

Monetary Policy

FROM: RACHEL LOMAX
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CHANCELLOR

cc: Economic Secretary
Sir P Middleton O.R.
Sir T Burns
Mr Cassell
Mr Lavelle
Mr Wood

GREENWELL'S BULLETIN: POST MORTEM

Greenwell's July Bulletin contains Gordon Pepper's reflections on the latest round of base rate rises. Pepper has always been sceptical of the argument that there are times when the authorities cannot resist market pressures. This article reflects some of that scepticism, but argues that the authorities were right to acquiesce "to some extent this time" though wrong to ratify a rise as large as 3 per cent.

2. The discussion of the role of the exchange rate in official thinking is rather helpful. The point that the fall in the effective rate prior to 26 June was primarily a reflection of the strength of the dollar is well illustrated by charts showing the dollar's effective rate and sterling's effective rate against currencies other than the dollar (attached). Greenwell's argue that there is no exchange rate target, but that movements in the exchange rate are an important trigger for changes in interest rates. Worries about monetary growth are acted on quickly only if they are confirmed by the exchange rate. Conversely, the case for benign neglect of the exchange rate depends on monetary growth being under control. Although narrow money is clearly behaving itself, worries about broad money justified some rise in interest rates when sterling weakened more generally at end June and early July.

3. That strikes me as a reasonable summary of past official behaviour, and a defensible description of the thinking behind the first rise in base rates to 10 per cent. Greenwell's do not say whether they would have wanted to go beyond 10 per cent on these grounds. But the authorities certainly did not want to.

The second rise in base rates, to 12 per cent, was forced. By implication, it is this forced element that Greenwell's think could have been avoided.

4. Their reasons for arguing that market pressures could have been resisted are not very fully spelt out and, as stated, do not address the central issue at all squarely. There is no great dispute about what Greenwell's call "the true position", ie. that the authorities cannot control the term structure, or distort interest rate relativities for any length of time, but they can peg the level of any one particular short term money rate. We might be more sceptical about our ability to hold the 3-month rate than Greenwell's, because it is more heavily influenced by expectations, but we would certainly agree that 7-day and 1-month money market rates are susceptible to considerable official influence.

5. Greenwell's are also quite correct to say that the change in the Bank's dealing rates on 26 June was an attempt to bring the structure of dealing rates more in line with the market. But it does not strike me as a particularly good example of the Bank's inability to control the term structure - except as an instance of how the market yield curve can change without there being any alteration in the Bank's dealing rates. Nor is the reference to "overwhelming arbitrage transactions" particularly apposite in this context.

6. To digress a little, prior to 26 June the market yield curve had steepened, while the Bank's dealing rates had stayed flat, reflecting an earlier structure of market rates. As a result, the Bank had found itself dealing only in longer term paper (Band 4). While daily shortages were small, the situation was manageable. But, with larger shortages in prospect, the Bank were worried that they might have to engage at shorter maturities. The risk was that by doing so at existing dealing rates they might have put upward pressure on very short market rates. To avoid this, they wanted to move Band I and II rates down, and Bands III and IV rates up; but they also wanted to make it clear that, by steepening the yield curve at a time when Lloyds had raised base rates by

$\frac{1}{4}$ per cent, they were not validating the market's implicit expectation that short term rates were set to rise. Hence the attempt to back up a delicate operation with a statement which, as Greenwell's argue, probably misfired.

7. Coming back to the central argument, no-one disputes the authorities' ability to peg some very short term rate, if they are so minded. What is missing from Greenwell's exposition is any recognition of the quantitative implications of holding rates down, and any discussion of the effect of large money market operations on expectations, and hence on shape of the yield curve, the exchange rate, and ultimately base rates.

8. Greenwell's argue cryptically that "arbitrage transactions would cancel out" and criticise officials who "argue there would be a huge demand for cheap funds from the Bank if the authorities were to peg, say, the 7 day rate when there were engrained expectations that it would rise". One interpretation of this passage is that Greenwell's think that money market rates can be pegged, in the face of engrained expectations to the contrary, without the Bank needing to supply additional cash to the market. It is difficult to believe that this is really their view. Gordon Pepper is, after all, a long time advocate of monetary base control, and critic of the Bank's activities as "lender of first resort". And if rates are not held down by varying the amount of cash supplied, it is not clear what other mechanism they have in mind.

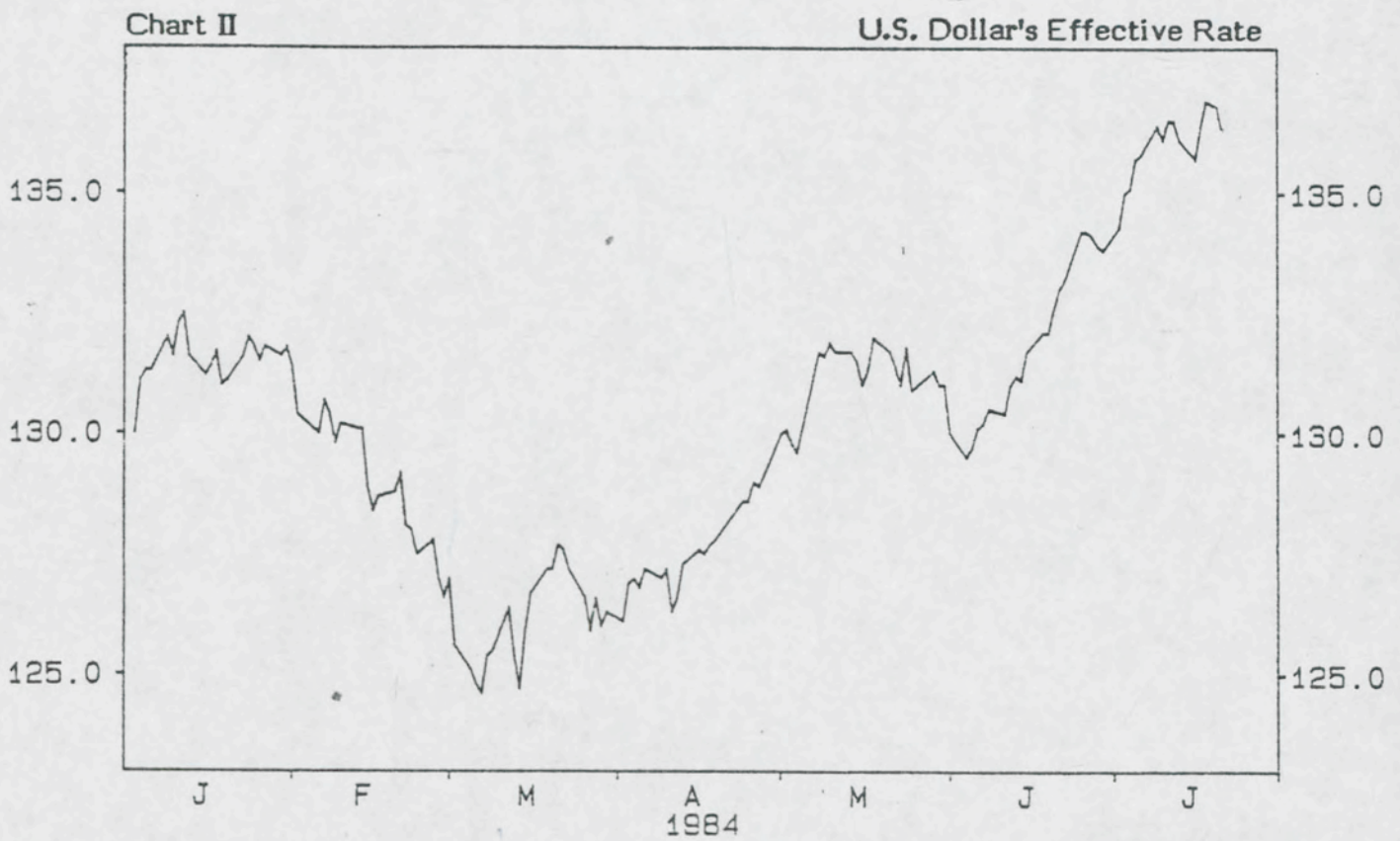
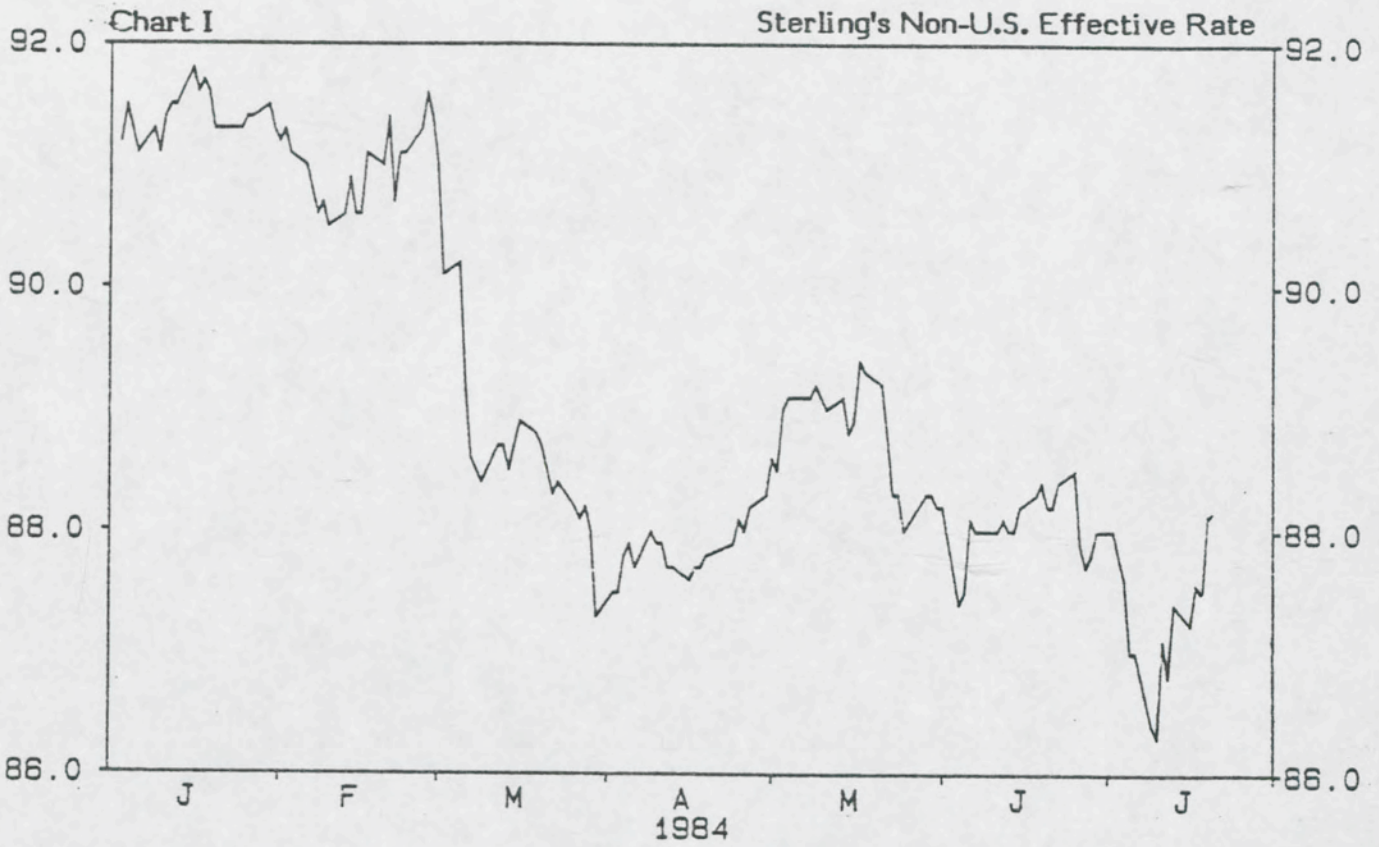
9. Another possibility is that Pepper believes that only a modest liquidity operation would have been needed in practice. He may be right, but there was no way of being sure before the event. The argument against trying to peg short term rates on 12 July was not that it would definitely have failed, but that it was very risky, because market expectations had hardened to the point where it might well have required more than a modest intervention to produce the desired results, and because the consequences of large scale money market operations, in such circumstances, are highly unpredictable and potentially counter-productive.

