

PRIME MINISTER 2

24 July 1986

£M₃ *ms*

The first two pages of this Greenwell's Bulletin are worth reading.

£M₃ has grown much more rapidly over the past 12 months than broad money growth in other countries (see Table 1). The Bulletin advances two arguments which, although not new, are well documented:

- a. High short-term interest rates relative to bond yields (negative yield curve) distinguishes the UK from its major competitors (Chart I shows this very clearly).
- b. Nominal and real short-term interest rates are significantly higher in the UK than other countries (Table 1).

The result is that short-term financial assets (some of which make up £M₃) make broad money in the UK a very attractive investment.

B.G.

BRIAN GRIFFITHS

MONETARY BULLETIN

**Greenwell
Montagu
Research**

No. 186

July 1986

Monetary Growth - the UK in a World Context

Markets have reacted adversely to the publication of further buoyant data for sterling M3. These Bulletins have, however, repeatedly stressed that sterling M3 is currently distorted upwards because:

- i) the rate of interest on bank deposits is higher than that on most other investments,
- ii) short term interest rates are higher than the rate of inflation, by a good margin, ie real interest rates are exceptionally high, and
- iii) investors' preference is swinging away from real to financial assets.

The result is that bank deposits are currently an excellent home for genuine savings, hence our argument that the buoyant growth of sterling M3 is reflecting a change in savings behaviour and not permissive monetary policy.

This Bulletin examines the first two of the above explanations in a global context. Because interest rate patterns in the UK are atypical, the conclusion is that the explanations do stand up to scrutiny.

Greenwell Montagu & Co.

Members of The Stock Exchange

Bow Bells House, Bread Street, London EC4M 9EL
Telephone 01-236 2040 Telex 883006 GRNWLL G
Facsimile (Groups 3, 2 & 1) 01-248 0702
Gifts and Bulldogs Only
Telephone : 01 283 3060

W. Greenwell Inc.
535 Madison Avenue, New York, N.Y. 10022
Telephone 0101 212 702 5480 Telex 429654
Facsimile (Groups 3, 2 & 1) 0101 212 702 5490

A Member of Midland Bank Group

Table I shows the pattern of monetary growth in six countries. It will be seen that the UK is the only country in which broad money is growing substantially faster than narrow money.

Table I
Monetary Growth over the past twelve months

<u>%</u>	<u>Narrow Money</u>	<u>Broad Money</u>
UK (Mo:£M3)	3	18
US (M1a:M2)	9	8
Japan (M1:M2 + CD)	7	8
Germany (M1:M2)	10	6
France (M1:M3)	6½	4½
Netherlands (M1:M2)	8	4

Notes

- UK:** Mo - currency + banker's deposit at central bank, latest data June 1986,
£M3 - latest data June 1986.
- US:** M1a - currency + non-interest bearing sight deposits, latest data June 1986,
M2 - latest data June 1986.
- Japan:** M1 - currency + demand deposits, including interest bearing, latest data April 1986
M2+CD - latest data April 1986.
- Germany:** M1 - currency + non-interest bearing sight deposits, latest data May 1986
M2 - latest data May 1986.
- France:** M1 - New series for currency + non-interest bearing sight deposits, latest data April 1986.
M3 - New series, latest data April 1986.
- Netherlands:** M1 & M2 - latest data April 1986.

The phenomenon of high broad monetary growth is peculiar to the UK and so is the first of our explanations. Chart I, on page 3, shows the interest rate differentials in the six countries, more specifically the difference between three month interest rates and ten year bond yields. It will be seen that, with the exception of Japan for a relatively brief period, the UK is the only country in which the three month rate have been above the ten year bond yield since the beginning of 1985. In our view, this negative yield curve has contributed to buoyant sterling M3 growth. High short term rates make bank deposits an excellent home for genuine savings.

