covering CONFIDENTIAL

FROM P N SEDGWICK
DATE 8 JULY 1983

SIR TERRY BURNS

cc Mr Middleton
Mr Littler
Mr Cassell
Mr Unwin
Mr Evans
Mr Lankester
Mr Lavelle
Mr Monck
Mr Odling-Smee
Mr Allen
Mr Hall
Mrs Lomax
Mr Peretz
Mr Pirie
Mr Riley
Mr Shields
Mr Bell
Mr Bennett
Mr Hood
Mr Johnston
Mr Lewis
Mr Matthews
Mr Pickford
Mr Vernon
Mr Willetts
Mr Milne
Mr A Ridley

Sir J Boreham - CSO

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

Professor A Walters No.

INTERPRETATION OF MONETARY CONDITIONS : JULY

... I attach the note for this month which reflects the discussion at your meeting yesterday.

P N SEDGWICK

INTERPRETATION OF MONETARY CONDITIONS

INTRODUCTION AND SUMMARY

The latest information on the nominal monetary aggregates shows that the six month growth rates of the broad aggregates have risen significantly in recent months (in spite of a downward revision to the growth rate following the introduction of revised seasonal adjustments). The six month growth rate of total M1, but not its non-interest bearing components, continues at a fairly high rate. There are, however, strong grounds for believing that structural change is currently distorting both M1 and its components. The latest recorded information on the PSBR together with the revised forecast for 1983-84 as a whole suggest that the rise in the growth of broad money is to a great extent the result of the loosening of fiscal conditions that has occurred in recent months.

2. Most measures of the real money stock are currently growing at very high rates and the growth rates of many of them have risen significantly since the beginning of the year.

3. Other indicators of monetary conditions suggest considerably tighter conditions than do the monetary aggregates, though it is possible that some of these indicators reflect monetary conditions at earlier periods. Price inflation and the growth of money GDP are currently at very low levels. The exchange rate has remained firm, though there is a risk that it could fall, while real interest rates are high and on some measures actually rising. Finally the available information on asset prices - houses, land, and new buildings -, which have in the past been very sensitive to monetary conditions, show the recent increases to have been at fairly modest levels by historical standards.

(1) THE BEHAVIOUR 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.

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

	Composite monetary indicator	MO	Non-interest bearing M1	M1	M2øø narrow definition (monetary sector)	M2øø broad definition	£M3	M3	PSL2
a) financial years									
980-81*	11.1	6.7	7.8	11.2			19.9	21.6	14.4
981-82*	5.4	2.1	-0.3	3.9			12.0	15.3	10.8
982-83*	10.9	5.1	11.3	14.3					
b) changes on same period in previous year+									
981(1)	8.8	7.3	4.6	7.7			18.7	20.9	13.5
(2)	11.6	5.7	8.6	11.8			18.6	22.5	13.9
(3)	12.2	5.0	9.2	11.4			16.1	22.4	13.6
(4)	8.2	4.2	4.9	7.8			13.0	18.6	11.1
982(1)	7.7	2.7	3.5	8.0			13.2	15.5	11.7
(2)	6.0	2.2	1.3	6.4			12.0	13.1	10.3
(3)	6.3	1.5	4.0	7.5			10.3	10.3	8.5
(4)	8.9	3.9	8.9	11.2	7.7		10.4	12.0	8.9
983(1)	10.5	5.2	10.9	12.8	8.5		10.2	13.5	9.8
(2)	11.4	7.0	10.5	14.5	9.5		11.7	13.0	11.8
c) changes on same period in previous year									
982 July	4.5	2.3	0.5	4.3			10.5	12.0	8.6
Aug	6.0	1.8	3.1	8.5			10.8	11.6	8.5
Sept	6.1	1.5	4.0	7.5			10.3	10.3	8.4
Oct	7.1	3.2	5.7	8.7			9.7	9.4	8.9
Nov	8.5	3.4	7.6	10.2	6.3	3.6	10.1	10.7	8.9
Dec	8.9	3.9	8.9	11.2	7.7	4.9	10.4	12.0	8.5
983 Jan	7.5	1.7	6.1	10.3	5.7	3.7	9.9	12.3	8.6
Feb	9.1	3.5	8.9	11.4	6.0	5.2	10.2	13.1	9.5
March	10.5	5.2	10.9	12.8	8.5	6.7	10.2	13.3	10.3
April	11.4	5.0	11.3	14.3	8.9	7.4	11.5	12.5	11.3
May	11.7	5.8	11.5	15.4	9.3	8.2	10.9	12.1	11.5
June	11.4	7.0	10.5	14.5	9.5	7.9	11.7	13.0	11.8
d) changes (at an annual rate) in 6 months to									
982 July	6.0	-1.3	3.8	5.6	7.5	2.7	8.5	12.5	7.9
Aug	7.7	1.2	7.8	9.7	6.2	3.6	9.9	12.9	7.9
Sept	9.8	4.9	11.9	12.2	7.1	4.4	10.4	12.1	8.3
Oct	9.7	5.3	12.6	13.4	11.4	7.5	10.5	10.7	8.2
Nov	11.3	6.6	15.4	17.3	8.3	6.9	10.7	11.9	7.7
Dec	9.5	6.3	13.2	14.1	6.6	5.7	9.6	13.0	6.9
983 Jan	9.2	4.8	8.4	15.1	3.9	4.7	11.3	12.2	9.3
Feb	10.6	5.9	10.1	13.1	5.8	6.8	10.5	13.3	11.1
March	11.3	5.6	9.9	13.3	9.7	8.9	9.9	14.7	12.3
April	13.1	4.8	10.0	15.2	6.4	7.4	12.5	14.8	14.5
May	12.1	5.1	7.7	13.7	10.2	9.5	11.2	12.2	15.4
June	13.3	7.9	7.8	14.9	12.4	10.0	13.7	13.1	17.1

(See page 3 for footnotes)

Footnotes to Table 1

* Through the financial year (mid-April on mid-April)

ø The growth rates for all monetary aggregates, except non-interest bearing M1, are adjusted for changes to the new monetary sector. The October 1982 figures were greatly distorted by the over-subscription of the STC share issue. The figures shown here are the Bank of England/Treasury best estimates of what would have happened in the absence of the distortion.

+ The quarterly figures are for the final banking month of the quarter

øø M2 is "seasonally adjusted" by using a seasonally adjusted series for the NIBM1 component and unadjusted series for the other components. When proper seasonal adjustment of M2 is eventually possible its within year movements will be different.

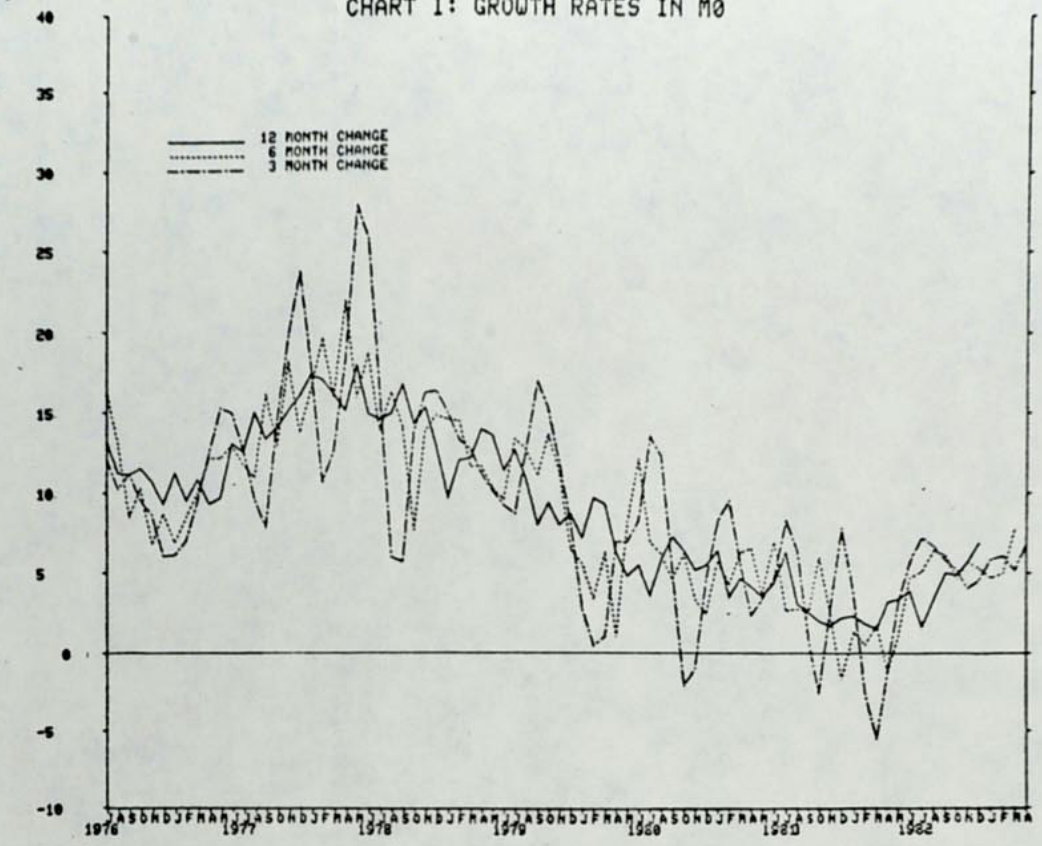
5. In the last few months the six month growth rate of £M3 has risen from a fairly steady level of just over 10 per cent in the final quarter of 1982 and the early months of 1983 to just over 13½ per cent. The rise in the growth in PSL2 has been even more striking. It looks as if the rise in the growth rates of the broad aggregates is to a great extent the result of a higher than expected level of public sector borrowing. This is a rather different explanation for the high growth rates of the broad aggregates than has been used in recent years. In the period between 1980 and the beginning of 1982, the relatively high growth of £M3 and other broad aggregates appears to have been the result of (a) a delayed reaction to the abolition of the corset, and (b) the desire of the private sector to hold additional financial wealth, some of which would take the form of interest bearing money, as a result of high real interest rates. Real interest rates are still high and the private sector may still be adjusting slowly to their persistent high levels, but the timing of recent changes in £M3 and other broad aggregates strongly suggests that the main reason for them is the high level of public borrowing.

6. The significance for the subsequent behaviour of the economy of the higher growth of £M3 depends critically on the reasons for it. If it were mainly the result of the private sector continuing to adjust to a higher ratio of financial wealth to income the higher growth of £M3 and the other broad aggregates far from being a signal that the private sector was about to raise the rate of growth of its spending, with the attendant risk of a subsequent rise in inflation, would be a signal that the growth of expenditure would be lower than expected. If on the other hand the higher growth of £M3 is, as seems more likely, the result of a loose fiscal policy there must be some risk that the private sector will increase the growth of its expenditure in response to finding itself with higher than expected money balances.

