

CONFIDENTIAL

FROM: P N SEDGWICK
DATE: 10 December 1982

MR BURNS

cc Sir D Wass
Sir K Couzens
Mr Littler
Mr Middleton
Mr Cassell
Mr Evans
Mr Lavelle
Mr Monck
Mr Odling-Smee
Mr Allen
Mr Hall
Mrs Lomax
Mr Peretz
Mr Riley
Mr Shields
Mr Turnbull
Mr Bennett
Mr Hood
Mr Lewis
Mr Matthews
Mr Pickford
Mr Vernon
Mr Willetts
Mr Milne

Sir J Boreham - CSO

Deputy Governor)
Mr George)
Mr Coleby) Bank
Mr Fforde) of
Mr Goodhart) England
Mr Plenderleith)
Mr Allen)
Mr Foot)

Professor Walters - No 10

INTERPETATION OF MONETARY CONDITIONS: DECEMBER

... I attach a copy of the note for this month.

P.N.S

P N SEDGWICK

INTERPRETATION OF MONETARY CONDITIONS

INTRODUCTION AND SUMMARY

The latest figures for the nominal monetary aggregates broadly confirm the pattern of recent months, which showed a rise in the growth of the narrow aggregates to levels significantly higher than the low (and for some months negative) growth at the end of 1981 and in the first half of this year. The latest data on £M3 suggests that the gradual rise in its six month growth rate since the middle of the year has come to an end.

2. There is conflicting evidence on monetary conditions from other indicators. Inflation has continued to fall and activity remains depressed. This may, however, reflect the lagged influence of monetary conditions in earlier periods. Until recently the exchange rate was remarkably stable, but has subsequently fallen by a substantial amount. Nominal interest rates have fallen through 1982 until the recent rise that followed the fall in the exchange rate. It is much more difficult to discover what has happened to real interest rates. Because recorded and forecast inflation have fallen significantly during 1982 the fall in real interest rates until mid-November has probably been fairly small in spite of the fall in nominal interest rates. The recent rise in nominal rates appears to have taken real 3 month interest rates back to a level close to that experienced at the beginning of the year.

3. The final section reviews the behaviour of asset prices - houses, agricultural land, and tender prices for public sector buildings. These have tended to lead movements in retail prices. The figures available for 1982 show that these prices have stopped falling, and have begun to rise, though as yet at fairly modest rates.

(1) THE GROWTH OF THE MONETARY AGGREGATES

4. Table 1 and Charts I to IV summarise the most recent information on the nominal monetary and financial aggregates as well as data for previous financial years. (NB the figures for October 1982 in all the tables and charts in this note are central estimates, agreed by the Bank and the Treasury, of what would have happened in the absence of the STC distortion).

TABLE 1 : % GROWTH RATES IN THE NOMINAL AND FINANCIAL AGGREGATES

	Composite monetary indicator	M0	Non- interest bearing M1	M1	£M3	M3	PSL1
(a) financial years							
1979-80*	6.2	9.6	4.2	3.2	11.0	12.4	11.3
1980-81*	10.2	7.4	7.9	11.3	19.8	21.5	14.0
1981-82*	6.2	1.1	0.3	4.3	12.4	15.7	11.1
(b) changes on same period in previous year+							
1981 (1)	8.1	7.5	4.2	7.4	18.3	19.4	12.8
(2)	10.4	5.8	8.9	12.1	18.7	21.3	13.4
(3)	12.1	5.0	9.4	10.6	15.3	21.1	13.8
(4)	8.6	4.2	4.8	7.7	13.1	18.8	11.6
1982 (1)	8.5	2.7	4.0	8.4	13.9	16.1	12.0
(2)	6.7	2.2	1.5	6.4	12.6	13.5	10.5
(3)	7.1	2.0	4.4	7.6	10.5	10.4	8.4
(c) changes on same period in previous year							
December	8.6	4.2	4.8	7.7	13.1	18.8	11.6
1982 Jan	10.6	6.8	7.4	11.1	14.3	17.8	12.3
Feb	8.8	3.3	4.2	9.0	13.9	16.8	12.4
March	8.5	2.7	4.0	8.4	13.9	16.1	12.0
April	6.2	1.1	0.3	4.3	12.4	15.7	11.1
May	5.7	0.7	0.0	4.0	11.9	14.1	10.4
June	6.7	2.2	1.4	6.4	12.6	13.5	10.4
July	5.7	2.3	1.1	4.7	11.1	12.5	8.9
Aug	7.0	-0.2	3.1	8.3	11.6	12.3	8.9
Sept	7.1	2.0	4.4	7.6	10.5	10.4	8.4
Oct ++	8.4	3.3	6.6	9.1	9.9	9.3	8.4
Nov	9.3	3.4	8.1	10.5	10.5	10.9	9.1
(d) changes (at an annual rate) in 6 months to							
December	5.8	2.3	-1.7	5.4	16.1	18.1	11.2
1982 Jan	5.2	7.2	-2.4	3.8	13.9	12.7	10.6
Feb	5.8	3.2	-1.1	8.3	12.1	10.6	9.9
March	3.1	-1.2	-3.5	2.9	8.9	7.5	7.9
April	5.0	0.2	-0.5	4.9	7.0	6.4	8.6
May	6.2	-0.5	1.4	4.1	8.7	8.6	9.7
June	7.5	2.1	4.8	7.5	9.2	9.1	9.7
July	6.1	-2.4	4.8	5.5	8.4	12.3	7.2
Aug	8.2	-3.4	7.5	8.4	11.2	14.0	8.0
Sept	11.3	5.2	12.9	12.7	12.2	13.5	8.9
Oct	11.8	6.4	14.2	13.8	12.9	12.3	8.3
Nov	12.5	7.5	15.2	17.4	12.3	13.1	8.6

(see page 3 for footnotes)

5. The November figures for the narrow aggregates show a continuation of the upward movement in both the twelve and six month growth rates. Whereas their growth rates were low (and for the monetary base and non-interest bearing M1 in some months negative) at the end of 1981 and in the first half of 1982 these have now risen substantially. Non-interest bearing M1 appears to have been the most interest rate sensitive of the narrow aggregates through 1982. Its six month growth rate over the previous six months has risen from -3.5 per cent in March to just over 15 per cent in November. The six month growth rate of M1 has risen again, but much of this increase in November was in interest bearing M1. There is a tendency for very large changes in this particular component of M1 to be reversed quite quickly.

6. It is most unlikely that the narrow aggregates as recorded up to banking November reflect the full effects of the successive reductions in short term interest rates during this year, and it is therefore quite possible that there are further increases in these growth rates "in the pipeline".

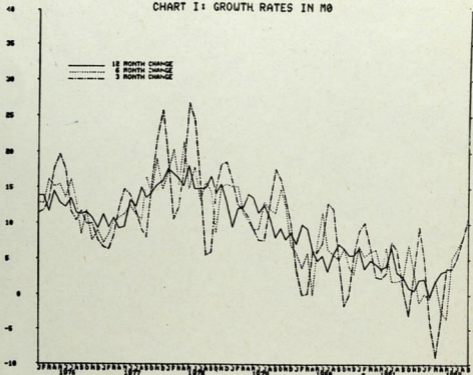
7. The growth rates of the broad aggregates tend not to react to short term fluctuations in interest rates in the same way as the narrow aggregates, and the changes in their growth rates in the past year have been much smaller than with the narrow aggregates. The latest figures suggest some very slight fall in the six month growth rates of £M3.

