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PREM 19/1456

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DOMESTIC ~~POLICY~~ MONETARY POLICY

ECONOMIC POLICY

Pt 1 : May 79

Pt 12 : Dec 84.

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~11.12.84~~		~~29.3.85~~					
~~2.1.85~~		~~10.4.85~~					
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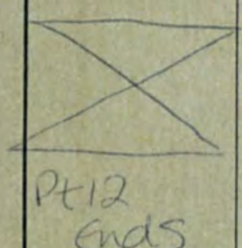
~~17.1.85~~							
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~~26.3.85~~							
~~28/3/85~~							

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PART 12 ends:-

JR to AT 26.4.85

PART 13 begins:-

Monthly Monetary Report 10/5/85

TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
CC (85) 2nd Conclusions, Minute 1	17.1.85
CC (85) 3rd Conclusions, Minute 5	24.1.85
CC (85) 4th Conclusions, Minute 6	31.1.85
CC (85) 12th Conclusions, Minute 5	28.3.85
CC (85) 13th Conclusions, Minute 4	18.4.85

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 OWayland Date 12 December 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.

House of Commons, Treasury and Civil Service Committee,
Session 1984-85: The Exchange Rate
Minutes of Evidence, 28 January 1985

Signed OWayland Date 12 December 2013

PREM Records Team

NBPM
AT 26/4

26 April 1985

MR TURNBULL

FUNDING MEETING

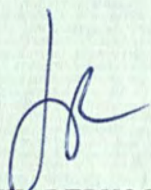
I attended the Funding Meeting on Wednesday.

Last year, National Savings raised £3.1 billion (£3 billion target) and the present year has begun satisfactorily. The last rate changes were taken well by the press; no further rate changes were discussed at the meeting.

Between March 1984 and March 1985, £16.1 billion of gilts were sold, against redemptions of £4.9 billion. Despite this, sterling M_3 has grown at 9.3% pa, reflecting the growth of public spending; whilst PSL2 has been growing at more than 14%. Lending to the private sector remains high - growing at 17% pa, because companies have been investing heavily and have probably also been borrowing to "round trip", earning a higher return in money market deposits.

The first 3 months of 1985/86 are expected to produce poor money figures, as government borrowing is again heavily slanted to the first part of the financial year and there is a large gilt maturity in June. If only £1.25 billion of stock is sold each month, £M_3 will near 14% growth on a 3-month basis by end June. (Target range 5-9%.)

In view of this, it was agreed that we have to fund to the maximum extent possible. It was decided not to trigger a rise in short rates, but noted that the bad money figures could cause problems in due course. This is also being transmitted to currency markets, along with renewed fears about oil prices. Analysts are also beginning to calculate the UK oil revenue losses from a strong pound. The short-term monetary prospect implies difficulties for the pound against the basket of currencies.



JOHN REDWOOD

008/11

File

MONTHLY MONETARY REPORT: MARCH-JUNE

SUMMARY

- Both £M3 and MO (despite a sizeable downward distortion) grew faster than forecast in March, bringing £M3 towards the top of its 1984-85 target range, and leaving MO a little below the middle of its 1984-85 range. The exchange rate (sterling index) is some 9 per cent higher than at the time of last month's report, and short term interest rates 1 per cent or so lower.

- With heavy sales of gilts and the PSBR and bank lending performing much as expected, the main factor tending to add to £M3 was the unexpectedly high proportion of gilts bought by banks and the overseas sector. The acceleration of MO, which is continuing in banking April, is a little puzzling.

- Bank lending is projected to continue at a high rate, declining only very slowly in response to the level of short term interest rates. The forecast assumes gross gilt sales of £1¼bn in banking April, a figure that may well not be met, and the same level of gross sales in May, and in June (a month of very heavy gilt redemptions).

- On these assumptions, by the end of banking June £M3 is forecast to be growing at 9.3 per cent on a twelve month basis, and at 13.7 per cent on a three month basis - compared with its 5-9 per cent target range for 1985-86.

- MO is projected by the same date to be growing within - but in the upper half - of its 3-7 per cent range. Assuming its growth after April falls back to a more normal rate, it is forecast by mid-June to be growing at 5.3 per cent on a twelve month basis and 6.3 per cent on a three month basis.

HF3 - 12 April 1985.

SECRET (AND PERSONAL UNTIL 2:30 PM THURSDAY 18 APRIL 1985)

MONTHLY MONETARY REPORT: MARCH-JUNE

Monetary Aggregates

In banking March £M3 growth was 0.3 per cent above forecast, at 1.0 per cent, with MO growth marginally above forecast at 0.4 per cent. £M3 is now at the top of its 1984-85 target range, while MO remains below the centre of its target range. Table 1 below shows recent growth in the main aggregates, and annex table 1 provides further detail, also covering real MO and real £M3. Other measures of money are shown in annex table 4.

Table 1: Main Aggregates : Recent Experience

per cent, s.a.

	MO	£M3	PSL2
monthly change			
February	0.1	0.5	1.1
March	0.4	1.0	1.1
Growth to mid-March at an annual rate			
over past:-			
3 months	- 1.3	9.3	15.4
6 months	5.3	9.8	14.8
12 months	5.3	9.3	14.6
Target period	5.4	9.9	15.2

2. In March MO growth was depressed by an unusually low level of bankers' operational deposits on make-up day when the markets were extremely short of funds and overnight rates reached 50 per cent. If this had not occurred MO would have grown by around 0.7 per cent. As a result of the same distortion MO growth in April will be correspondingly higher. This distortion masks a substantial rise in coins in circulation in March which was only partly offset by lower note issue. Coins have been growing at a rate of £12m or so a week (a monthly rate of over 3 per cent) since the beginning of the year, but until banking March this had been largely offset by a fall in the note circulation. It seems that more £1 coins are

2.

are being issued than £1 notes withdrawn. It is hard to explain this: but it may be that retailers and banks are for the time being maintaining separate stocks of coin and notes. Or the greater cost of transporting cash in bulk may be encouraging retailers and banks to maintain larger stocks of £ coins than they would of £ notes.

3. £M3 and bank lending were both distorted upwards by £140m (about 0.1 per cent) in banking March as a result of failure to complete one large transaction on make-up day, leaving one party with an unwanted deposit of £140m and the other with an unexpected overdraft of the same amount. The transaction was completed the following day. Even without allowing for this distortion, target period growth in £M3 at mid-March was slightly below the top of the 1984-85 target range, with six month growth at a similar rate, but twelve month growth substantially lower at 9.3 per cent.

4. With the PSBR much as expected one factor leading to a higher than expected outturn for £M3 was late and unexpected purchases of gilts by the banks and the overseas sector, dissipating the influence on £M3 of a very high level of gross sales. After allowing for the distortion mentioned above, sterling lending at £1,650m was close to forecast. If the indications of substantial round-tripping towards the end of banking March are correct our current estimate of underlying lending - of around £1.6bn - may even be on the pessimistic side.

5. PSL2 growth in March at 1.1 per cent was, unusually, almost in line with £M3 growth. Twelve month growth in PSL2 has fallen back slightly, to 14.6 per cent, but both three and six month rates are rather higher. Further adjustments to the building society components of M2 go some way to offset the improvement caused by last month's adjustments. Twelve month growth at 9.8 per cent is similar to £M3.

Other indicators of monetary conditions

6. **Inflation**. Retail price inflation is expected to remain at about 5½ per cent in March, but an increase is likely in April following the building societies' decision to raise mortgage rates with effect from April 1. Producer input prices increased by 9.6 per cent over the twelve months to March - the sixth consecutive month

that the annual growth rate has been 9 per cent or greater. However, the annual growth rate of producer output prices fell to 5.4 per cent in March. It would seem that producers are absorbing the impact on costs of the fall up to February in the exchange rate by reducing profit margins rather than increasing their prices.

7. Asset prices. The DoE monthly house price series suggests that house price inflation in the year to February was 7½ per cent. Three leading building societies - the Halifax, the Abbey National and the Leeds - agree. Their figures show that house prices rose by 7½-9 per cent in the year to the end of the first quarter.

8. Real interest rates. Real short term interest rates remain at historically high levels, despite the recent falls in banks' base rates. Expected inflation as measured by outside forecasters has edged upwards, suggesting that real rates may have fallen by more than nominal rates. Indexed gilt yields have almost returned to their February levels as the effect of the bondwashing provisions was largely offset by the unwinding of defensive positions after the Budget made it clear that pension funds income was not to be taxed.

9. Exchange rate. In the second half of March sterling recovered strongly against all currencies. Since 15 March it has risen 15 per cent against the dollar and 5 per cent against the Deutchemark giving a 9 per cent rise on the sterling exchange rate index. The index has stayed above 75 for three weeks, and is now at roughly the same level as last summer.

10. Money GDP. Provisional estimates for the fourth quarter of 1984 suggest that money GDP increased by 6½ per cent in 1984. But for the coal strike, it would have increased by just under 8 per cent, equivalent to real growth of about 3½ per cent.

Three month forecast

11. It is assumed that there will be no further change in interest rates, or differentials, during the forecast period beyond the increase in building society rates already implemented, and increases in National Savings rates already announced.

12. MO is forecast to rise by 0.9 per cent in banking April. About 0.3 per cent of this arises from the recovery of bankers' balances from last month's abnormally low level. The other main factor is rapid growth in coins without an offsetting fall in notes which started last month, and shows no sign of abating according to figures for the first two weeks of banking April. As a result of these factors, while the growth rate remains within the 1984-85 target range, there are now some signs of an acceleration, with the three and twelve month growth rates forecast to reach 6.1 per cent by the end of banking April.

13. We have not changed our estimate of the underlying level of sterling lending since last month, and continue to take a cautious view of the effect of high interest rates and of other special factors. On this basis, £M3 is forecast to grow by 1.1 per cent in banking April, taking annualised growth in the target period as a whole to 10.2 per cent, just outside the target range. And it assumes that the gross gilt sales target for April of £1¼bn is achieved, which, with substantial sales still required, and only 3 days of the banking month to go, looks increasingly unlikely. If we fell £½bn short of the gilt sales target the forecast for £M3 would rise to around 1.4 per cent.

14. Much more modest growth for £M3 is forecast in banking May (0.4 per cent), with £1¼bn assumed gross gilt sales, no redemptions and a £500m rights issue by Barclays. In banking June, in contrast, £M3 is forecast to increase by 1.8 per cent. This is largely because, with redemptions of almost £1¼bn, there would be no contribution from gilts to funding, unless a gross sales target for that month were set (and achieved) substantially higher than the £1¼bn we have assumed for the forecast.

Table 2: Main Aggregates : Summary of Forecast

per cent, s.a.

	MO	£M3	PSL2
Monthly change			
April	0.9	1.1	1.2
May	0.3	0.4	0.8
June	0.3	1.8	1.8
growth to mid-March at an annual rate			
over past:-			
3 months	- 1.3	9.3	15.4
6 months	5.3	9.3	14.8
12 months	5.3	9.3	14.6
Target period	5.4	9.9	15.2
growth to mid-June at an annual rate			
over past:-			
3 months	6.3	13.7	16.6
6 months	2.4	11.5	16.0
12 months	5.3	9.3	14.0

15. Table 2 summarises the forecast for the different aggregates, and Chart I shows past and projected movements in the twelve month and three month growth rates for MO and £M3. The expected outturn for the fourteen month target period from February 1984 to April 1985 using the traditional cone presentation is illustrated in Chart V at the back of this report.

Public Sector Borrowing

16. In March the PSBR outturn was close to forecast at £1.3bn. The CGBR accounted for virtually all this figure.

17. For the second half of calendar March the CGBR was close to the earlier forecast. Although the expected surge in supply expenditure was less than forecast, this was offset by higher than forecast on-lending to local authorities.

18. For the period after the end of calendar March, the forecast is based on the recently completed calendar month profiles for the

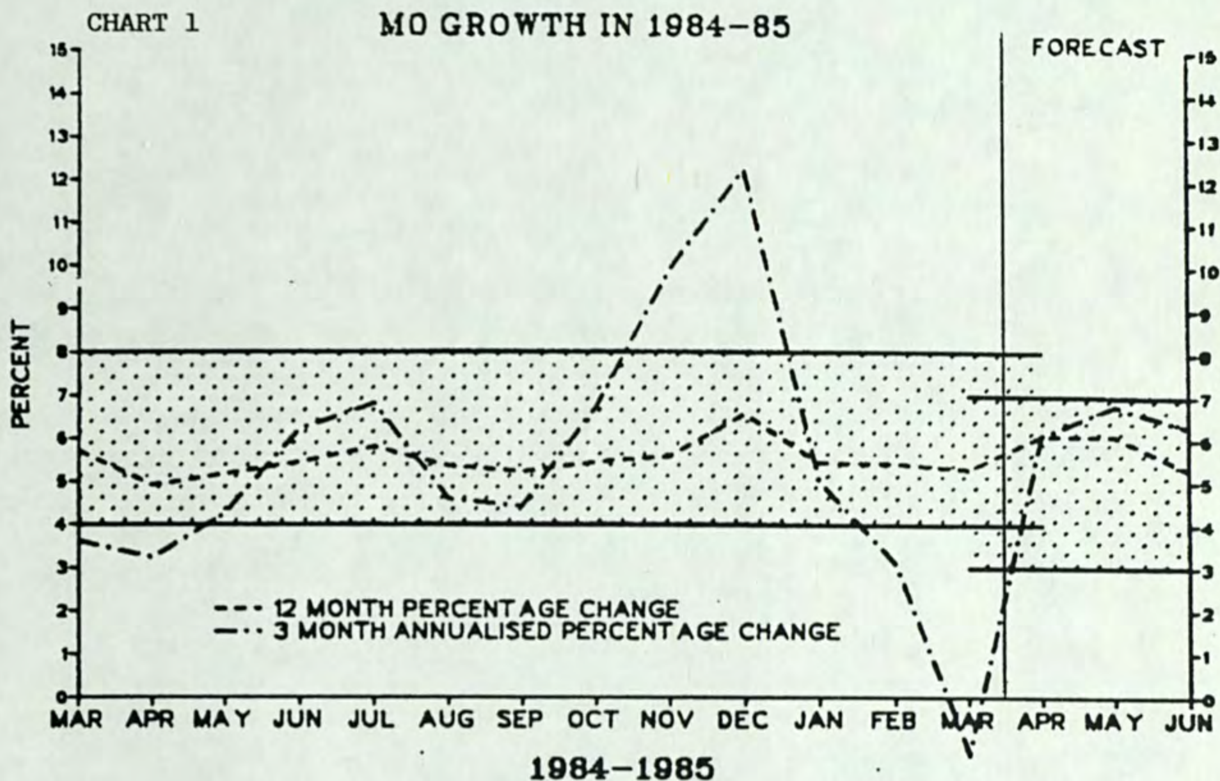
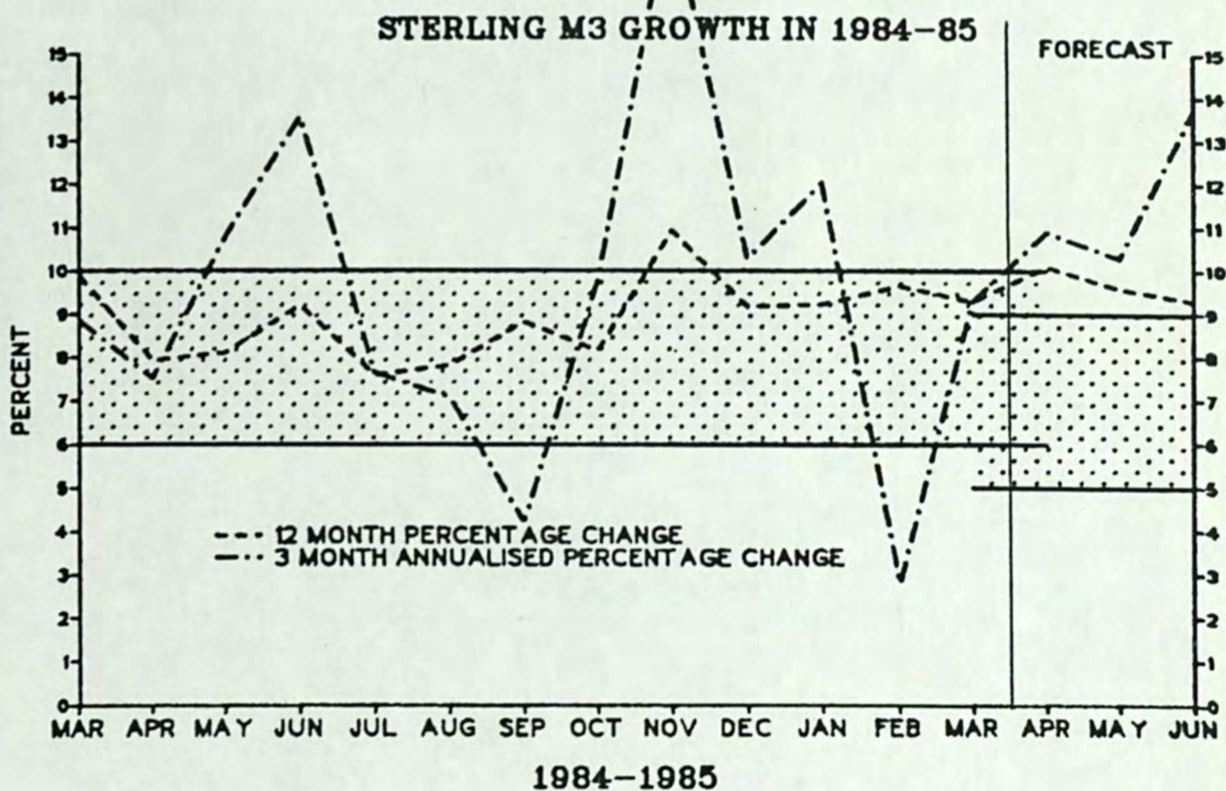


CHART 1
M0 GROWTH IN 1984-85
FORECAST
PERCENT
12 MONTH PERCENTAGE CHANGE
3 MONTH ANNUALISED PERCENTAGE CHANGE
MAR APR MAY JUN JUL AUG SEP OCT NOV DEC JAN FEB MAR APR MAY JUN
1984-1985


STERLING M3 GROWTH IN 1984-85
FORECAST
PERCENT
12 MONTH PERCENTAGE CHANGE
3 MONTH ANNUALISED PERCENTAGE CHANGE
MAR APR MAY JUN JUL AUG SEP OCT NOV DEC JAN FEB MAR APR MAY JUN
1984-1985

new financial year. The provisional profiles are similar to those for the same period last year when there was a surge in expenditure (see table 3). However there are a number of special factors relating to this year. Firstly in the second half of banking May there is the sale of British Aerospace shares which are expected to gross £180m. Secondly, affecting the CGBR but not the PSBR, there is, also in May, a large repayment of market borrowing by the Central Electricity Generating Board. The latter relied on market borrowing to finance purchases of oil during the miners' strike. Lastly there is the second call on BT, although this falls just outside the forecast period.

Table 3: Public Sector Borrowing

£ million, monthly average

	mid-Feb 84 - mid March 85	forecast mid-March 85 - mid-June 85	mid-March 84 - mid-June 84
CGBR(O)	513	943	1011
'LABR'	239	260	215
PCBR	96	- 115	- 73
'PSBR'*	848	1088	1153

* PSBR less non-bank private sector transactions in other public sector debt.

Debt Sales

(a) Gilts

19. Gross gilt sales in the four weeks of banking March totalled £1,704m, compared to a target of £1¼bn. £611m was raised through the second and final £77.50 per cent call on 11% Exchequer Loan 1990 (issued in banking February). New issues totalled £2,150m nominal, of which £637.4m remained at the end of the banking month. Details of new issues are set out in annex Table 8. Redemptions of 15% Treasury 1985 reduced the net total by £389m.

20. Despite the high level of sales, the contribution to funding was blunted by a late, and unexpected, surge in gilt purchases by the banks and the overseas sector. The banks' late purchases may reflect their particularly buoyant liquidity position at the end of last month, caused by high sterling inflows from both domestic and overseas depositors. The prospect of falling interest rates may also have been a contributory factor. Overseas gilt purchases (mainly of the new FOTRA stock) formed part of a heavy inflow into sterling denominated assets last month, probably prompted by a weakening dollar and high UK real interest rates.

21. Table 4 compares the March outturn with performance over the previous twelve months and summarises the three month forecast for gilt sales. With an assumed gross sales target of £1¼bn per month throughout the forecast period, the net sales profile, and the contribution to funding, is very uneven. With only days of banking April to go we remain around £½bn short of the gross sales target. We would expect about two-thirds of any shortfall to feed through to £M3, so under the worst possible scenario of no further sales, £M3 might be 0.3-0.4 per cent higher than in the forecast.

Table 4: Gilt Sales*

monthly averages, £m

	Actual Banking March	mid-Feb 84 - mid-Mar 85	Forecast mid-March 85 - mid-June 85
Gross sales	1704	1242	1250
Redemptions	- 389	- 274	- 372
Next maturities	3	- 106	- 167
Net sales	1318	862	711
of which:-			
Monetary sector	271	39	50
Public Corporations	- 10	3	- 13
Overseas	265	95	117
Non-bank private sector	792	725	557

* Excluding repos

22. The uneven net sales profile - and the corresponding uneven profile forecast for £M3 - reflects minimal projected buying-in in May, followed by both substantial buying in and a large redemption in banking June. It is the 3% Treasury 1985 that matures in June, and experience has shown that low coupons are normally held to maturity by the nbps; almost £1bn of the stock is therefore assumed to mature in market hands. Against this uneven pattern of redemptions the forecast simply assumes gross gilts sales of £1¼bn a month. In practice, it may be sensible to adjust the targets to achieve a more even pattern of net sales, and hence of £M3. Thus with no redemptions in May, and with institutional cash likely to be channelled away from gilts and into Barclay's rights issue and British Aerospace share sale in the same month, it may be that a lower target should be adopted. While in June a higher target might make sense given the possibility of attracting some of the cash freed by redemption of the 3% Treasury 1985 back into gilts.

(b) CTDs

23. Purchases of CTDs in March exceeded expectations by about £¾bn, with a few large purchases just before the Budget, perhaps reflecting a desire by companies to lock into higher interest rates in the expectation of post-budget falls in rates. Purchases so far in banking April have been substantial, with negligible surrenders, and a net contribution to funding of about £200m is now expected. Greater surrenders are expected to produce a neutral impact on funding in May and a small contribution in June.

(c) National Savings

24. National Savings contributed £¼bn (unadjusted) to funding in banking March (£170m adjusted), slightly above forecast. As anticipated the major contributors were the 30th Issue Certificate, the Income Bond and accrued interest. The 30th Issue benefitted from the customary surge of sales to high-rate taxpayers in the first few weeks of each new issue. This helped to ensure that the 1984-85 target was met: total net sales in the financial year were £3.1 bn.

25. The forecast assumes that the only changes in interest rates will be those already announced. This suggests that National Savings

competitiveness will rise gradually over the forecast period as the interest rate increases on the gross products come into effect. It is expected that the 30th Issue will continue to be a strong factor in the next three months, while the high Common Extension Rate should ensure that there are no heavy maturities of the 19th Issue stock. Although accrued interest is expected to bring in £100m per month over the forecast period, the major contributor is expected to be the Income Bond which looks to be a good option for non-taxpayers in the aftermath of CRT. In contrast, there is no evidence that the Investment Account has benefitted from the introduction of CRT on bank deposits: we do not envisage any sharp improvement in the performance of INVAC in the next three months.

The PSBR and Funding

26. Table 5 (over page) summarises net funding over the target period so far and that implied by the forecast. In banking March the "PSBR" was only modestly underfunded seasonally adjusted and modestly overfunded unadjusted. In the forecast period the projected front end loading of the PSBR, particularly in unadjusted terms, and the large gilt redemptions, imply small underfunding seasonally adjusted conventionally defined, and large underfunding (£3¾bn) unadjusted. For the 14-month target period to end April there is now expected to be overfunding of £2½bn seasonally adjusted conventionally defined. On the alternative definition, after taking account of external finance of the public sector overfunding seasonally adjusted in the target period is expected to reach £5bn..

Table 5 : The PSBR and Funding

£ billion

	Actual mid-Feb 84 - mid-Mar 85	Forecast mid-Feb 84 - mid-Apr 85	mid-Mar 85 - mid-Jun 85
"PSBR"	11.0	12.3	3.3
Debt sales to nbps	- 13.7	- 14.9	- 2.7
of which:-			
Gilts	-10.5	- 11.3	- 1.7
National Savings	- 3.7	- 3.9	- 0.8
CTDs	- 0.8	- 1.0	- 0.3
Over(-)/Underfunding(+)	- 2.6	- 2.6	0.5
Unadjusted	- 3.1	- 1.0	3.7
External Finance of the public sector	- 2.1	- 2.2	- 0.4
Over(-)/Underfunding(+) alternative definition	- 4.8	- 4.9	0.2
Unadjusted	- 5.4	- 3.4	3.4

Money market influences

27. Given the expected level of underfunding over the forecast period - due to seasonal factors - there should be a substantial decline in money market assistance. A fall of £3.3bn is projected between mid-March and mid-June. In March the small unadjusted CGBR combined with strong net gilt sales caused a shortage of £1.3bn. Outstanding money market assistance reached £17.6bn at the end of banking March.

Sterling Lending to the Private Sector

28. Sterling lending increased by £1.8bn last month, taking the three and six month annualised rates to 20 per cent, while the twelve month rate is now around 17 per cent. A delay in the clearing system resulted in an artificial increase of £140m on banking March make-up day, which was unwound the next day. The undistorted level of lending was therefore around £1660m, slightly above forecast.

TABLE 6

STERLING LENDING TO PRIVATE SECTOR

Seasonally adjusted

		Moving Averages of Underlying Lending						Moving Averages of Recorded Lending					
		3 months		6 months		12 months		3 months		6 months		12 months	
		£m	%*	£m	%*	£m	%*	£m	%	3m	%	£m	%
1984	Jan	1116	15.1	1117	14.9	1157	15.9	1195	15.6	1271	17.1	1084	14.9
	Feb	1076	13.7	1171	15.3	1158	15.6	1283	16.5	1278	16.7	1076	14.5
	Mar	1095	13.7	1303	17.0	1200	16.1	1282	16.2	1340	17.5	1161	15.5
	Apr	1627	20.9	1396	17.9	1268	17.0	1445	18.4	1320	16.9	1273	17.0
	May	1424	17.7	1250	15.7	1240	16.2	1322	16.4	1302	16.4	1230	16.1
	June	1563	19.2	1329	16.5	1262	16.5	1297	15.8	1290	16.0	1267	16.5
	July	882	10.4	1255	15.5	1186	15.3	936	11.1	1190	14.7	1231	15.9
	Aug	1098	12.9	1261	15.3	1216	15.3	887	10.3	1104	13.3	1191	15.0
	Sept	1028	11.9	1295	15.4	1299	16.3	850	9.81	1074	12.7	1207	15.1
	Oct	1637	19.4	1260	14.8	1328	16.3	1452	17.1	1194	14.0	1257	15.4
	Nov	1831	21.6	1464	17.1	1357	16.4	1785	21.0	1336	15.6	1319	16.0
	Dec	1788	20.8	1408	16.3	1368	16.3	1793	20.9	1321	15.2	1305	15.6
1985	Jan	1684	19.3	1660	19.3	1457	17.4	1748	20.1	1600	18.6	1395	16.7
	Feb	1614	18.1	1722	19.8	1492	17.5	1715	19.3	1750	20.1	1427	16.7
	Mar	1604	17.8	1696	19.2	1495	17.2	1821	20.3	1807	20.6	1440	16.6
Forecast													
	April	1654	18.0	1669	18.7	1464	16.7	1652	18.0	1700	19.0	1447	16.5
	May	1600	17.1	1607	17.7	1535	17.3	1610	17.2	1663	18.3	1499	16.9
	Jun	1550	16.3	1577	17.1	1492	16.6	1526	16.0	1674	18.2	1497	16.7

* Based on stock of recorded lending

29. The recent high level of lending can, in part, be explained by erratic factors. The 1984 Budget changes in investment allowances provided an incentive to borrow funds for investment, financed directly or by leasing, before the end of the fiscal year. This may have boosted the March figure and is expected have a slightly larger effect in banking April. There may also have been some base rate round-tripping in the last week of banking March. Blue chip companies are apparently able to borrow at 0.4 per cent above base rate (ie. at 14.4 per cent) and could earn over 14½ per cent throughout the week on 1-7 day money. (See Chart IV). Lending may have been particularly inflated by round-tripping on make-up day itself with companies borrowing from banks and investing the proceeds overnight to capitalise on the 50 per cent overnight rate.

30. We have assumed that the various forms of round-tripping boosted lending in March by some £200m but there is no way of gauging the accuracy of this assumption.

31. All the £200m is projected to unwind in banking April. However, in the first two weeks of this banking month there have been further arbitrage opportunities that could be exploited by issuing one month bills and investing the proceeds at one month interbank rates. This form of bill round-tripping is projected to boost lending in April by £200m, unwinding in May.

32. One of the reasons banks were able to increase their lending substantially in March was an exceptional net inflow of over £1½bn of sterling deposits from non-residents, as the exchange rate strengthened. These funds may give the banks increased scope for lending in future, albeit on the basis of deposits that could prove to be rather volatile.

33. Over the next three months we expect lending to increase at just over £1½bn a month which would bring the three and twelve month growth rates down to 16-17 per cent. The lower level reflects an assumption that the sustained high level of base rates will have some depressing effect on the demand for bank finance. In banking May the contractionary effect of the unwinding of one month round-tripping is forecast to be offset by increased borrowing associated with the Barclays and British Aerospace rights issues.

CHART II : BANK LENDING

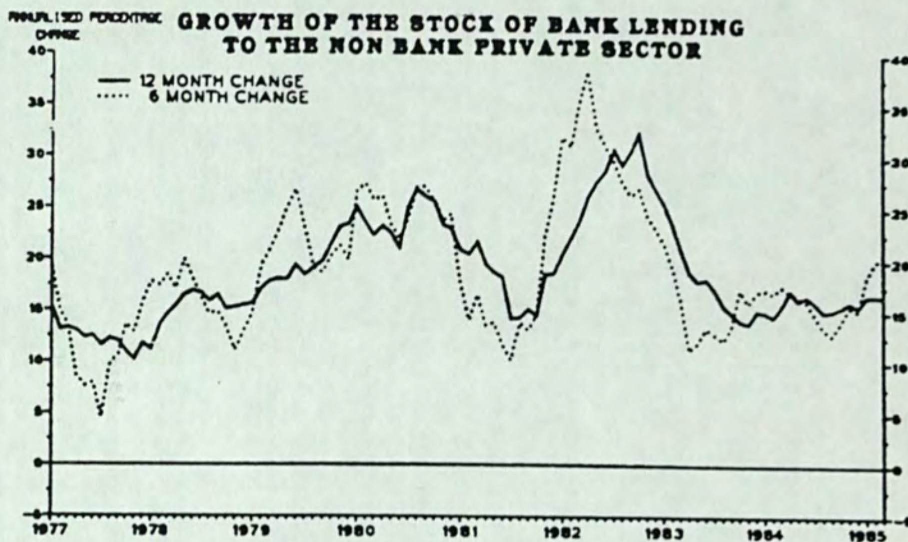


Chart III **REAL FT ALL SHARE INDEX**

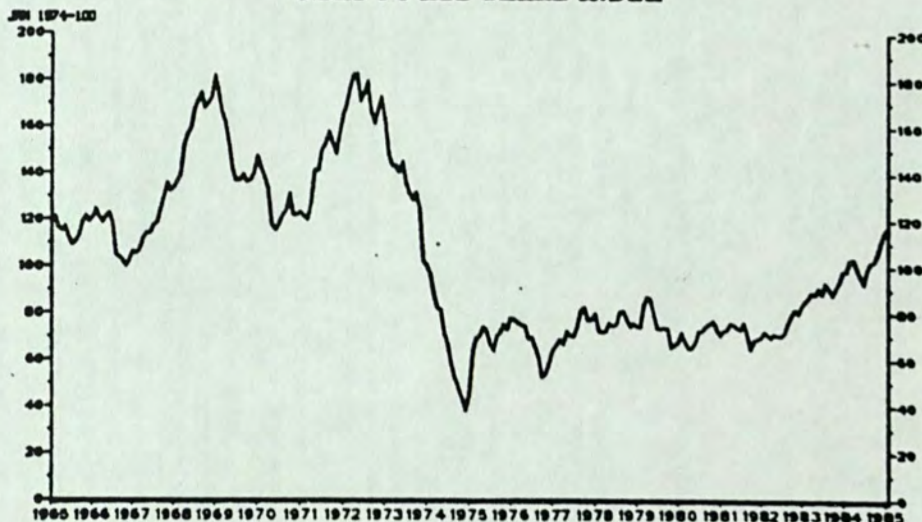
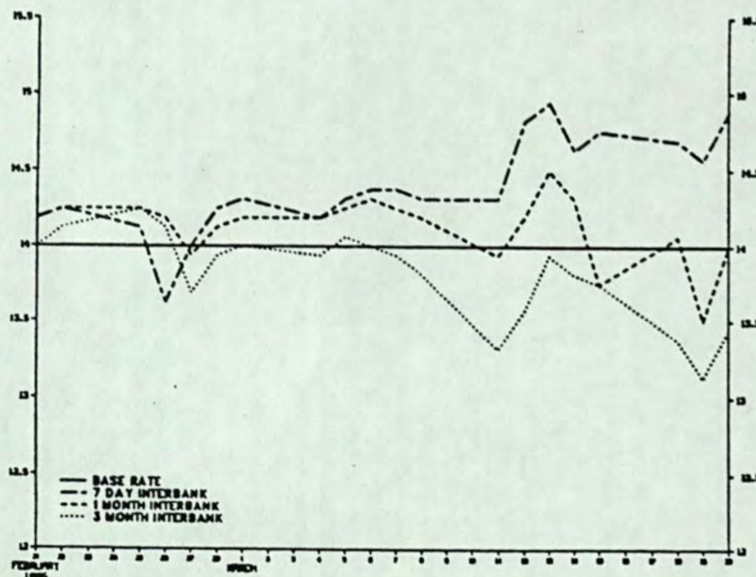


CHART IV INTERBANK VERSUS BASE RATE IN BANKING MARCH



34. Net issues by listed UK companies raised over £700m in calendar March. If this keeps up - and the further increase in the size of the equities queue suggests it will - 1985 is likely to be a record year for rights issues. As yet there is little sign that companies are using the proceeds of new issues to repay bank borrowing. This may be because the money is being used to fund acquisitions. It may also reflect the ability of companies to obtain a higher yield from investing in various financial assets than they are paying on their bank borrowing.

Table 7: Issues by Listed UK Companies

Calendar month averages, £m

	Net Issues	Gross Issues Queue* (Equities)
1982	97	-
1983	234	-
1984	143	-
1984 Q1	51	850
Q2	199	1510
Q3	218	1030
Q4	106	1215
1985 Q1	400	
1985 Jan	275	1610
Feb	201	2943
Mar	723	4100**

* Excluding privatisations, currently consisting of £1bn for British Airways and £½bn for British Aerospace.

** As of Thursday 4 April 1985

Externals and net non-deposit liabilities (NNDLs)

35. In March the externals had a neutral impact. However this masks huge offsetting changes in sterling deposits from abroad and UK banks net currency liabilities. Both increased by around £1½-£2bn, about £1bn higher than in any other single month in the past year. Both movements would seem likely to be related to the reactions of banks and their customers to currency instability. In the forecast period the externals are projected to be a positive influence on money by about £200m a month - close to the projected current account surplus.

36. In banking March <u>net non-deposit liabilities</u> were contractionary by £830m. Although this largely reflected strong capital issues there were also sizeable negative influences from the residual categories. These could be reversed in the coming months. Otherwise the nndl's forecast reflects continued strong capital issues by the monetary sector with Barclays issue of £500m in banking May being the most significant.

Building Societies

37. Retail inflows in banking March at £790m were £70m below forecast suggesting that the societies were hit rather harder than we had expected by the decline in their relative competitiveness. One result of this was a lower than expected building society contribution to PSL2: the overall figure was £865m as against a forecast of £1155m.

38. The table below shows our forecast for the seasonally adjusted balance sheet flows over the next three months.

Table 8

	RECEIPTS			PAYMENTS			TOTAL
	Net inflow of Shares and Deposits	Net inflow Wholesale Funds	Other*	Net mortgage Advances	Acquisition of Liquid Assets	Other**	
April	400	125	985	1280	- 175	405	1510
May	700	125	1020	1350	85	410	1845
June	700	150	1040	1375	100	415	1890

* Mainly receipt of mortgage interest payments
** Mainly payment of interest and taxation

39. On retail inflows we anticipate that the rise in building societies' ordinary share and premium rates, effective from April 1, will induce a sharp recovery from the middle of banking April. Underlying inflows to the top 16 societies of around £150m per week imply a monthly inflow at £700m for the industry as a whole. In banking June the forecast makes an allowance for the effects of the BT call early in banking July, for which private investors will need to mobilise their resources towards the end of banking June out of building society accounts into cheque accounts held with the banks.

40. The continuing high cost of wholesale funding assumed over the forecast period suggests that the latter will remain fairly subdued over the coming months. Taken together with a steadily rising level of mortgage demand, despite very high real lending rates, our forecast for inflows suggests that societies will continue to run down their liquid assets in banking April. Although there should be a small increase in liquid asset holdings in the succeeding two months, we expect to see a liquidity ratio of around 16.2 per cent by the end of banking June.

41. The forecast building society contribution to PSL2 reflects these trends:

Table 9

Average Monthly Contribution since mid-February 1984	Forecast April	May	June
1190	1340	1385	1390

Retail Inflows

42. Table 10 draws together the forecasts for retail inflows into building societies, banks and National Savings. In banking March we were surprised by the very low level of retail flows in total

TABLE : 10

A BREAKDOWN OF RETAIL FLOWS

Seasonally Adjusted
£ million

	OUTTURN		FORECAST		
	Average Monthly Increase since mid-February 1984	MARCH	APRIL	MAY	JUNE
RETAIL BANK DEPOSITS					
Nib. Sight	98	-133	280	180	160
Ib. Chequable	147	340			
Ib. Other	18	25			
TOTAL BANK DEPOSITS	265	232[590]	280	180	160
BUILDING SOCIETIES	1058	790[860]	915	1220	1225
NATIONAL SAVINGS	265	169[150]	205	250	315
TOTAL	1587	1191[1600]	1400	1650	1700

[Last month's forecast in brackets]

and, in particular, by the poor showing at the banks. Given that investors' interest rates in real terms are currently at near-record levels we did not anticipate that total retail saving would fall to less than 75 per cent of its average rate over the previous year. Moreover, we expected to see relatively high bank inflows in response to the strong improvement in bank competitiveness in recent months and the proliferation of high-interest easy-access money market accounts.

43. Two possible explanations at these figures suggest themselves. First, the CRT effect could be pulling down bank deposits more than we anticipated. But in that case one would expect flows elsewhere to have increased, which they have not. Secondly, it is possible that saving behaviour in banking March was dominated by the very high <u>lending</u> rates. Rather than invest money in intere-bearing deposit accounts it is possible that persons close to pay off expensive debts; or they may have drawn on savings to meet increased mortgage and other interest payments.

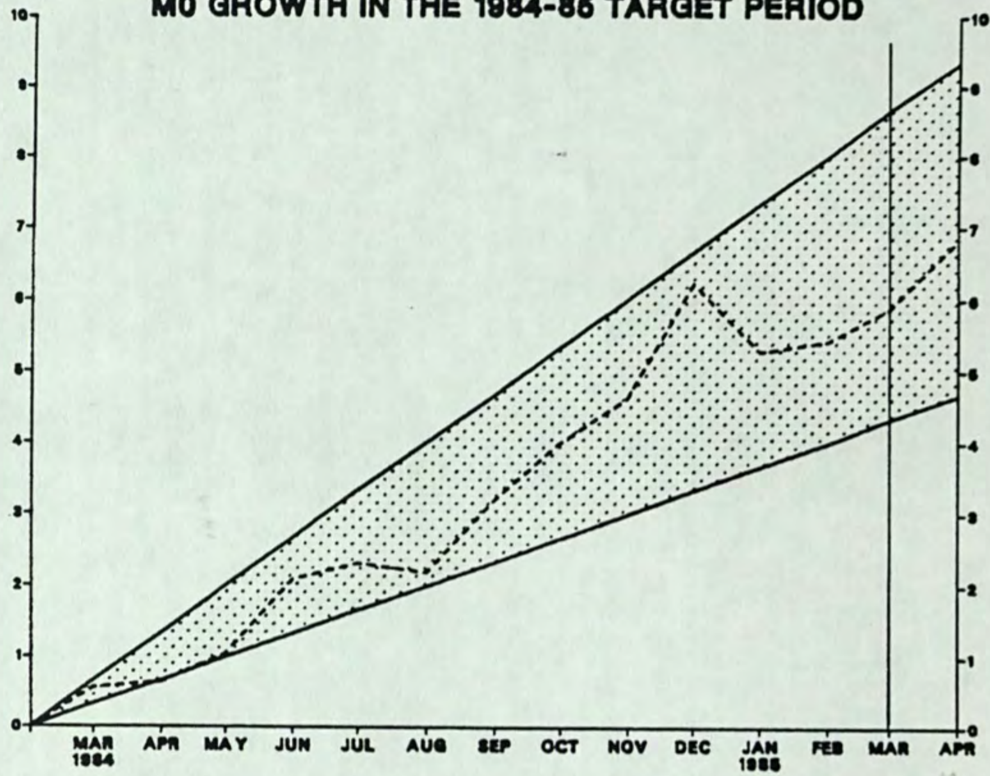
44. Given the uncertainties surrounding the banking March figures it has been more than usually difficult to construct a sensible projection for the next three months. The main features of Table 10 are:-

(i) a gradual rise in total retail flows each month from the low level observed in March up to £1700m in June;

(ii) a rise in bank inflows in April, representing a lagged response to the higher bank interest rates, followed by a fall off in bank inflows in May and June as a result of reduced competitiveness and CRT.

(iii) a gentle improvement in National Savings inflows and a sharp recovery in building society deposits due to improved competitiveness, CRT gains and the increased size of the savings pool caused by high real interest rates.

CHART V



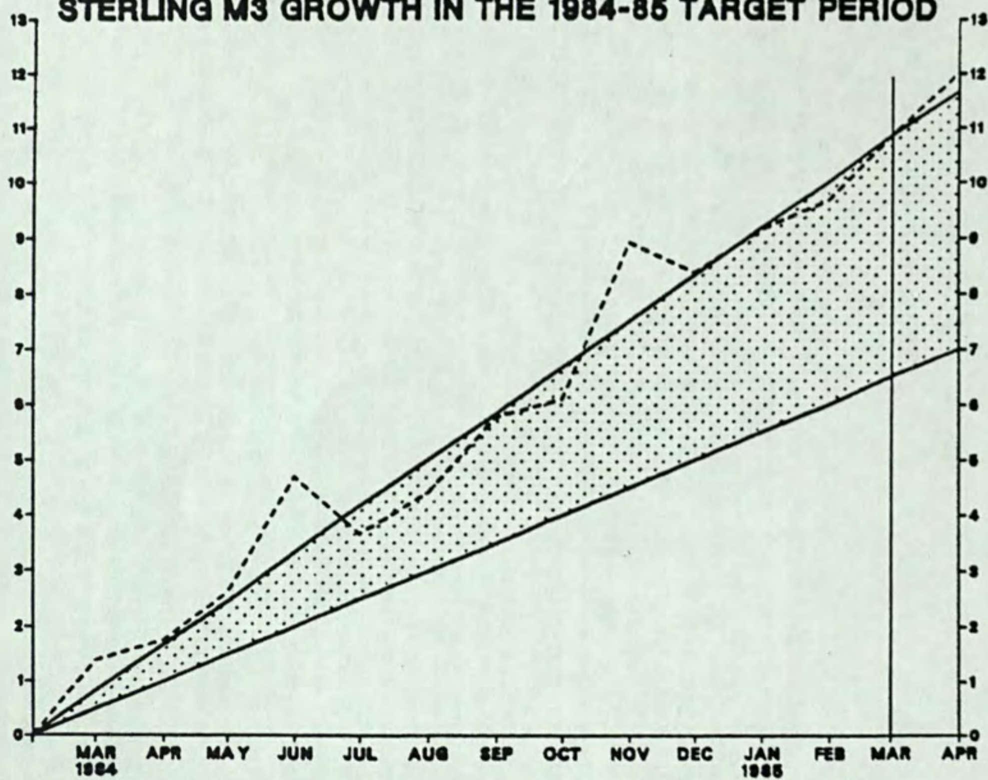
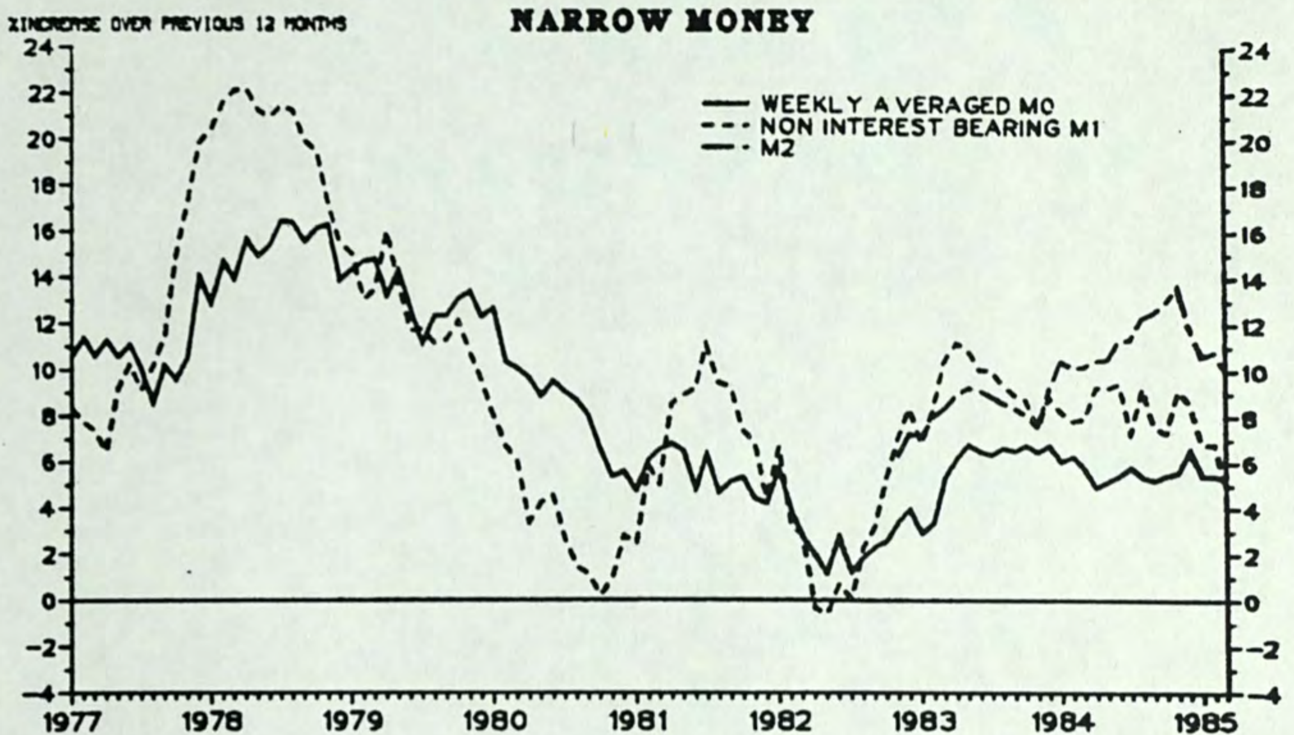


CHART VI: ANNUAL GROWTH RATES OF MONETARY AGGREGATES

NARROW MONEY



BROAD MONEY

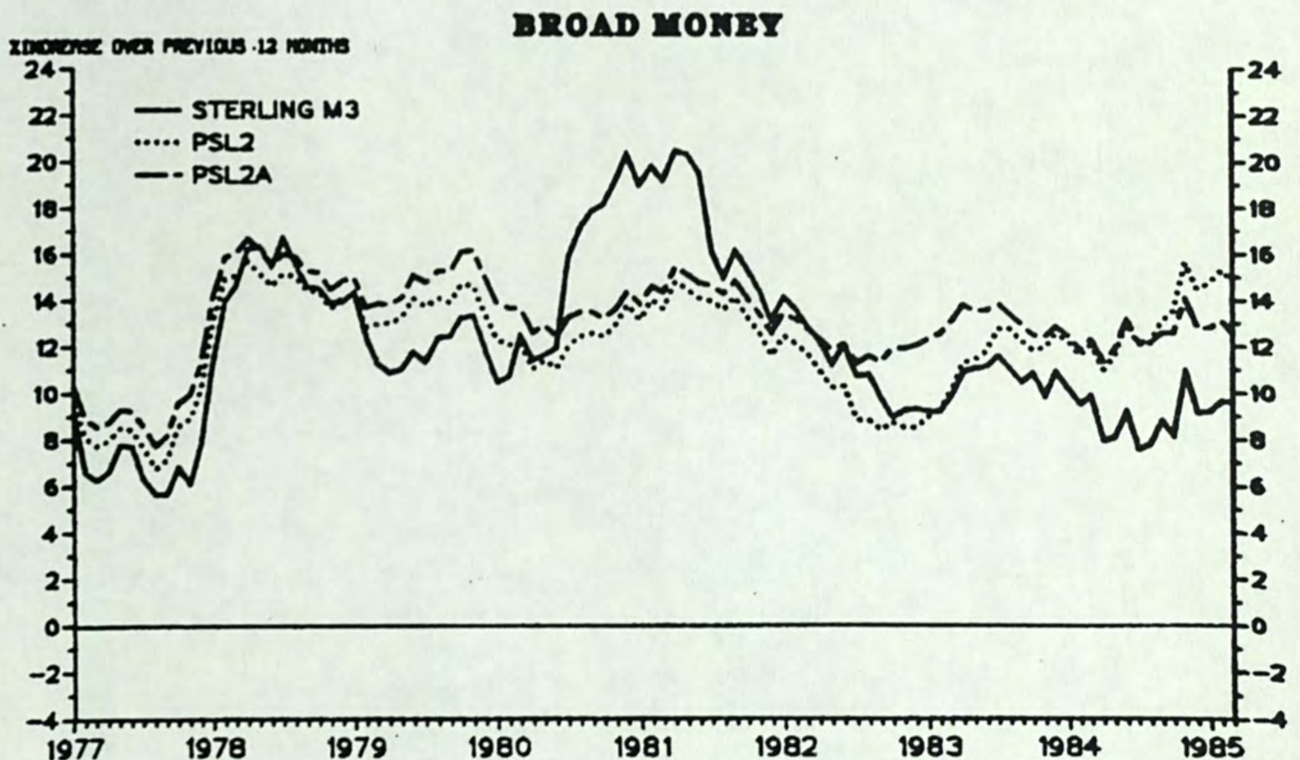
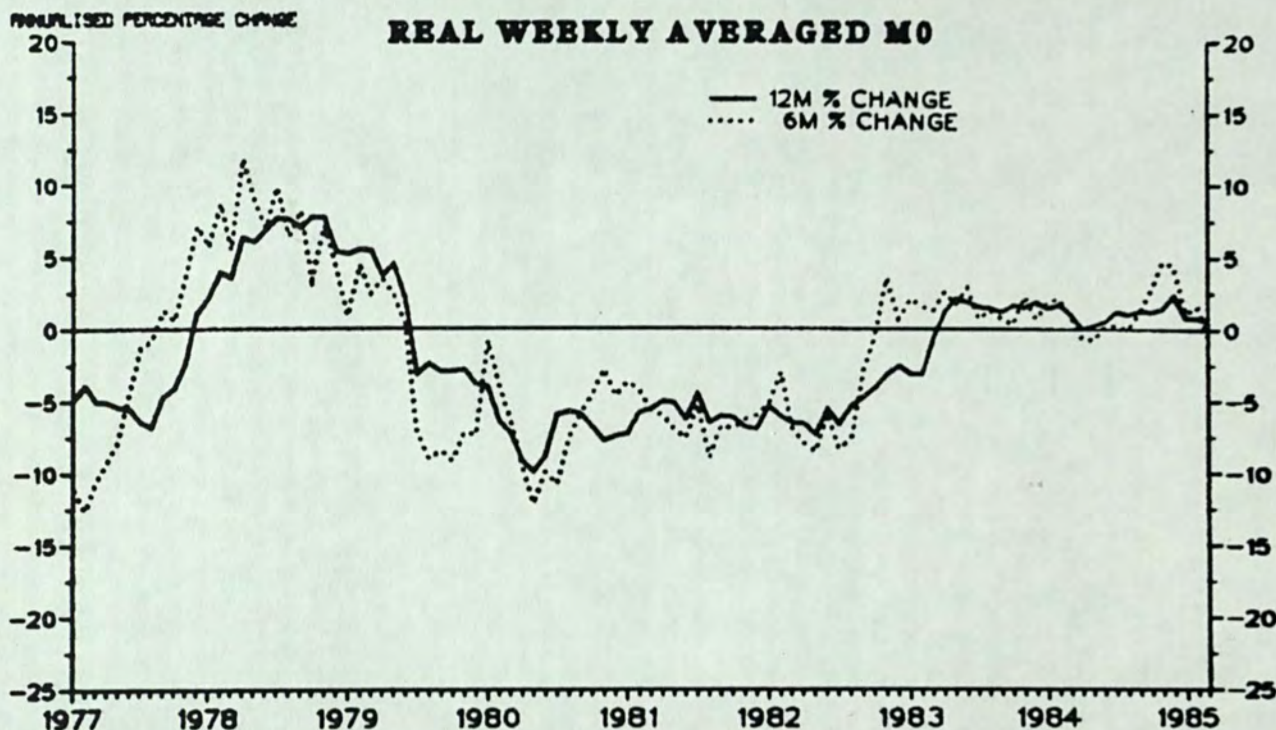
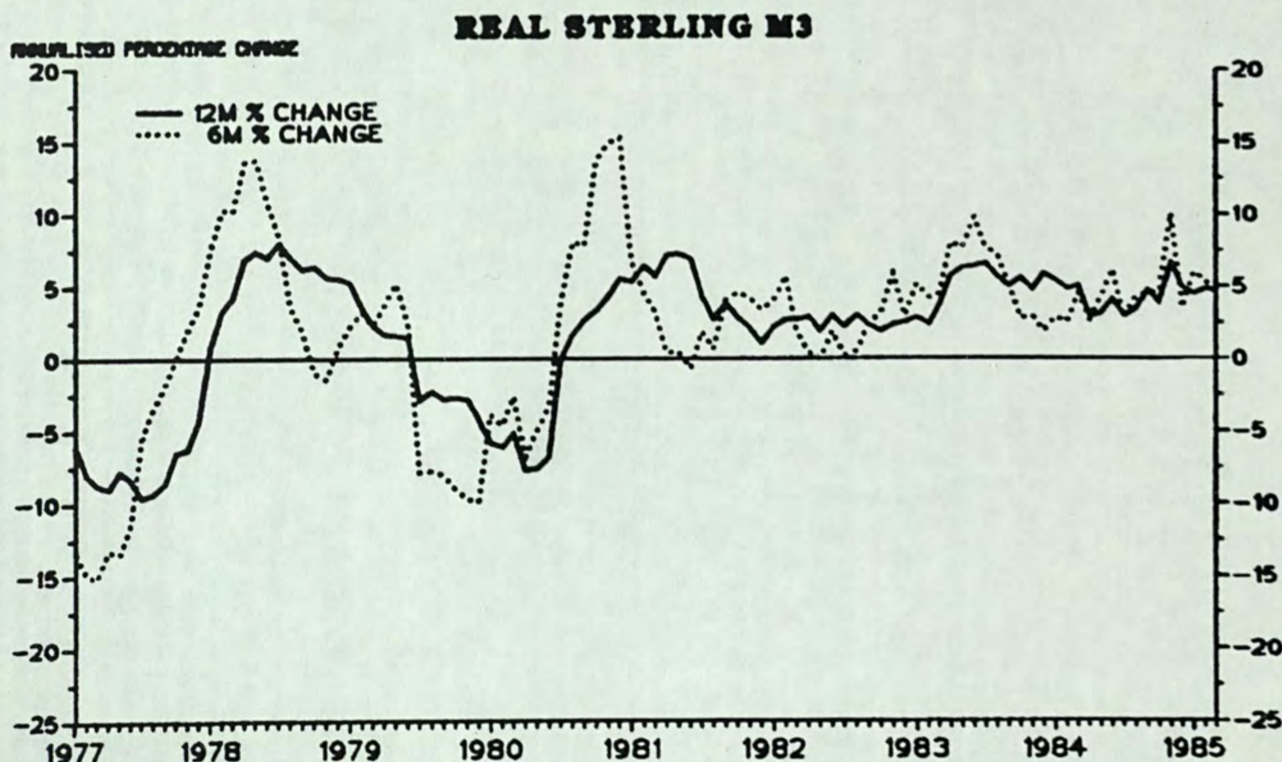


CHART VII : GROWTH RATES OF REAL MONETARY AGGREGATES





REAL GROWTH RATES ARE CALCULATED BY DEFLATING BY THE GROWTH OF THE RPI EXCLUDING THE MORTGAGE ELEMENT

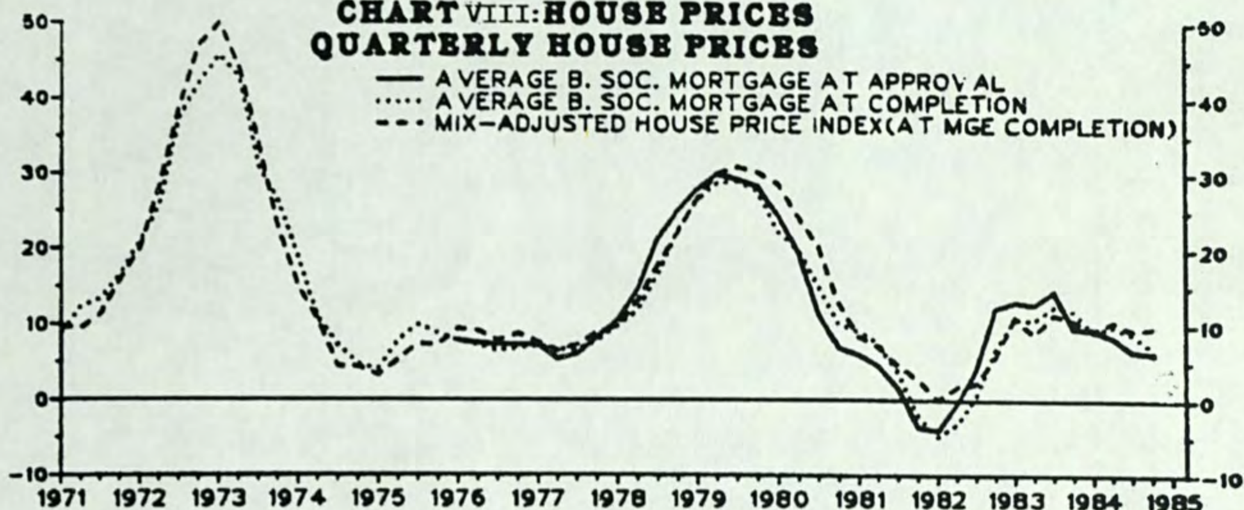
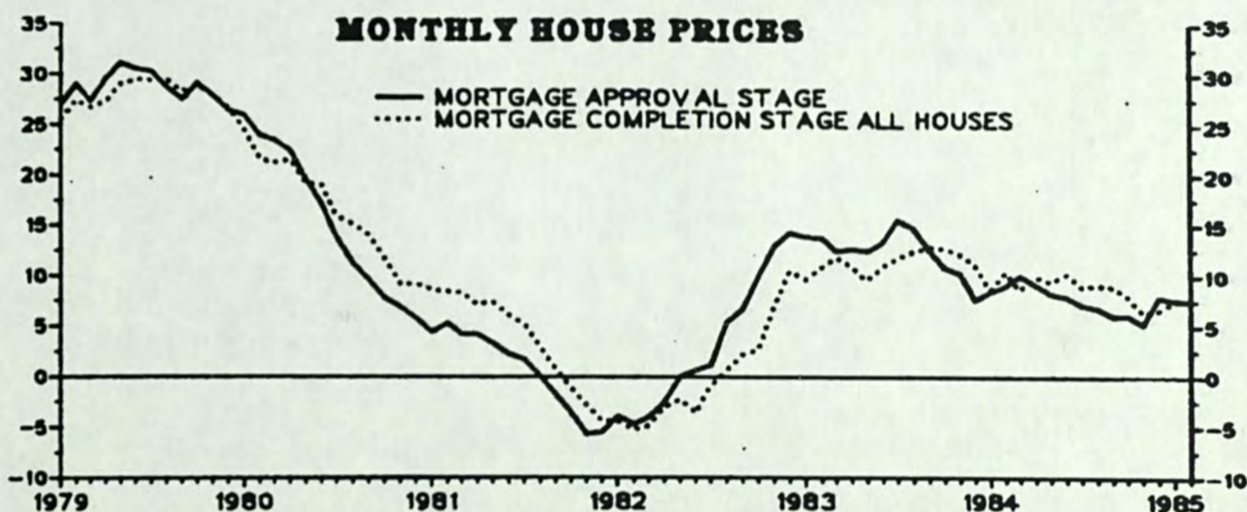


CHART VIII: HOUSE PRICES
QUARTERLY HOUSE PRICES
AVERAGE B. SOC. MORTGAGE AT APPROVAL
AVERAGE B. SOC. MORTGAGE AT COMPLETION
MIX-ADJUSTED HOUSE PRICE INDEX(AT MGE COMPLETION)
50
40
30
20
10
0
-10
1971 1972 1973 1974 1975 1976 1977 1978 1979 1980 1981 1982 1983 1984 1985


MONTHLY HOUSE PRICES
MORTGAGE APPROVAL STAGE
MORTGAGE COMPLETION STAGE ALL HOUSES
35
30
25
20
15
10
5
0
-5
-10
1979 1980 1981 1982 1983 1984 1985

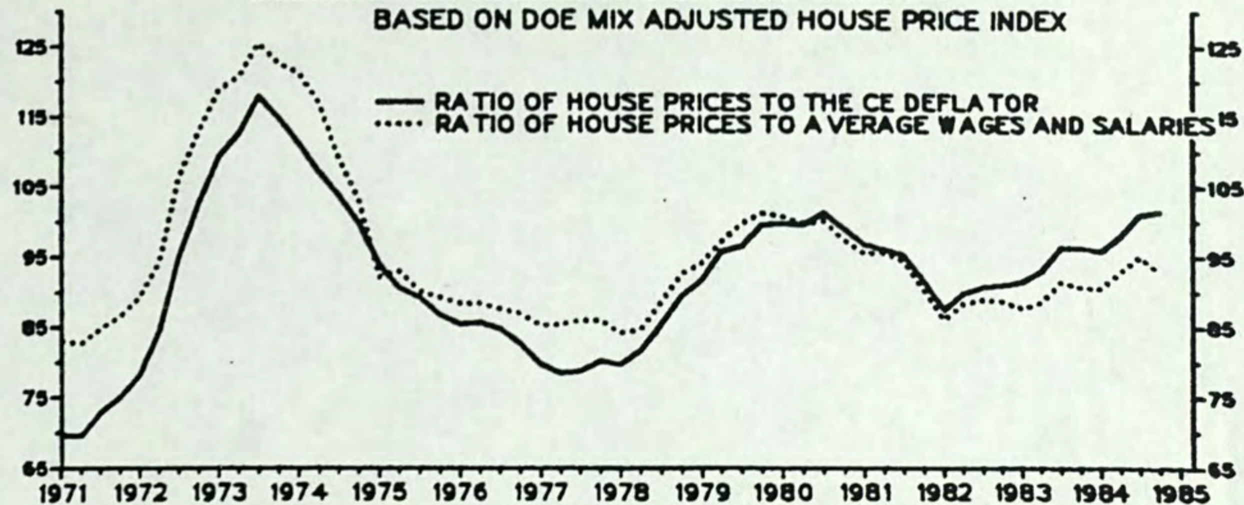
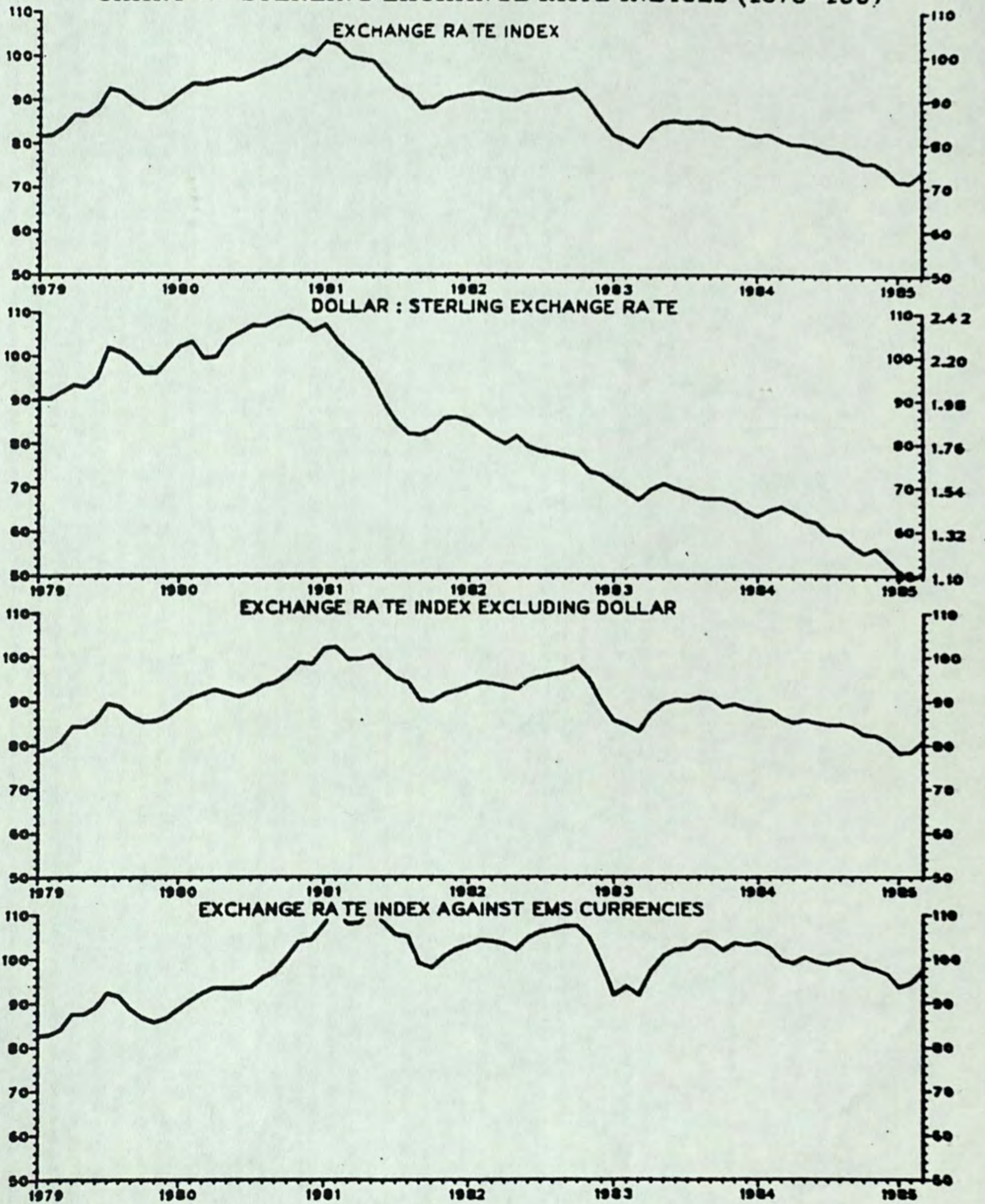

INDICES OF RELATIVE HOUSE PRICES
BASED ON DOE MIX ADJUSTED HOUSE PRICE INDEX
RATIO OF HOUSE PRICES TO THE CE DEFLATOR
RATIO OF HOUSE PRICES TO AVERAGE WAGES AND SALARIES
125
115
105
95
85
75
65
1971 1972 1973 1974 1975 1976 1977 1978 1979 1980 1981 1982 1983 1984 1985

CHART IX :STERLING EXCHANGE RATE INDICES (1975=100)



Relayed to Betty 13 45 10/4/85.

EMBARGO
NOT FOR RELEASE BEFORE
14 · 30 HOURS 10 APR 1985

It is thought unlikely that these figs will affect markets much. Will be able to report at the end of the day.

PROVISIONAL ESTIMATES OF MONETARY AGGREGATES: BANKING MARCH 1985

Preliminary information suggests that, in the four weeks to 20 March 1985, M0 may have risen by 1/4% to 1/2% and £M3 may have risen by about 1%, after seasonal adjustment.

M2 (not seasonally adjusted) may have risen by about 3/4%, and PSL2 (after seasonal adjustment) may have risen by 1% to 1 1/4%.

Note for Editors

1 The provisional estimates for March suggest that recent rates of growth are approximately as follows:

Cumulative rate of growth, annualised %

	Latest 3 months	Latest 6 months	Latest 12 months	Since start of 1984/85 target period
M0	- 1 1/4	5 1/4	5 1/4	5 1/2
£M3	9 1/4	9 3/4	9 1/4	10
M2 (not seasonally adjusted)	..	..	9 3/4*	..
PSL2	15 1/2	14 3/4	14 3/4	15 1/4

The growth of M2 over the 12 months to mid-March 1985 includes £490 million resulting from changes made by certain building societies in the terms of some accounts. Excluding such reclassified amounts, the growth in M2 over the latest 12 months is about 9 1/2%.

*The rise in the 12-month growth rate of M2 since the mid-February figure of 9.5% published on 21 March is the result of further revisions made to earlier figures for the building societies' contribution to M2 over the period from banking September 1984 to banking February 1985.

2 Provisional counterparts to the change in £M3 in banking March are:

£ billion, seasonally adjusted

PSBR (CGBR plus other public sector contribution)*	+1.2
Net purchases (-) of CG debt by non-bank private sector	-0.9
Sterling lending to private sectorø	+1.8
Other counterparts	-1.0
	+1.1

*Strictly, the PSBR less net purchases of local authorities' and public corporations' debt by the non-bank private sector.

øIncluding Issue Department holdings of commercial bills.

3 The influence of public sector transactions was expansionary by about £0.3 billion. The growth in sterling lending to the private sector was about £1.8 billion: this compares with an average of about £1.5 billion a month over the preceding twelve months (if allowance is made for the special factors in July and August 1984 arising from capital reorganisations to meet deferred tax liabilities). Other counterparts, ie, external and foreign currency counterparts and net non-deposit liabilities, taken together were contractionary.

4 Full money and banking figures for March, including revised estimates of the growth rates given above, will be published on 18 April.

BANK OF ENGLAND
10 April 1985

PRESS INFORMATION from Banking Information Service

10 Lombard Street, London EC3V 9AR
Telephone 01-626 8486

NOT FOR PUBLICATION BEFORE 2.30 pm
10th April 1985

MONTHLY STATEMENT OF THE CLEARING BANKS
MARCH 1985

The underlying growth in sterling advances in March was very substantial, but reflects some movement into overdraft finance from market borrowing.

Sterling advances to the U.K. private sector by the London Clearing Banks' Groups rose very sharply, by £1,484 million, in the four weeks to 20th March. There was little net seasonal movement expected (with debiting of interest by some banks being offset by other seasonal factors), but some increase in transit items outstanding; and the apparent underlying increase was therefore about £1,700 million. This does include, however, a sizeable switch back into overdrafts from market borrowing and bill finance (the Clearing Banks' own acceptances fell by £108 million), reflecting the relative level of market interest rates around the make-up date.

There was a substantial rise this month in lending to manufacturing industry; and also increases in borrowing by retail trade, hotels and transport industries. House purchase finance rose by £54 million; but there was a further reduction of £27 million in other personal borrowing, reflecting a seasonal fall (of about £75 million) in credit card credit outstanding.

Private sector sterling deposits rose by £452 million, which, allowing both for a substantial seasonal reduction expected and also for an increase in transit items outstanding, suggests an underlying rise of £800/900 million. Overseas residents' sterling balances again rose sharply, by £611 million.

The Bank of England renewed until 25th April the sale and repurchase arrangements due to expire on 14th March, and offered additional facilities on 1st March to be reversed on 29th March and in late April. In total the London Clearing Banks' Groups increased their utilisation of these arrangements by £381 million over the month - £351 million in E.C.G.D. promissory notes (classified as lending to non-residents) and £30 million in gilts. The overall total outstanding at 20th March for the London Clearing Banks was therefore £2,918 million.

Lending to the Discount Market fell sharply, by £969 million, and holdings of Treasury bills were down by £79 million; but net borrowing by the London Clearing Banks' Groups from other monetary sector institutions (including CD's) was reduced by £228 million.

The Scottish Clearing Banks' Groups' sterling deposits from the private sector rose, in line with the London banks, by £210 million, but there was little change in their private sector sterling advances.

Eligible liabilities of the London Clearing Banks rose sharply, by £1,715 million, but for the Scottish Banks fell by £41 million.

For further information, please contact:

Alec Grayson, Head of C.L.C.B. Statistical Unit (01-283 8866)
Brian Apps, Press and Information Officer (01-626 8486)

CONFIDENTIAL UNTIL 2.30 P.M. ON WEDNESDAY, 10TH APRIL, 1985

BALANCES OF THE LONDON CLEARING BANKS' GROUPS AS AT 20TH MARCH, 1985

These tables cover the business of offices of the London Clearing Banks and their subsidiaries (excluding Scottish and Northern Ireland banks) in Great Britain, the Channel Islands and the Isle of Man which are listed by the Bank of England as falling within the monetary sector. The items are defined as in Table 3 of the Bank of England's Quarterly Bulletin.

TABLE 1. AGGREGATE BALANCES

£ millions

		Total Outstanding		Change on Month		Change on Year	
LIABILITIES							
STERLING DEPOSITS:							
	U.K. monetary sector	18,675		+ 533		+ 947	
	U.K. private sector	59,550		+ 452		+ 5,627	
	U.K. public sector	1,558		+ 93		+ 216	
	Overseas residents	10,775		+ 611		+ 1,838	
	Certificates of deposit	5,466	96,025	- 388	+1,301	- 286	+ 8,341
	of which: Sight		*34,609*		*+1,938*		*+ 5,143*
	Time (inc. CD's)		*61,415*		*- 637*		*+ 3,198*
FOREIGN CURRENCY DEPOSITS:							
	U.K. monetary sector	15,627		- 781		+ 74	
	Other U.K. residents	4,987		- 159		+ 519	
	Overseas residents	48,039		-2,293		+ 8,222	
	Certificates of deposit	7,129	75,783	- 289	-3,522	+ 907	+ 9,722
TOTAL DEPOSITS			171,807		-2,221		+18,063
OTHER LIABILITIES[a]			21,891		+ 402		+ 1,343
	TOTAL LIABILITIES		193,698		-1,819		+19,407
ASSETS							
STERLING							
Cash and balances with Bank of England			1,293		- 54		- 141
Market loans:	Discount houses	2,246		- 969		- 1,152	
	Other U.K. monetary sector	16,151		+ 687		+ 2,355	
	U.K. monetary sector CD's	2,315		- 314		+ 109	
	Local authorities	804		-		- 228	
	Other	1,838	23,354	- 63	- 659	+ 783	+ 1,868
Bills:	Treasury bills	27		- 79		- 80	
	Other bills	1,625	1,651	+ 78	- 1	+ 562	+ 482
Special deposits with Bank of England			-		-		-
Investments:	British Government stocks	2,285		- 29		- 467	
	Other	2,628	4,913	+ 60	+ 31	- 1,381	- 1,848
Advances:	U.K. private sector	66,337		+1,484		+ 7,039	
	U.K. public sector	522		+ 132		+ 193	
	Overseas residents	2,591	69,451	- 386	+1,230	- 1,453	+ 5,779
Other sterling assets[a]			11,275		+ 840		+ 1,067
FOREIGN CURRENCIES							
Market loans:	U.K. monetary sector	15,981		-1,182		- 194	
	Certificates of deposit	1,001		- 41		+ 321	
	Other	32,244	49,225	- 166	-1,389	+ 4,582	+ 4,710
Bills			245		- 494		+ 134
Advances:	U.K. private sector	6,334		- 151		+ 1,499	
	U.K. public sector	1,240		- 72		+ 542	
	Overseas residents	18,616	26,189	- 875	-1,097	+ 3,418	+ 5,458
Other foreign currency assets[a]			6,102		- 224		+ 1,898
	TOTAL ASSETS		193,698		-1,819		+19,407
ACCEPTANCES			3,694		- 108		+ 561
ELIGIBLE LIABILITIES			72,409		+1,715		+ 6,587

(a) includes items in suspense and in transit

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

FOR TABLES 2 & 3 SEE OVER

TABLE 2. INDIVIDUAL GROUPS OF BANKS' BALANCES

£ millions

	TOTAL		BARCLAYS		LLOYDS		MIDLAND		NATIONAL WESTMINSTER		WILLIAMS & GLYN'S	
	Out-standing	Change on Month	Out-standing	Change on Month	Out-standing	Change on Month	Out-standing	Change on Month	Out-standing	Change on Month	Out-standing	Change on Month
LIABILITIES												
Total deposits	171,807	-2,221	42,903	- 779	32,026	- 102	34,024	+ 103	57,638	-1,472	5,215	+ 30
ASSETS												
Cash and balances with Bank of England	1,293	- 54	419	- 35	209	- 2	235	- 14	384	- 2	45	- 1
Market loans:												
UK monetary sector	34,377	-1,465	6,852	- 669	4,840	+ 216	4,187	+ 24	17,390	-1,069	1,109	+ 33
Other	38,201	- 584	9,658	- 319	7,887	- 682	8,480	+ 591	11,018	- 191	1,159	+ 16
Bills	1,897	- 496	674	+ 52	802	+ 131	252	- 408	167	- 242	1	- 29
British Government stocks	2,285	- 29	398	- 86	695	+ 1	495	+ 54	656	+ 3	42	-
Advances	95,640	+ 133	26,051	+ 138	18,363	+ 197	19,130	- 75	29,098	- 93	2,998	- 34
TABLE 3. INDIVIDUAL GROUPS OF BANKS' ELIGIBLE LIABILITIES	72,409	+1,715	21,316	+ 578	14,665	+ 498	12,791	+ 248	21,294	+ 386	2,341	+ 5

Committee of London Clearing Bankers' Statistical Unit
10 Lombard Street
London EC3V 9AP

10 DOWNING STREET

From the Private Secretary

29 March, 1985.

This is to confirm that the Prime Minister has seen your letter of 28 March about National Savings, and has agreed to the new rates proposed.

(Timothy Flesher)

Adrian Ellis, Esq.,
HM Treasury.

CONFIDENTIAL

SO.

CC NO

1

Treasury Chambers, Parliament Street, SWIP 3AG

A Turnbull Esq
10 Downing Street
LONDON SW1

28 March 1985

Prime Minister:

Agree to an increase of ½% in National savings rates as proposed?

AT 28/3

Yes mt

Dear Andrew

NATIONAL SAVINGS

As you know, the building societies are increasing their deposit rates by ¾ per cent net from 1 April. The banks, of course, reduced their rates by ½ per cent last week, and there has been a further ½ per cent reduction today. Depsite these reductions, it seems most unlikely that the building societies will change their rates again before June. The Societies are National Savings' main competitors, and we have therefore concluded that there should be some increase in National Savings rates. This is necessary to enable National Savings to start the new financial year on a reasonable course towards the £3 billion target, and to stem outflows from matured Savings Certificates.

A fully matching increase on all National Savings instruments could bring large inflows, particularly if we introduce a new certificate. It would also look rather aggressive at a time when base rates have fallen. We therefore judge that the increase in National savings rates should be confined to a ½ per cent increase on the variable rate instruments (on which interest is paid gross) and that no new certificate should be introduced at present.

The current and proposed new rates are:

	Current	Proposed
Income Bond	12.75%	13.25%
Deposit Bond	12.75%	13.25%
Invac	12.25%	12.75%
General Extension Rate (net)	9.00%	9.50%

We should be grateful for the Prime Minister's agreement to the proposed rates, if possible so that an announcement can be made tomorrow in order to effect the change in the extension rate from 1 April.

Yours ever,

Adrian Ellis

A M ELLIS
Private Secretary

28 MAR 1985

SECRET

13

PRIME MINISTER 26 March 1985

FUNDING MEETING

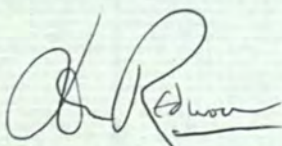
I attended the meeting today.

National Savings. Likely to end 1984-85 around the £3 billion figure. In order to preserve some competitiveness with Building Societies, rates will be increased by 0.5% to: 13.25% for Income and Deposit Bonds; 12.75% for Invac; and 9.5% for the Extension Rate. The 30th Issue will be left at 12.6% although it is not fully competitive. These conclusions seem reasonable, balancing the need to keep up sales against reluctance to drive rates higher.

Gilt-Edged. A partly-paid convertible or a package of tranchettes are under consideration to keep up the funding momentum, and a low coupon short will be issued.

£M_3 is expected to grow at 1.2% in banking April taking the annualised growth to 10.1%, assuming gross gilt sales of £1.25 billion. All agreed it would be desirable to sell more if possible.

The market expects another 0.5% off base rates, and this is reflected in long gilt prices. Both the Bank and the Treasury now think the dollar has peaked. This would permit interest rates to fall.



JOHN REDWOOD

SECRET

248/38

Treasury Chambers, Parliament Street, SWIP 3AG

ECONOMIC SECRETARY
REC'D 28 MAR 1985
ACTION
PS/CH PS/CS
PS/SIR P. MIDDLETON
MR A. WILSON
MR CASSELL
MR LANKESTER
MR HALL
~~MR HELL~~
MR D. JONES

Tony Blair Esq MP
House of Commons
LONDON SW1A 0AA

25th March 1985

Dear Tony,

JOHNSON MATTHEY BANKERS (JMB)

Nigel Lawson has asked me to reply to your letter of 5 March. He did, as you know, make a full statement to the House in response to the events at JMB, in which he announced the establishment of the review committee under the chairmanship of the Governor of the Bank of England. He will be reporting to the House on the review committee's findings as soon as it is practicable to do so.

The decision to rescue JMB was taken by the Governor on his own authority. He has made clear to the Chancellor, and has publicised, his reasons for doing so.

The Price Waterhouse study, about which you ask, was commissioned by the Bank of England and is a matter for the Governor. I am advised that it contains confidential information concerning the commercial affairs of customers of JMB, who are entitled to the normal confidentiality owed by a bank to its customers, and the Governor does not therefore propose to publish it.

JMB is of course still in business and it would therefore also be wrong to compromise the job of reconstruction which faces the new management by revealing facts and opinons, which are contained in the report, about the handling of specific cases. Publication would make such information available to directly interested parties.

For these reasons the Chancellor is not prepared to press either the Bank, or the authors, to publish or otherwise release the report. I can however assure you that the contents of the report will be taken fully into account by the official review committee in formulating its advice.

Yours ever

Ian Stewart

IAN STEWART

13/15

Domestic monetary policy

INTEREST AND MORTGAGE RATES

Factual

The Bank of England endorsed Wednesday's morning's ½ per cent base rate fall (to 13½ per cent) in their midday dealing rates. The Bank later gave a firm signal of the level of rates the authorities wished to see by, exceptionally, announcing the rate at which it would lend to the market at the end of market dealing for the day - so-called "2.30 lending".

The building societies are meeting today and the signs are that they will announce a 1 per cent rise in rates, to around 14 per cent.

Line to take

As the Chancellor said in his Budget Speech, no chances will be taken with inflation. Interest rates will be held at whatever level is needed to maintain monetary conditions that will continue to bring inflation down. [The Bank's action yesterday indicated that a ½ per cent fall in base rates is the most we judge, at present, to be consistent with this approach.]

Supplementaries

Why did banks cut base rates?

They were following a fall in market interest rates.

Why 2.30 lending?

Authorities wished to make it as clear as possible that ½ per cent was the largest fall at present considered consistent with taking no risks with monetary conditions and inflation.

Mortgage rates will go up?

A matter for the building societies.

More base rate cuts to come?

Only if and when justified by monetary situation.

What was the "2.30 lending" interest rate?

13¾ per cent for 14 day money. Given the present structure of short term rates this is the rate consistent with the signal the authorities wished to give to the market.

High interest rates put recovery at risk?

Cannot take risks with inflation. Tackling inflation is absolutely essential for continued growth and jobs. Longer term interest rates have risen much less than short-term rates, and firms in competition with overseas will benefit from the lower exchange rate.

High interest rates simply to defend sterling?

Exchange rate is taken into account in judging monetary conditions, but not in any mechanistic way. Interest rates are aimed at securing appropriate overall monetary conditions.

E.R.

21 March 1985

PRIME MINISTER

CURRENCY MARKETS

Following my note of 19 March, and our conversation about the likely weakness of the dollar and the strength of sterling, you may be interested in the following points.