7. The interpretation of the significance of movements in M1 and its components (see tables 1 and 1A) poses almost as intractable problems as does the interpretation of £M3. In recent months the six month growth of total M1 has been fairly high, but this high growth

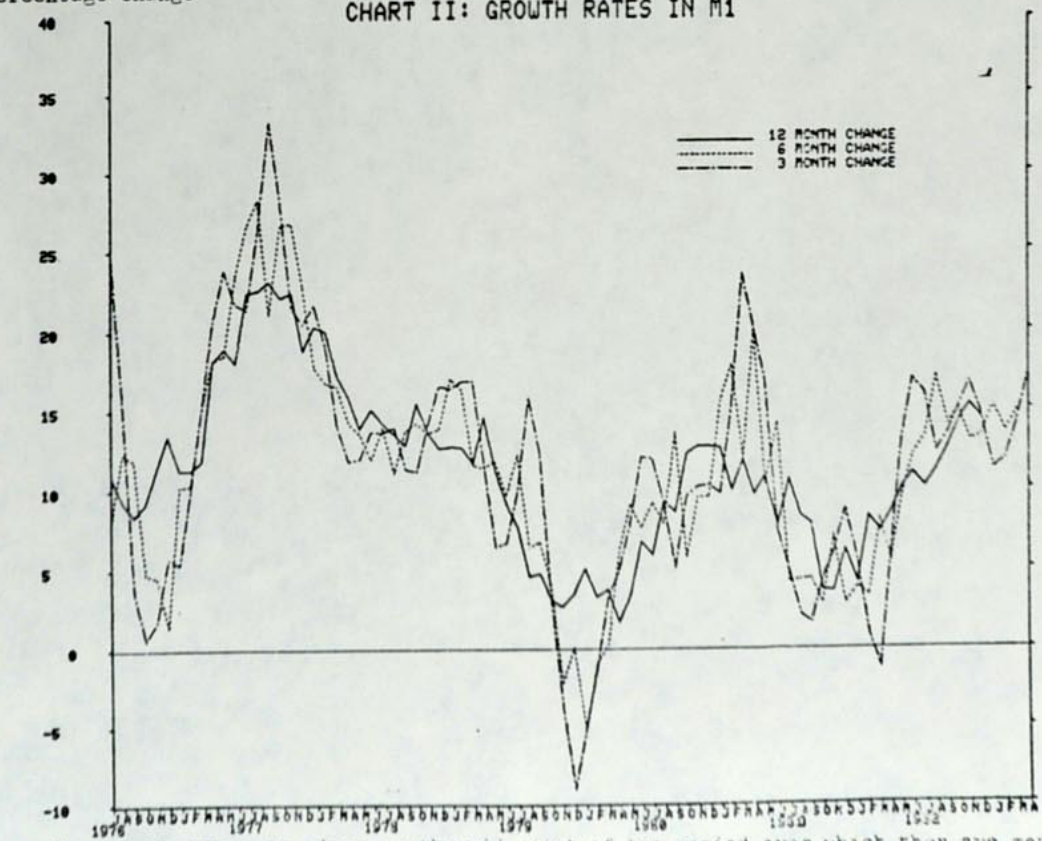
Annualised percentage change

CHART I: GROWTH RATES IN M0



Annualised percentage change

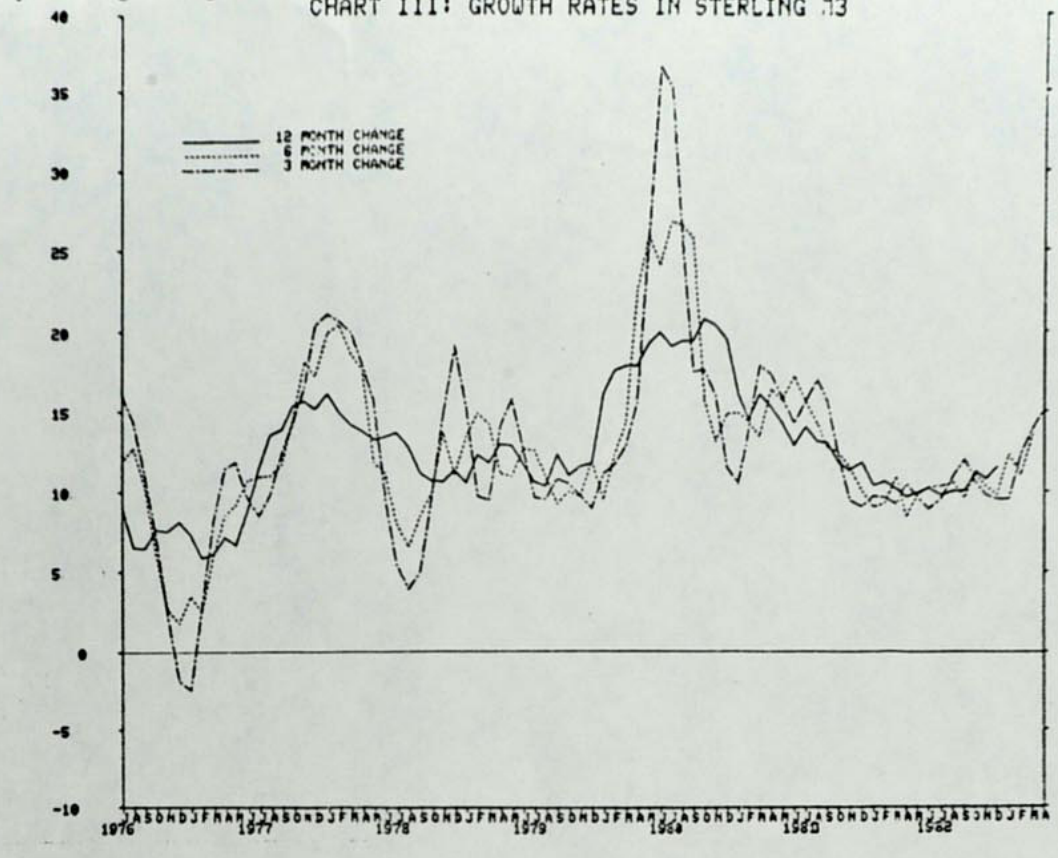
CHART II: GROWTH RATES IN M1



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.

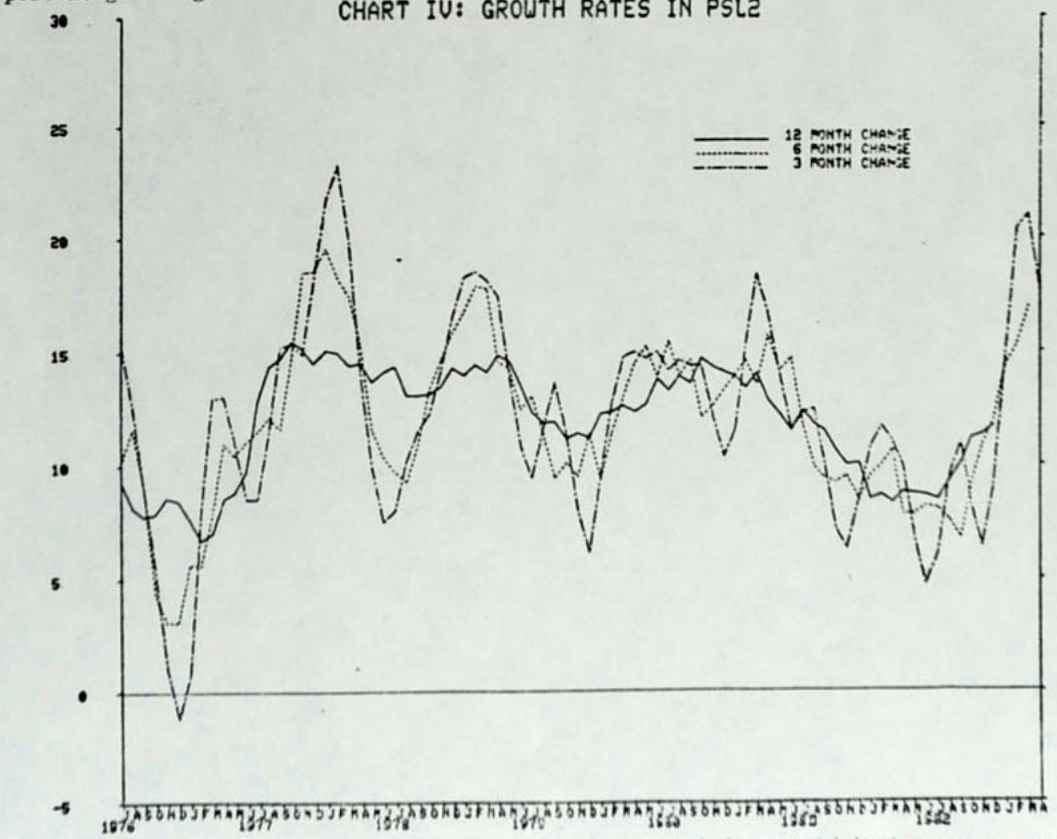
Annualised percentage change

CHART III: GROWTH RATES IN STERLING M3



Annualised percentage change

CHART IV: GROWTH RATES IN PSL2



Note: The growth rates are shown as 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.

is principally the result of very high growth of its interest bearing component. Non interest bearing M1 and its two principal components - notes and coin, and interest bearing sight deposits - have had relatively low six month growth rates. These developments are to a certain extent puzzling because it is non-interest bearing M1 - and in particular non-interest bearing sight deposits - that would normally be expected to be growing at a high rate in the period after a series of cuts in nominal interest rates.

