015/19

File 4a

SECRET (AND PERSONAL UNTIL THURSDAY 13 JUNE)

MONTHLY MONETARY REPORT: MAY-AUGUST

- The narrow and broad aggregates continue to give different messages. The 12 month growth rates for MO and NIBM1 are 5½ and 4 per cent; the equivalent rates for £M3 and PSL2A 11½ and 13 per cent. Other indicators, particularly real interest rates and the exchange rate, suggest that monetary conditions remain tight.

- Bank lending increased by £1½ billion in May tending to confirm that last month's extra lending to benefit from the 1984-85 capital allowances may take some months to unwind. April's massive increase in the externals has not been reversed.

- The forecast still suggests that June may be a month of high growth for £M3 and slightly higher growth for MO than recently. The exceptionally high level of gross gilt sales in June will be offset by large redemptions, and its impact of £M3 may be blunted by high overseas interest. We have revised upwards our forecast of bank lending - in part in recognition of our record of consistent underestimation in previous forecasts.

- By the end of banking August we are forecasting 12 month growth rates of MO and £M3 of around 5¾ and 13 per cent respectively. £M3 would have to grow by no more than ½% a month from now on to be within its target range by the end of 1985-6.

- The introduction of new accounts which happen to be classified as term shares has distorted PSL2 downwards in the last 2 months. PSL2A is unaffected and has remained remarkably stable over the last year with its 12 month growth rate staying in the 12%-14% range.

- All the major clearing banks have undertaken or announced foreign currency floating rate note issues, totalling around £3 billion. These are assumed to have little effect on £M3, causing offsetting changes in nndls and the externals. We are considering a redefinition of these counterparts to exclude such foreign currency issues.

HF3 June 1985

SECRET (AND PERSONAL UNTIL THURSDAY 13 JUNE)

MONTHLY MONETARY REPORT: MAY-AUGUST

Monetary Aggregates

In banking May £M3 grew by 0.5 per cent, 0.3 per cent above forecast. MO was marginally above forecast, falling by 0.1 per cent. 12 month growth in £M3 is now 11.6 per cent, with 6 month growth slightly lower and 3 month growth considerably higher. Annual growth in MO is now 5.5 per cent, where it has been throughout the last year. 3 and 6 month growth in MO is lower still. Table 1 below shows recent growth in the target aggregates, and annex table 1 provides further detail, also covering real MO and real £M3. Other measures of money are shown in annex table 4.

Table 1 Target Aggregates: Recent Experience

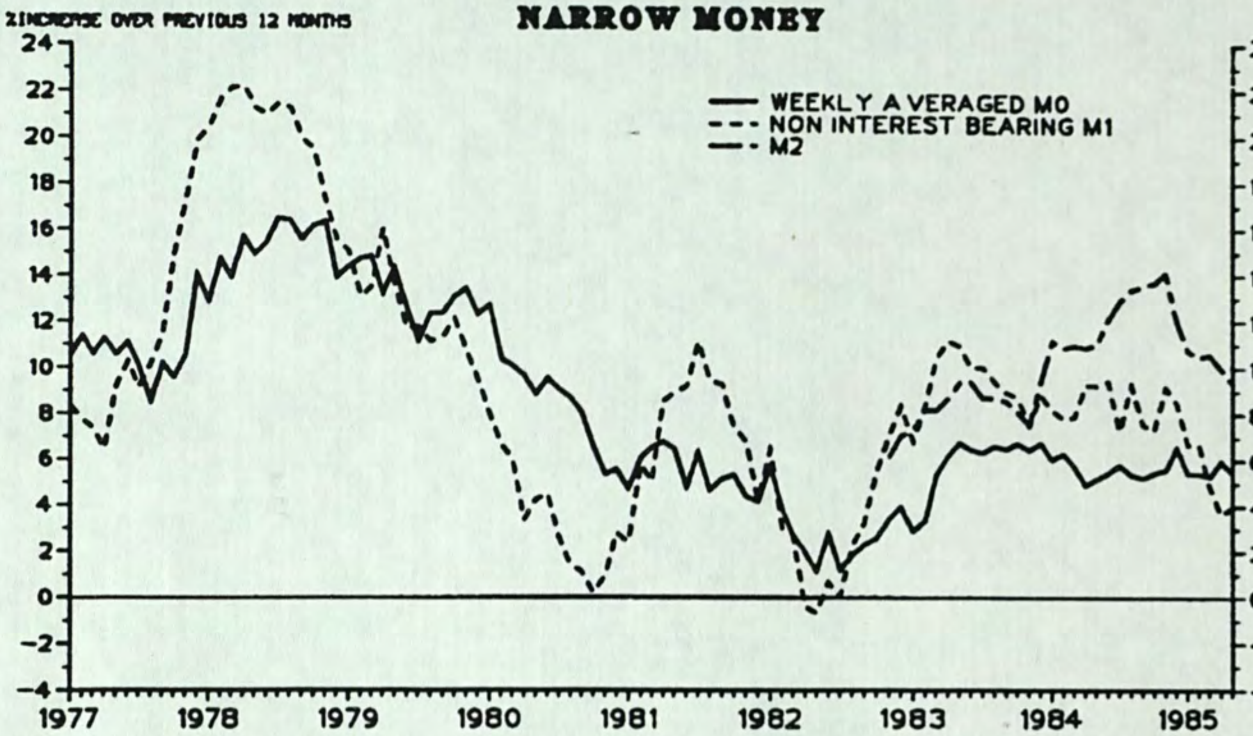
per cent, s.a.

	MO	£M3
Monthly change		
March	0.4	1.0
April	0.7	2.8
May	-0.1	0.5
Growth to mid-May at an annual rate over past:-		
3 months	4.4	19.0
6 months	3.7	10.6
12 months	5.5	11.6

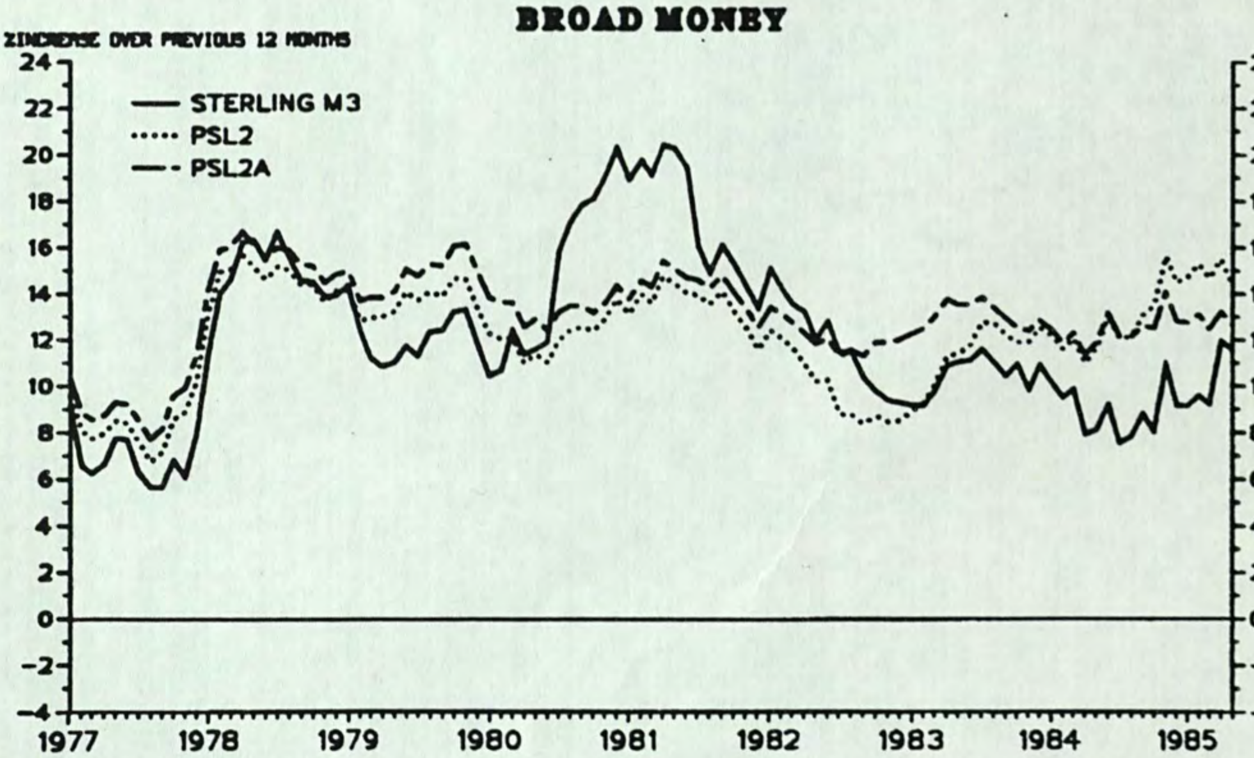
2. The replacement of the £1 note by the £1 coin has not proved to be smooth, and perhaps as a consequence the monthly path of MO growth has been erratic. However the longer period growth rates suggest that there is little reason to believe that the underlying growth rate has shifted from the 5-6% (annual rate) range, evident since early last year.

