M.P

SECRET & PERSONAL

7.11.79

THE CHIEF CASHIER

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

68 72

THE FINANCIAL PROSPECTS

As indicated in my last note of 6.11.79, I have now received Middleton's draft paper on the financial prospects. I attach a copy of this. His redrafting follows closely the lines agreed at the meeting yesterday morning, and I am content with it, and that it should go forward as a joint Bank/Treasury assessment.

If he is to make any changes, Middleton would need to receive drafting comments early this morning. If you do wish to pass comments on to Middleton, I should be grateful if you would also let me know what they are.

CAEG

7th November 1979.

C.A.E.Goodhart

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.

<u>The Present Target</u>

2. The Government's announced target for the growth in the stock of £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 £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 4 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.

<u>Prospects for the Remainder of the Financial Year</u>

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 guaged 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 £9¼ bn compared with the estimate of £8¼ 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

Monthly Averages
£ m

	OUTTURN	FORECAST	
		Corset On	Corset Off
	JUNE-OCT	OCT-JAN	OCT-JAN
CGBR	900	450	450
CG Debt Sales (-)	- 500	- 50	- 100
Other Public Sector	- 50	- 50	- 50
Bank Lending	650	650	1000
DCE	1000	1000	1300
Externals	- 350	-400	- 400
Other	- 50	-100	- 100
£M3	600	500	800
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] (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 degreee 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.

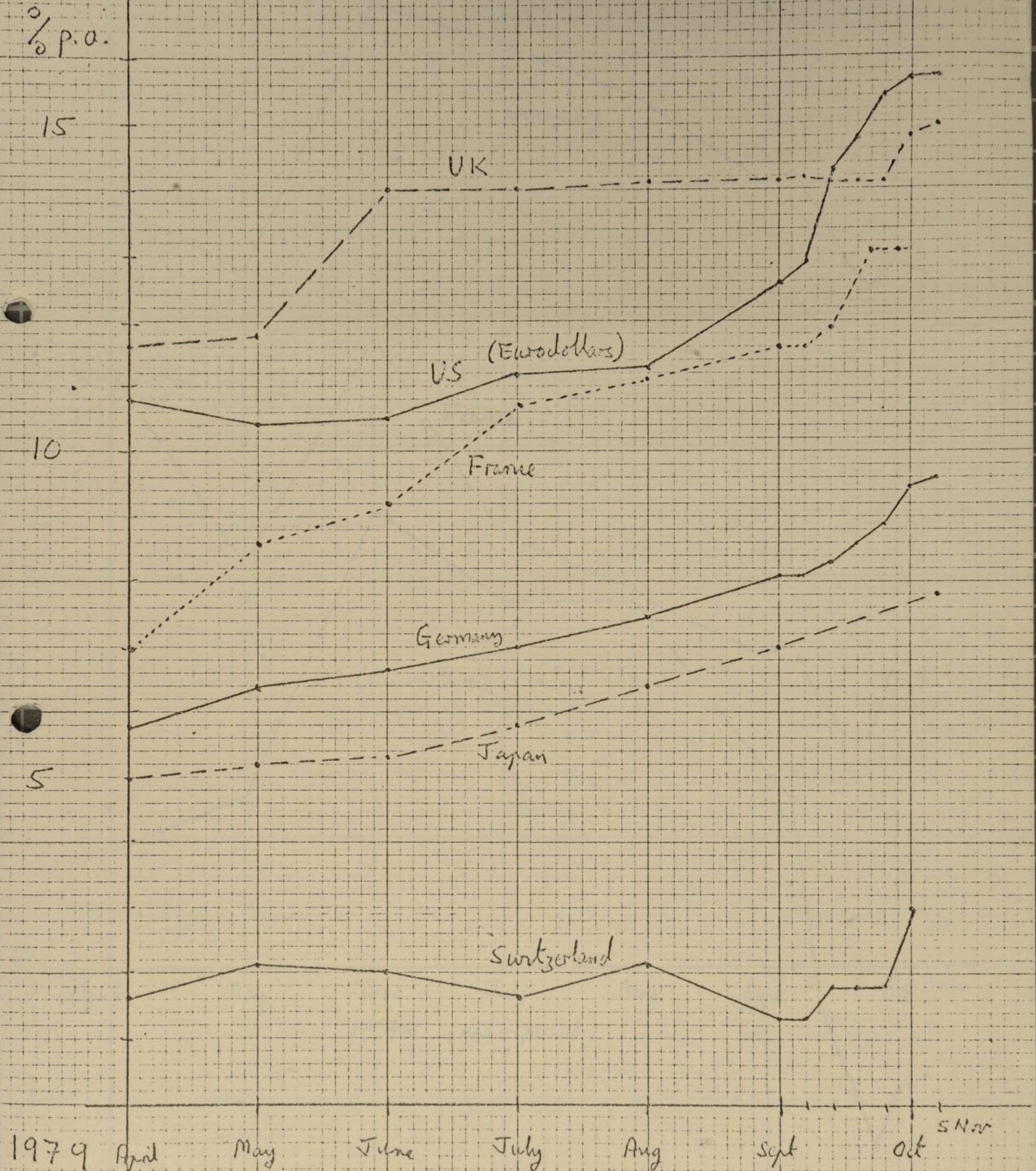
12. These judgements are all subject to large margins of error; in particular the recession may produce much lower bank lending than we have suggested. Some commentators have suggested this, though none of them are confident about the timing. On the other hand, if it becomes the view that the PSBR over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