1. The tightness of our money policy is now more generally recognised in the City.

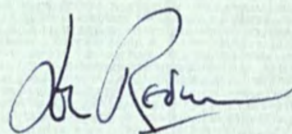
2. The events of the last 2 weeks have lost some Corporate Treasurers and exchange speculators money. That was always the first precondition for making them reluctant bears of sterling and bulls of the dollar.

3. News of a slowdown in American economic growth fuelled dollar weakness today, as it is another indicator that would suggest (as does the Ohio banking crisis) easier money and lower interest rates in the States.

4. Eddie George of the Bank of England has confirmed that many traders are more nervous of having exposed positions. Any reduction in the amount of leading and lagging in favour of the dollar by the large movers of money will help sterling.

Conclusion

I still think we may now be out of the woods on the dollar-sterling rate. It is encouraging that bad news from the dollar is now being taken bearishly by the Market. We have not seen this for many months.



JOHN REDWOOD

3.34

COVERING CONFIDENTIAL AND PERSONAL

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

15 March 1985

Andrew Turnbull Esq
10 Downing Street
LONDON SW1

Dear Andrew

MONTHLY NOTE ON PUBLIC SECTOR BORROWING

I enclose this month's note on the PSBR. As usual the main points are summarised on the first page.

The press notice giving the outturn figures for February will be published at 2.30pm on 18 March. (The following day, with the Budget, a forecast will be given of the PSBR outturn for 1984-85 as a whole.)

Yours sincerely,

Margaret O'Hara

for RACHEL LOMAX
Principal Private Secretary

Prime Minister
Good news for once. PSBR £0.6 billion better than expected. It appears that the Inland Revenue receipts which failed to appear last month have now shown up!
AT 15/3

PUBLIC SECTOR BORROWING

Summary

- The PSBR for February is provisionally estimated as a net repayment of debt of £0.2 billion, compared with last month's forecast of net borrowing of £0.4 billion. Central government's own account recorded a surplus of £0.6 billion, compared with forecast borrowing of £0.2 billion. Local authorities borrowed £0.4 billion, and public corporations showed a very small surplus.

- Borrowing in the first eleven months of 1984–85 (£7.6 billion) was about £2.3 billion higher than the Budget profile. In April–February last year the PSBR was £7.5 billion.

- The PSBR for 1984–85 is now expected to be around £10½ billion, although there are still very large uncertainties. This forecast implies borrowing of £2.9 billion in March. This is about £¾ billion higher than in March 1984 and close to the outturn for March 1983. The March surge in Supply Expenditure is expected to be greater than last year.

Figures in this report are not seasonally adjusted and also may not sum precisely because of rounding.

Chart 1 : Comparisons with Budget profiles for 1984-85

£ billion cumulative

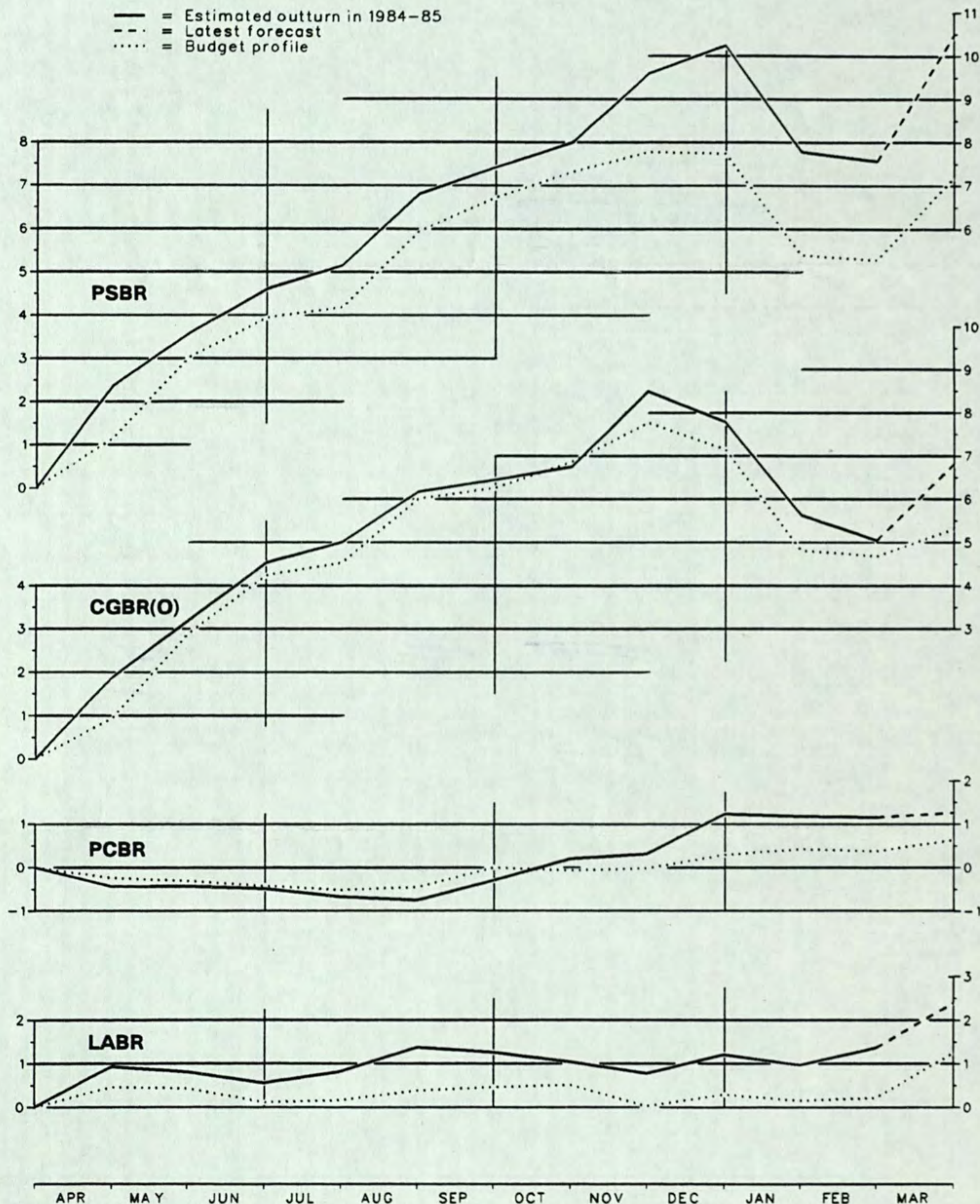


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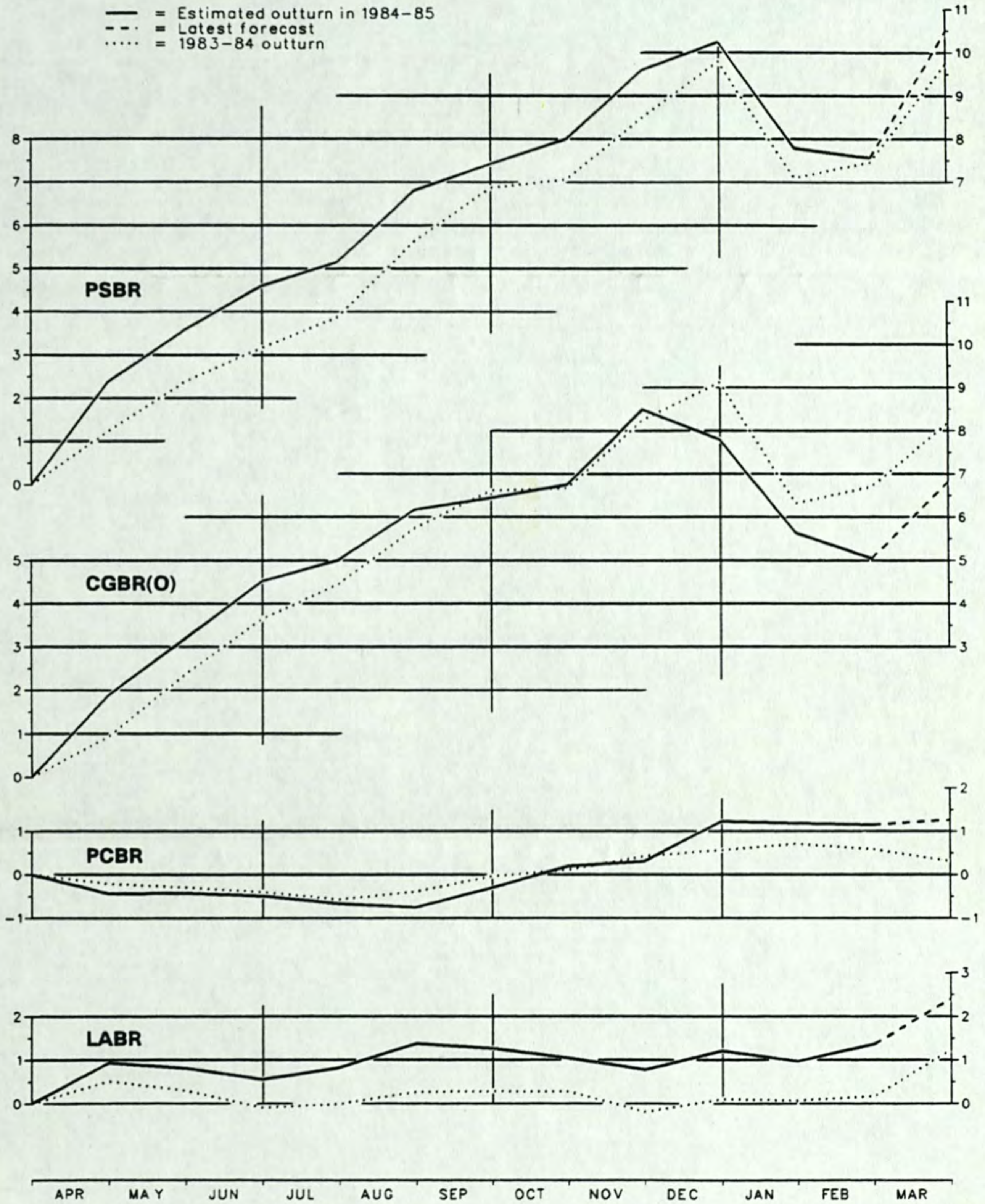
Chart 2 : Comparisons with last year's outturns

£ billion cumulative



Borrowing in February

(Comparisons in this section are with last month's forecast)

The provisional estimate of the PSBR in February is a surplus of £0.2 billion, compared with last month's forecast of net borrowing of £0.4 billion. The differences between forecast and outturn on the individual sub-sectors are shown in the table below.

Table 1: February 1985 borrowing requirements

£ billion

	PSBR	Comprising		
		CGBR(O)	LABR	PCBR
Forecast*	0.4	0.2	0.3	-0.1
Outturn	-0.2	-0.6	0.4	-
Difference	-0.6	-0.8	0.1	0.1

*made on 15 February

2. Net borrowing on central government's own account - CGBR(O) - was around £0.8 billion lower than forecast. The table overleaf shows our present view of where the differences occurred.

£ billion (-indicates lower borrowing)

Inland Revenue receipts	-0.3
Customs and Excise receipts	-0.3
Supply Expenditure	-0.4
National Insurance Fund	+0.2
Net effect on CGBR(O)	-0.8

3. Higher Inland Revenue receipts in February appear to be mainly due to the timing of both Income and Corporation tax receipts; shortfalls recorded in January appear to have been made up while some receipts due in March may have been paid early. Customs and Excise receipts were also substantially higher than forecast: this may be due to additional receipts resulting from the change in VAT on imports. Supply expenditure on a cheques issued basis was lower than forecast mainly due to the slippage of payments to defence contractors and the postponement of grant to the National Coal Board. A minor deficit was recorded on the National Insurance Fund in place of the forecast surplus.

4. Local authorities borrowed about £0.4 billion in February, about £0.1 billion more than forecast last month. This error is small compared with the recent erratic pattern of local authority borrowing. (The estimate for February is based on a smaller sample than usual because the GLC made no return.)

5. Public corporations showed a small surplus in February, which was about £0.1 billion smaller than the surplus forecast last month, mainly because of the postponement of grant to the National Coal Board (see paragraph 3).

April to February outturn

(Comparisons in this and following sections are with the Budget profile)

6. The cumulative PSBR for the first eleven months of 1984-85 was £7.6 billion. This is about £2.3 billion above the Budget profile (see Chart 1 and Table 2) and about £0.1 billion above the same period last year (Chart 2).

Table 2: Total April-February borrowing requirements

£ billion

	PSBR	Comprising		
		CGBR(O)	LABR	PCBR
Budget forecast	5.3	4.7	0.2	0.4
Outturn	7.6	5.0	1.4	1.2
Difference	2.3	0.4	1.1	0.8

7. Cumulative borrowing in April-February on <u>central government's own account</u> was £0.4 billion higher than the Budget profile. Reasons were lower Inland Revenue receipts (by £0.6 billion) and a smaller surplus on the National Insurance Fund (by £0.7 billion - see paragraphs 8 and 9.) These factors were partially offset by higher Customs and Excise receipts (by £0.4 billion - see paragraph 9), higher oil royalties (by £0.4 billion) and other changes. Supply expenditure, excluding on-lending, was £0.5 billion higher than in the Budget profile, more than acounted for by advance payments to the EC; however, this excess is offset by a reduction in payments to the EC from elsewhere in the account.

8. The Inland Revenue shortfall reflects lower receipts of Income and Corporation tax. The Income tax shortfall is due to: lower PAYE receipts because of the miners' strike; lower Schedule D from the self-employed (because of lower profits in 1983); and higher repayments (including those under MIRAS scheme which have been affected by higher interest rates). In addition mainstream Corporation tax receipts have been less than forecast in the Budget profile and a complete recovery before the end of the year seems unlikely. As a partial offset, PRT receipts are higher because of higher oil production and higher sterling oil prices (the main increase in PRT is however in March; it is known to have slightly exceeded earlier expectations). Also, duty on share transactions is higher because of higher share prices and turnover.

9. The Customs overshoot is mainly due to higher than expected receipts from the change in VAT on imports. The change is now estimated to have brought in £1.4 billion, compared

with the Budget forecast of £1.2 billion, owing to the lower value of sterling and high volume of imports. The reduction in the National Insurance Fund surplus results from a reduction in contributions (because of the miners' strike) and an increase in benefits (partly higher unemployment, partly increased take-up of invalidity benefit).

10. Local authorities borrowed about £1.4 billion in the period April-February, some £1.1 billion higher than the Budget profile. The difference reflects partly the likely capital overspend in the current year, and partly the high borrowing last April due to overspending last year.

11. Public corporations borrowed about £1.2 billion to end-February, compared with £0.4 billion in the Budget profile. Borrowing was below the Budget profile over the first half of 1984-85, but borrowing has been heavy over the last five months, reflecting the effects of the coal strike.

March

12. Table 5 shows the latest detailed profile of borrowing on central government's own account for March. The forecast is for net borrowing of about £1¾ billion, nearly £1¼ billion higher than the Budget profile.

13. Supply expenditure in March, excluding on-lending, is forecast to be higher by £1¼ billion than the Budget profile, mainly because of increased grants to the National Coal Board, and defence procurement postponed from earlier months. This forecast takes account of departments' F10 estimates of outturn, and does not imply any significant breach of cash limits. The forecast for March represents an increase of about 31 per cent on the average level of Supply in October - February, compared with corresponding increases of 27 per cent in March 1984, 36 per cent in March 1983 and 21 per cent in March 1982.

14. Apart from Supply, the 1984 EC refund expected in March 1985 in the Budget profile (and worth £½ billion) has now slipped into 1985-86. Debt interest payments in March are expected to be a little higher than in the Budget profile. These factors are partially offset by an increase in Inland Revenue receipts (by £¾ billion), mainly reflecting PRT (£1¾

billion, already received).

15. Local authorities are forecast to borrow just over £1 billion in March. This follows the pattern of the last 5 years, when the LABR has almost always been in the range £1.0 - 1.2 billion in March: the high borrowing occurs because in March no rate income is received and expenditure tends to be high. The CIPFA borrowing enquiries return also implies that March borrowing will be high.

16. Public corporations are expected to show net borrowing of around £0.1 billion in March. The Coal Board is expected to borrow £0.2 billion following the end of the stike, and the Electricity Supply Industry is expected to repay some of their borrowing out of their seasonally high receipts from customers.

17. Thus the PSBR in March is forecast at £2.9 billion, but there is a wide margin of error. (In March 1984 it was £2.3 billion and in March 1983 £2.9 billion).

1984-85

The February outturn seems broadly consistent with a forecast of £10½ billion for the year. There are still great uncertainties, however, about the March forercast.

Table 3: 1984-85: Outturns and latest forecasts

£ billion

	PSBR	Comprising		
		CGBR(O)	LABR	PCBR
1984-85				
Apr	2.4	1.9	0.9	-0.4
May	1.2	1.3	-0.1	-
Jun	1.0	1.3	-0.3	-0.1
Jul	0.6	0.5	0.3	-0.2
Aug	1.6	1.2	0.6	-0.1
Sep	0.6	0.3	-0.1	0.5
Oct	0.6	0.3	-0.2	0.5
Nov	1.6	1.7	-0.3	0.1
Dec	0.6	-0.7	0.4	0.9
Jan	-2.5	-2.2	-0.2	-
Feb	-0.2	-0.6	0.4	-
Mar	2.9	1.8	1.0	0.1
Cumulative				
Apr	2.4	1.9	0.9	-0.4
May	3.6	3.2	0.8	-0.4
Jun	4.6	4.5	0.6	-0.5
Jul	5.2	5.0	0.8	-0.7
Aug	6.8	6.2	1.4	-0.7
Sep	7.4	6.4	1.3	-0.3
Oct	8.0	6.8	1.0	0.2
Nov	9.6	8.5	0.8	0.3
Dec	10.2	7.8	1.2	1.2
Jan	7.8	5.6	1.0	1.2
Feb	7.6	5.0	1.4	1.2
Mar	10.5	6.8	2.4	1.3

Figures for April to February are outturns

Table 4: **PSBR for 1984-85 - Comparisons with 1983-84 and Budget profile**

£ billion

	1983-84	1984-85		Differences from	
	Outturn	Budget profile	Latest update[1]	1983-84 outturn	Budget profile
	1	2	3	3-1	3-2
Apr	1.2	1.2	**2.4**	1.1	1.2
May	1.1	1.9	**1.2**	0.1	-0.7
Jun	0.8	0.9	**1.0**	0.2	0.1
Q2	3.2	3.9	**4.6**	1.4	0.7
Jul	0.7	0.3	**0.6**	-0.2	0.3
Aug	1.7	1.8	**1.6**	-0.1	-0.1
Sep	1.2	0.8	**0.6**	-0.6	-0.2
Q3	3.7	2.8	**2.8**	-0.9	-
Oct	0.2	0.6	**0.6**	0.4	-
Nov	1.4	0.5	**1.6**	0.2	1.1
Dec	1.3	-	**0.6**	-0.7	0.7
Q4	2.9	1.0	**2.8**	-0.1	1.8
Jan	-2.7	-2.3	**-2.5**	0.2	-0.1
Feb	0.4	-0.1	**-0.2**	-0.6	-0.1
Mar	2.3	1.9	**2.9**	0.6	1.0
Q1	-0.1	-0.5	**0.2**	0.3	0.8
Cumulative					
Apr	1.2	1.2	**2.4**	1.1	1.2
May	2.4	3.0	**3.6**	1.2	0.6
Jun	3.2	3.9	**4.6**	1.4	0.7
Jul	3.9	4.2	**5.2**	1.3	1.0
Aug	5.6	6.0	**6.8**	1.2	0.9
Sep	6.9	6.7	**7.4**	0.6	0.7
Oct	7.1	7.3	**8.0**	0.9	0.7
Nov	8.5	7.8	**9.6**	1.1	1.8
Dec	9.8	7.7	**10.2**	0.5	2.5
Jan	7.1	5.4	**7.8**	0.7	2.4
Feb	7.5	5.3	**7.6**	0.1	2.3
Mar	9.7	7.2	**10.5**	0.7	3.3

[1]Figures for April to February are outturns

Table 5: Central government transactions – February outturn and latest forecasts for March

£ billion

	February		Latest forecasts
	forecast	outturn[1]	March
Receipts			
Consolidated Fund			
Inland Revenue	4.3	4.5	5.2
Customs and Excise	3.4	3.7	2.7
Other[2]	1.4	0.5	1.8
National Loans Fund			
Interest etc. receipts	0.4	0.4	0.8
Total Receipts	9.4	9.1	10.5
Expenditure			
Consolidated Fund			
Supply expenditure[3]	8.1	7.7	10.4
Adjustment to Supply Services basis[4]	–	–0.1	–0.5
Other	0.2	0.3	0.3
National Loans Fund			
Service of the national debt	1.0	1.0	1.0
Net lending	0.1	0.5	–
Total Expenditure	9.4	9.3	11.3
Other funds and accounts (+ increases borrowing) (– reduces borrowing)	0.4	–0.4	1.5
CGBR	**0.4**	**–0.2**	**2.4**
On-lending	0.1	0.4	0.6
CGBR(O)	**0.2**	**–0.6**	**1.8**

[1] Due to time lags in some items reaching their final accounting destination, figures of forecast and outturn may not be strictly comparable for the components identified, but there is no effect on the overall CGBR.
[2] Includes National Insurance Surcharge and receipts from sales of assets
[3] On a cheques issued basis. Supply includes an element of on-lending in the form of public dividend capital etc.
[4] Reflects changes in balances of departmental accounts with the Paymaster General, timing and other differences between cheques issued by departments and payments to them from the Consolidated Fund. An offset to this item is included in "Other funds and accounts".

Table 6: Central government transactions[1] – comparisons for 1983–84 and 1984–85

£ billion

	1983–84	1984–85	
	Outturn	Budget forecast	Latest update
Receipts			
Consolidated Fund			
Inland Revenue	45.9	50.5	50.5
Customs and Excise	31.4	35.0	35.3
Other[2]	11.0	12.6	12.6
National Loans Fund			
Interest etc. receipts	5.3	5.8	5.4
Total Receipts	93.7	103.9	103.9
Expenditure			
Consolidated Fund			
Supply expenditure[3]	86.7	91.7	93.8
Adjustment to Supply Services basis[4]	–	–	–
Other	4.3	5.0	4.5
National Loans Fund			
Service of the national debt	11.8	12.6	12.9
Net lending	3.4	4.9	2.4
Total Expenditure	106.2	114.2	113.6
Other funds and accounts (+ increases borrowing) (– reduces borrowing)	–0.2	0.8	0.4
CGBR	**12.3**	**11.1**	**10.1**
On-lending	4.1	5.8	3.3
CGBR(O)	**8.2**	**5.3**	**6.8**

[1] Due to differences in treatment of some items in the accounts between the periods/forecasts shown, and time lags in some items reaching their final accounting destination, figures for the components identified may not be strictly comparable.
[2] Includes National Insurance Surcharge and receipts from sales of assets.
[3] On a cheques issued basis. Supply includes an element of on-lending in the form of public dividend capital etc.
[4] Reflects changes in balances of departmental accounts with the Paymaster General, timing and other differences between cheques issued by departments and payments to them from the Consolidated Fund. An offset to this item is included in "Other funds and accounts".

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Monetary Bulletin

The Corporate bond market continues to be dormant. This is in spite of the Bank's indirect attempts to revive it by making very few long dated gilt-edged issues. The time is ripe for a change in the Bank's tactics.

In our view the Bank should now seek to encourage companies to issue medium dated rather than long dated bonds. This implies first a reversion to the Bank's traditional maturity mix of gilt-edged issues, which should work to eliminate the present hump in the yield curve in the medium dated area. Secondly, and more specifically, we suggest that the Bank should provide an important benchmark for the corporate bond market by issuing a long dated bond with a call option in the medium term.

REACTIVATING THE CORPORATE BOND MARKET

The corporate bond market in the U.K. has been largely dormant since 1972. Companies have instead largely relied on the greatly increased flexibility of the banking system to provide them with external finance. This has, in turn, contributed to difficulties in controlling the money supply and, via overfunding, to the ballooning of the Bank of England's holdings of eligible bank bills, from zero in 1980 to £14bn at present.

Background

The most important reason for corporate treasurers being unwilling to issue long dated bonds is that the current real rate of interest is perceived to be abnormally high and it is unattractive to concede such a high rate for a long period of time.

A second reason for the lack of long dated issues is that institutional investors demand greater security, in terms of asset backing, for long dated bonds than they do for medium dated bonds. This demand is difficult for most companies to accommodate. Indeed, it runs counter to euro-bond and international banking practice. In many cases, any increase in collateral granted for a long dated domestic bond would have to be extended to many other prior borrowings.

These and other factors suggest that corporate treasurers will for some time continue to be very reluctant to make substantial issues of long bonds. Given suitable conditions, however, they might be much more prepared to raise medium term finance. This was severely inhibited in the past by the lack of a natural supply of medium term finance in the U.K. Some reasons for this were given in a Bulletin in July 1983 (No. 147), excerpts from

R.H. Lawson, G.T. Pepper, 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, P.H. Beaufrère, K.A.J. Crawford, J.B. Lake, L. Maddy, R.J.M.L. Ottley, S.H. Wamsley, I.S. White

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which are included in the appendix at the back of this Bulletin. One very important factor was the distortion to the pattern of savings caused by tax legislation. In particular, life assurance premium relief was granted only to policies for a term of at least ten years. This very strongly discouraged the issue of short dated policies and, as a consequence, reduced life offices' demand for medium term bonds. The situation is now beginning to change because life assurance premium relief was abolished in last year's budget.

The Bank of England's Actions

A desire to assist the reopening of the corporate bond market has undoubtedly been a major factor behind the Bank's unwillingness to issue long dated stock in the last few years. Chart I shows the maturity pattern of conventional fixed interest gilt-edged issues since October 1981. The concentration on issues of relatively short dated conventional stock is clear. In addition, of course, there have been substantial issues of index-linked stock. This pattern of issues is consistent with the term structure of nominal interest rates. The long end of the yield curve has fallen and there has persistently been a hump in the medium dates.

The declining yield curve has failed to encourage the issue of corporate bonds, as hoped. The medium dated hump has definitely discouraged the issue of medium dated corporate bonds.

One suggestion, therefore, is that the Bank should go back to its old pattern of issues. The medium dated area should be left free. In due course the hump should disappear and the new pattern of relative rates should encourage corporate treasurers to issue medium dated bonds.

We do, however, have a more specific suggestion, one which would require the Bank to lead the way to encourage corporate borrowers to use the medium dated area of the market. In our view, the Bank should provide a benchmark for the corporate bond market by issuing a long dated bond with a call option in the medium term.

In our Bulletin in July 1983 we compared the situation in the U.K. with that in the U.S., where callable bonds are common. These bonds are repayable in the medium term at the borrower's option, albeit at a premium. The call option will give the borrower some protection against a major fall in interest rates, and it also allows financial planning within a time scale envisaged by most companies, at a yield only some way above yields on conventional long term corporate bonds. A lead by the Bank in this field would allow corporate bodies to gauge the reaction of the market to the instrument and, hopefully, persuade companies to follow on with their own debt issues.

As far as potential investors are concerned it will give them some additional return for the early redemption option against them as well as giving them a slightly higher yield if the bond runs to final maturity.

Specific Proposal

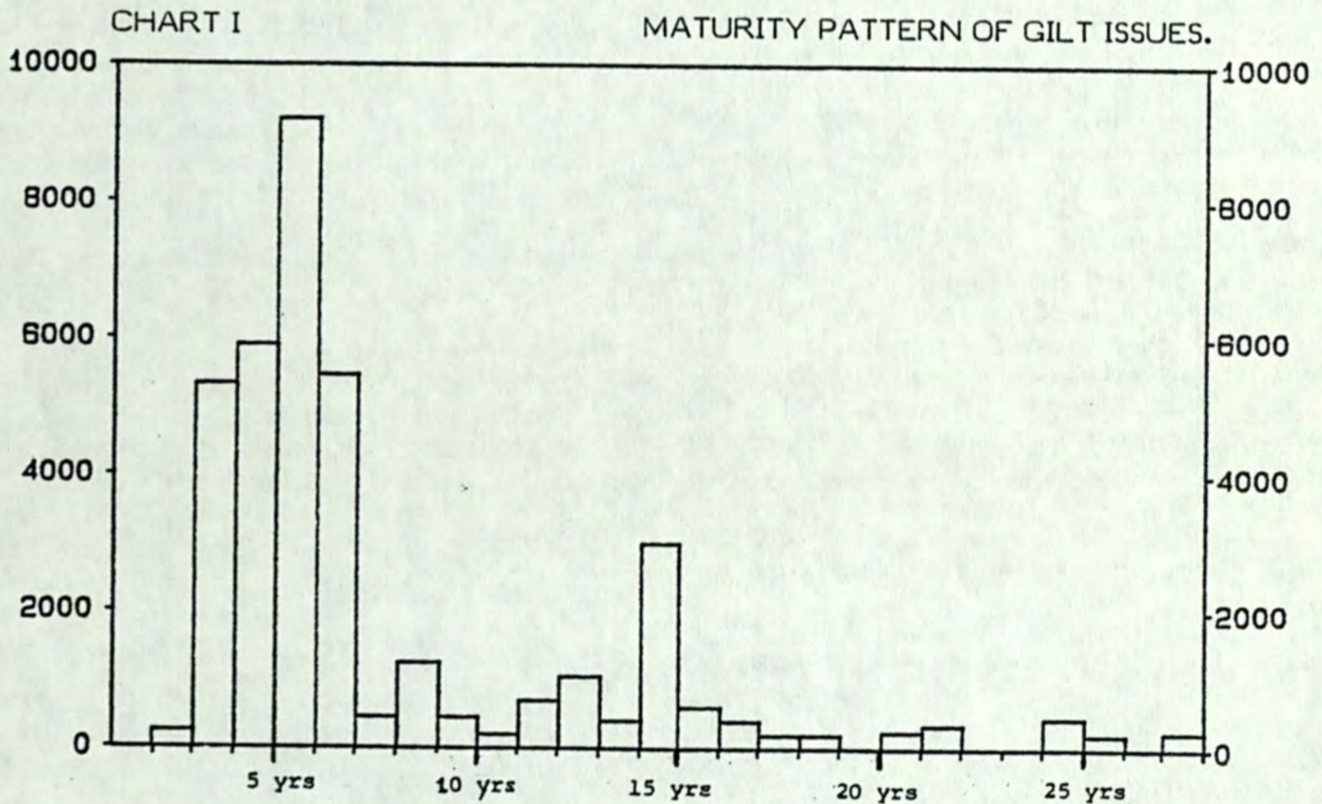
The following specific example of a callable bond outlines features which are most likely to encourage a future revival of the corporate fixed interest market.

The Bank should issue 10% Treasury 1997-2005 at a price of £91%. The 10% coupon indicates that a fall of long yields below 10% is needed for the call option to be activated, while a price of £91% is less than the largest discount at which companies may issue 20 year bonds, under the present legislation. It will thus act as a good indicator for any company considering an issue. At a price of £91% the stock would yield 11.39% on a 12 year basis and 11.13% on a 20 year basis. This represents a 45 basis point premium on current long gilt-edged yields with 10½% Exchequer 2005 currently yielding 10.68%, and a similar yield to a medium term bond (10½% Exchequer 1997 currently yields 11.39%). The attractiveness of medium term finance and the relatively small premium over long gilt yields needed to provide security against major falls in interest rates may finally encourage companies to venture in where they have previously feared to tread. At the same time investors may be attracted by the higher yield than that on normal twenty year gilt-edged stock.

We are not asserting that such an issue by the Bank, even if accompanied by a substantial switch in emphasis in the maturity pattern of gilt-edged issues to the long end of the market, would by itself lead to corporate bond issues on a major scale. There is possibly too great an expectation that interest rates will trend downwards over the next two or three years for that to follow. When some decline in rates has taken place, however, and when the term structure of interest rates changes to encourage medium term issues, the existence of a clear market guideline should make a significant contribution to the revival of the corporate bond market.

18th March, 1985.

RLT
RR
TQ



APPENDIX

Text (July 1983)	Current Comment
Financing Industry	
The third factor is the finance of industry in an economic upswing. Financing industry is not a major problem at the moment but the situation is likely to change. Additional funds will be required when re-stocking starts in earnest and as industrial investment recovers. Further, the current flow of rights issues of ordinary shares, which is raising considerable amounts of finance, is likely to wane after ordinary share prices peak. The equity market will not continue to rise for ever and rights issues are in part a function of a rising market. If industry has to rely on the banks for the bulk of its requirement there is likely again to be a clash between the buoyancy of bank loans and the Government's target for sterling M3.	These background comments are still valid.
The solution during the last few years has been for the Government to overfund in the gilt-edged market, with the Bank using the proceeds to finance industry through purchases of commercial bills. This is only a stop gap measure. Worse still, it raises long term interest rates relative to short term ones and thereby hinders a permanent solution.	Still the stop gap policy.
The best solution would be the rejuvenation of the corporate bond market. The authorities have been trying to achieve this for some time. What else can be done?	Still true.
The most important factor is, of course, the height of interest rates. If interest rates fall sufficiently for many companies to decide to issue bonds, a virtuous circle would be entered. The proceeds of the issues could be used to repay bank loans. This would decrease sterling M3 and interest rates could be reduced further.	Still a very important reason why corporate bonds have not been issued. The argument has, however, changed slightly. There is now more emphasis on current <u>real</u> rates of interest being abnormally high.
One possible experiment, which can be considered under the interest rate heading, would be for the Bank to issue a callable gilt-edged stock. Bonds which are repayable at the issuer's option, albeit at a premium, are common in the US but not in the UK. The option protects the issuer against a substantial fall in interest rates. This protection means that US finance directors are prepared to consider raising long term fixed interest finance at higher rates than UK finance directors will consider. The Bank could try to pave the way for industry with a callable gilt-edged issue but we doubt if it would be successful because the life assurance and pension funds are likely to be hostile to such issues.	The authorities have not so far adopted this suggestion. This Bulletin repeats it, and makes it specific.

Another impediment to the corporate bond market is the unfavourable treatment for tax. The provisions for zero coupon and deep discount bonds in the original Finance Bill were lost because of the election. Even if they had become law, there were difficulties over the ranking of accumulated interest in the event of default; amendment was needed to the 1914 Bankruptcy Act. But compared with gilt-edged stock, a corporate bond would still have been penalised by being subject to capital gains tax on inflation during the first year of a holding. Further, capital gains tend to be tax free in the gilt-edged market whilst losses tend to be allowable. In the corporate bond market it is the other way round. Real gains are taxed but the amount by which a gain does not compensate for inflation is not allowable as a loss.

Done in 1984 Budget - tax concessions extended from gilts to corporate bonds.

The corporate bond market is also impeded by the absence of the US shelf system of issue in the UK. The present system of queuing for bulldog issues would seriously jeopardise the capacity of the corporate bond market if it were applied to these bonds at a time when many companies would like to make issues. The Bank appears, however, to be prepared to adopt a more flexible attitude for industrial bond issues. Documentation can be carried out in advance and permission to proceed on 24 hours notice is probable if there is not a clash with an issue which has just come to the head of the queue.

Already adopted to a large extent by the Bank.

Another and major impediment is the question of security. Many finance directors are most reluctant to give security because of the precedent it would set for bank finance and on the grounds of inflexibility in the future; they much prefer the unsecured borrowing of the Euro-bond market. An investor lending long term funds, e.g. for twenty five years, has a special need for security because redemption is so far away. It may be possible to envisage what a company will look like in seven years time but not as far away as twenty five years, hence the demand for security.

Major impediment remains.

The obvious solution is for a company to issue a medium term bond. Further, many finance directors prefer this term of finance in its own right, considering that conceding a fixed rate of interest for twenty five years is too long. The snag is that there is little natural supply of fixed rate medium term finance in the UK, certainly relative to that in the US.

Specific suggestion of this Bulletin.

There are several reasons for this. The liabilities of UK life assurance companies tend to be longer than those in the US becuase UK offices pay bonuses at maturity (reversionary

Still valid and will not change.

bonuses) rather than each year (cash bonuses). Further, UK offices frequently do not guarantee surrender values and, therefore, have less need for bonds with a greater degree of capital certainty.

There is also an important distortion caused by the UK personal income tax laws. To qualify for tax relief on premiums, a life assurance policy must be for a term of at least ten years. If the premiums are not paid for a minimum of four years, the Inland Revenue can reclaim the relief. Further, if the premiums are not paid for three quarters of the term of the policy, the policy holder may be subject to higher rates of tax on the proceeds. The average term of annual premium policies and, hence, the liabilities of life assurance companies have been lengthened by these tax rules.

Adopted in 1984 Budget - life assurance premium relief withdrawn.

A few years ago, there was a substantial demand from the public for medium term single premium policies but the tax laws were altered and these policies are no longer attractive. This is another example of excessive zeal by the Inland Revenue distorting the financial system.

Still true.

Although strictly speaking the next two points are directly relevant only for the gilt-edged market, there are knock-on effects for corporate bonds. The first concerns unit trusts. Although the penal double taxation of dividends was abolished a few years ago, capital gains on gilt-edged stock are taxed in the hands of a unit holder, whilst they would be tax free if held directly. The tax laws still discourage fixed interest unit trusts.

Still true.

The second point is that these distortions to the UK financial system were not obvious until recently. Trustee savings banks and building societies used to be substantial purchasers of medium term gilt-edged stock. The former have already become similar to clearing banks and the latter are moving in that direction. As a result, both now prefer to invest in shorter dated bonds than previously.

Point disputed by various building societies.

There is no doubt that tax legislation hinders the marketing, collection and packaging of medium term money. In our opinion, these laws distorting the financial system should be reviewed as a matter of urgency.

Done in 1984 Budget - see above.

The final factor hindering the rejuvenation of the corporate bond market is competition from banks. There is nothing wrong with banks financing industry. What is wrong is the way in which banks raise the necessary funds by bidding for short term deposits. This is a form of printing money. Having raised funds in this

Still valid but see below.

w[illegible] banks offer extremely flexible financial packages to their prime corporate customers. The finance can be taken down when the customer wants and in virtually any currency. The customer can often also choose the type of finance when it is taken down, i.e. its term and whether the rate is fixed or floating. About the only thing banks are unable to offer is substantial amounts of fixed rate finance for terms significantly over 5 years.

The flexibility of the banks' package may seem most attractive from the point of view of an individual company. But for the economy as a whole it is extremely permissive. A decade or more ago, a company issued a bond to strengthen its balance sheet sufficiently to be granted further banking facilities. A rights issue of ordinary shares was made to strengthen a balance sheet to enable the company to make an additional bond issue. These disciplines have disappeared.

Still no credit rating agencies in the UK.

It is difficult to envisage a major rejuvenation of the corporate bond market as long as banks consider they have all the necessary resources to meet the needs of their prime customers. The main hope is that companies will want to make bond issues after interest rates have fallen further. But the competition from banks will still be there. The main advantage of a bond issue will be locking into a lower rate of interest for a long period of time. But this may have to be an obvious bargain before a lot of finance directors decide to make an issue. The snag is that when it appears to be a bargain, investors will not want to purchase the bonds. The task of The Stock Exchange is to marry willing investors with willing issuers. This requires an overlap of interests. Undue competition from banks will continue to prevent this overlap from occurring. There is no doubt that banks' ability to finance loans by printing money is a most important impediment for the corporate bond market and it could be a fatal one.

Banks now short of capital, because of LDC debts etc. Many bankers now willing to divert business away from the commercial banking division to the securities and capital markets division.

The "undueness" of the competition has lessened as banks have found it more difficult to attract non-interest bearing deposits, for example high interest cheque accounts have been introduced.

652/004

File

cc JF

FROM: D WALTON

DATE: FEBRUARY 1985

MR FOLGER

cc PPS/Chancellor
PS/FST
Sir Peter Middleton
Sir Terence Burns
Mr Cassell
Mr Monck
Mr Battishill
Mr Burgner
Mr Evans
Mr Allen
Mr Davies
Mr Culpin
Mr Griffiths
Mr Mowl
Mr Robson
Mr Hacche
Ms Leahy
Mr Page
Mr Pickering o.a.
Mr Pratt
Mr Vernon
Mr Webb
Miss Deyes

Mr T Jones - CSO
Mr N Coote - CSO

HE/17
Mr Turnbull

NORTH SEA OIL AND GAS AS A PROPORTION OF GDP

1. In response to a query from No 10, I have checked the figures for this in conjunction with DEn. The position in rounded terms is:

	percentage points of GDP		
	oil	gas	oil and gas
1983 (cf T3.7 of 1984 (Blue Book)	5½	½	6
1984 (estimate)	6	½	6½

2. The implicit all purpose formulation is thus that oil and gas account for "about 6 per cent" of GDP. This needs to be used from now on in place of the erroneous "about 5" formulation. The latter seems to have crept into briefing at the end of last month - not from EB - though perhaps we were remiss in not checking it!

David Walton

D WALTON

18 FEB 1985

File

NORTH SEA OIL : KEY FIGURES

Oil and gas as percentage of GNP	5%
Oil and gasas percentage of Government revenues	8½%
Oil exports as percentge of total exports	21%

of our production

E.R.

25 February 1985

PRIME MINISTER

THE DOLLAR

The dollar still shows no signs of falling, and the response to the President's statement demonstrates just how foreign exchange speculators wish to push the dollar higher. With dollar real interest rates as high as they are, with the balance of trade in the States not deteriorating for a few months, and with the US economy still strong, it's not surprising.

Our monetary policy is now tight, having been loose for too long. Whilst it would take some months to bring the money numbers back into shape, with short-term interest rates at these levels and with the funding programme and type of yield curve we have, we have done all the tightening we need do. It would be masochism to go to the defence of the pound against the dollar with yet another hike in interest rates.

Presentational effort should now be placed on stressing:

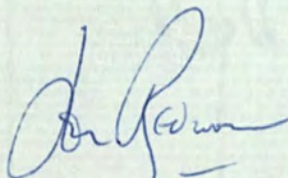
a. the Government has shown its commitment to a strong anti-inflationary policy by its monetary action;

b. money policy is now tight, and the Government means to get its expenditure and funding under control;

c. all currencies are falling against the dollar - it is not sterling weakness, but dollar strength;

d. international action to make the speculators lose money is still a possibility, but we cannot tell people when we're going to do it, as that would remove the major element of surprise;

e. we are still concentrating on our domestic economic and monetary policy, and do not have some hidden sterling exchange rate target.



JOHN REDWOOD

Domestic Monetary Policy

PRIME MINISTER

MONETARY CONDITIONS

John Redwood's note argues that UK financial conditions are too lax:

i) the PSBR has not been brought down significantly over the past 4 years, particularly if adjustments are made for asset sales, many of which are more like financing transactions than negative expenditure, and the capital uplift on indexed gilts;

ii) broad money has been growing at or above the top of the target range and considerably faster than inflation - see the figures at Flag A.

The Greenwell's bulletin - Flag B puts a different point of view on the monetary position. They argue that attention should be focused on the narrow aggregates and an increase in the broad aggregates in excess of the rate of inflation is not necessarily a cause for concern. The return on financial assets is now positive in real terms and this will produce a switch from real to financial assets, some of which will be held as interest bearing bank deposits. The accusation against fiscal policy seems to me to be better founded.

AT

ANDREW TURNBULL
22 February 1985

E.R.

21 February 1985

PRIME MINISTER

THE US AND UK ECONOMIES

It is now conventional wisdom that the US has a sloppy fiscal policy and a tight money policy, whereas we have the reverse. So, our critics say, why don't we copy the States?

How true is the popular view?

US money supply growth is far from slow. Over the last year, M_2 has risen 8.2% (target 6-9%) and M_3 10.2% (target 6-9%). Given that inflation is now under 3% and seems to be falling, this represents a very high level of real money growth. Only the short range aggregate, M_1, is under any kind of control.

There is no doubt that the US fiscal position is lax. A projected budget deficit of $220 billion in 1985, $230 billion in 1986, and $246 billion in 1987, is on the cards unless the cuts and savings proposed in this year's budget are implemented. The total take from the economy for US budget programmes is on a rising trend: 20.2% in 1970, 22.9% in 1980 and 25% forecast for 1985. The States is both lax in its deficit and in its monetary policy. (All figures from Panmure Gordon.)

relevant table attached at A.

The UK's monetary policy has become too lax, as our recent brief on the EMS indicated. But we should not be relaxed about our public sector borrowing stance either. We are confronted with a dilemma. We wish to convey the picture of tight control over borrowing in order to reassure markets and to prevent interest rates rising further. Yet our critics are saying that our fiscal policy is far too tough (PSBR planned at only 2.5% of GNP) compared with the US percentage of some 5%.

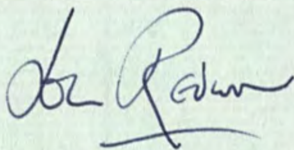
Wood Mackenzie have recently produced an adjusted figure for the PSBR, taking into account the privatisation sales, the council house sales, the lower rates of interest paid on index-linked gilts (where in the end the real capital has to be repaid in full) and other one-offs, eg the VAT on imports. The table below shows how the adjusted PSBR runs compared with the recorded PSBR, both in £billion and as a percentage of GDP:

PSBR	Reported/ £bn	Adjusted for Sales of Assets £bn	Reported % GDP	Adjusted % GDP
1978/79	9.3	9.5	5.4	5.5
1979/80	10.0	11.2	4.8	5.4
1980/81	12.7	13.7	5.4	5.8
1981/82	8.6	10.4	3.3	4.0
1982/83	8.9	10.9	3.1	3.8
1983/4	9.7	12.6	3.2	4.1
1984/85	9.5	14.2	2.9	4.3

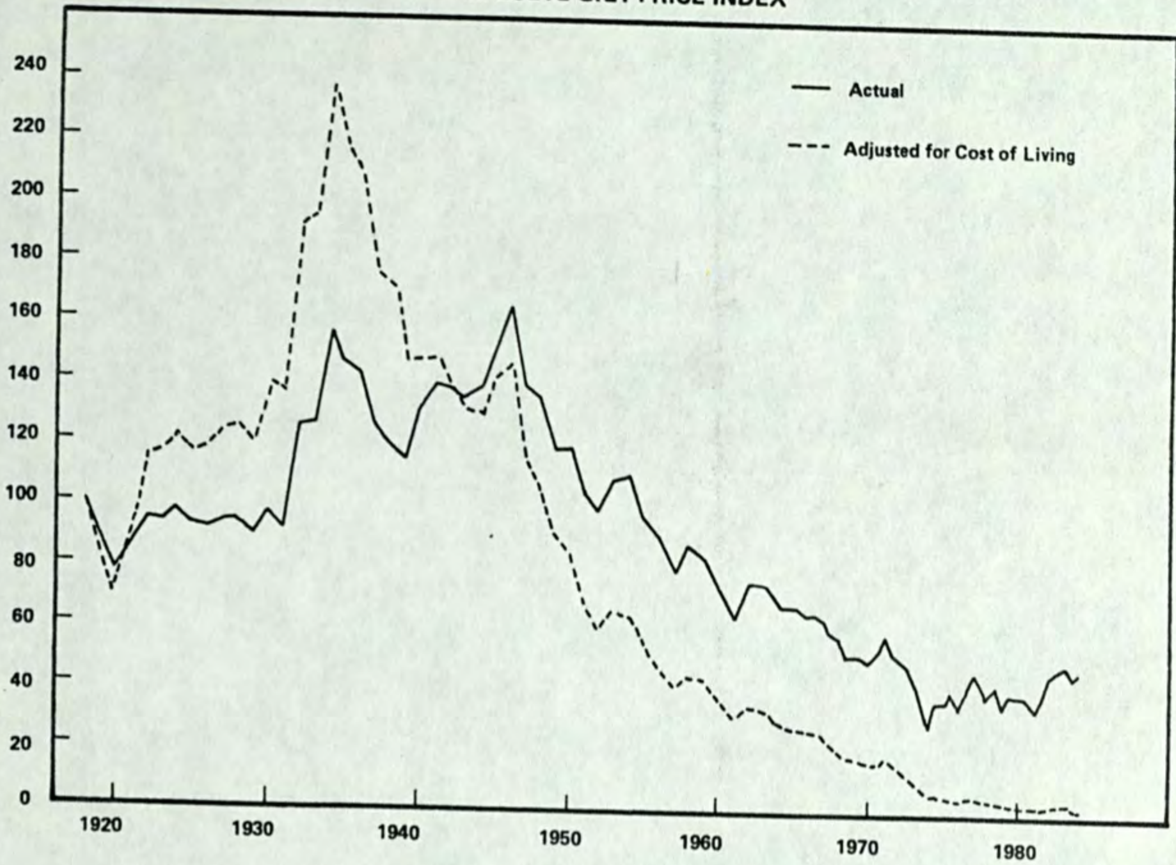
E.R.

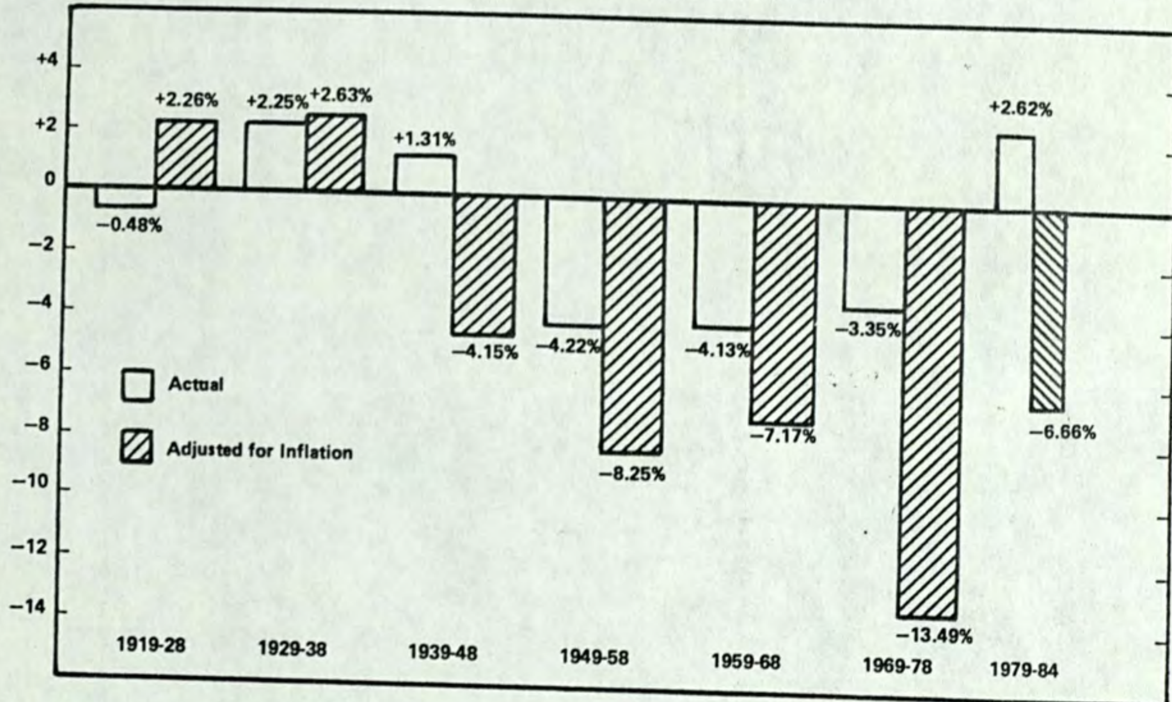
So the US fiscal position is not that much looser than the UK's if we view asset sales as an alternative means of financing a deficit, as they are; whilst the money position in both countries is a little loose, particularly in the UK.

The moral of both stories is that a high level of public deficit makes money control that much more difficult, and in the US it has a more benign influence because the supply side factors work so much better. The attached graphs show just what has happened to investors in UK bonds since the 1930s recession. There is still no blip in the graph of the real value of gilts, reflecting the high levels of interest rates and the large amount of gilts still being sold to pay for the Government's excess spending.



JOHN REDWOOD


de ZOETE GILT PRICE INDEX
Actual
Adjusted for Cost of Living
240
220
200
180
160
140
120
100
80
60
40
20
0
1920
1930
1940
1950
1960
1970
1980


Average Annual
% Change
de ZOETE GILT PRICE INDEX
+4
+2
0
-2
-4
-6
-8
-10
-12
-14
+2.26%
+2.25%
+2.63%
+1.31%
+2.62%
-0.48%
-4.15%
-4.22%
-4.13%
-3.35%
-8.25%
-7.17%
-13.49%
-6.66%
Actual
Adjusted for Inflation
1919-28
1929-38
1939-48
1949-58
1959-68
1969-78
1979-84

A

Has it fallen because money policy has been lax?

Sources: International Financial Statistics & Simon & Coates

% changes in real money growth

	Real M_1	Real £M_3	Real PSL_2	End	$/£
1979/80	-13.9	-5.8	-7.9	1980	2.4
1980/81	-6.4	2.7	-1.2	1981	1.9
1981/82	0.5	8.2	3.8	1982	1.6
1982/83	8.0	7.0	5.0	1983	1.4
1983/84	9.1	5.1	7.5		
1984/85	10.1	5.3	8.1		

(Tsy.est.)

Change in trend of sterling from rise to fall reflects change from tight to loose money.

ie: When the rapid growth in real pound notes and bank deposits started, the value of the pound fell. The velocity of circulation of money did not fall enough to offset the effect.

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Monetary Bulletin

No. 168

February 1985

Many commentators have attributed part of sterling's recent weakness to excessive monetary growth in the U.K. We disagree. A thorough reassessment of the monetary aggregates leads us to reaffirm our conclusion that sterling's weakness has other causes.

Given the existing mix of fiscal and monetary policies in the U.S. and the U.K., the Chancellor faces some exceptionally difficult options in the run up to the Budget. In our view he should definitely not tighten fiscal policy. Nor should he provide a major fiscal boost. Instead, he should aim for the middle of the target ranges for the money supply, particularly for Mo, and hold to his original intention to make modest tax cuts.

The UK - a Mirror Image of the US?

Many press and City commentators have attributed some of sterling's weakness to excessive monetary growth. If they are correct, the rise in base rates will bring the money supply back on track and will, in due course, help to strengthen sterling. An important extension of this argument is that the economic recovery will not peter out, because monetary growth, although lower, will not become inadequate.

Our Bulletins have disagreed with the view that monetary growth was a cause for concern prior to the rise in interest rates. If we are correct, the reduction in the money supply which will follow the rise in rates may well result in inadequate monetary growth. If interest rates remain at their current level for long, another leg of the recession is on the way.

Given the importance of the issue, a reassessment of the behaviour of the money supply is in order, particularly as the distortions caused by the British Telecom issue have now unwound. A full analysis is contained in the second part of this Bulletin. We have modified the view which we expressed last month only very slightly.

If excessive growth of the money supply is not an important explanation for sterling's persistent weakness, are there any other monetary forces at work? Last month we again discussed the theory that the mix of monetary and fiscal policies in different countries was having an important impact on exchange rates. In this respect, the UK is the mirror image of the US. In the US, the domestic demand for credit exceeds the domestic supply of credit, as argued by Dr Henry Kaufman. Funds are flowing to the US from abroad to bridge the gap.

R.H. Lawson, G.T. Pepper, 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. Buckner, M.S. Jesse, P.B. [illegible], A.J.E. O'Sullivan, G.R. Addison, K.M. Feery, P. Beaufrere, K.A.J. Crawford, J.B. Lake, L. Maddy, R.J.M.L. Ottley, S.H. Wamsley, I.S. White

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Our Bulletins have repeatedly argued that the domestic supply and demand for credit in the UK are roughly in balance, in complete contrast to the situation in the US. What is happening is that funds are flowing from a country with an adequate supply of credit to one with a substantial deficiency. There is no doubt that the imbalance in the US is the dominant factor, but those countries with an adequate domestic supply of credit are particularly exposed to a loss of funds to the US and, hence, to a weak currency.

If the UK is the mirror image of the US, there is a possibility that sterling will persistently remain rather weak, just as the dollar has remained persistently strong. In these circumstances, the Chancellor faces some exceptionally difficult choices.

One choice, already made, is to try to defend sterling by raising interest rates. The drawback, as we have already argued, is that this may well lead to inadequate monetary growth and another leg of the recession. The effect on sterling is not only the direct and immediate impact of the rise in interest rates. In due course, the inadequate domestic supply of money will tend to attract an inflow from abroad. The combined effect, however, may or may not be sufficient to offset the outflow of funds because of the credit forces just described.

A second choice is to ignore the fall in sterling. When the money supply is under control, we would normally argue that the best exchange rate policy is one of benign neglect. When a financial system is badly out of equilibrium, however, as is the case currently in the US, speculation can become destabilising. Speculative transactions in the same direction as the underlying financial flows acquire a track record of profitability and the herd instinct becomes dominant.

At present, the financial disequilibrium is in the US, not the UK. If it were in the UK, we would be arguing for remedial action. As it is in the US, remedial action is beyond the Chancellor's power.

Even in these exceptional circumstances, we would still argue that the best exchange rate policy is one of benign neglect as long as sterling is not obviously undervalued and its fall is not leading to a significant rise in price inflation. This was clearly the case until early January. It is not so clearly the case now.

In the US, the combination of control of the money supply and a strong dollar has resulted in rapid economic growth. The money supply has governed the growth of nominal GNP whilst the strong dollar has reduced inflation, thereby leaving room for substantial real growth. In the UK, a combination of control of the money supply and persistent weakness in sterling could result in a very sluggish real economy. The money supply will again tend to govern nominal GDP but persistently weak sterling would lead to a rise in inflation. This would leave little room for real growth.

This analysis will again seem "counter intuitive" to many people. A falling exchange rate has normally been seen to be expansionary. This is not necessarily so under a strict monetary regime. Summarising, both the choices analysed so far, i.e. raising interest rates and pursuing a policy of benign neglect, could result in a slowdown of the real economy.

Judging from various statements, the Chancellor is considering a third choice, the traditional one in sterling crises of tightening fiscal policy, in part to restore confidence. We strongly disagree with this course of action in the present peculiar circumstances. Such a policy would take us even further away from the policy mix of the US and might encourage an even greater flow of funds out of sterling into the dollar.

Finally, the Chancellor has the audacious, counter-intuitive option of seeking to defend sterling by relaxing his fiscal policy. Some commentators, eager perhaps for fiscal expansion

on other grounds, have used this argument to justify a major fiscal boost. In our view this is over-egging the pudding. The core of the counter-intuitive analysis is the assumption that investors have confidence in the resolve and ability of the authorities to control the money supply. If this confidence is undermined, the exchange rate will weaken. In our view, any clear reversal of the Government's policy of bringing down the PSBR as a percentage of GDP will undermine confidence and will put downwards pressure on sterling. We, therefore, argue that the Chancellor should state that he is aiming at the mid-points of his target ranges for the money supply, particularly for M0, and hold to his original intention to make modest cuts in taxation in the Budget.

Has monetary growth been excessive?

It cannot be repeated too often that the best way of assessing the stance of monetary policy is to monitor all the monetary aggregates, including M0, the monetary base. If any of them is behaving in a peculiar way, the explanation should be ascertained. The cause should be identified. Relative interest rates will often be responsible and unwinding transactions may have occurred. After full analysis, it is normally possible to make a sensible judgement about the current underlying trend of monetary growth.

We will go through this process in a moment, but first we wish to attack the misguided commentators who are comparing the current rate of growth of PSL2, the broadest aggregate, with that of M3 in the Heath/Barber era in the early 1970s.

More generally, there is unfortunately quite a widespread fixation in the UK on the behaviour of the broad monetary aggregates in general and sterling M3 in particular. Hard line Swiss and North American monetarists just do not understand why UK attention is focused in this way.

In the early 1970s, when many commentators learnt about monetarism, inflationary expectations were rising, real assets were perceived to be growing in attractiveness compared with nominal assets, and the real rate of interest was negative. Further, the demand for credit was exceeding its supply, and banks were providing the difference. The supply of money was, accordingly, exceeding its demand, the additional holdings of money were unintended and the increase in M3 was most certainly inflationary.

Currently, the situation is very different. Real assets are losing their premium status and nominal assets have come into their own. The real return on bank and building society deposits is extremely high. Such deposits are a most desirable home for genuine savings and their growth is not obviously inflationary.

A very good example of the mistake of looking at the broad aggregates in circumstances when attention should be paid to narrow ones occurred in the Autumn of 1980. In its Annual Monetary Review, December 1980, the Centre for Banking and International Finance at the City University forecast that its estimate of the underlying rate of growth of broad money would cause a rate of inflation in 1982 of 16%. In the event, inflation fell to 5%. The Centre failed to recognise the significance of the narrow aggregates. The buoyancy of the broad aggregates was a reflection of a rise in the personal savings ratio to a record 15½%. The rates of growth of the monetary base, currency, retail M1 and M1 were 7%, 7%, Nil and 1%, respectively. They correctly reflected the fact that inflationary pressures were falling.

Returning to the present, following the recent increase in base rates to 14%, the real rate of interest on bank deposits is at an all time record for periods when inflation has been positive. It will be no surprise if the broad monetary aggregates continue to be buoyant because of demand from genuine savers. Such buoyancy will not be a sign of inflationary pressure.

The latest position

The seasonally adjusted data for the five weeks to 16th January are given below. It should be noted that the rise in base rates to 12% occurred on 14th January and so there was very little time for the data to be affected by the recent rise in rates. Further, the unwinding of the distortions caused by the British Telecom issue has, as expected, led to a fall in Mo, retail M1 and M1.

Table I
Changes in the Month to Mid-January

	£m	pa
Mo	-125	-10%
Currency	-6	-1%
Retail M1	-625	-22%
M1	-1,033	-25%
Sterling M3	781	9%
PSL1	853	9%
PSL2	2,684	17%
Bank lending in sterling to private sector	2,038	21%

According to the published data, the position over the longer term is now as follows:-

Table II
Published Growth Rates

		3 months	6 months	11 months*	1 year
Narrow money:	Mo	5	6	6	5
	Currency	2	5	6	5
	Retail M1	5	6	7	7
	M1	8	13	16	15
	M2	n.a.	n.a.	n.a.	11
Broad money:	Sterling M3	12	11	10	9
	PSL1	11	11	11	10
	PSL2	15	15	15	15

* Target period so far

To a greater or lesser extent, every aggregate has been influenced by special factors. The following table shows the published rate of growth over the last six months together with our estimate of the underlying trend for each aggregate.

Table III
Underlying Trends

		Published % p.a.	Trend % p.a.	Target Range % p.a.	Notes
Narrow money:	Mo	5.9	6	4-8	
	Currency	4.7	5½		1
	Retail M1	6.2	8-9		2
	M1	13.3	10-11		3
	M2	11.2	10½		4
Broad money:	Sterling M3	10.9	10	6-10	5
	PSL1	11.3	10½		5
	PSL2	14.7	12½		6

Notes:
1. Revised upwards due to an erratically low figure for January.
2. Revised upwards because of a switch from current accounts to high interest cheque accounts.
3. Revised downwards because of the newly available high interest cheque accounts and for the greater use of overnight deposits by Other Financial Institutions.
4. The published rate is for the last year rather than the last six months, because the series is too new for seasonal adjustments to be calculated. The downward adjustment is for a reclassification of certain building society deposits as estimated by the Bank.
5. The downward adjustment is to allow for bill arbitraging.
6. The downward adjustment is for changes in term shares of building societies.

Assessment

Mo and currency are running right in the middle of the former's target range. Preliminary data for the month to mid-February suggest that this trend has continued.

There is a slight worry about the buoyancy of M1. The adjustments to both retail M1 and M1 are only approximate because the situation is confused by changes in banking habits. The situation warrants close attention in the coming months.

M2, sterling M3 and PSL1 are running at or slightly above the top of the target range for sterling M3. The earlier remarks about the significance of buoyant growth of the broad aggregates should be noted and there was an argument for running some degree of risk given the current height and trend of unemployment. A modest rise in base rates from the 9½% prevailing on 11th January was probably justified. But the rise to 14% was excessive.

The 12½% growth of PSL2 catches the eye of anyone wanting to find evidence of excessive monetary growth. The case in the current circumstances for disregarding this, the broadest of all the aggregates, has already been stated.

Bank Lending

Table IV
Bank Lending in Sterling to the Private Sector

	£m	Published	Bills Outside	Leasing Adj	Adj Total	3 Month Av
1984	June	1,571	186		1,757	1,406
	July	348	-268	+250	330	1,019
	Aug	743	-15	+450	1,178	1,088
	Sep	1,460	153		1,613	1,040
	Oct	2,155	111		2,266	1,686
	Nov	1,705	62		1,767	1,882
	Dec	1,484	-49		1,435	1,822
1985	Jan	2,038	-154		1,884	1,695

Table IV shows that bank lending, even after adjustment for changes in bills held outside the monetary sector and the Bank, rose by some £1,850m in the month to mid-January, which was similar to the average growth in the previous three months.

Various special factors may have inflated lending in banking-January. Bill arbitraging probably increased it by up to £500m and the unwinding of the BT distortions (involving suspense accounts) may have boosted it by a further £200m. After these adjustments our

central estimate of lending in banking-January is just over £1,250m but the average during the most recent three months is still £1,600m.

One final point, the data for bank lending during the last three months include the acquisition of £1,000m commercial bills by the Bank. This acquisition is financed by sales of gilt-edged stock. If companies had issued corporate bonds instead of commercial bills and if savers had bought these bonds rather than gilt-edged stock, this item would have been excluded from the data for bank lending.

GTP
RLT
RR

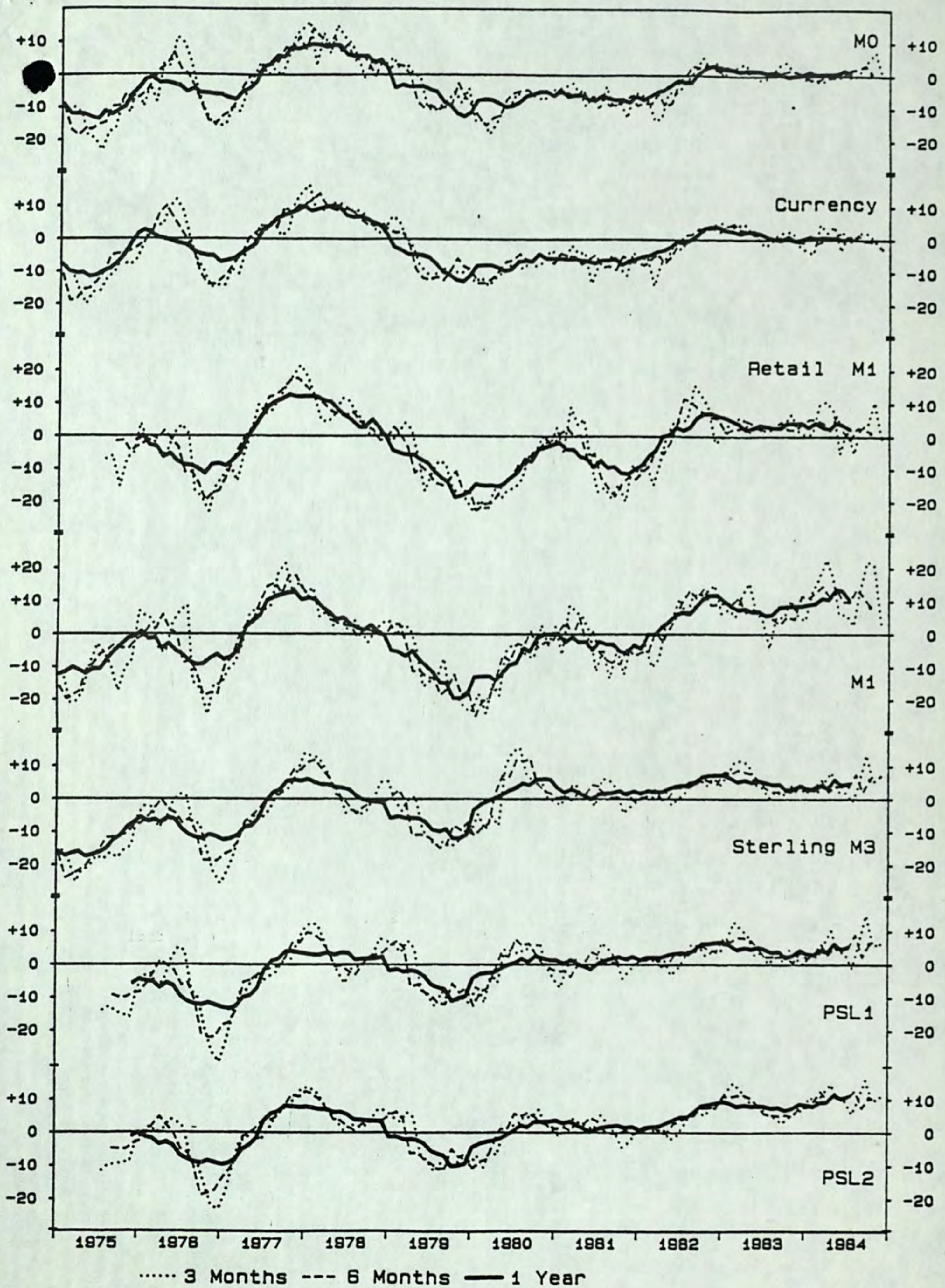
MONETARY GROWTH
In Nominal Terms

Percentage Annual rates		Mo	Currency	Retail M1	M1	M2	Sterling M3	PSL1	PSL2
Changes in year to:									
1984	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	5	5	9	14	11	9	9	13
	July	6	5	7	14	11	8	8	12
	Aug.	5	6	9	14	12	8	8	12
	Sep.	5	6	8	16	12	9	9	13
	Oct.	5	6	7	16	13	8	9	13
	Nov.	6	5	9	19	13	11	11	15
	Dec.	7	5	8	18	12	9	9	14
1985	Jan.	5	5	7	15	11	9	10	15
Changes in 6 months to:									
1984	Aug.	4	7	11	19		9	10	15
	Sep.	5	7	6	15		9	10	14
	Oct.	7	5	4	15		9	10	15
	Nov.	7	7	8	19		13	14	17
	Dec.	8	5	8	16		7	7	12
1985	Jan.	6	5	6	13		11	11	15
Changes in 3 months to:									
1984	Nov.	10	7	8	27		19	20	20
	Dec.	12	5	16	26		10	11	14
1985	Jan.	5	2	5	8		12	11	15

In Real Terms

		Mo	Currency	Retail M1	M1	M2	Sterling M3	PSL1	PSL2
Changes in year to:									
1984	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
	July	1	1	3	9	7	3	3	8
	Aug.	0	1	4	9	7	3	3	7
	Sep.	1	1	3	11	8	4	4	8
	Oct.	0	1	2	11	8	3	4	8
	Nov.	1	1	4	14	9	6	6	11
	Dec.	2	0	4	13	7	4	5	9
1985	Jan.	1	1	2	10	7	5	5	10
Changes in 6 months to:									
1984	Aug.	-1	2	6	14		4	5	10
	Sep.	0	2	1	10		4	5	9
	Oct.	2	0	-1	10		4	5	10
	Nov.	2	2	3	14		8	9	12
	Dec.	3	0	3	11		2	2	7
1985	Jan.	1	0	1	8		6	6	10
Changes in 3 months to:									
1984	Nov.	5	2	3	22		14	15	15
	Dec.	7	0	11	21		5	6	9
1985	Jan.	0	-3	0	3		7	6	10

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



W. GREENWELL & Co—Monetary Bulletin

STATISTICS

reprinted from Bank of England *Banking Statistics*

Money stock: amounts outstanding

[Table 11.1 in the *Quarterly Bulletin*]

£ millions

	Notes and coin in circulation with public	UK private sector sterling sight deposits		Money Stock 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*	
Month ended											
1984 Dec. 14 [e]	12,119	19,990	11,466	43,575	42,680	56,233	99,808	99,090	15,839	115,647	114,930
Jan. 18	11,467	19,320	11,915	42,702	42,980	56,613	99,315	99,730	16,041	115,356	115,770
Feb. 15	11,531	19,018	11,951	42,500	43,140	56,099	98,599	99,790	16,758	115,357	116,540
Mar. 21 [e]	11,641	19,467	12,637	43,745	44,440	55,701	99,446	101,190	17,013	116,459	118,200
Apr. 18	12,044	20,572	13,038	45,654	45,220	55,394	101,048	101,500	17,314	118,362	118,810
May 16	11,834	20,593	13,485	45,912	45,910	55,698	101,610	102,330	15,458	117,068	117,790
June 20 [e]	11,941	20,648	13,964	46,553	46,770	57,268	103,821	104,420	15,489	119,310	119,910
July 18	12,213	20,694	14,094	47,001	46,460	56,779	103,780	103,410	16,741	120,521	120,150
Aug. 15	12,156	20,981	14,035	47,172	47,140	57,147	104,319	104,170	16,270	120,589	120,440
Sept. 19 [e]	12,102	20,850	14,774	47,726	47,650	57,672	105,398	105,580	17,723	123,121	123,290
Oct. 17	12,115	21,022	15,483	48,620	48,460	57,385	106,005	105,900	17,317	123,822	123,710
Nov. 21	12,186	21,251	16,474	49,911	50,060	58,850	108,761	108,720	18,407	127,168	127,130
Dec. 12 [e]	12,641	22,272	16,617	51,530	50,590	58,041	109,571	108,650	19,274	128,845	127,930
1985 Jan. 16	12,113	20,895	16,268	49,276	49,560	60,156	109,432	109,430	20,843	130,275	130,270

Money stock: changes [f]

[Table 11.2 in the *Quarterly Bulletin*]

£ millions: *percentages in italics*

	Notes and coin in circulation with public	UK private sector sterling sight deposits		Money stock 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						Transactions	Valuation changes [g]		
	1	*2*	*3*	*4*		*5*	*6*		*7*		*8*	
Month ended (unadjusted)												
1984 Jan. 18	− 652	− 670	+ 449	− 873		+ 380	− 493		+ 104	+ 98	− 291	
Feb. 15	+ 64	− 302	+ 36	− 202		− 514	− 716		+ 1,000	− 283	+ 1	
Mar. 21	+ 110	+ 444	+ 671	+ 1,225		− 438	+ 787		+ 152	+ 73	+ 1,012	
Apr. 18	+ 403	+ 1,105	+ 401	+ 1,909		− 307	+ 1,602		+ 152	+ 149	+ 1,903	
May 16	− 210	+ 21	+ 447	+ 258		+ 304	+ 562		− 2,128	+ 272	− 1,294	
June 20	+ 107	+ 55	+ 469	+ 631		+ 1,555	+ 2,186		− 249	+ 255	+ 2,192	
July 18	+ 272	+ 46	+ 130	+ 448		− 489	− 41		+ 666	+ 586	+ 1,211	
Aug. 15	− 57	+ 287	− 59	+ 171		+ 368	+ 539		− 395	− 76	+ 68	
Sept. 19	− 54	− 131	+ 739	+ 554		+ 520	+ 1,074		+ 433	+ 1,015	+ 2,522	
Oct. 17	+ 13	+ 172	+ 709	+ 894		− 287	+ 607		− 404	+ 498	+ 701	
Nov. 21	+ 71	+ 229	+ 991	+ 1,291		+ 1,465	+ 2,756		− 854	− 264	+ 3,346	
Dec. 12	+ 455	+ 919	+ 133	+ 1,507		− 1,163	+ 344		+ 455	+ 352	+ 1,151	
1985 Jan. 16	− 528	− 1,377	− 349	− 2,254		+ 2,115	− 139		+ 304	+ 1,265	+ 1,430	
Month ended (seasonally adjusted)												
1984 Jan. 18	− 59	− 32	+ 390	+ 299	*+ 0.7*	+ 350	+ 649	*+ 0.7*	+ 104	+ 98	+ 851	*+ 0.7*
Feb. 15	+ 16	+ 40	+ 102	+ 158	*+ 0.4*	− 71	+ 87	*+ 0.1*	+ 1,000	− 283	+ 804	*+ 0.7*
Mar. 21	+ 58	+ 416	+ 811	+ 1,285	*+ 3.0*	+ 100	+ 1,385	*+ 1.4*	+ 152	+ 73	+ 1,610	*+ 1.4*
Apr. 18	+ 206	+ 375	+ 197	+ 778	*+ 1.8*	− 426	+ 352	*+ 0.3*	+ 152	+ 149	+ 653	*+ 0.6*
May 16	− 54	+ 194	+ 547	+ 687	*+ 1.5*	+ 168	+ 855	*+ 0.8*	− 2,128	+ 272	− 1,001	*− 0.8*
June 20	+ 118	+ 163	+ 576	+ 857	*+ 1.9*	+ 1,205	+ 2,062	*+ 2.0*	− 249	+ 255	+ 2,068	*+ 1.8*
July 18	− 7	− 394	+ 83	− 318	*− 0.7*	− 712	− 1,030	*− 1.0*	+ 666	+ 586	− 222	*+ 0.2*
Aug. 15	+ 64	+ 604	+ 17	+ 685	*+ 1.5*	+ 49	+ 734	*+ 0.7*	− 395	− 76	+ 263	*+ 0.2*
Sept. 19	+ 82	− 349	+ 774	+ 507	*+ 1.1*	+ 873	+ 1,380	*+ 1.3*	+ 433	+ 1,015	+ 2,828	*+ 2.3*
Oct. 17	+ 63	+ 158	+ 590	+ 811	*+ 1.7*	− 487	+ 324	*+ 0.3*	− 404	+ 498	+ 418	*+ 0.3*
Nov. 21	+ 58	+ 662	+ 878	+ 1,598	*+ 3.3*	+ 1,226	+ 2,824	*+ 2.7*	+ 854	− 264	+ 3,414	*+ 2.8*
Dec. 12	+ 14	+ 257	+ 151	+ 422	*+ 0.8*	− 958	− 536	*− 0.5*	+ 455	+ 352	+ 271	*+ 0.2*
1985 Jan. 16	− 6	− 619	− 408	− 1,033	*− 2.0*	+ 1,814	+ 781	*− 0.7*	+ 304	+ 1,265	+ 2,350	*+ 1.3*

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

Transactions balances and components of M2

[Tables 11.1 and 11.2 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									
1984 Jan. 18	11,467	19,320	30,787	30,340	58,114	1,765	121,006	1,072	3,125
Feb. 15	11,531	19,018	30,549	30,057	58,855	1,777	121,238	962	3,083
Mar. 21[c]	11,641	19,467	31,108	29,953	60,046	1,778	122,885	1,124	3,106
Apr. 18	12,044	20,572	32,616	29,896	60,902	1,788	125,202	995	3,116
May 16	11,834	20,593	32,427	29,879	61,775	1,776	125,857	1,073	3,187
June 20[c]	11,941	20,648	32,589	30,455	63,230	1,743	128,017	1,079	3,193
July 18	12,213	20,694	32,907	30,736	64,055	1,750	129,448	886	3,308
Aug. 15	12,156	20,981	33,137	30,613	64,340	1,736	129,826	945	3,185
Sept. 19[c]	12,102	20,850	32,952	30,677	64,944	1,741	130,314	972	3,357
Oct. 17	12,115	21,022	33,137	30,863	65,696	1,749	131,445	1,089	3,289
Nov. 21	12,186	21,251	33,437	31,283	66,097	1,761	132,578	1,177	3,391
Dec. 12	12,641	22,272	34,913	31,043	66,906	1,731	134,593	890	3,399
1985 Jan. 16	12,113	20,895	33,008	31,511	68,649	1,784	134,952	1,087	3,539
Changes in month ended [d]									
1984 Jan. 18	− 652	− 670	−1,322	+ 122	+2,410	+ 15	+1,225	+ 173	− 116
Feb. 15	+ 64	− 302	− 238	− 283	+ 572	+ 12	+ 63	− 110	− 42
Mar. 21	+ 110	+ 444	+ 554	− 104	+1,144	+ 1	+1,595	+ 162	+ 23
Apr. 18	+ 403	+1,105	+1,508	− 57	+ 856	+ 10	+2,317	− 129	+ 10
May 16	− 210	+ 21	− 189	− 17	+ 833	− 12	+ 615	+ 78	+ 71
June 20	+ 107	+ 55	+ 162	+ 576	+1,405	− 33	+2,110	+ 6	+ 6
July 18	+ 272	+ 46	+ 318	+ 281	+ 825	+ 7	+1,431	− 193	+ 115
Aug. 15	− 57	+ 287	+ 230	− 123	+ 285	− 14	+ 378	+ 59	− 123
Sept. 19	− 54	− 131	− 185	+ 64	+ 604	+ 5	+ 488	+ 27	+ 172
Oct. 17	+ 13	+ 172	+ 185	+ 186	+ 752	+ 8	+1,131	+ 117	− 68
Nov. 21	+ 71	+ 229	+ 300	+ 420	+ 401	+ 12	+1,133	+ 88	+ 102
Dec. 12	+ 455	+ 919	+1,374	− 240	+ 809	− 30	+1,913	− 287	+ 8
1985 Jan. 16	− 528	−1,377	−1,905	+ 468	+1,743	+ 53	+ 359	+ 197	+ 140

[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 [e] to Table D on page 3.
[d] See footnote [f] to Table E on page 3.

Private sector liquidity, and other deposits

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

£ millions

	'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] [c]		Seasonally adjusted change in month [b] [c]		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
Month ended	*1*	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*		*10*		*11*	*12*
1984 Jan. 18	98,165	2,951	64,067	*60,958*	2,077	1,955	103,193	167,138	+ 450	*+0.4*	+1,892	*+1.1*	18,649	+166
Feb. 15	98,229	2,888	65,317	*62,317*	1,869	1,726	102,986	168,160	− 173	*−0.2*	+1,056	*+0.6*	18,768	+119
Mar. 21	99,650	2,950	66,543	*63,520*	2,077	1,891	104,677	171,034	+1,682	*+1.6*	+2,875	*+1.7*	18,922	+154
Apr. 18	99,955	2,914	67,823	*64,520*	2,105	1,917	104,974	172,609	+ 351	*+0.3*	+1,630	*+1.0*	18,961	+ 39
May 16	100,846	3,023	69,083	*65,450*	1,982	1,794	105,851	174,746	+ 907	*+0.9*	+2,167	*+1.3*	18,985	+ 24
June 20	102,893	3,368	70,416	*66,631*	2,209	2,006	108,470	178,683	+2,602	*+2.5*	+3,920	*+2.2*	18,979	− 6
July 18	101,869	3,296	71,727	*67,780*	2,147	1,941	107,312	178,833	−1,166	*−1.1*	+ 142	*+0.1*	18,896	− 83
Aug. 15	102,573	3,479	72,719	*68,654*	2,004	1,777	108,056	180,548	+ 730	*+0.7*	+1,701	*+1.0*	18,775	−121
Sept. 19	103,983	3,735	73,685	*69,811*	1,823	1,575	109,541	182,978	+1,473	*+1.4*	+2,418	*+1.3*	18,660	−115
Oct. 17	104,289	3,679	74,997	*71,394*	2,263	2,000	110,231	184,965	+ 691	*+0.6*	+1,988	*+1.1*	18,540	−120
Nov. 21	107,144	3,438	76,365	*72,872*	2,538	2,109	113,120	189,056	+2,890	*+2.6*	+4,092	*+2.2*	18,309	−231
Dec. 12	107,062	3,299	76,957	*73,642*	2,502	2,072	112,863	189,390	− 741	*−0.7*	− 150	*−0.1*	18,159	−150
1985 Jan. 16	107,861	3,157	78,625	*75,670*	2,698	2,431	113,716	192,074	+ 853	*+0.8*	+2,684	*+1.4*	17,979	−180

[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.
[c] In December 1984, the changes are stated after exclusion of the bank deposits and certain other liquid assets of British Telecom PLC.

6.38

Fed subsequently intervened by $15 in sterling

AT 19/2

SECRET

12

FROM: R LAVELLE
DATE: 19 February 1985

CHANCELLOR

cc Sir P Middleton
Mr Cassell
Mr Hannah

EXCHANGE MARKETS

The Bank rang me at about 6pm to report an offer by the Fed to buy sterling. In response the Bank had expressed gratitude, and they said they would of course welcome such a purchase. But if the Fed offer was rationed, they had said they wondered if it might best be put on ice until an intervention looked more propitious in market terms. The Fed saw the force of this and there matters rest for the moment.

2. The background is another day in which the dollar has shown exceptional strength against the deutschemark. It currently stands at DM 3.32. Sterling has been on the side-lines all day, holding its own against the dollar - at a level of $1.0950 or so - and strengthening against the deutschemark and in effective terms. At 6.30pm we were at DM 3.63½ with an estimated ERI of 71.7.

3. In these circumstances the Bank felt this was not the optimum moment for a Fed intervention. They also would prefer, as and when the moment comes, to spend (say) $20 m themselves and conduct a joint pincer movement.

4. There seems good tactical market sense in this. However it seems not unlikely that the Fed action reflects political promptings immediately ahead of the Prime Minister's visit. I asked the Bank, therefore, if they were sure their response would not be regarded in any wway as a rebuff. They gave me that assurance.

5. The Germans have spent $300 m today without evident effect: the Italians $70 m and the French $20 m. We have not intervened so far.

R LAVELLE

19 FEB 1985

E.R.