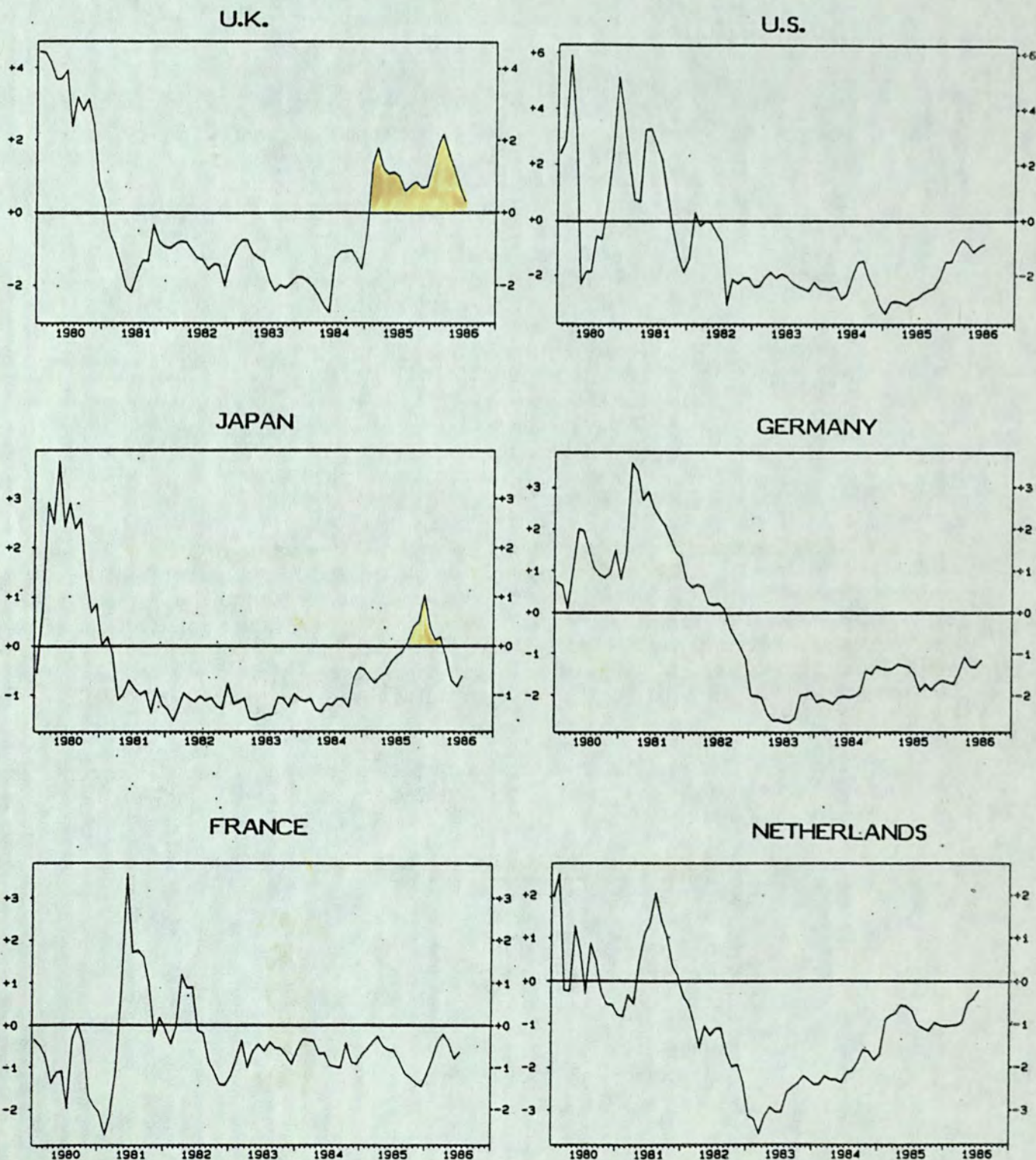
Our second explanation for the buoyant growth of sterling M3 is also peculiar to the UK. Table II shows that UK short term interest rates are the highest in any of the countries, in both nominal and real terms.

