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DAUFROM: RACHEL LOMAX
DATE: 17 FEBRUARY 1984

- Em 9/2*
1. SIR PETER MIDDLETON
 2. CHANCELLOR . .

cc: Chief Secretary
Financial Secretary
Economic Secretary
Sir T Burns
Mr Littler
Mr Cassell
Mr Monck
Mr Battishill
Mr Lavelle
Mr Lankester
Mr Sedgwick
Mr Mowl
Mr Peretz
Mr Riley
Mr O'Donnell
Mr Willetts
Mr Willoughby
Mr Wynn Owen
Mr Lord
Mr Ridley
Mr George - B/E
Prof. Sir A Walters - UKTSD
Washington
Mr Redwood - No 10

MONETARY PROSPECTS

This minute summarises our latest assessment of the monetary situation and prospects, and the discussion at Sir Peter Middleton's usual monthly meeting with the Bank to review our approach to short term interest rates and funding. This month the meeting also considered papers on personal borrowing and M2.

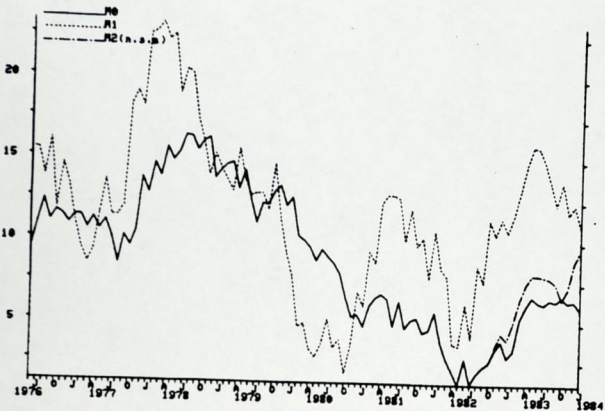
Monetary Aggregates

2. As expected, monetary growth moderated in January, following sharp rises in all the target aggregates in December. This month's figures bring £M3 just within the target range (on both new and old definitions), but leave PSL2's growth since mid-February 1983 little changed. The sharp slowdown in August and September last year is still reflected in relatively low six month growth rates, though the growth in broad money has been higher over the past three months. The relatively rapid growth in PSL2 reflects high inflows into the building societies; the January inflow was an all time record, probably boosted by movements out of offshore roll up funds. Foreign currency deposits have also

CHART 1

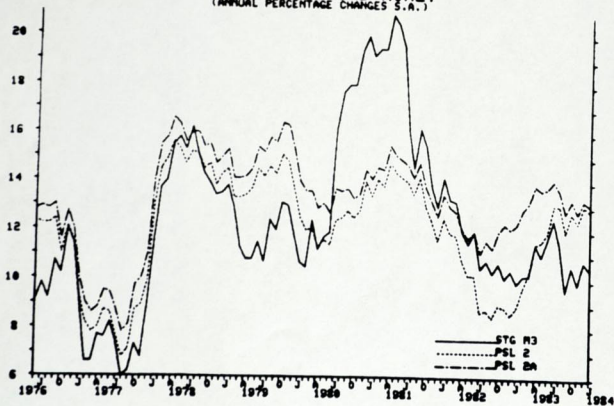
GROWTH IN NARROW MONEY

(ANNUAL PERCENTAGE CHANGES S.A.)



GROWTH IN BROAD MONEY

(ANNUAL PERCENTAGE CHANGES S.A.)



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grown rapidly since October, bringing the increase in total M3 over the past three months to 17 per cent (at an annual rate).

3. The trend in narrow money may, if anything, have eased slightly. Notes and coin have been virtually flat since November, and growth over the target period is now only 5 per cent. The apparent acceleration in M2 reflects a large revision to the December outturn to incorporate some building society accounts whose terms have changed (without the change, the year on year growth would be 8.2 per cent; on the same basis, annualised growth over the target period, using partial seasonal adjustments, is 7.9 per cent).