6.11.79

CHART II

THREE MONTH INTEREST RATES

(Source Morgan Guaranty & Bank of England)



(end-period)

CHART III

UNCOVERED 3 MONTH INTEREST DIFFERENTIALS

COMPARED WITH STERLING (+ in favour of sterling, − against sterling)

(Source Morgan Guaranty & Bank of England)

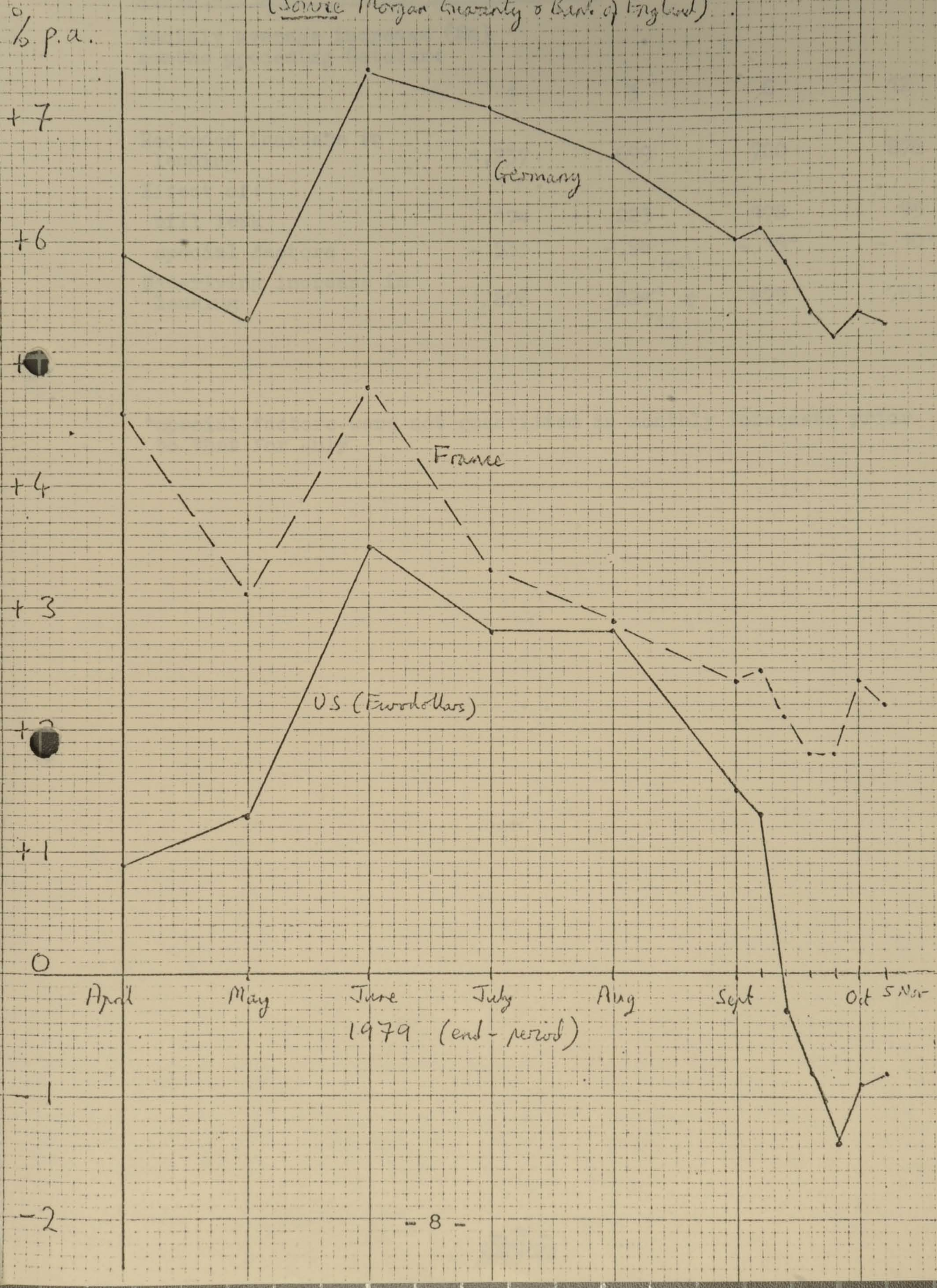


Table IV: Bank Lending: Recent History

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~~ 140	- 19*	- 10*
Underlying increase in lending	876	~~824~~ 782	879	761

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

7.11.79

72

SECRET

71 74

Mr Littler

copies attached for:

Chancellor of the Exchequer
Financial Secretary
Chief Secretary
Sir Douglas Wass
Sir Lawrence Airey
Sir Fred Atkinson
Sir Kenneth Couzens

PS/Governor (B/Eng)

cc Mr Barratt
Mr Hancock
Mr Bridgeman
Mr Unwin
Mrs Gilmore
Mr Riley
Mr Ridley

Mr Fforde)
Chief Cashier) B/Eng
Mr Goodhart)

MONETARY POLICY

The attached note on the prospect, which has been agreed with the Bank, should be read alongside Mr Bridgeman's submission of today's date.

E. K. Clarke

pp P E MIDDLETON
7 November 1979

Enc

SECRET

THE MONETARY PROSPECT

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

The Present Target

2. . The Government's announced target for the growth in the stock of £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 £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 million a month. (See Table IV 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, were disappointed with the Public Expenditure White Paper. There is no longer any expectation of an early fall in interest rates.

Factors Affecting the Prospect 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. The PSBR. When discussing the short term forecasts with Ministers we said 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 £9¼ bn compared with the estimate of £8.3 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 the end of the year, which is at the optimistic end of the range of possibilities. The PSBR is however 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.

b. Bank Lending may be expected to abate in due course, not least because of the recession we forecast. But there are no signs of this yet and the timing of any reduction is very difficult to predict. Indeed, in the initial stages of the recession there could be upward pressure on lending.