TABLE 1A : GROWTH RATES OF COMPONENTS OF M1 (%)

	Notes/Coin		Non-interest bearing sight deposits		Interest bearing sight deposits	
	12 months	6 months (annual rate)	12 months	6 months (annual rate)	12 months	6 months (annual rate)
1981 Q1	6.3	5.1	-	12.0	-	8.7
Q2	5.8	6.8	11.7	15.9	23.8	6.8
Q3	5.5	6.4	13.8	13.6	11.7	23.9
Q4	5.3	3.7	7.5	-5.4	19.3	34.7
1982 Q1	4.7	3.1	2.7	-7.2	27.2	30.6
April	3.5	2.4	-2.6	-2.8	21.8	24.5
May	3.5	2.7	-2.8	-1.1	21.3	15.5
June	3.4	3.1	0.1	5.9	28.1	21.9
July	3.6	0.3	-1.3	6.1	19.9	12.3
Aug	3.7	2.9	2.7	11.1	31.1	16.3
Sept	3.5	3.9	4.3	17.3	21.6	13.2
Oct	3.8	5.	6.9	17.5	20.3	16.3
Nov	4.4	6.2	9.6	21.6	19.6	23.9
Dec	4.8	6.6	11.5	17.4	19.5	17.1
1983 Jan	3.9	7.7	7.4	8.8	25.5	40.2
Feb	5.8	8.8	10.9	10.9	19.8	23.5
March	6.3	8.8	13.8	10.6	19.3	25.7
April	7.2	9.1	14.0	10.8	24.8	33.9
May	7.3	8.4	14.2	7.3	29.1	34.6
June	7.7	8.9	12.2	7.2	28.1	40.2

8. It seems very likely that the rate of innovation in financial markets is currently very high and is distorting the movements of both total M1 and its components. The main problem appears to be the development and increased use of interest bearing sight deposits. Until recent months the stock of interest bearing sight deposits, while tending to grow as a share of M1, was subject to quite sharp

fluctuations. These fluctuations appear to be changes in wholesale deposits, mainly held by OFI's, that are principally held to invest at an opportune moment in other financial assets, eg gilts. In the recent past rather than month to month fluctuations there have been sharp rises in interest bearing sight deposits in successive months. There seem to be two forces at work here.

(i) A number of schemes operated by the clearers and other banks have caused the private sector to switch funds from non interest bearing to interest bearing sight deposits. This tendency is most evident in the personal sector, but companies as well are exploiting opportunities for economising on non-interest bearing money without losing liquidity. This particular shift is <u>within</u> M1 and leaves total M1 unchanged while making growth of non-interest bearing M1 appear misleadingly low.

(ii) There are indications that the more widespread availability of interest bearing sight deposits are causing persons and companies to switch into them from interest bearing time deposits and other relatively illiquid financial assets. In some cases rates of interest at or close to money market rates are now available on sight deposits, so the incentive to remain illiquid is much reduced. This particular shift is <u>within £M3</u> (or <u>within PSL2</u> if deposits are switched from building societies and national savings), but it inflates total M1 which grows more quickly than would otherwise be the case.

The broad conclusions of this analysis are that growth in total M1 may be inflated by financial innovation, while growth in non-interest bearing M1 may be understated. (It is not possible to give precise estimates of the size of these biases.) If these conclusions are correct it is difficult to regard the recent behaviour of total M1 as particularly worrying. A relatively high growth of M1 is only to be expected following a period when short term interest rates have tended to fall.

9. Table 1B splits total £M3 into its non-interest and interest bearing components. This gives a clear idea of the very rapid rate at which interest bearing deposits - whether those in M1 or those excluded from M1, but in £M3 - have tended to grow over the period since 1980.

TABLE 1B : GROWTH RATES OF COMPONENTS OF £M3

Banking* Quarters	(i) Non-interest bearing M1			(ii) Interest bearing M1			(iii) Interest bearing time deposits ie £M3 less M1 less public sector deposits			(iv) All private sector interest bearing deposits (ii) + (iii)		
	12 months	6 months (annualised)	Level (£bn)	12 months	6 months (annualised)	Level (£bn)	12 months	6 months (annualised)	Level (£bn)	12 months	6 months (annualised)	Level
1980 Q1	5.4	0.0		1.5	1.4		21.1	24.4		18.6	21.5	
Q2	4.7	-0.5		-3.0	7.0		21.6	29.8		18.4	27.1	
Q3	1.4	2.7		20.8	43.8		33.2	42.5		31.7	42.6	
Q4	3.3	7.2	25.4	31.3	61.1	6.1	34.0	39.0	41.1	34.0	41.3	47.2
1981 Q1	5.8	9.0		27.9	13.7		29.8	18.2		30.0	17.7	
Q2	9.7	12.3		33.7	6.8		25.8	13.5		26.6	12.6	
Q3	9.8	10.8		23.9	23.9		19.9	20.2		20.4	20.6	
Q4	4.9	-2.0	26.6	19.9	34.7	7.3	16.9	20.3	48.0	17.3	22.0	55.3
1982 Q1	3.4	-3.5		27.2	30.6		16.7	13.3		18.0	15.4	
Q2	1.2	4.6		28.1	21.9		16.0	11.8		17.5	13.1	
Q3	3.9	11.9		21.6	33.2		11.5	9.8		12.8	10.3	
Q4	8.8	13.2	28.9	19.5	17.1	8.8	8.6	5.4	51.9	10.0	7.0	60.7
1983 Q1	10.9	9.9		19.3	25.7		8.2	6.6		9.7	9.1	
Q2	10.5	7.8		28.1	40.2		8.8	12.4		11.5	16.2	

*Banking quarters refer to the end of banking March, June, September and December respectively.

10. The other nominal monetary aggregates have tended to rise in recent months. The six month growth rate of the composite monetary indicator has risen from just under 10 per cent at the beginning of th year to just over 13 per cent. While the six month growth rate of MO rose in June this in part reflects an erratic rise in bankers' balances in that month which may well be reversed. There has been a tendency for the twelve month growth rates of both the broad and narrow versions of M2 to rise slowly, albeit from very low levels.

11. Table 2 and Charts V and VI show the latest data on the growth of real money. The tendency for the growth rates of most of the

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

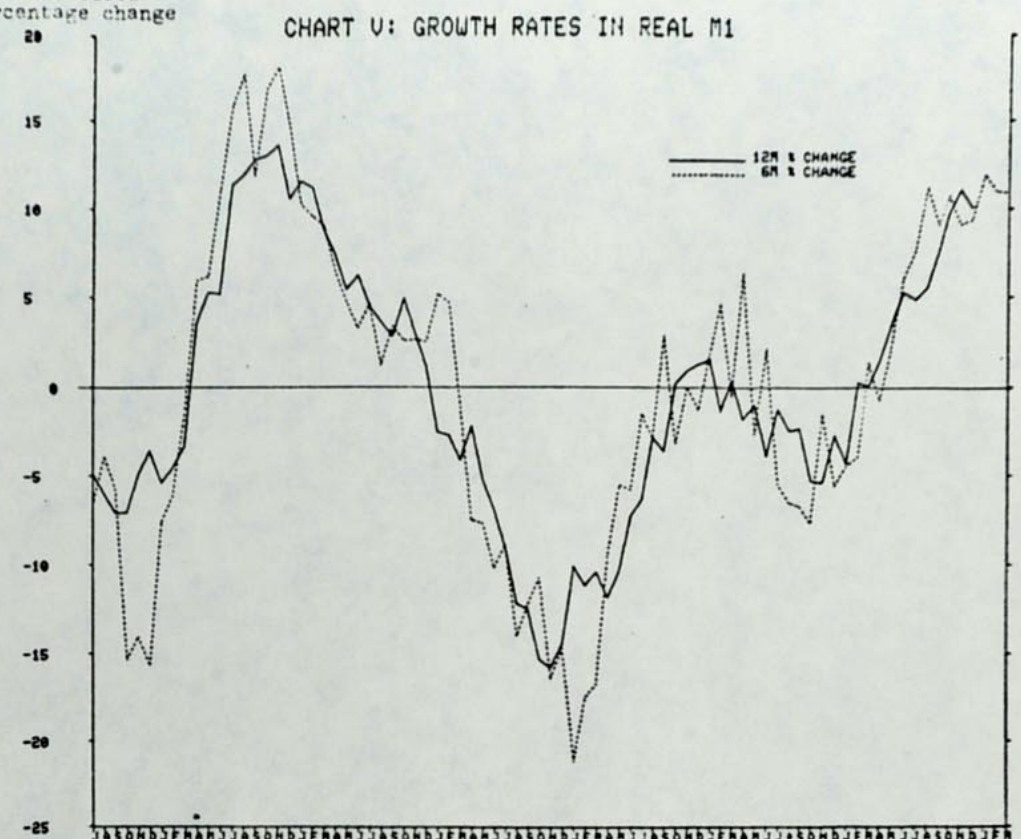
	RPI+	Composite monetary indicator	MO	Non interest bearing M1	M1	£M3	PSL2
(a) Financial years*							
1980-81	12.0	-0.9	-4.9	-2.7	0.3	7.9	2.5
1981-82	9.4	-3.6	-6.7	-8.9	-5.2	2.3	1.3
1982-83	4.1	6.6	1.0	7.0	9.9	7.3	6.4
(b) Changes in same period in previous years							
1981(1)	12.6	-3.3	-4.6	-6.1	-3.5	6.1	1.0
(2)	11.3	0.3	-5.0	-1.5	1.4	7.4	2.7
(3)	11.4	0.7	-5.8	-1.4	0.5	4.3	2.5
(4)	12.0	-3.4	-6.6	-6.3	-3.9	0.9	-0.3
1982(1)	10.3	-2.4	-6.9	-6.2	-2.3	2.6	1.2
(2)	9.2	-2.9	-6.4	-7.2	-2.6	2.6	1.0
(3)	7.3	-0.9	-5.4	-3.0	0.1	2.8	1.1
(4)	5.4	3.4	-1.4	3.4	5.5	4.7	3.3
1983(1)	4.6	5.6	0.6	6.0	7.8	5.3	4.9
(2)	(3.8)	(7.3)					
(c) Change in 12 months to							
1982 July	8.7	-3.9	-5.9	-7.6	-4.2	1.6	-0.1
Aug	8.0	-1.8	-5.7	-4.5	0.3	2.6	0.8
Sept	7.3	-1.1	-5.4	-3.0	0.1	2.8	1.1
Oct	6.8	0.3	-3.4	-1.1	1.6	2.7	2.0
Nov	6.3	2.2	-2.7	1.3	3.7	3.6	2.5
Dec	5.4	3.3	1.4	-3.4	5.5	4.7	3.3
1983 Jan	4.9	2.5	-3.1	1.1	5.1	4.7	3.5
Feb	5.3	3.6	-1.7	3.4	5.8	4.6	3.9
Mar	4.6	5.6	0.6	6.0	7.8	5.3	5.3
April	4.0	7.1	1.1	7.1	10.0	7.2	7.0
May	3.7	7.7	2.0	7.5	11.3	7.0	7.5
June	(3.8)	(7.3)	3.0	6.4	10.3	7.5	7.7
(d) Change in 6 months to							
1982 July	6.3	-0.2	-7.0	-2.2	-0.5	2.3	1.7
Aug	7.1	0.5	-5.5	0.7	2.4	2.6	0.8
Sept	5.7	3.9	-0.7	6.0	6.3	4.6	2.6
Oct	5.0	4.3	0.1	7.1	7.9	5.0	2.9
Nov	5.3	5.7	1.3	9.7	11.4	5.2	2.3
Dec	4.4	4.9	1.8	8.4	9.3	5.0	2.3
1983 Jan	3.8	5.2	1.0	4.4	10.9	7.2	5.3
Feb	3.5	6.8	2.3	6.3	9.3	6.7	7.2
Mar	3.5	7.5	2.0	6.1	9.5	6.2	8.3
April	2.8	10.0	2.1	7.1	12.2	9.4	11.4
May	2.2	9.6	2.8	5.3	11.2	8.7	12.9
June	(3.4)	9.6	4.3	4.3	11.2	9.9	13.2

+The simple method of seasonal adjustment for the RPI for use in calculation of the six monthly growth rates was described in the February 1982 Interpretation of Monetary Conditions.

