COVERING SECRET

Econ Pol. 2

Treasury Chambers, Parliament Street, SW1P 3AG
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12th September, 1979

Dear Tim,

THE MONETARY SITUATION

I enclose a note on the present domestic monetary situation as a basis for discussion of this when the Prime Minister sees the Chancellor tomorrow. The Chancellor has seen and approved it.

Yours ever,

MH

(M.A. HALL)
Private Secretary

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COVERING SECRET

DOMESTIC MONETARY PROSPECT AND BANK BORROWING

Note by the Treasury

General Prospect

Since the Monetary seminar in July, we have had figures for two more months - banking July and August, the latter to be published on Thursday.

2. £M3 grew by just under 1 per cent in both months - about the top of the target range. Because of monthly fluctuations two months is too short a period on which to base statements about the underlying trend. Looking backwards, in the financial year so far £M3 grew at about 14 per cent pa.

£ billion (seasonally adjusted)

	May/June	July/August
CGBR	2.10	1.07
less sales of cg debt outside banking system		
gilts	-1.70	-1.30
other	-0.27	+0.24
Bank and overseas lending to other public sector	-0.08	+0.32
Bank lending to private sector	+1.84	+1.06
In £ overseas	-0.01	+0.12
DCE	1.88	1.51
External (net)	-0.13	-0.46
Other adjustments	-0.42	-0.12
Change in £M3	+1.33	+0.93
Equivalent Annual Rate (%)	16.6%	11.0%

Memorandum

	May/June	July/August
Increase in acceptances held outside the banking system	+0.27	+0.45

3. In broad terms, bank lending to the private sector and overseas has continued to be at a much higher rate, and with an exceptionally high figure in banking June, than was allowed for over the year as a whole in the post-Budget forecast (referred to in the note for the Prime Minister's July seminar): £3.0 billion in 4 months compared with £7 billion for the year. But this has been significantly offset by higher gilt sales than this allowed for: £3.0 billion in 4 months, plus payments due on part-paid stocks of £0.6 billion, compared with just over £6 billion estimated for the year. For the rest, the lower growth of the money stock in the second two months compared with the first has been due to the monthly incidence of the CGBR, and other fluctuations, notably the contractionary effect of external items in banking August - there was little overall change in the reserves, but the deficit of the private sector, on capital and current account, with overseas was largely offset by an increase in non-resident bank deposits.

4. Looking forward, the Treasury and Bank's best guess is that the growth of the money supply in banking September will be about the same as in the preceding months, but that thanks to the central government actually being in surplus, money supply may fall in banking October, before growing again in November. The net effect may be to bring the rate of growth of the money supply over the first five months of the target period (i.e. mid-June to mid-November) to the middle of the target range. This assumes only a slight fall in the underlying rate of increase of bank lending to the private (there will be monthly fluctuations in the recorded figures due to the timing of tax payments and reliefs). But there are many other uncertainties: in particular

i. we cannot be certain about the effect of external factors - the high bank lending may have been due in part to a switch from foreign borrowing, and the external adjustment between DCE and M3 in August may have been unique, and could be reversed in part (the Bank and we are seeking to establish more clearly the factors underlying these external effects);

ii. although we do not need significant net gilt receipts until banking November, we are faced with another substantial maturity then and will need substantial sales to finance it. This could pose problems. Sentiment in the gilts market may be affected in the next two months by the fact that it will not be apparent to the market that the money supply is coming within the range until the October figures are published - first for the CGBR and then for the money supply. Sentiment could also be affected by industrial disputes, and by any high pay settlements.

Bank Lending to the Private Sector: Recent Trends

5. The monthly increase in bank lending in nominal terms started to accelerate towards the end of last year, from a level of £300-400 million a month to about £500 million a month: it rose sharply in February and since then has averaged nearly £1 billion a month - if banks acceptances held outside the banking system are included. These figures for the monthly changes conceal the fact that the acceleration had started somewhat earlier when looked at in real terms.

Changes in Lending Outstanding

	Year to mid-Feb 1978	Year to mid-Feb 1979	6 months to mid-August 1979 (Annual Rate)
1. £ bank lending to the private sector			
% increase in nominal terms	12.2%	18.1%	23.5%
% increase in "real" terms	1.1%	8.3%	2.2%
2. £ bank lending to the private sector, plus non-bank holdings of banks acceptances			
% increase in nominal terms	11.3%	19.6%	28.4%
% increase in "real" terms	0.3%	9.7%	6.3%
Memo item			
Increase in real GDP (at factor cost)	1.3%	1.6%	na

Thus there was little change in the real level of bank credit outstanding in the year to mid-February 1978, inspite of the sharp fall in interest rates. But there was an 8 per cent or 9 per cent increase in the following year, despite rising interest rates. Since February that real increase continued until it was offset by the sharp "once-for-all" increase in prices in the Budget: the level of lending may not yet have fully adjusted to that changes.

