

INTEREST RATES OVER THE NEXT FEW WEEKS

The position now - market conditions

1 The agreed interest rate band for Treasury bills with less than fourteen days to maturity remains, as it has since the end of September, at 14-16%. Our recent dealing rate for these bills has been 14 3/8%, and there seems no immediate prospect of downward pressure from the market. Indeed, longer rates have edged up in the last few days and today all rates have increased. Our dealing rates have responded partially, with our lowest rates rising today by 1/8% for band 2 bills and 1/4% for band 3 bills.⁽¹⁾ Certainly, a fall in rates could not be engineered without very obvious official action that went against current market pressures.

2 The gilt-edged market has been dull for some days, with a redemption and buying-in of next maturities in (three-week) banking December outweighing new sales. After the massive net sales in October and November some pause was probably inevitable⁽²⁾ and, we began banking January with the assurance of some £420 million to come from the balance due on the short-dated tap. Even so, the balance of expectations has apparently shifted towards the next move in US market interest rates being upward (in sharp contrast to the position, say, three weeks ago); and the market has had to absorb some gloomy domestic monetary and industrial news. There is no immediate prospect of an improvement in sentiment and a fall in short rates engineered by the authorities in present circumstances would probably undermine confidence still further.

(1) The current level of rates does not immediately threaten a rise in banks' base rates from their present 14 1/2%.

(2) As a separate exercise, further statistics to aid the discussion of the appropriate scale of funding in the coming months are being prepared.

3 On the foreign exchanges, sterling has weakened quite sharply in the last week, with the effective rate falling some 2 points. The decline has been greater against the US dollar than against the deutschemark, despite the continuing uncovered interest rate differential in favour of sterling over the dollar. Although the prospect of a continuing liquidity squeeze during the tax revenue season should help to limit any downward movement in sterling, the chances of further significant upward pressure now look considerably less than they did a week or two ago.

Monetary aggregates

4 The sterling M3 figures for banking November can only be regarded as disappointing, with growth of 1/2% despite the large central government surplus (generated by the recovery of some 20% of the estimated back tax left by the Civil Service) and massive sales of debt. Bank lending to the UK private sector - at £2 1/2 billion - was, of course, to blame with businesses rather than persons accounting for the increase.

5 The November result is so difficult to interpret that the forecasts are unusually uncertain, because it is impossible to know whether November indicates another jump in the underlying level of bank lending (perhaps because of an end to destocking) or was a freak result. The financial forecasts have given some weight to both probabilities and have put underlying £M3 growth (ie excluding the unwinding of strike effect) at 2% in banking December, 2 3/4% in January and 1/2% in February. While the actual figures consistent with these forecasts would show considerably lower rates of growth (as back tax is likely to continue to flow in on a substantial scale), they would still mean that the Chancellor might be presenting the Budget against the background of a rise in recorded £M3 of 16 1/2-17% in the year from mid-February 1981, (against the annual rate of 17 3/4% in the first nine months of that period).

6 The other monetary aggregates by and large make less worrying reading. The wide monetary base fell again in banking November (making an annual rate of growth since mid-February of 1 1/2%, while M1 grew only modestly (annual rate 10% since mid-February). All the broader aggregates grew more slowly than sterling M3 in November (total M3 actually fell); the PSL aggregates continue to show annual rates of growth since mid-February somewhat below that for sterling M3 (15 1/2% for PSL1, 14% for PSL2).

Other factors

7 The recent Industry Act forecasts can only have confirmed the view that the chances of inflation of less than 10% over the next year are now modest. Nevertheless, the wage round - although still at an early stage - continues to offer some hope (in respect of private sector settlements at ~~least~~^{least}) and the exchange rate is, for now at least, still well above its end September level. On almost any measure, real interest rates in the UK must look more attractive, relative to the United States at least, than in the early autumn.

Conclusion

8 There is currently no pressure in the money markets for a fall in short-term interest rates; indeed the last few days have seen rates edging up. The case on external grounds for a decline in rates appears less pressing than it did a week or two ago while domestic monetary considerations argue even more strongly than they did a month ago against any early downward move.