Table 1: Main Aggregates: recent experience

(per cent, seasonally adjusted)

	<u>M1</u>	<u>£M3</u>	<u>PSL2</u>	<u>MO</u>		<u>M2*</u>
				<u>End Month</u>	<u>Weekly Averaged</u>	
monthly change:-						
December	+1.6	+1.3	+1.0	-	+0.4	+2.7
January	-0.2	+0.6	+1.1	-0.4	+0.4	+0.3
growth at an annual rate over past:-						
3 months	8.1	10.4	10.9	2.6	5.1	<u>13.6</u>
6 months	8.6	7.5	9.5	4.9	6.6	<u>7.0</u>
target period (11 months)	11.4	10.7	12.3	5.6	6.7	<u>10.0</u>
12 months	11.1	10.5	13.0	5.7	6.0	9.7

* not seasonally adjusted

4. Over the next three months £M3 is expected to be around the top of the target range, averaging around 1 per cent a month, broadly in line with growth since mid-September. Since building society inflows show no signs of tailing off, PSL2 may continue to grow slightly faster. Six month growth rates could rise sharply in February and March as the period of slow growth in the late Summer enters the base. The projected growth in MO over the period is in line with the trend over the target period so far. On the basis of the Weekly Bank Return, weekly averaged

MO may have risen by $\frac{1}{4}$ per cent in banking February; notes and coin rose slightly faster. The end month MO series seems to have jumped by about 2 per cent, reflecting a rise in bankers' balances of nearly £170 million.

Table 2: Summary of the Forecast

	MO	percentage changes		
		M1	£M3	PSL2
growth at an annual rate:				
mid-Jan - mid-Apr	6 $\frac{1}{4}$ to 9 $\frac{1}{2}$	16	12 $\frac{1}{2}$	17 $\frac{1}{4}$
<u>Target period</u>				
<u>to mid-Feb</u>	6 $\frac{1}{4}$ *	11 $\frac{1}{2}$	11	12 $\frac{1}{2}$
<u>to mid-Apr</u>	6 $\frac{1}{2}$ to 7 $\frac{1}{4}$ *	12 $\frac{1}{2}$	11	13 $\frac{1}{4}$

* Growth rates apply to weekly averaged MO.

FSBR and Debt Sales

5. Over the next three months the 'FSBR' is expected to total £3 $\frac{1}{2}$ billion, seasonally adjusted (£3 billion unadjusted). On both bases the profile is extremely uneven. February is expected to show a small unadjusted surplus, but a large seasonally adjusted deficit. Both adjusted and unadjusted figures point to a broadly flat position in March, and heavy borrowing in April. The forecasts are derived from the latest calendar month profile which, at this time of year, tends to be updated ahead of the NIF. Receipts from asset sales are £175 million (for Cable and Wireless) in banking March. The assumed £ $\frac{1}{2}$ billion EC refund has its main effect in April. On-lending to the rest of the public sector may be £1 $\frac{1}{2}$ billion over the three months, slightly below the total for the comparable period last year, bringing the total for the year to mid-April to £4 $\frac{1}{2}$ billion. The provisional CGBR for banking February is put at an unadjusted surplus of £265 million (a seasonally adjusted deficit of £1920 million). Once again, the unadjusted CGBR(0) surplus was larger than expected.

6. The gross gilt sales target of £1 $\frac{1}{2}$ billion was slightly exceeded in January, and almost exactly met in banking February. Despite heavy redemptions, net sales to the UK non-bank and overseas sectors reached £900 million in January, and should exceed £1 billion in February,

thanks to a pause in redemptions and buying-in. With gross sales assumed to stay at £1½ billion a month, heavy redemptions imply a sharp dip in funding through gilts in March, but some recovery in April. National Savings continue to do well, despite increased outflows from index-linked securities. Inflows into DNS have reached £2.7 billion in the financial year to mid-February, and the £3 billion target should be achieved. Purchases of CTD's have been unusually high as a result of more aggressive pricing, more than offsetting heavy surrenders of Series 5 Certificates. But public corporations seem to have been large buyers in February, so the net contribution to funding may have been negative.

7. The public sector's contribution to £M3 has been contractionary in every month but one since July, and the PSBR was overfunded by £1½ billion in January alone. But there may be some underfunding over the next three months, especially in April and (in seasonally adjusted terms only) in February. As table 3 shows, this would leave the PSBR substantially overfunded in the year to mid-April 1984, but slightly underfunded over the target period as a whole. We should be close to a full fund for the year to mid-February (in seasonally adjusted terms).

