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SECRET

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

David Norgrove Esq
10 Downing Street
LONDON
SW1

9 December 1986

Dear David,

INTEREST RATES

I attach a paper on interest rates for discussion at the Prime Minister's meeting tomorrow.

I am copying this to John Footman (Bank of England).

Yours
Alex

A C S ALLAN

SECRET

INTEREST RATES

Note by Treasury and Bank of England

We have been considering our stance on interest rates in the light of the latest monetary indicators, with an eye also on the pressures that have beset us in the past two Januaries.

2. Until the summer the general picture was that broad money and some asset prices (notably houses and equities) were suggesting fairly loose monetary conditions, whereas the generally more reliable indicators, M0 and the exchange rate (when allowance was made for the fall in the oil price), were indicating that policy was, if anything, rather tight. With inflation coming down well and signs that the economy was sluggish, we accordingly brought our interest rates down.

3. In recent months, however, while broad money has gone on expanding at a rapid rate, the exchange rate has been weak and M0 growth has accelerated sharply (see attached chart) signalling that monetary conditions have been getting easier. This has coincided with evidence that activity in the economy is picking up sharply and with an increase in inflationary expectations in the markets.

4. Despite the rise in nominal interest rates, the increase in inflationary expectations may mean that our real interest rates have actually fallen slightly recently. If real rates are calculated by taking the differential between nominal rates and current retail price inflation then, of course, our rates remain well above those in most other countries. The picture, however, is far less clear when real interest rates are measured by movements in producers' prices. On this basis our real rates are about the same as those in the United States, and lower than those in Germany or Japan (see table attached).

5. There were some signs in September that monetary conditions were loosening, particularly the pick-up in M0 growth and the fall in the exchange rate. It was this evidence that led us to wish in

early October to raise interest rates. But looking forward over the autumn and beyond, with the Autumn Statement ahead of us, there was considerable tactical merit and medium-term advantage in limiting the rise to 1 per cent. Having made this judgement, it was necessary to act firmly and decisively in order to make it stick, and in this we were successful. We recognised, however, that we would need to keep the monetary situation under especially close review as more evidence became available.

6. The monetary evidence that has come to hand since then suggests that monetary conditions are still too lax. MO growth has continued to accelerate; the growth of broad money has shown no signs of slowing; the exchange rate has remained close to the low level it reached at the beginning of October; and financial markets generally have remained fragile, with the gilts market now having fallen substantially since the October rise in base rates, raising long-term rates above 11 per cent. And the sluggishness of the economy that was apparent in the summer appears to have given way to fairly brisk growth.

7. Short-term market rates have been edging up in recent weeks. The three-month inter-bank rate has risen from 11 per cent at the beginning of November, to just under 11½ per cent. Money market rates overseas have also tended to firm. Rates in the United States, France and Germany are now higher than in early October: only in Japan, with the end October ½ per cent cut in the discount rate, have rates fallen.

8. We have concluded, therefore, that if we are to avoid taking risks with inflation, we ought to raise our rates very shortly by a further 1 per cent. The market at the moment is not expecting us to make a further move before the New Year - in both 1985 and 1986 interest rates rose in the first half of January - and we therefore need to consider the timing carefully. We need to move in circumstances that will inspire confidence rather than diminish it - for example by engendering fears that we know something the market doesn't.