Footnotes to Table 1

- * through the financial year (mid-April on mid-April).
- ♠ the growth rates for all monetary aggregates, except non-interest bearing M1, are adjusted for recent changes in definition.
- + quarterly figures are for the final banking month of the quarter.
- ++ the October 1982 figures have been greatly distorted by the over-subscription of the STC share issue. Changes shown here are the Bank of England/Treasury best estimates of what would have happened in the absence of the distortion. These estimates lie towards the lower end of the published ranges.

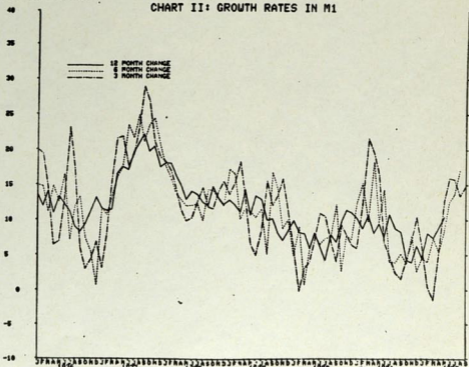
percentage change

CHART I: GROWTH RATES IN M0



Annualised
percentage change

CHART II: GROWTH RATES IN M1



Note: The growth rates are shown as the mid-point of the period over which they are measured. Thus the growth from September 1981 to September 1982 is shown as March 1982 and the six month annualised growth rate from March 1982 to September 1982 is shown as June 1982.

8. Table 2 and Charts V and VI show the twelve and six month growth rates of the real monetary aggregates. The turnaround since the first half of 1982 with the narrow aggregates is even more striking than with the nominal aggregates in Table 1. Whereas at the beginning of the year the six month growth rates for the real narrow aggregates were significantly negative they are now all positive, following the simultaneous rise in the growth rates of the nominal narrow aggregates and the sharp fall in inflation. The six month growth rates of real £M3 has been higher in the last four months than earlier in the year (though it has fallen slightly in banking November).

9. It is not easy to assess the implications of the recent behaviour of the nominal and real monetary aggregates. Since the mid 1970's, and in particular in the last few years, the movements in the narrow aggregates appear to have been better predictors than the broad aggregates of subsequent movements in real output and prices, (although neither the broad nor the narrow aggregates have been adequate predictors if used on their own and it has been necessary to supplement them with other indicators such as oil prices). Some increase in the growth rates of the nominal and real monetary aggregates was necessary to offset the low, and at times negative, growth at the end of 1981 and in the first half of 1982. A rise in the growth of real money balances is a normal (and necessary) development towards the end of a period when monetary policy is used to reduce the rate of inflation. The problem is to determine whether the recent growth of the narrow aggregates has been more than necessary to make good earlier shortfalls, and if so by how much. There are no clear criteria derived from past experience to determine whether particular growth rates of the narrow aggregates are or are not "excessive". There must, however, be some suspicion that the turnaround from very tight to more relaxed monetary conditions may have been somewhat too great.

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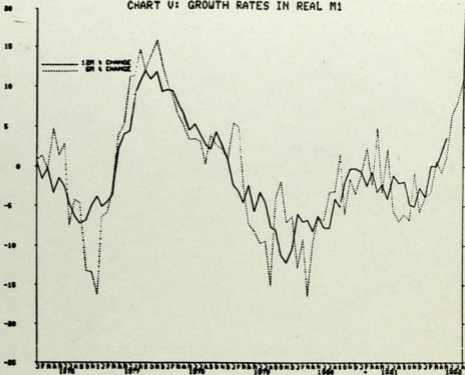
TABLE 2 : CHANGES IN THE REAL MONEY SUPPLY (%)

	<u>RPI*</u>	<u>Composite monetary indicator</u>	<u>M0</u>	<u>Non Interest Bearing M1</u>	<u>M1</u>	<u>£M3</u>	<u>PSL2</u>
(a) Chance in 12 months to							
1981 Dec	12.0	-3.0	-7.0	-6.4	3.9	1.0	-0.4
1982 Jan	12.0	-1.3	-4.6	-4.1	-0.8	2.0	0.3
Feb	11.0	-2.0	-7.0	-6.2	-1.8	2.6	1.2
March	10.4	-1.7	-6.9	-5.8	-1.8	3.2	1.5
April	9.4	-2.9	-7.6	-8.3	-4.7	2.7	1.5
May	9.5	-3.4	-8.0	-8.6	-5.0	2.2	0.9
June	9.2	-2.3	-6.4	-7.1	-2.5	3.1	1.1
July	8.7	-2.8	-5.9	-7.0	-3.7	2.2	0.2
Aug	8.0	-0.9	-7.6	-4.5	0.3	3.4	0.9
Sept	7.3	-0.1	-4.9	-2.7	0.3	3.0	1.1
Oct	6.8	1.5	-3.3	-0.2	2.3	2.9	1.5
Nov	(6.5)	-2.7	-2.8	1.6	3.8	3.8	2.5
(b) Chance (at an annual rate) 6 months to							
1981 Dec	11.8	-5.4	-8.5	-12.1	-5.8	3.8	-0.6
1982 Jan	11.3	-5.5	-3.7	-12.3	-6.7	2.4	-0.6
Feb	8.7	-2.7	-5.1	-9.0	-0.4	3.1	1.1
March	8.8	-5.2	-9.2	-11.3	-5.4	0.1	-0.8
April	8.6	-3.4	-7.8	-8.4	-3.4	-1.5	0.0
May	7.5	-1.1	-7.4	-5.6	-3.1	1.2	2.1
June	6.6	0.9	-4.2	-1.7	0.9	2.4	2.9
July	6.3	0.0	-8.0	-1.3	-0.6	2.1	1.0
Aug	7.1	1.0	-9.8	0.4	1.2	3.8	0.8
Sept	5.7	5.4	-0.4	6.9	6.7	6.2	3.1
Oct	5.0	6.3	1.2	8.6	8.2	7.4	3.0
Nov	(5.6)	6.5	1.8	9.0	11.1	6.3	2.8

*The simple method of seasonal adjustment for the RPI for use in calculation of the six monthly growth rates was described in the February Interpretation of Monetary Conditions.