CHART I : ANNUAL GROWTH RATES OF MONETARY AGGREGATES

NARROW MONEY



BROAD MONEY



3. The British Aerospace oversubscription may have inflated £M3 this month. To the extent that deposits were built up in anticipation of the sale this will have distorted £M3 upwards this month, since the money will still have been in the system, on suspense account, on make-up day. Though no accurate assessment of this effect can be made, the £¼ billion distortion assumed in last month's forecast remains a reasonable central view. NIBM1 is the only aggregate we can be fairly certain was affected by the BAe oversubscription. This is because on make-up day the partially successful applicants' refunds were in suspense accounts, 60% of which are conventionally allocated to non-interest bearing deposits. This partly explains why NIBM1 grew by 0.8 per cent last month, some way above recent experience.

4. Of the public sector counterparts to £M3 the "PSBR" was close to forecast (with lower own account requirements more than offset by higher "other public sector" borrowing), while debt sales to the nbps were slightly lower then forecast. Overall the public sector impact on £M3 was neutral.

5. As to the other counterparts we have been looking for any signs that last month's erratic increases might be beginning to unwind. Sterling lending, at £1.4 billion was some £0.4 billion lower than the average for the last 6 months. But this was still some £150 million above the forecast, which allowed for some net unwinding of round tripping, and for the beginning of the unwinding of April's investment borrowing surge. But it does look therefore as if the underlying growth in bank lending may now be higher than the £1½ billion a month on which last month's forecast was based. Our assumption for underlying lending has therefore been increased this month.

6. The other counterparts taken together were close to forecast. After allowing for identifiable factors the externals were expansionary again this month, and their make-up provides little evidence of an unwinding of last month's massive build up of foreign currency assets by the banks (the counterpart to a run down in

such assets - and a build-up of sterling assets in £M3 - by the nbps).

7. Though building society retail inflows have improved since the rise in rates on April 1 they are still below the level we believe the societies desire. The introduction of a new type of term share by some of the major building societies has been the major influence on those aggregates which include building society liabilities. Substantial inflows into these accounts appear to have been at the expense of other building society accounts. Since term shares are outside PSL2, this has depressed the growth of PSL2, but has not affected PSL2A, which includes them. This goes some way to offset the drift out of term shares, and into other building society accounts, which has distorted PSL2 upwards over the last year or so. PSL2A, in contrast, has not been subject to these distortions, and its 12 month growth rate has remained fairly steady at around 12½ to 13 per cent for most of the last year.

Other indicators of monetary conditions

8. Inflation: There was another unexpectedly large rise in retail price inflation in April taking the twelve-month growth rate up to 6.9 per cent. Movements in the RPI are being exaggerated by changes in mortgage rates. The annual rate of growth to April in the RPI excluding the mortgage interest payments element was 5.3 per cent. The twelve-month increase to May in the all items RPI may well go a little above 7 per cent and in the following months the twelve-month increase may reach a peak of 7½ per cent. The underlying annual growth rate of average earnings continues to run at 7½ per cent. Private sector wage settlements in the current pay round covering about one-half of employees are ½ per cent higher than at the same point last year. Recent unit wage cost figures are always difficult to interpret because they are likely to be revised downwards when better information on manufacturing output becomes available. Nonetheless the figures for the first quarter of 1985 suggest an increase in the growth of unit wage costs compared with the

first quarter of 1984. In contrast, the forward indicators of prices suggest a slowing of the rate of increase. Input prices fell in April and are expected to have fallen again in May. Commodity prices in SDRs have been increasing slowly in the last few months but are still about 2½ per cent lower than in last May.

9. Asset prices: The DOE monthly house price data, which are not mix-adjusted, suggest that house price inflation may be increasing a little. In the twelve months to April prices at the mortgage approval stage increased by 9 per cent and prices at the mortgage completion stage increased by 7½ per cent.

10. Real interest rates: The incrase in real short term interest rates in May shown in Annex Table 8 is due to an apparent fall in inflation expectations. This is directly attributable to the latest forecast by NIESR, which included a downward revision of their inflation forecast. In practice, with nominal rates slightly lower and the RPI increasing by unexpectedly large amounts, real short rates may be little changed or even lower than in recent months.

11. Exchange rate: The exchange rate improved modestly against most currencies during May. The sterling index is about 8% higher than it was in March, and the £/DM rate about 5% higher.

Three month forecast

12. As usual no change in the interest rates is assumed over the forecast period. MO is forecast to rise by 0,7 per cent in banking June. This high figure reflects information already available on the first three weeks of banking June. For July (0.3 per cent) and August (0.4 per cent) more moderate growth is projected, reflecting the high level of interest rates. It is still assumed that the continued increase in the £1 coin issue will be broadly offset by slower growth in the note issue. Annual growth in MO is projected to fall to 5.1 per cent at the end of June, but to rise again to 5.8 per cent by the end of the forecast period.

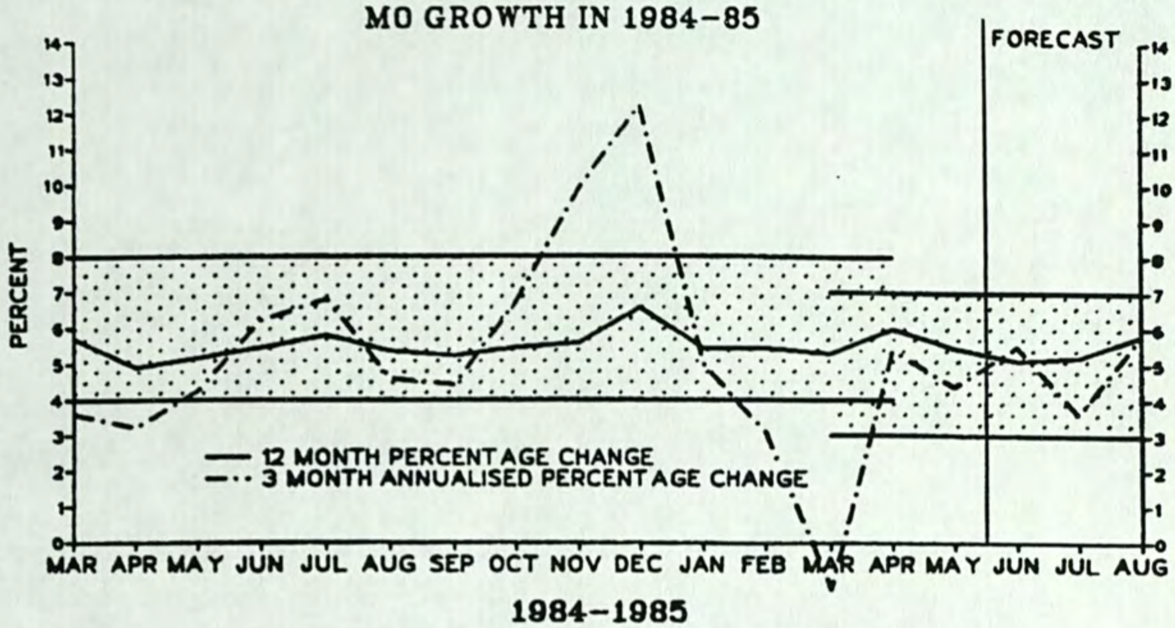
13. A part (0.1 per cent) of the MO growth forecast in August relates to the ending of the deferred payment scheme for £1 coins on 31 July. As a transitional measure £1 coins held by banks at cash centres were counted as holdings by the Bank of England, rather than the banks concerned. From 31st July they will be counted as belonging to the banks concerned, and will thus be included in MO. Over time the extra cost of holding these coins might be expected to encourage the banks to reduce their holdings at cash centres.