10. Greenwell's failure to explain clearly why they think the authorities could successfully have resisted pressure for higher interest rates undermines the value of their policy prescriptions. In the circumstances, they postulate - a weak exchange rate, but low growth in narrow money and broad money growth high due to funding difficulties - a policy of benign neglect towards the exchange rate would have considerable appeal. But the real problem that may have to be faced is how to put it into practice. As Greenwell's point out "The belief that the authorities will concede to market pressure and will alter interest rates in accordance with sterling's behaviour is reinforced each time they do so. It is now more firmly engrained than ever". Rhetoric may not be enough. To quote Greenwell's again "Experience has taught the market to ignore what the authorities say and to pay attention to what they do". A convincing demonstration of benign neglect may well be needed - but there is little doubt in my mind that it will be easier to mount if £M3 is coming back on target. (That was part of the argument for the element of overkill involved in going to 12 per cent).

11. Happily, these problems are looking less immediate. Volcker's statement has had a very cheering effect on the markets; we have sold a lot of stock this morning, the exchange rate is strong, and the money market yield curve is sloping down to $11^{13}/16$ at 12 months (with the 3-month rate only just above 12 per cent).



RACHEL LOMAX





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Introduction

During the last nine months we have been relatively relaxed about the behaviour of the monetary aggregates. In the light of the latest data this position must obviously be thoroughly scrutinised; this is done in some detail below but it may be helpful to begin with a broad summary.

The most striking feature of the monetary statistics at present is the marked acceleration in all of the broader aggregates. The growth of PSL2 has been high for some time but its six month rate of growth has continued to rise since the turn of the year. PSL1 and, now, sterling M3 are also growing at rates clearly greater than the target range.

The picture is rather different for the narrower aggregates. Mo remains well within its target range. Currency, on a properly calculated basis, is not too different. The growth of retail M1 looks to be slowing down after a temporary acceleration in March and April, while M2 is trending very slowly upwards in a way that is consistent with reasonable economic growth.

There is, therefore, a striking contrast between the behaviour of the two sets of monetary aggregates. With inflation relatively low and stable and with real interest rates at the height they are now, it is obviously true that a growing portion of genuine savings are being held in the form of interest-bearing money, e.g. with building societies and in bank deposit accounts. It is also true that such savings can subsequently be spent, thereby raising inflationary pressures, but there are no signs yet of a strong spending boom. If anything, retail sales seem to be losing their momentum, and the rise in interest rates must make a further slowdown more probable.

Monetary Growth in the Month to Mid-June

The seasonally adjusted data for the five weeks to 20th June were as follows:-

	<u>£m.</u>	<u>p.a.</u>
Mo	144	13%
Currency	118	12%
Retail M1	279	10%
M1	853	22%
Sterling M3	2,064	24%
PSL1	2,589	29%
PSL2	3,874	27%
Bank lending in sterling to private sector	1,549	17%

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The longer-term picture of monetary growth at mid-June becomes:

<u>% p.a.</u>	<u>3 months</u>	<u>4 months**</u>	<u>6 months</u>	<u>1 year</u>
Narrow money: Mo	6	7	5	5
Currency	10	9	5	5
Retail M1	13	15	9	9
M1	23	27	20	14
M2	n.a.	n.a.	n.a.	11*
Broad money: Sterling M3	14	15	11	9
PSL1	16	17	12	10
PSL2	19	20	17	13

* 8% after allowing for reclassification of building society deposits

** Target period so far

The growth of Mo continues to be reassuringly in the middle of its 4-8% p.a. target range. We estimate that it will have risen by less than $\frac{1}{2}\%$ in banking July, bringing its three, six and twelve month growth rates to $7\frac{1}{2}\%$ p.a., $5\frac{1}{2}\%$ p.a., and 6% respectively.

Currency has grown at a similar rate to Mo over the last six and twelve months, but has been more buoyant over the last three. About half of this more rapid growth arises from the fact that the currency series is based on a single, relatively volatile mid-month calculation rather than on an average of weekly data within a banking month. The latter basis produces a three month growth rate for currency of 8% pa.

The growth rate of retail M1 was again not very high in the month to mid-June. As we pointed out last month, the growth of retail M1 in real terms was lower after mid-1983 than would have been expected given the trend in interest rates; its acceleration in March and April is no cause for alarm if all that was happening was a return of retail M1 to a normal relationship with interest rates. The last two months' figures suggest that this might be happening. Further, the recent rise in interest rates should cause retail M1 to decelerate sharply, starting in the banking month to mid-August.

As the Chancellor stated in his Financial Statement last March "the increasing share of interest bearing deposits within the total has complicated interpretation and made M1 an increasingly inadequate measure of transactions balances". The reclassification of certain deposits late last summer is still boosting the twelve month growth rate of M1 but not the three and six month rates. More recently, however, M1 has been increased by the introduction of high interest checking accounts by Midland and Barclays. Even after making allowance for these accounts, we estimate that M1's three, four and six month growth rates remain high at about 19% pa, 23% pa and 17%pa respectively.

M2 will no doubt become the authorities' preferred indicator of narrow money but, as a seasonally adjusted series is not yet available, only its annual growth rate is relevant. After adjusting for the reclassification of certain building society deposits, its annual growth rate continues at a very reasonable 8.3%.

The very rapid growth in sterling M3 in the month to mid-June reflects an above average PSBR (at twice the rate of the Budget forecast for the year) coinciding with high bank lending, low sales of gilt-edged stock and unfavourable external finance and non-deposit liabilities. This extreme combination of every counterpart is exceptional. Turning to future growth, it should be noted that the recent rise in interest rates has

altered the structure of rates. In particular, banks' deposit rates have risen relative to building society share rates. This should encourage a faster growth of bank deposits and, therefore, of sterling M3. To the extent this merely reflects a change in the form which people hold their savings, this rise in sterling M3 would not be especially worrying.