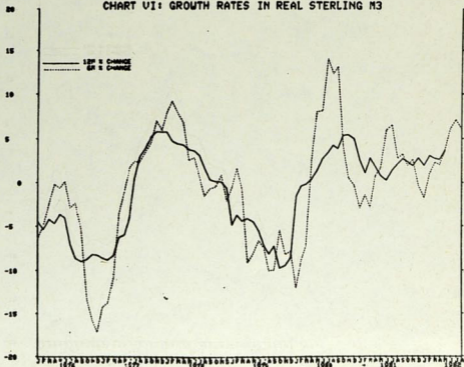
Annualised
percentage change

CHART V: GROWTH RATES IN REAL M1



Annualised
percentage change

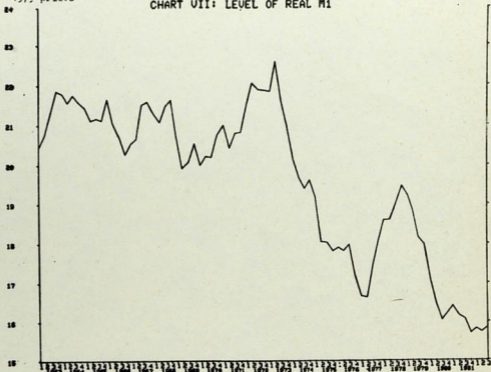
CHART VI: GROWTH RATES IN REAL STERLING M3



Note: The growth rates are shown as the mid-point of the period over which they are measured. Thus the growth from September 1981 to September 1982 is shown as March 1982 and the six month annualised growth rate from March 1982 to September 1982 is shown as June 1982

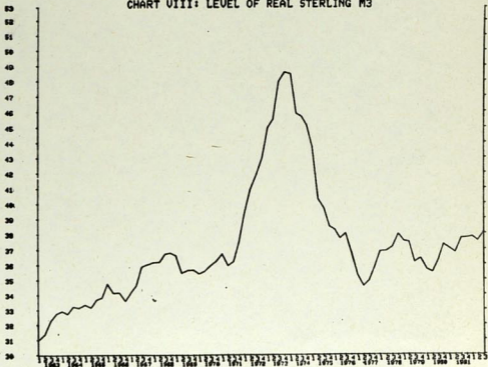
£bn
1975 prices

CHART VII: LEVEL OF REAL M1



£bn
1975 prices

CHART VIII: LEVEL OF REAL STERLING M3



£bn
1975 prices

CHART IX: LEVEL OF REAL PSL2

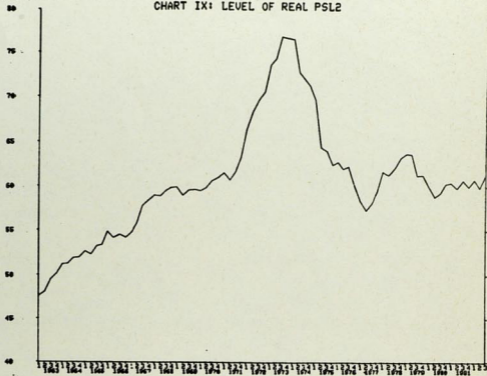
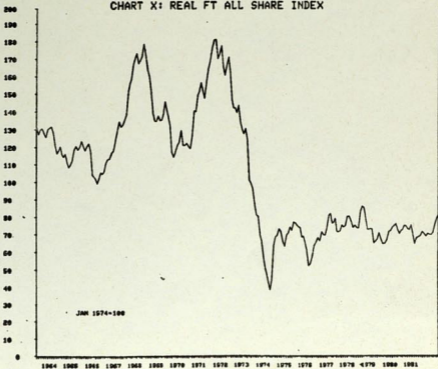


CHART X: REAL FT ALL SHARE INDEX



JAN 1974=100

(2) OTHER INDICATORS OF MONETARY CONDITIONS

10. Table 3 shows that the growth of money GDP has fallen through 1982. This fall is particularly pronounced in the growth rates over the previous six months.

TABLE 3 : GROSS DOMESTIC PRODUCT AT CURRENT PRICES

	GDP at market prices (expenditure based)		GDP at market prices (CSO's average estimate)	
	% change on a year earlier	% change over six months (annual rate)	% change on a year earlier	% change over six months (annual rate)
1981 Q1	12.6	10.7	10.9	9.6
Q2	10.1	7.9	9.3	8.7
Q3	8.2	5.7	9.4	9.2
Q4	8.5	9.0	9.0	9.3
1982 Q1	8.8	11.9	9.2	9.1
Q2	9.3	9.6	8.8	8.3
Q3	(8.3)	(5.2)	(7.4)	(5.7)

11. Table 4 shows that retail price inflation has fallen almost continuously through 1982. The latest indications are that the November figures for the RPI will show a continuation of this trend. The most recent fall in the exchange rate should not have a significant effect on retail prices in the immediate future, and conditions in the domestic economy will probably continue to exert downward pressure on inflation. On the other hand the November figures for wholesale input prices already show the effects of the recent fall in the exchange rate.

TABLE 4 : RETAIL AND WHOLESALE PRICES
(% change on same period a year before)

	Retail prices		Wholesale output prices (home sales)	Wholesale input prices
	Recorded	Underlying λ		
1981 Q1	12.7	12.2	10.9	8.5 (12.1)*
Q2	11.7	11.2	10.3	12.2 (23.4)*
Q3	11.3	12.3	10.1	16.8 (21.7)*
Q4	11.9	12.7	11.2	16.7 (10.4)*
1982 Jan	12.0	11.5	11.0	13.9 (5.1) ϕ
Feb	11.0	10.0	10.6	12.1 (2.6) ϕ
March	10.4	9.0	9.7	8.0 (-2.2) ϕ
April	9.4	8.0	8.8	7.7 (0.4) ϕ
May	9.5	9.0	8.7	4.8 (0.5) ϕ
June	9.2	9.0	8.2	5.6 (5.6) ϕ
July	8.7	8.5	8.5	5.2 (6.8) ϕ
Aug	8.0	8.0	7.9	3.0 (3.4) ϕ
Sept	7.3	7.5	7.5	3.3 (9.1) ϕ
Oct	6.8	7.5	7.6	3.4 (6.6) ϕ
Nov	(6.3)		7.4	6.2 (12.2) ϕ

λ The underlying rate of inflation is based on recent movements in the RPI which have been purged of influences which make difficult the assessment of the trend. More precisely, increases in rents, rates, Nationalised Industry prices and seasonal food are computed on a twelve month basis whilst changes in the remaining items that comprise retail prices are calculated in a fashion that gives more weight to (annualised) one month changes than to twelve month changes. The series is rounded to the nearest 0.5

* Increase over two quarters before at an annual rate.

ϕ Increase over past six months at an annual rate.

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12. Table 5 shows that short term sterling interest rates have risen in the recent past to take them above the average levels for October and November, though still just below the average level for September and August. This experience contrasts with the behaviour of the three month Eurodollar rate which is still below the average level in August and September.

TABLE 5 : NOMINAL INTEREST RATES (period averages)

	<u>Three month Interbank</u>	<u>Three month Eurodollar</u>	<u>Base Rate</u>	<u>Long Rate (20 year gilts)</u>	<u>Yield gap</u>
1981 Q1	13.3	16.5	13.6	13.8	0.5
Q2	12.5	17.7	12.0	14.2	1.7
Q3	14.2	18.4	12.3	15.2	1.0
Q4	15.6	14.3	15.1	15.7	0.1
1982 Jan	15.0	14.5	14.4	15.6	0.6
Feb	14.4	15.8	13.9	14.7	0.3
March	13.5	15.0	13.9	13.8	0.3
April	13.8	15.3	13.0	13.9	0.1
May	13.4	14.3	13.0	13.7	0.4
June	13.0	15.7	12.5	13.6	0.6
July	12.4	14.2	12.3	13.2	0.8
Aug	11.2	11.7	11.3	12.1	1.9
Sept	11.0	12.0	10.5	11.4	0.4
Oct	9.8	10.4	9.8	10.5	0.7
Nov	9.4	9.8	9.2	10.6	1.2
Dec 9	10.8	9.6	10-10½	11.7	0.9

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13. Table 6 shows estimates of real interest rates. There

TABLE 6 : REAL INTEREST RATES (period averages)