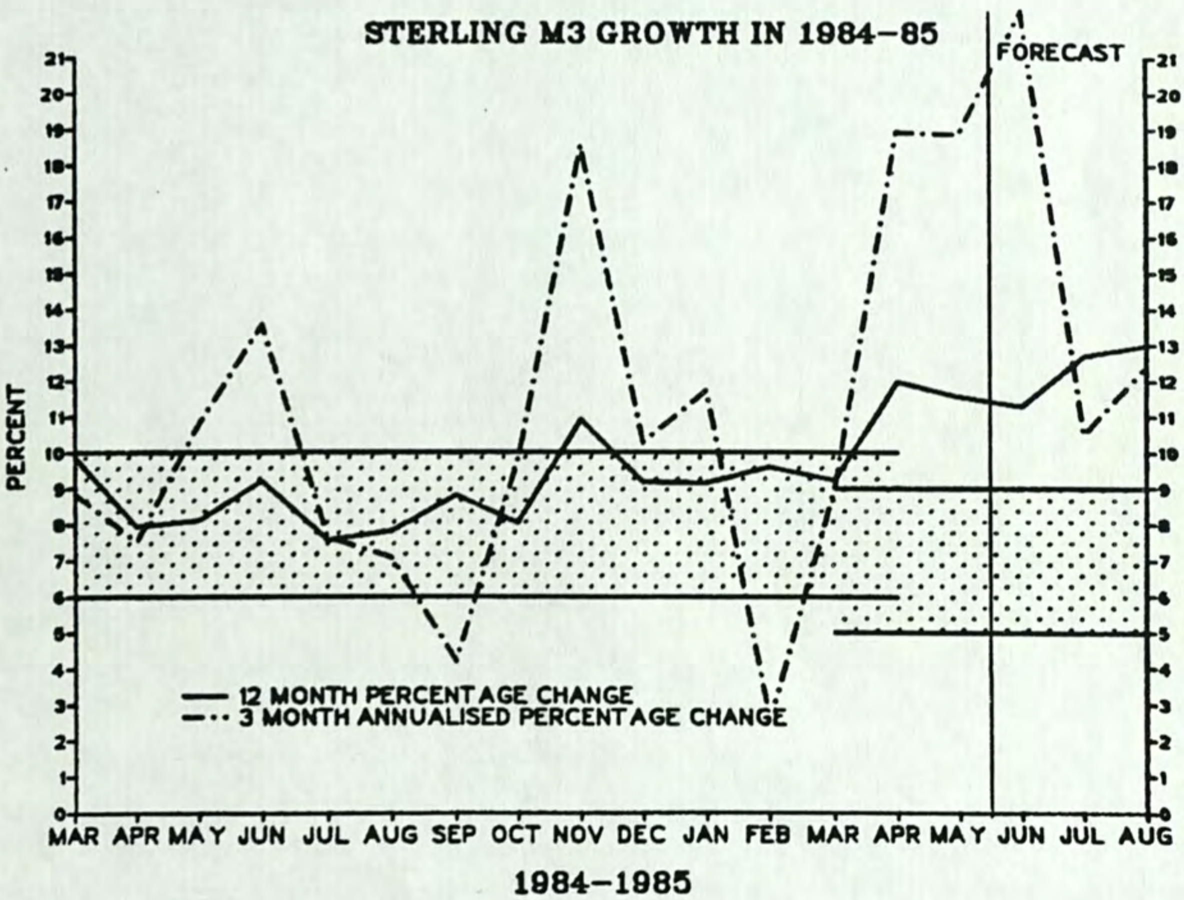
14. June is still expected to be a month of particularly high growth in <u>£M3</u>. But our forecast of 1.7 per cent growth in the month is below last June's figure of 2 per cent - so the 12 month growth rate is nevertheless projected to fall - to 11¼ per cent. We have revised upwards our estimates of both underlying bank lending (see paragraph 5 above and gross gilt sales (because of the level of sales already achieved since last month's forecast.

15. The picture over the forecast period as a whole is once again very uneven, attributable mainly to an uneven "PSBR" profile (partly due to the BT call in July). June's large increase is followed by a small rise in July, and a fairly high figure for August. On the basis of gross sales of almost £2 billion already in June, we have pushed up expected gilt sales in June to £2¼ billion but have retained the stylised assumption of £1¼ billion gross sales in July and August. Funding therefore exerts only a slightly contractionary influence in July, when there is another large redemption. Annual growth for £M3 on this projection would rise again to 12.7 per cent at the end of July, (as the negative figure for last July drops out) and reach 13 per cent by the end of the forecast period.

16. Table 2 summarises the forecast for the target aggregates, and Chart II shows past and projected movements in the 12 and 3 month growth rates for MO and £M3. If £M3 growth is as expected

CHART II


MO GROWTH IN 1984-85
FORECAST
PERCENT
12 MONTH PERCENTAGE CHANGE
3 MONTH ANNUALISED PERCENTAGE CHANGE
MAR APR MAY JUN JUL AUG SEP OCT NOV DEC JAN FEB MAR APR MAY JUN JUL AUG
1984-1985


STERLING M3 GROWTH IN 1984-85
FORECAST
PERCENT
12 MONTH PERCENTAGE CHANGE
3 MONTH ANNUALISED PERCENTAGE CHANGE
MAR APR MAY JUN JUL AUG SEP OCT NOV DEC JAN FEB MAR APR MAY JUN JUL AUG
1984-1985

over the next 3 months, the monthly increase from then on would have to be less than 0.4% for £M3 is to be within its target range by the end of 1985-86. (To get to the centre of its range monthly growth would have to be no more than 0.1%.)

Table 2 Target aggregates: Summary of forecast

per cent, s.a.

	MO	£M3
Monthly change		
June	0.7	1.7
July	0.3	0.3
August	0.4	0.9
Growth to mid-May at an annual rate over past:-		
3 months	4.4	19.0
6 months	3.7	10.6
12 months	5.5	11.6
Growth to mid-August at an annual rate over past:-		
3 months	5.8	12.4
6 months	5.1	15.6
12 months	5.8	13.0

Public Sector Borrowing

17. In banking May the PSBR of £0.7 billion was very close to forecast. However there were offsetting errors with the CGBR £0.2 billion below forecast and the OPS £0.3 billion above forecast.

18. The outlook for the CGBR, based on calendar month profiles, is uneven over the forecast period in both seasonally adjusted and unadjusted terms. In particular there are large CGBR's of around £1½ billion in June and August and a £¾ billion surplus in July. The reasons for this are complex but there are two main factors. First, June and August are five week banking months whereas July is a four week month. Although adjusted for known tax payments, it seems that the seasonals do not fully offset

the extra supply expenditure in five week months, so a longer month means a larger CGBR. Secondly in July there is the BT second call (£1.2 billion), particularly heavy tax receipts and low debt interest payments. Again the seasonals do not it seems fully pick up the latter, which reflects the timing of gilt dividend dates. Indeed in the same period a year ago the CGBR displayed a similar monthly pattern seasonally adjusted and allowing for BT.

Table 3 Public Sector Borrowing

£ million monthly average

	mid May 1984 -mid May 1985	mid May 85 -mid Aug 85	mid May 84 -mid Aug 84
CGBR (0)	457	588	752
'LABR'	255	210	110
PCBR	120	40	-43
'PSBR'*	832	838	819

* PSBR less non-bank private sector transactions in other public sector debt

19. In the forecast period the CGBR(0) adjusted for asset sales is running about £200 million a month higher than a year ago. Similarly the LABR is higher. The latter reflects in a small way extra borrowing by those local authorities who have not set a rate but the main cause of the higher projected borrowing is the new arrangement which allows large corporate rate payers to pay monthly rather than semi-annually. This smooths rate income but means that at this time of year when large rate bills are usually paid, income is less then 'normal'. There are no special factors affecting the PCBR.

Debt Sales

(a) Gilts

20. Gross gilt sales in the 4 weeks of banking May totalled £1,029 million, compared to a target of £1¼ billion. Net official sales were £990 million. The remainder of the 9½% conversion

2004 was sold out and, together with the £650 million of tranchettes issued on 19 April, raised almost £800 million. Indexed gilts raised £150 million. With minimal buying in of next maturities, net sales were close to £990 million, but larger than usual purchases by the overseas sector meant sales to the nbps were under £600 million.

21. Table 4 compares the May outturn with performance in the previous year and projections for the forecast period. With gilt sales close to £2 billion already achieved, and 10 days of the banking month still to go, the forecast assumes gross gilt sales of £2¼ billion in June. This means that despite the £1.2 billion redemption of the 3% Treasury 1985, and high forecast overseas sales, gilt sales are now expected to exert a contractionary influence on £M3 of almost £½ billion in June.