Table II - Three Month Interest Rates

<u>% pa</u>	<u>Nominal</u>	<u>Real</u>
UK	10.0	7.5
US	6.7	5.1
Japan	4.3	3.6
Germany	4.5	4.7
France	7.4	5.1
Netherlands	5.7	5.5

Chart I - Interest Rate Differentials

Three Month Money Rates less Ten Year Bond Yields



The two factors provide good explanations for both the high rates of broad monetary growth in the UK as well as for the fact that the rate of growth of broad money is much more rapid than that for narrow money. They give significant reassurance that the sharp rise in the growth of sterling M3 is still not yet a serious worry. This is not to deny that remedial action might well be required when short rates fall significantly, especially relative to long rates.

Monetary Growth in the Month to Mid-June

The seasonally adjusted data for the four weeks to 18th June are shown in Table III.

Table III
Changes in the Month to mid-June

	<u>£m</u>	<u>pa</u>
Mo	76	6%
Currency	131	12%
Retail M1	-78	-3%
M1	737	14%
Sterling M3	1,714	15%
PSL1	1,970	17%
PSL2	3,200	15%
Bank lending in sterling to private sector	2,148	17%

The pattern over the longer term, together with our estimates of the underlying trend over the last six months, are shown in Table IV. Our estimates of the underlying trend make allowance neither for the high relative level of short term interest rates nor for the move away from overfunding, but they do make some downwards adjustment to allow for part of the abnormal increases in banking May.

Table IV
Monetary Growth in the Longer Term

	<u>3 months</u>	<u>6 months</u>		<u>One Year</u>	<u>Notes</u>
	<u>Published</u>	<u>Published</u>	<u>Underlying</u>	<u>Published</u>	
	<u>% p.a.</u>	<u>% p.a.</u>	<u>% p.a.</u>	<u>%</u>	
Narrow money: Mo	3.8	4.4	4	3.1	
Currency	8.0	6.3	5	2.9	1
Retail M1	16.1	8.6	10	0.2	2
M1	35.4	20.8	15	18.6	3
M2	n.a.	n.a.	11	11.5	4
Broad money: Sterling M3	33.6	23.4	18	18.3	5
PSL1	32.5	22.5	17	17.2	5
PSL2	20.1	17.2	17	14.1	6

- Notes.
1. Revised downwards because of abnormally low level in December 1985.
 2. Upwards revision because of a switch from current accounts to high interest cheque accounts.
 3. Revised downwards because of high interest cheque accounts, and the greater use of overnight deposits.
 4. The published rate is for the last year rather than the last six months, because the series is too new for seasonal adjustments to be calculated.
 5. There is a downward adjustment to allow for arbitraging, and the increase in high interest cheque accounts where funds have not come from other bank deposits.
 6. This is the revised series published in last month's Bank of England Quarterly Bulletin. It includes all term shares and deposits with building societies.

Our estimates of underlying monetary growth have generally been slightly raised again in banking June, as shown in Table V, although that for M2 has been reduced by 1%. Mo is estimated to have risen slightly by up to $\frac{1}{4}$ % in banking July, implying three, six and twelve month growth rates averaging under 3%, well inside the bottom half of its target range.

Table V
Underlying Monetary Growth

	Six months growth rates (% pa) to mid-				
	<u>Feb.</u>	<u>Mar.</u>	<u>Apr.</u>	<u>May</u>	<u>June</u>
Mo	3	3	4	4	4
Currency	2	2	2	3	5
Retail M1	8	8	8	10	10
M1	12	13	13	15	15
M2	9	9 $\frac{1}{2}$	10 $\frac{1}{2}$	12	11
£M3	13	13	16	17	18
PSL1	12	13	16	16	17
PSL2	12	13	15	16	17

Bank Lending

Bank lending continues to grow rapidly. Lending to companies should be lower in the next few months, as the boost due to the final reduction in capital allowances at the end of last March ends. Personal borrowing, however, especially for mortgages continues to rise rapidly. There is likely to be a drop in the rate of increase in bank lending in the summer but not by so much as there was last year.