SECRET

File

11

MR TURNBULL 19 February 1985

At today's Funding Meeting, it was agreed that:

1. National Savings should reach the £3bn target for 1984-85.

2. The National Savings target should stay at £3bn for 1985-86 in view of the Composite Rate introduction.

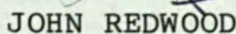
3. For Banking February the Bank is forecasting £2bn of gross gilt sales and a 0.6% increase in $£M_3$.

4. Why is private bank lending rising so fast? Partly because companies have been playing the foreign exchanges, and partly to finance VAT on imports and heavy capital spending (especially via leasing).

5. The market is expecting £9-9.5bn of PSBR, but it will probably exceed £10bn - this makes money control more difficult.

6. As much stock as possible should be sold to get as close to the money targets as possible for the year.

7. There should be some more stock offered, probably a package of tranchettes. The Bank are still keen on a full-scale long.



JOHN REDWOOD

SECRET

R30

SECRET

Prime Minister (2)

AT 18/2

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

Andrew Turnbull Esq
10 Downing Street
London SW1

18 February 1985

Dear Andrew,

THE OFFICIAL RESERVES SINCE 1979

One issue emerging from last Wednesday's EMS seminar was the evolution of the reserves over the past five years. The Prime Minister may be interested to see the attached tables. Table 1 shows the level of the reserves and how it breaks down to its four main components. Since mid-1979, the fall in the reserves is largely accounted for by the fall in our holdings of US dollars. Movements in gold reserves reflect price rather than volume variations as, to some extent, does the fall in the dollar value of our non-dollar currency holdings.

Table 2 looks at changes in the reserves, stripping out valuation changes and identifying the relative contributions of intervention and official debt repayments. Since mid-1979, the reserves have fallen by $6½ billion, more than accounted for by net repayments of official debt.

Yours ever
Rachel.

MRS R LOMAX

SECRET

TABLE 1 - COMPONENTS OF UK'S OFFICIAL RESERVES, 1979-1985

$ billion

Mid-year	US dollars+	Other foreign currency	Gold+	SDRs and IMF reserve tranche position	Total reserves
1979	12.5	4.4	4.1	1.1	22.1
1980	12.5	5.3	8.7	1.7	28.2
1981	9.0	5.1	9.1	2.4	25.6
1982	5.6	4.0	5.7	2.4	17.7
1983	4.3	3.2	7.4	2.8	17.7
1984	3.4	2.3	6.8	3.0	15.5
1985 (January)	3.8	2.2	6.8	2.7	15.5

+ including amounts pledged to EMCF

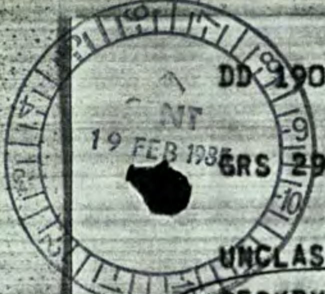
TABLE 2 - CHANGES IN THE RESERVES SINCE MID-1979

$ billion

Period	Intervention+	Debt repayments*	Valuation changes	SDR allocations	Total change in reserves
mid '79-mid '80	+ 2.5	- 1.5	+ 4.7	+ 0.4	+ 6.1
mid '80-mid '81	+ 1.3	- 4.6	+ 0.4	+ 0.4	- 2.5
mid '81-mid '82	- 2.1	- 1.2	- 4.6	-	- 7.9
mid '82-mid '83	- 1.3	- 0.4	+ 1.7	-	-
mid '83-mid '84	- 1.0	- 0.3	- 0.9	-	- 2.2
mid '84-Jan '85	- 0.7	+ 0.6	+ 0.1	-	-
Cumulative change since mid-1979	- 1.3	- 7.4	+ 1.4	+ 0.8	- 6.5

+ Market and off-market.

* Net figures. A positive sign indicates net borrowing receipts.



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M BRAITHWAITE
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PS/CHANCELLOR
M LITTLER
M LAVELLE } TSY
M LOEHNIS, B/ENG

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FM WASHINGTON 190410Z FEB 85
TO IMMEDIATE FCO
TELEGRAM NUMBER 564 OF 18 FEBRUARY

THE DOLLAR

WEEKEND PRESS REPORTS INDICATE THAT TREASURY SECRETARY BAKER HAS SOME DISQUIET ABOUT THE RECENT RISE IN THE DOLLAR. BUT HE SUGGESTS THAT INTERVENTION IS BEST CONFINED TO QUOTE DISORDERLY MARKETS. UNQUOTE

DETAIL

BAKER IS REPORTED IN THE WASHINGTON POST AND NEW YORK TIMES TO HAVE CALLED THE RECENT G5 MINISTERS' AGREEMENT A QUOTE MODERATION OF TONE UNQUOTE OF THE INTERVENTION GUIDELINES. HE BELIEVED THAT REDUCING THE FEDERAL BUDGET DEFICIT WOULD BE MORE EFFECTIVE IN THE LONG RUN IN SLOWING THE DOLLAR'S RISE THAN INTERVENTION. QUOTE I THINK THE POSITION IS BASICALLY THAT IT'S OUR VIEW THAT OPEN SQUARE BRACKET INTERVENTION IS CLOSE SQUARE BRACKET BEST DONE AND MORE PROPERLY DONE ONLY IN THE CASE OF DISORDERLY MARKETS. UNQUOTE AT THE JANUARY 17 MEETING QUOTE WE AGREED TO TAKE A LOOK AT IT WHEN TO DO SO WOULD BE HELPFUL. THAT'S A RATHER VAGUE STANDARD. WE HAVE DONE THAT SINCE THEN. WITHOUT GETTING INTO MORE DETAIL, WE HAVE INTERVENED, AND WE HAVE IN FACT DONE SO SINCE I'VE BEEN HERE. UNQUOTE IN ANSWER TO QUESTIONS ABOUT THE SUCCESS OF THE INTERVENTIONS, BAKER REPLIED QUOTE I THINK THAT THERE WAS SOME EFFECT BUT THE DOLLAR CONTINUED TO RISE NOTWITHSTANDING THOSE INTERVENTIONS. WHAT I CAN'T TELL YOU IS HOW MUCH MORE IT WOULD HAVE RISEN IF WE HAD NOT INTERVENED. UNQUOTE AN UNNAMED SENIOR OFFICIAL IS REPORTED AS SAYING QUOTE THERE'S BEEN SOME INTERVENTION IN CASES, NOT LIMITED TO DISORDERLY MARKETS. UNQUOTE ACCORDING TO THE NEW YORK TIMES, BAKER INDICATED THAT THE REAGAN ADMINISTRATION IS MUCH LESS CHEERED BY THE RISE OF THE DOLLAR THAN IT WAS A MONTH OR TWO AGO AND WAS PARTICULARLY CHAGRINED BY THE RECENT STRETCH DURING WHICH THE DOLLAR GAINED DAY AFTER DAY.

FCO PLEASE ADVANCE TO PS/PRIME MINISTER, PS/CHANCELLOR, LITTLER AND LAVELLE (HMT), BRAITHWAITE (FCO), LOEHN'S (BANK).

WRIGHT

Fi[handwritten]

A L COLEBY
Assistant Director
01-601 4541

BANK OF ENGLAND
LONDON
EC2R 8AH

14 February 1985

Andrew Turnbull Esq
10 Downing Street
London
SW1

Dear Andrew,

ACTION TO DISCOURAGE SPECULATION

I had a long session yesterday afternoon with Mr Keswick, seeking to elucidate what exactly were the propositions he wished to advance, and what thinking lay behind them. Clarity was by no means easy to achieve, but I set out below the position that I believe we reached.

The first and most important conclusion is that he does not argue that it is possible to inflict a severe penalty on speculators bearing sterling, without substantial ripple effects on domestic interest rates. He claims that he has never held that position, which would be very half-baked. The ground on which he now stands is that it is desirable to inflict severe penalty on the speculators despite the effects on domestic interest rates, and the damage to domestic institutions, that might be expected to follow.

We were not able to reach agreement on what exactly those effects might be. He did however agree that if overnight rates of 3% per diem were to be brought about, and to persist for the three business days necessary to ensure that they were brought to bear on speculators, it would be inconsistent for the rate for one month money to be below 36% per annum. Arguably it would be a good deal higher. He accepted that this sharp departure from the established experience on which existing institutional behaviour is based would cause widespread disturbance among domestic practitioners. His memorandum had singled out the discount houses, whose essential business is to provide liquidity to other banks by borrowing very short and investing somewhat longer. But he agreed that the effects could go much wider. All banks with committed borrowing facilities for customers would be in grave difficulties, which they could escape only by sharply raising base rates (in the case of base rate-related facilities) or bidding up the relevant inter-bank rates (in the case of inter-bank related facilities). That would in turn threaten the viability of customers having outstanding drawings under similar facilities. Mr Keswick's position was that the duration of the squeeze would be sufficiently short-lived for these wider repercussions to be ignored.

The upshot is, I think, that we do now see a little more clearly what policy prescription he offers, and it does not contain any new insights making our current problems easier to solve.

Our discussion on the content of his second memorandum dated 8 February was even more inconclusive. I took him through the mechanics of the existing arrangements for managing money as we understand them, starting with the virtually autonomous behaviour of banks in putting on sterling assets and finishing with the money market operations which put to use the positive cash flow which central government has at its disposal once it has achieved the funding necessary to manage M3. Whether he was unable to understand or simply unwilling to accept that version of the system I was uncertain, but he persisted in seeing our money market operations as the initiating source of a chain of transactions leading to inflated bank lending and a desperate attempt to fiddle the monetary figures through gilt sales. He was entirely explicit in believing that the behaviour of bank lending was a more valid indicator of monetary conditions than that of M3 or other monetary aggregates. His evident belief that higher interest rates would correct the overshoot of bank lending was not based on any analysis or evidence not already well known to us, but was implicitly resting to some extent on there being an accompanying supply of funds discipline on the behaviour of banks.

My conclusion from that part of the discussion was a depressing one. First, because it revealed how little understanding of the objectives and techniques of current policy there was even in quarters where one might reasonably expect it to be total: secondly, because of the readiness it revealed in those quarters to reject current policy on grounds as superficial as those of the least well-informed commentators: and thirdly because of the absence of any new insights in offering alternatives, or even of a coherent expression of the case that can be made for alternative approaches. There is no doubt that we are suffering quite a lot from the unflattering perception of policy exemplified by Mr Keswick, and should spare no efforts to counter it at every possible opportunity.

Yours sincerely,

Tony Coleby

15 FEB 1985

PERSONAL

11/2/85

I think it important that you should glance over this memorandum which came to me last Friday from Chips Keswick. I think he has some valid points which are being obscured by possibly fallacious opposition. I think it would be a good idea for him to see the Governor of the Bank of England or some top official there so that they can argue the matter through.

Chips Keswick is very intelligant and a great fan of yours.

W.W.

Enc.

10 DOWNING STREET

From the Private Secretary

11 February 1985

Dear Tony.

ACTION TO DISCOURAGE SPECULATION

No. 10 has received three approaches, each through different channels, from Mr. Keswick, urging a policy of high interest rates for overnight money as a way of discouraging speculation. A first approach gave rise to the request for the Treasury/Bank paper of 25 January on a "bear squeeze". The conclusions of that paper were fed back to Mr. Keswick who replied with his notes of 4 and 8 February.

We agreed that as these notes raise questions about the Bank's conducting of money market operations you would see Mr. Keswick in an effort to explain the position of the authorities.

Yours sincerely
Andrew Turnbull

ANDREW TURNBULL

A. L. Coleby, Esq.

Speculation against Sterling

The Nation's banking system as currently operated by the Bank of England does not appear to have a defence against speculators bearing sterling except with resort to the U.K. reserves or bringing back exchange control.

In recent times the per diem cost of borrowing money has not been sufficient to erode the profit margins of selling sterling short and borrowing to cover the position. To quote LEX on Tuesday 29.1.85 "For short-term traders, the penalty is ludicrously small, since the daily impact of the extra two points of interests costs is of the order of one two-hundredth of a cent, negligible in relation to the currency movement."

The conclusion therefore is that instead of base rates at 14% per annum a rate of 350% or 1000% per annum overnight to give a flat cost of 1% or 3% is required to discourage the speculator. Speculators only desist if they actually lose money or feel that there is a system in place to cause them to lose money. The solution which is needed is the short sharp corrective violence of 300/1000% interest rates without the ripple effect into everyones daily lives as well as the longer term damage to the economy.

At the present time the Bank of England controls the Nation's liquidity and with it short term interest rates (under one year) through the medium of the discount market.

As keeper of the Nation's books the Bank alone knows the daily shortages or surpluses on the Nation's account. First thing in the morning they publish their guess at the shortage or surplus for the day. If there is a shortage in excess of £500m the Bank purchases Treasury Bills, Bank Bills and Local Authority Bills from the discount market thereby releasing liquidity into the system. This operation is repeated at noon and again if necessary between 2-2.30 p.m. If the shortage is not completely taken out by the Bank the natural result is for short term interest rates to rise. There are other means of alleviating a shortage of liquidity:-

a) Repurchase agreement of assets from discount houses.

b) The sale and repurchase between the commercial banks and the Bank of England of percentages of the commercial bank's eligible liabilities.

c) Last resort lending facilities to the discount houses.

This entire operation puts no fear into the speculator for two reasons. Firstly he can see what is happening in advance, and secondly he is in the spot market and not the cash market. In other words he is always borrowing money two days in advance to meet his liability under a bear position. Therefore even if there is a sharp rise in the cost of money for one day he need not be caught if he is nimble due to the two day settlement period on the foreign exchange market.

For the reasons above the discount market as currently operated is too slow and too obvious to catch the speculator and it takes too long for the hidden shortage to reach the commercial lender to enable him to raise his interest rate to catch the covering speculative borrower.

cont'd..

Furthermore the combined capital and reserves of the discount market of £200m are inadequate to stand the necessary substantial losses in their books which violent upswings in interest rates would produce on their carried assets. In other words the whole market is badly financed which makes it an unlikely medium for corrective violence.

The other leg for controlling sterling interest rates are the eligible banks, lead by the clearing banks who are obliged to keep credit balances of say £200m with the Bank of England.

The daily clearing has to produce a balanced book so that the clearing banks are not overdrawn at the Bank of England and in practice they should not reduce their agreed balances much below the £200m agreed level. Under the current system the clearing banks put up their base rates on a lead from the interest rates as operated through the daily assistance provided by the Bank of England to the discount market through the four date bands of bill purchases. These rates as explained above are based on the Bank of England's view of the shortages/surpluses through their accounts. The weakness therefore is inherently the same as with the discount market in other words the speculator can always see the Bank of England and the Clearing Banks coming.

Within the present system therefore it is very difficult for the Bank of England to disguise the position, unless it puts out a false shortage on any particular day and subsequently refuses to give help, which undoubtedly would cause a sharp rise in short term interest rates, but due to the speculator dealing two days in advance might well not catch him, and everybody ends up paying except for the miscreant. The Bank therefore has to be prepared to run a shortage for a number of days in succession. Clearly the longer the period of shortage and the higher the daily rates, the greater is the danger of effecting the three month rates with its attendant influence on the economy. Here however the objective must not be lost sight of which is to regain the initiative against active and/or defensive speculation and the restoration of confidence. Introducing lack of confidence in the speculator is a key component.

Conclusion

To the outsider the Bank of England appeared in the January crisis to have an attitude of "benign neglect" so that speculators turned their attention to what others were doing and the herd instinct ran rampant.

Put another way, uncertainty makes people cover their foreign exchange positions. If every foreign receiver of sterling covers automatically you are bound to get a run on sterling due to the simple fact that there are more genuine receivers of sterling round the world than there are financial speculators. A genuine receiver of sterling may be defined as a defensive speculator, give him confidence and he will not automatically cover.

Finally there appears to be a misapprehension that there is a mysterious supply of sterling held abroad. This is irrelevant since sterling interest rates are controlled or should be controlled in London. Only a madman keeps a large number of coins in his pocket on which he is not receiving interest.

J.C.L. Keswick

4th February, 1985.

Speculation against Sterling

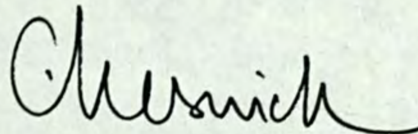
This is a sequel to my memorandum of 4/2/1985, a copy of which is attached.

A banking economist has apparently advised that very high rates of interest induced by the Bank of England through its money market mechanism for short periods, for say up to one week, would so effect the yield curve that the disruption to the economy would be too great. This begs a question, but does not give an answer. The unpalatable truth may be that money supply has been out of control. The attached graph B shows the private sector lending figures, and the point to concentrate on is the growth since the low of 1982. Graph C shows 3 months London interbank rates falling in 1983 and the first half of 1984 whereas private sector lending was rising. The conclusion to be drawn is that the Bank of England was supplying liquidity during this period to prevent interest rates from rising. How was this financed? The answer appears to be through the building up of a bill mountain which from a low start during the time of the Corset in 1980 has risen to £5b in 1981, £8b in 1982, and £10½-11b in 1984, and possibly to £13-15b today. In turn therefore how was the bill mountain financed by the Bank of England? The answer appears to be over-funding the PSBR by selling gilts. I suspect that this circle has distorted what appears to have been reasonable M3 figures in recent times. You even have to ask where has the money gone which has been lent by the banking system to the private sector, and the answer presumably is more into the stock market and overseas investment than into working capital for industry. Hence the weakness in sterling.

The conclusion that I draw is that if the bill mountain was not so high (and incidentally the discount market not so badly financed) then the short sharp shock of very high interest rates for short periods would be workable. However the whole system is so over geared when the crisis arrives that there is no leeway to take short term action.

Conclusion

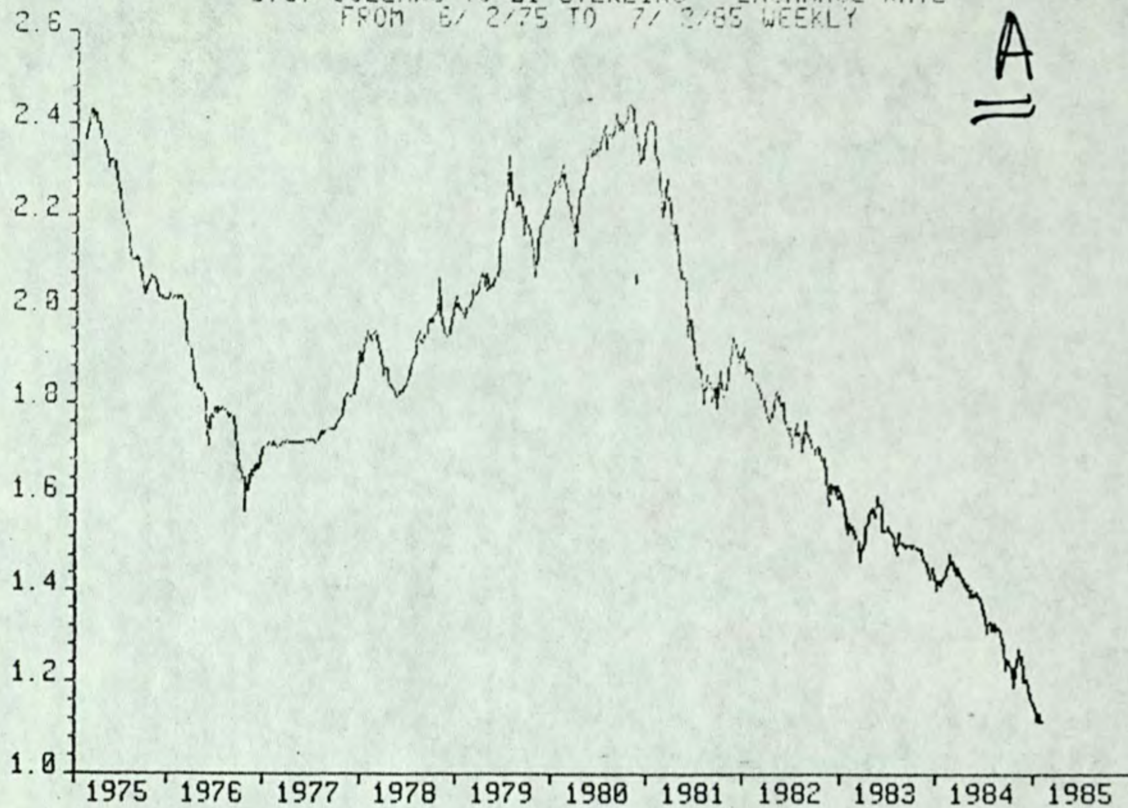
This is a complicated subject, but if banking practice were followed rather than economic theory I suspect that we would not be in the mess we now appear to be in. The key question remains why is the bill mountain so high and why is the Nation's liquidity based on a discount market which is so badly financed.



J.C.L. Keswick

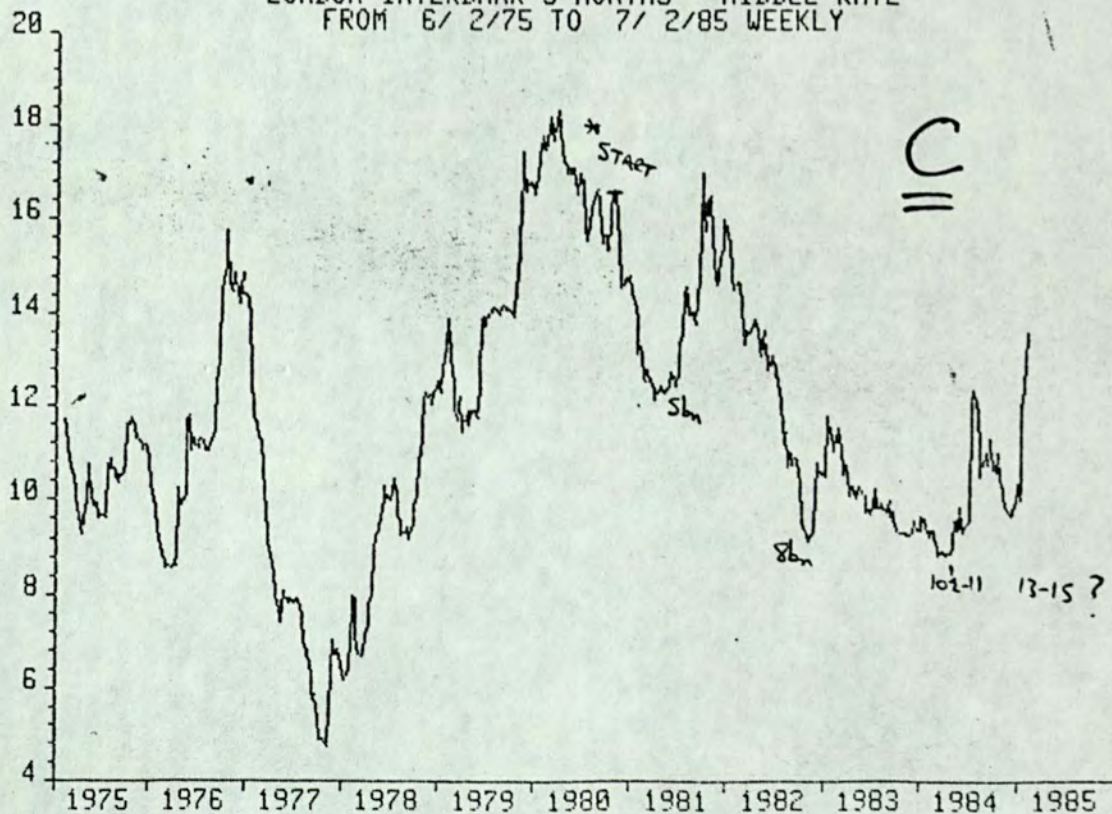
8th February, 1985.

U.S. DOLLARS TO £1 STERLING - EXCHANGE RATE
FROM 6/ 2/75 TO 7/ 2/85 WEEKLY



HIGH 2.4425 23/10/80 LOW 1.1165 7/ 2/85 LAST 1.1165

LONDON-INTERBANK 3 MONTHS - MIDDLE RATE
FROM 6/ 2/75 TO 7/ 2/85 WEEKLY

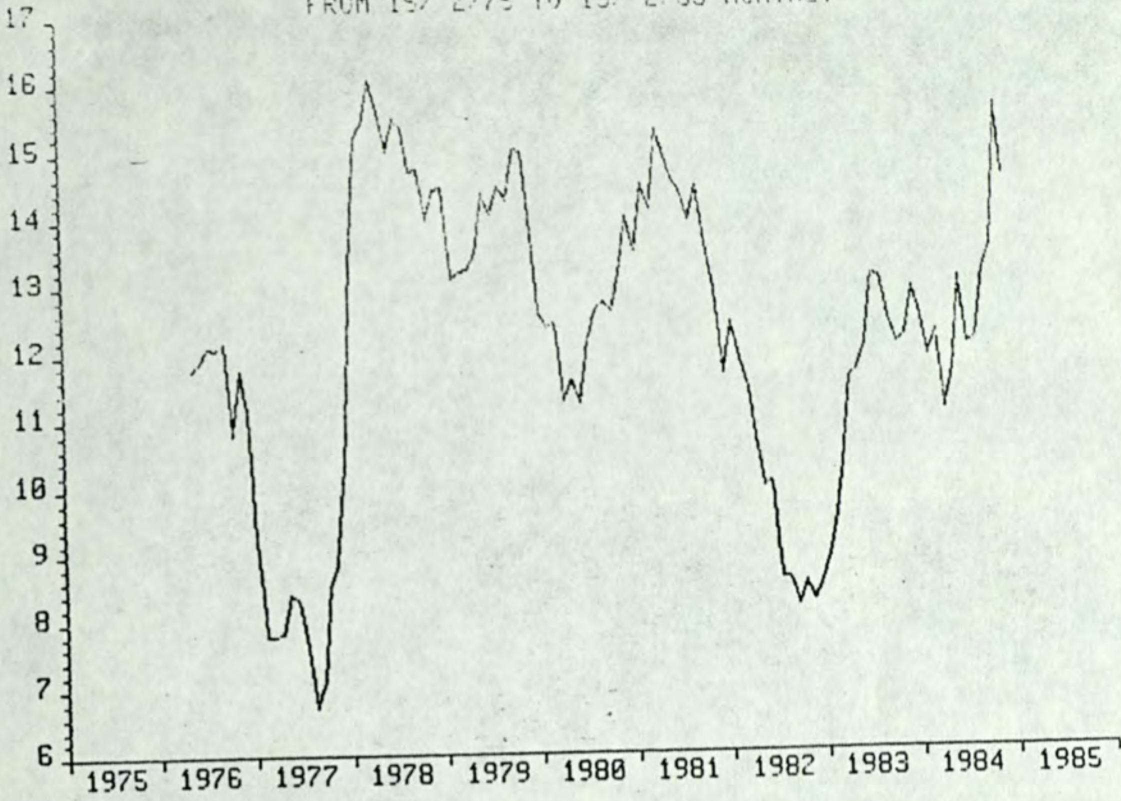


HIGH 18.375 3/ 4/80 LOW 4.781 10/11/77 LAST 13.563

* BILL MOUNTAIN

B

PCH%(UKPSL2..B,1Y)
FROM 15/ 2/75 TO 15/ 2/85 MONTHLY



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SECRET (AND PERSONAL UNTIL 2:30 PM THURSDAY 14 FEBRUARY 1985)

MONTHLY MONETARY REPORT: JANUARY-APRIL

SUMMARY

- With BT distortions unwound, it is now clear that the underlying growth of £M3 accelerated at the end of last year. The underlying growth of MO has remained around the centre of its target range.

- With the rise in base rates to 14%, monetary conditions have been tightened substantially since early January. Long term rates, nominal and real, have risen little since early January and remain below their level after the July rise in base rates.

- Bank lending was again at a very high level in January. This forecast assumes that lending has been running at an underlying rate significantly higher than assumed in previous forecasts: around £1½bn-£1¾bn a month. But there are reasons - the better outlook for the £, the high forecast PSBR, and the present pattern of interest rates - why lending could be somewhat below the level of recent months.

- Gilts sales have been very heavy in February. The figure for gross sales of £2bn, assumed in the forecast, has already been exceeded by around £250m. The usual rule of thumb would reduce £M3 growth by around 0.1% for every £150m of gilts sales.

- On the forecast the £3bn National Savings target would be met.

- MO is forecast to fall below the middle of its target range, ending the current target period (and starting the next one) with a 12-month growth rate of under 5½%.

- £M3 is forecast to fall below the top of its target range in February, with target period growth of 9.8%. Recent gilts sales could push this lower still. But it is then forecast to accelerate again, ending the target period (and starting the next one) above the top of its range.

HF3 - 8 February 1985

SECRET (AND PERSONAL UNTIL 2:30 PM THURSDAY 14 FEBRUARY 1985)

MONTHLY MONETARY REPORT: JANUARY-APRIL

Monetary Aggregates

In banking January £M3, at 0.7 per cent, grew rather more than forecast, while MO, at -0.9 per cent, fell more than forecast. All BT-related distortions to the aggregates now appear to have unwound, leaving £M3 at the top of its target range, and MO at the middle of its range. Table 1 below shows recent growth in the key aggregates, and annex table 1 provides further detail, also covering real MO and real £M3. Other measures of money are shown in annex table 4.

TABLE 1 MAIN AGGREGATES : RECENT EXPERIENCE

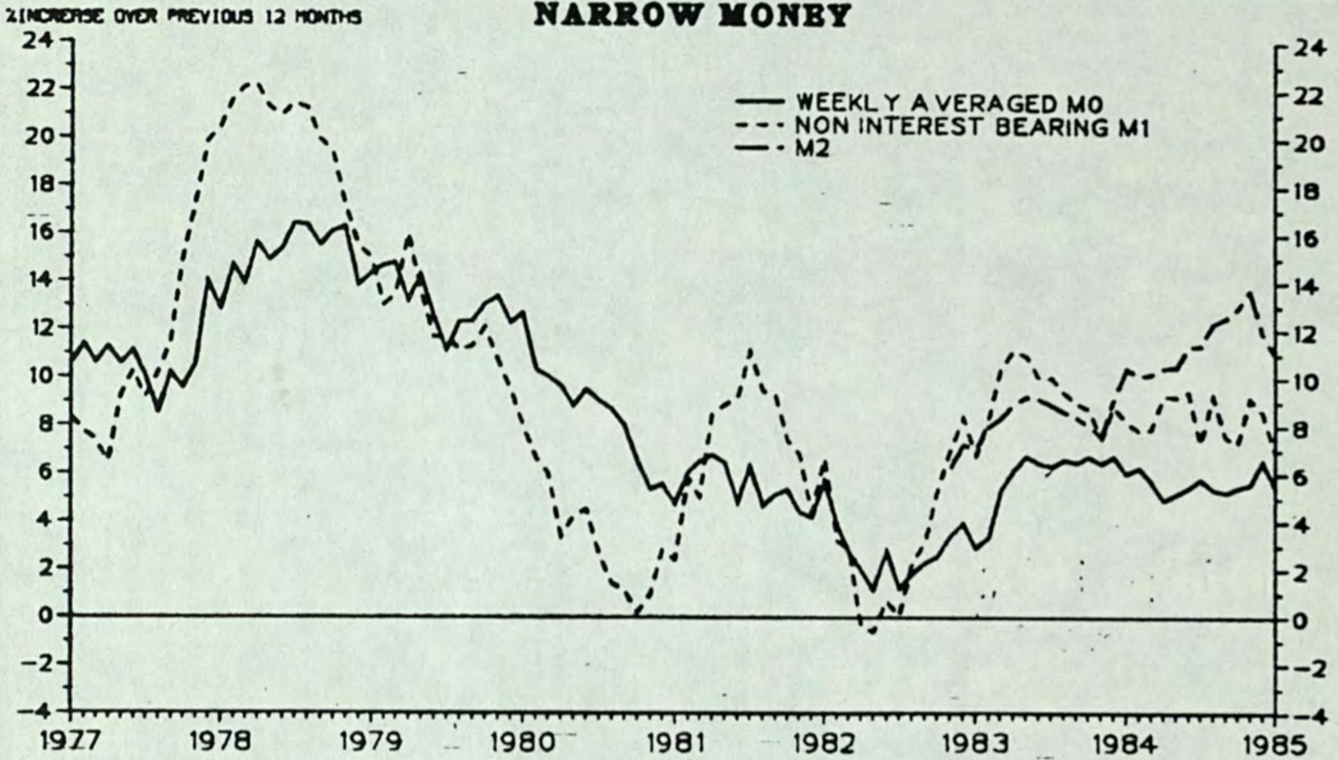
per cent, s.a

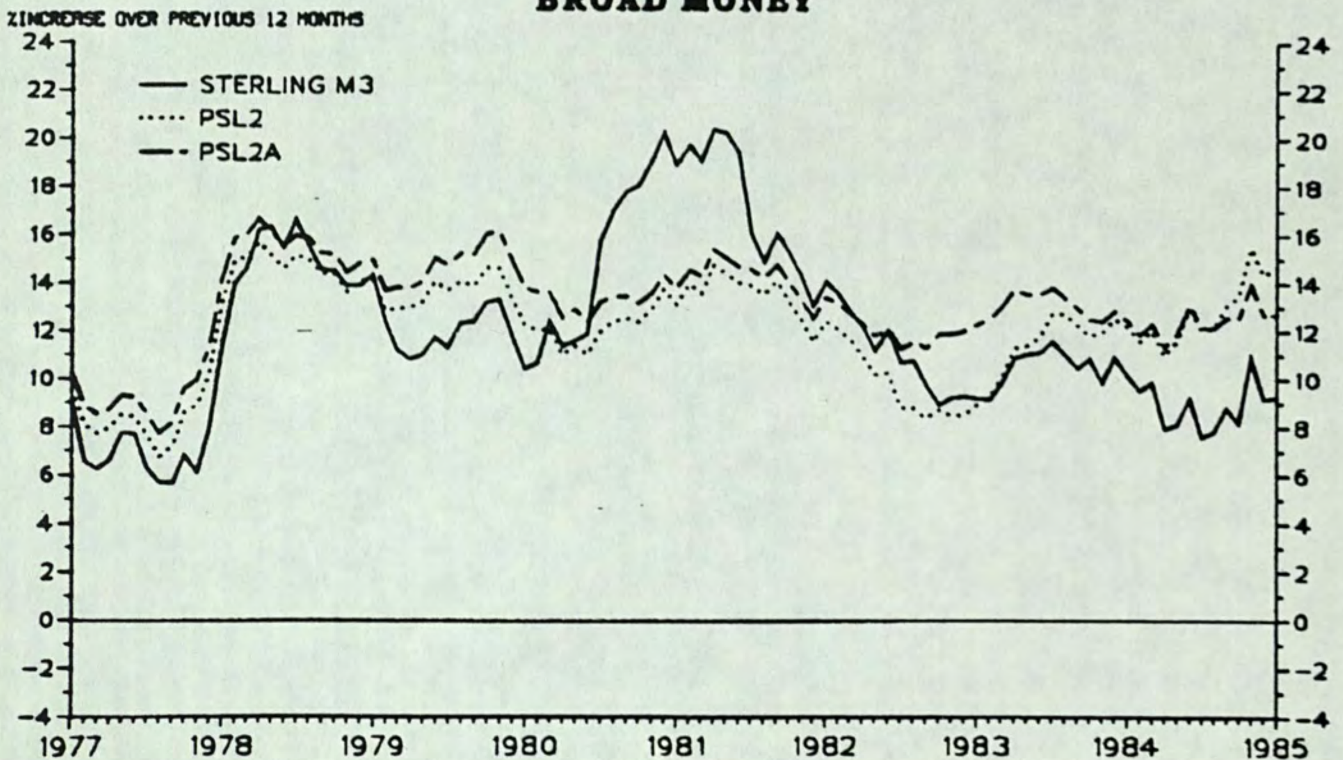
	MO	M2*	£M3	PSL2
Monthly change				
December	1.5	1.4	-0.5	-0.1
January	-0.9	0.3	0.7	1.4
Growth to mid-January at an annual rate				
over past :-				
3 months	5.0	*	12.1	15.1
6 months	5.9	*	11.0	14.8
12 months	5.4	11.2	9.3	14.7
Target Period	5.8	*	10.0	15.3

* not seasonally adjusted

2. December's sharp rise in MO, due to a temporary build up in bankers' balances at the Bank of England on account of BT has now been reversed. Underlying (ie. excluding BT effects) growth in MO this month was around +¼ per cent. All the period growth rates for MO are now back close to where they were in the Autumn. As we suspected, the rather higher growth in the intervening period, particularly in notes and coin, appears to have been temporary,

CHART I : ANNUAL GROWTH RATES OF MONETARY AGGREGATES





possibly the result of an unusual seasonal pattern. The growth in the note issue in particular has now slowed down again and only part of this can be explained by the £1 coin.

3. With the BT effect unwound, we can now also look at how £M3 has moved since the Autumn when the last relatively distortion-free figures were available. Though target period growth in £M3 is (just) in the target range, both 3 and 6 month growth rates, at 12.1 and 11 per cent respectively, are rather higher. Thus even with BT effects unwound, the underlying position appears to have worsened since late Autumn, when target period growth was around 9 per cent, and 6 and 12 month rates were lower still. The banks increasing success in attracting interest bearing retail sight deposits (in competition with the building societies and national savings) over this period has contributed to this deteriorating position. In short, rather than the steady decline in the growth of £M3 one might ideally hope for over the year, we seem to have seen an acceleration (see Chart II, which gives a "parallel lines" version of progress against the target range). On the counterparts side sterling lending has been high, averaging £1.75 bn, for 5 months now. The effect of this on £M3 has been limited by heavy overfunding over the last two months, in relation to a low "PSBR", largely due to the BT sale and accelerated VAT in imports. With an end year surge in public expenditure expected, this could prove harder to achieve in the remainder of the target period.

4. The rate of growth of PSL2 in the target period is little changed since the Autumn, but remains above 15 per cent, reflecting a sustained increase in the building society contribution to PSL2. Twelve month growth in M2 is now rather lower than in the Autumn, but higher than it was this time last year. £M3 is thus the only key nominal aggregate suggesting that the monetary situation has actually deteriorated since before BT effects began to distort the figures.

<u>**Other indicators of monetary conditions**</u>

5. <u>Inflation</u> Retail price inflation is forecast to rise from 4.6 per cent in December to around 5-5½ per cent in the first half of 1985,

SECRET

CHART II

STERLING M3 GROWTH IN 1984-85

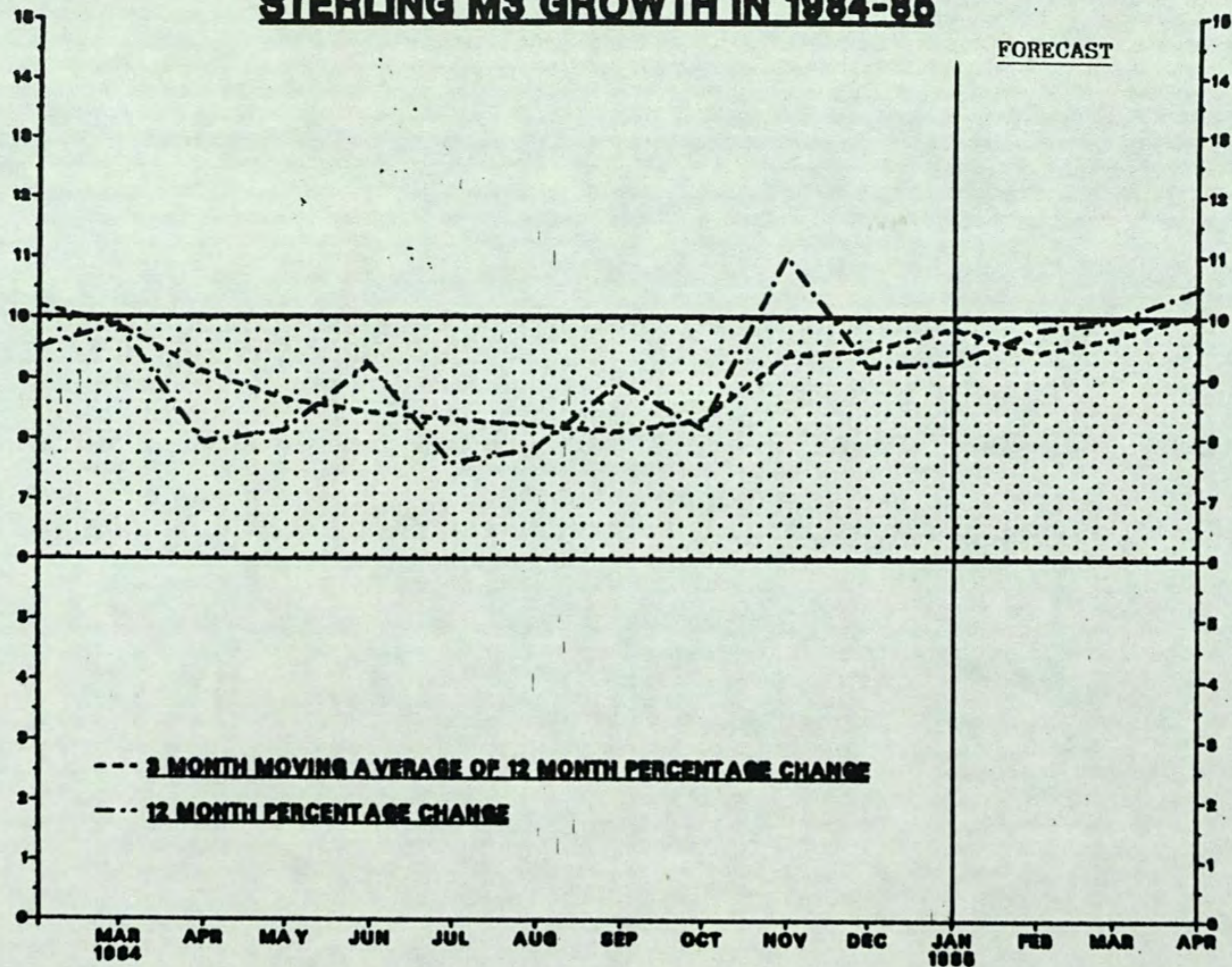
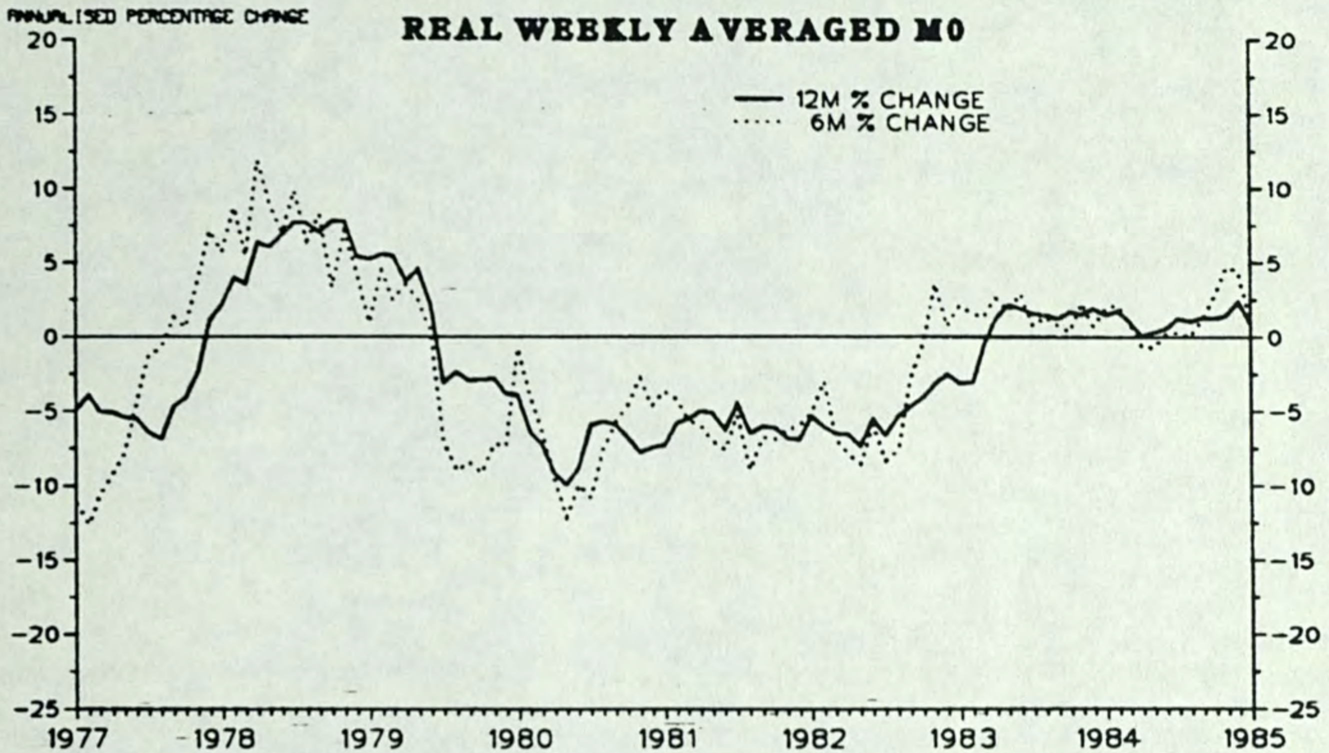
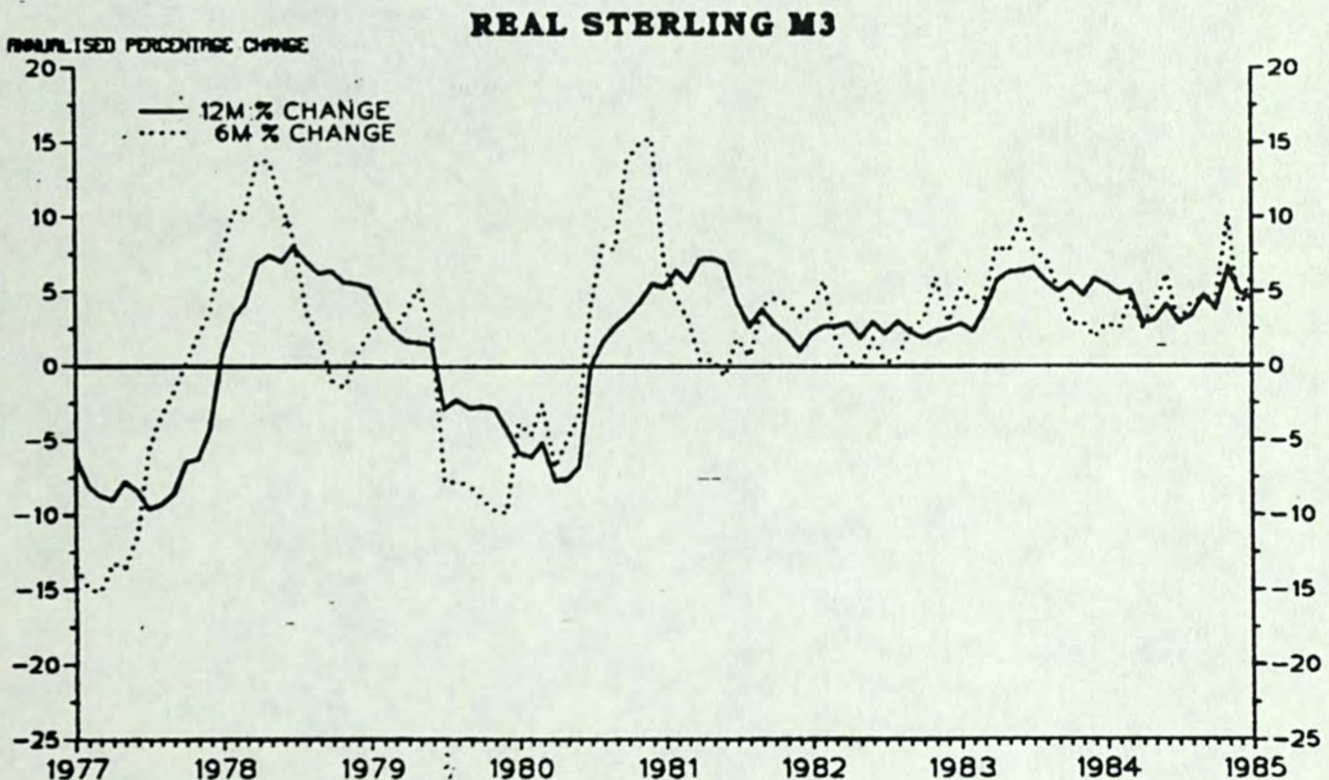


CHART III: GROWTH RATES OF REAL MONETARY AGGREGATES





REAL GROWTH RATES ARE CALCULATED BY DEFLATING BY THE GROWTH OF THE RPI EXCLUDING THE MORTGAGE ELEMENT

partly reflecting the rise in mortgage rates. Average earnings are still growing at an underlying rate of 7½ per cent; but wage settlements in the 1984-85 pay rounds so far are running about ½ per cent higher than at the same point last year. Commodity prices measured in SDR's have changed very little since July, but with the fall in sterling/rise in the $, the sterling commodity price index is 13¼ per cent higher than in July.

6. Asset prices The equity market remains at a near record level. While house prices have not been accelerating so far, there is now the first sign of an upturn. The 12-month growth in prices at mortgage approval stage had risen to 7.9 per cent in December, a rise of nearly 3.0 per cent from November.

7. Real interest rates Real short term interest rates are now higher than at any time since 1929-31 or 1921 when low nominal rates were accompanied by a falling level of prices. The only recent comparable episode was in the US in 1981 and 1982 when real rates were higher than they are currently in the UK. Although inflation expectations are probably higher than actual inflation, calculations using a comparison of yields on index-linked and conventional gilts suggests that market expectations of inflation have increased only slightly in the last month, aand that they are lower now than in mid-1984. Real long rates as measured by IG yields have hardly risen at all since the beginning of January.

8. Exchange rate Compared with its level on Budget day 1984, on 7 February sterling had fallen 24 per cent against the dollar, 11 per cent on the sterling index, and 4¾ per cent against other EMS currencies.

Three month forecast

9. The present differential between bank and building society interest rates is not thought to be sustainable for long, so exceptionally, the forecast was prepared assuming a small fall in base rates, to 13 per cent by the end of the period. The alternative would have been to assume unchanged base rates and a rise in mortgage rates. In that case, assuming unchanged funding, it seems likely,

on balance, that £M3 would grow a little more slowly than in the forecast.

10. MO target period growth is forecast to fall to 5.2 per cent by the end of the forecast (and target) period. This marked fall in trend reflects past experience that rises in short term interest rates have a substantial downward effect on MO. Growth in MO in banking February is forecast to be slightly lower than in March and April mainly because we already know that MO has fallen slightly in the first two weeks of banking February.

11. £M3 growth in banking February is now forecast at 0.6 per cent, bringing target period growth (at 9.8 per cent) temporarily back within the target range; this will be the last set of figures published ahead of the budget. This substantial improvement over last month's forecast reflects high sales of gilts and CTDs so far in banking February. Indeed, since the level of gross gilt sales assumed in this forecast has now been exceeded with over a week of banking February to go, the 0.6 figure may well be too high. As a rough rule of thumb every £150m of gilt sales should reduce the monthly and cumulative target period growth of £M3 by around 0.1 per cent, although to the extent that sales may have been more than usually to the overseas sector the effect will be less.

TABLE 2 MAIN AGGREGATES : SUMMARY OF FORECAST

per cent, s.a

	MO	M2*	£M3	PSL2
Monthly change				
February	0.2	0.6	0.6	1.2
March	0.3	1.0	1.5	1.4
April	0.3	1.5	0.8	1.2
growth to mid-January at an annual rate				
Over Past :-				
3 months	5.0	*	12.1	15.1
6 months	5.9	*	11.0	14.8
12 months	5.4	11.2	9.3	14.7
Target Period	5.8	*	10.0	15.3
growth to mid-April at an annual rate				
Over Past :-				
3 months	3.3	*	12.4	16.7
6 months	4.1	*	12.3	15.9
12 months	5.4	11.0	10.5	15.4
Target Period	5.2	*	10.5	15.6

* not seasonally adjusted

12. The forecast is consistent with the latest PSBR forecast for 1984-85, and shows a high "PSBR" of £3.6 bn for February and March combined. In the recent past we have consistently underforecast the rate of growth of sterling lending. This forecast includes an assumption for underlying lending of £1.4 bn, £150m higher than in previous forecasts (see paragraphs 24-27 below). On this basis, and assuming gross gilts sales of £1¼ bn in March and April, £M3 growth would move above the target range in banking March, reaching 10.5 per cent at the end of banking April, which is also the end of the target period. The rapid growth in March and April would also mark a very poor start to the 1985 target period if, as hitherto, it began at the end of banking February.

Public Sector Borrowing

13. In banking January the "PSBR" registered a small deficit of £0.2 bn. Within this the CGBR was also £0.2 bn and the other public sector (OPS) position was flat. While the CGBR was close to forecast, the OPS was £0.5 bn below forecast, mainly because the expected local authority surplus never occurred. It is now thought that the local authorities will not make up for this implied overshoot in the coming months.

14. The forecast is constrained to the recently completed financial year outlook for the PSBR, with the same assumptions. For the short period (second half of banking April) falling in the next financial year the forecast has been based on previous year's trends.

Table 3: Public Sector Borrowing

£ million, monthly average

	Mar-Sept 1984	Oct-Jan 1985	Forecast Feb-Apr 1985
CGBR(O)	824	-123	1123
'LABR'	185	337	211
PCBR	- 53	281	216
'PSBR'	956	495	1550

* PSBR less non-bank private sector transactions in other public sector debt.

15. Looking at table 3 it can be seen that there have been thre distinct periods in the target period. In the most recent four months both local authorities and public corporations have been borrowing considerably more than they were in the early months of the target period, while the CGBR(0), due to BT and accelerated VAT on imports, has been in surplus. In the forecast period the CGBR(O) surges due to heavy end financial year expenditure. The LABR falls back but the PCBR continues to be high. Over the next 3 months the "PSBR" is expected to average £1½ bn a month, equivalent to an annual rate of close to £19 bn.

Debt Sales

(a) Gilts

16. Gross gilt sales in the five-week month of banking January were £906m, not far short of the £1 bn target. The final call on 9¾% Exchequer 1992 'A', together with Issue Department sales of the partly paid stock left over from December, raised £418m. Sales of the three taplets issued on 17 December (£250m of 2½% Exchequer 1987 £150m of 2½% Index-linked Treasury 2001 and £100m of 2½% Index-linked Treasury 2011) were modest. Substantial volumes of stock were borrowed from the Debt Commissoners for sale in the last few days of the month when the gilts market rallied after the rise in base rates to 12 per cent on 14 January. Buying in cost £439m, mainly accounted for by 15% Treasury 1985 which matures in banking March. At the end of the month £800m of a new partly-paid long stock, Exchequer 10½% 2005, was issued to the Bank with the first and second payments timed to fall in banking February.

17. Table 4 compares the January outturn with performance over the previous 12 months and summarises the forecast for gilt sales in the forecast period. It assumes gross sales in February (a five week banking month) of £2 bn, and in March and April of £1¼ bn. The February figure has already been exceeded (after taking credit for the recent call on the new 2005 stock), the 2005 stock and the

three taplets announced on 30 January (£200m of Treasury 10½% 1989, £200m of Treasury 2½% 1995 and £100m of 10¼% Conversion 1999 having been exhausted on 7 February with more than a week to go until the end of the month.

Table 4: Gilt Sales*

monthly averages, £m

	Actual Banking January	mid-Jan 84 - mid-Jan 85	Forecast mid-Jan 85 - mid-Apr 85
Gross sales	906	1114	1500
Redemptions	- 1	- 268	- 180
Next maturities	-438	- 111	- 91
Net sales	467	735	1228
of which:-			
Monetary sector	-345	6	- 108
Public Corporations	-	- 1	-
Overseas	182	59	- 77
Non-bank private sector	630	672	1043

* Excluding repos

(b) **CTDs**

18. Last month's forecast for banking February, seasonally adjusted, was for a net outflow due to heavy surrenders in payment of tax. The new forecast includes higher surrenders, but overall is for a net inflow of over £200m, largely owing to very heavy inflows on 30 January. On the previous day, after the rise in base rates to 14 per cent appeared to have stabilised the market, new rates for CTDs were set a little under market rates at the time to take effect on 30 January. However, the market opened sharply down on 30 January and although we succeeded in suspending the scheme at 1pm, heavy inflows beat the deadline. We continue to forecast a net outflow for March, reflecting heavy forecast PRT payments, but a small net inflow for April when the peak of the tax-gathering season will have passed.

(c) National Savings

19. National Savings contributed £306m (unadjusted) to funding in banking January (£178m adjusted), slightly above forecast. The major contributors to the net inflow were accrued interest and the 29th Issue, whilst outflows from index-linked certificates were rather lower than expected at £5m in the month.

20. Over the forecast period we expect to see continuing outflows from index-linked with strong inflows from accrued interest and the Income Bond. In February we assume that total inflows will be reduced slightly by a fall in competitiveness relative to the banks and to the building societies. In particular, we expect to see a negative contribution from fixed-interest certificates as people wait to buy the 30th Issue and some money is withdrawn from maturing 19th Issue. In March sales of the 30th Issue are expected to raise inflows and the imposition of composite rate tax (CRT) on bank deposits in April suggests an increase in the competitiveness of the DNS gross products giving a further small boost to the total inflow.

21. The forecast unadjusted inflow is around £200m per month, but large negative seasonals in each month reduce the seasonally adjusted totals. The forecast suggests there will be little difficulty in meeting the £3 bn target by the end of the financial year.

The PSBR and Funding

22. Table 5 summarises net funding over the target period so far and that implied by the forecast to mid-April. The large unadjusted PSBR surplus in January meant that there was overfunding of £2.7 bn. Seasonally adjusted overfunding was £1 bn. For the financial year so far there has been overfunding both seasonally adjusted (£2.2 bn) and unadjusted (£0.4 bn).

Table 5 The PSBR and Funding

£ billion

	Actual mid Feb 84 - mid Jan 85	Forecast mid Jan 85 - mid Apr 85	mid Feb 84 - mid Apr 85
'PSBR'	8.7	4.7	13.4
Debt sales to nbps of which	-10.9	-3.6	-14.5
Gilts	- 7.0	-3.1	10.1
National Savings	- 3.2	-0.4	3.6
CTD's	- 0.9	-0.1	-1.0
Over (-)/Underfunding (+)	- 2.2	1.1	-1.2
Unadjusted	(- 0.4)	(0.3)	(-0.1)
External finance of the public sector	- 0.9	-0.2	-1.1
Over (-)/Underfunding (+) alternative definition	- 3.1	0.9	-2.2
Unadjusted	(- 1.3)	(0.1)	(-1.2)

23. In the forecast the large CGBR's are offset by large gilt sales in unadjusted terms, conventionally defined, but not seasonally adjusted. By the end of the target period there is forecast to be overfunding on all definitions.

Money market influences

24. There were large shortages in the money markets in January and these are expected to recur in February. In January the daily shortages were around £550m with the CGBR in surplus, due to seasonal tax payments and accelerated VAT, and modest funding. In February the CGBR moves into small deficit but there have been very heavy gilt sales. In the forecast the stock of money market assistance would

peak in banking March, but fall back by the end of the month to £16 bn, before declining in April as the large CGBR deficit offsets the more modest debt sales. By mid-April the stock of market assistance is forecast to be £ 15 bn. To the extent that gilt sales are higher than assumed in the forecast, and that seems likely, all these figures would be higher.

Sterling Lending to the Private Sector

25. Sterling lending to the private sector rose £2 bn last month, again exceeding expectations. Over the last 5 months lending has increased by just over £1¾ bn a month, equivalent to an annual growth rate of around 20 per cent. Part of January's figure can be explained by the particularly low 'PSBR' and accelerated VAT payments on imports. There may also have been some bill round tripping, although this may have been partially offset by the unwinding of bills issued for the same purpose towards the end of banking September.

26. The distortions to bank lending associated with the sale of British Telecom appear to have fully unwound so it is now easier to guage the underlying trend in lending. As table 6 shows recorded lending is running at between £1.4 bn and £1.7 bn a month depending upon whether you focus on the 12 month or 3 month moving average (ie. between 17% and 20% at an annual rate). Underlying lending - that is the recorded figures adjusted using estimates of the various distortions over recent months - is increasing at between £1.5 and £1.7 bn a month.

27. These figures may overstate the likely underlying level of lending in the forecast period for four reasons. First some of the extra borrowing in recent months may have been associated with concern about the sterling exchange rate and could drop off or be unwound if sterling stabilises. Second, companies would be expected to borrow less as they benefit from large public sector deficits in the next 3 months. Third, companies also appear to be meeting more of their borrowing requirements through new issues (see table 7), and there are some signs that new issues could continue

CHART IV : BANK LENDING AND FT INDEX

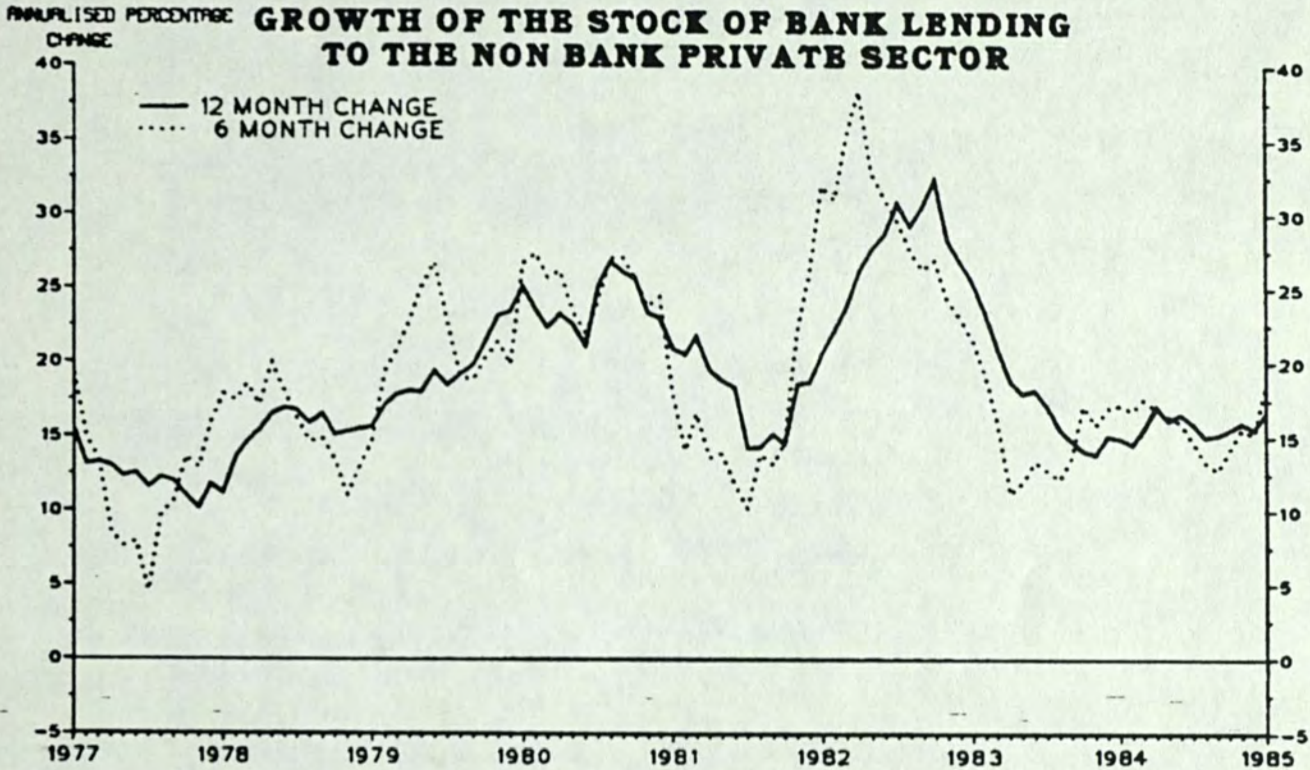


TABLE 6 £ LENDING TO THE PRIVATE SECTOR

UNDERLYING

Moving Averages of Levels, £m, s.a.

	3 Month	6 Month	12 Month
1984M1	1166	1117	1157
1984M2	1077	1171	1159
1984M3	1095	1303	1200
1984M4	1628	1397	1269
1984M5	1425	1251	1241
1984M6	1563	1329	1263
1984M7	882	1255	1186
1984M8	1098	1261	1216
1984M9	1028	1296	1299
1984M10	1638	1260	1328
1984M11	1831	1465	1358
1984M12	1788	1408	1369
1985M1	1740	1689	1472
1985M2	1566	1699	1480
1985M3	1473	1630	1463
1985M4	1400	1570	1415

Moving Average of Percentage Changes (%)

	3 Month	6 Month	12 Month
1984M1	15.2	15.0	15.9
1984M2	13.7	15.3	15.6
1984M3	13.7	17.0	16.1
1984M4	20.9	18.0	17.0
1984M5	17.8	15.8	16.3
1984M6	19.3	16.5	16.5
1984M7	10.4	15.6	15.4
1984M8	13.0	15.3	15.3
1984M9	12.0	15.5	16.3
1984M10	19.5	14.9	16.4
1984M11	21.6	17.2	16.5
1984M12	20.9	16.3	16.4
1985M1	20.0	19.6	17.6
1985M2	17.4	19.5	17.3
1985M3	16.1	18.5	16.9
1985M4	15.0	17.5	16.1

RECORDED

Moving Averages of Levels £m, s.a.

	3 Month	6 Month	12 Month
1984M1	1196	1272	1085
1984M2	1283	1278	1077
1984M3	1283	1341	1161
1984M4	1445	1320	1273
1984M5	1322	1303	1230
1984M6	1298	1290	1267
1984M7	936	1191	1231
1984M8	887	1105	1191
1984M9	850	1074	1207
1984M10	1453	1195	1257
1984M11	1773	1330	1317
1984M12	1781	1316	1303
1985M1	1742	1597	1394
1985M2	1629	1701	1403
1985M3	1551	1666	1370
1985M4	1298	1520	1357

Moving Average of Percentage Changes (%)

	3 Month	6 Month	12 Month
1984M1	15.6	17.1	14.9
1984M2	16.5	16.8	14.5
1984M3	16.2	17.5	15.6
1984M4	18.4	16.9	17.1
1984M5	16.4	16.5	16.2
1984M6	15.8	16.0	16.6
1984M7	11.1	14.7	15.9
1984M8	10.4	13.4	15.0
1984M9	9.8	12.8	15.2
1984M10	17.1	14.1	15.5
1984M11	20.9	15.6	16.0
1984M12	20.8	15.2	15.6
1985M1	20.0	18.5	16.7
1985M2	18.1	19.5	16.4
1985M3	17.0	18.9	15.8
1985M4	13.9	16.9	15.5

to run at a higher level. Fourth, the rise in base rates can be expected, on balance, to reduce borrowing, particularly since short rates have risen so far in relation to long rates.

28. We are therefore forecasting underlying lending to increase at £1.4 bn a month, rather below recent experience. Recorded lending is forecast to be somewhat lower at around £1.3 bn on average. Banking February's figures could be boosted by around £75m as a result of round tripping into CTDs offering 14¼ per cent on 30 January. On the other hand, with interbank rates remaining somewhat below base rates, some companies may have withdrawn deposits from wholesale markets and used the proceeds to reduce their bank lending. Despite our record of under-estimating the growth of lending, there are reasons for thinking this forecast could be on the high side: in particular we have made only a rather modest allowance for the impact of the very high level of forecast PSBR.

Table 7: Issues by Listed UK Companies

Calendar month averages, £m)

	Net Issues	Gross Issues Queue* (Equities)
1982	97	-
1983	234	-
1984	143	-
1984 Q1	51	850
Q2	199	1510
Q3	218	1030
Q4	106	1215
1985 Jan	274	1610**

* Excluding privatisations, currently consisting of £1bn for British Airways and £½bn for British Aerospace.

** As of Monday 4 February.

Externals and net non-deposit liabilities (NNDLs)

29. Both the externals and the NNDLs statistics for this month have been affected by the merger of Barclays Bank and Barclays Bank International and may therefore be more unreliable than usual. The externals were slightly contractionary in January, partly as a result of heavy overseas purchases of gilts and a rundown of just under £¾bn in the reserves. The private sector balance of payments moved heavily into deficit with borrowing up by £1.7bn, deposits up by only £0.3bn and foreign currency NNDLs of £0.4 bn. Over the next 3 months the externals are expected to be contractionary mainly as a consequence of a projected current account deficit which narrows over the forecast period. In banking February the reserves may fall further as net intervention of around £100m to date is not expected to be unwound in the near future. For March and April the forecast assumes no net intervention.

30. Net non-deposit liabilities were contractionary by £430m which is in line with our expected trend of £400m a month. In March and (particularly) April NNDLs may be somewhat larger as a result of known rights issues by banks.

Building Societies' Inflows

31. Retail inflows in banking January were about £250m higher than forecast. We have assumed that much of this represents unsuccessful BT money returning belatedly to the building societies via retail bank accounts. The societies probably also benefitted from private investors' profit-taking on the rise of BT share prices. It seems that rather more money went into the smaller building societies than we would normally have expected: several of these raised their interest rates slightly after losing money in the run up to the BT sale.

32. Despite the sharp decline in building societies' competitiveness (banks 7 day deposit rates have risen 3.15% net whilst the societies have increased their rates by only ¾% net) the latest weekly figures show that societies' retail inflows are holding up well. We have

assumed that inflows remain buoyant in banking February, though below the BT inflated levels in banking January. However, in March and April societies' inflows are expected to fall slightly in response to the increase in bank competitiveness. In part, offsetting this, the forecast assumes that bank rates will ease a little over the next few months. The net effect of these influences is expected to be a gradual fall in building society retail inflows from £1300m in February to £113om in April (including accrued interest and seasonally adjusted).

33. Net mortgage lending has been reasonably constant in recent months with some societies reporting a low level of demand. Recent indicators of mortgage demand over the next few months are mixed, with the figures for new commitments rising in December but falling back slightly in January. This may provide an explanation for the fairly relaxed attitude of the societies to the recent interest rate increases on the part of the banks. The societies were able to increase their holdings of liquid assets by nearly £500m over the last two months. In contrast, we anticipate some reduction in liquid assets in February as tax payments are made.

Building Societies' contribution to PSL2 and M2

34. Table 8 below shows the societies' contribution to PSL2 and M2. We expect that the building society contribution to PSL2 over the forecast period will be greater than the average over the previous 11 months. This is largely a result of the higher inflows into accounts which are part of PSL2 (ie. non-term share accounts).

Table 8: Building Societies' Inflows

	monthly rate, £m, seasonally adjusted			
	mid-Feb to mid-January	Feb	Forecast March	April
1. Total retail Inflows (including interest credited)	1074	1300	1155	1130
2. Term Shares	- 72	- 150	- 150	- 150
3. Net issues of CDs and time deposits to NBPS	+ 69	- 50	+ 75	+ 75
4. BS acquisitions of liquid assets (excl. gilts)	+ 57	- 160	+ 60	- 50
5. BS contribution to PSL2 (1-2+3-4)	+1158	+1560	+1320	+1405
6. BS contribution to M2*	+ 878	+ 820	+ 815	+ 695

* seasonally unadjusted

In March the lower building society contribution helps to explain why PSL2 is forecast to grow less rapidly than £M3. The forecast for M2 assumes that the share of money going into liquid building society accounts remains high in February as uncertainty about interest rate movements persists. Thereafter we expect that the share will fall so that over the forecast period as a whole the proportion of the inflow which is in M2 stands at the usual level of 70 per cent.

Retail Inflows

35. Table 9 draws together the forecasts for retail inflows into building societies, banks and National Savings. In banking January, total retail inflows were higher than we anticipated, probably because of profit taking after BT or because people did not pay off as much debt as we had expected. The high January figure relative to forecast suggests that we failed to anticipate an increase in the underlying level of total retail inflows last month.

36. Over the forecast period we expect that the recent rise in retail interest rates will induce a further increase in the underlying

Table 9: RETAIL FLOWS BREAKDOWN

£million, seasonally adjusted

	OUTTURN		FORECAST		
	Average Monthly Increase Since Mid-February	JAN	FEB	MARCH	APRIL
Retail Bank Deposits					
N.i. b Sight	133	-620	}		
I.b. Chequable	135	-66	} 360	380	360
I.b. Other	-10	+93	}		
TOTAL RETAIL BANK	258	-593 (-400)	360 (300)	380 (300)	360
BUILDING SOCIETIES *	1074	1598 (1355)	1300 (1190)	1155 (1055)	1110
NATIONAL SAVINGS	294	178 (140)	90 (125)	120 (90)	150
TOTAL	1626	1183 (1095)	1750 (1615)	1655 (1445)	1640

* Including Term Shares and SAYE

Figures in brackets denote last month's forecast

level of total inflows. The main features of the forecast are:

(a) Compared to previous months bank inflows are significantly higher, reflecting increased competitiveness and the increased level of saving in total.

(b) The Building societies only begin to lose deposits to the banks in banking March, reflecting lags in the system and investor uncertainty. In general the societies' inflows hold up well.

(c) National Savings lose out slightly to the banks in February, but gain ground in March and April following the introduction of the new Certificate and CRT.