	<u>Expected inflation over 12 months*</u>	<u>Real 3 month Interbank Rate</u>	<u>Yield on 1996 indexed gilts</u>
1981 Q1	10.7	2.6	2.1
Q2	10.0	2.5	2.4
Q3	10.3	3.9	3.1
Q4	10.1	5.5	3.2
1982 Jan	10.5	4.5	3.2
Feb	10.4	4.0	3.2
March	10.1	3.5	2.8
April	9.3	4.4	2.9
May	9.3	4.0	3.0
June	9.0	4.0	3.1
July	8.2	4.2	3.2
Aug	8.1	2.9	2.9
Sept	7.7	3.0	2.9
Oct	7.5	2.3	2.7
Nov	5.4	3.9	2.7
Dec 9	5.9	4.9	2.6

*Unweighted average of forecasts by Phillips & Drew, National Institute and the London Business School, calculated over the six months forward and six months back.

are severe conceptual and practical problems involved in measuring real rates of interest. The estimate in the second column of Table 6 adjusts the nominal three month interbank rate by means of an estimate of expected inflation over the immediate future based on three outside forecasts. The resulting real rate of interest for early December is higher than in recent months not only because nominal interest rates have risen but because the estimate of expected inflation has fallen. It is quite probable that between April and October 1982 operators in financial markets had lower inflation expectations than the available outside forecasts suggested. If this were the case the real short rate of interest would have been higher than column 2 of Table 6 shows for these months. The yield on indexed gilts suggests that there has been no appreciable fall in the real long rate of interest during 1982.

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14. Table 7 records the sharp fall in the effective and £/\$ exchange rates. The recent rise in sterling interest rates

TABLE 7 : EXCHANGE RATES*

	Effective rate	£/\$ rate	uncovered differential	
			£/\$	£/DM
1981 Q1	101.8	2.31	-3.1	1.0
Q2	97.8	2.08	-5.0	-0.7
Q3	90.6	1.84	-4.2	1.6
Q4	89.7	1.88	1.3	4.4
1982 Jan	91.1	1.88	0.5	4.8
Feb	91.5	1.85	-1.4	4.3
March	90.8	1.81	-1.5	3.7
April	90.1	1.78	-1.4	4.5
May	89.9	1.81	-1.0	4.3
June	91.0	1.76	-2.7	3.8
July	91.2	1.72	-1.8	3.0
Aug	91.3	1.72	-0.5	2.4
Sept	91.7	1.72	-1.0	2.9
Oct	92.5	1.70	-0.6	2.6
Nov	89.3	1.63	-0.4	2.3
Dec 9	85.8	1.61	1.2	4.5

* Period averages

** Between 3-month UK Interbank rate and 3-month Eurdollars rate

rates has brought about a significant improvement in the uncovered differential between sterling and both the dollar and the Dm.

3 ASSET PRICES

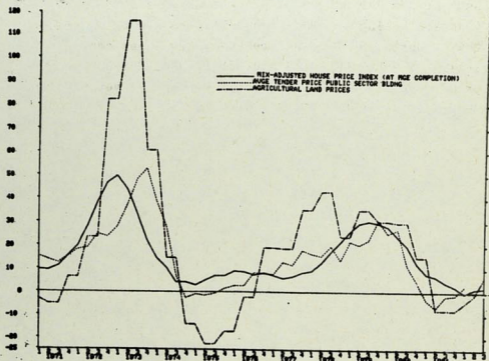
15. Chart IX shows recent movements in house prices, tender prices for public sector buildings, and agricultural land prices. The house price index shown is the recently published DOE mix-adjusted index, which adjusts for changes in the mix of houses mortgaged with building societies, for example through competition from banks at the top end of the market. The percentage change over a year earlier in house prices on this measure reached zero in the first quarter of 1982, but did not turn negative (although quarterly changes indicate that house prices were falling in 1981 Q4 and 1982 Q1). There has been a very modest recovery to 2 per cent in the annual rate of increase in the last two quarters.

16. Agricultural land prices, which proved more volatile than other asset prices during the 1970s have shown a more pronounced recovery after falling in 1981. However, the growth in prices in the third quarter of 1982 had reached only 6 per cent over a year earlier. Second and third quarter figures for public sector tender prices are not yet available. There are as yet no signs of sustained growth in these prices following falls during 1981.

CHART IX Asset prices, inflation and monetary growth

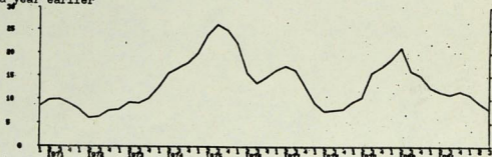
Percentage change
over a year earlier

ASSET PRICES



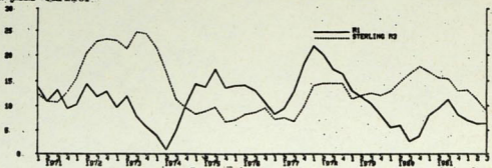
Percentage change
over a year earlier

RETAIL PRICE INDEX



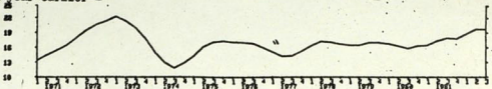
Percentage change
over a year earlier

GROWTH RATE OF M1 AND STERLING M3



Percentage change
over a year earlier

STOCK OF MORTGAGES OUTSTANDING



SECRET (AND PERSONAL UNTIL 2.30PM, THURSDAY 16 DECEMBER 1982)

MR MIDDLETON

FROM: A TURNBULL
10 December 1982

MONETARY PROSPECTS: DECEMBER-MARCH

I attach a copy of the report on the prospects for the monetary aggregates over the next four months.

AT

A TURNBULL

Circulation

List A

Sir D Wass
Mr Burns
Sir K Couzens
Mr Byatt
Mr Middleton
Mr Evans
Mr Lavelle
Mr Monck
Mr Odling-Smee
Mr Kemp
Mr Hall
Mr Feretz
Mr Collinson
Mr R Allen
Mr Riley
Mrs Lomax
Mr Sedgwick
Mr Shields
Mr Vernon
Mr Bell
Mr Bennett
Mr Johnston
Mr Page
Mr Perfect
Mr Pickford
Mr Willetts
Mr Fisher
Mrs Jutsum
Mr Milne
Mr Willoughby
Ms Greenwood
Mr Blower

Bank of England

Mr McMahon
Mr Dow
Mr Fforde
Mr George
Mr Loehnis
Mr Somerset
Mr Coleby
Mr Goodhart
Mr Walker
Mr Gill
Mr Plenderleith
Mr Kentfield
Mr Burman
Mr Wright
Mr Foot
Mr Iles
Miss Feirson
Mr Townend
Mr W A Allen
Mrs P Jackson
Mr I Thompson
Mr S Sabine

List B

Mr Stibbard
Mr Mountfield
Mr Bottrill
Mr Pirie
Mr Spencer
Mr Mowl
Mr Hood
Mr Williams
Mr Page
Mr Patterson

CSO

Sir J Boreham
Mr Wells
Mr Alexander

Mr J Anson - Economic Department, British Embassy, Washington

Professor Walters, No 10

MONETARY PROSPECTS: DECEMBER-MARCH

Summary

(i) With the STC distortion assumed to have been fully unwound in November the trends in the monetary aggregates which emerge are more or less the same as those seen up to October - £M3 growing at around 12 per cent, M1 at about 17 per cent but so far still within the target range.

