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PRIME MINISTER

MONETARY POLICY

Following our meeting last Friday and my minute to you of 9 November I have been discussing further with the Governor and with officials the proposals I shall need to announce tomorrow in the light of the latest monetary and other developments.

2. We are faced with an exceedingly difficult situation. It is widely known that the PSBR for this year is out of line (and, even if we were to volunteer nothing further on this ourselves tomorrow, it will be apparent from the PSBR figures for the first 6 months due to be published next week); market rates have already moved upward in anticipation of a significant increase in MLR; and the publication of a revised (and very tight) monetary target for the next 12 months is bound to create strong adverse expectations about interest rates. This is especially true if it becomes thought - as it is already in some quarters - that the corset is a piece of self delusion on the part of the authorities.

3. If we are to hold confidence and create the atmosphere in which there is a reasonable prospect of achieving the large gilt sales that are needed quickly (£1.5 to £2 billion over the next 3 months), we must announce proposals that do not disappoint market expectations. This entails - as you have recognised - an increase, unwelcome though it is, in interest rates. But it is also essential, as I think we are both agreed, to be seen to be taking action to correct the overshoot in this year's PSBR that is now apparent. To a substantial degree the overshoot is due to adventitious factors (notably the Post Office strike and delayed VAT payments) which can and will be explained. But - particularly given the other bad news that the markets will have to absorb, such as today's trade figures - I do not believe explanation alone is enough and that we need to supplement an increase in MLR with specific fiscal action.

4. This is easier said than done and the range of choice is a narrow one. It is too late to make any significant changes in public expenditure this year; and, although I have gone into this in detail with Customs and Excise, I do not think we can announce any steps to

accelerate VAT payments which would not risk being counterproductive (most of the big firms pay promptly already; and there would have to be a de minimis limit that would exclude most of the little ones).

5. The only major proposal that I consider feasible is an advancement of PRT receipts by 2 months into 1979-80. This would require immediate legislation (a short Bill) and would yield an extra £700 million or so this year and around a further £300 million next year. Although in one sense an accounting transaction it would nevertheless bring forward a stream of payments with continuous benefit to the PSBR for some years to come and would, I believe, be the only effective response to the PSBR problems now facing us.

6. In view of the instability of the world oil situation it would not in itself be an attractive proposal. There could be accusations of bad faith and perhaps even law suits in relation to the BP issue, although this would depend on what happens to the BP share price (BP will pay about two-thirds of the £700m on top of their share of the BNOC forward oil sales). Any row that might ensue could to some extent offset the beneficial effects of our overall proposals. But I am satisfied that there is no viable fiscal alternative; and I am convinced that without the inclusion of a measure of this magnitude there is a serious risk that the statement will prove inadequate and that we should be faced with the prospect of even higher interest rates and a further deterioration in the prospects for gilt sales and confidence in the Government generally. The fact is that a new situation has arisen since the BP issue and the action we must unavoidably take is one answer to any criticisms of the kind referred to above.

7. I also propose to announce three National Savings measures designed to produce a net inflow of some £700m in the present financial year. This will produce a valuable contribution to funding the PSBR at a slightly lower average interest rate and help to reassure the gilts market. The additional funding of the PSBR will come at a time when the gilts market may be very uncertain. In the judgement of the Governor and myself this addition will significantly increase the chance of the package succeeding. However, much of the inflow (perhaps a half) would be at the expense of the building societies and consequently at the expense of mortgage lending early next year.

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Their immediate reaction might be to slash any new mortgage commitments for the period February to April. It could also bring forward the date of a further mortgage rate increase. But the alternative is running a greater risk that the general level of interest rates will have to increase even further.

8. I propose, therefore, that my statement tomorrow should in addition to the MLR change which the Bank will have announced at 12.30 pm, include:-

(i) The PRT advancement described above;

(ii) a roll-forward of the £M3 target at the present 7-11% target range for the 16 months from mid-June to mid-October 1980 (thus avoiding any "base drift" arising from the excessive rate of growth in recent months);

(iii) extension of the "corset" at the present rate for a further 6 months, although announcing that it will be phased out in due course and that there will be early consultations on monetary base control;

(iv) The National Savings measures referred to above.

9. I attach a draft of the statement I have in mind. As you will see I have left open the crucial figure for the MLR increase. I fear that the movement in market rates has been such that 16% would no longer be sufficient. But I think we must leave this open until tomorrow morning. It would be fatal to undershoot; but I shall be reviewing the position with the Governor and with officials further this afternoon before I see you.

10. I thought it would be helpful to set out my conclusions, and to let you see a draft of my statement, before our discussion this afternoon. Among other things I should like to take your view on how we might present the proposals to our colleagues at Cabinet tomorrow morning when final decisions will have had to be taken.

G. H.

Geoffrey Howe
14 November 1979

DRAFT STATEMENT.

Mr Speaker with the permission of the House I would like to make a statement on monetary policy.

The figures for banking October, published earlier this afternoon, show that £M3 grew by £1,080 million, or 2% in that month. The rate of growth over the 4 months since mid-June, the beginning of the present target period, has therefore been equivalent to just over 14%. Although a number of factors point to the figure for banking October being erratically high, just as that for the previous month was erratically low, it is clear that the underlying growth of £M3 is still significantly above the top of the target range which I set, namely 7-11% per annum for the 10 months from mid-June 1979 to mid-June 1980.

£9m
INCL
RUDD: £100m
DISPOSALS £100m
£9m

U.S. BANKS ABROAD
TOTAL: $3-6BN
UK $2BN

$200m - LONG TAP '89
£350m
2007/2003: £1BN 13 3/4

EARNINGS GROWTH
IND. ACTION
L.A./N.I. SPENDING

The excess has been largely due to the sustained rapid growth of bank lending and the high PSBR in the first half of the year.