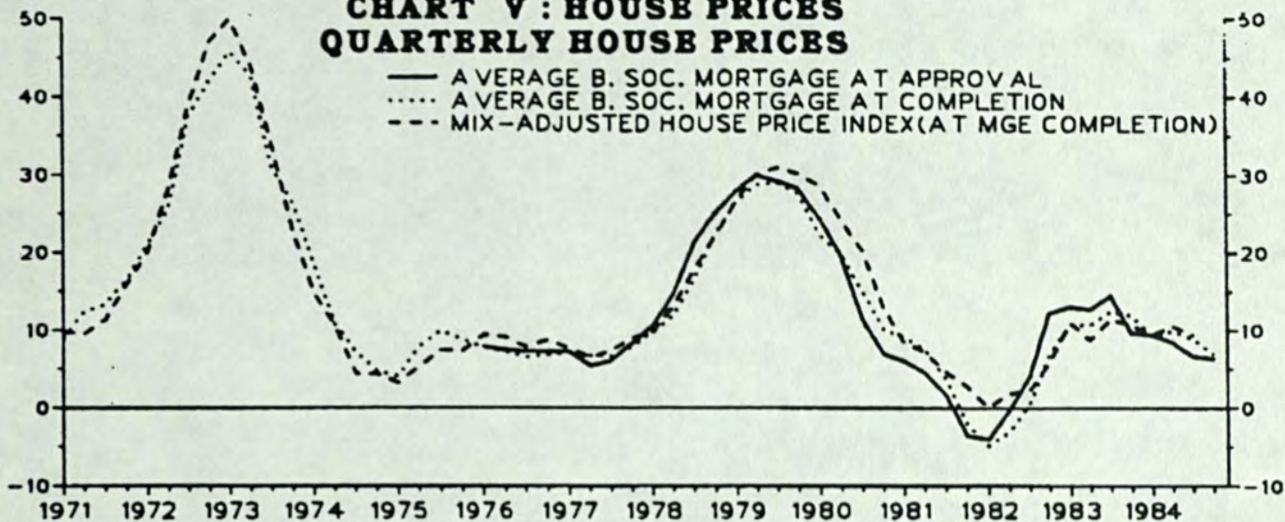
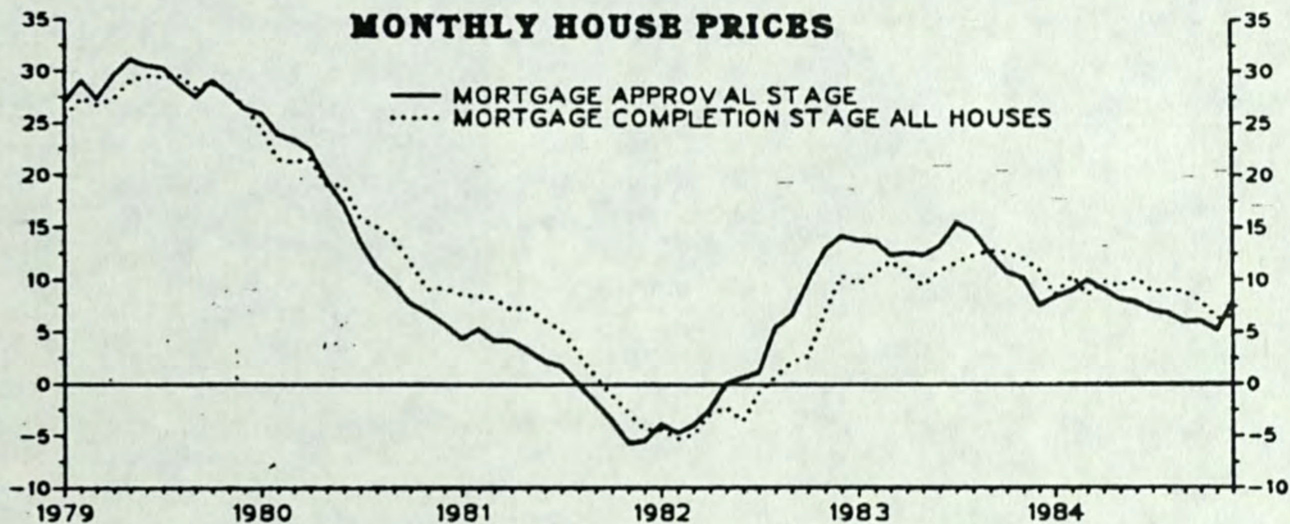


CHART V : HOUSE PRICES
QUARTERLY HOUSE PRICES
AVERAGE B. SOC. MORTGAGE AT APPROVAL
AVERAGE B. SOC. MORTGAGE AT COMPLETION
MIX-ADJUSTED HOUSE PRICE INDEX(AT MGE COMPLETION)
1971 1972 1973 1974 1975 1976 1977 1978 1979 1980 1981 1982 1983 1984


MONTHLY HOUSE PRICES
MORTGAGE APPROVAL STAGE
MORTGAGE COMPLETION STAGE ALL HOUSES
1979 1980 1981 1982 1983 1984

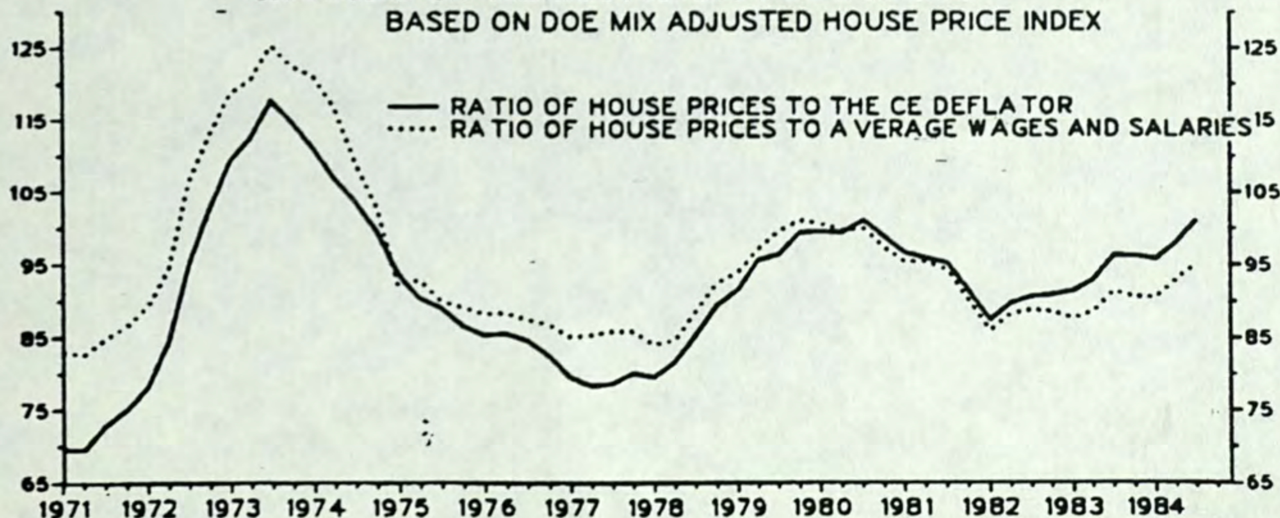

INDICES OF RELATIVE HOUSE PRICES
BASED ON DOE MIX ADJUSTED HOUSE PRICE INDEX
RATIO OF HOUSE PRICES TO THE CE DEFLATOR
RATIO OF HOUSE PRICES TO AVERAGE WAGES AND SALARIES
1971 1972 1973 1974 1975 1976 1977 1978 1979 1980 1981 1982 1983 1984

CHART VI: EXCHANGE RATE INDICES (1975=100)

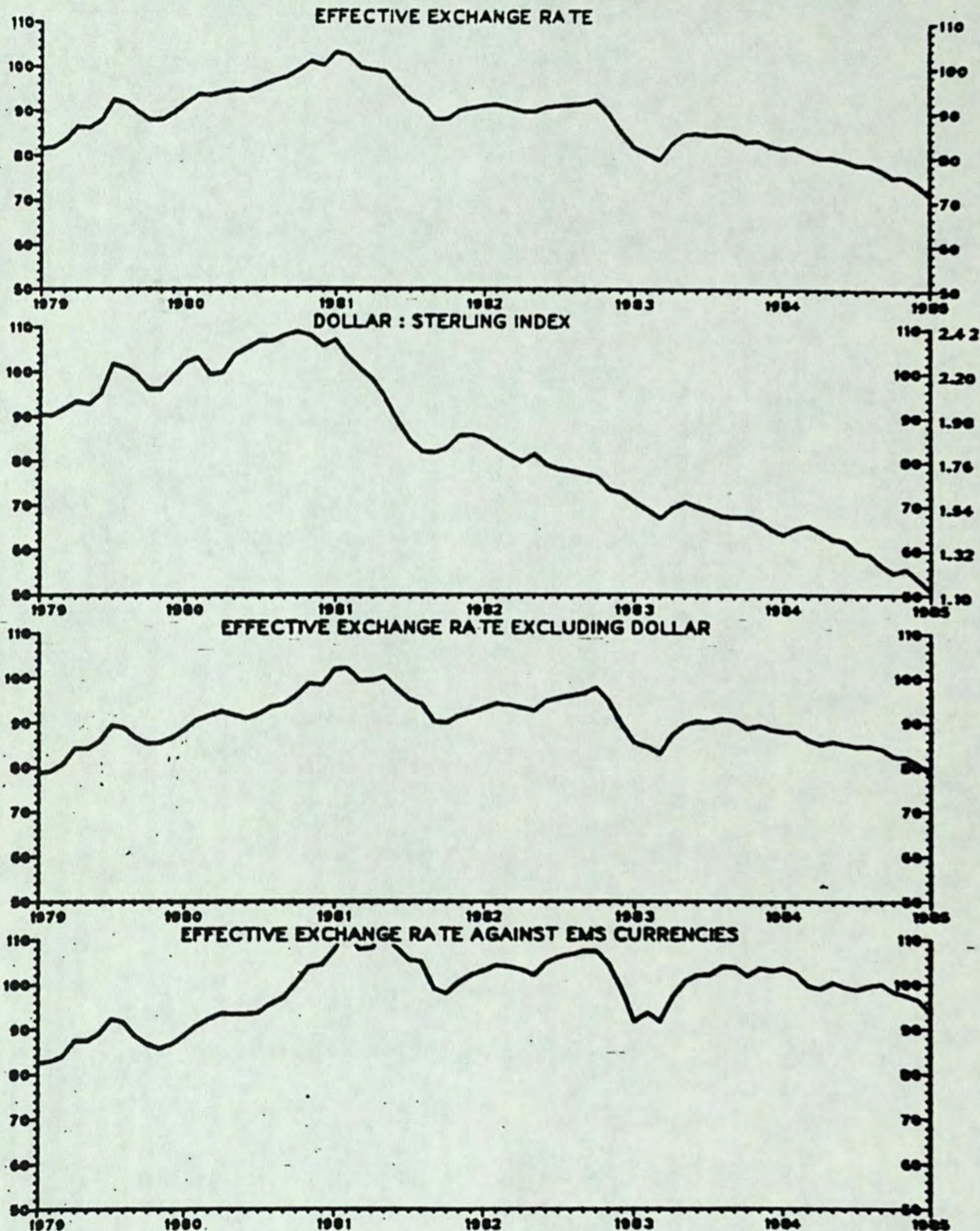


CHART VII: **ANNUAL GROWTH RATES OF WEEKLY AVERAGED NOTES & COINS AND M0**

Monthly Monetary Report: Tables

Money

1. Nominal and real target aggregates: historical
2. Monetary aggregates: forecast summary
3. Counterparts to change in £M3: forecast summary
4. Other monetary aggregates: historical

   (a) target aggregates
   (b) other narrow aggregates
   (c) other wide aggregates

5. (a) Components of £M3 : historical
   (b) Components of broader liquidity: historical
6. Composition of MO: historical
7. Retail deposits: historical

Other indicators of monetary conditions

8. Nominal and real interest rates
9. Prices and earnings

Details of forecast

10. Bank lending: forecast summary
11. Gilts: forecast summary
12. Money market influences: forecast summary

TABLE 1: PERCENTAGE GROWTH RATES IN SELECTED MONETARY AGGREGATES

		Weekly averaged MO	M2	£M3	PSL2	Real* MO	Real* £M3	RPI less Mortgage Element
(a)	Financial Years (12 month changes to banking April)(%)							
	1980-81	6.8		20.4	14.8	-5.0	7.1	12.4
	1981-82	2.0		12.2	10.9	-6.6	2.8	9.1
	1982-83	6.1	8.9	10.9	11.4	1.2	5.7	4.9
	1983-84	4.9	10.4	7.9	11.0	0.0	2.9	4.9
(b)	Changes in 12 months to (%)							
1984	February	6.3	10.1	9.5	11.6	1.7	4.8	4.5
	March	5.7	10.2	9.9	12.0	1.0	5.0	4.6
	April	4.9	10.4	7.9	11.0	0.0	2.9	4.9
	May	5.2	10.5	8.1	11.6	0.3	3.1	4.9
	June	5.4	11.3	9.2	13.0	0.5	4.1	4.9
	July	5.8	11.4	7.6	12.0	1.2	2.9	4.5
	August	5.4	12.3	7.8	12.1	1.0	3.4	4.3
	September	5.2	12.5	8.8	13.1	1.3	4.7	3.9
	October	5.4	12.9	8.0	13.4	1.2	3.8	4.2
	November	5.6	13.7	10.9	15.5	1.4	6.6	4.1
	December	6.6	12.1	9.2	14.4	2.4	4.9	4.1
1985	January	5.4	11.2	9.3	14.7	0.9	4.6	4.5
(c)	Changes (at an annual rate) in 6 months to (%)							
1984	February	6.3	11.4	6.7	9.0	2.1	2.5	4.1
	March	5.1	13.5	8.8	11.6	1.0	4.5	4.1
	April	4.1	15.3	7.4	12.0	-0.6	2.7	4.8
	May	4.0	15.7	9.2	14.1	-0.7	4.2	4.8
	June	4.9	15.6	11.2	17.1	0.2	6.1	4.7
	July	5.0	12.2	7.6	14.6	0.3	2.7	4.7
	August	4.4	13.1	8.9	15.3	0.0	4.3	4.5
	September	5.3	11.4	8.8	14.5	1.2	4.5	4.1
	October	6.8	10.8	8.7	14.6	2.7	4.6	3.9
	November	7.2	11.6	12.7	17.0	4.7	10.0	2.4
	December	8.3	8.7	7.2	11.7	4.5	3.5	3.6
1985	January	5.9	10.2	11.0	14.8	1.3	6.1	4.5
(d)	Changes (at an annual rate) in 3 months to (%)							
1984	August	4.6	10.8	7.1	13.9			
	September	4.4	7.2	4.2	9.9			
	October	6.7	10.9	9.8	14.4			
	November	9.9	12.4	18.6	20.2			
	December	12.3	10.2	10.3	13.6			
1985	January	5.0	9.6	12.1	15.1			
(e)	Changes in month to (%) (£m figures in brackets)							
1984	November	0.6(83)	1.4(1801)	2.7(2824)	2.2(4092)			
	December	1.5(210)	0.1(146)	-0.5(-536)	-0.1(-150)			
1985	January	-0.9(-125)	0.8(1094)	0.7(790)	1.4(2696)			

SECRET

TABLE 2 : PERCENTAGE CHANGES IN MONETARY AGGREGATES

per cent, s.a

Banking months	MO	NIB M1	M1	M2*	£M3	M3	PSL2	PSL2A
(1) In month								
Jan	-0.9	-1.8	-2.0	0.3	0.7	1.6	1.4	1.2
Feb	0.2			0.6	0.6		1.2	1.0
Mar	0.3			1.0	1.5		1.4	1.2
Apr	0.3			1.5	0.8		1.2	1.1
(2) latest 3 months (a.r)								
Jan	5.0	4.5	8.5	*	12.1	21.0	15.1	12.3
Feb	3.3			*	3.3		10.7	8.6
Mar	-1.6			*	11.9		17.5	14.7
Apr	3.3			*	12.4		16.7	14.1
(3) latest 6 months (a.r)								
Jan	5.9	6.2	13.3	*	11.0	16.4	14.8	12.3
Feb	6.6			*	10.7		15.3	12.7
Mar	5.1			*	11.1		15.6	12.9
Apr	4.1			*	12.3		15.9	13.2
(4) latest 12 months (a.r)								
Jan	5.4	6.8	15.0	11.2	9.3	12.0	14.7	12.7
Feb	5.5			11.8	9.8		15.3	13.2
Mar	5.2			11.4	9.9		15.0	12.8
Apr	5.4			11.0	10.5		15.4	13.0
(5) target period (a.r)								
Jan	5.8	7.2	16.0	*	10.0	12.3	15.3	13.2
Feb	5.5			*	9.8		15.3	13.2
Mar	5.3			*	10.5		15.6	13.4
Apr	5.2			*	10.5		15.6	13.4

* not seasonally adjusted

SECRET

TABLE 3: £M3 COUNTERPARTS

£ millions

	JANUARY		FORECAST			TARGET PERIOD	
	FORECAST	OUTTURN	FEB	MAR	APRIL	MID-APRIL 84 TO MID-APRIL 85	MID-APRIL 84 TO MID-APRIL 85
1. CGBR							
Own-account (u.a)	-2575	-2557	160	2560	370	7358	4083
On-lending (u.a)	535	555	135	25	785	3719	3460
Total (u.a)	-2040	-2002	295	2585	1155	11077	7543
TOTAL CGBR (s.a)	195	234	1700	605	2010	11617	9441
2. NET PURCHASES OF CG DEBT BY NBPS							
Gilts	-480	-630	-1550	-700	-880	-9415	-8246
Treasury bills	0	-12	0	0	0	191	144
National Savings	-140	-178	-90	-150	-120	-3425	-2915
CTDs.etc	-165	-194	-215	-25	945	-178	74
TOTAL DEBT	-785	-1014	-1855	-875	-55	-12827	-10943
3. OTHER PUBLIC SECTOR							
Local Authorities	-465	-50	-265	90	-135	-33	-323
Public Corps.	-45	60	310	420	-60	654	888
TOTAL OPS	-510	10	45	510	-195	621	565
4. £ LENDING TO PRIVATE SECTOR	1750	2038	1365	1280	1250	18086	15009
5.NET EXTERNALS	160	-62	-220	10	-90	-224	602
6.NET NON-DEPOSIT LIABILITIES	-330	-425	-400	-600	-450	-5037	-4175
CHANGE IN £M3 £m	480	790	635	930	1670	11445	9708
(%)	(0.4)	(0.7)	(0.6)	(1.5)	(0.8)	(10.5)*	(10.0)*
"PSBR"	-315	244	1745	1115	1815	12238	10006
OVER(-)/UNDERFUNDING(+)	-1100	-770	-110	240	1760	-589	-937

* at an annual rate

1984-85 KEY AGGREGATES **Table 4A**

TARGET AGGREGATES

		MAY	JUNE	JULY	AUG	SEP	OCT	NOV	DEC	JAN
£M3	(Exc. Public sector deposits)									
	Monthly change (£ millions)	+855	+2,062	-1,030	+734	+1,380	+324	+2,824	-536	+790
	Monthly % change	+0.8	+2.0	-1.0	+0.7	+1.3	+0.3	+2.7	-0.5	+0.7
	Three-monthly % change a.r.	+10.8	+13.6	+7.6	+7.1	+4.2	+9.8	+18.6	+10.3	+12.1
	Six-monthly % change a.r.	+9.2	+11.2	+7.6	+8.9	+8.8	+8.7	+12.7	+7.2	+10.9
	12 Monthly % change	+8.1	+9.2	+7.6	+7.8	+8.8	+8.0	+10.9	+9.2	+9.2
	% Change since Feb-83 a.r.									
	% Change since Feb-84 a.r.	+10.8	+14.7	+8.9	+8.9	+10.1	+9.2	+12.0	+10.1	+10.0
MO	Averaged weekly									
	Monthly change (£ millions)	+53	+137	+30	-17	+133	+105	+83	+210	-125
	Monthly % change	+0.4	+1.0	+0.2	-0.1	+1.0	+0.8	+0.6	+1.5	-0.9
	Three-monthly % change a.r.	+4.3	+6.2	+6.8	+4.6	+4.4	+6.7	+9.9	+12.3	+5.0
	Six-monthly % change a.r.	+4.0	+4.9	+5.0	+4.4	+5.3	+6.8	+7.2	+8.3	+5.9
	12-monthly % change	+5.2	+5.4	+5.8	+5.4	+5.2	+5.4	+5.6	+6.6	+5.4
	% Change since Feb-83 a.r.									
	% Change since Feb-84 a.r.	+4.3	+6.4	+5.7	+4.4	+5.5	+6.1	+6.2	+7.5	+5.8

CROSS CHECKS

		MAY	JUNE	JULY	AUG	SEP	OCT	NOV	DEC	JAN
PSL2	Monthly change (£ millions)	+2,167	+3,920	+142	+1,701	+2,418	+1,988	+4,092	-150	+2,684
	Monthly % change	+1.3	+2.2	+0.1	+1.0	+1.3	+1.1	+2.2	-0.1	+1.4
	Three-monthly % change a.r.	+16.8	+19.3	+15.2	+13.9	+9.9	+14.4	+20.2	+13.6	+15.1
	Six-monthly % change a.r.	+14.1	+17.0	+14.6	+15.3	+14.5	+14.8	+17.0	+11.7	+14.7
	12-monthly % change	+11.6	+13.0	+12.0	+12.1	+13.1	+13.4	+15.5	+14.4	+14.7
	% Change since Feb-83 a.r.									
	% Change since Feb-84 a.r.	+16.8	+20.1	+16.0	+15.3	+15.6	+15.4	+16.9	+15.0	15.3
M2	Monthly change (£ millions)	+615	+2,110	+1,431	+378	+488	+1,131	+1,133	+1,913	+359
unadjusted	Monthly % change	+0.5	+1.7	+1.1	+0.3	+0.4	+0.9	+0.9	+1.4	+0.3
	12-monthly % change	+10.5	+11.3	+11.4	+12.3	+12.6	+12.9	+13.6	+12.0	+11.2
	(exc re-classifications)	(+7.9)	(+8.5)	+8.7	+9.5	+9.8	+10.1	+10.8	+10.6	+10.6
Levels :	£M3 (Exc. Pub Sec Deps)	102,330	104,416	103,406	104,171	105,577	105,900	108,718	108,646	109,425
	MO (Averaged weekly)	13,295	13,432	13,462	13,445	13,578	13,683	13,766	13,976	13,851
	PSL 2	174,746	178,683	178,833	180,548	182,978	184,965	189,056	189,390	192,074
	M2 (unadjusted)	125,857	128,017	129,448	129,826	130,314	131,445	132,528	134,593	134,952

Table 4B

OTHER WIDE AGGREGATES

		MAY	JUNE	JULY	AUG	SEP	OCT	NOV	DEC	JAN
PSL1	Monthly change (£ millions)	+907	+2,602	-1,166	+730	+1,473	+691	+2,890	-741	+853
	Monthly % change	+0.9	+2.5	-1.1	+0.7	+1.4	+0.6	+2.6	-0.7	+0.8
	Three-monthly % change a.r.	+11.9	+15.6	+9.2	+8.4	+3.8	+11.2	+20.1	+10.8	+11.3
	Six-monthly % change a.r.	+8.4	+11.6	+8.3	+10.2	+9.6	+10.2	+14.1	+7.3	+11.3
	12-monthly % change	+7.8	+9.4	+7.7	+7.8	+9.0	+8.6	+11.2	+9.4	+9.8
	% Change since Feb-83 a.r.									
	% Change since Feb-84 a.r.	+11.9	+17.0	+10.5	+10.2	+11.2	+10.8	+13.4	+11.1	+10.9
PSL2A	Monthly change (£ milions)	+2,133	+2,958	+173	+1,639	+2,292	+1,885	+3,829	-290	+2,486
	Monthly % change	+1.1	+2.0	-	+0.8	+1.1	+0.9	+1.9	-0.1	+1.2
	Three-monthly % change a.r.	+15.3	+17.2	+13.4	+12.1	+8.3	+12.2	+16.9	+11.1	+12.3
	Six-monthly % change a.r.	+13.5	+15.8	+13.2	+13.7	+12.7	+12.8	+14.5	+9.7	+12.2
	12-monthly % change	+11.9	+13.1	+12.2	+12.2	+12.6	+12.5	+14.0	+12.7	+12.7
	% Change since Feb-83 a.r.									
	% Change since Feb-84 a.r.	+15.3	+18.1	+14.4	+13.7	+13.8	+13.5	+14.8	+13.0	+13.2
M3	(Exc. Public Sector Deposits)									
	Monthly change (£ millions)	-1,001	+2,068	+222	+263	+2,828	+418	+3,414	+271	+2,350
	Monthly % change	-0.8	+1.8	+0.2	+0.2	+2.3	+0.3	+2.8	+0.2	+1.8
	Three-monthly % change a.r.	+4.4	+5.9	+4.4	+9.0	+11.5	+12.2	+24.0	+14.0	+21.0
	Six-monthly % change a.r.	+9.6	+8.8	+7.7	+6.7	+8.8	+8.2	+16.2	+12.8	+16.4
	12-monthly % change	+9.2	+10.0	+9.4	+9.2	+11.3	+10.2	+12.9	+10.8	+12.0
	% Change since Feb-83 a.r.	-								
	% Change since Feb-84 a.r.	+4.4	+8.8	+7.5	+6.7	+10.0	+9.2	+12.2	+11.2	+12.3

Levels :

	MAY	JUNE	JULY	AUG	SEP	OCT	NOV	DEC	JAN
PSL1	105,851	108,470	107,312	108,056	109,541	110,231	113,120	112,863	113,716
PSL2A	195,214	199,189	199,270	200,923	203,227	205,111	208,939	209,133	211,619
M3 (ex. Pub. Sec. Deps)	117,787	119,908	120,152	120,440	123,291	123,713	127,127	127,925	130,266

Table 4C

OTHER NARROW AGGREGATES

		MAY	JUNE	JULY	AUG	SEP	OCT	NOV	DEC	JAN
NIB M1	Monthly change (£ millions)	+140	+281	-401	+668	-267	+221	+720	+271	-625
	Monthly % change	+0.4	+0.9	-1.2	+2.1	-0.8	+0.7	+2.2	+0.8	-1.8
	Three-monthly % change a.r.	+16.2	+13.3	+0.2	+6.9	-	+7.9	+8.4	+15.7	+4.5
	Six-monthly % change a.r.	+10.6	+9.4	+7.4	+11.5	+6.4	+4.0	+7.7	+7.6	+6.2
	12-monthly % change	+9.2	+9.4	+7.3	+9.3	+7.6	+7.3	+9.2	+8.5	+6.8
	% Change since Feb-83 a.r.									
	% Change since Feb-84 a.r.	+16.2	+14.9	+8.5	+11.5	+8.3	+8.3	+10.5	+10.4	+7.2
M1	Monthly change (£ millions)	+687	+857	-318	+685	+527	+791	+1,598	+422	-1,033
	Monthly % change	+1.5	+1.9	-0.7	+1.5	+1.1	+1.7	+3.3	+0.8	-2.0
	Three-monthly % change a.r.	+28.0	+22.6	+11.3	+11.1	+7.9	+18.4	+27.1	+26.8	+8.4
	Six-monthly % change a.r.	+18.2	+20.0	+16.7	+19.3	+15.0	+14.8	+18.9	+16.5	+13.3
	12-monthly % change	+13.7	+13.7	+13.5	+14.3	+15.7	+15.5	+18.5	+18.2	+15.0
	% change since Feb-83 a.r.									
	% change since Feb-84 a.r.	+28.0	+27.2	+19.3	+19.3	+18.5	+19.0	+21.8	20.7	+16.0
M2	Partially seasonally adjusted									
	Monthly change (£ millions)	+1,268	+1,804	+142	+1,326	+772	+1,262	+1,801	+146	+1,045
	Monthly % change	+1.0	+1.4	+0.1	+1.0	+0.6	+1.0	+1.4	+0.1	+0.8
	Three-monthly % change a.r.	+15.4	+15.7	+10.7	+10.7	+7.2	+10.9	+12.4	+10.2	+9.4
	Six-monthly % change a.r.	+15.7	+15.6	+12.1	+13.0	+11.4	+10.8	+11.6	+8.7	+10.1
	12-monthly % change	+10.4	+11.3	+11.3	+12.3	+12.5	+12.9	+13.7	12.1	+11.2
	% Change since Feb-83 a.r.									
	% Change since Feb-84 a.r.	+15.4	+16.1	+13.0	+13.0	+12.3	+12.2	+12.8	+11.6	+11.5
Levels :	NIBM1	32,406	32,689	32,288	32,956	32,689	32,910	33,630	34,002	33,377
	M1	45,910	46,770	46,460	47,140	47,670	48,460	50,060	50,590	49,560
	M2 (Partially S/A)	126,661	128,517	128,659	129,949	130,743	132,008	133,826	134,046	135,168

SECRET

TABLE 5 (a)

The Components of £M3

seasonally adjusted

		Notes and Coins	Banking Deposits: Retail nib	Retail ib	Wholesale	Change in £M3
		A	B	C	D	E
% change						
1982-83[1]		7.1	13.9	6.3	16.2	11.2
1983-84		5.6	11.3	-1.8	15.2	7.9
over 12 months						
1984	February	4.3	10.1	2.0	16.8	9.2
	March	4.0	9.7	-0.1	19.8	9.5
	April	5.6	11.3	-1.8	15.2	7.9
	May	4.7	12.0	-3.0	17.5	8.1
	June	5.3	12.0	-2.3	19.8	9.2
	July	5.4	8.4	-1.7	16.5	7.6
	August	5.5	11.6	-1.5	15.2	7.8
	September	5.5	8.8	-0.7	18.8	8.9
	October	5.5	8.4	0.2	15.9	8.2
	November	5.4	11.4	1.1	21.6	10.9
	December	4.8	10.7	2.9	15.4	9.2
1985	January	5.3	7.7	3.8	16.0	9.2
over 6 month at annual rate						
1984	July	5.9	8.3	3.1	12.4	7.6
	August	6.7	14.4	4.8	11.2	8.9
	September	7.1	6.0	6.1	13.8	8.8
	October	4.5	3.7	7.6	14.5	8.7
	November	6.5	8.4	9.5	19.4	12.7
	December	4.6	9.3	3.8	9.6	7.2
1985	January	4.6	7.1	4.6	19.9	10.9
£mn changes						
monthly average						
1982-83[1]		62	190	239	345	836
1983-84[1]		56	183	-39	445	645
monthly change						
1984	August	64	604	26	40	734
	September	82	-349	196	1439	1368
	October	63	158	217	-102	336
	November	58	661	365	1740	2825
	December	14	257	-137	-670	-537
1985	January	-6	-620	27	1379	781

1 April on April

SECRET

SECRET

TABLE 5 (b)

Components of Broader Liquidity

Seasonally adjusted

			Building Societies						
		Money[1]	Retail[2]	Wholesale	Liquid Assets (inc -1)	Other[3]	PSL2	PSL2A	PSL2A and National Savings
% change		F	G	H	I	J	K	L	M
1982-83[4]		10.3	11.1	-	9.2	9.3	10.8	13.2	13.1
1983-84[4]		7.9	19.0	-	-46.8	5.2	11.0	11.8	11.8
Over 12 months									
1984	February	9.3	17.6		-30.6	7.7	12.0	12.2	12.0
	March	9.5	18.5		-44.2	8.7	12.2	12.5	12.3
	April	7.9	19.0		-46.8	5.2	11.0	11.4	11.3
	May	8.2	19.2	N/A	-44.1	7.5	11.7	12.0	11.8
	June	9.3	19.7		-36.6	11.4	13.0	13.2	12.9
	July	7.6	19.5		-28.1	9.7	12.1	12.2	12.0
	August	7.8	19.4		-22.1	8.7	12.1	12.2	12.0
	September	8.9	20.1		-26.2	9.7	13.1	12.6	12.7
	October	8.2	21.6		-21.4	11.9	13.5	12.5	12.5
	November	11.0	22.7		-14.8	11.1	15.5	13.9	13.7
	December	9.2	22.4		-9.9	10.0	14.3	12.7	12.5
1985	January	9.4	22.9		-17.6	11.7	14.6	12.7	12.5
Over 6 months at annual rate									
1984	August	9.0	20.2		26.4	16.6	15.3	13.7	13.3
	September	8.8	19.1		22.8	11.3	14.5	12.6	13.1
	October	8.7	20.4		6.2	16.1	14.8	12.8	13.3
	November	12.7	22.6		-16.8	16.9	16.9	14.5	14.8
	December	7.2	21.6		-34.3	5.2	11.7	9.7	10.3
1985	January	11.1	23.8		-60.4	9.5	14.7	12.2	12.4
£mn changes									
monthly average									
1982-83		781	447	-	36	-31	1295	1677	1849
1983-84		639	852	59	-100	38	1488	1711	1911
monthly change									
1984	August	675	878	-3	121	31	1702	1640	1902
	September	1391	1029	115	-222	91	2404	2278	3239
	October	307	1473	104	-338	436	1982	1879	2045
	November	2857	1568	-149	-300	109	4085	3822	4039
	December	-547	789	-19	-189	-185	-150	-290	-216
1985	January	808	1778	250	-300	160	2696	2498	2573

1. £M3 less deposits of over 2 years maturity.
2. Net inflow excluding Term shares, SAYE, CD's and Time deposits
3. Treasury bills, bank bills, LA temporary debt, CTD's and some national savings accounts.
4. April on April.

SECRET

26/7 TABLE 6

GROWTH RATES OF COMPONENTS OF WEEKLY AVERAGED MO

		Notes and Coins	Bankers Balances	Total MO
(a)	Financial Years (12 month change to banking April) (%)			
1980-81		5.9	27.4	6.8
1981-82		2.1	-0.2	2.0
1982-83		6.6	-15.6	6.1
1983-84		5.4	-23.4	4.9
(b)	Changes in 12 months to (%)			
1984	February	5.9	39.3	6.3
	March	5.6	15.9	5.7
	April	5.4	-23.4	4.9
	May	5.2	5.3	5.2
	June	5.3	20.1	5.4
	July	5.4	57.1	5.8
	August	5.4	1.2	5.4
	September	5.4	-9.7	5.2
	October	5.4	7.2	5.4
	November	5.6	5.3	5.6
	December	5.1	129.7	6.6
1985	January	6.2	-37.4	5.4
(c)	Changes (at an annual rate) in 6 months to (%)			
1984	February	5.7		6.3
	March	4.4		5.1
	April	4.3		4.1
	May	4.6		4.0
	June	4.6		4.9
	July	6.0		5.0
	August	5.1		4.4
	September	6.4		5.3
	October	6.5		6.8
	November	6.6		7.2
	December	5.6		8.3
1985	January	6.3		5.9
(d)	Three month moving average change (£m) (% change at an annual rate in brackets)			
1984	August	41 (3.8)	9	50 (4.6)
	September	62 (5.7)	-13	49 (4.4)
	October	69 (6.4)	4	74 (6.7)
	November	102 (9.5)	5	107 (9.9)
	December	60 (5.5)	72	133 (12.3)
1985	January	69 (6.3)	-13	56 (5.0)
(e)	Changes in the month to (£m) (% changes in brackets)			
1984	November	81 (0.6)	2	83 (0.6)
	December	34 (0.3)	176	210 (1.5)
1985	January	92 (0.7)	-217	-125 (-0.9)

TABLE 7: RETAIL DEPOSITS

Seasonally adjusted

	BANKS interest bearing deposits	non-interest bearing deposits	Total	Building[1] Societies	National[2] Savings
% Change					
1982-83[3]	6.3	13.9	8.7	17.3	15.8
1983-84[3]	-1.8	11.3	3.2	18.7	14.3
Over 12 months					
1984 February	2.0	10.1	5.1	16.9	13.3
March	-0.1	9.7	3.6	17.6	14.2
April	-1.8	11.3	3.2	18.0	14.5
May	-1.8	11.3	3.2	18.0	14.5
June	-2.3	12.0	3.1	18.6	14.1
July	-1.7	8.4	2.1	18.2	13.8
August	-1.5	11.6	3.4	17.9	13.8
September	-0.7	8.8	3.0	17.4	15.7
October	0.2	8.4	3.4	17.6	14.9
November	1.1	11.4	5.0	17.5	14.7
December	2.9	10.7	6.0	16.7	14.0
1985 January	3.8	7.7	5.4	16.7	13.7
Over 6 months at annual rate					
August	4.8	14.4	8.5	15.3	12.0
September	6.1	6.0	6.1	13.9	17.8
October	7.6	3.7	6.0	14.5	17.5
November	9.5	8.4	9.0	15.6	17.7
December	3.8	9.3	6.0	14.6	16.3
1985 January	4.6	7.1	5.6	16.1	15.6
£mn changes					
monthly average					
1982-83[3]	239	190	429	864	257
1983-84[3]	-39	183	144	1050	271
monthly change					
1984 August	26	604	630	762	238
September	196	-349	-153	919	971
October	217	158	375	1359	221
November	365	661	1026	1343	292
December	-137	257	120	639	87
1985 January	27	-620	-593	1598	178

Notes

1. Total retail funds, including terms shares and SAYE.
2. Total inflows
3. April on April.

TABLE 8

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NOMINAL AND REAL INTEREST RATES

		NOMINAL RATES				REAL RATES				
		Three month interbank	Three month Eurodollar	Base Rate	Long Rate (20 year Gilts)	Expected inflation over 12 months*	Real 3-month interbank rate	Yield on Index-linked Gilts** 1988	1996	2011
1982	(1)	14.3	15.1	14.1	14.7	10.3	4.0		3.0	
	(2)	13.4	15.1	12.8	13.7	9.2	4.1	3.5	3.4	3.0
	(3)	11.5	12.6	11.4	12.2	8.0	3.4	3.6	3.3	3.0
	(4)	9.9	9.9	9.7	10.8	6.3	4.8	2.7	2.6	2.7
1983	(1)	11.1	9.2	10.8	11.5	6.3	4.8	2.7	2.6	2.5
	(2)	10.2	9.4	10.0	10.5	6.2	4.0	3.7	3.2	2.7
	(3)	9.8	10.1	9.5	10.9	6.3	3.5	4.2	3.6	3.1
	(4)	9.4	9.9	9.0	10.4	6.0	3.4	3.7	3.5	3.0
1984	(1)	9.2	10.1	8.9	10.3	5.8	3.4	4.1	3.6	3.2
	(2)	9.3	11.4	8.9	10.9	5.6	3.4	4.8	3.8	3.3
	(3)	11.1	11.7	11.0	11.2	5.5	3.7	5.6	4.4	3.7
	(4)	10.1	9.8	10.0	10.6	5.6	4.5	4.7	3.8	3.2
1984	March	9.0	10.4	8.7	10.3	5.7	3.3	4.4	3.8	3.3
	April	8.9	10.9	8.6	10.4	5.6	3.3	4.4	3.6	3.2
	May	9.6	11.6	9.0	11.0	5.4	4.2	4.8	3.8	3.3
	June	9.5	11.8	9.2	11.2	5.7	3.8	5.1	4.0	3.5
	July	11.6	11.7	11.5	11.7	5.6	6.0	5.7	4.4	3.7
	August	10.9	11.8	10.9	11.0	5.5	5.4	5.5	4.4	3.7
	September	10.8	11.6	10.5	10.8	5.5	5.3	5.5	4.4	3.6
	October	10.6	10.7	10.5	10.8	5.6	5.0	4.7	3.9	3.2
	November	9.9	9.6	9.9	10.4	5.6	4.3	4.7	3.7	3.2
	December	9.8	9.0	9.5	10.5	5.7	4.1	4.8	3.7	3.1
1985	January	11.3	8.3	11.0	10.9	5.7	5.6	5.2	3.8	3.3
	February 6	13.6	8.8	14.0	11.1	5.8	7.8	5.1	3.8	3.3

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

** Average of yields calculated for each Friday of month or quarter. Assumes inflation averages 5 per cent per annum to redemption.

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TABLE 9

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PRICES AND EARNINGS (% change on same period a year before)

	Retail Prices	Producer Price Index (All manufactured products)		Underlying Average Earnings	Unit Wage Costs*	Commodity Prices***
		Output Prices (home sales)	Input Prices			
1982 (1)	11.1	9.5	13.2	10.8	3.8	-4.4
(2)	9.3	7.7	7.6	10.1	5.2	-9.4
(3)	8.0	7.4	4.8	8.9	5.8	-12.4
(4)	6.2	6.5	4.0	8.4	6.1	-8.9
1983 (1)	4.9	5.3	5.6	7.9	3.4	-1.3
(2)	3.8	5.6	6.7	7.5	3.3	16.3
(3)	4.6	5.4	8.1	7.7	1.7	20.1
(4)	5.0	5.6	7.5	7.8	1.3	19.8
1984 (1)	5.1	6.0	7.2	7.8	3.3	15.5
(2)	5.1	6.3	8.4	7.8	3.2	-3.8
(3)	4.7	6.1	7.2	7.5	4.8	-13.8
(4)	4.8	5.9	9.2			-10.7
1984 March	5.2	6.5	7.0	7.8	4.6	11.8
April	5.2	6.6	8.7	7.8	3.6	3.8
May	5.1	6.3	8.5	7.8	3.1	-5.2
June	5.1	6.2	8.1	7.8	2.8	-10.0
July	4.5	6.3	8.4	7.5	4.3	-13.9
August	5.0	6.2	6.6	7.5	4.7	-13.2
September	4.7	6.0	6.6	7.5	5.3	-14.2
October	5.0	6.0	9.4	7.5	5.3	-12.3
November	4.9	5.9	9.3	7.5	4.9	-9.7
December	4.6	6.0	9.0	7.5		-9.9
1985 January	(4.9)	6.2	8.4			-10.7

* In manufacturing - percentage change of the latest 3 months on the same 3 months a year earlier.

** Department of Employment estimate.

*** Economist industrial (non-oil) commodity price index in SDRs.

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SECRET (AND PERSONAL UNTIL 2.30PM, THURSDAY 14 FEBRUARY 1985)

Table 10: Sterling lending to the private sector

£ million
Seasonally adjusted

	Actual			Forecast		
	NOV	DEC	JAN	FEB	MAR	APR
Adjusted lending	1920	1680	1470	1400	1400	1400
Bills held by NBPS(-)	- 60	+ 35	+170	+125	-	-100
PSBR offsett	-955	-195	+295	-285	-200	+ 80
Round tripping	-	-175	+ 75	+ 75	-	-150
Capital allowances	-	-	-	+ 50	+ 50	+ 50
Accelerated VAT on imports	-	-	+525	-	-	-
B.T.	+800	-250	-500	-	-	-
Actual/forecast recorded lending	1705	1485	2035	1365	1250	1280

Table 11: Gilts

£ million

	Actual			Forecast		
	NOV	DEC	JAN	FEB	MAR	APR
Calls*	-	337	331	420*	-	-
Other gross sales	1459	- 15	575	1330	1250	1250
'GROSS' SALES	1459	322	906	2000	1250	1250
Buying-in next maturities≠	- 43	-193	-438	-25	-	-250
Redemptions	- 2	- 1	- 1	-	-390	-150
TOTAL NET SALES	1414	128	467	1775	860	850
Purchases (-) by:						
Overseas	-111	- 79	-182	-200	70	-100
Banks	-163	112	130	} -225	- 50	- 50
LDMA	-105	226	215	)		
Public Corporations	-	-	-			
NET SALES TO NBPS (+)	1035	387	630	1550	880	700

* of which calls on : - 10½ Exchequer 2005
-

≠ of which, buying in of: - 3% Treasury 1985 to be redeemed on 21 May
-

3/2d

SECRET (AND PERSONAL UNTIL 2.30 PM, THURSDAY

Table 12: Money Market Influences

£ million
not seasonally adjusted

	Actual	Forecast		
	JAN	FEB	MAR	APR
A. Money market influences				
CGBR (increase +)	-1840	276	1086	2474
Reserves etc (+)	-104	-100	-	-
Notes and coin (-)	568	-20	-105	-355
National Savings (-)	-306	-195	-190	-145
CTDs (-)	71	-30	100	-75
Gilts (-)	-465	-1975	-860	-850
Other Exchequer items etc	-110	-	-	-
TOTAL MONEY MARKET INFLUENCES (Market surplus + / shortage -)	-2186	-2044	31	1049
B. Money market operations				
Commercial bills (purchase +)				
- Issue Department	-2016			
- Banking Department	3151			
LA bills (purchase +)				
- Issue Department	237			
- Banking Department	82			
Treasury bills (purchase +)	241			
Market advances	88			
Other	389			
TOTAL MONEY MARKET OPERATIONS	2172	2044	-31	-1049
Change in bankers' balances	-15			
TOTAL ASSISTANCE OUTSTANDING*	13995	16039	16008	14959

* excluding Treasury bills

Domestic Mon. Policy

THE
R.A.O. BRIDGE MEMORIAL LECTURE

The Stock Exchange at the Turning Point

Delivered by

Sir Nicholas Goodison

Chairman of The Stock Exchange

6th February 1985

THE STOCK EXCHANGE AT THE TURNING POINT

I am greatly honoured this evening to have been invited to deliver the R.A.O. Bridge Memorial Lecture for 1985. Not only do I follow a long line of distinguished lecturers. I am also given the opportunity to underline the importance to the City of London of gifted practitioners like Roy Bridge. The City is not short of stars whose names adorn the financial pages of our newspapers. It is as well to be reminded from time to time of the vital role played over the years by skilled dealers whose names are not put up in lights but who actually make the City's markets work. Without them the City of London would not enjoy the high reputation it has today. It is right that your association should commemorate the memory of Roy Bridge, and indeed all those like him, in this way.

I need not remind this audience that The Stock Exchange is a market. You often would not know it from reading much of the commentary on its affairs: and we have sometimes contributed ourselves to the mystique when talking about The Stock Exchange as a channel for savings or when emphasizing its role as a regulatory authority. But first and foremost it is a market. It is a market where Government and industry can raise capital and a market where savers can freely buy and sell the securities which represent the money they have lent to Government or put at risk in industry. Everything else to do with The Stock Exchange is built round its market — its membership rules, which have evolved since the first formal agreements in the late eighteenth century; the rules for the financial standing of its members; the rules which regulate dealings in securities; the rules regulating the settlement of business; the generous arrangements for compensating investors who lose money if a member firm fails; the listing requirements which are imposed on companies whose securities are listed in the market, including the regular publication of information; the publications and information systems through which The Stock Exchange conveys both company news and market information to practitioners and to the public; and all the panoply of rules, regulations, codes, checks, inspections and disciplinary procedures which are the necessary work of a major regulatory authority. At the core of all this there is a market, and none of it would exist without it.

It is not only one market. It is a market in fixed interest securities, in equity securities, in a whole range of securities in between, in options and so on. It is a market in UK securities and in the securities of every other free country in the world.

The Stock Exchange is going through a period of change. Some would say that this is the understatement of the century. It is going through a period of very public change and a period of concentrated change. Everything is happening very fast in a very short time.

It is worth trying to stand back for a moment and to look with the eye of an historian on how we got to where we are and then, switching the historian's hat for the prophet's, to make an attempt to see where we are going. These are the two subjects which I will try to cover this evening.

When I joined The Stock Exchange in 1958 the UK economy was only just being freed from many of the post War controls. The excess levy on company profits had been abolished in 1954. Building controls were abolished in 1958. The artificial distinction between distributed and undistributed profits was abolished in the same year. The cult of the equity had not quite arrived. People had not woken up fully to the prospect that income from ordinary shares could rise substantially faster than the rate of inflation. Institutional investors were only a minor part of the scene. Their holdings of ordinary shares accounted for under 18% of the total. Funded pension schemes were in their boyhood if not their infancy. Trading conventions in the stock market were set in ways which were laid down by regulations going back to the early years of this century. Broking members acted as agents, jobbing members as principals, and severe rules prevented each of them from poaching on the other's preserve. These rules meant that everyone in the market knew where he was and they provided a high degree of inbuilt protection to the investor. They also ensured a fluid and continuous market because the compact between the two categories of member meant that all business came to the market, thus ensuring maximum liquidity. There were 313 firms of brokers in London and 108 firms of jobbers. They were nearly all partnerships and partnership laws forbade any partnership to be larger than twenty partners. There was a large market in gold shares, dollar stocks and other overseas securities derived from Britain's imperial traditions, on the floor of the market. The telephones were ancient and often more inefficient than they are today. There was no trunk dialling. Instructions from customers arrived by post or by cable. The typewriters were upight, as were the ladies (and often gentlemen) behind them. There were very few calculating machines and the ones that existed worked on nineteenth century mechanical principles. There was no central settlement system: Accounting was largely done by hand. Business was checked by word of mouth in the basement of The Stock Exchange on the following morning. The Stock Exchange's information system relied entirely on the letterpress. Analysts had hardly been heard of.

What changes we saw in the next two decades. The institutional investor grew and grew (so did the

number of analysts). Partly to fund continuing Government deficits and partly to satisfy the appetite of mushrooming pension funds in an inflationary age, Government debt also grew, until it became three quarters of the market. The markets in foreign stocks gradually shrank. Individual investors found it expensive to buy them owing to exchange control restrictions, while institutions found it convenient to do their shopping abroad or with the foreign securities houses who came to London partly in order to satisfy their demands. The technology of communications, accounting, settlement and the distribution of information changed out of all recognition.

It is worth dwelling on some of the other changes at greater length, because they are much in the news today.

First, the membership of The Stock Exchange. In 1967 the law was changed so that partnerships could exceed twenty partners. This in itself did not cause change in The Stock Exchange. It was, however, a reflection of the compelling need for greater strength and greater diversity in a whole range of professional services. The Stock Exchange membership for example concentrated sharply in the 1960's and 1970's. By 1980 there were only 103 broking firms in London and (more remarkable) only 14 jobbing firms. A similar contraction had taken place outside London. Jobbing firms had to concentrate, partly in order to spread the risks of being involved in too few markets, and partly in order to pool capital resources. This was necessary in order to cope with the larger risks involved in transacting business for institutions and business in the ever-increasing gilt-edged market. Broking firms, despite the lesser need for capital involved in agency business, also had to finance development including, for example, overseas offices, and also wished to diversify their risks and increase resources in order to satisfy an increasingly sophisticated clientele.

In 1969 the Council of The Stock Exchange, recognising that firms needed to tap outside capital, changed the rules to allow member firms to form themselves into limited companies and to take in outside shareholders. From that day firms have been allowed to sell 100% of their capital to outsiders. In order to preserve the integrity of the market and to avoid domination by any one outside investor, a limit of 10% was placed on any one investor. Very few firms took advantage of this change. Partly this was because most broking firms did not need it. Mostly, I suspect, it was because of the peculiarly favourable tax treatment in the UK of partnerships. It was not worth giving up the tax advantages by incorporating. I need not remind this audience that the amazingly complex tax structure of the UK was a major and unfortunate preoccupation of businessmen in the 1960's and the 1970's and did much to divert them from thinking about strategic growth and profitability.

In 1982 The Stock Exchange Council raised the limit placed on any one outside shareholder from 10% to 29.9%. They did this in order to encourage the introduction of further capital into firms in an increasingly competitive industry. Before making this change the Council debated whether this limit should be 100% — in other words no limit at all — or some lesser percentage such as 49% or whatever. Higher limits were thought desirable in order to enable firms to compete in international markets and increasingly in domestic markets too. But the Council decided to restrict the limit to 29.9% — just under the figure at which the Take-over Panel reckons that effective control passes — for two basic reasons. First, there was no official policy on whether or not banks, who are also major financiers of industry and trade, should be allowed to get involved in securities markets. Discussion has raged in many countries on this subject and it cannot be said that the direct involvement of banks in certain countries has been an unqualified success. The Council of The Stock Exchange did not feel able in 1982 to take an irrevocable step which would have opened its membership to banks. Second, we feared that effective control by outsiders of our member firms might threaten the single capacity/fixed commission dealing system, as I am sure it would have done.

Two things will be apparent to you. First, the current changes taking place in the City of London which are involving the creation of large financial conglomerate businesses combining banks, brokers and jobbers and which are breaking down the traditional lines of demarcation in financial services, owe their origin directly to these decisions of The Stock Exchange in 1969 and 1982. Second, the decisions were taken before any agreement with the Government to abandon fixed commissions. The consent granted to the introduction of outside capital into member firms was not the result of this agreement, as the media would have us believe.

Next, the market system. I have already mentioned that during the two decades following 1960 there was a gradual loss of foreign business in The Stock Exchange. In order to secure some of this business again our member firms took to opening offices in foreign countries. In 1970 The Stock Exchange changed its rules to allow the overseas offices of a member firm to compete overseas on equal terms with overseas securities houses, in other words to disregard our traditional dealing rules if local practice was different. During the 1970's a continuing debate within the Council was provoked by the wish to permit our member

firms to compete on equal terms with overseas houses, and particularly with the very large number of North American houses who had established themselves in London. We were slow to react. Why? — because again and again the debate came back to the threat to the single capacity dealing system which was serving investors well in the market in domestic securities. There was a collective fear that if we converted any part of the market to overseas dealing practice it would spill over into the domestic market and play havoc with investor protection. In 1979 of course Exchange Controls were abolished and this above all gave impetus to the need to change dealing practices in overseas securities, whatever the consequences.

Meanwhile, also in the 1970's, strains were appearing in the domestic market. Single capacity remained the rule, sustained by the system of fixed minimum commissions. Let me take these in turn.

In 1976 we had already been reduced to only five substantial jobbing firms. An internal report which I commissioned in that year made it clear that business in leading securities was not profitable and that a further reduction in the number of firms would be caused by another bear market. The Monopolies Commission cleared a merger between two of the five firms, which never occurred owing to the delay in the Commission's study. We knew however, and we said it publicly, that any further reduction would put an intolerable strain on the single capacity dealing system, would not provide adequate competition in the market and would force a change. Our publicly stated policy became that we would maintain the system as long as it was commercially possible to do so.

The strains on minimum commissions were not so obvious. Wisely The Stock Exchange reduced fixed commissions in the early 1970's because they were too high. During the 1970's there was continuous pressure from institutional investors for further reductions, especially on gilt-edged securities in which the volume of trade was becoming enormous. Meanwhile, brokers competed fiercely on services and many of them were looking for ways of giving commission concessions in order to attract business. In 1982 another downward adjustment of commissions reflected this. Institutional investors professed themselves content with the rates on equities but still wanted further reductions on gilt edged securities. Very few of them were prepared to support a system of fixed commissions overtly, despite accepting the importance of fixed commissions as a prop to the dealing system.

The trends were visible but not conclusive. Nobody knew whether change to the whole market system would inevitably come. It looked possible and we had to prepare for it. It was at least obvious that change had to come in overseas securities and the rules were substantially changed in the early 1980's. It was even obvious that if London was to be a large market in overseas securities we would either have to allow our members freedom outside the market or invite the outsiders in.

In the domestic market the Council's publicly stated policy remained to maintain the single capacity dealing system as long as it was commercially possible to do so. The Council took this view both because of the disruptive change to the market, to the issuers of capital, to practitioners and to investors which appeared inevitable in any contrary view and because the system had the wide support of users of the market, large and small, and of the Bank of England, the manager of the market in British Government debt.

Against this background the appearance at the end of the 1970's of the Restrictive Practices Court case was a distraction. It is now history, so I will not trouble you with the details. Suffice it to say that this highly complex legal case, brought against The Stock Exchange under UK competition law by the Office of Fair Trading, potentially attacked every rule and regulation laid down by The Stock Exchange. Every rule and regulation was assumed to be against the public interest unless proved otherwise. If it were found in the process of law that a rule was against the public interest we had to abandon it forthwith. Given the fragile interlinkage between the body of rules which regulated the stock market and protected investors, the sudden abandonment of any one rule could have been disastrous to the fabric of the whole. It was a matter which needed close and long study and preferably a public examination not constrained by the requirements of litigation or the straightjacket of court procedure. Unfortunately the Government turned down the idea of such an examination and we were forced into a position of entering a defence of rules, not all of which we would necessarily wish to keep. While we were playing for time in this way, open debate became impossible because anything said could, as it were, be taken down as evidence and used in the Court. The case pre-empted resources, effort and thought. In short, it was a foolish way in which to study the future of a great international market — a point which Government failed to concede in 1979 but eventually conceded in 1983.

The Government's wish to stop the case in 1983 had on it a high price tag, namely the abolition of fixed minimum commissions by the end of 1986. The Stock Exchange had to be released from the constraints of the case and to revert to a process of orderly planned change rather than being threatened by sudden unpremeditated change. There was no choice. We knew that if minimum commissions were abolished

then single capacity was unlikely to survive, a fact which the Government did not wish to believe but which has been confirmed by the events since July 1983.

The agreement with the Government has acted as a catalyst for change far beyond the borders of The Stock Exchange. Banks, implicitly encouraged by Government, have declared their intention to become involved in securities markets. They and other outside houses, who could have done so before but chose not to, have suddenly taken advantage of the changes in the membership rules which I mentioned earlier. Lines of demarcation between various financial services are breaking down.

Where are we now and where are we going?

We have already published the proposed changes to our dealing systems. Our paper covering future changes in British Governnment securities has been devised in close co-operation with the Bank of England. The proposals for the dealing system in equities and other securities are very similar to it. Both of them envisage committed market makers who will be obliged to enter their quotations into a central electronic quotations system. The gilt-edged system is closely modelled on the primary bond market in New York and the equity system on the NASDAQ system also in the USA; a double tribute you might say, to an ex-colony. There is hardly anyone who does not regret the passing of our present dealing system because it provides a degree of built-in protection to investors and is in a very real sense self policing. I do not however share the pessimism of those Jeremiahs who view the new systems which we propose with alarm. They seem to have an apocalyptic vision of financial scandal, disaster and ruin. In fact the new systems will ensure a high degree of surveillance. The Stock Exchange has long experience of enforcing regulations to ensure the highest degree of investor protection. None has a better record. We are confident that this tradition will continue. Work on the technical systems to ensure an enhanced level of investor protection has started. Work on the new regulations is well under way. Our recent paper on the regulations necessary to cope with potential conflicts of interest has been widely praised.

We have not yet announced changes to the membership structure of The Stock Exchange or to the constitution of The Stock Exchange. These both raise complex issues, most of which are of no great public interest. Two things however are important. First, we will surely permit any one outsider in due course to own 100% of a member firm. This reform is necessary not only to introduce capital. It is essential because without it a substantial amount of trade in securities would remain outside The Stock Exchange and that is to no-one's advantage, least of all the present members. Second, despite some public comment to the contrary, I have no doubt at all that The Stock Exchange will continue to offer very generous compensation arrangements.

All this work is proceeding while the world continues to change. We are only too conscious that anything we devise has to be adaptable. Perhaps I should conclude therefore by mentioning the four main threads of change which I believe to be woven inextricably into our future.

First, competition. There is no sign whatever that competition is decreasing. Far from it. It has always been intense in London and it will become more so. Practically every overseas securities house of any importance is now established in London. On top of this major resources are being committed to the stock market by large domestic financial houses and by some large foreign banks.

Second, the changing pattern of domestic savings. For many years it has been possible to argue that the individual investor has been in decline. I doubt if this is any longer true. The last Labour Government (a long time ago now) instituted the first share owning profit-sharing schemes. The present Conservative government has enlarged their scope considerably. This government has also made a worthwhile start on getting rid of some of the taxes which deter people from owning and buying shares in industrial companies. It has put a lot of effort into enlarging the number of share owners in our society through its denationalisation programme and it has re-introduced share option schemes as incentives to senior managers. I believe that the Chancellor will take further steps in coming budgets to get rid of some of the tax penalties on direct share ownership and that the Conservative party is at last paying more than lip service to the idea of a share owning democracy. If this is so the future liquidity of domestic securities markets will be greatly improved.

The third thread is the increasingly international flavour of securities markets. London has always been an international market. The origins of this go back to its role as a major market for the capital needed for the development of the United States and the British Empire and other countries in the nineteenth century. In the twentieth century Britain's importance has waned. The Empire has been dismantled, the British economy has been in relative decline, and from 1939 our capital markets suffered from the imposition of exchange controls. It is nothing short of astonishing that the market maintains an international flavour despite all this. There are perhaps several reasons. London is very conveniently situated half way between the time zones of Tokyo and New York, which have been the financial centres of the two major

economies of the post war world and account between them for something like three quarters of the free world's free world risk capital. British investment managers have always taken an interest in international markets and have not regarded a portfolio as balanced unless it has included overseas securities. In recent years they have concentrated particularly on the two largest economies. The investment and dealing skills in London are known throughout the world and skilled people tend to congregate together. English is the world language of business. London is also the home of the other major markets such as banking, insurance and commodities. The system of regulation is traditionally thorough and flexible and does not stifle business. And finally London is a convenient place from which North American, Japanese and other houses can administer their European and Middle Eastern business.

Since the abolition of exchange controls in 1979 there has been an enormous increase both in Britain's investment overseas and in American and other foreign investment in UK securities. There seems little doubt that foreign interest will lead to a significant turnover in UK securities abroad and that conversely turnover in foreign securities in London will also increase. This means intense competition for Britain's securities houses because American and Japanese houses are so much larger and more heavily capitalised. But it also means opportunities as they attempt to capture some of the business in foreign securities which until 1979 was almost entirely in the hands of overseas houses.

I would like to dwell for a few moments on London's place in Europe. London is the biggest market in Europe. It is a truism to say that turnover in shares on our Stock Exchange is broadly equivalent to the turnover of all the other European stock exchanges put together. One of the most significant recent trends has been the increasing amount of business in European securities done by British houses. This has been partly due to the analytical skills of certain British broking houses who have literally opened up some of the continental markets for British and American investors. It has been partly due to the incipient interest of investment funds in the continent of Europe as a relatively underdeveloped and therefore potentially profitable market. I suspect that the structural changes which are now taking place in London will increase its importance in European markets because they are going to increase competition and therefore the volume of trade.

My friends on the continent sometimes express the fear that London is mounting a take-over bid for European securities business and that in doing so it is following the old British imperial tradition. This is not true. We have worked hard and for a long time to encourage the development of capital and securities markets in Europe. It is to everyone's interest that the capital market in each country should flourish. It is also in eveyone's interest to see faster moves towards the integration of markets in Europe. There are two ways of achieving this. The European Commission is encouraging greater integration through a certain amount of bureaucratic pressure from Brussels. The European stock exchanges have included the Commission in their counsels and are themselves co-operatively working towards greater integration on a technical level. Work has already strated on integrating information systems and plans are in hand to consider a closer integration of settlement systems. Mind you, none of these attempts to integrate services or indeed to create easier access to markets across international frontiers will get very far unless European governments do more to dismantle restrictions on the movement of capital and to bring taxation systems more into line. The European Commission knows this but has no powers to do much about it. The second way of achieving integration is to allow greater competition and that is what is happening in the real world. I believe that the changes now taking place in London will themselves cause changes in other European stock exchanges. My friends in Amsterdam are already taking steps to alter their commission structures to meet the competition from London. Markets such as Paris, where there are great rigidities in the way in which business is conducted, will have to change. And all European markets will find that they have to extend the hours in which trade in securities is possible.

I am not saying that we will necessarily see the breakdown of traditional ways of doing business in a wide range of domestic securities in each European market. A large number of securities attract only domestic buyers and sellers and it is likely that even in Britain and certainly in other European countries traditional methods of trading in those securities will not change very much. But I do believe that trade in the securities of larger companies will no longer necessarily take place in the country of their origin.

I hope that as time goes by closer integration between European markets can take place not only at the level of dealing in securities. There is a lot to be said for closer co-operation between the official markets in order to ensure common standards and provide better services both to investors and to governments and companies who want to raise capital. Fragmented markets are dangerous because they cream off the large business in important securities, create a two-tier pricing structure in which small investors will inevitably find themselves at a disadvantage, threaten the ability of issuers to raise capital on the finest terms and disrupt the work of the regulators. The Stock Exchange which I represent is the national market of two of the nine member countries of the European community, Britain and Ireland. Sometimes I have

a vision of a future federal structure in which a stock exchange organisation would cover more than two European countries. It would not be easy to achieve but the benefits could be enormous: and now that the lines of demarcation between different financial services are breaking down in Britain one of the greatest impediments to a future federation on these lines is disappearing.

The fourth and final thread is technology. I do not mention this merely because the market authorities and the practitioners are making huge and expensive strides in the improvement of services to their customers with the application of technology. This is obvious. No, I mention it because technology raises fundamental questions. In the days of the cable, the letter and the long distance telephone call which had to be booked in advance, it was easy to see that business would be done in a traditional manner in a traditional market place. Technology has altered all that. Communications all over the world are now instant.

Where is business going to be done in future? What indeed is a stock market?

I do not think that a stock market is a trading floor. Nor do I think it is a communications system. Either or both of these can be part of a stock market. Equally you could in theory transact business in securities over a communications system with a lot of help from the telephone, without having an organised stock market.

Many people think that this is precisely what will happen. I do not agree. A stock market comes into being because a body of practitioners see sense in a common effort to establish market systems, working practices and the regulatory framework which will protect both themselves and their customers. They reckon that by doing this they will attract the business of both borrowers and lenders. I cannot see this wish for a cohesive effort disappearing even among the most competitive practitioners and I am greatly encouraged by the wish of practitioners who are now outside our Stock Exchange to come inside it.

It is in each country's national interest that there should be a national stock market. Despite the enormous international competition, despite the fact that the British Stock Exchange has no monopoly of trade even in domestic securities in Great Britain, I believe that it will continue to be a potent force in the capital markets of the world. A century ago a Royal Commission into the operation of The Stock Exchange reported that "so great is the accommodation provided by the (dealing) system that purchases required on the foreign bourses are constantly sent to London to be made on The Stock Exchange there." That is still our aim — to be the most effective, most liquid market in our time zone. That is what the radical reforms which are now in hand are all about.

SECRET

File 8 JR.
bc J.R.

10 DOWNING STREET

From the Private Secretary

6 February 1985

EXCHANGE RATE POLICY

The Prime Minister invited Sir Alan Walters to attend next Wednesday's meeting, but he is unable to travel from Washington. It will be helpful to those attending the meeting to know of his views and, with his agreement, I am circulating the chapter on Monetary Targets and EMS from the draft of his book. Sir Alan may also circulate a further short note early next week.

I am copying this letter, and enclosure, to Len Appleyard (Foreign and Commonwealth Office) and John Bartlett (Bank of England).

(ANDREW TURNBULL)

Mrs. Rachel Lomax,
HM Treasury.

CST.

VII. 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 harmonization 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 the European view that there should be some substitute for the role of reserve currency. The initial "snake", introduced in early 1972, was modelled on the late lamented Bretton Woods, with exchange rates "fixed but adjustable".[1] The EMS was introduced in

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

early 1979 and included all the major currencies of Europe except sterling.

The essence 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 ± 2-1/2 percent, except Italy where the band is ± 6 percent. 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 D mark, to the U.S. dollar. The most important exchange rate in the trading world, the D mark/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 D mark are fixed.

But if the exchange 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 be roughly the same. If, after six months, I can exchange my lira for D marks at the same rate at which I bought them, I will find it proftable 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; portfolio arbitrage will ensure the outcome.[1] It follows that by joining the EMS, as in any fixed exchange

[1] 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.

rate system, Britain would have to forego a substantial degree of sovereignty over her monetary policy.[2]

[2] The government would have a number of other monetary instruments -- such as reserve ratios and varying the maturity structure of public debt -- which could be used, but there is no doubt that interest rate policy is the primary weapon.

This interest rate equality illustrates one of the main difficulties -- an inherent contradiction 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 inflation rate of about 15 percent, would eventually converge to the German inflation rate of about 3 percent. But the requirement that, under a fixed exchange rate, Germany and Italy have the same nominal interest rate -- say 9 percent -- means that the real interest rate in Germany is high and positive (6 percent) whereas the real rate in Italy is negative at minus 6 percent. 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 Italy, whereas in Germany there will be a substantial financial squeeze.

This is precisely the opposite monetary policy to that which would move towards "convergence". Monetary policy has not been merely neutralized by the 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 its distortions.[1/]

[1/] Am I alone in finding it odd that exchange rate fixity and the concomitant 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 outlined 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 considerably 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 more 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 percent for all except Italy which can move as much as 12 percent.[1] But the main reason is that changes in the

[1] It must be noted that the practice of countries was to attempt to keep their exchange rate on the average close to the central value and not to bump against ceilings and floors.

have been frequent and sometimes quite sudden. The average percentage change (ignoring sign) from month to month (end) in the exchange rate of the French franc and the Italian lira from 1979 to 1983 was 0.8 percent.[1/]

[1/] See Five Years of Monetary Cooperation in Europe, Table 1.

If the movement is all one way, as it was substantially in the case of Italy, this represents about a 10 percent 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.

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 D mark, were and are usually larger than the ones pertaining to the United Kingdom.[2/] Being inside the

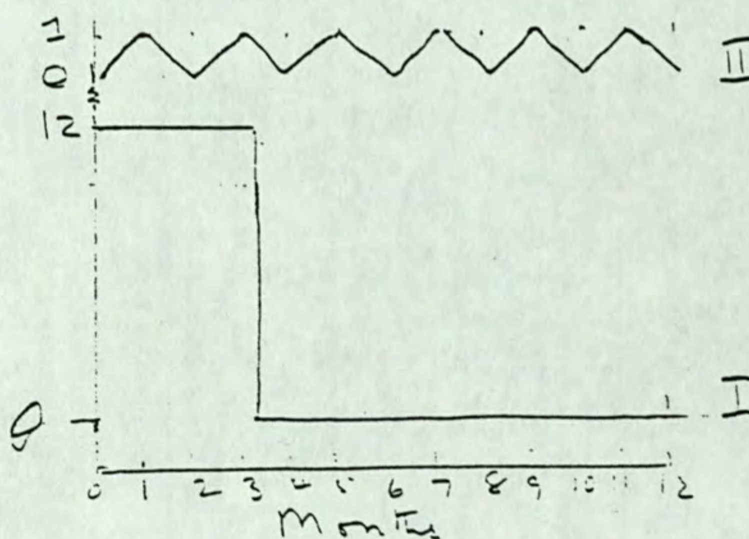
[2/] Thus on March 27, 1984 three month forward dollars commanded a 5 percent premium in D marks, and a 6 percent discount in the lira. This corresponds to the annual 10 percent draft of the lira against the D mark in 1983. Sterling, however, was at a premium of only 1.74 percent. And, of course, three month inter-bank rates reflected these at 5.85 in Germany, 17.4 in Italy, and 9 in London.

EMS did not seem to reduce the insurance premium one had to pay to avoid exchange rate risk. On the contrary, insuring against exchange risk cost more if you were in Italy, France or Eire than if you were outside in the

United Kingdom or the United States. 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.[1/] This variation in EMS exchange

[1/] The ECE Study, "Five Years of Monetary Cooperation in Europe", measures exchange rate instability by the size of the average monthly absolute change in percentage terms. It is worth noting therefore that the same measure of variability (i.e., 1 percent a month) would apply to the following two series. In series I there is one big 12 percent fall (not

Figure No.



atypical of the EMS realignments), whereas in the other series II there is a plus one minus one pattern for each month. Additional unemployment in series I arises from the fact that no one known when the big fall will take place. Thus, the same measured result masks a very distinct and different reality.

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 inducing "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 between annual price inflation increased slightly from 4.2 percent in 1979 to 4.4 percent 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. It has also provided a rationalization for trade restrictions.

The EMS was also presented as a step in 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 forces and divergence, not centrepetal forces and convergence. The road to convergence is to harmonize 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 fiscal and monetary discipline required for convergence. The policies of France in the period of the socialist government 1981-1984 are presented as an example of such discipline. And it is true that the expansionary program of the Mitterrand government from the assumption of

power in 1981 ran only until March 1983. Then after successive devaluations in October 1981, June 1982, and March 1983, the government instituted an austerity program, aimed at reducing the budget deficit to 3 percent of GNP and monetary growth to 9 percent. Of course one cannot be sure what policy the French government would have pursued if they had not been members of the EMS. But we do know that the behavior of the British Labour government in the period 1974-1976 was quite similar.[1] Unbridled expansionism

[1] The main exception is that Britain did not devalue until 1977.

in 1974-1975 was followed by substantial 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 significantly 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 difficult to see what the United Kingdom would gain from joining the EMS. Certainly under the Thatcher government, and conceivably under alternative governments, there 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 weekly, or monthly, variations in the exchange rate against the EMS currencies. But research suggests that because of thick and almost perfect forward markets such short-term movements have little if any effect in inhibiting

trade.[1/] On the other hand, those who seek eventual monetary union of

[1/] A survey of firms by the British North American Association showed little concern with the short-term variability of exchange rates, and firms were apparently well versed in buying 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 real fixed rate system that choice is denied them. For a contrary view, however, see M. A. Akhtar and R. Spence Hilton, "Effects of Exchange Rate Uncertainty on German-U.S. Trade", Federal Reserve Bank of New York, Quarterly Review 9, 1 Spring 1984, p. 7-16.

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.

Finally, the EMS failed, indeed it was bound to fail, in insulating policies from politics. One of the great attractions of fixed parities of the past, such as the gold standard, is that the rules determined policy. If, for example, there was a run on the gold stock, then no one doubted that a monetary squeeze was on the cards, as manifest in the Horsley-Palmer rule. The room for political discretion and dissembling was small.

It would be nice if the great nations of Europe periodically discussed the existence and rationale for the fundamental disequilibria in exchange markets, and then proceeded to a rational conclusion. Such ideals are far from reality. In the EMS the periodic realignments are grand political events which present many opportunities for horse-trading, threats, counterthreats, bluff, etc. Quid-pro-quos are extracted for any "concession" on exchange rate parities. And exchange rates become another pawn in the grand game of Europe. Indeed, it would be naive to expect anything else. (The same characteristics emerged in the Bretton Woods system, and eventually led to its demise.) At the very least one may claim that it is not clear that the psuedo-fixed rates and other policies that emerge from this political bargaining process are "superior" to the free market solutions.

An Exchange Rate Target

Of course it would have been possible for the government to pursue an exchange rate target without joining the EMS.[1/] The set of possible

[1/]Logically it could have pegged at a central rate with respect to the EMS currencies and behaved as if it were in the EMS, without the political hassle of the realignments, etc.

exchange rate targets is virtually infinite. However, if one is seeking stability, not merely in terms of foreign currency but also in terms of domestic monetary-fiscal policy, one should choose that currency, or a combination of currencies, together with an appropriate rules of reaction, which is thought likely to give rise to such stability. If we restrict our search, for the time being, to particular currencies -- suppose it is the U.S. dollar -- then the targetting is an act of faith in the greater likelihood of the United States pursuing suitable stable policies.[2/]

[2/]The experience of pegging to the United States in effect through gold in 1925-1931 and in the Bretton Woods system after World War II to 1971 is not reassuring. In the period from 1947 to the 1960s it was complained that the United States was exporting deflation, whereas from the mid 1960s onwards, they were said to be exporting inflation. In the 1970s under the dirty floats they were said to be exporting both. And in 1984 few would claim that the United States is a paragon of financial prudence and stability.

The choice of the EMS is essentially a decision that the German economy is, in the future, likely to be managed in monetary terms so that it is a suitable model for the United Kingdom. Perhaps it will. The post-war years have certainly seen Germany pursue the most stable of monetary and fiscal policies. But things may change, especially with the transformation of the SPD and the emergence of persistent unemployment.

If there was a desire, however irrational and misplaced, for more stable exchange rates in the United Kingdom, then it would have been more sensible and consistent with the objectives if the exchange rate target had been expressed in terms of the effective rate rather than the EMS/ECU package.[1/] This takes the exchange rates and weighs them according to the composition of trade of the United Kingdom. Thus, targetting an effective rate, compared with the EMS regime, would enable us to avoid slavishly following the D mark as it depreciates (or appreciates) with respect to the dollar, and so, by stabilizing with respect to the D mark, introducing greater instability with respect to the dollar.

In the long run an effective exchange rate target would ensure that the United Kingdom inflated, with respect to the prices of traded goods, at roughly the same rate as her trading partners, whereas an EMS target that did not suffer periodically large one-way "realignments" in respect to the D mark would ensure that we inflated at the same rate as Germany.

Interpreting Exchange Rate Movements

One of the main criticisms of adopting either a fixed exchange rate, or an exchange rate target, is that the value of a currency reacts -- sometimes dramatically -- to many factors besides monetary behavior. The exchange rate is the relative price of liquid financial assets. Although the stocks and changes in the stocks of such assets are important determinants of the relative price, they are only part of the story. The exchange rate is much affected by anticipations, expectations and uncertainties, which are in turn affected by political events, rumor and report. In effect the exchange rate has many of the characteristics of the price of an ordinary share of a corporation. One must expect a fair degree of volatility in free markets for the foreign currencies.

Consider, for example, the effects of targetting an exchange rate during the periods of particularly large political uncertainty such as the run up to the general election. A conservative government committed to a policy of sound finance will find the exchange rate coming under increasing downward pressure. The markets will take a view of the likelihood of Labour government and the consequential fall in sterling (or combination of exchange controls and regulations). Provided there is a high enough probability of a Labour government being relected, the markets will anticipate the event.[1/]

[1/] In the 1983 general election the chances of a Labour government, as reflected in the polls, was virtually zero.

The higher the likelihood of a Labour government being elected, and the greater the differences between the expected monetary and fiscal policies

of the two parties, the greater the depressing effect on the exchange rates in the year or months before the date of the election.

Suppose the authorities were pursuing an exchange rate target for monetary policy. Then in the year before the election the authorities would increase interest rates and induce a monetary squeeze in order to maintain the parity. This is likely to result in a decline in real growth, and perhaps a decline in real output, together with other effects such as an increase in enemployment -- hardly the sort of policy which any government would wish to impose during the election year. Furthermore, the greater the difference between the parties -- the Conservative "sound policy" and the Labour "profligate policy" -- the tighter the squeeze. Worst of all, the greater the likelihood of a Labour government, the higher must interest rates go to deliver the exchange rate target, and so the policy will increase still further the probability of a Labour government being elected. Thus a good chance of a Labour government may be turned into a sure thing.[1/]

[1/] The bias induced by this policy to elect profligate governments is still present in the case where the existing government pursues an inflationist policy. If the alternative Conservative government were believed to be in favor of sound finance, then if they had a good chance of being elected, this would have a favorable effect on the exchange rate of the Labour government and so enable them more easily to pursue an appropriate expansionist policy in the run-up to the election.

Clearly the exchange rate target for monetary policy is bad political economy.[1] But even if it were not, there are strong objections to a

[1] It is, of course, conceivable that an exchange rate target may be proposed precisely to offset the normal temptations of governments to expand and inflate during the run-up to the general election. But, according to the argument in the previous footnote, it would have the opposite effect on an incumbent profligate government, making it yet more inflationary on the approach to the election. It will restrain only the government that pursues, relatively speaking, a sound monetary policy.

monetary policy that routinely reflects all the alarms and excursions that affect exchange rates. If, for example, the United States, in order to contain the inflationary impact of the large Federal deficit, induces a very tight monetary squeeze so that the dollar-sterling rate comes under great pressure, why should the United Kingdom respond in a like manner, in order to defend the parity? It may well be that the domestic monetary conditions in the United Kingdom are entirely satisfactory and do not call for any such squeeze. The exchange rate target will induce artificial oscillations and additional instability in monetary conditions in order to preserve stability of exchange rates.

Granted that it is undesirable to make monetary policy a consequence of the vagueries of exchange rate movements, it is worthwhile considering whether the movements in exchange rates can be used to interpret and get useful assessment of prevailing monetary conditions. If, for example, a high exchange rate meant that monetary conditions were "tight" and a low exchange rate implied that monetary conditions were "loose", then the

exchange rate could rank along with interest rates, both nominal and real, as a measure worthy of close attention but not targetting. The exchange rate could provide corroborating evidence for our main targets, the monetary aggregates.

The difficulty with this subsidiary role for exchange rates is one of interpretation. One would need to identify the causes of movements in the exchange rate before it could be used safely for monetary analysis. One would need to filter out those movements which are due to political factors, changes in the policies or prospects of our trading partners, accidents and the vaguries of nature, market "confidence", etc., which account for a substantial fraction of the variation of the exchange values. This is difficult. There is no repetitive historical record so that one can isolate such effects.

Exchange rate movements must, therefore, be considered as generally rather dubious indicators of monetary conditions. There are exceptional circumstances where very large exchange rate movements, combined with other evidence may be used as a clinching argument. (I shall argue that this was the case in the winter of 1980-1981.) But one whould not look to exchange rates for any subtle interpretation of monetary conditions.

MP 48A

Although the authorities may decide to eschew exchange rate targets and to concentrate on delivering a target for monetary growth, it will be difficult to ignore the exchange rate effect if the market still believes that the authorities will react to exchange rate changes. The authorities will be driven by the market. Again one finds that the critical element in the policy is its "credibility."

Consider for example conditions which, as we shall see, broadly apply to the United Kingdom. The authorities announce that the level of short-term interest rates will depend primarily on the assessement of the movements in the monetary aggregates. The exchange rate is to be the object of benign neglect. However the markets are not convinced that the politicians and central bankers can so readily jettison their concern for the level of the exchange rate. (There are many in the Bank of England who have made no secret of the fact that they believe it would be appropriate to pay much more, not less, attention to the exchange rate). The question will be put: "Can ministers stand idly by as the exchange rate sinks (or rises) with all that that will entail?"

Whatever the reasons for the markets distsrust, portfolio managers will act on the basis of these beliefs. Thus suppose that there is a rise in the United States dollar brought about by some draconian tightening of monetary conditions in the United States. The authorities, surveying domestic monetary conditions, observe no surge of monetary growth and broadly believe that monetary conditions are ´right´. The market however sees sterling

sinking against the dollar and anticipates that there is a good chance that the authorities will be driven to raise interest rates to stop the precipitous fall. The expectation of the authorities increasing interest rates substantially will be enough to generate falls in the price of financial assests. Portfolio managers will be induced to sell gilts in the expectation that they will be able to buy in later at a lower price. Similarly the discount market will reduce the price that it offers for new bills. Thus there will be all the appearances of a 'gilt strike'!

Broadly speaking the authorities have two choices. First they could stick to their announced policy and not ratify the market moves, or secondly they could follow the lead of the market and behave as if they were defending the parity of sterling. The first path is a difficult one. Changing ingrained expectations is a harrowing business. The authorities would have to sit out the funding strike and use other sources of funds - such as running down foreign assets or borrowing from foreigners.[1/]

It would be wise to avoid monetizing any of the borrowing requirement and so inflating the monetary aggregates, but as a temporary measure this might be a last resort. The dangers of such a policy choice - the possibility of inciting inflationary expectations, and indeed the fact that the authorities may lose the confrontation - are clear and present.

1/ The implications for the exchange rate are clear and need not be elaborated here.

The second choice seems to avoid all such risks. If the authorities raise interest rates so that there is no risk of them going up further, then the funding strike is over and the flood begins; and sterling will return to the range at which there are no market fears of authority reaction. The temptation to follow this seemingly obvious path is clear.

But this will simply validate the markets expectations that there is an exchange rate target. The next time the rate comes under pressure, the authorities will be locked ever more closely into the exchange rate target by the more certain expectations of the market. Believing it is so makes it so. All that is needed for an exchange rate target is the belief, however acquired, in the market that the authorities just could not tolerate substantial depreciation of sterling. Then the authorities can argue that they cannot fight market pressure - or at least it would be foolhardy to do so. Thus does rumour beget policy.

In one sense the second alternative of capitulation to the market has many attractions for governments and monetary managers. The markets and foreigners can be blamed for the painful oscillations in interest rates as well as the instability of exchange rates. It avoids eyeball to eyeball confrontation of the authorities and the market, and the government is unlikely to get a bad press if it does what is expected. The older heads in the corridors of Whiehall and the City will recall that in battles between the authorities and the city (not to mention the gnomes, etc.) it is the latter that always wins.

But the markets may take the view that some pressures on the exchange rate cannot be countered effectively by feasible movements in interest rates. Portfolio managers may be convinced that, on fundamental grounds of purchasing power parity, the exchange rate must move. Their guess about the intentions of the authorities is reciprocated by the authorities trying to adduce what the market foresees or wants, and so on... As in all game-theoretic strategies, such behaviour defies any neat analysis. The extent to which the authorities were driven unwillingly by market expectations cannot easily be assessed from overt behaviour. The attempts to attribute causation in the following pages are tentative. The subject deserves more analysis and reflection.

File. Relay to David Wolfson
AT 8/2

Speculation against Sterling

The Nation's banking system as currently operated by the Bank of England does not appear to have a defence against speculators bearing sterling except with resort to the U.K. reserves or bringing back exchange control.

In recent times the per diem cost of borrowing money has not been sufficient to erode the profit margins of selling sterling short and borrowing to cover the position. To quote LEX on Tuesday 29.1.85 "For short-term traders, the penalty is ludicrously small, since the daily impact of the extra two points of interests costs is of the order of one two-hundredth of a cent, negligible in relation to the currency movement."

The conclusion therefore is that instead of base rates at 14% per annum a rate of 350% or 1000% per annum overnight to give a flat cost of 1% or 3% is required to discourage the speculator. Speculators only desist if they actually lose money or feel that there is a system in place to cause them to lose money. The solution which is needed is the short sharp corrective violence of 300/1000% interest rates without the ripple effect into everyones daily lives as well as the longer term damage to the economy.

At the present time the Bank of England controls the Nation's liquidity and with it short term interest rates (under one year) through the medium of the discount market.

As keeper of the Nation's books the Bank alone knows the daily shortages or surpluses on the Nation's account. First thing in the morning they publish their guess at the shortage or surplus for the day. If there is a shortage in excess of £500m the Bank purchases Treasury Bills, Bank Bills and Local Authority Bills from the discount market thereby releasing liquidity into the system. This operation is repeated at noon and again if necessary between 2-2.30 p.m. If the shortage is not completely taken out by the Bank the natural result is for short term interest rates to rise. There are other means of alleviating a shortage of liquidity:-

a) Repurchase agreement of assets from discount houses.

b) The sale and repurchase between the commercial banks and the Bank of England of percentages of the commercial bank's eligible liabilities.

c) Last resort lending facilities to the discount houses.

This entire operation puts no fear into the speculator for two reasons. Firstly he can see what is happening in advance, and secondly he is in the spot market and not the cash market. In other words he is always borrowing money two days in advance to meet his liability under a bear position. Therefore even if there is a sharp rise in the cost of money for one day he need not be caught if he is nimble due to the two day settlement period on the foreign exchange market.

For the reasons above the discount market as currently operated is too slow and too obvious to catch the speculator and it takes too long for the hidden shortage to reach the commercial lender to enable him to raise his interest rate to catch the covering speculative borrower.

cont'd..

Furthermore the combined capital and reserves of the discount market of £200m are inadequate to stand the necessary substantial losses in their books which violent upswings in interest rates would produce on their carried assets. In other words the whole market is badly financed which makes it an unlikely medium for corrective violence.

The other leg for controlling sterling interest rates are the eligible banks, lead by the clearing banks who are obliged to keep credit balances of say £200m with the Bank of England.

The daily clearing has to produce a balanced book so that the clearing banks are not overdrawn at the Bank of England and in practice they should not reduce their agreed balances much below the £200m agreed level. Under the current system the clearing banks put up their base rates on a lead from the interest rates as operated through the daily assistance provided by the Bank of England to the discount market through the four date bands of bill purchases. These rates as explained above are based on the Bank of England's view of the shortages/surpluses through their accounts. The weakness therefore is inherently the same as with the discount market in other words the speculator can always see the Bank of England and the Clearing Banks coming.

Within the present system therefore it is very difficult for the Bank of England to disguise the position, unless it puts out a false shortage on any particular day and subsequently refuses to give help, which undoubtedly would cause a sharp rise in short term interest rates, but due to the speculator dealing two days in advance might well not catch him, and everybody ends up paying except for the miscreant. The Bank therefore has to be prepared to run a shortage for a number of days in succession. Clearly the longer the period of shortage and the higher the daily rates, the greater is the danger of effecting the three month rates with its attendant influence on the economy. Here however the objective must not be lost sight of which is to regain the initiative against active and/or defensive speculation and the restoration of confidence. Introducing lack of confidence in the speculator is a key component.

Conclusion

To the outsider the Bank of England appeared in the January crisis to have an attitude of "benign neglect" so that speculators turned their attention to what others were doing and the herd instinct ran rampant.

Put another way, uncertainty makes people cover their foreign exchange positions. If every foreign receiver of sterling covers automatically you are bound to get a run on sterling due to the simple fact that there are more genuine receivers of sterling round the world than there are financial speculators. A genuine receiver of sterling may be defined as a defensive speculator, give him confidence and he will not automatically cover.

Finally there appears to be a misapprehension that there is a mysterious supply of sterling held abroad. This is irrelevant since sterling interest rates are controlled or should be controlled in London. Only a madman keeps a large number of coins in his pocket on which he is not receiving interest.

Chenwick

J.C.L. Keswick

4th February, 1985.

P5

CONFIDENTIAL

FROM: P WYNN OWEN
DATE: 4 February 1985

PS/ECONOMIC SECRETARY

cc Sir P Middleton
Sir T Burns
Mr Littler
Mr Cassell
Mr Unwin
Mr Lavelle
Mr Lankester
Mr Odling-Smee
Mr Battishill
Mr Sedgwick
Mr Folger
Mr Peretz
Mr Shields
Mr Culpin
Mr Collinson
Mr Hannah
Mr Gray
Mr Vernon
Mr McSharry
Mr Segal
Mr Cropper
Mr Turnbull No.10

THE RESERVES IN JANUARY 1985

The Chancellor has seen Mr McSharry's minute of 1 February to the Economic Secretary and Mr Hannah's of the same date.

2. He has made two amendments to the Q and A briefing:-

(i) the answer to Q2 should read

"Markets encouraged by Government's reaffirmation of commitment to financial discipline and control of inflation. ERI risen signficantly from 28 January low.";

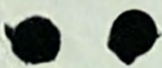
(ii) the answer to Q5 should now read

"As Chancellor has recently explained on a number of occasions, the fact that the market system is the best system does not imply that the market always gets it right."

PWO.

P WYNN OWEN

E4 FEB 1985



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Covering Secret

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FMR (85)1

January 1985

FINANCIAL MARKETS REPORT

Prepared by HF3 and EF(1)

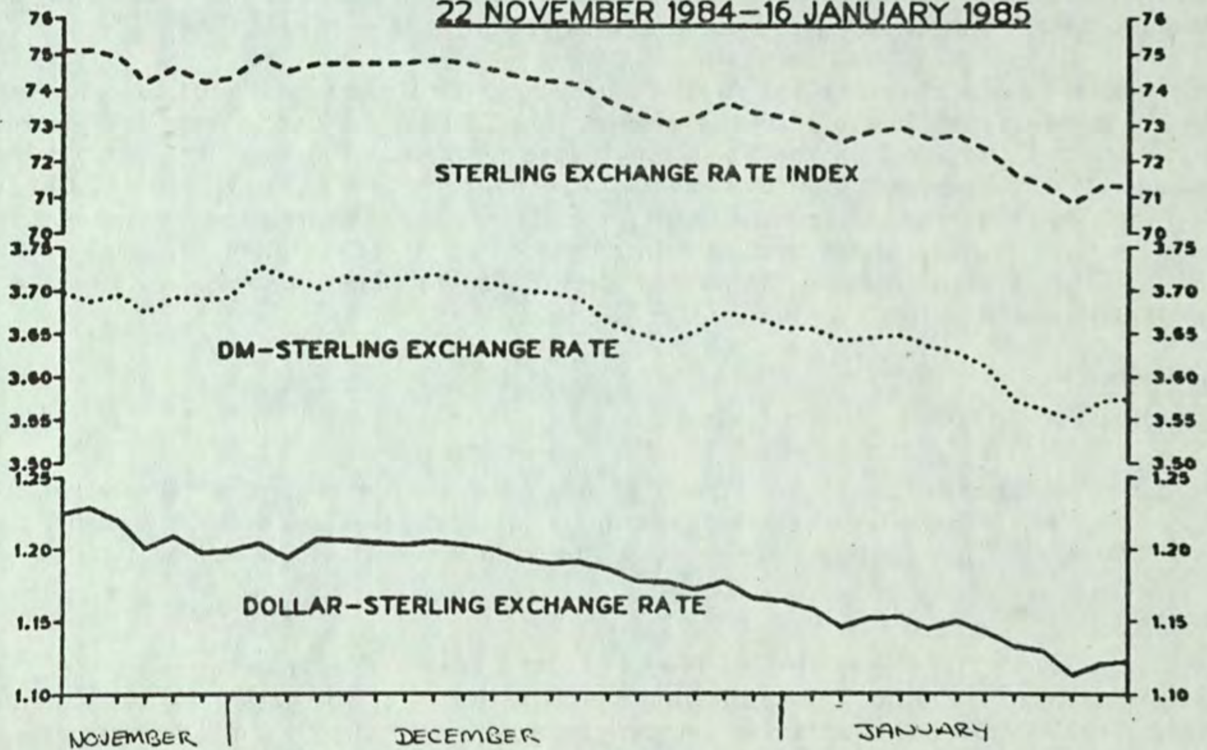
The attached note reports on developments in the foreign exchange and domestic financial markets during banking December and banking January (November 22 to January 16). The main developments were:

- Against a background of continued oil price weakness and an obstinately firm dollar, and some market concern about domestic financial conditions the pound came under considerable pressure in the early part of January, falling to new all-time lows of ERI 70.6, $ 1.1020 and DM 3.50¼ early on the 14th, before the one day reimposition of MLR at 12 per cent eventually helped to stabilise the exchange rate in the short term.
- Market interest rates were steady throughout banking December but climbed from late December, as sterling weakened. The clearers raised their base rates to 10½ per cent on 11 January. The situation deteriorated over that weekend and market rates opened sharply up on 14 January. The Bank announced a minimum rate of lending for that day of 12 per cent, and the clearers raised their base rates to the same level almost immediately.
- Gross gilt sales in the review period totalled £1¼ billion, against a target of £1½ billion. Buying in of next maturities reduced net sales to £610 million.
- The equity market reached record levels in early January, and though set back by the subsequent sharp rise in interest rates, ended the period back at close to these levels.

R N G BLOWER

D McSHARRY

FOREIGN EXCHANGE MARKETS



Spot sterling

November

The pound dipped sharply in the latter part of November, touching lows of $1.1927 and ERI 74.1 on the 28th, reflecting a combination of a stronger dollar and renewed oil price sensitivities, before recovering to end the month little changed at ERI 74.9 ($1.2037 and DM 3.7269).

December

Sterling took on a slightly better tone at the beginning of December, but renewed oil price sensitivities, coupled with chartist inspired selling, forced sterling lower in anticipation of the OPEC meeting beginning on the 19th. Pressure mounted on the 19th in the absence of conclusive news from OPEC, together with a strengthening of the dollar on better than expected GNP data. After falling to new lows of $1.1605 in the Far East and ERI 72.7 shortly after the London opening on the 20th, the pound remained depressed, but recovered slightly in the final days before Christmas. Continued oil prices uncertainties plus a strong dollar then saw the pound weaken further, touching $1.1560 on the 31st.

January

The pound began 1985 under strong downward pressure as news of post-tax losses by Midland Bank's subsidiary, Crocker National Bank, coupled with continued oil price sensitivities and a

sharply stronger dollar, resulted in new lows for sterling of ERI 72.3 and $1.1395 on the 2nd. Thereafter, the pound generally reflected the fluctuations of the dollar, but began to loose ground on the 7th after a poor weekend press and nervousness about base rate increases began to mount in advance of the money supply figures. Following the release of the figures on the 8th (£M3:-½ per cent), the pound was marked down, as the likelihood of a rise in interest rates faded, and touched $1.1370 and ERI 72.2 on the 9th. The slide continued on the 10th, with dealers concerned about weak oil prices and the Government's supposed indifference to the exchange rate. After opening at ERI 71.6 on the 11th, a 1 per cent increase in base rates proved insufficient to halt the pound's decline (ERI 71.1 and $1.1125 lows), although nervousness about concerted intervention and talk of the G5 meeting caused the dollar to weaken, allowing the pound to make a tentative recovery.

Poor weekend press coverage led to confusion about the Government's attitude to situation and the pound opened on the 14th at a new all time ERI low of 70.6, having hit record lows of $1.1020 and DM 3.50¼ in the Far East, before news that the Bank had set a minimum lending rate of 12 per cent that day enabled a recovery to ERI 71.7, $1.1310 and DM 3.5796 at 11 am. But a strengthening dollar during the afternoon and Statoil's announcement that it would be negotiating a more market related price for its oil in January, sparked further selling (ERI 70.8 at the close). The pound eventually stabilised at around 71.3 on the 15th, as attention began to focus on the G5 meeting.

The Dollar

November

The dollar established itself above the DM 3.0 level in the latter part of November, despite aggressive central bank intervention, cuts in US interest rates and weak US data (Q3 GNP revised from + 2.7 per cent to + 1.9 per cent), to end the month at DM 3.0962.

