply of new stock and, in return, would be required to deal in a certain size at reasonable prices at any time in normal training hours.

(b) The Government broker would cease to be based at Mullens, but would move to the Bank and work with Eddie George.

(c) A wider group would be licensed dealers in gilts with lesser obligations and fewer privileges.

(d) In order to avoid crooked dealing, the contract note rendered to each client would have printed on it the time of the deal, the price charged, and the average market price which would be computed, minute-by-minute, based on the screen prices of all the market-makers.

The provisions for disclosure of information and rendering contracts are ideal, and should prevent any undue scandal. We cannot judge yet whether the Bank's wish to preserve a central market under its own control will work or not: it will depend on how many people wish to be market-makers, how many have to be turned away, and how stringent the requirements on these market-makers might be. There is one danger in the Bank's programme. The Bank sees itself as becoming a more active dealer in gilt-edged stock under this new regime. Its relationship with the market-makers would need careful watching to avoid it becoming either too cosy, or unduly authoritarian and interventionist in the market - this could damage the market and could be costly, as foreign exchange activities have been at times.

2. Current funding

Eddie remains very pessimistic about the prospects for funding, but is certainly in no mood to issue a full-sized new long tap in the wake of the most recent upset when they tried that mechanism.

JMEAAK

SECRET

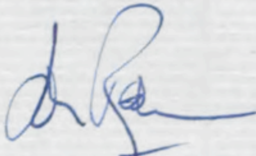
SECRET

3. Equity sales programme

The Bank are reluctant to see the equity sales programme speeded up, despite the fact that the equity market is very strong and would take more stock at the moment, thereby easing the funding problem. Their main argument seems to be that selling too much equity now would make the sale of BT more difficult, coupled with their fear that having published a clear target for equity asset sales, the market would take it amiss if this target were then exceeded.

I fear there are two misconceptions here. Firstly, selling stock into a strong market in May is unlikely of itself to make the sale of British Telecoms any more difficult in November. The market receives new money on a month-by-month basis, and the time gap is too great for May sales to have any real impact. Secondly, it is true that the market would be unhappy if there were a massive increase over the published target for equity sales, although many people in the market have been very sceptical about the low target, and have pencilled in a higher figure in their forecasts. However, the enormous size of the BT issue projected on the first call in November is in itself quite difficult for the market to digest. Further spreading out of the calls on BT would help the market, and would mean that more stock could be sold before the summer recess in the equity market, and some compensating reduction made in the first call on BT in the autumn. I also fear that people are still being too optimistic pencilling in £8 billion as a valuation for BT. BT will only succeed if it is realistically priced; and it will only succeed politically if the powers of competition are strong enough and are seen to be strong enough. Any strengthening in the powers of competition does, of course, lower the future stream of potential profits for BT as perceived by the market; and this in turn has some impact on its valuation.

I have been putting these points to Eddie, John Moore, Ken Baker and others as the discussions continue in the run-up to the BT sale.



JOHN REDWOOD

JMEAAK

SECRET

H M Treasury
Parliament Street London SW1P 3AG
Switchboard 01-233 3000
Direct Dialling 01-233 3620

Sir Peter Middleton KCB
Permanent Secretary

PERSONAL

Robin Butler Esq
10 Downing Street
LONDON
SW1

30 April 1984

Paper at x1 please
ERB
1.5

Dear Robin,

ALAN WALTERS' MANUSCRIPT

x| Thank you for your letter of 11 April. I was interested to read the article - and agree with your comments on it. I can see no reason why it should not be published.

But it was not the article I had in mind. Alan Walters clearly has two companion pieces of work in draft. One, which he sent you on monetary policy. And one which he sent me on fiscal policy. The latter is in a less finished state, but contains the dangerous material I spoke about. You might like to have a copy - I am sure that you will see what I mean - so you can subject it to close scrutiny when Alan Walters clears it with you. And when you clear the monetary article, could you take particular care not to imply that you are clearing any other writings.

I am copying this letter to Robert Armstrong.

Yours ever,

Peter

P E MIDDLETON

IN CONFIDENCE

File VC/SLH

10 DOWNING STREET

From the Principal Private Secretary

11 April 1984

Alan Walters gave me, as you suggested, a manuscript of his monograph on monetary policy, which I have now read.

I think that this must be a revised version of the piece which he gave to you since it does not appear to include some of the passages, eg about "the wets", which you mentioned to me. You will be better able than I to say whether any of the views on policy - eg the attack on the EMS - are likely to cause a flutter among the dovecotes of the cognoscenti but subject to that, I have worries on only two passages. One is the reference to the views of the Bank of England about the MTFS in the bottom paragraph of page 30 and the top paragraph of page 31; and the other is to the reference of the names of Sir Geoffrey Howe and Mr. Lawson in the bottom paragraph of page 22: the latter could be easily dealt with by the omissions which I have indicated on the text, without changing the general sense.

Subject to these points, it would not seem to me objectionable that Alan Walters should publish this monograph in its present form, but I should prefer that he does so after August when the arrangement that he acts as a part-time consultant to the Government in return for a fee will come to an end.

I should be grateful if you and Robert Armstrong (to whom I am copying this letter) could let me know whether you agree that I should say to Alan Walters that we would be content for him to publish this monograph subject to the points I have mentioned.

BF

E.E.R. BUTLER

Sir Peter Middleton, K.C.B.

IN CONFIDENCE

CONFIDENTIAL

22 March 1984

File

MR TURNBULL

FUNDING MEETING

I attended the Funding Meeting on Tuesday, 20 March.

The Bank of England are preparing the ground again for another attack on the policy of not selling long gilts. Whilst they are still chastened by their experience with the unfortunate 1998 stock, they wish to keep open the possibility of selling longs at some stage across the summer.

I note also that the Governor of the Bank of England has been making remarks about the adverse impact of the Budget on the banks. Would it not be a good idea for the Governor to come in and have a short meeting with the Prime Minister to discuss:

(a) the position of the banks;

(b) markets and the privatisation programme;

(c) Stock Exchange reforms;

(d) funding policy?

JOHN REDWOOD

SECRET (AND PERSONAL UNTIL 2.30 PM THURSDAY 15 MARCH) File

MONTHLY MONETARY REPORT: FEBRUARY-MAY

SUMMARY

The main points from this month's report are:-

- with the exception of PSL2, monetary growth was less than expected in February. Over the year to mid-February, £M3 was well within the target range, M1 at the top and PSL2 less than 1½ per cent outside the range. Despite fairly low growth in the last three months, the trend in MO still looks fairly flat
- over the next three months the growth in £M3 (on the new definition)is expected to average 1 per cent a month, slightly less on the old definition. PSL2 may continue to grow more rapidly, even if, as we assume, building societies widen their margins (by about ¼ per cent) when the likely fall in the general level of short term rates materialises. There may also be some shift out of M2, if the societies also trim back special premia. Lower interest rates may keep the average growth of MO around ½ per cent a month
- the record rate of inflow into building societies continued in banking February. Advances are still growing strongly, and net new commitments have been steady at the high level reached at the end of last year. The mortgage rate looks set to fall from 1 April
- sterling bank lending to the private sector was much as expected in February, and underlying growth is forecast to level off over the next three months
- despite overfunding of about £2 billion since mid-July, the 'PSBR' has been slightly less than fully funded over the target period. If the £1¼ billion gross gilt sales target is met, public sector influences on monetary growth may be broadly in balance over the forecast period as a whole, though the path may be erratic
- the stock of money market assistance reached £11¼ billion during February, and may peak at over £12 billion in March (a record). Pressures should ease in April as the unadjusted CGBR swings into heavy deficit
- the externals and net non-deposit liabilities have been notably erratic in the last two months. Over a longer period, forecast errors have been broadly offsetting, but the February £M3 outturn was depressed by a large interbank reporting difference, which should be unwound in March.

HF3 Division

March 1984

SECRET (AND PERSONAL UNTIL 2.30 PM THURSDAY 15 MARCH)

MONTHLY MONETARY REPORT: FEBRUARY-MAY

Monetary Aggregates

Monetary growth in banking February was well below expectations - with the exception of PSL2, which continues to grow rapidly. This month's figures left the target period growth rate of £M3 well within the range, with M1 at the top and PSL2 within 2 per cent of the top. The 6-month growth of M1 and £M3 has fallen in recent months, but the growth of PSL2 continues to move up. Among the other aggregates, the growth of weekly averaged M0 has slowed down over the last 3 months, but on a 6-month basis the trend remains fairly flat. The low February outturn for M2 has brought its year-on-year growth back to 9 per cent (around 7½ per cent, after allowing for the recent reclassification of building society deposits).

Table 1: Main Aggregates: recent experience

(per cent, seasonally adjusted)

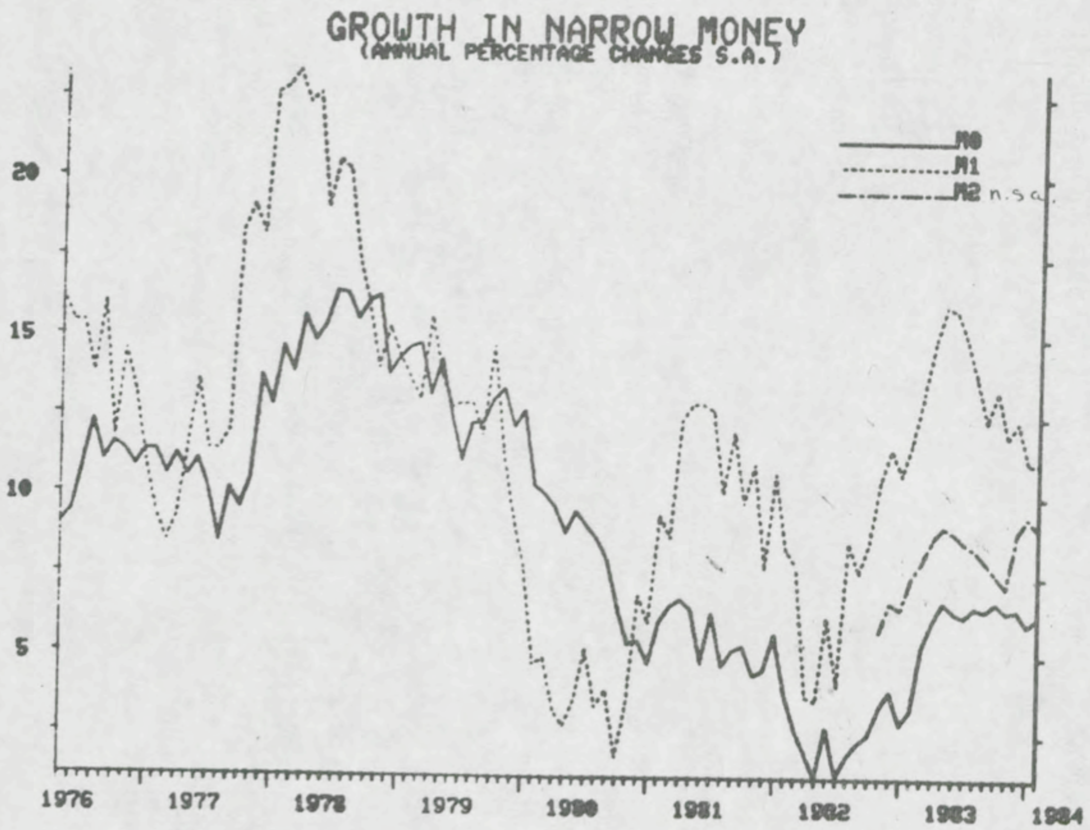
monthly change:	M1	£M3	PSL2	M0 (Weekly Averaged)	M2*
January	-0.2	+0.6	+1.2	+0.4	+0.3
February	+0.7	-	+1.2	+0.2	-
growth at an annual rate over past:-					
3 months	+8.4	+7.9	+14.4	+3.7	-
6 months	+8.2	+7.1	+10.5	+6.3	-
12 months (target period to date)	+11.1	+9.7	+12.3	+6.3	9.0

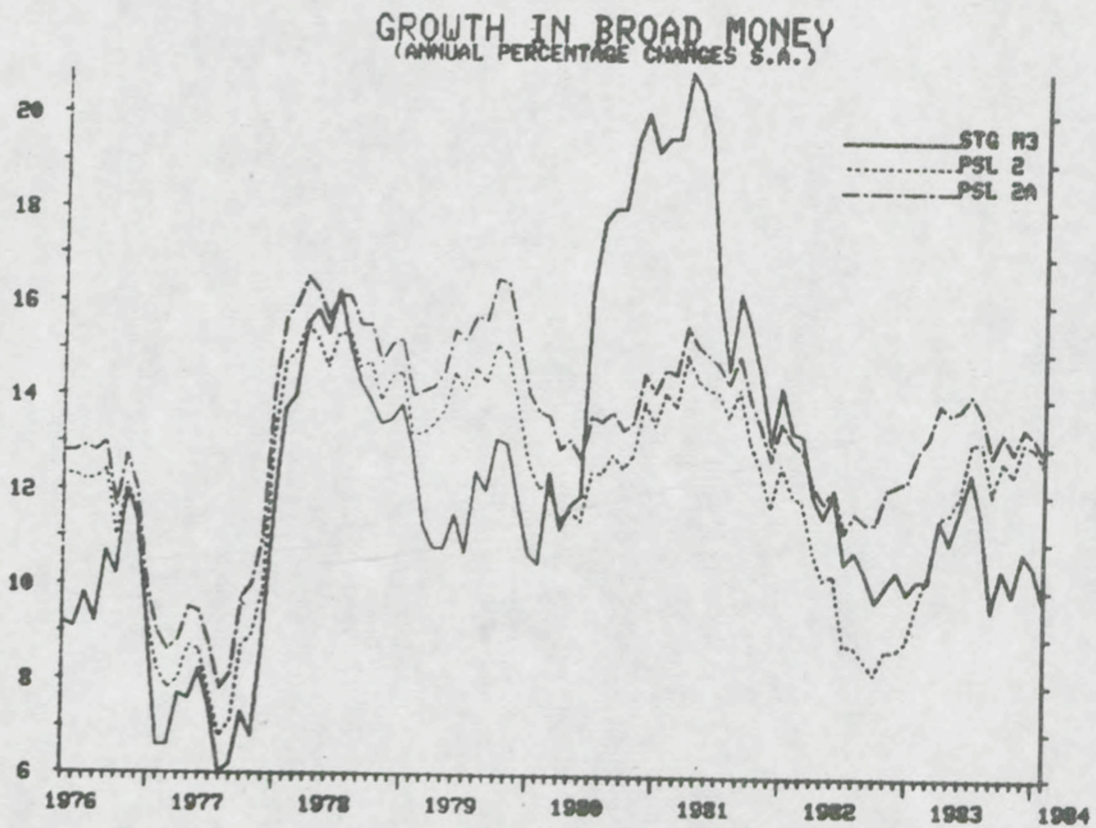
* not seasonally adjusted

Full details of the growth in all the main aggregates are given in the Annex. Chart 1 shows the recent path of year-on-year changes for both broad and narrow money.

2. The evidence for a decline in the growth in the narrower aggregates is still mixed. The growth of M1 and its non-interest bearing component NIB M1 has clearly fallen since the middle of last year. While the growth of notes and coin in circulation with the public also seems to have come down, this has not yet been clearly reflected

CHART 1





in the behaviour of M0. Recent revisions to the M2 series suggest that it was growing more rapidly in the first half of last year than we thought at the time; but any easing since then has been fairly slight, even after adjusting for the most recent classification changes.

3. Since the Autumn, £M3 has been the slowest growing measure of broad money (the redefinition to exclude public sector deposits makes little difference to this pattern). The growth of total M3 has now fallen back a little, but the three month growth rate is still over 15½ per cent (with the target period growth rate around 11¾ per cent). Once again the faster rise in PSL2 principally reflects high inflows into building societies; the banking February inflow was again over £1 billion, similar to January's record level.

4. In contrast to recent months, the public sector's contribution to £M3 growth was expansionary in February. There has been total overfunding of around £2 billion since mid-July, though over the target period as a whole, the 'PSBR' has been underfunded by about £½ billion. The underlying growth in bank lending was fairly well in line with expectations, though the recorded figures were inflated by borrowing by BAT to finance the purchase of Eagle Star at the very end of the banking month (much of which will be offset by a negative influence on the externals in March, as the proceeds are paid abroad). The trend in bank lending may be levelling off, though it remains at a higher level than in the first half of 1983. Building Societies lending continues to grow rapidly. While the increase in net new commitments has flattened off, it shows no signs of falling back.

5. The February outturn for £M3 was depressed by an erratically large increase in net non-deposit liabilities, in part due to a sizeable negative interbank reporting difference, which is likely to be unwound the following month. Taken together, our forecasts for the externals and NNDL's have not been biassed over the past 6 months. But there have been offsetting errors and we do seem to have underestimated the growth in NNDL's, some of which has been due to increases in foreign currency capital and reserves, which probably have a positive impact on the externals.

6. Some further change in the general level of short term interest rates looks likely, but this is unlikely to have much effect on monetary

growth over the next three months. We assume that building societies will take the opportunity to increase their margins (by about ¼ per cent), following the recent ruling on the taxation of their holdings of gilts. This could mean a slackening in the pace of inflows and, if it takes the form of reducing special premium rates, possibly some switching out of M2. But we expect the relatively rapid growth of PSL2 to continue for the time being.

7. The growth in private sector £M3 is expected to average about 1 per cent a month over the period as a whole, reflecting a fairly flat public sector contribution and an unchanged trend in bank lending. The March outturn may be inflated by the unwinding of special factors affecting February. Growth on the old definition of £M3 may be slightly lower, since local authorities normally run down their bank deposits at this time of year. Lower interest rates may prevent the growth of MO falling below its recent trend of around ½ per cent a month. We are not in a position to forecast M2: growth averaging slightly less than ¾ per cent a month would be broadly in line with recent trends (abstracting from classification changes - though we know that at least one further fairly small change of this kind is in the pipeline).

Table 2: Summary of the Forecast

percentage changes

monthly change:	MO*	M1	Private £M3	£M3	PSL2
March	½ per cent a month	1¼ per cent a month	1¼	1	1½
April			1	¾	1½
May			¾	n/a	1¼
growth at an annual rate:					
mid-Feb '83 - mid-Apr '84 (Full 14 months of old target period)	6¼	11¾	10¼	10	13½
mid-Feb '84 - mid-May '84 (First 3 months of new target period)	6¼	n/a	12½	n/a	18½

* weekly averaged basis

Public Sector Borrowing

8. In seasonally adjusted terms the 'PSBR' was over £1¾ billion in banking February, a little larger than forecast, reflecting a higher than expected other public sector contribution. Over the next three months the 'PSBR' is forecast to total some £2¾ billion seasonally adjusted, over £4 billion unadjusted. Banking March is still expected to be flat, on both the 'PSBR' and the CGBR.

9. The unadjusted CGBR(O) profile remains extremely erratic over the next three months, accentuated by erratic forecast movements in central government bank deposits. From a surplus of almost £1 billion in March, a deficit of £3 billion is expected in April, despite assumed receipts of £400 million from the EC refund. The May figures make no allowance for additional asset sales, the timing of which is still uncertain. On-lending to the rest of the public sector may amount to just over £1½ billion in the next three months. This is about £¾ billion less than in the corresponding period last year, but still sufficient to meet the other public sector's combined borrowing requirement. Borrowing from the central government is expected to match the LABR, but even so the local authorities are expected to raise a further £¼ billion from the non-bank private sector (which will depress £M3). This reflects well established behaviour at this time of year which may be linked with the absence of rate income in calendar March and April.

Table 3: Public Sector Borrowing

£bn s.a.

	mid-April - mid-February	mid-February - mid-May	mid-April - mid-April**
CGBR	+11.7	+ 3.2	+13.3
own-account	+ 8.0	+ 1.6	+ 8.5
on-lending	+ 3.7	+ 1.6	+ 4.8
'PSBR'*	+10.0	+ 2.8	+11.3

* PSBR less non-bank private sector transactions in other public sector debt.

** Adjusted to include the effect of movements in public sector deposits.

10. Table 3 shows total public sector borrowing over the latest 10 banking months and summarises the forecast and its implications for the 'financial year' (the 12 banking months to mid-April). Although the forecast has been prepared on the basis of the revised definitions of £M3 and the PSBR, the relevant data in the table have been adjusted to present the PSBR on the existing definition. Timing differences and the fact that the PSBR cannot be measured precisely over a banking month mean that borrowing over the 12 months to mid-April is likely to be much higher than over the financial year. After allowing for the approximate effect of these factors, the forecast is consistent with a financial year PSBR of about £9½-10 million.

Debt Sales

(a) Gilts

11. Table 4 compares the February outturn with performance over the 10 months since mid-April 1983, and summarises the forecast for the next three months.

Table 4: Gilt Sales

monthly averages £m

	Banking February	mid-April '83 - mid-February '84	mid-February - mid-May 84
Gross sales	1240	1335	1283
Redemptions	- 51	- 140	- 246
Next Maturities	+ 20	- 140	- 288
Net sales	1209	1055	750
of which:			
Monetary sector	79	49	-
Public corporations	10	1	-
Overseas	14	72	100
Non-bank private sector	1106	932	650

12. Gross sales in banking February were almost exactly on the £1250 target. The month began with £450 million of calls lined up on the 10% Treasury Convertible 1990 issued at the end of banking

January. The main further contribution to sales during the month came from the £600 million package of short term medium tranchettes announced towards the end of January which sold out in about a week. February saw unusually small redemptions and buying of next maturities so net sales of £1210 million were close to gross sales. In contrast to recent months, the monetary sector was a modest net purchaser of gilts. But, with little overseas interest, sales to UK non-banks of £1100 million comfortably exceeded the monthly average for the year so far.

13. The gross sales target for banking March is £1250 million and more if possible. Gross sales already achieved and known future calls have now brought us to £975 million. The major contribution has come from the last call on the 1990 convertible stock and the exhaustion of the £1 billion of the 9½% Treasury 1998 which languished when it was issued on 3 February. But buying-in of stock, other than next maturities, has been unusually high so far this banking month, largely as a result of purchases of low coupons shed by building societies after the tax announcement on 23 February.

14. March is a long banking month, with a fortnight still to run. The Authorities now have the £630 million balance of the newly issued 10% 1989 'A' stock to sell - of which about £300 would fall into this month. Provided the market stays firm, it seems reasonable to assume gross sales of £1350m in the month as a whole. But, with heavy redemptions and buying-in of next maturities, net sales of gilts may only be £450 million. Thereafter the position should improve as buying-in of next maturities declines in April and May. On the assumption of £1¼ billion gross sales a month, net sales to non-banks could be around £650 million in April, and nearly £1 billion in May. We are also looking for some pick up in sales to overseas, with dollar denominated debt becoming less attractive. The banking sector has not been an active net buyer of gilts for some time, partly because some banks are close to their capital ratio limits, (and March will be affected by the conditions attached to the gilt repo); we expect no net purchases by the monetary sector over the forecast period.

(b) National Savings

15. National Savings contributed almost £300 million to funding in banking March. Inflows in the latest five banking months have averaged

over £300 million compared with just over £200 million in the previous five months. Much of this improvement reflects the recent performance of the income bond which attracted £125 million in February. INVAC also attracted inflows of over £100 million, possibly reflecting, in part, the change to daily interest crediting.

16. The forecast for the next three months assumes unchanged DNS interest rates relative to the building societies. On this basis inflows are expected to average £250 million a month, exactly the monthly striking rate needed to meet the restated(£3 billion) National Savings target for 1984-85. The income bond is still expected to account for the lion's share of inflows, attracting £25 million a week. In addition, there may be more of a contribution from the fixed-interest certificate once the heavy 18th Issue maturities have passed.

17. Total inflows to National Savings were £2630 million (seasonally adjusted) in the 10 banking months to mid-February. Even allowing for timing differences the forecasts imply that the £3 billion target for 1983-84 should be comfortably achieved.

Funding and the PSBR

18. Table 5 shows the funding position (on both the conventional and alternative presentations) over the target period and 'financial year' to date, together with the forecast for the next three months. While on the conventional definition, the PSBR was underfunded by £½ billion over the first 12 months of the target period, it was overfunded by £½ billion after taking account of the external finance of the public sector. Over the next three months, as a whole, the net effect of public sector transactions on £M3 is expected to be broadly flat with a modest negative contribution in March being offset in April. This would imply overfunding of nearly £2 billion over the 12 months to mid-April (or about £3 billion including external finance of the public sector). In unadjusted terms the PSBR is forecast to be massively underfunded in banking April (as last year), which should significantly ease money market pressures.

Table 5: The 'PSBR' and the Funding Position

£billions, seasonally adjusted
(figures in brackets are unadjusted)

	mid-Feb-mid-Feb (target period)	mid-April - mid-Feb	mid-Feb - mid-May	mid-April -mid-April
'PSBR'	12.9	10.0	2.8	11.3
Debt seales to NBPS(-)	-12.4	-11.7	-2.7	-13.2
of which:				
Gilts	- 9.5	- 9.3	-2.0	-10.3
National Savings	- 3.0	- 2.6	-0.7	- 3.1
CTDs	0.1	0.2	-	0.3
Over(-)Underfunding(+)	+ 0.5(-0.6)	- 1.7(-3.4)	+0.1(+1.2)	-1.9(-2.0)
External finance of public sector (-)	- 1.1	- 0.9	-0.3	- 1.0
Funding (alternative definition)	- 0.6	- 2.6	-0.2	- 2.9

Money Market Influences

19. Money market shortages averaged £425 million a day during banking February, of which some £350 million was due to maturing assistance. Total funds supplied to the market rose by a further £1½ billion to nearly £11½ billion. (The stock of assistance peaked at £11¾ billion within the banking month). Two-thirds of the additional assistance was provided by Banking Department as the NLF continued to build up its balances.

20. Our forecasts imply a further increase in the stock of assistance during banking March (+ £¾ billion), taking the total over £12 billion for the first time (see Table F). The pressure on the bill market from this further increase in assistance should be tempered, however, by the injection of £670 million into the market by the gilt repo. As the unadjusted CGBR swings back into heavy deficit in banking April, there should be scope for unwinding £1½ billion of outstanding assistance.

Lending to the Private Sector

21. Sterling lending to the private sector increased by about £1 bn.

in banking February, much as expected after allowing for the higher PSBR and extra lending by BAT on the last day of the banking month to finance part of its takeover of Eagle Star. The February figures provide further support for our view that the underlying level of lending is around £1300 million a month. In Table 6 recent actuals are compared with two indicators of the underlying trend. The first, a simple six month moving average of the actuals, points to a levelling off of the recent rise in the trend at a level of about £1.3 billion. The second indicator refers to "underlying" lending, ie. recorded lending adjusted for deviations from trend in the PSBR less asset sales. Over the last five months, the six month moving average of underlying lending has hovered around £1.2 billion. None of this alters our view that underlying lending will continue at around £1.3 billion a month.

Table 6: Recorded and Underlying Lending

Banking month data £m, sa

	Recorded bank lending	6-month moving average of recorded lending	6-month moving average of "underlying" lending
1983 May	1087	831	1017
June	1559	861	1204
July	304	716	1155
August	1185	821	1029
September	1154	991	1047
October	1561	1088	1264
November	1138	1026	1233
December	1747	1278	1194
1984 January	1254	1340	1121
February	1032	1314	1205

22. Little new information on the composition of £ lending has become available this month. The London Clearing Banks have just issued the first of a revised quarterly analysis of advances based on the 1980 Standard Industrial Classification. The LCB advances figures are a reasonable guide to what is happening to personal lending, but they provide a potentially misleading picture of lending to companies and

other financial institutions. Table 7 shows the increases in LCB advances in the banking quarter from mid-November last year to mid-February. The figures show that lending for house purchase is growing rather less rapidly than lending to persons for other purposes (mainly consumption). Additional evidence on personal lending is contained in the DTI's retail credit figures for January. These show that lending to individuals under regulated agreements was 10per cent higher in the 3 months November to January than in the previous 3 months. During the same period lending under other agreements (which is mainly to companies) grew by only 5 per cent. At the end of January the total amount outstanding to finance houses, other specialist consumer credit grantors and retailers was 24 per cent up on a year earlier.

Table 7: Advances to UK Residents by the London Clearing Banks' Groups Changes: Mid-November '83 to Mid-February '84

Persons				Other		Total			
House Purchase		Other						(of which of foreign currencies	
£m	%*	£m	%*	£m	%*	£m	%*	£m	%*
276	10.7	357	14.6	1045	10.4	1678	11.1	379	32.3

* as % stock at mid-November (annualised)

23. There are some signs that companies have been raising less finance in the form of equity. As table 8 shows, there appears to have been a significant decline in the rate of new issues both in the last quarter of 1983 and in the first two months of 1984. It is conceivable that recent rumours about reductions in the rate of stamp duty on equities have had an effect. Whatever the cause, the high level of the gross issues queue in January and February suggests that the level of new issues is likely to pick up again in the near future.

Table 8: Net Issues by Listed UK Companies

(monthly averages) (£m)

	Net Issues	Gross Issues Queue (Equities)
1983 Q1	157	610
Q2	238	950
Q3	235	670
Q4	73	500
1984 January	60	920[1]
February	41	1130[1*]

[1] Excluding privatisations (currently 5750 mostly accounted for by British Telecom).

* As of March 5.

24. The forecast for bank lending is again based on a flat underlying trend of £1.3 billion a month. But as usual the monthly path is expected to reflect the erratic path of the PSBR. The exceptionally low PSBR in March is likely to result in rather higher bank lending in this month and we expect an extra £100 million due to more borrowing by BAT to cover the remainder of the cost of Eagle Star. In banking April the PSBR would be exceptionally high were it not for an assumed EC refund of £400 million. However, the refund is excluded from the PSBR definition used for calculating bank lending offsets, so we expect a rather low recorded lending figure. Banking May sees a return to a more normal PSBR and hence the expected recorded figure is close to the assumed underlying level.

Building Societies

25. Retail inflows in banking February, excluding interest credited, reached £1 billion for the second month running, and were only slightly short of banking January's record level. This continued massive inflow reflects the overall competitiveness of building society accounts and the recently improved terms on some of the societies' notice accounts. As mentioned last month, there is still a possibility that more leading societies could reduce the required notice on some

of their term deposits, which has the effect of artifically boosting the M2 series if the required notice falls to less than a month. Recent changes by Yorkshire building society are likely to add around £¼ billion to the March M2 figure. Wholesale deposits were about £120 million in banking February, though since then the weekly figures for the 16 largest societies show some repayment of wholesale funds.

26. For the purposes of the forecast we have assumed that societies will take the opportunity of a general fall in short rates to improve their margins by about ¼ per cent. This could mean some loss of competitiveness relative to the banks which could take the form of trimming special premia as well as lower rates on ordinary shares. But the effect is unlikely to be marked, especially in the light of the current size of the interest rates differential (and the possible impact of Budget announcements). Building societies' inflows are expected to remain buoyant, albeit slightly below the record level reached in the past two months. There are no signs of a deceleration in the rate of growth of mortgage lending.

Table 9: Building Society Inflows

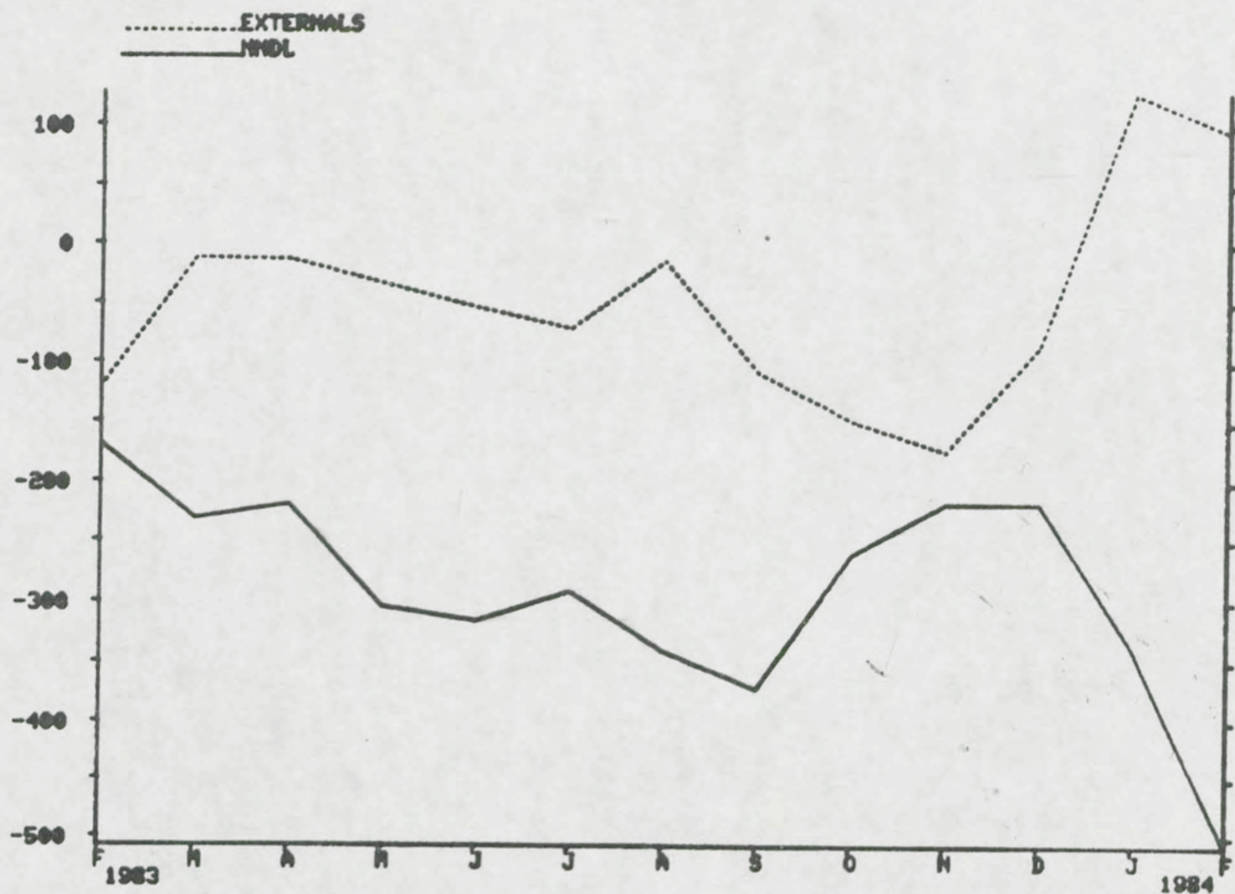
monthly rate, £m	(3 month periods, monthly averages)		
	mid-Aug. - mid-Nov	mid-Nov. - mid-Feb	Forecast: mid-Feb - mid-May
Total retail inflows (incl.interest credited)	1200	1250	1275
of which: term shares (outside PSL2)	500	225	160
Net issues of CDs and time deposits	175	130	n/a
of which: net purchases by NBPS(inside PSL2)	60	100	75

Externals and Net Non-Deposit Liabilities

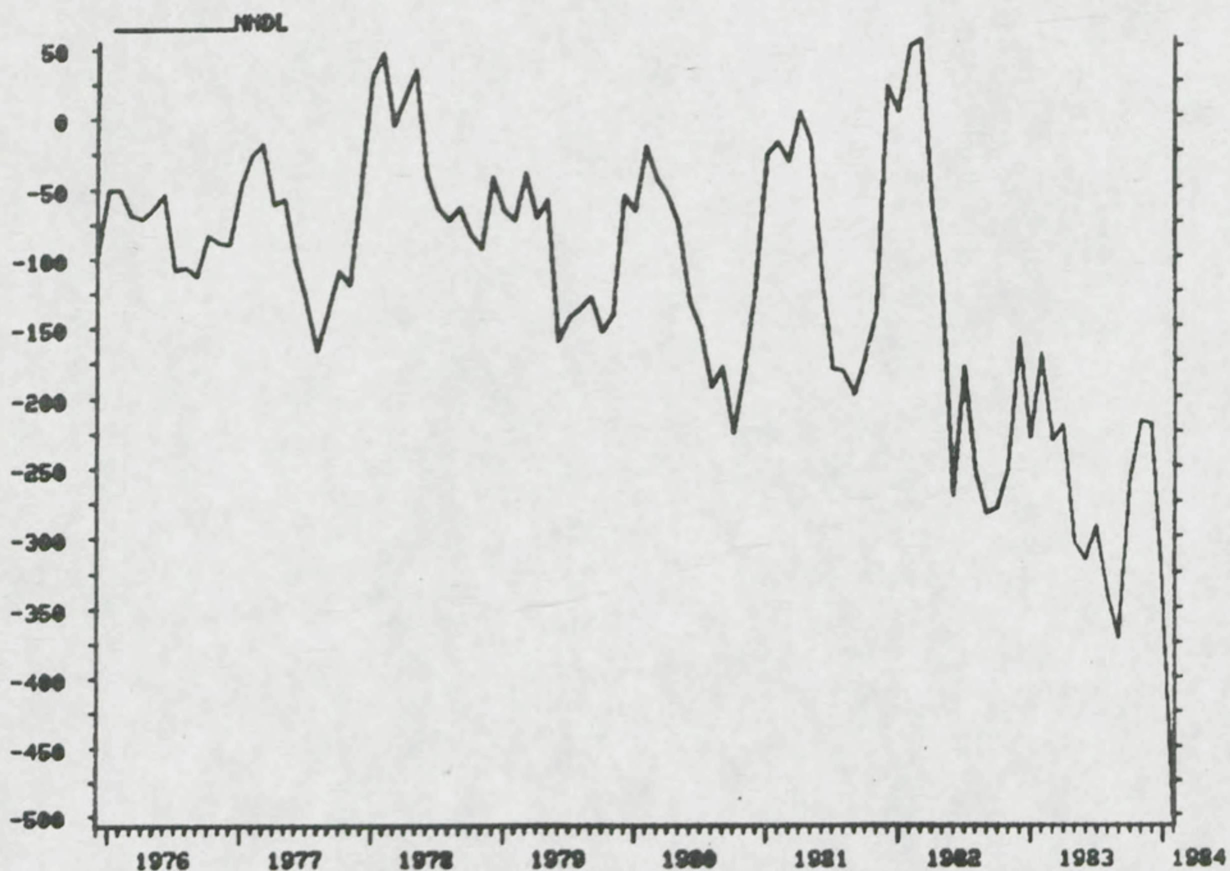
27. The behaviour of both the externals and NDL's has been notably erratic in recent months. In January the externals boosted £M3 by around £1.3 billion, while in February they were contractionary to the tune of £600 million. NDLs, on the other hand, were highly negative in banking January (-£550 million) and even more negative in February (-£1 billion). So while the externals and NDLs effects were

CHART 2

EXTERNALS AND NNDLS*



NNDLS*



Note: Sign conventions are as in the £M3 counterparts table, ie. a growth in net non-deposit liabilities is shown as negative.

* 6 MONTH MOVING AVERAGE

offsetting in January(and hence had no net effect on £M3) the effects went in the same direction in February, and were very largely responsi- for the overall forecast error on £M3.

28. Over the longer run, changes in the externals and NDLs tend to be offsetting. Chart 2 shows a fairly pronounced negative correlation between the two series. This is not altogether surprising. If, as seems likely, the trend towards more negative NDLs, in part, reflects pressure on the banks to build up their foreign currency reserves to meet bad overseas debts, then we would expect to see an offsetting increase in the externals (in the banks' switched position). This offsetting effect also shows up in our forecast errors since June of last year: we have on average overpredicted the externals by £150 million and underpredicted NDLs by £135 million.