Table 4 Gilts Sales

Banking monthly averages £mn

	Actual		Forecast		
	June 84-May 85	May	June	July	August
Gross Sales	1299	1029	2250	1250	1250
Redemptions	-247	-1	-1177	-979	-
Next maturities	-86	-42	-50	-30	-100
Net Sales	966	986	1025	240	1150
of which					
Monetary Sector*	70	53	100	-40	50
Public Corporations	3	-	-20	-	-
Overseas	120	347	450	-50	175
Non-bank private sector	774	586	495	330	925

* excluding repos.

22. The stylised assumption of £1¼ billion gilt sales has been retained for July and August. A further redemption in July produces a minimal contribution to funding from gilts in that month. On these assumptions both net gilt sales, and net sales to the nbps, would in June-August be substantially below last year's monthly average. They would also be lower than in the same three months last year.

(b) CTDs

23. Both purchases and surrenders of CTDS were higher than forecast in banking May, and the net result was an expansionary influence on £M3 of around £100 m. We expect CTDs to continue to have a midly expansionary impact over the forecast months. Purchases are expected to pick up from their May level, in preparation for the heavy tax payments in the Autumn. On average, surrenders are likely to outstrip purchases, in part reflecting heavy surrenders in banking August when an unusually large amount of ACT falls due, in addition to the normal PRT payment.

National Savings

24. National Savings contributed £215m (unadjusted, £234m seasonally adjusted) to funding in banking May, some £50m below forecast. Unusually sales all but dried up in the last week of the month, since when they have improved. We have assumed that the dip may to some extent have reflected personal sector bidding for shares in British Aerospace. The effects of the BAe flotation and the call for BT shares on National Savings and other retail savings are discussed in more detail below in the section on retail inflows.

25. On the assumption of no change in interest rates we expect National Savings' inflows to be about £300m per month (seasonally adjusted) over the forecast period. The income bond and accrued interest are expected to be the main contributors. We have assumed that the 3rd issue of index-linked certificates is introduced on 1st July and that the 2nd Issue is withdrawn simultaneously. We do not expect that this development will alter the prospects for index linked certificate sales substantially.

26. The forecast suggests that by the end of banking August the total inflow to National Savings will be only a little below the monthly striking rate required to attain the £3 billion target.

The PSBR and Funding

27. Table 5 summarises net funding over the last 12 months and that implied by the forecast. In May there was a full fund on a seasonally adjusted conventional basis (sacb) but over the last year there has been overfunding of £3.3 billion (sacb). In the forecast period there is expected to be a full fund (sacb) but a modest underfund in unadjusted terms.

28. In May there was again some contribution to funding from the overseas sector. Indeed with the forecast projecting continued strong gilt sales to overseas the total for external finance in the first 8 months of calendar 1985 is expected to reach over £2 billion compared with £0.8 billion for the same period in 1984.

Money Market Influences

29. In May there was a small (£0.3 billion) increase in the need for assistance. This was met by purchasing £0.8 billion of commercial bills and reducing market advances by £0.4 billion. In the forecast period the outstanding level of assistance remains high. In June the large unadjusted CGBR ensures a surplus but heavy gilt sales mean that the surplus, at £1¾ billion, is around £1¼ billion less than thought a month ago. With a large shortage in July and a neutral outlook for August, total assistance is projected to be £17.5 billion at the end of banking August compared with the last end banking month peak of £17.6 billion in March.

Table 5: The PSBR and funding

£ billion, seasonally adjusted

	Actual mid May 1984- mid May 1985	Forecast mid May 1985- mid August 85	mid August 1984- mid August 1985
'PSBR'	10.0	2.5	10.1
Debt sales to nbps	-13.3	-2.3	-12.2
of which:-			
Gilts	-9.3	-1.8	-8.5
National Savings	-3.1	-0.9	-3.4
CTDs	-1.0	0.4	-0.5
Over(-)/Under Funding(+)	-3.3	0.2	-2.1
(Unadjusted)	(-3.4)	(0.7)	(-2.3)
External finance of the public sector	-1.8	-0.6	-2.5
Over(-)/Under funding(+) alternative definition	-5.1	-0.4	-4.6
(Unadjusted)	(-5.2)	(0.1)	(-4.8)

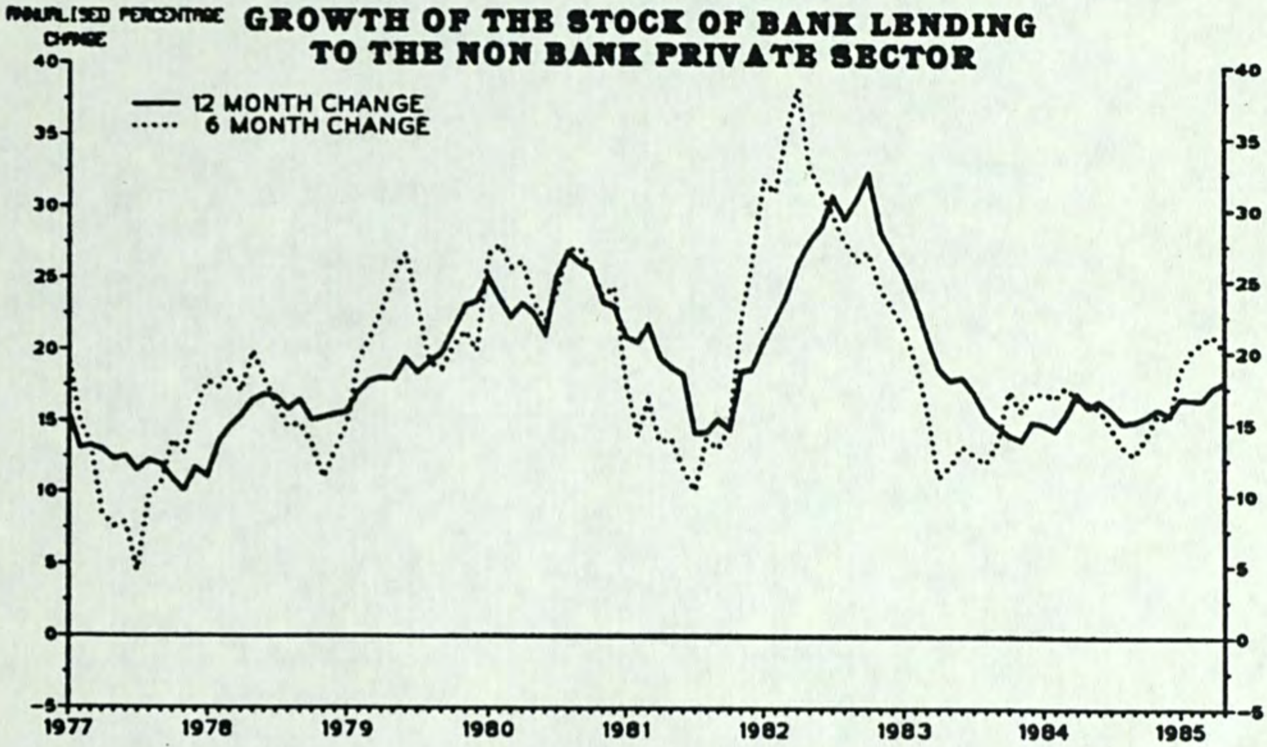
Sterling lending to the private sector

30. Sterling lending increased by £1½ billion in May taking the 3 and 6 month growth rates over 20%. The 12 month rate, at around 18%, is only a little lower and has been increasing fairly steadily since the Autumn of 1983. The May figure may have been boosted a little by borrowing to finance BAe share applications.

31. We had expected lending to be around £¼ billion lower due to some unwinding of last month's £1 billion surge to finance investment at the 1984-5 level of capital allowances and also because extensive round tripping in one month bills issued in April should have unwound in May. It seems likely, therefore, that underlying lending is running somewhat above our previous estimate, perhaps reflecting a lower or slower response to the continuing high level of base rates. For the forecast period we have increased our estimate of the underlying rate of monthly lending by £100 million. We have also included a more modest decline than assumed hitherto as a response to the high level of interest rates. We have also taken the view that the large

CHART III : BANK LENDING AND FT INDEX

GROWTH OF THE STOCK OF BANK LENDING TO THE NON BANK PRIVATE SECTOR



REAL FT ALL SHARE INDEX

predicted swings in the PSBR, will not offset changes in bank lending in the usual way. In banking June and August the PSBR is forecast to be about £¾ billion above trend while in July it may be £½ billion below trend. The forecast assumes that, as usual, only around 40% of the changes in the PSBR will feed through to £M3 but we have allocated only half of the offset onto bank lending and the other half has been divided equally between the externals and net non deposit liabilities (NNDL's).

