Covering S E C R E T

Econ Pol 1 ...

Prime Minister
Even allowing for the reintermediation, this is very worrying.

Treasury Chambers, Parliament Street, SW1P 3AG
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1 August 1980

TL 1/8

T.P. Lankester, Esq.,
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Dear Tim,

MONETARY SITUATION

When the Chancellor spoke to the Prime Minister yesterday morning, he promised her a note on the current monetary situation for her weekend box. This is attached.

Yours

John

A.J. WIGGINS

I am a little worried about the last sentence of the draft release to News Agencies etc.

Treasury have changed it - made it less bland

TL.

7

S E C R E T

JULY MONEY SUPPLY FIGURES

The preliminary analysis of the monthly returns for banking July show that £M3 grew by £2.9 billion (5.0%). An indication of this figure will be given by the Bank to news agencies, in the normal way, at the same time as the publication of the Eligible Liability figures at 2.30pm on Tuesday, 5 August. The full figures, together with the analysis of counterparts, will be published on Thursday, 14 August.

2. The Annex to this note sets out the main counterparts of this growth, as currently estimated, and compares them with the average of the last four months, as well as setting out the cumulative position in the first five months of the current target period. The figure of the growth of the money supply could change slightly - by perhaps up to ¼% - before the final figure is published on Thursday week: the figures for counterparts could change by more as the analysis of the returns is completed.

3. As the following paragraphs on particular elements bring out, the very high figure for banking July is due to some combination of:-

i. reintermediation, that is bringing back onto banks' balance sheets business which was diverted during the operation of the SSD scheme, without actually affecting underlying monetary conditions: the most clearly identifiable example of this is the bill leak which has unwound to the extent of £1 billion during banking July;

ii. the adjustment by banks of their balance sheet structure following the end of the SSD scheme: the proportion of banks' balance sheets lent to the private sector has been growing, and that lent to the public sector falling, for some time. The banks significantly increased their holdings of Treasury bills, gilts and local authority debt during the month;

iii. a blip in monetary growth: for example, there now appears to be a well established 3 monthly cycle in the level of bank lending to the private sector, and July was another high month in that sequence.

It is impossible to say precisely how much each of these elements contributes to the total, or indeed whether the underlying rate of monetary growth is also running above the top of the target range. We may learn some more about the extent of reintermediation from the discussions which the Bank is currently having with individual clearing banks about their figures, and from further analysis of the returns generally. Any conclusion about the underlying trend must similarly really wait for the banking August figures. However, as explained in the paragraph below on the development of other aggregates, there are some grounds for disquiet.

Main Developments in the Counterparts

4. The Central Government Borrowing Requirement was exceptionally low in banking July at £0.4 billion (the calendar month figure to be published on 11 August was only a little higher at £0.8 billion). There will however be a further high figure for the CGBR in banking August, partly because of the effect of the income tax refunds affecting the payments from employers to the Inland Revenue during the month.

5. The take-up of central government debt, particularly gilts, outside the banking system was much lower than had been expected, given the very high gross gilts sales by the Issue Department. The banks appear to have increased their holdings by £0.6 billion, a much larger amount than had been expected: this is an important element in the restructuring of banks' balance sheets referred to above. The overseas take-up of gilts (£0.3 billion) was relatively modest. The non-bank sector's holdings of other public sector debt was reduced during the month, largely because of the extent to which the banks were bidding for Treasury bills, probably partly as a result of the pressure on reserve assets ratios.

6. Banks lent £0.6 billion to the rest of the public sector during the month, overwhelmingly to local authorities. We have not yet any basis for

telling how far this was a form of "reintermediation", in which the banks were bidding short term local authority debt away from non-bank holders, and how far it was the result of a high local authority borrowing requirement during the month. We may have a better idea of this when we have the results of the local authority borrowing survey for 31 July.

7. Sterling bank lending to the private sector was at a record level of £2.4 billion. However, the bill leak was reduced by £1 billion, so the adjusted figure is only £1.4 billion. This is very much in line with the peak levels of banking January and banking April. Unless there is a significant further element of reintermediation which we have not identified, therefore, this figure indicates that the level of bank lending is continuing at about its recent level, rather than declining. The increase in clearing bank lending (not seasonally adjusted) was £2.2 billion. Of this £1.3 billion was to manufacturing industry - a phenomenal increase of 21% of the stock oustanding in one month. The other major sector for which advances increased was the service sector though their increase was only some 6%. The increase in personal lending of just over £0.1 billion was more than accounted for by interest debited to accounts.

8. Sterling lending to overseas was also high (£0.7 billion): it would appear that this too included some element of reintermediation.

9. Taken together, these elements made DCE £3.7 billion, very little less than the total for the four previous months taken together.

