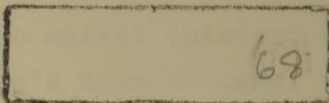


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Topspared.

THE CHIEF CASHIER



- Copies to Mr.Fforde o/r
- Mr.Dow
- Mr.McMahon
- Mr.Walker
- Mr.Payton
- Mr.George o/r
- Mr.Dicks-Mireaux
- Mr.Quinn
- Mr.Foot
- Mr.Green
- G.P.S.

1116

THE MONETARY PROSPECT

1. Middleton (HMT) held a meeting with Bridgeman, myself and MDKWF and the Bank/Treasury forecasting team this morning. The purpose of the meeting was to discuss the short-term monetary forecasts and the prospects for the near future, and against that background to consider the submission of papers on the outlook to Ministers. The intention now is to submit two papers to Treasury Ministers by lunch-time tomorrow, Wednesday, 7th November, in time for a discussion on immediate interest rate policy, should that be felt to be necessary, e.g., in the light of market reaction to this afternoon's news. The two papers are to be, respectively, first, a more factual description of the immediate monetary outlook and second, a policy-orientated paper. HMT would like to put forward both of these as representing a joint Bank/Treasury viewpoint. The policy paper, currently being drafted by Bridgeman, should come over in draft, to you and me, by mid-afternoon <sup>today</sup>. We discussed a draft of the more factual paper on the monetary prospects, which had been prepared by Middleton, at this morning's meeting. It is not worth circulating at this stage because so many changes will be incorporated in the second draft. Middleton has promised to send over a copy of this by close of play today to me, and I will try to circulate it as soon as possible after I have received it. The Treasury will clearly need comments by as early as possible, and not later than early morning on Wednesday, if they are to incorporate these into their final papers for Ministers.

2. The background of the prospects paper is, of course, the current short-term monetary forecasts. Full details of these will be circulated in the ordinary way for the Monetary Review Committee. Suffice it to say for the moment that the forecast is not markedly



encouraging. With market interest rates already having risen, and with this afternoon's news to come, the forecasters thought it difficult to proceed on the basis of an unchanged MLR and in practice an assumption that MLR is raised by 1%, to accommodate the movements in market interest rates that have already taken place, has been made. Despite that, with the CGBR remaining quite sizeable in November and December, and bank lending continuing strong through these months, monetary growth remains on average just below 1% per month, even with the 'corset' assumed to be continuing; the rate of growth of £M3 is forecast to hover on this basis around 13% per annum during these months. If in addition the 'corset' was removed, the recorded rate of monetary expansion is seen as accelerating, perhaps to around 16% by the January banking month.

3. Turning to the fiscal outlook, the official Treasury forecasters now believe that the best guess for the PSBR in 1979/80 is £9½ bn.; moreover, this figure incorporates the assumption that the whole of the current shortfall in VAT receipts is recouped, which Customs still expect officially to occur within the next few months. Unofficially, and at lower working levels, there is some expectation that the balance of probabilities is that the PSBR might rise by another £½ bn. with a shortfall in VAT receipts. Turning back to the more immediate future, despite this assumption on VAT recoupment, the CGBR for November and December, at about £600 mn. per month, remains as high as had been expected last month, before the error of £1 bn. in the PSBR for banking October had been seen at all. Accordingly, the PSBR and CGBR figures by end-December are likely to be ~~very~~ high, of the order of £9 bn., and will seem to the market to be clearly inconsistent with the target of £8½ bn. At present, the forecast to be published later will incorporate a PSBR figure for 1979/80 of £8½ bn., but HMT may come to the view that the current developments in the CGBR and PSBR, which will be known to the market, may make that figure incredible and therefore in need of upwards revision. That having been said, HMT's current expectation of a PSBR of £9.2 bn. in 1979/80 still requires a very sharp downturn in the CGBR and PSBR in the first calendar quarter of 1980 (the last quarter of fiscal 1979/80). There are reasons to believe that such a downturn will occur, for example asset sales; and the Treasury accountants' forecast for the CGBR, seasonally adjusted, in banking January is only £90 mn. Nevertheless, it would be my best guess that we should now be planning on the basis of a PSBR for 1979/80 which is most likely going to end in the region of £9½-10 bn.