32. So far in banking June there have been a few opportunities for <u>bill arbitrage</u> but the level of profits attainable has been negligible. No extra lending is therefore included for this or other types of arbitrage over the next 3 months. In theory, bill arbitrage opportunities are most likely to occur when the authorities are attempting to resist a rise in interest rates. However, if participants in the bill market are - as it often said - more optimistic about the prospects for falls in rates then those operating in the interbank market, arbitrage opportunities would tend to open up when base rate cuts were expected. This hypothesis is supported by the evidence for the period 21st March-9th April 1985 when profitable one month bill arbitrage opportunities existed continuously and base rates were widely expected to fall. (In fact some base rates were cut by ½% on 29th March and thre was a further ¼% cut on 2nd April. On the other hand, the evidence from last July, when base rates peaked at 12% and thereafter cuts were generally expected is not consistent with this theory, as there were very few profitable arbitrage opportunities in subsequent weeks).

33. The provisional Q1 sectoral breakdown of bank lending, analysed in last month's report, showed that most of the extra borrowing was being undertaken by OFI's and companies, both incorporated and unincorporated. The CBI's April survey suggested that both new orders and investment are expected to rise so that gives little reason for believing that companies' demand for finance will fall. But net new issues continue to provide much of the required finance. In the first five months of 1985 listed

SECRET

TABLE 6 **STERLING LENDING TO PRIVATE SECTOR**

Seasonally adjusted

		Moving Averages of Underlying Lending						Moving Averages of Recorded Lending					
		3 months		6 months		12 months		3 months		6 months		12 months	
		£m	%*	£m	%*	£m	%*	£m	%	3m	%	£m	%
1984	Jan	1116	15.1	1117	14.9	1157	15.9	1195	15.6	1271	17.1	1084	14.9
	Feb	1076	13.7	1171	15.3	1158	15.6	1283	16.5	1278	16.7	1076	14.5
	Mar	1095	13.7	1303	17.0	1200	16.1	1283	16.2	1340	17.5	1161	15.5
	Apr	1627	20.9	1396	17.9	1268	17.0	1445	18.4	1320	16.9	1273	17.0
	May	1424	17.7	1250	15.7	1240	16.2	1322	16.4	1302	16.4	1230	16.1
	June	1563	19.2	1329	16.5	1262	16.5	1297	15.8	1290	16.0	1267	16.5
	July	882	10.4	1255	15.5	1186	15.3	936	11.1	1190	14.7	1231	15.9
	Aug	1098	12.9	1261	15.3	1216	15.3	887	10.3	1104	13.3	1191	15.0
	Sept	1028	11.9	1295	15.4	1299	16.3	850	9.81	1074	12.7	1207	15.1
	Oct	1637	19.4	1260	14.8	1328	16.3	1452	17.1	1194	14.0	1257	15.4
	Nov	1831	21.6	1464	17.1	1357	16.4	1785	21.0	1336	15.6	1319	16.0
	Dec	1788	20.8	1408	16.3	1368	16.3	1793	20.9	1321	15.2	1305	15.6
1985	Jan	1684	19.3	1660	19.3	1457	17.4	1748	20.1	1600	18.6	1395	16.7
	Feb	1614	18.1	1722	19.8	1492	17.5	1715	19.3	1750	20.1	1427	16.7
	Mar	1599	17.7	1693	19.3	1494	17.2	1835	20.5	1814	20.7	1444	16.6
	Apr	1668	18.2	1676	18.7	1468	16.7	2021	22.3	1884	21.2	1539	17.5
	May	1635	17.5	1624	17.9	1544	17.4	1959	21.3	1837	20.3	1586	17.9
Forecast													
	June	1640	17.3	1619	17.6	1513	16.9	1817	19.3	1826	19.9	1573	17.5
	Jul	1550	16.8	1648	17.5	1654	18.4	1507	15.5	1764	18.8	1682	18.7
	Aug	1620	16.5	1628	17.1	1675	18.3	1435	14.5	1697	17.8	1723	18.9

* Based on stock of recorded lending

SECRET

UK companies have raised over £2.8 billion, more than in the whole of 1983, which was itself a record year. But as yet there are no signs of such finance substituting for bank borrowing.

Table 7: Issues by Listed UK Companies

Calendar month averages, £m

		Net Issues	Gross Issues Queue* (Equities)
1982		97	-
1983		234	-
1984		143	-
1984	Q1	51	850
	Q2	199	1510
	Q3	218	1030
	Q4	106	1215
1985	Q1	400	
1985	Jan	275	1610
	Feb	201	2943
	Mar	723	4100
	Apr	989	4332
	May	620	4350**

* Excluding privatisations, currently consisting of British Airways and Britoil/

** As of 3 June 1985.

Externals and net non-deposit liabilities (NNDL's)

34. After the very large positive externals in banking April there was no noticeable unwinding in May. Even allowing for foreign currency issues, externals were again positive. However, nndls and externals together had a negative influence on money of £0.8 billion compared with a positive influence of a similar amount in April and a £0.4 billion average contradiction in the year to banking March.

35. In the forecast period both nndls' and externals are dominated by foreign currency issues. All the major clearing banks have now either made or announced issues in the market,

totalling around £3 billion. These issues affect both nndls and externals in equal and offsetting amounts. The Bank are considering redefining these counterparts to remove foreign currency issues as these tend to swamp underlying changes in externals and nndls. This new definition, which if agreed would be incorporated in the published figures from June onwards, has been used in Annex table 3 (the full counterparts table).

Building Societies and Broad Liquidity

36. At £1025m, seasonally adjusted retail inflows in banking May (including interest credited) were in line with last month's forecast. We estimate that the underlying level of inflows in May was nearer £1100m, with the BAE flotation and preparation for the BT second call reducing actual inflows slightly.

37. Our retail savings model suggests that, with no change in interest rates, retail inflows will continue at about £1100m per month over the next 3 months. With little change in net mortgage advances and only moderate wholesale funding we expect a continued, though gradual, fall in the liquidity ratio. Table 8 attached shows the impact of these projections on the building societies balance sheet (unadjusted).

38. The table shows inflows of principal (column 5) somewhat below the striking rate necessary to maintain a constant liquidity ratio. The unadjusted liquidity ratio is projected to fall to about 16¼ per cent by the end of banking August. The fall is not as steep as we projected last month, principally because we now forecast inflows of principal to be slightly higher than last month.

39. An interesting development has been the renewed interest in building society term shares. Revised data for calendar April and May have shown a very large movement of savings into term shares - to the tune of over £1½ billion. The substantial movement in savings undoubtedly reflects a campaign by the major societies to revitalise term shares. It should be noted that total retail

TABLE 8 BUILDING SOCIETIES BALANCE SHEET FLOWS [UNADJUSTED]

£ million

	Total Flow	Assets: Mortgages	Assets: Liquid assets	Assets: Other (fixed investment)	Liabilities: Retail Inflows principal	Liabilities: interest credited	Liabilities: Wholesale	Liabilities: Other (mainly additi[c] to reserves)	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	
Calendar years*									
1983	1059	911	142 (19.9)	6	570	310	136	42	
1984	1277	1189	72 (18.3)	16	710	387	136	51	
Calendar quarters*									
1984 Q1	896	977	-83 (19.2)	1	870	302	33	-308	
Q2	1145	1326	-201 (18.1)	21	598	414	99	34	+37
Q3	1476	1345	114 (17.6)	17	543	272	278	384	
Q4	1592	1109	459 (18.3)	24	831	560	133	96	
Calendar months									
Jan	-39	942	-999 (17.3)	18	823	726	-102	-1486	
Feb	452	967	-533 (16.7)	18	474	64	-138	52	
March	1116	1181	-83 (16.4)	18	214	272	151	479	
April	1469	1149	302 (16.5)	18	507	417	149	396	
May[2]	1694	+1335	+341 (16.5)	+18	598	430	270	396	+58
Banking Mth forecast									
June	1335	+1457	+178 (16.5)	18	531	+1020	+222	-123	
July	1491	+1181	+162 (16.4)	18	578	+720	+100	-37	
August	1256	+1547	+128 (16.3)	18	613	+163	+131	+786	

* monthly average in the period

Note 1. figures in () show liquidity ratio.

2. Calendar May figures are provisional.

inflows have not been revised; the figures reflect a move out of 90 day accounts. The term shares have identical characteristics to 90 day accounts except that they guarantee a fixed differential over the ordinary share rate for two years.