29. For the forecast period we have increased our estimate of the underlying growth in NDLs from £250 million per month to £400 million, in line with the average for the past year. This is assumed to reflect higher foreign currency capital issues and reserves, which will be offset by higher (ie. more positive) externals.There is no net effect on £M3. In banking March NDLs may be a further £200 million higher as the interbank difference unwinds (adding to £M3). In banking February this difference (mainly due to reporting errors) was £232 million; and in the past such large figures have generally been reversed in the next month. The externals are also likely to be affected by special factors in the next two months. In March we have allowed for a reduction of £300 million as Allianz transfer into Deutschemarks their receipts from the sale of their Eagle Star shares to BAT, while in April we have included inflows of £400 million as a result of the assumed EC rebate.

Table A: Percentage Changes in Monetary Aggregates
Seasonally adjusted data

Banking month	MO (weekly AV)	NIB M1	M1	M2*	Priv £M3	£M3	M3	PSL2	PSL2A
Outturn									
- September	+1.1	+0.9	- 0.2	+0.1	-0.1	-0.5	- 0.4	+ 0.2	+ 0.4
- October	+0.6	+0.5	+ 1.5	+0.6	+1.3	+1.4	+ 1.8	+ 1.0	+ 1.2
- November	+0.5	+0.4	+ 0.6	+0.2	+0.2	+0.6	+ 0.8	+ 0.4	+ 0.6
- December	+0.4	+2.0	+ 1.6	+2.7	+1.5	+1.3	+ 2.3	+ 1.0	+ 1.0
- January 1984	+0.4	-1.4	- 0.2	+0.3	+0.3	+0.6	+ 0.8	+ 1.1	+ 1.1
- February	+0.2	+0.5	+ 0.7	-	+0.1	-	+ 0.6	+ 1.2	+ 1.1
Last 3 months at annual rate	+3.7	+4.5	+ 8.4	..	+7.8	+7.9	+15.6	+13.9	+14.1
Last 12 months (target period)	+6.3	+8.1	+11.1	+9.0	+9.7	+9.7	+11.8	+12.3	+12.6
Forecast									
(i) Percentage change in month									
- March	½ per cent a month		1¼ per cent a month		+1.2	+1.0		+ 1.6	+ 1.5
- April					+1.0	+0.8		+ 1.5	+ 1.4
- May					+0.8	..		+ 1.2	+ 1.2
(ii) Percentage change since Feb 1983 (annual rate)									
- March	6¼ per cent		+11½		+10.1	+9.9		+12.9	+13.1
- April			+11¾		+10.3	+10.0		+13.4	+13.4
(iii) Percentage change since Feb 1984 (annual rate)									
- March	6¼ per cent				+14.7	..		+20.5	+19.0
- April					+13.9	..		+19.8	+18.6
- May					+12.6	..		+18.5	+17.5

* not seasonally adjusted

SECRET (AND PERSONAL UNTIL 2.30PM, THURSDAY 15 MARCH 1984)

Table B: £M3 Counterparts

	February		Forecast			Target Period:	
	Forecast	Outturn	March	April	May	mid Feb 83 to mid - Feb 84	mid - April 83 to mid - April 84
1. CGBR							
(a) Own-account (u.a.)	- 645	- 614	- 900	+ 2950	+ 730	+ 8,317	+8,252
(b) On-lending (u.a.)	+ 380	+ 406	+ 625	+ 530	+ 450	+ 5,732	+4,807
Total (u.a.)	- 265	- 208	- 275	+ 3480	+ 1180	+14,049	+13,059
TOTAL (s.a.)	+ 1920	+ 1864	-	+ 1615	+ 1635	+15,358	+13,277
2. Net purchases of CG debt by NBPS							
(a) Gilts	- 1045	- 1106	- 350	- 650	- 950	- 9,471	-10,317
(b) Treasury bills	-	- 40	-	-	-	- 46	- 52
(c) National Savings	- 280	- 284	- 275	- 215	- 250	- 2,955	- 3,120
(d) CTDs, etc	+ 160	+ 125	+ 70	- 15	- 65	+ 83	+ 291
TOTAL	- 1165	- 1305	- 555	- 880	- 1265	-12,389	-13,198
3. Other public sector							
(a) Local authorities	- 165	- 76	- 70	- 135	- 145	-2,188	-2,070
(b) Public corporations	- 175	+ 90	+ 25	+ 190	- 285	- 268	+ 91
TOTAL	- 340	+ 14	- 45	+ 55	+ 430	-2,456	- 1,979
4. £ lending to private sector	+ 970	+ 1032	+ 1760	+ 485	+ 1120	+ 12,851	+14,262
(adjusted lending)	(1300)	(1224)	(1300)	(1300)	(1300)		
5. Net externals	- 100	- 577	+ 185	+ 165	+ 140	- 30	+ 156
6. Net non-deposit liabilities	- 250	- 1044	- 200	- 400	- 400	- 4272	- 4143
TOTAL £M3	+ 1035	- 16	+ 1145	+ 1040	+ 800	+ 9062	+ 8375
% change in period	+ 1.0	-	+ 1.2	+ 1.0	+ 0.8	+ 9.7	+ 8.8

SECRET (AND PERSONAL UNTIL 2.30 PM THURSDAY 15 MARCH 1984)

TABLE C: COMPONENTS OF M1 AND £M3

(£ million, seasonally adjusted)

	banking February 1984	Cumulative total since mid-February 1983	%
notes and coin in circulation	+ 91	+ 596	(+ 5.4)
non-interest-bearing £ sight deposits	+ 53	+1741	(+ 9.8)
NIB M1	+144	+2337	(+ 8.1)
interest bearing £ sight deposits	+143	+1975	(+20.0)
M1	+287	+4312	(+11.1)
private sector £ time deposits and £CDs	-181	+4484	(+ 8.6)
private sector £M3	+106	+8796	(+ 9.7)
public sector £ deposits	-122	+ 266	(+12.3)
£M3	- 16	+9062	(+ 9.7)

(Figures in brackets show % change at annual rate over target period)

SECRET AND PERSONAL UNTIL 2.30 PM, THURSDAY 15 MARCH 1984

Table D : Gilts

£ million

	Outturn February	March to date	Remainder of March	March	Forecast April	May
Calls*	+ 427	-	+ 647	+ 647	+ 367	+ 104
Other 'gross' sales	+ 813	+ 318	+ 385	+ 703	+ 883	+1146
'GROSS' SALES	+1240	+ 318	+1032	+1350	+1250	+1250
Buying-in next maturitiesϕ	+ 20	- 165	-	- 165	- 500	- 200
Redemptions	- 51	- 735	-	- 735	-	-
TOTAL NET SALES	+1209	- 582	+1032	+ 450	+ 750	+1050
Purchases (-) by:						
Overseas	- 14			- 100	- 100	- 100
Banks	+ 20			)		
LDMA	- 99			) -	-	-
Public Corporations	- 10			)		
NET SALES TO NBPS (+)	+1106			+ 350	+ 650	+ 950

* of which calls on:						
- 10% Treasury 1990				+ 300		
- 9¾ Exchequer 1998				+ 347	+ 256	
- 10% Exchequer 1989 'A'					+ 111	+ 104
ϕ of which, buying in of:						
- 14% Exchequer 1984				- 165	- 500	
- 3% Exchequer 1984						- 200

SECRET(AND PERSONAL UNTIL 2.30 PM, THURSDAY 15 MARCH 1984)

Table E : Sterling lending to the private sector

£ million
Seasonally adjusted

	Actual			Forecast		
	DEC	JAN	FEB	MAR	APR	MAY
Adjusted lending	+1554	+ 425	+1224	+1300	+1300	+1300
Bills held by NBPS(-)	- 18	+ 204	+ 117	-	- 150	- 100
PSBR offset	+ 211	+ 625	- 559	+ 360	- 665	- 80
Other*	-	-	+ 250	+ 100	-	-
Actual/forecast recorded lending	+1747	+1254	+1032	+1760	+ 485	+1120
Centered 3-month moving average of adjusted lending	1180	1070	980	1275	1300	

* Borrowing by BAT o/a take-over of Eagle Star

3/2d

SECRET (AND PERSONAL UNTIL 2.30 PM, THURSDAY 15 MARCH 1984)

Table F: Money Market Influences

£ million
not seasonally adjusted

	Actual	Forecast		
	FEB	MAR	APR	MAY
A. Money market influences				
CGBR (increase +)	- 208	- 275	+ 3480	+1180
Reserves etc (+)	+ 47	-	- 105	- 50
Notes and coin (-)	- 37	- 100	- 520	- 55
National Savings (-)	- 315	- 290	- 230	- 245
CTDs (-)	+ 324	+ 10	- 90	- 90
Gilts (-)	- 1209	- 450	- 750	-1050
Other Exchequer items etc	+ 115	+ 290	- 290	-
TOTAL MONEY MARKET INFLUENCES (Market surplus + / shortage -)	- 1283	- 815	+1495	- 310
B. Money market operations				
Commercial bills (purchase +)				
- Issue Department	+ 522			
- Banking Department	+ 939			
LA bills (purchase +)				
- Issue Department	- 54			
- Banking Department	+ 91			
Treasury bills (purchase +)	- 17			
Market advances	- 31			
Other	-			
TOTAL MONEY MARKET OPERATIONS	+ 1450	+ 706	- 1495	+ 310
Change in bankers' balances	+ 167	- 109	-	-
TOTAL ASSISTANCE OUTSTANDING*	11, 447	12,153	10658	10968

* excluding Treasury bills

SECRET

TABLE G

	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb
TARGET AGGREGATES									
£M3 Monthly change (£ millions)	+1,611	+796	+157	-460	+1,415	+551	+1,326	+620	-16
Monthly % change	+1.7	+0.8	+0.2	-0.5	+1.4	+0.6	+1.3	+0.6	0
3-monthly % change A.R.	+16.9	+12.9	+11.1	+2.0	+4.6	+6.3	+14.1	+10.4	+7.9
6-monthly % change A.R.	+13.7	+13.6	+12.5	+9.2	+8.7	+8.7	+7.9	+7.5	+7.1
12-monthly % change	+11.7	+12.5	+11.5	+9.6	+9.6	+9.9	+10.8	+10.5	+9.7
% change since Feb-83 A.R.	+15.9	+14.7	+12.5	+9.7	+10.8	+10.4	+11.0	+10.7	+9.7
M1 Monthly change (£ millions)	+954	-153	+347	-82	+633	+250	+655	-84	+287
Monthly % change	+2.4	-0.4	+0.8	-0.2	+1.5	+0.6	+1.6	-0.2	+0.7
3-monthly % change A.R.	+22.0	+14.6	+11.9	+1.1	+9.1	+8.0	+15.8	+8.1	+8.4
6-monthly % change A.R.	+16.8	+13.8	+14.2	+11.0	+11.8	+9.9	+8.2	+8.6	+8.2
12-monthly % change	+15.9	+15.0	+13.8	+12.4	+11.2	+11.9	+12.4	+11.1	+11.1
% change since Feb-83 A.R.	+20.3	+14.9	+14.2	+11.6	+12.7	+12.1	+12.9	+11.4	+11.1
PSL2 Monthly change (£ millions)	+1,654	+1,362	+1,231	+257	+1,608	+662	+1,519	+1,863	+1,973
Monthly % change	+1.1	+0.9	+0.8	+0.2	+1.0	+0.4	+1.0	+1.1	+1.2
3-monthly % change A.R.	+16.0	+10.9	+11.3	+7.4	+8.0	+6.3	+9.8	+10.4	+13.9
6-monthly % change A.R.	17.4	+16.6	+14.7	+11.6	+9.4	+8.8	+8.6	+9.2	+10.1
12-monthly % change	+11.9	+13.0	+13.0	+12.0	+12.1	+12.3	+12.9	+12.8	+12.3
% change since Feb-83 A.R.	+17.0	+15.7	+14.7	+12.8	+12.7	+11.8	+11.9	+12.1	+12.3
Levels : £M3	97,526	98,300	98,420	98,020	99,430	100,000	101,540	102,180	102,180
M1	41,140	40,960	41,290	41,200	41,810	42,040	42,690	42,580	42,830
PSL2	158,265	159,573	160,742	161,034	162,623	163,232	165,005	166,864	168,827

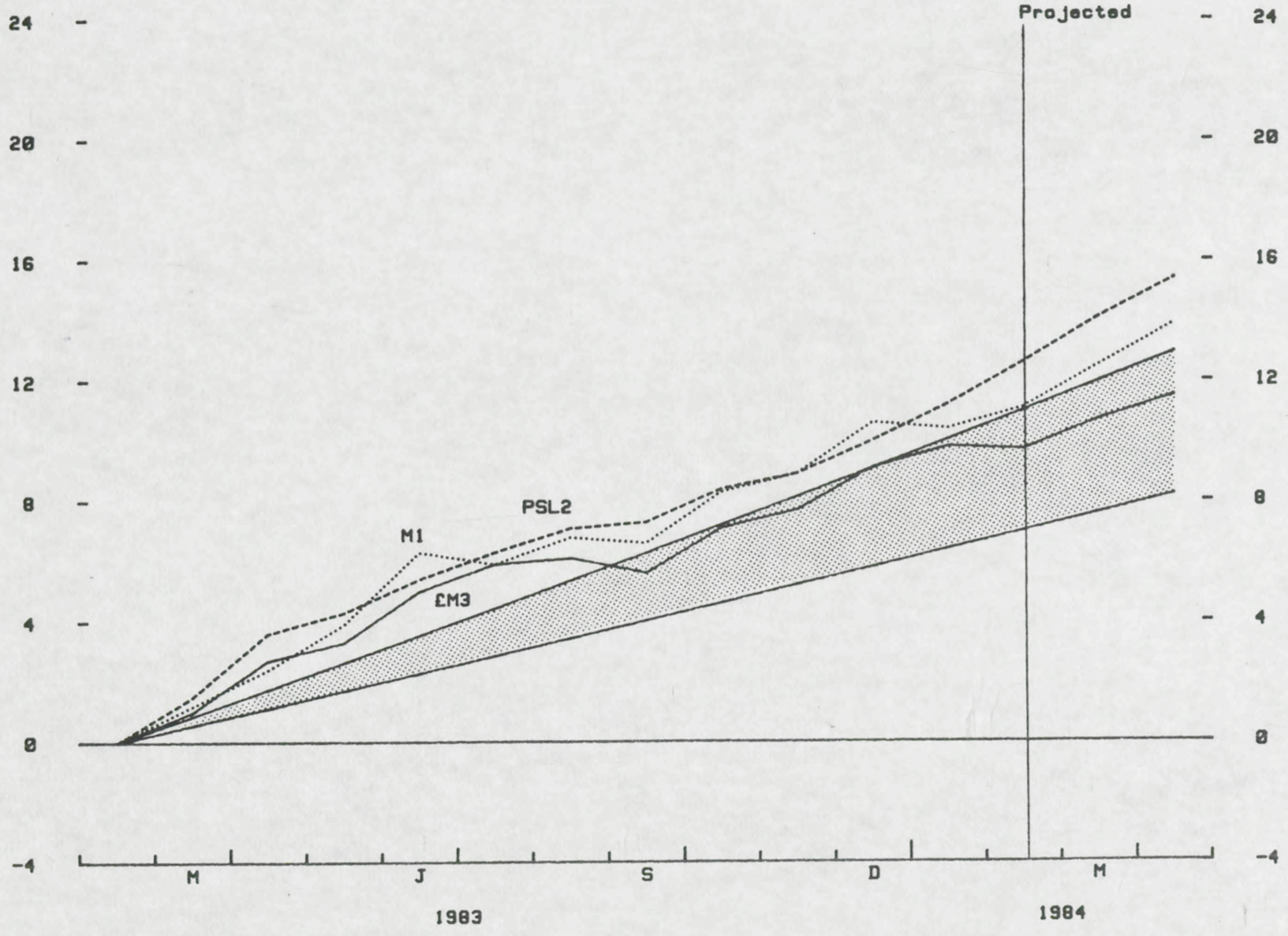
TABLE H

	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb
MO (AVERAGED WEEKLY)									
Monthly change (£ millions)	+97	-14	+37	+142	+73	+62	+46	+51	+20
Monthly % change	+0.8	-0.1	+0.3	+1.1	+0.6	+0.5	+0.4	+0.4	+0.2
Three monthly % change a.r.	+7.3	+3.3	+3.9	+5.3	+8.2	+9.0	+5.8	+5.1	+3.7
Six-monthly % change	+7.5	+5.5	+6.2	+6.3	+5.7	+6.4	+5.5	+6.6	+6.3
12-Monthly % change	+6.4	+6.3	+6.6	+6.5	+6.7	+6.4	+6.5	+6.0	+6.3
% change since February 1983 a.r.	+8.9	+6.6	+6.2	+7.3	+7.3	+7.1	+6.9	+6.7	+6.3
OTHER NARROW MEASURES									
NIB M1 Monthly change (£ millions)	+360	+365	+3	+271	+144	+121	+623	-428	+140
Monthly % change	+1.2	+1.2	-	+0.9	+0.5	+0.4	+2.0	-1.4	+0.5
3-monthly % change A.R.	+7.9	+11.7	+10.2	+8.8	+5.6	+7.3	+12.2	+4.2	+4.4
6-monthly % change A.R.	+8.0	+13.2	+10.4	+8.3	+8.6	+8.7	+10.5	+4.9	+5.8
12-monthly % change	+10.5	+10.7	+10.2	+9.1	+4.9	+8.2	+9.2	+9.0	+8.1
% change since Feb-83 A.R.	+11.8	+12.6	+10.4	+10.5	+9.9	+9.3	+11.0	+8.3	+8.1
M2 (NOT seasonally adjusted)									
MONTHLY CHANGES (£ MILLIONS)	+1,095	+1,095	-547	+84	708	+178	+3,124	+366	+36
LEVELS	112,291	113,386	112,839	112,943	113,651	113,829			
						....			
						114,587	117,997	116,394	118,429
MONTHLY % CHANGE	+1.0	+1.0	-0.5	+0.1	+0.6	+0.2	+2.7	+0.3	0
12 MONTHLY % CHANGE	+8.9	+8.6	+8.4	+8.0	+6.7	+7.2	+8.9	+9.4	+9.0

SECRET

TABLE I

OTHER WIDE MEASURES	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb
M3 Monthly change (£ millions)	+1,804	+1013	+157	-433	+1,978	+935	+2,661	+921	+657
Monthly % change	+1.7	+0.9	+0.1	-0.4	+1.8	+0.8	+2.3	+0.8	+0.6
3-monthly % change A.R.	+13.5	+12.1	+11.3	+2.7	+6.2	+9.2	+21.5	16.8	+15.6
6-monthly % change A.R.	+13.3	+14.0	+11.4	+7.9	+9.1	+10.2	+11.7	+11.4	+12.3
12-monthly % change	+13.1	+13.1	+12.4	+11.2	+11.1	+11.3	+12.5	+12.7	+11.8
% change since Feb-83 A.R.	+13.9	+13.4	+11.4	+8.9	+10.7	+10.6	+12.6	+12.3	+11.8
£M3 Excl Public Sector Deposits									
Monthly change (£ millions)	+1,276	+635	+434	-59	+1,218	+174	+1,435	+302	+106
Monthly % change	+1.4	+0.7	+0.5	-0.1	+1.3	+0.2	+1.5	+0.3	+0.1
Three monthly % change	+16.1	+10.8	+10.4	+4.5	+7.0	+5.7	+12.1	+8.2	+7.8
Six-monthly % change	+13.6	+13.6	+12.8	+10.0	+8.8	+8.0	+8.2	+7.5	+6.7
12-monthly % change	+11.2	+11.8	+11.2	+9.7	+10.0	+9.9	+10.9	+10.5	+9.7
% change since Feb-83 A.R.	+15.8	+14.3	+12.8	+10.7	+11.4	+10.3	+11.2	+10.5	+9.7
PSL1 Monthly change (£ millions)	+1,169	+444	+564	-183	+1,278	+166	+1,261	+159	-69
Monthly % change	+1.2	+0.4	+0.6	-0.2	+1.3	+0.2	+1.2	+0.2	-0.1
3-monthly % change A.R.	+16.2	+8.1	+9.2	+3.4	+6.8	+5.1	+11.3	+6.4	+5.5
6-monthly % change A.R.	+14.4	+14.1	+13.1	+9.6	+7.5	+7.1	+7.3	+6.6	+5.3
12-monthly % change	+10.7	+11.4	+10.8	+9.1	+9.4	+9.8	+10.8	+10.3	+9.1
% change since Feb-83 A.R.	+16.7	+14.4	+13.1	+10.8	+11.5	+10.4	+10.9	+10.1	+9.1
PSL2A Monthly change (£ millions)	+1,676	+1,493	+1,330	+798	+2,201	+1,032	+1,970	+2,113	+2,110
Monthly % change	+1.0	+0.8	+0.7	+0.4	+1.2	+0.6	+1.0	+1.1	+1.1
3-monthly % change A.R.	+14.4	+10.1	+10.7	+8.5	+10.1	+9.3	+11.9	+11.6	+14.1
6-monthly % change A.R.	+16.3	+15.3	+13.5	+11.4	+10.1	+10.0	+10.2	+10.8	+11.7
12-monthly % change	+13.8	+14.1	+13.7	+12.8	+12.8	+12.8	+13.2	+13.0	+12.6
% change since Feb-83 A.R.	+15.3	+14.4	+13.5	+12.3	+12.8	+12.1	+12.2	+12.4	+12.6


Monetary growth since mid February 1983
CHART A
Per cent
Seasonally adjusted
Projected
24
20
16
12
8
4
0
-4
PSL2
M1
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FMR (84)3
MARCH 1984

FINANCIAL MARKETS REPORT

Prepared by HF3 and EF(1)

The attached note reports on developments in the foreign exchange and domestic financial markets during the period banking and calendar February.

P WYNN OWEN
R BLOWER
D McSHARRY

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SUMMARY OF THE MARKETS IN BANKING AND CALENDAR FEBRUARY

(18 January to 29 February 1984 inclusive)

- The dollar fell sharply against most major currencies in February as concerns about the inflationary and balance of payments effects of high US budget deficits turned market sentiment. Sterling benefited from renewed fears over Middle East oil supplies, as well as the weaker dollar, rising in effective terms (though falling a little against the deutschemark).

- The money markets were bullish in the face of sterling's good showing but a number of adverse factors caused the gilts market to hold back.

- The FT index rose to a record high of 840.5 on 25 January but closed February some 4.1 points down on its 18 January level. The new FTSE 100-share index was launched, with a base date of 3 January.

- Total net issues by UK listed companies in calendar February were £41 million, which along with January represents a quiet start to 1984.

HF3/EF1 Divisions

8 March 1984

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Introduction

1. On the foreign exchange markets the dollar weakened sharply. Sterling strengthened against the dollar and in effective terms, but lost some ground against a generally firmer deutschemark. The money markets were bullish in the face of sterlings good showing, with a firm downwards trend in rates developing by the end of the period. The Gilts market was strong through the second half of calendar January, but fell into a deep sleep for most of February. The equity market's growth of recent months was also arrested during February, with relatively little activity on the capital issues front.

FOREIGN EXCHANGE MARKETS

Spot Sterling

2. Sterling was largely on the sidelines in the second half of January, trading fairly steadily against Continental currencies, while continuing to fluctuate against an erratic dollar. After closing at $1.4074, DM 3.9618 and 82.0 on 18 January, sterling ended the month on a slightly softer tone, $1.4033, DM 3.9513 and 81.8, after some heavy commercial selling on the 31st.

	$/£	DM/£	£ Effective
1 February (open)	1.4062	3.9359	81.7

3. Sterling began February firmer against a sharply weaker dollar, but failed to match gains made by the Continental currencies, in anticipation of a large commercial selling order against deutschemarks overhanging the market.

	$/£	DM/£	£ Effective
10 February (close)	1.4144	3.8740	81.4

4. During the period leading up to the 10th sterling traded generally softer, encountering widespread commercial selling on the 7th which also included the first part of the expected large commercial selling order against deutschemarks. Sterling's weaker tone against the Continental currencies persisted on the 8th, but a weakening of the dollar in New York later that day lifted the pound to a high point of $1.4205. However, the rate subsequently eased to a low £$1.4110 and a closing effective of 81.4 (its lowest closing level since last April) on the 10th following reports that OPEC might allow Nigeria to increase its output quota and sell at below official prices.

	$/£	DM/£	£ Effective
21 February (close)	1.4474	3.9102	82.7

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5. Sterling traded within a narrow range in the early part of the period between 11 and 21 February, but some sizeable commercial demand towards the close on 14th pushed the pound up to \$1.4220, DM 3.8899 and 81.8. However, after rising to \$1.4407 on the 15th, as the dollar weakened sharply, sterling began to ease, more so against European currencies following the completion of the final stage of the large commercial operation initiated earlier in the month. By the close sterling had eased to DM 3.8630, with the effective rate unchanged on the previous day's close. However, rumours on the 17th that Iran might try to close the Straits of Hormuz, boosted sterling to a sharply firmer close of \$1.4500, DM 3.8918 and 82.5. Renewed fears about oil supplies from the Persian Gulf caused a further sharp rise on the 21st with sterling touching highs of 82.8, \$1.4550 and DM 3.92 1/8 during the day.

29 February (close)	1.4915	3.8690	83.5

6. Persistent market sentiment towards a lower dollar and concern about the possible disruption to Middle East oil supplies continued to be the main factors underlying sterling's firmer tone in the period leading up to the end of the month. Rumours early on the 25th, subsequently denied, that Iraq had attacked the Iranian Kharg Island terminal, bolstered sterling to a high point of \$1.49½ and a noon effective of 83.5. As the dollar dropped sharply on the 29th, in reaction to the worse than expected US January trade deficit, sterling rose to the \$1.49½ level but was restrained from moving higher by some fairly heavy professional selling which emerged around the same time as the release of the UK January trade figures (£129 million current account deficit after a surplus of £568 in December). The main reason behind the selling however, was thought to be the absence of fresh news from the Middle East in previous days.

The dollar

7. The dollar traded erratically during the second half of January reflecting general uncertainty about the pace of the US recovery and the prospects of reducing high US budgets deficits. After closing at DM 2.7890 on the 18th, the dollar subsequently fluctuated between this level and DM 2.83 before closing the month at DM 2.8157.

8. Increasing uncertainty about the prospects for the dollar and emerging signs that investment funds were being switched from the US to European markets caused the dollar to ease sharply to below DM 2.76 at the start of February. However, subsequent release of the December FOMC minutes indicated that the Fed had voted in favour of a slight tightening of monetary policy, and with renewed tensions in Lebanon drawing attention to safe haven considerations, the dollar staged a brief recovery. But remarks by Volcker about the US budget and trade deficits caused a sharp decline (DM 2.7305 on the 9th) which was temporarily interrupted by rumours on the 10th that the Soviet leader Andropov had died.

However, profit-taking followed the official confirmation and the dollar resumed its eaiser tone. Failure to react to strong US economic indicators on the 14th and rumours, quickly denied, that President Reagan had died caused the dollar to fall sharply, closing in London the following day at DM 2.6907. The revised US Q4 GNP figures (+4.9 per cent from 4.5 per cent) and a $2½ billion rise in US M1 steadied the dollar on the 17th before news of escalating Middle East hostilities temporarily boosted it to high of DM 2.71½ on the 21st. But persistent bearish sentiment stemming from growing concern over the inflationary and balance of payments effects of high US budget deficits caused a series of sharp falls thereafter. The announcement of a record $9.47 billion US trade deficit in January caused the dollar to dip to low of 2.5875 on the 29th resulting in a loss of around 26 pfennigs since it reached a 10 year high of DM 2.85 on 10 January and its lowest closing level since last October.

Other currencies

9. Within the EMS the Belgian franc remained firmly established as the weakest currency, despite increases in their discount and Lombard rates by 1 per cent to 11 per cent and 12 per cent respectively. The deutschemark rose to the top of the narrow band which was fully stretched for most of the month, as pressures mounted on other currencies. The Yen traded largely on the sidelines throughout February, benefiting little from the weaker dollar.

THE DOMESTIC MARKETS

Money Markets

10. The markets continued the quiet period begun in January until well into banking February. However, as the end of calendar February approached, a strengthening in sterling against the US dollar prompted speculation that a fall in clearing banks base rates might be imminent.

11. Money rates had started banking February at $9^3/8$ and $9^{15}/16$ for 3 and 12 month Interbank rates respectively but by 2 March they had fallen to $9^1/16$ and $9^5/16$ which dealers said discounted an 8½ per cent base rate. Eligible bill rates have remained close to the Bank's dealing rates throughout due to large market shortages effectively making the bank the market maker in the money market.

12. Money market shortages averaged £430 million during banking February with new assistance totalling £1450 million during the month bringing the total stock of market assistance outstanding to £11,447 million, a little down on the peak of about 11.6 billion in

mid-calendar February. The main influences taking money out of the market were funding, which accounted for £1.2 billion and £200 million of seasonal surpluses in the CGBR. A decrease in the note issue returned £315 million to the market.

The Gilts Market

13. The gilts market was not in very buoyant form for much of the period under review. Gross sales amounted to £1.2 billion in the six weeks between January 19 and 29 February inclusive, over half of which was sold before the announcement of 9¾ per cent Exchequer 1998 on Friday 3 February. The rest of calendar February saw about £100 million of new sales alongside payment of a large call on the 10 per cent Treasury Convertible 1990.

14. Banking February began on January 19 with the £1 billion of the new 10 per cent Treasury 1990, convertible at various points during the next three years into 9½ per cent Conversion stock 2004, fully allotted above the minimum tender price at issue with 20 per cent initial payment (£200 million was also issued to NILO). This success, and the ongoing firmness in the market, led the Authorities to follow this up on Tuesday 24 January with the announcement of three new tranchettes to replenish the Issue Department's Stock - one short, a medium and a 1999 medium-long gilt. By the end of calendar January the latter had sold out with half the 9 per cent Treasury 1992-96 stock also absorbed and by mid-morning on Friday 3 February the whole package was exhausted. At close that afternoon the Authorities announced the issue (by tender at a minimum price of 94½) the following Wednesday of £1 billion of 9¾ per cent Exchequer 1998, technically still a medium though the longest conventional tap stock to the launched for over three years. The market reacted badly to this announcement, exhibiting doubts about the pricing of the new stock and its maturity, which combined to make it look rather aggressive to some commentators.

RECENT GILTS ISSUES

	Stock	Date Announced	Issue Price	Gross Yield to Redemption	£m Total amount
10%	Treasury Convertible 1990	13/1	96	10.90	1200
9½%	Treasury 1988	24/1	95¼	10.82	250
9%	Treasury 1992-96	24/1	93½	10.48	150
9½%	Treasury 1999	24/1	94	10.35	100
9¾%	Exchequer 1998	3/2	94½	10.51	1000

15. The subsequent fall in the gilts market on Monday 6 and Tuesday 7, combined with the gloomy noises from Mr Volcker in the US, conspired to make the minimum price look rather

high by the Wednesday. The Issue Department took up £896 million of the new stock and the market fell into a long and fruitless torpor. Some £433 million of a call on the 10 per cent Treasury Convertible 1990 was received by the Authorities on 13 February.

16. The gilts market was only stirred from its lethargy at twenty minutes past five on the evening of Thursday 23, when the Inland Revenue announced that it had written to the Building Societies Association to say that, following legal advice they proposed to tax building societies' profits from realisations of gilt edged stock as trading income rather than as capital gains. In the next few hours building societies disposed of several hundred pounds worth of low coupon shorts so as to try to avoid the new rules. Prices opened well down on Friday 24, with some shorts £2 or more off. During the day the Bank arranged a £200 million swap of low coupon shorts in exchange for the 9¾ per cent Exchequer 1988, so as to check the fall in prices. By Monday 27, the market had regained its nerve, however, and some cheap buying of low coupons began to occur which has resulted in about a £2 fall in their average price. By the end of the month the market was showing distinctively bullish signs, except at the short low coupon end, and £409 million nominal of the 9¾ per cent Exchequer 1998 was sold in the last two days.

17. Gilt yields (see Annex) firmed a little in the second half of calendar January. They fell by over ¼ at the short end over the first three weeks of calendar February, while remaining fairly steady at the medium and long end. The building societies furore pushed average short yields up by over ¼, but these had fallen back again by the 29 February to close below their levels at the start of the period. Short low-coupon yields, however, have slipped by about ¾ and stayed there. Only long yields rose fairly consistently over the period, closing 1/8 up on their mid-January level. From 17 February Mullens (and therefore the Bank) had begun to quote index-linked gilt yields on a new, standard basis. As interest in IGs continued to wane over the period yields rose a little.

Gilts Futures

18. The 20 year gilt futures contract on the LIFFE (London International Financial Futures Exchange) market continued to follow the fortunes of the conventional markets closely with total turnover only around 3024 contracts on average per day underlining the immaturity of the market. The March price started and finished the month at around 109(£) with a minor dip to below 108 on 7-9 February due to the prevailing quietness in the conventional market.

Equity Market

19. Over the period as a whole the 30-share index has fallen by 4.1 to 819.8, having closed at a record high of 840.5 on 25 January.

20. The FTSE ("footsie") 100-share index has been introduced with a base date of 3 January (1,000.0). This index is not perfectly representative of the whole market, having 18 per cent of its value represented by oil shares. On 19 January the 100-share index stood at 1,058.1; on 29 February it stood at 1,040.3 having recorded a high in the period of 1,075.9 on 27 January.

21. The market began the period encouraged by optimism on economic recovery; the 30-share index closed at a new high of 826.9 on 20 January.

22. The market continued to advance storngly during the following week beginning 23 January with US demand for Bowater, Hawker Siddeley and ICI. The market traded cose to these record levels for the next seven trading sessions until sentiment was unsettled by large falls on Wall Street. On 6 and 7 February the index registered a two-day fall of 32.7 (-4 per cent) to 799.7. By the end of that week the market had steadied with the index closing at 805.4 on 10 February.

23. A firmer tone was seen over the fortnight beginning 13 February with demand for ICI in advance of their figures on 23 February. Clearing banks advanced prior to their dividend season. Commercial Union's poor results on 22 February did not affect insurances generally although life offices reacted nervously on 24 February following the announcement of the new building society tax treatment. On 24 February the index closed at 815.8.

24. The market was subdued for the first three days of the week beginning 27 February with openings reflecting closes on Wall Street. Wednesday, 29 February saw financial sectors weaker with reported concern over possible taxation changes. The index closed at 819.8.

Capital Issues

25. Total net issues by UK listed companies for calendar February were £41 million, compared with £63 million a year ago. Gross issues by industrial and commercial companies were £31 million, which included a £15 million rights issue by Sketchley and £5 million by Ellis and Everard. An £11 million placing of loan stock was the largest of three issues made by financial companies while three overseas bodies also made loan stock issues - Asian Development Bank £22 million (first instalment of an £88 million offer); Province of Quebec £12 million (first instalment of £49 million placing) and Commonwealth of Australia £72 million (last and major tranche of a £96 million offer). There were eleven newcomers to the Unlisted Securities Market, two of which made rights issues, the largest of which, Micro Focus, raised £9 million.

