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Policy Unit

(2) To note. It is possible, however, that some stockbuilding could be financed by running down liquidity which is high rather than borrowing.

AT 10/1

PRIME MINISTER

BANK LENDING AND THE MONEY SUPPLY

Today's money figures confirm the comparative laxity of our monetary policy. The main underlying cause of growth is sterling lending to the UK private sector, particularly to individuals. In 1981, sterling lending to the private sector grew by 22 per cent, in 1982 by 22.8 per cent, and in 1983 the growth will have exceeded 15 per cent. The borrowing is still going on.

Loan demand growing this rapidly without offsetting action to reduce its monetary effect is not compatible with long-term price stability. Of course bank lending will grow as individuals become more sophisticated, as banks intervene in more transactions, and as more people turn to bank accounts in place of the pound note under the mattress. Even allowing for these changes, however, bank lending is growing too rapidly.

In 1984, there is also the possibility (which would be good news for the unemployment figures) that stock building will resume. In 1980, stocks were reduced by £3.2 billion-worth, in 1981 by £2.7 billion-worth, and in 1982 by £1 billion. 1983 saw very little increase from the low levels achieved by the end of 1982. Stock rebuilding is also usually associated with companies borrowing more from the banks, and this would add to the pressures on money policy.

There are three responses that the Government can make to a surge in bank lending and to the consequent monetary growth it generates. The Government can:

1. Reduce public expenditure, thereby reducing its own borrowing requirement to ease some of the credit pressures on money markets.

2. Over-fund its own deficit to a greater extent than it has been doing. Over-funding means that the authorities finance part of the loan demand by buying commercial bills from banks which restrains the growth in banks' assets and liabilities which count as money growth.

3. Engineer an increase in interest rates as a signal to money markets and to banks that credit growth is excessive.

The general thrust of Government policy is to revitalise the private sector, to create the jobs and the prosperity which the economy needs. This therefore means that the appropriate response to excessive monetary growth is a combination of routes 1. and 2. Public expenditure has a habit of rising during a financial year, and Ministers are usually happy to bring forward proposals for additional spending or requests for matching spending overruns from the Contingency Fund. In the coming year or so, the pressures have to go the other way so that where spending is reviewed, it is more likely to go down than up.

JOHN REDWOOD