December

The dollar began December firmer, rising to DM 3.12½ in thin trading on the 3rd, before easing sharply to DM 3.0600 the following day in a technical correction to its earlier sharp gains. The US currency fluctuated erratically on the 6th and 7th amid reports of central bank intervention, before moving higher on news of an unexpected 0.2 per cent fall in the US unemployment rate in November. Thereafter, the dollar traded steadily at around the DM 3.09 level, in thin and featureless markets. The effects of cuts in US prime rates from 11¼ per cent to 10¾ per cent and inconclusive US data were short-lived, with the US currency moving up to DM 3.11 in thin trading on the 20th in response to the previous day's better than expected Q4 GNP 'flash' estimate (+2.8 per cent). The dollar continued to make gains, in a thin market, for the rest of the month on a growing belief that US interest rates had bottomed out. The ½ per cent cut in the discount rate - announced late on the 21st - had been widely expected and had little impact on the dollar.

January

After breaking through new heights against many currencies on 2 January, fears of possible central bank intervention caused the dollar to trade erratically within a range of DM 3.18 to DM 3.13 until the 14th when it surged to new highs, including DM 3.2005 in the Far East on the 15th. The dollar was unable to sustain its higher levels as dealers became nervous ahead of the G5 meeting and speculation mounted over rise in W Germany interest rates but failed to move significantly lower, despite cuts in US prime rates (10½ per cent to 10¾ per cent on the 15th) and weaker than expected US data.

OTHER RELATED DEVELOPMENTS

	EMS Top	EMS Bottom	Spread %	Yen	Gold
21 November (close)	Dkr	Bfr	1 1/8	245.90	340.30
2 December (close)	Dkr	Bfr	1 1/4	248.02	329.50
20 December (close)	Dkr	Dfln	1 9/16	247.77	307.50
31 December (close)	Dkr	Dfln	1 11/16	251.55	309.00
7 January (close)	Dkr	Dfln	2	255.70	298.25
16 January (close)	Dkr	Dfln	1 11/16	254.78	302.70

SECRET

GILT EDGED MARKET

Gross gilt sales in banking December totalled £319 million against a target of £500 million. Buying in of next maturities reduced net sales to £125 million. The second call on the 9¾ per cent Exchequer 1998, due on 10 December, contributed £335 million to the sales target but was partially offset by £134 million of buying of other than next maturities.

Gross gilt sales in banking January totalled £918 million, against a target of £1 billion. Buying in of next maturities reduced net sales to £487 million. The final call on the 9¾ per cent Exchequer 1998, on 14 January, contributed £335 million to the sales target.

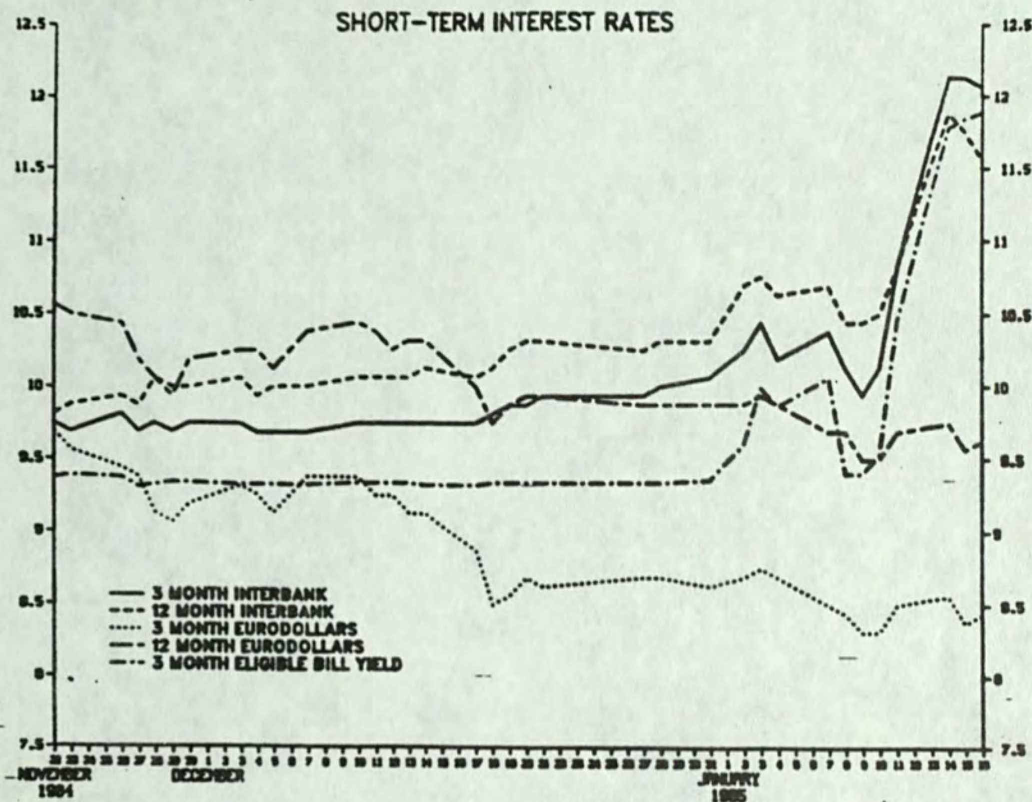
The 22 November cuts in base rates did little to attract new interest in the Gilts market with most operators distracted by the profit potential of the BT sale. On 10 December a set of heavily BT-distorted money supply figures increased market nervousness; with unfavourable press comment on the underlying PSBR arousing some concern, and, combined with a weaker trend in sterling, caused yields to rise steadily for the rest of December. At the year-end most yields were around ½ per cent higher than they were at the beginning of December and at the end of 1983.

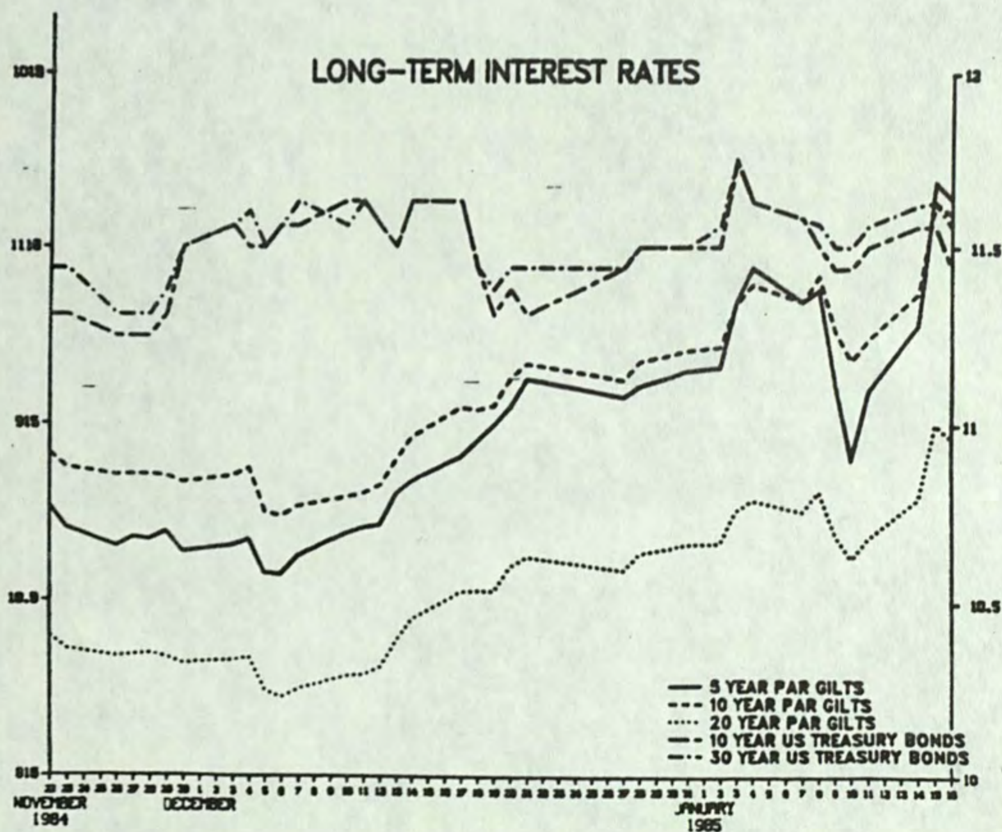
In early January nervousness on account of sterling weakness dominated the gilt market, and prices fell sharply from 10 to 14 January, as market interest rates, and subsequently basic rates, rose sharply. By the end of banking January yields were close to ½ per cent higher than at the turn of the year.

£168 m of 9¾ per cent Exchequer 1998 "A" issued on 7 November was still on Issue Department books at end-December but the tap was finally exhausted on 8 January. No new stock was issued in banking December, and £1.3 billion in banking January of which £85 million had been sold by 16 January. Though the 10½ per cent 2005 was put in the Issue Department on 14 January it did not become available for sale to the public until banking February.

Stock	Date Issued	Amount (£m)	Price	GRY[1]	Exhausted
2½% Exchequer 1987	17.12.84	250	87½	8.92	-
2½% Index-Linked Treasury 2001	17.12.84	150	101¼	-	-
2½% Index-Linked Treasury 2011	17.12.84	100	106	-	-
10½% Exchequer 2005	14. 1.85	800		10.73	

(1) GRY = Gross Redemption Yield


SHORT-TERM INTEREST RATES
3 MONTH INTERBANK
12 MONTH INTERBANK
3 MONTH EURODOLLARS
12 MONTH EURODOLLARS
3 MONTH ELIGIBLE BILL YIELD
NOVEMBER
1984
DECEMBER
JANUARY
1985


LONG-TERM INTEREST RATES
5 YEAR PAR GILTS
10 YEAR PAR GILTS
20 YEAR PAR GILTS
10 YEAR US TREASURY BONDS
30 YEAR US TREASURY BONDS
NOVEMBER
1984
DECEMBER
JANUARY
1985

MONEY MARKETS

The ½ per cent cut in base rates on 22 November was well-discounted, Barclays having reduced theirs some days earlier by ¼ per cent (to 9¾ per cent), and with, all eyes on British Telecom, the market became very quiet. By the time attention had turned from BT, around 10 December, a set of distorted money supply figures together with weakening spot oil prices combined to counter-balance the decline in US interest rates, and the market remained quiet. 3 month interbank remained steady at around 9¾ per cent from the beginning of the review period until 17 December, while 3 month eurodollar eased ½ per cent over this period.

In late December the sterling index began to fall markedly, reflecting the strong dollar, oil prices weakness and concern about monetary conditions and the level of Government borrowing and expenditure. This forced market interest rates up; 3 month interbank rose steadily, reaching 10 per cent on 7 January. Publication of provisional December money supply figures on 8 January caused rates to ease temporarily, but by 11 January 3 month interbank had risen to 10 15/16 and all the major clearers raised their base rates to 10½ per cent. The situation deteriorated over that weekend, and market interest rates opened sharply up on January 14. (3 month interbank at 11 13/16). The Bank acted immediately, announcing its minimum rate for lending to the Discount Houses for that day would be 12 per cent. The clearers followed, raising their base rates to 12 per cent on the same day. Following the base rate rises market interest rates stabilised with the 3 month interbank rate settling around 12¼ per cent.

The average daily shortage during the review period was £570m, compared to an average of £460m over the calendar year as a whole. Maturing assistance accounted for most of this, but the British Telecom flotation was also a major factor. To deal with these pressures the Bank announced a further temporary facility for eligible banks to offer their gilts and export credit paper for repurchase. On 4 December £1,111m was taken up at an interest rate of 9 21/32 per cent and the facility unwound on 31 December. With the prospect of major shortages in the money markets with the onset of the revenue season, a further repurchase facility was announced, under which £1.5 billion was taken up on 15 January. This facility unwinds on 14 February but money market pressures are likely to require further repurchase facilities.

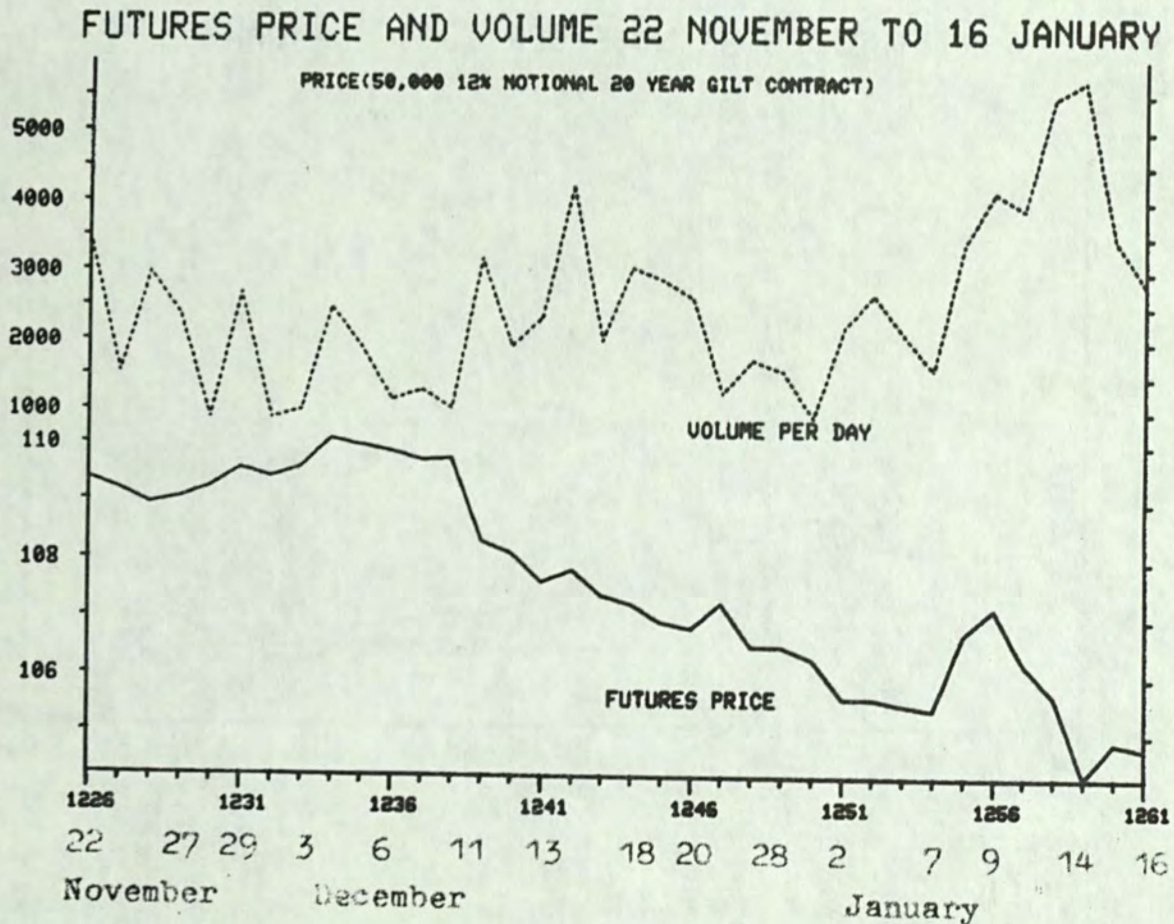
SECRET

GILT-EDGED FUTURES

The futures market edged upwards until the beginning of December when with BT distractions it reached a plateau. The money supply numbers and the weaker trend in sterling unnerved operators and in moderate trading the March contract fell sharply. Contract price fell further on 11 and 14 January in heavy trading as a result of the rises in interest rates and sterlings' lack of response to the same. Trading became cautious as the banking month came to a close and expectations of further interest rate rises built up.

	Price*	Volume
Highest	110.02(4/12)	5709(14/1)
Lowest	104.09(31/12)	870(31/12)
Average	107.08	2464

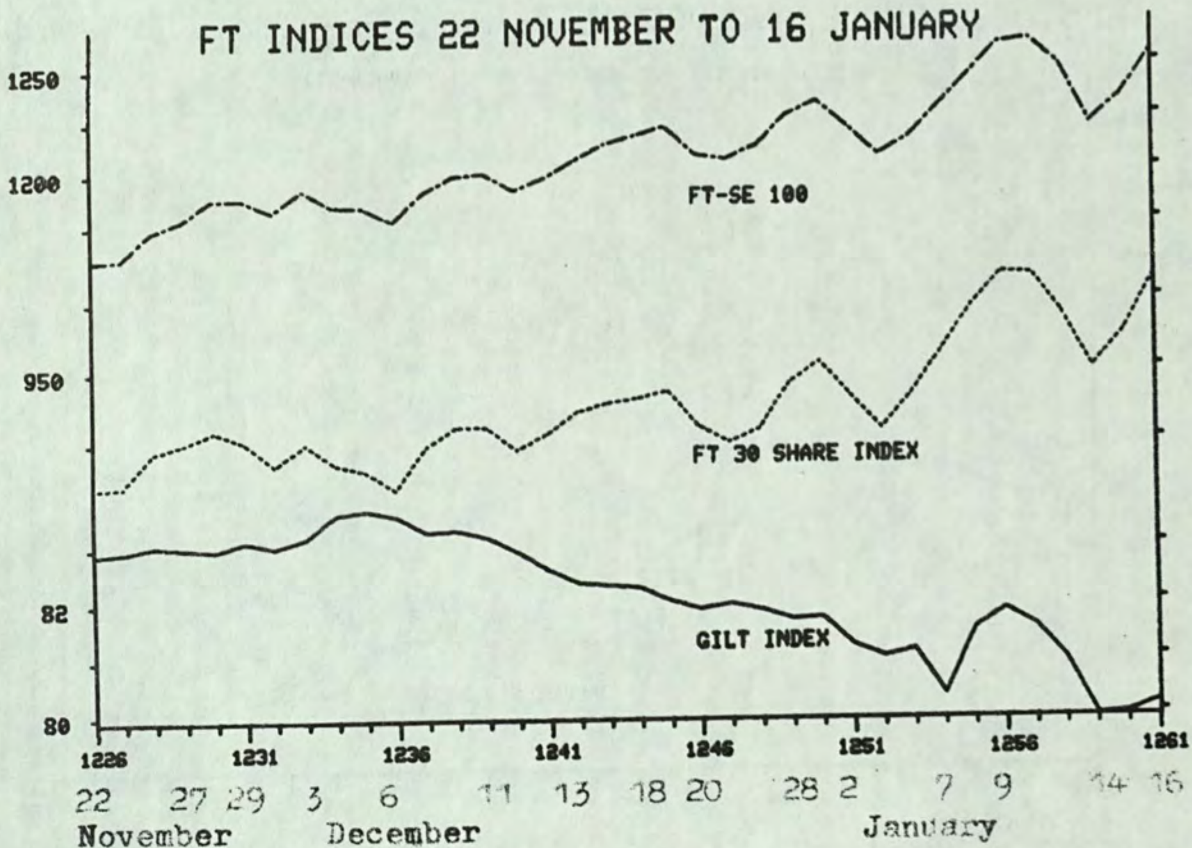
* Figures after decimal represent 1/32 NDS.



Equity Market

The successful launch of British Telecom at the beginning of December buoyed the market and market prices in general moved ahead. Towards the end of December, the apparent halt in declining US interest rates, a worsening sterling and some associated worries about domestic interest rates caused the market to falter. However by the end of December sentiment had recovered and the FT 30 shares index closed 176.6 points up on the year at 952.3 a new record and up 42.1 points since the beginning of banking December.

As sterling fell further in the first ten days of January, the equity market continued to rise, and the FT 30 shares index reached yet another new record level, of 983.1 on 9 January. The sharp rise in market interest rates, and the 2½ per cent rise in base rates up to 14 January set back the market,(the 30 share index lost 34 points in two days), but by the end of banking January the equity market was back at close to record levels.



SECRET

INTEREST RATES SUMMARY

INTERBANK RATES (X)

DATE	7 Days	1 Month	3 Months	12 Months
25 November	9.44	9.69	9.75	9.88
30 November	9.69	9.69	9.75	10.00
7 December	-	-	-	-
14 December	9.25	9.56	9.75	10.13
21 December	9.0	9.56	9.94	10.31
28 December	9.38	9.56	10.00	10.31
4 January	9.19	9.81	10.19	10.63
11 January	10.44	10.69	10.81	10.81
18 January	12.25	12.25	12.00	11.50

EURODOLLAR RATES (Y)

DATE	7 Days	1 Month	3 Months	12 Months
23 November	8.75	8.94	9.25	10.13
30 November	8.81	8.94	9.19	10.19
7 December	-	-	-	-
14 December	8.69	8.84	9.13	10.31
21 December	8.56	8.31	8.63	9.94
28 December	8.50	8.50	8.68	9.88
4 January	8.38	8.38	8.69	9.88
11 January	8.06	8.06	8.50	9.69
18 January	8.19	8.19	8.38	9.63

UNCOVERED DIFFERENTIAL (X-Y)

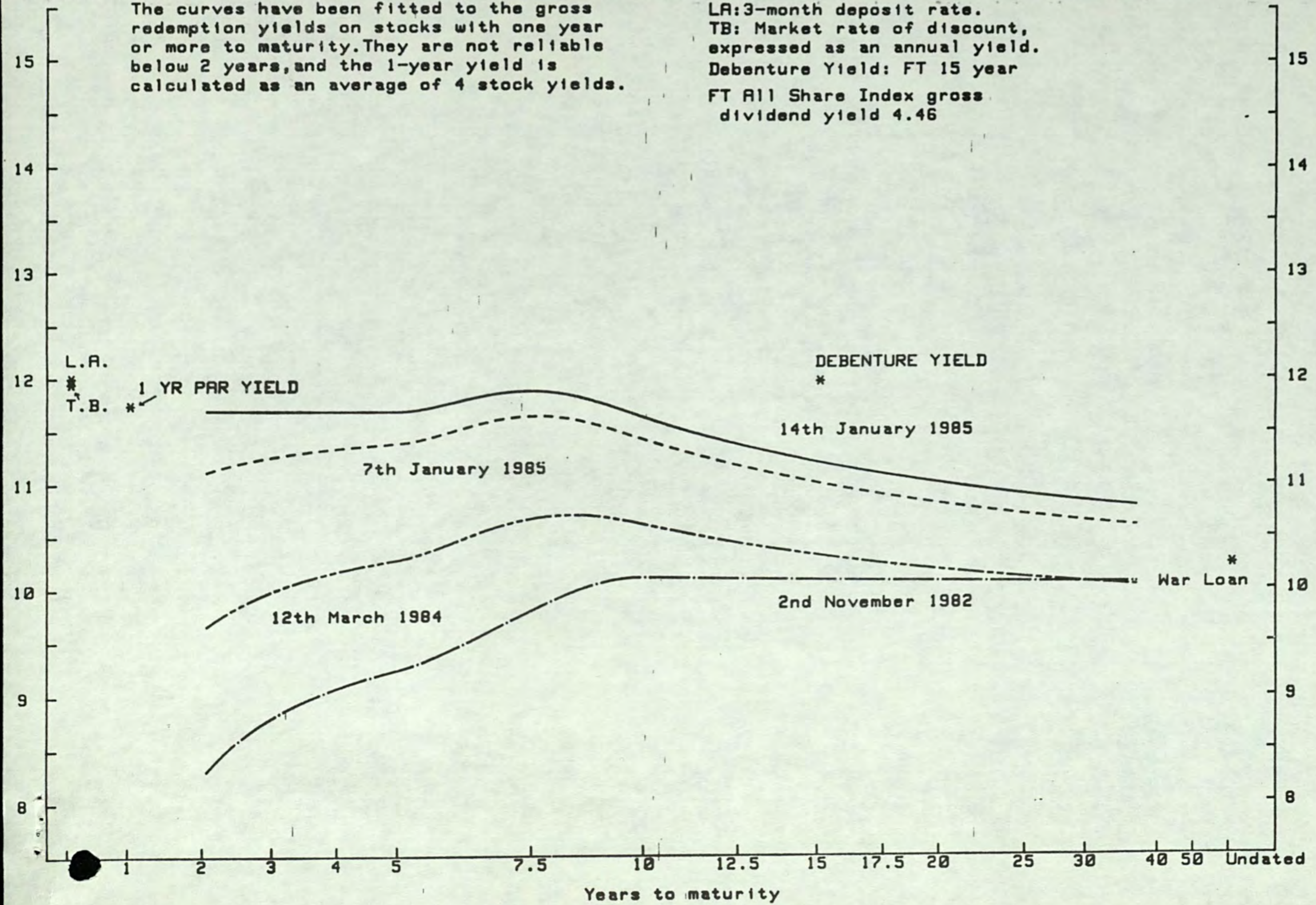
DATE	7 Days	1 Month	3 Months	12 Months
23 November	+0.69	+0.75	+0.50	0.25
30 November	+0.88	+0.63	+0.56	-0.19
7 December	-	-	-	-
14 December	+0.56	+0.63	+0.63	-0.19
21 December	+0.44	+1.25	+1.31	+0.38
28 December	+0.88	+1.06	+1.31	+0.44
4 January	+0.81	+1.44	+1.50	+0.75
11 January	+2.38	+2.63	+2.31	+1.13
18 January	+4.06	+4.06	+3.62	+1.88

Par Gilts Yields	5 year	10 year	20 year
23 November	10.705	10.876	10.363
30 November	10.637	10.836	10.324
7 December	-	-	-
14 December	10.839	10.966	10.450
21 December	11.127	11.171	10.624
28 December	11.108	11.176	10.634
4 January	11.440	11.394	10.787
11 January	11.097	11.244	10.683
18 January	11.631	11.709	11.102

SECRET

International Comparisons

	USA	FRG	World Basket	UK/World Basket Differential
17 November	9.20	5.98	9.07	+0.96
23 November	9.33	5.93	9.13	+0.59
7 December	9.00	5.85	9.00	0.78
14 December	8.97	5.90	8.96	0.77
21 December	8.48	5.83	8.79	0.93
28 December	8.35	5.80	8.72	1.18
6 January	8.35	5.78	8.69	1.40
13 January	8.25	5.73	8.53	1.78



Per cent
Time / Yield Curves of British Government Stocks
16th January 1985
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 4.46
15
14
13
12
11
10
9
8
L.A.
T.B.
1 YR PAR YIELD
DEBENTURE YIELD
14th January 1985
7th January 1985
War Loan
2nd November 1982
12th March 1984
1
2
3
4
5
7.5
10
12.5
15
17.5
20
25
30
40
50
Undated
Years to maturity

File

PRIME MINISTER (2)

BEAR SQUEEZE

I had a talk earlier today with John Forsyth of Morgan Grenfell. He is one of the few merchant bankers I have come across who both understands economics and has a feel for financial markets. I raised with him the suggestion which had been put to us that the authorities ought to engineer a sharp rise in the cost of overnight funds in order to impose losses on speculators and thereby induce a better balance of risk in the markets for sterling. (David Wolfson has also been on to me about this proposition; he too has had his ear bent by Chips Keswick.)

Forsyth took the view that in current circumstances, any rise in the overnight rate which was large enough to have an impact on the profit and loss calculations of speculators would be bound to have repercussions further down the yield curve. He doubted whether this kind of operation could have been mounted successfully, even when the UK had exchange controls. The analogy we are often presented with is France which engineered a very sharp rise in the cost of Euro franc funds. It would have been difficult to engineer a corresponding rise in Euro sterling funds without repercussions on domestic markets. (Euro sterling market comprises largely sterling deposits with banks in Paris and Brussels). Even with exchange controls, a significant proportion, perhaps 8%, of UK bank deposits were held by the foreigners who were not subject to exchange control. At the first sign of a sharp rise in the Euro sterling market they would have been free to move across, thereby equalising rates in the two markets.

Forsyth believed that recent selling pressure on sterling had come from New York investment institutions. These are not deposit takers - they are investing the partner's funds - and hence they are not required to declare their overnight positions to the Fed. They are, therefore, able to operate very freely. Forsyth thought that the continent, by contrast, had been buyers of sterling.

Forsyth believes that our thinking about intervention is outdated. We have been brought up on the problems of the 1970's when

/ we were

we were trying to defend a declining rate for sterling. Over this period Britain was highly borrowed and short of credit. Reserves were therefore used sparingly, mostly according to the doctrine of stabilising markets or breaking the fall.

A new attitude was required. Far from intervention to stabilise markets, the authorities ought to intervene to inject unpredictable movements, thereby inducing caution into the behaviour of speculators. The Bundesbank had done this in September when in one day it moved the rate by several pfennigs. As a result, no investors now dare take a big open position against the Deutschmark when the rate gets close to $3.17. By contrast speculators have seen little prospect of loss when operating against sterling. No dealers going short of sterling have been hauled up before the directors for making losses. A profitable operation was to sell UK gilts, go out of sterling, wait for the authorities to react by raising interest rates, and then to come back into gilts at lower prices.

Forsyth argued, therefore, that the UK should operate to acquire reserves which it could do very cheaply. It should be prepared, when the moment was right, to spend on intervention on a large scale. In current circumstances the Bank would be seen as an operator with a long purse, what is known in auction circles as a "goer-on". The objective of intervention would not be to hold a rate or to provide stability, but the opposite, to inject a certain amount of uncertainty and to impose the losses which interest rate movements are unable to do.

AT

Andrew Turnbull
31 January 1985

31 January 1985

PRIME MINISTER

AT 31/1

EMS

Joining the EMS would not solve the currency problems we have been experiencing.

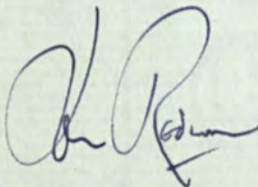
Oil has a substantial impact upon sentiment towards sterling. This makes sterling unlike the other member currencies of the EMS.

If we joined the EMS, speculators would still put pressure on sterling. But we would have to defend the rate. We could no longer allow a gentle depreciation of the currency. Each time the currency was under pressure you could guarantee headline treatment and a sterling crisis. It would be like the sterling crises which beset the Labour Government of the late 1960s, and we would be forced into regular devaluations or revaluations against the EMS currencies, and would doubtless lose on intervention on the way.

You cannot have both an exchange rate target and a monetary target. You have to decide what is most important and stick to it. You can only defend raising interest rates in recent weeks on the grounds that you had accepted the market's

verdict that money policy had become a little lax - and it had become too lax - and that speculators had gone too far and needed correcting.

If we wish to retain sovereignty over our economic policy; if we wish to avoid being constantly up-ended and caught between different targets; and if we wish to avoid a series of sterling crises; we should not join the EMS. A more honest policy line than saying we would join when the time is right would be to drop all reference to the EMS at all.



JOHN REDWOOD

Interest Rates

3.33 pm

Mr. Ian Wrigglesworth (Stockton, South): Mr. Speaker, I should like to ask the Chancellor of the Exchequer the question of which I have given him prior notice. As you know, Mr. Speaker, the Labour party has —*[Interruption.]*

Mr. Speaker: Order. I called the hon. Member to ask a private notice question. It is only fair that he should be heard. I cannot hear.

Mr. Wrigglesworth: Mr. Speaker, the Labour party has illusions of adequacy. *[Interruption.]*

Mr. Speaker: Order. The hon. Member should ask the private notice question that he gave to me.

Mr. Wrigglesworth: If I may be allowed to do that, Mr. Speaker. I should like to ask the Chancellor of the Exchequer the question of which I have given him prior notice—if he will make a statement of the current level of interest rates.

The Chancellor of the Exchequer (Mr. Nigel Lawson): At noon yesterday, following a rise in market interest rates, one of the clearing banks raised its base rate from 12 per cent. to 14 per cent. The Bank of England raised its dealing rates by a corresponding amount when it dealt in the bill market at 12.15 pm. The other clearing banks followed within the next hour or so.

Yesterday afternoon I gave evidence on these and related matters at considerable length to the Select Committee on the Treasury and Civil Service, under the Chairmanship of my right hon. Friend the Member for Worthing (Mr. Higgins), which I understand will be reporting to the House shortly.

Mr. Wrigglesworth: Is the Chancellor aware that the Government's "outstanding" record, to which his hon. Friend the Member for Winchester (Mr. Browne) referred earlier, is the highest level of unemployment since the 1930s and now the highest level of real interest rates since Britain came off the gold standard in 1931? Is he aware that the Government bear a very heavy responsibility for that record because they have been responsible for the uncertainty and confusion about exchange rate policy, because they have taken no action on oil prices or the rate of depletion of our North sea oil, as his hon. Friend the Member for Winchester also pointed out, and because the international markets are reflecting their lack of confidence in the non-oil sector of our economy?

Will the Chancellor now make clear exactly what the Government's exchange rate policy is, at what level he expects to keep the pound and whether he is prepared to take action on oil prices or on the rate of North sea oil depletion? Is he aware that if he does not do that he and his colleagues will be causing the people of this country to pay the price of the Government's own incompetence and blind devotion to economic dogma?

Mr. Lawson: The hon. Gentleman should know perfectly well that no Chancellor is ever prepared to comment on market tactics and matters of that kind which would benefit only speculators and others and would be of no benefit to our country.

Sir Peter Tapsell (East Lindsey): Will my right hon. Friend bear in mind that those who dominate the exchange markets of the world are seldom, anyhow in my experience, much preoccupied with the British public sector borrowing requirement; and that until we apply our minds to their practical concerns rather than to our own theoretical shibboleths we are unlikely to be able to restore sterling to its proper level in world exchange markets?

Mr. Lawson: My hon. Friend is a much travelled man with great experience of financial operators throughout the world. Nevertheless, in my experience, there is and always has been considerable concern in the markets, among finance ministries and indeed within the IMF, as some Opposition Members will recall, about the public sector borrowing requirement of this and other countries and about the budget deficit of the United States, a matter about which my hon. Friend himself has expressed concern in the past.

Mr. John Maxton (Glasgow, Cathcart): As the Bank of England is now intervening to protect the pound, and as the Chancellor has restored minimum lending rate and is prepared to co-operate with other economies to protect the pound against the dollar, does he still hold to the dogma that free market forces should be allowed to operate?

Mr. Lawson: Of course free market forces will operate. It is one of the illusions of right hon. and hon. Members on the Labour Benches that by a wave of a wand they can abolish free market forces. As I have said on a previous occasion, the decision taken by the Finance Ministers of the five major industrialised countries of the Western world a fortnight ago in Washington was that the time had come when it would be appropriate from time to time to intervene in a concerted way in the foreign exchange markets. [HON. MEMBERS: "Oh."] That was of course fully in line with the Williamsburg declaration which was signed some time ago.

Mr. Speaker: Order. These are hardly laughing matters.

Mr. David Howell (Guildford): On the influence of the crude oil price on sterling, would not my right hon. Friend agree that the status of sterling as a petro-currency can be and probably is being very much exaggerated? Might we not do better to free ourselves completely from involvement in trying to fix the international oil price and to withdraw the price-fixing function of the British National Oil Corporation?

Mr. Lawson: My right hon. Friend is correct in saying that markets attach excessive importance to the value of North sea oil in our economy as a whole, sizeable though it is. Indeed, there is an idea that we are almost a one-commodity economy, whereas in fact oil and gas account for about 5 per cent. of gross domestic product and only 8½ per cent. of our total tax revenues. The price of oil is set by the market, not by BNOC.

Mr. Tony Benn (Chesterfield): In view of the Chancellor's statement that public expenditure levels may have played some part in the fall of the value of the pound, could it be that world markets do not share his view that the £5 billion spent on fighting the miners was a worthwhile investment? Taking into account the fact that, since the fall in the value of the pound, not a single pit in Britain is uneconomic, would it not be wise for the Government to settle with the miners, who are responsible for building so much of our industrial future?

Mr. Lawson: The right hon. Gentleman's paranoia is well known. The Government are in no sense fighting the miners. They are supporting the working miners and the coal industry.

Mr. Nigel Forman (Carshalton and Wallington): Is it not true that one of the unfortunate but inevitable consequences of the rise of interest rates by more than four percentage points in recent weeks has been to add more than £1,000 million to the costs of British industry? Will my right hon. Friend therefore pay attention to the strong arguments for taking action in the Budget directly to reduce the costs of industry and so to help to offset that adverse effect?

Mr. Lawson: I shall take note of what my hon. Friend has said when I make my Budget judgments and frame the Budget. It was with this in mind that I abolished the national insurance surcharge in last year's Budget. However, I think that my hon. Friend is basing his calculation of the effect of interest rates on industry on an assumption that may well not be correct — the assumption that the present level of interest rates will remain in force for a full year.

Mr. Richard Wainwright (Colne Valley): Now that sterling has fallen to a relatively realistic exchange rate with the deutschmark, will the Chancellor embark on negotiations with a view to joining the exchange rate mechanism of the European monetary system?

Mr. Lawson: As the hon. Gentleman knows, that is a matter that we keep continually under review. I do not think, however, that recent events have changed the balance of the argument one way or the other with regard to joining the exchange rate mechanism of the European monetary system.

Mr. Neil Hamilton (Tatton): Does my right hon. Friend recognise that one of the major features of the speculation against the pound in recent weeks has been the fear that the Chancellor may be getting soft on inflation and in particular that his control of the wider monetary aggregates may be rather too loose? Is not the prescription required to steady the market's nerves, therefore, the reverse of that suggested by many hon. Members? Should we not keep firm control of public expenditure and concentrate on increasing demand for industry's products through tax cuts rather than cutting costs in other ways?

Mr. Lawson: I agree very much with the thrust of my hon. Friend's remarks.

Mr. Gordon Wilson (Dundee, East): Does the Chancellor realise that, whether he likes it or not, the international financial world regards the pound sterling as a petro-currency? Is he aware that the policy that he as Secretary of State for Energy and his predecessors followed, of aggressive over — production, is now undermining the value of oil in the world market and is leading to the problems that he is encountering, especially higher interest rates? Will he contact OPEC to see what he can do with it to keep the value of oil stable? He will find that that is beneficial to the United Kingdom economy.

Mr. Lawson: North sea oil has been one of the great successes of the British economy in the past few years. The policies that we have pursued have considerably assisted that success, which has led to the creation of many jobs in Scotland in the oil industry and in the offshore supplies industry.

Mr. Nicholas Soames (Crawley): Does my right hon. Friend agree that the public find it difficult to understand why the Opposition, whose stewardship of the pound sterling has been nothing short of an unmitigated disaster, take such pleasure at the pound having a rough ride? Does he agree that reactions of this type do not help stiffen the currency in international markets?

Mr. Lawson: My hon. Friend is right. He will be aware that, against the EMS index, the pound sterling is higher today than it was when we took office in 1979.

Mr. Roy Hattersley (Birmingham, Sparkbrook): Will the Chancellor take this belated opportunity to remove some of the uncertainty which still prejudices the pound and therefore interest rates? Will he make it unequivocally clear that he has now abandoned the policy of allowing the pound to float freely?

Mr. Lawson: The policy of the Government under my predecessor and me has been that the sterling exchange rate is always taken into account in assessing the correct financial policy at the time.

CHECK Fully AGAINST DELIVERY

cc Press Office

File

OPENING STATEMENT: TCSC HEARING: 28 JANUARY

Renewed weakness of the pound on the foreign exchanges led to upward pressure on domestic interest rates this morning. We believe the anxieties over sterling have been greatly overdone, with exaggerated emphasis on potential oil price developments. The fundamental problem remains the excessive strength of the dollar worldwide. However, we were not prepared, by resisting the market pressures, to run any risks of misapprehension as to our continuing resolve to conquer inflation.

The authorities therefore promptly endorsed the market move. The resulting level of interest rates represents a degree of financial tightness which may not yet have been fully appreciated by the markets.

It is important to set today's events in context. The world's foreign exchange markets have for a long period been dominated by the remarkable strength of the US dollar. All other major currencies have fallen in value against the dollar. Between May 1979, when the present Government assumed office, to the end of last week, the Swiss franc has fallen 35 per cent against the dollar, the Deutschemark by 40 per cent, Sterling by 46 per cent, and the French franc and Italian lira by 55 per cent. Looking at it, more realistically, the other way round, the effective exchange rate index of the dollar over that period has risen by 54 per cent.

Last September, when there was a sudden and rapid surge in the strength of the dollar against other currencies, the Bundesbank took the initiative by intervening substantially in the market and successfully arrested the movement and restored a calmer market. There was some discussion at the time of the possibilities of

concerted intervention, but the main emphasis then was on the need for the US to make the dollar less attractive by lowering interest rates.

By the middle of January, despite a 3½ point reduction in short-term US interest rates, the dollar had again drifted up to and even beyond the levels previously reached in September, and was threatening to rise still further. In the discussions among Finance Ministers and central bank governors of the five leading industrial countries in which I took part in Washington last week, there emerged a collective judgement that the dollar was grossly overvalued and that this warranted concerted action by our monetary authorities to demonstrate our concern and in practical terms to show the two-way risks in foreign exchange dealing. Such action, which gives practical effect to the intentions expressed at Williamsburg, has now been taken, and the authorities involved stand ready to continue to work in co-operation.

Sterling was caught up, along with other currencies, in the effects of the strengthening dollar. But over the past few weeks two other factors have affected sterling and have caused its value to decline to some extent against other currencies, as well as the dollar.

One factor - outside our control - was uncertainty about the price of oil, which had indeed weakened significantly on the spot market. It is not unreasonable that the price of oil should have some impact on the relative value of sterling, but I must say that the attention given to it in the markets seems to me disproportionate. It is worth remembering that there is no weakness in the oil price measured in currencies other than the dollar: in terms of DMs the spot oil price is now as high as it has been over the past year. To read some market comment you would think that Britain was a one-commodity economy, whereas in fact oil accounts for only 5 per cent of our national output and 8½ per cent of tax revenues.

Finally, the external influences which I have mentioned were accompanied also by some feeling in the markets that the Government was no longer giving sufficient priority to maintaining downward pressure on inflation.

These doubts about domestic policy were fanned by indications that public expenditure and borrowing were running much higher than intended this year, and by calls for yet further increases in public expenditure.

The action we have taken has clearly shown that these uncertainties are unfounded. We have acted domestically and, in concert with other major countries, internationally to calm the turbulence in the exchange markets. We have demonstrated that this Government, while anxious to see unemployment come down, is most emphatically <u>not</u> prepared to take any risks with inflation.

There have however been many misconceptions in the press and elsewhere about the intentions and implementation of our policy. So I am happy to answer your questions today.

28 January 1985

(2) To raise at Cabinet? AT 28/1 - Yes

PRIME MINISTER

INTEREST RATES AND THE BUDGET DEFICIT

Very high real interest rates - they are now 9% - destroys hopes of jobs and increases the burden on public sector finances.

Paying for Government borrowings was already the fastest growing Government programme as set out in this year's Public Expenditure White Paper.

Forecast of net debt interest payments (£bn):

78/79	79/80	80/81	81/82	82/83	83/84	84/85	85/86
2.2	3.4	4.5	5.7	5.9	7.2	8.5	9.0

Following the 5.5% increase in interest rates in recent weeks, the burden of interest will rise higher than this forecast suggests. In 1984/85 alone, interest payments probably totalled £1,000 million over forecast.

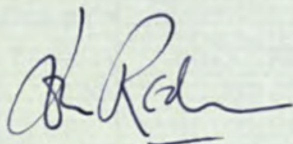
These high interest rates will be good at depressing real activity that depends on low interest rates for success - eg housing. It should also begin to squeeze those in the corporate sector, flush with money and devoid of positive

ideas, who have been busy borrowing to go short of the currency and to round trip in money and gilt markets.

As soon as it does, we have to lower interest rates again and bring back the downward pressure on rates.

To be able to do so with comfort, we need to use this period of gloom and doom to sharpen the knives on public expenditure. Real public expenditure is 9% higher than when the Conservative first took over. Even in those programmes where people feel it has been cut to the bone - eg education - it is considerably higher in real terms than when the Government took over, despite falling pupil numbers.

We would recommend that the gravity of the economic position be brought to the attention of Cabinet; that the job destruction properties of higher interest rates be brought to their attention; and the impact of compound interest on Government finances. If we are to avoid much of the Government's scope for tax cuts being swallowed up by higher interest burdens and expenditure, we need to take action now to reduce public expenditure programmes across the board.



JOHN REDWOOD

SECRET

JR2AAJ

File 7

CC MASTER SET

10 DOWNING STREET

From the Private Secretary

28 January 1985

Dear Rachel.

INTEREST RATES AND THE EXCHANGE RATE

The Prime Minister held a meeting this morning to discuss developments in the financial markets. Present were the Chancellor of the Exchequer, Sir Peter Middleton, and the Deputy Governor of the Bank of England.

The Chancellor reported that sterling had opened lower in the morning at $1.1100, reflecting concerns about the OPEC meeting in Geneva. Later in the morning money market interest rates had risen sharply to just over 13 and on the back of this the exchange rate had risen to around $1.1140. He had discussed with the Bank what response the authorities should make. While they had originally concluded in favour of raising interest rates by 1 per cent in the course of the Bank's 12.15 dealing operations, a further rise during the course of the morning, reflecting reports of disarray at the OPEC meeting, had made it clear that 1 per cent would be insufficient. It was decided, therefore, to raise dealing rates by approximately 2 per cent. At the same time the clearing banks were raising their base rates to 14 per cent.

The Prime Minister said she agreed with this course but felt it was important to establish the way in which it would be presented. She accepted that the Government did not have a specific exchange rate target but nevertheless she felt that sterling at its current level was a serious cause of concern for the Government. Not only did it put at risk the Government's inflationary objectives but it did not reflect accurately the true state of the British economy. She accepted that there was little that could be done through use of foreign exchange reserves. It was necessary, therefore, to deploy higher interest rates. As had been the case last July, she believed higher interest rates need only be temporary. The Prime Minister was particularly concerned that expectations about sterling in foreign exchange markets all ran one way. She hoped something could be done to make speculation against sterling a more risky proposition.

The Chancellor agreed that the behaviour of the exchange rate was a major cause of concern and that the Government was right to respond by raising interest rates. He advised,

however, that it would be dangerous to present this action as being in response to the level of the exchange rate. This could also too easily leave the Government in the worst of all possible worlds, seeking to control the exchange rate and not having the instruments required to do it. The Government could be faced with the question of what to do if, even after the latest interest rate rise, sterling fell further. If the market perceived that the Government was not prepared to intervene and had gone as far as it could on interest rates, the problem of one-way expectations would reappear. It was essential, therefore, to relate the Government's action to the need to eliminate doubt about its commitment to sound financial conditions and a reduction in inflation.

It was argued that to raise interest rates in response to exchange rate movements could push the Government off its medium term strategy. Interest rates were now very high in real terms. While there was little threat of higher inflation, there was a danger that recovery could be damaged. It was important to look at the totality of financial pressure. Against this it was argued that the market was concerned about the perceived willingness of the Government to relax financial conditions, particularly as indicated by the PSBR, bank lending and broad money and that higher interest rates, at least for a time, were a proper response.

The Prime Minister said she had seen the note prepared by the Treasury on the possibilities for mounting a "bear squeeze" and had noted that this was difficult in the absence of exchange control. She asked whether there was any way of operating in the very short-term money markets which would not spill over into other parts of the yield curve. The Deputy Governor said action to raise very short money rates would affect all the participants in the money market and could not be confined to speculators. High interest rates could contribute little to discouraging speculation as, even at their present level, the cost of borrowing overnight was likely to be small relative to the possible gain on the exchange rate. The most effective course was significant intervention but this was difficult while the UK's foreign exchange reserves were low. The markets were aware of the resources available to the authorities and of the fact that the Government had not undertaken any borrowing to replenish them. One possibility in the short term was activation of the Fed swap though this would be a very major step. The Prime Minister agreed that this should not be pursued at present.

The discussion then turned to the EMS. The Prime Minister said she had asked Mr. Lubbers why the Netherlands as a major energy producer was not experiencing similar problems to the United Kingdom. Mr. Lubbers thought that the EMS gave some protection as no major change in the exchange rate was expected, other than in the context of a re-alignment. The Deputy Governor pointed out that, even when re-alignments took place, there was often no change in the market exchange rates; all that occurred was that parities changed so that a given market rate appeared at the top rather than the bottom of the band. This left little opportunity for speculators to make significant gains. The Chancellor pointed out that the

Netherlands sold its gas under long-term contracts and was therefore less vulnerable to short-term movements in oil prices.

The discussion then turned to the US dollar. It was argued that, following the G5 meeting, there had been a perceptible change in US attitudes, and expectations about the future course of the dollar were now more evenly balanced. Nevertheless, the Fed was inhibited from intervening too strongly as it was worried that this could trigger a major fall. It was difficult for any central bank to be seen as a seller of its own currency. Ironically, one of the side effects of the more stable dollar was that the recent fall in sterling was identified as a UK phenomenon.

Summing up the discussion, the Prime Minister asked the Chancellor of the Exchequer to draft the line to be taken on the rise in interest rates. This should stress that the Government's action was not in defence of a specific level of the exchange rate but in order to eliminate any doubt about its commitment to reducing inflation. The Government should stress that markets were over-emphasising the impact of changes in oil prices. The Chancellor should continue work on whether, in present circumstances, it was right for the UK to join the EMS. The Treasury and the Bank should look further at whether there was any way of reducing speculative activity against sterling and should seek to identify opportunities for such action.

I am copying this letter to the Private Secretaries to the Governor and Deputy Governor of the Bank of England.

Yours sincerely

Andrew

(ANDREW TURNBULL)

Interest Rates: 28 January

Line to take

Renewed weakness of the pound on the foreign exchanges led to upward pressure on domestic interest rates this morning. We believe the anxieties over sterling have been greatly overdone, with exaggerated emphasis on potential oil price developments. The fundamental problem remains the excessive strength of the dollar worldwide. However, we were not prepared by resisting the market pressures to run any risks of misapprehension as to our continuing resolve to conquer inflation.

We therefore promptly endorsed the market move. The resulting level of interest rates represents a degree of financial tightness which may not yet have been fully appreciated by the markets.

File

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3.5120
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Interest Rates and the Exchange Rate.

The Treasury View

Influence. (i) We cannot control the exchange rate and do not have an exchange rate target

Does matter.

No - it does not - but means we care about it

(ii) To move interest rates now, and in particular to lead interest rates up will confirm the view that we do have an exchange rate target

Over-worried

(iii) If sterling becomes still weaker as post OPEC meeting we will have to raise interest rates still further

Talking about only weapon we have unpromising

(iv) Financial conditions are satisfactory and even the 2½ per cent rise is not justified, still less anything more.

The Alternative View

(i) There is strong downward pressure on sterling, in addition to the strength of the dollar, which after G5 has abated

why uncertainty worse now than 1 month ago

(ii) The market view on sterling reflects
- oil
- worries about financial conditions, especially PSBR and bank lending
- the feeling that the authorities don't care and respond to pressure on sterling only when have no alternative

ONE-WAY

(iii) These factors create one way expectations. To adopt the "following the market" philosophy will do nothing to alter expectations.

(iv) To show reluctance in raising interest rates will, as it has done already, encourage a fall and again put £ in position where a rise in interest rate is forced on us. Thus creeping rises in interest rates are more likely if we cannot, for a time, take pressure off sterling

(v). Arguments about level of interest rates assume they stay up. In previous episodes, it was possible to reverse quite quickly.

10 DOWNING STREET

Prime Minister (2)

Treasury have looked into bear squeezes. While the note sets out the difficulties clearly enough, it is not very encouraging on the options available. The main risk from acting on short rates is that it might [illegible] repercuss too widely.

AT 25/1

What can we do?

Is there any possibility of securing the co-operation of the banks in not lending overnight for this purpose?

014/10

CONFIDENTIAL

A "bear squeeze" on speculators against Sterling

With Exchange Controls

The classic "bear squeeze" technique against currency speculators depended on the existence of exchange controls.

2. Under exchange controls residents were not allowed to hold dollar deposits; so opportunities for currency speculation by UK residents were limited, and important speculators were non-residents.

3. Nor were UK residents allowed to lend sterling to non-residents. So if non-resident speculators wished to borrow sterling to sell they had to borrow sterling from other non-residents in the offshore ("Eurosterling") market. Exchange controls, in effect, separated the eurosterling market from the domestic sterling market, and interest rates in the former could rise a long way without - in the short term at least - affecting domestic interest rates.

4. The eurosterling market was quite a narrow one. In those circumstances, the Bank could operate quite easily to push up rates in that confined market - that is the rates at which speculators had to borrow - to very high levels. The classic technique was for the Bank to sell dollars and buy sterling spot (hence taking money out of the short term eurosterling market, and pushing up rates) and sell sterling forward.

5. When the French - who still have exchange controls - used a similar technique before the last EMS realignment, they pushed overnight interest rates in the Euro French Franc market up to 1,000 per cent or more for a day or so, without affecting domestic interest rates.

Without Exchange Controls

6. Clearly, we cannot use this particular technnique nowadays.

The only equivalent would be to act to raise domestic short term rates to very high levels.

7. There is no need to operate in the foreign exchange market to push up overnight sterling interest rates. The Bank could achieve this relatively simply through their domestic money market operations. They would keep the market short through the day, causing a scramble for funds - which they could relieve late in the day by lending to the discount market at a rate of their choosing.

8. The difficulties are:-

(i) This of course would hit all who operate in the short term market - banks, discount houses, and so on - as well as currency speculators. There is no way to discriminate.

(ii) It would be hard to prevent this rise in overnight (and perhaps up to 7 day) rates feeding through to one month or three month rates - which would risk triggering a rise in clearing bank base rates.

(iii) Unless the purposes of the operation were clearly explained, it could easily be interpreted by the markets as a signal that the authorities wanted a rise in base rates.

(iv) It certainly could not be held for more than a day or so without bringing about a rise in base rates: so all would turn on there being an immediate impact on the exchange rate. If there were not we would be in a worse position than had it not been tried.

9. To give any reasonable chance of success:-

(a) We would probably have to explain clearly what we were doing and why. This would be the best way of reducing risks (ii) and (iii) above. But, of course, it would also increase the problems should we not quickly succeed

in raising the exchange rate. And we might be seen as coming very close to having a public exchange rate target, with all that would imply for the future operation of policy

(b) We would want to choose a period in which we could be reasonably confident that there would be no "bad news" (eg. on oil prices) weakening sterling - or better still in which we knew of some "good news" to come.

Intervention

10. The other way of seeking to "burn speculators' fingers" is straightforward intervention. Speculators can lose money without a rise in short term interest rates, simply by the exchange rate moving against them in an unexpected way. The purpose of the G-5 agreement on intervention was precisely to keep them guessing.

11. Of course speculators in that case can always maintain open positions, and hope that exchange rates move back their way: and if short term interest rates have not gone up, the cost of keeping an open position against sterling will not be increased. But they are unlikely to want to sit for too long on a unrealised exchange loss that looked as if it could get bigger.

12. It is, though, in this context important to distinguish between concerted G-5 intervention against the dollar, which we believe could have a useful impact, and large scale intervention on our own. Even the Germans have not had significant success intervening against the dollar by themselves. For us there would be an additional problem - of the kind that the Government of the day faced in the mid-1970s - that as intervention was seen to deplete the reserves, the figures for which are published monthly, confidence could turn further against sterling on that account.

PRESS OFFICE BULLETIN

cc incl. AT RC(HMT) NP(Bank)

date: 24.1.85

No: 8

File

G5: "MESSAGE FROM PM TO PRES. REAGAN"

If asked about a message which the PM is alleged to have sent to the President at the time of the G5, we should say only (non-attributably):

- that we never comment on reports of inter-Governmental messages;

- that as far as the G5 meeting is concerned, there is no question of the discussion being addressed to "saving sterling"; in so far as it was about currencies at all, it was about the current strength of the dollar against all other currencies and about coordinated intervention (see telegram on G5 statement:

  "... in the light of recent developments in foreign exchange markets, [the G5*] reaffirmed their commitment mad at the Williamsburg Summit to undertake coordinated intervention in the markets as necessary....").

NT

*US, UK, Japan, West Germany, France

SECRET

E.R.

7

File

24 January 1985

MR TURNBULL

FUNDING MEETING

I attended the Funding Meeting yesterday.

The balance of the long tap has been sold, taking the total of sales for banking February to £1,000 million already. Index-linked gilts have been in strong demand.

It was agreed that:

1. The policy would be to sell as much as possible, up to £1.5 billion in banking February, and even further sales of stock with calls in banking March.

2. On Friday, tranchettes of index-linked stocks will be issued if the indexed market is still strong.

3. Issue tranchettes of conventional stocks at the same time, or a new short tap.

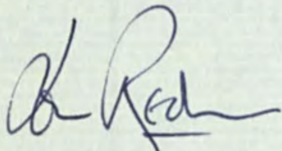
4. New National Savings rates will be set: 12.75% for the Income and Deposit Bonds; 12.25% for Invac; and 8.85% tax-free for a new National Savings Certificate. This compares with current rates of 12%, 11.25% and 8%.

SECRET

SECRET

There was a discussion on the value and hazards of intervention in the currency market. It was pointed out that intervention had stemmed the decline in the pound, and occasionally the rise of the dollar. The market had hesitated to go on selling sterling and DMs because it was afraid it could now lose money; but remained to be convinced, as it was not sure that the Americans would put very much weight of cash behind intervention.

There was general welcome that short selling was no longer a sure-fire way of making money. I argued that sterling now required a series of better money supply figures, and reassurance that public expenditure was under control. These two things could only come as the figures improved and active funding was essential.



JOHN REDWOOD

SECRET

MAY I TRANSMIT PLEASE ?
KN

cc MASTER OPS.

SUBJECT

6

PLS WAIT ONE I SET UP MY EQUIPMENT

PRIME MINISTER'S PERSONAL MESSAGE
SERIAL No. T9/85

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OTOTVMMXMMMMPUWT Z GAGAGAGG SEND PLSH

V

CAB/WHCA ØØ1/22

OO WHITE HOUSE

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S E C R E T
FROM CABINET OFFICE LONDON 221153Z JAN 85.
TO IMMEDIATE WHITE HOUSE
TELEGRAM NUMBER MISC 27 DATED 22 JANUARY 1985.

THIS MESSAGE IS PARTICULARLY SENSITIVE AND WE REQUEST THAT IT BE GIVEN MOST LIMITED POSSIBLE DISTRIBUTION.

MESSAGE TO PRESIDENT REAGAN FROM THE PRIME MINISTER:

''DEAR RON,
I HAVE HAD AN APPRECIATIVE REPORT FROM CHANCELLOR LAWSON ABOUT SECRETARY REGAN'S HELPFUL APPROACH TO THE DISCUSSION OF FOREIGN EXCHANGE MARKETS AMONG G5 FINANCE MINISTERS LAST WEEK.

THE ANNOUNCEMENT THEY MADE INITIALLY CALMED THE MARKETS. BUT THIS MORNING THE MARKETS ARE TESTING OUR INTENTIONS AND WE NOW HAVE TO DEMONSTRATE, IN COOPERATION TOGETHER, THAT WE MEANT WHAT WE SAID. I AM MOST GRATEFUL TO YOU FOR YOUR HELP IN THIS MATTER.

I TAKE THE OPPORTUNITY TO SEND YOU WARMEST CONGRATULATIONS ON YOU INAUGURATION FOR YOUR SECOND TERM. YOU AND NANCY BOTH LOOKED SPLENDID ON TELEVISION AND MY THOUGHTS WERE WITH YOU.

YOURS EVER, MARGARET''

NNNN

SENT AT 22123ØZ JAN 85 BY DMH INT QSL PLEASE ?.

File

10 DOWNING STREET

Prime Minister

Attached is a draft message to President Reagan, thanking him for his help in securing the outcome of the G5 and reemphasising US commitment to intervene if it proves necessary.

This does not need your signature as it will be transmitted over the direct link.

Approve text?

AT

21/1

Yes

M

SECRET

10 DOWNING STREET

THE PRIME MINISTER

January 1985

Dear Ron

I have had an appreciative report from Chancellor Lawson about Secretary Regan's helpful approach to the discussion of foreign exchange markets among G5 Finance Ministers last week.

The announcement they made ~~seems for the moment to have calmed the markets, which is good for all of us. If the markets test our intentions over the coming days and weeks,~~ we shall ~~be able~~ to demonstrate - in co-operation together - that we meant what we said. I am most grateful to you for your help in this matter.

I take the opportunity to send you warmest congratulations on your Inauguration for your second term. You and Nancy both looked splendid on television and my thoughts were with you.

Y S

Margaret

But this morning the markets are testing our intentions - We now have - - -

The President of the United States of America.

Andrew

As promised – a draft message for the PM to send to President Reagan

Rachel.

21/xi.

LPOAB9

GTR
Pl type

3.22

SECRET

DRAFT LETTER FROM THE PRIME MINISTER TO PRESIDENT REAGAN

Dear R

I have had an appreciative report from Chancellor Lawson about Secretary Regan's helpful approach to the discussion of foreign exchange markets among G5 Finance Ministers last week. I am most grateful to you for your help in this matter.

The announcement they made seems for the moment to have calmed the markets, which is good for all of us. If the markets test our intentions over the coming days and weeks, we shall be able to demonstrate - in co-operation together - that we meant what we said. ~~I am~~ ~~[illegible]~~

~~Thank you.~~ ~~I too look forward to our February meeting.~~

I take the opportunity to send you warmest congratulations on your Inauguration for your second term. ~~I thought~~ ~~that~~ ~~[illegible]~~ You & Nancy both looked splendid on television and my thoughts were with you.

10 DOWNING STREET

From the Private Secretary

Prime Minister

Chancellor wishes

(i) to report on outcome of G5
(ii) to review recent developments in the market
(iii) to discuss the public expenditure meeting now scheduled for Tuesday (the same day as publication of the PEWP).

You have already seen the papers but I have put them in the box for another look.

AT
18/1

GRS 2700 **RESTRICTED**

RESTRICTED

FM WASHINGTON 190006Z JAN

TO IMMEDIATE FCO

TELEGRAM NUMBER 173 OF 18 JANUARY

MFF 102/606/7
RECEIVED IN REGISTRY
21 JAN 1985
TOP COPY

Monetary policy file

MEETING OF FIVE FINANCE MINISTERS IN WASHINGTON:
BACKGROUND BRIEFING BY CHANCELLOR OF THE EXCHEQUER

1. THE CHANCELLOR OF THE EXCHEQUER GAVE A BACKGROUND BRIEFING THIS MORNING TO THE BRITISH PRESS ON THE MEETING IN WASHINGTON OF FINANCE MINISTERS AND CENTRAL BANKERS OF FRANCE, GERMANY, JAPAN, THE UNITED STATES AND U.K. WHICH IT WAS AGREED COULD BE USED BY JOURNALISTS QUOTING BRITISH OFFICIAL SOURCES IN WASHINGTON.

2. FOLLOWING IS A PARTIAL TRANSCRIPT OF THE BRIEFING. IT IS AS NEAR TO VERBATIM AS COULD BE ACHIEVED UNDER INFORMAL CONDITIONS BUT MAY CONTAIN A FEW MINOR INACCURACIES.

CHANCELLOR:

AS I THINK YOU ALL KNOW THIS MEETING OF G5 WAS ARRANGED IMMEDIATELY AFTER THE PRESIDENTIAL ELECTION TO GIVE US A CHANCE TO DISCUSS IN PARTICULAR THE ATTITUDE OF THE US ADMINISTRATION IN THE SECOND REAGAN TERM TO THE BUDGET AND TO THE DEFICIT. WE ALSO HAVE THE SPRING MEETINGS COMING UP.

WE DID DISCUSS BOTH THOSE TOPICS. ON THE DEFICITS, WE ALL EXPRESSED OUR CONCERN AT THE LATEST PROJECTIONS OF THE SIZE OF THE DEFICIT. DON REGAN EXPLAINED WHAT THE ADMINISTRATION WAS DOING. I THINK THERE'S DEFINITELY A GREATER DEGREE OF DETERMINATION THAN A YEAR AGO, CERTAINLY A GREATER DEGREE OF DETERMINATION THAN 6 MONTHS AGO TO TAKE MEASURES WHICH WILL HAVE A SIGNIFICANT EFFECT ON THE DEFICIT, ALTHOUGH ALL OF US, CERTAINLY I WOULD LIKE TO SEE A BIGGER BITE TAKEN OUT OF THE DEFICIT. BUT WHAT IS PROPOSED IS BY NO MEANS INSIGNIFICANT. WE SHALL JUST HAVE TO JUDGE THAT BY SEEING WHAT HAPPENS IN THE EVENT. AND SO I THINK OUR CONCERN OVER THE DEFICIT WAS MADE VERY VERY CLEAR TO THE AMERICANS. THAT DISCUSSION WAS A SATISFACTORY ONE AND AS I SAY I THINK THAT WHAT THE ADMINISTRATION IS NOW DOING IS MUCH MORE SERIOUS THAN ANYTHING THAT HAS BEEN DONE BEFORE.

WE ALSO SPENT TIME OF COURSE WHICH HADN'T BEEN PLANNED IN ADVANCE BUT IN THE LIGHT OF RECENT CIRCUMSTANCES WE SPENT QUITE A LOT OF TIME DISCUSSING THE MARKETS AND WE REACHED AGREEMENT ON THE STATEMENT WHICH YOU HAVE SEEN. THE MOST IMPORTANT PART OF THAT WITHOUT ANY DOUBT IS THE REAFFIRMATION OF THE AGREEMENT ON CONCERTED INTERVENTION IN VERY CLEAR TERMS AND THIS I THINK IS AN INDICATION THAT WE MEAN BUSINESS ON THAT. I CAN'T RECALL AN OCCASION EVER BEFORE WHERE A G5 MEETING HAS PRODUCED A STATEMENT OF ANY KIND WHATEVER AND I WAS VERY SATISFIED WITH THE AGREEMENT THAT WE REACHED AND THE FACT THAT WE DO ALL SEE EYE TO EYE ON THIS ISSUE. I THINK THAT'S PROBABLY ENOUGH THERE. I'LL BE HAPPY TO ANSWER YOUR QUESTIONS.

RESTRICTED /Q ROBERT

Q. ROBERT CHESSYRE (OBSERVER): IN PRACTICAL TERMS DO YOU FEEL THAT THE UNITED STATES IS NOW GOING TO BE MORE INVOLVED IN THE MARKETS THAN THEY HAVE BEEN IN THE FIRST TERM. THAT STATEMENT WAS ACTUALLY READ DIFFERENT WAYS THIS MORNING BY THE NEWSPAPERS.

CHANCELLOR: I THINK THAT THIS IS A CLEAR INDICATION OF A READINESS ON THE PART OF ALL OF US TO TAKE ACTION, TO TAKE ACTION IN A CONCERTED WAY. IN THINK THAT'S QUITE CLEAR.

Q. BAILEY MORRIS (TIMES): BUT WHAT KIND OF SITUATION ARE WE TALKING ABOUT? WE HAVE NOT SEEN, AT LEAST TO OUR KNOWLEDGE, CONCERTED ACTION OVER A SUSTAINED PERIOD. DESPITE THE ACCORD REACHED EARLIER, WHAT SORT OF CONDITIONS DOES IT TAKE? I MEAN DO YOU HAVE TO SIT DOWN FOR A LONG NEGOTIATION AS TO WHAT DISORDERLY MEANS AGAIN.

CHANCELLOR: NO REFERENCE TO DISORDERLY AS YOU WILL NOTICE IN THAT COMMUNIQUE. QUITE RIGHT. POINT TWO. NO WE HAVE GOT A SUFFICIENT UNDERSTANDING BETWEEN US SO THAT THIS THING CAN BE MOBILIZED AT ANY MOMENT OVER THE TELEPHONE, IT WOULD REQUIRE NO MEETING, NOTHING, IT WOULD BE VERY QUICK.

Q. ALEX BRUMMER (THE GUARDIAN): MY UNDERSTANDING IS THAT YOUR OWN GOVERNMENT'S POSITION HAS ALWAYS BEEN THAT INTERVENTION WAS NOT A GOOD IDEA AND THAT FREE MARKET FORCES SHOULD BE SEEN TO OPERATE. DOES THIS REPRESENT A HARDER LINE OR THE QUOTE WE MEAN BUSINESS STATEMENT UNQUOTE WHICH YOU MADE EARLIER. DOES THIS REPRESENT A CHANGE IN POLICY FOR YOUR OWN GOVERNMENT?

CHANCELLOR: NO, BECAUSE THAT HASN'T BEEN OUR POSITION. OUR POSITION IS THAT WE CERTAINLY DON'T BELIEVE IN INTERVENTION AS A WAY OF LIFE BUT WE HAVE ALWAYS BELIEVED THAT THERE WAS A ROLE FOR INTERVENTION IN CERTAIN CIRCUMSTANCES, IN THE SIGNATUR S TO TH WILLIAMSBURG DECLARATION WHICH IS REFERRED TO THERE. AND THERE HAVE ALSO BEEN OTHER OCCASIONS ON WHICH WE HAVE MADE THIS CLEAR AND INDEED WHEN I WAS ASKED, WHETHER IT WAS BY YOU OR SOMEBODY ELSE, WHEN I GAVE A PRESS CONFERENCE AT THE IMF MEETING LAST AUTUMN, I MADE IT CLEAR THAT THERE WERE IND ED CIRCUMSTANCES IN WHICH WE WOULD CONSIDER IT RIGHT TO INTERVENE. BUT I WAS NOT PREPARED TO STAT AND IT IS FOOLISH TO DO SO BECAUSE YOU'R ONLY JUST HELPING THE SPECULATORS IF YOU DO SP LL IT OUT.
I WAS NOT PREPARED TO SPECIFY THE CIRCUMSTANCES PRECISELY IN WHICH W COULD CONSIDER IT RIGHT. SO THAT HAS ALWAYS BE N OUR POSITION. I THINK THAT WHAT IS TH IMPORTANT THING IN THIS IS THAT NOT ONLY IS IT MADE CLEAR NOW THAT WE ARE MUCH CLOSER TO THOSE CIRCUMSTANCES BUT ALSO THAT WE HAVE REACH D A COMPL TE UNDERSTANDING BETWEEN ALL THE MEMBERS OF THE GROUP OF FIVE AND THAT THE INTERVENTION WHEN IT OCCURS IS LIK LY TO BE OF A CONCERTED NATURE.

Q. BRUMMER. CAN I JUST FOLLOW UP? TALKING ABOUT INTERVENTION OF A CONCERTED NATURE, WILL THIS BE IN DEFENCE OF ANY ONE PARTICULAR CURRENCY OR IN DEFENCE OF SEVERAL CURRENCIES?

CHANCELLOR: WHAT I THINK WE WERE LOOKING AT WAS WHAT HAS BEEN HAPPENING TO THE DOLLAR IN RELATION TO ALL CURRENCIES. THAT IS I THINK WHAT ASSISTED IN GETTING THIS GENERAL AGREEMENT.

Q. MARK HOSENBALL (SUNDAY TIMES): CLEARLY THIS WOULD SEEM TO BE A MAJOR ADVANCE FORWARD FROM THE WILLIAMSBURG POSITION. THE NEW MECHANISM HERE FOR COORDINATING INTERVENTION AND THE CIRCUMSTANCES UNDER WHICH YOU WOULD INTERVENE ARE DEFINED MORE IMMEDIATELY AS IT WERE. CLEARLY YOU HAVE TAKEN A STEP FORWARD FROM WILLIAMSBURG.

CHANCELLOR: YES, I THINK THIS IS IN ONE SENSE A STEP FORWARD, IN ANOTHER SENSE IT IS SOMETHING WHICH EMERGES NATURALLY FROM THE WILLIAMSBURG AGREEMENT IN THE LIGHT OF THE CONDITIONS AND DEVELOPMENTS THAT THERE HAVE BEEN IN THE FOREIGN EXCHANGE MARKETS SINCE THE TIME OF THE WILLIAMSBURG AGREEMENT. BUT I THINK IT IS A STEP FORWARD, A STEP FORWARD PRODUCED NOT BY A CHANGE OF POLICY BUT BY AN EVOLUTION OF EVENTS IN THE MARKETS.

Q. STEWART FLEMING (FINANCIAL TIMES): COULD YOU TELL US A LITTLE ABOUT THE MECHANICS OF IT WITHOUT TELLING US THE CIRCUMSTANCES IN WHICH YOU ARE GOING TO INTERVENE? HAVE YOU DEFINED MORE CLOSELY THE DEGREE OF VOLATILITY OR THE LEVELS OF EXCHANGE RATES WHICH WOULD LEAD TO SOME SORT OF INTERVENTION.

CHANCELLOR: I DON'T THINK THAT I CAN TELL YOU MORE WITHOUT REVEALING MORE THAN IT IS WISE TO DO BUT WE DID NOF COURSE DISCUSS NUTS AND BOLTS. WE DIDN'T SIMPLY DISCUSS GENERAL PRINCIPLES. BUT I DON'T THINK IT WOULD BE WISE TO SAY ANYTHING MORE.

Q. BRIAN BARRON (BBC TELEVISION): IN THE LIGHT OF THIS AGREEMENT AND DEVELOPMENTS THIS WEEK ON THE EXCHANGE MARKET, HOW DO YOU SEE THE POUND AT THE MOMENT, WHAT'S YOUR FEELING ABOUT THE WAY ITS GONE NOW ITS FRIDAY?

CHANCELLOR: WELL THE POUND HAS BEEN VERY STEADY EVER SINCE THE INCREASE IN BRITISH INTEREST RATES ON MONDAY AND I THINK THAT THE EXCHANGE MARKETS GENERALLY HAVE BEEN VERY STEADY.

Q. BARRON: DOES THAT MEAN THAT YOUR FEELING THAT THE IMMEDIATE THREAT, THE IMMEDIATE PRESSURE IS REALLY DIMINISHED AND THAT THE CRISIS FOR THE MOMENT IS OVER?

CHANCELLOR: WELL I NEVER LIKE USING THE WORD CRISIS, I THINK I WOULD PUT IT THIS WAY, I THINK THE TURBULENCE IS OVER.

Q. TORDAY (REUTERS): THERE HAS BEEN A LACK OF INTERVENTION BY THE UNITED STATES SINCE WILLIAMSBURG. ARE YOU CONCERNED THAT THIS COMMITMENT WILL MEET THE TEST? SECONDLY, DO YOU THINK THE US TREASURY WILL BE MORE FLEXIBLE UNDER BAKER THAN UNDER REGAN ON THIS ISSUE?

CHANCELLOR: I DON'T KNOW MR BAKER. I CAN'T GIVE YOU ANY GUIDANCE ON THAT. BUT THE PLAIN FACT IS THAT THE AMERICANS ARE FULLY COMMITTED TO THIS STATEMENT. THIS STATEMENT WAS PRODUCED AT A MEETING UNDER AMERICAN CHAIRMANSHIP AND WAS RELEASED TO THE PRESS BY DON REGAN SO THE AMERICANS ARE CERTAINLY FULLY COMMITTED TO THIS. I AM IN NO DOUBT WHATEVER ABOUT THAT.

Q. FRANK TAYLOR (DAILY TELEGRAPH): YOU MENTIONED THAT YOU CAME AWAY WITH THE IMPRESSION THAT THE AMERICANS ARE NOW MUCH MORE SERIOUS THAN BEFORE - SAY 6 MONTHS AGO IN CUTTING THE DEFICIT. WHAT DO YOU THINK HAS MADE THEM MORE SERIOUS IN THE INTERIM - WHAT HAS TAKEN PLACE?

CHANCELLOR: TO BE HONEST WITH YOU I REALLY DON'T FULLY UNDERSTAND EXACTLY WHY IT IS. BUT THERE IS NO DOUBT ABOUT IT. I DON'T THINK I'M THE ONLY PERSON - I HAVE TALKED TO PAUL VOLKER AND HE IS NOT QUITE SURE WHY, BUT NEVERTHELESS IT HAS RISEN MUCH HIGHER ON THE POLITICAL AGENDA, ON THE AGENDA OF THE AMERICAN POLITICAL DEBATE. THERE IS NO DOUBT ABOUT IT. BUT PRECISELY WHY THIS IS HAPPENING IS DIFFICULT TO FATHOM. I HOPE THAT THE CONSTANT PRESSURE THAT WE AND A NUMBER OF OTHER COUNTRIES HAVE EXERTED HAS PLAYED SOME PART IN THE MATTER, BUT I SIMPLY DON'T KNOW WHY EXACTLY THIS HAPPENED. THEN IN ADDITION TO THAT I THINK THERE IS A GROWING CONCERN WITHIN THE AMERICAN TREASURY OF THE PROBLEM THEY CAN SEE WITH THE EVER RISING BURDEN OF DEBT INTEREST. I THINK THAT INITIALLY THIS WASN'T - THERE ARE SOME PEOPLE WHO HAD FOCUSED ON IT A LITTLE EARLIER, SAY MARTY FELDSTEIN FOR ONE, BUT I DON'T THINK THIS HAS BEEN WIDELY PERCEIVED AS A REAL PROBLEM. I THINK THAT IT IS NOW MUCH MORE ONE OF THE THINGS IN THE FOREFRONT OF THEIR MINDS AND THERE IS ALSO THE ASSOCIATION BETWEEN THAT AND THE TRADE DEFICIT WHICH CAUSES THEM CONCERN. SO I THINK THAT THE WHOLE DEFICIT ISSUE HAS BECOME A PROBLEM FOR THEM AND THEY SEE THAT AS PART OF IT.

Q. BRUMMER (THE GUARDIAN): HOW LONG DO YOU THINK IT WILL BE BEFORE THE UPWARD PRESSURE ON INTEREST RATES EASES. WILL THIS AGREEMENT ALLOW YOU TO EASE THE UPWARD PRESSURE ON INTEREST RATES OR BRING INTEREST DOWN SOMETIME IN THE NEAR FUTURE.

CHANCELLOR: I DON'T THINK THAT THIS AGREEMENT ITSELF WILL AFFECT THE LEVEL OF INTEREST RATES IN THE UK. WHAT WE'RE ENGAGED IN IS A BATTLE AGAINST INFLATION. WE HAVE BEEN EXTREMELY SUCCESSFUL. THE LATEST FIGURES OUT TODAY IS 4.6 PERCENT YEAR ON YEAR, DECEMBER ON DECEMBER. AND WE ARE DETERMINED TO HOLD ON TO THAT GAIN AND TO MAINTAIN THE DOWNWARD PUSH ON INFLATION. AND IT WILL - INTEREST RATES WILL COME DOWN AS SOON AS IT IS PRUDENT AND SAFE FOR THEM TO DO SO BUT NOT BEFORE.

Q. SUNDAY TELEGRAPH. AS A FOLLOW UP TO THAT QUESTION COULD THE FALL IN THE POUND AND RISE IN INTEREST RATES HAVE BEEN ARRESTED IF THE AGREEMENT ON INTERVENTION HAD BEEN IN PLACE?

CHANCELLOR: I DON'T KNOW IS THE HONEST ANSWER TO THAT.

Q. WOULD YOU HAVE LIKE TO HAVE HAD THE OPPORTUNITY ....

CHANCELLOR. I THINK THAT IN THE PECULIAR CIRCUMSTANCES THAT WE HAD AT THAT TIME I THINK THAT A RISE IN INTEREST RATES WAS - A SHARP RISE IN INTEREST RATES - WAS INEVITABLE.

/Q BAILEY

Q. BAILEY MORRIS: A DOUBLE QUESTION. IN THE MEETINGS DID YOU SENSE THAT THE AMERICANS WOULD LIKE TO SEE A LOWER DOLLAR. IS IT NOW NOT SO THAT IN YOUR BATTLE AGAINST INFLATION AND IN THE INTERESTS OF BRITISH INDUSTRY THAT A LOWER POUND IS IN FACT GOOD FOR BRITAIN?

CHANCELLOR: I THINK THAT THE AMERICANS DO FEEL THAT THE DOLLAR IS TOO HIGH, YES. BUT THAT DOESN'T MEAN TO SAY THAT THEY ARE VERY KEEN TO SAY THIS OPENLY. I WOULD BE VERY SURPRISED IF THEY DID. AS FOR THE POUND I SHARE THE AMERICAN VIEW - I THINK THAT THE DOLLAR IS OVERVALUED. I THINK SOONER OR LATER THERE IS GOING TO BE A CORRECTION BUT WHEN IT WILL HAPPEN WHO KNOWS. I THINK THAT THE DOLLAR IS OVERVALUED, BUT I'M QUITE SATISFIED WITH THE STERLING EXCHANGE RATE AGAINST OTHER CURRENCIES.

Q. FLEMING (FINANCIAL TIMES): MR LAWSON YOU SAID YOU EXPRESSED YOUR CONCERNS ABOUT THE BUDGET DEFICIT. WHAT ARE THOSE CONCERNS NOW, AND IF YOU LOOK AT THE TIMETABLE IT WOULDN'T BE BEFORE THE MIDDLE OF THE YEAR BEFORE ANY ACTION WAS TAKEN ON THE FY 86 DEFICIT. THE ECONOMIC EFFECTS WON'T COME UNTIL AFTER 1986. ARE YOUR CONCERNS NOW MUCH MORE ALONG THE LINES OF PROTECTIONIST PRESSURES - ARE YOU GOING TO TRY AND SHORT CIRCUIT THE PROBLEMS OR WHAT ?

CHANCELLOR: YES THERE ARE TWO THINGS - THERE ARE CONCERNS ABOUT PROTECTIONIST PRESSURES AND THERE ARE CONCERNS ABOUT THE LEVEL OF UNITED STATES INTEREST RATES. THOSE ARE THE TWO THINGS WE ARE CONCERNED WITH.

Q. HOSENBALL (SUNDAY TIMES): ARE YOU DETERMINED TO DO EVERYTHING YOU CAN TO KEEP THE POUND FROM FALLING TO PARITY WITH THE DOLLAR.

CHANCELLOR: I DON'T SEE THIS AS LIKELY TO HAPPEN AT ALL. I THINK THERE WAS A LOT OF LOOSE TALK - I DON'T SEE ANY EXPECTATION - I HAVE'NT SEEN ANY INDICATION THIS IS LIKELY TO HAPPEN.

Q. CLIVE SMALL (BBC): IT HAS ALWAYS BEEN THOUGHT OF THAT INTERVENTION OF THIS SORT, OF ALMOST ANY OTHER SORT, AS A TEMPORARY PALLIATIVE AND THAT REALLY YOU'VE GOT UNDERLYING PROBLEMS IN THE CURRENCY MARKET THAT NEED TO BE TACKLED. WHAT DO YOU FEEL ABOUT THAT NOW SAY YOU HAD TO ACT IN THE TERMS OF THIS AGREEMENT. HOW LONG AND HOW LONG LASTING WOULD SUCH ACTION BE TAKEN BEFORE THE LONGER TERM IMPROVEMENT THAT YOU DO DOUBT LOOK TOWARDS IN MARKETS WOULD ACTUALLY ARRIVES.

A. AS I SAY I AM NOT PREPARED TO COMMENT ON HOW AND IN WHAT CIRCUMSTANCES AND HOW LONG THAT INTERVENTION WOULD TAKE PLACE. BUT OF COURSE WE ARE NOT TALKING SIMPLY ABOUT, AS FAR AS THE POUND IS CONCERNED, INTERVENTION ON ITS OWN. THERE HAS ALREADY BEEN A SHARP INCREASE IN STERLING INTEREST RATES.

Q. PETER TORDAY (REUTERS): (GARBLED) DID THE PRIME MINISTER DISCUSS THIS ISSUE WITH THE PRESIDENT IN DECEMBER. DO YOU EXPECT SHE WILL TOUCH ON IT WHEN SHE MEETS THE PRESIDENT IN FEBRUARY.

FEBRUARY - I WOULD HAVE THOUGHT THEY WOULD PROBABLY RANGE PRETTY WIDELY OVER THE WHOLE WATER FRONT-THAT'S THE POLITICAL AND ECONOMIC, EAST/WEST, THE GENEVA TALKS ....EVERYTHING. THEY TEND WHEN THEY MEET TO HAVE APRETTY FREE RANGING DISCUSSION. BUT I DON'T THINK THERE WILL BE ANY SPECIFIC AGENDA ITEM OF THIS KIND. IT COULD COME UP, BUT I DON'T KNOW WHETHER IT WILL. I WOULDN'T EXCLUDE IT, BUT IT WOULDN'T SURPRISE ME IF IT DIDN'T.

Q. SUNDAY TELEGRAPH: (GARBLED) QUESTION ON WHETHER THERE WOULD BE DISCUSSIONS IN THE CONTEXT OF THE AGREEMENT IF THE DOLLAR WERE TO FALL.

CHANCELLOR. I THINK IT IS QUITE POSSIBLE THAT WE WILL HAVE DISCUSSIONS WITHIN THE G5 IF AND WHEN, AND ITS PROBABLY WHEN RATHER THAN IF THAT HAPPENS. WHAT CONCLUSIONS WE WILL REACH IS PREMATURE TO SAY. I DON'T THINK THAT ANYBODY WANTS HAVOC ON THE EXCHANGE MARKETS.

Q. (GARBLED)

CHANCELLOR: THAT'S ANOTHER WHICH I'M SURE WE SHALL DISCUSS AT THE TIME.

Q. FLEMING (FINANCIAL TIMES): MR LAWSON - ONE OF THE TOPICS YOU WERE DUE TO DISCUSS WAS THE FORTHCOMING MEETINGS OF THE INTERIM COMMITTEE AND THE DEVELOPMENT COMMITTEE. COULD YOU GIVE US A RUN DOWN OF JUST WHAT WAS DECIDED. ARE THE INTERIM COMMITTEE AND THE DEVELOPMENT COMMITTEE GOING TO MEET TOGETHER OR SEPARATELY UNDER EACH CHAIRMANSHIP.

CHANCELLOR: THE DEVELOPMENT COMMITTEE WILL MEET UNDER THE CHAIRMANSHIP OF GHULAM KAHN, THE PAKISTAN FINANCE MINISTER, WHO IS CHAIRMAN OF THE DEVELOPMENT COMMITTEE. THE INTERIM COMMITTEE WILL MEET UNDER THE CHAIRMANSHIP OF ONNO RUDING, THE DUTCH FINANCE MINISTER, WHO IS CHAIRMAN OF THE INTERIM COMMITTEE. I SUSPECT THAT THERE MAY BE SOME JOINT OCCASION, BUT BASICALLY THE IDENTITY OF THESE TWO COMMITTEES IS CLEAR. IT WON'T BE CONFUSED.