40. For the forecast months we have assumed that new inflows to term shares exactly offset redemptions of existing term shares, and as a result the building societies' contributions to PSL2 and PSL2A are equal.

41. Given the similarity between the latest generation of term shares (which are excluded from PSL2) and 90-day accounts (which are inside PSL2) these developments tend to emphasise the merits of PSL2A (PSL2 plus term shares) as a better indicator than PSL2.

42. Table 9 below compares recent 12 month growth rates of £M3, PSL2 and PSL2A. Several interesting points emerge:

(i) The growth rate of PSL2A has been more stable than for £M3 or PSL2 over the last year (see standard deviations)

(ii) The diffence between the growth rates of PSL2A and £M3 has narrowed substantially in recent months, reflecting the fact that bank deposit interest rates have improved relative to building society rates. (The degree of convergence of the two series may be overstated by the raw figures in banking April and May because of the effect of the BAe issue and BT call).

(iii) The growth rate of PSL2 has been distorted by movements in and out of term shares. In September 1984 there was a one-off increase in the growth rate of PSL2 relative to PSL2A as the first batch of term shares, issued 5 years earlier, began to mature. Similarly in the last two months the growth rate of PSL2 has declined relative to PSL2A with the substantial movement of funds into the new breed of term shares.

Table 9 Growth rates of monetary aggregates

(12 month growth rates, %)

	£M3	PSL2	PSL2A	PSL2A-£M3
1984				
Banking:				
May	8.1	11.6	11.9	3.8
June	9.2	13.0	13.1	3.9
July	7.6	12.0	12.2	4.6
Aug	7.8	12.1	12.2	4.4
Sept	8.8	13.1	12.6	3.8
Oct	8.0	13.4	12.5	4.5
Nov	10.9	15.6	14.1	3.2
Dec	9.1	14.5	12.8	3.7
1985				
Jan	9.2	14.9	12.9	3.7
Feb	9.7	15.3	13.1	3.4
Mar	9.3	14.7	12.5	3.2
April	12.0	15.5	13.6	1.6
May	11.6	14.4	13.1	1.5
Standard Deviations	1.4	1.4	0.6	-
Mean	9.3	13.8	12.8	

Retail Inflows

43. Table [10] brings together our forecast for retail inflows to National Savings, building societies and banks. In banking May retail bank deposits were some £250m higher than forecast, building societies and national savings inflows a little below forecast, and total savings almost £200m above forecast. The error undoubtedly reflects, in part at least, a build up of bank deposits in preparation for the flotation of BAe, and perhaps in preparation for the second payment for BT shares.

44. In interpretting the banking April and May outturns we have assumed that building society inflows were below their

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SECRET

TABLE 10

RETAIL INFLOWS

	Ave. monthly inc. mid May 1984 to mid May 1985	OUTTURN APRIL	OUTTURN MAY	FORECAST JUNE	FORECAST JULY	FORECAST AUGUST
RETAIL BANK DEPOSITS						
NIB Sight	+56	+186	+195	)		
IB Chequable	+195	+536	+529	) +420	+100	+400
IB Other	+72	-96	-211	)		
Total Bank	+323	+626 (+526)	+733 [+470] (+400)	+190 (+430)	+100 (+400)	+400 (+400)
Building Societies	+1030	+791 (+891)	+1026 [+1065] (+1076)	+1090 (+1100)	+1100 (+1100)	+1180 (+1100)
National Savings	+261	+218	+234 [+265] (+274)	+345 (+265)	+280 (+280)	+305 (+305)
TOTAL RETAIL	+1614	+1635	+1993 [+1800] (+1750)	+1625 (+1795)	+1480 (+1780)	+1885 (+1805)

[ ] = last month's forecast

( ) = underlying inflows

underlying level (also National Savings in May) as money was transferred to bank accounts in preparation for share purchases. As a result bank deposits were above their underlying level in both months. In particular in banking May, bank deposit inflows were, we have assumed, £330 million above their underlying level reflecting money submitted unsuccessfully for BAe shares.

45. In banking June we forecast that bank inflows will be £240m below their underlying level. This reflects an assumed unwinding of unsuccessful money subscribed for BAe shares (£330m) offset in part by a further transfer of money from building societies to bank accounts (£90m) in preparation for the BT second call.

46. By banking July, bank accounts are assumed to have benefitted from a cumulative £200m transferred over previous months from building societies in preparation for BT share payments. This, with a further £100m from bank accounts, is used to pay for the BT shares in banking July. Hence bank deposits are £300m below trend in that month. We have assumed that the other £100m needed to finance the personal sector's payment for BT shares (assumed to total £400m) is financed from bank borrowing. By banking August all these various distortions are assumed to have unwound, and inflows to the three groups of savings institutions (banks, building societies and national savings) return to their underlying levels.

Wholesale Deposits

47. As last month, we have looked at the prospects for wholesale deposits within £M3. Forecasting wholesale flows is not easy. Chart (iv) plots the movement of these deposits since 1982. There does at least seem to be a clear negative correlation between the flow of wholesale deposits in one month and the next. Taking forecast growth of £M3 over the next 3 months, together with our forecast for notes and coin and retail bank deposits, implies a pattern of wholesale flows very similar (with a similar month by month fluctuation) to the past.