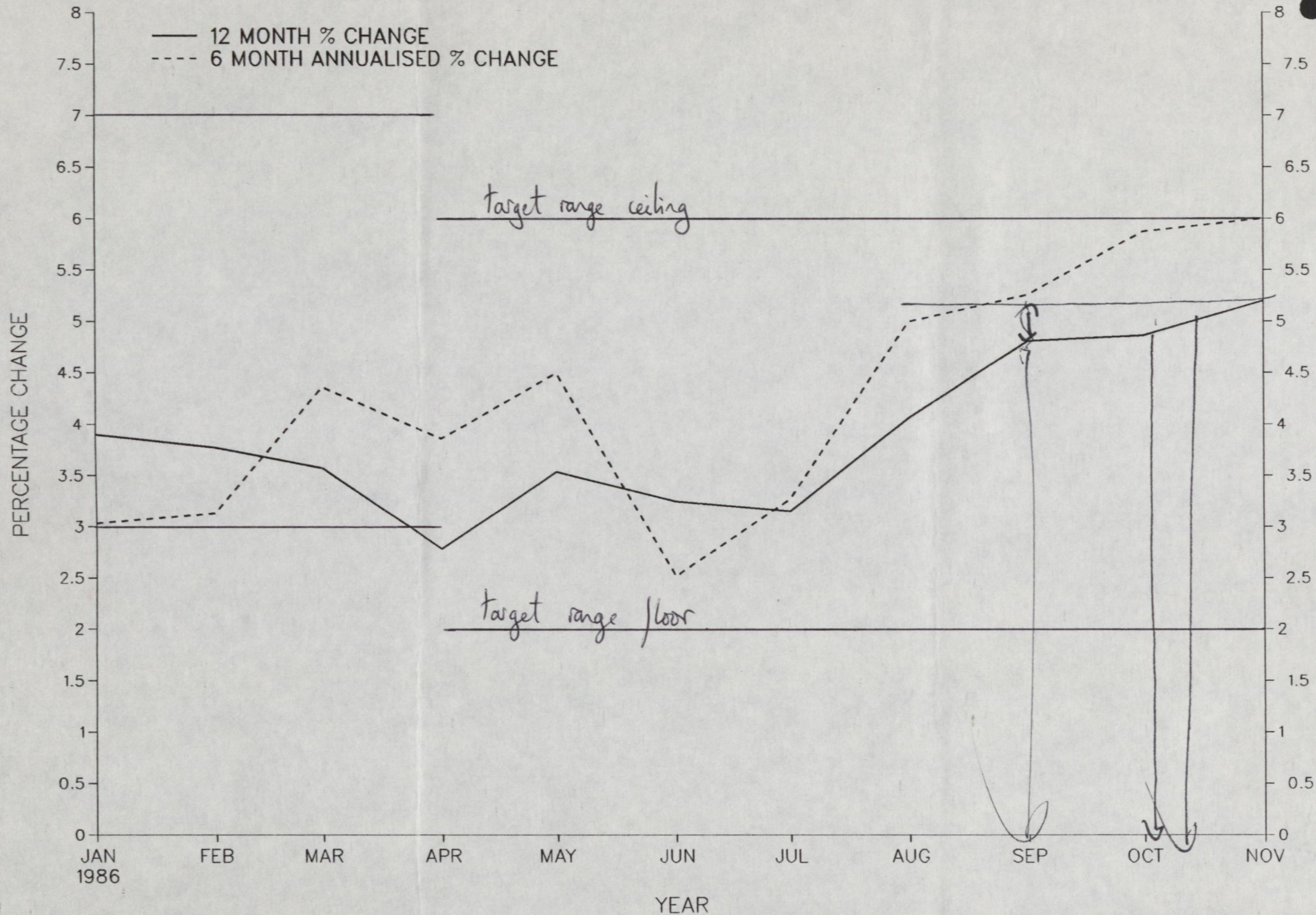
9. There is, however, considerable advantage in moving well before our hand is forced by the market. Last January the fact that we were prepared to raise interest rates promptly by 1 per cent enabled us to avoid the sort of drastic action we had had to take in July 1984 and January 1985. An early move would help to re-establish the credibility of our policies, which is under question in the markets following the increases in public expenditure plans and the approach of the General Election. It would give us the best chance of keeping the rise in interest rates over the months ahead to the minimum necessary, and the best hope that we could look forward to the next move being downwards. The consequent improvement in market sentiment should also enable us to replenish the reserves.

