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SECRET 30.7.79

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THE GOVERNOR
VIA THE CHIEF CASHIER

Copies to Mr.McMahon o/r
Mr.Dow
Mr.Walker o/r
Mr.Payton
Mr.M.J.Balfour
Mr.George
Mr.Green
Mr.Foot o/r

rec'd 31/7
Top passed to Gov 31/7 am
C. retained by CC
Gov's mtg arranged for 2.30 31/7

CC

This was dictated in rather a hurry. A further version with some drafting tidying-up, but with the substance unchanged, will be on its way to you (& others) later this evening, for you to cover it with such comments as you wish before passing on to the Governor

SOME REFLECTIONS ON MONETARY DEVELOPMENTS

In recent speeches the Prime Minister, and other members of the Government, have claimed that interest rates would have to remain high until the rate of growth of the money supply and of bank lending diminished and came into line with the projected target for the rest of this year. This stance, indeed, had been argued by the Bank earlier. On the basis of the preliminary figures for banking July that we now have, and the forecasts for the next two months, such as they are, it would be difficult to justify a claim that these objectives had been achieved, so that high interest rates could be seen to have achieved this objective. As reported in the note (attached) setting out the first guess on the monetary aggregates in banking July, the outturn of 1% was well above the forecast, which had been for a much smaller increase of 0.2%. This leaves the annualised rates of growth of £M3 - at about 13-14% - above the relevant target rates, even without taking into consideration distortions involved through the bill leak.

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Bank lending was, thankfully, considerably lower than in recent months, with lending to the private sector now put at around £350 mn. Nevertheless the forecast had noted a number of special transitory effects (particularly the temporary increase in company liquidity as the higher VAT rates are initially collected) which were expected to depress bank lending in July by about £200/£250 mn. below the 'underlying' rate. So the growth in bank lending of about £350 mn. in July ought, perhaps, to be thought of as an 'underlying' £550 mn. In any case this is but a single month's figures, with all the qualifications that flow from that. Moreover, unadjusted, the bank lending figures remained extremely high, with a seasonal factor of over £700 mn. In view of 'corset' pressures, which bear on the unadjusted figures and which might, therefore, have made the banks rather more cautious in extending loans, this is not inconsistent with a continuing high 'underlying' rate of growth of bank lending.

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Certainly there would be no way in which one could now claim that the trend in bank lending could be described as falling.

Indeed, the Bank forecasters would tend, as yet, not to wish to change their forecast for the future rate of growth of such lending in the next two months. I attach a further table setting out the short-term monetary forecasts made on 10th July and a revised set of forecasts for banking August and banking September made today. These latter are pessimistic, in that they assume no further sales of gilts until the end of banking September (an extremely pessimistic assumption) and also leave their bank lending forecast unchanged, despite the somewhat lower July outcome. If this pessimistic forecast was to come true, then there would be by the end of banking September a significant acceleration in monetary growth to a rate of some 16% or 17% which would, on present policies, require some kind of further action to offset. The forecasters have, however, considered a more optimistic variant with bank lending rather lower in banking August (at £500 mn.) and with all of the remainder of the long tap sold (though with £200 mn. of that going to overseas residents). This more optimistic variant would reduce the £M3 figures in August by £200 mn. and in September by £700 mn., leaving the banking August figure at about ½% and the banking September figure at 1¼%. Even so the annual rate of growth at the end of banking September, on these more optimistic figures, would be at a rate of about 11½% from the end of banking June (the current monetary target period) and at a rate of 13% as from banking April. On either basis, therefore, the more optimistic forecast variant still leaves the rate of monetary growth outside the monetary target.

Against this background as it currently seems, it would be difficult to give a justification to a cut in MLR on domestic monetary grounds. However, there are some arguments, even on domestic monetary grounds that one might try to deploy if it was decided, essentially on external grounds, to go down that route. First, the main reason why the forecasts, at least in the more pessimistic variant, now show a faster monetary growth for the three months banking July to banking September than in the forecast of 10th July is because the extent of monetary expansion arising from intervention and flows over the exchanges has been increased. It could be argued that the more the source of monetary expansion arises from external inflows, the less sensible does it become to seek to offset such monetary growth by maintaining high interest rates. Second, of course, it can always be

said, and with some considerable validity, that the likely difference on financial behaviour, in particular on the demand for bank loans of a reduction of MLR by 1% from 14% to 13%, is likely to be minimal.

It is abundantly clear that the present conjuncture contains an acute conflict between preferred external objectives of a somewhat lower and more stable exchange rate, and domestic monetary objectives. One solution, which at any rate would be clear cut, would be to announce plainly that the balance of priorities and objectives had changed and that, at any rate for the time being, their main objective would be to stabilise the exchange rate, and that while this objective had priority, monetary growth might have to be allowed to exceed the target. I assume, however, that the Bank would not be willing, and I myself would not support, such a move yet. The question then arises what steps can be taken to ameliorate the upwards pressure on the exchange rate without appearing to relax domestic monetary control. This is ground that we have already discussed.

In the light of these monetary figures it would, I think, be difficult to argue that we were not, in fact, relaxing prematurely before the monetary objectives had been achieved (see, for example, Sam Brittain's Lombard column of today). Moreover, currently, market trends are rather for an increase in interest rates than a decline.

Furthermore, we will shortly have to decide how to proceed with the second, larger, planned recall of Special Deposits, of 1% on 10th August. If there should be simultaneously a reduction in MLR and a further postponement of this Special Deposit recall, it would seem likely to signal to outsiders a reduction in the authorities' commitment to the achievement of the planned monetary targets. Indeed, if, largely on external grounds, it was thought appropriate to reduce MLR in the near future, I myself would argue strongly, though in advance of yet seeing detailed figures of the banks' reserve asset and Ibels figures, that the Special Deposit recall should go ahead as planned. There just might be a case for lowering MLR while at the same time tightening up further on the corset. This would be consciously putting more pressure on direct controls rather than on market interest rates. On general analytical and philosophical grounds, JSFf and most others in the Bank have argued against going down this route

medium term would almost seem bound to fail. In the short term, and at this difficult juncture, it might just help to enable MLR to be

brought down without damaging the stance of monetary policy too far. On the other hand, the additional pressure on the 'corset' would force up market interest rates and this would be likely to cause a distorted pattern of short-term interest rates; but such a pattern of higher bank lending rates and commercial bill rates, possibly considerably in excess of MLR, but with lower deposit rates, might even help marginally to resolve the external/internal dilemma.

The above is not a policy prescription which I would want to put forward positively. Rather it emerges from my worry that if MLR should be brought down against the background of these monetary figures one would have to envisage using all possible other endeavours to prevent it being the case, and seen to be the case, that monetary policy was relaxed before its objectives were achieved.

30th July 1979.

C.A.E.Goodhart

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Discussed at Gov's mtg 31.7.79 with CAEG EAJG MDKWF

30.7.79

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Top copy passed to Governor's annotated "No case for a reduction in MLR in my opinion." (Init.) JBP 31/7

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