CHART IV

MONTHLY CHANGE IN NBPS WHOLESALE BANK DEPOSITS

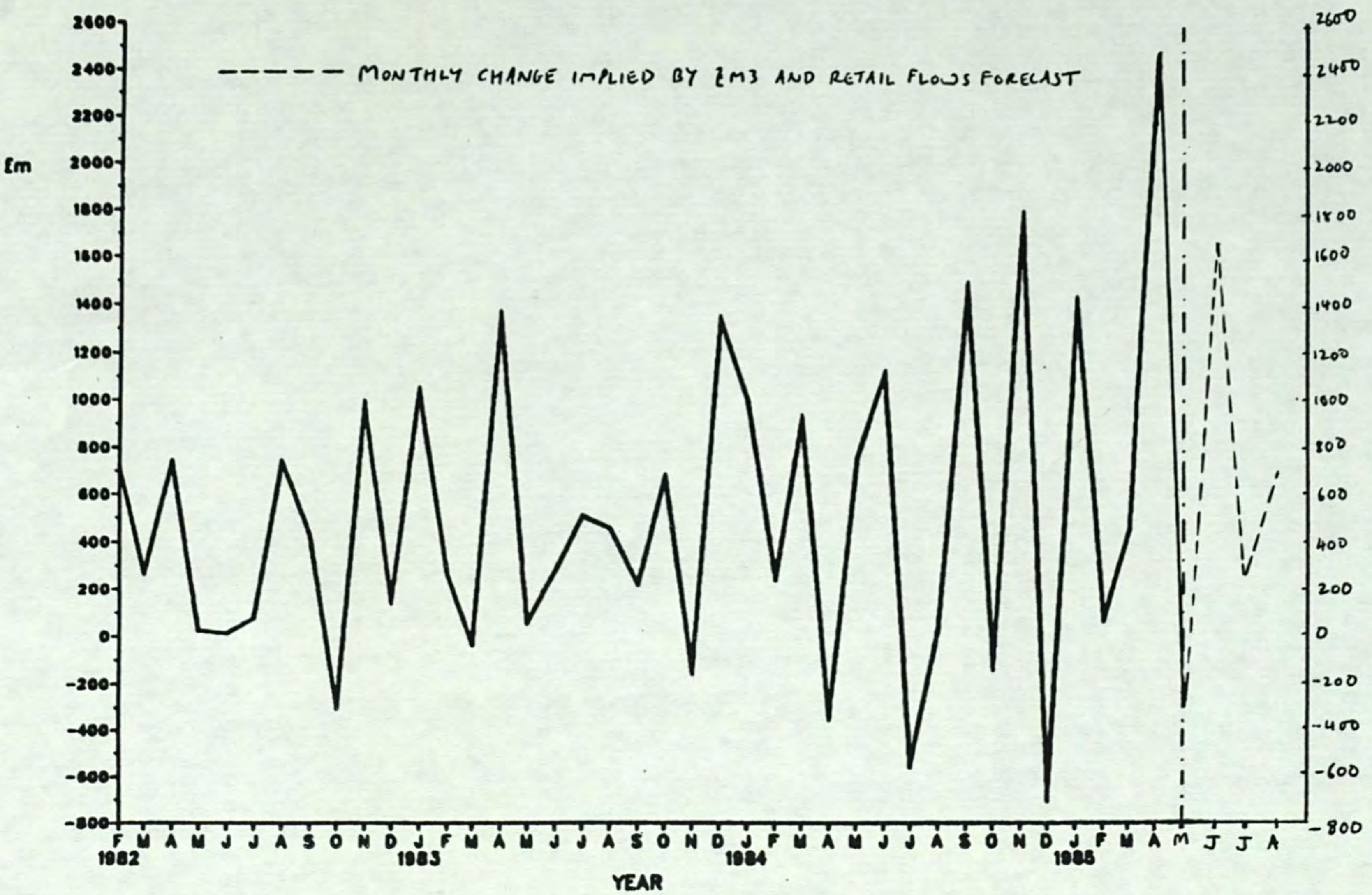
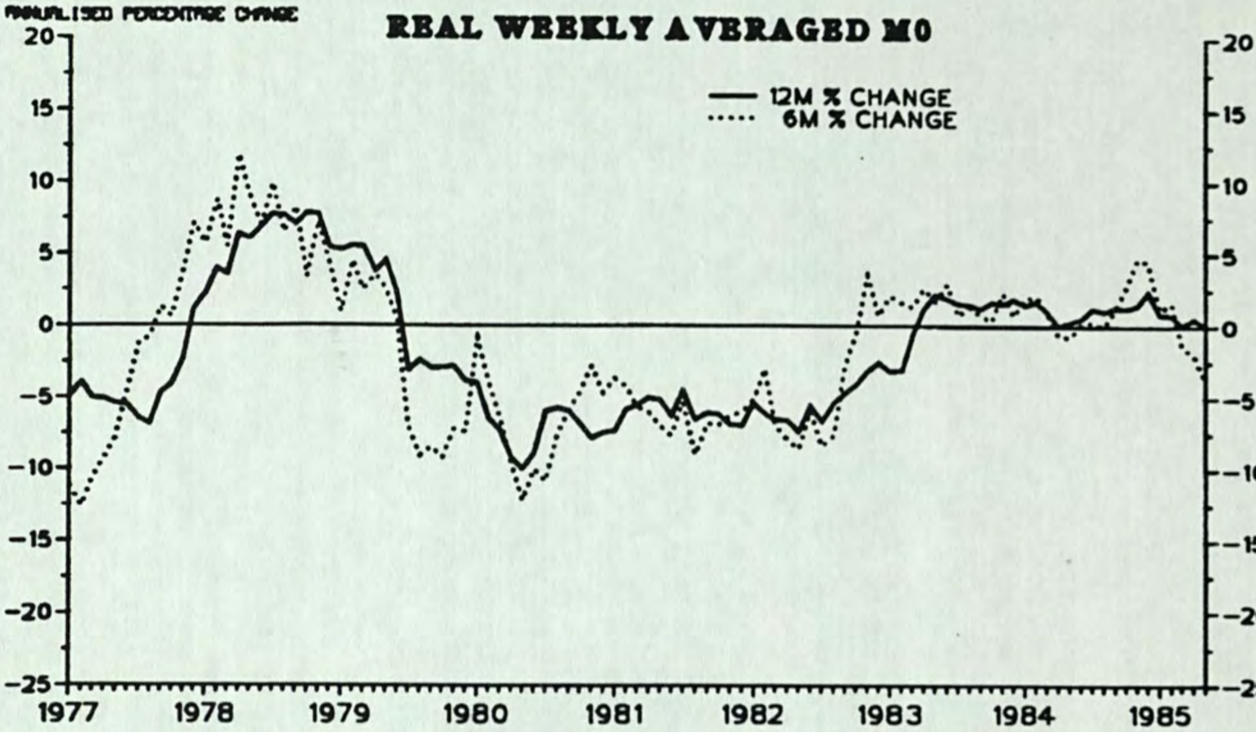
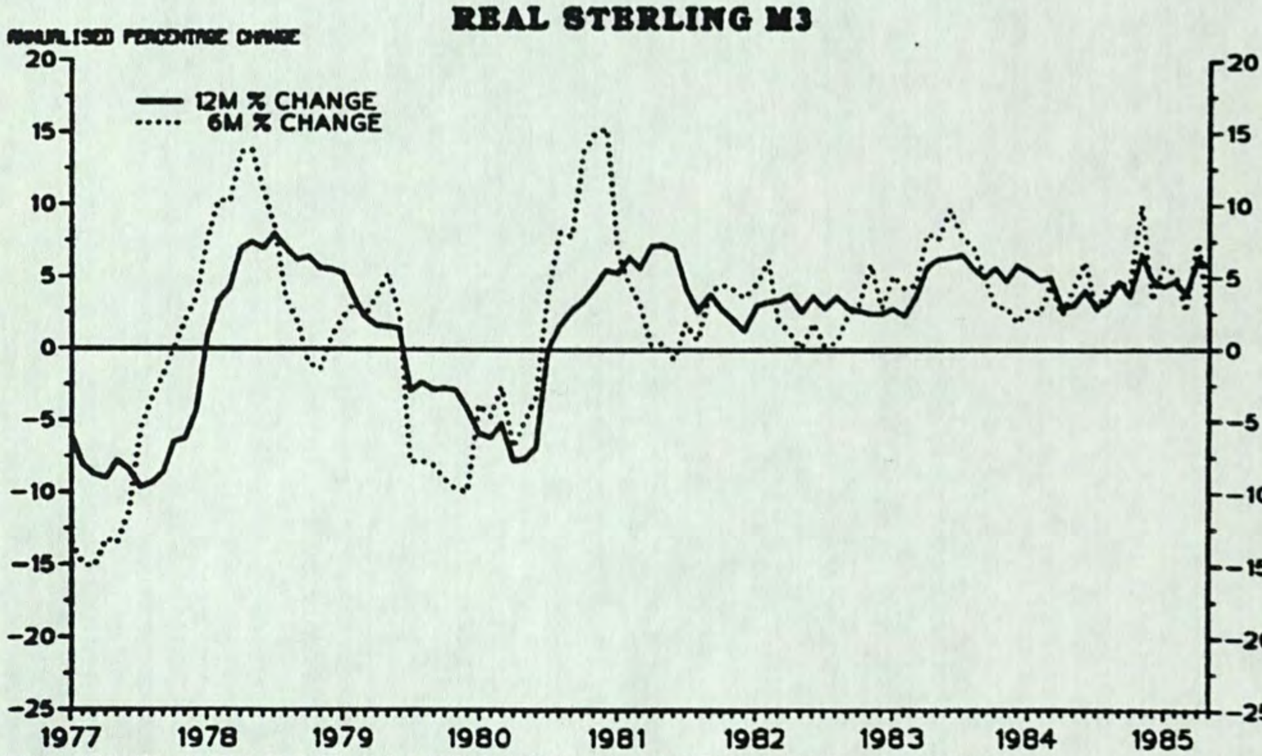