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COVERING SECRET

	Band 1 (0-14 days)	Band 2 (15-33 days)	Band 3 (34-63 days)	Band 4 (64-91 days)
Dealing Rates (unchanged since 4 October)	$9^{1}/16$	9	$8^{15}/16$	$8^{7}/8$

Eligible Bill Rates	**Band 1**	**Band 2**	**Band 3**	**Band 4**
January 19	$9^{1}/16$	9	$8^{15}/16$	$8^{7}/8$
February 2	$9^{1}/32$	9	$8^{15}/16$	$8^{7}/8$
February 17	$9^{1}/32$	$8^{63}/64$	$8^{59}/64$	$8^{55}/64$
February 29	$9^{1}/16$	9	$8^{55}/64$	$8^{55}/64$

Interbank rates

	7 days	1 month	3 months	12 months
January 19	9.19	9.25	9.38	9.94
February 12	9.19	9.19	9.38	9.88
February 17	9.19	9.25	9.38	9.81
February 29	9.13	9.19	9.19	9.50
Eurodollar rates				
January 19	9.50	9.56	9.75	10.31
February 2	9.56	9.56	9.75	10.25
February 17	9.75	9.81	10.00	10.63
February 29	9.69	9.75	10.13	10.81

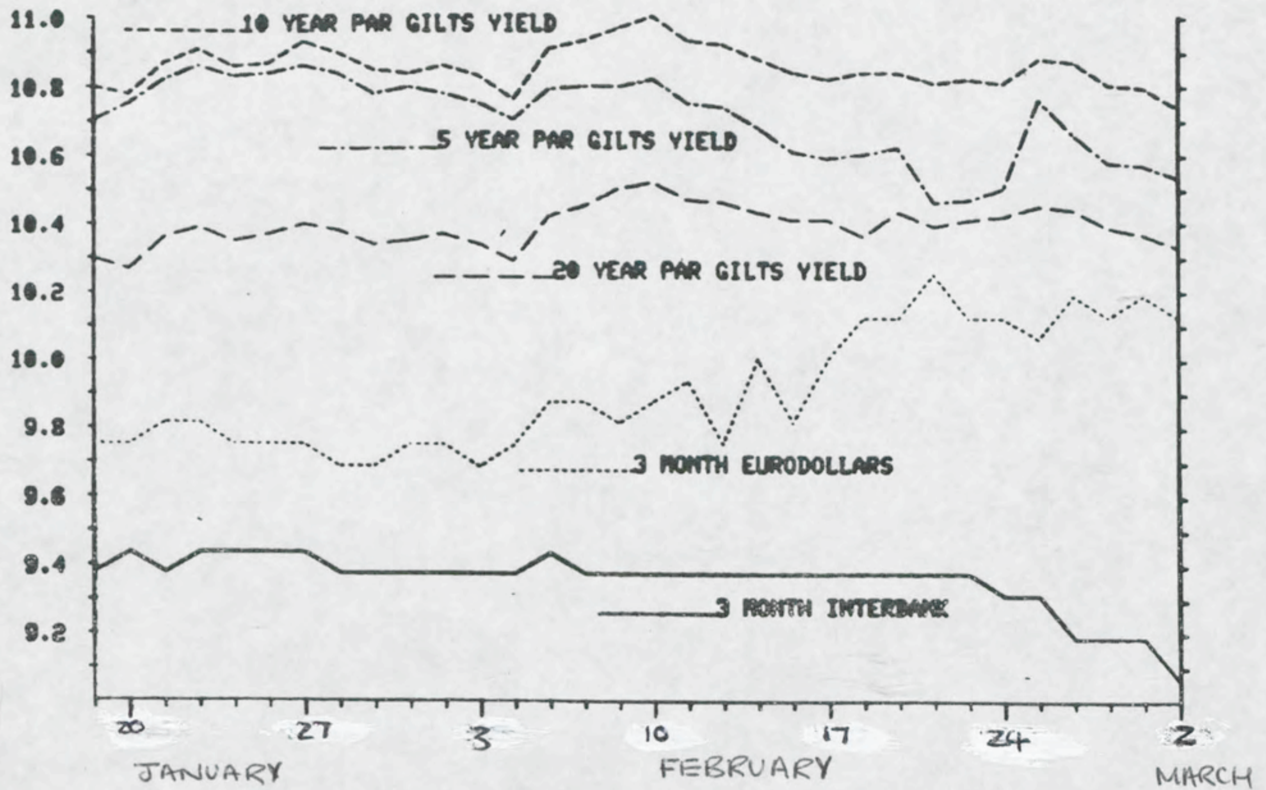
International Comparisons Closest analogies to 3 month interbank rates:

Week ended	USA	Germany	Average 6 leading OECD (barring UK)
January 21	9.25	6.10	10.34
February Feb 4	9.30	6.15	10.31
February Feb 18	9.45	6.03	10.33
February Feb 25	9.65	5.85	10.24

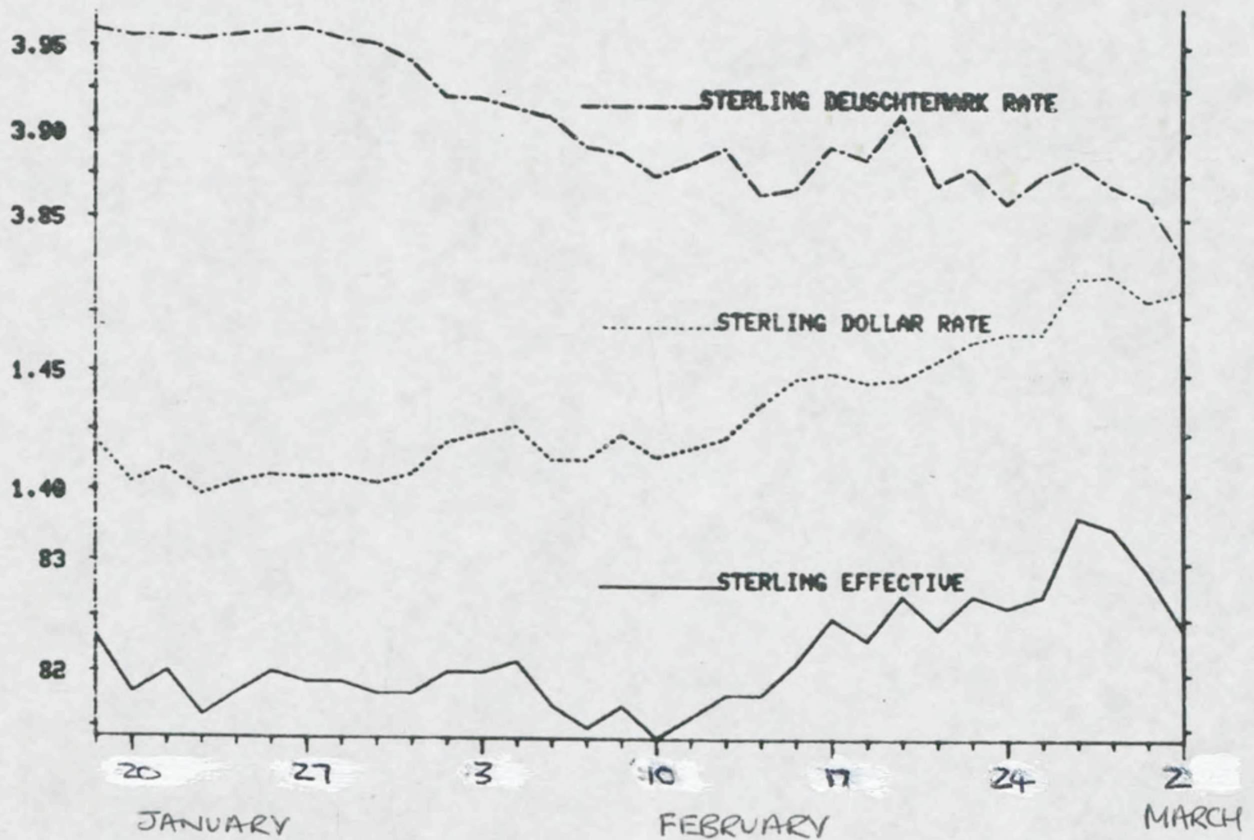
				IG Yields	
Gilt Yield curves	**5 year**	**10 year**	**20 year**	**2% 1988**	**2½% 2011**
January 19	10.733	10.753	10.263	3.80	3.09
February 2	10.779	10.855	10.365	3.91	3.12
February 17	10.586	10.818	10.406	3.89*	3.13*
February 22	10.457	10.807	10.392	3.82*	3.14*
February 27	10.764	10.882	10.453	4.12*	3.20*
February 29	10.580	10.805	10.387	4.24*	3.22*

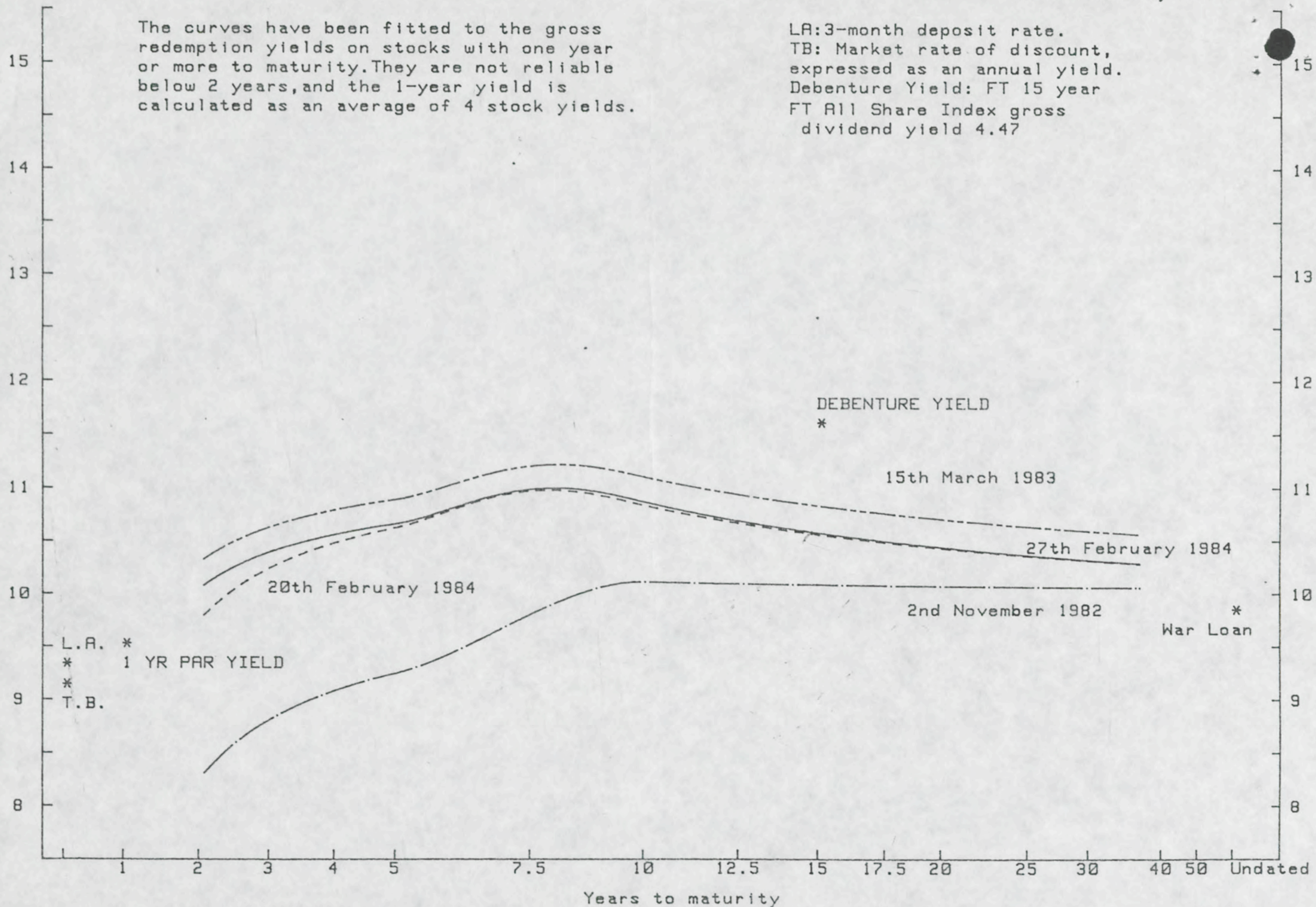
*New Mullens IG Yield method

INTEREST RATES 19 JAN 84 TO 2 MAR 84



EXCHANGE RATE 19 JAN 84 TO 2 MAR 84





Per cent
Time / Yield Curves of British Government Stocks
28th February 1984
The curves have been fitted to the gross redemption yields on stocks with one year or more to maturity. They are not reliable below 2 years, and the 1-year yield is calculated as an average of 4 stock yields.
LA: 3-month deposit rate.
TB: Market rate of discount, expressed as an annual yield.
Debenture Yield: FT 15 year
FT All Share Index gross dividend yield 4.47
15
14
13
12
11
10
9
8
DEBENTURE YIELD
15th March 1983
27th February 1984
20th February 1984
2nd November 1982
War Loan
L.A.
1 YR PAR YIELD
T.B.
1
2
3
4
5
7.5
10
12.5
15
17.5
20
25
30
40
50
Undated
Years to maturity

(2)

AT 22/2

22 February 1984
Policy Unit

PRIME MINISTER

STOCK EXCHANGE COMMISSIONS

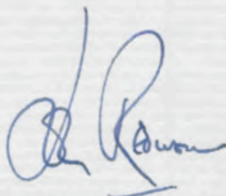
The decision by the Stock Exchange on commission scales is good news.

On 9 April, commissions on overseas securities will be negotiated rather than fixed. At the same time, gilt-edged commissions will fall, by an average of around 12 per cent on medium- and long-dated stocks. For the big buyers of longs, the reduction could be more than 20 per cent. There will be further reductions later.

Equity commissions will be negotiated from the autumn of 1985, and all the adjustment will take place at one date.

The outcome is a political triumph. Competition has worked. As a result, users will now pay less for the service. At the same time, because the Government has stood aloof from the fray, the stockbroking community is not blaming the Government for the reduction in the easy income they have enjoyed from commissions on Government securities. The Stock Exchange itself has taken the decision and the animosity over such a sensitive subject is being directed between different factions within the Stock Exchange.

It is a great advance that brokers and banks will now have to compete on price as well as on service, and this could be used as an example in speeches of the way in which Government can give a gentle nudge in favour of better practice.



JOHN REDWOOD

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21 February 1984
Policy Unit

PRIME MINISTER

FUNDING

I attended the Funding meeting today.

The meeting agreed that the National Savings target for 1984-5 would be raised from £3 billion to £3.5 billion. The actual increase over this year is likely to be less than £0.5 billion, as this year will probably see some overshoot of the funding target.

The meeting reviewed recent progress with gilt-edged funding. A reasonable level of sales has been maintained, but the Bank of England decided that it had to issue a longer stock in order to maintain the momentum, and persuaded the Economic Secretary of this view between Funding meetings. The resulting stock, £1,000 million Exchequer 9.75 per cent 1998, flopped. The market was worried that the stock was wrongly priced, and took it as a sign of weakness. Investors felt it meant that the Government wished to over-fund in order to offset too rapid a growth in bank lending, and took it as a major reversal of the longstanding policy of not funding in the long end of the market.

At previous meetings, the Bank had been warned that this was a strong possibility, and that the very instrument which they thought would sell well would jeopardise their market operations. They are now arguing that it is inappropriate to introduce a new short-dated stock until sales of the longer gilt build up some momentum: so far, they have sold practically nothing.

I suggested at the meeting that the moral of this tale was that they should now avoid any further major long-medium or long-dated tap stock, and should attempt to win the market's confidence back through a mixture of short stocks, index-linked and possibly convertibles. The Bank seemed somewhat chastened by the experience, and admitted that they now did not wish to go ahead with a major long-dated issue programme. The problem of "re-entry" into the longer-dated market is still one which they have on their mind, and I am sure they will return to the charge when they have recovered their balance.

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The dollar is at last falling and the pound is making some progress. This is a welcome sign. The large dollar deficits on both trade and government accounts at last seem to be having an impact, and this offers a modest respite for us.

JOHN REDWOOD

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SECRET (AND PERSONAL UNTIL 2.30 PM THURSDAY 16 FEBRUARY)

MONTHLY MONETARY REPORT: JANUARY-APRIL

SUMMARY

The main points from this month's note are:-

- this month's slower growth brings £M3 within the target range. All the target aggregates have risen by less than 10 per cent over the last six months. The growth of M0 has fallen slightly; the apparent acceleration in M2 reflects a revision to the December outturn to include some reclassified building societies' accounts

- over the next three months, £M3 is expected to stay at the top of the target range: PSL2 may continue to grow a little faster. But six month growth rates could rise sharply in February and March, as the period of slow growth in the late Summer enters the base. The projected growth in M0 is in line with the trend over the target period so far

- building societies' inflows were an all-time record in January, boosted by movements out of offshore funds. This is unlikely to be repeated, but inflows and mortgage demand should remain strong. No change in mortgage rate is expected. Building societies were probably heavy buyers of gilts in 1983 H2, reducing £M3 (but not PSL2)

- sterling lending to the private sector was unexpectedly low last month. But the evidence still points to some acceleration in the underlying trend since the Autumn. The forecast for underlying lending has not been changed, but recorded lending may be erratic, reflecting an uneven PSBR

- in seasonally adjusted terms, the PSBR is expected to be high in February and April, broadly flat in March. In unadjusted terms the PSBR should be in surplus until April

- the National Savings target for 1983-84 looks like being met. Even assuming gross gilts sales of £1¼ billion a month, the seasonally adjusted 'PSBR' may be underfunded over the three months as a whole. But the unadjusted figures imply a £2billion rise in the stock of money market assistance between mid-January and mid-March, to reach perhaps £12 billion. The money market position should ease significantly in April.

HF3
FEBRUARY 1984

MONTHLY MONETARY REPORT: JANUARY-APRIL

Monetary Aggregates

As expected, monetary growth moderated in January, following sharp rises in all the target aggregates in banking December. This month's figures bring £M3 just inside the target range, and M1 to within ½ per cent of the top, but leave PSL2's growth since mid-February 1983 virtually unchanged. Six-month growth rates still show some slackening in growth since the Summer, though the growth in broad money has been higher over the past three months. Among the other aggregates, the growth of M0 has, if anything, fallen recently. The apparent acceleration in M2 largely reflects a reclassification of building society accounts on 1 December.

Table 1: Main Aggregates: recent experience

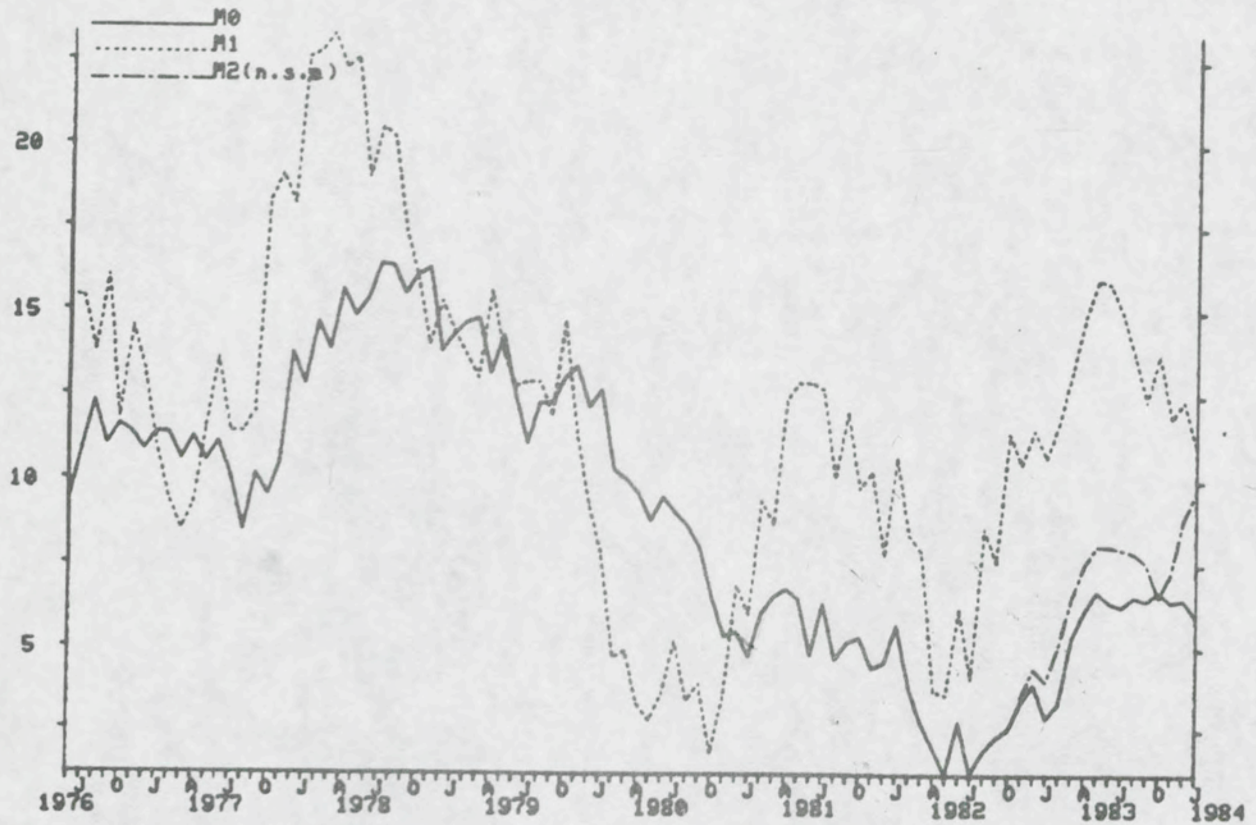
(per cent, seasonally adjusted)

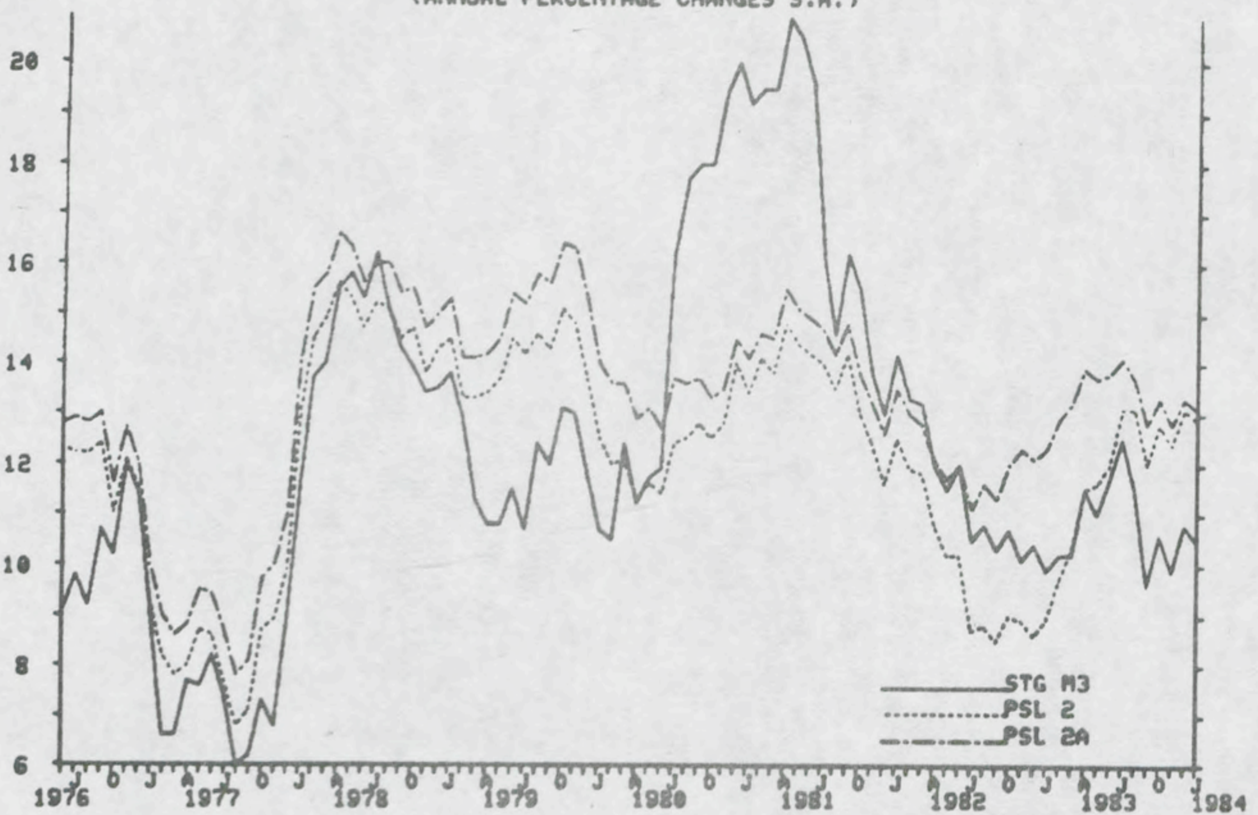
	M1	£M3	PSL2	M0 End Month	M0 Weekly Averaged	M2*
monthly change:-						
December	+1.6	+1.3	+1.0	-	+0.4	+2.7
January	-0.2	+0.6	+1.1	-0.4	+0.4	+0.3
growth at an annual rate over past:-						
3 months	8.1	10.4	10.7	2.6	5.1	[13.6]
6 months	8.6	7.5	9.4	4.9	6.6	[7.0]
target period (11 months)	11.4	10.7	12.2	5.6	6.7	[10.0]
12 months	11.1	10.5	12.9	5.7	6.0	9.7

* not seasonally adjusted

Full details of the growth in all the main aggregates are given in the Annex. Chart 1 shows the recent path of year-on-year changes for both broad and narrow measures of money.

CHART 1





2. The slowdown in the end-month series for M0 is exaggerated by make-up day falls in bankers' balances in the last two months. The main influence on the weekly averaged series has been the behaviour of notes and coin, which have been virtually flat since November; the target period growth rate in notes and coin is now only 5 per cent. Recent changes in non-interest bearing sight deposits have been notably erratic; this month's sharp fall follows an even larger rise last month. But since there were similar movements this time last year, the 12-month growth has remained fairly steady, at around 9 per cent (compared with about 10½-11 per cent in the first half of the target period). There has been a large revision to the December outturn for M2, to incorporate some building society accounts whose terms have changed, thus bringing them within the present definition of M2; this reclassification has added 1¼ per cent to the year-on-year growth rate.

3. During the last six months, £M3 has generally been the slowest growing measure of broad money (the proposed redefinition makes little significant difference to growth over the target period). Foreign currency deposits have been rising strongly since October, reflecting both transactions and valuation changes; with another rise of nearly £0.4 billion in January, the three month growth in total M3 is now about 17 per cent, bringing the change since mid-February to 12½ per cent. As in recent months, the faster rise in PSL2 principally reflects high inflows into building societies; the January inflow was an all time record, probably boosted by movements out of offshore roll-up funds.

4. The public sector's contribution to £M3 has been contractionary in five out of the last six months; in January high inflows into Government debt exceeded the unusually low (seasonally adjusted) 'PSBR' by about £1½ billion. But the evidence suggests some underlying acceleration in sterling lending to the private sector. Seasonal adjustment has been particularly difficult over the Christmas period, and the (low) January and (high) December figures need to be taken together. More tentatively, the private sector's borrowing from the UK monetary sector may have been temporarily depressed last month by exceptionally high balance of payments inflows (the externals were a massive £1.3 billion), possibly associated with large current account surpluses, especially in calendar December.

5. Over the next three months, £M3 is expected to be around the top of the target range, averaging around 1 per cent a month. PSL2 may continue to grow slightly faster. Building societies inflows show no signs of falling off, though the January figure is unlikely to be repeated. Last month's forecast for an underlying growth in bank lending of around £1.3 billion a month still looks plausible, despite the unexpectedly low January outturn. On the view that the slower growth in MO in the last few months does not signal a change in trend, we continue to project monthly growth in the range ½-¾ per cent a month; the end-month series will almost certainly move more erratically than the weekly averaged series, but there is no reason to expect the two series to diverge systematically.[I]

6. Over the next few months, six-month growth rates for £M3 will be influenced by the sharp slowdown in growth that took place in the late Summer. If £M3 grows at a steady 1 per cent a month, annualised six-month rates will rise to 9 per cent and 12 per cent in February and March respectively.

Table 2: Summary of the Forecast

percentage changes

	MO	M1	£M3	PSL2
monthly change:				
February	½ to ¾	1¼	1	1½
March	per cent	per cent	1	1¼
April	a month	a month	1	1¼
growth at an annual rate:				
mid-Jan - mid-Apr	6¼ to 9½	16	12½	17¾
Target period				
to mid-Feb	5½ to 6 *	11¾	10¾	12¾
to mid-Apr	5¾ to 6½*	12½	11	13¼

* Growth rates apply to end-month MO. Comparable figures for weekly averaged MO over the target period are: 6½-7 (to mid-February) and 6½-7¼ (to mid-April)

[I] The introduction of CHAPS on 9 February may in time allow banks to economise on operational balances. But this is not expected to happen in the near future.

Public Sector Borrowing

7. Over the next three months the 'PSBR' is expected to total £3½ billion, in seasonally adjusted terms, and some £3 billion, unadjusted; on both bases the time profile is extremely uneven. There is a big difference in February, which is expected to show a small unadjusted surplus, but a large deficit after seasonal adjustment. Both sets of figures point to a broadly flat position in March, and heavy borrowing (especially in unadjusted terms) in April. While the unadjusted picture for March and April is remarkably similar to the outturns for the same months last year, especially on the CGBR(O), the seasonally adjusted path is very much more uneven this year.

8. It would be wrong to put too much weight on seasonally adjusted figures at this time of the year; the present adjustments are based on forecasts, and will be revised in the light of the outturns as part of the annual update (May). We are already aware of a discrepancy between the latest PRT forecasts (used to construct the unadjusted figures) and the older forecasts implicit in the seasonals. If the latest forecasts turn out to be right, the recorded figures in March for both the 'PSBR' and (to a much lesser extent) £M3 will understate the true position; the corollary is that the seasonally adjusted figures we now have for recent months may turn out to be an overstatement.

9. The forecasts are derived from the latest calendar month PSBR profiles (which, at this time of year, tend to be updated ahead of the NIF). The only significant receipts from asset sales are £175m for Cable and Wireless in banking March. The assumed £½ billion EC refund has its main effect in April. On lending to the rest of the public sector is forecast to total £1½ billion over the next three months, slightly below the total for the comparable period last year: the implied total for the year to mid April is £5 billion. Local authorities borrowing from central government has been running at a high level since the last week of banking January, and it is expected to exceed the LABR over the forecast period. Table 3 (over page) summarises the outlook for the next three months.

Table 3: Public Sector Borrowing

£bn s.a.

	mid-April - mid-January	mid-January - mid-April	mid-April - mid-April
CGBR	+ 9.9	+ 4.2	+14.1
own account	+ 6.6	+ 2.6	+ 9.2
on-lending	+ 3.3	+ 1.6	+ 4.9
'PSBR'*	+ 8.2	+ 3.5	+11.7

* PSBR less non-bank private sector transactions in other public sector debt

Debt Sales

(a) Gilts

10. Table 4 compares the January outturn with performance over the nine months since mid-April 1983, and summarises the forecast for the next three months.

Table 4: Gilt Sales

monthly averages £m

	Banking January	mid-April 83 - mid-January	mid-January - mid April 84
Gross sales	1347	1345	1250
Redemptions	- 296	- 147	- 257
Next Maturities	- 239	- 159	- 127
Net sales	812	1040	866
of which:			
Monetary sector	- 90	50	22
Public corporations	-	-	-
Overseas	164	75	92
Non-bank private sector	738	915	753

11. Gross sales in banking January totalled almost £1,350 million, compared with a target of £1,250 million. This was a considerable

achievement given that only about £270 million of calls were tied up before the month began. Three main types of instrument dominated our sales - the £500 million of medium-dated tranchettes issued early in calendar December, which sold out at the beginning of the banking month; the package of £300 million low coupon conventionals and £300 million of a new 1990 IG issued over the Christmas break; and at the end of the month the 10% Treasury 1990 convertible into 9½% conversion stock 2004 which was more than fully subscribed. (A full account of gilt operations and yields is given in this month's Financial Markets report). Heavy redemptions and buying-in reduced net sales to about £810 million. But, as forecast, the monetary sector was once again a modest seller of gilts, bringing sales to UK non-banks and to overseas sectors to £900 million, quite close to the monthly average for the year so far.

12. Building societies have probably been heavy buyers of gilts over the past six months, contributing to the slower growth of £M3 (though with no effect on PSL2). The societies were very modest net sellers of gilts in the first half of 1983 but, as their liquidity recovered, they made £640 million of net gilt purchases in 1983 Q3 (a record for any one quarter). The fourth quarter probably saw further high purchases (though there are no reliable figures yet). This would be consistent with our success in funding heavily through shorter stocks and convertibles with a short first leg.

13. The gross sales target for banking February is £1,250 million (and more if possible). Gross sales already achieved and known future calls have brought us to within £75 million of the target. The major contribution to sales this month has come from the £500 million of short-medium tranchettes issued towards the end of January, further demand for low coupon stocks, and a large call on the 1990 convertible sold in the previous month. The response to the 9¼% Exchequer 1998 stock was disappointing after US developments brought the market down, leaving the minimum tender price high and dry.

14. In the absence of significant redemptions or buying in this month, we are expecting substantial net sales of over £1,200 million and sales to UK non-banks of over £1 billion. Banking March is rather

different because £800 million of redemptions and buying-in heavily offset the assumed gross sales of £1,250 million, and funding to UK non-banks may be below £500 million. These offsets should be smaller in April; the gross sales target is again assumed to be £1¼ billion.

(b) National Savings

15. As expected, inflows in banking January were high, helped by special factors such as the crediting of the 3 per cent supplement on holdings of over £500 in the NSB ordinary account and, maybe, some switching from offshore roll-up funds. Income bonds, which have been heavily advertised, and the 26th issue of conventional certificates together accounted for about 90 per cent of net transactions (excluding interest credited). Outflows from index-linked certificates declined to a trickle around the turn of the year, but have since resumed, possibly on increased expectations of low inflation over the next year. The NSB investment account, which is inside PSL2, has also been attracting moderate net inflows, particularly since January 1st when the introduction of daily logging effectively increased the liquidity of the instrument without a compensating interest rate cut.

16. Over the next three banking months, the income bond is expected to continue to fund at a rate of £25-£30 million per week, while net outflows from index-linked certificates are forecast to settle down to a rate of about £12 million a week. During February and to a lesser extent March, net sales of conventional certificates are likely to be depressed as about £200 million of 18th issue certificates reach maturity. The loss to National Savings is likely to be considerably less; on past form only a proportion will be redeemed on maturity and, of those that are, a significant proportion will be reinvested in the existing 26th issue, which remains attractive, or other National Savings instruments.

17. Total DNS funding may average around £250 million a month over the next three months - total funding during the financial year to mid-January was £2,460 million (seasonally adjusted), and the forecast implies that the £3 billion target will be just met, as it was in 1982-83. But any outturn between £2,900 and £3,100 is still quite possible, and outcomes outside that range cannot be entirely ruled out.

(c) Certificates of Tax Deposits

18. CTDs have made a net contribution to funding in every month but one since banking September, totalling about £235 million in the past five banking months, of which about £70 million came in banking January. This has been achieved despite heavy surrenders of series 5 CTDs. On the assumption that we continue to set rates fairly aggressively, gross inflows should stay high. The forecast is for net purchases (sa) in each of the next three months, despite further high surrenders.

Funding and the PSBR

19. Table 5 shows the funding position (on both the conventional and alternative presentations) over the target period and "financial year" to date, together with the forecast for the next three months. As expected, the PSBR was heavily overfunded in banking January (£1½ billion). Although the (seasonally adjusted) 'PSBR' is forecast to be underfunded by about £½ billion over the next three months, this would still be consistent with overfunding of nearly £2 billion over the twelve months to mid-April, (or about £3 billion including the external finance of the public sector). In unadjusted terms the 'PSBR' is forecast to be overfunded in both February and March, but substantially underfunded in April.

Table 5: The 'PSBR' and the Funding Position

£billions, seasonally adjusted
(figures in brackets are unadjusted)

	mid-Feb-mid-Jan (target period)	mid-April - mid-Jan	mid-Jan - mid-Apr	mid-April - mid-Apr
'PSBR'	11.0	8.2	3.5	11.7
Debt sales to NBPS(-)	-11.1	-10.5	-3.1	-13.6
of which:				
Gilts	- 8.4	- 8.2	-2.3	-10.5
National Savings	- 2.7	- 2.4	-0.7	- 3.1
CTDs	-	0.1	-0.1	-
Over(-)Underfunding(+)	- 0.1(0.6)	- 2.3(-2.2)	0.4(0.1)	-1.9(-2.1)
External finance of public sector (-)	- 1.0	- 0.7	-0.3	- 1.0
Funding (alternative definition)	- 1.1	- 3.0	0.1	- 2.9

Money Market Influences

20. Total money market influences were contractionary by over £1½ billion in banking January, reflecting mainly the large unadjusted CGBR surplus. The total volume of eligible commercial bills rose by nearly £¾ billion during the month, and those in official hands by £1½ billion, taking the outstanding stock of assistance to almost £10 billion. Issue Department's holdings of commercial bills alone totalled £8.8 billion on make-up day, the highest end-month figure yet recorded. As a consequence, Issue Department's ways and means advances were run down, and the NLF has deposited surplus balances with Banking Department on a number of occasions since 20 January.

21. The stock of money market assistance is projected to rise by a further £2 billion over the next two months. The main influences are seasonally low CGBR's, in February and March, and high net official sales of gilts, especially in February. In banking April the money market position should ease significantly as the CGBR swings back into heavy deficit.

Lending to the Private Sector

22. Both recorded and underlying lending were unexpectedly low in banking January, following the erratically sharp jump in December. On a longer view, however, the evidence is still consistent with the monthly projection of underlying lending of £1.3 billion made a month ago, since the upward revision to the forecast looked, at the time, a rather cautious one. Table 6 compares recent actuals with two indicators of the underlying trend. The first, a simple six month moving average of the actuals, clearly points to some acceleration in the trend since the summer (see also chart 2). The second is a six month moving average of what we normally mean by "underlying lending", ie. the recorded figure adjusted for erratic movements in the PSBR.(Chart 3 illustrates the marked past correlation between abnormally high PSBR's and low recorded lending figures). This measure suggests that at least some of the apparent acceleration in lending may have been induced by the profile of the PSBR through the year.

CHART 2 **RECORDED STERLING LENDING**

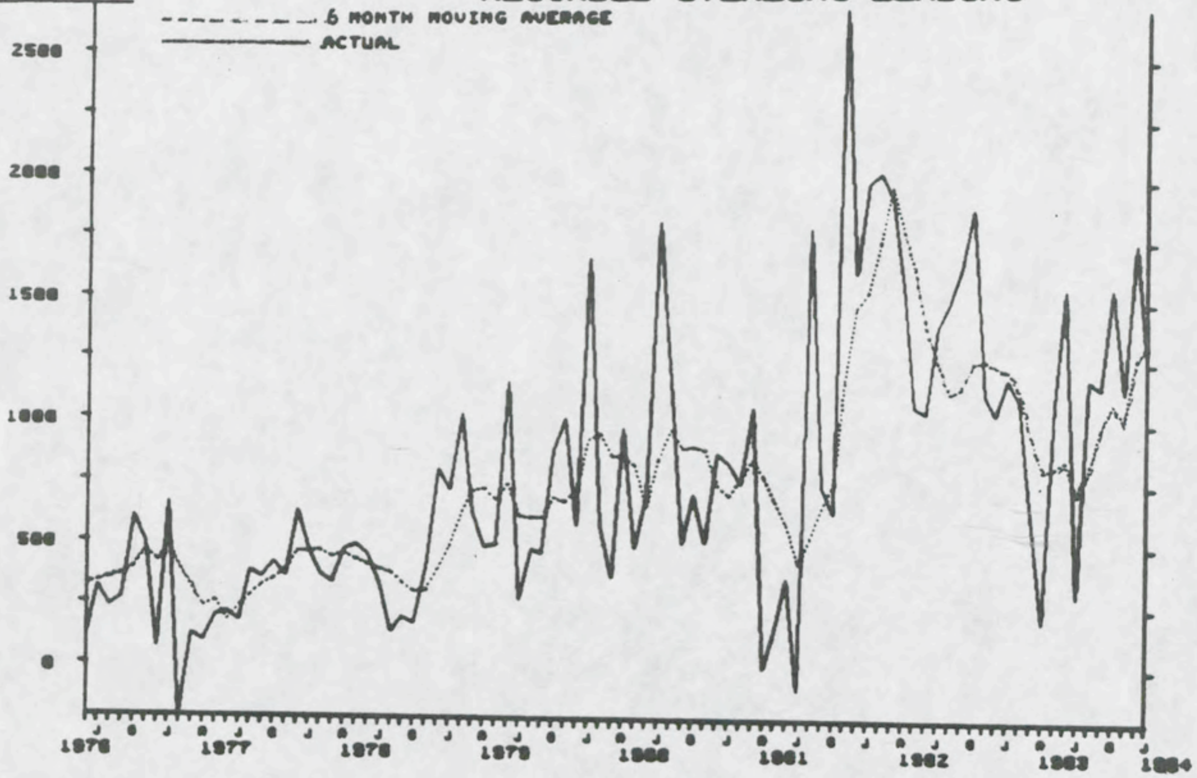


CHART 3 **RECORDED LENDING AND PSBR SHOCKS**

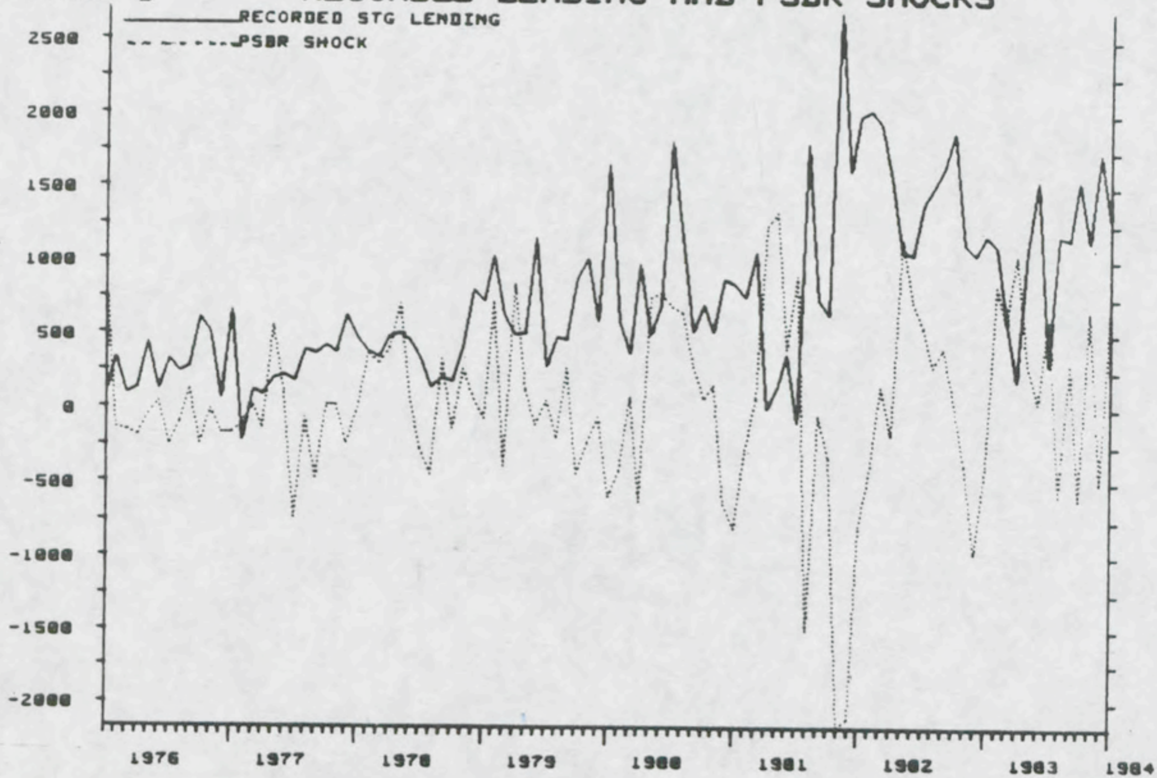


Table 6: Recorded and Underlying Lending

Banking month data

£m, sa

	Recorded bank lending	6 month moving average of recorded lending	6 month moving average of "underlying" lending
1983 May	1087	831	1017
June	1559	861	1204
July	304	716	1155
August	1185	821	1029
September	1154	991	1087
October	1561	1088	1150
November	1138	1026	1194
December	1747	1278	1172)) 1258
1984 January	1275	1332	1344)

23. Monthly figures provide little useful information about the composition of lending. Fortunately, the quarterly series provides a reasonably up-to-date breakdown this month. The latest figures, summarised in table 7, show a fairly clear increase in lending for personal consumption in the second half of the year, and a marked turn round in borrowing by ICC's. But there is no clear upward movement, and some signs of a fall, in other forms of lending.