*Through the financial year (mid-April on mid-April)

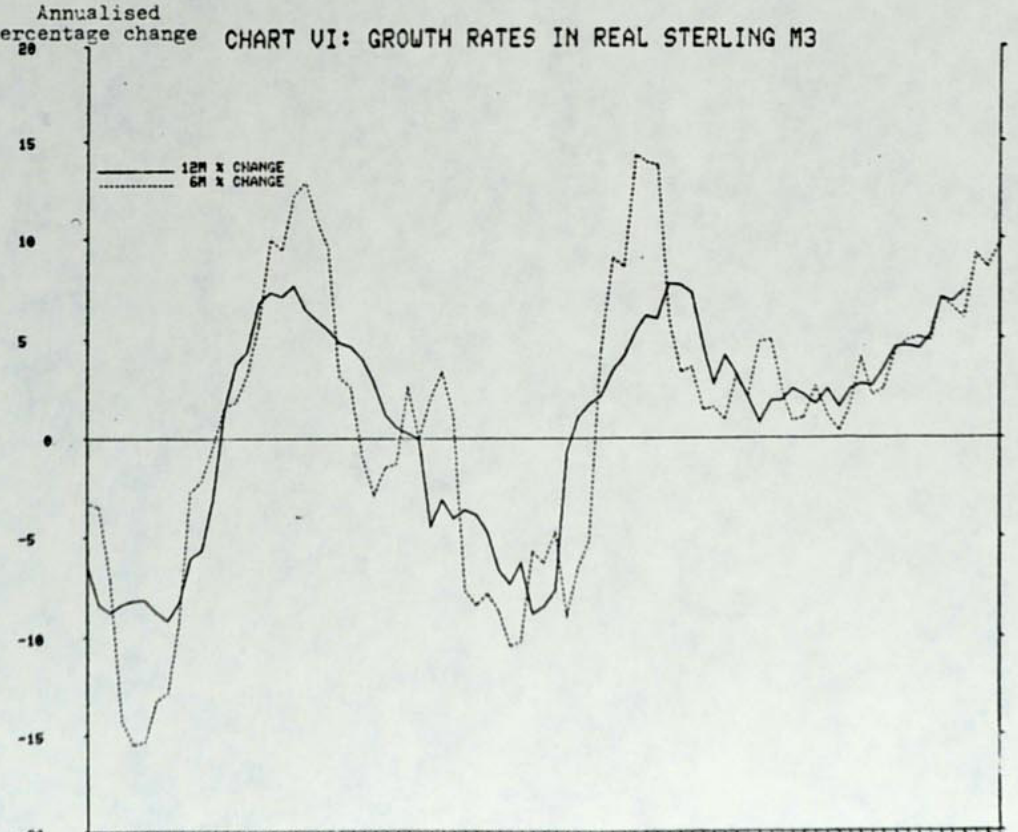
Annualised percentage change

CHART V: GROWTH RATES IN REAL M1

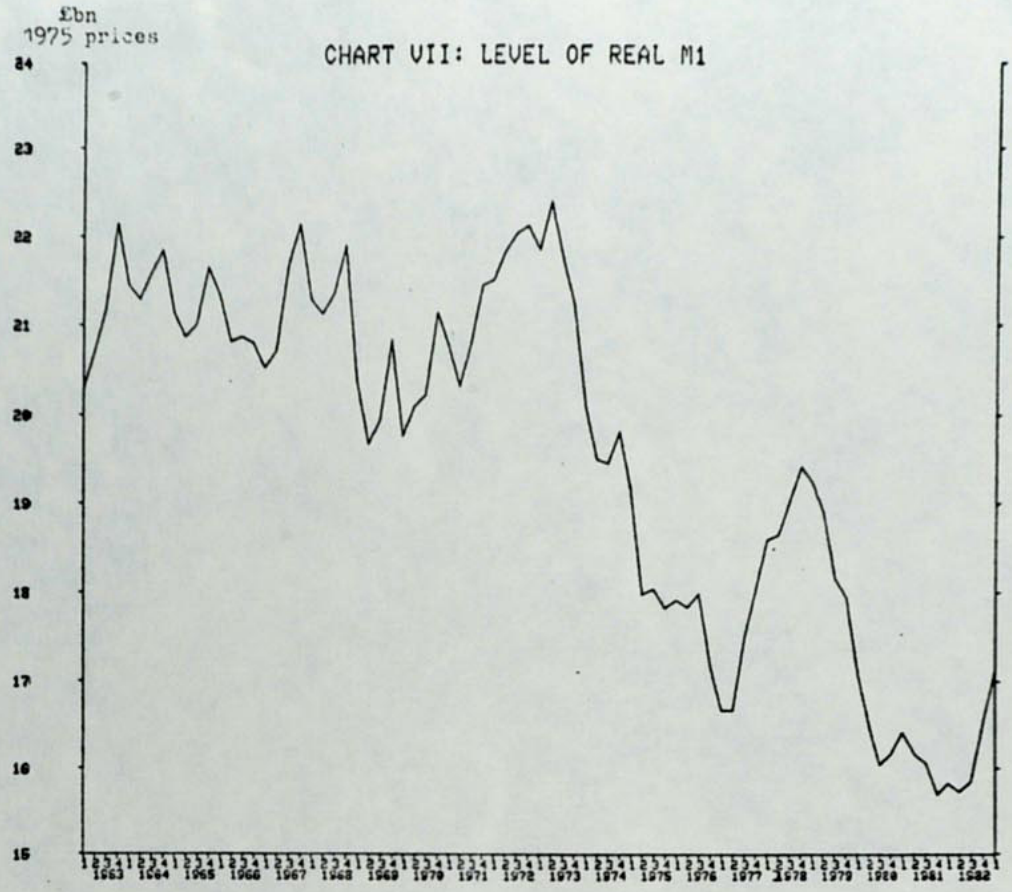


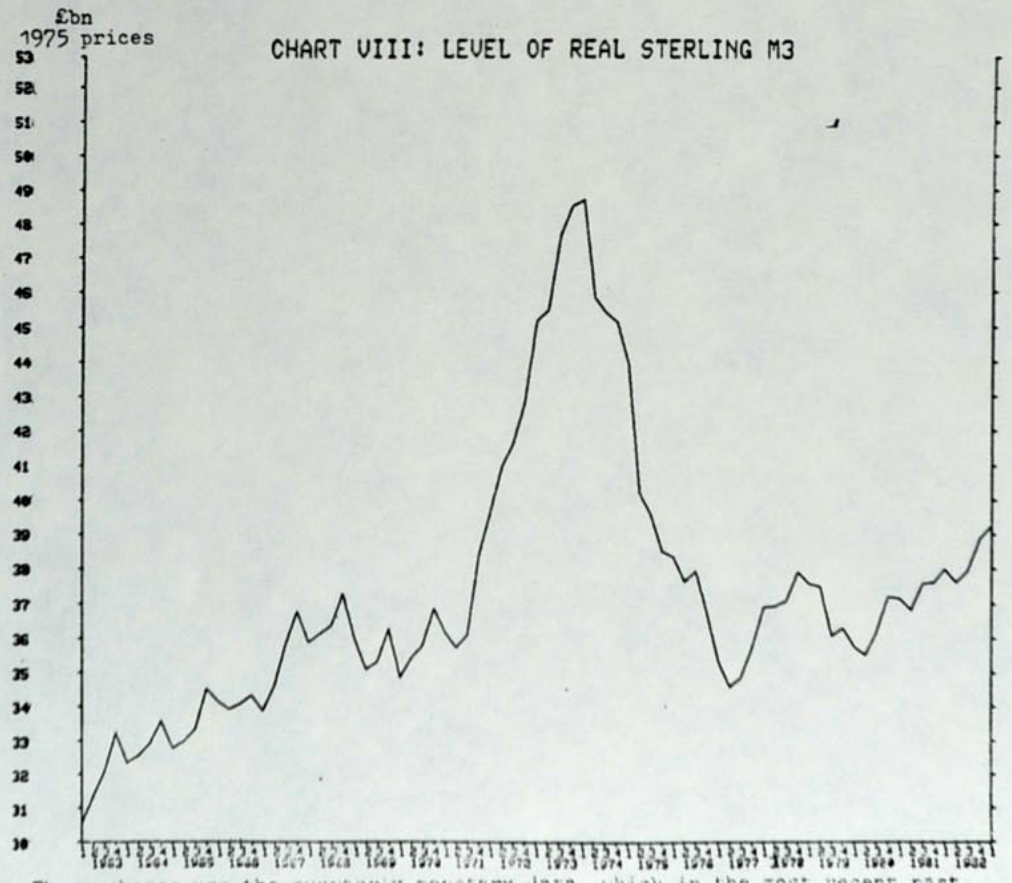
Annualised percentage change

CHART VI: GROWTH RATES IN REAL STERLING M3

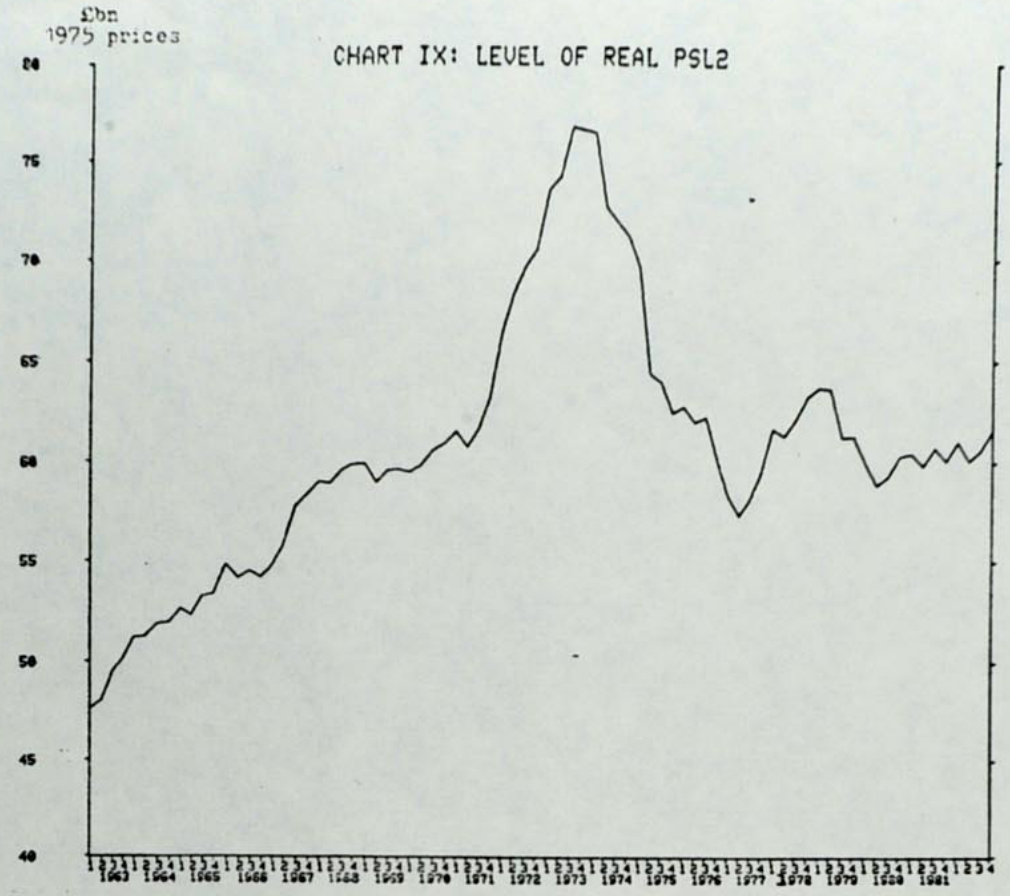


Note: The growth rates are shown as the mid-point of the period over which they are measured. Thus the growth from September 1981 to September 1982 is shown as March 1982 and the six month annualised growth rate from March 1982 to September 1982 is shown as June 1982





Note: These charts use the quarterly monetary data, which in the most recent past produce lower increases in the monetary aggregates than the monthly data.


£bn
1975 prices
CHART IX: LEVEL OF REAL PSL2
80
75
70
65
60
55
50
45
40

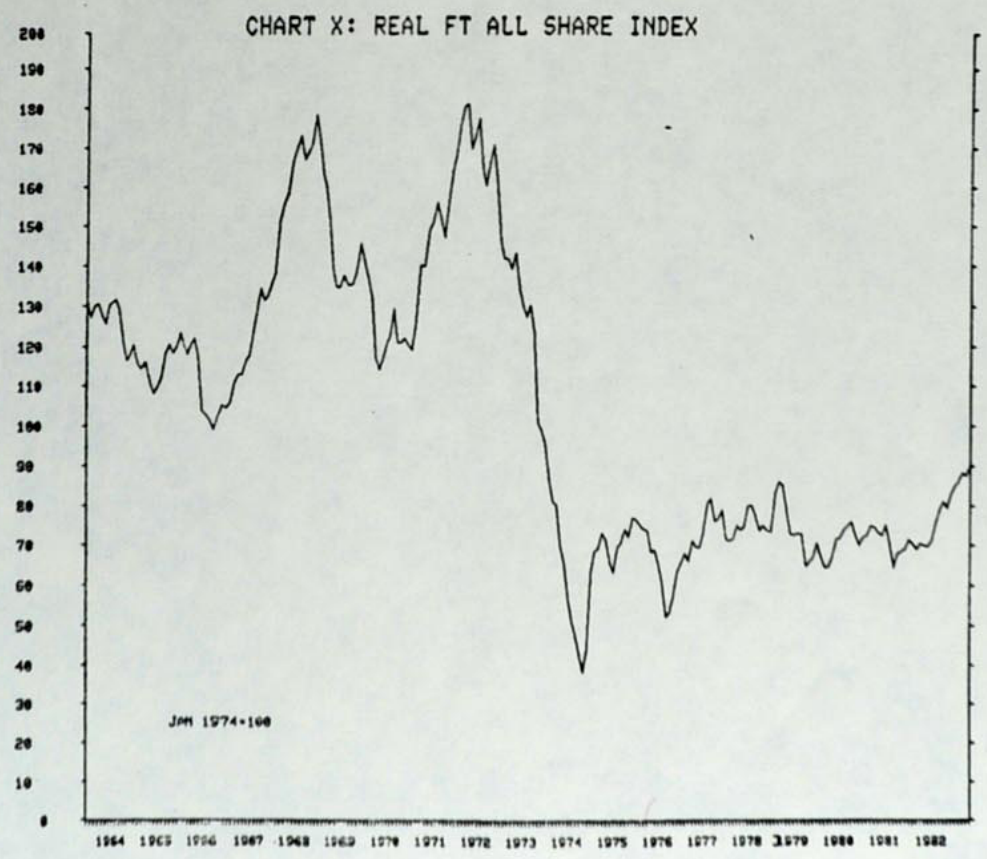


CHART X: REAL FT ALL SHARE INDEX
200
190
180
170
160
150
140
130
120
110
100
90
80
70
60
50
40
30
20
10
0
JAN 1974=100
1964 1965 1966 1967 1968 1969 1970 1971 1972 1973 1974 1975 1976 1977 1978 1979 1980 1981 1982

nominal monetary aggregates to rise, together with the gradual reduction in the inflation rate, have brought about significant increases in the growth rates of the real monetary aggregates. The growth of real £M3 has been positive for some years, but recent developments have for M1, the composite monetary indicator, and M0 involved a very sharp change from negative growth rates a year ago to growth rates of about 10 per cent now. Some rise in the growth of real money is inevitable and necessary when the process of reducing inflation comes to an end. There are, however, no clear criteria to determine if and when particular growth rates become excessive.

12. Table 3 shows that the fall in the growth rate of bank lending has for the moment at least come to an end.

TABLE 3 : BANK LENDING
(monetary sector, banking months, seasonally adjusted)

		Percentage change in stock of lending over	
		12 months	6 months (at annual rate)
1981	October	12.8	11.6
	November	16.3	20.2
	December	17.3	24.3
1982	January	18.9	31.7
	February	20.9	31.5
	March	21.7	35.3
	April	24.2	38.2
	May	25.6	31.3
	June	26.5	28.6
	July	28.8	25.9
	August	27.6	23.8
	September	28.6	22.3
	October	29.5	21.4
	November	26.9	22.8
	December	25.5	22.5
1983	January	23.6	21.3
	February	21.7	19.7
	March	19.5	16.8
	April	17.3	13.3
	May	16.9	11.4
	June	17.2	12.2

3 OTHER INDICATORS OF MONETARY CONDITIONS

13. Although the numbers for particular quarters have been erratic Table 4 shows that the growth rate for money GDP appears to have been continuing to decline in the recent past.

TABLE 4 : GROSS DOMESTIC PRODUCT AT CURRENT PRICES

	GDP at market prices (CSO's average estimate)	
	% change on a year earlier	% change over six months (annual rate)