PSL1 & PSL2 are growing even more rapidly than sterling M3. The growth of PSL1 has been boosted by non-bank holdings of eligible bills having risen by more than £1bn in the four months to mid-June. The rapid growth of PSL2 reflects a 22% p.a. increase in its building society component over the same four months.

Counterparts to Monetary Growth

Sterling M3 was also giving cause for concern a year ago. An obvious approach is to compare this year's overshoot with that of last year, which is done in Table I.

TABLE I
Counterparts to Monetary Growth

<u>£bn</u>	<u>4 months</u> <u>to June '83</u>	<u>4 months</u> <u>to Oct '83</u>	<u>4 months</u> <u>to Feb '84</u>	<u>4 months</u> <u>to June '84</u>
PSBR*	4.9	4.1	3.1	4.0
less CG Debt sales	-2.4	-5.5	-4.3	-3.3
Bank Lending	3.3	4.8	4.9	5.5
External Finance and banks' non-deposit liabilities	-1.3	-1.3	-1.8	-1.6
Sterling M3	<u>4.5</u>	<u>2.2</u>	<u>1.9</u>	<u>4.6</u>
Deviation of sterling M3 from:				
mid-point of target range	+1.8	-0.5	-0.8	+2.0
top of target range	+1.2	-1.1	-1.4	+1.3

* plus purchase of local authority & public corporation debt from non-bank private sector.

Remembering the mini-Budget last July, the surprising factor about the above table is that the most important cause of excessive monetary growth last June was very low debt sales rather than an especially high PSBR. The main cause this year is high bank lending. We discuss the PSBR and bank lending in turn.

The Profile of the PSBR

Ever since the Budget, the profile of the PSBR has been expected to be skewed this year. On a seasonally adjusted basis, the borrowing requirement is expected to be more than £2bn greater in the first half than in the second half of the year.

This is mainly because the tax changes and the asset sales announced in the Budget will have a very uneven impact. Additional VAT receipts, proceeds from asset sales and EEC rebates will be heavily concentrated in the second half of the year. Table II shows the impact of the Budget changes on the PSBR's expected profile.

TABLE II

Influences on PSBR Profile in 1984/5

<u>£m</u>	<u>First Half</u>	<u>Second Half</u>
EEC rebate	-400	-650
Asset sales	-600	-1,300
Extra VAT	-50	-1,500
End of N.I.S.	-	+350
	<u>-1,050</u>	<u>-3,100</u>

It should be noted that on a non-seasonally adjusted basis almost the whole of the PSBR is expected to occur in the first half of the year, £6 $\frac{3}{4}$ bn compared with £ $\frac{1}{2}$ bn. The published figure of £4.7bn (£3.4bn seasonally adjusted) for the first quarter of the fiscal year is quite consistent with this estimate.

The miners' dispute is likely to have a further impact on the PSBR profile, as well as putting the total under some pressure if it is not settled fairly soon. Our estimate of the weekly rate of loss for the NCB and the rest of the public sector is shown in Table III.

TABLE III
Weekly Accounting Losses

	<u>£m</u>	
NCB: reduced revenue from lower sales	65	
reduced expenditure	<u>-35</u>	
		30
CEGB: increased expenditure on oil	43	
reduced expenditure on coal	<u>-26</u>	
		17
British Rail		4
British Steel		4
Police		4
Income tax lost and benefits paid		<u>7</u>
		<u>66</u>

The impact of the dispute on the PSBR will be different from the accounting losses shown above because it will lead to a fall in the NCB's stocks of coal and the CEGB's stocks of coal and oil, which will release finance. The NCB's coal stocks were virtually unchanged in April but the CEGB's coal and oil stocks fell by £130m and £50m respectively. Data for May and June have not yet been published but reductions in stocks are likely to be lower because the CEGB increased its purchases of fuel oil and because the seasonal reduction in the demand for electricity enabled coal stocks to be conserved.

Allowing for the finance released by the fall in stocks, our estimates of the effect of the miners' dispute on the PSBR during April, May and June are £115m, £240m and £200m respectively. If the dispute were to end by the beginning of August, which does not now look likely, there would be a PSBR increase of some £230m in July. The rebuilding of coal stocks by the NCB and CEGB and the continuation, for a few months, of a higher than normal oil burn by the CEGB would continue to raise the PSBR in subsequent months. These additional effects could amount to some £300m, of which £100m would increase the 1985/6 PSBR.

On the assumption that the miners' dispute ends within a month, its total impact on the PSBR this fiscal year will be less than £1,000m, as compared with a contingency reserve of £2 $\frac{3}{4}$ bn for the year as a whole.

There are further identified claims on the contingency reserve. First, public sector pay increases are running above the 3% assumption made in the Public Expenditure White Paper. The outcome is likely to be an overrun of about 1½% which would increase expenditure for 1984/5 by £550m, before any offsetting manpower reductions. The increase in the PSBR will be lower at £325m, as almost 40% of the extra wage costs will be offset by higher receipts of income tax and national insurance contributions.

Secondly, unemployment is continuing to rise slowly, compared with the Budget assumption of an unchanged level. Social security costs are likely to be £200m higher than planned.

There is one important factor which will reduce the PSBR this year. According to the Budget estimates, receipts of petroleum revenue tax (PRT) and oil royalties will be £8bn in 1984/5. As receipts in a fiscal year are determined by production in a calendar year, information for half of the current year is already available. Not only has the volume of oil production risen by 13% in the first half but the sterling oil price has also risen with the fall in the sterling/dollar exchange rate. The Budget assumed that "oil prices do not change much from current levels". At that time sterling was above \$1.46. In the first half of the year it averaged \$1.41. If the average is, say, \$1.33 in the second half, and dollar oil prices are maintained, the sterling oil price will be 6% above the Budget assumption. If these assumptions are correct, receipts from PRT and oil royalties will exceed the Budget estimate by some £500m.

All these factors suggest that the PSBR will be close to the Budget forecast of £7¼bn. The PSBR is, however, likely to be under real pressure if the miners' dispute extends very far into the autumn.

Bank Lending

As Table I shows, high bank lending is an important factor behind the rapid monetary growth in the last four months. Indeed, compared with the same period a year ago, bank lending is more than £2bn higher. A full breakdown is not available but partial data clearly indicate that lending to persons is no higher than a year ago (group data for the London Clearing Banks show that lending to persons was about £1.2bn in the four months to mid-June, some £50m lower than last year). The increase of £2bn, therefore, arises from lending to companies and unincorporated businesses.

The quarterly analysis of bank lending to mid-May confirms that the lending is to companies rather than persons. Further, it is widespread across different industries rather than confined to merely a few.

The other source of information is data for industrial and commercial companies' net borrowing in the first calendar quarter, which have recently been published. In spite of a record financial surplus of £3.6bn, bank lending was still high at £2.6bn. This was not because of a strong build-up of liquid assets, which at only £1.1bn were less than a third of the previous quarter's increase. Rather, there was a record level of "unidentified" items, at £5.2bn. These include errors and omissions as well as trade credit and unrecorded transactions, e.g. foreign currency flows and changes in leads and lags of trade. The first quarter accounts, therefore, suggest that corporate bank borrowing in the four months to mid-June may reflect lower remittances to the UK and more rapid transfers abroad, presumably responding to the continued rise in the US dollar.

A Post-mortem

Before coming to overall conclusions, there are some important lessons to be learned from a post-mortem into the recent rise in short term interest rates. To begin with, we focus on the contrast between three firmly held impressions and reality.

Impressions

First, it is very widely believed that sterling has been weak since March. Confidence in the foreign exchange market is determined to a very large extent by sterling's exchange rate against the US dollar, because the US dollar is involved in the majority of sterling's foreign exchange transactions. Almost invariably, the press concentrates on the sterling/dollar exchange rate. Throughout the period since March there have been continual headlines of sterling falling to new all-time lows.

Secondly, most participants in the money and gilt-edged markets believe that sterling weakness is the single most important cause of increases in short term interest rates. They do so because they have observed that there has nearly always been a foreign exchange explanation when the Bank of England has altered its dealing rates in the bill market or, in the old days, when it altered MLR.