Table 7: The Sectoral Composition of £ Lending to the Private Sector

Calendar quarterly data

(£m, sa)

	Persons		Unincorporated Businesses	Total Personal Sector	OFIs*	ICCs*	Total
	House Purchase	Consumption					
1983 Q1	884	410	633	1927	542	-495	1974
Q2	990	576	851	2417	810	37	3264
Q3	1020	729	645	2394	940	444	3735
Q4	710	1096	250	2056	590	1422	3923
% increase in stock, 1983 on 1982:	33%	22%	20%	24%	23%	4%	16%

* The figure for OFIs and ICCs take account of the banks reclassification of lending to leasing companies from ICCs to OFIs from December 1983.

24. Other evidence on consumer borrowing is more difficult to interpret. The DTI series for HP and other consumer credit accelerated sharply in Q4, but this could also reflect higher lending to companies and unincorporated businesses, which is (indistinguishably) included within the DTI figures.

25. Net capital issues by UK listed companies reached a record £2.8 billion in 1983. The Q4 figure was, however, sharply down - possibly the result of seasonal factors, as well as the upturn in bank borrowing. The Bank's new issues queue nearly doubled in January, no doubt encouraged by the strength of equity prices, as well as the need to get in ahead of the large public sector asset disposals planned for the Summer and Autumn.

Table 8: Net Issues by Listed UK Companies

Monthly averages (not seasonally adjusted)

	Total Net Issues £m	Gross Issues Queue* (Equities)
1983 Q1	209	610
Q2	312	950
Q3	314	670
Q4	98	500
1983 December	3	500
1984 January	60	920

* Excludes privatisations (currently 4548, mostly British Telecom).

26. The forecast for bank lending assumes a flat underlying trend of £1.3 billion a month; but the monthly path may be very erratic, reflecting the uneven path of the PSBR, with the possibility of very low outturns in February and April, and an exceptionally large increase in March. The March figure could also be swollen by BAT, who are due to borrow up to £470 million to pay for Eagle Star. But about one-third of the money is likely to be converted into Deutschmarks, and we have taken the view that the net effect on £M3 is likely to be negligible over the banking month as a whole.

Building Societies

27. Retail inflows in banking January, excluding interest credited, reached £1091 million. This very high level probably reflects two factors, other than the overall competitiveness of building society accounts: money switched out of offshore roll-up funds at the turn of the year; and the improved terms on some of the societies' notice accounts. Two of the top five societies have reduced the required notice on what were previously three month notice accounts to 28 days, artifically boosting the M2 series in the process. There may be a further £5-6 billion of similar two or three month notice accounts remaining with the other societies, but it is not clear at present whether they will wish to compete by reducing the notice period. Wholesale deposits raised about £90 million during the month, a substantial decline on earlier months.

28. The recent success of the building societies (and National Savings) in attracting funds has been at the expense of the banks.

Table 9: Changes in Personal Sector Sterling Bank Deposits

Calendar quarterly data £m, s.a.

	1983 Q3	1983 Q4	(1983 H2)
Sight deposits	+427	-163	+ 264
Time deposits	-513	-563	-1067
Total	- 86	-726	- 812

Table 9 shows that personal sector time deposits declined fairly rapidly during the second half of 1983, and the decline spread to sight deposits in Q4.With lending to the private sector buoyant, banks have had to rely on attracting deposits from companies (especially ICC's, whose interest bearing sight deposits rose by a massive £1½ billion in Q4 alone). Since record inflows have probably allowed building societies to make heavy purchases of gilts, thus depressing bank lending to the public sector, the net effect has probably been to reduce £M3, as well as to increase the marginal cost of funds to the banks.

29. The demand for the building societies' mortgages remains strong, and a recent article and press release from the BSA suggested that there is considerable further potential demand which could be stimulated by the societies, and hinted that the societies would prefer to meet this demand rather than reduce their interest rates. In these circumstances, the likelihood of a general cut in building society rates looks increasingly remote, despite the backing of the Halifax and Abbey National for such a cut. These two societies have a differential mortgate rate structure (unlike, say, the Woolwich and Nationwide) and may be unable to invest their current inflow of funds in mortgages as fast as they would like. On the other hand, they are probably unwilling to reduce their rates unilaterally.

Table 10: Building Society Inflows

monthly rate, £m	mid-June - mid-Sept	mid-Sept - mid-Jan	Forecast: mid-Jan - mid-April
Total retail inflows (incl.interest credited)	1000	1250	1175
of which: term shares (outside PSL2)	250	375	250
Net issues of CDs and time deposits	200	150	125
of which: net purchases by NBPS (inside PSL2	80	75	75

The forecast of building society inflows (Table 10) shows only a small decline from recent months, as the one-off effect of inflows from offshore roll-up funds wears off.

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Table A: Percentage Changes in Monetary Aggregates
Seasonally adjusted data

Banking month	Wide monetary base (MO)	NIB M1	M1	M2*	Priv £M3	£M3	M3	PSL2	PSL2A
Outturn									
- August	+ 0.7	-	+ 0.8	- 0.5	+ 0.5	+ 0.2	+ 0.1	+ 0.8	+ 0.7
- September	+ 1.0	+ 0.9	- 0.2	+ 0.1	- 0.1	- 0.5	- 0.4	+ 0.2	+ 0.4
- October	-	+ 0.5	+ 1.5	+ 0.6	+ 1.3	+ 1.4	+ 1.8	+ 1.0	+ 1.2
- November	+ 1.0	+ 0.4	+ 0.6	+ 0.2	+ 0.2	+ 0.6	+ 0.8	+ 0.4	+ 0.6
- December	-	+ 2.0	+ 1.6	+ 2.7	+ 1.5	+ 1.3	+ 2.3	+ 1.0	+ 1.1
- January 1984	- 0.4	- 1.4	- 0.2	+ 0.3	+ 0.3	+ 0.6	+ 0.8	+ 1.1	+ 1.1
Last 3 months at annual rate	+ 2.6	+ 4.2	+ 8.1	. .	+ 8.1	+ 10.4	+ 17.1	+ 10.7	+ 11.9
Last 11 months (target period) at annual rate	+ 5.6	+ 8.3	+ 11.4	. .	+ 10.5	+ 10.7	+ 12.4	+ 12.2	+ 12.5
Last 12 months	+ 5.7	+ 9.0	+ 11.1	+ 9.7	+ 10.5	+ 10.5	+ 12.7	+ 12.9	+ 13.1
Forecast									
(i) Percentage change in month									
- February	$\frac{1}{2}$-$\frac{3}{4}$ per cent a month	$1\frac{1}{4}$ per cent a month			+ 0.9	+ 0.9		+ 1.5	+ 1.4
- March					+ 1.0	+ 0.9		+ 1.3	+ 1.3
- April					+ 1.1	+ 1.1		+ 1.3	+ 1.3
(ii) Percentage change since Feb 1983 (annual rate)									
- February	+ 5.8	+ 11.8			+ 10.6	+ 10.8		+ 12.8	+ 13.0
- March	+ 5.9	+ 12.1			+ 10.7	+ 10.8		+ 13.1	+ 13.3
- April	+ 6.0	+ 12.4			+ 11.0	+ 11.0		+ 13.3	+ 13.5

*Revised definition; not seasonally adjusted

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Table B: £M3 Counterparts

£ millions seasonally adjusted

	JANUARY Forecast	JANUARY Outturn	Forecast Feb	Forecast Mar	Forecast Apr	Target Period: mid Feb 83 to mid - Apr 84	mid - April 83 to mid - Apr 84
1. CGBR							
(a) Own-account	- 375	- 169	+1725	- 545	+1455	+10849	+ 9233
(b) On-lending	+ 340	+ 362	+ 305	+ 720	+ 570	+ 6921	+ 4841
TOTAL	- 35	+ 193	+2030	+ 175	+2025	+17770	+14074
2. Net purchases of CG debt by NBPS							
(a) Gilts	- 715	- 738	-1045	- 490	- 725	-10624	-10470
(b) Treasury bills	-	- 10	-	-	-	- 6	- 12
(c) National Savings	- 325	- 360	- 250	- 280	- 210	- 3457	- 3132
(d) CTDs, etc	- 70	- 66	- 50	- 15	- 15	- 122	+ 31
TOTAL	-1110	-1174	-1345	- 785	- 950	-14209	-13583
3. Other public sector							
(a) Local authorities	- 330	- 421	- 175	- 85	- 360	- 2732	- 2059
(b) Public corporations	+ 115	- 17	- 90	- 235	+ 220	- 468	- 324
TOTAL	- 215	- 438	- 265	- 320	- 140	- 3200	- 2383
4. £ lending to private sector	+2025	+1275	+ 860	+2070	+ 450	+15230	+14396
(adjusted lending)	(+1350)	(+ 460)	(+1300)	(+1300)	(+1300)		
5. Net externals	- 60	+ 1339	+ 100	- 10	- 25	+ 418	+ 254
6. Net non-deposit liabilities	-	- 574	- 250	- 250	- 250	+ 4009	- 3280
TOTAL £M3	+ 605	+ 621	+ 930	+ 880	+1110	+12000	+ 9478
% change in period	+ 0.6	+ 0.6	+ 0.9	+ 0.9	+ 1.1	+ 11.0(a.r.)	+ 9.9

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TABLE C: COMPONENTS OF M1 AND £M3

(£ million, seasonally adjusted)

	banking January	Cumulative total since mid-February %
notes and coin in circulation	- 5	+ 505 (+ 5.0)
non-interest-bearing £ sight deposits	- 423	+ 1688 (+10.4)
NIB M1	- 428	+ 2193 (+ 8.3)
interest bearing £ sight deposits	+ 344	+ 1832 (+20.4)
M1	- 84	+ 4025 (+11.4)
private sector £ time deposits and £CDs	+ 387	+ 4667 (+ 9.8)
private sector £M3	+ 303	+ 8692 (+10.5)
public sector £ deposits	+ 318	+ 388 (+15.3)
£M3	+ 621	+ 9080 (+10.7)

(Figures in brackets show % change at annual rate over target period)

B/2c

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Table D : Gilts

£ million

	Outturn JAN	FEB to date	Remainder of FEB	FEB	Forecast MAR	APR
Calls*	+ 354	-	+ 423	+ 423	+ 271	-
Other 'gross' sales	+ 993	+ 750	+ 77	+ 827	+ 979	+1250
'GROSS' SALES	+1347	+ 750	+ 500	+1250	+1250	+1250
Buying-in next maturities ø	- 239	+ 20	-	+ 20	- 100	- 300
Redemptions	- 296	- 50	-	- 50	- 720	-
TOTAL NET SALES	+ 812	+ 720	+ 500	+1220	+ 430	- 950
Purchases (-) by:						
Overseas	- 164			- 125	-	- 150
Banks	+ 38			} - 50	+ 60	- 75
LDMA	+ 52					
Public Corporations	-			-	-	-
NET SALES TO NBPS (+)	+ 738			+1045	+ 490	+ 725
* of which calls on:						
- 10% Treasury 1990				+ 423	+ 271	
-						
-						
ø of which, buying in of:						
- 14% Exchequer 1984					- 100	- 300
-						

Table E : Sterling lending to the private sector

£ million
Seasonally adjusted

	Actual			Forecast		
	NOV	DEC	JAN	FEB	MAR	APR
Adjusted lending	+1568	+1538	+460	+1300	+1300	+1300
Bills held by NBPS(-)	- 35	- 18	+208	+ 50	+ 50	- 150
PSBR offset	- 395	+ 227	+607	- 490	+ 620	- 700
Other	-	-	-	-	+ 100*	-
Actual/forecast recorded lending	+1138	+1747	+1275	+ 860	+2070	+ 450
Centered 3-month moving average of adjusted lending	+1508	+1189	+1099	+1020	+1300	

* Borrowing by BAT o/a take-over of Eagle Star

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Table F: Money Market Influences

	Actual	Forecast		
£ million not seasonally adjusted	JAN	FEB	MAR	APR
A. Money market influences				
CGBR (increase +)	-1234	- 155	+ 190	+3600
Reserves etc (+)	- 58	+ 90	-	- 115
Notes and coin (-)	+ 769	- 75	- 125	- 385
National Savings (-)	- 370	- 280	- 295	- 225
CTDs (-)	+ 265	+ 175	- 75	- 90
Gilts (-)	- 812	-1220	- 430	- 950
Other Exchequer items etc	- 236	-	-	-
TOTAL MONEY MARKET INFLUENCES (Market surplus + / shortage -)	-1676	-1465	- 735	+1835
B. Money market operations				
Commercial bills (purchase +)				
- Issue Department	+1623			
- Banking Department	- 131			
LA bills (purchase +)				
- Issue Department	+ 125			
- Banking Department	-			
Treasury bills (purchase +)	+ 11			
Market advances	+ 9			
Other	-			
TOTAL MONEY MARKET OPERATIONS	+1637	+1523	+ 735	-1835
Change in bankers' balances	- 39	+ 58	-	-
TOTAL ASSISTANCE OUTSTANDING*	9979	11502	12237	10402

* excluding Treasury bills

SECRET

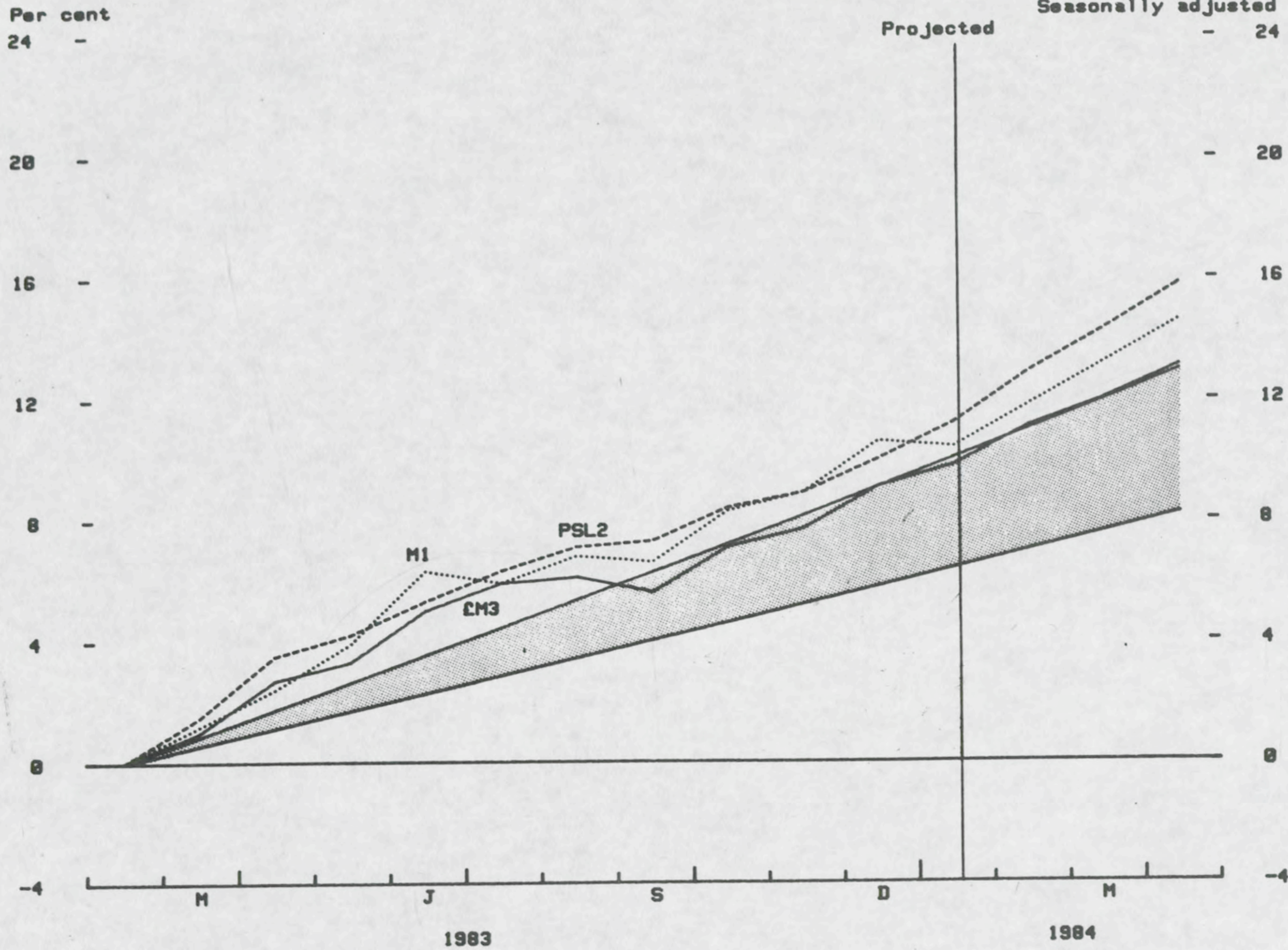
		May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan
TARGET AGGREGATES										
£M3	Monthly change (£ millions)	+540	+1,611	+796	+157	-460	+1,415	+552	+1,326	+621
	Monthly % change	+0.6	+1.7	+0.8	+0.2	-0.5	+1.4	+0.6	+1.3	+0.6
	3-monthly % change A.R.	+13.8	+16.9	+12.9	+11.1	+2.0	+4.6	+6.3	+14.1	+10.4
	6-monthly % change A.R.	+11.2	+13.7	+13.6	+12.5	+9.2	+8.7	+8.7	+7.9	+7.5
	12-monthly % change	+11.0	+11.7	+12.5	+11.5	+9.6	+9.6	+9.9	+10.8	+10.5
	% change since Feb-83 A.R.	+13.8	+15.9	+14.7	+12.5	+9.7	+10.8	+10.4	+11.0	+10.7
M1	Monthly change (£ millions)	+578	+954	-153	+347	-82	+633	+250	+655	-84
	Monthly % change	+1.5	+2.4	-0.4	+0.8	-0.2	+1.5	+0.6	+1.6	-0.2
	3-monthly % change A.R.	+16.5	+22.0	+14.6	+11.9	+1.1	+9.1	+8.0	+15.8	+8.1
	6-monthly % change A.R.	+13.8	+16.8	+13.8	+14.2	+11.0	+11.8	+9.9	+8.2	+8.6
	12-monthly % change	+16.0	+15.9	+15.0	+13.8	+12.4	+11.2	+11.9	+12.4	+11.1
	% change since Feb-83 A.R.	+16.5	+20.3	+14.9	+14.2	+11.6	+12.7	+12.1	+12.9	+11.4
PSL2	Monthly change (£ millions)	+1,046	+1,654	+1,362	+1,231	+257	+1,664	+722	+1,682	+1,776
	Monthly % change	+0.7	+1.1	+0.9	+0.8	+0.2	+1.0	+0.4	+1.0	+1.1
	3-monthly % change A.R.	+18.2	+16.0	+10.9	+11.3	+7.4	+8.2	+6.8	+10.5	+10.7
	6-monthly % change A.R.	+15.9	+17.4	+16.6	+14.7	+11.6	+9.5	+9.0	+8.9	+9.4
	12-monthly % change	+11.5	+11.9	+13.0	+13.0	+12.0	+12.2	+12.4	+13.1	+12.9
	% change since Feb-83 A.R.	+18.2	+17.0	+15.7	+14.7	+12.8	+12.8	+12.0	+12.1	+12.2
Levels :	£M3	95,950	97,523	98,296	98,417	98,018	99,436	99,997	101,541	102,181
	M1	40,209	41,140	40,963	41,286	41,204	41,814	42,041	42,686	42,579
	PSL2	156,674	158,265	159,573	160,742	161,034	162,679	163,388	165,263	166,035

SECRET

	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan
MO COMPONENTS (£m)									
Notes and coin in circulation (S.A.)	+41	+99	-30	+71	+106	+41	+80	-9	-5
Banks' Till money (NFT) (S.A.)	+56	+49	+25	-10	+24	-23	-14	+58	-5
Operational Bankers' Balances	-61	+127	-105	+30	+1	-14	+64	-49	-39
Total MO (S.A.)	+56	+275	-110	+91	+131	+4	+130	-	-49
MO Monthly change (£ millions)	+56	+275	-110	+91	+131	+4	+130	-	-49
Monthly % change	+0.5	+2.2	-0.9	+0.7	+1.0	-	+1.0	-	-0.4
3-monthly % change A.R.	+5.2	+9.0	+7.3	+8.5	+3.6	+7.4	+8.6	+4.3	+2.6
6-monthly % change A.R.	+5.3	+8.0	+6.5	+6.8	+6.3	+7.4	+8.6	+3.9	+4.9
12-monthly % change	+6.2	+7.3	+6.0	+6.4	+6.0	+6.3	+6.9	+5.9	+5.7
% change since Feb-83 A.R.	+5.2	+10.9	+6.4	+6.8	+7.7	+6.8	+7.4	+6.7	+5.6
OTHER NARROW MEASURES									
NIB M1 Monthly change (£ millions)	+105	+360	+365	+3	+271	+144	+121	+623	-428
Monthly % change	+0.4	+1.2	+1.2	-	+0.9	+0.5	+0.4	+2.0	-1.4
3-monthly % change A.R.	+10.6	+7.9	+11.7	+10.2	+8.8	+5.6	+7.3	+12.2	+4.2
6-monthly % change A.R.	+7.7	+8.0	+13.2	+10.4	+8.3	+8.6	+8.7	+10.5	+4.9
12-monthly % change	+11.5	+10.5	+10.7	+10.2	+9.1	+4.9	+8.2	+9.2	+9.0
% change since Feb-83 A.R.	+10.6	+11.8	+12.6	+10.4	+10.5	+9.9	+9.3	+11.0	+8.3
M2 (NOT seasonally adjusted)									
MONTHLY CHANGES (£ MILLIONS)	+577	+1096	+1073	-563	+98	+711	+171	+3111	+354
LEVELS	110130	111226	112299	111736	111854	112565	112736 113494	116615	116969
MONTHLY % CHANGE	0.5	+1.0	+1.0	-0.5	+0.1	+0.6	+0.2	+2.7	+0.3
12 MONTHLY % CHANGE	+8.1	+8.1	+8.0	+7.9	+7.6	+6.6	+7.3	+8.9	+9.7

SECRET

	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan
OTHER WIDE MEASURES									
M3 Monthly change (£ millions)	+335	+1,804	+1013	+157	-433	+1,978	+951	+2,646	+983
Monthly % change	+0.3	+1.7	+0.9	+0.1	-0.4	+1.8	+0.8	+2.3	+0.8
3-monthly % change A.R.	+11.4	+13.5	+12.1	+11.3	+2.7	+6.2	+9.2	+22.5	+17.1
6-monthly % change A.R.	+12.4	+13.3	+14.0	+11.4	+7.9	+9.1	+10.3	+11.7	+11.5
12-monthly % change	+12.2	+13.1	+13.1	+12.4	+11.2	+11.1	+11.3	+12.5	+12.7
% change since Feb-83 A.R.	+11.4	+13.9	+13.4	+11.4	+8.9	+10.7	+10.6	+12.6	+12.4
£M3 Excl Public Sector Deposits (S.A.)									
Monthly change (£ millions)	+558	+1,276	+635	+434	-59	+1,218	+175	+1,435	+303
Monthly % change	+0.6	+1.4	+0.7	+0.5	-0.1	+1.3	+0.2	+1.5	+0.3
% change since Feb-83 A.R.	+15.2	+15.8	+14.3	+12.8	+10.7	+11.4	+10.3	+11.2	+10.5
PSL1 Monthly change (£ millions)	+306	+1,169	+444	+564	-183	+1,278	+167	+1,261	+111
Monthly % change	+0.3	+1.2	+0.4	+0.6	-0.2	+1.3	+0.2	+1.2	+0.1
3-monthly % change A.R.	+17.2	+16.2	+8.1	+9.2	+3.4	+6.8	+5.2	+11.3	+6.2
6-monthly % change A.R.	+12.5	+14.4	+14.1	+13.1	+9.6	+7.5	+7.2	+7.3	+6.5
12-monthly % change	+10.4	+10.7	+11.4	+10.8	+9.1	+9.4	+9.8	+10.8	+10.3
% change since Feb-83 A.R.	+17.2	+16.7	+14.4	+13.1	+10.8	+11.5	+10.4	+10.9	+10.0
PSL2A Monthly change (£ millions)	+1,042	+1,676	+1,493	+1,330	+798	+2,244	+1,107	+1,980	+2,092
Monthly % change	+0.6	+1.0	+0.8	+0.7	+0.4	+1.3	+0.6	+1.1	+1.1
3-monthly % change A.R.	+16.4	+14.4	+10.1	+10.7	+8.5	+10.2	+9.6	+12.4	+11.9
6-monthly % change A.R.	+15.6	+16.3	+15.3	+13.5	+11.4	+10.2	+10.2	+10.4	+11.0
12-monthly % change	+13.6	+13.8	+14.1	+13.7	+12.8	+12.8	+12.8	+13.3	+13.1
% change since Feb-83 A.R.	+16.4	+15.3	+14.4	+13.5	+12.3	+12.8	+12.2	+12.4	+12.5



Monetary growth since mid February 1983
CHART A
Per cent
Seasonally adjusted
Projected
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12
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4
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-4
M1
PSL2
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1983
1984

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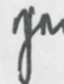
HA/04

BACKGROUND ECONOMIC BRIEFING

COMPARISON OF SELECTED SHORT-TERM FORECASTS

Compiled by
EB Division
HM Treasury (Tel 01-233-4489)

I attach one-page summaries of the latest forecasts from Phillips and Drew (February), Simon and Coates (February), and Henley Centre (February). Updated summary tables for 1983, 1984 and 1985 are also provided; Table 1 shows the consensus and range of outside forecasts for a number of selected variables.



N J MACKINNON
15 February 1984

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TABLE 1 OUTSIDE FORECASTS

	CONSENSUS	RANGE	
GDP (Output) growth			
1983	2.1	1.8 (LBS) -	2.3 (S&C)
1984	2.2	2.0 (NIESR,CBI) -	2.5 (P&D)
1985	1.6	1.0 (NIESR) -	2.4 (LBS)

Note: On expenditure measure, Liverpool at top end of range in all three years ie 3½ per cent (1983), 3¾ per cent (1984), 3 per cent (1985). On average measure the CBI expect 3 per cent in 1983 and P&D expect 2½ per cent in 1984 (both at top end of range).

	CONSENSUS	RANGE	
RPI Inflation			
1984 Q4	6.0	5.6 (P&D) -	6.8 (NIESR)
1985Q4	6.0	5.0 (S&C) -	7.0 (Henley)
UK Unemployment (adults sa)			
1984 Q4	2.98	2.9 (CBI) -	3.12 (LBS)
1985Q4	3.06	2.88 (LBS) -	3.3 (NIESR)

Note: Cambridge expect 3.4m in 1984 and 3.7m in 1985, but figure is yearly average, includes school leavers,and on old basis. Liverpool expect an average of 2.7m in 1984 and 2.3m in 1985.

	CONSENSUS	RANGE	
PSBR (£ billion)			
1983-84	9.6	8.9 (NIESR) -	10.0 (Henley)
1984-85	8.3	6.4 (Liverpool) -	10.1 (NIESR)
1985-86	7.7	4.7 (Liverpool)	10.2 (NIESR)
Current Account (£ billion)			
1984	0.7	-0.4 (CBI) -	2.2 (Cambridge)
1985	1.2	-1.1 (P&D) -	5.6 (Liverpool)
Effective Exchange rate (1975=100)			
1984Q4	80.7	78.8 (NIESR) -	84.0 (P&D)
1985Q4	77.9	73.5 (NIESR)	81.0 (P&D)

*'Consensus' is defined as an unweighted average of major outside forecasts.

15 February 1984

SIMON AND COATES (FEBRUARY) FORECAST

S&C expect less growth in output this year than most other outside forecasters though their forecast of 1½ per cent growth in 1985 is in line with consensus opinion. Inflation remains within a 5-6 per cent band during 1984 and 1985.

THE WORLD ECONOMY: There is little change from their previous forecast ie OECD GNP grows by 3½ per cent in 1984 and 2½ per cent in 1985 assuming unchanged fiscal-monetary policies and an unchanged oil price. World trade volume (average of OECD export and non-oil import volumes) expands by 4 per cent in 1984 and in 1985. OECD consumer prices rise by 5½ per cent in 1984 and 7 per cent in 1985. Oil prices remain unchanged in nominal terms until 1985Q1. US interest rates (fed Funds) increase to 11 per cent by end-1985.

BUDGET ASSESSMENT: Budget will be "roughly neutral" with little change in the broad thrust of fiscal stance between the current financial year and next. Details of offsetting tax changes are difficult to forecast though a reduction in the rate of stamp duty on stock exchange transactions is a possibility. Tax increases are not likely for political reasons but neither is a tax reduction - for macroeconomic reasons ie demand is already buoyant and a further stimulus might upset the outlook for inflation, monetary growth, and the balance of payments. S&C are more concerned with the monetary situation especially if the corporate sector increases its bank borrowing for stockbuilding thus increasing monetary growth. However S&C feel that the "next move in interest rates will be downwards" as consumer borrowing eases off. S&C argue that government's medium-term plans for the welfare state and income tax reductions depend on the future of North Sea oil output and taxation especially as oil output approaches its peak.

MAIN POINTS FROM THE FORECAST (see table below)

- Consumers' expenditure experiences increased difficulty in making progress from the high levels reached at the end of 1983 though a further slight advance is not ruled out. In 1984 consumer spending rises by 1½ per cent on the basis of the savings ratio remaining around 8 per cent together with a small rise in disposable income.

- Retail price inflation is expected to move upwards to 6 per cent by mid-year (though S&C have yet to incorporate the January reduction in the RPI). There after inflation moves downwards to reach 5 per cent by end-1985. Average earnings (including drift) rise by 7 per cent in the current payround and basic pay settlements are in the region of 5½-6 percent. Import costs stay within a 6-7 percent range for most of 1984 reflecting the effect of world recovery on the commodity price cycle and negative rates of year-on-year change in the sterling - dollar exchange rate.

- A special article looks at the relationships between output, pay, employment and productivity over the period 1979-83. Over the whole of 1979-83 evidence is presented to show that relative pay moderation has not led to higher employment (though for the period 1981-83 there appears to be positive association), that industries with high productivity gains have not paid correspondingly higher wages, and finally industries that have lost output during the recession have performed least well in productivity terms.

- In the medium-term S&C expect a resumption of a prolonged period of continuous, if not subdued, growth in output. Over the period 1982-87 real GDP grows by 1½ per cent pa, retail prices by just under 5½ percent, but unemployment rises to 3½ million by 1987.

KEY INDICATORS (January 1984 forecast in brackets)

	GDP(O) % change in previous year		RPI % change on year earlier - Q4		PSBR (fiscal year) bn		Current Account £bn	
1983	2.3	(2.2)	5.0*	(5.1)	9.4	(9.3)	2.0*	(1.7)
1984	2.1	(1.8)	5.8	(5.8)	8.0	(8.0)	1.5	(2.1)
1985	1.5	(1.6)	5.0	(5.0)	7.0	(7.0)	2.4	(1.8)

* actual

15 February 1984

PHILLIPS AND DREW (FEBRUARY) FORECAST

P&D remain at the optimistic end of the range of outside forecasts. Their latest assessment shows upward revisions to GDP growth this year and next, reflecting stronger contributions from consumer spending and investment. Inflation remains within a 5-6 per cent band during 1984 and 1985. In the medium-term (1984-88) GDP grows 1½ per cent pa, retail prices grow 5½ per cent pa, and unemployment reaches 3.3m in 1988.

ASSUMPTIONS: World trade volume grows by 3 per cent in 1984 and 1985 after little growth in 1983. OECD real GNP growth declines slowly up to 1986 as US activity slowsdown. Average OPEC term price stays at $29/bl to the end of 1985.

BUDGET ASSESSMENT: Most of the assumptions included in the Autumn Staement are adhered to. Measures are taken to meet the PSBR target for 1984-85 of £8bn (2¼ per cent of GDP) though the outturn is estimated to be nearer £8½ bn. This requires a negative fiscal adjustment (net tax increase) of £½bn which is likely to fall on excise duties and the curbing of various tax loopholes rather than direct taxation. The National Insurance Surcharge (NIS) is phased out by April 1985. Monetary targets of 6-10 per cent for 1984-85 are confirmed for £M3 and PSL2, though a lower range is expected to be adopted for the narrow money aggregates.

MAIN POINTS FROM THE FORECAST (see table below)

- An outcome almost 3 per cent growth in GDP (average measure) is expected for 1983, consistent with the IAF. Greater optimism concerning consumer spending, investment, and exports contributes to growth of 2½ per cent this year. However in 1985 GDP grows by 1½ per cent, mainly reflecting an easing in the growth of consumer spending. In the medium-term, growth is expected to be "sluggish". North Sea production is expected to peak this year thus providing a diminishing contribution to growth in GDP, though the resulting fall in the real exchange rate may partially offset this.

- Retail price inflation peaks at 6 per cent in 1984Q2 and declines slowly to 5 per cent by 1985Q4. P&D do not rule as "completely out of court" the Industry Act forecast of 4½ percent by 1984Q4. Moderate pay settlements, strong productivity growth, and a "resilient" rate for trade weighted sterling help to contain domestic inflation.

- Consumers' expenditure grows 2 per cent in 1984. The savings ratio shows only a little fall this year, reflecting a lagged response to the fall in inflation and this contributes to a small rise in consumer spending over and above the increase in real incomes this year. In 1985 consumer spending and real incomes move together at 1-1½ per cent.

- GDFCF grows 4½ per cent in 1984 in response to the improvement in company profits and rising output. Total private sector investment grows by nearly 5½ per cent and manufacturing investment by 6¾ per cent.

- The current account shows a surplus of £½ bn in 1984 and a deficit of about £1bn in 1985. Exports grow 4-4½ per cent this year mainly in response to rising world trade. Imports show similar growth but this eases in 1985 as consumer spending falls back.

KEY INDICATORS (January forecast in brackets)

	GDP (O) % change on year earlier		Unemployment (UK adults sa) Q4-millions		RPI (% change on year earlier - Q4)		PSBR (fy) £bn		Balance of payments on current account £bn	
1983	2.2	(2.0)	2.97*	(2.94)	5.0*	(5.0)	9.5	(9.4)	1.3	(1.3)
1984	2.5	(2.2)	2.93	(2.94)	5.6	(5.6)	8.5	(8.5)	0.4	(0.4)
1985	1.3	(1.2)	2.99	(-)	5.1	(5.3)	-	(-)	-1.1	(-0.6)

* actual

15 February 1984

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HENLEY CENTRE (FEBRUARY) FORECAST

Henley now expect an outcome of 3 per cent for GDP growth in 1983 mainly reflecting buoyant consumer spending. This year output slows down slightly though more balanced growth is expected with greater contributions from investment and exports. Retail price inflation is expected to accelerate this year reflecting the strengthening economic recovery (though Henley have yet to incorporate the January reduction in the RPI into their forecasts).

ASSUMPTIONS: OECD output growth

averages 2.8 per cent pa 1984-89 with the peak occurring in 1984-85. OECD inflation averages 6.9 per cent pa reflecting generally restrictive economic policies and relatively weak world output growth. World trade (world exports of market economies) expands by 4 per cent this year and 5 per cent in 1985. Oil prices fall in nominal terms in 1984 and even further in real terms. US interest rates gradually increase this year on the assumption of no major change in the Fed's monetary policy. Sterling depreciates more than in line with relative inflation 1984-89 compared to the rest of the OECD area; a sharp depreciation of 6.5 per cent pa in sterling is assumed for 1985-87. UK productivity averages 2 percent pa 1984-89.

BUDGET ASSESSMENT: Expected to be "broadly neutral". This assumes no change in the standard rate of income tax, full indexation of personal allowances and thresholds, no change in VAT, full revalorisation of specific excise duties, and no change to the rate of NIS.

MAIN POINTS FROM THE FORECAST (see table below)

- Consumer spending rises by 2¼ percent in this year in response to a 2.3 per cent expansion of real income rather than any further falls in the savings ratio.

- The growth of average earnings is not expected to decelerate, increasing 7.8 percent in the year to 1984Q3. It is anticipated that wage drift will widen, especially in the manufacturing sector, reflecting activity-related payments and improved company profitability.

- Henley's five year inflation projections have been revised downwards as the result of a "fundamental re-assessment of our medium-term view of the prospects for UK employment." On the basis of their GDP forecasts there is little scope for any increase in employment levels after 1984, more specifically, employment falls more than previously forecast by 0.4 per cent pa over the period 1985-89. This implies stronger productivity growth and consequently upward pressure on unit costs. The "underlying" rate of inflation averages 5½-6 per cent in 1984 compared with 4½-5 per cent in 1983. Retail price inflation increases steadily throughout the year to areound 5.7 per cent by the final quarter.

- A relatively weak exchange rate, a modest rise in international interest rates, potential upward pressure on monetary supply growth from the corporate sector, suggest that UK interest rates are more likely to move upward rather than downwards. A PSBR outturn of £10 bn is expected for 1983-84 and £9bn for 1984-85.