1981 Q2	9.3	8.7
Q3	9.4	9.2
Q4	9.0	9.3
1982 Q1	9.4	9.4
Q2	9.5	10.1
Q3	8.5	7.7
Q4	8.7	7.3
1983 Q1	8.5 (6.6)	9.3 (6.0)*

* CSO projections.

14. Table 5 shows that RPI inflation has reached a very low level. There are as yet no indications of a significant upward movement.

TABLE 5 : RETAIL AND WHOLESALE PRICES
(% change on same period a year before)

	Retail prices	Wholesale output prices (home sales)	Wholesale input prices
1981 Q1	12.7	10.9	8.5 (12.1)*
2	11.7	10.3	12.2 (23.4)*
3	11.3	10.1	16.8 (21.7)*
4	11.9	11.2	16.7 (10.4)*
1982 Q1	10.4	9.7	8.0 (-2.2)*
July	8.7	8.5	5.2 (6.8)ø
Aug	8.0	7.9	3.0 (3.4)ø
Sept	7.3	7.5	3.3 (9.1)ø
Oct	6.8	7.6	5.7 (7.4)ø
Nov	6.3	7.4	6.6 (13.1)ø
Dec	5.4	8.0	8.0 (10.6)ø
1983 Jan	4.9	7.4	9.4 (13.8)ø
Feb	5.3	7.1	7.1 (10.8)ø
Mar	4.6	7.3	9.5 (10.2)ø
April	4.0	7.3	6.5 (5.9)ø
May	4.7	7.3	6.5 (0.0)ø
June	(3.8)	7.2	4.4 (-1.5)ø

*Increase over two quarters before at an annual rate.
øIncrease over past six months at an annual rate.

15. UK short term market interest rates fell between May and June and have been fairly stable since then. Short term eurodollar rates have risen by almost a point since May. The short term yield curve has tended to slope upwards in recent weeks, which may indicate that the market believes that short rates are more likely to rise than fall. Long rates have fallen by the same amount as short rates from the beginning of the year until June but have risen by about 0.5 in recent days.

TABLE 6 : NOMINAL INTEREST RATES (period averages)

	Three month Interbank	Three month Eurodollar	Base Rate	Long Rate (20 year gilts)	Yield gap
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 Q1	14.3	15.1	14.1	14.7	0.4
1982 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	1.4
Oct	9.8	10.4	9.8	10.5	0.7
Nov	9.4	9.8	9.2	10.6	1.2
Dec	10.5	9.5	10.1	11.4	0.9
1983 Jan	11.2	9.0	10.7	11.9	0.7
Feb	11.3	9.1	11.0	11.5	0.2
March	10.8	9.4	10.7	11.2	0.4
April	10.3	9.3	10.2	10.6	0.3
May	10.3	9.0	10.0	10.6	0.3
June	9.9	9.8	9.7	10.4	0.5
July 7	9.8	9.9	9.5	10.9	1.1

16. Table 7 shows a slight fall in recent weeks in the estimate of real short term interest rates that is calculated by deducting from the short term nominal interest rate the average forecast inflation rate of the main outside forecasters. This measure of the expected or ex ante real interest rate may, however, understate its true value for June and July. It is unlikely that markets expect inflation in the immediate future to be quite as high as do the outside forecasting bodies. If expected inflation is currently lower than the outside forecasters believe and therefore real short term interest rates are at the moment higher than Table 7 suggests it follows that there has been little if any fall in real short term interest rates over the last year and they might even have risen (as IG yields suggest).