Table VI
Bank Lending in Sterling to the Private Sector

	<u>£m</u>	<u>Published</u>	<u>Bills Outside</u>	<u>Adj Total</u>	<u>3 Month Av</u>
1985	Oct	2,237	-9	2,228	1,660
	Nov	2,069	207	2,274	1,768
	Dec	1,851	-55	1,796	2,099
1986	Jan	612	68	680	1,583
	Feb	1,494	-164	1,330	1,269
	Mar	2,461	152	2,613	1,541
	Apr	3,142	538	3,680	2,541
	May	1,683	-	1,683	2,659
	June	2,148	42	2,190	2,514

Ray Richardson
Robert Thomas
Gordon Pepper

MONETARY GROWTH

In Nominal Terms

Percentage Annual rates		Mo	Currency	Retail M1	M1	M2	Sterling M3	PSL1	PSL2
Changes in year to:									
1985	July.	5	4	3	16	7	12	12	13
	Aug.	4	4	3	18	7	14	14	14
	Sep.	4	4	2	17	8	14	14	14
	Oct.	3	2	2	18	9	15	14	13
	Nov.	3	2	2	17	10	14	13	13
	Dec.	2	2	1	18	9	15	14	13
1986	Jan.	4	2	3	19	10	14	13	12
	Feb.	4	2	3	20	10	15	14	13
	Mar.	4	2	4	21	10	16	15	14
	Apr.	3	2	4	20	11	17	16	14
	May.	3	2	7	22	13	19	18	15
	June.	3	3	0	19	12	18	17	14
Changes in 6 months to:									
1986	Jan.	4	2	7	19		15	13	12
	Feb.	4	1	3	12		13	12	12
	Mar.	4	1	6	18		14	14	14
	Apr.	5	2	6	18		20	19	16
	May.	4	3	10	22		22	20	16
	June.	4	6	9	21		23	22	17
Changes in 3 months to:									
1986	Apr.	0	1	4	21		29	29	21
	May.	3	4	20	42		39	38	21
	June.	4	8	17	35		34	32	20

In Real Terms

Changes in year to:									
1985	July.	-2	-3	-4	9	0	5	5	6
	Aug.	-2	-2	-4	12	1	7	7	8
	Sep.	-2	-2	-4	11	2	8	8	8
	Oct.	-2	-3	-3	12	3	9	8	8
	Nov.	-2	-3	-4	12	4	9	8	7
	Dec.	-3	-3	-5	12	4	9	9	8
1986	Jan.	-1	-3	-2	14	4	9	8	7
	Feb.	-1	-3	-2	15	5	10	9	8
	Mar.	-1	-3	-1	16	6	12	11	9
	Apr.	0	-1	1	17	8	14	13	11
	May.	1	-1	4	19	10	17	16	12
	June.	1	1	-2	16	9	16	15	12
Changes in 6 months to:									
1986	Jan.	0	-2	2	15		11	9	8
	Feb.	0	-3	-1	9		9	8	9
	Mar.	0	-3	2	15		11	10	10
	Apr.	2	-1	3	15		16	16	13
	May.	1	0	7	19		19	17	13
	June.	1	3	6	18		20	19	14
Changes in 3 months to:									
1986	Apr.	-3	-2	0	18		26	26	18
	May.	0	1	18	39		36	35	18
	June.	1	5	14	32		31	29	17

Chart 1 - Monetary Growth in NOMINAL Terms (% p.a.)

