9.11.79

SECRET

THE GOVERNORS

Copies to: Mr. McMahon
Mr. Dow
The Chief Cashier
Mr. Goodhart

GR 9/11.

THE MONETARY PROBLEM (TODAY'S MEETING AT NO.10)

1. This note is dictated following yesterday's meeting of the Monetary Review Committee and therefore benefits from a cooler look at the situation than I have been able to take hitherto.

2. The public sector. The incidence of VAT payments, tax rebates, and very large but erratic on-lending by the central government to the rest of the public sector makes it very difficult to understand what is going on with regard to the public sector as a whole. But two broad conclusions can be drawn from what has been happening and what looks like happening over the next few months. Firstly, and despite the forecasting error in October, the PSBR does seem to be falling well below the levels prevailing earlier in the year. Secondly, we have not over the past two months succeeded in financing the PSBR wholly outside the banking system, as we need to do. We failed in September because of the exceptionally high borrowing requirement of that month and we failed in October because of the forecasting error. We will continue to fail unless we can resume sales of gilt-edged. As a broad order of magnitude, these sales need to reach some 500 net a month over November to January if full non-bank financing of the PSBR is to be achieved. This is not a formidable task in itself and represents a lower level of sales than was required earlier in the year. But it does require a consolidation of the gilt market.

3. The level of bank lending in October was erratically high, for broadly the same set of reasons (though operating in reverse) as September was erratically low (as we said at the time). But whereas we had reasons for hoping in September that the underlying demand for credit for domestic purposes had fallen back within a range of 500 - 700 per month, it is now prudent to judge that this demand may still be as high as 800. Evidence so far from weekly figures in banking November do not discourage such prudence - although the recorded figure for November may end up some way below 800.

So far as can be gathered from the confidential clearing bank analysis, the pattern of lending in October was not very different from September, allowing for some rebound in advances to the engineering industry. Clearing bank lending to persons, other than for house purchase, continued at quite a high level but a good deal lower than earlier in the summer.

The <u>total</u> demand for bank loans continued to be inflated, in our view, by private sector external outflows associated with the relaxations of exchange control.

CAEG's note draws attention to some underlying reasons why the level of bank lending has not subsided as much as or as soon as had been hoped. These reasons will support arguments for a further increase in interest rates.

4. The private sector external outflow remains high, and evidence for the first two weeks of November confirms this. It is expected to continue. Until recently it was financed by short-term inflows into the public and banking sectors. But in the last two weeks it seems to have been financed more through the reserves. With the rise in interest rates overseas, and with the growing public knowledge of our external financing situation which the sequence of monthly statistics will provide, the fragility of the external situation looks like becoming increasingly apparent, even though propped up from time to time by the antics of OPEC. This again supports the case for an increase in UK short-term rates.

5. If we can resume sales in gilt-edged on the required scale and at the same time avert a deterioration on the external side, the rate of monetary expansion should fall away very significantly. But the banks, in endeavouring to meet the continuing demand for credit, will come under increasing reserve asset pressure. This in turn will keep money market rates and bank lending rates high and, with or without the corset, will tend to encourage the maintenance of disintermediation in various forms.

6. It would of course be possible to try to meet the situation by a drastic tightening of direct controls while endeavouring to hold MLR at 14%. We could, for example, bring acceptances within the corset control; or we could abandon the corset and revert to lending ceilings of the kind used in the 1960's. This would provoke a whole new set of unmonitored avoidances on an unknown scale, the more so now we do not have exchange control. It is difficult to imagine

that 'control of the money supply' by these means would either carry conviction in markets or impose the kind of discipline in the private sector, and revisions of inflationary expectations, which a properly firm monetary policy is designed to do.

9th November 1979