6th November 1979. *CAEG*  
C.A.E. Goodhart



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7 71

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financial prospect. The following  
the Treasury and the Bank of these

target for the growth in the  
to April with a centre point of

9%. This is equivalent to 10% for the full financial year 1979-80.

3. So far this financial year up to October:

- a. the money supply has increased by 15% at an annual rate. During the first 4 months of the target period the money stock has increased at a rate of 14% - well above the upper end of the range.
- b. If we allow for the distortions caused by the SSD scheme, underlying monetary growth has been even higher. The effect is difficult to quantify but it seems that near-money substitutes of £1 billion or more have been created since April.
- c. Some £7 bn of the forecast £8½ bn borrowing requirement has already taken place.
- d. Bank lending has remained obstinately high - at an underlying rate of over £800 m a month. (See Table 1 attached).
- e. Externals have been negative by £240 million a month. Some of this has been the result of the outward movement from the private sector resulting from the relaxation of exchange controls. This has offset DCE of nearly £980 million a month.
- f. Market sentiment has noticeably deteriorated recently. Markets unsettled by the removal of exchange controls and were disappointed with the Public Expenditure White Paper. There is no longer any expectation of an early fall in interest rates.

Prospects for the Remainder of the Financial Year

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



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

#### The Present Target

2. The Government's announced target for the growth in the stock of  $\text{£M3}$  is 7-11% from June to April with a centre point of 9%. This is equivalent to 10% for the full financial year 1979-80.
3. So far this financial year up to October:
  - a. the money supply has increased by 15% at an annual rate. During the first 4 months of the target period the money stock has increased at a rate of 14% - well above the upper end of the range.
  - b. If we allow for the distortions caused by the SSD scheme, underlying monetary growth has been even higher. The effect is difficult to quantify but it seems that near-money substitutes of  $\text{£1 billion}$  or more have been created since April.
  - c. Some  $\text{£7 bn}$  of the forecast  $\text{£8}\frac{1}{2}$  bn borrowing requirement has already taken place.
  - d. Bank lending has remained obstinately high - at an underlying rate of over  $\text{£800 m}$  a month. (See Table 1 attached).
  - e. Externals have been negative by  $\text{£240 million}$  a month. Some of this has been the result of the outward movement from the private sector resulting from the relaxation of exchange controls. This has offset DCE of nearly  $\text{£980 million}$  a month.
  - f. Market sentiment has noticeably deteriorated recently. Markets unsettled by the removal of exchange controls and were disappointed with the Public Expenditure White Paper. There is no longer any expectation of an early fall in interest rates.

#### Prospects for the Remainder of the Financial Year

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



a. Exchange Control Relaxation. In the various submissions we pointed out that interest rates might need to rise to keep monetary growth within the target range if, as seems likely, there is some downward effect on the exchange rate.

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

c. The SSD Scheme. The artificial reduction in recorded £M3 since the imposition of the corset may now be around 3% though we have no way of knowing precisely. And the abolition of exchange controls opens up the potentially important new channels of offshore disintermediation. If the corset is removed, the recorded money stock could increase quite rapidly - by perhaps 3% as reintermediation takes place. The effect on market confidence if the corset is removed also has to take into account that: it will appear to some as though we have relaxed a control. But to others retention of the corset, causing continuing large disintermediation - some of it overseas - might itself be seen as a sign of weakness and cast doubt on the strength of the Government's commitment to genuine monetary control.

d. When discussing the forecast with Ministers however, we mentioned that the PSBR for 1979-80 was being reconsidered in the light of recent information. The PSBR for the financial year is now expected to be around £9½ bn compared with the estimate of £8½ bn at the time of the Budget. A good deal of uncertainty surrounds this figure: in particular, it assumes that all of the current shortfall in VAT receipts is recouped by Christmas, which is at the optimistic end of the range of possibilities. The PSBR is still likely to be much lower in the second half of the year than in the first.