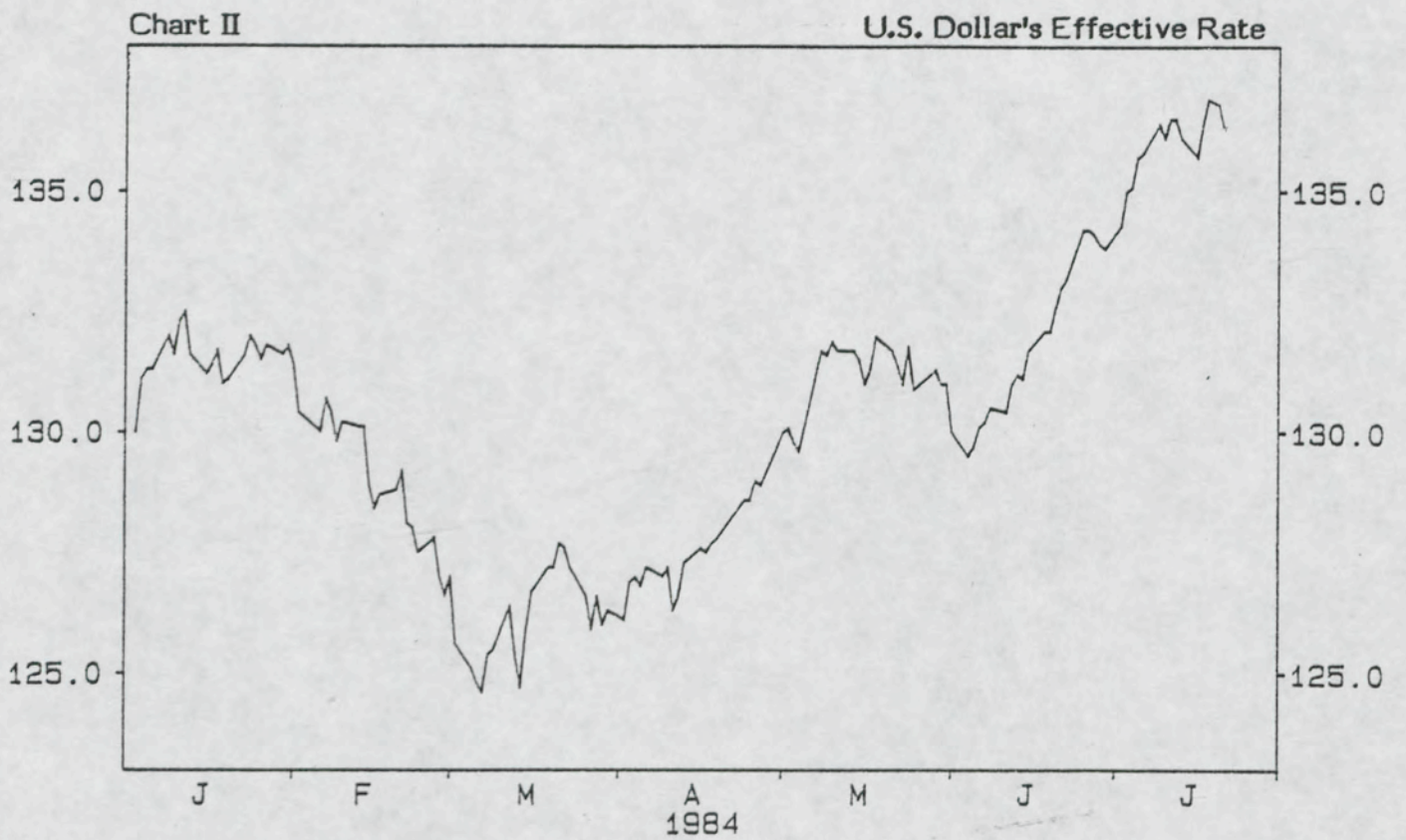
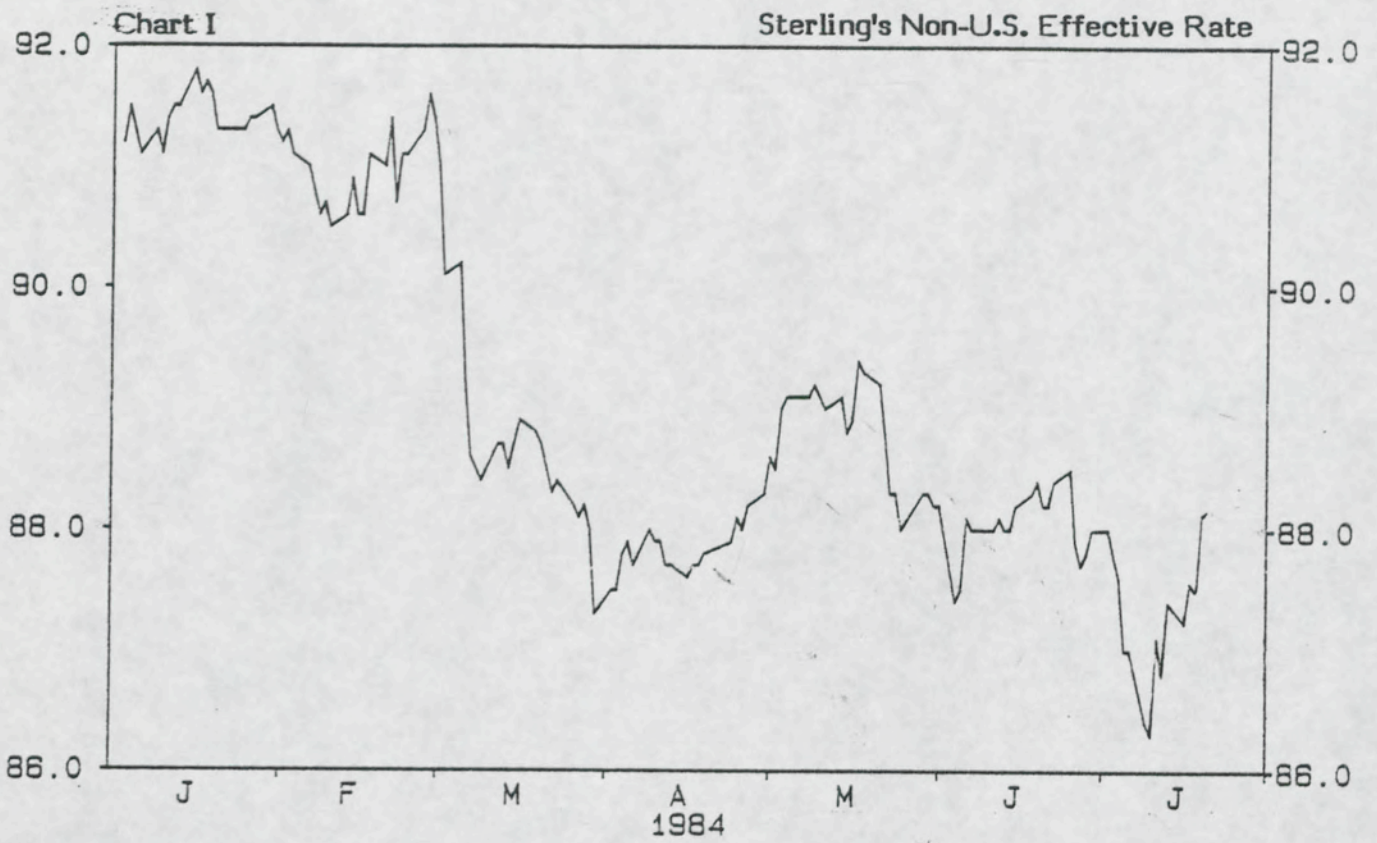
Thirdly, many officials believe that the authorities have to accede to market pressure when expectations of an increase in interest rates become really engrained.

Reality

Reality was certainly different from the first of the above impressions. If the behaviour of the US dollar is excluded, sterling was not weak during April, May and June. The Bank's index of sterling's "effective exchange rate" measures sterling against a basket of currencies weighted according to their importance in our overseas trade. It is possible to calculate an index leaving out the US dollar. Chart I, at the top of page 7, shows that this index actually rose by some $1\frac{1}{2}\%$ between 30th March and 25th June. During the same period, the dollar's own effective exchange rate rose by no less than $6\frac{1}{4}\%$, as shown in Chart II, at the bottom of page 7. The sterling/US dollar exchange rate fell because sterling rose by substantially less than the US dollar. Despite the newspaper headlines, sterling was not weak before 26th June - the US dollar was strong.

On 26th June the Bank, in a most unusual statement, claimed that "there is no need on monetary policy grounds for any general increase in the level of domestic interest rates". On the 28th June, the West German discount rate was raised from 4% to $4\frac{1}{2}\%$. An interpretation of these events was that Germany was following the rise in US interest rates but the UK was not. Sterling's weakness became general. Between 25th June and 10th July its effective rate, excluding the US dollar, fell by some $2\frac{1}{2}\%$. The first report of substantial selling occurred on the afternoon of Thursday 5th July and this continued into the morning of Friday 6th July. The Bank reacted at once; base rates rose by $\frac{3}{4}\%$ at midday on the Friday and the Bank's dealing rates in the bill market were raised by 1%. The crisis, such as it was, broke extremely quickly.

Sterling continued to be weak in spite of this rise in interest rates. The provisional data for the money supply for the month to mid-June, which were published on Tuesday 10th July, were poor and base rates rose by another 2% on Wednesday 11th July. Sterling's effective rate, excluding the US dollar, has subsequently recovered over three-quarters its post-25th June losses.



Turning now to the belief that the behaviour of sterling is the dominant cause of changes in short term interest rates, the authorities continue to claim that they are following a domestic money supply policy and have no target for the exchange rate. The Chancellor has explained the policy on two recent occasions, in his Mansion House Speech last October and in his Mais Lecture in June.