(STATEMENT HANDED OUT - THAT'S NOTHING NEW - I MEAN YOU'RE ALL WELCOME TO IT .... HAVING BEEN A JOURNALIST MYSELF AT ONE TIME I REALISE THAT WHAT HAPPENED YESTERDAY IS STALE AND THAT IS JUST YESTERDAYS NEWS, BUT IMPORTANT NEWS)
I THINK THAT WHAT DEVELOPMENTS ... WE ENCOURAGED OUR DEPUTIES TO GO AWAY AND WORK THINGS OUT IN MORE DETAIL AND WE DID GIVE THEM SOME GENERAL GUIDANCE. BUT ONE OF THE THINGS THAT APPEARS TO BE THE CASE IS THAT THE STAFFS, THE PEOPLE ASSOCIATED WITH THESE TWO COMMITTEES ARE WORKING VERY WELL TOGETHER AND WE ARE SURE THAT THERE IS NOT DUPLICATION OF THE SUBJECTS THAT WILL BE ASSIGNED TO ONE COMMITTEE OR TO THE OTHER COMMITTEE AND THAT TOGETHER WE SHALL COVER THE MAIN ISSUES. IT'S GOING TO BE A VERY DIFFICULT SET OF MEETINGS I THINK BECAUSE OF THE EXPECTATIONS AND THE DANGER OF EXPECTATIONS BEING BUILT UP IN ADVANCE OF IT PARTICULARLY AMONG THE DEVELOPING COUNTRIES OF THE KIND THAT CAN'T POSSIBLY BE SATISFIED, AND I THINK IT IS VERY IMPORTANT THAT EXCESSIVE EXPECTIONS ARE NOT ENCOURAGED. ON THE OTHER HAND IT WILL BE A GREAT DEAL MORE THAN A PHILOSOPHICAL OR THEOLOGICAL SEMINAR.

/THANK

THANK YOU GENTLEMEN

3. FCO PLEASE ADVANCE TO ERD AND NEWS DEPARTMENT AND TO H.M. TREASURY (CHANCELLOR'S PRIVATE OFFICE AND ROBERT CULPIN, PRESS SECRETARY).

WRIGHT

FINANCIAL

ERD
NEWS D

COPIES TO

PS/ CHANCELLOR
MR R CULPIN, TSY

PRIME MINISTER

The Chancellor has reported by telephone from Washington. G5 have issued an agreed statement at the end of their meeting which covers a number of subjects and you will be able to get the full text from the tape. But the key passage is to the effect that "Ministers and governors reaffirmed their commitment made at Williamsburg to undertake guaranteed intervention in the market as necessary".

The Chancellor said that it was unprecedented for G5 to issue a statement and that in itself should have an effect on the market, as well as the content of the statement. But he said that it was not bluff and if the statement was tested by a further significant upward movement in the dollar, the G5 countries had agreed that there would be concerted intervention on a significant scale. The United Kingdom, French and Germans are having a private meeting later this evening in Washington to tie up the practical arrangements for such intervention.

The Chancellor added that the Prime Minister's message had had a substantial effect in altering US attitudes. He believes that, as a result of that message, he could have got a separate statement from the United States about action to prevent a further fall in the value of the pound. But he thinks that both on political grounds and in terms of the impact on the market this more general statement on behalf of all the members of G5 would have a more significant effect. The Chancellor said that he was very pleased with this outcome which gave him all that he had hoped for when he came to Washington. He suggested that we let the statement speak for itself and I have suggested to Bernard that if asked about it he should simply say that we are extremely satisfied with this outcome of the G5 meeting.

The statement does not cover the United States deficit, but the Chancellor said that the line on that was that all other G5 members expressed their grave concern at the size and persistence of the United States deficit. The Chancellor said that Secretary Regan thought this line would be helpful to him in working for a reduction of the deficit.

As regards your talks with Chancellor Kohl tomorrow, there was nothing that Mr Lawson particularly wanted you to say other than to express your satisfaction at the unanimity which had been achieved and at the similarity of view between Mr Lawson and Herr Stoltenberg.

Robin Butler

17 January 1985

WSHFO 108/17

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UNCLASSIFIED
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FM WASHINGTON 172315Z JAN 85
TO IMMEDIATE FCO
TELEGRAM NUMBER 152 OF JANUARY

FROM LITTLER FOR NO. 10 DUTY CLERK

FOLLOWING IS TEXT OF ANNOUNCEMENT ISSUED TO PRESS BY DON REGAN IMMEDIATELY AFTER G5 MEETING THIS AFTERNOON.
BEGINS

THE MINISTERS OF FINANCE AND CENTRAL BANK GOVERNORS OF FRANCE, GERMANY, JAPAN, THE UNITED KINGDOM, AND THE UNITED STATES ANNOUNCED TODAY THAT THEY HAD MET TO DISCUSS A RANGE OF INTERNATIONAL ECONOMIC AND FINANCIAL ISSUES. THE MEETING, PART OF A REGULAR SERIES OF CONSULTATIONS AMONG THESE COUNTRIES ON ECONOMIC AND FINANCIAL MATTERS OF MUTUAL INTEREST, ALSO INVOLVED IMF MANAGING DIRECTOR DE LAROSIERE FOR A DISCUSSION OF THE ECONOMIC POLICIES AND PROSPECTS OF THE MAJOR INDUSTRIAL COUNTRIES.

THE MINISTERS AND GOVERNORS, NOTING THE RECENT DEVELOPMENTS IN THE EXCHANGE MARKETS, EXPRESSED THEIR COMMITMENT TO WORK TOWARD GREATER EXCHANGE MARKET STABILITY. TOWARD THIS END, THE MINISTERS AND GOVERNORS:

—REAFFIRMED THEIR COMMITMENT TO PURSUE MONETARY AND FISCAL POLICIES THAT PROMOTE A CONVERGENCE OF ECONOMIC PERFORMANCE AT NON-INFLATIONARY, STEADY GROWTH;

—STRESSED THE IMPORTANCE OF REMOVING STRUCTURAL RIGIDITIES IN THEIR ECONOMIES TO ACHIEVING THE OBJECTIVES OF NON-INFLATIONARY, STEADY GROWTH AND EXCHANGE MARKET STABILITY, AND EXPRESSED THEIR INTENT TO INTENSIFY EFFORTS IN THIS AREA; AND

—IN LIGHT OF RECENT DEVELOPMENTS IN FOREIGN EXCHANGE MARKETS, REAFFIRMED THEIR COMMITMENT MADE AT THE WILLIAMSBURG SUMMIT TO UNDERTAKE COORDINATED INTERVENTION IN THE MARKETS AS NECESSARY.

THE MINISTERS AND GOVERNORS BELIEVE THAT THIS APPROACH WILL PROVIDE A SOLID FRAMEWORK FOR SUSTAINING RECOVERY, REDUCING INFLATION, INCREASING EMPLOYMENT, AND ACHIEVING GREATER EXCHANGE RATE STABILITY.

ENDS

FCO PLEASE PASS IMMEDIATE DESKBY 04.45Z TO NO. 10 DUTY OFFICER AND TO PS/FOREIGN SECRETARY.

AND DESKBY 08.00Z TO PS/CHANCELLOR, SIR P. MIDDLETON, MR. CASSELL, MR. LAVELLE (HM TREASURY), PS/GOVERNOR, MR. LOEHNIS, MR. GAILL AND MR. BYATT (BANK OF ENGLAND)

WRIGHT

US Declassified

PRIME MINISTER'S PERSONAL MESSAGE SERIAL No. T 8/85

c MASTER OPS

Prime Minister

As much as could be expected at this stage.

AT 16/1

5

File

DSCWAGØØ4
OO WTE24
DE WTE £Ø359 Ø161745
O 16182ØZ JAN 85
FM THE WHITE HOUSE
TO CABINET OFFICE
ZEM
S E C R E T VIA CABINET OFFICE CHANNELS WHØØ359

JANUARY 16, 1985

DEAR MARGARET:

REGARDING YOUR MESSAGE ON THE POUND.

WE UNDERSTAND YOUR CONCERN, AND RECOGNIZE THAT ON OCCASION DISORDERLY MARKETS MAY DEVELOP. WE TAKE SERIOUSLY OUR JOINT COMMITMENT MADE AT THE WILLIAMSBURG SUMMIT WHICH, AS YOU RECALL, WAS TO PURSUE CLOSER CONSULTATIONS ON POLICIES AFFECTING EXCHANGE RATES AND ON MARKET CONDITIONS. IN THAT CONNECTION, WE ALSO DISCUSSED COORDINATED INTERVENTION WHERE IT WAS AGREED SUCH INTERVENTION WOULD BE HELPFUL.

SECRETARY REGAN WILL BE PREPARED THIS THURSDAY TO DISCUSS THE CURRENT AND PROSPECTIVE EXCHANGE MARKET SITUATION AND RELATED ISSUES WITH CHANCELLOR LAWSON AND THE OTHER G-5 FINANCE MINISTERS.

I HAVE ASKED SECRETARY REGAN TO GIVE ME A FULL REPORT ON THE MEETING FRIDAY MORNING.

I LOOK FORWARD TO SEEING YOU IN FEBRUARY.

SINCERELY,

RON

Ø196
£Ø359

US Declassified

NNNN

SUBJECT
cc OPS
Master

4

PRIME MINISTER'S
PERSONAL MESSAGE
SERIAL No. T6/85

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FM CABINET OFFICE LONDON
TO THE WHITE HOUSE
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S E C R E T
MESSAGE FROM THE PRIME MINISTER
TO THE PRESIDENT OF THE UNITED STATES

THIS MESSAGE IS PARTICULARLY SENSITIVE AND WE REQUEST THAT IT BE GIVEN THE MOST LIMITED POSSIBLE DISTRIBUTION.

DEAR RON,

''WE HAVE BEEN THROUGH A PERIOD OF INTENSE PRESSURE ON STERLING IN THE PAST FEW DAYS ALTHOUGH THERE IS NO JUSTIFICATION FOR MARKET WORRIES ABOUT OUR POLICIES OR THE PERFORMANCE OF OUR ECONOMY. THE ECONOMY IS GROWING WITH NO SIGN OF AN UPTURN IN INFLATION. WE HAVE MADE CLEAR OUR DETERMINATION THAT PUBLIC EXPENDITURE AND BORROWING WILL BE KEPT UNDER CONTROL DESPITE THE PRESSURES RESULTING FROM HIGHER UNEMPLOYMENT.

WE HAVE RAISED OUR INTEREST RATES BY TWO AND ONE HALF PER CENT SO THAT THEY NOW STAND AT 12 PER CENT OR OVER COMPARED WITH AROUND EIGHT AND ONE HALF PER CEN IN THE UNITED STATES. I HAVE DONE AS MUCH AS CAN BE ASKED TO TIGHTEN POLICY. BUT WE ARE FACED WITH CONTINUED DOLLAR STRENGHTH. THIS LED TO DISORDERLY MARKETS YESTERDAY CARRYING THE DOLLAR TO LEVELS WHICH HAVE BEEN MAINTAINED TODAY. IT IS NOT JUST A QUESTION OF STERLING. THE DOLLAR IS STRONG AGAINST ALL CURRENCIES - IT IS AT RECORD LEVELS AGAINST THE SWISS FRANC, FRENCH FRANC AND ITALIAN LIRA, AND AT A 12-YEAR HIGH AGAINST THE DEUTSHCH-EMARK.

WHEN THERE WERE SIMILAR CONDITIONS IN THE SUMMER, THE GERMANS INTERVENED STRONGLY WITH SOME US HELP. THIS TOOK THE EDGE OFF DOLLAR STRENGTH AND CALMED THE MARKETS. WE HAVE INTERVENED ON ONLY A LIMITED SCALE AS EXPERIENCE INDICATES THAT COUNTRIES ACTING INDIVIDUALLY CAN HAVE LITTLE IMPACT ON THE MARKET.

THE FINANCE MINISTERS OF THE GROUP OF FIVE MEET IN WASHINGTON ON THURSDAY AMID WIDESPREAD EXPECTATIONS THAT THEY WILL TAKE SOME ACTION. COULD YOU CONSIDER WITH SECRETARY REGAN AND YOUR ADVISERS WHETHER THE US CAN JOIN WITH THE OTHERS IN A COLLECTIVE ATTEMPT TO RESTORE REALITY TO THE MARKETS ON FRIDAY OF THIS WEEK?

I AM NOT ASKING THE US TO DO ANYTHING WHICH COULD CAUSE A PRECIPITATE FALL IN THE DOLLAR - NOR DO I CONTEMPLATE ANYTHING WHICH WOULD ADVERSELY AFFECT THE MONETARY OBJECTIVES OF THE COUNTRIES CONCERNED. BUT SUCH ACTION COULD MAKE A SIGNIFICANT CONTRIBUTION TO EASING THE DIFFICULTIES FACED BY THE UK AND OTHER EUROPEAN COUNTRIES. IN THE CIRCUMSTANCES WE FACE, IT IS IMPORTANT THAT WE CONCERT OUR ACTIONS.''

YOURS SINCERELY
MARGARET THATCHER

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Direct. 3A

MESSAGE TO PRESIDENT REAGAN FROMM THE PRIME MINISTER

This message is particularly sensitive and we request that it be given the most limited possible distribution.

Message follows:

DEAR RON,

"We have been through a period of intense pressure on sterling in the past few days although there is no justification for market worries about our policies or the performance of our economy. The economy is growing with no sign of an upturn in inflation. We have made clear our determination that public expenditure and borrowing will be kept under control despite the pressures resulting from higher unemployment.

We have raised our interest rates by 2½ per cent so that they now stand at 12 per cent or over compared with around 8½ per cent in the United States. I have done as much as can be asked to tighten policy. But we are faced with continued dollar strength. This led to disorderly markets yesterday carrying the dollar to levels which have been maintained today. It is not just a question of sterling. The dollar is strong against all currencies - it is at record levels against the Swiss franc, French franc and Italian lira, and at a 12-year high against the Deutschemark.

When there were similar conditions in the summer, the Germans intervened strongly with some US help. This took the edge off dollar strength and calmed the markets. We have intervened on only a limited scale as experience indicates that countries acting individually can have little impact on the markets.

The Finance Ministers of the Group of Five meet in Washington on Thursday amid widespread expectations that they will take some action. Could you consider with Secretary Regan and your advisers whether the US can join with the others in a

collective attempt to restore reality to the markets on Friday of this week?

I am not asking the US to do anything which could cause a precipitate fall in the dollar - nor do I contemplate anything which would adversely affect the monetary objectives of the countries concerned. But such action could make a significant contribution to easing the difficulties faced by the UK and other European countries. In the circumstances we face, it is important that we concert our actions."

Yours sincerely.

MARGARET THATCHER

① Mr Mountfield ② PM   Monetary Policy

DAVID HOWELL - INTERVIEW ON STERLING (EMS)

Transcript from: BBC Radio 4, Wor d at One, 15 January 1985

INTERVIEWER : (Robin Day) ... I asked Mr Howell if he thought the Chancellor and the Prime Minister had mishandled the defence of sterling?

HOWELL: Well I think in a very volatile international exchange rate world it's very easy to make accusations and throw charges around. So those were bound to come anyway. I do think that perhaps the public relations side of the Government's thinking could have been handled a little better. It did seem to me that on Monday morning we suddenly got a very different message from the one that was flying around on Sunday. And that doesn't help the enormously sensitive exchange markets where confidence and total control of the situation are the prime requirements.

INTERVIEWER : What you're saying is that the briefing of the Sunday newspapers at the weekend hinting that the Government was going to take a hands off sterling attitude was clearly a blunder?

HOWELL: It certainly didn t, it came over very obvious to me anyway.

INTERVIEWER : Why did you suggest in your question yesterday Mr Howell that the high interest rates might be relatively short lived?

HOWELL: Because looking ahead the inflation outlook is really very good. And indeed if the world oil price comes down and if the dollar comes off the top a bit bringing down the dollar price of oil that will help still further. Inflation now is down to 1.8% in America, it's practically flat in Germany and prices are actually falling in Japan. So that if people are worried about

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domestic monetary conditions it can't be because they are worried behind that about a vast upsurge in inflation and this must be a very short term worry. And it's a short term wory, then short term ups and downs in interest rates, which are part of the management equipment for stabilising the monetary and financial situation, ought to do the trick.

INTERVIEWER : Do you think that the Government's strategy has been blown off course, particularly with regard to their intention of cutting taxes in the Budget?

HOWELL : No I don't. I thought the reports this morning indicating that somehow the Chancellor was going to move away from his commitment to a tax cutting strategy and getting on top of unemployment by a variety of new measures I thought those were very exaggerated. I don't think there has been a blowing off course. If interest rates had to stay up very high, or go higher and stay higher for a good long time then it would start having an effect on unemployment, on investment and all sorts of other things. But if this is just part of the levers needed to manage the monetary situation in a very uncertain world dominated by this vastly over strong dollar then I think once that's over we'll see things back to normal.

INTERVIEWER : The vastly over strong dollar you said; what should Mr Lawson say in Washington tomorrow at the meeting of the western Finance Ministers? Should he tell the Americans to reduce their interest rates and will they do so?

HOWELL : Well he should certainly join in the view, which I think is actually shared in the White House, certainly by the new White House supremo - Mr Reagan who was the Treasury Secretary - that they must have a medium term programme. Not for surgery

on the budget defict in America but on bringing it under some sort of control over the next 3 or 4 years. I certainly don't want to see a precipited drop in the dollar; and blood letting on all sides of the American economy. But they must start bringing their fiscal policy into some kind of line with their monetary policy - which means in less fancy language; getting their budget deficit down so they aren't forced to keep pushing interest rates even further.

INTERVIEWER : Mr Howell, can you explain to us a as a former Energy Secretary and as student of these matters; why is it that Britain, which is the only oil rich big European country, is saddled with a crisis in its currency and the other countries are not?

HOWELL: Well I think that the currency markets'; belief, and I think it's a much over exaggerated belief, that our sort of sole means of livelihood is our vast oil exports and therefore if the price of them goes down in world terms - even though it's very high in dollar terms - we are going to be in difficulties. That's a belief I thin k is much exaggerated and I've never swallowed this idea that we're an absolute petro currency like middle eastern currencies. And I think the markets just beleive that but I happen to think they are exaggerated in their views. The other thing is of course that sterling is not in the European monetary system, or not a full member of it, the way that all the other currencies are.

INTERVIEWER : I was going to ask you about that because you suggested inthe House yesterday that things would be smoother if we were in the EMS: why?

HOWELL: Because the system is one in which when one currency, one member currency, is under attack the central bank facilities of all the other European members are bought into line to support it.

Now that doesn't work if there are fundamental differences pulling the currencies apart. But if they're just really small differences and there's all the time this great threat of the demand for the dollar; and investment running away to the United States, then it possibly could help.

INTERVIEWER : But the Chancellor of the Exchequer says that joining EMS would bring a financial discipline of its own kind which would require the use of interest rates, as we've seen in the last couple of days, wherever necessary to maintain a particular value of the £?

HOWELL: Well, except it's not a rigid system. It's rather like a harness on a coach and four.

INTERVIEWER : Oh it's not a snake or a basket?

HOWELL : No it's a harness. It allows movement of the currencies within it. I mean the lira , for instance, which is within the EMS moves quite considerably and is free to do so without causing some great monetary crisis every time the movement takes place. The plain fact is we're now down to quite a healthy exchange rate withthe deutchmark at 3.50 or whatever it is. That's very good for our exports and it's the sort of range in which I think we might sit quite comfortably with the other currencies. I also believe the question of the oil price slide has now really fed through. It's had its impact on sterling. I think sterling will bounce up again, it may go a few points lower but I frankly doubt it, and we could really settle down with a stable but slightly lower oil price. But that's really another story raising some also very difficult policy issues here in London.

Sterling (Exchange Rate)

3.38 pm

Mr. Roy Hattersley (Birmingham, Sparkbrook) *(by private notice)* asked the Chancellor of the Exchequer if he will make a statement on the sterling exchange rate and the prospects for interest rates in Great Britain.

The Chancellor of the Exchequer (Mr. Nigel Lawson): Movements of the exchange rates on the markets over the past few days have been fully reported.

As my predecessor made clear to the House on a previous occasion, successive Governments have made it their practice not to make statements about the level of the exchange rate; and like him I do not intend to depart from that practice.

So far as interest rates are concerned, the Bank of England announced this morning that its minimum rate for lending to the discount market would be 12 per cent. This demonstates the Government's resolve to maintain sound monetary conditions and to take whatever steps are necessary to ensure continued success in the battle against inflation.

Mr. Hattersley: Does the Chancellor of the Exchequer recognise that today's events demonstrate that the Government's economic policy is a shambles, and that its inadequacy has been emphasised by his incompetence and vacillation during the past week? Will he confirm that interest rates now stand at the figure which the Government inherited in 1979? We have had public spending cuts, and unemployment has been pushed up to record levels, but the central objective of lower interest rates has not been achieved.

Secondly, what, if anything, is the Chancellor's exchange rate policy? Will the pound soon be left once more to market forces, or is today's open intervention an admission that his supine inactivity during the past fortnight has contributed to today's crisis, and will result in a certain increase in mortgage rates during the next 14 days? Will he have the grace to admit that a policy which he repeated and confirmed only a week ago—leaving interest rates to be determined solely by market forces—has been abandoned, in disaster for the economy and in humiliation for the Chancellor of the Exchequer?

Mr. Lawson: I note, as the House will have noted, that the right hon. Gentleman described the level of interest rates that we inherited from his Government as a shambles. The objective of Government policy is to reduce inflation, to hold it down and to reduce it still further. We have succeeded in doing that, but the Labour Government failed conspicuously to do it, despite the fact that, on several occasions, the right hon. Gentleman declared that to be the central objective of their policy.

As to open intervention, I should remind the right hon. Gentleman that, when the new arrangements for monetary control were published on 5 August 1981 in a Treasury press notice, the relevant section read as follows:

> "The Bank will cease to post a continuous Minimum Lending Rate from 20 August, as this would be inconsistent with the objective of the new arrangements to give the market more influence over the structure of interest rates. The option"—

[Interruption.] Hon. Members should be patient. I continue:

> "The option will, however, be retained for use in some circumstances of announcing in advance the minimum rate which for a short period ahead the Bank would apply to any lending to the market."

That is precisely what happened today. It was my decision on the advice of the Governor of the Bank of England.

Finally, I should say that several factors have been at play here, one of which is uncertainty about oil prices. Another is the sharp rise of the dollar against other currencies. A third factor has been doubts about the Government's resolve to persist with their counter-inflationary policy in the light of the continued pleas for still higher public borrowing and expenditure. The Government's decision today demonstrates that those siren voices cannot be listened to if inflation is to be brought under control. That is the purpose of our action.

Mr. Terence Higgins (Worthing): Is it not essential to consider recent events in an international context? Does my right hon. Friend agree that the high rate of the dollar has been a fundamental aspect of the problem? Given that that is so, will he make renewed representations to the United States Administration on the need to reduce the American deficit and interest rates?

Mr. Lawson: My right hon. Friend is right. That is the view not only of him, myself and the Government, but of most European Governments. As my right hon. Friend is aware, I shall be flying to Washington the day after tomorrow — *[Laughter]* — for a discussion with the American Treasury Secretary and other finance Ministers. These matters will be very much under discussion.

Mr. Richard Wainwright (Colne Valley): To avoid further damage, will the Chancellor try to reverse the clear impression that he has given to foreign exchange operators in recent weeks that he has been relying on the weakness of the pound against the dollar in respect of our North sea oil earnings in order to make partisan measures in his forthcoming Budget? Will he make it clear at last that he has no intention of using adventitious and possibly short-term exchange positions to make long-term Budget decisions?

Mr. Lawson: I have given no indications of the kind that the hon. Gentleman is referring to.

Mr. David Howell (Guildford): As the main influences on sterling — the strong dollar and the oil price — are largely outside the Government's control, and as the outlook for inflation is very good, can we assume that the hike in interests rates will be relatively short-lived? Would the situation be rather smoother in the future if we now joined the European monetary system as a full member?

Mr. Lawson: On my right hon. Friend's first question, interest rates will obviously remain at this level for no longer than is necessary to secure proper monetary control, proper monetary conditions and a continuation of our success against inflation. They will have to continue just as long as is necessary to achieve that.

The question of full membership of the European monetary system is continually under review, but that is a financial discipline of its own kind, which requires the use of interest rates whenever necessary to maintain a particular parity.

Mr. Robert Sheldon (Ashton-under-Lyne): Why is it that, three years after abandoning minimum lending rate, the Chancellor is returning to it? Is it because a clear signal was required that the Government have an interest rate and exchange rate policy? Does not that show up the irrelevance of the Government's money supply policies?

Turks and Caicos Islands (Airport)

68. **Mr. Spearing** asked the Secretary of State for Foreign and Commonwealth Affairs if he will make a statement concerning the closure of the new airport at Providenciales in the Turks and Caicos Islands.

Mr. Raison: The airport was closed to scheduled jet services from 29 November to 19 December while maintenance work was undertaken on the runway. It is now open and operating normally.

Mr. Spearing: Does the Minister recall that another report of the Foreign Affairs Select Committee expressed dissatisfaction with his Ministry's arrangements for the construction of the runway? Will he assure the House that he will investigate the events of that time and the effect that they may or may not have had on the closure of that controversial airport?

Mr. Raison: I do not believe that the events of that time had any effect on the recent developments. I am advised that it is not unusual for such cracks to appear. The runway is now operating successfully and so, I believe, will the Club Med project.

Mr. Lawson: Not at all. As I showed with my quotation from the press notice issued when the new arrangements were set in place in 1981, this was deliberately retained for use in circumstances where it was necessary for a clear signal to be given of the Government's policy and resolve. That has been given. We will return immediately to arrangements that do not involve the posting of a particular minimum lending rate.

Mr. Peter Hordern (Horsham): Since the new level of interest rates must, at least in part, reflect the expansion of credit on the broad measurement, does my right hon. Friend still think it appropriate that there should be £1·5 billion available for the reduction of taxation in the Budget?

Mr. Lawson: I have as yet no reason to depart from the indication that I gave at the time of the autumn statement in November, but, of course, I shall be reviewing it, as I said at the time, before the Budget and it would be very unwise to assume that that amount of tax reductions can necessarily be given. But these matters will have to be reviewed at the time of the Budget and I think that there is no point in speculating about that now.

Mr. J. Enoch Powell (South Down): Does the Chancellor of the Exchequer agree that, provided that the Government can fund their borrowing requirement and meet their sight liabilities, which are their first obligation, nothing but benefit can accrue to the economy and to the unemployed from the prospect of a fall in oil prices and the associated fall in the exchange rate of sterling?

Mr. Lawson *rose*——

Hon. Members: In theory, yes.

Mr. Lawson: I have always understood that it was part of the right hon. Gentleman's credo not to express particular views about the desirability of particular price levels for any particular commodities—that goes for oil as well. I believe that disruptive movements in either direction are harmful to the world economy and to the United Kingdom economy.

Mr. Nigel Forman (Carshalton and Wallington): Do not the events of the past few days show that it was always possible and right for the Government to take account of movements in exchange rates in deciding their financial policy, but that, equally, it is not sensible to isolate one target as the benchmark, be it the public sector borrowing requirement, the exchange rate or any other shibboleth?

Mr. Lawson: My hon. Friend is correct, in the sense that a number of indicators of monetary conditions have to be used in assessing the conditions appropriate for a continued decline in inflation and a continued economic recovery of the kind that we are enjoying and will continue to enjoy. Indeed, that recovery compares far better against the performance of the rest of the world, and particularly of the rest of the countries of the European Community, than was the case when the Labour Government were in office.

Mr. Alfred Morris (Manchester, Wythenshawe): What does the Chancellor expect the effect of these higher interest rates to be on the level of unemployment?

Mr. Lawson: The one thing that would really cause a sharp increase in the level of unemployment would be a resurgence of inflation, which is precisely what would follow from the policies advocated by Opposition Members and which is precisely what we are determined not to indulge in.

Mr. John Townend (Bridlington): What influence has the miners' strike had on the recent fall in the value of sterling? Does not my right hon. Friend agree that there are underlying factors that justify a higher level of sterling, such as a balance of payments surplus and a low rate of inflation?

Mr. Lawson: As the House knows, one of the problems that we face is that public borrowing this year is running ahead of what we had planned, partly because of the cost of the coal strike but partly for other reasons. But this only reinforces our resolve to keep public expenditure firmly under control. With regard to my hon. Friend's second question, there are indeed several very positive factors, and such fluctuations in the market place do tend to be excessive from time to time.

Mr. Anthony Beaumont-Dark (Birmingham, Selly Oak): Does my right hon. Friend accept that most of us would agree that he was quite right not to throw reserves at the sterling rate, a practice which proved so disastrous in 1973-74? Bearing that in mind, does he accept that some of us are disappointed at this departure from the free market economy and free market exchange workings? If my right hon. Friend is right, and this is meant to be only a short-term move in interest rates, will he—as we have already made a dent in the free market — ask the building societies not to take any precipitate action to increase the cost of house borrowing for at least a month?

Mr. Lawson: Of course, the level of mortgage rates is a matter for the building societies and not for me, but I am sure that they will have heard what my hon. Friend has said.

Mr. Ian Wrigglesworth (Stockton, South): Is not the truth of the matter that the panic measures that the Government have had to take today are a direct consequence of the complacency and contradictory statements that we have heard in recent times from Government Departments? Can the Chancellor explain why, in recent days, different briefings have emanated from No. 10 Downing street and the Treasury? Will he confirm that his statement and the action taken by his Department today is supported by the Prime Minister?

Mr. Lawson: Of course, the measure that I have announced today is part of a policy that is the policy of the entire Government. I have read some of the stories that have appeared in the newspapers with both amazement and dismay, but I do not think that this is the first time that Governments have had that experience when reading newspaper stories.

Mr. Patrick McNair-Wilson (New Forest): May I warmly congratulate my right hon. Friend on his firm action today? A strong and internationally respected currency is an essential weapon in the fight against inflation. However, as oil prices are a significant factor in achieving that goal, will he ensure that the British National Oil Corporation does not take unilateral action which could affect prices so that it could be regarded as an unfriendly act by other producers and so lead to an oil price war?

Mr. Lawson: I am grateful to my hon. Friend for his opening remarks. The second part of his question is not

[Mr. Lawson]

strictly speaking a matter for me. But it is the Government's policy — which has been pursued for many years and which was, I believe, held by the previous Government—that United Kingdom oil prices should be in line with the market and that there should not be artificial prices. Nevertheless, I think that BNOC realises that it has a duty to conduct its day-to-day policy in a way that causes as little political or economic disruption as possible.

Mr. Gordon Brown (Dunfermline, East): Will the Chancellor stop blaming everyone but himself? Does he not recall that on 29 July 1980 the Prime Minister told the House that the pound was high and strengthening, because

"investors overseas believe that our economic policies are right, that they will succeed, and that under a Tory Government Britain is worth investing in."—*[Official Report,* 29 July 1980; Vol. 989, c. 1305.]

Now that the pound is half as high, what does the Chancellor think is the markets' verdict on his Government's economic failure?

Mr. Lawson: If we are going to talk about quotations, I was interested to read—[HON. MEMBERS: "Answer the question."] I have already answered the question. As the House knows well, there are basically three factors affecting the exchange rate at the present time. There is the oil price weakening, the strength of the dollar against all currencies, not just against sterling, and the doubts about whether monetary conditions are fully consistent with a lower rate of inflation and, indeed, whether public expenditure may not be running excessively high. I emphasise the last point in particular. There is no way in which we can consistently be getting inflation down with scope for increases in public expenditure or increases in public borrowing. I think that that must be fully understood.

I have a quotation from the right hon. Member for Birmingham, Sparkbrook (Mr. Hattersley) at the Aneurin Bevan lecture on 13 October 1984—about three months ago. He said:

"Of course, we need an exchange rate which encourages exports rather than assists imports. And some adjustment in the value of sterling may therefore be necessary—at least against the weighted average of currencies."

As there has been a reduction since then of 6 per cent., is that adjustment bigger or smaller than the adjustment that he sought?

Mr. Robert McCrindle (Brentwood and Ongar): Is it not about time that we told our American allies that their continued failure to deal with the strength of the dollar is an unfriendly act which makes a mockery of economic interdependence? Will the Chancellor give an undertaking to the House that when he meets the new American Secretary of the Treasury later this week he will underline the fact that that feeling is widespread in the British Parliament?

Mr. Lawson: I am grateful to my hon. Friend. Certainly, I think that I shall be underlining, as others will underline, the need for the United States to take measures to reduce its budget deficit.

Mr. Gordon Wilson (Dundee, East): If, as is manifest, the pound has slumped against the dollar partly because of a mild softening in world oil prices, what steps does the Chancellor intend to take in the longer term to deal with the crisis which is already on the horizon — that declining oil production will reveal to the world the disastrous state of the United Kingdom balance of payments?

Mr. Lawson: Oil production in this country is going to be very substantial for many years to come. I think that it is foolish of the hon. Member for Dundee, East (Mr. Wilson) to assume that it will suddenly disappear. It will be a major factor in our economy for many years to come.

Mr. Roger Freeman (Kettering): Is my right hon. Friend aware that on this side of the House his move is seen as both inevitable and correct? When my right hon. Friend goes to the United States in two days time, will he draw the attention of Mr. Baker, the new Secretary of the Treasury, to the fact that it is in the best interests of the United States itself that the inevitable continuing rise of the dollar is halted, so that international trade, particularly between western Europe and the United States, is carried out on a more even keel?

Mr. Lawson: Sooner or later, I believe, the value of the dollar in the foreign exchange markets will decline, but it is impossible to say when that will occur. One of the problems about much of the criticism from Opposition Members is that they find it impossible to understand the nature of the markets and the fact that we have to conduct our policies within a context of markets which are often wayward and unpredictable.

Several Hon. Members *rose*——

Mr. Speaker: Order. I remind the House that this is a private notice question and an extension of Question Time. There is an important debate tomorrow on the reduction of unemployment through public investment. Although the motion is not yet on the Order Paper, I have no doubt that hon. Members will be able to allude to this matter in that debate.

WELSH AFFAIRS

Ordered,

That the matter of Regional Policy as it affects Wales, being a matter relating exclusively to Wales, be referred to the Welsh Grand Committee for its consideration.—*[Mr. Biffen.]*

Chancellor's answer to Mr Hattersley's PNQ

Movements of the exchange rates on the markets over the past few days have been fully reported.

As my predecessor made clear to the House on a previous occasion successive Governments have made it their practice not to make statements about the level of the exchange rate; and like him I do not intend to depart from that practice.

So far as interest rates are concerned the Bank of England announced this morning that its minimum rate for lending to the discount market would be 12 per cent.

This demonstrates the Government's resolve to maintain sound monetary conditions and to take whatever steps are necessary to ensure continued success in the battle against inflation.

Stoke-on-Trent

West Midlands

14 January

2,400.

Points to make

1. **No** risks with inflation. Determined to stick to strategy.

2. Markets have heard siren voices urging Government to relax. Government not going to let up.

3. Firm action. Will do whatever necessary to maintain fight against inflation.

4. False dilemma implied by some. Not true that must **either** have precise target for exchange rate **or** be totally indifferent to it. Always said don't have target but do take it into account.

5. Not end of recovery. ~~Profits strong. While companies must pay higher interest rates,~~ Profits ~~benefit from lower pound~~ up, Investment strong.

6. No simple implication for Budget. Must look at many factors together. Considerable uncertainties. Need to be a bit cautious about Budget prospect.

7. 1981 arrangements kept MLR for occasional use. Used today to act quickly and decisively.

8. Only sure way to get interest rates down and keep them down is to keep on getting inflation down.

MR HATTERSLEY

NOTES FOR SUPPLEMENTARIES

Q1. Is this an end to 1981 arrangements/return to MLR?

A1. No. 1981 arrangements made provision for "use in some circumstances of announcing in advance the minimum rate which for a short period ahead the Bank would apply to any lending to the market". (Press notice on introduction of new arrangements, 5 August 1981.) That is what the Bank have done today.

Q2. Has the Bank intervened in the foreign exchange market?

A2. Not the practice to reveal details of intervention in the foreign exchange market. But Government's policy remains that the Bank should intervene, if necessary, to seek to smooth sharp movements and to maintain orderly markets.

Q3. Exchange rate target?

A3. We have no exchange rate target. But the exchange rate may to some extent reflect concerns about monetary conditions and the level of public borrowing and expenditure. Always said take account of exchange rate movements when we think they may be reflecting domestic monetary conditions and when aggregates difficult to interpret.

Q4. Should not be blown off course by financial markets?

A4. We are still on course. Cannot behave as if financial markets did not exist, and we will not take risks on monetary policy or inflation. Interest rates are bound to fluctuate. As always priority is to maintain downward pressure on inflation through control of monetary conditions.

Q5. How long will rates stay up?

A5. We do not forecast interest rates. Government determined to maintain counter-inflation strategy. With inflation kept under control, interest rates will come down.

Q6. **What does this mean for mortgage rates?**

A6. A matter for the commercial judgement of building societies and banks.

Q7. **Effect on inflation?**

A7. Effect depends on how long higher rates persist, and on whether mortgage rates are affected. Many other factors are involved. In longer term, lower inflation depends on maintaining firm monetary control.

Q8. **End of recovery?**

A8. Of course not. Although higher interest costs will not be welcome to British firms, they will benefit from the recent fall in the exchange rate.

Q9. **Why did you not move sooner to raise rates to 12 per cent?**

A9. The situation has changed since last Friday.

Q10. **Are you simply being led by the markets?**

A10. No. On this occasion felt it right to cut through the markets' uncertainty by giving a lead.

Q11. **Implications for Budget?**

A11. Cannot anticipate my/the Chancellor's Budget Statement. But should be no doubts at all about my [the Government's] resolve to stick to the counter-inflation strategy.

5.12 EMS

Our position is unchanged, that we intend to join when the circumstances are right. No reason to think market conditions over the weekend - or their management - would have been easier. The opposite is more likely to be true.

5.13 Level below which not prepared to see sterling go?

It has been the practice of successive governments not to make statements about the level of the exchange rate. Do not propose to depart from that practice now.

COMPARATIVE GROWTH AND INFLATION RECORDS

I Facts

(a) GDP

	annualised growth per cent	of which, contribution from N. Sea	from investment	duration
previous upswing 1975 H2 to 1979 H1	3	1	¼	15 quarters
current recovery to date 1981 H1 to 1984 H1	2½	½	1¼	3 years to 1984 H1; and by 1985 Q2 16 quarters. the longest since 1945

1983 Q2 to 1984 Q2

UK	2.9 (allowing for coal strike)
EC average	1.8

(b) RPI inflation, annualised per cent rates

	UK	OECD average over corresponding quarters
February 1974 to May 1979	15½	~~[illegible]~~ 9½
May 1979 to date	9½ (Nov)	8½ ~~[illegible]~~ (1984 Q3)
12 months to May 1979	10½ and rising,	[illegible]½ per cent above OECD rate
12 months to November 1984	4.9	in line with OECD rate.

II LINES TO TAKE

(a) Growth

Current policies have secured broadly-based expansion at a rate comparable with that seen in the upswing between 1975 and 1979. And this has been secured with much smaller annual contribution from North Sea oil (½, rather than 1 per cent). Much bigger contribution from investment (1¼ per cent rather than ¼).

Over year following 1983 election, UK GDP up nearly 3 per cent (allowing for effects of coal strike) compared with EC average under 2 per cent.

(b) Inflation

Governments policies have brought inflation down sharply and have kept it down. RPI in year to November rose 4.9 per cent, less than half the accelerating rate inherited from Labour. And UK inflation is no longer, as under Labour, way above the OECD average.

As Chancellor said on BBC radio this morning, the Government is not prepared to take any risks with monetary conditions and inflation and will take whatever steps are necessary to maintain its counter-inflationary strategy. Following weekend uncertainty in the markets the Government has acted quickly and decisively. The Bank has announced that its minimum rate for lending to the discount market today is 12 per cent.

The uncertainty, both in exchange market and domestic markets, reflected not only weakness of oil price and strength of $ but also concern about domestic monetary conditions and the level of Government borrowing and expenditure.

Always said authorities take account of exchange rate movements to the extent they may be reflecting domestic monetary conditions and when there is difficulty in interpreting monetary aggregates.

Today's action demonstrates Government's resolve to maintain sound monetary conditions.

STATEMENT   Chancellor 14 Jan 1985

Movements of the exchange rates on the markets over the past few days have been fully reported.

As my predecessor made clear to the House on a previous occasion successive Governments have made it their practice not to make statements about the level of the exchange rate; and like him I do not intend to depart from that practice.

So far as interest rates are concerned the Bank of England announced this morning that its minimum rate for lending to the discount market would be 12 per cent.

This demonstrates the Government's resolve to maintain sound monetary conditions and to take whatever steps are necessary to ensure continued success in the battle against inflation.

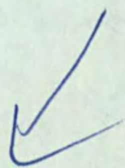
Cab.

Liverpool Echo

Sch. of Shellcare

Wood Pugs

Underage [illegible]



Sheffield Star   Hopefully soon

Dumo ... – Tunes – Thrillers

Brighton Post & Mail

Irish Press – (London / Dublin)

Points to make

1. No risks with inflation. Determined to stick to strategy.

2. Markets have heard siren voices urging Government to relax. Government not going to let up.

3. Firm action. Will do whatever necessary to maintain fight against inflation.

4. False dilemma implied by some. Not true that must either have precise target for exchange rate or be totally indifferent to it. Always said don't have target but do take it into account.

5. Not end of recovery. ~~Profits strong.~~ While companies must pay higher interest rates, profits ~~benefit from lower pound~~ up, investment strong

6. No simple implication for Budget. Must look at many factors together. Considerable uncertainties. Need to be a bit cautious about Budget prospect.

7. 1981 arrangements kept MLR for occasional use. Used today to act quickly and decisively.

8. Only sure way to get interest rates down and keep them down is to keep on getting inflation down.

Wales

N.C.B.
Govt) Pure Intention

Lib Churchill Newcastle - Dundas

Lib [illegible] - Regime

Progress of the Motherland.

13 - Slavery
Janson

Liberation Maltby

Leicester - Legislation - (Strength of the motherhood)

BULL POINTS.

- GDP (average measure) at highest ever level; up around 3½% between 1982 and 1983. 4½% above peak level in 1979 even allowing for the effects of the coal strike.

- Output per head (manufacturing) rose by an average 6% between 1981 and 1983 in 1984 Q3 was nearly 24% higher than end - 1980 low.

- Since 1979 output per head (MFG) has increased by around 3% a year compared with 1% in the period 1974 Q2 - 1979 Q2.

- Real Personal Disposable Income rose 2% over year to 1984 Q2

- Consumers Expenditure in Q3 1984 1% higher than year earlier and now at highest level ever recorded.

- Industrial and commercial company profits up by over 20% between first three quarters of 1983 and 1984.

- Manufacturing investment estimated to have risen by nearly 15% in 1984 Q1 - Q3 compared to same period a year earlier. Investment in construction and service industries up by nearly 12¼% over the same period.

- Non-oil export volumes up nearly 12½% in year to three months ending November.

- Inflation between 1982 and 1983 was only 4.6% the lowest for 16 years. Inflation below the EC average of 5.4%

- Cost competitiveness in manufacturing (as measured by relative unit labour costs) improved by around 20% since early 1981.

- ~~Number of people in work in economy - including estimated self-employed, estimated to have risen by around 250,000 over year to June 1984~~

- In 3 months to October manufacturing employment rose on average by 3,000 a month

- Service sector - nearly 300,000 new jobs in year to June 1984.

- Total fixed investment is forecast to be at its highest ever level (£45½ billion at 1980 prices) this year

- Investment in private dwellings was at its highest ever level in 1983; investment in dwellings, other than new buildings and works, up 11½% in first half of 1984 on the previous year

- Retail sales for 1984 4% higher in volume than in 1983

Sept 26th

- Wales - Millennium
Bardy

L[illegible] Rates Change

L [illegible]

Stand Led — Manchester

Durham [illegible]

Fireworks Display

[illegible] - Pensions

Great Shops

Rate-Capping Policy

018/9

SECRET (AND PERSONAL UNTIL 2.30 PM THURSDAY 17 JANUARY 1985)

File

MONTHLY MONETARY REPORT: DECEMBER-MARCH

SUMMARY

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

- the growth rates in MO and £M3 were distorted in banking December by the effects of the BT sale, but in opposite directions. MO was inflated by about 1% due to an increase in bankers' balances and £M3 depressed as part of the November increase was unwound
- 3 month interbank rates reached 10½% in early January before coming back to under 10% after the December money figures had been digested. Money market rates remained high relative to base rates until Friday morning, when the clearers increased base rates from 9½% to 10½%
- bank lending was unexpectedly high again in December; it has averaged £1¾ bn a month (equivalent to an annual rate of 20%) since September, although the underlying trend is almost certainly lower. Round-tripping opportunities were available on a number of days around the turn of the year and may inflate bank lending in January
- the outlook for public sector borrowing is poor partly because the coal strike is now assumed to last longer and there are no significant asset sales: March in particular looks like being a month of heavy borrowing
- money market cash pressures are likely to intensify and the authorities will resort to repurchase arrangements. The stock of assistance may be around £15bn by the end of banking March and possibly higher still in the earlier part of that month
- National Savings inflows are likely to be modest over the next 3 months but the £3bn target should be achieved, (just)
- building society inflows were hit badly in banking December by the BT sale but have since recovered strongly; the PSL2-£M3 gap expanded through 1984
- MO is expected to stay in the middle of its range, but £M3 may be above target throughout, with target period growth to March reaching 11%
- non-monetary indicators suggest that output and employment may be picking up. As a result of dollar strength and oil price uncertainties, sterling has fallen, particularly against the dollar.

HF3 - January 1985

018/9

SECRET (AND PERSONAL UNTIL 2:30 PM THURSDAY 17 JANUARY 1985)

MONTHLY MONETARY REPORT: DECEMBER-MARCH

Monetary Aggregates

In banking December both the targetted monetary aggregates performed as expected. £M3 fell by ½ per cent to stand just above its target range and MO rose 1½ per cent, staying a ½ per cent within target. M2 and PSL2 were more or less flat. As in banking November, all of the aggregates were distorted by the BT issue.

TABLE 1 MAIN AGGREGATES : RECENT EXPERIENCE

			per cent, s.a	
	MO	M2*	£M3	PSL2
Monthly change				
November	0.6	0.9	2.7	2.2
December	1.5	1.2	-0.5	0.1
Growth to mid-December at an annual rate over past :-				
3 months	12.3	*	10.3	14.4
6 months	8.3	*	7.2	12.1
12 months	6.6	11.8	9.2	14.5
Target Period	7.5	*	10.1	15.2

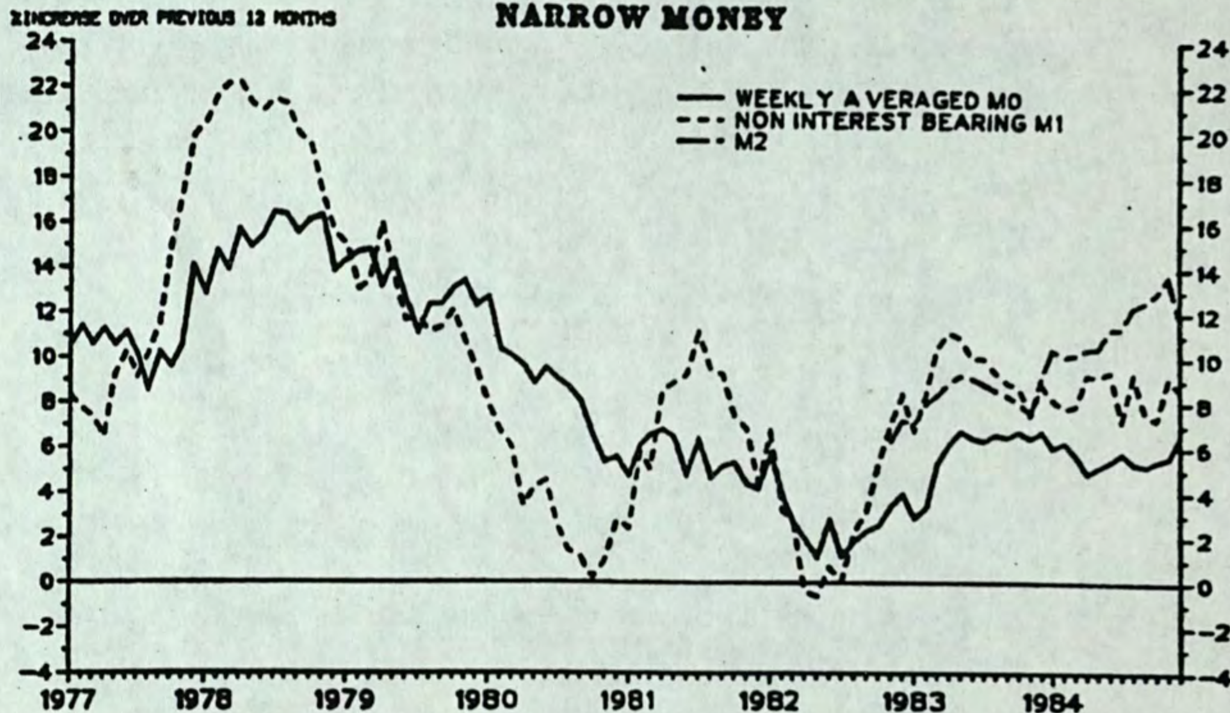
* not seasonally adjusted

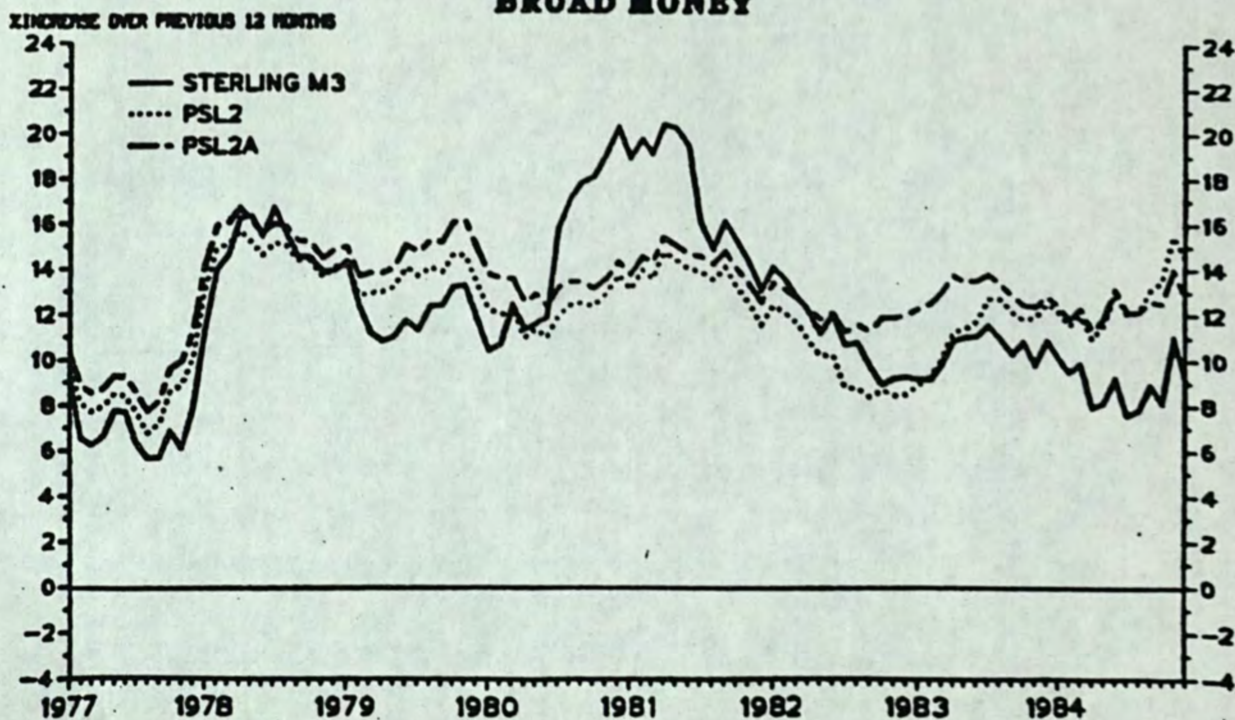
Annex table 1 summarises the past behaviour of all the key aggregates, and of real MO and real £M3. Other measures of money are shown in table 4.

2. The unusually high growth in weekly averaged MO was due largely to a sharp build-up of bankers' deposits at the Bank of England on BT impact day. End-month MO rose only 0.4 per cent. Abstracting from this temporary effect the trend in growth of MO is broadly unchanged. The three and six month growth rates are above the 12 month rate, which has been remarkably steady at around 5½ per cent since last spring. Growth in the target period to date remains in the middle of the 4%-8% range. The growth of notes and coin in December was around half that for the last six months, causing the six and twelve month growth rates to fall below 5 per cent.

SECRET (AND PERSONAL UNTIL 2.30 PM THURSDAY 17 JANUARY 1985)

CHART 1 : ANNUAL GROWTH RATES OF MONETARY AGGREGATES





However weekly figures for banking January have subsequently shown some acceleration. This suggests that the seasonal trend in notes and coin has been unusual this year. This would fit in with anecdotal evidence that Christmas shopping began late.

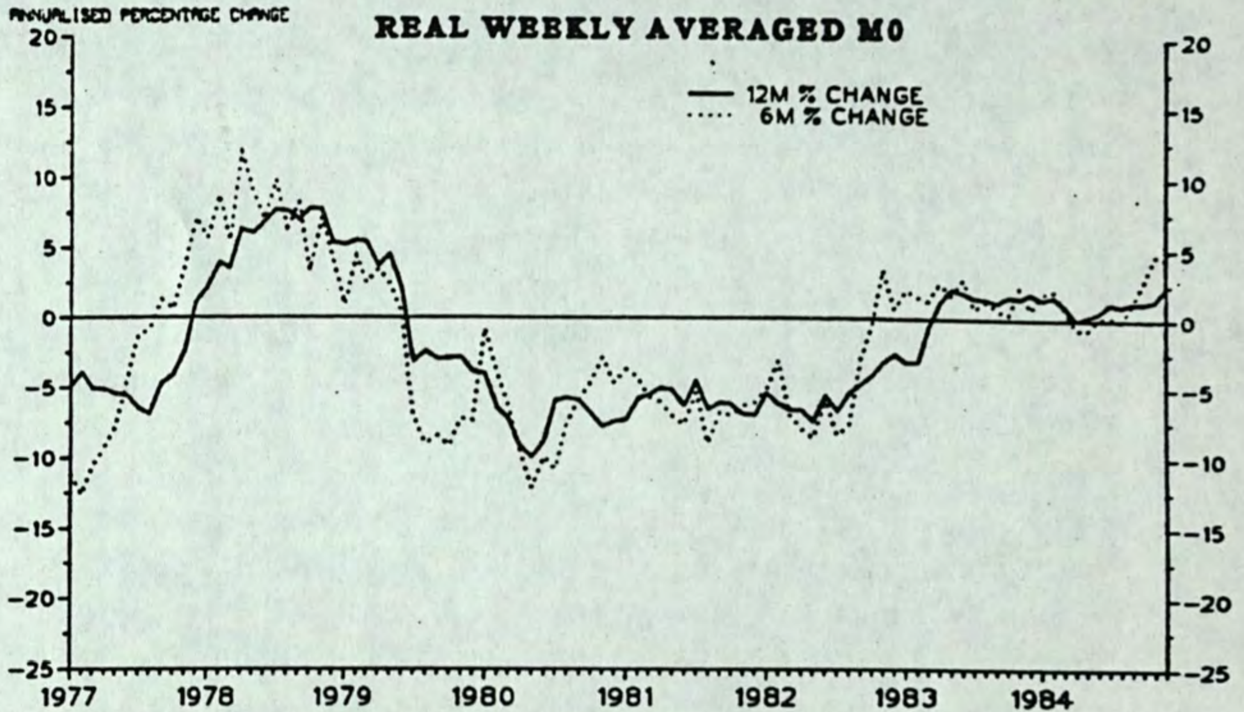
3. The ½ per cent decline in £M3 left it fractionally above target at the end of banking December, with the 12 month growth rate back under 10 per cent. As last month, the BT sale dominated the statistics and the view expressed then that the November figures were distorted was vindicated. Sight deposits, both interest-bearing and non-interest-bearing, recorded large increases in the first part of the banking month, which were largely, but not entirely, unwound in the latter part. M1 still rose by almost 1 per cent. Time deposits and CDs fell by just under £1 billion. Despite the decline in £M3, it is still not yet clear whether there is more of the BT effect still to unwind. We felt last month that with around £1 billion of over-subscription money still in suspense account at the end of the banking month it would not be until banking January that the full effect would be unwound. This still remains the most sensible judgement and the continued build-up, in particular, of non-interest-bearing sight deposits - £950 million in the last two months - reinforces this view.

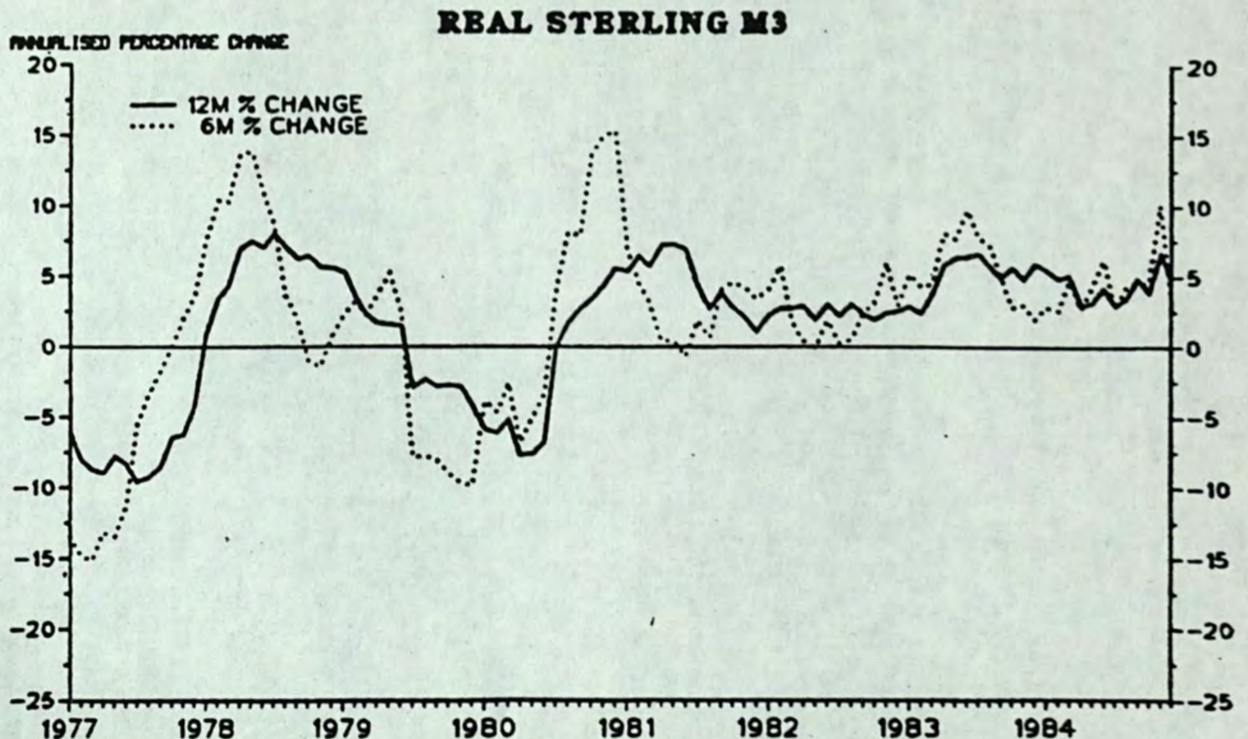
4. As in November, it is not easy to reconcile the counterparts with the view that BT had distorted the statistics. There was a surplus of £1 billion on the PSBR, modest funding but continued high bank lending. Arithmetically the swing in the growth of £M3 (between November and December) can be accounted for by the swing in the PSBR. Nonetheless, even allowing for the BT receipts, it is not obvious why this swing should be associated with the unwinding of BT liquidity. Even so, taking the two months together, the PSBR outturns are consistent with the view that public borrowing is running ahead of the Autumn Statement forecast.

5. The continued strength of bank lending is puzzling. There were a number of special factors boosting bank lending in the autumn, noticeably roundtripping in September, the surge in imports perhaps in anticipation of accelerated VAT on imports and British

SECRET (AND PERSONAL UNTIL 2.30 PM 17 JANUARY 1985)

CHART II : GROWTH RATES OF REAL MONETARY AGGREGATES





REAL GROWTH RATES ARE CALCULATED BY DEFLATING BY THE GROWTH OF THE RPI EXCLUDING THE MORTGAGE ELEMENT

Telecom. Nevertheless in the last four months recorded lending has been running at a rate of £1¼ billion a month compared with £1 billion a month in the previous four months. The limited information we have on the sectoral split suggests that in banking December corporate borrowing slowed but personal borrowing was strong. However not too much should be read into these statistics.

6. Inflows into building societies slowed sharply in banking December, due almost certainly to the BT issue. Consequently with £M3 declining, PSL2 was essentially flat. The loss of deposits by building societies to the BT issue in banking December was probably around £½ billion, but some of that should come back in banking January. Indeed, the calendar December figures show buoyant inflows for building societies. The strength of building society inflows and maturing term shares helps explain the widening gap between the growth rates of PSL2 and £M3. Since the beginning of 1984 this gap, as measured by twelve month growth rates, has widened from 2 per cent to 5 per cent.

Other indicators of monetary conditions

7. Since there is reason to believe that the monetary aggregates were again distorted by the BT sale, the evidence of other indicators is particularly important.

8. Money market interest rates remained steady throughout banking December, with the 3 month interbank rate at around 9¾ per cent. Towards the end of calendar December sterling weakness, caused by oil price worries, together with a growing unease about domestic monetary growth, put upward pressure on market rates. In early January, 3-month interbank reached $10^7/16$ before coming back to under 10 per cent on publication of the provisional December money figures. Sterling remains at close to its lowest levels, and any further fall would renew pressure on interest rates. The fall in sterling cannot be solely attributed to the dollar's strength as it has also fallen against other currencies, presumably reflecting worries about oil prices.

9. Real short term interest rates are about one percentage point higher than they were a year ago, while longer real rates are only up by about ¼ per cent. The widening gap between the real yields on short and long IGs implies a more pronounced downward sloping IG real yield curve.

10. There has been little change in the growth of prices and earnings, but there is some evidence from labour market indicators of increased buoyancy in the economy. Retail price inflation is expected to be lower in December, largely as a result of lower mortgage rates. House price inflation fell to 5.2 per cent in November (based on mortgage approvals) and has dropped to 6.3 per cent based on mortgage completions. Producers cost inflation continues to show considerable stability, with producers input prices still rising at around 9 per cent, a figure which reflects the recent depreciation of sterling. Commodity prices measured in SDR's has been broadly flat since July. Evidence on labour costs is somewhat contradictory: average earnings are rising more slowly than at the beginning of the year but the rate of change in unit wage costs has risen 2½ per centage points since June (although this series is subject to considerable revision).

11. Other non-monetary indicators show some buoyancy, with manufacturing output, employment and average hours all rising recently. Total employment continues to grow, and the latest Gallup/CBI Survey suggests that this is likely to continue throughout 1985. This impression is strengthened by the recent increase in the stock of vacancies to around 170 thousand.

Three month forecast

12. The forecast was prepared assuming that interest rate differentials remained at the levels obtained prior to today's 1 per cent increase in base rates. It is assumed that the effect of the BT sale on the aggregates will have fully unwound by the end of banking January. The sharp rise in bankers' balances on account of BT unwound quickly so M0 is expected to fall in banking January. Nevertheless, the weekly figures so far indicate underlying growth of around ½ per cent in line with that earlier

in the target period. Growth in MO in the target period to banking March is forecast at 6.2 per cent, almost exactly in line with the Winter overview forecast of 6.1 per cent.

13. £M3 growth in banking January is forecast at 0.7 per cent, bringing target period growth exactly to the top of its range. There were substantial opportunities for round-tripping in the month which may inflate sterling lending. The factors containing £M3 growth in January - notably the unwinding of the BT distortion and receipts from accelerated VAT on imports - have a one-off effect, and in February and March the full impact of higher public borrowing needs and buoyant sterling lending become apparent. The end year rush in public spending is expected to inflate the CGBR in the last two weeks of banking March.

14. Though the "PSBR" will be fully funded over the forecast period if the gross sales targets are achieved, this is not likely to be sufficient to dampen monetary growth, particularly in March when a large redemption exacerbates the problem. Thus target period growth in £M3 up to the end of banking March is forecast at 11 per cent, indicating a significant acceleration in £M3 since mid-October, when the last relatively distortion-free figures were available.

TABLE 2 MAIN AGGREGATES : SUMMARY OF FORECAST

per cent, s.a

	MO	M2*	£M3	PSL2
Monthly change				
January	-0.3	-0.4	0.7	1.0
February	0.4	0.4	1.1	1.3
March	0.4	1.0	1.6	1.4
growth to mid-December at an annual rate				
Over Past :-				
3 months	12.3	*	10.3	14.5
6 months	8.3	*	7.2	12.1
12 months	6.6	11.8	9.2	14.5
Target Period	7.5	*	10.1	15.2
growth to mid-March at an annual rate				
Over Past :-				
3 months	2.0	*	14.2	15.9
6 months	7.0	*	12.4	15.2
12 months	6.2	10.3	10.6	14.8
Target Period	6.2	*	11.0	15.4

* not seasonally adjusted

Public Sector Borrowing

15. The £1 billion PSBR surplus in December was virtually on forecast. Within this total the CGBR was also close to forecast, but the other public sector contribution contained two large offsetting errors. Particularly surprising was the large LABR; following the deficit in November - a traditionally a surplus month - (confirmed by the calendar month figures) a surplus had been expected. It is now assumed that this will come in January.

16. Despite the deterioration for the year as a whole, the outlook for the PSBR for January and February has improved because of lower than expected expenditure already in banking January and higher than expected receipts from the North Sea oil licence sales. The 'PSBR' only totals £900 million in the two months, but the underlying rate (after VAT acceleration) is around £1 billion. In March a large deficit is forecast. This is partly the result of an end-year surge in the PSBR but also reflects the need to reconcile the banking month and daily forecast figures with the latest financial year forecast. The latter has higher figures than is implied by the daily forecast, and the difference, by assumption, has mainly fallen in March.

Table 3: Public Sector Borrowing

£ billions

	Financial year* to mid-December	mid-December to mid-February
CGBR	6.3	3.1
on account	4.4	2.0
on lending	2.1	1.1
'PSBR'[x]	7.1	2.1
of which:		
Asset Sales	1.7	0.1
Vat on imports	-	1.2

* banking April is divided by two to obtain a (very rough) estimate from end March.

[x] PSBR less non-bank private sector transactions in other public sector debt. (This is consistent with a PSBR of £10.1 billion.)

17. It is now assumed that the miners' strike finishes at the end of calendar March. The impact of this change in assumption (from end December) falls on the PCBR, and partly, through higher on-lending to the CGBR; the extra cost is around £½ billion. It is now accepted that there will be no sale of British Airways this financial year and the forecast assumes no further asset sale takes its place.

Debt Sales

(a) **Gilts**

18. Gross gilt sales fell short of the £0.5 billion target in the three weeks of banking December. Total sales were some £320 million: the second call on 9¾% Exchequer 1998 A brought in some £338 million, but buying-in exceeded other sales. Nearly £200 million of next maturities, mainly 15% Treasury 1985, which is due for redemption in banking March, was bought in. The table excludes £283 million of repos by Issue Department on 5 December (for resale on 31 December). There were no new issues during the month, which was dominated by the BT offer.

TABLE 4 : GILT SALES *

monthly averages ,£m

	Actual		Forecast
	Banking Dec	mid-Dec 1983 -mid-Dec 1984	mid-Dec 1984 -mid-Mar 1985
Gross Sales	322	1151	1000
Redemptions	0	-292	-156
Next Maturities	-193	-94	-143
Net Sales	129	764	701
of which : -			
Monetary Sector	-338	27	0
Public Corporations	0	-1	0
Overseas	79	62	-67
Non-bank private sector	386	676	768

* excluding Repos

19. Table 4 compares the December outturn with performance over the target period so far and summarises the forecast for gilt sales in the forecast period. It assumes gross sales in each of January, February (both five week banking months) and March of £1 billion. Until the publication of the December provisionals the authorities had been net buyers, but the market reacted positively to the announcement and the tap was exhausted. The third call will bring in over £330 million in banking January, but there is still a good deal of leeway to make up in the last few days if the target is to be achieved.

(b) CTDs

19. Shell have again been significant net purchasers. We expect CTDs, after seasonal adjustment, to make a significant positive contribution of over £100 million to funding in banking January, but forecast that this will be largely reversed in banking February. March may well see a substantial outflow, in excess of £100 million, owing to heavy surrenders to meet PRT payments of around £2 billion due on 1 March.

(c) National Savings

20. National Savings contributed only £81 million (unadjusted) to funding in banking December (£87 million adjusted), slightly below forecast, as a result of timing factors. Accrued interest and the Income Bond were the major contributors to the net inflow, whilst the outflow from index-linked continued at £40 million in the month.

21. Over the forecast period we expect further outflows from index-linked certificates, an improved performance from the 29th Issue and a continuing contribution from the Income Bond and accrued interest. Invac shows no sign of recovery, despite its recent gain in competitiveness relative to building society rates. The forecast unadjusted inflow is £270 million for January declining slightly in February and March. This is reduced by large negative seasonals in each month.

22. It is possible that these seasonals derive less from the behaviour of savers than from the pattern of policy initiatives in previous years. Our forecast assumes no such initiatives are introduced, so the seasonally adjusted inflows are expected to average only £120 million a month. However, this is still enough to ensure that we meet the £3 billion target for the financial year.

The PSBR and Funding

	Actual	Forecast	
	mid-Feb 84 - mid-Dec 84	mid-Dec 84 - mid-Feb 85	mid-Feb 84 - mid-Feb 85
'PSBR'	8.3	2.5	10.8
Debt sales to nbps of which			
Gilts	-6.3	-1.9	-8.2
National Savings	-3.0	-0.4	-3.4
CTD's	-0.7	0.1	-0.6
Over (-)/Underfunding (+)	-1.8	0.3	-1.5
Unadjusted	(2.0)	(-3.7)	(-1.8)
External finance of the public sector	-0.5	-0.2	-0.7
Over (-)/Underfunding (+) alternative definition	-2.3	0.1	-2.2
Unadjusted	(1.5)	(-3.9)	(-2.5)

23. Table 5 summarises the net funding position over the target period so far and that implied by the forecast to mid-March. The large PSBR surplus in banking December meant that despite relatively modest gilt sales there was overfunding of £1.4 billion. However taking November and December together, there was only modest (£0.3 billion) overfunding seasonally adjusted.

24. In the target period to date there has been a £1.8 billion overfund on the conventional definition seasonally adjusted and a £2 billion underfund seasonally unadjusted. The forecast shows overfunding of £3.7 billion on an unadjusted basis, but much of this is due to seasonal factors. There is small underfunding on a seasonally adjusted basis.

Money market influences

25. There was little change in the stock of money market assistance in banking December, although maturing assistance kept the market short by an average of £600 million a day, net of the BT share sale and the gilt repurchase operation undertaken on December 4. In January and February large seasonal tax payments and accelerated payment of VAT on imports, together with continued funding, will cause a large shortage of around £3 billion. Consequently, the Bank have announced another repurchase operation starting on January 15 and unwinding on February 14, of about £2 billion. By the end of banking March the stock of market assistance is forecast to reach £15.1 billion - a new record (see annex table 12).

Sterling Lending to the Private Sector

26. Bank lending once again grew faster than expected last month, rising by just under £1½ billion. Over the last four months lending has averaged around £1¾ billion a month, equivalent to an annual rate of increase of 20 per cent. Over the four month period there have been a number of upward distortions, such as round-tripping in September, the BT sale in November and the need to finance unusually high imports . This makes it difficult to discern the underlying trend. Table 6 shows various moving averages of lending in both £ million and percent terms. Underlying lending - that is the recorded figure adjusted to allow for the tendency of lending to be unusually high when the PSBR is above trend - seems to be running at between £1¼ and £1½ billion (or between 15 per cent and 18 per cent at an annual rate). Recorded lending has accelerated more sharply with the 3-month moving average at £1¾ billion in December, although the 6 and

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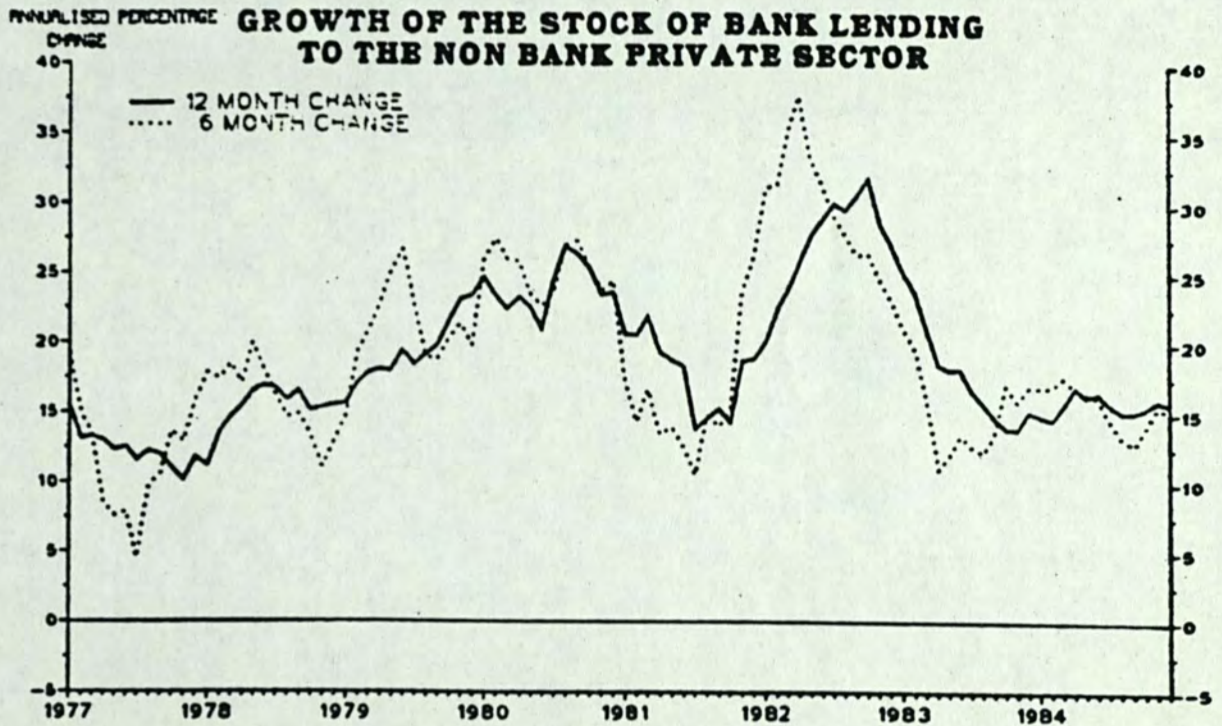
CHART III : BANK LENDING AND FT INDEX



KJ

TABLE 6 — £ LENDING TO THE PRIVATE SECTOR

	UNDERLYING MOVING AVERAGES OF LEVELS, £m, sa				RECORDED MOVING AVERAGES OF LEVELS, £m, sa		
	3 MONTH	6 MONTH	12 MONTH		3 MONTH	6 MONTH	12 MONTH
1984M2	1056	1096	701	1984M2	1283	1278	805
1984M3	1093	1215	827	1984M3	1282	1348	943
1984M4	1621	1306	991	1984M4	1445	1320	1062
1984M5	1390	1223	1049	1984M5	1322	1302	1136
1984M6	1559	1326	1217	1984M6	1297	1290	1267
1984M7	882	1251	1140	1984M7	936	1190	1231
1984M8	1094	1242	1169	1984M8	884	1103	1190
1984M9	1029	1294	1254	1984M9	850	1074	1211
1984M10	1638	1260	1283	1984M10	1452	1194	1257
1984M11	1735	1414	1318	1984M11	1776	1330	1316
1984M12	1570	1299	1312	1984M12	1781	1315	1302
1985M1	1401	1519	1385	1985M1	1546	1499	1345
1985M2	1276	1506	1374	1985M2	1531	1653	1378
1985M3	1250	1410	1352	1985M3	1456	1618	1346

	MOVING AVERAGE OF PERCENTAGE CHANGES (%)				MOVING AVERAGE OF PERCENTAGE CHANGES (%)		
	3 MONTH	6 MONTH	12 MONTH		3 MONTH	6 MONTH	12 MONTH
1984M2	13.5	14.2	9.2	1984M2	16.5	16.7	10.6
1984M3	13.7	15.6	10.8	1984M3	16.1	17.4	12.3
1984M4	20.4	16.6	12.8	1984M4	18.0	16.8	13.8
1984M5	17.3	15.4	13.5	1984M5	16.3	16.4	14.7
1984M6	19.3	16.5	15.6	1984M6	15.7	15.9	16.3
1984M7	10.8	15.6	14.6	1984M7	11.1	14.6	15.7
1984M8	13.3	15.3	14.8	1984M8	10.4	13.4	15.0
1984M9	12.2	15.8	15.7	1984M9	9.8	12.8	15.1
1984M10	19.3	15.0	15.8	1984M10	17.1	14.1	15.4
1984M11	20.2	16.8	16.1	1984M11	20.7	15.6	16.0
1984M12	17.9	15.0	15.8	1984M12	20.5	15.2	15.5
1985M1	15.6	17.4	16.5	1985M1	17.3	17.2	15.9
1985M2	13.9	17.1	16.2	1985M2	16.9	18.8	16.1
1985M3	13.4	15.6	15.7	1985M3	15.8	18.2	15.5

12 month rates are nearer £1¼ billion (or between 16 per cent and 17 per cent).

27. We have assumed that the underlying level during the forecast period will be more in line with its longer run trend at around £1¼ billion a month. Recorded lending over the next 6 months is, however, likely to be affected by a number of special factors. There may be about £½ billion extra lending from the BT sale to be unwound in January. But this is more than offset by the need to finance accelerated VAT on imports, about two-thirds of which we expect to come from higher bank borrowing. Companies are also likely to increase their expenditure on investment as the date for the next reduction in capital allowance approaches.

28. The January recorded series may be further distorted by round-tripping, the conditions for which appear to have been favourable almost continuously from the 20 December to the 7 January (ie. 10 working days). The Bank take the view that market nervousness about base rate increases and the thin market over this period, may have dissuaded company treasurers from indulging in round-tripping, but it is possible that treasurers may not have been so timid. As usual it is almost impossible to quantify the effect at all precisely, but round-tripping may add around £150 million to lending in January. After allowing for these assumed distortions, recorded lending is forecast to average £1.4 billion over the next 3 months. This implies a 15½ per cent increase between 1983-84 and 1984-85.

29. New issues were as usual fairly rare in calendar December, with redemptions slightly above gross issues. But overall 1984 has been a particularly good year for raising money on the stock market, considering the unprecedented scale of the privatisations programme. The gross issues queue for equities is up by over £½ billion: almost half this increase relates to one financial institution.

Table 7: Net issues by Listed UK Companies

(Calendar month averages, £M)

	Net Issues ø	Gross Issues Queue* (Equities)
1983	234	
1984	143	
1984 Q1	51	850
Q2	199	1510
Q3	218	1030
Q4	106	1215
October	222	919
November	125	1177
December	- 28	1550**

* Excluding privatisations (currently £1 billion, entirely accounted for by British Airways)

**As of Monday, 7 January

ø Includes convertible loan stock.

30. The buoyancy of the new issues market makes it all the more difficult to explain why company borrowing appears to have been so high in the first three quarters of 1984. It is even mor puzzling that in the last four banking months, bank lending in foreign currency (which is almost entirely to companies) have increased by over £½ billion a month compared to £200 million on average over the previous eight months.

Building Societies' Inflows

31. Retail inflows in banking December were about £80 million lower than forecast last month. The December figure was, of course, expected to be low as money that would have otherwise been deposited with building societies was submitted for BT shares. In the event it seems that about £½ billion was diverted from building societies to the BT offer; rather more than the £400 million assumed last month.

32. On the assumption of no change in interest rates, the broad picture for retail inflows over the forecast period is very similar to last month. It is expected that the underlying trend in retail

inflows will be just over £1.1 billion per month (including interest credited, s.a.). However, the actual profile is a little different, for the following reasons:-

(i) In banking January retail inflows are inflated by about £¼ billion. This reflects unsuccessful money put up for BT shares returned to building societies (£190m) and realised profits from the sale of BT shares (£50m) deposited with building societies. Last month we assumed these two factors would inflate retail inflows by only £150 million in banking January, but since it now seems that the BT flotation reduced inflows in December by rather more than expected in last month's forecast, we assume that rather more is returned in banking January.

(ii) In banking February inflows are a little higher than trend; in March a little lower. Since banking February is longer, and March shorter, than usual this year, the seasonals tend to distort the profile.

33. Wholesale borrowing increased by over £200 million in banking December, with a large proportion coming from the banking sector, mainly due to depressed retail inflows. Wholesale borrowing may remain fairly buoyant over the forecast period as the tax gathering season comes around.

34. Net mortgage lending has remain fairly constant recently, though the latest figures for new commitments suggest mortgage lending may pick up in the latter half of the forecast period. This, coupled with the low level of retail inflows in December (only partly offset by higher wholesale borrowing), meant that liquid assets were built up by only £50 million in banking December. As a result the liquidity ratio probably declined to just over 17 per cent (s.a.) in banking December. The latest calendar month figures show the liquidity ratio falling from 17.5 per cent at end-October to 17.2 per cent at end-November.

35. With a revival of retail inflows and little change in mortgage lending, we expect a substantial build-up in liquid assets in

banking January which should push the liquidity ratio up. However, with composite tax payments assumed to be paid in banking February (this is consistent with the PSBR forecast), liquid assets are run down in that month before rising slightly in March. This picture is consistent with a slight decline in the seasonally adjusted liquidity ratio between the end of banking December and banking March.

Building Societies' contribution to PSL2 and M2

36. Table 8 below shows the societies' contribution to PSL2 and M2. The average monthly contribution to PSL2 over the forecast period is higher than between February and December. This reflects the fact that retail inflows are forecast to be higher than experienced so far this year (in part due to the buoyant January figure) and term shares (which are outside PSL2) are expected to be run down more quickly. The forecast contribution to M2 reflects the assumption that 70 per cent of retail inflows (the historical average) will be inside M2.

Table 8: Building Society Inflows

monthly rate, £m, seasonally adjusted

	mid-Feb to mid-December	Forecast: mid-November to mid-March
1. Total retail inflows (incl.interest credited)	1014	1210
2. of which: terms shares	- 62	- 150
3. Net issues of CDs and time deposits to NBPS	+ 55	+ 75
4. BS acquisitions of liquid assets (excl.gilts)	+ 14	+ 120
5. Building Societies' contribution to PSL2 (1-2+3-4)	+1117	+1315
6. Building Societies' contribution to M2	+ 742	+ 765

Total retail inflows

37. Table 9 below draws together the forecasts for retail inflows to building societies, National Savings and the banking sector. Over recent months we have been assessing our forecast for inflows to the three sectors against the background of the likely scale of the flow of retail funds in total. In banking December the total flows of retail funds was £830 million, £150 million above last month's forecast. Within the total, retail bank deposits were about £¾ billion higher than expected, and building societies' inflows were £80 million lower than forecast. We have assumed that the higher than expected inflow of retail bank deposits means that most of the rundown in bank deposits, as the BT effect unwinds will occur in banking January rather than, as assumed last month, being spread more evenly over banking December and January.

38. As a result, bank's retail inflows are forecast at £700 million below trend in banking January. (This feature is reflected in the forecast for bank lending.) Thereafter bank report inflows return to their trend levels. The resulting total inflow of retail funds is put at just over £1½ billion per month, in line with experience so far this year.