TABLE 7 : REAL INTEREST RATES (period average)

	Expected inflation over 12 months*	Real 3 month Interbank Rate	Yield on indexed gilts	
			1988	1996
1981 Q1	10.7	2.6	-	2.1
Q2	10.0	2.6	-	2.4
Q3	10.3	3.9	-	3.1
Q4	10.1	5.5	-	3.2
1982 Q1	10.3	4.0	-	3.1
1982 May	9.3	4.0	2.8	3.0
June	9.0	4.0	2.8	3.1
July	8.2	4.2	2.9	3.2
Aug	8.1	2.9	3.1	2.9
Sept	7.7	3.0	3.3	2.9
Oct	7.5	2.3	3.2	2.7
Nov	5.4	3.9	2.8	2.7
Dec	5.9	4.6	2.7	2.8
1983 Jan	6.1	5.1	2.8	2.5
Feb	6.4	4.9	2.9	2.5
March	6.5	4.3	2.9	2.5
April	6.5	3.8	3.0	2.5
May	5.9	4.4	3.4	2.9
June	6.2	3.7	3.9	-
July 7	6.4	3.4	4.2	-

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

17. Table 7 shows also that the yield on indexed gilts has risen during the course of 1983. For technical reasons related to the calculation of yields on IG's it is likely that the true rise in the yield is somewhat more, although the level of yields is slightly less than the figures in Table 7 suggest. Even when full account is taken of this bias and the recent rise in conventional yields a comparison of conventional and indexed gilts suggests that in the past few months it is true both that the acceptable real yield on IG's has risen, and that the average inflation rate expected over the next few years has fallen.

18. Although the uncovered differentials against the dollar and Deutschemark have fallen again in recent weeks and are now much lower than in February and March, the exchange rate, which rose in each successive month between March and June, has been remarkably stable.

TABLE 8 : EXCHANGE RATES (period averaged)

		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	Q1	91.1	1.85	-0.8	4.3
1982	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	85.4	1.62	1.0	4.2
1983	Jan	82.0	1.57	0.1	4.5
	Feb	80.8	1.53	2.2	5.8
	March	79.1	1.49	1.4	5.8
	April	82.1	1.53	1.0	5.3
	May	85.0	1.58	1.3	5.3
	June	85.2	1.55	0.1	4.5
	July 7	85.1	1.54	-0.1	4.5

*Between 3 month UK Interbank rate and 3 month Eurodollar rate and the 3 month Euro DM rate.

4 HOUSING FINANCE AND THE HOUSING MARKET

19. The figures for building society financial flows in May show a further decline in net inflows and an increase in net advances (seasonally adjusted) compared with recent months. As a result, the liquidity ratio declined to 17.2 per cent, its lowest level since 1974. Gross advances continued at a high level, although new commitments have shown signs of falling off since March, probably as a result of increased mortgage rationing by the building societies rather than a reduction in demand. Figures for June are not yet available, but are expected to show a similar pattern to earlier months, and the liquidity ratio is likely to fall below 17 per cent. The changes in the mortgage and ordinary share rates to 11¼ and 7¼ respectively announced on 22 June did not become fully effective until 1 July. The changes will improve the societies' position by reducing the demand for mortgages while increasing the supply of funds, but it remains to be seen whether the change in relative interest rates will be sufficient for societies to rebuild their liquidity and (assuming that they want to do this) eliminate mortga queues.

TABLE 9 : BUILDING SOCIETY FINANCIAL FLOWS
(calendar months and quarters, seasonally adjusted)

	Liquidity Ratio (end period)	Net increase in shares & deposits	Net advances	Gross advances	Net new commitments
	£m	£m	£m	£m	£m
1982 Q1	19.0	2311	1275	2754	3323
Q2	19.5	2499	1922	3768	4031
Q3	20.0	2623	1984	3897	4077
Q4	20.1	2842	2674	4717	5273
1983 Q1	18.0	2390	2933	5196	5284
October	20.2	1049	838	1490	1591
November	20.2	1148	882	1552	1760
December	20.1	645	954	1675	1922
January	19.4	725	955	1728	1706
February	18.7	795	918	1637	1772
March	18.0	870	1060	1831	1806
April	17.8	719	900	1620	1572
May	17.2	574	1036	1708	1551

20. Table 10 shows that bank lending for house purchase continued at the relatively low rates of recent months, recording an estimated £270 million in May. Advances are expected to decline further in response to additional lending restrictions recently applied by, for example, National Westminster and Lloyds. Table 10 shows, however, that while the growth rate of bank lending for house purchase has fallen (from a very high level) the growth of total bank and building society lending has been remarkably stable at an annual rate of about 25 per cent.

TABLE 10 : NET LENDING FOR HOUSE PURCHASE
(£m., seasonally adjusted, calendar months)

		Building Societies	Banks (Est)	Total
	July	651	450	1101
	August	638	470	1108
	September	695	420	1115
	October	838	410	1248
	November	882	390	1272
	December	954	360	1314
1983	January	955	260	1215
	February	918	320	1238
	March	1060	280	1340
	April	900	250	1150
	May	1036	270	1306
Amount outstanding End December 1982		56894	10600	

Percentage change in stock of lending

		Building Societies		Banks (excl. TSBs Estimated		Total Banks and Building Societies	
		12 months	6 months	12 months	6 months	12 months	6 months
1982	June	12.8	13.4	95.8	98.7	19.5	21.1
	July	13.0	14.4	96.3	100.7	20.2	22.5
	Aug	13.0	15.4	96.7	99.5	20.3	23.6
	Sept	13.4	16.0	94.8	92.3	20.8	24.0
	Oct	14.2	17.0	91.7	88.2	21.6	24.8
	Nov	15.0	17.5	86.9	82.4	22.2	25.0
	Dec	16.0	18.7	87.9	77.8	23.4	25.8
1983	Jan	17.1	19.7	83.1	67.1	24.1	25.8
	Feb	18.0	20.7	78.0	58.9	24.7	25.8
	Mar	19.0	21.9	71.0	52.2	25.1	26.1
	April	19.7	21.8	65.6	45.7	25.0	25.2
	May	19.8	22.1	60.4	41.0	24.9	24.9

21. It is probable that the withdrawal of the banks and mortgage rationing by the building societies is having a restraining effect on the growth in house prices. Table 11 and Chart XII show that following the rise in the annual rate of increase in the second half of 1982, the rate of growth of house prices over a year earlier has flattened off or even declined somewhat. This is not inconsistent with reports from some building societies that house prices have risen rapidly over the past quarter - a similar spurt occurred at the same time in 1982. It is not clear to what extent these increases are due to seasonal factors. Last year, house prices rose much less rapidly after May, so that figures for June and July this year could be decisive in showing whether house prices growth can continue to be contained in the 10-12 per cent range of recent months, which is still fairly low given the historical record of house prices.

TABLE 11 : HOUSE PRICES
(% change on a year earlier)

	Based on mortgage approvals	Based on mortgage completions	Mix-adjusted (based on completions)	Nationwide (based on approvals)
1982 Q1	-4.0	-4.9	0	2
Q2	-0.7	-3.0	1	2
Q3	4.0	0.5	2	3
Q4	12.2	6.8	6	8
1983 Q1	13.0	11.3	11	9
Q2				11
1982 October	9.9	3:1		
November	12.9	6.9		
December	14.2	10.4		
1983 January	13.8	9.6		
February	13.7	10.8		
March	12.4	11.8		
April	12.6	10.9		
May	12.4	9.5		