(ii) £M3 is projected to grow over the next four months by about 1 per cent a month on average. This would produce a February figure (the one published just before the Budget) just below 12 per cent.

(iii) The underlying growth of M1 has been about $1\frac{1}{4}$ per cent a month since the summer. We expect growth to continue at that rate over the next few months as the lagged effects of interest rate cuts come through. At that rate M1 would go over the top of the range in January or February.

(iv) PSL2 is still growing more slowly than the other two target aggregates, but with premium rates on term shares being cut and INVAC inflows strong we expect PSL2 growth to rise closer to that of £M3.

(v) The CG own account and FCBR projections are tentatively put rather lower than the Autumn Statement figures, by about £ $\frac{1}{2}$ billion and £ $\frac{1}{4}$ billion respectively. But with on-lending much stronger than expected in the Industry Act forecast the CGBR could easily exceed £11 billion.

(vi) There is likely to be a marked end-year surge in all elements of the FSBR, especially the CG own account as the in-filling measures take effect.

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(vii) In recent months the other public sector contribution to monetary growth has been substantially negative. This is expected to continue, as both local authorities and public corporations continue to refinance borrowing from banks (as well as from non-banks) with NLF borrowing. Recent moves to make the variable rate facility more attractive to local authorities could be useful when **as** rate borrowing appears to have halted for the moment.

(viii) Gilt sales in December were very low despite calls of £650 million. We have provisionally assumed that the December shortfall on the gross sales target of £1 billion a month is recouped over the next three months. There are further substantial calls lined up for January and February totalling £1 billion, but heavy buying-in and redemptions are also expected in the next three months.

(ix) The outlook for National Savings has improved since last month. Not only did the 24th issue certificate attract more inflows than we expected in its last days, and the premiums appear to have virtually stemmed net outflows from indexed certificates, but also INVAC and the Income Bond are proving very attractive. At current rates we would now expect National Savings almost to meet the £3 billion target for the financial year as a whole.

(x) Between April and November overfunding has totalled about £1 billion. Further overfunding of £1½ billion in all over the next three months is expected, with some unwinding in March. In the 12 months approximating to the financial year overfunding is on this forecast expected to total £1½-2 billion.

(xi) Although the STC distortion has made interpretation difficult, underlying growth of bank lending has if anything accelerated in recent months, with lending to companies mainly

responsible. Lending for house purchase does appear to be tailing off slightly, and we have assumed that this will continue over the forecast period, while growth of other lending categories continues at about the current levels. The underlying rate of lending has been revised upwards to over £1½ billion a month.

(xii) In November the externals were strongly negative, as forecast. We expect that to continue in each month except January, when the EC rebate (only part of which is assumed to be taken on the reserves) is due.

(xiii) In December the money market was in surplus, but in January and February further shortages totalling over £1 billion are anticipated. With Ways and Means advances standing at only £360 million at the beginning of banking January, some substantial NLF balances are likely to be necessary, perhaps of about £1½ billion (or even higher on certain days), before unwinding in March as money market conditions ease.

Assumptions and forecast of £M3

The recorded outturn for £M3 was distorted by the STC oversubscription in both banking October and November. We have assumed that the distortion has been fully reversed and there is no effect on later months. The Britoil offer is most unlikely to have distorted the November and December figures.

2. The forecast takes into account recent movements in the exchange rate and banks' base rates, and assumes no further significant movements over the forecast period. We have assumed that the authorities take a large proportion of the EC rebate due in banking January into the reserves, offsetting partially the loss of reserves suffered in banking December. Thereafter any 'creaming off' is likely to be only on a small scale and we have made no allowance for this.

3. Tables 1 and 2 show our forecast of £M3 growth over the banking months December to March. We have (unusually) constructed a forecast for four months, given the interest in the PSBR and funding over the financial year. The 12 banking months April 1982-March 1983 cannot be directly compared with the financial year, but they can be of use in forming a judgement on it. The tables also show the November outturn, both in recorded terms assuming the conventional 60:40 split and (in brackets) the underlying outcome incorporating the Bank's best guess of the STC distortion.

4. The forecast of £M3 shows rather uneven growth over the four months, but averaging about 1 per cent a month. The monthly path is heavily influenced by the expected movements in the PSBR and debt sales. We are expecting growth of 1 per cent in December, reflecting poor debt sales in the month; $\frac{1}{2}$ per cent growth in January as the PSBR swings into surplus; and 1 per cent in February. Growth of perhaps $1\frac{1}{2}$ per cent is anticipated in March, a combination of a likely increase in the PSBR (partly as a result of the in-filling measures) and a large gilt redemption. But it should be emphasised that the outlook for March is more uncertain than for the earlier months and the estimates for March given here are intended only as a indication of broad orders of magnitude.

5. The naive equation for £M3 based on its past movements is for lower growth than we have forecast, at about $\frac{1}{2}$ per cent a month. However our central forecast shown here assumes a rather higher underlying growth in bank lending than we were previously expecting, and is consistent with money maintaining its normal share of gross domestic wealth. On this forecast cumulative growth in the target period would remain around the top, but still inside, the target range up to February (the last figures published before the Budget). But we tentatively expect it to exceed the target range in March.

Forecast of the other monetary aggregates

6. M1 is again likely to have been heavily distorted in November. The underlying increase in October and November averaged about $1\frac{1}{4}$ per cent, continuing the trend since the summer. We are forecasting growth to continue at about this rate - despite the recent increase in interest rates, there is probably still some of the effect of the interest rate falls earlier in the year to come through to M1. There is reason to think that some of the erratic movements in M1 reflect movements in the CGBR, so we would expect M1 to grow rather more slowly than the $1\frac{1}{4}$ per cent average in January and rather faster in March. On this forecast cumulative M1 growth annualised over the target period would continue to rise, reaching the top end of the range in January. The PSL2 forecast summarised in table 1 is for growth of about 1 per cent a month on average. PSL2 growth is expected to come more into line with that of £M3 despite the fall in building society rates, because we expect a greater proportion of societies' inflows to be into accounts classified within PSL2 and because at current interest rates we expect strong inflows into Invac. On this forecast PSL2 would move up to the middle of the target range by March.

Forecast of £M3 counterparts

7. The main features of the counterparts to the £M3 forecast are summarised in table 2:

(i) The seasonally adjusted CGBR is forecast to be in deficit in each month, by over £½ billion in December, under £½ billion in January, £1 billion in February and over £1½ billion in March. In January the corresponding own account position is a surplus of £700 million (not seasonally adjusted), reflecting high receipts of Schedule D income tax, composite tax from building societies, corporation tax receipts, and the EC rebate. In March by contrast we have tentatively forecast a deficit of about £1 billion on own account, as the in-filling measures start to take effect. On these figures it appears likely that the CG own account will turn out somewhat lower than the £7½ billion incorporated in the Industry Act forecast, by perhaps £½ billion. However, the lower figure assumes relatively little shortfall on expenditure plans.

(ii) The on-lending component of the CGBR is expected to continue at a fast rate. Local authorities borrowed (net) nearly £400 million from PwLB in December before interest rates rose. Although there has been no significant borrowing since then, we are envisaging gross borrowing of perhaps £200 million a month, either fixed rate or under the variable rate facility (which has recently been made more attractive). Public corporations are also expected to borrow significant amounts from central government. It appears likely that net on-lending by central government to both local authorities and public corporations may well exceed £4 billion in the financial year 1982/83.