6. It is difficult to discern yet a downward trend, if the June figure is regarded as a "freak". Allowing for acceptances, and in the last two months very crudely for such exceptional factors, e.g. the Post Office strike and the incidence of tax payments, as we can identify, the sequence for the underlying growth is:-

	£bn
March	.8
April	.7
May	.75
June	1.4
July	.7
August	.95

The Recipients of Bank Lending

7. We have only partial information about the recipients of bank lending - and none about its purpose. The annex, which summarises the available information, shows that in the last eighteen months the rate of growth has been fairly evenly spread between sectors, the exception being the more rapid growth of lending to the services sector in 1978: the latter includes the financing of leasing to other sectors. In 1978 advances to persons grew about 13 per cent in real terms. In the last 6 months however the growth of personal lending (which includes lending through Access and Barclaycard) has been 17 per cent in money terms, some 7 per cent in real terms. (These figures are not seasonally adjusted and so should not be converted into annual rates.) However, personal sector lending is not a large element in the total - accounting for 17 per cent of the stock in mid-August.

Bank Lending: the Prospect

8. The increase in bank lending over the last 18 months has been much greater than we would have expected on the basis of past experience, especially given the increase in interest rates over that period. Clearing bank base rates were 6½ per cent in the first quarter of 1978 and are now 14 per cent. Past experience has suggested that the growth in lending outstanding is reasonably stably related to the growth in prices and real incomes, subject only to some time lags. The recent break with past experience makes it very difficult to predict when lending will turn down: in the early months of 1979 we thought that it might only be a temporary break due to factors such as the disruption following the road haulage dispute, but it has now persisted too long for such temporary factors to be the main cause.

9. There are a number of reasons to expect a turndown in the rate of increase in lending at some stage and possibly even a reversal:-

i. continuation of present rates of increase would involve the ratio of lending outstanding to nominal GDP to continue to rise. It would mean a rate of growth of lending outstanding some 10 per cent p.a. faster than the rate of growth of nominal GDP in the coming months, which is implausible since it has already been increasing faster for the last 18 months, the step change in nominal GDP due to VAT apart;

ii. interest rates should be progressively affecting the demand for lending: though they tend to take effect after a lag, base rates have now been over 12 per cent for nearly 10 months, and they should now be having an effect;

iii. similarly, attempts by the banks to restrict lending by tightening their criteria for granting facilities takes time to take effect. The clearers and some other banks have only been under pressure in relation to the SSD scheme or "corset" for a few months and they can generally only "ration" credit when new facilities are granted, or existing facilities renewed. The clearers have been tightening the criteria for personal and other low priority lending recently and this should begin to have an effect soon. (Banks can do little to influence the use of existing facilities, except encourage switching into acceptances.)

iv. some of the recent lending to persons may well have been in anticipation of the tax rebates which are due in November, and so may be repaid then.

10. On the other hand, there are two reasons for thinking that the turndown may not come quickly or sharply:

i. borrowers may not have adjusted fully yet to the step-change in prices following the Budget e.g. retailers to the higher rates of VAT on their stocks;

ii. the company sector will be facing cash flow problems, for example from the slow-down in activity leading to involuntary increases in stocks, the higher exchange rate reducing the sterling value of export receipts, and increases in pay before they are passed on in prices. These factors can be expected to add to some companies' demand for bank finance at least until they have been able to adjust to the lower level of activity and higher level of prices.

11. While therefore we are reasonably confident that the rate of growth of bank lending will fall eventually, we cannot be confident about the timing.

Conclusion

12. It is possible that the growth of £M3 in the first half of the target period from mid-June to mid-April next may be about in the middle of the target range, notwithstanding the growth in bank lending. The growth of the £M3 statistic will, however,

understate somewhat the changes in liquidity and credit because of disintermediation through banks acceptances held outside the banking system, and so overstate the potential effect of monetary policy on inflation.

13. There is no case at present for an increase in interest rates. But it is too soon to tell whether there will be scope for a reduction in either long or short term rates: while there is a reasonable chance that, thanks partly to the fluctuations in the CGBR, the rate of growth in the first 5 months after the Budget will be about the middle of the target range, we do not yet know whether that will continue. We may be in a better position to judge in mid-October by when:-

i. we will have the forecasters reassessment of the prospect for the rest of the financial year;

ii. in particular, we will have the reassessment of the PSBR for the rest of this year, taking account of any decisions on disposals;

iii. in particular we will know whether the expected central government surplus in banking October has occurred;

iv. we may have a somewhat better understanding of what has been happening on the external side, and what may result from the relaxations of exchange control;

v. we will know the gilt-edged markets reaction to the continuing relatively high money supply figures;

vi. we will have one months further bank lending figures.