There is likely to be an increasingly difficult problem in dealing with market expectations. The cumulative unadjusted



Central Government Borrowing Requirement at the end of December could itself be as much as £9 bn, on the above conservative assumptions about the payment of VAT. This is likely to cause concern in the markets about the size of the PSBR for the year as a whole.

e. Bank lending may be expected to abate in due course, not least because of the recession we forecast. But the timing of this effect is very difficult to predict, and in the initial stages of the recession there could be upward pressure on lending.

5. Interest rates in the market have already moved upwards; they are currently over 13½% at the long end and nearly 15% at the short end. We would not attribute this solely to special factors; there seems to have been some deterioration in inflationary expectations, and growing concern about the coming wage round. It is of course possible to imagine favourable circumstances - especially if a rapidly declining PSBR tightens up monetary conditions - in which the current level of interest rates is satisfactory or even too high. But the balance of risks points in the other direction. It is impossible to be precise about the change in interest rates which might be necessary to bring monetary growth to the centre of the target range.

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

7. We have looked in detail at the prospects for the next 3 months on the assumption that changes in MLR do no more than accommodate recent movements in market rates. On this basis, as the table below shows, we expect monetary growth since mid-June to remain above the top end of the target range even if the corset remains in place. If, on the other hand, the corset were to be removed we would expect a substantial acceleration in recorded monetary growth as the figures increasingly start to reflect the underlying monetary position.



Table I  
1979-80

	OUTTURN	FORECAST		Monthly Averages £ m	
			<u>Corset On</u>		<u>Corset Off</u>
		JUNE- OCT	OCT- JAN		OCT- JAN
CGBR	900	450	450		
CG Debt Sales (-)	- 500	- 50	- 100		
Other Public Sector	- 50	- 50	- 50		
Bank Lending	<u>650</u>	<u>650</u>	<u>1000</u>		
DCE	1000	1000	1300		
Externals	- 350	-400	- 400		
Other	<u>- 50</u>	<u>-100</u>	<u>- 100</u>		
£M3	<u>600</u>	<u>500</u>	<u>800</u>		
Percentage increase in £M3 since mid-June (at annual rate)	14%	13%	17%		

8. The main points are:

- a. The CGBR comes down, as VAT receipts increase. But the assumption that the current VAT shortfall is entirely recouped by the end of the year may be optimistic.
- b. With MLR doing no more than following market rates up, gilts and other public sector debt sales are low, against a background of continued weak domestic and foreign confidence.
- c. The underlying growth in bank lending remains strong. We expect some reduction to occur eventually but we are extremely unsure about the timing. So the most we feel able to say is that there might be some slight deceleration compared with recent months.



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

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

#### The Prospect for 1980-81

10. The prospect for inflation in 1980-81 is relatively poor, unless the current pay round turns out to be much better than now seems likely and the exchange rate holds up extremely well. The PSBR prospect, even if it is held constant as a proportion of GDP, is for a substantially higher nominal figure than in 1979-80. With target monetary growth well below both the likely rate of accumulation of financial assets by the private sector and the growth of nominal incomes, it is difficult to see much change in interest rates from current levels. If rates are raised sharply in response to the deterioration in the immediate outlook some falling back may be possible but even this is far from certain.

11. There might indeed be some further upward movement in interest rates. This could happen, for example, if any of the PSBR increase which we now foresee for the present year has to be carried forward into next. And of course the interest rate outlook next year depends critically on the target for monetary growth which is adopted as well as the accompanying fiscal stance. Looking at it crudely the tighter the monetary target the higher interest rates will have to be unless there is an accompanying tightening of fiscal policy. Some forms of fiscal tightening - for example increases in indirect taxes - may not even help much. But the relation between the monetary target and the interest rate outlook is not quite as simple as this suggests. Much depends on



how the markets interpret any change in the target. For example, to the extent that a reduction in monetary tightness is foreshadowed - say by allowing some degree of base drift - inflationary expectations are likely to be adversely affected and this itself would have some adverse impact on interest rates. This is not to say that a looser monetary stance would imply higher interest rates than a tighter one, but simply that the gain in terms of interest rates from a loosening may not be very great.