CHART V: GROWTH RATES OF REAL MONETARY AGGREGATES

REAL WEEKLY AVERAGED M0

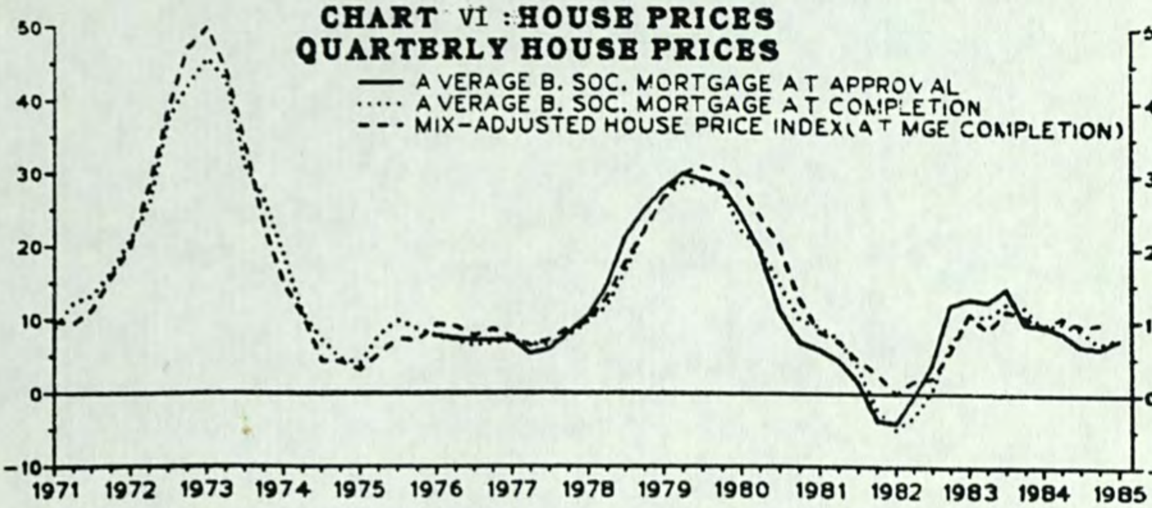


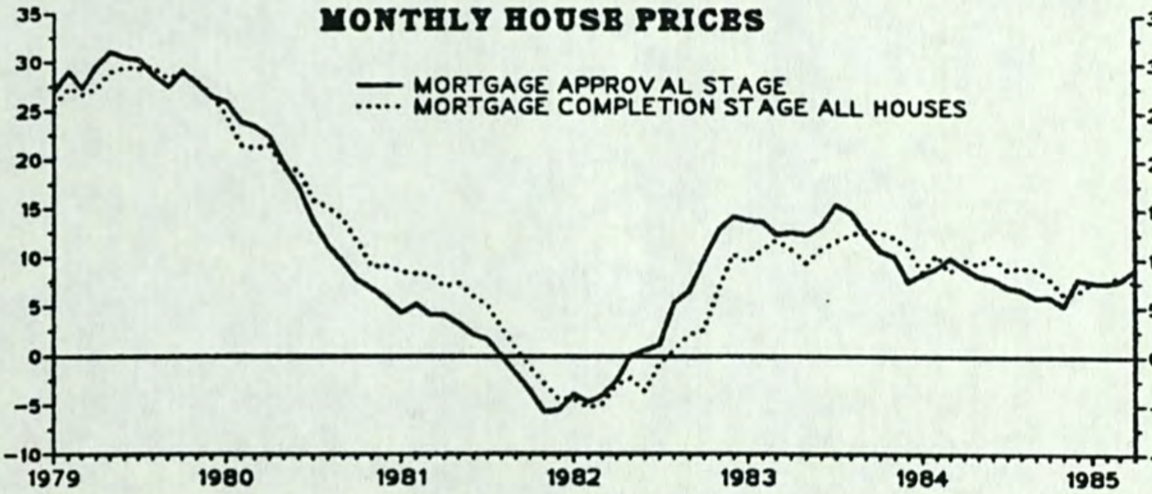
REAL STERLING M3



REAL GROWTH RATES ARE CALCULATED BY DEFLATING BY THE GROWTH OF THE RPI EXCLUDING THE MORTGAGE ELEMENT

CHART VI : HOUSE PRICES





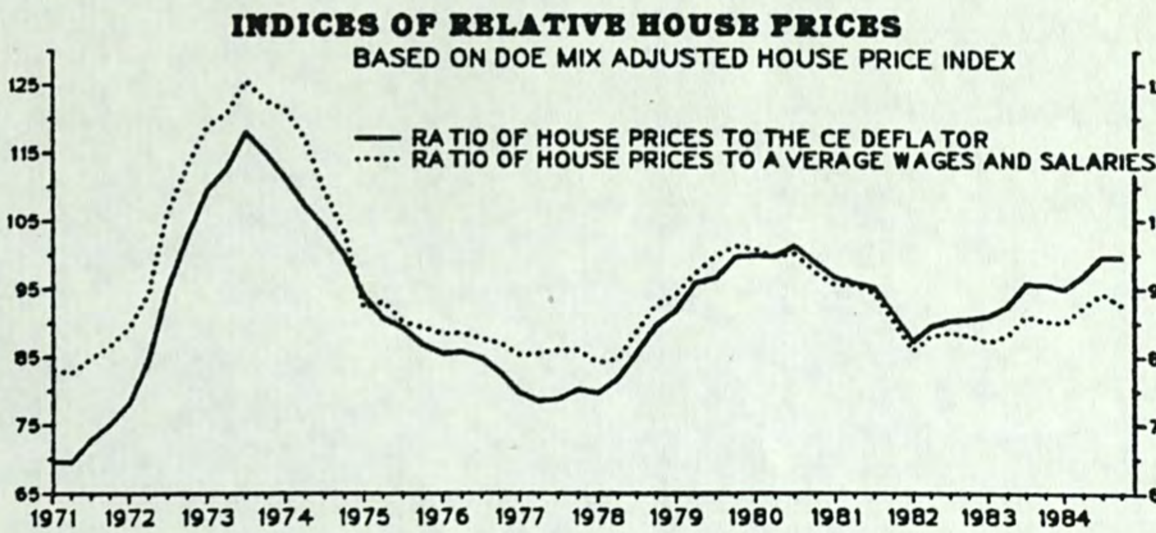
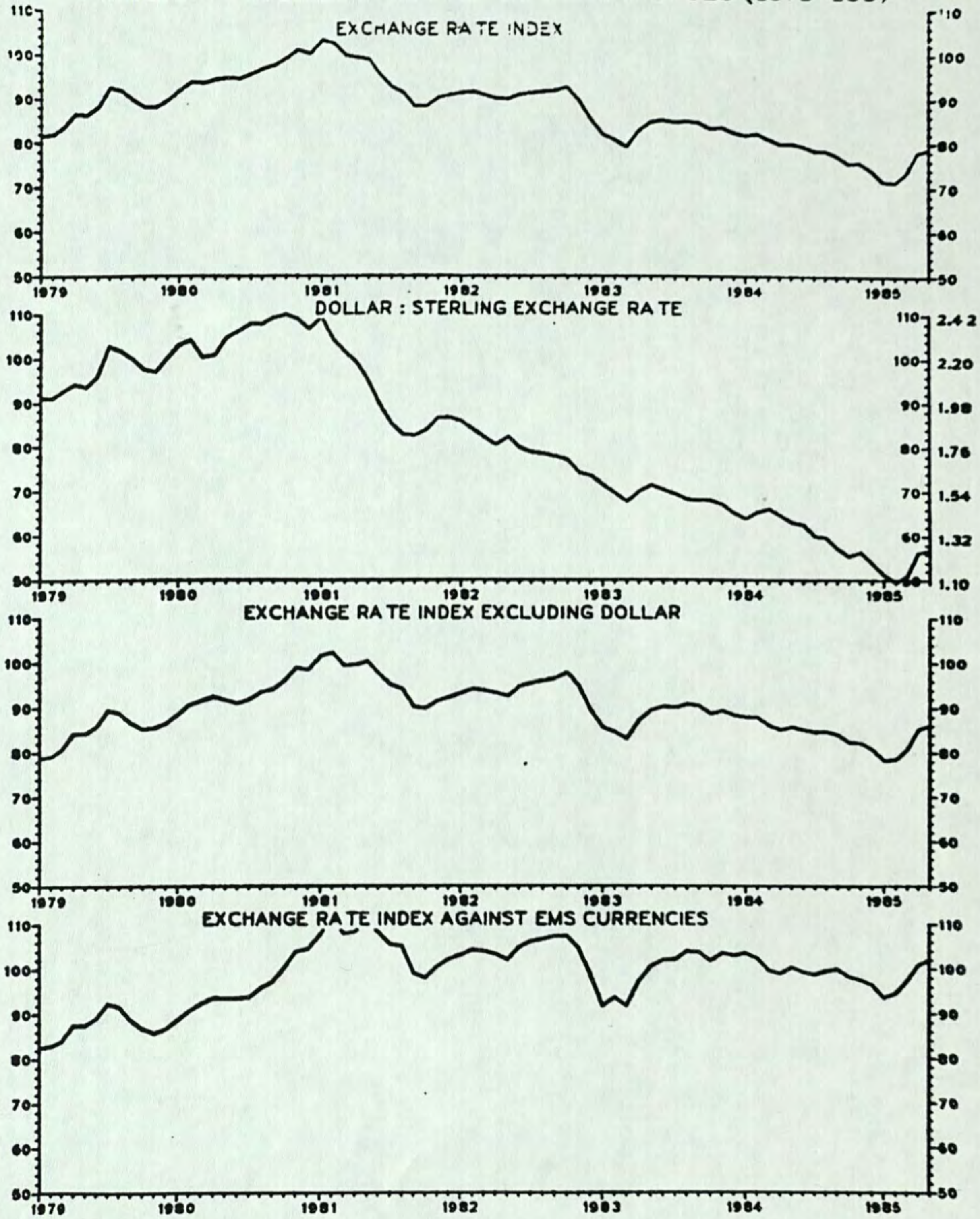


CHART VII: STERLING EXCHANGE RATE INDICES (1975=100)



NOTE : ALL SCALES ARE EQUIV ALENT