KEY INDICATORS (January forecast in brackets)

	GDP(E) % change on year earlier		RPI % change on year earlier - Q4		PSBR (fiscal year) £bn	PSBR (fiscal year) % of GDP	Current Account £bn	
1983	2.9	(2.7)	5.0*	(5.1)	10.0 (10.0)	3.3 (3.3)	2.0*	(1.4)
1984	2.5	(2.4)	5.7	(6.0)	9.0 (9.5)	2.7 (2.9)	-0.3	(-0.3)
1985	1.7	(1.4)	7.0	(7.2)	10.0 (10.0)	2.8 (2.8)	-0.4	(-0.7)

* actual

15 February 1984

COMPARISON OF FORECASTS: SUMMARY TABLE (* new forecast) 15 February 1984

FORECASTS FOR 1984

Except where specified figures are percentage changes on previous year (GDP components in constant 1980 prices)

	NIESR	LBS[p]	P&D	Simon& Coates	Henley	Camb E'metric	L'pool	CBI	OECD	FSBR[m]	IAF
Date of forecast	Nov '83	October '83	Feb '84*	Feb '84*	Feb '84*	Jan '84	Dec '83	Nov '83	Dec '83	March '83	Nov '83
GDP (output measure)	2.0	2.4	2.5	2.1	2.5[b]	2.1	3.7[b]	2.0	2¼[a]	2.5[b]	2.8b
Consumers' expenditure	0.3	2.0	2.1	1.6	2.2	1.3	2.1[c]	1.7	1¾	2.5	2.5
Gen. Gov. consumption	1.0	0.3	1.5	0.8	1.4	0.9	0.1[d]	1.1	½	1.0	1.0
Gross fixed investment	3.5	4.4	4.4	1.3	4.9	3.1	10.0[e]	4.7	4	3.5	4.1
- public	0.8	3.7	2.1	-7.6	2.1	-	-	-1.7	1	-	-
- private	4.1	4.6	5.3	3.9	6.0	-	-	6.4	-	-	-
Stockbuilding (£bn)	2.6	0.7	0.2	1.1	1.5	0.9	-	0.8	-	-	2.0
Exports (goods & services)	4.0	3.1	4.2	4.2	4.2	4.1	-	2.5	4½	5.0	4.1
Imports (goods & services)	4.1	3.8	4.5	3.3	4.4	3.9	-	4.9	4½	5.0	5.2
RPI (CPI) Q4	6.8	(6.0)	5.6	5.8	5.7	(6.3)[f]	(3.3)[f]	(5.1)	(6.0)[f]	6.0 (Q2)	4.5
Average earnings[g]	6.2	6.4	7.1	7.0	7.6	5.6	4.6	6.2	7	-	-
RPDI	0.5	1.0	1.8	1.0	2.3	-	-	1.3	-	-	-
Unemployment (UK adults) (million Q4)	3.1	3.12	2.92	2.92	2.93	3.4[f,h,j]	2.7[f]	2.9	-	-	-
World trade[g]	4.0	4.7	3.0	4.0	4.0	-	6.0	3.9	6	6.0	5.0
Current account (£bn)	0.2	0.3	0.4	1.5	-0.3	2.2	2.0	-0.4	-	2.0[n]	0.0
Exchange rate Q4 (Effective level 1975=100)	78.8	79.0	84.0	79.0	82.1	81.3[f]	85.7[f]	81.5	-	-	-
Forecasts for 1984-85											
£M3 growth	10.0	10.5[k]	10.6[k]	9.1	10.0	-	4.0[l]	-	-	-	-
PSBR (£bn)	10.1	7.6	8.5	8.0	9.0	9.1[k]	6.4	8.6	-	8.0	8.0
Short term interest rate[g]	-	7.9[k]	9.2[k]	8.0	9.8[k]	9.0[k]	7.8[k]	-	-	-	-

(a) average measure
(b) expenditure measure
(c) non durable consumption
(d) current and capital including stockbuilding
(e) private sector investment and stockbuilding and durable consumption
(f) average of year
(g) [illegible]r definition see individual forecast summaries
(h) includes school leavers
(j) old basis
(k) calendar year 1984
(l) M1 growth year end
(m) forecast is for year to 1984 H1
(n) H1 annualised
(p) GDP components at constant 1975 prices.

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COMPARISON OF FORECASTS: SUMMARY TABLE (* new forecast) 15 February 1984

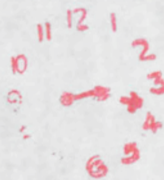
FORECASTS FOR 1985

Except where specified figures are percentage changes on previous year (GDP components in constant 1980 prices)

	NIESR	LBS[n]	P&D	Simon& Coates	Henley	Camb E'metric	L'pool	CBI[p]	OECD[p]
Date of forecast	Nov '83	October '83	Feb '84*	Feb '84*	Feb '84*	Jan '84	Dec '83	Nov '83	Dec '83
GDP (output measure)	1.0	2.4	1.3	1.5	1.7 [b]	1.4	3.0[b]	1.9	2[a]
Consumers' expenditure	0.0	1.8	1.4	0.8	1.2	1.0	3.5[c]	0.9	2
Gen. Gov. consumption	1.0	0.7	0.9	0.2	1.1	0.6	-1.1[d]	1.6	¾
Gross fixed investment	0.6	3.4	2.5	2.2	2.8	2.5	0.9[e]	-	4½
- public	1.0	5.1	1.9	1.9	1.4	-	-	0.0	3¼
- private	1.4	2.8	2.7	2.0	3.3	-	-	4.3	
Stockbuilding (£bn)	2.5	0.7	0.2	0.8	1.2	0.7	-	0.2	-
Exports (goods & services)	5.0	4.5	2.4	3.3	4.3	3.9	-	3.5	4
Imports (goods & services)	2.6	2.7	2.6	2.9	2.6	2.7	-	2.1	5
RPI (CPI) Q4	6.8	(6.5)	5.1	5.0	7.0	(6.3)[f]	(1.2)[f]	(5.6)	(5¼)[f]
Average earnings[g]	6.2	6.6	6.5	6.5	8.2	4.6	0.5	6.9	-
RPDI	-0.8	1.7	1.4	0.1	1.5	-	-	1.1	-
Unemployment (UK adults) (million Q4)	3.3	2.88	2.93	3.10	3.10	3.7[f,h,j]	2.3[f]	-	
World trade[g]	5.0	5.1	3.0	4.0	5.0	-	6.0	3.6	5½
Current account (£bn)	-0.4	1.0	-1.1	2.4	-0.4	2.4	5.6	-0.2	-
Exchange rate Q4 (Effective level 1975=100)	73.5	79.0	81.0	80.0	76.2	80.6[f]	87.4[f]	80.5 (Q2)	-
Forecasts for 1985-86									
£M3 growth	11.7	9.4[k]	9.5[k]	8.0	10.0	-	6.0[l]	-	-
PSBR (£bn)	10.2	6.4	-	7.0	10.0	11.4[k]	4.7	-	-
Short term interest rate[g]	-	7.9[k]	9.2[k]	7.5	10.5[k]	8.5[k]	7.9[k]	-	

(a) average measure
(b) expenditure measure
(c) non durable consumption
(d) current and capital including stockbuilding
(e) private sector investment and stockbuilding and durable consumption
(f) average of year
(g) for definition see individual forecast summaries
(h) includes school leavers
(j) old basis
(k) calendar year 1985
(l) M1 growth year end
(n) GDP components in constant 1975 prices
(p) forecast up to Q2

16 JAN 1984



CONFIDENTIAL HL

10 February 1984

Public sector bank deposits, the PSBR and money stock

The Prime Minister has seen your letter to me of 8 February and is content with the proposed changes to the definitions of the PSBR and of £M3.

Andrew Turnbull

John Kerr, Esq.,
H.M. Treasury.

CONFIDENTIAL

10 DOWNING STREET

②

Prime Minister

The bank deposits of nationalised industries and local authorities are currently included in £M3 but movements in such deposits tell us nothing about activity in the economy as the level of deposits is largely determined by administrative rules.

Sometimes, month to month fluctuations in such deposits obscure movements in private sector deposits. So it is right to remove them.

It is all a question of finding the right moment which Chancellor thinks is now.

AT
9/2

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CONFIDENTIAL

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

8 February 1984

Andrew Turnbull Esq
10 Downing Street
LONDON SW1

Dear Andrew,

PUBLIC SECTOR BANK DEPOSITS, THE PSBR AND MONEY STOCK

The Prime Minister may wish to be aware that the Chancellor proposes to announce on Friday a modest change to the statistical treatment of public sector bank deposits, excluding them from our definitions of the PSBR and of £M3. The draft Written Parliamentary Answer and Treasury press notice announcing the change are attached.

Currently, increases in public sector bank deposits increase the PSBR and also increase the money stock as measured by £M3 and M3. In future changes in these deposits will be recorded as financing items - increases being counted as negative financing of the PSBR, like other acquisitions of liquid assets by the public sector - and will be excluded from £M3 and M3. For the PSBR the change will take effect from the new financial year, and for £M3 it will apply from the beginning of the new target period (ie banking March). The Chancellor thinks it sensible to announce the changes in advance so that essentially statistical matters do not confuse the presentation of Budget decisions and the new MTFS.

when I was in HMT.

The current treatment of public sector deposits has long been regarded as anomalous (eg by you) and the change now to be made has been considered for some time (eg by you). It will remove a small but very erratic element which has no economic significance but can distort the monthly figures for both the PSBR and £M3 by large amounts. It will bring the definitions of £M3 and M3 into line with all the other monetary and liquidity aggregates which already exclude public sector deposits. And, as you will recall, the new definition will be in line with IMF guidelines on Government financial statistics, which recommend excluding public sector deposits. Other countries, such as the USA and Switzerland, already exclude some or all public sector deposits from the broad money supply.

Since changes in public sector deposits are on average very small their exclusion should have little significant effect on the annual figures for the PSBR or the growth of £M3. The growth of £M3 through the target period to date would be about 10½ per cent on the proposed new definition, as against 10¾ per cent on the existing definition. If the PSBR had been similarly redefined this year it would have totalled £9.8 billion in the period to end-December as against the published figure of £10.1 billion.

There may be some press comment from the technical experts and City commentators. Both Treasury and the Bank of England press offices are being briefed to deal robustly

with any suggestion of "fiddling the numbers". They will be explaining that these are modest statistical changes which are intended to improve the quality of our recorded PSBR and £M3 figures, and to bring them into line with international practice.

Yours ever,

J O Kerr.

J O KERR
Principal Private Secretary

ANNEX A

DRAFT WRITTEN PQ

To ask Mr Chancellor of the Exchequer, whether he is content with the treatment of changes in the public sector's holdings of bank deposits in the current definitions of the Public Sector Borrowing Requirement and £M3.

DRAFT REPLY

On current definitions, changes in deposits held by the public sector with UK banks affect the size of the PSBR; and these deposits are included in £M3 and M3 (but not in the other monetary aggregates). Although the level of public sector deposits is relatively small, changes in individual months can be large. These changes, however, are erratic, and tend to be reversed over a fairly short period. They ~~seem to be~~ are of no economic significance. In future therefore public sector deposits will be excluded from £M3 and M3 (with effect from the beginning of the next target period) and from the PSBR (with effect from the 1984-85 financial year). These changes in definition are likely to have only minor effects on annual totals.

Further details of the proposed re-definitions, and figures for earlier periods, will be given in 'Economic Trends' and the Bank of England Quarterly Bulletin.

CONFIDENTIAL

DRAFT PRESS NOTICE

PUBLIC SECTOR DEPOSITS: PSBR AND £M3

The Chancellor of the Exchequer announced in a Written Answer in the House of Commons this afternoon that a technical modification is to be made to the definitions of the PSBR and £M3, to exclude sterling bank deposits held by the public sector*.

2. The redefinitions will take effect from the start of the 1984-85 financial year (for the PSBR) and the 1984-85 target period (for £M3 and M3). More detail will be given in the February edition of 'Economic Trends' and in the March Bank of England Quarterly Bulletin.

3. Public sector bank deposits comprise:-

i. Central Government bank deposits, which are extremely small on average, but can show large temporary fluctuations (eg reflecting tax receipts in the form of uncleared cheques).

NLF balances held with the Bank of England under Section 12 of the National Loans Act are already excluded from the PSBR, £M3 and M3.

ii. Local authorities' bank deposits, which are also small relative to local authorities' expenditure, and subject to

---

* Foreign currency deposits of the public sector will also be excluded from the PSBR and the M3 measure of the money stock. Public sector holdings of other liquid assets will also be excluded from the PSBR, but this will not affect £M3 and M3.

considerable month-to-month volatility (eg because of temporary delays before they are used to repay borrowing).

iii. Public corporations' bank deposits. Since public corporations have guaranteed access to central government funds within set limits, they have less need to hold liquidity balances than private companies. Working balances are normally held within the public sector.

4. These changes in definition will remove a small but very erratic element, which has no significance either for the level of public expenditure or wider economic activity, but can sometimes distort the monthly figures for the PSBR and £M3 by large amounts. The effect on the annual figures is likely to be small - over the last six financial years public sector deposits and other liquid assets have risen on average by £180 million within a year. Changes have ranged from an increase of £500 million in 1980-81 to a fall of £100 million in 1979-80. In the first three quarters of the current financial year public sector deposits etc rose by £360 million.

5. This change will bring £M3 and M3 into line with other monetary aggregates (including PSL1 and PSL2), which already exclude public sector deposits. The effect of the change on the long-term behaviour of £M3 is likely to be very small: on average public sector deposits have grown by less than £20 million a month over the last eight years, and they amount to only some 2½ per cent of the stock of £M3. Over short periods, however, sharp fluctuations in public sector deposits can distort the

path of month-to-month changes in £M3. In individual months public sector deposits have risen by as much as £500 million and fallen by over £400 million. The growth in £M3 at an annual rate over the current target period to mid-January is 10½ per cent on the revised basis, compared with 10¾ per cent on the existing definition. These changes in the definition of the PSBR will bring the UK into line with international conventions, as set out in the International Monetary Fund's guidelines on government financial statistics. Most other countries (eg US and Switzerland) exclude all, or some, public sector deposits from broad money measures.

55:1

FROM: M T FOLGER
DATE: 6 February 1984

MR TURNBULL - No.10 —

cc Miss O'Mara
Sir Terence Burns
Mr Battishill
Mr Hall
Mrs Lomax
Mr Shields
Mr A Smith
Mr MacKinnon
Mr Portillo
Mr Kavanagh CSO

5% GROWTH: MR NIGHTINGALE OF HOARE GOVETT

In response to your inquiry of the Chancellor's Office this morning, I attach a transcript of the interview on Radio 4.

2. You will see that Mr Nightingale's main assertion is that since the trough in 1981 GDP has probably grown at an annual rate of 5%. (The currently recorded figure of about 3% is in his view likely to prove an underestimate, judging by past CSO performance.) He seems to suggest that a credit squeeze will be needed "probably in the spring" to rein in growth of the money supply and so avoid "severe problems on the inflation front". He would then put 1984 growth at 3% in line with official projections.

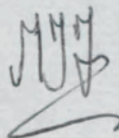
3. The main points to make (see attached advance copy of A10 from today's TWEB) are:

(i) despite all the uncertainties, there is no basis for suggesting that the rate of growth has been as high as 5%.

(ii) monetary growth is under control: after the faster growth in the first half of 1983, the annualised rate of monetary growth in the latest 6 months has been well within the target range. [NB provisional January money numbers, to be published at 2.30pm tomorrow, will bear on this comparison.]

(iii) growth has not come from any "very expansive policy", fiscal or monetary. It has been sustained by reductions in inflation and interest rates. The responsible policies which have brought these reductions will be maintained: there is no question of slamming on the brakes.

4. CSO confirm that, historically, underestimates of growth rates have typically been in the range ½ to 1%. They believe that current work will improve on that.



M T FOLGER

ROGER NIGHTINGALE - INTERVIEW ON SPIRAL EFFECTS OF HIGH BORROWING

Transcript from: BBC Radio 4, Today, 6 February 1984

INTERVIEWER : (John Timpson) Easy availability of money is driving the economy along at a feverish pace which could soon lead to higher inflation, a wages [surge?] and a credit squeeze, according to economic experts in the stockbroking firm of Hoare Govett Which may come as a surprise, not only to people who haven't found money to be all that easily available lately, but also to other economists who've been talking about a gentle growth rate of 2½ to 3%. With me is Roger Nightingale, chief economist of Hoare Govett . ..... How does this tally with these other economists; I mean, for instance, in the paper this morning one of your fellow brokers, Rowe + Pitman, produce a report saying that most commentators agree that the economy will expand by between 2½ and 3% this year?

NIGHTINGALE: Yes, it's very difficult to account for exactly what other people are saying. I mean I don't think there's a great deal of disagreement actually, funnily enough, on what is going to happen in 1984. Really the disagreement centres probably more on what happened in the last 2 or 3 years. And our view is that having reached bottom in say Spring of 1981 the economy grew very quickly. And indeed in the last 12 months or so has been growing at something like 5% per annum . Our view is that in fact at the present time and with present policies the growth would carry on being of the order of 5%, but that would create such an explosion in inflation the authorities will have to come in and dampen things down. Funnily enough we actually agree with the figure in the region of 3% for the current year but as a result of deflation rather than as a result of stimulation.

INTERVIEWER : Your figures of past growth of 5%, that's higher than the Government's figure isn't it?

NIGHTINGALE: Indeed it is yes yes. But of course figures are always revised upwards. If you remember 1982 was initially announced to be something in the region of only ¾% growth, it has now been revised up to 2½% growth. And this is not an exception. Every single year in the last 20 has been revised up very substantially over time and 1983 is probably going to be revised up we think to something in the region of 5, 5½%.

INTERVIEWER : It's surprising that the Government hasn't made more of this if this is the case I should think Mr NIghtingale, because this justifies their policies doesn't it?

NIGHTINGALE: Again it's difficult to account for how Governments behave sometimes. It's much more difficult actually to account for the inaccuracies in the data. But the fact of the matter is that these inaccuracies are there and that the revisions are of a consistent nature. They are always revised upwards.

INTERVIEWER : Well now if we do indeed have this economy going at a feverish pace presumably, as you say, something will have to be done about it - what would you predict the Chancellor would do in his Budget?

NIGHTINGALE: He could of course do very little as Heath and Barber did 10 years or so ago. In which case you do get very severe problems on the inflation front. They don't build up immediately but they are certain to emerge ultimately. The alternative is that he does something to constrain activity. At the moment he has money supply growth in the region of 4 or 5 or 6% per annum in real terms. And it is a very expansive policy. Again the last sort of people who had polides of that sort were Heath and BArber 10 years ago. It is almost certain

that he can't keep things like that forever. That is why the economy is so feverish. The chances are therefore he will at some stage, probably in the spring, decide to clamp down on credit availability. He will sell more gilts, raise interest rates, make it more difficult for us to get hold of consumer credit.

1. TF
2 CF

10 DOWNING STREET

(2)

Prime Minister

Mr Nightingale is correct in his assertion that the first estimates normally underestimate the growth of GDP. But Treasury think he is ~~to~~ exaggerating in claiming growth is close to 5% p.a.

Treasury also argue that it will not be necessary to slam on the brakes, merely keep Government borrowing coming down.

AT
6/2

File

10 DOWNING STREET

From the Private Secretary

6 February 1984

The Prime Minister was grateful to you for your letter of 26 January, bringing to her attention the very striking differences between the experience in the United States, where the number of jobs has increased substantially, and that in Western Europe where there has been a fall in the number of jobs. This illustrates that the spread of technology, which has been common to both areas, cannot be blamed for the failure to increase employment in Europe.

Andrew Turnbull

Walter Goldsmith, Esq.

2

PRIME MINISTER

OECD PAPERS

On a number of occasions recently you have mentioned the OECD work on social expenditure. At Questions on Thursday, however, you mentioned explicitly the two OECD papers. This has sparked a number of enquiries, e.g. from George Gardiner. There are difficulties in responding to this.

The longer paper was prepared for a meeting of Government experts. It has not been published, though it is likely that a number of journalists have seen it. After further discussion, it could emerge several months hence as an OECD study.

The shorter paper has been prepared for the Ministerial Conference on long-term issues in mid-February. It too is confidential to OECD and the member governments. It is not the usual practice of OECD to publish the papers of Ministerial meetings but I am investigating whether the Secretariat has any plans to publish a report or communique after the meeting. Meanwhile, I think it would be wrong for the U.K. Government to release an OECD Secretariat document without their agreement.

There is a way out of this. OECD will be publishing an article in the OECD Observer (their equivalent of the economic progress report) which summarises the longer paper. I believe this will appear on 31 January. A rough proof copy is attached.

I suggest that when the article appears we use it to satisfy requests for the OECD documents. We will need to make clear that the U.K. Government is not endorsing the specifics of the scenarios, merely welcoming the debate which they provoke. Some commentators might interpret the article as meaning that there is no problem as the Welfare State can be afforded, ignoring the caveats about the powerful upward pressures for more social expenditure.

AW

27 January, 1984

There were leaders in the FT over the years.
MS

INSTITUTE OF DIRECTORS

From the Director General

Director General
Walter Goldsmith

116 Pall Mall
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SW1Y 5ED
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Telegrams
Boardrooms
London SW1
Telex 21614

Prime Minister
I will reply.

AT 6/2

R1/2

26th January 1984

The Rt Hon Mrs Margaret Thatcher, MP
10 Downing Street
London SW1

Dear Prime Minister

I am enclosing an extremely interesting article that appeared in the Wall Street Journal yesterday, which I thought you might like to see.

I am sure that you will agree that it is significant that between 1973 and 1982 15 million new jobs were created in the United States, whilst, at the same time, Western Europe has suffered from a net loss of 3 million jobs.

Yours sincerely

Walter Goldsmith

WALTER GOLDSMITH

P.S. why not send a small mission of ministers, civil servants and businessmen to find out why?

Why America's Got So Many Jobs

Drucker on Management

Why is this new economy an American phenomenon? There are harbingers of a similar development in Japan, but few signs of entrepreneurial dynamism in Western Europe.

B[illegible]er F. Drucker

CLAREM[illegible], Calif. – "Where have all the jobs gone?" has been the constant question in all Western industrial countries these past few years. But another question is at least as important – perhaps much more so – and yet it is never asked: Where have all the jobs come from? All developed industrial countries are losing jobs in the "smokestack" industries – even Japan. But the U.S. economy is creating new jobs at a much faster rate than the smokestack industries are losing old ones, indeed at a rate that is almost unprecedented in America's peacetime history.

Between 1965 and 1984, America's population aged 16 to 65 grew 38%, to 178 million people from 129 million. But jobs during that period increased 45%, to 103 million from 71 million. By this fall, they are likely to reach 105 million or 106 million, which would mean a rise of almost 50% since 1965. And more than half this growth occurred since the energy crisis in the fall of 1973 – years of "oil shocks," of two recessions and of the near-collapse of the smokestack industries. Indeed the 1981-82 recession, for all its trauma, barely slowed the rapid pace of new-job creation. At its bottom, in fall 1982, there still were 15 million more jobs than there had been in 1973, despite record unemployment.

In Japan, jobs these past 10 years have grown about 10%, only half the U.S. rate, to 56 million from 51 million. Western Europe has had job *shrinkage*. In Western Europe, there are now three million fewer jobs – after full allowance for cyclical unemployment – than there were in 1974.

High-Tech a Marginal Source

And the U.S. economy now has about 10 million more jobs than even optimists predicted 15 years ago. Such a careful and authoritative expert as Columbia University's Eli Ginzberg then thought that during the late 1970s and early 1980s the federal government would have to become the "employer of first resort" to provide jobs for the children of the "baby boom." But without any government help Americans have provided half as many again as needed to absorb the members of the baby boom. This was in order to accommodate what nobody foresaw 15 years ago – the rush of married women into jobs. Where have all these jobs come from?

They didn't come from the sectors that for almost 40 years through the 1960s provided virtually all the new jobs in the U.S. economy – government and big business. Government stopped expanding its employment in the early '70s and has barely maintained it since. Big business has been losing jobs since the early '70s. In the past five years alone, the Fortune 500 – the country's biggest manufacturing companies – have permanently lost around three million jobs. Nearly all job creation has been in small and medium-sized businesses, and practically all of it in entrepreneurial and innovative businesses.

"Aha," everyone will say, "high-tech." But everyone will be wrong. High technology is tremendously important – as vision setter, pace setter, excitement maker, maker of the future. But as a maker of the present it is still almost marginal, accounting for no more than 10% of the jobs created in the past 10 years. And it is reasonably certain that its job-creation rate won't increase significantly until after 1990.

New-job creation mainly is in "low-tech" or "no-tech" businesses. One indication is Inc. magazine's annual list of the fastest-growing publicly owned businesses more than five years and less than 15 years old. Being confined to publicly owned companies, the list has a strong high-tech bias. Yet 80 of the 100 companies on the 1982 list were decidedly low-tech or no-tech – women's wear makers, restaurant chains and the like. And Inc.'s list of the 500 fastest-growing closely held companies is headed by a maker of exercise equipment for the home.

The most illuminating analysis, however, is a study of "mid-sized growth companies" – those with annual sales of $25 million to $1 billion a year – made by the consulting firm McKinsey & Co. A majority of these concerns aren't high-tech; a majority are manufacturers rather than services. These mid-sized growth companies grew three times as fast as the Fortune 250 – the economy's big companies – in sales, profits and employment during 1975-80. Even during the worst of the recent recession, when the Fortune 250 cut employment nearly 2% in one year, the mid-sized growth companies added one million jobs – or 1% of the country's employed labor force. And all that these companies have in common is systematic entrepreneurship and purposeful innovation.

For about 10 years now, the U.S. economy's dynamics have been shifting to entrepreneurial and innovative businesses – mostly low-tech or no-tech. In economics 10 years is a long time – long enough to talk of a "structural change." What explains this shift isn't clear yet. Surely there has been a sharp shift in values, attitudes and aspirations of a lot of educated young people – a shift totally different from the "Greening of America" promised 15 years ago, when the real change actually began. There are many people around now who are risk-takers and who want material success badly enough to impose on themselves the grueling discipline and endless hours of the entrepreneur.

But where does the money come from? A decade ago, Americans worried that there would be no capital available for new ventures – now it seems there is more venture capital than there are ventures. The biggest factor in the entrepreneurial explosion – and the one truly new technology – is probably a managerial breakthrough: the development since World War II of a body of organized knowledge of entrepreneurship and innovation.

Why is this new economy primarily an American phenomenon? While there are harbingers of a similar development in Japan, there are few signs of entrepreneurial dynamism in Western Europe.

The American development clearly disproves the most widely held and most serious explanation of the economic crisis of the past 10 years, and the most widely held and most serious prediction for the decades to come: the "no-growth" theory based on the "Kondratieff long wave" (named after the Russian Nikolai Kondratieff – born in 1892 and executed sometime in the 1930s on Stalin's orders because his economic model accurately predicted that collectivization would cut rather than multiply farm output).

According to the long-wave theory, developed economies enter a long period of inexorable stagnation every 50 years. The technologies that carried the growth in the earlier ascending stages of the "Kondratieff cycle" still seem to do very well during the last 20 years before the "Kondratieff bust." Indeed, they show record profits and can pay record wages; being "mature" they no longer need to invest heavily.

But what looks like blooming health is, in effect, wasting sickness; the "record profits" and "record wages" are already capital-liquidation. And then, when the tide turns with the Kondratieff bust, these mature industries all but collapse overnight. The new technologies are already around, but for another 20 years they can't generate enough jobs or absorb enough capital to fuel a new period of economic growth. For 20 years there is thus a "Kondratieff stagnation" and "no growth"; and there is nothing anybody – least of all government – can do about it but wait it out.

The smokestack industries in the U.S. and Western Europe do seem to conform to the Kondratieff cycle. In Japan, too, they seem to be headed the same way and to be only a few years behind. High-tech also conforms; it doesn't generate enough new jobs or absorb enough new capital yet to offset the shrinkage in the smokestack industries.

But the job-creation by entrepreneurial and innovative businesses in the U.S. simply isn't compatible with Kondratieff. Or, rather, it bears a remarkable resemblance to the "atypical Kondratieff wave" of Germany and the U.S. after 1873 – 25 years of great turbulence in these countries and of economic and social change, but also 25 years of rapid economic growth.

This atypical Kondratieff wave was discovered and described by Joseph Schumpeter (1883-1950) in his classic "Business Cycles" (1939). This book introduced Kondratieff to the West; but it also pointed out that the Kondratieff stagnation occurred only in England and France after 1873, the period on which Kondratieff based his "long wave." Germany and the U.S. also had a "crash." But recovery began almost at once, and five years later both countries were expanding rapidly and continued to do so up to World War I. And what made these two countries atypical and made them the growth economies of the late 19th century was their shift to an entrepreneurial economy.

A Commodity Crisis

There are massive threats in the world economy. There is the crisis of the welfare state with its uncontrolled and seemingly uncontrollable government deficits and the resulting inflationary cancer. There is the crisis of the commodity producers everywhere, in the Third World as much as on the Iowa farm. Commodity prices for several years have been lower in relation to the prices of manufactured goods than at any time since the Great Depression – and in all economic history, there has never been a prolonged period of very low commodity prices that wasn't followed by depression in the industrial economy. And surely the shrinkage of jobs in the smokestack industries and their conversion to being capital-intensive rather than labor-intensive, that is to automation, will put severe strains – economic, social, political – on the system.

But at least for the U.S., the Kondratieff no-growth prediction is practically ruled out by what has already happened in the American economy and by the near-50% increase in jobs since the smokestack industries reached their "Kondratieff peak" 15 or 20 years ago.

Mr. Drucker is Clarke professor of social sciences at the Claremont Graduate School.

HENDRY VS FRIEDMAN AND SCHWARTZ: GUARDIAN

Background

Today's Guardian reports the imminent publication by the Bank of England of a paper by Professor Hendry of Oxford, which criticises the econometric evidence contained in "Monetary Trends in US and UK 1867-1975" massive book published last year by Professor Milton Friedman and Anna Schwartz, part of a wider research project that has taken 20 years.

2. Hendry paper was prepared for a recent meeting of the Bank of England's Academic Panel, and, as is normal with such papers, it will appear as a Bank of England discussion paper. It is highly technical: its main purpose is to argue that Friedman and Schwartz's econometrics is out of date.

3. Professor Hendry is a very reputable econmetrician, not generally favourable to Government policy, and well knownfor setting very demanding standards. We have not yet seen a final draft of this paper.

Points to make

1. Friedman's book only appeared last year. Widely hailed as impressive achievement in US and UK, though - of course - some critics Friedman has written countless other books.

2. Publication of Hendry paper by Bank of England does not mean Bank agrees with his views. [If pressed:- one of Bank's leading economists - Charles Goodhart - wrote favourable review of Friedman's book - see attached quote].

3. Will be in a better position to judge strength of Hendry's case when article is published (next week).

4. Always technical disputes between econometricians. Given the state of the art, absurd to claim Government policies stand or fall by any particular piece of econometric research. Agree with

S Brittan (today's FT):

"My remaining hair stands on end at the thought of policy being determined by the rapidly shifting findings of econometricians."

Quotations from Reviews of Friedman and Schwartz

Charles Goodhart (Bank of England) Review in Journal of Economic Literature December 1982:

"This is an important and valuable book, in which the statistical evidence on the interrelationships between money, prices and output and interest rates is assess carefully and rigorously, though in a somewhat idiosyncratic manner. There are, however, some flaws.... nevertheless it remains a work of major empirical importance."

Prof. D Laidler (Bank of W. Ontario) Review as above:

"A marvellous book". I find it difficult to seriously fault this book.... "The Quantity Theory ... emerges as a clear winner".

T Congdon (Messel's) The Banker

"Friedman and Schwartz have produced another great book.... represents a powerful contribution to academic understanding."

nted in London and Manchester Thursday December 15 1983 23p

Monetarism's guru 'distorts his evidence'

By Christopher Huhne

Nobel prize-winner, Milton Friedman, guru of the monetarist counter-revolution in economics, has effectively been accused of disturbing evidence for his theories in a devastating critique to be published by the Bank of England.

The study will cause considerable embarrassment to the Government. One implication, which has survived close inspection by the Bank's academic consultants, is that it is well-nigh impossible to set realistic targets for the money supply, and it could be dangerous to try.

The research, initially funded by the then Social Science Research Council, may provoke a row between Downing Street and the Bank over the cachet given to the work by official publication. The Treasury continues to set targets for the growth of money supply.

The authors of the study are David Hendry, acting director of Oxford University.s Institute for Economics and Statistics, and Neil Ericsson, of Nuffield Colleges.

Their target is Professor Friedman's evidence for a link between money supply and incation. They say he reaches "conclusions devoid of empirical support" based on evidence of "dubious validity."

Hendry and Ericsson concentrate on Professor Friedman's book Monetary Trends in the United States and the United Kingdom, co-written with Anna Schwartz and intended when it was published last year, to be the definitive statement of his theories and supporting evidence.

Monetarism is bunk, page 19

Professor Hendry said yesterday that Professor Friedman resorts to "simply incredible" manipulation of official data and that "almost every assertion in the book is false." A Bank of England economist said that the study "blows Friedman out of the water."

In an attempt to prove that inflation is "always and everywhere" due to too much money chasing too few goods, Professor Friedman manipulates official statistics to reduce the money supply between 1921 and 1955, and to increase prices after the second world war.

But even then his theory just does not stand up, according to Professor Hendry. It is essential for Professor Friedman to prove a stable link between money supply and total money spending, but the relationship varies so widely and unpredictably as to be random.

A given level of money supply is thus able to finance widely different levels of total money spending and inflation, so that the money supply numbers themselves are a very poor indicator of the state of the economy. They could be unduly restrictive, despite an apparent overshooting of monetary targets.

"David Hendry is the leading member of the younger generation of British econometricians," Mr David Savage, editor of the National Institute Economic Review said yesterday. "This devastating critique is a very efficient hatchet job."

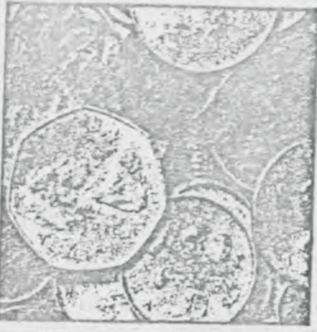
Professor Friedman was sent a copy two months ago, but has not yet responded.

The paper is scheduled for publication by the Bank of England next week. Publication in the Bank's academic series does not imply that the views are shared by the authorities, but merely that they are deemed worthy of note.

A Treasury spokesman said last night that the Government had no intention of changing its monetary policy.

6

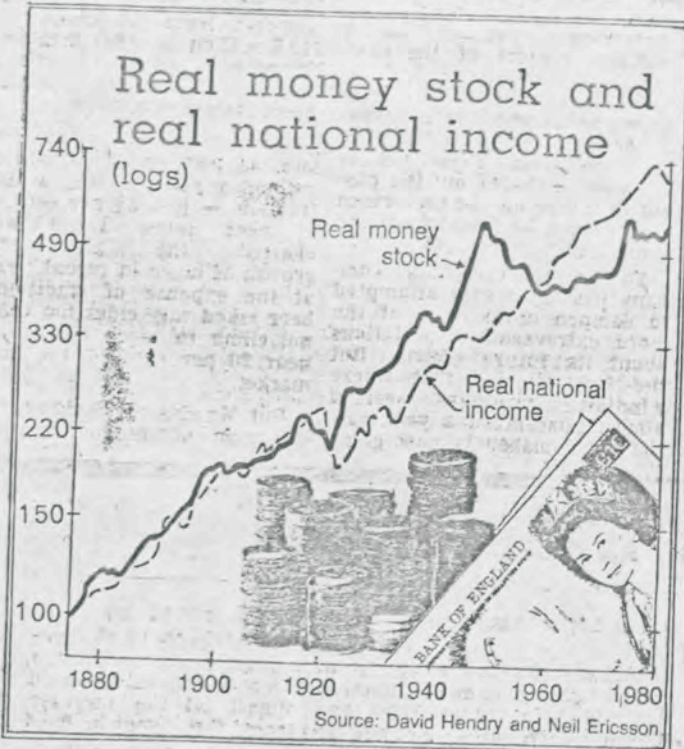
Why Milton's monetarism is bunk



ECONOMICS

Christopher Huhne

Oxford Dons show why Friedman is 'devoid of empirical support'



Milton Friedman . . . emperor of international monetarism

IT IS A very long time since there have been any bombshells from Oxford University quite like the one which Professor David Hendry has just dropped on Professor Milton Friedman. Friedman, the emperor of international monetarism, is roundly declared to have no clothes on.

The implications for business economists, market dealers, students, academics and governments are quite simply shattering, for no single piece of research that I can remember has so effectively undermined the monetarists' conventional wisdom that inflation is always caused by "too much money chasing too few goods."

What is more, the critique of Friedman comes from a scrupulous econometrician who is widely respected throughout the profession, and who has in the past delivered shafts in equal measure at both the monetarist and Keynesian camps.

He is at pains to point out that his work is "pro-econometrics" and pro-rigorous empiricism rather than "anti-monetarist," though anto-monetarist its results clearly are.

At issue is Friedman and Anna Schwartz's magnum opus, the 660-page culmination of the Nobel Laureate's life work in monetary theory, which was published last year under the title "Monetary Trends in the United States and United Kingdom: there relation to Income, Prices, and Interest Rates 1867-1975." In a brief paper, Hendry and his co-author Neil Ericsson succeed in destroying the evidence Friedman offers brick by crumbling brick.

Professor Friedman has dedicated his energies to resuscitating the ancient quantity theory of money. It is a very simple view of the world, which is one of the reasons why it has proved so attractive to governments and voters. It has been easy to popularise, while Keynesian theory is far more difficult.

In essence, Friedman's view is that the growth of the money stock or supply — formed on notes, coin and bank accounts — determines the rise of prices. This is based first on the uncontroversial notion that M (money supply) times V (the speed at which it circulates — or velocity equates the price level (P) times the amount of goods and services in the economy (T for transactions).

Thus MV-PT (the Fisher equation) is a simple identity which is true by definition, since the PT is the total of money spending in the economy, whicle V is defined as the number needed so that M multiplied by V also gives total money spending.

But the monetarists go on to argue that V is stable over time, and so is the number of transactions, since these are determined by real factors such as training or entrepreneurship rather than by monetary disturbances. If these propositions are true, then it must also be true that a change in the money supply (M) bigger than the growth of transactions leads to a change in the price level (P).

Yet it is precisely these propositions which Professor Hendry has so devastatingly undermined. Indeed, he undermines them even on the basis of Friedman's own data, which is subject to manipulations Hendry describes as "simply incredible" and which less academic souls would call jiggery-pokery.

In order to establish a more stable figure for velocity — the key number which ensures a stable link between money and prices — Friedman arbitrarily reduces the money stock by some 20 per cent for a period of no less than 34 years between 1921 and 1955 — nearly a third of the entire span he studies. This is on the grounds that "war and depression" cause people to hold more money in their bedsocks).

He also then boosts the price level in the period after the second world war to allow for price controls and rationing. In other words, Friedman argues that the price level must have been higher than official statistics showed, since the money supply grew more quickly then prices. He then uses the manipulated data to prove the link between money and prices. This is very circular, and very naughty.

Professor Hendry's feat, however, is to take this severely massaged data and show that not even such distortions can save the empirical support for Friedman's theory. "One of the most amazing things about our study," says Hendry, "is that we have not been able to find any evidence that money supply creates either income growth or inflation." It seems, if anything, to be a passive respondent to the rest of the economy.