Table 3: The 'PSBR' and Funding

	mid-Feb 83 - mid Jan 84 (target period)	mid-April 83 - mid Jan 84	Forecast £bn, s.a.	
			mid-Jan 84 - mid Apr 84	mid-Feb 84 - mid-Feb 84
'PSBR'	11.0	8.2	3.4	12.6
Debt sales to NBFS	-11.1	-10.5	-2.9	-12.3
Over(-)Under(+)funding	- 0.1(0.6)	- 2.3(-2.2)	0.5(0.1)	0.3(-0.8)
External finance of public sector	- 1.0	- 0.7	-0.3	- 1.1
Over(-)under(+)funding alternative definition	- 1.1	- 3.0	0.2	- 0.8

Figures in brackets are unadjusted.

8. Money market influences were contractionary by over £1½ billion in banking January and money market shortages have continued through

February. The stock of money market assistance reached an all-time high of £11½ billion on February 13, and the NLF has deposited surplus balances with the Banking Department on a number of occasions since 20 January. Assistance may reach a seasonal peak of £12 billion or more in banking March; thereafter the money market position should ease significantly, as the unadjusted CGBR moves into large deficit in April.

Sterling lending to the Private Sector

9. Lending was unexpectedly low in January, following an erratically sharp jump in December. Taking the two months together, the evidence is consistent with some acceleration in the underlying trend since the Autumn, and the fairly cautious upward revision we made to the forecast last month still looks justified. But the picture is very unclear. This month's figure may have been depressed by expansionary external influences (which were about £½ billion, even after correcting for distortions caused by valuation changes). There is little useful information about the composition of lending since the turn of the year. The quarterly figures show a fairly clear increase in lending for personal consumption in the second half of 1983. There is also a marked turnaround in borrowing by ICC's, though this may have been, in part, a response to the swing in the public sector's net position during the course of the year. There is no clear upward movement, and some signs of a fall, in other forms of lending. The recorded figures for the next few months could be very erratic, reflecting the uneven path of the PSBR.

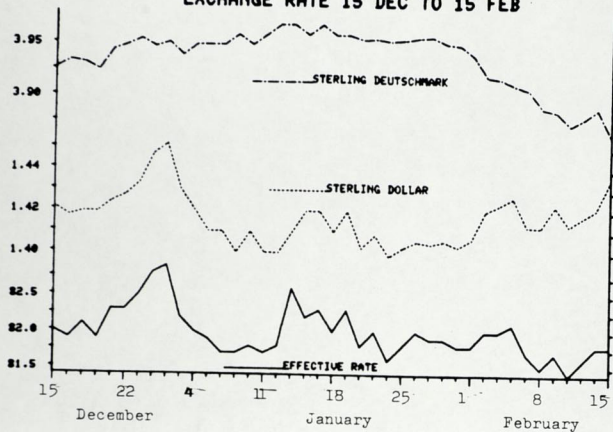
Building Societies

10. The building societies' recent success in attracting funds seems to have been at the expense of the banks, whose personal sector deposits fell by over £½ billion in the second half of 1983. Since record inflows have allowed the societies to make heavy purchases of gilts (maybe as much as £1½ billion in the second half of last year), the net effect has probably been to reduce £M3, as well as to increase the marginal cost of funds to the banks, who have been forced to rely on attracting wholesale money.

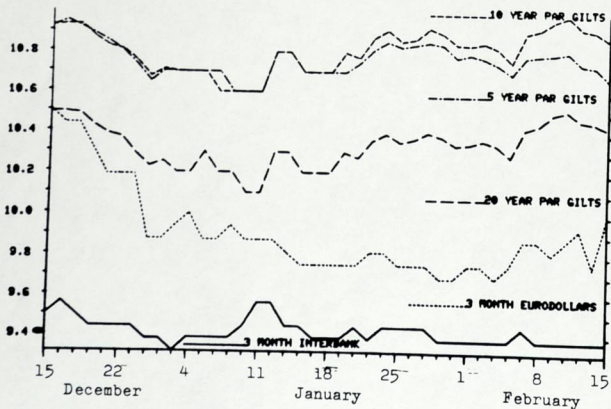
11. With the demand for mortgages staying strong, the prospect of a cut in the mortgage rate looks increasingly remote. Support for lower

Chart 2

EXCHANGE RATE 15 DEC TO 15 FEB



INTEREST RATES 15 DEC TO 15 FEB



rates comes mainly from those large societies who have a differential rate structure, who may be finding it difficult to invest their current inflow as fast as they would like. But they may prefer to get rid of some expensive premium schemes, before unilaterally reducing their rates.