Conclusion

10. The Treasury and the Bank are agreed that in the light of the latest evidence a further 1 per cent rise in interest rates is needed to ensure that our strategy against inflation is not undermined. We will need to consider carefully the precise tactics and timing of making the move. The next set of money numbers, to be published on 18 December, could provide a suitable opportunity. But in any event we need to be prepared to move quickly should financial confidence start to deteriorate.

9 December 1986

MO (sa)



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REAL INTEREST RATES

3 month Real Rates (relative to consumer prices)

		UK	US	Japan	West Germany
1981		1.1	5.4	2.5	5.8
1982		2.8	6.1	4.3	3.6
1983		5.0	5.9	4.7	2.5
1984		4.3	6.1	4.0	3.6
1985		5.6	4.6	5.3	3.3
1986	Q1	6.6	4.5	4.1	3.9
	Q2	6.7	5.1	3.8	4.8
	Q3	6.9	4.3	4.4	5.0
	Oct	8.1	4.2	5.4	5.5
	Nov*	8.1	4.3	5.0	5.6

3 Month Real Rates (relative to producer prices)

		UK	US	Japan	West Germany
1981		3.5	6.5	6.3	6.1
1982		3.6	8.2	6.5	4.0
1983		4.1	7.4	7.3	4.3
1984		3.2	8.3	6.3	3.2
1985		6.1	7.3	8.2	3.4
1986	Q1	6.6	7.7	8.4	5.8
	Q2	5.0	8.5	8.8	7.6
	Q3	5.1	7.7	10.1	8.3
	Oct	6.8	7.4	11.2	9.4
	Nov*	7.0	7.5	10.8	9.5

*In November, for which price data is only available for UK producer prices, latest available data has been used.

FROM: P H BROOK
DATE: 9 December 1986

1. MR KELLY 9.12.
2. CHANCELLOR

cc: Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Peretz
Mr Grice
Mr Richardson
Mr Pike
Mr Heath
Mr Ross Goobey

MONEY SUPPLY IN NOVEMBER: "FIRST GUESS"

(All figures are unadjusted unless specified otherwise)

This note summarises the Bank's "first guess" at the money supply figures for November.

Summary

2. The growth rate of MO to November was 5.2 per cent (5.3 per cent seasonally adjusted), in line with expectations. In November MO rose by 1.0 per cent (1.0 per cent seasonally adjusted).

3. The annual growth rate of £M3 to November is estimated to be 18.4 per cent. This suggests that the final outturn will be in the range 18.3 to 19.1 per cent compared with a forecast of 18.6 per cent. In November £M3 is estimated to have increased by 1.5 per cent (1.3 per cent seasonally adjusted). On this basis the final outturn is estimated to be in the range 1.3 to 2.1 per cent (1.1 to 1.9 per cent seasonally adjusted). It should be noted that the "first guess" had consistently underestimated the growth of £M3 over the six months prior to banking September.

Table 1: Monetary Aggregates - November

	per cent	
	MO	**£M3**
Target range	2-6	11-15
Annual growth rate		
First guess	5.2 (5.3)	18.4
Likely outturn	5.2 (5.3)	18.3-19.1
Change in month		
First Guess	1.0 (1.0)	1.5 (1.3)
Likely outturn	1.0 (1.0)	1.3-2.1 (1.1-1.9)

NB Figures in brackets are seasonally adjusted

£M3 components

4. The outturn in calendar November is affected by the British Gas share sale. Application forms were posted to potential subscribers on 25 November, but applications could be made up to 10am on Wednesday 3rd December. In total, applications by the UK public amounted to some £3.2 billion for shares worth only £1.3 billion in partly paid form (the remaining shares, worth £0.7 billion in partly paid form, were taken up by UK institutions and overseas investors). It is not possible to estimate to what extent applicants had built up funds by end-November, but comparing the increase in deposits in the final 10 days of the month with the average "end month surge" suggests substantially increased deposits (SID) by British Gas applicants at end November of £1/2 billion to £1 billion.