The message has not yet got through. This is not because market participants are simple-minded or do not want to understand. Experience has taught the market to ignore what the authorities say and to pay attention to what they do. The simple fact is that the authorities react to foreign exchange pressure and concede to persistent market expectations of a change in interest rates that are based on sterling's behaviour.

The policy which the authorities are trying to follow is quite subtle. The monthly data for the money supply are volatile. When the data are published, it is often far from clear whether a deviation which appears in the monetary aggregates is a random fluctuation or the start of a trend, and the authorities are right to pay attention to all available information. The behaviour of sterling is an important confirming indicator. Put simply, if sterling's behaviour confirms the latest deviation in the money supply, the authorities tend to act quickly. If it does not, they tend to delay.

There is no doubt that the behaviour of sterling has been a most important factor determining the timing of increases in short term interest rates. Many market participants fail to distinguish between the trigger for a change and the underlying reason for it. The distinction should be important on those occasions when sterling and the money supply persist in giving opposite signals, as they did, for example, during February and March 1983 when sterling was weak but the money supply was under control. Such periods are unusual because domestic monetary pressures have an important influence (although with a lag) on the short term capital account (and balancing item) of the balance of payments and, therefore, on sterling. If such a period of divergence occurs, non-monetary reasons for sterling's behaviour (eg the current miners' and dockers' strikes) should be assessed and the data for the money supply should be examined to make quite certain that they have been correctly interpreted. If the inconsistency persists, history in the UK shows that it has been right to focus policy on the behaviour of the money supply and adopt a foreign exchange policy of benign neglect. March 1983 was an excellent example.

We now consider the third impression, the belief on the part of many officials that the authorities have to accede to engrained market expectations of a change in interest rates. The true position is as follows:

- (i) The authorities cannot control the term structure of money rates, eg they cannot peg the seven day rate and the three month rate at levels at which the difference between them is contrary to market expectations of a change in their levels.
- (ii) The authorities cannot for long distort interest rate relatives, in particular they cannot hold down bank base rates relative to LIBOR.
- (iii) The authorities definitely have the ability to peg the level of one particular money rate, eg either the seven day rate or the three month rate but not both.

If the authorities were to attempt either of the first two courses of action, arbitrage transactions would soon become overwhelming. The situation on 26th June, when the Bank issued its statement on interest rates, was quite a good example. The term structure of money rates was wrong. The Bank had been dealing in seven day and three month bills at the same yield, which was not in accordance with market expectations. The statement was issued to reassure the market about the general level of rates when the Bank changed the term structure.

The authorities should definitely be able, however, to peg any one particular money rate, because arbitrage transactions will cancel out. Some officials argue there would be a huge demand for cheap funds from the Bank if the authorities were to peg, say, the seven day rate when there were engrained expectations that it would rise. This argument is fallacious; people would not borrow for seven days and invest for, say, three months if the gradient of the yield curve were allowed to reflect expectations accurately.

There is no doubt that officials who argue that the authorities must react to engrained market expectations have a powerful voice. In practice, they tend to win the argument unless it is clear that the change in interest rates is inconsistent with controlling the money supply.

The belief that the authorities will concede to market pressure and will alter interest rates in accordance with sterling's behaviour is reinforced each time they do so. It is now more firmly engrained than ever.

The Provisional Money Supply Data

The authorities' statement on the 26th June seemed to be inconsistent with the publication on 10th July of poor provisional data for sterling M3 in banking June. We suspect that the authorities were very surprised by these data. They have up-to-date daily information about the majority of the counterparts to sterling M3, namely the CGBR, sales of central government debt and the government's external transactions; these were satisfactory. Up-to-date data for bank lending and banks' external transactions are not, however, available, and early indications for a banking month have to be obtained by survey. We, ourselves, discuss what has been happening widely within the banking sector. The indications we obtain are usually reasonably accurate providing that proper allowance is made for variation in holdings of commercial bills, in particular in the Bank's own holdings. Our discussions for the banking month of June suggested that lending would be about £1,000m lower than it actually was; the error was our largest ever. The Bank was probably surprised in the same way.

The vital practical point is that there was a waning in the belief that monetary growth was satisfactory at the same time as the start of substantial selling of sterling. Arguments for a foreign exchange policy of benign neglect were undermined by poor data for the money supply.

Conclusions

The behaviour of sterling is a very important factor determining the timing of changes in interest rates. When sterling is weak and monetary growth is satisfactory, however, the authorities should not readily acquiesce in a rise in interest rates. Given the conflicting signals from the broader and narrower money aggregates, the authorities were right to acquiesce to some extent this time. They were wrong, however, to ratify a rise as large as nearly 3%.

Looking through the behaviour of sterling, the reason for the substantial rise in UK interest rates was, of course, the upward trend of those in the US. We are most concerned that US rates may rise still further. Dr Henry Kaufman, amongst others, is forecasting that this will happen. More specifically, his current view is that "the peak in interest rates is not near - both in terms of level and when it will occur . . . much higher interest rates loom ahead".

In America, the contractionary effect of high interest rates is offset by grossly easy fiscal policy. In developed countries other than the US, high interest rates are not generally offset by easy fiscal policy to anything like the same extent as they are in the US. The UK is, in particular, at the opposite end of the spectrum to the US. It can be argued that UK fiscal policy is tight rather than easy. Without the offsetting factor of clearly easy fiscal policy, there is a distinct danger that the economic recovery in the UK will collapse if we follow US rates up again.

Such a collapse is not yet in sight. It will be preceded, if it occurs, by a slowdown in the growth of the narrower monetary aggregates in the UK. Historically, the money supply has declined in real terms, i.e. after allowing for inflation, prior to every recession. The slowdown does not, however, necessarily occur in the broader aggregates.

The experience of the second half of 1980 illustrates this. There was at that time a loss of confidence, a rise in the savings ratio (from $11\frac{1}{2}\%$ to $15\frac{1}{2}\%$) and buoyant growth of the broader aggregates, as genuine savings were invested in bank deposits. Something somewhat similar could happen in the coming months. The possibility of another rise in US rates is a dark cloud overhanging the gilt-edged market. We have recently had a dreadful demonstration of what can happen to our market when the US bond market is in disarray. In these circumstances it would be no surprise at all if sales of government debt in the UK did not respond as they should to the current height of UK interest rates. Investors may easily prefer to hold bank deposits rather than gilt-edged stock.

In his recent Mais Lecture, the Chancellor stressed that Mo and sterling M3 have equal weight in guiding policy decisions. In our view he should modify this rule in the coming months and place greater weight on the narrower monetary aggregates. If these start to decline in real terms, the authorities should act as they did in the second half of 1980 and reduce short term interest rates, even if the broader aggregates are still buoyant.

There remains the question about how sterling would react. Ideally, the UK should strive for international agreement, particularly with Germany and Japan, not to follow US interest rates upwards. If such an agreement cannot be achieved and sterling comes under pressure, the UK authorities should adopt a foreign exchange policy of benign neglect and resist those who argue that they must accede to engrained market expectations of a rise in interest rates.

GTP
RLT
RR

MONETARY GROWTH
In Nominal Terms

Percentage annual rates		Mo	Currency	Retail M1	M1	M2	Sterling M3	PSL1	PSL2
Changes in year to:									
1983	July	6	8	10	14	9	12	11	13
	Aug.	7	8	9	13	8	11	10	13
	Sept.	6	8	8	12	8	10	9	12
	Oct.	7	8	7	13	7	11	10	13
	Nov.	6	8	8	12	7	10	9	12
	Dec.	7	8	8	12	9	10	10	13
1984	Jan.	6	7	9	11	10	10	10	13
	Feb.	6	5	8	11	10	9	9	12
	Mar.	6	5	8	13	10	10	9	12
	Apr.	5	6	9	14	10	8	7	11
	May	5	5	9	14	10	8	8	12
	June	6	5	9	14	11	9	10	13
Changes in 6 months to:									
1984	Jan.	7	5	7	10		8	7	10
	Feb.	6	4	7	10		7	6	9
	Mar.	5	4	9	16		9	9	12
	Apr.	4	7	11	16		8	7	12
	May	4	4	11	18		9	9	14
	June	5	5	9	20		11	12	17
Changes in 3 months to:									
1984	Apr.	3	10	15	22		8	8	14
	May	4	7	16	28		11	12	17
	June	6	10	13	23		14	16	19