The Other Aggregates

10. All the other monetary aggregates appear to have risen sharply in the month also. M1 rose by nearly £1 billion or 3.6%: this follows a run of months over which it had, on average, hardly moved at all. More significantly, measures of private sector liquidity which are less distorted by reintermediation also rose strongly. The narrower measure, PSL1, which is £M3 together with non-bank holdings of bills and of short

term public sector paper, is estimated to have risen by 2.2%. This had been rising more rapidly in recent months than £M3, because of disintermediation, so since February its annual rate of growth has been just over 20%. The wider measure of private sector liquidity, PSL2, which also includes deposits with building societies, rose by nearly 2% in the month bringing the rate of growth since mid-February to about 17% per annum. It is the fact that these other measures, less affected by disintermediation and now reintermediation, are all growing fairly rapidly which gives cause for concern that not all the growth in £M3 this month was due to special factors, so underlying monetary growth may be exceeding the target range.

The PSBR

11. The PSBR in the first 3 months of the financial year is now estimated to have been £5 billion - subject to an error at this stage of plus or minus £250 million. This is significantly more than half the Budget estimate of £8½ billion/ for the year. There are some grounds for thinking that this year the PSBR will be even more front-end loaded than last year, when one third of the final borrowing requirement was borrowed in the first 3 months - one element in this is the retiming of PRT which has removed £0.7 billion of receipts from those months, while because of the rising trend, receipts in the rest of the year are expected to be over £1 billion above what they were last year. A similar point arises on the forward oil sales, where BNOC is now delivering oil against the advance payments made in March. That said, the forecasters now consider that their central estimate for the PSBR this year has risen by rather more than £1 billion since the Budget. The largest elements in the change are additional supply expenditure of £0.4 billion, and a reduction in the estimate of excise duty revenue of like amount.

Conclusion

12. A large element of the exceptional increase in the money supply in banking July was almost certainly due to reintermediation, and other

adjustments to the structure of banks' balance sheets following the end of the SSD scheme. This will almost certainly be accepted by the markets. The point will also be made that while it is difficult to interpret the data, and so to identify the underlying rate of monetary growth, it would be premature to conclude that the underlying rate was outside the target range. The market may well be willing to suspend judgement on that, so that any adjustment in market interest rates and the exchange rate will not get out of control in a way which forces the authorities' hand. But there must be a very real chance that the August figures would confirm the grounds cited above for concern that the underlying growth is too high.

RECENT BEHAVIOUR OF £M3 AND ITS COUNTERPARTS

£ billion, seasonally adjusted

	Average banking March-June (4 months)	banking July	Cumulative banking March-July (5 months)
Central Govt. Borrowing Requirement	+0.71	+0.42	+3.27
Purchase of Central Govt. debt by non-bank private sector (increase:-)	-0.59	-0.41	-2.78
of which: gilts	(-0.55)	(-0.55)	(-2.76)
other	(-0.04)	(+0.14)	(-0.02)
Net other public sector	+0.05	+0.58	+0.79
Sterling bank lending to:			
private sector	+0.70	+2.43	+5.22
overseas	+0.10	+0.66	+1.08
Domestic Credit Expansion	+0.98	+3.68	+7.58
External and foreign currency finance adjustment	-0.28	-0.42	-1.56
Net non-deposit liabilities, etc.	-0.14	-0.34	-0.89
£M3	+0.55	+2.92	+5.13
% increase	1.0	5.0	21.0*

<u>Memo item</u>

Sterling bank lending to the private sector plus "bill leak"	+0.86	+1.43	+4.88
PSL1 (% increase)	1.4	2.2	20.7*
PSL2 " "	1.2	1.8	16.8*

*at annual rate

non-bank holdings
PSL1 = M3 + Tsy Bills + acceptances
PSL2 = PSL1 + building [illegible]
[illegible]

SECRET

DRAFT RELEASE TO NEWS AGENCIES - 2.30 pm, TUESDAY, 5 AUGUST

A Bank of England spokesman said that preliminary information suggested that £M3 (seasonally adjusted) may have grown by about 5% during the month. This figure may of course need to be revised in the light of subsequent information.

The spokesman commented that the July figures were massively exaggerated by the unwinding of distortions within the financial system that had built up over the period of operation of the Supplementary Special Deposits Scheme (the "corset"). As one example of this, provisional information indicates a fall in the volume of bank acceptances held outside the banking system equivalent to about one third of the recorded increase in £M3. Other forms of post-corset adjustment cannot be measured as precisely. But there appears to have been a correspondingly large increase in the banking system's claims on the public sector which had been run down through the corset period; and there may also have been some switching of foreign currency or offshore sterling transactions back into domestic sterling associated with the ending of the corset.

While it is difficult to interpret the data, and thus accurately to identify the underlying rate of monetary growth, the authorities have no reason to conclude that the July figures represent a sudden upturn. ?