SECRET

TABLE 9 — A BREAKDOWN OF RETAIL FUNDS — Seasonally adjusted £ million

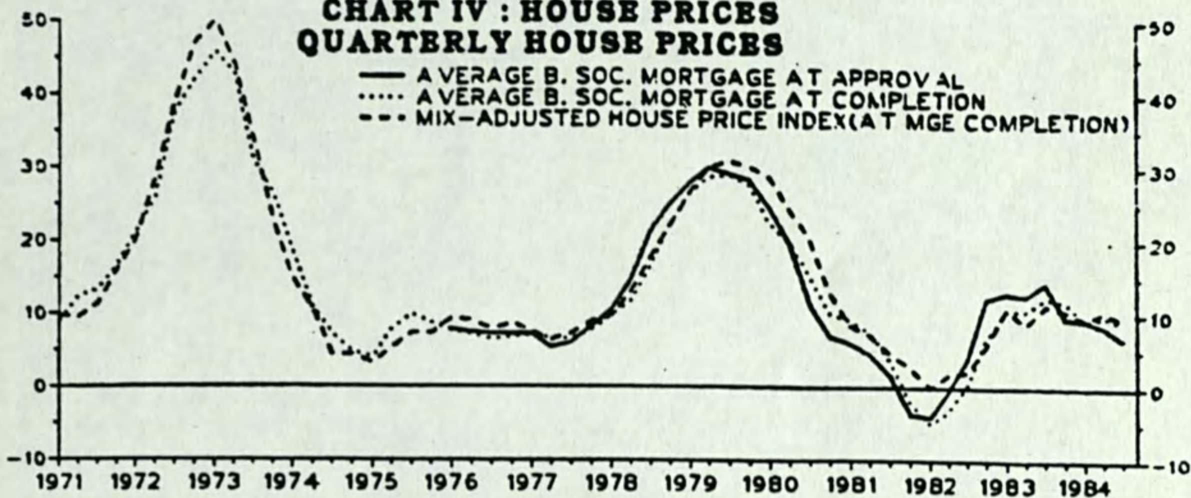
	OUTTURN			FORECAST		
	Average Monthly Increase					
	since mid-June	since mid-Feb	DECEMBER	JANUARY*	FEBRUARY*	MARCH*
Retail Bank Deposits						
Nib Sight	162	212	291	)		
ib Chequable	79	156	59	) -400	300	300
ib Other	15	-23	-214	)		
Total Retail Bank	256	345	136	-400 (300)	300 (300)	300 (300)
Building Societies Shares and Deposits[x]	983	1014	609	1355 (1115)	1190 (1120)	1055 (1125)
National Savings	342	304	87	140 (205)	125 (200)	90 (195)
TOTAL	1581	1663	832	1095 (1620)	1615 (1620)	1445 (1620)

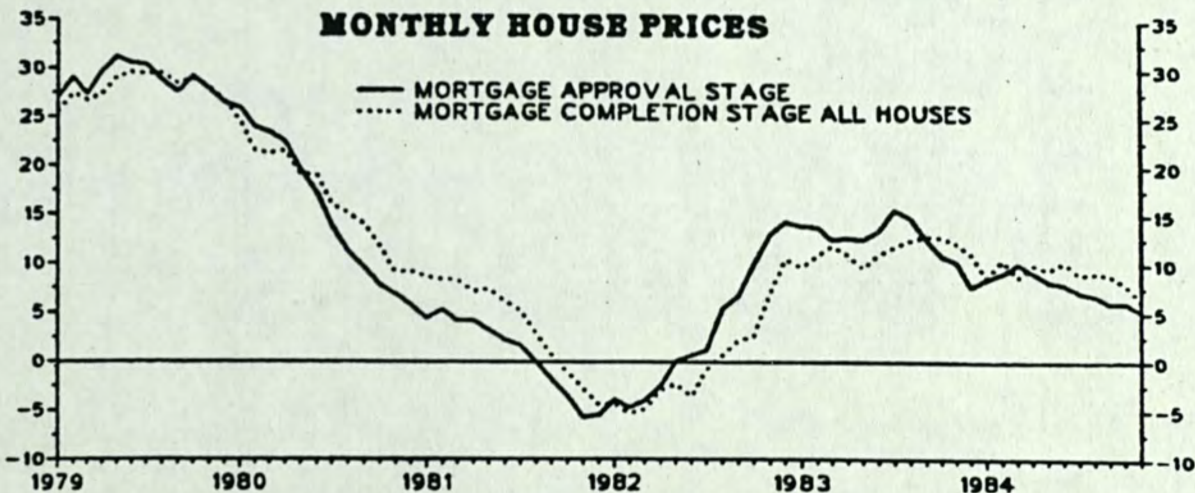
*Figures in brackets show underlying figures, ie adjusted for BT effects, and inappropriate seasonal factors.

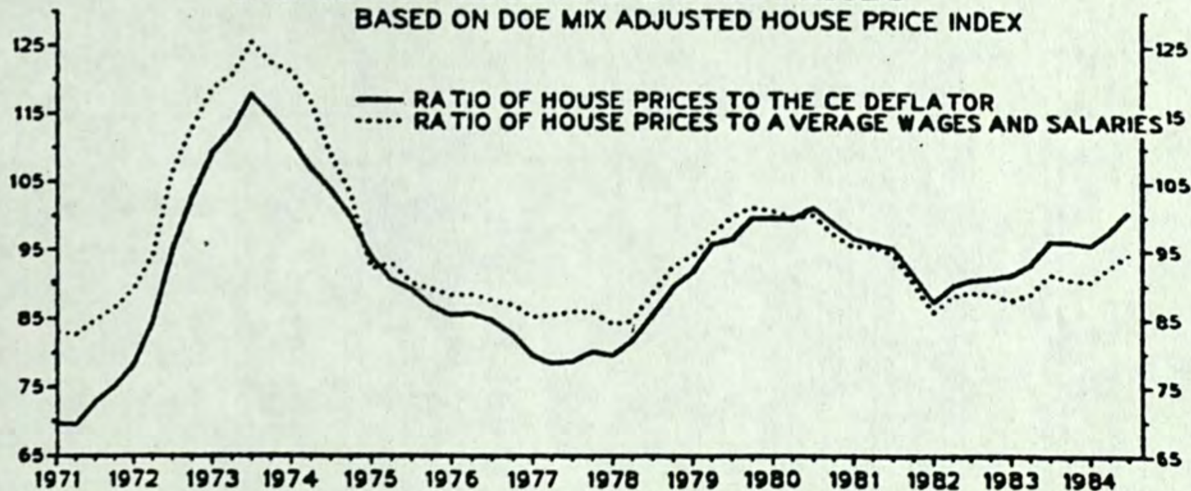
[x]Including Term Shares and SAYE

SECRET (AND PERSONAL UNTIL 2.30 PM 17 JANUARY 1985)

CHART IV : HOUSE PRICES

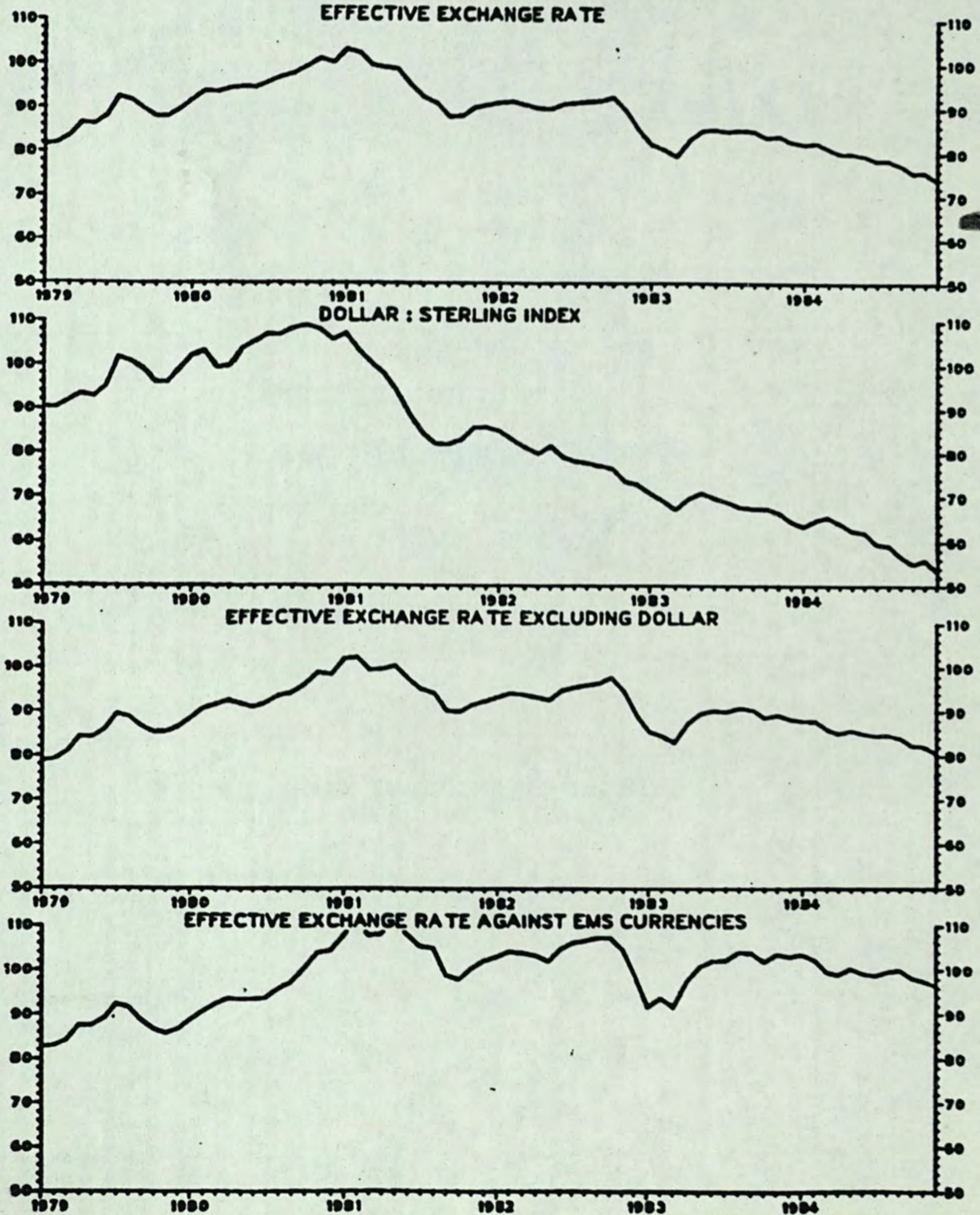






SECRET (AND PERSONAL UNTIL 2.30 PM 17 JANUARY 1985)

CHART V: **EXCHANGE RATE INDICES (1975=100)**



Monthly Monetary Report: Tables

Money

1. Nominal and real target aggregates: historical
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3. Counterparts to change in £M3: forecast summary
4. Other monetary aggregates: historical
   - (a) target aggregates
   - (b) other narrow aggregates
   - (c) other wide aggregates
5. (a) Components of £M3 : historical
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6. Composition of MO: historical
7. Retail deposits: historical

Other indicators of monetary conditions

8. Nominal and real interest rates
9. Prices and earnings

Details of forecast

10. Bank lending: forecast summary
11. Gilts: forecast summary
12. Money market influences: forecast summary

TABLE 1: PERCENTAGE GROWTH RATES IN SELECTED MONETARY AGGREGATES

		Weekly averaged MO	M2	£M3	PSL2	Real* MO	Real* £M3	RPI less Mortgage Element
(a)	Financial Years (12 month changes to banking April)(%)							
	1980-81	6.8		20.4	14.8	-5.0	7.1	12.4
	1981-82	2.0		12.2	10.9	-6.6	2.8	9.1
	1982-83	6.1	8.9	10.9	11.4	1.2	5.7	4.9
	1983-84	4.9	10.4	7.9	11.0	0.0	2.9	4.9
(b)	Changes in 12 months to (%)							
1984	January	6.0	10.4	10.2	12.2	1.4	5.4	4.5
	February	6.3	10.1	9.5	11.6	1.7	4.8	4.5
	March	5.7	10.1	9.9	12.0	1.0	5.0	4.6
	April	4.9	10.4	7.9	11.0	0.0	2.9	4.9
	May	5.2	10.4	8.1	11.6	0.3	3.1	4.9
	June	5.4	11.3	9.2	13.0	0.5	4.1	4.9
	July	5.8	11.3	7.6	12.0	1.2	2.9	4.5
	August	5.4	12.3	7.8	12.1	1.0	3.4	4.3
	September	5.2	12.5	8.8	13.0	1.3	4.8	3.9
	October	5.4	12.9	8.2	13.5	1.2	3.8	4.2
	November	5.6	13.6	11.0	15.5	1.4	6.6	4.1
	December	6.6	11.9	9.2	14.5	2.4	4.9	4.1
(c)	Changes (at an annual rate) in 6 months to (%)							
1984	January	6.6	10.4	7.6	9.5	1.9	2.8	4.6
	February	6.3	11.4	6.7	9.0	2.1	2.5	4.1
	March	5.1	13.5	8.8	11.6	1.0	4.7	4.1
	April	4.1	14.9	7.6	12.2	-0.6	2.7	4.8
	May	4.0	15.7	9.2	14.0	-0.7	4.2	4.8
	June	4.9	15.6	11.2	17.0	0.2	6.1	4.7
	July	5.0	12.1	7.6	14.6	0.3	2.7	4.7
	August	4.4	13.0	8.9	15.3	0.0	4.3	4.5
	September	5.3	11.3	8.8	14.5	1.2	4.5	4.1
	October	6.8	10.7	8.7	14.8	2.7	4.6	3.9
	November	7.2	11.5	12.8	17.0	4.7	10.1	2.4
	December	8.3	8.2	7.2	12.0	4.5	3.5	3.6
(d)	Changes (at an annual rate) in 3 months to (%)							
1984	July	6.8	10.7	7.6	15.2			
	August	4.6	10.7	7.1	13.8			
	September	4.4	7.1	4.2	9.8			
	October	6.7	10.8	9.8	14.3			
	November	9.9	12.3	18.8	20.3			
	December	12.3	9.3	10.3	14.2			
(e)	Changes in month to (%) (£m figures in brackets)							
1984	October	0.8 (105)	1.0 (1256)	0.3 (324)	1.1 (1982)			
	November	0.6 (83)	1.4 (1801)	2.7 (2871)	2.2 (4131)			
	December	1.5 (210)	-0.1 (-109)	-0.5 (-588)	0.0 (76)			

* Real rates of growth of the monetary aggregates are calculated by deflating the nominal money supply using the RPI less mortgage element.

SECRET

TABLE 1 : PERCENTAGE CHANGES IN MONETARY AGGREGATES

per cent, s.a.

	MO	NIB M1	M1	M2*	£M3	M3	PSL2	PSL2A
Banking months								
(1) In month								
Dec	1.5	0.9	0.9	1.2	-0.5	0.2	0.1	0.0
Jan	-0.3			-0.4	0.7		1.0	0.8
Feb	0.4			0.4	1.1		1.3	1.1
Mar	0.4			1.0	1.6		1.4	1.2
(2) latest 3 months (a.r)								
Dec	12.3	16.1	26.1	*	10.3	14.2	14.4	12.0
Jan	7.5			*	12.1		14.1	11.6
Feb	6.7			*	5.0		9.9	8.0
Mar	2.0			*	14.2		15.9	13.4
(3) latest 6 months (a.r)								
Dec	8.3	7.8	16.5	*	7.2	12.7	12.1	10.1
Jan	7.1			*	11.0		14.2	11.9
Feb	8.3			*	11.7		14.9	12.5
Mar	7.0			*	12.4		15.2	12.7
(4) latest 12 months (a.r)								
Dec	6.6	8.6	18.2	11.8(10.3)**	9.2	10.8	14.5	12.9
Jan	6.1			10.2(10.2)**	9.3		14.4	12.6
Feb	6.3			10.7(11.0)**	10.3		15.1	13.1
Mar	6.2			10.3(10.9)**	10.6		14.8	12.7
(5) target period (a.r)								
Dec	7.5	10.6	20.7	*	10.1	11.1	15.2	13.3
Jan	6.5			*	10.0		15.0	13.0
Feb	6.3			*	10.3		15.1	13.1
Mar	6.2			*	11.0		15.4	13.3

* not seasonally adjusted

** excluding reclassifications

SECRET

TABLE 3 : £M3 COUNTERPARTS

£ millions

	DECEMBER		FORECAST			TARGET PERIOD MID-MARCH 84 TO MID-MARCH 85	MID-APRIL 84 TO MID-MARCH 85
	FORECAST	OUTTURN	JAN	FEB	MARCH		
1. CGBR							
Own-account (u.a)	515	304	-1720	-625	-50	6920	3645
On-lending (u.a)	400	472	610	-245	710	3392	3133
Total (u.a)	915	776	-1110	-870	660	10312	6778
TOTAL CGBR (s.a)	-1045	-1185	890	590	1625	10781	8605
2. NET PURCHASES OF CG DEBT BY NBPS							
Gilts	-225	-387	-620	-775	-510	-8233	-7064
Treasury bills	-100	56	0	0	0	188	141
National Savings	-85	-87	-140	-125	-90	-3395	-2885
CTDs,etc	35	38	-115	75	145	-609	-357
TOTAL DEBT	-375	-380	-875	-825	-455	-12049	-10165
3. OTHER PUBLIC SECTOR							
Local Authorities	-400	123	-515	-285	-60	-439	-729
Public Corps.	450	33	-70	300	0	472	706
TOTAL OPS	50	156	-585	15	-60	33	-23
4. £ LENDING TO PRIVATE SECTOR	1020	1484	1450	1660	1000	17532	14455
5.NET EXTERNALS	80	122	160	45	0	313	1139
6.NET NON-DEPOSIT LIABILITIES	-330	-734	-330	-330	-330	-4624	-3762
CHANGE IN £M3 £m	-600	-537	710	1155	1780	11985	10248
(%)	(-0.6)	(-0.5)	(0.7)	(1.1)	(1.6)	(11.0)*	(10.5)*
"PSBR"	-995	-1029	305	605	1565	10814	8582
OVER(-)/UNDERFUNDING(+)	-1370	-1409	-570	-220	1110	-1235	-1583

* at an annual rate

1984-85 KEY AGGREGATES **Table 4A**

TARGET AGGREGATES

		APR	MAY	JUNE	JULY	AUG	SEP	OCT	NOV	DEC
£M3	(Exc. Public sector deposits)									
	Monthly change (£ millions)	+352	+855	+2,062	-1,030	+734	+1,380	+324	+2,825	-537
	Monthly % change	+0.3	+0.8	+2.0	-1.0	+0.7	+1.3	+0.3	+2.7	-0.5
	Three-monthly % change a.r.	+7.5	+10.8	+13.6	+7.6	+7.1	+4.2	+9.8	+18.6	+10.3
	Six-monthly % change a.r.	+7.6	+9.2	+11.2	+7.6	+8.9	+8.8	+8.7	+12.7	+7.2
	12 Monthly % change	+7.9	+8.1	+9.2	+7.6	+7.8	+8.8	+8.2	+10.9	+9.2
	% Change since Feb-83 a.r.	+9.7								
	% Change since Feb-84 a.r.	+10.9	+10.8	+14.7	+8.9	+8.9	+10.1	+9.2	+12.0	+10.1
MO	Averaged weekly									
	Monthly change (£ millions)	+11	+53	+137	+30	-17	+133	+105	+83	+210
	Monthly % change	+0.1	+0.4	+1.0	+0.2	-0.1	+1.0	+0.8	+0.6	+1.5
	Three-monthly % change a.r.	+3.2	+4.3	+6.2	+6.8	+4.6	+4.4	+6.7	+9.9	+12.3
	Six-monthly % change a.r.	+4.1	+4.0	+4.9	+5.0	+4.4	+5.3	+6.8	+7.2	+8.3
	12-monthly % change	+4.9	+5.2	+5.4	+5.8	+5.4	+5.2	+5.4	+5.6	+6.6
	% Change since Feb-83 a.r.	+5.9								
	% Change since Feb-84 a.r.	+3.9	+4.3	+6.4	+5.7	+4.4	+5.5	+6.1	+6.2	+7.5

CROSS CHECKS

		APR	MAY	JUNE	JULY	AUG	SEP	OCT	NOV	DEC
PSL2	Monthly change (£ millions)	+1,625	+2,164	+3,913	+138	+1,702	+2,404	+1,982	+4,085	+167
	Monthly % change	+1.0	+1.3	+2.2	+0.1	+1.0	+1.3	+1.1	+2.2	+0.1
	Three-monthly % change a.r.	+13.9	+16.8	+19.3	+15.2	+13.8	+9.8	+14.3	+20.1	+14.4
	Six-monthly % change a.r.	+12.2	+14.0	+17.0	+14.6	+15.3	+14.5	+14.8	+16.9	+12.1
	12-monthly % change	+11.0	+11.6	+13.0	+12.0	+12.1	+13.0	+13.5	+15.5	+14.5
	% Change since Feb-83 a.r.	+12.4								
	% Change since Feb-84 a.r.	+17.1	+16.8	+20.1	+16.0	+15.3	+15.6	+15.4	+16.9	+15.2
M2 unadjusted	Monthly change (£ millions)	+2,317	+615	+2,110	+1,431	+378	+488	+1,131	+1,133	+1,598
	Monthly % change	+1.9	+0.5	+1.7	+1.1	+0.3	+0.4	+0.9	+0.9	+1.2
	12-monthly % change	+10.5	+10.5	+11.3	+11.4	+12.3	+12.6	+12.9	+13.6	+11.8
	(exc re-classifications)	(+8.0)	(+7.9)	(+8.5)	+8.7	+9.5	+9.8	+10.1	+10.8	+10.3
Levels :	£M3 (Exc. Pub Sec Deps)	101,497	102,330	104,416	103,406	104,121	105,467	105,800	108,658	108,526
	MO (Averaged weekly)	13,242	13,295	13,432	13,462	13,445	13,578	13,683	13,766	13,976
	PSL 2	172,589	174,723	178,653	178,799	180,458	182,828	184,814	188,933	189,502
	M2 (unadjusted)	125,202	125,857	128,017	129,448	129,826	130,314	131,445	132,578	134,278

Table 4B

OTHER NARROW AGGREGATES

		APR	MAY	JUNE	JULY	AUG	SEP	OCT	NOV	DEC
NIB M1	Monthly change (£ millions)	+581	+140	+281	-401	+668	-267	+221	+720	+305
	Monthly % change	+1.8	+0.4	+0.9	-1.2	+2.1	-0.8	+0.7	+2.2	+0.9
	Three-monthly % change a.r.	+15.0	+16.2	+13.3	+0.2	+6.9	-	+7.9	+8.4	+16.1
	Six-monthly % change a.r.	+10.7	+10.6	+9.4	+7.4	+11.5	+6.4	+4.0	+7.7	+7.8
	12-monthly % change	+9.3	+9.2	+9.4	+7.3	+9.3	+7.6	+7.3	+9.2	+8.6
	% Change since Feb-83 a.r.	+9.7								
	% Change since Feb-84 a.r.	+22.1	+16.2	+14.9	+8.5	+11.5	+8.3	+8.3	+10.5	+10.6
M1	Monthly change (£ millions)	+778	+687	+857	-318	+685	+507	+811	+1,601	+428
	Monthly % change	+1.8	+1.5	+1.9	-0.7	+1.5	+1.1	+1.7	+3.3	+0.9
	Three-monthly % change a.r.	+22.3	+28.0	+22.6	+11.3	+11.1	+7.7	+18.4	+27.1	+26.1
	Six-monthly % change a.r.	+16.3	+18.2	+20.0	+16.7	+19.3	+14.9	+14.8	+18.9	+16.5
	12-monthly % change	+13.6	+13.7	+13.7	+13.5	+14.3	+15.6	+15.5	+18.6	+18.2
	% change since Feb-83 a.r.	+14.0								
	% change since Feb-84 a.r.	+32.3	+28.0	+27.2	+19.3	+19.3	+18.5	+19.0	+21.9	20.7
M2	Partially seasonally adjusted									
	Monthly change (£ millions)	+1,513	+1,268	+1,804	+142	+1,326	+766	+1,256	+1,801	-110
	Monthly % change	+1.2	+1.0	+1.4	+0.1	+1.0	+0.6	+1.0	+1.4	-0.1
	Three-monthly % change a.r.	+13.6	+15.4	+15.7	+10.7	+10.7	+7.1	+10.8	+12.3	+9.3
	Six-monthly % change a.r.	+14.9	+15.7	+15.6	+12.1	+13.0	+11.3	+10.7	+11.1	+8.2
	12-monthly % change	+10.4	+10.4	+11.3	+11.3	+12.3	+12.5	+12.9	+13.6	11.8
	% Change since Feb-83 a.r.	+11.0								
	% Change since Feb-84 a.r.	+16.6	+15.4	+16.1	+13.0	+13.0	+12.2	+12.2	+12.8	+11.3
Levels :	NIBM1	32,267	32,406	32,689	32,288	32,986	32,703	32,922	33,668	34,057
	M1	45,220	45,910	46,770	46,460	47,170	47,660	48,470	50,100	50,620
	M2 (Partially S/A)	125,354	126,661	128,517	128,659	129,949	130,696	131,955	133,767	133,731

Table 4C

OTHER WIDE AGGREGATES

		APR	MAY	JUNE	JULY	AUG	SEP	OCT	NOV	DEC
PSL1	Monthly change (£ millions)	+351	+907	+2,602	-1,165	+730	+1,472	+691	+2,891	-837
	Monthly % change	+0.3	+0.9	+2.5	-1.1	+0.7	+1.4	+0.6	+2.6	-0.6
	Three-monthly % change a.r.	+7.4	+11.9	+15.6	+9.2	+8.4	+3.9	+11.2	+20.1	+11.2
	Six-monthly % change a.r.	+7.1	+8.4	+11.6	+8.3	+10.2	+9.6	+10.2	+14.1	+7.5
	12-monthly % change	+7.2	+7.8	+9.4	+7.7	+7.8	+9.0	+8.7	+11.2	+9.5
	% Change since Feb-83 a.r.	+9.3								
	% Change since Feb-84 a.r.	+12.4	+11.9	+17.0	+10.5	+10.2	+11.2	+10.8	+13.4	+11.2
PSL2A	Monthly change (£ milions)	+1,656	+2,136	+2,951	+169	+1,640	+2,278	+1,879	+3,822	+17
	Monthly % change	+0.9	+1.1	+2.0	-	+0.8	+1.1	+0.9	+1.9	-
	Three-monthly % change a.r.	+13.1	+15.2	+17.2	+13.4	+12.1	+8.3	+12.2	+10.9	+11.7
	Six-monthly % change a.r.	+12.3	+13.4	+15.7	+13.2	+13.7	+12.6	+12.8	+14.5	+10.0
	12-monthly % change	+11.3	+11.9	+13.1	+12.2	+12.1	+12.6	+12.5	+13.9	+12.8
	% Change since Feb-83 a.r.	+12.4								
	% Change since Feb-84 a.r.	+15.8	+15.2	+18.1	+14.3	+13.7	+13.8	+13.5	+14.7	+13.2
M3	(Exc. Public Sector Deposits)									
	Monthly change (£ millions)	+653	-1,001	+2,068	+222	+263	+2,772	+418	+3,415	+312
	Monthly % change	+0.6	-0.8	+1.8	+0.2	+0.2	+2.3	+0.3	+2.8	+0.2
	Three-monthly % change a.r.	+11.0	+4.4	+5.9	+4.4	+9.0	+11.3	+12.0	+23.8	+14.2
	Six-monthly % change a.r.	+12.6	+9.6	+8.8	+7.7	+6.7	+8.6	+8.2	+16.2	+12.7
	12-monthly % change	+10.6	+9.2	+10.0	+9.5	+9.2	+11.3	+10.4	+12.9	+10.8
	% Change since Feb-83 a.r.	+11.8	-							
	% Change since Feb-84 a.r.	+12.2	+4.4	+8.8	+7.5	+6.7	+9.9	+9.2	+12.1	+11.1
Levels :										
	PSL1	104,974	105,851	108,470	107,313	108,000	109,438	110,133	113,058	112,823
	PSL2A	193,091	195,191	199,159	199,236	200,833	203,077	204,960	208,816	209,235
	M3 (ex. Pub. Sec. Deps)	118,813	117,787	119,908	120,152	120,390	123,141	123,563	127,007	127,785

TABLE 5(a)

The Components of £M3

seasonally adjusted

	Notes and Coins	Banking Deposits			Change in £M3
		Retail		Wholesale	
		nib	lb		
% change	A	B	C	D	E
1982-83[1]	7.1	13.9	6.3	16.2	11.2
1983-84	5.6	11.3	-1.8	15.2	7.9
over 12 months					
1984 January	5.5	11.1	3.4	16.7	9.9
February	4.3	10.1	2.0	16.8	9.2
March	4.0	9.7	0.0	19.8	9.5
April	5.6	11.3	-1.8	15.2	7.9
May	4.7	12.0	-3.0	17.5	8.1
June	5.3	12.0	-2.3	19.8	9.2
July	5.4	8.4	-1.7	16.5	7.6
August	5.5	11.6	-1.5	15.2	7.8
September	5.5	8.8	-0.7	18.8	8.9
October	5.5	8.4	0.2	15.9	8.2
November	5.4	11.4	1.1	21.6	10.9
December	4.8	10.9	2.9	15.3	9.2
over 6 month at annual rate					
1984 January	4.9	8.6	-6.4	20.9	7.6
February	4.3	8.8	-7.6	19.5	6.7
March	3.8	11.7	-7.1	24.1	9.1
April	6.5	13.2	-6.8	17.6	7.6
May	4.4	14.5	-6.7	23.9	9.2
June	4.9	12.2	2.1	21.5	11.2
July	5.9	8.3	3.1	12.4	7.6
August	6.7	14.4	4.8	11.2	8.9
September	7.1	6.0	6.1	13.8	8.8
October	4.5	3.7	7.6	14.5	8.7
November	6.5	8.4	9.6	19.4	12.7
December	4.6	9.6	3.7	9.5	7.2
£mn changes					
1982-83[1]	62	190	239	345	836
1983-84[1]	56	183	-39	445	645
monthly change 1984					
July	-7	-394	-84	-535	-1030
August	64	604	26	40	734
September	82	-349	196	1451	1380
October	63	158	217	-114	324
November	58	661	365	1740	2825
December	14	290	-155	-686	-537

[1] April on April

TABLE 5(b)

Components of Broader Liquidity

Seasonally adjusted

	Money[1]	Building Societies			Other[2]	PSL2	PSL2A	PSL2A and National Savings
		Retail[2]	Wholesale	Liquid Assets (inc -1)				
% Change	F	G	H	I	J	K	L	
1982-83[4]	10.3	11.1	-	9.2	9.3	10.8	13.2	13.1
1983-84[4]	7.9	19.0	-	-46.8	5.2	11.0	11.8	11.8
Over 12 months								
1984 January	10.0	16.5		-5.6	12.4	13.0	13.2	13.0
February	9.3	17.6		-30.6	7.7	12.0	12.2	12.0
March	9.5	18.5		-44.2	8.7	12.2	12.5	12.3
April	7.9	19.0		-46.8	5.2	11.0	11.4	11.3
May	8.2	19.2	N/A	-44.1	7.5	11.7	12.0	11.8
June	9.3	19.7		-36.6	11.4	13.0	13.2	12.9
July	7.6	19.5		-28.1	9.7	12.1	12.2	12.0
August	7.8	19.4		-22.1	8.7	12.2	12.2	12.0
September	8.9	20.1		-26.2	9.7	13.1	12.6	12.7
October	8.2	21.6		-21.4	11.9	13.5	12.5	12.5
November	11.0	22.7		-14.8	11.1	15.5	14.0	13.7
December	9.2	22.3		-7.1	10.8	14.5	12.8	12.7
Over 6 months at annual rate								
June	11.3	23.1		9.6	15.2	17.0	15.7	16.1
July	7.7	21.9		13.5	14.0	14.6	13.2	12.7
August	9.0	20.2		26.4	16.6	15.3	13.7	13.3
September	8.8	19.1		22.8	11.2	14.5	12.6	13.1
October	8.7	20.4		6.2	16.1	14.8	12.8	13.3
November	12.7	22.6		-16.8	16.9	16.9	14.6	14.8
December	7.2	21.6		-27.7	6.8	12.1	10.0	10.6
£mn changes								
monthly average								
1982-83	781	447	-	36	-31	1295	1677	1849
1983-84	639	852	59	-100	38	1488	1711	1911
monthly change								
1984								
July	-1044	1013	131	162	-124	138	69	316
August	675	878	-3	121	31	1702	1640	1902
September	1391	1029	115	-212	91	2404	2278	3239
October	307	1473	104	-338	436	1982	1879	2045
November	2857	1568	-149	-300	109	4085	3822	4039
December	-541	769	75	-50	-80	167	17	94

1. £M3 less deposits of over 2 years maturity

2. Net inflow excluding Term shares, SAYE, CD's and Time deposits

3. Treasury bills, bank bills, LA temporary debt, CTD's and some national savings accounts.

[4] April on April

TABLE 6: GROWTH RATES OF COMPONENTS OF WEEKLY AVERAGED MO

		Notes and Coins	Bankers Balances	Total MO
(a)	**Financial Years (12 month change to banking April) (%)**			
1980-81		5.9	27.4	6.8
1981-82		2.1	-0.2	2.0
1982-83		6.6	-15.6	6.1
1983-84		5.4	-23.4	4.9
(b)	**Changes in 12 months to (%)**			
1984	January	5.7	24.7	6.0
	February	5.9	39.3	6.3
	March	5.6	15.9	5.7
	April	5.4	-23.4	4.9
	May	5.2	5.3	5.2
	June	5.3	20.1	5.4
	July	5.4	57.1	5.8
	August	5.4	1.2	5.4
	September	5.4	-9.7	5.2
	October	5.4	7.2	5.4
	November	5.6	5.3	5.6
	December	5.1	129.7	6.6
(c)	**Changes (at an annual rate) in 6 months to (%)**			
1984	January	4.7		6.3
	February	5.7		6.3
	March	4.4		5.1
	April	4.3		4.1
	May	4.6		4.0
	June	4.6		4.9
	July	6.0		5.0
	August	5.1		4.4
	September	6.4		5.3
	October	6.5		6.8
	November	6.6		7.2
	December	5.6		8.3
(d)	**Three month moving average change (£m) (% change at an annual rate in brackets)**			
1984	July	71 (6.6)	3	73 (6.8)
	August	41 (3.8)	9	50 (4.6)
	September	62 (5.7)	-13	49 (4.4)
	October	69 (6.4)	4	74 (6.7)
	November	102 (9.5)	5	107 (9.9)
	December	60 (5.5)	72	133 (12.3)
(e)	**Changes in the month to (£m) (% changes in brackets)**			
1984	October	66 (0.5)	39	105 (0.8)
	November	81 (0.6)	2	83 (0.6)
	December	34 (0.3)	176	210 (1.5)

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TABLE 7: RETAIL DEPOSITS

(Seasonally adjusted)

	BANKS				
	interest bearing deposits	non-interest bearing deposits	Total	Building Societies[1]	National Savings[2]
% Change					
1982-83[3]	6.3	13.9	8.7	17.3	15.8
1983-84[3]	-1.8	11.3	3.2	18.7	14.3
Over 12 months					
1984 January	3.4	11.1	6.4	13.8	13.4
February	2.0	10.1	5.1	17.5	13.3
March	0.0	9.7	3.6	15.7	14.1
April	-1.8	11.3	3.2	18.7	14.3
May	-3.0	12.0	2.6	21.7	14.2
June	-2.3	12.0	3.1	22.2	13.9
July	-1.7	8.4	2.1	13.3	13.7
August	-1.5	11.6	3.4	15.2	13.7
September	-0.7	8.8	3.0	17.5	15.7
October	0.2	8.4	3.4	17.6	14.9
November	0.9	11.4	4.9	17.5	14.6
December	3.7	10.9	6.5	16.6	14.0
Over 6 months at annual rate					
June	2.1	12.2	5.9	18.8	11.7
July	3.1	8.3	5.1	17.2	11.9
August	4.8	14.4	8.5	15.3	12.0
September	6.1	6.0	6.1	13.9	17.8
October	7.6	3.7	6.0	14.5	17.4
November	9.1	8.4	8.8	15.6	17.7
December	5.4	9.6	7.0	14.5	16.3
£mn changes					
monthly average					
1982-83[3]	239	190	429	864	257
1983-84[3]	-39	183	144	1050	271
monthly change					
1984 June	681	163	844	973	232
July	-84	-394	-478	933	244
August	26	604	630	762	238
September	196	-349	-153	919	971
October	217	158	375	1353	221
November	365	661	1026	1333	292
December	159	290	449	609	87

Notes

1. Total retail funds, including terms shares and SAYE
2. Total inflows
3. April on April

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TABLE 8 **NOMINAL AND REAL INTEREST RATES**

		NOMINAL RATES					REAL RATES			
		Three month interbank	Three month Eurodollar	Base Rate	Long Rate (20 year Gilts)	Expected inflation over 12 months*	Real 3-month interbank rate	Yield on Index-linked Gilts** 1988	1996	2011
1982	(1)	14.3	15.1	14.1	14.7	10.3	4.0		3.0	
	(2)	13.4	15.1	12.8	13.7	9.2	4.1	3.5	3.4	3.0
	(3)	11.5	12.6	11.4	12.2	8.0	3.4	3.6	3.3	3.0
	(4)	9.9	9.9	9.7	10.8	6.3	4.8	2.7	2.6	2.7
1983	(1)	11.1	9.2	10.8	11.5	6.3	4.8	2.7	2.6	2.5
	(2)	10.2	9.4	10.0	10.5	6.2	4.0	3.7	3.2	2.7
	(3)	9.8	10.1	9.5	10.9	6.3	3.5	4.2	3.6	3.1
	(4)	9.4	9.9	9.0	10.4	6.0	3.4	3.7	3.5	3.0
1984	(1)	9.2	10.1	8.9	10.3	5.8	3.4	4.1	3.6	3.2
	(2)	9.3	11.4	8.9	10.9	5.6	3.4	4.8	3.8	3.3
	(3)	11.1	11.7	11.0	11.2	5.5	3.7	5.6	4.4	3.7
	(4)	10.1	9.8	10.0	10.6	5.6	4.5	4.7	3.8	3.2
1984	March	9.0	10.4	8.7	10.3	5.7	3.3	4.4	3.8	3.3
	April	8.9	10.9	8.6	10.4	5.6	3.3	4.4	3.6	3.2
	May	9.6	11.6	9.0	11.0	5.4	4.2	4.8	3.8	3.3
	June	9.5	11.8	9.2	11.2	5.7	3.8	5.1	4.0	3.5
	July	11.6	11.7	11.5	11.7	5.6	6.0	5.7	4.4	3.7
	August	10.9	11.8	10.9	11.0	5.5	5.4	5.5	4.4	3.7
	September	10.8	11.6	10.5	10.8	5.5	5.3	5.5	4.4	3.6
	October	10.6	10.7	10.5	10.8	5.6	5.0	4.7	3.9	3.2
	November	9.9	9.6	9.9	10.4	5.6	4.3	4.7	3.7	3.2
	December	9.8	9.0	9.5	10.5	5.7	4.1	4.8	3.7	3.1
1985	January 11***	10.8***	8.5***	10.5***	10.8	5.8	5.0***	5.1	3.8	3.2

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

** Average of yields calculated for each Friday of month or quarter. Assumes inflation averages 5 per cent per annum to redemption.

*** Rates starred are 11 January noon, other rates are closing rates on 10 Janary.

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TABLE 9: PRICES AND EARNINGS (% change on same period a year before)

	Retail Prices	Producer Price Index (All manufactured products)		Underlying Average Earnings	Unit Wage Costs*	Commodity Prices***
		Output Prices (home sales)	Input Prices			
1982 (1)	11.1	9.5	13.2	10.8	3.8	-4.4
(2)	9.3	7.7	7.6	10.1	5.2	-9.4
(3)	8.0	7.4	4.8	8.9	5.8	-12.4
(4)	6.2	6.5	4.0	8.4	6.1	-8.9
1983 (1)	4.9	5.3	5.6	7.9	3.4	-1.3
(2)	3.8	5.6	6.7	7.5	3.3	16.3
(3)	4.6	5.4	8.1	7.7	1.7	20.1
(4)	5.0	5.6	7.5	7.8	1.3	19.8
1984 (1)	5.1	6.0	7.2	7.8	3.3	15.5
(2)	5.1	6.3	8.4	7.8	3.2	-3.8
(3)	4.7	6.1	7.2	7.5	4.8	-13.8
(4)	(4.8)					-10.8
1984 March	5.2	6.5	7.0	7.8	4.6	11.8
April	5.2	6.6	8.7	7.8	3.6	3.8
May	5.1	6.3	8.5	7.8	3.1	-5.2
June	5.1	6.2	8.1	7.8	2.8	-10.0
July	4.5	6.3	8.4	7.5	4.3	-13.9
August	5.0	6.2	6.6	7.5	4.7	-13.2
September	4.7	6.0	6.6	7.5	5.3	-14.2
October	5.0	6.1	9.0	7.5	5.3	-12.3
November	4.9	5.9	9.3	7.3**		-9.7
December	(4.6)	5.8	8.8	7.3**		-10.4

* In manufacturing - percentage change of the latest 3 months on the same 3 months a year earlier.

** Department of Employment estimate.

*** Economist industrial (non-oil) commodity price index in SDRs.

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SECRET (AND PERSONAL UNTIL 2.30PM, THURSDAY 17 JANUARY 1985)

Table 10 Sterling lending to the private sector

£ million
Seasonally adjusted

	Actual			Forecast		
	OCT	NOV	DEC	JAN	FEB	MARCH
Adjusted lending	1748	1623	1331	1250	1250	1250
Bills held by NBPS(-)	-128	-59	+37	+50	+150	+50
PSBR offsett	+535	-660	+541	-	+60	-350
Round Tripping	-	-	-175	+75	-	-
VAT on imports	-	-	-	+ 5	+150	-
BT	-	+800	-250	-500	-	-
Capital Allowances	-	-	-	+50	+50	+50
Actual/forecast recorded lending	2155	1704	1484	1450	1660	1000

Table 11 Gilts

£ million

	Actual			Forecast		
	OCT	NOV	DEC	JAN	FEB	MARCH
Calls*	257	-	335	335 *		
Other gross sales	1146	1459		665	1000	1000
'GROSS' SALES	1403	1459	322	1000	1000	1000
Buying-in next maturities‡	-4	-43		-380	-50	
Redemptions	-651	-2	-1	-		-467
TOTAL NET SALES	748	1414	128	620	950	535
Purchases (-) by:						
Overseas	163	-111	-79	-100	-100	
Banks	-105	-163	112	) 100	-75	-25
LDMA	46	-105	226	)		
Public Corporations	25	-	-	-		
NET SALES TO NBPS (+)	877	1018	387	620	775	510

* of which calls on : - 9¾% Exchequer 1988A

‡ of which, buying in of: - 15% Treasury 1985 to be redeemed on 22 February

SECRET (AND PERSONAL UNTIL 2.30 PM, THURSDAY 17 JANUARY 1985)

Table 12 Money Market Influences

£ million
not seasonally adjusted

	Actual	Forecast		
	DEC	JAN	FEB	MAR
A. Money market influences				
CGBR (increase +)	583	-1110	-870	660
Reserves etc (+)	451	10	-5	10
Notes and coin (-)	-577	580	-25	-105
National Savings (-)	-81	-270	-230	-180
CTDs (-)	-90	150	400	100
Gilts (-)	-128	-620	-950	-535
Other Exchequer items etc	-218	-	-	-
TOTAL MONEY MARKET INFLUENCES (Market surplus + / shortage -)	-60	-1260	-1680	-50
B. Money market operations				
Commercial bills (purchase +)				
- Issue Department	-889			
- Banking Department	174			
LA bills (purchase +)				
- Issue Department	-87			
- Banking Department	-83			
Treasury bills (purchase +)	-199			
Market advances	48			
Other	1112			
TOTAL MONEY MARKET OPERATIONS	76	1260	1680	50
Change in bankers' balances	+16	-	-	-
TOTAL ASSISTANCE OUTSTANDING*	12064	13324	15004	15054

* excluding Treasury bills

E.R.

Robert Culpin

LINE TO TAKE [if asked!]

Interest Rates and Exchange Rate

i) Market interest rates have moved up because of concern about domestic monetary conditions and Government borrowing and expenditure. The clearers have responded by raising their base rates by 1%.

(So far only Nat West has moved but the rest are expected to.)

[The Bank of England's dealing rates have also been raised by 1% in line with market rates.]

ii) Although exchange rate movements largely reflect the strength of the dollar and uncertainty about oil prices, there may be an element of concern about financial conditions in the UK. Sterling M3 is right at the top of its range though it may be subject to distortions in the wake of the BT sale.

iii) The Government has no exchange rate target, buthas always said it will take the behaviour of the exchange rate into account in assessing monetary conditions.

iv) With sterling M3 at the top of its range and possibly subject to distortions, the Government does not feel it would be right to ignore the effects of the exchange rate and resist upward market pressures.

v) The rise in interest rates demonstrates that the Government will take no risks in maintaining sound monetary conditions and in keeping inflation under control.

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FROM: S N WOOD
DATE: 11 JANUARY 1985

MR CULPIN

cc: Chancellor
Chief Secretary
Financial Secretary
Minister of State
Economic Secretary
Sir P Middleton
Mr Littler
Mr Cassell
Mr Lankester
Mr Battishill

Mr Lavelle

Mr Folger
Mr Kelly
Mr Peretz
Mr Hannah
Mr Page

Mr Turnbull - No.10

Mr George) B/E
Mr Kent)

RISE IN BASE RATES

Natwest have announced an increase in their base rate by 1 per cent to 10½ per cent, following further rises in money market rates. The other main clearers are expected to follow suit and the Bank will move up their dealing rates for bills at mid-day.

2. The rise in rates reflects sterling weakness and market concern over domestic monetary conditions, with £M3 at the top of its target range and concern about the level of public borrowing and expenditure. In these circumstances, to attempt to resist the market pressures for higher rates would carry risks for monetary growth or inflation.

3. The Chancellor has approved the attached line to take, which we are also passing to No 10 and the Bank.

S N Wood

S N WOOD

DOMESTIC INTEREST RATES

Line to take

Rise in interest rates reflects market pressures which clearers have been obliged to respond to. Money market rates have risen sharply, in part reflecting market concern about monetary conditions - with £M3 at the top of the target range - and about the level of Government borrowing and expenditure.

2. Exchange rate may well have been affected by these concerns, as well as by oil factors and the rise in the $. Always said take account of exchange rate movements to the extent they may be reflecting domestic monetary conditions, and when there is difficulty in interpreting the monetary aggregates.

3. In view of this, not right to resist upward pressure in market interest rates.

4. As we have always made clear, government not prepared to take any risks with monetary policy or inflation.

File

I am not putting in Bank's paper

AT 10/1

10 DOWNING STREET

JR

Bank's paper on gilts

Your doubts on the Bank's paper may be valid, but I wonder whether it is right to use the Prime Minister's name to raise them. These are not issues on which she has, or can be expected to have, clearly worked out views.

Can you feed in your comments directly?

AT

10/1

AT

I am happy to raise them myself. My paper would be a useful antidote if you are putting in the Bank's paper

JR

9 January 1985

MR TURNBULL

The Bank's paper on gilt dealing reveals some problems.

1. The Bank intends to monitor solvency. Markets will be fast-moving and gilt traders will take positions many times larger than their capital. Will this monitoring be more successful than banking supervision (eg JMB)? Does it imply Government underpinning if grave errors are made?

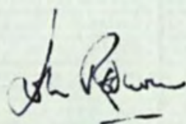
2. How will market-makers feel having to report their daily positions only to the Bank, which in another capacity is the principal seller of stock to the market? The Bank not only retains but strengthens its position as privileged insider.

3. Liquidity in a market "will be supported by the primary obligation that market-makers will be required to accept, ie 'to make, on demand and in any trading conditions, continuous and effective two-way prices'".

   Market liquidity comes from the aggregate capital ventured in the market, coupled with the opportunity for profit which will determine how much a business is prepared to put at risk over and above its capital

base. Liquidity itself can never come from an obligation. How is it to be enforced? How wide a spread on prices are people allowed? If it was effective, wouldn't it conflict with the need for prudence and profit?

Maybe we should raise doubts about these issues now. In practice, market liquidity will increase as more entrants bring more capital to bear - and the provisions for more price information and time-stamping of contracts are excellent. The only guarantee against bankruptcy of a market-maker is good management. Monitoring overnight positions may be too late or too difficult to interpret.



JOHN REDWOOD

File

CONFIDENTIAL

JOHNSON MATTHEY

1. Why did the Bank of England bail out Johnson Matthey Bankers?

I understand from the Governor of the Bank of England that Johnson Matthey Bankers (JMB) ran into serious difficulties with its commercial lending book. Its much larger bullion business was not affected. The Bank of England decided to organise the rescue of JMB because the failure of this bank would have caused severe problems for the other members of the London gold market. A number of other banks assisted with the rescue package.

2. Did the Government approve the Bank's original decision/commitment to indemnities?

The Bank neither sought nor required the Government's approval for these operations.

3. Why wasn't the Government's approval required?

The Bank's contribution to the rescue is being provided from within the resources of ~~the~~ its Banking Department. The Bank is responsible for those resources. This has been the position under successive governments.

4. [IF PRESSED. At what point do rescue operations require the Treasury's approval?

When the Bank is no longer able to bear the operations on its Banking Department's balance sheet. This point has not been reached.]

5. Does the Government agree with the Bank's decision?

It is not a question of approving or disapproving the Bank's actions on individual matters which lie within the Bank's traditional responsibilities and sphere of competence as they have been recognised by successive Governments. (of Healey/Skinner exchange on Slater Walker in 1976 at Annex A).

6. Is £75m a small contribution?

[On information from the Governor that the Bank would be providing no more than 10 per cent of a maximum indemnity package of £100m, the Chancellor told Mr Skinner in a written answer (Annex A) that the Bank would be providing a "small contribution" to the indemnity. Unfortunately, the Bank have been forced by the clearers to increase their commitment to a half share of up to a total of £150m - please see background note for more detail.]

The Bank has so far paid only £1 from its Banking Department's own resources. It is too early to say whether and to what extent the indemnity will be called. [**IF PRESSED** - The Chancellor's reference to a "small" contribution in his written reply to the Hon Member for Bolsover accurately reflected the position reported to him by the Governor at that time.]

7. Rescue makes mockery of Government's belief in market forces.

Not at all. The original shareholders in JMB lost their entire investment and more. The private sector is making a very substantial contribution towards the rescue, in particular by providing indemnities against any further losses in JMB's commercial loan book.

8. Did the Bank warn the Treasury?

The Governor notified the Chancellor of the action he intended to take before the rescue was announced.

9. Waste of tax payers' money

The Bank's indemnity is a contingent liability on the Banking Departments own resources. No voted money is involved.

BACKGROUND

Johnson Matthey Bankers (JMB)

The Bank of England became concerned earlier this year at the extent of JMB's exposure to two groups of Liberian shipping companies. In July the Bank asked for JMB's auditors to scrutinise the loan book in more detail. During the last week of September this and other investigations suggested that JMB's losses on these large loans and other bad lending exceeded capital and were beyond the capacity of the parent company to cover.

2. Attempts to arrange takeover by a private sector bank failed over the weekend of 29/30 September mainly because the extent of JMB's bad assets was not yet certain and seemed to be worsening by the hour. The Bank therefore:

(a) arranged for the parent company to inject an additional £50m into JMB;

(b) organised liquidity support for the parent and initiated discussions among the parent's shareholders;

(c) acquired JMB itself for £1;

(d) began protracted negotiations with private sector banks to arrange indemnities to cover any losses which may emerge in JMB's loan book beyond the £168m covered by JMB's capital and reserves and the parent company injection at (a).

3. The Bank notified the Treasury some days before the rescue was announced. However, up to a few hours before the decision was taken this notification was on the basis that the Bank hoped

to find a new parent for JMB in the private sector. The full gravity of the situation only emerged over the evening/night of 30 September/1 October. The Governor informed the Chancellor of his decision at 7.30 am on 1 October, and the announcement was made at the opening of the gold market.

4. The Bank initially committed itself to an indemnity of 10 per cent of up to £100m, with the balance provided by a consortium of private sector banks. Subsequently, however, the clearers hardened their position. Under the plan which the Bank confirmed on 7 November, the private sector banks will provide up to £75m of indemnities to be matched £ for £ by the Bank. The Governor estimates that under a "worst case" scenario, not more than about £40m of this would be at risk, with the prospect of recouping some of the outlay as and when the Bank disposes of Johnson Matthey Bankers.

5. The Prime Minister should be aware of the Chancellor's letter and written answers of 22 and 23 October respectively to Mr Dennis Skinner (Annex B) and his correspondence with Dr Owen (Annex C). The Chancellor referred Dr Owen's second letter to the Governor, whose reply is at Annex D. At Annex E is a letter from Bryan Gould calling for a Parliamentary statement. The Chancellor does not wish to offer a statement and will be replying accordingly.

6. Initial press reports praised the speed of the Bank's intervention but later comment has questioned the rescue on grounds of moral hazard, the need to intervene at all and the extent to which the Bank is the main actor in the story, rather than, for example, the other members of the gold market.

7. The Chancellor has now received a report from the Governor on JMB; as soon as he has fully considered it, he will be discussing the lessons of the JMB affair with him.

Reference 58/35/03

Extract from Hansard

WA col 142-143

13th October 1976

NATIONAL FINANCE

Slater Walker Securities

Mr. Skinner asked the Chancellor of the Exchequer whether he was fully informed of the £70 million and £40 million loans to Slater Walker Securities from the Bank of England in November 1975; and whether he gave approval to the loans.

Mr. Healey: I was aware of the general approach adopted by the Bank of England to the problems of the Slater Walker Group and accepted the Governor's assessment that the Bank's actions offered the best prospect of securing the interests of outside depositers in Slater Walker Limited, an authorised bank, with the least potential call on public funds. The Bank made available a standby loan facility of up to £70 million and a guarantee of up to £40 million in respect of certain potential losses arising from Slater Walker Ltd's loan portfolio. The two are not cumulative, and to the extent that the guarantee is called upon the loans under the facility would be repaid. My specific approval of the standby loan facility and guarantee was neither sought nor required.

CODS 18-75

Sir P Middleton
Mr Cassell
Mr Hall
Mr Ilett
Mr Lankester

ANNEX

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

Dennis Skinner Esq MP
House of Commons
London SW1A 0AA

22 October 1984

Dear Dennis

The Prime Minister has asked me to reply on her behalf to your letter of 11 October about Johnson Matthey Bankers (JMB).

The Bank of England took the decision to rescue JMB and arranged a financial package with a number of other banks and JMB's parent company, Johnson Matthey plc. The Bank acquired JMB for £1; to date this represents the total expenditure of the Bank's resources. The Bank is arranging an indemnity against the possibility that, on further investigation of JMB's commercial loans, JMB's capital and reserves (including an additional £50m injected by Johnson Matthey plc) do not prove sufficient to cover the losses on those loans. The Bank is making a small contribution to the indemnity; it is not providing a £100m as a safety net as you suggest.

The Bank did not seek nor did it require the Government's authority for carrying out this operation.

You suggest that certain shareholders ought to have been present at discussions at the Bank of England on this matter. It was neither necessary nor practical to invite all shareholders in Johnson Matthey plc. In any event, any proposals affecting the share capital of the parent company will require the approval of shareholders at an Extraordinary General Meeting.

As the Bank of England has made clear, JMB's problems arose entirely from its commercial lending activities, and were on a sufficient scale to bring down the whole business, including the bullion business which constitutes much the largest part of JMB's activities. The Bank of England took the view that the failure of JMB would have caused severe problems for other members of the London Gold Market, and would have jeopardised London's hard-won position as a major bullion trading centre. At the same time, the Bank believed that JMB's bullion business was viable and would remain so. It was on this basis that the Bank mounted the rescue operation.

I do not agree that the rescue is inconsistent with the Government's economic philosophy and policies towards other sectors. Most of the support for JMB is coming from the private sector and no taxpayers' money has been involved. The shareholders of Johnson Matthey plc have lost their entire investment in JMB and more.

The Government have no plans for a Parliamentary debate in Government time on this matter.

Yours
Nigel

NIGEL LAWSON

Hansard
23/10/84
Vol 65 No 207
WA 530

X

Johnson Matthey

Mr. Skinner asked the Chancellor of the Exchequer (1) whether he will make a statement on the recent Johnson Matthey gold bullion dealers collapse; and what arrangements the Bank of England has made to rescue it; (2) why he authorised the rescue of Johnson Matthey.

Mr. Lawson: I understand from the governor of the Bank of England that it became evident over the period immediately preceding the bank's acquisition of Johnson Matthey Bankers on 1 October 1984 that JMB was experiencing very serious problems with the commercial lending side of its business. As the failure of JMB would have caused severe problems for the other members of the London gold market, the bank organised the rescue package which was announced on 1 October.

The main features of this package were that the parent company, Johnson Matthey plc, injected an additional £50 million capital into JMB; the Bank of England acquired JMB for the nominal sum of £1; a number of City institutions are providing indemnities for the event that JMB's losses may exceed the capital and reserves now available to JMB, with the Bank of England itself providing a small contribution to that indemnity; and a consortium of banks agreed to supply a loan facility of £250 million to support Johnson Matthey plc should that prove necessary.

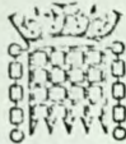
I understand that discussions involving some shareholders in Johnson Matthey plc as to the means by which further capital may be injected into that company are not yet concluded. Any proposals affecting the share capital of that company would have to be approved by shareholders before they could be implemented.

The Bank of England did not require my authority in order to carry out these operations.

Mr. Skinner asked the Chancellor of the Exchequer if he is satisfied that all investors of Johnson Matthey were invited to the crisis meeting on 30 September at which the governor of the Bank of England was present.

Mr. Lawson: On 30 September the sole shareholder in Johnson Matthey Bankers was the then parent company, Johnson Matthey plc. Johnson Matthey plc was represented at the meeting which I believe the hon. Member has in mind. It was neither necessary nor practical for all shareholders in Johnson Matthey plc to be invited to that meeting.

THE RT HON DR DAVID OWEN MP



HOUSE OF COMMONS
LONDON SWIA OAA

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

ANNEX

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

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?

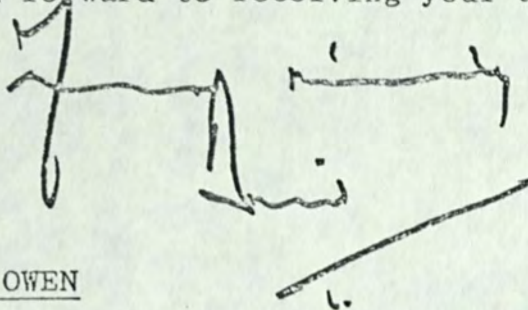
The Bank of England press notice for 12 October 1984 outlined the Bank's intentions towards JMB Ltd and its 14 subsidiaries very clearly: ie "... that the various businesses of Johnson Matthey Bankers Ltd should be continued and their strength developed to the point at which there can be a sale on a 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.

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

Sir P Middleton
Sir T Burns
Mr Littler (OR)
Mr Cassell
Mr Sedgwick Mr Ilett
Mr Lankester Mr Monck
Mr Fitchew Mr Unwin
Mr Kelly Mr Battishill
Mr Hannah Mr Culpin
Mr Lavelle Mr Hall
Mr Ridley

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

The Rt Hon Dr David Owen MP
House of Commons
London SW1A 0AA

31 October 1984

Dear David

You wrote to me on 19 October about sterling and the EMS; and on 23 October about Johnson Mathey Bankers. Perhaps I could reply to both letters at the same time.

Sterling and the EMS

You suggest that sterling has in recent months moved into a closer relationship with the major European currencies; that market confidence in sterling would be further enhanced by our joining the mechanism; and that membership would provide a sensible alternative to raising interest rates.

On your first proposition, I wonder if you are not attributing your own views to the market. The predominant factor in the exchange market over the period has surely been the strong dollar: only in this sense would it seem reasonable to speak of sterling having a closer relationship with other non-dollar currencies. In intermittent periods of dollar weakness the ERM has in fact come under strain.

More recently, the oil market has been another significant factor in the exchanges: and in times of oil market uncertainty, the performance of sterling and the deutschemark has also tended to diverge. It may be that divergence which you recognise in the third paragraph of your letter: but since the rate you quoted there, rather unexpectedly, was the dollar/deutschemark rate of the day, it is difficult to be sure.

Membership of the mechanism would not, in any event, abolish these influences or the differences in the effects of such uncertainties on European currencies.

Turning to your other comments, you began by attributing - to me this time - a statement in the Mansion House speech about the interpretation of domestic monetary conditions which I did not make: and on that basis went on to question the logic of my position.

When I spoke in this context of the markets' misplaced preoccupation in July with the sterling/dollar rate I did

not say that the markets should instead take notice of the sterling trade weighted index. On the contrary, the point I was making was that the market had shown a misconceived preoccupation with the exchange rate as such. This took the form in July, when there was a surge in the dollar, of a misplaced preoccupation with the sterling/dollar exchange rate. I went on to explain that we take the exchange rate into account when its behaviour suggests that the domestic monetary indicators are giving a false reading, which I did not believe they were. And I added that the markets seem now to be taking a more balanced view of financial developments and the central role of monetary aggregates in judging monetary conditions and determining interest rates.

At the end of your letter, this time after attributing sentiments to the Bank of England which they do not recognise, you spoke of joining the ERM as an alternative to raising interest rates.

Leaving aside the fact that during the recent autumnal turbulence interest rates have not, in fact, risen, it is misleading to suppose that membership of the ERM as such would have removed any such requirement. In fact the position is rather the reverse. You quoted an average sterling/deutschemark rate in recent months of DM3.80. The fall in that rate to DM3.6696 on 19 October would have taken sterling well outside the 2¼% band. Resisting this might well have required us to consider raising interest rates.

More generally, the Government have never regarded the ERM as some kind of easier option. What we have said, and what I said in the Mansion House speech, is that provided monetary conditions are kept under firm control, excessive movements whether in the money or exchange markets in response to outside influences will tend to correct themselves relatively quickly.

Johnson Mathey Bankers

Unlike the EMS, the rescue of Johnson Mathey Bankers (JMB) is primarily a matter for the Bank of England. The Bank has substantial, and traditional, freedom to take its own decisions about the use of its own resources. As I have already made clear to Parliament, the Governor neither required nor sought my approval for the operations he undertook, including the Bank's acquisition of JMB and the Bank's commitment on a contingent basis to the indemnity being arranged.

Turning to the specific questions you ask, you will by now, of course, have seen the speech given by the Deputy Governor at the Manchester Chamber of Commerce on the day on which you wrote (23 October).

On your first point, the Bank's view is that you are wrong to attribute JMB's difficulties to insufficient business in the bullion market. JMB's difficulties arose entirely with its commercial lending business - smaller than, and separate from, its main activity as a bullion trading bank. Whether and how to realise assets and run down the commercial lending side of the business is a matter which those now in charge of the operation are considering: the quickest solution may not necessarily be the best. But the Bank's judgment is that the prospects for the future viability of JMB's bullion activities is a good deal better than you suggest; and therefore that the dangers to the Bank from its exposure to JMB are much less than you imply.

The Bank saw the main purpose of the rescue operation as being to prevent damage that might otherwise have occurred to members of the London Gold Market. The rescue package had to be in place before the markets opened on 1 October. The reason why the Bank acquired JMB was, essentially, that no other solution was possible in the time available; but as you know, the private sector is making a very substantial contribution through the indemnity which the Bank is in the process of negotiating.

On your final question, I am advised that Johnson Mathey PLC did not give any form of guarantee to its former subsidiary and was not, in strictly legal terms, under any obligation to make good JMB's liabilities.

For my part, I have little doubt that there will be important lessons to be drawn from the JMB failure, and the Bank is reviewing the events surrounding the failure with this very much in mind.

Yours
Nigel

NIGEL LAWSON

THE RT HON DR DAVID OWEN MP

HOUSE OF COMMONS
LONDON SWIA OAA

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ACTION Mr Lavelle
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Mr Sedgwick, Mr Lankester
Mr Fitchew, Mr Kelly
Mr Hannah, Mr Illett
Mr Monck, Mr Unwin
Mr Battishill, Mr Culpin
Mr Hall, Mr Ridley.

2 November 1984

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

Dear Nigel.

Your letter of 31 October reveals that you have clearly decided to distance yourself, and by implication, the Government, from the decisions taken by the Bank of England in the rescue of Johnson Matthey Bankers (JMB) Ltd from financial collapse. In sum you have supplied six evasive and disingenous answers, expressing the Bank's views throughout - until the final paragraph - in response to the questions raised in my letter of 23 October.

1 You state "(quote) the Bank's view is that you are wrong to attribute JMB's difficulties to insufficient business in the bullion market. JMB's difficulties arose entirely with its commercial lending business ...." This is a misleading statement. JMB's principal earnings were made on commercial loans which often compensated for losses made on its bullion business. JMB's problems arose when a small number of the commercial loans turned sour; however, its recent difficulties in the depressed commodities and precious metals markets had been known to other companies, operating in the same business, for some time prior to the collapse.

2 You state "(quote) the Bank's judgement is that the prospects for the future viability of JMB's bullion activities is a good deal better than you suggest". All the available evidence points to the contrary, however. The bullion business is currently depressed and for other participants very unprofitable. But if the Bank is so keen to play its adopted role of company doctor - attempting to restore JMB Ltd to health - why does it not answer the question in my letter, i.e. is it the Bank's intention to stand behind all of the JMB Ltd subsidiaries in future, and is it prepared to guarantee any trading and credit losses should they ever be incurred by these subsidiaries? The Bank's failure to answer affirmatively to this question will confirm suspicions that it knows privately that the prospects of future profitability for nearly all of these subsidiaries are slim indeed.

3 You state that "(quote) the Bank saw the main purpose of the rescue operation as being to prevent damage that might otherwise have occurred to members of the London Gold Market". This ignores the fact that a number of the other bullion dealers, and clearing banks, involved in the rescue did not believe that the London Gold Market was ever in danger and, at the time of the rescue,

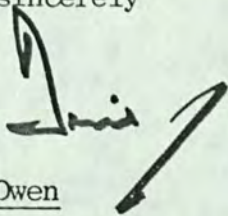
expressed this view clearly to the Bank. It was entirely the Bank's own decision, prompted by its own analysis of the market, to stage a rescue operation of JMB Ltd.

4 You make, for once, a personal observation that "(quote) the private sector is making a very substantial contribution through the indemnity which the Bank is in the process of negotiating". This conceals the considerable difficulties which the Bank is currently experiencing in securing private sector agreement for an indemnity much wider than was agreed originally at the time of the rescue. In the initial deal, the bullion dealers and the clearing banks agreed only to underpin any further shortfall in the JMB Ltd commercial loanbook. They are now objecting strongly to the Bank's subsequent attempts to broaden this indemnity and oblige them to guarantee a set of continuing businesses with a high degree of exposure to trading losses in future. The Bank's refusal to answer my question - as to whether it believes it can ever sell the commercial loanbook of JMB Ltd - serves only to heighten suspicion about the viability of the company.

5 You state "(quote) I am advised that Johnson Matthey PLC did not give any form of guarantee to its former subsidiary ....." But it is my understanding that Johnson Matthey PLC was asked by the Bank, at the time and as a condition of the rescue deal, to give an unlimited guarantee of its subsidiary. This the parent company agreed to do. However, it is also clear that the £50m injection by Johnson Matthey PLC into JMB Ltd was the price demanded by the Bank to effectively buy off the liability of this guarantee, for the benefit of the parent company's shareholders.

6 In the only part of the letter, the final paragraph, where a personal view is expressed in full, you evidently have "(quote) little doubt that there will be important lessons to be drawn from the JMB failure ...." The key lessons all stem from the Bank of England's failure to regulate the bullion and commodities market. The Bank claims that it knew for more than a year that JMB Ltd was getting into difficulties but, if so, why did it not examine the JMB balance sheet long before the actual collapse? Instead the Bank is currently attempting to conceal its mistakes and convince an increasingly sceptical City audience that public money will not be used and lost in a futile effort to turn round a failed company and its subsidiaries.

Yours sincerely



David Owen

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

SIR P. MIDDLETO
MR CASSELL
MR MONCK
MR LANKESTER
MR HALL
~~MR ILETT~~
~~MR CULPIN~~
PS/GOVERNOR

6 November 1984

Mr Capstick

The Rt. Hon. Dr David Owen MP
House of Commons
LONDON
SW1

Dear David

You ask a number of further detailed questions about Johnson Matthey Bankers in your letter of 2 November.

As I explained in my letter of 31 October, this is primarily a matter for the Bank of England. I have therefore spoken to the Governor and sent him a copy of your letter, and he will be letting you have a reply.

Yours ever
Nigel

NIGEL LAWSON

THE RT HON DR DAVID OWEN MP

HOUSE OF COMMONS
LONDON SWIA OAA

CH/EXCHEQUER
REC. - 8 NOV 1984
ACTION Mr Hall
COPIES TO CST, EST, Sir P. Middleton, Sir T. Burns, Mr Littler, Mr Cassell, Mr Sedgwick, Mr Lankester, Mr Fitchew, Mr Kelly, Mr Hannah, Mr Ilett, Mr Monck, Mr Unwin, Mr Battishill, Mr Culpin, Mr Lord, Mr Ridley

8 November 1984

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

Dear Nigel,

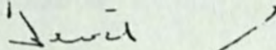
Your reply of 6 November to my further questions about Johnson Matthey Bankers (JMB) is wholly unacceptable since you seem intent on transferring responsibility for this matter to the Governor of the Bank of England.

The fact is however that you are responsible because taxpayers' money is being exposed, through the Bank's continuing involvement with JMB, with no public accountability or explanation. The Bank, I now read from the newspapers, has decided to significantly increase its commitments, as I predicted it would have to in my first letter to you, from 10 million pounds in the original package to 75 million pounds in the new package of indemnities - agreed with the clearers, accepting houses and bullion dealers - to cover the mounting losses at JMB. I was told to expect a letter from the Governor this afternoon but I am now told it will come tomorrow. In the meantime, the only public accountability for the Bank's actions seems to be the press.

The indemnities will be called once JMB's capital of 170 million pounds is used up. Since most reliable estimates suggest that the size of the bad loans at JMB will be around 250 million pounds, this means that the Bank will have to pay its share of the indemnities, thus damaging its eventual dividends to the Treasury and so representing indirectly a cost to public funds. This is a serious misuse of public money and it is imperative, in these circumstances, that you call the Bank to account for its actions instead of deliberately distancing yourself from the matter.

Although not directly comparable, as I stated in my first letter, the outcome of the Johnson Matthey Bankers crisis is starting to omniously resemble that of the secondary banking crisis twelve years ago which finally cost the Bank, and so the taxpayer, about 100 million pounds in losses. Is it your intention that a similar sum of public money be placed at risk by the Bank's increased exposure in the JMB crisis?

Yours sincerely



David Owen

Mr Cassell
Mr Hall
Mr Ilett
Mr Lankester
Mr Culpin

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

12 November 1984

The Rt. Hon. Dr David Owen MP
House of Commons
LONDON
SW1

Dear David

Thank you for your further letter of 8 November about Johnson Matthey Bankers (JMB)

I have nothing to add to what I said in my letter of 31 October or what the Governor has said in his letter to you of 9 November. I would only reiterate that the decision to rescue JMB was a matter for the Bank of England. The Bank's contribution to the indemnity that has now been agreed does not include voted money. It is a contingent liability on the resources of the Banking Department and the Bank is responsible for those resources. This has been the position under successive governments, including the government of which you were a senior member.

Yours ever
Nigel

NIGEL LAWSON

Bank of England
London EC2R 8AH

The Governor

9 November 1984

CH/EXCHEQUER
REC. - 9 NOV 1984
ACTION Mr Hall
COPIES TO Sir P. Middleton
CST / EST
Mr Cassell
Mr Monck
Mr Lankester
Mr Ilett
Mr Culpin

The Rt Hon Dr David Owen MP
House of Commons
London
SW1A 0AA

Dear Dr Owen

I know the Chancellor has written to you in response to your letter of 2 November concerning Johnson Matthey Bankers, indicating that he believes it would be right for me to reply to the points which you raise. As he said in his reply to your letter, the decision to intervene to rescue Johnson Matthey Bankers was a matter for the Bank of England, although the Chancellor was informed before the decision was implemented.

I will deal with the points which you make in your letter in the order in which you raise them.

It is not correct to say that Johnson Matthey Bankers' principal earnings were made on commercial loans, nor that the profits of these loans compensated for losses made on its bullion business. Johnson Matthey Bankers has made profits in every year from its dealing operations since at least 1980, and indeed for each of the years between 1980 and 1984 these operations, which primarily reflect its bullion business, were responsible for over three-quarters of the total. It is true that Johnson Matthey PLC experienced losses in its jewellery business during 1983 and that knowledge of these losses was widespread. That business and these losses, however, had nothing to do with Johnson Matthey Bankers.

We do not agree that all the available evidence suggests that bullion business is generally unprofitable for participants in these markets. Trading in bullion markets has been quiet for the last year or so and opportunities have been correspondingly reduced. It remains to be seen how long the quieter conditions in these markets will persist. Notwithstanding the quieter conditions, however, the published reports of all of the principal bullion dealers in the UK indicated that they traded profitably in 1983, in some cases in substantial degree.

You suggest that the Bank has failed to give an affirmative answer to the question whether it is prepared to stand behind the subsidiaries of Johnson Matthey Bankers. In the immediate aftermath of the

rescue of the bank, we naturally received enquiries from its counterparties in many countries regarding our relationship with it and its subsidiaries. We have replied on the following lines:

"Johnson Matthey Bankers and its subsidiaries are now wholly-owned by the Bank of England and as such may be considered undoubted for all their engagements."

We do not accept that the outlook for nearly all of the subsidiaries is poor. The subsidiaries have consistently made a significant contribution to the profits of the group and our preliminary examination gives no grounds to believe that they will not continue to do so.

You have been misinformed that a number of other bullion dealers and banks involved in the rescue did not believe that the London gold market was in danger. None of the banks involved expressed this view at the time of the rescue and it was and remains the unanimous view of the members of the London gold market that the market would have been badly damaged by the failure of Johnson Matthey Bankers.

An indemnity agreement, of which the Bank's share is 50%, has now been agreed to cover up to £150 mn of possible losses over and above those of £167 mn matched by the bank's capital and provisions. This indemnity covers only losses on the commercial loan book, since this is the particular area of the bank's business where losses are expected to arise. Since the Bank stands behind JMB as owner, any sharing of possible losses reduces the potential cost to the Bank correspondingly. The increase in the indemnity from that originally discussed does not imply an expectation of increased losses on the commercial loan book. The work to establish the scale of these losses has not been completed and in the meantime it seems prudent to put in place an indemnity which limits the Bank's exposure to loss and demonstrates the support of the banks for the system.

At the time of the rescue Johnson Matthey PLC acknowledged their responsibility for Johnson Matthey Bankers, but they were clear that they could not by themselves re-establish its net worth. It was against this background that the package involving an injection of capital from Johnson Matthey PLC was decided upon as the most appropriate and effective arrangement in the time available. At no time was Johnson Matthey PLC asked by the Bank to give an unlimited guarantee nor did it ever agree to do so.

It is incorrect to state that Johnson Matthey Bankers' difficulties arose from the Bank of England's failure to regulate the bullion and commodities markets. The difficulties of the bank arose exclusively from its commercial lending operations.

The Bank has not claimed to have known for more than a year that Johnson Matthey Bankers was getting into difficulties. Whilst we had some general concerns about the bank, the existence of problems in its commercial loan book became apparent only during the summer of this year.

Yours sincerely,

R. Leigh-Pemberton

ANNEXE

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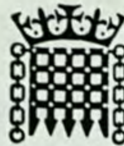


cc Mr D Jones
+ return pl.
NR.

HOUSE OF COMMONS
LONDON SW1A 0AA

HM TREA
-9 NOV 1984
ACTION
SIGNATURE

8 November 1984

Rt. Hon. Nigel Lawson MP,
HM Treasury,
London SW1.

Chancellor / Ec Sec
Sir P Middleton
cc Mr Cassell
Mr Lankester
~~Mr Hett~~
Mr Culpin

Dear Nigel,

Today's reports that up to £75 million of public sector (if not tecnhically taxpayers') money is to be used to bale out Johnson Matthey Bankers is a further worrying instalment in what is becoming a saga of how not to run City affairs.

As you know, the original failure of JMB gave rise to a good deal of disquiet as to the Bank of England's apparent failure to exercise adequate supervision. There was also some concern about the terms of the "lifeboat" operation, and some scepticism - now shown to be fully justified - about the assurances that it was most unlikely that any call would have to be made on public money.

This latest development reinforces much of the concern about this particular case, and about the reasons for treating a failed City concern any differently from those enterprises in other fields which, unfortunately, are failing with all too great a frequency. But it also throws up a number of worrying questions for the future.

At a time when the whole issue of effective supervision and regulation in the City is in the melting pot, we must ask ourselves whether what has happened in the JMB case is the shape of things to come. With the much greater possibility in future of lapses from the most prudent standards, must we expect the same pattern of weak and ineffective supervision, of unsatisfactory and prejudicial emergency action, and, in the end, of the public purse being raided to save the City's reputation?

I am glad to see that you recognise that the case does raise serious issues and that some review of the Banking Act, at least, is now necessary. But there are many questions which now need answering. Are you satisfied with the way the Bank has handled the case? What are the consequences for the category of "recognised" banks? In what circumstances should public money be used to rescue failed City institutions? What lessons should be drawn for the future of City regulation?

I hope that you will make an early and comprehensive statement on these points which are now assuming very worrying dimensions.

Yours sincerely,

Bryan Gould MP

14 NOV 1984

A billion pound fraud stings the bankers

Hugh Sharpe

Deputy City Editor
118 Fleet Street,
London EC4P 4DD
01-353 8000

AS accountants Thomson McLintock put the finishing touches to their report on the downfall of **Johnson Matthey** fascinating details are beginning to emerge on its former banking side's unwitting role in a massive currency smuggling and documentation fraud which is fast heading for the title of crime of the century.

It's a crime in which a handful of people seem to to have enriched themselves to the tune of well over £1 billion, but nobody has come forward to state categorically they have lost money. Warrants have been issued for some seven fugutives but the Director of Public Prosecutions has (so far) declined to press ahead with extradition proceedings.

To date no charges have been made.

Kicking their heels in frustration are officers of both the City and Metropolitan fraud squads who are waiting for a breakthrough after two years of investigation.

It is, of course, hugely complicated but basically centres on forged documents confirming the existence of goods to be exported to Nigeria. These documents were presented to banks in London and elsewhere — **Johnson Matthey Bankers, Standard Chartered, United Commercial Bank** and **Central Bank of India** among them—who advanced cash to facilitate the deals.

The banks were not the intended victims (at least originally) because this official recognition enabled the fraudsters to get a permit to export currency to repay their London debts. Armed with this they were able to buy pounds at the official rate of just over one to the Nigerian naira against the blackmarket rate of six.

HAMPERED

In crude terms it meant they could pocket something like £6,000,000 for every £1,000,000 of forged documents.

The fraud first came to light in 1982 when Johnson Matthey queried £7,000,000 documents purporting to come from Nigeria's agents, Societe Generale de Surveillance. The deal was stopped in midstream.

With the help of the Nigerian government further investigations were carried out and it now emerges that no less than 62 million dollars worth of false documents had been honoured by Johnson Matthey bankers in the previous 18 months. With cash advanced by another eight banks (that they know of) police believe several hundreds of millions of forged documents have been involved.

They fear, however, that other banks may have been victims of a similar operation and certainly the fraud was still in operation last year.

Their investigations are being hampered by the apparent lack of interest from the new Nigerian government after an initial flurry of activity and also by banks who may prefer to believe they are victims of delayed payments from Nigeria rather than actual frauds.

Meanwhile Johnson Matthey bankers struggle on under the control of the Bank of England which has asked accountants Price Waterhouse to carry out a thorough review of the £350 million loan book. Early estimates of likely provisions vary between £170 million and £250 million.

The Bank blames most of the trouble on the collapse of the Sipra group of companies rather than Nigeria but there are fears that there could be still further nasty shocks when the accountants get to grips with some of their loans needed to finance exports to the Third World.

The Standard: Wednesday 9 January 1985.

f010

cc Mr Willetts

TELEPHONE
01-601 4444

BANK OF ENGLAND
LONDON EC2R 8AH

7 January 1985

Mr Turnbull
8/1

T Flesher Esq
10 Downing Street
London
SW1

Dear Tim

In your letter of 14 November to Ruth Thompson at the DTI, you indicated that the Prime Minister would be interested in an account of the thinking underlying the Bank of England's consultation document on gilt dealing. I enclose a note that has been prepared here and which I hope will meet your request.

I am sending a copy of this letter with enclosure to Ruth Thompson and to David Peretz.

Yours sincerely

John Bartlett

John Bartlett
Private Secretary
to the Governor

THE THINKING UNDERLYING THE BANK OF ENGLAND'S
CONSULTATION DOCUMENT ON GILT DEALING

(Paragraph references in brackets refer to the respective paragraphs in the consultation document.)

1 The Bank's thinking on the future structure of the gilt-edged market has been directed to three basic objectives -

(i) to open up the market to greater effective competition;

(ii) to ensure as high a degree of investor protection as possible, consistently with (i); and

(iii) to ensure that the continuous liquidity of the market is preserved, in the interests both of investors and of the Government as borrower.

These basic objectives and the way in which they have been addressed are discussed in turn below. In seeking to achieve them, certain fundamental steps (eg the switch from single to dual capacity) have to be taken by a particular date in the future ie "Big Bang Day". This abrupt transition will involve substantial but inescapable risks and uncertainties. Given this, the Bank is endeavouring, as a supplementary aim, to avoid, over the period of transition, adding further risks associated with other changes, which may in due course be desirable but which are not immediately necessary to bring about the essential restructuring of the market.

Competition

2 The present gilt-edged market structure centres upon two dominant (and six much smaller) single capacity jobbing firms which perform the key market-making role. There are a considerable number of other British and foreign firms (mostly banks and securities houses) which would wish to participate in this role, and which - in terms of capital, and of management and trading capability - could make a positive contribution to it, but which are at present effectively precluded from doing so by the rules for Stock Exchange membership (including single capacity).

3 The Bank is seeking to open this structure up to greater competition (paragraph 32) by offering technical market-making facilities (paragraphs 12-22) hitherto confined to the gilt-edged

jobbers, in principle, to all those willing (and having the capacity) to assume a continuous market-making obligation (paragraphs 5-7). This freedom of access should, as a matter of general principle, contribute to greater market efficiency - though it has to be said that the existing structure is in itself highly effective from many points of view. In particular -

(i) the change should make for a more robust structure, less dependent on just two key firms in a high risk business; and

(ii) it should, by making our securities trading structure more compatible with structures overseas, assist British securities firms in competing internationally.

4 Notwithstanding this basic commitment to openness the Bank has reserved the right to limit the number of participants in the initial, transitional, phase if it appears that there would otherwise be a serious risk of disorder which would damage confidence in the new structure from the outset (paragraph 33). Thereafter freedom of access would be restored.

5 Although not directly relevant to the consultation paper, which is concerned exclusively with the gilt-edged market, the Prime Minister will wish to be aware that the Bank is adopting a similar open approach in relation to the discount market. We have made it plain to the discount houses and to the market generally -

(a) that we are not opposed to ownership links between discount houses and other financial companies, subject only to prior agreement with the Bank on any necessary conditions to ensure that the facilities made available to discount houses (to enable them to perform their function as bill market-makers and as intermediaries between the Bank and the rest of the monetary sector) are confined to that purpose, and are not used simply to benefit the treasury operation of the associated company; and

(b) that we will be prepared to establish a full discount house relationship with newcomers, once they can demonstrate to us an adequate track record as bill market-makers. - Catch 22?

It will be possible, in principle for all-comers, from the outset under (a) above, or after a year or two following "Big Bang Day" under (b) above, to run gilt-edged and bill market-making activities alongside each other, enjoying a trading relationship with the Bank in both areas, against acceptance of the related market-making obligations. The more evolutionary approach under (b) above, compared with the discrete change in the arrangements for gilt-edged market-making reflects the fact that there is no equivalent of "Big Bang Day" in the discount market area, and the supplementary aim described in paragraph 1 above.

Investor protection and liquidity

6 These two objectives are, in the Bank's view, inter-connected. Arrangements for investor protection which engender confidence in the market will contribute to its liquidity; and arrangements to ensure the liquidity of the market will contribute to investor protection by helping to ensure that the investor receives not only a "fair" market price but a "good" market price.

7 Investor protection in the gilt-edged market is currently ensured by the Stock Exchange, both generally through its insistence on high professional standards in its membership, and more specifically through the system of single capacity trading.

8 The Bank's proposals aim to preserve as far as possible the benefits of the Stock Exchange's tradition for effective investor protection in this sense in the new market structure. It is for this reason that we have stated our intention to confine our own dealings in gilt-edged to market-makers, who are Stock Exchange member firms (paragraph 8). But we have made it clear to the Stock Exchange from the outset that we will be unable to maintain that position unless their terms of access to Stock Exchange membership are seen to be "reasonable" in general market perception. The Stock Exchange authorities recognise this. On the assumption that the gilt-edged market does indeed remain within the Stock Exchange on this basis, the Exchange authorities will monitor all bargains with non-members for "fairness", and will pursue, and initiate, complaints if bargains are outside the normal trading range at the time.