c. 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 guaged 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.

d. Exchange Control Relaxation. In the various submissions preceding the decision to relax exchange controls we pointed out that interest rates might need to rise to keep monetary growth within the target range. UK interest rates are no longer insulated as they were to some extent in the past from the movements in international rates referred to above.

e. 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; it has also concentrated attention on the disintermediation which has already taken place.

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. To others however 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.

5. Interest rates in the market have already moved upwards; they are currently over 13½% at the long end and over 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.

The Next Three Months

6. We have looked in detail at the prospects for the next three 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

Monthly Averages £m

	OUTTURN	FORECAST Corset On	FORECAST Corset Off
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£M3	600	500	800
Percentage increase in £M3 since mid-June (at annual rate)	14%	13%	17%
£M3 adjusted roughly for disintermediation	19%	17%	17%

7. The main points are:

a. The CGBR comes down, as VAT receipts increase. The assumption is that the current VAT shortfall is entirely recouped during this period - and this could 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 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.

The Remainder of the Present Financial Year

8. 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 once 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.

9. It is of course still possible to imagine more favourable circumstances - especially if the PSBR does fall rapidly and tighten up monetary conditions or if bank lending falls sharply or if external markets remain buoyant because of fears of further changes in the world oil price - in which the current level of interest rates is satisfactory or even too high. But the balance of risks points in the other direction though 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.

