SECRET

Prime Minister ②

PRIME MINISTER

MRS 12/7

MONETARY POLICY

Monetary Conditions

Monetary conditions are moderately lax. The wider monetary aggregates are soaring seemingly out of control. On a six month basis the growth of sterling M3 was 13.7% and PSL2 17.1%. On the other hand the narrow, non interest bearing, aggregates are much more constrained. With the exception of the accidental figure for June, the monetary base is still around about 5%. And non interest bearing M1 has, if anything, tended to decline over the past six months and is now running at about 7-8%.

The narrow aggregates are far more important in determining future nominal GNP and inflation and the broader aggregates. (I believe that Terry Burns has now come round to this point of view.) However, even the narrow aggregates are running too high for the ultimate objective of bringing and keeping inflation down below 5% and ultimately reaching price stability. There is therefore cause for concern rather than alarm.

Funding

The alarms about the borrowing requirement and monetary conditions as well as anticipations of interest rate increases in the United States, have all made funding difficult during the current month. (This follows successful high funding in the previous two months). Yet with one week to go in Banking July, the Bank has sold very nearly £1 billion. The indexed convertible of £388 million was cleared out this morning and, netting out the stock in exchange, this is a contribution of £250 billion [million]. There might be some follow through in the days ahead.

As far as funding is concerned, there is no urgent need for any changes in interest rates. In particular, there is no need at all for a "Duke of York" exercise (ie a sharp increase in interest rates followed by a gentle protracted fall). The monetary overrun is mainly due to interest bearing elements and in the short run such credit instruments will not be reduced by higher interest rates.

/Other Indicators of Monetary Conditions

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Other Indicators of Monetary Conditions

It is useful, when any doubt exists, to turn to secondary indicators which might be useful in interpreting monetary conditions. The first is the exchange rate. I think everyone would agree that that is, if anything, rather on the high than the low side, which would indicate continued monetary constraint. Although the exchange rate is notoriously difficult to interpret, it is clear that we cannot adduce from this evidence of obvious monetary laxity. Secondly, real interest rates are high. There is no evidence of monetary ease on that score. Thirdly, there are no obvious signs of asset prices, and in particular house prices, taking off in the next financial rise. year?

Conclusion

Monetary conditions are somewhat more lax than they ought to be but they do not call for dramatic monetary action. The markets need some assurance in addition to last Thursday's package, that we have not relaxed our policy, particularly on the public sector borrowing requirement. After Friday next, they should at least be partially reassured when the PSBR figures appear. More reassurance will come as the expenditure review proceeds during the next few months; then we shall be seen to be imposing restraint.

It may be necessary to adjust interest rates upwards during the next few weeks, particularly if, as I suspect may happen, the Americans tighten their monetary policy. But we should not envisage a Duke of York. On the contrary, if we move up then it should be only by ½ or perhaps 1 percentage point. And it should probably be possible to show that the increase was induced primarily by the movement of American rates.

Tomorrow there is a meeting with the Chancellor and the Governor which I shall attend.

(Dictated but not seen by AAW)

ALAN WALTERS
12 July 1983