Other Indicators of Monetary Conditions

12. Nominal and real interest rates have been remarkably stable in recent months. The same is true of the effective exchange rate, despite the uncertainty about the dollar that is increasingly preoccupying the foreign exchanges. Recent indicators of both inflation and output have been rather better than expected and there is further tentative evidence of a slackening in house price inflation. But the CBI survey results on prices are slightly worrying, and, with underlying earnings growth remaining around 8-8½ per cent, the prospects for containing the rise in unit wage costs depend critically on sustaining a high rate of productivity growth.

Policy

13. The meeting agreed that there was no case for changing interest rates in either direction, especially before the Budget. The better January money figures have done something to allay the Bank's worries; but they remain nervous about bank (and building society) lending, and concerned about the future trend in unit wage costs. While they now feel less averse to resisting upward pressures than a month ago, they would still want to be somewhat more resistant to a downward move.

14. Given the uncertain international situation, it is possible to envisage pressures in either direction. It is particularly hard to anticipate how sterling might be affected by a sharp fall in the dollar. It might be easier to decouple our interest rates from US rates, if there was a sharp change in the dollar not prompted by a change in US policy. American interest rates might rise, in response, but the flow of funds across the exchanges could be quite modest. Moreover, the fact that UK long rates have gradually departed from US rates over the past year may reflect an important difference in the perception of the thrust of policy in the two countries, which could stand us in good stead when, and if, the dollar eventually breaks.

15. The Bank warned that it might become necessary to supplement normal bill operations by gilt re-purchase arrangements, possibly early in March. An alternative would be to do more 2.45 lending, but gilt repos were used last year, and for that reason are less likely to attract attention. Since the Bank normally gives seven days' notice of such operations, a submission seeking contingent authority will be coming forward next week.

16. The meeting noted that recent CGBR outturns have been unexpectedly good. However, since the local authority borrowing requirement seems to be running on the high side, a forecast for the PSBR of around £10 billion for the year as a whole still looks reasonable. It would be quite wrong to ease up on funding, in the expectation that the PSBR will undershoot.

Personal borrowing

17. The meeting discussed a paper on personal borrowing that had been agreed at working level between the Treasury and the Bank. The following points were made:-

(i) the rapid growth of credit relative to money in recent years raises difficult questions about their respective importance for economic behaviour. The strength of the upturn in consumer durables suggests that credit may have exerted an independent influence;

(ii) future trends in borrowing are highly uncertain, but the scope for a further rapid rise in lending by building societies, in particular, looks considerable. Quite apart from tax relief on mortgage credit, secured borrowing is relatively very cheap. The societies have scarcely begun to exploit the possibilities created by the huge equity "cushion" built up during years of high inflation;

(iii) holdings of liquid financial assets have increased along with borrowing. The economy could become still more liquid as lower inflation reduces the costs of both borrowing and holding financing assets. This is difficult to forecast,

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or to take into account in setting money ranges; but it is important to bear it in mind in assessing monetary conditions;

(iv) perhaps the main worry is the shortage of effective policy instruments, should the situation look like getting out of control. Given the difficulty of abolishing mortgage interest tax relief, there is no real alternative to higher interest rates. An important implication is that the authorities should be very hesitant about leaning on the building societies' interest rates.

M2

18. The meeting briefly discussed a paper on M2, which will shortly be submitted to Ministers. It was agreed that we are uncomfortably short of useful information about its likely behaviour, and that the current definition is exposed to distortions caused by the reclassification of building societies' accounts, as their terms change. The latest reclassification in December will inflate year-on-year growth rates until next January. In view of this, Sir Peter Middleton asked the Treasury and the Bank to re-examine the case for using partial seasonal adjustments, to allow us to monitor M2 over shorter periods.