CHART XI: QUARTERLY HOUSE PRICES

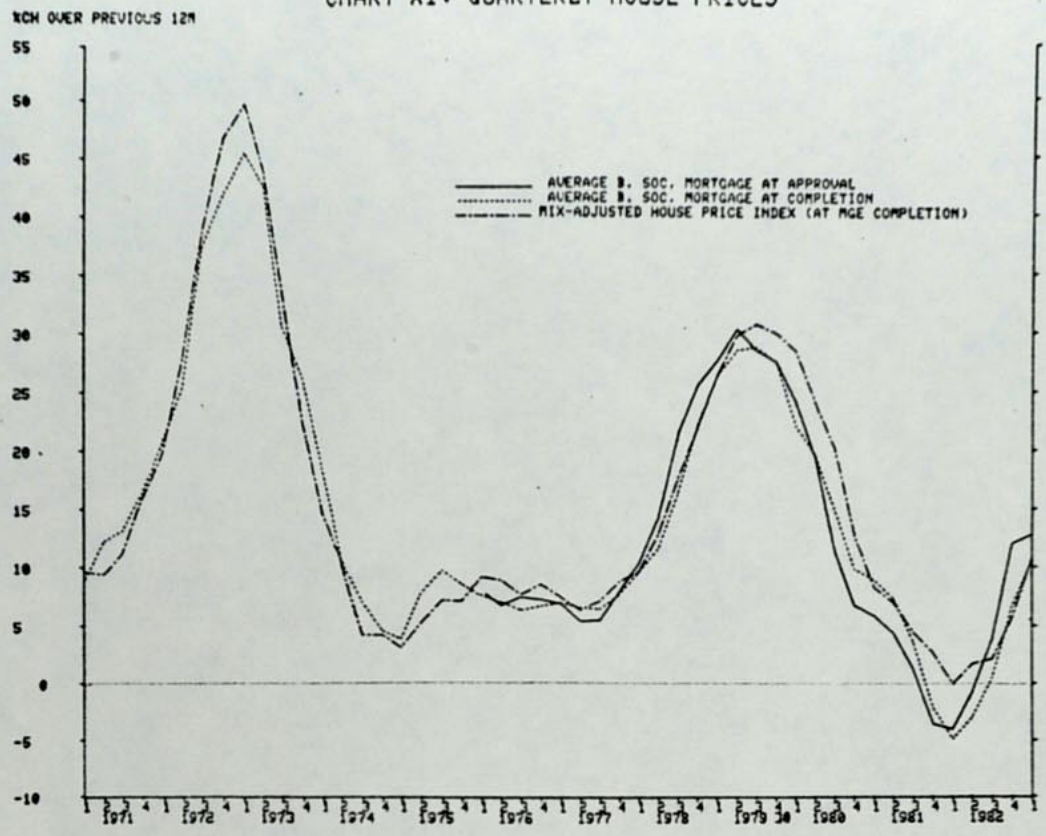


CHART XII: MONTHLY HOUSE PRICES

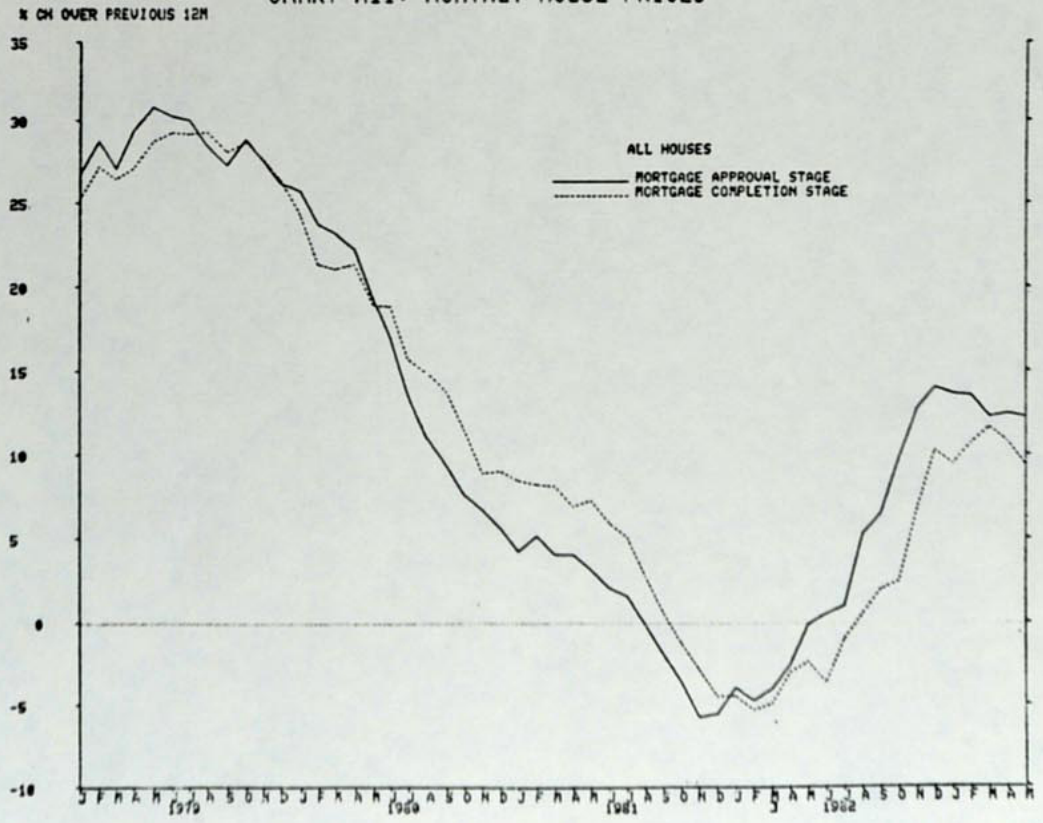
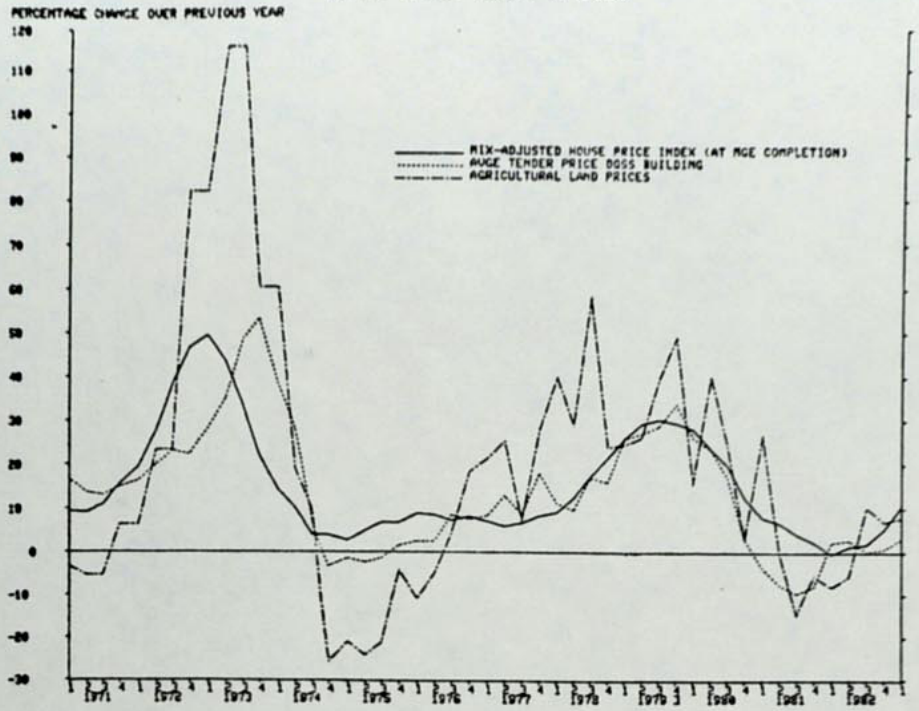
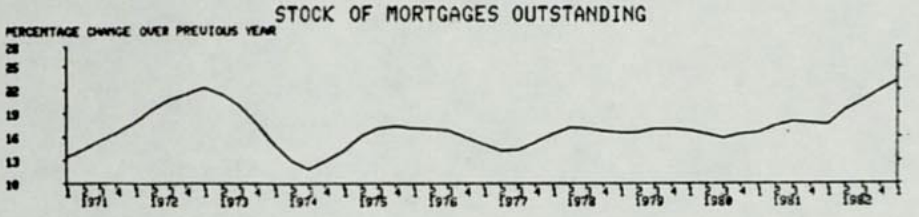


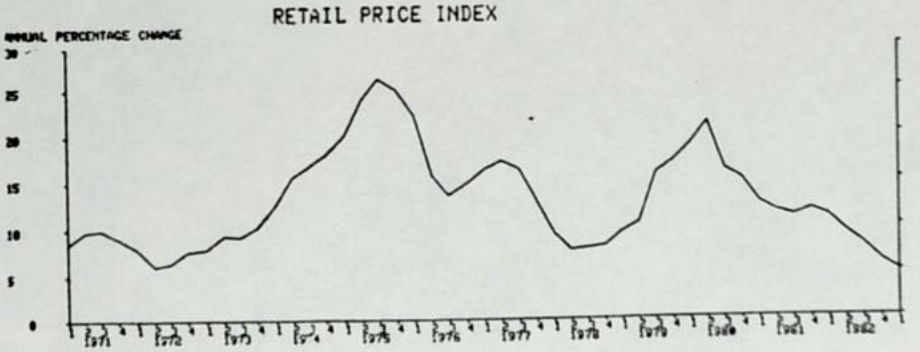
CHART XIII: ASSET PRICES



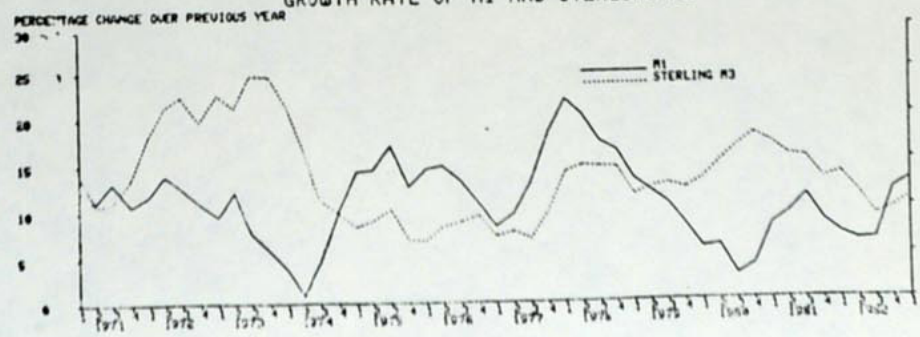
STOCK OF MORTGAGES OUTSTANDING



RETAIL PRICE INDEX



GROWTH RATE OF M1 AND STERLING M3



Copies to Professor Sir A Walters
GPS
DGPS
Mr Loehnis
Mr Fforde
Mr Coleby
Mr Goodhart
Mr Plenderleith
Mr Gill
Mr Foot
Mr Townend
Mr W A Allen

SECRET

BANK OF ENGLAND
Threadneedle Street
London
EC2R 8AH.

8 July 1983

P E Middleton Esq
H M Treasury
Parliament Street
London
SW1P 3AG

Dear Peter,

I enclose our regular monthly note on interest rates over the next few weeks for our meeting on Monday afternoon.

Yours sincerely,

Eddie.

SECRET

INTEREST RATES OVER THE NEXT FEW WEEKS £ millions

1 The unpublished interest rate band for bills with up to 14 days to maturity is 9-11%, where it has stood since last October. Within this band, our operations have been conducted at a rate of 9 9/16% since 14 June.

Market conditions

2 The main influences on market conditions are first, the monetary and fiscal overshoot, the dimensions of which are gradually becoming apparent to the public as more statistics are published, and the fiscal measures taken by the Government in response to it, and second, the deepening pessimism about financial prospects in the US. These factors have influenced different markets in different ways.

3 The main feature of the foreign exchange markets in the last month has been the continued strength of the dollar. This reflects a growing concern that the pace of monetary growth in the US means that the next move in US interest rates will be upwards, which has evidently been a more important influence on the dollar than the actual and prospective deterioration in the current account of the US balance of payments.

4 Sterling fell back to around 84 in effective terms after the reduction in base rates from its pre-election peak of 87.4. Last week, however, it held its own against a strong dollar and appreciated to around 85 by mid-week in effective terms, on expectations that the rapid rate of monetary expansion here would at least prevent any further cut in UK interest rates and could force an increase. It appreciated by a further half-point after the announcement of the fiscal package, indicating that expectations of firm UK interest rates had not immediately diminished; but it later fell back to about 85 on further fears about US interest rates.

5 In the money market rates have risen, particularly at longer maturities. The three-month inter-bank rate went up from 9 13/16% just after the cut in base rates to 9 7/8% in mid-week, whilst over the same period the one-year inter-bank rate hardened from 10% to 10 3/8%. The initial reaction to the fiscal package was for rates to edge up further: the three month rate to 10% and the one-year rate to 10 1/2%. Offerings of bills to us have been concentrated in the longer maturity bands; and on 6 July and again on 8 July some offerings were made at above our established Band 4 dealing rate.

6 The gilt-edged market has been the worst affected; apart from fears about short-term interest rates, in the US and UK, the market is concerned about the funding implications of the fiscal and monetary overshoot. As in the foreign exchange market and the money market the initial effect of the fiscal package was to cause a further weakening of prices, though they recovered much of their initial losses during the course of Friday. Market conditions have prevented us from adding more than 90 to the gross sales of 640 for banking July that had been secured by sales of partly-paid stock before the month began. Hopeful signs of an incipient revival in the index-linked sector disappeared with the setback to the whole gilt market after the publication of a disappointing US M1 figure on 1 July and the provisional UK money figures on 5 July.