10. Interest rate changes do however 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.

The Prospect for 1980-81

11. 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.

12. 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 losser 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.

13. 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.

P E MIDDLETON
7 November 1979

CHART II

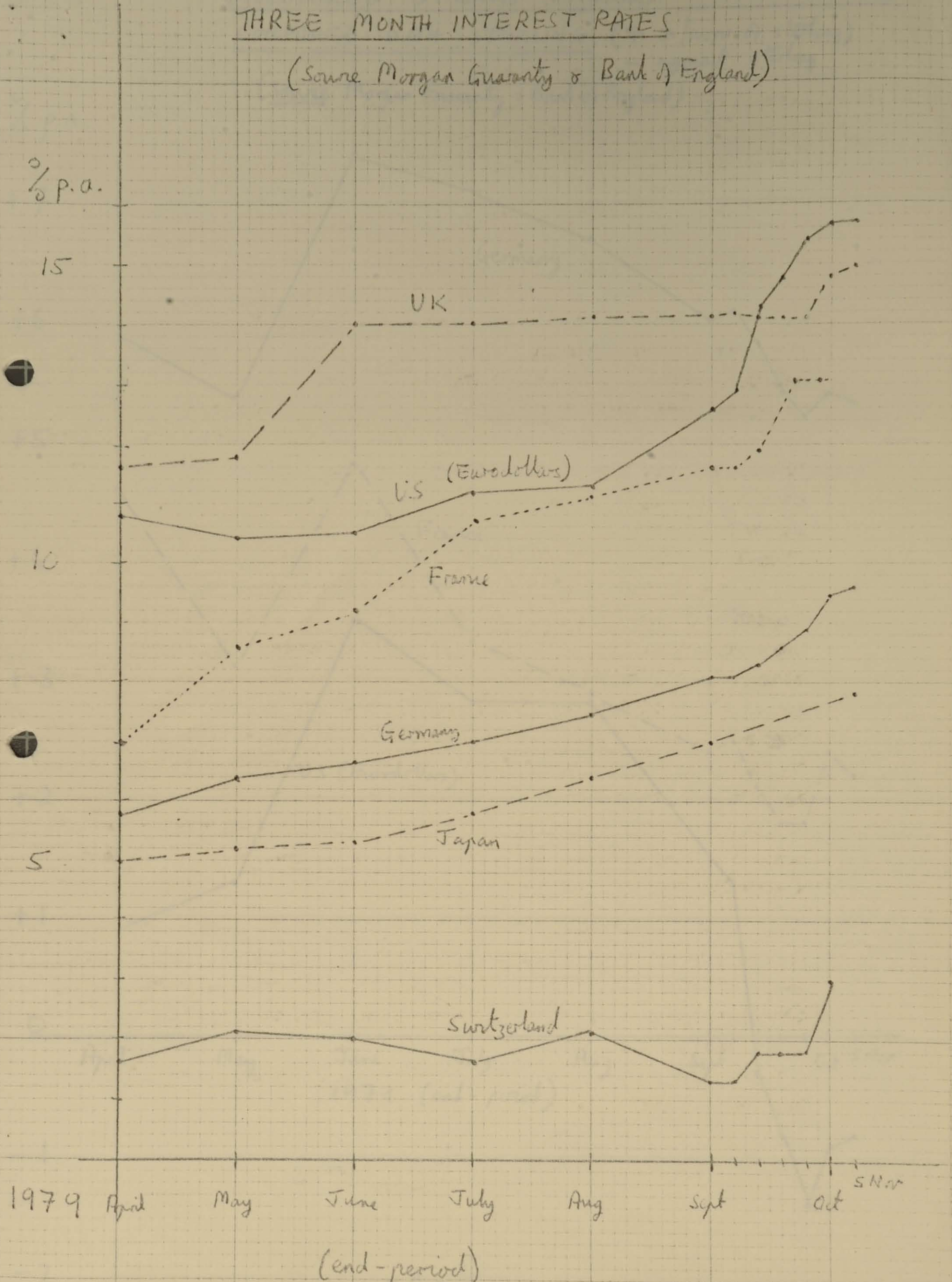