5. Among the components of £M3, notes and coin increased by 410, and private sector non-interest-bearing sight deposits increased by 530. Private sector interest bearing sight deposits increased by 1160. Private sector time deposits (including CDs) decreased by 130.

£M3 counterparts

6. Table 2 (attached) compares £M3 counterparts in the first guess with the average monthly change over the twelve months to October.

7. Overall the growth of £M3, even with the effects of BGC, is not out of line with recent months. The "PSBR" is estimated at £440 million, somewhat lower than average. Central Government net debt sales, to the nbps, at £1,120 million are higher than the average over the previous 12 months of around £520 million. Sterling leading at £1,330 million is lower than the average over the previous year, which is about £2,200 million. However, seasonally adjusted sterling lending is increased by £590 million to £1,920 million.

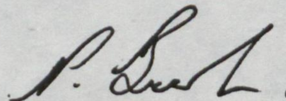
8. At this stage, the division between NNDLs and private externals is complicated by the treatment of the residual error, which is included in NNDLs. But the externals and NNDLs taken together were expansionary by £1,860 million compared with an average contractionary influence over the previous 12 months of £317 million.

9. Wide overfunding was £950 million.

Timetable

10. We hope to receive provisional November figures on Tuesday 16 December, and they will be published on Thursday 18 December. Full money and banking figures will appear on Wednesday 31 December.

11. I am sending a copy of this minute to Mr Norgrove at No 10 Downing Street on a personal basis.



P H BROOK

TABLE 2 : CALENDAR NOVEMBER 1986

"First guess" compared with average monthly change in the last year

£ millions, unadjusted

		FIRST GUESS		AVERAGE MONTHLY CHANGE IN YEAR TO OCTOBER
CGBR (O) (ex bank deposits)		+820		+457
Other public sector: LABR+	-30		+70	
PCBR	-350		-5	
OPS debt sales	-		+195	
	---		---	
		-380		+260
CG debt: Gilts	NA		-314	
Treasury Bills	NA		)	
National Savings	NA		) -209	
CTD's etc.	NA		)	
	----		) ----	
		-1,120		-523
External and fc. finance of the public sector		-280		-147
Sterling lending to UK private sector (inc. Issue Dept. commercial bills)		+1,330		+2,180
Net private externals **		-440		) -317
Residual (includes NNDLs** and reporting differences)		+2300		)
		------		------
£M3		+2,240		+1910
		------		------
(Monthly percentage change)		(+1.5%)		(+1.4%)
(12 Month percentage change)		(+18.4%)		
Wide over(-)/underfunding(+)		-950		+47

+ Modified local authority contribution in November

* As circulated in Mr Grice's "Monetary Prospects" submission of 2 December 1986.

** For the first guess, foreign currency NNDLs cannot be separately identified and are included with £NNDLs and the residual. In the forecast they are attributed to the Externals, in line with the convention used for the published figures.

Prime Minister ✓ See the final few paragraphs. DRN 4/12

MONETARY BULLETIN

Greenwell Montagu Research

No. 188

December, 1986

Why Does The Chancellor Lack Credibility?

A Talk by Gordon Pepper to the
Forex Association London
on 2nd December 1986

I start by outlining Mr. Lawson's case, and then go on to that of the market place, before I attempt to reconcile the two differing views.

An historian dispassionately analysing the evidence to date is almost bound to reach the conclusion that Mr. Lawson has gone out of his way to explain how monetary policy is being operated in practice, and how it has evolved, probably more so than any previous Chancellor. He should be given credit for it.

A lot of evidence is contained in the annual "Red Book" - the Financial Statement and Budget Report - that accompanies each budget. The original statement of the Medium Term Financial Strategy was in 1980; it has been updated each year since then. An examination of the sequence of updates shows that policy has not chopped and changed but that there has been a continued drift, the possibility of which was clearly envisaged in 1980, both from broad to narrow money and towards greater emphasis on the exchange rate, especially the latter when data for the money supply are suffering from distortion.

