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Prime Minister

17.10.79

Economic Policy

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

17th October, 1979

Dear Tim,

LUNCH WITH THE CLEARING BANKERS

I attach for the Prime Minister a Treasury brief for tomorrow's lunch which she is giving to the Chairman and Vice-Chairman of the CLGB.

The brief is in two parts. The first suggests some topics for discussion, and the second provides the factual background. The latter includes the money supply figures for banking September, which the Prime Minister and the Chancellor may wish to draw on. We understand that the Clearing Bank Chairmen will not be leaving before 2.30 p.m. when the figures will be published.

Yours ever,
Tony Battishill
(A.M.W. BATTISHILL)

T. Lankester, Esq.,

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LUNCH WITH THE CHAIRMAN AND VICE CHAIRMAN OF THE CLCB
THURSDAY 18 OCTOBER 1979

Possible Topics for Discussion

A factual brief is attached on recent monetary trends, the position of the clearing banks and some other points of background information. This note suggests some points for discussion.

The General Economic Strategy

2. Ministers will presumably wish to start by underlining their commitment to control inflation by controlling the growth of the money supply, and having a series of progressively lower targets for that purpose. In particular, given that the general attitude in the City appears to be one of good will towards the overall policy, but some scepticism about whether it will be carried through, they will presumably wish to impress upon the Clearing Bank Chairman that they have the resolve to carry this through, and that, unlike some of their predecessors, they accept that this will require taking a politically unpopular decisions in particular cases, and forgoing some of the other objectives until the counter-inflation objective is achieved. (The general line of argument is that developed in the Chancellor's Mansion House Speech for that evening.)

The Need to Affect Expectations

3. Ministers will then presumably deal with the critical need to break the pernicious expectation that a high rate of inflation will be a continuing feature of the scene, and to bring it home that the Government are determined to break the circle of inflation feeding upon inflation. The banks could contribute significantly to this by bringing it home to their customers that the Government's monetary objectives mean that it will not be possible to increase bank facilities to match whatever level of wage settlements is granted. If the employers do not restrain wage increases which they grant, they will not find the finance necessary - if the banks start to give them that finance, interest rates will just have to rise to keep the money supply under control.

4. Ministers may like to ask the Clearing Bank Chairman how they think that they could best get this message across to their customers. Ideally, one would like the clearing banks to discriminate, granting increased facilities to those employers who had resisted wage claims, riding out a strike if necessary, but not granting facilities to those who have granted them. However, this is probably impracticable. However the message does need to be got across that money will not be available without limit, and that if the demand for it goes up beyond what can be accommodated within the monetary target, interest rates will have to rise to choke it off.

The Clearers' Lending Policies

5. There is some circumstantial evidence that the clearers are not taking monetary restraint very seriously. It may be that most of the increase in personal lending recently has been increased utilization of existing facilities, but one suspects not. The clearing banks still seem to be marketing personal lending, and at least one of the bank credit card companies has increased the credit limits for virtually all its customers. Ministers may like to ask the Clearing Bank Chairmen how they reconcile this with the directional guidance that personal lending should be constrained in order to allow room for lending to priority categories, such as manufacturing. Similarly, it would appear that the clearing banks have been using acceptances as a way round the SSD scheme, in particular as a way of providing finance to their finance house and leasing subsidiaries. Ministers might like to make the point that monetary control ought not to be considered as a game betweem the authorities and the banks, with the latter considering how they can get round the rules. In assessing monetary conditions, and the appropriate interest rates, the authorities have to look at both the published £M3 statistic, and the amount of evasion. Therefore, to the extent that the clearing banks failed to take what measures they could to restrain lending, but instead resorted to evasion, the higher interest rates needed to be. It is hardly helping the clearing banks' customers to force the Government to either raise interest rates, or to maintain interest rates at their present level longer than would otherwise have been necessary.

Bank Profits

6. As the factual brief brings out, the clearing banks have declared high profits for the first half of this year, and it is likely that they will be high again in the second half, because of the "endowment income" which the clearing banks earn on current account when interest rates are high. There is a risk that if the banks declare high profits for the second half of the year, this will bring criticism on the Government for adopting high interest rates which favour the banks. Ministers might express the hope that the clearing banks would show some sensitivity when the time ~~cames~~ comes to declare profits next February.

7. Lloyds increase in charges for current accounts, which was announced at the beginning of this week, singularly failed to show such sensitivity. It is rumoured that the other banks are also about to increase their charges. The apparent reason for the increase in charges is that the clearing banks are guarding themselves against the position in which interest rates generally are lower and they therefore get less "endowment income" on their current accounts. While it is entirely reasonable for the clearing banks to look forward to the situation of lower interest rates, and how they will finance the operation of their branch network when that happens, it seems unnecessary to increase their charges now, ahead of the fall in interest rates, ~~than~~ and when they are making substantial profits.