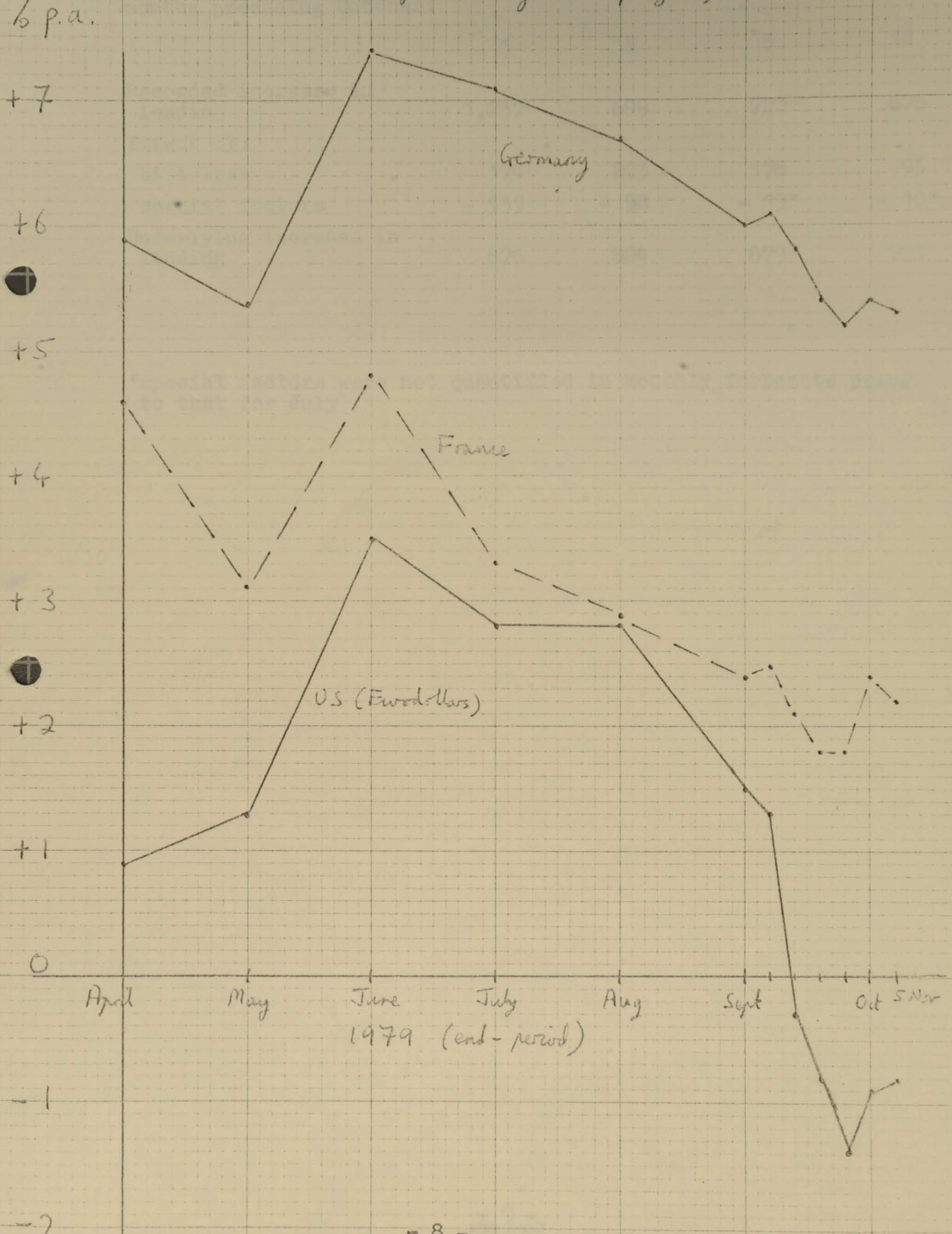

THREE MONTH INTEREST RATES
(Source Morgan Guaranty & Bank of England)
% p.a.
15
10
5
UK
U.S (Eurodollars)
France
Germany
Japan
Switzerland
1979 April
May
June
July
Aug
Sept
Oct
5 Nov
(end-period)

CHART III

UNCOVERED 3 MONTH INTEREST DIFFERENTIALS

COMPARED WITH STERLING (+ in favour of sterling) − against sterling

(Source Morgan Guaranty & Bank of England).



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