Monetary conditions

7 The aggregates accelerated once more in banking June, although the figures for the three preceding months were revised downwards in the light of new information about seasonal factors. As the table shows (second column of figures), the target aggregates are all well above the current range.

Table

Annualised growth rates of the monetary aggregates (percentages)

	mid-Aug 1982 - mid-Feb 1983	mid-Feb - mid-June 1983	Forecast mid-June - mid-Sept 1983
M1	13.2	17.6	16
Sterling M3	10.5	15.8	13 1/2
PSL2	11.1	17.8	12 1/2
Wide monetary base	5.8	10.7	
NIB M1	10.1	11.6	
PSL1	8.6	16.5	
PSL2A	13.4	16.4	
M3	13.3	14.0	
M2 (not seasonally adjusted)	4.5 (1)	7.5 (2)	

(1) Three months to mid-February 1983 compared with the same period a year earlier.

(2) Four months to mid-June 1983 compared with the same period a year earlier.

8 The figures for banking May and June, the seasonal adjustments to which have been carefully reassessed, make it clear that the increase in the PSBR which began in the second half of calendar March has continued into this financial year. The pace of gilt-edged funding was stepped up in response, but nevertheless over the first four months of the target period the PSBR was underfunded by 2,250.

9 In addition there was a sharp increase in sterling bank lending to the private sector in banking June. Such lending amounted to 1,670 (including the "bill leak") compared with an average of 680 on the same basis in the preceding three months. The additional increase was only in small part in lending to persons and could perhaps therefore have been associated with a further rise in output. Meanwhile the pace of building society mortgage lending has been maintained at 900 - 1,000 a month; total mortgage lending, including the banks' contribution, is probably still running at around £1 1/4 billion a month.

10 The three-month money supply forecast offers no prospect of relief, even on the assumption that gilt-edged funding can be re-started and gross sales pushed up to 1,000 this month, with 1,250 a month in banking August and September. It makes no allowance for additional asset sales, however. The annualised growth rates of sterling M3, PSL2 and M1 over the target period to mid-September are put at 14 1/2%, 15 1/2% and 17% respectively. The PSBR* for the three forecast months is put at 3,750; this would bring the total for the five months from mid-April (ie excluding the surge at the end of the 1982/83 financial year) to 5,800 - an annual rate of nearly £14 billion. Sterling bank lending to the private sector is put at 1,010 a month on average.

11 The recently-completed NIF puts the PSBR for 1983/84 as a whole at £11.7 billion (before the fiscal package). The growth rates of the monetary aggregates are, of course, calculated on a financial year basis, but they are consistent with annualised growth rates over the 1983/84 target period (mid-February 1983 - mid-April 1984) of 12 1/2% (£M3), 13 1/4% (PSL2) and 14% (M1) - all well above the 7-11% target range.

12 The surge in monetary growth has not as yet had any discernible effect on inflationary expectations, though this could be changed by the publication of the figures for banking June. Stockbrokers' circulars expect the 12-month increase in the RPI to rise to around 6% by the end of this year and to peak at 6 1/2 - 7 1/2% in the spring/summer of next year. On this basis, the real one-year inter-bank rate is 3-4%, not allowing for tax. An alternative measure, which allows for standard rate income tax, is the real rate on building society ordinary shares, which on the basis of the above estimate of expected inflation over the next year is roughly zero.

Conclusions

13 The Government has now taken fiscal action. The immediate market reaction to it has been disappointing, despite the fact that

---

* Strictly the PSBR minus net purchases of local authority and public corporation debt by the non-bank private sector.

the market's impression of the overrun in the PSBR started below that implied by the latest official forecast. This adverse initial reaction suggests that market participants suspect that the measures taken will be insufficient to prevent a rise in short-term interest rates. It will, however, be several days before the markets' more considered reaction becomes clear.

14 The other main influence on market sentiment is financial developments in the US, where the FOMC is meeting on 12 and 13 July. After that meeting, Chairman Volcker has to testify to the Senate Banking Committee by 19 July, reviewing monetary policy to date and giving provisional monetary targets for 1984.

15 In these circumstances we need to wait and see how the markets develop. It is possible that sentiment will now consolidate and enable funding to be resumed at current yield levels by reactivating our tap stocks at lower prices. If the climate remains depressed and if expectations of higher interest rates persist, the question will arise as to whether gilt-edged funding can be re-activated by action in the gilt-edged market alone. Gilt-edged prices might have to be allowed to fall sufficiently further so that we could cut tap prices later and by a larger amount, and re-start funding on that basis. Or we may now need to consider the more positive option of a new long conventional stock, either in straight or in convertible form.

16 However, given the persistence of market uncertainty about short-term interest rates in the aftermath of the fiscal package, it is not at all clear that it will be possible to re-start funding by either of these actions in the gilt-edged market alone. It may be necessary to let short-term interest rates rise as the only means of resolving the uncertainty.

SECRET

RECORD OF A DISCUSSION BETWEEN THE CHANCELLOR AND THE GOVERNOR ON MONETARY PROSPECTS: 6.30 P.M., 13th JULY, AT NO.11 DOWNING STREET

Present:			
	Chancellor	Sir A Walters	Governor
	Economic Secretary	Mr Littler	Deputy Governor
	Mr Middleton	Mr Cassell	Mr Loehnis
	Sir T Burns	Mr Monck	Mr George

The Governor said that he agreed with the analysis of the present position set out in Mrs Lomax's minute of 12 July. As for the policy response, he agreed that further action on the fiscal side was not possible before the autumn. The question therefore was whether and when to take action on interest rates, and he had to warn that the option of inaction was becoming progressively less attractive. The money markets thought a rise in rates likely, and the upward slope of the yield curve, which had existed for a fortnight and was steepening, was creating tension. Following the announcements about public expenditure, and new funding successes, a period of consolidation might be feasible, and he hoped that no action on interest rates would be necessary for at least a week. But if US rates rose, rises here could hardly be avoided.

2. The Chancellor stressed the desirability of the early introduction of a new instrument, preferably a long IG. The case for this would no doubt be discussed at the Economic Secretary's Funding meeting on 19 July. It was suggested that launching a new long-dated IG might be difficult while the market expected short term rates to rise, and that the IG market was still rather narrow. The options should include a conventional convertible issue, and perhaps an ultra-long conventional issue. It was noted that the market would keep an eye on the exchange rate, and that their expectations of rising short-term rates would increase if the exchange rate fell. It was also noted that the markets might derive some reassurance on borrowing from the June quarter seasonally-adjusted PSBR figure, to be published on 21 July, which might be only some £1.8 billion.

3. Sir T Burns suggested that the key issue was not whether successful funding required higher short-term interest rates, but whether they were necessary for the health of the

economy. It was important to agree on one's assessment of monetary conditions. All the the monetary aggregates were growing above-target but the picture was not too worrying if one took account of the balance between interest-bearing and non interest-bearing money, and the continuing relative strength of the exchange rate. This suggested that the case for higher interest rates had not yet been made out; and that, if a rise was required, it should be small. Sir A Walters agreed that monetary conditions were less lax than a first glance at the aggregates might suggest, though he thought that they might be a little laxer than Sir T Burns had suggested. Nevertheless, he agreed with the policy advice. It would be best not to take interest rates up; though if US discount rates rose, our rates would probably have to rise too.

4. The Chancellor reported that German representatives at ECOFIN on 11 July, and the Japanese Deputy Finance Minister on 13 July, had indicated that neither Government thought a rise in their interest rates desirable. Indeed the Germans had suggested that, if US rates rose, German rates would not follow, and that a policy of benign neglect of the Deutschemark would be pursued. The Governor thought that such a policy would be difficult for the UK, particularly if US discount rates rose steeply. But Volcker had suggested, during the Basle meetings on 10/11 July, that he hoped that US rates would rise only modestly.

5. It was agreed that the right policy for the present was to aim for a further period of consolidation. But a rise in UK interest rates was not excluded; and it was agreed that it might be unavoidable if US rates rose sharply.

National Savings

6. Mr Monck asked about measures to restore the competitive position of DNS instruments. The increases in yields which were under consideration were small in comparison to the recent rise in Buildling Society rates; and it might be appropriate to announce them before long, in order to ensure that they were seen as a response to the Building Societies' action, rather than as a potential excuse for further action. The Chancellor said that he had no doubt that increases were necessary; the question was one of timing, and the key factor was whether conditions in the gilts market would be made more difficult. Mr George said that the Bank had been cautious about increases in DNS yields, which might have been seen as an inadequate response to the PSBR and Funding picture. But following the expenditure announcement on 7 July, and the breaking of the funding log-

jam, this risk had diminished. Moreover, the process of consolidation now might actually be assisted by an increase, for the markets would regard it as a considered move, designed to establish rates for some time, and therefore perhaps reflecting an expectation that short-term interest rates generally would not rise.

7. It was agreed that, while no final decision would be taken before the funding meeting on 19 July, the presumption should be that an announcement of increases in DNS yields would be made in the week beginning 25 July.

BP

8. The Chancellor referred to the abortive plan for a BP placing on 11 or 12 July. He had on reflection concluded that a conventional secondary Offer for Sale in the autumn, which might bring in £0.5 billion, was preferable to a July placing of some £350 million. There should be no difficulty about going for a full £0.5 billion in the autumn: the 1977 sale had been larger. And it might make sense to look again to the New York market, as had been done in 1977, but not 1979.

9. Mr George agreed that an Offer for Sale could be for a larger sum than the proposed placing. He hoped that £0.5 billion would be possible. The comparison with 1977 was however potentially misleading: the market's appetite for oil shares had since diminished with increased supply. And US involvement might be unwelcome to UK institutions: a high proportion of the BP shares sold on Wall Street in 1977 had migrated back across the Atlantic very quickly.

10. The Chancellor said he understood that the Bank and the Company had doubts about an early announcement of the Government's intentions. He was clear that Parliament must be told before the summer recess. It was agreed that this should not cause diffculty, provided that BP were taken into the Government's confidence first. An announcement immediately after the aborted placing might have been unfortunate, but it would be in order to announce before the House rose that an autumn Offer of Sale of up to £0.5 billion was being considered. BP would be informed forthwith. The right timing for the Offer might be shortly after BP's interim results came out on 1 September.

11. The meeting ended at 7.15 p.m.

J O KERR

15 July 1983

Distribution

Those Present
Chief Secretary
Financial Secretary
Mr Battishill
Mr Lavelle
Mr Lankester
Mr Ridley o.r.
Mr Burgner
Mrs Lomax
Mr Turnbull
Mr Hall