9 Keeping the gilt-edged market within the Stock Exchange will also provide the best chance of preserving a presence on the "floor" of the Exchange, where certain gilt-edged market-makers will operate effectively in much the same way as single capacity jobbers under the present arrangements. This would mean that the smaller, private investor in particular would continue to have the option of having his business transacted on an agency basis through a broker and so, if he so chooses, to enjoy the present form of protection (enhanced by time-stamping of contracts, publication of time-related prices in the Stock Exchange Official List, and by Stock Exchange monitoring of all bargains with non-members of the Exchange as in paragraph 8 above).

10 It is not proposed that there should be a public last trade (price and volume) tape in the gilt-edged market as is proposed for the equity market. The essential reason for this is that, in the gilt-edged market, there is a substantial risk that such information would be damaging to market liquidity.

11 The gilt-edged market is fundamentally different from the market in equities. There are only a comparatively limited number of gilt-edged stocks, essentially similar to one another, and all liable to be influenced in a broadly similar way by the same (mostly macro-economic) market developments. As a result, compared with the equity market, market-makers in government securities tend to be far more dependent for their return on position-taking than on the margin between their buying and selling prices. Such position-taking, which provides the essential liquidity to the market, would be inhibited if the position were to become public knowledge: for example, a market-maker would, in that case, be reluctant to bid for a sizeable amount of stock, because the market would move against him when he sought to sell it again. Basically for this reason there is no last trade tape in any government bond market anywhere in the world; and we have been strongly advised by participants in the US markets, who are generally enthusiastic about a tape for equities, against any equivalent in the gilt-edged market. There will nevertheless - in addition to the arrangements for investor protection in paragraphs 8 and 9 above - be far more <u>price</u> information publicly available in the new gilt-edged market structure than at present (paragraph 22).

12 As a further aspect of investor protection, the Bank is also concerned to ensure that investors are protected against default by the gilt-edged market-makers, and to this end proposes that they should

accept a fairly rigorous form of prudential supervision (including daily reporting of gilt-edged positions) which is the substance of the detailed proposals in Annex 1 of the consultation paper. This supervision, and in particular the requirement for dedicated sterling capital in the UK, should also help to underpin continuous market liquidity. As longstops, the investor will be further protected by -

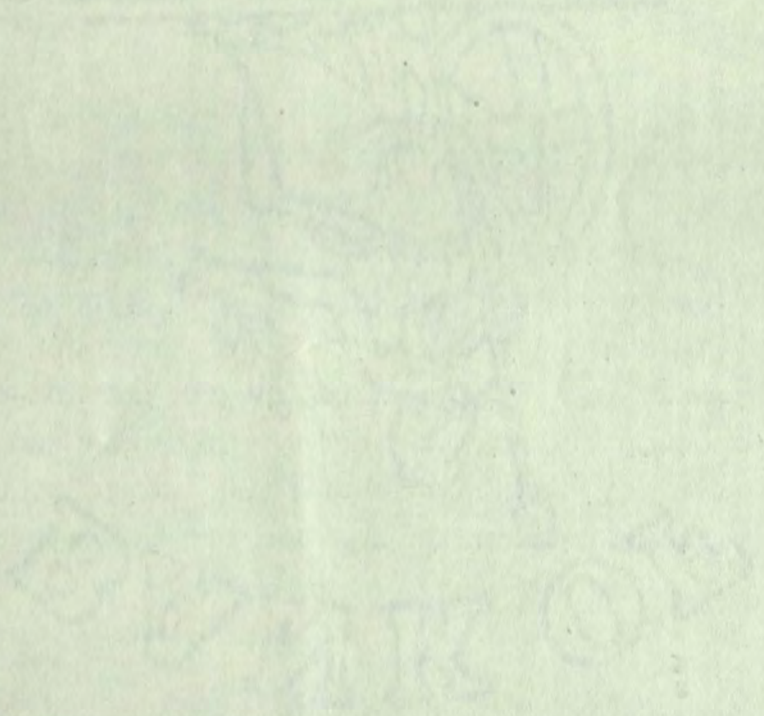
(i) assurances to be sought from substantial shareholders in any gilt-edged market-making entity that they accept ultimate responsibility for its liabilities; and

(ii) the Stock Exchange Compensation Fund.

13 The liquidity of the new market structure will be supported by the primary obligation that market-makers will be required to accept, ie "to make, on demand and in any trading conditions, continuous and effective two-way prices" (paragraph 5). In practice we would expect that the real assurance of continuous liquidity will be provided by the intensity of competition between the market-makers; but the explicit market-making obligation will provide additional support to this objective, and provide a yardstick against which the justification for the facilities extended to market-makers can be monitored in each individual case on a continuous basis.

Accountability

14 The proposed arrangements will mean a considerable extension of the Bank's role in supervising the gilt-edged market, and we recognise the desirability of established procedures for external oversight of the manner in which the new arrangements are administered. We have therefore indicated (paragraph 34) our readiness to accept the jurisdiction of the proposed new securities and investment body, which would include, when the new securities legislation is in place, the jurisdiction of the appeals tribunal.



7 JAN 1985

Fde

2 January 1985

MR TURNBULL

I have seen the minutes of an informal meeting held on Thursday 20 December by the Economic Secretary in lieu of the regular Funding Meeting.

The one piece of bad news is the current Treasury forecast for Sterling M_3. They anticipate a fall of 0.5 per cent in December, to be followed by rises of 1 per cent in both January and February.

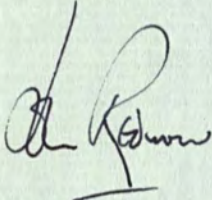
I spoke to Tim Lankaster today. Latest indications are that the December figure, to be released on 8 January, could be even better - perhaps minus 0.7 per cent. If this is the case, it may provide some temporary respite in what is a rapidly declining market both for the currency and for bonds.

However, the prospective figures for January and February are too high, and reflect overspending on Government account, combined with reasonably buoyant bank lending. The correct response should be to bring public spending back into line with targets: only proper control of public spending can reassure the markets, otherwise we will be into a position where interest rates may have to go up.

E.R.

<u>Conclusion</u>

Struggle through until Tuesday 8 January, and see what impact the figures have. In January and February, try a more ambitious funding target than the £1 billion a month sketched in for the figures above. And above all, remind Cabinet that overspending does lead directly to a collapse in the currency and to pressure for higher interest rates.



<u>JOHN REDWOOD</u>

SECRET

Chancellor's bilateral B. on FRI

3

12 December 1984

MR TURNBULL

JMB

I spoke to David Walker of the Bank today.

You may like to know that:

1. If the total risk is only £250 million, the Bank is committed to £75 million. Over £250 million, and the Bank is on risk for everything.

2. Walker's view - which he has held to consistently throughout - is that they will dig themselves out of it with very little loss.

3. You should be aware that this is not without risks. New men have been brought in both to run the JMB loan book and to trade the JMB bullion activities.

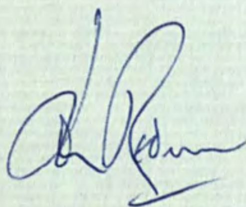
4. Walker says that the bullion trading is profitable, as it has been throughout, and that they are not increasing the amount of risk on the bullion book. It would be important to avoid, for example, taking a very long position in a weak market and losing on bullion on top of the losses of the loan book.

SECRET

5. The loan book is also under new direction. They will take a very conservative view of the bad debt problem. However, you should be aware that they are also increasing lending to the better clients, to try and balance the loan portfolio and bring on some better business.

Conclusion

Enough people are thinking about the implications for Bank regulation and going on a witch-hunt of what went wrong. But no-one seems to be asking questions about how the Bank is handling the dénoument of this story. It is a difficult operation for them (running effectively what is a nationalised bank) and important that their new team should show a steady hand and not take on undue risks in the hope of easy profit. Couldn't the Treasury ask for monthly monitoring figures? Although this is not "public" money, a clean exit is important to Government as well as to the Bank.



JOHN REDWOOD

Prime Minister ④

MR TURNBULL AT 11/12

Opening up Bank Clearing

Citibank and Standard Chartered have been trying to get full membership of the Clearers club. The Clearers responded by setting up a review of the system in March. The report is out today. It proposes a new umbrella body for both paper and electronic clearing to replace the Committee of London Clearing Bankers. The report explicitly envisages that Citibank and Standard Chartered should join the new arrangements.

Provided there are no hidden catches this should be the the end of another cosy restrictive practice in the City.

David Willetts

David Willetts

11 December 1984

SECRET AND PERSONAL

dl uk 2

c David Willetts

10 DOWNING STREET

From the Private Secretary

11 December 1984

Johnson Matthey Bankers

The Prime Minister has seen the Chancellor's minute of 10 December. While she will wish to discuss the issues raised with the Chancellor at their next meeting, she is content for an early announcement of the reviews to be made. She has asked that careful consideration be given to the form in which the announcement is made to the House.

(ANDREW TURNBULL)

David Peretz, Esq.,
HM Treasury.

SECRET AND PERSONAL

023/5

SECRET AND PERSONAL

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

PRIME MINISTER

JOHNSON MATTHEY BANKERS

I have now considered with the Governor of the Bank of England the events leading up to the rescue of Johnson Matthey Bankers (JMB) on 1 October. I have reached the view that the episode raises important questions about our system of bank supervision. I have therefore asked the Governor - and he has agreed - to chair a joint Bank/Treasury Committee of Review. This will involve an outside consultant.

2. I attach (on a strictly personal basis) the Bank's accounts of the main events preceding the rescue, and of the considerations leading to the Governor's decision. These are attached at annexes A and B. Under present arrangements, the Bank does not require Treasury approval for rescue operations unless support is required in excess of the range permitted by their reserves. The JMB operation did not fall into this category. The Governor therefore notified me of his decision shortly before the announcement - as I have already made clear to the House - and neither sought nor required my approval.

3. It is inevitably a matter of judgment as to how serious the consequences would have been of letting JMB fail, and whether they would have outweighed the moral hazard risk incurred by a rescue. I am not myself yet persuaded that the consequences of failure, either for the gold market or the rest of the banking system, would have been as serious as the Bank clearly believe (see Annex B), particularly if a decision had been taken by the authorities to stand firmly behind the rest of the gold market

with a large short term credit line in cash and gold. Nor do I think the circumstances are anything more than superficially similar to the Continental Illinois case.

4. I do not think an inquest into whether or not the Governor was justified in rescuing JMB could be conclusive or useful. But it is of great importance that we look closely at why JMB collapsed so suddenly and with bad debts on such a large scale, and what can be done to reduce significantly the chances of similar problems in the future.

5. Prime responsibility for a bank's affairs must lie with its management, and whatever the failures of supervision, supervisors cannot be expected to double-check all management decisions. JMB's management quadrupled the bank's loan book between 1981 and 1984. Profitability in the years to 1983 was artifically boosted by inadequate provisioning; and the management failed to inform the Bank of the connection between its major exposures. As problems in the business multiplied, JMB were considerably less than frank, not to say evasive; and they were dilatory in submitting vital statistical returns. Although the Bank were significantly misled, they consider they have no grounds to believe that there was fraud on the part of the JMB's officers. The senior management of JMB has, of course, been culled since the rescue operation.

Failures of supervision

6. This said, however, there clearly were failures of supervision. In particular, the supervisors:-

(i) failed to obtain information and hold meetings with JMB as soon as they should have done. Most crucially, JMB's end-March 1984 statistical return, showing a sharp increase in large exposures, was two months late. There was a further month's delay in arranging a meeting to discuss these figures. This reflects a clear failure

to recognise the significance of early warning signals, and a lack of firmness in obliging JMB's management to conform to supervisory requirements. A faster reaction in either case would not have prevented the collapse of JMB; but it might have reduced the scale of the disaster.

(ii) gave the management of JMB too much benefit of the doubt. This reflects the high degree of confidence which the supervisors habitually place in the managers of recognised banks as compared with those of licensed deposit-takers.

(iii) failed to spot serious shortcomings in the quality of JMB's assets. Even when the bad loans were building up so fast, they were still concentrating in their discussions with JMB's management on other areas of concern. It is clear that the supervisors relied far too much in this respect on JMB's external auditors, Arthur Young McClelland Moores. The Bank report that the auditors signed off on 18 June, saying that provisions were adequate, and it was only when the Bank followed up the August meeting that the auditors were called back to re-examine the loan book. Following this, JMB reported to the Bank on 25 September that substantial extra provisions were needed - themselves well short of the provisions eventually judged necessary as the loan book was scrutinized.

7. Some of these omissions stem from failure to operate the present system effectively. Others are due to gaps in the statutory framework provided by the Banking Act 1979. The Review Committee I have set up will accordingly have terms of reference sufficiently wide to cover both these aspects.

8. The Review Committee will report to me as soon as possible after the end of the year on the present supervisory system, and whether any early changes in supervisory procedures are called for in the light of the problems which have arisen in Johnson Matthey Bankers. I have also agreed with the Governor to approach a senior outside expert experienced in commercial banking to report to the Committee. I have in mind for this task Mr Peter Graham, ex-Chief General Manager of Standard and Chartered Bank.

9. I would expect the main issues to be covered in this first phase to be the following:-

(a) The relationship between auditors and supervisors. At present the auditors and supervisors are prevented respectively by professional secrecy and the terms of the Banking Act 1979 from communicating directly about the affairs of a particular bank. There might, however, be immediate scope for improved communication, compatible with existing legislation, with the express consent of the management of the bank concerned;

(b) the staffing of the Banking of England's Supervision Department. Do its staff have the right experience of training? Are their resources adequate, and are they deployed to best effect?

(c) How can the supervisors be better placed to take a view on the quality of assets?

(d) Can procedures be improved for notification and discussion with supervisors of large and connected exposures?

(e) Can improvements be made to ensure prompt reporting of the necessary supervisory statistics collected from banks by the Bank of England?

10. The Committee will also draw attention to any proposed changes arising from this enquiry which may support the need to review or amend the Banking Act 1979. In parallel with this, a group of Treasury and Bank officials under Treasury chairmanship will consider in detail the desirability of legislative changes in the supervisory framework. This group will make recommendations to the Governor's Committee in the spring of 1985. I intend that in the light of the lessons of the JMB case, and other shortcomings in the Banking Act which experience has brought to light, it should take a radical and comprehensive view. Among the issues I have asked it to address are:-

(i) Is it right, with a rapidly expanding banking sector, to maintain the two tier system, whereby recognised banks are subject to a much less strict supervisory regime than licenced deposit-takers?

(ii) Are there lessons to be learned from foreign systems of banking supervision? In particular, without undermining the undoubted advantages of our present flexible and discretionary system, would it be wise to include some quantitative guidelines in statute - e.g. on large exposures?

(iii) (See para 6 (iii) above). Does the law concerning confidentiality of supervisory information need to be changed, e.g. to permit the Bank to communicate directly with the auditors?

I suggest A (iv) Should there be legal sanctions on those who mislead the supervisors?

11. I shall also be considering further with the Governor the adequacy of the present arrangements for notification and consultation about potential rescues by the Bank.

Announcement

12. There has already been considerable criticism in the House, and in correspondence, of the decision to rescue JMB, with David Owen and Dennis Skinner particularly prominent. Subject to your views, I propose to announce the review in a Written Answer on the lines set out in annex C at the earliest convenient date.

NIGEL LAWSON
10 December 1984

The Rescue Operation for JMB

Tuesday 25 September The Bank was advised by JMB, following a special investigation by their auditors, Arthur Youngs, that substantial provisions of the order of £70mn were required against two large exposures. JMB proposed to ask their clearing bank (National Westminster) to guarantee the loans for a substantial fee and an option to acquire the bank in six months' time.

Wednesday 26 September We were advised that Johnson Matthey PLC could not itself recapitalise JMB and that a rights issue would be difficult. National Westminster declined to provide a guarantee but offered to arrange liquidity support from the clearing banks. National Westminster doubted that they would be prepared to buy JMB but agreed to consider it seriously.

Thursday 27 September Arthur Youngs having conducted an urgent review of the majority of the loan portfolio estimated the need for provisons was now £99.6mn. The Deputy Governor saw representatives of the clearing banks to discuss liquidity support for JMB of £200mn - the Bank would contribute 10%. National Westminster expressed reluctance to buy JMB but were asked to think again.

It became clear that liquidity support would also be required for Johnson Matthey plc; Morgan Guaranty, the lead bank for an existing $175mn syndicated facility, agreed to coordinate support.

The Board of Johnson Matthey plc reluctantly agreed that JMB would have to be sold and acknowledged their responsibility to stand behind it. Bank of Nova Scotia was approached for liquidity support as a substantial lender of gold to Johnson Matthey plc and indicated their interest in acquiring JMB.

Friday 28 September The clearing banks reported that their partial examination of the loan book suggested a provisioning requirement of at least £150mn. National Westminster confirmed

that the uncertainties about JMB's true position precluded an acquisition by them. Charter Consolidated, the principal shareholder of Johnson Matthey plc, indicated that they could not mount a takeover for the group, not least because of anti-trust difficulties, but that they would consider what support they could make available.

Saturday 29 September The clearing banks were asked to purchase JMB's loan portfolio. They warned that any price they could pay would leave JMB insolvent but they offered to work out the loan book on a no profit, no loss basis. Bank of Nova Scotia confirmed that they were keen to buy JMB but wanted an unlimited guarantee.

Sunday 30 September It was determined that a £250mn liquidity support package was needed for Johnson Matthey PLC. The Morgan Guaranty syndicate made achievement of this target a condition of their continued support.

The gold market offered liquidity support for JMB. Bank of Nova Scotia confirmed again that they were looking for an unlimited guarantee. The clearing banks, Morgan Guaranty syndicate and other large lenders to the group were asked to contribute to a limited guarantee; they were reluctant. In the evening, Bank of Nova Scotia finally turned down a limited guarantee except in terms quite unacceptable to the Bank and withdrew.

It was then decided that the only alternative was for the Bank to buy JMB for a nominal consideration and Johnson Matthey PLC agreed to put £50 million in cash into JMB. At the same time an indemnity was sought from the banks to limit the Bank's risk on the loan book: the aim was for an indemnity of £100mn, so that approximately £250mn of JMB's loan book would be covered. The gold market agreed to provide £30mn and the clearing banks very reluctantly £20mn. A general liquidity support arrangement for JMB was no longer considered necessary but a support arrangement for gold liquidity was put in place.

The £250mn of facilities for Johnson Matthey plc were substantially in place by the morning. Charter Consolidated agreed to subscribe for £25mn of convertible preference shares in Johnson Matthey plc to assist the company to pay down the £50 million to JMB.

The arrangements were notified to the Chancellor and announced at 8.00am on Monday 1 October.

On Tuesday 2 October heads of agreement between the Bank and Johnson Matthey plc for the sale of JMB were signed.

Subsequently changes were negotiated with other shareholders of Johnson Matthey PLC in the terms of the subscription of preference shares by Charter Consolidated.

The indemnity arrangement and the contributions from individual institutions have now been agreed.

n.b. (Treasury note : the private banks finally agreed to provide indemnities of up to £75m, on condition that this be matched £ for £ by the Bank. The Bank would be liable for any further indemnity required).

ANNEX B

The reasons for rescuing JMB

1. The primary argument for rescuing JMB was its membership of the London gold market. The failure of JMB would, in the opinion of the Bank and of the other members of the gold market, have had a critical effect on the other members and thus on the market itself, with the serious risk that the loss of confidence would spread much more widely to affect other British banks and the banking system and London's position as an international financial centre.

2. The London gold market is probably the most important international gold market. Although there are no reliable statistics to prove this, it is possible that as much as half the world's gold trading is carried out here. The failure of one of the five main participants would in the Bank's view have dealt a substantial blow to the reputation and functioning of that market and would very likely have led to the transfer of much of the business abroad, mainly to Switzerland. Business would have been withdrawn rapidly in the face of uncertainty over the extent of the crisis and once removed would have been very difficult to recapture. The apparent inability or unwillingness of the authorities to deal with the problem would have undermined confidence not just in the gold market but in London as a banking and financial centre at a time when it is undergoing major structural changes which should help to maintain its standing as one of the primary financial centres.

3. The Johnson Matthey group played a special role in the London gold market. Not only was it one of the five members of the daily fixing but alone among the participants it had refining capacity. This is an important encouragement to overseas traders to use the London market, particularly because of the facility to break down standard bars into small bars, for which there is an increasing demand, but also for the ability to refine gold in other forms into standard bars.

4. A further reason arguing for the rescue was the nature of some of JMB's customers. As part of its bullion operations it had received substantial deposits of gold from several foreign governments and central banks, particularly in Eastern Europe, the largest of these amounting to the equivalent of over £50 mn. Losses on these

deposits would have had serious implications for the standing of, and confidence in, British banks generally and could well have added a troublesome dimension to our political relations with the countries concerned.

5. Over and above these factors, it is important to recognise that the London gold market is not simply a market in the sense of, say, the London Metal Exchange. It is a group of institutions, a substantial proportion of whose liabilities are in the form of deposits of gold traditionally withdrawable at short notice so increasing their vulnerability to a loss of confidence. The members of the market do substantial amounts of business amongst themselves and also provide a specialist service to the rest of the banking system, both here and abroad. The other four members of the gold market, Samuel Montagu, Rothschilds, Sharps Pixley and Mocatta and Goldsmid risked being severely affected by the failure of JMB and the losses incurred by its bullion counterparties. Already in Hong Kong in the early hours of Monday morning, 1 October, some banks were refusing to lend them dollars; failure to deal with the situation would have risked deposits being called from them, their borrowing lines being severely curtailed, borrowing costs increased and some counterparties and customers ceasing to do business with them. Two of the houses expressed the view to us that if JMB was not rescued their own businesses would come under very serious strain and might be unable to continue to trade within a few days.

6. Rothschilds and Samuel Montagu are members of the Accepting Houses Committee, as is Kleinwort Benson which owns Sharps Pixley. (Samuel Montagu and Mocatta and Goldsmid are subsidiaries of Midland Bank and Standard Chartered respectively.) It was the clear view of the Bank and of others involved in the rescue operation over the weekend of 29/30 September that the ramifications of a failure would not have been confined to the members of the gold market but would have spread to other British banks. One Accepting House not involved in the gold market had its name refused in Hong Kong on the Monday morning. Major US and European banks were reported to be refusing to deal with any UK House. Midland and Standard Chartered would inevitably have been involved in supporting their subsidiaries. Given Midland's problems with Crocker and its well advertised exposure

to problem debtor countries, market anxieties, still heightened after the Continental Illinois failure, could quickly have spread to Midland Bank itself. Standard Chartered might also have been affected. A number of other UK banks also had sizeable direct exposures to JMB and to other members of the Johnson Matthey group, and would have been directly affected by their failure. It is not likely that the danger to all those banks with exposures to the group would have been unmanageable but for those closer to the gold market the repercussions could have been severe.

7. When considering its response to JMB's problems, the Bank had the example of Continental Illinois very much in its mind. Although Continental Illinois was eventually rescued, the crisis lasted over a number of weeks. With hindsight, it is clear that the relatively indecisive handling of the problem by the US authorities was a major contributory factor to the upset in markets. Large amounts of money were moved from US banks into UK, Japanese and other European banks which were able to take the funds on favourable terms; these movements have not yet been completely unwound. The rapid and decisive action in the event taken to rescue JMB has subsequently been praised and welcomed by supervisory authorities and banks abroad. The failure of JMB, because of its prominence as a member of the gold market, rather than its size, risked provoking a similar upset in markets and reviving comment about the capital strength of major British banks. A substantial outflow of funds from London would, of course, have had adverse repercussions on the exchange rate and interest rates.

8. The alternative of allowing JMB to fail was also examined. In order to try to contain the repercussions outlined above it would probably have been necessary to support the liquidity positions of the other members of the gold market and of other British banks with very large facilities.

9. Support facilities on the scale which would have been required, including in particular substantial lines in gold, could not have been provided by the Bank relying on its own resources. Either the EEA's gold would have had to be made available or a Government guarantee would have had to be sought to support gold borrowings from other sources. The Bank was very reluctant to contemplate involving

public funds directly in the rescue operation. Furthermore, it was only late on Sunday that the negotiations for the purchase of JMB by Bank of Nova Scotia - the favoured solution - broke down. It would have been impossible in the remaining time available to have arranged the support facilities which might have been required on the scale likely to be necessary. Moreover, the Continental Illinois rescue demonstrated the lack of reliance which can nowadays be placed on even very large liquidity safety nets to stem a loss of confidence. Experience with crisis management in the past has also demonstrated that the most effective response is to take decisive action to overcome the initial problem and prevent shock waves arising. It is far more difficult to contain the repercussions and restore confidence at one or more removes.

10. A further alternative considered at a meeting on the Sunday night was the liquidation of both PLC and JMB and the immediate purchase by the Bank from the liquidator of the bullion business of JMB. It is however very doubtful whether such an operation could have been organised in the few hours available even if the Board of PLC had been able to contemplate it as a proper course given their responsibilities to the shareholders. Moreover, JMB is the largest creditor of PLC through gold placed with its refineries and the liquidation of the parent company would almost certainly have made the bullion business of JMB unviable: JMB could not in the circumstances have survived if PLC went down. This factor was crucial in the appraisal of how much capital could be injected into JMB by PLC as a condition of the disposal. The aim of the Bank was to maximise this injection without producing such an erosion of the net worth of PLC as to render unachievable the agreement of the safety net which was necessary for its own survival.

The conclusion

11. Late on the Sunday night, the Bank had come down to two options. The only solution which would ensure that JMB could open for business in London on the Monday morning was for the Bank itself to acquire the company. The alternative was liquidation. For the reasons described above we were convinced that JMB had to be rescued, a view which we have not departed from with the benefit of hindsight.

316.37

ANNEX C

I have now considered with the Governor of the Bank of England the events leading up to the rescue operation for Johnson Matthey Bankers. It is clear there are some important issues to be considered about our present system of banking supervision, and the legislative framework within which it is conducted.

2. We have therefore agreed jointly to review the present supervisory system and whether any early changes in supervisory procedures or amendment of provisions of the 1979 Banking Act are called for.

3. I shall of course inform the House of the results of the review and any legislative changes I consider necessary in the light of it.

Chancellor's bilateral

10 DOWNING STREET

Prime Minister

The Chancellor would like your agreement overnight to announcement of the two phase review (he wishes to forestall questions at the next Treasury questions on Thursday).

He would be happy to discuss the conclusions at the next bilateral.

Agree?

AT 10/12

Yes but – I think he will have to deal with a written answer now.

7.4

COVERING SECRET

cc. Sir A Walters

File

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

5 December 1984

Andrew Turnbull Esq
10 Downing Street
LONDON
SW1

Dear Andrew

CONTINGENCY PLANNING FOR BANKING PROBLEMS CAUSED BY EVENTS OVERSEAS

I understand that the Chancellor mentioned to the Prime Minister last week a Treasury paper that had been produced on this subject about a year ago, and undertook to show a copy to the Prime Minister.

... I attach a copy of the fairly full paper produced in the Treasury in November 1983. Although, as you will see, it takes for the sake of example support operations required in the case of a major debtor country's ceasing to service its debts, the analysis in practice would also cover a situation where problems were caused by the failure of one or more US banks.

Yours ever,
David

D L C PERETZ
Principal Private Secretary

POSSIBLE SUPPORT OPERATIONS FOR BANKS BY UK AUTHORITIES IF A MAJOR DEBTOR COUNTRY CEASED TO SERVICE ITS DEBTS

I Introduction

The purpose of this paper* is to consider, so far as this can sensibly be done in advance of a crisis, what effects and decisions the UK Authorities would face if a major debtor country ceased to service its debts to banks. Brazil is used as a topical illustrative case, but the paper would in general be valid for other countries. The uncertainties are far too great for it to be realistic to attempt a detailed contingency plan. These uncertainties - about the development of a crisis and the reactions of depositors and the authorities in different countries - pervade the whole paper. But subject to these the paper aims to cover the following ground:

(a) the likely nature of the difficulties for banks in London caused by a crisis in which one or perhaps two major debtor countries ceased to service their debts to banks. This would not necessarily cause serious problems in the UK, especially if the UK authorities acted quickly to supply liquidity to their banks. But it could do so, probably in the form of a withdrawal of dollar bank deposits. Withdrawals would arise from loss of confidence in the quality of some banks' assets and hence in banks' ability to repay deposits. This scenario envisages liquidity problems but not a crisis of default by several major countries together in which the value of some British banks' assets could be reduced so far that they were worth less than their liabilities. Nevertheless, the scenario envisages a reduction in the profitability and the capital base of certain major banks as a result of the reduced value of their assets which could leave continuing problems even after a liquidity crisis of this kind had been handled successfully; (Sections II and VII).

(b) the broad decisions which would face the UK authorities about whether, when and how to act either by making statements designed to restore confidence or by providing liquidity support. These decisions would be difficult but would have to be taken quickly and almost certainly on the basis of inadequate information. Decisions would probably also be needed on intervention in the foreign exchange market and on the supply of UK Government debt; (Section III).

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* The paper reflects a major contribution from Bank representatives dealing with the Banking Department, overseas, banking supervision and home finance. But it has not been formally agreed with the Bank.

2. The paper assumes that despite the arguments for avoiding or minimising the extent and cost of support by the authorities acting as a lender of last resort in a crisis, the case for taking such action in certain circumstances is accepted in principle.* The difficult judgement is when those circumstances exist.

3. The immediate purpose of any domestic operations to provide liquidity would be to prevent a bank with assets worth more than its liabilities from becoming insolvent in the sense of being unable to meet its liabilities on the due date. But the underlying intention would be to protect economic activity (at levels compatible with adequate performance on inflation) from the damage which a breakdown in the financial system would or could cause. The purpose of support would not be to protect banks' shareholders, management or employees, or even their depositors. The extent to which the banks should bear the full losses arising from a crisis which called for a support operation is again something that can only be judged in an actual situation; however, a major aim must be to minimise any cost falling on the taxpayer.

II Future and Possible Effects of a Crisis

4. The effect of a crisis on UK domestic institutions will depend in the first instance on the form Brazil's failure to pay takes, the speed with which it develops and its presentation. The decision to stop payments could be explicit and sudden. But the most likely contingency may be a gradual slide in which it becomes clear - with no formal repudiation of debts (and indeed perhaps repeated assurances about resuming debt servicing as soon as possible) - that there is no prospect of repayment in the foreseeable future. Annex A describes more fully how a crisis might develop.

5. A cessation of debt service payments would affect the confidence of depositors because of fears about the effect on the value of some banks' assets. We cannot predict

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* In other words it is assumed that of the two doctrines expressed in the following quotations Bagehot, who believed in providing support on "onerous terms", prevails.

> "...... the most mischievous doctrine ever broached in the monetary or banking history of this country, viz. that it is the proper function of the Bank of England to keep money available at all times to satisfy the demands of bankers who have rendered their own assets unavailable". (Hankey, 1866)

> "Theory suggests, and experience proves, that in a panic the holders of the ultimate Bank reserve (whether one bank or many) should lend to all that bring good securities, quickly, freely and readily. By that policy they allay a panic; by every other policy they intensify it". (Bagehot, 1873)

> These quotations are lifted from a paper by Lipton and Griffiths-Jones on "International Lenders of Last Report.

which banks or class of banks will suffer first or worst from loss of confidence and withdrawal of deposits; nor the extent to which switching of deposits between different banks (or banking centres), accompanied and helped by "tiering" of interest rates, will prevent serious liquidity problems arising for the banking system as a whole in the UK (or the main centres taken together). But for the purpose of this paper we assume that a Brazilian debt crisis leads among other things to a very large withdrawal of dollar deposits from banks in London, including but not confined to some of the big 4 clearing banks. Total foreign currency liabilities of British banks in London alone are over $100 billion.

6. Although the exposure of British banks to Brazil is very large, even a complete and final default by Brazil would leave the banks' assets well above the value of their liabilities.

7. The total exposure of British banks to Brazil had risen to $5.8 billion or about £3.8 billion at the end of June. This figure excludes risks transferred to ECGD and also loans to American banks heavily exposed to Brazil. If the two clearing banks worst affected had to provide fully against their Brazilian assets at the end of the current accounting year, as a result of a default, they would lose all their profits and up to one third of their capital base. In practice whether full provision would be appropriate would depend on the nature of Brazil's inability to repay. The full figures would first emerge when the banks made their annual report to shareholders, unless an earlier announcement was made.

8. The difficulties would of course be worse in degree if another Latin American country ceased to make debt service payments. The total exposure of British banks to Argentina is $2.5 billion or £1.6 billion. Eighteen British banks have exposure either to Brazil or Argentina, of which 14 have exposure to both. Three of these had a combined exposure at the end of June 1983 exceeding 50 per cent of their capital base. Of these two are major (big four) clearing banks. None of them should become insolvent as a result - their assets would still be worth more than their liabilities - provided these two countries alone cease to service their debts.

9. That could change if Mexico and Venezuela, where British banks' exposure is of the same order as in Brazil and Argentina respectively, also ceased payments. But this paper does not cover that scenario. It is concerned with the liquidity problems that could arise if one or two major countries stopped paying. These problems would arise from loss of confidence as much as from banks' objective balance sheet position, even though the exposure of British banks as well as of other countries' banks is large in absolute terms.

10. So long as the banks losing deposits can replace them eg by paying higher interest rates to the banks gaining deposits, who will thus profit from the rising interest rate differential, there is no need for support by the authorities (except on preemptive "stitch in time" grounds - see paragraph 22 below). But once the market ceases to redistribute deposits between banks in this way, the authorities will need to consider acting. The potential liquidity shortage of individual banks would build up over time and could reach large figures. The Bank has calculated, on certain rather extreme assumptions, that two clearing banks could need liquidity assistance of up to $1 billion in foreign currency alone by the end of the first month after Brazil had ceased payments, even after realising as far as possible their foreign currency assets and using up their sterling liquid assets, at a time when other UK-based banks would certainly face unusual liquidity pressures.

III Main Decisions Facing Authorities

International Co-operation

11. It will be in the UK's interests to press for the maximum amount of agreement between national authorities on the responsibility for arranging and providing liquidity support. The UK authorities must avoid taking on an unfair share of support. The exposure of UK owned banks to Brazil is third in volume after USA and Japan; but the London market's exposure is second only to that of New York. This is discussed on Section IV.

Statements and other 'Pre-emptive' Action

12. Liquidity problems inevitably pose difficult choices for the authorities. These decisions, which are bound to be based on judgement and incomplete knowledge, may need to be taken fast. On the one hand it is not necessary for the authorities to respond immediately to the first rumours affecting confidence, tiering of interest rates or difficulties of individual institutions not important for the system. Such tremors have occurred in the past and been overcome without official action. On the other, since confidence is at issue, there is a case for early preemptive action by the authorities - either statements which may need to contain a blank cheque element to be effective but may cost nothing if they succeed; or perhaps providing 'early' liquidity help to an individual bank.

Intervention in Currency Market and Supplying More Debt

13. Apart from decisions on international negotiations, statements, and liquidity support for individual banks, the authorities may well face decisions on whether to intervene in the foreign exchange market and/or whether to supply additional domestic debt instruments.

14. It is uncertain in which direction any pressure on sterling might be working. It would be downward if banks in London had to purchase dollars to meet withdrawals of dollar deposits. Even if US banks were perceived to be at greater risk than UK banks depositors could shift into US Government debt. But it is also possible that sterling would benefit from movement of international funds out of dollars. The decision on whether and how to intervene to support sterling or to offset a rise in the value of sterling would have to be taken at the time as would possible decisions on interest rates. The scope for the UK Authorities acting alone to intervene is limited first by the size of the immediately liquid dollar reserves (around $4 billion) and second by the size of funds that could be borrowed abroad at short notice.

15. Additional demand for government debt might arise from switches out of bank deposits by depositors or by banks out of interbank loans or from an inflow into sterling. If so the authorities might wish to supply more gilts or Treasury bills in order to prevent interest rates from being bid down to an undesirable level.

16. To the extent that the authorities intervened to support sterling or supplied more debt, the scale of the money market shortage and hence of the Bank's normal operations to supply cash would be increased. But this would not in itself involve a major policy decision on support operations. These points are amplified in Annex B.

Providing Liquidity Support

17. There would be a preliminary stage during which the Bank would be monitoring London markets closely to get the information on which to base a judgement about the seriousness of the situation caused by the cessation of debt service payments. It would also be in close touch with central banks elsewhere especially in the USA. It would in particular be looking at a range of evidence including:

(i) unusual withdrawals of dollar or other deposits;

(ii) exchange rate movements;

(iii) interest rate tiering between different classes of banks, different banking centres, and between bank assets and UK or US government debt;

(iv) bank share prices.

Some tiering can be survived without any special official action. Annex D describes what happened in 1982 when no special liquidity support was provided.

18. During this period the Bank and the Treasury would be in close touch on how the situation was developing. A new phase would start if a decision were taken to embark on providing liquidity support to individual institutions, as distinct from the Bank's normal provision of cash to the money market through the discount houses. This decision would involve consultation between the Governor and the Chancellor.

19. Liquidity support to individual banks, which would be given in sterling, can be provided through the purchase of assets, lending or guarantees of loans made by third parties. These techniques and the terms which should fully reflect the risk so far as this was compatible with the purpose of liquidity support are discussed in some detail in Section VI. The knowledge that such sterling support was available would help confidence, but in certain circumstances the availability of additional dollar swap lines with the Fed might also need to be made known.

20. The next main issue is which institutions should and should not receive support once the case for some action has been accepted. The aim of preventing economic activity from being damaged by a breakdown of the banking system implies that support should be given to those banks whose survival is both at risk and vital for the system as a whole, but not to others, (though this would involve some inequity since not all those banks peripheral to the system would have been managed with less than average prudence.) We and the Bank have found it difficult to get beyond this level of general presumption in advance of an actual crisis, but the Bank have provided a description of their approach in paragraphs 21-26 below. This is helpful though it necessarily leaves many questions open including the treatment of branches or subsidiaries of foreign banks for which we hope the parent central bank would accept responsibility (see Section IV). The Bank's approach does not rule out assistance to banks not themselves essential to the system on grounds of specific knock on effects or confidence effects. But it does not seem realistic to settle general policy on this in advance of a specific crisis.

<u>The Bank's Approach</u>

21. Given the central importance of the clearing banks to the economy as a whole, as well as to the banking system, it must be presumed that it would always be necessary to arrange support for any of them which got into difficulties.

22. Beyond this group it is difficult to identify any bank whose survival would be so obviously important. It would be necessary to consider in each case the nature of the particular crisis and therefore what the reaction to it should be. This means that it is vital

not to rule in advance that any particular bank would always, or could never, be support-worthy. It may be that offering limited support early on in a crisis to an otherwise unlikely candidafe would prevent the need for larger-scale assistance to a wider group of banks, more important to the system, at a later stage. (This was an important reason for support to the secondary banks in 1974-75.) Thus while there would be no presumption that any particular categories of banks would be supported it must be recognised that in the heat of a crisis the Bank would want to offer assistance in the most effective way even if this were to a candidate not obviously identifiable in advance.

23. It would, for example, be necessary to take account of the particular structure of an individual bank's balance sheet in deciding whether it should be a candidate for support. The liabilities of some banks are concentrated heavily in the form of interbank deposits, including deposits with clearing banks and important accepting houses; if the borrowing bank should as a result of the liquidity difficulties fail to meet these deposits as they fell due, the liquidity pressures could be transferred to its counterparties. The Bank does not have detailed information on all depositing counterparties with any given bank nor, if it did, would it necessarily be able to judge immediately how vulnerable they themselves might be.

24. On the assets side, likewise, without detailed knowledge of all of the borrowing customers of any given institution, the repercussions of a closure arising from liquidity difficulties is impossible to forecast; but it could be damaging to particular sectors or to particular customers in sensitive areas of the economy.

25. Another uncertainty concerns the amount of time available in which to decide upon action. The subsidiary of a foreign bank located here might be unable to ascertain that it would receive the necessary support from its parent because of such accidental factors as public holidays, the availability of senior officials, or the time needed to arrive at an agreed distribution of support in the case of multiple parentage. In such cases, the Bank's knowledge of the circumstances and its informal contacts with the responsible monetary authorities might lead it to the view that it was sensible and prudent to give support against a presumption of transfer of responsibility in due course.

26. Above all the Bank would have to take account of the effect on confidence of the failure, through liquidity difficulties, of even a small bank. The circumstances in which we envisage such an incident could very well be an important turning point in market sentiment and confidence, affecting the banking system as a whole. If the banking community should at such a juncture observe the Bank declining to assist a given institution the shock to confidence could, in some cases, be severe and seriously aggravate the situation. This is not

to say that the Bank would always intervene to provide support whatever the nature of the institution in trouble. That again would depend on its place in the market, the complexion of its customers on both sides of the balance sheet, the amount of publicity which might attend the failure, etc. There are, no doubt, institutions where the balance of judgement would point to allowing them to fail; otherwise London would become the depository for the bulk of the bad or doubtful international assets in the banking system. But until a particular case arises it is impossible to anticipate where the balance would lie.

IV International Co-Operation

27. The September paper assumed that there would be agreement on parallel action to support banks at least by the US and UK authorities and preferably by other countries as well. We have explored with the Bank what such co-operation might amount to in terms of action as well as of possible statements. The Bank have asked that the information in paragraphs 28-31 below should not be passed on by the Chancellor to the Finance Ministers of other countries. The reason for this is that some other central banks, which have not passed similar information on to their governments, might react badly if they learnt that British Ministers had been given it. The risk is that this would harden attitudes and so make it more difficult to agree on action in an actual crisis.

29. The earlier paper quoted the 1974 statement on euro-markets by G10 Governors that:

> "...... it would not be practical to lay down in advance detailed rules and procedures for the provision of temporary liquidity. But they were satisfied that means were available for that purpose and will be used if and when necessary."

29. During 1982 the Bank initiated discussions in Basle aimed at reaching agreement on:

(a) a new reassuring statement that could be used if the international debt situation required it; and

(b) a broad division of responsibility between central banks which would enable them, if necessary, to honour the collective assurance given by the G10 Governors in 1974.

30. It proved impossible to agree on (a). Indeed the Bank doubts whether it would have been possible last year to agree even on the 1974 text if it had not already existed.

31. On (b) some progress was made in agreeing which central banks should be primarily concerned with banks' foreign establishments and should "take the initiative in making the arrangements" for dealing with their liquidity problems, as follows:

Type of Bank	Central Bank Responsible
Branch	Parent
Subsidiary	Parent and host jointly
Joint Venture	Host

The responsibility for "initiating" these arrangements for subsidiaries was thus not clear cut and no decisions were taken about the sharing out among central banks of responsibility for providing liquidity support as opposed to initiating the arrangements. However, the UK authorities would clearly have responsibility for the consortium banks which would be hard hit in the scenario described in this paper.

32. Joint responsibility for initiating arrangements for subsidiaries reflects conflicting arguments. As subsidiaries are legally distinct entities incorporated in the host countries, the legal argument points to the host central bank being responsible. The practical argument points in most situations to the parent central bank since most large banks operating an international network treat wholly owned and even majority owned subsidiaries in much the same way as branches.

33. Turning from responsibility for initiating arrangements to the actual provision of liquidity, we have agreed in principle with the Bank that in an actual crisis our aim should be to agree with the US and as many other countries as possible that parent central banks should be responsible in general for providing subsidiaries as well as branches with liquidity. (In practice the host central bank might act as agent and unless the nature of the crisis pointed clearly, as in the case of difficulties for Crocker in California in the aftermath of an earthquake, to a particular situation there would be some tricky individual cases eg with Grindlays in London as well as Crocker in the USA.) This division of responsibility would be in the UK interest since the liabilities of subsidiaries and branches of UK banks operating in the US is about half of the equivalent figure for branches and subsidiaries of US banks in the UK (about $130 billion). Equivalent figures for other G10 countries are not available but in general the UK is more significant as a host than as a parent.

34. There are doubts about the willingness of other central banks to adopt a distribution of responsibilities for support on the lines suggested in paragraphs 32 and 33 above, and not even the US could at this point be counted upon to agree to them. However in a real crisis the US authorities* might be prepared to accept them and with the possible support of Canada and the Netherlands the Bank might be able to achieve an agreement on these lines

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* This paper is based on the assumption that this is correct. If it were not, the results would be serious as Annex C explains.

at a Basle meeting of the G10 Governors. But on past form a number of major countries are likely to prove difficult. These include Germany, France, and Italy. The pattern of Japanese business in London, mainly through branches, is very skewed in favour of this principle - their dollar liabilities in London are over $130 billion, while the British banks' yen liabilities in Tokyo must be negligible by comparison. There is a fair chance that the Japanese would follow the US-UK lead.

35. However, for self-protection we cannot rule out assisting non-British banks. Non-G10 banks have nearly $50 billion of liabilities in London; they are a mix of subsidiaries and branches and are a very heterogeneous group. It would be impossible to predict with any certainty which authorities would support their own and which would not. In aggregate, however, these banks clearly have enough weight to cause considerable damage. There might be a case, if the system seemed otherwise at risk, for making an exception to the home country principle. Before reaching that conclusion, we would seek to insulate the vital organs of the market from them - perhaps by attaching a condition to liquidity support that it could only be used to meet obligations to banks whose home central banks were co-operating in an international effort. Indeed, that intention might be an effective weapon of suasion.

36. The position therefore is that there is no clear cut internationally agreed plan for implementing the 1974 assurance: silence then and since then about what would actually be done is not attributable only to a wish to avoid moral hazard for the banks. We have discussed with the Bank the possibility of seeking to fill this gap. They are, however, certain that any attempt to do so in Basle in advance of a crisis would fail. The reasons for this include legal inhibitions (Germany), the political need to defend in public any agreement reached before a crisis arises (US), and the wish to keep one's hands as free as possible. The Bank consider that the same would be true if discussions were opened at Ministerial level. Failure accompanied by leaks about failure would be the worst of all worlds. Treasury officials agree that it seems best to rely on the pressures of crisis to bring about the sort of agreement described in paragraph 32 above. At that point the Chancellor and other G5 Ministers could exert pressure for a workable plan of action to be agreed.

V Statements

37. We have concluded that there is no point in embarking on a contingency drafting exercise. But Annex G usefully brings together a range of past statements that have been made. These include:

(a) the full communique issued by G10 Governors in 1974;

(b) a reference back to this in a speech by the Deputy Governor in 1982;

(c) a statement by the Canadian central bank Governor about the availability of lender of last resort facilities for banks in difficulties;

(d) a similar statement about an individual Canadian bank;

(e) a press report of a Bank of England statement about National Westminster in 1974;

(f) a statement by National Westminster itself on the same occasion.

38. If a crisis arose, statements might also be made by the IMF and perhaps by governments. Timing is clearly a vital factor for statements designed to maintain confidence. It would be risky to make one before confidence is in question. Equally statements should not be delayed until confidence has been destroyed.

39. Any statement implying a commitment to provide support by the authorities in the UK, which would be subject to parallel action by other major countries, would be cleared with Ministers.

40. Of course it is possible to get through a crisis without a statement. Apart from their comment on rumours about National Westminster in Annex G, the Bank made no general statement during the domestic secondary banking crisis. It was, of course, known at a very early stage that the lifeboat had been formed.

VI Operational Aspects of providing Liquidity Support

41. (a) Techniques. The main forms of support for individual banks open to the Bank would be:

(i) purchase of assets;

(ii) secured lending;

(iii) unsecured lending;

(iv) guarantees by the Banking Department of loans from third parties.

42. Annex E gives details about the capacity of the Banking Department and Issue Department. The Issue Department has no powers to borrow currency or to give guarantees. Moreover since its assets back the note issue and its profits are paid into the National Loans Fund, it is preferable that it should not hold risky assets. In general the Bank would use the Banking Department when this was not ruled out either by the sheer size of the operation or

by the risk in relation to the Banking Department's balance sheet - its free reserves are about £180 million - and profitability.

43. The terms for these operations should be as 'commercial' as is compatible with their object - in line with Bagehot's support for "onerous terms". There would thus in general be a presumption in favour of exhausting the scope for giving support by purchasing sound assets and by secured lending before embarking on unsecured lending or guarantees. In practice, however, the scope for using the less risky techniques may not be large for two reasons. First, the banks in liquidity difficulties may have sold off all their sound assets before the issue of support by the Authorities arises.

44. Second, to the extent that assets are still available for sale the safest assets to purchase would be claims on or guaranteed by the public sector (Treasury Bills, gilts, local authority debt, and export credit paper guaranteed by ECGD). On these grounds there would be a case in support operations with individual banks for buying these assets before even the best claims on the private sector such as eligible bills. On the other hand to insist on this in all cases might leave the supported bank with an inadequate balance sheet and a choice would have to be made at the time. (For the purposes of the Bank's normal money market operations so far as these could be distinguished it would clearly in the interest of confidence to continue the normal practice of dealing mainly in eligible bills.)

45. In the statistics the Banking Department is deemed to be in the private sector and therefore its transactions are not relevant to public expenditure or the PSBR. The Issue Department is considered part of the public sector but its expenditure on the purchase of eligible bills does not count as public expenditure nor add to the borrowing requirement. This is because these operations - or any dealings in short-term instruments which are close substitutes for money market transactions - are regarded as essential short-term provision of funds as part of the normal central banking. Nor do these operations increase monetary growth as they displace one asset by another in the banking system's total balance sheet: they do not increase the size of that balance sheet. But of course increased purchases of central government debt by the non-bank private sector which may be the originating cause of the shortage would reduce monetary growth. Support operations by the Issue Department would only be defined as public expenditure and increase the PSBR if they involved long-term commitments rather than money market operations - eg taking the form of long-term loans or the acquisition of capital. These criteria will apply whether money market operations take the form of general assistance to the market via the discount houses or direct support for individual banks.

46. (b) Distribution of risk and reward between the Exchequer and the Bank. If an asset acquired by the Issue Department turns out to be worth less than it cost, the Exchequer bears it directly in the form of reduced Issue Department profits. This should not, however, occur unless the Department has begun to acquire assets of an unusual kind (see paragraph 51 below).

47. If the same thing happens to an asset acquired by the Banking Department, the Bank bears it unless there is a Treasury guarantee or indemnity. The same goes for loans by the Banking Department.

48. If the Bank asks for a guarantee of repayment or an indemnity against any loss on a Banking Department loan and the Treasury agrees to provide one, decisions would be needed on the allocation of risk and reward. The Treasury would want a slice of any profit if it was bearing part of the risk.

49. (c) Powers and Parliament. Any guarantees or indemnities by the Treasury to the Bank of England would be given not under a statutory power but under the Crown's common law power; this procedure is permissible since there is no legislation which precludes it. There are, however, standard procedures for non-statutory guarantees, including the laying of minutes before Parliament.

50. If there were any question of loans by a Government Department to individual banks, which is unlikely on the scenario considered here, the conditions for drawing on the Contingencies Fund would have to be satisfied; these are set out in Annex F.

51. The Accounting Officer for the National Loans Fund must be consulted if any unusual use of the Issue Department's resources is ~~likely~~ contemplated. This would include consultation between the Bank and the Accounting Officer before the Issue Department were used in a way that might be regarded by Parliament as an alternative to public expenditure.

52. The scale and destination of the flow of funds in a crisis are uncertain. But one possibility is that a surplus might build up in the National Loans Fund. This could happen if the authorities decided either to supply extra Government debt or to intervene in support of sterling in the foreign exchange market on a very large scale. The Treasury Solicitor's Department has confirmed that in those circumstances the Treasury has the power to borrow and to deposit the NLF surplus with the Banking Department. The Banking Department could then use the surplus to provide liquidity support under Section 12 of the National Loans Act 1968 as amended by Section 152(i) of the Finance Act 1982, so long as

the Treasury considered this "expedient for the purpose of promoting sound monetary conditions". However since the power conferred by this wide wording would in practice be being used in a scenario very different from the one originally described to the House - sales of debt designed to control the growth of monetary aggregates - there would be a strong case on grounds of Parliamentary propriety for informing the House if the powers are used in this way, preferably before they are so used, unless a Parliamentary statement would be incompatible with the purpose of the operation - preserving or restoring confidence.

VII <u>Problems Remaining after a Liquidity Crisis</u>

53. The loss or diminution of assets would remain a problem even after a liquidity/confidence crisis had been successfully handled. Doubts about the affected banks would have to be resolved and the supervisors would wish to ensure that this was done. The route would depend on the nature of the crisis and the way in which each bank had been affected. A bank which had suffered a loss of deposits, but without significant erosion of its net worth, would be in a different position from one which had suffered serious capital losses. In the first case the bank would need to restore its liquidity and re-establish its reputation. The workings of the markets and the concern of the supervisors might mean that some reduction in new lending for a period might be part of this process.

54. In the second case, however, it would be necessary to prepare a plan for a phased return to normal supervisory ratios over a longer period. The timescale would depend on the extent of its losses and the availability of support. It would be unhelpful to force a rapid return to normal ratios if this means cutting back the bank's existing good business or precipitate sales of assets at below book value as this would reduce the bank's ability to generate new capital resources. Mergers, sales of investments and participations and giving up less remunerative activities are all possibilities that would need to be considered. During the period of convalescence the Bank of England as supervisory authority would need to be flexible whilst laying down for each bank clear ultimate objectives.

HF Group
HM Treasury
4 November 1983

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LIST OF ANNEXES

A Scenario

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ANNEX A

BRAZIL: DOMESTIC SUPPORT OPERATIONS

SCENARIO

The analysis which follows is necessarily speculative; there are many possible scenarios, and the order of events cannot be predicted with any confidence.

Background

2. That said, the background in very broad terms could look something like the following:

(i) Brazil fails to meet due dates by growing delays and creditors/international institutions etc. are unable to gloss this over; this leads to gradual recognition that a state of default effectively exists as "excessive" arrears build up (eg arrears which trigger prudential or accounting responses and are perceived as threatening banks' asset positions). At the other extreme, though less likely, Brazil might simply repudiate her debts.

(ii) Other Latin American countries, notably Argentina, might follow suit.

(iii) Serious damage results to banks' asset side. The precise extent of damage may only emerge later, eg when annual accounts are published and the scale of provisions becomes evident. If it were great enough the solvency of some banks could be called into question. But there will be an growing impact in terms of loss of confidence as depositors and other members of the financial community take a view, probably on very uncertain information, of the impact on banks known or believed to be most exposed to these risks. This loss of confidence could be sharp if it were triggered by an unexpected event such as an assassination, coup or natural disaster. It could lead to substantial and unpredictable disturbances on banks' liabilities side, which would be influenced by factors such as the response of different national authorities and shifts in the relative confidence placed in different banks, different financial centres, and different currencies. The disturbances could lead to a local or to a more widespread liquidity crisis. Solvency difficulties could follow later for some banks when assets had to be reclassified formally - even if the liquidity storm had been weathered.

(iv) In these circumstances one cannot predict in which directions funds would flow, whether there would be marked exchange rate effects, whether UK banks would be net beneficiaries of a flight into quality, to what extent the interbank market

would continue to recycle liquidity, to what extent funds could escape from the banking system, or to what extent the authorities in different countries could interyene to restore the flow of liquidity to where it was needed. If, for example, funds went into notes and coin, the authorities could hardly direct holders to put them back. There is a question in extremis whether dollar clearing in New York would seize up if confidence in key US banks broke down.

(v) The scope for responses by Governments and Central Banks is considered in part III of the main paper. The paragraphs which follow set out the possible anatomy of the liquidity crisis in more specific terms, both in the international (ie mainly US dollars) and in the domestic context (both dollars and sterling) to the extent that they can be separated. Events would not necessary follow in the order suggested. Official responses would have to be made on the best available information about the position which the crisis had reached. The situation would be bound to be fluid and uncertain, and could accelerate out of control at any time. On the other hand, there are points where the authorities could reverse the chain of events - eg if the USA made it plain that whatever happened the 10/15 largest US banks would not be allowed to fail.

<u>Detailed consequences: international scene</u>

3. In more detail, we could expect most if not all of the following developments:

(i) Once confidence starts to erode Brazilian banks in international centres (mainly New York) could lose interbank deposits and be forced to close. Same could happen if another country defaulted to its banks.

(ii) Other Latin American banks in international centres could suffer acute confidence difficulties by contagion.

(iii) Major US banks with large exposures would face tiering in the markets and would have to resort to the Fed. discount window to obtain cash. Their branches outside the USA could suffer similar tiering.

(iv) Precautionary moves by banks generally could make the markets less efficient as a channel of liquidity. All banks would take defensive steps to protect liquidity.

(v) Tiering could spread to non-US banks with large exposures to Brazil (some UK banks) or particularly dependent on the interbank market for funds (Italian, perhaps Japanese).

(vi) Possible segmentation of international market if markets perceive different liquidity prospect between centres.

(vii) "Safe" banks offered huge deposits as there are only very limited opportunities for cash to "leak" from international wholesale market.

(viii) Non-bank depositors attempt to shift out of bank deposits into safer assets - government securities, other financial institutions etc. causing relative yields to shift sharply.

(ix) Possible exchange market pressures as depositors seek to move to "safer" currencies, and banks seek to retain the balance between their foreign currency assets and liabilities.

(x) In practice some of these developments could not be reconciled; the international money market could seize up; international and perhaps some national payments transactions (ie in the ordinary course of non-banks' business) could not be made.

Details: domestic scene

4. The major parallel developments on the domestic scene are:

(xi) If the flight into quality is against the UK, UK banks, including clearers, experience difficulty in obtaining new interbank funds to finance non-renewal of bid deposits in foreign currency with fixed maturity dates. Limited stocks of short-term currency assets held for normal market conditions become inadequate to meet non-renewals.

(xii) UK banks face exceptional sterling withdrawals which their stock of liquid assets cannot finance - as with (xi), though liabilities structure is very different - most sterling liabilities are withdrawable at or very near sight but are historically very stable.

(xiii) Points (v), and (viii) and perhaps (vii) and in the worst case (x) apply within the UK domestic system and on the national level as well as on the international plane.

ANNEX B

SUPPORT OPERATIONS AND MONEY MARKET FLOWS

Faced with a run on its liabilities a bank needs to dispose of its assets rapidly, or replace its liabilities to the public with borrowing from other banks. If overall portfolio preferences are unchanged (depositors still wish to hold their funds with banks but allocated differently between them) then the banking system may be able to reallocate the funds to keep the threatened banks liquid. But the system could begin to fragment with strong banks reluctant to increase their claims on weak banks. These pressures could first affect dollar deposits. It could be that even with no move out of dollar deposits as a whole, UK banks could lose dollar deposits to overseas banks. But these changes in dollar holdings would not lead to overall sterling shortages unless the Authorities intervened to provide dollars to UK banks.

2. If there were an overall change in depositors' sterling portfolio preferences and they wished to hold their assets as liabilities of the public sector rather than the banks, then the Authorities would perceive an increase in the demand for public sector debt. The Authorities would then need to decide rapidly whether to intervene with extra supplies of public debt (to keep prices more stable) or to limit their supply to a more normal level and allow prices to adjust. If they intervened and supplied more debt there would be an increase in the size of money market shortages. The shortages would have to be relieved as the short-term money flows between the public and private sectors have to balance and if no explicit assistance were provided the ultimate balancing mechanism would be a reduction in bankers' deposits at the Bank of England.

3. An analogous situation could arise <u>if</u> the events also gave rise to downward pressure on sterling in the foreign exchange markets, for example if sterling depositors sought to move their deposits into dollars or to acquire US government debt; or if banks had to convert sterling liquid assets into dollars to meet withdrawals of dollar deposits. If the Authorities decided to intervene they would be running down foreign claims in the reserves and the payment for these claims would increase the size of money market shortages to be relieved. If the Authorities did not intervene then the flows into and out of sterling would balance but possibly at a much lower exchange rate. It might well be that, in the circumstances, other countries would also be intervening in the foreign exchange market on a larger than normal scale. The scope for the UK Authorities acting alone to intervene is limited first by the size of the immediately liquid dollar reserves - at present not more than around $4 billion - and second by the size of funds that could be borrowed abroad at short notice. It might be possible in a crisis to negotiate an increase in swap lines with the Fed. At present these

stand at $3 billion. The Bank believe that an attempt to increase the swap network now would not be successful, but that it would be successful in an emergency.

4. It is possible, of course, that the pressures on sterling could be in the other direction with sterling actually benefitting from international movements of funds. In these circumstances the Authorities could intervene to sell sterling to stop the exchange rate rising. This could happen at the same time as the Authorities were selling more domestic claims on the UK Government. In these circumstances the foreign exchange transactions would be offsetting the money market flows caused by Government debt sales.

5. The prime agent for assistance to relieve money market shortages is the Issue Department of the Bank of England. The total size of its balance sheet is determined by its liability, the note issue. Increased acquisition of assets from the banking system to relieve money market shortages needs to displace another asset already held by the Issue Department - its ways and means advances with the NLF. These currently stand at approximately £1½ billion. If and when these had been reduced to zero, any surplus in the NLF ~~would start~~ accumulated ~~a surplus~~ under the terms of the 1982 Finance Act ~~which~~ would be deposited with the Banking Department, to enable the Department to carry on purchasing assets from banks.

6. In some circumstances depositors might set such store on security that the Authorities would also notice an increase in demand for their non-interest bearing liabilities. There could be an increase in demand for notes (though rapidly meeting the physical constraint of our limited stocks). This would constitute a negative money market influence as they would need to be paid for by the banks, but as the notes determine the size of the Issue Department's balance sheet there would be a corresponding increase in the capacity of the Issue Department to relieve shortages. The other component of the wide monetary base could also increase if banks increased the desired level of their balances at the Bank of England, which would increase the capacity of the Banking Department to purchase bills and hence would also not involve the NLF going into surplus.

N.B.
The point about the alteration is that the Bank/Treasury could actively acquire assets of any kind to displace Ways & means held by Issue Department - when these are exhausted - only to the extent that there is a surplus can the Banking Department take over. Thereafter on any day when the Exchequer/NLF is in deficit the NLF surplus will reduce. After the surplus is reduced to nil further deficits involve the availability of W&M in Issue Dept. The position is thus rather different since the W&M are exhausted, the initiative to purchase assets only exists so far as there is a daily surplus.

ANNEX C

BREAKDOWN IN THE US

It is widely believed, probably correctly, that the Fed would step into rescue any very large US bank. Most of those with the largest exposures to Brazil are in this category. However this cannot be taken entirely for granted and a situation is not impossible in which the US authorities were unable or unwilling to participate in international action to provide emergency liquidity. The American domestic political climate is at present very unsympathetic towards the banks and any actions requiring congressional support could be frustrated by opposition. More likely the sheer size of the problem could be beyond the resources immediately available to the Fed if several major banks were ailing at the same time. In such a crisis there could also be a breakdown of the US dollar clearing system, which is managed by the large New York banks most likely to be affected, and through which all international and domestic US dollar transactions are cleared. US banks are particularly concerned over the problem of "daylight overdrafts" ie the exposure arising from the despatching of payments early in the day before the receipts needed to meet them arrive. Fear that some banks were insufficiently liquid to meet their own obligations could paralyse the system, including dollar transactions between banks and central banks in other centres.

2. It is also possible that the Fed could refuse access in the US to its discount facilities, if the intention were to use them to meet a dollar liquidity shortage in another country. It is unlikely, but not impossible, that a liquidity crisis would start elsewhere, but, if it did, normal market mechanisms could lead to such an intention. Non-US banks without a US dollar base of their own typically have lines of credit arranged with branches of US banks either in their own centres or in New York. If these were honoured in a crisis, the US branches could finance such drawings by using their non-overdraft facilities with their head offices. If this led to a liquidity shortage in New York, the first recourse of US banks would normally be to the discount window of the Fed, but such access is at the discretion of the Fed, not automatic.

ANNEX D

TIERING IN THE INTERBANK MARKET

There is always an element of price discrimination in the interbank market but the discrimination against the less than prime banks is generally modest with normally no more than 1/8 or 1/4 percentage point separating the best from the worst rate. It may however be greater when the market is unsettled and this is when the market tends to talk of "tiering".

2. Tiering in this sense occurred in the summer and autumn of 1982. By July 1982 it was reported that it had become quite pronounced and that a span of ½ per cent had developed between the best and the worst rates. At that time the prime US banks were able to fund themselves the most cheaply, as is usual. Thereafter, using the rates paid by the US banks as a base, the following tiers could be identified:-

1/16% premium	- UK clearers and prime continental banks (excluding French and Italian banks).
1/8% premium	- French and Japanese banks.
3/16% premium	- smaller banks (including UK merchant banks).
1/4% premium	- Latin American and other banks from developing countries.
1/2% premium	- East European banks

3. In addition to this general "stretching" of the tiering structure, at various times individual banks or groups of banks (notably American, Canadian, German and Italian), many of them normally accepted as prime names, found themselves having to pay more than usual for funds because the market associated them closely with country debt problems and/or the events surrounding Dome Petroleum, AEG, Drysdale, Penn Square and Ambrosiano. By September, when the debt problems of Mexico had become fully apparent, it was being reported that US banks were no longer unquestioned prime names in the interbank market and that the UK clearers and Japanese banks were able to raise funds more cheaply than many of them. Continental Illinois and Canadian Imperial Bank of Commerce may have faced discrimination against them of as much as 1 per cent. Such rates may, however, have been quoted as signals of unwillingness to deal and it does not follow that business was actually transacted at those rates.

4. There is a limit to the amount of tiering which is likely to occur in the market because of the reactions of both <u>borrowing</u> and of <u>lending</u> banks. Borrowing banks will strongly resist

tiering against them because if their cost of funds gets seriously out of line with that of the market as a whole they could find that they can no longer make an adequate return on their syndicated lending. Borrowing banks fear that by making a concession on price they will simply confirm the lending bank's view of their creditworthiness (and desperation for funds) and encourage lenders to demand higher and higher premia in future. Their reaction is therefore not to borrow from counterparties at rates which are "over the odds" but to delay their funding, if possible, or to seek alternative sources of funds (borrowing on standbys from parents for example). Equally, on the side of the lending banks, a point is reached in their perception of counterparties in the market at which they are not prepared to assume the credit risk even at higher than normal rates. Their reaction is rather to withdraw deposits, cut lines etc. The outcome of lines being cut is, of course, the reduction in interbank activity which has been detectable over the last year.

5. In addition to the market effects described, there has been unusual pricing of interbank loans to Mexican and Brazilian branches outside those countries. Some banks have sought to take advantage by asking as much as 3 per cent or 4 per cent over market rates, but we believe that the branches have refused. They are typically paying 1 per cent above for 6 months money, a little less for shorter maturities. The deposits are however part of the agreement by the international banking community to maintain their exposure and their pricing is to an extent artificial.

6. From October 1982 onwards market sentiment began to improve and is now considerably stronger than that prevailing last autumn. This is due to a number of factors, including the market's inherent ability to adjust, reasonably successful handling of debt problems, and the emergency of generally easier market conditions as interest rates have both declined and become more stable. A selective enquiry carried out by the Bank in August this year revealed that no systematic tiering in price seemed to be taking place (though the French banks were said to be paying over their normal position in the market from time to time) and that the span of rates appeared to have returned to a more normal range of 1/4 per cent. There were, however, indications of lines to banks from developing countries and small banks being cut.

7. Another aspect of the uncertainties prevalent in the international banking markets last year was a shift in investor preference away from commercial bank instruments into US government paper. As a result, starting in May 1982, at around the time of the Drysdale affair, an unusually large differential opened up between US Treasury Bill rates and US commercial bank CD rates. After peaking in September 1982 (see attached table) the differential has narrowed considerably this year.

3 MONTH TREASURY BILL/CD AND CP DIFFERENTIAL (%)

	Treasury bills	CDs	Differential	CPs	Differential
7 May (average)	12.48	14.06	1.58	14.00	1.52
14 May (average)	12.32	13.74	1.42	13.56	1.24
Monday 17 May	12.27	13.75	1.48	13.44	1.17
Tuesday 18 May ≁	12.21	14.00	1.79	13.56	1.35
Wednesday 19 May	11.87	13.85	1.98	13.56	1.69
Thursday 20 May	11.37	13.35	1.98	13.31	1.94
Friday 21 May	11.70	13.55	1.85	13.31	1.61
28 May (average)	11.49	13.35	1.86	13.11	1.62
4 June (average)	12.01	13.76	1.75	13.34	1.33
11 June (average)	12.02	13.77	1.75	13.49	1.47
Monday 14 June	12.32	14.15	1.83	13.94	1.62
Tuesday 15 June	12.25	14.20	1.95	14.19	1.94
Wednesday 16 June	12.30	14.30	2.00	14.19	1.89
Thursday 17 June ≠	12.61	15.00	2.39	14.56	1.95
Friday 18 June	12.69	15.05	2.36	14.56	1.87
25 June (average)	12.77	15.11	2.34	14.59	1.82
2 July (average)	12.68	15.11	2.43	14.69	2.01
9 July (average)	12.12	14.44	2.32	14.22	2.10
16 July (average)	11.65	13.88	2.23	13.34	1.69
23 July (average)	10.57	12.41	1.84	11.89	1.32
30 July (average)	10.34	11.96	1.62	11.71	1.37
6 August (average)	9.70	11.64	1.94	11.21	1.51
Monday 9 August	9.70	11.80	2.10	11.44	1.74
Tuesday 10 August	9.99	11.75	1.76	11.44	1.45
Wednesday 11 August	9.87	11.75	1.88	11.19	1.32
Thursday 12 August ϕ	9.19	11.55	2.36	11.06	1.87
Friday 13 August	8.84	10.80	1.96	10.56	1.72
Monday 16 August	8.53	10.30	1.77	9.94	1.41
Tuesday 17 August*	8.03	9.70	1.67	9.56	1.53
Wednesday 18 August	7.97	9.70	1.73	9.06	1.09
Thursday 19 August	6.90	9.80	2.90	9.31	2.41
Friday 20 August	7.20	9.55	2.35	9.31	2.11
Monday 23 August	7.45	9.55	2.10	9.31	1.86
Tuesday 24 August	7.52	9.60	2.08	9.06	1.54
Wednesday 25 August	7.32	9.65	2.33	9.19	1.87
Thursday 26 August	6.95	9.85	2.90	9.44	2.49
Friday 27 August	7.94	10.35	2.41	9.69	1.75
Monday 30 August	8.04	10.25	2.21	9.69	1.65
Tuesday 31 August	8.40	10.40	2.00	9.56	1.16
Wednesday 1 September	8.37	10.60	2.23	10.31	1.94
Thursday 2 September	8.29	10.65	2.36	10.31	2.02
Friday 3 September	8.37	10.60	2.23	10.31	1.94
Tuesday 7 September	8.37	10.45	2.08	10.19	1.82
Wednesday 8 September	8.16	10.55	2.39	10.19	2.03
Thursday 9 September	8.20	10.65	2.45	10.31	2.11
Friday 10 September	8.32	10.85	2.53	10.44	2.12
Monday 13 September	7.97	11.00	3.03	10.56	2.59
Tuesday 14 September	7.72	10.80	3.08	10.56	2.84
Wednesday 15 September	7.95	11.05	3.10	10.56	2.61
Thursday 16 September	7.95	10.95	3.00	10.69	2.74
Friday 17 September	8.08	10.95	2.87	10.56	2.48

≁ Drysdale affair

≠ Sudden change in outlook for interest rates after a poorly received Treasury auction led to increased fears of bankruptcies

ϕ Collapse of Lombard Wall

* Henry Kaufman's statement about interest rate prospects.

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ANNEX E

CAPACITY OF BANK TO PROVIDE SUPPORT

I POWERS

	Banking Department	Issue Department
Power to borrowing sterling	Yes	No
Power to lend sterling (see Notes 1 and 2 below)		
(a) Secured	Yes	Yes
(b) Unsecured	Yes	Yes
Power to hold sterling assets	Yes	Yes
Power to borrow currency	Yes	No
Power to lend currency	Yes	Yes
Power to hold currency assets	Yes	Yes (last used 1932)
Power to guarantee		
(a) Sterling	Yes	No
(b) Currency	Yes	No
Contraints on size of operation	Prudential considerations - Size of Department's own balance sheet	Operational requirements of Issue Department - Size of Note Issue
Could Treasury guarantee?	Yes	HMT automatically liable to make good any depreciation at quarterly revaluation of assets
Other Comments		Size of note issue may expand if demand for notes increases in extreme crises

Note 1

Banks which have issued laon stocks have generally written in to those agreements provisions which would make the stocks repayable immediately if other creditors were offered better security. This could in practice to prevent the Bank from taking security against support loans, whether in sterling or currency.

Note 2

Anybody who knowingly lends to an insolvent institution risks being ruled by the courts to have assumed responsibility for all that institutions liabilities. In practice, however, it is unlikely that a support loan made in good faith would be taken as evidence of intent to keep

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the borrower in business for fraudulent ends and of course the implication of providing assistance is that the question of default to other creditors will not arise.

SECRET

II METHODS OF SUPPORT

Method	Role of Bank	Amount Now Available To 4 Major Clearers (Highly Speculative)	Comment
(a) Recall of funds lent to discount and gilts market	Waive undertakings given by banks	Up to £3 billion	
(b) Purchase of assets			
(i) commercial bills	Purchase by Banking, then Issue Departments	Up to £2 billion	The value of commercial bills may be less certain
(ii) Treasury and local authority bills	Purchase by Banking, then Issue Departments		
(iii) gilts	Purchase by Banking, then Issue Departments	Over £3 billion	Risk that purchase and resale agreements could be construed as loans against security
(iv) CDs of other banks	Purchase by Banking, then Issue Departments	Up to £2 billion	Asset, might be of dubious value
(v) loans to local authority	Purchase by Banking, then Issue Departments	£1 billion	Unwieldy formalitites necessary
(vi) ECGD + DTI shipbuilding guaranteed assets	Banking, then Issue Departments	£4 billion	Up to 30 per cent can be refinanced in times of liquidity difficulty under present arrangements
(vii) Loans and advances to non-bank private sector, excluding loans to persons and overdrafts	Purchase by Banking, then Issue Departments	£24 billion	Possible major administrative difficulties uncertain value profound long term consequences

NB - CONSTRAINTS ON USE OF BOTH DEPARTMENTS MEAN THAT FIGURES CANNOT BE CUMULATIVE

SECRET

	Method	Role of Bank	Amount Now Available To 4 Major Clearers (Highly Speculative)	Comment
(c)	Bank guarantees	Bank Banking Department, possibly supported by Treasury guarantee,	£+ Prudential constraint	
(d)	Direct Treasury guarantees to ultimate borrowers			
(e)	Treasury loans/grants/equity purchase			Initial recourse to Contingencies Fund. Thereafter legislation needed. Extreme option.

ANNEX F

CONDITIONS FOR THE USE OF THE CONTINGENCIES FUND

The Treasury Solicitor has advised that the Contingencies Fund could be used to enable the Treasury to make loans to individual banks providing the conditions for drawing on the Fund are satisfied. Payments would ultimately be made from a Treasury vote and would be accounted for by a Treasury Accounting Officer.

2. The main considerations which would need to be borne in mind are the following:-

(a) the advances must be in respect of urgent services in anticipation of the provision made or to be made by Parliament for those services becoming available (Section 3(1) of the Miscellaneous Financial Provisions Act 1946);

(b) the Treasury must be satisfied that it is not precluded from providing the money either by the absence of statutory powers (see (c) below) or by the implications to be drawn from any relevant statutory provision. For example, if the law already provided powers to make payments for a certain purpose, but these powers did not extend to a related purpose, the inference might be that Parliament had precluded payment for that related purpose. However, the Treasury Solicitor has not identified any such inhibitions in the circumstances we have been looking at;

(c) the general rule is that "the use of the Contingencies Fund to finance expenditure which requires specific legislation in order to meet accepted constitutional propriety is to be condemned" (the 1932 concordat between the PAC and the Treasury);

(d) advances from the Fund should not be made unless it is reasonable to assume that the provision in terms of legislation to authorise the use of public funds for this purpose will be made by Parliament so that the Fund will thus be repaid (this requires inter alia an informed assessment of the outcome of the vote);

(e) in principle, advances from the Fund should be deferred until the legislation has had a second reading. Exceptionally, if it is impossible to postpone the payments until the necessary money has been voted, the Fund may be used to meet urgent expenditure in anticipation of legislation which the Government has the firm intention of introducing at the first available opportunity; and

(f) use of the Fund should be preceded by a statement to Parliament either separately or during the Second Reading Debate on the legislation.

G10 GOVERNORS' COMMUNIQUÉ ISSUED SEPTEMBER 1974 (R)

At their regular meeting in Basle on 9th September, the Central Bank Governors from the countries of the Group of Ten and Switzerland discussed the working of the international banking system. They took stock of the existing mechanisms for supervision and regulation and noted recent improvements made in these fields in a number of major countries.

They agreed to intensify the exchange of information between Central banks on the activities of banks operating in international markets and, where appropriate, to tighten further the regulations governing foreign exchange positions.

The Governors also had an exchange of views on the problem of the lender of last resort in the Euromarkets. They recognized that, it would not be practical to lay down in advance detailed rules and procedures for the provision of temporary liquidity. But they were satisfied that means are available for that purpose and will be used if and when necessary.

more sharply aware of the risks involved in their exposure to particular countries in difficulties, there could be a problem if they began more generally to withdraw from, or at least to run down their involvement in, individual countries or groups of countries, without a fully balanced assessment of those countries' positions. We have seen similar behaviour in respect of involvement in lending to companies, both domestically and internationally. Excessive prudence can be as dangerous in some circumstances as excessive exuberance in others.

Perhaps it would be useful at this point to recall the line which we at the Bank have taken on the whole subject of country lending—and I think it has been a broadly consistent line ever since the problem leapt into prominence in 1974.

First, we have always wanted to see the maximum possible contribution from the official international institutions—and especially the IMF. This has been because we believe that funds from these institutions with their associated conditionality are likely to carry the best prospects of facilitating appropriate adjustment. At the same time it has always been clear that the magnitude of the financing task has been such that official funds could not play more than a minor role. The major part has had to come from the banking system. That being so, we have concentrated on trying to ensure that international bank lending was prudently and appropriately carried out. We have encouraged the provision and distribution of as much information as possible. We have, with other central banks, worked to develop a collaborative approach to supervision of international lending. And we have encouraged banks not to react abruptly or short-sightedly to changes either in a borrowing country itself or in other countries with superficial similarities.

You will recall that the Governor addressed this question in a speech he gave in Bonn in December.[1] He noted that, as with domestic bankers in their dealings with companies, international bankers face a dilemma when a country begins to experience debt difficulties. Prudent banking practice may suggest that exposure should be reduced, by the refusal of requests for new credit and the termination of existing lines or deposits as they mature; on the other hand, action of this sort, if precipitate or taken simultaneously by a number of the country's creditors, may well hasten and exacerbate the very difficulties from which the banks are trying to escape. Action by a single bank taken in its own narrow interests can easily prove detrimental not only to its own longer-term interest, but also to the interests of the wider banking community. In such circumstances there can be no guiding rule, but each case must be judged on its individual merits.

A more widespread difficulty might arise if problems deriving from a particular rescheduling caused banks to react defensively towards other indebted countries, precipitating difficulties for them. Banks must consider carefully whether the difficulties faced by a country are transient or whether they reflect fundamental maladjustment or mismanagement. A solution may, in some cases, lie in a widening of spreads with a consequent increase in the return on capital, so as to encourage further lending. But any banks which do withdraw support at an inappropriate moment, even if in one particular instance they manage to protect their immediate interest at the cost of precipitating difficulties for others, could find that damage done to their standing in the market might not serve them well in the longer term.

I do not underestimate the difficulties there are in making the appropriate differentiation between borrowers. Obviously there will be occasions when some common external factor, economic or political, influences a range of countries. Nevertheless, more often than not, there will be differences in the impact such factors have or in the reaction to them; and it is of great importance that such differences be properly assessed and appropriately responded to, in the longer-term interests of the banks, the borrowers and the wider world community.

The question is sometimes raised whether central banks are adequately prepared to deal with failures if, despite all efforts to guard against them, they arise. Recently the Group of Thirty risk study group has noted commercial bank concerns in this area. Traditionally, at times of uncertainty, confidence has been restored by resolute action by the relevant central bank. If problems were to arise from international lending, co-ordination between a number of authorities would be required, simply by virtue of the international nature of markets: responsibility would need to be shared amongst them. This need is fully acknowledged by the central banks of the major industrial countries. Indeed, as long ago as September 1974 the Governors of the Group of Ten central banks stated publicly in the wake of the Herstatt affair that they were satisfied that means were available for the provision of temporary liquidity to the euromarkets and would be used if and when necessary.

That statement still stands. As was also said in 1974, however, it would not be practicable or advisable to lay down in advance detailed rules and procedures for the provision of such liquidity. In particular, if such provision were to be in any sense automatic or if the factors or criteria which determined it were precisely specified, there would be a danger that the disciplines of the market would be overriden—if the arrangements looked too restrictive—or undermined, if they looked too lax.

Financial sanctions on Argentina

After these rather general remarks, I would now like to turn to one particular question on which I am sure you will expect me to say something.

(1) See the March *Bulletin*, page [illegible]

(C)

Miss Carney: You have mentioned that the Bank of Canada's responsibility relates to the liquidity of the chartered banks. What role would the Bank of Canada play if a chartered bank became illiquid; if a chartered bank, say, ran into trouble because of a failure of a large corporate client?

Mr. Bouey: There are two aspects to that I think I should mention. One is that in terms of short-term problems, if a bank finds difficulty in meeting its reserve requirements, for some particular reason, then we will lend the money pretty well automatically, at least up to some limits. And that is a temporary thing having to do with the way in which their clearing swings moved against them—unexpected swings arising out of certificates of deposits that were not rolled over, or something like that. We do that fairly frequently; not all the time, but fairly frequently.

The situation you are really talking about I think is where a bank gets into a more serious liquidity problem, really because some lack of confidence develops and people are reluctant to renew their deposits or place as many deposits in the bank as one would like to see. In that case, the Bank of Canada will certainly stand behind the bank and we will lend against its assets. We can only make secured loans.

Miss Carney: Okay. Is there any limit to that? Say one of the large corporate chartered banks in Canada ran into really serious problems, because some of them are over-extended in relation to one or more companies, how far would you support them? Would you bail out the chartered bank? Is that within your power?

Mr. Bouey: This is a very hypothetical question. I do not believe any bank is in that situation. But if a bank, and I am not going to refer to any particular kind of bank, was suffering liquidity problems for some reason of lack of confidence, the bank will go as far as necessary. That is not bailing them out; that is just lending money against sound assets. ?

Extract from Minutes of the House of Commons Standing Committee on Finance, Trade and Economic Affairs.

(d)

BANK OF CANADA

BANQUE DU CANADA

press statement

communiqué

FOR IMMEDIATE RELEASE

January 26, 1983

CANADIAN COMMERCIAL BANK

OTTAWA, January 26, 1983. In response to a number of enquiries concerning the Canadian Commercial Bank which arose following the annual meeting of that bank in Edmonton yesterday, Gerald K. Bouey, Governor of the Bank of Canada, stated that the Canadian Commercial Bank is a solvent and profitable bank and if it requires any liquidity support, the Bank of Canada will provide it.

(f)

National Westminster Bank Limited

41 Lothbury, London, E.C.2

PRESS RELEASE

In view of the fall in the price of National Westminster Bank shares during this week and particularly on Friday, we have felt it necessary to make a statement concerning certain rumours of which we are aware and which have absolutely no foundation.

In the first place, there have been rumours surrounding the allegations made by Signor Sindona in his submission to the Milan Tribunal, and I now state that, after a detailed investigation, International Westminster Bank is satisfied that the alleged letter of 30th November 1972 is false and supporting documents have been submitted through our legal representatives to the Milan authorities.

Furthermore, we would reiterate our earlier statement that the Bank has no outstanding liabilities or losses in relation to the Sindona Group of banks or from foreign exchange operations undertaken by any of its units throughout the world.

A further rumour current this week relates to the suggestion that we have received a substantial amount of support from the Bank of England on the grounds, apparently, that we feel unable to make a Rights Issue. This rumour has been categorically denied by the Bank of England and is again wholly false. Indeed, we have had no discussions whatever concerning the possibility - or otherwise - of our making a Rights Issue.

National Westminster Bank much regret that our shareholders, depositors and staff should have to be faced with suggestions currently appearing in the Press and elsewhere which are, as I have stated earlier, totally without foundation.

J. F. Prideaux

30th November, 1974.

Sir John F. Prideaux, O.B.E.

Chairman

(e)

EVENING STANDARD 29.11.74

Bank of England denies Natwest rescue move

THE BANK OF ENGLAND this afternoon firmly denied a rumour that had swept round the City that the National Westminster Bank had sought or been offered substantial support by the Bank.

"Absolute nonsense," said a spokesman.

Natwest's shares had been clobbered by the rumour, dropping 6p to 88p at one time—12p below their par value. Earlier this year they were more than 300p. Other Bank shares fell in the atmosphere of uncertainty surrounding the commitments to the "fringe" banks and the wobbling property world.

Elsewhere business was down to the merest trickle and market minds had plenty of time to exercise a rather-rueful sense of humour.

Although Mr Harold Wilson is not the City's best friend he could take credit for supplying the ammunition for today's fun.

So dealers spent their time contemplating the "weevils nibbling away at the pound in their pockets." They also posted such notices on their price boards as "please don't feed the weevils" while others, according to an Exchange Telegraph reporter, clapped their [illegible] to ears, mouth and eyes and proclaimed "Hear no weevil, speak no weevil and see no weevil."

PART 11 ends:-

DW to AT 26/11/84

PART 12 begins:-

HMT to AT + attached 5/12

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