AR/LA/GR
CON: PRO
PM/MB/NL -17%

It had always been expected that the PSBR would be higher in the first half of the year than the second, because many of the effects of the Budget - notably the receipts from the higher rate of VAT, and reductions in public expenditure, would mainly affect the second half. But the PSBR was further increased in the first half year by the effects of industrial action, notably on telephone bills and VAT collection. The greater part of This shortfall will be made good in the second half year. But the best estimate which can now be made for the PSBR for the year as a whole is that it would be £9¼ billion, if no action were taken. This compares with the estimate of £8¼ billion at the time of the Budget. The Public Sector Borrowing Requirement

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will be significantly lower in the second half of the financial year not only because of the factors originally envisaged but because of the partial recovery of the receipts in the first half year. Thus monetary conditions will be tighter on this account in the second half than in the first.

The other main factor contributing to the high rate of monetary growth has been the growth of bank lending to the private sector. This has fluctuated markedly from month to month but over the last 3 months has averaged about £700 millio a month. This level can be expected to fall in due course from the changes in interest rates earlier in the year [and with the decline in the level of economic activity], although its timing is difficult to predict.

Some of the causes of the recent high rate of growth of the money supply are essentially matters of timing; and there are good reasons to expect it to decline somewhat in the future. But the

~~While there are good reasons to expect that the rate of growth of the money supply will decline somewhat in the future, the~~ Government consider that it is necessary to take action now in order to bring the growth of the money supply back within the target range. Accordingly, we will be seeking to reduce the PSBR by bringing forward by [2] months (in place of the present 4) the due date for payment of petroleum revenue tax. The Bill to achieve this will be introduced shortly. This change will yield £700 million this year, and a further £300 million next. Next year's PSBR will also benefit from some £400 million of telephone bills not collected this year.

Take in new paragraphs at end

The Bank of England announced this morning, with my approval, that Minimum Lending Rate would be increased to [17%]. This both confirms the recent rise in market interest rates which have been generated by reactions both to the domestic monetary situation, and to the general rise in interest rates in other countries, notably the United States and shows the Government's determination to act in the way which my r.h.f. the Prime Minister foreshadowed on Monday.

In addition to operations in the markets, we will be taking steps to secure a further funding of the PSBR through National Savings. The limit on holdings of the National Savings Certificates Retirement Issue - the Granny Bonds - will be increased next month from £700 to £1,200. A new ordinary National Savings Certificate will be introduced early next year The Interest Rate on National Savings Bank Investment Account will be raised to 14½% from 1 January next.

The Government have been reviewing the methods which are available to the authorities for controlling the growth of the money supply. The main methods must continue to be the policies on public expenditure and tax, which together determine both the size and the composition of the PSBR, and interest rate policies, both at the short end and in the gilts market. However, successive governments have supported these methods by some more direct method of control of the banking system such as the ceilings on lending used in the 1960s or the supplementary special deposits scheme, usually referred to as the corset, which has been applied at various times since December 1973. The efficacy of the SSD scheme has diminished

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over time with the development of alternative channels of liquidity and credit outside the control, and it has nearly outlived its usefulness.

It would be inappropriate in present circumstances to dismantle the scheme completely. I have therefore agreed with The Governor that the scheme should be phased out over a period rather than brought to an abrupt end: the Bank of England announced, with my approval, this morning the basis on which it would be extended for a further 6 months.

It is possible that other techniques of control, possibly one of the variants of monetary base control, might have a useful role to play in the future, without having the disadvantages of the SSD scheme. The Bank and Treasury will accordingly shortly be starting technical consultations on the basis of a discussion paper with those most concerned to establish whether such a scheme is technically feasible, and whether it would have the desired effects of either smoothing the growth of the money supply, or of bringing about more readily the interest rate changes which may be necessary for monetary control. But I must stress to the House that any such scheme of monetary base control is not a substitute for the appropriate fiscal policy and interest rates: indeed one of the possible advantages is that they improve the response of interest rates to changes in monetary conditions.

Finally I intend to extend by 6 months, to mid-October next year, the period for which the present target range of 7-11%

per annum for the rate of growth of £M3. That target at present applies to the 10 months from mid-June to mid-April next, and it will now apply to the 16 months from mid-June to mid-October. I am extending it in this way, because to adopt the more normal procedure of setting the target for the 12 months from mid-October this year to mid-October next year would involve building into the new target the excess growth of the money supply in the recent past. It would be totally at variance with this Government's philosophy of controlling the money supply to allow that, and to do what the experts call "base drift". Instead, we are allowing a reasonable period over which we can offset the more rapid growth which has already taken place.

Mr Speaker, this Government is committed to bringing the money supply under control, and thereafter to reduce progressively the rate of monetary growth over the years. The measures which I have announced today show that we are ready to take the action which appears necessary to achieve that objective.

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[Additional paragraphs for insertion on page 2.]

~~ANNOUNCEMENT~~

I am not satisfied that the present arrangements for collecting petroleum revenue tax are entirely satisfactory as regards the speed with which this tax, as distinct from royalties, reaches the Exchequer. This is not a criticism of the oil industry but, rather, of the tax collection rules themselves in the Oil Taxation Act 1975. The House will appreciate that very large sums are involved and that we must ensure that PRT reaches the Exchequer with the minimum delay consistent with collection arrangements that are workable in practice. I therefore intend to bring before the House a short Bill, before the recess, containing the Government's proposals for changing the present PRT collection rules.

Further details are given in a Press Notice being issued by the Board of Inland Revenue.