In Real Terms

Changes in year to:									
1984	July	2	4	5	10	4	7	7	9
	Aug.	2	3	5	9	4	6	6	8
	Sept.	1	2	3	7	3	5	4	7
	Oct.	2	3	2	8	2	6	5	8
	Nov.	2	3	3	7	3	5	5	7
	Dec.	1	3	3	6	4	5	5	8
1984	Jan.	1	2	4	6	5	5	5	8
	Feb.	1	0	3	6	5	4	4	7
	Mar.	0	0	3	8	5	5	4	7
	Apr.	0	1	4	8	5	3	2	6
	May	0	0	4	9	5	3	3	7
	June	0	0	4	9	6	4	4	8
Changes in 6 months to:									
1984	Jan.	2	0	2	5		3	2	5
	Feb.	1	-1	2	5		2	1	4
	Mar.	0	-1	4	12		4	4	7
	Apr.	-1	1	5	11		2	2	7
	May	-1	-1	5	13		4	3	9
	June	0	0	4	15		6	7	12
Changes in 3 months to:									
1984	Apr.	-2	5	10	17		2	2	9
	May	-1	2	11	23		6	7	12
	June	1	4	8	17		8	10	14

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

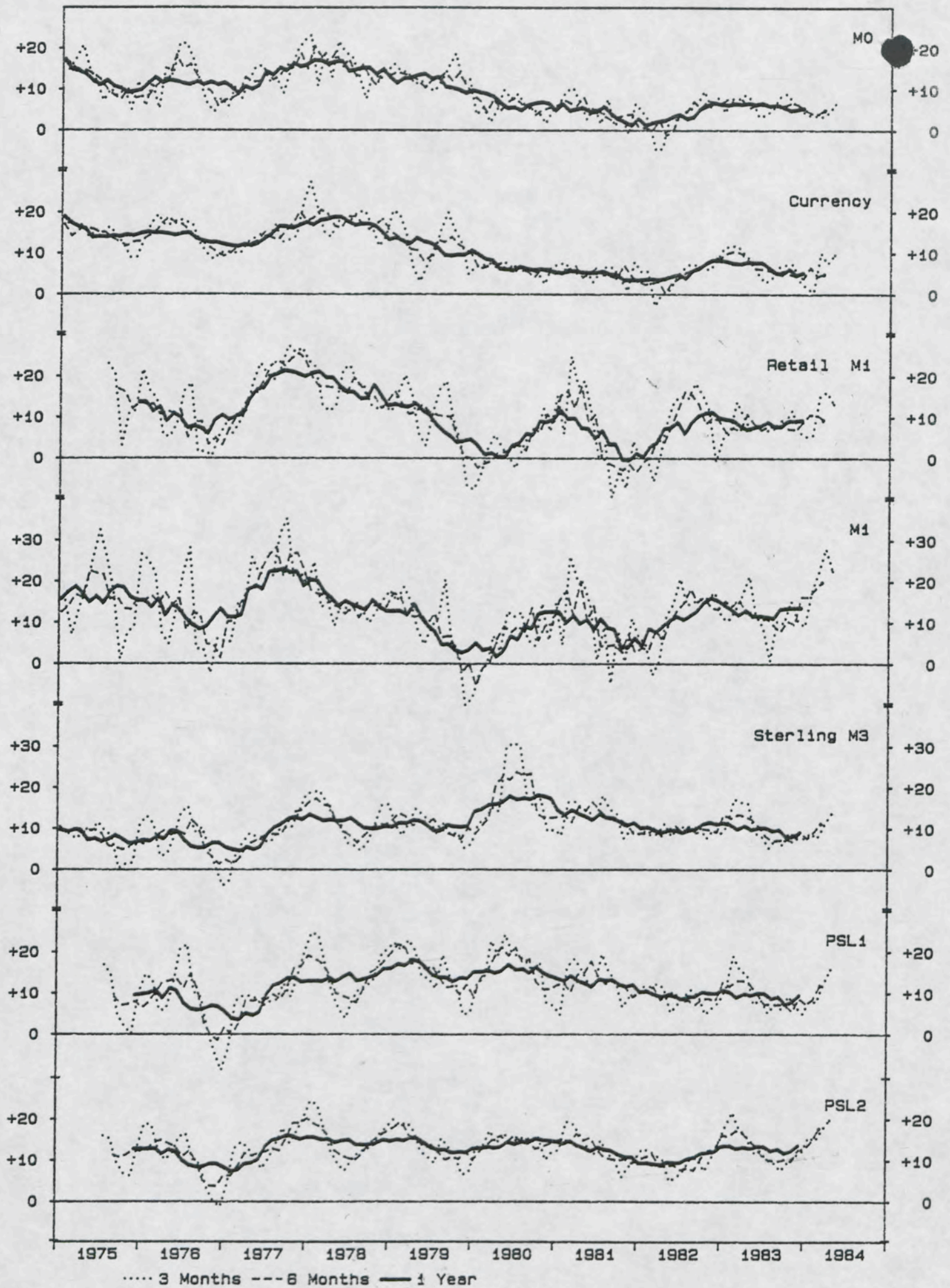


Chart 2 - Monetary Growth in REAL Terms (% p.a.)

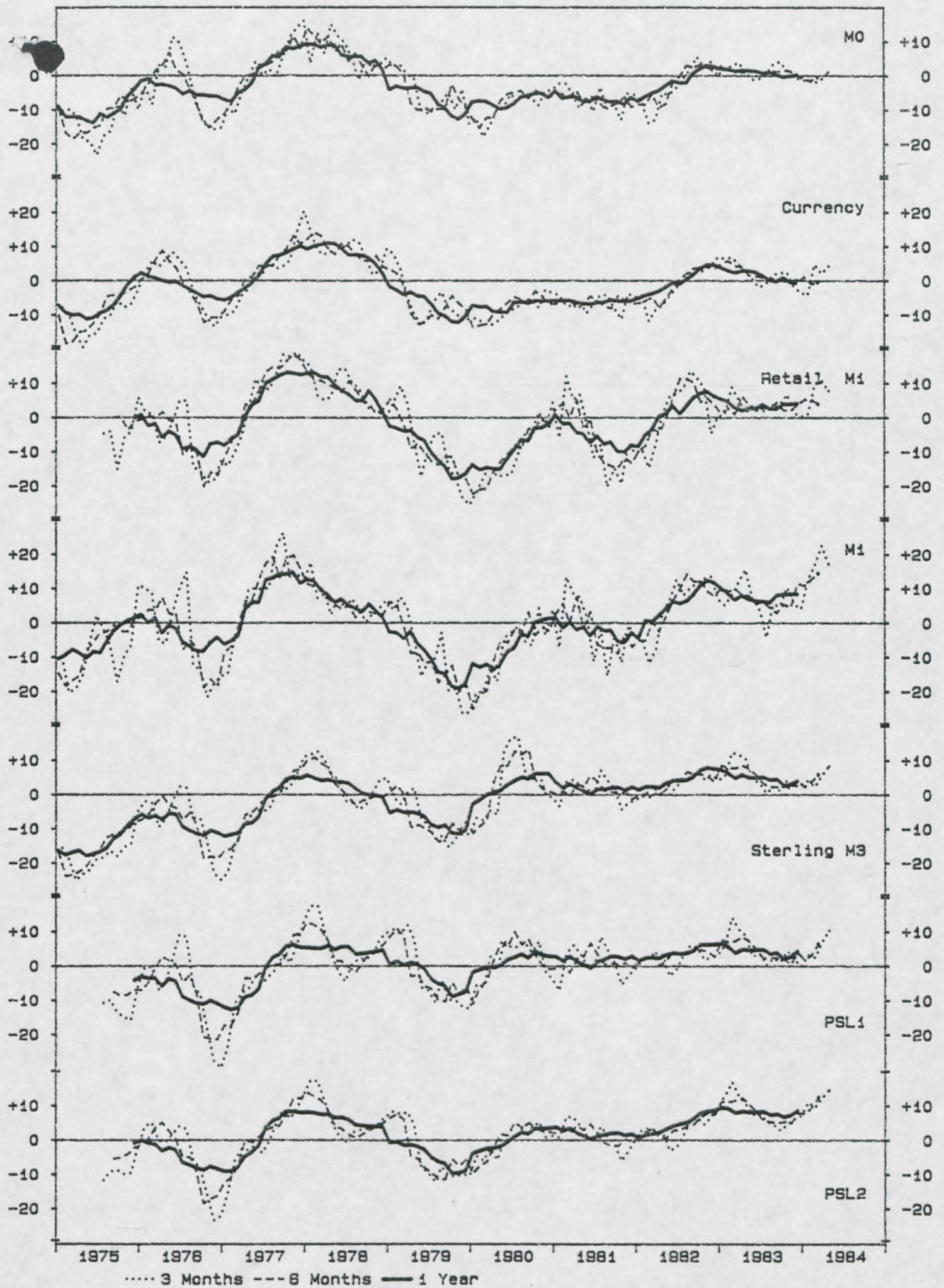
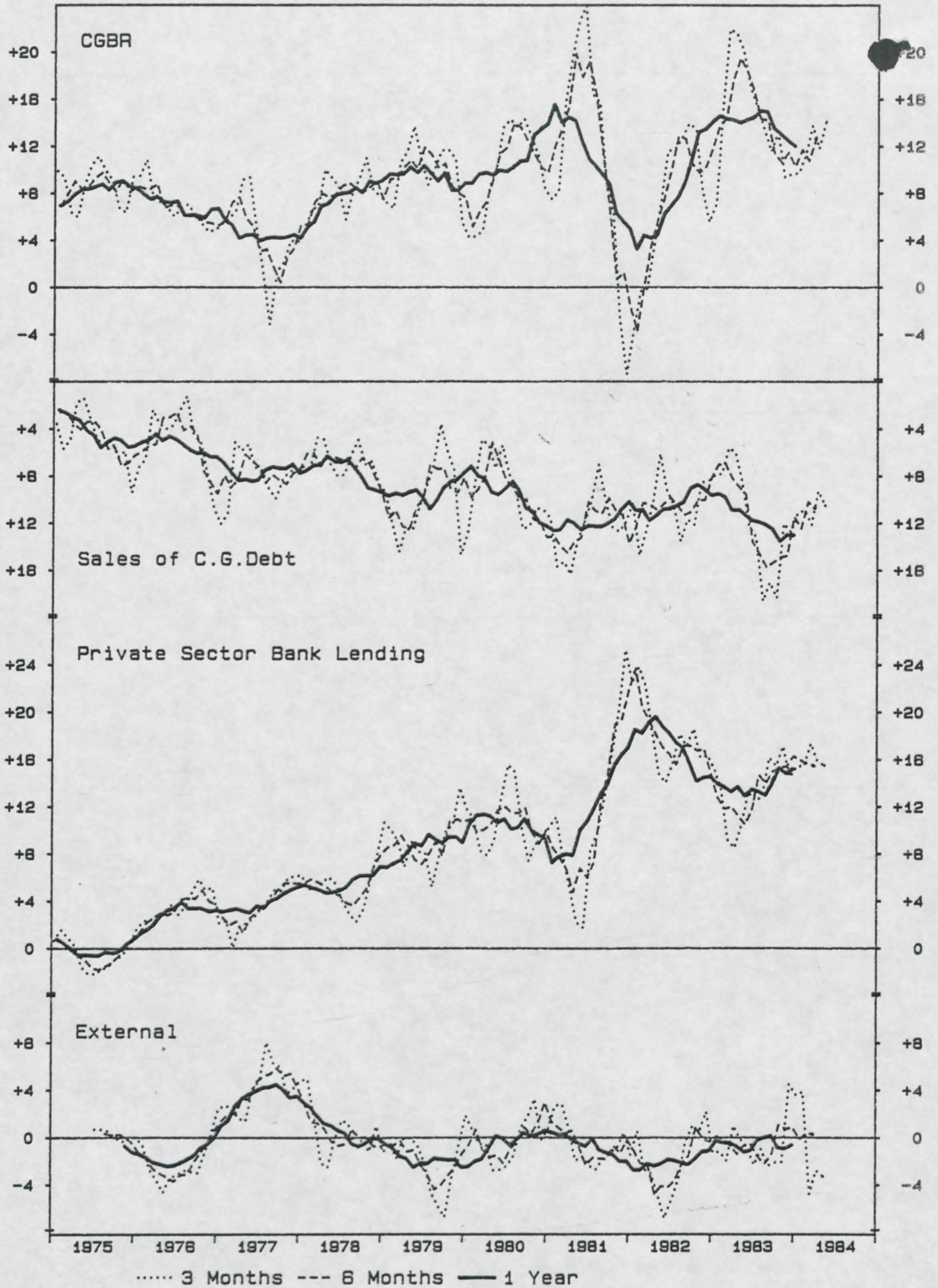