One of hendley's graphs shows the lack of a relationship between the price level and money supply (deg9ned by Friedman as M2, broadly similar to the present broad money definition of sterling M3). There was a steady incerase in the money stock from 1870 to 190, but a stable price level followed by a surge in inflation in 1919.

The money supply then tently rose through the late '20s and '30s, while prices fell. There was then a rapid increase in money during the '50s, while the price level grew only gently.

The graph we reproduce is even more telling. According to monetarist theory, any extra money created over and above the amount needed to finance real grwoth in national income (or tansactions) will be dissipated in price rises. Therefore the real money stock, after allowing for inflation, should track the growth of real national income more or less exactly.

This, indeed, is what the graph shows — but only up to 1920 when Britain was a relatively simple economy with a simple financial system. After 190, the real money stock diverges sharply from real national income, first upwards and then downwards in the '50s and '60s. There could be no more graphic and simple illustration of why monetar-

Econometrics, though, is the science (art ?) of putting into quantitative form the relationships (or lack of them) which we can see in a graph, so Hendry and Ericsson's work gives us a good idea of just how unstable, unreliable and unpredictable—indeed, dangerous—the monetarist "relationships" are.

Take velocity, for example. Without stable velocity, there will be no predictable relationship between money and money spending or prices. Yet Friedman's own work shows a "standard error" in predicting the demand for money of 5 per cent. What this means is that two thirds of the time, money could change by up to 5 per cent on either side of the theory's prediction. A third of the time it will even be out of this range.

Professor Hendry likens velocity to the walk home of a drunken man: he's heading roughly in the right direction but one can never predict whether his next step will be backwards, forwards or sideways. It is a "random walk."

What this means for policy-makers, and market watchers, is that a given money supply target could finance vastly different levels of transactions and inflation, and in a wholly unpredictable manner.

Apparently excessive money supply growth, such as that of 1980, can in fact be supremely restrictive. How on earth can the Government set realistic money supply targets when it has no idea of how much money the economy will generate ?

Another important finding of Hendry and Ericsson's work is that the money supply is clearly not independent of events in tht rest of the economy, yet the Friedmanite claim of independence ("exogeneity") is vital if he is to saddle governments and central banks with the responsibility for controlling it.

Similarly, the paper shows clear examples of where rises in interest rates have preceded—and possibly caused—falls in velocity, which contradicts Friedman's theory explaining why velocity is stable.

Of course, the fact that Friedman's assertions are, as Hendry and Ericsson write, "devoid of empirical support" does not necessarily mean that they are wrong. But until the monetarists provide some evidence which stands the test of modern econometric methods, it does mean that their views on the economy should be treated as gingerly as those of, say, meteorologists or astrologers.

*"Assertion without empirical basis: An econometric appraisal of 'Monetary Trends in . . . the United Kingdom' by Milton Friedman and Anna Schwartz" by David F. Hendry and Neil R. Ericsson shortly to be published by the Bank of England.

MR. TURNBULL

Q. IN VIEW OF THE COMPLETE DISCREDITING BY PROFESSOR DAVID HENDRY OF THE VIEWS OF THE LEADING MONETARIST, MILTON FRIEDMAN, WOULD THE PRIME MINISTER NOW AGREE THAT IT IS ABSURD TO HAVE ANY MONETARY TARGETS FOR CONTROLLING THE ECONOMY?

A. The Right Honourable gentleman is presumably referring to the academic discussions that have followed publication of the study by Milton Friedman and Ernie Schwartz of Monetary Trends in the United Kingdom and the United States. These academic controversies have just started and I have no intention of either entering the fray or pre-judging the outcome.

BACKGROUND NOTES

The Friedman/Schwartz study is notable for its extraordinarily high standard of scholarship, very unusual in economics nowadays. All the reviews I have seen pay a great tribute to the care and honesty with which the data was measured, adjusted, deployed and used.

The draft of Professor Hendry's study that I saw also paid a considerable tribute to the scholarship which had been lavished on the data. The adjustments were described meticulously and the reader is usually given alternative results if he wishes to reject the Friedman adjustments.

The main criticism of Hendry arises from Hendry's belief that there is only one econometric methodology, his own, for dealing with these data. Hendry believes that only his statistical tests are appropriate. Furthermore, the tests and statistical manipulations which Hendry carries out are extraordinarily complex and would be appreciated only by a handful of people in the United Kingdom. It is a small charmed circle*. The Friedman/Schwartz volume, however, is much more accessible. Most people can understand the analysis and results.

The Guardian's headline and articles are a scandalous distortion of the discussion. In the version that I read, Hendry never makes the accusation that Friedman "distorts his evidence" as appears in The Guardian headline. And indeed in the first paragraph of that article Huhne says that Friedman "has effectively been accused of distorting evidence". Friedman and Schwartz are entirely open and above board in all that they do, as Hendry readily acknolwedged.

ALAN WALTERS
15 December 1983

GUARDIAN ARTICLE: "WHY MILTON'S MONETARISM IS BUNK"

(Hendry and Ericcson Paper)

Line to take

Absurd to presume that Government policies stand or fall by any particular piece of econometric research. I refer the hon Gentleman to the evidence that, thanks to the Government's economic policies, inflation is down to 5 per cent. The proof of the pudding is in the eating.

CONFIDENTIAL

File   bc: A. Walters

19 January 1984

MONETARY TARGETS

The Prime Minister has seen your letter to me of 16 January, and the record of the meeting and the draft section of the MTFS which were attached to it. She is content with the agreement reached to have two target ranges, with two aggregates in each range, though with one aggregate having rather higher status than the other.

Andrew Turnbull

John Kerr, Esq.,
H.M. Treasury.

CONFIDENTIAL

10 DOWNING STREET

From the Private Secretary

Prime Minister

I believe the Bank were right to argue that both the broad and the narrow ranges should have two aggregates in them, albeit with one senior and one junior

(i) it would be wrong to drop PSL2 when building society deposits are rising so fast.

(ii) the economic case for M0 is not that well based that we can rely on it as the sole indicator of the narrows

(iii) conceptually M2 is the best indicator indicator of transactions balances, having been designed specifically for this purpose. The only mark against it is its youth.

I think, therefore, that the compromise agreed upon is the best outcome.

AT

18/1

10 DOWNING STREET

From the Private Secretary

Prime Minister

The PSBR for December is £1.3 billion bringing the total for the year to £10.1 billion. This is on course for £10b. for 1983-84 as after nine months the cumulative total is often greater than the figure for the whole year after the revenue season. £10.1 billion is about £1 billion better than the profile of the July forecast would have indicated.

AT 17/1

Linda Rust looking

Andrew

At last night's meeting of Special Advisers, the P.M. referred to the OECD report (or 2 OECD reports.) on public expenditure. Special Advisers would like the reference etc

1. Can you please tell me what precisely these papers are so I can pass it on.

2. Could I at some stage have ~~sight~~ sight of these papers?

Steve 17/1

CONFIDENTIAL

cc SR

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

16 January 1984

Andrew Turnbull Esq
No 10 Downing Street
LONDON SW1

Dear Andrew,

MONETARY TARGETS

The Prime Minister spoke to the Chancellor last week about the paper enclosed with my letter of 9 January to you. My letter mentioned that the Chancellor would be discussing with the Governor, on 13 January, the form of the monetary targets to be included in the MTFS in this year's Red Book. I now enclose my record of that meeting: as you will see, the outcome was, as the Chancellor hoped, agreement on the last option set out in the Treasury paper, for which the Bank in the end promised full support.

As before, a copy of this letter and enclosure goes to Alan Walters.

Yours ever,

Jon Kerr.

J O KERR

Enc

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MONETARY TARGETS: NOTE OF A DISCUSSION IN THE CHANCELLOR'S OFFICE AT 2.45 P.M. ON 13 JANUARY 1984

Present:	Chancellor of the Exchequer Economic Secretary Sir P Middleton Sir T Burns	Governor Deputy Governor Mr George Mr Goodhart	Mr Cassell Mr Battishill Mr Lankester Mr Ridley Mrs Lomax

Papers: Treasury paper of 6 January;
Bank paper of 10 January

It was agreed at the outset that it would be necessary, in the 1984 MTFS, to move to two target ranges, one for broad and one for narrow money. The discussion then centred on the choice of narrow money target aggregate(s).

2. The Governor and Mr George argued that M2 was conceptually the best measure of transactions balances. But, because its track record was as yet very short, it would be rash to go for M2 as the single narrow money target aggregate. It would however be no less rash to choose M0 alone, for, just as it had proved useful to refer specifically to PSL2 as a cross check on £M3, so it would be useful to have two narrow money target aggregates. Sir T Burns thought that introducing M2 would invite questions which, given the short track record, would be very hard to handle; but it was noted that the Mansion House speech references to M0 had similarly raised a number of questions. Sir P Middleton pointed to the danger of differential movements in M0 and M2, and the Chancellor pointed out that the reasons for their recent similar movements were not fully understood. Targeting either carried risks, but they would not be reduced by targetting both.

3. The Deputy Governor however argued that the aim now should be to make a modification to the targets which should prove durable. To bring in M2 would be helpful in avoiding a risk of discontinuity if, as its track record lengthened, its primacy became obvious. Moreover M0 figures could virtually be derived on a weekly basis by outside observers: if M0 were the only narrow money target aggregate, we might face something similar to the weekly problems now faced by the Fed. And two target aggregates would be mutually reinforcing: if only one were adopted, the difficulty of defending inaction in the face of a couple of aberrant months would be considerable. The Chancellor thought that the converse was that the market might think that having two target aggregates represented a recipe for inaction. The authorities might be perceived to have moved still further away from the initial firm stress on £M3, with a plethora of target aggregates to ensure that at least one would be hit. This risk was however thought to be containable: Mr George thought that the market was in no doubt that the Government took the exercise seriously, and that it made sense to look at both broad and narrow aggregates. He saw a considerably greater risk of an adverse market reaction if M0 were singled out as the narrow money target aggregate, and the Governor thought it important to go for two broad and two narrow target aggregates.

4. It was agreed that option 3 in the Treasury paper of 6 January would be the appropriate solution for the 1984 MTFS. For broad money one would look at £M3 (and PSL2) and for narrow money M0 (and M2). Sir P Middleton presented a possible MTFS formula (attached) which was agreed to be satisfactory, subject to further discussion on the length of the target period (and possible consideration of a change of name for PSL2). The Governor expressed satisfaction with the decision taken: the new arrangement was in his view logical and workable, and would have the whole-hearted support of the Bank.

J O KERR
16 January 1984

Distribution

Those present
Chief Secretary
Financial Secretary
Minister of State
Mr Monck

DRAFT SECTION FOR MTFS

Money ranges

2.10 As announced in the Budget Speech, there will be two target ranges for monetary growth in 1984-85. The target for broad money is to be set /‾at the 6-10 per cent indicated in last year's Financial Statement_7. The target for narrow money will be /‾X-Y per cent_7. As usual these ranges apply to the annual rate of growth over the 14 months beginning in February 1984. Illustrative ranges for the next few years are shown in table 2.2. Precise targets for the later years will be decided nearer the time.

Table 2.2 Ranges for Monetary Growth

	Percentage change during year		
	1984-85	1985-86	1986-87
Broad money - £M3 (and PSL2)			
Narrow money - MO (and M2)			

2.11 The main measure of broad money for target purposes will remain £M3; the authorities will continue to take account of other indicators of broad money, especially PSL2. The target for narrow money applies to MO; in judging the performance of MO as an indicator of transactions balances, particular attention will also be paid to the behaviour of M2. The interpretation of monetary conditions will continue to take account of all the available evidence, including the exchange rate. The ranges shown in Table 2.2 have again been constructed on the assumption that there is no major change in the exchange rate from year to year.

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Pt II

FILE

10 DOWNING STREET

From the Private Secretary 12 January, 1984

The Prime Minister has from time to time expressed interest in the tables which show the distribution of income before and after income tax. She remembers the time when the table showed the various ranges of income, the numbers of taxpayers, the total income before tax, tax paid, and income after tax. In the 1960s, the Inland Revenue Annual Report produced tables of this kind. I attach a copy of the table in the report for the year ending March 1963. These tables enabled the user to calculate how much was being paid in income tax (and surtax) by those with incomes over a specified level.

More recent annual reports do not contain tables of this kind. In Social Trends, however, tables of a different type are published, with the ranges being specified by quantile groups rather than income ranges. The Prime Minister has asked whether tables of the original kind are still published elsewhere. If not, she has asked whether consideration could be given to publishing them.

I am sending a copy of this letter to John Kerr (HM Treasury).

(Andrew Turnbull)

A.J. Walker, Esq.,
Board of the Inland Revenue

1. INCOME TAX

Estimated classification of incomes by size before tax for 1961–62

TABLE 68 — Numbers thousands: Amounts £ million

Range of income before tax	Number of incomes	Income before tax	Tax	Income after tax
£ — £				
180 – 199 . . .	*355*	68	—	68
200 – 249 . . .	*900*	202	1	201
250 – 299 . . .	*950*	261	4	257
300 – 399 . . .	*2,000*	702	27	675
400 – 499 . . .	*2,100*	947	50	897
500 – 599 . . .	*2,250*	1,238	75	1,163
600 – 699 . . .	*2,400*	1,561	105	1,456
700 – 799 . . .	*2,450*	1,837	130	1,707
800 – 999 . . .	*3,800*	3,387	273	3,114
1,000 – 1,499 . . .	*3,400*	4,026	420	3,606
1,500 – 1,999 . . .	*725*	1,231	205	1,026
2,000 – 2,999 . . .	*370*	890	214	676
3,000 – 4,999 . . .	*193*	724	216	508
5,000 – 9,999 . . .	*84*	558	217	341
10,000 – 19,999 . . .	*18·6*	245	137	108
20,000 and over . . .	*4·3*	133	106	27
TOTAL . .	*22,000*	18,010	2,180	15,830

Estimated classification of incomes by size after tax for 1961–62

TABLE 69 — Numbers thousands: Amounts £ million

Range of income after tax	Number of incomes	Income before tax	Tax	Income after tax
£ — £				
180 – 249	*1,320*	290	—	290
250 – 499	*5,820*	2,340	120	2,220
500 – 749	*5,210*	3,320	260	3,060
750 – 999	*6,230*	5,740	460	5,280
1,000 – 1,999	*3,020*	4,370	640	3,730
2,000 – 3,999	*335*	1,240	350	890
4,000 – 5,999	*51·4*	430	180	250
6,000 and over . . .	*13·6*	280	170	110
TOTAL . .	*22,000*	18,010	2,180	15,830

3·620

2

10 DOWNING STREET

Prime Minister

I believe the table on page 76 is the one you remember. It's successor does not appear in current reports of Inland Revenue but, in slightly different and perhaps less usable form, in Social Trends. — see A.

Yes

AT
4/11

Can we possibly get a modern table equal to that on page 76?

Table for next edition of Social Trends

Table 5. DISTRIBUTION OF TOTAL INCOME[1] BEFORE AND AFTER TAX[2]

1980-81

United Kingdom Pounds and percentages

	Average income before tax (£s)	Average income after tax (£s)	Percentage of income paid in tax
Quantiles of tax units			
Top 1%	31,200	20,000	35.9
1-2%	15,100	11,700	23.0
6-10%	11,300	9,010	20.2
Top 10%	14,800	11,200	24.6
11-20%	8,700	7,080	18.6
21-30%	6,970	5,720	17.9
31-40%	5,700	4,710	17.3
41-50%	4,520	3,800	16.0
51-60%	3,480	3,010	13.5
61-70%	2,480	2,260	8.8
71-75%	1,660	1,600	3.4
Bottom 25%[3]	..	..	..

[1]Gross income (earned or unearned) less employees superannuation contributions, employment expenses, losses, capital allowances, stock relief, and any expenses allowable as a deduction from gross rents assessable under Schedule A.

[2]After deduction of income tax, but before deduction of national insurance contributions.

[3]Covers approximately 7.4 million tax units whose income in the main was not subject to tax. See Appendix Part 5 Distribution of personal incomes.

Source Survey of Personal Incomes, Inland Revenue

CONFIDENTIAL

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

9 January 1984

Andrew Turnbull Esq
No 10 Downing Street
LONDON SW1

Dear Andrew,

MONETARY TARGETS

Before Christmas the Chancellor told the Prime Minister about the progress of work in the Treasury on the form of the monetary targets for inclusion in the MTFS in this year's Red Book. It was agreed that some changes from the previous form were required, not least because it would not make sense to have a single target range for both broad and narrow money in the next MTFS. And, as was indicated in his Mansion House Speech, the Chancellor wishes to signal the importance for interest rate policy of movements in narrow money.

Provisional decisions were taken in-house at a meeting last month which Alan Walters attended - Alan is of course very much au fait with all this work - and have been reflected in the attached paper which has now been sent to the Bank, as a basis for further discussion with them. (I believe that the Chancellor promised to let the Prime Minister see a copy of the paper.) The Chancellor will be discussing it with the Governor at a meeting on Friday: while the Bank have in the past been inclined to argue for something along the lines of option 2 b, the outcome may be along the lines of option 3 in para 27.

A copy of this letter and the paper goes to Alan Walters.

Yours ever,

John Kerr.

J O KERR

MONETARY TARGETS

This paper sets out some issues still to be resolved on the form of monetary targets for the next MTFS - in particular what aggregates should we target. It is concerned entirely with the form of the targets. The appropriate numbers for the target ranges can be decided later.

2. The paper first records the points on which there is general agreement following the discussion of the Strategy papers last summer and identifies four main issues for decision. It then surveys what other people have said about monetary targets, and particularly about MO, after the Mansion House speech and reports what we have learned from our further research on narrow money since the papers circulated in mid-October. It also looks in more detail at the differences between MO and notes and coin, particularly in the context of operating a target for narrow money. The final section - paragraphs 26-27 - sets out what look to be the main options for the next MTFS.

WHERE WE STAND

3. There seems to be general agreement that:

i. In assessing monetary conditions it is necessary to look at both broad and narrow money.

ii. Whatever numbers are targetted, it will also be necessary to take into account other monetary indicators, including the exchange rate, in assessing monetary conditions.

iii. We cannot continue with the present arrangement in which there is one target range embracing both broad and narrow money. Last year was exceptional. Their different characteristics indicate different target ranges for broad and narrow money.

iv. M1 is an unsatisfactory measure of narrow money because of its substantial element of wholesale, interest-bearing deposits.

v. £M3 (and PSL2) continue to be reasonable measures of broad money.

vi. All monetary aggregates are subject to technological or institutional change.

4. Some changes in the form of monetary targets are necessary. The opportunity is therefore available to re-think the presentation of policy. There is no suggestion that the present process of arriving at interest rate decisions - or of market operations to support them - should be altered. These considerations underlay the Chancellor's speech at the Mansion House in October.

5. There are four issues for decision:

a. Should we move to two target ranges, one for broad and one for narrow money. If so,

b. Which aggregates are suitable for target purposes;

c. Should each target range refer to one monetary aggregate or to more than one;

d. What should be said about non-targetted indicators of monetary conditions.

The Target for Broad Money

6. At present broad money for MTFS purposes is referred to as "£M3 (and PSL2)" - 1983-84 FSBR paragraph 2.11. It is agreed that £M3 should remain a target aggregate for broad money. PSL2 does not, in practice receive much public attention, nor so far has it added much to the explanatory power of £M3. It is therefore for consideration whether it should cease to be referred to for target purposes and, instead, included among the

other measures of liquidity which are taken into account in assessing monetary conditions. The main problem in removing it - even in its present bracketed form - is that it might be taken to mean that we are taking less interest in the activities of building societies. This is not a message we should wish to convey given the present very strong growth of building society deposits.

The Target for Narrow Money

7. M1 needs to be replaced for target purposes for two reasons. First, it has a substantial and growing interest-bearing component, which means that like much of £M3 it can be held as an income earning asset. Second, it contains a large proportion of wholesale money and so cannot be said to be a very good indicator of the transactions function of money. The choice of narrow aggregate is not easy. In principle there are two candidates:

i. M2, which has been specially designed to measure retail transactions, but which nonetheless contains a considerable interest-bearing element.

ii. Various non-interest-bearing measures which might provide a good guide to transactions while avoiding the complication of having a complex interest-bearing element. These are NIBM1, M0 or notes and coin.

8. The difficulty with M2 is that it has not been in existence long enough - certainly not for use on its own. At the Mansion House the Chancellor said of M2:

"I think and hope that it will come to play an important part in policy decisions. But its time has not yet come."

So the Chancellor went on to say:

"Meanwhile, there is some recent evidence that other measures of narrow money - particularly measures of non-interest bearing money such as the wide monetary base, MO, and its predominant component, notes and coin with the public - have not been subject to the same distortions as M1."

9. A little later in his speech the Chancellor said that:

"... It does appear that MO could have a more important part to play as a key indicator in the growth of narrow money.

Whichever indicators we choose to emphasize, it is unlikely that it would be appropriate to maintain a single range for both broad and narrow aggregates ..."

There was no commitment to targetting MO, but a clear indication of looking in that direction. It is this aspect that has been seized on by most of those commenting on the speech.

REACTION TO MANSION HOUSE SPEECH

10. Reaction has been mixed, with the critics (mainly from the City) more vocal than the supporters.

11. Majority opinion in the City is critical, with particularly hostile pieces from Simon and Coates, Capel-Cure Myers (Roger Bootle) and Messel's (Tim Congdon). Hoare Govett (Paul Temperton, ex Bank author of the December 1982 BEQB article on cash) and Laing and Cruickshank are tersely dismissive, while Grievson-Grant, on the basis of the present Chancellor's allegedly sceptical remarks about narrow money in his 1981 Zurich speech, suggest that perhaps he "will not take MO as seriously as one might think at first sight". The exceptions are Phillips and Drew (Bill Martin, ex CPRS), with a generally sympathetic and perceptive note, and Greenwell's who were welcoming but worried about controlling MO "under present arrangements" (Greenwell's December Bulletin, however,

strikes a less grudging note, prompted by the recent Treasury EPR article on narrow money).

12. There has been little serious academic comment. Minford has been almost silent, approving the "sensible upgrading" of MO in a single sentence. Beenstock (in 'The Times') was enthusiastic, for the wrong reasons, stressing that MO is "unique because it is directly under the authorities' control ... controllable down to the last penny ... The Chancellor has really stuck his neck out this time." The City University (Roy Batchelor), long time MBC advocates, are actually critical, arguing that MO is essentially a means of controlling broad money, and unsuitable as a target in its own right. None of the outside forecasting groups (including the new LBS Financial Outlook) have commented.

13. Parts of the general argument of the speech have emerged almost unscathed:

i. Most commentators are prepared to accept the case for targetting narrow money as a measure of transactions balances.

ii. M1 has no defenders.

iii. Beenstock aside, the message that no move to MBC is being contemplated seems to have got across (though it has not pleased supporters of monetary base at Greenwell's and the City University).

iv. MO is widely seen as the main option, but there is some recognition of alternatives. Several commentators (eg the Economist, Greenwell's, Christopher Johnson) refer to "retail" or NIB M1, with varying degrees of

conviction. M2 comes in for favourable mention, but the view that it is too new to act as a target aggregate is not seriously questioned. Most (but not all) see notes and coin and M0 as synonymous.

14. The proposition that some measure of narrow money may be particularly relevant to short-term interest rate decisions is more contentious. Notable dissenters from this view are Roger Bootle and Tim Congdon, who say interest rate decisions should be based on an overall assessment of "financial conditions", consistent with the Government's objectives for inflation. Criticism of M0 itself is based on three oft-repeated points:

i. Interest rates have little or no direct effect on it, so it will be difficult to control (other than by "controlling the economy"). Some commentators challenge the sign of the effect (apparently on statistical grounds; no-one gives a convincing economic explanation of why there should be a perverse effect). The BEQB article - very occasionally supported by a chart - is the sole basis for these assertions. Only Christopher Johnson refers to the small (0.5 per cent) semi-elasticity in the current public version of the Treasury model. Greenwell's are the most explicit in drawing the conclusion that the lack of interest-sensitivity means that there is no reason to associate M0 in any special way with short-term interest rates.

ii. M0 has been, and will go on being, heavily affected by structural changes in the use of cash. The velocity trend is high and has risen sharply since the late 70s. So target setting will be difficult. Again, the main source is the BEQB. Some commentators add, presumably also on the basis of the Bank's work on the demand for cash, that at best M0 provides a very limited snapshot of current monetary conditions, being chiefly related to personal sector behaviour.

iii. The relationship with future inflation and growth is not well established (though there may well be a link with past or current rates of inflation). This appears mainly in the most critical of the brokers, unsupported by statistical evidence other than charts. Some commentators note that the link looks closer since the mid-70s, but suggest that this is fortuitous.

15. There are two widespread misconceptions:

i. That MO would necessarily be a fourth target, additional to the existing target variables. This is taken for granted in early articles (some of which complain of a proliferation of targets). However, on 18 November, Samuel Brittan reported that "the present intention is to replace the existing three targets by two: one for so-called "little MO" ... the other will be some measure of broad liquidity".

ii. That the chief appeal of MO is as a rationale for cuts in interest rates. In the more superficial places, this is tied simply to the relatively slow growth in MO in recent years. More sophisticated commentators argue that technical change will make it easy to underestimate future trends in MO velocity, and hence set a "soft target"; or that the lack of interest sensitivity will mean that MO is not an effective brake on interest rate cuts.

The second point, very fashionable immediately after the Mansion House speech, is beginning to lose favour as some commentators focus on the probable target range for MO. Serious suggestions are:

3-7 per cent	Minford
4-8 per cent	Greenwell's, Phillips & Drew, Christopher Johnson
5-9 per cent	Laing and Cruickshank

(The Banker notes a 6 per cent trend increase in MO velocity in recent years, but spoils it by concluding that the 7-11 per cent range set for the other aggregates would be uncomfortably tight). Sam Brittan says the likely range for 1984-85 is 3-7 per cent or 4-8 per cent.

Several people (eg Greenwell's, Henry Kaufman and Phillips and Drew) have argued that with current MO growth well above last year's rate and towards the top of any plausible range, targetting MO is not a soft option.

16. The brokers have not finished with this subject yet. Judging by informal contacts, one question that we may hear more of over the coming weeks is: "If you do not intend to move to MBC, why choose the monetary base?" The point has already begun to surface: the Economist noted that operational balances are not included in any other monetary aggregate, and Capel-Cure Myers suggest that MO is a surprising choice if there is no intention to move to MBC. The Lex Column on 19 December commented that "by linking notes and coin with bankers' deposits and till money, MO raises the spectre of monetary base control". The point of the CUBS article is, of course, to argue that targetting MO makes no sense without a move to MBC. No-one yet appears to have concluded that notes and coin would be a preferable option to MO: the focus has rather been on highlighting those objections to MO that are common to notes and coin (and readily culled from the BEQB article on cash).

FURTHER RESEARCH ON NARROW MONEY

17. Over recent months Treasury economists have undertaken extensive research on narrow money, including the demand for notes and coin and for MO. There have been several discussions with the Bank, who are still sceptical about some aspects of the work. In addition we have consulted two academics - Professor Hendry of Nuffield College and Dr Bean of the LSE - who occasionally attend our academic panel. They have made some helpful suggestions which we have now largely taken on board.

18. The Treasury's latest work tends to confirm the assessments in the note reporting the earlier work*, including the conclusion that, based on their apparent demand properties, notes and coin would seem to have a very slight edge over MO and both have a fairly clear advantage over NIB M1 (the demand for which seems to be rather poorly determined and probably distorted by the growth of interest-bearing sight deposits in recent years).

i. There appears to be small but significant interest sensitivity in the demand for both cash and MO. This issue has particularly exercised some commentators since the Mansion House speech. We have now investigated this effect on a run of monthly data that goes back to the early 1960s. This examination indicates that conclusions about interest sensitivity do to a certain extent depend on the period used for estimation. A significant, though fairly small, interest rate effect is only well established in data since the mid-1970s. (The Bank's economists agree with this finding.) The role of interest rates in earlier periods - on which we are still working - is more uncertain.

ii. The recent work confirms the importance of financial innovation in explaining the rising trend in the velocity of notes and coin and MO. The rising proportion of the population holding bank and building society accounts seems to have been particularly important. (The Bank's work suggests this too.)

iii. The later work, like the earlier, yields slightly better results for notes and coin than for MO. Our greater ability to account for fluctuations in notes and coin compared with total MO reflects the erratic nature of the bankers' balances and, to a lesser extent, till money. Separate work to explain movements in these confirms how difficult it is to model them.

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* "Research into Narrow Money and its Implication for the Choice of Target Variable", October 1983.

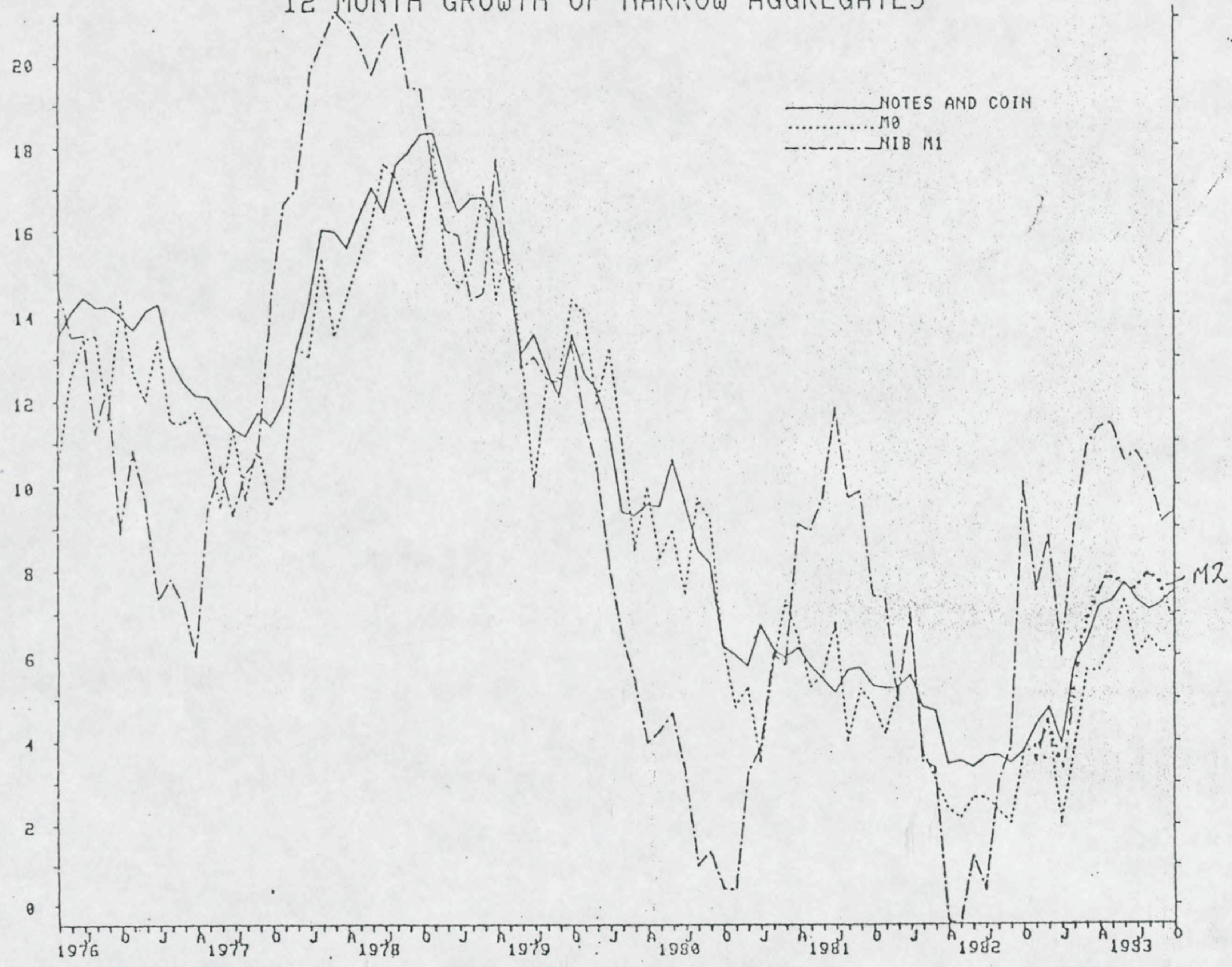
iv. We have also looked further at the high <u>short-term volatility</u> of MO. About half the volatility in changes in MO appears to be due to "noise" in bankers' balances. The proportion of the "noise" in total cash (ie non-bank holdings of notes and coin <u>plus</u> banks' till money) that is due to fluctuations in till money is small. So once bankers' balances have been excluded from MO there does not appear to be a further significant reduction in volatility to be achieved by excluding till money.

While we can take some comfort from the progress of this research, it must be recognised that it cannot point to conclusive evidence. Such research, no matter how successful it may appear to be at the time, can only have a modest role in any justification of targetting a very narrow monetary aggregate. Data revisions or new econometric techniques can all too often upset previous results.

19. There will always be room for legitimate doubts about the extent to which such work "explains" the past, and still more about how far it can be used to forecast the future. It would be unwise to let any public target range for very narrow money rest on particular assumptions about future financial innovation and its effect on the demand for cash. It seems best here to stick firmly to the practice of not justifying target ranges by econometrics. But it is important to have reputable published research available so that we are not vulnerable to the charge of adopting targets for monetary aggregates without having studied their past behaviour.

<u>MO or Notes and Coin</u>

20. The chart on the next page shows the movements since 1976 in the three narrow aggregates that consist entirely of non-interest-bearing money (and also, for its brief life, of M2). As will be seen NIB M1 is subject to very wide swings (probably reflecting its high interest sensitivity), and seems to have no advantage over the smoother series for MO and notes and coin.



12 MONTH GROWTH OF NARROW AGGREGATES
NOTES AND COIN
M0
NIB M1
20
18
16
14
12
10
8
6
4
2
0
1976
1977
1978
1979
1980
1981
1982
1983
M2

21. A choice between MO and notes and coin revises complex issues because MO is one of the aggregates on which a monetary base control regime could be based.

22. The Government's position on monetary base control is:

a. It has no present intention of moving to monetary base control. This was made clear again in the Mansion House speech and is the agreed position.

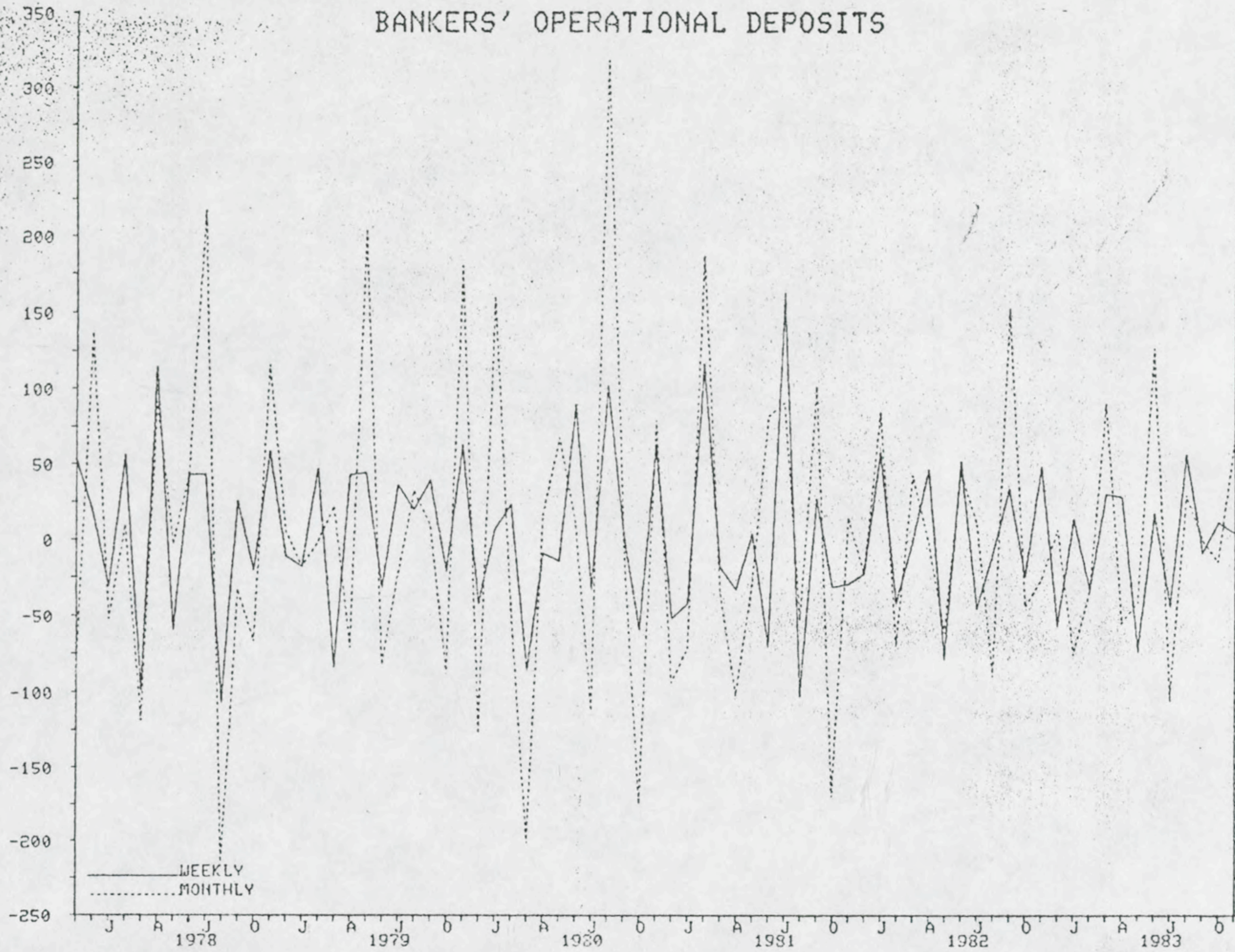
b. We are still in the business of taking 'steps which are desirable in their own right' and which 'would be consistent with a gradual evolution towards a monetary base system and will help us to judge how far such a system would contribute towards our medium-term objectives' (Sir G Howe, 24 November 1980).

23. The research, as noted above, gives notes and coin a slight edge over MO: the statistical series is less noisy, the demand equations are better specified and have lower standard errors. As against that, MO sounds more like a serious monetary aggregate - it is an "M" - with a good pedigree in monetary theory. Targetting notes and coin sounds primitive. However, MO has some unattractive features:

i. It consists as to 90 per cent of notes and coin in circulation outside the banks and a further 8 per cent is notes and coin held in bank tills. It is difficult to argue that either till money or bankers' balances contribute much - if any - additional information about monetary conditions.

ii. It does not fit cleanly into the structure of monetary aggregates. Two of its components - till money and bankers' balances - are bank assets, whereas the other monetary aggregates are built on non-bank holdings of notes and coin and bank liabilities.

iii. This non-currency component - bankers' operational balances at the Bank of England - though only small is subject to what look to be sharply erratic movements, which


BANKERS' OPERATIONAL DEPOSITS
350
300
250
200
150
100
50
0
-50
-100
-150
-200
-250
WEEKLY
MONTHLY
J A J O J A J O J A J O J A J O J A J O J A J O
1978
1979
1980
1981
1982
1983

generate a high level of variability in the series. It would be possible, however, to smooth this by averaging the weekly or even daily figures for these balances over the banking month. Our experiments with weekly averaging suggest that it produces a much more stable series (see chart).

iv. This non-currency component would only be of economic significance if the banks are being controlled by operating on their monetary base.

v. MO consists entirely of the liabilities of the monetary authorities. This indeed is its great virtue if one is operating a system of monetary base control. But it is not easy to explain why we are choosing this aggregate to target if it is intended <u>not</u> to introduce MBC.