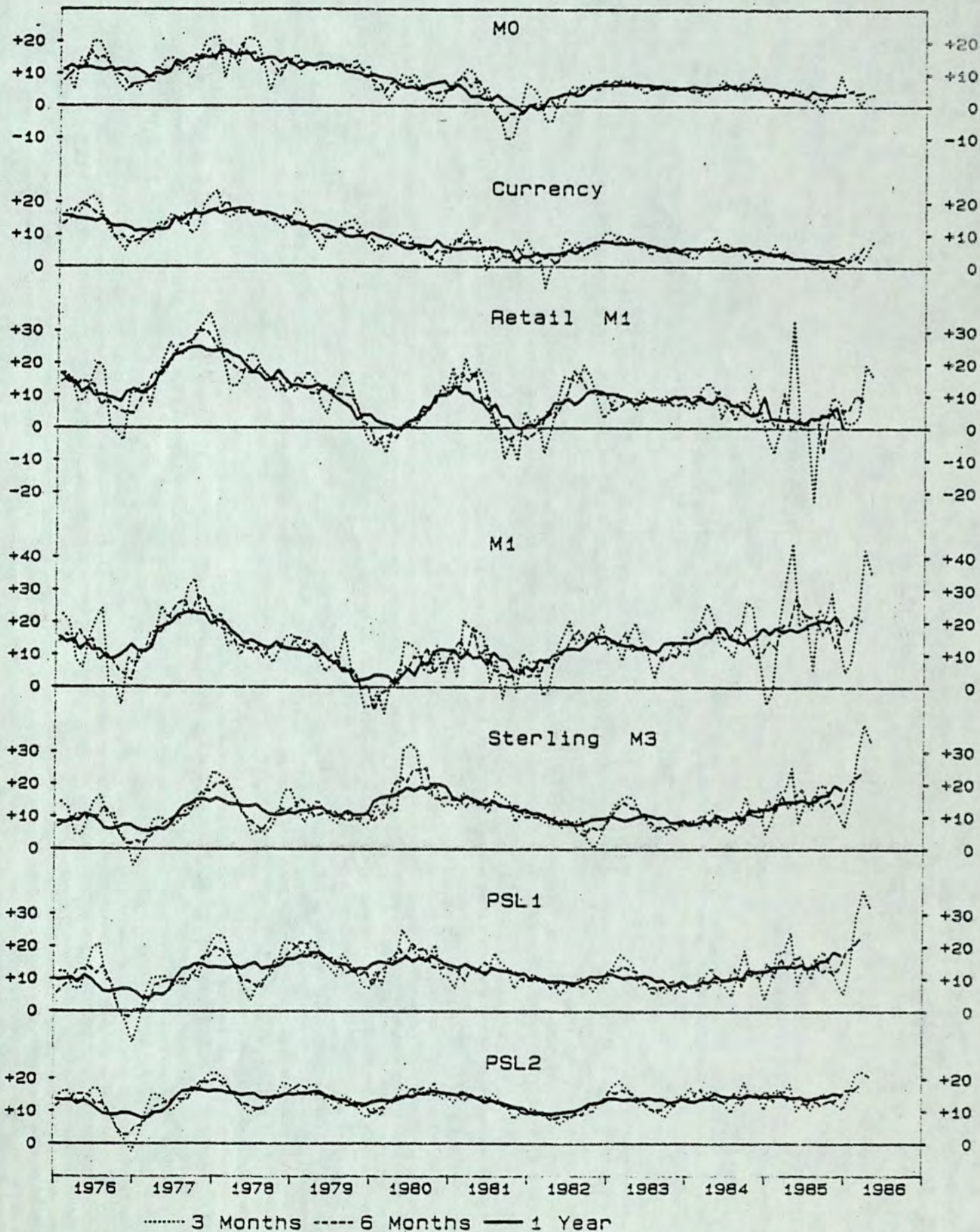


Chart 2 - Monetary Growth in REAL Terms (% p.a.)