Chart 3 - Components of Monetary Growth (bns)



STATISTICS

reprinted from Bank of England *Banking Statistics*

[Table 11.1 in the
Quarterly Bulletin]

Money stock: amounts outstanding

Month ended	Notes and coin in circulation with public <i>1</i>	UK private sector sterling sight deposits		Money stock M1(b)		UK private sector sterling time deposits(c)	Money stock EM3(b)(d)		UK private sector deposits in other currencies (c)	Money stock M3(b)(d)	
		Non-interest-bearing(a)	Interest-bearing	Unadjusted	Seasonally adjusted		Unadjusted	Seasonally adjusted		Unadjusted	Seasonally adjusted
1983 May 18	11,263	18,415	10,656	40,334	40,300	53,261	93,595	94,460	13,095	106,690	107,560
June 15	11,328	18,564	11,102	40,994	41,060	53,803	94,797	95,430	13,274	108,071	108,700
July 20	11,601	18,978	10,714	41,293	40,860	55,029	96,322	95,930	13,497	109,819	109,430
Aug. 17	11,507	18,785	10,902	41,194	41,180	55,579	96,773	96,380	13,489	110,262	109,870
Sept. 21(e)	11,477	18,876	10,601	40,954	41,170	55,952	96,906	96,740	13,545	110,451	100,290
Oct. 19	11,473	19,369	11,172	42,014	41,910	56,135	98,149	97,750	14,086	112,235	111,830
Nov. 16	11,531	19,264	11,352	42,147	42,190	55,757	97,904	97,850	14,523	112,427	112,380
Dec. 14(e)	12,119	19,990	11,466	43,575	42,680	56,238	99,813	99,100	15,865	115,678	114,960
1984 Jan. 18	11,467	19,320	11,914	42,701	42,980	56,619	99,320	99,740	16,036	115,356	115,770
Feb. 15	11,531	19,018	11,951	42,500	43,140	56,119	98,619	99,810	16,754	115,373	116,560
Mar. 21(e)	11,641	19,467	12,637	43,745	44,440	55,735	99,480	101,220	17,047	116,527	118,270
Apr. 18	12,044	20,572	13,038	45,654	45,220	55,449	101,103	101,550	17,329	118,432	118,870
May 16	11,834	20,593	13,485	45,912	45,910	55,925	101,837	102,550	15,474	117,311	118,020
June 21(e)	11,941	20,646	13,962	46,549	46,770	57,501	104,050	104,620	15,528	119,578	120,150

[Table 11.2 in the
Quarterly Bulletin]

Money stock: changes(f)

£ millions: percentages in italics

Month ended (unadjusted)	Notes and coin in circulation with public <i>1</i>	UK private sector sterling sight deposits		Money stock M1(b)	UK private sector sterling time deposits(c)	Money stock EM3(b)(d)	UK private sector deposits in other currencies (c)		Money stock M3(b)(d)
		Non-interest-bearing(a)	Interest-bearing				Transactions	Valuation changes(g)	
1983 June 15	+ 55	+ 149	+ 446	+ 660	+ 542	+ 1,202	- 102	+ 281	+ 1,381
July 30	+ 273	+ 414	- 388	+ 299	+ 1,226	+ 1,525	+ 285	- 62	+ 1,748
Aug. 17	- 94	- 193	+ 188	- 99	+ 550	+ 451	- 37	+ 79	+ 443
Sept. 21	- 30	+ 71	- 306	- 265	+ 323	+ 38	- 66	+ 37	+ 79
Oct. 19	- 4	+ 493	+ 571	+ 1,060	+ 183	+ 1,243	+ 460	+ 81	+ 1,784
Nov. 16	+ 58	- 105	+ 180	+ 133	- 378	- 245	+ 357	+ 80	+ 192
Dec. 14	+ 588	+ 716	+ 109	+ 1,413	+ 291	+ 1,704	+ 870	+ 682	+ 3,056
1984 Jan. 18	+ 652	- 670	+ 448	- 874	+ 381	- 493	+ 73	+ 98	- 322
Feb. 15	+ 64	- 302	+ 37	- 201	- 500	- 701	+ 1,005	- 287	+ 17
Mar. 21	+ 110	+ 444	+ 671	+ 1,225	- 424	+ 801	+ 190	+ 73	+ 1,064
Apr. 18	+ 403	+ 1,105	+ 401	+ 1,909	- 286	+ 1,623	+ 130	+ 152	+ 1,905
May 16	- 210	+ 21	+ 447	+ 258	+ 315	+ 573	- 2,133	+ 278	- 1,282
June 21	+ 107	+ 53	+ 467	+ 627	+ 1,561	+ 2,188	- 226	+ 255	+ 2,217
1983 June 15	+ 48	+ 154	+ 554	+ 756 + 1.9	+ 179	+ 935 + 1.0	- 102	+ 281	+ 1,114 + 1.0
July 20	- 14	+ 236	- 434	- 212 - 0.5	+ 704	+ 492 + 0.5	+ 285	- 62	+ 715 + 0.7
Aug. 17	+ 46	+ 17	+ 266	+ 329 + 0.8	+ 130	+ 459 + 0.5	- 37	+ 79	+ 451 + 0.4
Sept. 21	+ 32	+ 146	- 269	- 41 - 0.1	+ 337	+ 296 + 0.3	- 66	+ 37	+ 317 + 0.3
Oct. 19	+ 36	+ 228	+ 454	+ 738 + 1.8	+ 260	+ 998 + 1.0	+ 460	+ 81	+ 1,539 + 1.4
Nov. 16	+ 62	+ 73	+ 148	+ 283 + 0.7	- 173	+ 110 + 0.1	+ 357	+ 80	+ 547 + 0.5
Dec. 14	+ 36	+ 352	+ 38	+ 476 + 1.1	+ 576	+ 1,052 + 1.1	+ 670	+ 682	+ 2,404 + 2.1
1984 Jan. 18	- 59	- 32	+ 389	+ 298 + 0.7	+ 351	+ 649 + 0.7	+ 73	+ 98	+ 320 + 0.7
Feb. 15	+ 16	+ 40	+ 103	+ 159 + 0.4	- 57	+ 102 + 0.1	+ 1,005	- 287	+ 820 + 0.7
Mar. 21	+ 58	+ 416	+ 811	+ 1,285 + 3.0	+ 114	+ 1,399 + 1.4	- 190	+ 73	+ 1,662 + 1.4
Apr. 18	+ 206	+ 375	+ 197	+ 778 + 1.8	- 405	+ 373 + 0.4	+ 130	+ 152	+ 655 + 0.6
May 16	- 54	+ 194	+ 547	+ 687 + 1.5	+ 179	+ 366 + 0.9	- 2,133	+ 278	- 989 - 0.8
June 21	+ 118	+ 161	+ 574	+ 853 + 1.9	+ 1,211	+ 2,064 + 2.0	- 226	+ 255	+ 2,093 + 1.8