(iii) The other public sector contribution to £M3 growth is forecast to be negative in each of the forecast months, averaging over £400 million a month in the first three months but only £50 million in March. Local authorities are expected to continue borrowing from FWLB in order to refinance borrowing from banks and non-banks. We have revised down the public corporations' borrowing requirement consistent with only some £1½ billion for 1982/83, and we expect corporations to continue borrowing from the NLF in excess of their total borrowing requirement (as they have done consistently throughout this financial year). For both sectors therefore we anticipate continued repayment of borrowing from banks and overseas, and hence a negative contribution to monetary growth.

(iv) The forecast for gilt sales is shown in detail in table 3. Despite calls on partly-paid stock of nearly £650 million, there have been virtually no net sales in banking December, the calls being cancelled out by net buying-in. However, we expect that both banks and overseas will have been net sellers of gilts, so sales to the non-bank private sector are expected to total up to £300 million. We have assumed that the shortfall in December is added to the planning target of £1 billion gross sales over the subsequent three months. For January and February calls already lined up reduce the further gross sales (net of buying-in of non-next maturities) required to meet the higher target to £550 million and £750 million respectively. No calls are yet in place for March. Further buying-in of next maturities is expected over the next two months, but this would still leave a large amount of stock in market hands for redemption in March. (The stock in question is a low coupon gilt a large proportion of which is held through to redemption.)

After allowing for small purchases by banks and overseas, gilt sales to the non-banks would on these assumptions total £500 million or more in January and February but only £200 million in March.

(v) Sales of National Savings instruments are forecast to contribute some £300 million a month to funding on average over the next four months. The main features are the continued attractiveness of the income bond and INVAC (assuming no change in rates), fairly buoyant inflows into the 25th issue, together with the tailing-off of outflows from index-linked certificates. Banking November's outturn (£400 million) was significantly higher than forecast. Insufficient allowance appears to have been made for last-minute inflows into the 24th issue, whilst there is evidence that a sizeable proportion of the repayment warrants issued for index-linked certificates were neither cashed nor returned during the period (and therefore were not scored as an outflow of funds). Provisional data for banking December, however, suggests that some of the warrants have been returned for cancellation. Although such transactions boosted the apparent inflows into certificates the total inflow to all forms of National Savings is unlikely to have been affected because DNS Ways and Means advances to the NLF fell back from the very high levels seen in November. After making these timing adjustments, an inflow of £300 million is expected in banking December. INVAC seems likely to account for half of this, although this was also affected by a timing adjustment. During the ensuing three months, moderate sales of the 25th issue are forecast, although some tailing-off is likely after the initial introductory phase. The 2.4% bonus on index-linked certificates appears to have largely stemmed the earlier outflows and a virtually

flat position is envisaged over the period. The interest rate on INVAC was reduced to 11% from 1 December whilst that on the income bond will fall to 11½% from 12 December. Even at such levels, however, these instruments will remain competitive with the various higher yielding building society accounts and on the assumption of unchanged interest rates the average monthly inflows into INVAC and the income bond over the three months January-March are forecast as £75 million and £90 million respectively. On this forecast total National Savings inflows for the twelve banking months April 1982-March 1983 would reach £3 billion, although the equivalent figure for the financial year is likely to be slightly lower.

(vi) Purchases of CTDs are not expected to be particularly buoyant over the next few months. But we also anticipate fewer surrenders than is usual during this heavy tax-paying season since companies are unlikely (at current interest rates at least) to surrender existing holdings of CTDs bought when rates were higher. As a result CTDs are expected to make a positive contribution to funding (in seasonally adjusted terms) in three of the four months.

(vii) Details of the sterling lending forecast are given in table 4. Underlying lending appears to have risen again in November, although the exact split between October and November depends crucially on the estimate of the STC distortion. We estimate that the current growth in underlying lending is made up (in round terms) of £450 million lending for house purchase, £200 million other personal lending, £250 million to unincorporated businesses and £½ billion to ICCs. In recent months we have seen slight tailing-off in lending for house purchase which we expect to continue. But lending to ICCs appears to have accelerated again, and we have assumed it will stabilise at that level. We continue to be surprised by

the strength of corporate loan demand, but we will be better able to assess the future trend when the new short term forecast of ICCs' borrowing requirement is ready. After making allowance for the PSER offsets (which we now believe are rather larger than we had previously been assuming) and other special factors, recorded lending is forecast as £1 $\frac{1}{2}$ billion in the three months December to February, but to dip below £1 billion in March.

(viii) The forecast of net externals is shown in tables 5 and 6. The outturn for November was close to forecast and we have continued to forecast the underlying flows in line with the recent past, with the current balance anticipated to decline over the next few months. In December the underlying picture of negative external contribution is made even more negative by the intervention which has occurred; in January the contribution is expected to become positive as the EC rebate is only partially taken on the reserves; and in March some of the PRT payment is forecast to be brought in across the exchanges.

(ix) The increase in non-deposit liabilities is forecast at £200 million a month on average, although recently this counterpart has become much more erratic.

Money markets and overfunding

8. The following table shows that we are forecasting persistent overfunding in December, January and February totalling £1 $\frac{1}{2}$ billion, partially unwound by underfunding of £1 billion in March:

£ billion, seasonally adjusted

	Last 12 months to <u>mid-Nov.</u>	Apr 82- <u>Nov 82</u>	<u>Dec.</u>	<u>Jan.</u>	<u>Feb.</u>	<u>Mar.</u>	Apr 82 <u>-Mar 83</u>
'PSBR' (CGBR + OPS contribution)	5.2	5.7	0.3	-	0.5	1.6	8.1
CG debt sales to NBPS (of which, gilt sales)	10.5 (5.8)	6.7 (4.2)	0.5 (0.3)	1.2 (0.6)	0.9 (0.5)	0.5 (0.2)	9.8 (5.8)
OVERFUNDING (increase +)	5.3	1.1	0.2	1.2	0.3	-1.1	1.8

Cumulative overfunding in the 12 months to mid-March (the closest we can approximate to the financial year) is now expected to total about £1½ billion. Since last month we have revised this figure up substantially, not only because our PSBR forecast is reduced but also because National Savings inflows are considerably stronger.

9. Table 7 summarises our forecast of money market influences over the period to banking March. The market was broadly in balance in November, with the expansionary effect of the CGBR (£1,370 million n.s.a.) being largely offset by debt sales. Conditions were somewhat easier during December and total money market influences may have been expansionary by up to £½ billion. Over the following three months the money market position reflects largely the pattern of the CGBR. With a small surplus forecast for January and only a similar size deficit in February the market is forecast to be short by £½ billion and £½ billion in the two months respectively. Conditions seem likely to ease in March as a result of the higher borrowing requirement. Ways and Means advances are forecast to follow the pattern of total money market influences, but with larger swings in individual months. Assuming that only as much stock is created to meet the gross sales target, we are forecasting a fall of some £½ billion in Ways and Means advances between mid-December and mid-March.