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

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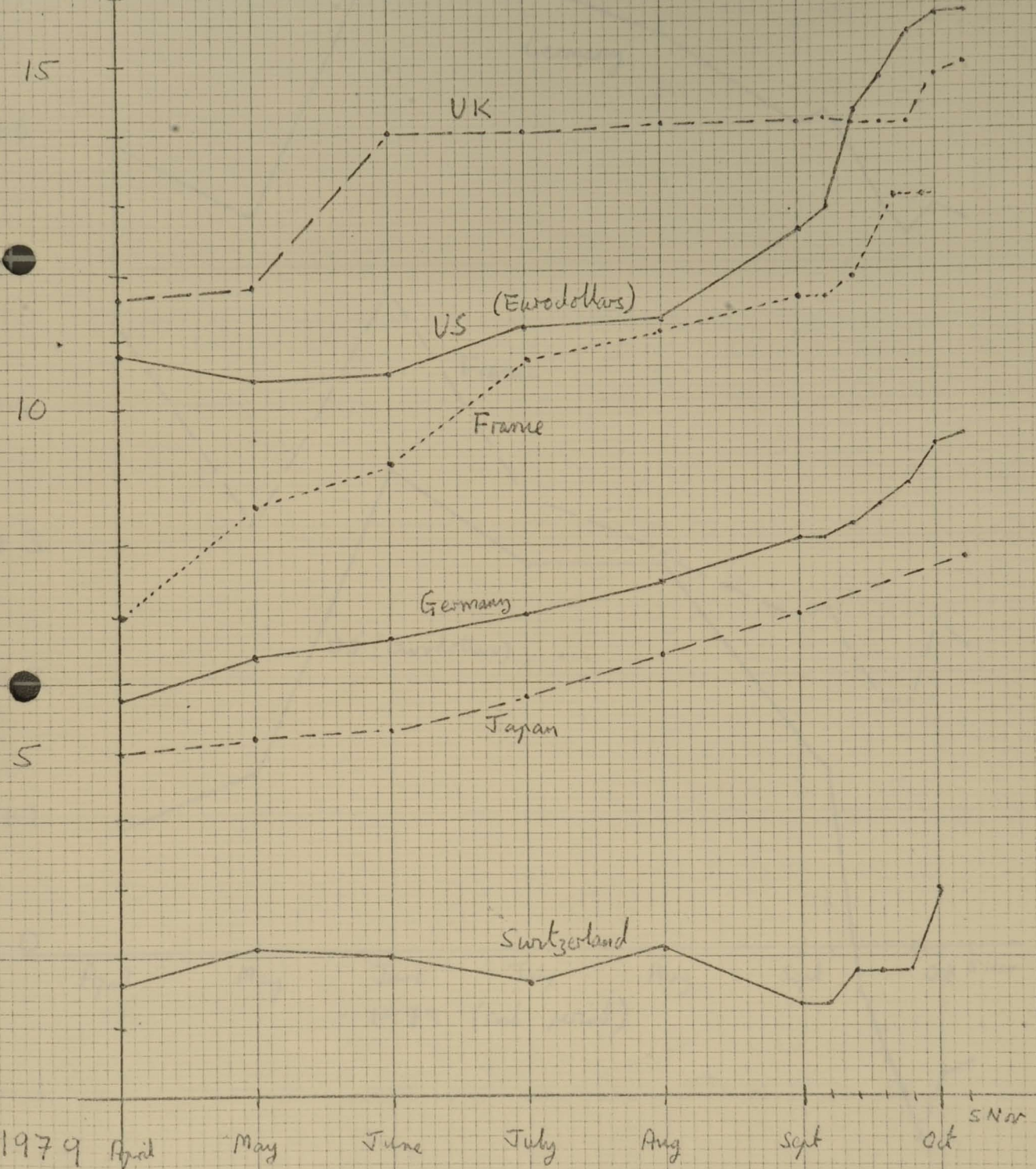


CHART II

THREE MONTH INTEREST RATES

(Source Morgan Guaranty & Bank of England)

% p.a.



1979 April May June July Aug Sept Oct S.N.M.

(end-period)



UNCOVERED 3 MONTH INTEREST DIFFERENTIALS

COMPARED WITH STERLING (+ in favor of sterling)

- against sterling

(Source: Morgan Guaranty & Bank of England)

% p.a.