[a] After deducting 60% of net debit transit items (see additional notes to Table 6 of the *Quarterly Bulletin*).

[b] M1 equals columns 1 + 2 + 3. EM3 equals M1 + column 5. M3 equals EM3 + column 7.

[c] Including certificates of deposit.

[d] Excluding public sector deposits.

[e] Changes in the monthly-reporting population occurred in these months. See also the additional notes to Table 3 in the *Quarterly Bulletin*, and, for December 1983, footnote (b) to Table 3 on page 5.

[f] Changes in the money stock may differ from those which can be calculated by reference to amounts outstanding. (See additional notes to Table 11 of the *Quarterly Bulletin*.)

[g] See additional notes to Tables 6 and 11 of the *Quarterly Bulletin*.

Transactions balances and components of M2

[Table 11.1 in the Quarterly Bulletin]

Figures: not seasonally adjusted

	Notes and coin in circulation with public	UK private sector sterling non-interest-bearing sight deposits with banks(a)	Non-interest-bearing M1(b)	Other UK private sector sterling retail deposits with banks	UK private sector retail shares and deposits with building societies	National Savings Bank ordinary account	M2(b)	Public sector retail deposits with banks	Overseas retail deposits with banks
	1	2	3	4	5	6	7	8	9
Amounts outstanding									
1983 June 15	11,328	18,564	29,892	30,259	51,822	1,751	113,724	1,160	2,637
July 20	11,601	18,978	30,379	30,512	52,018	1,749	114,858	1,193	2,741
Aug. 17	11,507	18,785	30,292	30,360	51,952	1,729	114,333	949	2,721
Sept. 21(c)	11,477	18,876	30,353	30,176	52,193	1,742	114,464	864	2,732
Oct. 19	11,473	19,369	30,842	30,086	52,562	1,742	115,232	935	2,794
Nov. 16(d)	11,531	19,264	30,795	30,089	52,811	1,745	115,440	1,045	2,669
Dec. 14(c)	11,331	19,264	30,795	30,347	52,811	1,745	116,198	1,045	2,996
1984 Jan. 18	12,119	19,990	32,109	30,218	55,673	1,750	119,750	899	2,999
Feb. 15	11,467	19,320	30,787	30,340	58,280	1,765	121,172	1,072	3,124
Mar. 21(c)	11,531	19,018	30,549	30,057	58,969	1,777	121,352	962	3,083
Apr. 18	11,641	19,467	31,108	29,953	60,121	1,778	122,960	1,124	3,106
May 16	12,044	20,572	32,616	29,896	60,944	1,788	125,244	995	3,116
June 20	11,834	20,593	32,427	29,879	61,777	1,775	125,858	1,073	3,187
July 20	11,941	20,646	32,587	30,455	62,980	1,743	127,765	1,079	3,193
Changes in month ended									
1983 June 15	+ 65	+ 149	+ 214	+ 356	+ 585	- 18	+1,137	+ 162	- 99
July 20	+ 273	+ 414	+ 687	+ 253	+ 196	- 2	+1,134	+ 33	+ 104
Aug. 17	- 94	- 193	- 287	- 152	- 66	- 20	- 525	- 244	- 20
Sept. 21	- 30	+ 71	+ 41	- 184	+ 241	+ 13	+ 111	- 35	+ 11
Oct. 19	- 4	+ 493	+ 489	- 90	+ 369	-	+ 768	+ 71	+ 62
Nov. 16	+ 58	- 105	- 47	+ 3	+ 249	+ 3	+ 208	+ 110	- 125
Dec. 14	+ 588	+ 716	+1,304	- 629	+2,586	+ 5	+3,266	- 146	+ 3
1984 Jan. 18	- 652	- 670	-1,322	+ 122	+2,405	+ 15	+1,220	+ 173	+ 125
Feb. 15	+ 64	- 302	- 238	- 283	+ 520	+ 12	+ 11	- 110	- 41
Mar. 21	+ 110	+ 444	+ 554	- 104	+1,104	+ 1	+1,555	+ 162	+ 23
Apr. 18	+ 403	+1,105	+1,508	- 57	+ 823	+ 10	+2,284	- 129	+ 10
May 16	- 210	+ 21	- 189	- 17	+ 792	- 13	+ 573	+ 78	+ 71
June 20	+ 107	+ 53	+ 160	+ 576	+1,203	- 32	+1,907	+ 6	+ 6

(a) After deducting 60% of net debit transit items (see additional notes to Table 6 of the Quarterly Bulletin).

(b) Non-interest-bearing M1 equals columns 1+2. M2 equals non-interest-bearing M1+columns 4+5+6.

(c) See footnote (f) to Table 11.1 on page 3.

(d) In November 1983 twenty contributors joined the population providing figures in columns 4, 8 and 9, and seven contributors left the series. All monthly-reporting monetary sector institutions contribute to column 2. (See article in June 1982 Bulletin, page 225.)

Private sector liquidity, and other deposits

[Summary of Table 12 in the Quarterly Bulletin]

£ millions	'Money'	Other money-market instruments	Savings institution deposits and securities		Certificates of tax deposit		PSL1 (columns 1+2+5)	PSL2 (columns 1+2+3+6)	PSL1	PSL2	Other shares and deposits with building societies			
			Seasonally adjusted		Seasonally adjusted						Unadjusted			
			Total (net)	of which shares and deposits with building societies (a)	Issues net of sur-renders	Column 5 less building societies holdings					Amount outstanding	Change in month		
Month ended	1	2	3	4	5	6	7	8	9	10	11	12		
1983 June 15	93,997	2,842	59,355	55,000	2,136	1,954	98,975	158,148	+ 949	+1.0	+1,572	+1.0	16,519	+ 14
July 20	94,479	3,040	60,342	56,058	2,000	1,818	99,519	159,679	+ 529	+0.5	+1,518	+1.0	16,632	+113
Aug. 17	94,912	3,265	61,171	56,950	1,905	1,723	100,082	161,071	+ 563	+0.6	+1,392	+0.9	16,712	+ 30
Sept. 21	95,272	3,081	61,786	57,508	1,975	1,774	100,328	161,913	+ 168	+0.2	+ 764	+0.5	17,242	+530
Oct. 19	96,237	3,064	62,037	58,098	2,070	1,852	101,371	163,190	+1,043	+1.0	+1,276	+0.3	17,802	+560
Nov. 16	96,369	3,153	62,477	58,952	2,116	1,884	101,638	163,883	+ 275	+0.3	+ 699	+0.4	18,241	+439
Dec. 14	97,603	3,124	63,073	59,841	2,048	1,795	102,775	165,595	+ 948	+0.9	+1,522	+0.9	18,557	+316
1984 Jan. 18	98,170	2,954	64,409	61,149	2,077	1,955	103,201	167,488	+ 451	+0.4	+1,918	+1.2	18,720	+163
Feb. 15	98,249	2,890	65,673	62,522	1,869	1,726	103,008	168,538	- 159	-0.2	+1,084	+0.6	18,823	-103
Mar. 21	99,684	2,984	66,916	63,742	2,077	1,891	104,745	171,475	+1,728	+1.7	+2,938	+1.7	18,957	+134
Apr. 18	99,999	2,975	68,178	64,734	2,105	1,917	105,079	173,069	+ 391	+0.4	+1,552	+1.0	19,002	+ 45
May 16	101,052	3,095	69,453	65,690	1,982	1,794	106,129	175,394	+ 929	+0.9	+2,204	+1.3	19,002	-
June 20	103,091	3,420	70,753	66,852	2,206	2,003	108,717	179,267	+2,589	+2.4	+3,874	+2.2	19,002	-

(a) Including UK non-bank private sector's holdings of certificates of deposit and time deposits issued by building societies.

(b) Percentage changes are shown in italics.