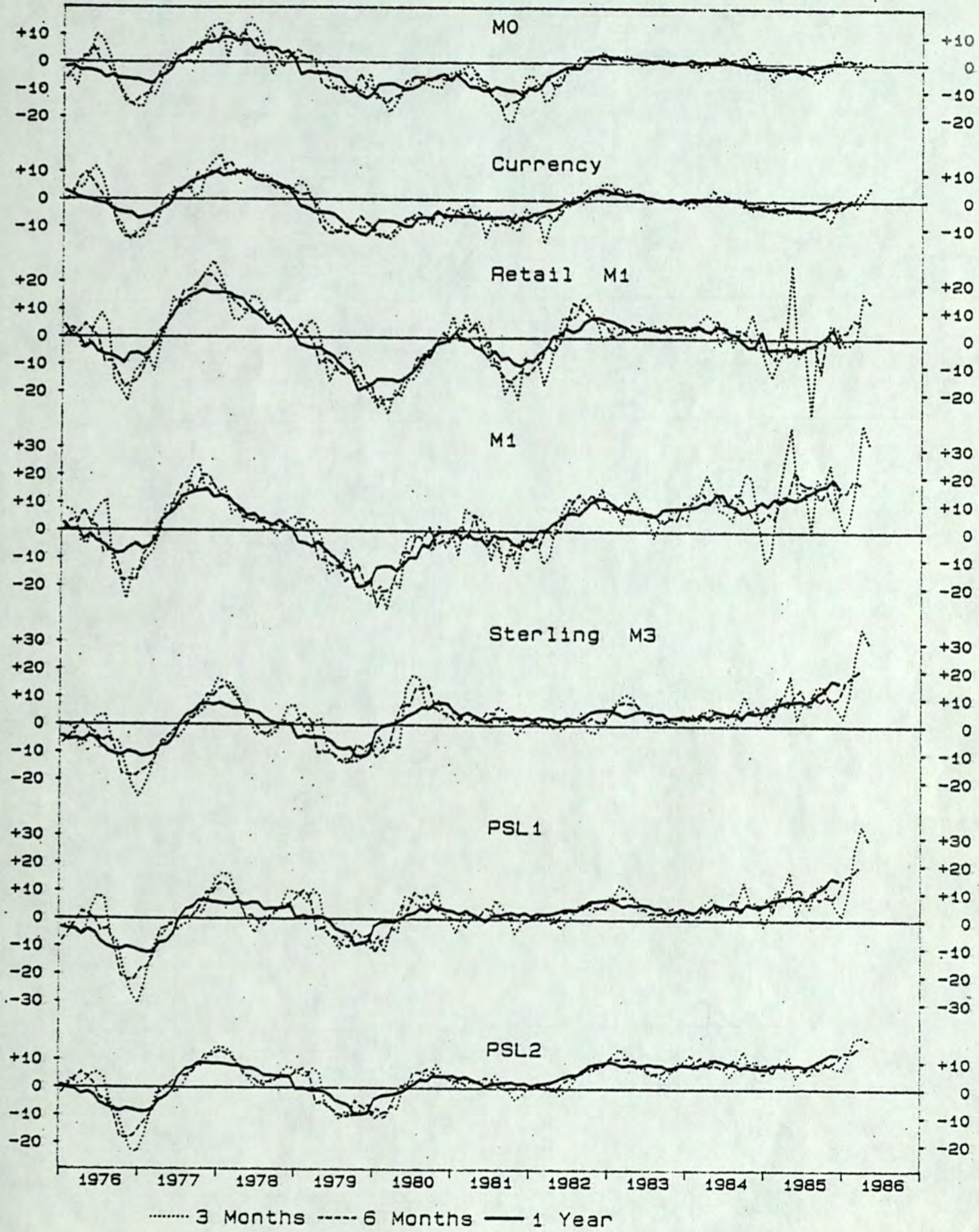


Chart 3 - Components of Monetary Growth (bns)