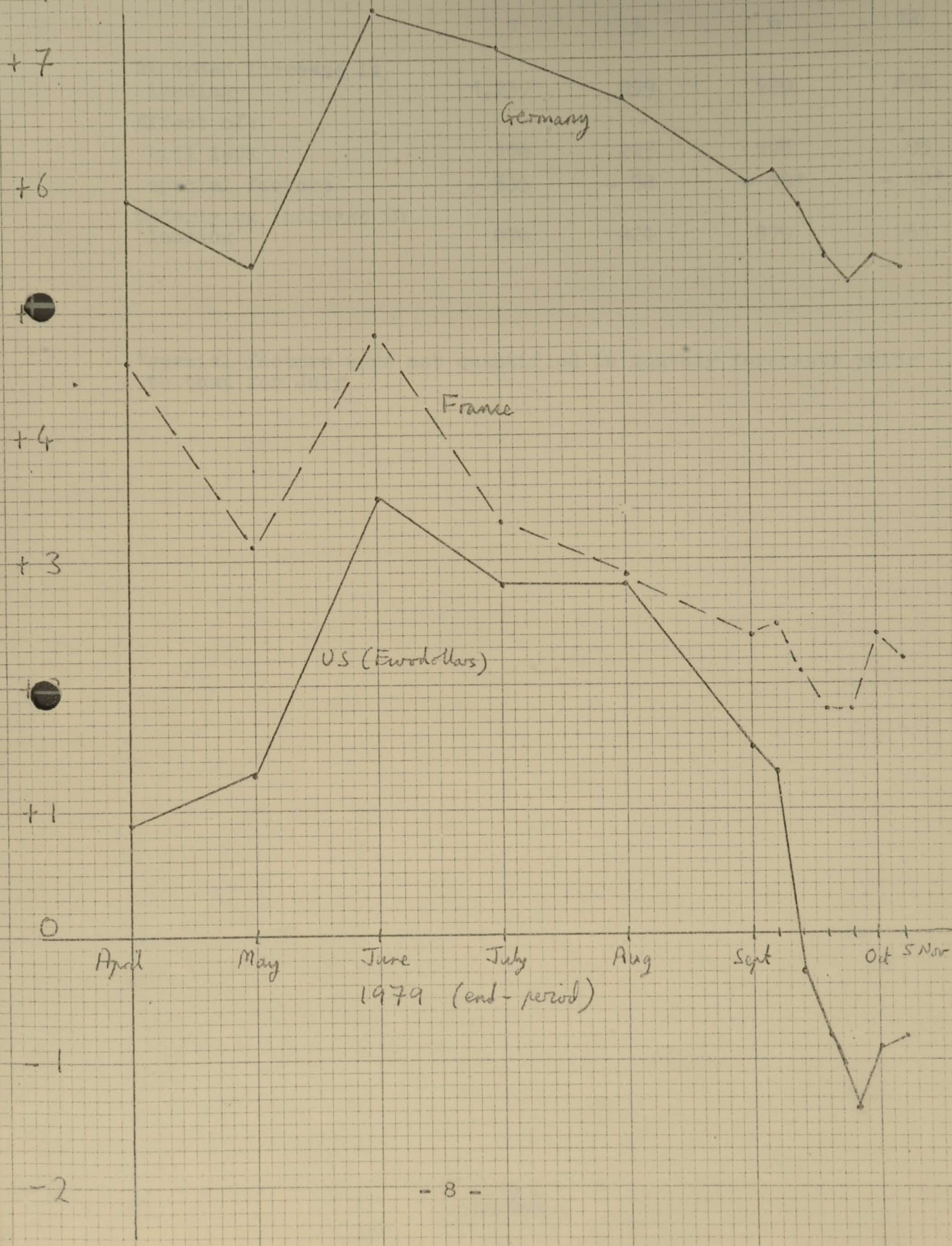




Table IV: Bank Lending: Recent History

monthly average increase (£m) months preceding October:	1	3	6	12
Recorded increase in lending	1,237	699	720	676
Effect of:				
bill leak	174	223	178	95
special factors	- 535	- 98	- 19*	- 10*
Underlying increase in lending	876	824	879	761

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