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Econ Pol 1

cc Mr. Duguid

MR. LANKESTER

MONETARY AND FUNDING CONDITIONS

Yes please
I hope the
building will
be done

Princhester

I think it would be useful if
I sent the Treasury a letter based
on this, and in particular making the
point about
funding
at X below.

Although the public sector borrowing requirement seems so far to be even below the target and likely to be either on target or under-shoot by the end of the year, there are great difficulties with the time profile. In particular, it looks as though October will be a very difficult month indeed, following an awkward September. However, for the rest of the financial year there is likely to be little or no requirement for public sector borrowing. Although there remains the possibility of over-funding to offset private borrowing.

Agree?

12

18/9

The main difficulties in September and October arise because of the Civil Service strike. In particular in October there is likely to be a net requirement of nearly £2 billion in order to pay off VAT refunds. These payments are being made before calling in the overdue VAT receipts. A second difficulty arises because borrowing by the private sector has been considerably augmented by the banks switching into the personal loan and particularly into mortgage loan business. To some extent this is simply the switch from other institutions, such as building societies, but some of it is undoubtedly a net increase.

The increase in demand for loans from the public sector and private sector comes at a particularly difficult time. All eyes are focused on the United States and the likelihood of rates of interest, particularly on long bonds, declining. Even though long term interest rates in the UK market are as high as 16%, there has been no funding going on for some time. The situation is, however, quite brittle. It may change dramatically if suddenly there is convincing evidence by the Reagan administration that they intend to bring down the budget deficit.

Whatever happens, however, we have a very difficult corner in October.

The actions that might be taken to ease our way round this corner are:

/To make it clear to

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1. To make it clear to the markets that there are very unusual but transitory items, such as the £2 billion VAT repayments, which will be offset by in-flows later. If we can tell a convincing story about these movements, then it is likely the markets will not read the blip in the borrowing requirements as a permanent shift.

2. It may well be necessary to prepare the markets for an unduly large M₃ figure. This can again largely be attributed to strike effects.

3. It is important to get funding moving again. There are a number of ways this might be done. Probably best is to bring forward the plans for a non-restricted indexed gilt. This would have the effect of soaking up a lot of the liquidity, and hopefully bank balances etc, from the personal sector. It might also ease the present stickiness in the long term conventional gilt market. But, realistically, the best hope for the conventional gilt market lies in a break in the United States conditions.

It seems to me very doubtful whether anything more should be done to discourage private sector lending. The 2% rise in short term rates and probably in base rates will give rise to some restraint later on in the year. This is not going to help for the period when the difficulties are greatest, namely, October. And in any case there is no sign of any take-off in house prices, they remain fairly stagnant. The construction industry is still very much in the doldrums.

All the evidence is consistent with the fact that our basic monetary conditions are healthy. I am concerned that appearances in banking September and October, may be deceptive. We should do as much as we can to allay the fears that might be generated in the markets.



17 September 1981

ALAN WALTERS