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(until 2.30pm Thursday 18 October)

FACTUAL BRIEF

Contents:

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GENERAL MONETARY SITUATION

1. Recent Monetary Growth

	£bn seasonally adjusted Banking Months			
	Average April to June	July	August	September
CGBR	+ 1.2	+0.8	+0.3	+ 1.6
Purchases of central government debt by non-bank private sector (increase:-)	- 1.1	-0.8	-0.2	- 1.0
Other public sector	-	+0.1	+0.2	+ 0.1
Sterling bank lending				
to private sector	+ 0.8	+0.4	+0.7	+ 0.2
to overseas	-	-	+0.1	-
DCE	+ 0.9	+0.4	+1.1	+ 0.9
External and foreign currency finance adjustment	- 0.1	-	-0.4	- 0.5
Net non-deposit liabilities, etc	- 0.1	-	-0.1	- 0.1
Change in £M3	+ 0.7	+0.4	+0.5	+ 0.3
(Percentage)	(+ 1.4)	(+0.8)	(+1.0)	(+ 0.6)
(% at an annual rate in target period mid-June 1979 to mid-April 1980)			(+11.6)	(+10.3)

Memo item

Change in acceptances held by non-banks	+ 0.1	+0.1	+0.3	+ 0.2

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2. Banking September

   i. £M3 growth (at annual rate) back within the target range.

   ii. High CGBR as expected; only two thirds financed by sales of debt to non-banks. External factors were contractionary.

   iii. Much smaller increase in bank lending, but published figure understates underlying trend. Underlying figure about £600-£700 million, compared with about £1 billion in recent months.

3. Monetary Target

   i. Current target: 7-11% (annual rate) for 10 months mid-June 1979 to mid-April 1980: equivalent to 10% in year to mid-April 1980.

   ii. Target to be rolled forward to cover 12 months to mid-October 1980: an announcement might best be made in mid-November.

   iii. Decision on whether to roll forward SSD scheme, and if so with what guideline, might be announced at the same time.

4. Interest Rates

Short term rates have changes very little since the Budget. Main rates currently are:

MLR - 14%
Clearing Banks' Base Rate - 14% (ie 15% for prime borrowers)
3 month inter-bank - 13⅞%

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THE CLEARERS' POSITION

1. Bank Lending

Clearing bank advances have been accounting for about half the increase in bank lending.

£ billion

	Banking Months			
	Average April to June	July	August	September
Not seasonally adjusted:				
Clearers' advances	+0.4	+0.8	+0.1	-0.3
Other bank lending*	+0.4	+0.3	-	+0.4
TOTAL	+0.8	+1.1	+0.1	+0.1
Seasonally adjusted:				
TOTAL	+0.8	+0.4	+0.7	+0.2

(* includes lending by clearers other than by advances.)

In banking September, relative structure of interest rates on make-up day encouraged borrowers to reduce their overdrafts with the clearers and to increase their market borrowing.

2. Sectoral Split

The sectoral breakdown of the clearers' advances has been:

£m unadjusted

	Banking Months				
	Average April to June	July	August	September	Percentage increase over last 12 months
Advances					
manufacturing	+ 88	+246	+ 74	-328	+22
personal	+152	+130	+ 62	+120	+28
other	+177	+428	+ 13	-108	+21
TOTAL	+417	+804	+149	-316	+23

Advances to the personal sector (which include credit card lending) continued to grow strongly, though more slowly than earlier in the year. Advances to manufacturing fell sharply in banking September; the engineering strike may have reduced borrowing from banks as stocks were run down.

3. Directional Guidance

The banks, including the clearers, have for the last 5 years been requested to give priority to finance required by manufacturing industry, for exports and for the saving of imports, and "in order to ensure their future ability to meet those [priority] requirements"to exercise restraint on other lending, particularly lending and the granting of facilities to persons, to property companies and for purely financial transactions.

4. The SSD Scheme

SSD scheme pressure was less severe in banking September than recently and the London clearing banks were all within the penalty free limit. Some of the clearers did incur penalties in the previous two months. The clearers have taken advantage recently of the acceptance leak to avoid the corset: they do not normally accept many bills, but they have more than tripled the amount in the last year. Anecdote suggests that much of this has been to replace direct lending to their finance house and leasing subsidiaries.

The clearers have been dissatisfied with the SSD scheme. A committee of their economists under Professor Harold Rose (Barclays) has prepared a report on the scheme and possible successors. Their report is still being considered within the CLCB, before being put to the Bank.

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OTHER ISSUES

1. Bank Profits

The main clearers announced interim results at the end of July.

Group pre-tax profits

	1976	1977	1978	First half 1979
Lloyds	148*	166	182	123
Nat West	188*	238	297	221
Barclays	198	295	373	244
Midland	167	197	231	138

* Not strictly comparable with other figures in the table.

These figures are not adjusted for inflation, and in recent years greater part of profits taken to reserves to maintain capital adequacy. Bank profits are extremely dependent on interest rates (because no interest is paid on current accounts); this means that large second half profits are expected.

2. Banking Act

i. Most parts of Banking Act came into operation on 1 October 1979.

ii. Existing organizations have to apply to be recognised as banks or licensed deposit takers by 1 April 1980.

iii. A deposit protection fund will come into existence in 6 months (no definite date).

iv. Late amendments to the Bill met most of clearers' points, but they may mention:

a. the Deposit Protection Scheme, which they feel it is unfair for them to have to subsidize;

b. their finance house subsidiaries, which are looking for recognition as banks. This is entirely a matter for the Bank of England.

3. <u>Export Credit</u>

The Government is proposing some changes in fixed rate sterling financing scheme to reduce public expenditure. Banks are not aware of detailed proposals, although a meeting of officials has been arranged with their representatives. At this stage Ministers need only express hope that banks will respond helpfully to proposals that would reduce public expenditure.