SECRET (AND PERSONAL UNTIL 2.30PM, THURSDAY 16 DECEMBER 1982)

Table 1: PERCENTAGE CHANGES IN MONETARY AGGREGATES (The figures shown in brackets are after adjustment for the estimated effect of the STC distortion)

Seasonally adjusted data

<u>Banking month</u>	<u>Wide monetary base (M0)</u>	<u>Non-interest bearing M1</u>	<u>M1</u>	<u>M2</u>	<u>£M3</u>	<u>M3</u>	<u>PSL1</u>	<u>PSL2</u>
<u>Outturn</u>								
- June	+1.7	+1.4	+2.0	+1.1	+0.8	+0.6	+0.6	+0.5
- July	+0.2	+2.2	+0.9	+1.9	+0.8	+1.5	+0.4	+0.1
- August	-1.7	-	+1.2	-0.1	+1.4	+1.1	+1.3	+1.0
- September	+3.9	+1.9	+1.3	+0.5	+1.1	+0.5	+1.3	+1.1
- October	-0.6	+5.2(+0.9)	+2.9(+0.6)	+2.6(+1.3)	+1.7(+0.8)	+2.1(+1.4)	+1.4(+0.6)	+1.3(+0.8)
- November	+0.3	-3.3(+0.7)	-0.2(+2.2)	-2.1(-0.8)	- (+0.9)	+0.4(+1.1)	-0.6(+0.2)	+0.1(+0.6)
Last 12 months	+3.4	+8.1	+10.6	+4.8	+10.4	+10.8	+9.7	+9.1
Last 9 months (target period) at annual rate	+2.4	+10.0	+11.3	+6.0	+11.4	+13.6	+9.8	+9.0
<u>Forecast</u>								
(i) Percentage change in month								
- December					+1.1		+0.8	+0.7
- January					+0.7		+0.7	+0.9
- February					+1.1		+1.1	+1.2
- March					+1.6		+1.7	+1.6
					{ 1½ percent a month			
(ii) Percentage change since Feb '82 (Annual rate)								
- December					+11.6		+9.7	+8.9
- January					+11.4		+9.6	+9.1
- February			+12.4		+11.6		+10.0	+9.6
- March			+12.7		+12.4		+10.9	+10.4

SECRET (AND PERSONAL UNTIL 2.30PM, THURSDAY 16 DECEMBER 1982)

TABLE 2: £M3 COUNTERPARTS

	<u>November</u>		<u>Forecast</u>				<u>Target period</u>
	<u>Forecast</u>	<u>Outturn</u>	<u>Dec</u>	<u>Jan</u>	<u>Feb</u>	<u>March</u>	<u>mid-Feb 1982</u> <u>to mid-Feb 83</u>
(CGBR, n.s.a., surplus -)	(+1730)	(+1366)	(+1560)	(-170)	(+185)	(+1500)	(+8728)
1 CGBR, s.a.	+1395	+1031	+ 640	+380	+1015	+1660	+8573
(o/w, on-lending)	(+ 435)	+ 410)	(+ 710)	(+510)	(+155)	(+ 500)	(+4419)
2 Net purchases of CG debt by NBPS							
a. Gilts	-640	-621	-286	-630	-500	-210	-6443
b. Treasury bills	-	+136	-	-	-	-	- 69
c. National Savings	-235	-409	-300	-370	-250	-260	-3223
d. CTDs, etc.	- 30	+ 31	+ 70	-155	-115	- 70	-800
TOTAL	-905	-863	-516	-1155	-865	-540	-10,535
3 Other public sector							
a. Local authorities	-200	-387	-150	-210	-230	+ 50	-1182
b. Public corporations	+ 40	-216	-210	-200	-250	-100	-1305
TOTAL	-160	-603	-360	-410	-480	- 50	-2487
4 £ lending to private sector	+645	+1294(+1804)*	+1775	+1775	+1750	+900	+19477
(adjusted lending)	(+1450)	(+1711)	(+1625)	(+1575)	(+1550)	(+1550)	(+19011)
5 Net externals	-410	-375(-125)*	-370	+285	-150	-240	-2,537
6 Net non-deposit liabilities	-225	-457	-200	-200	-200	-200	-2615
TOTAL £M3	+340	+ 27 (+787)*	+969	+675	+1070	+1530	+9876
% change in period	+0.4	- (+0.9)*	+1.1	+0.7	+1.1	+1.6	(+11.6 annual rate)

* After adjustment for the estimated effect of the STC distortion.

SECRET (AND PERSONAL UNTIL 2.30PM, THURSDAY 16 DECEMBER 1982)

Table 3: GILTS FORECAST

£ million

	<u>Actual</u>	<u>Forecast</u>			
	<u>Nov.</u>	<u>Dec.</u>	<u>Jan.</u>	<u>Feb.</u>	<u>March</u>
ACTUAL AND KNOWN FUTURE TRANSACTIONS					
Redemptions	- 1	-	-119	-	- 838
Buying-in next maturities	-239	-425			
Sales	+560	-182			
Calls	+395	+643	(+252) (+347)	+399	-
FORECAST					
Assumed buying-in of next maturities					
3% Exchequer 1983 (21/2)			- 50		
12% Treasury 1983 (17/3)			-200	-500	
Further gross sales			+550	+750	+1150
TOTAL NET SALES	<u>+715</u>	<u>+ 36</u>	<u>+780</u>	<u>+650</u>	<u>+ 310</u>
Overseas purchases (-)	+ 34	+100	-100	-100	- 50
Banks (-)	- 94	+150	- 50	- 50	- 50
LDMA (-)	- 34				
PCs (-)	-				
NET SALES TO NBPS	<u>+621</u>	<u>+286</u>	<u>+630</u>	<u>+500</u>	<u>+ 210</u>

SECRET (AND PERSONAL UNTIL 2.30PM, THURSDAY 16 DECEMBER 1982)

Table 4: STERLING LENDING TO THE PRIVATE SECTOR

£ million
Seasonally adjusted

	<u>Actual</u>			<u>Forecast</u>			
	<u>Sept.</u>	<u>Oct.</u>	<u>Nov.</u>	<u>Dec.</u>	<u>Jan.</u>	<u>Feb.</u>	<u>March</u>
<u>Adjusted lending</u>	+1878	+1492	+1711	+1625	+1575	+1550	+1550
Bills held by NBPS	- 5	- 79	+ 33	- 50	+ 50	+ 50	- 50
PSBR offset	+ 60	- 125	+ 100	+ 250	+ 100	+ 100	- 550
Liquidity	+ 100	-	- 50	- 50	+ 50	+ 50	- 50
STC	-	+ 500	- 500	-	-	-	-
Actual/forecast recorded lending	+2033	+1788	+1294	+1775	+1775	+1750	+ 900
Centred 3-month moving average of adjusted lending	+1585	+1695	+1610	+1635	+1585	+1560	

TABLE 5 : FACTORS CONTRIBUTING TO EXTERNALS

£million

Ex ante demand for £ by sector

	<u>Dec.</u>	<u>Jan.</u>	<u>Feb.</u>	<u>Mar.</u>
1. <u>Non-bank private sector</u>				
a. Current balance	200	150	100	100
b. Ex ante exchange control outflow	-350	-350	-350	-350
c. Underlying outflows	-200	-200	-200	-200
d. Britoil	90	-	-	-
e. PRT	-	-	-	100
	-260	-400	-450	-350
2. <u>Banks</u>	-	-	-	-
3. <u>Overseas</u>				
a. Overseas £ deposits	350	350	350	350
b. Sterling lending overseas	-300	-300	-300	-300
	50	50	50	50
4. EC Rebate	-	550	-	-
5. <u>TOTAL EX ANTE DEMAND FOR £</u>				
(1 + 2 + 3 + 4)	-210	+200	-400	-300
6.				
a. Intervention (increase in reserves -)	+400	-300	-	-
b. NBPS equilibrating flow	-125	+ 65	+265	+200
7. PSBR offset	+ 15	+ 70	+ 35	- 90
8. <u>EXTERNALS</u> (1 + 4 + 6(b) + 7)	-370	+285	-150	-240