The problem of short-term volatility can probably be dealt with by calculating MO as a weekly or daily average for the month. There is indeed much to be said for that. This series would then differ from notes and coin mainly because it included till money. On statistical grounds, there is little to choose between total notes and coin and currency in circulation with the public. The two series move closely together and are virtually indistinguishable in terms of volatility and predictability; if little is gained from including till money, little is lost either. The fact that the series for total notes and coin is, in principle, better measured, suggests some presumption in favour of looking at the total.(While the monetary authorities know how much currency they have coined in total, the split between the public's holdings and till money has to be estimated from banking sector returns. Within month information about this split is only available from the smaller sample of banks that report weekly.)

24. So far as the markets are concerned, there might be a period of adjustment as they accustom themselves to narrow and broad aggregates with equal weight. But this should not prove difficult provided they do not believe policy is being relaxed.

Policy will in fact be conducted in the same way as in the past; we have simply given a sharper expression to what we are doing.

25. There is a problem in targetting MO which arises because some will think that, whatever we say, we shall have moved to monetary base control. There might also be some pressure to move more quickly in the direction of monetary base control. These problems arise so long as MO is given a place in the constellation of monetary indicators which we monitor. So long as we continue to take a range of monetary indicators into account - and indeed have two targets - it is difficult to see that any serious misunderstanding of our intentions could arise.

THE OPTIONS FOR 1984

26. For the reasons given at the beginning of this paper, there are strong grounds for wanting to change the form of the monetary targets. In particular we need to find a better measure of narrow money than M1 and to sharpen the presentation of our policy. We would presumably not want more than two target ranges - one for broad money, the other, and lower, one for narrow money - and we would like them to have equal status. We would also want to stress that in assessing monetary conditions we took account of all the aggregates (whether explicitly targetted or not) and other indicators as well.

27. The three options set out below are essentially about how the target ranges are labelled. It is important that each range contains the same number of aggregates - to convey equal status.

OPTION 1: Two Aggregates

a. £M3 and MO

b. £M3 and notes and coin (NC)

Comments:- Clearcut; even-handed between broad and narrow. But hard to justify ditching target for PSL2; and both MO and NC have some unattractive

features for targetting. Essential to emphasise that we would be monitoring other aggregates as well as those specifically targetted.

OPTION 2: Four Aggregates

a. £M3 + PSL2 and M0 + M2

b. £M3 + PSL2 and NC + M2

Comments:- This grouping has attractions because it includes a wide range of aggregates. But it is complicated and also has risks, given our limited knowledge of M2.

OPTION 3: A Compromise between Options 1 and 2

This would give primacy to one aggregate within each target range but would specifically mention another aggregate as well:-

broad money: £M3 (PSL2) as now
narrow money: M0 (M2).

HM Treasury
6 January 1984

COVERING SECRET

FROM: P WYNN OWEN AND
D MCSHARRY
DATE: 9 JANUARY 1984

MR CASSELL

cc: as on attachment

MONTHLY FINANCIAL MARKETS REPORT

We attach a report on the financial markets in banking and calendar December, which is the joint work of HF and EF.

2. The list of copy recipients is attached. It is essentially, a list of those people who receive HF's monthly monetary report, since it replaces some of the material that used to appear as on Annex to the report. If anyone wishes not to receive this report on a monthly basis, or has any suggestions of anyone else who should receive it, could they please let us know.

D. McSharry Philip Wynn Owen.

D McSHARRY
EXT 5105

P WYNN OWEN
EXT 5871

MONTHLY FINANCIAL MARKETS REPORT

Sir P Middleton
Sir T Burns
Mr Littler
Mr Cassell
Mr Monck
Mr Unwin
Mr Battishill
Mr Lavelle
Mr Lankester
Mr Bottrill
Mr Folger
Mr Hall
Mrs Lomax
Mr Mowl
Mr Peretz
Mr Pirie
Mr Sedgwick
Mr Vernon
Mr Page
Mr Bennett
Mr Collinson
Mr Davies (S)
Mr Hannah
Mr Hood
Mr R B Johnston
Mr Lewis
Mr O'Donnell
Mr Perfect
Miss Roach
Mr Willetts
Mr Fisher
Mr Harrison
Mr Willoughby
Mr Wynn Owen
Mr King
Mr McSharry
Mr Blower

Mr Turnbull - 10 Downing Street, SW1

FINANCIAL MARKETS IN BANKING AND CALENDAR DECEMBER

SUMMARY

- The dollar rose sharply against all currencies in December, reaching all-time highs against a number of European currencies including sterling ($1.4100 on 14 December). Sterling traded steadier in the latter part of the month as expectations of a fall in oil prices eased.

- The money markets were quiet throughout the period, but with some firming of Eurodollars and period interbank rates in the first half of calendar December. These shaded down again towards the New Year as the market took on a more stable and quieter tone.

- In the Gilts Market the largest transactions tended to be redemptions and calls on part-paid stock sold previously. Nonetheless, the Authorities made three issues (amounting to £1 billion nominal) and announced a further £600 million of stock at the end of the year.

- The FT index rose by over 50 points between mid-November and the year end. Notable features were the undersubscription of the Cable and Wireless offer and the lengthy battle to takeover Eagle Star, which ended in an expensive victory for BAT.

- The Autumn Statement, right at the start of the period, was greeted quietly by the markets, since the upward revision in the PSBR had been discounted.

INTRODUCTION

Throughout the period from mid-November to end-December money and gilts markets were fairly stable despite increasing world political tensions. Sharp increases in US interest rates and the dollar contributed to some firming in short term interest rates in the first half of calendar December. Towards the New Year financial markets returned to a more stable and still quieter state, due to the festive season, some easing of concern about oil prices, a slightly quieter dollar and some signs of softness in US rates.

Spot Sterling

Trading in sterling was generally active in the latter part of November. Initial selling pressure from the US on the 18th and 21st and the larger than expected trade deficit for October (current account: -£200 million) together with easier spot on prices towards the end of the month caused the rate to ease from $1.4788 and 83.9 in effective terms on the 17th to 1.4664 and 83.1 at the close on the 30th.

	$/£	DM/£	£ Effective
1 December (open)	1.4642	3.9441	83.0

Sterling opened the month on a softer tone as weakening oil prices coincided with a general strengthening of the dollar to depress the rate.

	$/£	DM/£	£ Effective
8 December (close)	1.4417	3.9459	82.5

The pound held up better than most currencies after the dollar surged on the 5th, closing at 83.1 and DM 3.97½. Sentiment changed, however, following the news that the Soviet Union had cut its oil price and sterling met some widespread commercial selling on the 6th which caused the rate to fall to a low point of $1.4432 during the morning before recovering to $1.4500 at the close. Further sizeable selling late on the 7th, which continued in the Far East on the 8th, on worries about the outcome of the OPEC meeting pushed sterling to a low of $1.4345 and 82.2 before short-covering in London aided a recovery to $1.4422 and 82.5 in the afternoon.

	$/£	DM/£	£ Effective
14 December (close)	1.4185	3.9207	81.8

As the dollar stengthened further on the 9th following Regan's comments on interest rates, sterling eased to $1.4305 during the morning but news during the afternoon that OPEC had left production quotas and prices unchanged helped the pound to recover slightly to $1.4369

and 82.6. Sterling encountered widespread selling following the close on the 12th and again on the 13th particularly after rumours of a possible cut in BNOC oil prices in the New Year. These rumours, coupled with a further dollar surge on the 14th, caused sterling to fall to a record low against the dollar of $1.4100. However, the BNOC announcement later in the day proposing unchanged oil prices and a slight easing of the dollar enabled the pound to recover to $1.4185 with the effective index at 81.8.

30 December (close)	1.4520	3.9516	82.9

Sterling traded slightly firmer on the 15th, rising to $1.4257 at one point, as the market became more confident that oil prices would hold up. Markets were generally much quieter in the second half of the month as many dealers began to square their books for the end of the year. Sterling moved steadily upwards towards the end of this period, on reports that several major oil companies were supporting unchanged North Sea oil prices and met some demand as spot oil prices firmed.

The dollar

The dollar fluctuated sharply between 17 and 30 November as a variety of factors emerged to influence trading. After rising to DM 2.7210 at the close on the 29th following news of corruption charges against the West German Economics Minister Lambsdoff and his predecessor Friderichs, the dollar fell sharply on the 30th in reaction to the larger than expected $8.79 billion US trade deficit for October. The dollar strengthened sharply during December, rising from DM 2.6925 at the beginning of the month to a ten-year high of DM 2.7792 on the 16th as well as reaching record levels against other European currencies including sterling ($1.4100), the French franc (Ffr 8.4865) and the lira (1682). Renewed fears of higher US interest rates in view of the continued strength of the US economic recovery and the dollar's attraction as a safe haven currency in the face of international tensions were the main factors behind the dollar's rapid ascent. However, at the end of December, evidence emerged that the US recovery might be slowing and this together with other indications that US interest rate pressures were easing, led to a sharp fall in the dollar in thin trading which closed on 30 December at 2.7215.

Other currencies

Since mid-November the Belgian franc has remained firmly established as the weakest currency in the EMS, with the French franc, Irish punt, Dutch guilder and Danish krone alternating at the top. The narrow band remained at or close to its 2¼ per cent limit. The yen held up better than most against the stronger dollar during December, only temporarily

lo[illegible]g ground following the ruling Liberal Democratic Party's poor showing in the Japanese general election.

Money markets

Banking December began quietly on November 17 with money market rates quite stable. The Chancellor's Autumn Statement the same day met little response in the money markets, which continued along a sluggish path (see attached table). After several weeks of market rumours about possible reductions in interest rates the tide began to turn towards the end of calendar November, possibly due to expectations of disappointing US and UK money figures in early December, concern about the exchange rates and nervousness about the oil price .

As the dollar began to firm against sterling in early December there was a sharp rise in Eurodollar rates and increasing nervousness in the domestic money markets with firming in shorter money rates. In particular, twelve month interbank rates rose into double figures and closed on December 16 at $10^3/_{16}$, while three month interbank rates rose ¼ over the first two full weeks of December to $9^9/_{16}$. Despite firm US rates and repeated record lows for sterling against the dollar, however, the market remained fairly quiet and the Bank of England's dealing rates were unchanged. Activity in the markets almost disappeared in the week or so before Christmas and the pre Christmas US Bond auctions, which implied slightly lower rates, led to some easing in the UK. When some dealers returned for the few days between Christmas and the New Year there were signs of a more confident, stable attitude to the prevailing rates.

The Gilts Market

The market was fairly soggy throughout most of the period under review. With previous low coupons having sold out, £½ billion of a new low coupon conventional, 2½ Exchequer 1986, was issued on 24 November. It came in for some criticism in the press, but was quite well received by the market, where it helped to attract funds after the Financial Secretary's statement of 17 November on offshore funds. By end-December less than £50 million nominal of 2½ Exchequer 1986 remained in the Issue Department. A very quiet calendar December was marked by a large redemption on 14 December and a couple of sizeable calls on part-paid stocks sold earlier. The Bank announced the issue of two conventional tranchettes of medium stock on 7 December - £300 million of 10¼ per cent Exchequer 1995 and £200 million of 10½ per cent Exchequer 1997 - which both sold out by the end of the year. Otherwise, the level of gilt sales was fairly low, with little or as market arising for some of the stock held by the Authorities, most notably the 2½ per cent Index-Linked 2020.

Yield curves in banking December rose by between a ¼ to a ½, but the final weeks of calendar December saw them shade down a little again, with most closing less than [illegible] up on their mid-November level. Over the period as a whole, the shape of the curve remained largely unchanged. Indexed gilts saw very little trading activity and prices languished. The end-year announcement of a new IG further depressed prices a little.

RECENT GILTS ISSUES

Stock	Date Announced	Issue Price	Gross Yield to Redemption	£m Total amount
2½% Exchequer 1986	21/11	84½ minimum	8.46	500
10¼% Exchequer 1995	7/12	101$^{1}/_{8}$	10.67	300
10½% Exchequer 1997	7/12	102$^{7}/_{8}$	10.53	200
3% Treasury 1986	29/12	89	8.19	100
3% Treasury 1987	29/12	83^{8}/16xd	8.59	200
2% Index-Linked 1990	29/12	91	3.63	300

Finally, on 29 December, following the announcement of the exhaustion of the previous low coupon stock and the implementation of the new regime for offshore funds, the Bank announced a package of £600 million nominal of stock for issue early in the New Year, half of it comprising of two short tranchettes of conventional stock and half of a new 2 per cent Index-Linked 1990 stock.

The Equity Market

The FT 30 Share Index closed at 722.8 on Wednesday 16 November. Equities advanced towards the end of November helped by Courtaulds excellent interim results. US demand continued for ICI, while Eagle Star advanced as the rival bidders outmatched each other (Allianz has now withdrawn and BAT's final bid is £7 a share). At the tender on Friday 2 December the offer for sale of Cable and Wireless was undersubscribed. Early in December the market gained further ground and the 30 Share Index broke through the 750 barrier. Particular interest was shown in the financial sector, with discount houses and merchant banks in strong demand. The 30 Share Index stood at 775.7 at 30 December, having touched a high of 776.2 on 22 December. It stood at 596.7 a year ago.

Capital Issues

The net amount of new money raised by UK listed companies on the stock market in calendar December was £3 million, the lowest figure in the year. Total net issues by UK listed companies for 1983, however, were at the record level almost of £2.8 billion. With redemptions at £124 million, net issues were only £20 million. Gross capital issued by

industrial and commercial companies were £42 million, including the first instalment (10) of a £40 million loan stock placing by ELK UK. Three financial companies raised money by rights issued. Of the overseas issues, the most notable was the Kingdom of Spain raising £15 million as the first instalment of a £50 million loan stock issue.

	Band 1	Band 2	Band 3	Band 4
Dealing Rates (unchanged throughout period)	9 1/16	9	8 15/16	8 7/8

Eligible Bill Rates	Band 1	Band 2	Band 3	Band 4
November 16 (close)	9 5/64 - 1/16	9 1/16 - 9	8 15/16 - 59/64	8 7/8 - 55/64
December 2 (close)	9 1/16 - 9	9 - 8 63/64	8 61/64 - 59/64	8 57/64 - 7/8
December 16 (close)	9 1/16 - 8 7/8	9 1/64 - 8 63/64	9 - 8 31/32	9 1/32 - 8 31/32
December 30 (close)	9 1/16 - 9	9 - 8 63/64	8 15/16 - 59/64	8 7/8 - 55/64

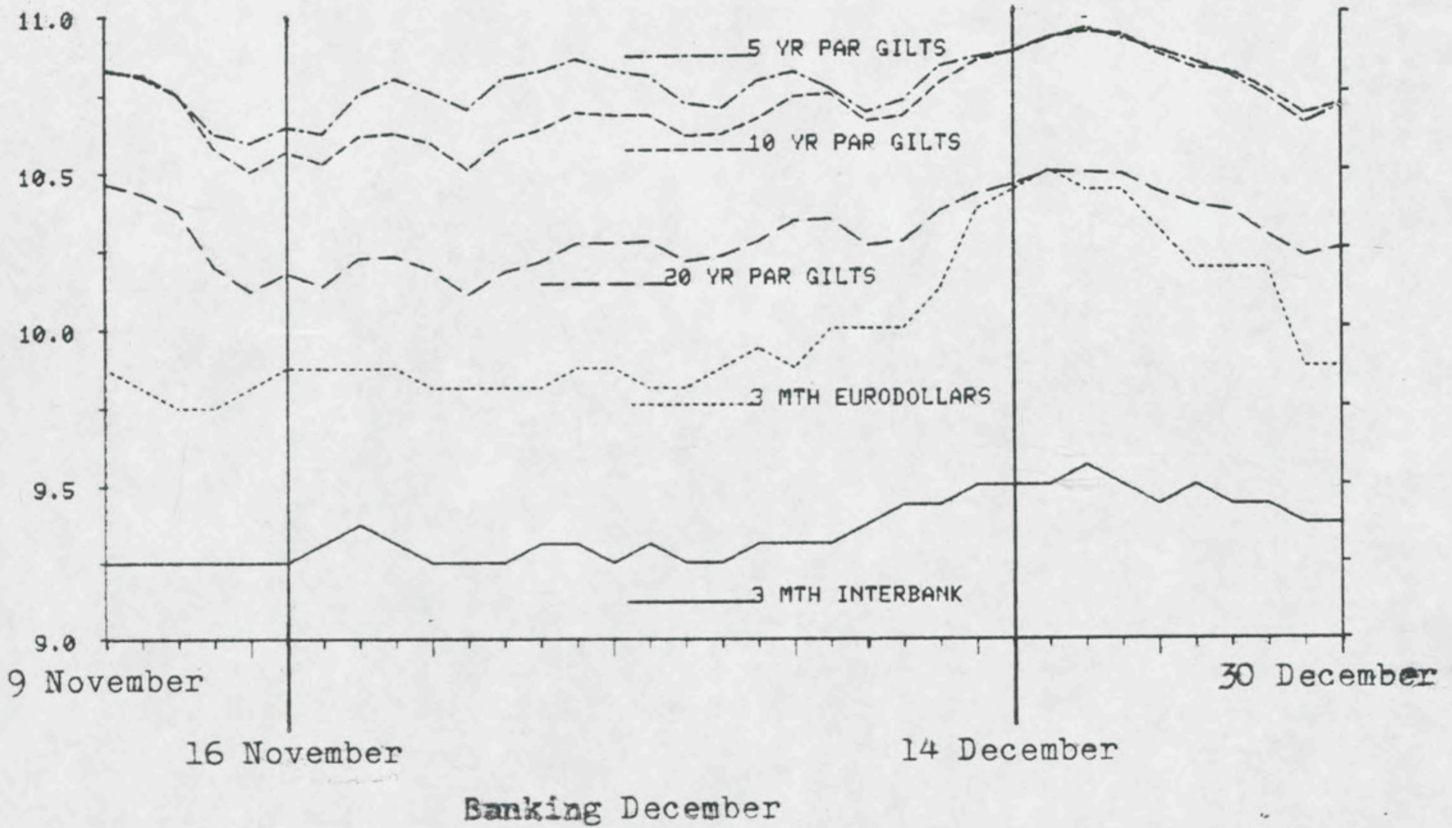
Interbank Rates	7 days	1 month	3 months	12 months
November 16 (close)	9 1/8	9 1/8	9 1/4	9 5/8
December 2 (close)	9 1/16	9 1/8	9 5/16	9 7/8
December 16 (close)	8 15/16	9 3/16	9 9/16	10 3/16
December 30 (close)	9 3/16	9 3/16	9 3/8	9 13/16

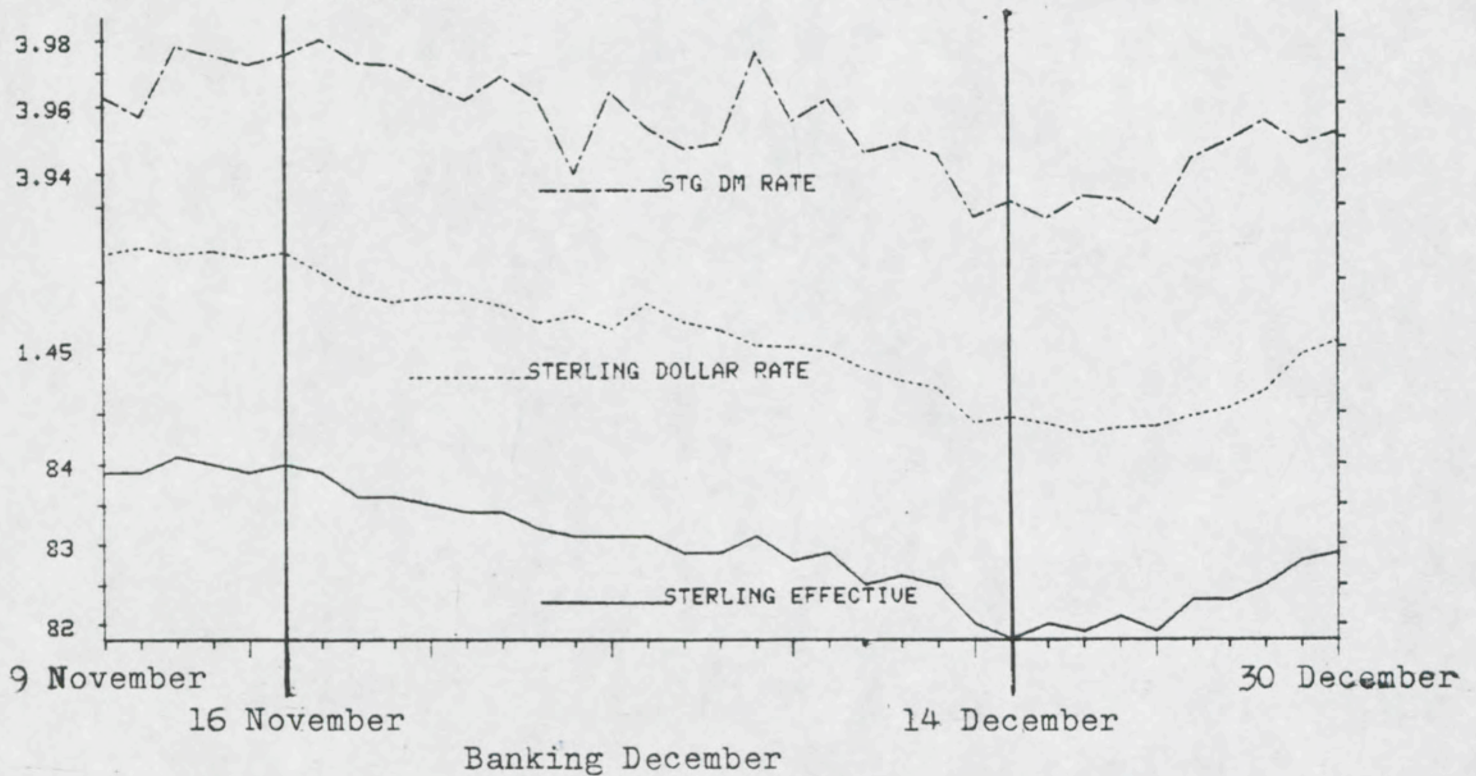
Eurodollar Rates				
November 16 (close)	9 1/2	9 9/16	9 7/8	10 1/4
December 2 (close)				
December 16 (close)	9 13/16	10 1/2	10 7/16	10 15/16
December 30 (close)	9 11/16	9 3/4	9 7/8	10 7/16

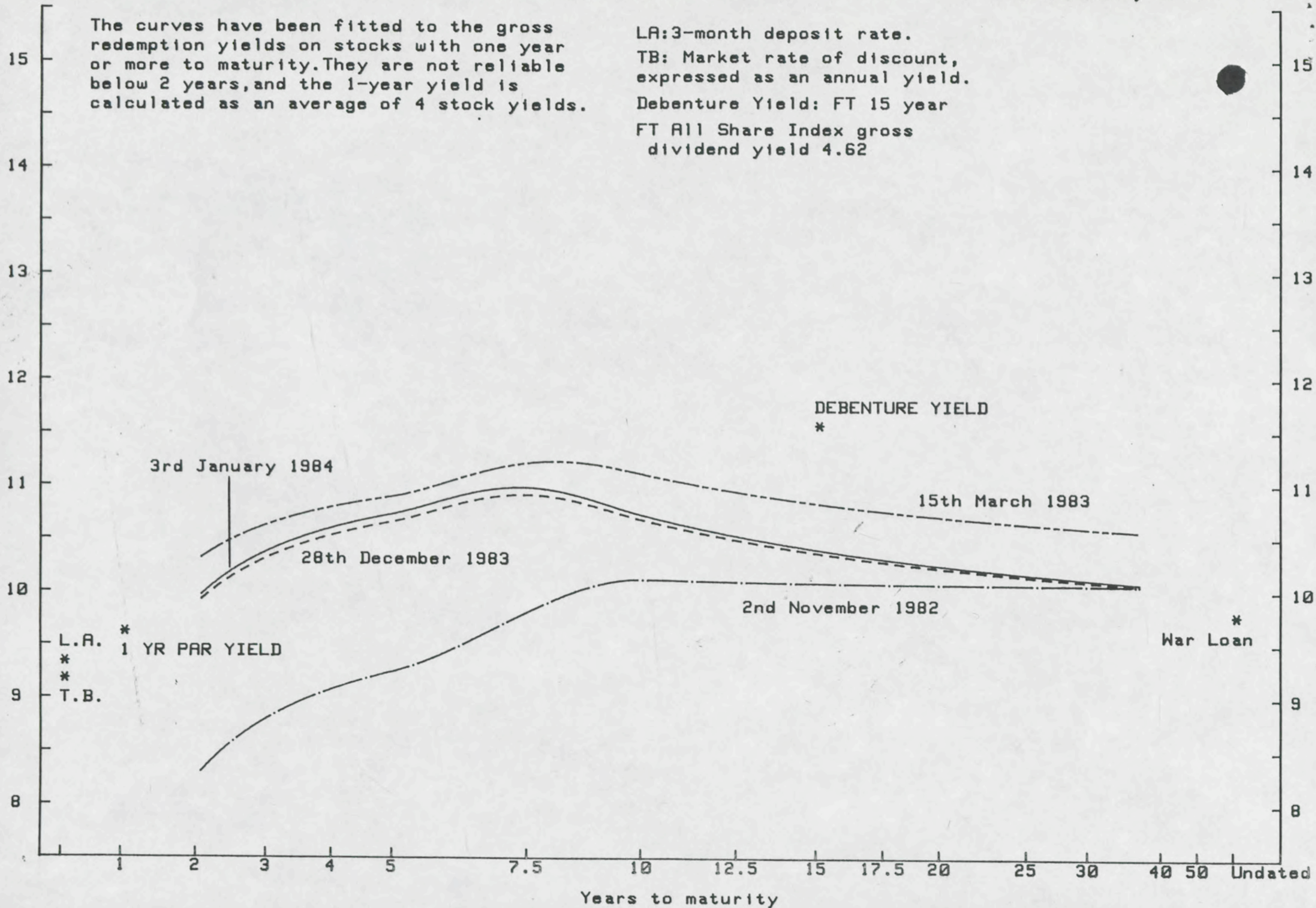
International Comparisons Closest analogies to 3 month interbank rates:

Week starting	USA	Germany	Average 6 leading OECD (batting UK)	
Nov 21	9.4	6.3	10.2	
Nov 28	9.3	Na	10.3	)
Dec 5	9.5	Na	10.4	) Approximate
Dec 12	9.6	Na	10.4	)

Gilt Yield Curves	5 year	10 year	20 year	IG Yields 2% 1988	IG Yields 2½ 2011
Wednesday 16 November	10.643	10.565	10.180	3.46	2.97
Friday 2 December	10.698	10.617	10.228	3.61	3.02
Friday 16 December	10.951	10.938	10.492	3.58	3.08
Friday 30 December	10.702	10.711	10.251	3.72	3.09


INTEREST RATES 16 NOV. TO 30 DEC.
11.0
10.5
10.0
9.5
9.0
5 YR PAR GILTS
10 YR PAR GILTS
20 YR PAR GILTS
3 MTH EURODOLLARS
3 MTH INTERBANK
9 November
16 November
14 December
30 December
Banking December


EXCHANGE RATE 16 NOV. TO 30 DEC.
3.98
3.96
3.94
1.45
84
83
82
STG DM RATE
STERLING DOLLAR RATE
STERLING EFFECTIVE
9 November
16 November
14 December
30 December
Banking December


Per cent
Time / Yield Curves of British Government Stocks
4th January 1984
The curves have been fitted to the gross redemption yields on stocks with one year or more to maturity. They are not reliable below 2 years, and the 1-year yield is calculated as an average of 4 stock yields.
LA: 3-month deposit rate.
TB: Market rate of discount, expressed as an annual yield.
Debenture Yield: FT 15 year
FT All Share Index gross dividend yield 4.62
15
14
13
12
11
10
9
8
DEBENTURE YIELD
3rd January 1984
15th March 1983
28th December 1983
2nd November 1982
L.A.
T.B.
1 YR PAR YIELD
War Loan
1
2
3
4
5
7.5
10
12.5
15
17.5
20
25
30
40
50
Undated
Years to maturity

Thank you
MT

10 DOWNING STREET

From the Private Secretary

Prime Minister

Midland Bank today increased its mortgage rate from 10 3/4% to 11 1/4% (11.7% true annual rate). This is the first increase since November 1982 and represents a catching with the Building Societies, also on 11 1/4% (11.8% APR)

At the same time Midland are increasing their allocation for mortgage lending from £300 million to £500 million this year.

This move does not represent any increase in interest rates generally.

Lloyds has also raised its rate from 11 to 11 3/4%.

AT 6/1

10 DOWNING STREET

From the Private Secretary

Prime Minister

You might like to look (skim) through these papers as background to Thursdays meeting on social expenditure.

(i) A note on housing benefit

(ii) OECD work on social expenditure

(iii) An updated version of the Green Book of social services statistics.

An annotated agenda and a Policy Unit note will reach you on Tuesday.

AT

6/1

CC: MR. REDWOOD

(2)

PRIME MINISTER

Weekend box please

GROWTH OF SOCIAL EXPENDITURE

TUESDAY'S FT REPORTED THAT:

> "A RECENT STUDY BY OECD HAS SUGGESTED THAT SOCIAL BENEFITS WILL NEED TO BE CUT IN MOST COUNTRIES IF PUBLIC SPENDING IS TO STAY UNDER CONTROL".

AS FAR AS I CAN ESTABLISH, THERE IS NO STUDY AS SUCH WHICH OECD HAS RECENTLY COMPLETED. WORK IS GOING ON UNDER THE DIRECTORATE FOR SOCIAL AFFAIRS MANPOWER AND EDUCATION ON THE FACTORS BEHIND THE GROWTH OF SOCIAL EXPENDITURE AND THE IMPLICATIONS FOR THE FUTURE GIVEN CERTAIN ASSUMPTIONS ABOUT THE GROWTH OF GDP. THIS WORK IS BEING CONDUCTED LARGELY IN RELATION TO THE OECD AREA AS A WHOLE, RATHER THAN AS A SERIES OF PROJECTIONS RELATING TO SPECIFIC COUNTRIES. THE METHODOLOGY IS RATHER SIMILAR TO THAT USED BY THE TREASURY IN ITS LONG-TERM PUBLIC EXPENDITURE EXERCISE. WORK IS NOT YET COMPLETE BUT IT MAY LEAD EVENTUALLY TO A PUBLISHED DOCUMENT.

THE MOST LIKELY SOURCE OF THE FT REPORT IS THAT, IN THE COURSE OF THE PRESS CONFERENCE OECD GAVE TO LAUNCH ITS ECONOMIC OUTLOOK JUST BEFORE CHRISTMAS, THERE WAS SOME DISCUSSION ABOUT THE FUTURE WORK OF THE ORGANISATION. THEY ARE ORGANISING A CONFERENCE ON 13/14 FEBRUARY ON THE LONGER TERM PERFORMANCE OF OECD ECONOMIES AND THE CHALLENGES FACING GOVERNMENTS. THE UK WILL BE REPRESENTED BY THE CHIEF SECRETARY.

THE SECRETARY GENERAL OF OECD HAS CIRCULATED A PAPER IDENTIFYING THREE THEMES FOR THIS CONFERENCE - A COPY OF THE DOCUMENT IS ATTACHED.

/PART I

Part I	Pressures on the public Sector
Part II	Flexibility and efficiency in the private sector
Part III	National policies and the international framework

These are summarised in pages 1-5.

The public sector chapter draws on the unfinished work referred to above. You might like to look at pages 6-12 which are interesting in the way they illustrate the changing economic consensus in the industrial world.

I would not put too much emphasis on the "thought experiment" in paragraph 1.7 This claims that if unemployment were held constant and benefit rates and coverage were frozen in real terms some fall in social expenditure as a proportion of GDP might be achieved even with quite moderate rates of growth. It is clear, however, from subsequent paragraphs that the Secretariat regards this as no more than a piece of arithmetic. The difficulty facing governments is that expectations about social expenditure continue to rise. A number of schemes, particularly pensions, have real increases built into them as pensions schemes established some years ago come to maturity. This, plus the difficulty of cutting back programmes which ought to be on the decline, means that expenditure cuts have to be found merely to stand still.

One interesting feature of the study is shown on page 12 which demonstrates that general government debt as a proportion of GDP has fallen in the UK in contrast to most other industrial countries. (Increases are particularly notable in Japan, Italy, Denmark and Belgium). This fall is probably the result of two different factors; first the erosion of the real value of public sector debt by inflation in the 1970s and secondly the reduction in public sector deficits since then.

AJ

5 January 1984

cc TF

Sheenagh
copied Hall

FROM: M A HALL
3 January 1984

PRESS OFFICE NOTE

c c Chancellor
Mr Bailey

FINANCIAL TIMES STORY : "TREASURY SHELVES WORK ON PUBLIC SPENDING STUDY"

In commenting on-the-record on Max Wilkinson's story in today's FT, we should say there is no truth in the story that the Treasury's work on long term public expenditure has been shelved. Work is in fact continuing on long term public expenditure trends.

2. A Green Paper is only one of a number of possible ways of carrying forward discussion of long-term public expenditure, and Treasury Ministers have at no point made undertakings to publish one. It is still for consideration whether the Government will in fact publish a document. A good deal of work is involved, and it is most unlikely that anything would be published before the next Public Expenditure White Paper.

3. We can explicitly deny, if asked, the idea that the Treasury's work has run into the ground because of an absence of political decisions.

MAH

M A HALL

Mr A Turnbull

FROM: P WYNN OWEN

DATE: 23 December 1983

2

1. MR WILLETTS DLWilletts 23/12/83
2. CHANCELLOR

pa 28/12

cc Chief Secretary
Financial Secretary
Economic Secretary
Mr Middleton
Sir T Burns
Mr Cassell
Mr Battishill
Mr Lankester
Mr Monck
Mrs Lomax o.r.
Mr Mowl
Mr Sedgwick
Mr O'Donnell
Mr Johnston
Miss Roach
Mr Willetts
Mr Willoughby

Prime Minister

Satisfactory for £M3; M0 which is increasingly looked at as the best indicator of narrow money has been growing slowly. Banking December has only three weeks. Thus there is not a lot of information in these figures.

AT 23/12

MONEY SUPPLY IN BANKING DECEMBER: "FIRST GUESS"

I attach a note by the Bank giving their first guess at the money figures for Banking December. £M3 is estimated to have risen by 0.9 per cent, (compared to our forecast of 0.8 per cent), PSL2 by 1.0 per cent and M1 by 2.4 per cent. Recent experience with the accuracy of the "first guess", and the Bank's explanation of a probable alteration to the M1 change suggest eventual outturns of between $+\frac{3}{4}$ to $1\frac{1}{4}$ per cent for £M3, + 0.8 to 1.3 per cent for PSL2 and $+1\frac{1}{2}$ to 2 per cent for M1. M0, the wide monetary base, fell by 0.2 per cent, as estimated from the Bank's weekly returns last week. Table 1 (attached) gives implied growth rates in the target aggregates, M0 and both definitions of Notes and Coin.

2. The M1 change can be expected to come down to between $1\frac{1}{2}$ and 2 per cent, because the reorganisation of the TSBs will result in their final figures showing a switch of £360 million of interest-bearing deposits from sight to time. Nonetheless, the M1 change will still be well above forecast. Both interest-bearing and non-interest bearing private sector sterling sight deposits rose by substantial amounts (£457 million and £600 million respectively, seasonally adjusted) but the Bank are as yet unable to explain these large increases.

3. The "first guess" of the counterparts to £M3 growth is given in the table attached to the Bank's note. Of the public sector counterparts, sales of Central Government debt to the non-bank private sector exceeded total net sales for the second month

running, though by not such a wide mrgin as in banking November. Local Authority borrowing returned to its unpredictable path, exerting a very large contractionary influence which was only partially offset by the rather expansionary public corporations. While the public sector counterparts should be reasonably reliable at this stage, the private sector figures are certainly not. For the time being, it appears that sterling lending to the private sector at £1350 million, was very close to the forecast level. Externals and net non-deposit liabilities were very wide of expectations taken separately, but quite close to forecast when taken together.

4. We will receive the provisional December money figures some time towards the end of the first week of January and they will be published on 10 January. Full money and banking figures appear on 19 January.

5. I am sending a copy of this submission to Mr Turnbull at 10 Downing Street.

Philip Wynn Owen

P WYNN OWEN

TABLE 1 : MONETARY AGGREGATES - FIRST GUESS

% (seasonally adjusted)

	M1	£M3	PSL2	M0	Notes and coin with public	Total notes and Coin ‡
"First Guess"	+ 2.4	+0.9	+1.0	- 0.2	- 0.1	+ 0.2
Likely Outturn	+1½ to 2	+¾ to 1¼	0.8 to 1.3	- 0.2	- 0.1	+ 0.2
Annualised rate of growth in target period to date (10 months)	12.8 to 13.4	10.3 to 11	12 to 12½	+ 6.4	+ 5.6	+ 5.9
3 month annualised growth rate	15½ to 18	12 to 14¼	10 to 12¼	+ 3.3	+ 3.9	+ 3.3
6 month annualised growth rate	8 to 9¼	6¾ to 8	8¾ to 9¾	+ 3.4	+ 4.6	+ 4.7
Growth over past 12 months	12¼ to 13	10¼ to 10¾	13 to 13½	+ 5.7	+ 6.7	+ 6.3

‡ *ie* including till money

SECRET

FOR THE ATTENTION OF PHILIP WYNN-OWEN

MONETARY AGGREGATES IN BANKING DECEMBER: A FIRST ESTIMATE
(£ million, seasonally adjusted)

1 The figures provided by the weekly-reporting banks show a rise in £M3 of 920 (+0.9%) in banking December. This suggests a final outturn for £M3 in the range of +¾% to +1¼% (as compared to the forecast of +0.8%), giving an annualised rate of growth during the target period of between +10.3% and +11.0%.

2 M1, according to the weeklies rose by 1,020 (+2.4%) in banking December. The full figures, however, are expected to show a somewhat lower figure than this because the TSBs have told us that their full figures will show a switch from sight to time of some 360 interest-bearing deposits, the terms of which are apparently being changed following the reorganisation of the TSBs last month. Thus, the full figures seem likely to show an outturn of between +1½% and +2.0%, giving an annualised rate of growth during the target period of between 12.8% and 13.4%.

3 According to the weeklies, notes and coin in circulation fell by 10, till money rose by 30 and bankers' balances fell by 50, resulting in an estimated fall in M0 of 30(-0.2%), the annualised rate of growth since mid-February would thus fall back to 6.4%.

NIB sight deposits rose by 560, producing a rise in NIBM1 of 560 (+1.8%) IB sight deposits rose by 460 and time deposits including CDs rose by 30. Public sector sight and time deposits fell by 130, of which LA deposits -70 and PCs -60.