19. The Bank accepted that there were potential problems with M2. Nevertheless, they still felt it was important to have it as a cross check on the behaviour of M0. We should be prepared to discount movements outside the range that were due to reclassification changes. They argued that, without M2, the target range for narrow money would need to be reconsidered: 4-8 per cent looks too high for M0 alone. It was agreed that the concept of M2 is a useful one, and that it could have a role as a cross check. But it will be important not to overplay it, and to stress in the MTFS that it is going to need a lot of careful interpretation.

RL.

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Table A: Percentage Changes in Monetary Aggregates
Seasonally adjusted data

Banking month	Wide monetary base (M0)	NIB M1	M1	M2*	Priv EM3	EM3	M3	PSL2	PSL2A
Outturn									
- August	+ 0.7	-	+ 0.8	- 0.5	+ 0.5	+ 0.2	+ 0.1	+ 0.8	+ 0.7
- September	+ 1.0	+ 0.9	- 0.2	+ 0.1	- 0.1	- 0.5	- 0.4	+ 0.2	+ 0.4
- October	-	+ 0.5	+ 1.5	+ 0.6	+ 1.3	+ 1.4	+ 1.8	+ 1.0	+ 1.3
- November	+ 1.0	+ 0.4	+ 0.6	+ 0.2	+ 0.2	+ 0.6	+ 0.8	+ 0.5	+ 0.6
- December	-	+ 2.0	+ 1.6	+ 2.7	+ 1.5	+ 1.3	+ 2.3	+ 1.0	+ 1.1
- January 1984	- 0.4	- 1.4	- 0.2	+ 0.3	+ 0.3	+ 0.6	+ 0.8	+ 1.1	+ 1.2
Last 3 months at annual rate	+ 2.6	+ 4.2	+ 8.1	• •	+ 8.1	+ 10.4	+ 17.1	+ 10.9	+ 12.2
Last 11 months (target period) at annual rate	+ 5.6	+ 8.3	+ 11.4	• •	+ 10.5	+ 10.7	+ 12.4	+ 12.3	+ 12.6
Last 12 months	+ 5.7	+ 9.0	+ 11.1	+ 9.7	+ 10.5	+ 10.5	+ 12.7	+ 13.0	+ 13.2
Forecast									
(i) Percentage change in month									
- February)	1 ³ / ₄ per cent	)	1 ¹ / ₄ per cent		+ 1.0	+ 1.0		+ 1.4	+ 1.4
- March)	2 ¹ / ₄ per cent	)	a month		+ 1.0	+ 0.9		+ 1.3	+ 1.3
- April)	a month	)			+ 1.1	+ 1.1		+ 1.3	+ 1.3
(ii) Percentage change since Feb 1983 (annual rate)									
- February	+ 5.8	+ 11.8			+ 10.7	+ 10.9		+ 12.8	+ 13.1
- March	+ 5.9	+ 12.1			+ 10.9	+ 10.9		+ 13.1	+ 13.4
- April	+ 6.0	+ 12.4			+ 11.1	+ 11.1		+ 13.3	+ 13.6

*Revised definition; not seasonally adjusted

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TABLE B. £M3 COUNTERPARTS

£ millions
seasonally adjusted

Banking months	Outturns			Forecast			Target period to mid-Feb
	Nov	Dec	Jan	Feb	Mar	Apr	
1. CGBR (CGBR n.s.a.)	+1495 (+1005)	+ 585 (+1790)	+ 195 (-1235)	+1920 (- 265)	+ 190 (+ 205)	+2025 (+3600)	+15460
2. Debt sales to NBPS	-1660	- 730	-1175	-1165	- 785	- 950	-12295
3. Other public sector	+ 265	+ 80	- 440	- 340	- 235	- 140	- 2815
Over (-)/Underfunding(+)	+ 100	- 65	-1420	+ 415	- 830	+ 935	+ 350
4. Sterling lending to private sector	+1135	+1745	+1275	+ 970	+2010	+ 450	+12820
5. Externals	- 240	+ 230	+1340	- 100	- 10	- 25	+ 455
6. NNDLs	- 445	- 585	- 575	- 250	- 250	- 250	- 3510
Change in £M3	+ 550	+1325	+ 620	+1035	+ 920	+1110	+10115
Memo items:							
"PSBR" (1+3)	1760	665	- 245	1580	- 45	1885	12645
"Underlying" bank lending	1570	1540	460	1300	1300	1300	