Table 6: FINANCING OF NET EXTERNALS

£ million

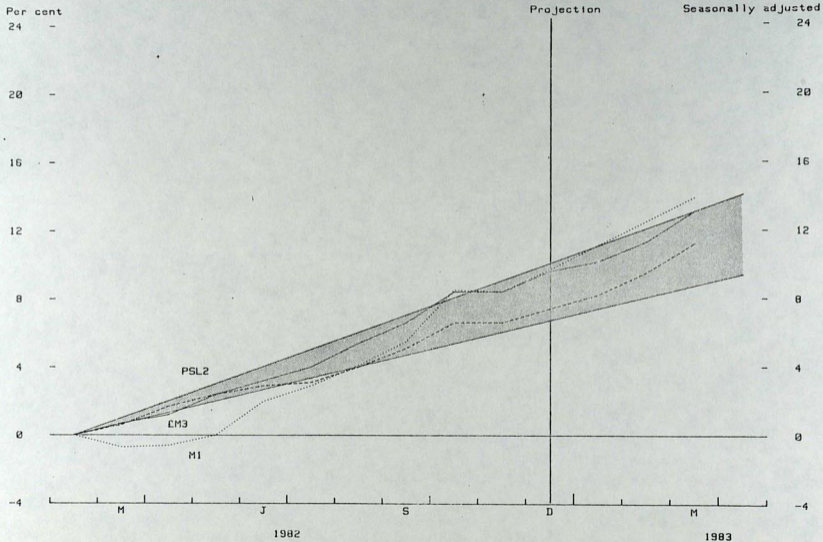
	<u>Dec.</u>	<u>Jan.</u>	<u>Feb.</u>	<u>Mar.</u>
Sterling deposits net from banks abroad (-)	+ 25	-151	-136	- 13
Sterling deposits net from non-banks abroad (-)	-150	-	- 50	- 50
Bank's net foreign currency liabilities (-)	- 50	+170	+135	- 40
Overseas holdings of gilts (-)	+100	-100	-100	- 50
Overseas holdings of Treasury bills and local authority sterling debt (-)	-	-	-	-
Reserves net of official borrowing	-400	+300	-	-
<hr/>				
TOTAL NET EXTERNALS (n.s.a.)	-475	+219	-151	-153
Seasonal adjustment	+105	+ 66	+ 1	- 87
<hr/>				
TOTAL NET EXTERNALS (s.a.)	-370	+285	-150	-240
<hr/> <hr/>				

Table 7: MONEY MARKET INFLUENCES

£ million
not seasonally adjusted

	Actual	Forecast			
	Nov.	Dec.	Jan.	Feb.	March
CGBR (increase +)	+1366	+1560	-170	+185	+1500
Reserves etc (+)	- 89	- 396	+218	- 50	- 3
Notes and coin (-)	- 47	- 420	+485	- 10	- 70
National Savings (-)	- 395	- 279	-364	-253	- 257
CTDs (-)	- 31	-	+ 50	+ 50	+ 25
Gilts (-)	- 715	- 36	-780	-650	- 310
Other Exchequer items etc	- 37	-	-	-	-
	+ 52	+ 429	-561	-728	+ 885
TOTAL MONEY MARKET INFLUENCES (Market surplus + / shortage -)					
Change in bankers' balances	+ 19	+ 10	+ 10	+ 10	+ 10
	- 33	- 419	+571	+738	- 875
MONEY MARKET OPERATIONS REQUIRED					

Percentage growth in monetary aggregates since mid-February 1982 (monetary sector data) CHART A



Daily range of rates in the interbank market Chart B

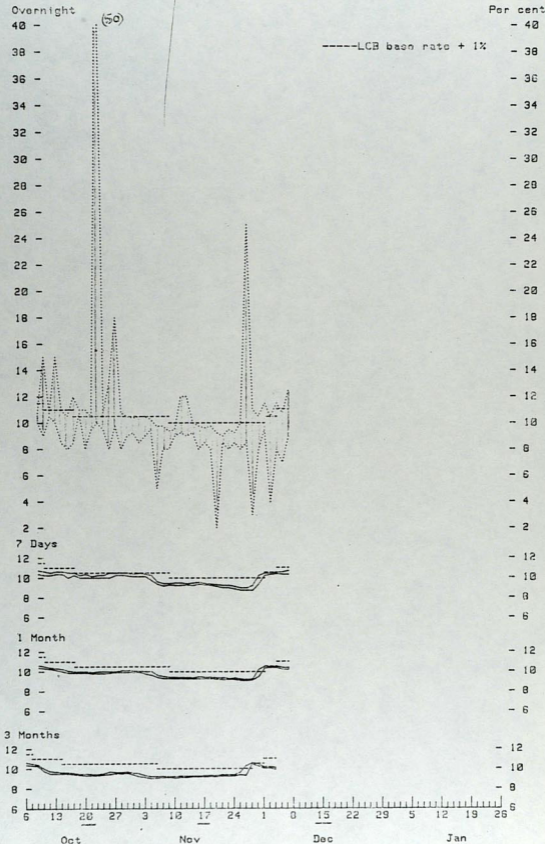
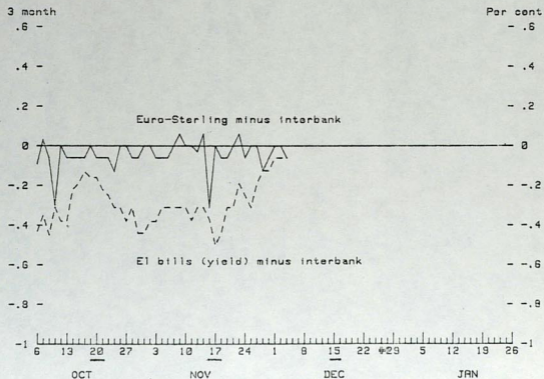
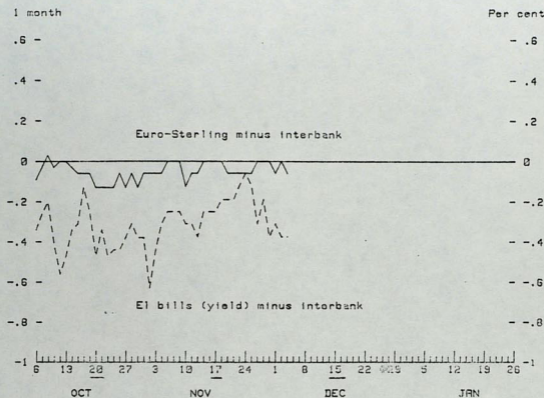


Chart C

Daily differentials between rates in the interbank market and Euro£ rates/rates on eligible bills*



* Rates taken at noon each day † Bank holidays (make-up days underlined)