Prime minister

PRIME MINISTER

Following our talk on Tuesday it may be useful if, before we both go on holiday, I set out the way I see the monetary picture at present, and the prospects over the coming weeks.

2. Our general objectives are clear. We should try to maintain the steady downward momentum of short term interest rates in line with the market while this is justified by monetary conditions and supported by continued progress on inflation. I believe we can be reasonably satisfied with what has been achieved so far and modestly optimistic about the short term prospects.

3. As the attached tables show, none of the three target monetary aggregates is emitting danger signals at the moment. Both £M3 and PSL2 are growing at annual rates slightly below the centre of the target range - the "first guess" for banking July suggest that these growth rates are being maintained. M1 is still below the bottom of the range, and although June and July have seen some resurgence - as one might expect when interest rates are falling - there is plenty of leeway to make up before we need be concerned. The monetary base continues to grow very slowly.

4. Among the counterparts of £M3, the PSBR seems to be on course and accepted to be so by the markets, and bank lending, which caused us concern over the winter, has now started to grow at a less extravagant pace, though it may be too soon to identify a clear change of trend. The banks, led by Barclays, seem to be easing up in their mortgage lending. The effective exchange rate has been remarkably firm despite the easing of short term rates here and some deterioration in the current account since the first quarter. There have been considerable gyrations in the relative position of different currencies - especially the dollar on the one hand and European

currencies on the other. This has been so despite the fact that the external component of £M3 has become increasingly negative - showing an outflow of money from the UK private sector. This has been offset by inflows to the public sector and the banks. Sterling's recent firmness may in part be attributable to falls in US rates. But over the year it has survived both high US interest rates, low oil prices and the uncertainties of the Falklands. It undoubtedly owes more to the market's confidence in our determination to hold to our monetary and financial policies, than any other single factor.

5. The prospect for inflation during the summer also looks encouraging with the prospect of a figure below 9 for July and may be getting close to 8 in August.

6. Looked at in the round, therefore, the performance of the various indicators would seem to justify further falls in interest rates. But success so far has been based on maintaining a degree of caution in moving with the market, and justifying the moves in relation to monetary conditions. We should continue to move, therefore, as market conditions permit - a bit quicker when as at present world conditions seem favourable. But never so precipitately that we risk destroying the confidence, not least confidence in sterling, on which our success has been based.

7. Last Friday I discussed the strategy for the next four weeks with the Governor, the Economic Secretary, Alan Walters and officials here. There was a complete agreement about our objectives. The Bank moved their dealing rates down again on Wednesday, for the third time since the last base rate change and the ninth downward change since early July.

8. The funding programme has to be looked at against this background. Our broad objective here is to sell enough stock

to fund the PSBR over the year by sales to the public - but not to banks. This objective will however be modified in selling more or less stock according to monetary conditions and past performance. We sold large amounts of stock early in the year and, as I have said, conditions are looking good at the moment. So there is no cause for any special anxiety - but of course we want to keep up the good news on the monetary front.

9. Our current funding targets - gross gilt sales of £1,200 million in August and £900 million in September, are acceptable to all. In fact over the two months taken in isolation this represents a sizeable underfund of the PSBR, particularly in view of the small contribution of National Savings. But if we achieved these sales, over the target period to end September, we would be modestly ahead of the game, and - if all else goes according to plan - £M3 would still be around the centre of the range. I think this is where we should aim to be.

10. There is, as you know, more divergence of views on the appropriatemix of funding instruments to use and I have arranged for this to befurther considered: Alan Walters will, of course, be involved in this. But already there is a lot of common ground. We would all accept that with the inflation prospect as it is we should wish to avoid long-dated conventional gilts as far as possible. The real yields implied by the prices of long fixed-interest stocks look very high. Long-dated indexed stocks would be a better bet from the Government's point of view. Even so, it is the Governor's judgement, which I accept, that it could be difficult to achieve the level of funding we need if we attempted to eschew long conventionals entirely. This is especially true if we want to see a sustained fall in short-term rates and particularly the mortgage rate - which is due to fall by 1½% at the beginning of September.

why?

11. Plainly we were right to conclude that it would be unwise

to put up the rate on National Savings Certificates and pull in funding thatway; these will be activated as interest rates come down.

We were told they would need or would buy long. They didn't. They bought short long term

12. We must take some account of the preferences of investors in determining the range of funding instruments and it is unlikely that we shall be able to push all the long-term institutional funds into short-dated stocks. In recent weeks we have indeed concentrated on the short end to a large extent, and will continue to do so when we can; that has been shown by the response to the £500 m 1987 which had in fact been authorised before we spoke on Tuesday. But circumstances could well arise in which a longer stock, perhaps maturing in the early years of the next century, would be appropriate. There are a number of reasons for going a bit beyond 2000 from time to time. The yield curve shows a hump in the early 90s. There are very heavy maturities in the late 90s, and some very light years early in the next century. There is a case for trying to engineer a fall in yields in the 90s, the area in which we are most likely to see the reappearance of corporate bonds.

No

No

13. We shall certainly not neglect the indexed market. As inflation falls IGs are, for a time, less attractive to investors, and the existing stocks have sold slowly. Policy here has been to wait until the existing long IGs are finally exhausted and then allow a modest interval before bringing additional tranches, in the hope of breaking the commonly held expectation that we shall always bring new IGs as the portfolio is emptied.

Why?

14. Sales ofstock - both conventional and indexed - have been brisk this week. It isunlikely that we shall need to issue any new stock in banking August - though we might want to think about the possibility of a partly paid stock to help with September. We can rely on sales of the new 1987 stock and

the 1988 IG, both of which have gone well this week. So the position looks pretty sound. Officials will now be considering further steps in the funding programme including both further indexed gilts in the autumn and - on a rather longer timescale - the feasibility of converting some existing long dated stock from conventional into indexed form.

15. The immediate prospect, then, is for further progress on interest rates as long as the financial picture remains as I have described. An essential feature of this progress is the maintenance of sound monetary conditions and in this funding must play a part. I think the market operators, who will of course continue to consult Jock Bruce-Gardyne as appropriate, have clear guidelines within which to operate as we take our break.

GEOFFREY HOWE
9 August 1982