5 PSL2 may have grown by around 1,550 (1.0%). A range of around 0.8% to 1.3% would give an annualised growth rate since the start of the target period of between 12% and 12½%. It should be noted, however, that some elements of PSL2 are strongly seasonal although seasonal adjustments are not yet applied to them: in particular, the building societies strongly increase their holdings of liquid assets in the months up to banking December and then run them off as they pay their taxes. This causesthe cumulative growth of PSL2 in the target period up to banking December to be reduced and subsequently to rise. If PSL2 were fully seasonally adjusted, the cumulative rate of growth of PSL2 up to banking December (annualised) would be 12½% to 12¾%. This difference will unwind in banking January and February.

6 Private sector £M3 contributed 1,040 to the rise in PSL2. Private sector bank bills may have risen +100 but their holdings of CTDs fell -50. The building societies attracted lower net (non-wholesale) inflows than in banking November (+590 in banking December compared with +910 in banking November, plus interest creidted in banking December +360). The lower net inflow was partly seasonal and partly because the term share offers are no longer being promoted on a large scale. Thus the inflow into term shares seems to have continued to drop, to an estimated 250 compared with 370 in banking November. Building societies are also estimated to have raised 110 in wholesale funds from the non-bank private sector (mainly time deposits), but to have continued to build up their liquid assets (-350, reducing PSL2 compared with £M3), if not at quite the high rate of banking October and November. National Savings in PSL2 contributed 30.

7 PSL2A, which includes term shares, may have risen by around 1,800 (1.1%). However, the same point about seasonals applies as to PSL2.

DEC 23 12:47 GMT BK ENGLAND LONDON 601 4771

SECRET

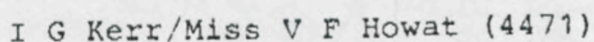
8 The attached table compares changes in £M3 and its counterparts with the forecast (as circulated in the Financial Report of 15 December). The CGBR is estimated at +530, less than the forecast (+975). On-lending to LAs was +590 and to PCs +130. Net purchases of central government debt by the non-bank private sector are estimated to have raised 730 (slightly more than the forecast of 630), of which gilts were 590 (compared to the forecast of 405) and National Savings were 220.

9 The other public sector's direct contribution is estimated to have been expansionary by 190, compared to the forecast of -280. Local authorities were +30 (of which bank lending +140) and public corporations were +160 (of which bank lending +200 and deposits with the NLF -130).

10 Bank lending in sterling to the private sector is estimated to have risen by +1,350 (forecast +1,180). This includes a decrease in the Bank of England's holdings of commercial bills of 350 (Issue -280, Banking -70).

11 Identified external items are +510 and the residual (net non-deposit liabilities plus differences between weekly and non-weekly reporters) is -930. Taken together, they are very close to the sum of the forecast externals (-155) and net non-deposit liabilities (-250).

Financial Statistics Division
Money & Banking Aggregates Group HO-4
23 December 1983


I G Kerr/Miss V F Howat (4471)

BANKING DECEMBER

£ millions
seasonally adjusted

FI[illegible]T ESTIMATE COMPARED TO FORECAST

		First estimate ø		Forecast*	
CGBR			+530		+ 520
CG Debt:	Gilts	−590		− 330	
	Treasury bills	+ 30		−	
	National Savings	− 220		− 220	
	CTDs etc	+ 50		+ 50	
			−730		− 500
Other public sector:	LA	+30		−460	
	PC	+160		+275	
			+190		− 185
Bank lending to UK private sector (inc Issue commercial bills)			+ 1,350		+ 1400
SUB-TOTAL OF DOMESTIC COUNTERPARTS			+1,340		+ 1,235
External and foreign currency counterparts			+ 510		− 155
Residual (includes NNDLs & reporting differences)			− 930		− 250
STERLING M3			+ 920		+ 830
(percentage monthly increase)			(+ 0·9%)		(+0·8%)
Notes and coin			− 10		
Private sector sight deposits			+ 1,020		
M1†			+ 1,020		
(percentage monthly increase)			(+2·4%)		
£M3 annualised since February 1983			+10·6%		
M1 annualised since February 1983			+14·0%		

ø Some figures do not sum because of roundings

* As circulated in Mrs Lomax's Monetary Prospects submission of 16 December 1983.

† But see para 2 of covering note.

2/3, FSD

23 DEC 1983

BF 19.12.83

~~To check with AT whether a meeting with AW will take place.~~

Andrew —

has a date been fixed to discuss the money market yield curve with Alan Walters?

Susan
19.12.83

This have been done AT 19/12

Domestic Mon

(2)

PRIME MINISTER

We are observing the tilt in the money market yield curve which often takes place when there is uncertainty about the exchange rate which in turn generates uncertainty about interest rates. The rates for periods over 3 months rise while those for shorter periods fall.

This occurs because those with money to deposit go short in the hope that rates will rise and they will be able to re-invest later at these higher rates. Conversely, borrowers try to extend the time period of their borrowing.

This phenomenon can be troublesome to deal with. The Bank's first response is to "overdo the help", i.e., by buying in more bills than are strictly necessary they keep liquidity plentiful. This often works if it is accepted as a signal that the authorities wish to maintain the level of interest rates. But it can backfire in more extreme circumstances if the market believes that the authorities are not going to succeed. All that is then achieved is that the more plentiful liquidity helps the exchange rate on down.

AT

We must discuss with Alan Walters.

When is he due here again?

MT.

12 December, 1983.

BF 6/12

Domestic Monetary Policy

10 DOWNING STREET

Prime Minister ②

To note. I interpret JR's first suggestion not as a wish to reopen the 1983 PES Survey, but as the call to start work identifying the options which will provide the savings which will inevitably be needed in 1984's Survey.

On the state of the economy and the tightness or otherwise of policy, a discussion with the Chancellor would be useful

Yes These two items for a bilateral?

Chancellor has also attempted to clarify capital / current debate in his speech - see attached.

AT
28/11

BF 6/12

28 November 1983
Policy Unit

PRIME MINISTER

THE STATE OF THE ECONOMY

Since the recession hit bottom in the second quarter of 1981, there has been a strong recovery in many areas. It has been led by buoyant consumer spending, with total consumers' expenditure likely to be up 3.5 per cent in 1983 following growth of 1.3 per cent in 1982. This year is likely to see 14 per cent growth in the sales of durable goods, and 20 per cent growth in cars and motor cycles. Housing activity and the sales of furniture, clothing and footwear have also been growing rapidly.

The current debate about how the recovery can be sustained is common at this stage of the cycle. It would be fatal to take any action which added to demand from Government sources or by monetary stimulus at this juncture. Such action would increase the chances of requiring heavy restraint next year. The worry at the moment should not be about the economy and its recovery running out of steam, but about overheating in certain sectors that are responding well.

Companies are already reporting shortages of skilled labour in some areas. Whilst much industrial capacity lies unutilised, in those areas where the shifting patterns of demand are having their biggest impact, there are shortages of capacity. The falling savings ratio, growing consumer spending, the upturn in general investment, and the continued high level of government spending all point to the need for caution rather than for expansion.

Why are our opponents arguing for an increase in general demand?

The Labour Party, the CBI, NIESR, NEDO and others all draw on the same common fear which emanates from the poor performance of basic manufacturing industry in the UK. The inability of the car industry to meet the demand in the best ever vehicle year is a symbol of the conflict. The deficit on trade in motor vehicles has surged in the first 9 months of 1983 by 168 per cent, from £751 million to £2,010 million. Nothing would be gained by pumping even more money in the system to enable people to buy yet more cars, other than some further increase in imports. Our message to manufacturing industry must be that the demand is there, and it is up to them to produce the right goods at the right price to satisfy it.

We have frequently used this argument

Will the rate of growth in consumer expenditure tail off next year?

The savings ratio has fallen to 8.5 per cent this year, compared with almost 11 per cent last year. Some think this is now far too low, and implies that consumers will have to stop borrowing. Messels have recently argued that consumer borrowing has been rising because wealth has increased. The substantial rise in house prices in the last 2 years has meant that the consumer can borrow more money without worsening the relationship between his total borrowings and his total assets. In addition, much of the new borrowing has gone towards the purchase of assets which will have some second-hand value. Messels overstate their case: it would be difficult for there to be a good market in second-hand videos of sufficient size to make people regard their video as they do their savings deposit - as a liquid asset. Nonetheless, there is some truth in their case.

The prospects for the pay round in 1983/4 also imply continued consumer spending. There is little prospect of wage settlements falling below the 5-6 per cent range. This implies that average earnings growth will remain around 8 per cent in 1984, as the year will still see some increase in activity and a satisfactory background for bonus payments and overtime. This will be ahead of the rate of price increase, and will therefore mean that consumers' real incomes will carry on rising next year. At the same time, the level of unemployment will tail off and so consumers will be less nervous about losing their jobs. All this points to further buoyancy in retail spending, and we would expect an extremely good Christmas this year for most shopkeepers.

Are we spending enough on capital account?

Total capital expenditure rose by 5.8 per cent in real terms in 1982, and is set for further modest growth in 1983. It is rising in both the public and the private sectors this year. The nationalised industries are spending more, housebuilding will be up by at least 10 per cent in real terms, and in every area of the private sector, apart from manufacturing, increasing investment is the order of the day.

It is important that we begin to win the argument about the virtues and vices of capital expenditure. Not all capital expenditure is a good. Capital expenditure may be undertaken for one of three reasons:

(a) For growth. There is no point in spending money on building new schools or additional electricity generating capacity when school rolls are falling and when we already have 30 per cent more power capacity than we need on average.

(b) To improve efficiency. This type of expenditure is already under way on a large scale throughout the private, industrial and service sectors. More could be done in the public sector, particularly in automating offices.

(c) For replacement. The Social Democrats have begun to move their position and to accept that not all capital expenditure is a good thing. They are left with attacking the Government on the grounds that it is not replacing the sewers. The whole system is not as bad as a few pieces under the most heavily trafficked streets of Manchester would imply. New technology may also come to our rescue in cheapening repairs. It is true that there are some other sections of the public infrastructure that are tatty and need better maintenance or replacement. We are already tackling the difficult problems of refurbishing and maintaining the ageing motorway network, whilst at the same time trying belatedly to complete it.

Chancellor also

Peter Rees has voiced some interesting arguments analysing in more detail our capital spending activities. It is also important to win the general argument that not all capital expenditure is a good thing, and that in those areas where it is a good thing, this Government is making steps to improve our programme.

The Public Sector Borrowing Requirement and the Government's Fiscal Stance

The Chancellor has fought long and hard to come up with a reasonable settlement for public spending next year. However, the outturn is still a little disappointing for the first year of a Government which wishes to embark on a major programme of tax reductions.

The £8,500 million PSBR for 1984-5 is not the full story. It is struck after crediting £1,900 million of asset sales which are an alternative method of financing a deficit. Part of the action taken to curb spending entails additional sales of council houses. £730 million has been slashed off the programme for public

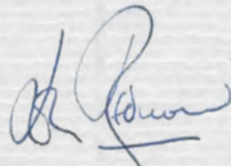
corporations. Past experience indicates that public corporations usually come back during the financial year at an inconvenient time seeking more money. Next year is likely to see problems in the basic industrial businesses controlled by the DTI which could well blow the public expenditure target off course.

Finally, we have to remember that we have now sold over £6,000 million of indexed gilts. In the early years, the interest service costs on these are artificially depressed, and this would account for another £400 million plus of public spending if we had issued conventional debt instead of index-linked debt.

The facts underline the need to look at certain of the large programmes like the programme on industrial and nationalised industries support, with a view to improving our controls and taking some of the painful decisions that need to be taken to arrest and reverse the spending in those programmes. They also underline the need for the Government this year to press ahead with its funding programme as monetary policy is at the top end of the 7-11 per cent target range against the background of 5 per cent inflation. This is generous, and the results can be seen in asset markets and in the buoyancy of consumer spending.

Conclusion

Action is needed in two areas. Firstly, we need to return to the attack on public spending as we cannot rest contented with the settlement we have reached so far. You could review with the Chancellor and Chief Secretary the measures they are taking to gain greater discipline over public spending and to identify more targets for genuine cuts. Secondly, we need to be careful in the present conduct of our monetary policy as the dangers are on the side of undue laxity. It is better to tighten a little now than to have to tighten in a year's time against a more explosive background.



JOHN REDWOOD

Andrew. How far has the [illegible] study of the future go. (Highly confidential - only ask [illegible] private office or Ken Stowe's private office)

[Mr. Lawson]

and since then it has been falling steadily year by year. The main reason why it increased was that the economy was affected by the world recession.

We in this country are not alone in that perception. The world recovery now under way is built not on some artificial expansion of demand but on a strategy of monetary and fiscal discipline endorsed at successive summits at Ottawa, Versailles and Williamsburg. There is a strategic consensus throughout the industrialised world on what has to be done, a consensus which even embraces Socialist Governments in Paris and Rome. It has helped to reduce inflation in the major countries to its lowest rate for more than a decade and has laid firm foundations for economic recovery. Only the British Labour party cannot accept the logic of the policies or commend their success. Evidently the world is out of step with the Labour party.

The need for firm monetary and fiscal policies applies equally to the developing countries, which have been especially hard hit in recent years by the combination of high interest rates, depressed commodity prices and more costly oil imports. Firm adjustment programmes supported by the International Monetary Fund are crucial. I particularly welcome the long-awaited decision of the United States Congress to support the increase in IMf quotas. I hope that the Administration will be no less successful in securing support from Congress for measures to reduce the Federal Budget deficit, because a fll in dollar interest rates would be the single most significant boost to recovery in the developing and industrial countries alike.

I have outlined our policy on the overall level of spending. Many of my right hon. and hon. Friends in particular are anxious about the balance between capital and current expenditure in the public sector. Gross fixed investment in the public sector, as it is defined in the national accounts, fell under Labour between 1974 and 1979 from 6·5 per cent. of total national output to 4·4 per cent. It fell further until mid-1981 to about 3·4 per cent., but has been broadly stable since then.

The amount of capital expenditure within the public expenditure White Paper planning total, which is the usual basis on which this argument is conducted, provides a poor guide to the impact of the public sector on this country's capital goods industry. For example, the White Paper figure for capital spending amounts to only a fraction of the total public sector capital spending. It does not, for example, include the capital spending of the nationalised industries, which is running at about £7 billion in the current year, which is broadly the same as the 1979-80 level in real terms.

Furthermore, all these capital spending figures are expressed net of asset sales. Sales of public sector housing amounting to over £2 billion last year have to be added back to the totals. The existing convention leads to the absurdity that the more successful the Government are in pushing forward their privatisation programme, the lower the public capital spending figures appear. The figures are also further distorted by the somewhat eccentric treatment of defence in the official statistics. By international convention, virtually all defence spending is classified as current; even expenditure on new barracks or a new service hospital. More importantly, a fleet support vessel in one berth for the Navy counts as current expenditure while its neighbour built for BP scores as capital expenditure.

With the defence equipment programme running at about £7 billion, much of which is capital spending, it makes a big difference to the figures and, because defence spending has been growing as a proportion of public expenditure, it makes a difference to the trend. If we consider these figures outside the straitjacket of the misleading White Paper definition of capital spending, we find that between 1978-79 and 1982-83 total public sector capital spending, including nationalised industries' investment, rose by 38 per cent. from just over £12 billion to £17 billion.

If we adjust the 1982-83 figures to take account of special sales of assets and council house sales, that figure rises to nearly £20 billion or twice the White Paper figure for the earlier year. The figure would be still higher if some credit were taken for defence capital spending. In other words, taking defence equipment as capital expenditure, total public sector capital expenditure in real terms has been broadly stable since 1978-79. As I told my right hon. Friend the Member for Guildford (Mr. Howell) last Thursday, I hope to improve the clarity with which these matters are presented in the next public expenditure White Paper.

Mr. Hal Miller (Bromsgrove): On the subject of capital expenditure, will my right hon. Friend accept that, for example, local authority road programmes rarely meet planning targets and that local authority borrowing for capital expenditure since the introduction of the GRE penalties has dropped from £2·287 billion to £7 million? Widespread anxiety is felt that the necessary capital expenditure on infrastructure is not being undertaken.

Mr. Lawson: It is true that over the years local authorities have regrettably shown a tendency to overspend on their current account and underspend on capital account. The responsibility for that lies with the local authorities.

In any event, what matters most is investment as a whole — private as well as public sector. The autumn statement forecast is for fixed investment rising by 4 per cent. next year against a rate of growth of up to 3 per cent. in the economy as a whole.

Mr. Terence Higgins (Worthing): My right hon. Friend is making an important distinction within the public sector between capital formation as regards defence expenditure and other public sector investment. Does he agree that, in terms of the country's productive capacity, it is only public sector investment outside the defence sphere that increases our capacity to produce? That is not true of capital formation in defence industries.

Mr. Lawson: I have the greatest respect for my right hon. Friend, but I am afraid there is absolutely no distinction between a hospital built by the private sector for the defence services and one built for civilian use. It is precisely the same. Conventional treatment in the public sector White Paper is totally different.

I come to another issue which has aroused a fair amount of comment — the Government's programme of asset sales. The privatisation programme is designed to improve efficiency and to bring about greater competition, to the benefit of the customer and the nation. It reduces the Government's need to borrow, but that is not the programme's principal aim although the beneficial effect on the gilts market is welcome.

LecJR

10 DOWNING STREET

Prime Minister ④

This is an old story. Eternal vigilance, which John Redwood is helping to provide, is needed to stop the Bank selling long gilts. These should be sold only as a very last resort and then in limited quantities, ie further small tranches of existing stocks rather than full scale issues.

AT

25/11

SECRET

24 November 1983

MR TURNBULL

John - who would you like on the Court? New appointments are being made and I should like someone who really knows about money supply & funding. MT

FUNDING MEETING, 23 NOVEMBER

I attended the meeting yesterday where the following propositions were generally agreed:

1. Monetary conditions are a little lax, and in the absence of better controls over public spending, more stock has to be sold.

2. National Savings have been doing quite well recently, bringing the annual total to end-October to £1.6 billion compared with the target of £3 billion for the year as a whole. Likely flows over the Christmas period will leave National Savings with an estimated £700 million to raise in the last 2 months of the year. If building society interest rates have fallen by then, this is realistic. Otherwise they will need a new product to be able to achieve this target.

3. Following last month's meeting, the Bank has issued a 10 per cent 1989 conventional tap stock, and has now issued a £500 million low coupon short in order to mop up some of the funds available from the roll-up funds, whose tax break expires at end-December. The Bank argued that it would not be able to meet the £1.25 billion a month of sales it needs in December and January without moving longer.

The Treasury and I have been sceptical about the Bank's requests to sell a large amount of long stock. Their demand has been whittled down to tranchettes of 1990s stock if they have reached an impasse with other instruments.

4. The Bank do not seem to have exploited the rising market in gilts in the last 5 weeks as actively as we would have liked. They now face a 2-week period of inactivity with respect to new stocks during the Cable & Wireless sale. The Economic Secretary, therefore, may well be forced to accept small tranchettes of 1990s stock in 2-3 weeks' time, mainly because of the Bank's tactics.

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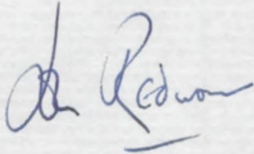
SECRET

5. The long-dated index-linked tap stock remains unattractive to the market in current conditions.

6. Before the year end, the Bank will probably launch a short convertible stock to attract some of the building society money. That would seem an acceptable idea.



JOHN REDWOOD

SECRET

BACKGROUND ECONOMIC BRIEFING

MINISTERIAL STATEMENTS

Compiled by
EB Division
HM TREASURY
Tel 233 5503

7 November 1983

This issue covers speeches and appearances during October and the beginning of November. On 20 October the Chancellor made his annual major speech at the Mansion House (pages 40, 44, 45, 48-9, 50 and 51); Government thinking on the privatisation of public sector industries was set out by the (new) FST in a 'theme' speech on 1 November (pages 42 and 43). The Treasury was First Order for Questions on 27 October (pages 40, 45 and 49).

At the end of this issue of Ministerial Statements you will find a revised index to the whereabouts in this and the previous three issues of latest key comments on a number of economic and financial topics.

7 November 1983

Macro-Economic Policy

'For the past two years or more GDP has been growing at a rate of 2.5 to 3 per cent a year. This is the consequence of sound monetary and fiscal policies, which have brought down inflation and interest rates.' Chancellor answering Questions 27.10.83 Hansard col 413

'Underpinned by the fall in inflation and interest rates, and hence in the savings ratio, we have seen output recover ... It is no coincidence that the turn round can now be seen to date from the time of my predecessor's 1981 Budget.' Chancellor at Mansion House 20.10.83.

How recovery has and will come about

'In the first half of this year the British economy grew by 3½ per cent compared with a year earlier. That's an impressive figure: well above the average pre-recession rate. It means that despite a still depressed world economy, British industry and commerce is on the mend.

And it means that for the first time in this country's recent history, recovery has come about not by the inflationary actions of Government - which carry with them the seeds of their own destruction - but through the hard work and enterprise of the British people.' Chancellor in Sunday Express 9.10.83.

'Within the context of the Medium Term Financial Strategy, what happens on the supply side will in the long run be the main determinant of our national economic success.' Chancellor at Mansion House 20.10.83

MINISTERIAL STATEMENTS

4 November 1983

Industrial and Regional Policy

Competition Policy

'Our economy is going through a period of very rapid change. ... there are many pressures on the economy to adapt, and adapt rapidly. For it to do so, resources need to shift to expanding areas of activity.

It is the essence of our economic policy that wherever possible this adaptation should take place directly in the market place. It is in a free and competitive market that consumers can best assert their preferences, and reap the benefits of a growing economy ... the market ... should have the overwhelming role in deciding on the developing patterns of our trade and industry. This is central to our policy for industrial recovery; working with the grain of market forces.' DTI Parliamentary Under Secretary (Mr Fletcher) at FT Conference 20.10.83.

Exceptions to market determination

'...wider questions may arise, where the market may not be the best or only judge. The competitive success of a particular company may itself lead to its becoming unduly dominant, leading to a monopoly. (I am not saying there is an automatic presumption against dominant positions or large market shares; in some sectors these are inevitable.) The same applies to mergers. ... There are a few cases (usually less than a dozen a year) where the merger, however attractive to companies or shareholders, raises questions about the power or efficiency of the merged unit, or about the risk of creating a dominant position ... Where that risk exists there has to be machinery for looking at it.

Under our legislation, the decision whether to refer a merger to the Monopolies and Mergers Commission lies with the Secretary of State. ... The Director General has an essential role in analysing each case and the statutory function of making a recommendation. ... But Parliament has left the final decision to the Secretary of State; and ultimately Ministers have no option but to weigh the issues for themselves.

I have to say that complete predictability is not achievable with such a system. Nor perhaps is it desirable; the essence of the system is flexibility. ... But I am concerned that a pattern should develop and be traceable, and that the decisions taken at any one time should not be regarded as unpredictable and capricious. It is the Government's intention to give as much guidance as possible to the market on the policy in particular cases, eg by giving brief reasons for decisions.' DTI Parliamentary Under Secretary (Mr Fletcher) at FT Conference 20.10.83.

Government Regional Policy

'The Government are continuing to review regional economic policy with a view to making it more effective in the creation of jobs. We shall publish the results of our review in due course.' DTI Parliamentary Under Secretary (Mr Trippier) answering Questions 26.10.83. Hansard WA col 91

Publicly-owned industries - rationale of privatising

'We have over the next four to five years an historic opportunity to reform key areas of the British economy ...The privatisation programme is coherent, and well thought-out. It holds substantial advantages for the management of the industries, their employees, the consumer and the taxpayer. And it also, of course, brings benefits to the PSBR and furthers our objective of reducing the size of the public sector. But these important by-products are secondary to the main theme. Our main objective is to promote competition and improve efficiency.

As the programme moves into the heartlands of the public sector, maximising competition will become of dominant importance. No state monopoly is sacrosanct. We intend through competition and privatisation to open up the State sector to the stimulus of competition, and reverse the creeping bureaucratisation of the last 35 years. The long-term success of the privatisation programme will stand or fall by the extent to which it maximises competition. If competition cannot be achieved, an historic opportunity will have been lost.' FST (Mr Moore) at stockbrokers' conference in the City 1.11.83.

Other considerations besides encouraging competition

The advantages of privatisation are many. It brings clear benefits to the companies concerned. Managers are set free to manage and new opportunities are opened up. It is no surprise to me that companies which have been privatised to date are trading extremely successfully in the private sector. ...

[These] companies have revelled in their new-found independence. Their balance sheets have been geared to the particular needs of the business and their finance can now be drawn from the normal capital markets rather than from the Government. Commercial investment can increase and a completely new set of financial criteria operates attuned to the company rather than to the needs of the PSBR....

And it is not just the companies who have benefited. Attention is too seldom focussed on the benefits that privatisation can bring to those who work for the companies concerned.

These moves will continue. At the same time, it is clearly essential to ensure that privatisation does not erode essential services. An advantage of privatisation is that it forces into sharp relief a distinction between activities which are commercial and activities which are not. If uncommercial activities merit support, subsidies should be direct, contractual and specifically targeted.' FST at stockbrokers' conference in the City 1.11.83.

7 November 1983

Prices and Inflation

Dramatic fall in inflation

'Inflation has fallen dramatically. It is now running at about 5 per cent compared with an average rate of around 15 per cent for most of the 1970s. It has fallen very much more rapidly in the last two years than most people expected, even though the recovery in the economy has been stronger than many foresaw.' Chancellor at Mansion House 20.10.83.

Further outlook and objective

'... prospects for inflation remain encouraging. Recent indicators, so far from pointing to higher figures through next year, suggest if anything a downward trend. It is perhaps puzzling that inflationary expectations should lag so far behind performance ... the Government's message must be ..."we mean what we say: and we mean to keep on top of inflation". ... The Government's ultimate objective is price stability.' Chancellor at Mansion House 20.10.83.

Role of lower inflation in recovery

'The control of inflation was - and remains - an essential precondition for sustained economic revival. We have fought hard to bring the rate of inflation down to only a quarter of what it was in 1980. Greater price stability means business can take decisions, plan ahead, invest with greater certainty. This is the only foundation for durable economic growth, lasting prosperity and the creation of jobs.' Chancellor in Sunday Express 9.10.83.

7 November 1983

Fiscal

'Our determination to cut public sector borrowing as a proportion of GDP has been an important part of the financial strategy we have pursued since 1979. ... The reduced demands of Government borrowing on the nation's savings have allowed interest rates to decline from their peak levels of 1980 and 1981, and have thereby stimulated the recovery ...

We shall continue to put downward pressure on the PSBR over the medium term. This will require continued strict control of Government spending. We must curb the growth of public expenditure: and this is a task not just for today but throughout this Parliament and beyond.' Chancellor at Mansion House 20.10.83.

PSBR and funding policy

'The broad aim of funding policy will continue to be to fund the PSBR by raising finance outside the banking system from the UK private sector, and from external flows, to which too little attention is often paid. By thus limiting the public sector's contribution to monetary growth, this will provide a basic control of the growth of liquidity, however measured. As in the past there may be occasions when funding ought to be either higher or lower than the PSBR, in order to take account of the private sector's demand for credit, and to provide a measure of control if the wider aggregates are growing excessively rapidly. But over the medium term there should be no systematic tendency either to overfund or to underfund the borrowing requirement.' Chancellor at Mansion House 20.10.83.

Progress of 1983 public expenditure survey

'The 1983 public expenditure survey is still in progress. For 1984-85 and 1985-86 our objective is still to hold to the totals of expenditure published in the last public expenditure White Paper [Cmnd 7879]. For 1986-87 we aim to keep total expenditure at broadly the same level in real terms'. CST answering Question 27.10.83. Hansard col 419.

Spending on the NHS

'The Government is now spending £15½ billion [in a year] on the NHS. That compares with £7¾ billion when we took over. Spending on the NHS has risen 17 per cent more than prices. ... half a million more patients are admitted to hospital each year now than when we took over and two million more outpatient and emergency treatments are provided by our hospitals each year ...

All these things add up to one central aim. A modern, efficient health service, not one which forgets that it must always show a caring face to its patients, not one which thinks the answer to every problem is more money, but a health service which is always looking at how it uses the money the taxpayer gives to it to see if it can give better value and better services. Let no-one doubt that this Government is committed to the NHS.' Social Services Secretary in Sun 25.10.83.

Taxation policy

'We are determined to maintain our sound financial policies, to build on the successes achieved against inflation, and to remove the barriers to enterprise and employment. One of the most important barriers is the present burden of taxation ...

During our first term of office we improved the structure of the tax system ... the overall burden of taxation has yet to be reduced. It's a task we have to tackle.' Chancellor in Sunday Express 9.10.83.

'We will be able to reduce the burden steadily during the lifetime of this Parliament, provided we can stop public expenditure rising in real terms.' Chancellor interviewed in Daily Express 11.10.83.

Priorities

'We attach very high priority to raising the starting point of income tax ... The cost ... will be large ... A further reduction in the rates of income tax must ... yield precedence to that.' CST at Blackpool 11.10.83.

Rating system

'No Government have searched harder for an acceptable alternative to rates ... we were unable to find a more satisfactory alternative.' Environment Secretary at Question Time 26.10.83. Hansard col 273

Local Government reform

'In our first term of office we took a series of measures designed to reduce the share of resources consumed by the public sector, including local government ... The abolition of the GLC and the Metropolitan Counties will eliminate the overheads of a whole tier of local government; it will also eliminate a source of conflict and overlap. The results will be more economical and effective local government.' Environment Secretary (Mr Jenkin) in FT 28.10.83.

7 November 1983

Monetary Policy

'There has been ... speculation that I have been engaged in a review of the operation of monetary policy. I have indeed: but not with the intention of changing policy objectives ... I thought it worthwhile to re-examine some of the technical aspects of the operation of policy ... as a result I am considering some changes of emphasis ... but they represent merely a continuing evolution of a well-tried strategy. The MTFS is alive and well ... we shall continue to seek gradually to reduce monetary growth.' Chancellor at Mansion House 20.10.83.

Possible role of MO as an additional indicator

'Monetary targets have provided an indispensable financial discipline. They have not been, nor have they ever been intended to be, a form of automatic pilot. Over the years we have adjusted the targets themselves; and we have always sought to take account of shifts in the demand for money - whether due to financial innovation or to institutional change ...

But there never was a time when it was thought that one monetary indicator said all there was to be said about monetary conditions. ...

None of the Ms is a perfect guide to the underlying concept they seek to reflect ... M1 has been the traditional measure of 'narrow money'. The problem with M1 however is that it now has a large interest-bearing component ... it has thus acquired some of the characteristics of broad money ... M2 was specifically designed as a measure of transactions balances ... But it is still relatively new ...

Meanwhile there is some recent evidence that other measures of narrow money - particularly measures of non-interest-bearing money such as the wide monetary base, MO, and its predominent component, notes and coin with the public - have not been subject to the same distortions as M1 ... and for MO we do have a series of figures stretching some way back. ...

It does appear that MO could have a more important part to play as a key indicator of the growth of narrow money.

The remarks I have just made should not be taken to mean that I am advocating a move to monetary base control.' Chancellor at Mansion House 20.10.83.

General conduct of monetary policy

'Whichever indicators we choose to emphasise, it is unlikely that it would be appropriate to maintain a single range for both broad and narrow aggregates ... it will not be possible to ensure that all target aggregates are held always within their ranges, and we will continue to interpret their behaviour in the light of the other available evidence.' Chancellor at Mansion House 20.10.83.

Interest rates

'There was a fall only a few days ago [30 October]. ... Provided we can continue to keep public expenditure and borrowing under firm control, then the long run trend of interest rates should come down.

We're not helped by the level of American interest rates. Interest rates are still high. But the long term trend is downwards.' Chancellor interviewed in Daily Express 11.10.83

'The recent reductions in the clearing banks' base rates to 9 per cent means that they have fallen 7 points from their last major peak in October 1981, and are now back to their lowest level of the last 5½ years'. Chancellor answering Questions 27.10.83. Hansard col 423.

7 November 1983

Balance of Payments and External Finance

Relevance of exchange rate to monetary policy

'The exchange rate ... by providing information about financial pressures at home and overseas, is of key importance to the interpretation of monetary conditions. In particular its movements can throw light on whether there have been unexpected shifts in the demand for money. But equally, the exchange rate can change for many reasons, some quite unconnected with fundamental developments here or abroad: its signals as to the tightness of monetary policy can therefore be misleading. So while we shall continue to take the exchange rate into account in interpreting monetary conditions, there will, as before, be no target for it, nor ... any complicated mechanical formula linking it with other indicators.' Chancellor at Mansion House 20.10.83.

Discussions continuing on reform of European Community finances

'Up to this time not much has been agreed at all. But I think it is also true that people's positions have become more and more clear, the room for manoeuvring becoming a little bit more easy to see. And I think we're making rather slow progress. ... the other nations have seen that we are serious, that we're not going to go on making an unduly large contribution to Europe, especially when we're one of the countries who are below the average of the gross national product per capita of Europe ... We're prepared to remain net contributors on a small scale.

We have two conditions which we will insist on before the consideration of increasing own resources can be undertaken. The first condition is that there shall be some control we're asking for but control nonetheless. The second condition is that the imbalances, ie the contributions which countries like us who oughtn't be contributing at all are asked to make, shall be rectified by some automatic and lasting formula to put us right.' FST (Mr Ridley) interviewed in Athens 10.10.83.

MINISTERIAL STATEMENTS

4 November 1983

World Economy and International Monetary Matters

'In some respects the international economic scene is more favourable than it has been for some time. World recovery is now under way and the prospects for continued growth in 1984 and beyond look good. The pace has so far been set in North America, but the prospect of stronger growth in Europe and Japan should ensure a more balanced expansion from now on.' Chancellor at Mansion House 20.10.83.

Remaining uncertainties

'There are still a number of uncertainties ... Real interest rates remain too high - primarily because budget deficits, in particular that of the US, still absorb too much of the world's savings ... But perhaps the greatest immediate problem is that of international debt ... substantial adjustment by debtor countries is inescapable. But ... debtor countries need time to carry out effective adjustment programmes - with adequate financing ...

That is why it is so important the US Congress should follow the lead of other legislatures ... and ratify the proposed increase in IMF resources ... the role of commercial banks [also] remains important.' Chancellor at Mansion House 20.10.83.

MINISTERIAL STATEMENTS

7 November 1983

Civil Service Matters

Manpower

'In May 1979 there were 732,00 civil servants. An urgent review was put in hand, and within a few months a tough but realistic target was set of a reduction to 630,000 to be achieved by April 1984. I am glad to confirm that we remain steady on course to achieve this target by the end of the financial year. We may even do slightly better. By 1 July the number was down to 642,800. ...

The main thrust of our manpower policies has been directed towards ensuring that the tasks placed upon the Civil Service by Government and Parliament are performed as efficiently and effectively as possible. However, we have sought also to eliminate functions that are unnecessary, or better done in the private sector. During the four years from 1979-80 to 1982-83 over half the reduction in manpower has been achieved by improving efficiency; about 20 per cent by dropping or materially curtailing functions; about 10 per cent by privatisation, including contracting out; and some 2 per cent by hiving off to new or existing private sector bodies. ..

The significant reductions in Civil Service manpower to which I have referred have been achieved against a background of an increasing workload in many areas of the Civil Service.

Manpower targets and cash limits encourage efficiency, especially in the public sector, where the usual profit and loss disciplines to not apply. An example of how manpower reductions have gone hand in hand with greater efficiency is the DHSS net staff reductions since 1979 which have amounted to 6,000 but unit costs for delivering benefits have been reduced by about 20 per cent. There has been a real productivity gain in that area of Government activity.' MST in Adjournment Debate 28.10.83. Hansard cols 551 and 552

Scrutinies and reviews

'Scrutinies are examinations by Departments of specific areas of work. The test that they apply is value for money; but do they have to be done at all? Do they have to be

done in their present way and can more value be added for the same or less c[illegible] Multi-departmental reviews are scrutinies of a single common topic conducted by several Departments together. The work is co-ordinated by a central team, and reports to my right hon Friend the Prime Minister.

There have been 194 individual departmental scrutinies since 1979. All major departments have participated, with some of the larger departments having done 10 or more studies each. Five multi-departmental reviews have examined Government forms, statistical services, running costs, personnel work and support services in research and development establishments.

The present approach to reviews has changed to some extent. Initially, the emphasis was on finding areas of Government activity where value for money was not provided. We are now looking at areas of work to see whether better services can be provided and whether the job can be done in a better way; but we must always bear in mind the overall constraints of the Government's economic position.' MST in debate 28.10.83. Hansard col 554

Contracting out, hiving off, and 'quangos'

'Privatisation and contracting out are key elements in the Government's economic strategy. They are perhaps more often thought of in relation to the public sector as a whole, but they are relevant also to the public services. Our aim is to privatise or contract out services whenever this will improve efficiency and effectiveness. We are continually reviewing functions to see whether it would be more appropriate for them to be privatised or contracted out.

Of course, not all Government functions are suitable for privatisation, and the savings can often be very small. Larger savings have been achieved by contracting out. For example, by the end of 1983, contract cleaning and catering will have been introduced in well over 600 Ministry of Defence establishments, with a saving of about £12 million a year. ...

A small percentage of the savings in Civil Service manpower has been achieved by "hiving off". I know that some people suspect that we are achieving our manpower targets by setting up quangos. That is not so. Only 2 per cent of the reductions are in the hived-off area. ... we are in the business of getting rid of as many quangos as we can. Some 500 quangos have been eliminated already with a saving to the taxpayer of about £100 million a year. We are continuing the hunt and hope to increase these

figures. ... We are keeping up the pressure to ensure that quangos are set up only when there is a genuine need, and every proposal is rigorously examined. More to the point, we review each advisory body every year, and each executive body is subject to a review every three to five years. On the quango front, we are determined to review functions and seek economies when it makes sense to do so.' MST in Debate 28.10.83. Hansard cols 551 and 552

Technology

'Information technology provides an important aid to Government Departments in widening policy choices, improving efficiency and providing a better service to the public. Total spending last year on computers, telecommunications and office machines was about £350 million. Some 680 medium to large computer systems are already installed in Government or are on order, and they serve both administrative and scientific purposes ...

The Board of Inland Revenue, for instance, plans to computerise PAYE in about 600 local tax offices by means of 47 large computers in 12 regional processing centres linked to the local offices by a telecommunications network. The efficiency and flexibility of tax assessment will be much enhanced by this system, and staff savings of some 6,800 are involved in the full installation of the computerised PAYE system. Likewise, the Department of Health and Social Security is developing an operational strategy for the administration of social security benefits over the next 20 years. An investment in new technology of some £700 million will enable the full range of an individual's and his or her family's social security business to be handled in one place, more efficiency, and with a better service to the public. At the same time, this computerisation is expected to offer cost reductions of nearly £2 billion, mainly from staff savings.

The changes to information technology do not just affect the large administrative system. A wide variety of small, stand-alone applications are also being introduced in Departments. Over the four years ending in 1982-83, some 925 microcomputers and some 1,250 word processors were purchased by Departments. This pace is quickening as familarity grows and proven applications in one area are replicated elsewhere, and new applications are identified constantly by studies and trials.' MST in Debate 28.10.83. Hansard col 553.

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KODAK Q-60 Color Input Target

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A																							A
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C																							C
D																							D
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	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	

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FTP://FTP.KODAK.COM/GASTDS/Q60DATA

Q-60R2 Target for
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