Money Supply

In 1980, the Government said that "no single statistical measure of the money supply can be expected fully to encapsulate monetary conditions ..... in assessing monetary conditions, the authorities have to have regard to a range (of indicators)" and that "the way in which the money supply is defined for target purposes may need to be adjusted from time to time as circumstances change."

In 1981, the Government observed that "taken on its own £M3 has not been a good indicator of monetary conditions in the past year."

In 1982, a target was announced for narrow money, M1, as well as for broad money, £M3 and (PSL2). Narrow money was mentioned in second place.

In 1983, narrow money was mentioned first.

In 1984, it was stated that "broad and narrow money will have equal importance". This was later stressed in the Mansion House Speech. The previous year's speech had explained the change in the chosen measure of narrow money from M1 to Mo.

In 1985, narrow and broad money were again given equal weight. Later, in the Mansion House Speech, the Chancellor announced that he was "no longer seeking to control the recorded growth of £M3 by systematic overfunding" and that the target for £M3 "was clearly set too low."

Mr. Lawson elaborated on the March 1986 Red Book a few weeks later in his Lombard Association Speech. In this, he clearly highlighted Mo and downgraded £M3. Most recently, in his latest Mansion House Speech he stated that "neither broad money nor credit was a trigger for this week's rise in interest rates" and that the edging upward of the "more reliable" indicator Mo could not be ignored.

The detailed elaboration of the process of evolution has been given in a number speeches by the Chancellor. The most important of these were the 1983 Mansion House Speech, the 1984 Mais Lecture, the 1985 Mansion House Speech and the 1986 Lombard Association Speech.

Mr. Lawson's first Mansion House Speech in 1983 is, for example, well worth re-reading. The first part describes in detail the way in which policy had evolved under his predecessor, Sir Geoffrey Howe. He then "kite flew" the evolution to come. At the time I thought this part muddled but with the benefit of hindsight it becomes clear; for example, the decision not to overfund persistently and, if need be, to downgrade £M3, had already been taken.

Exchange Rate

The growth in the importance attaching to the exchange rate was also reported and discussed in very much the same way as the switch in emphasis from broad to narrow money.

As early as 1982, the Government explained how the exchange rate becomes crucially important when the monetary aggregates are known to be distorted. A fall, or a rise, in sterling is often the result of an easing, or a tightening, of monetary pressure in the UK relative to that abroad. So, the exchange rate can indicate a change in monetary pressure but its movements must be interpreted very carefully; they may arise from non-monetary causes.

Most recently we have seen that sterling can fall out of fear of a Labour Government or as a consequence of a fall in the price of oil. In these cases, it is not serving as an indicator of monetary pressure. This is why there can be no simple formula relating the exchange rate with monetary conditions. This point has been stressed again and again in Mr. Lawson's speeches.

Mr. Lawson has also explained that a large fall in the exchange rate for non-monetary reasons cannot be ignored, because of its direct impact on the price level. This is because a shock to the price level can easily translate into a rise in inflation, i.e. continuing increases in the price level. In other words, the authorities must make quite sure that monetary policy does not accommodate a rise in inflation the proximate cause of which is not monetary.

Mr. Lawson has also explained that the exchange rate can be very important for the timing of interest rate changes. His Lombard Association Speech gives four examples but stresses that, except in the short run, the objective is to deliver the monetary conditions which will reduce inflation.

After examining the evidence, a dispassionate observer from outside the City would most probably conclude that Mr. Lawson has done almost everything that might be expected

of him to explain a complex situation. Sir Alan Walters, the Prime Minister's Economic Adviser, has also given a full account of policy during Mrs. Thatcher's first term of office in his book, Britain's Economic Renaissance, Oxford University Press, 1986. As Sir Alan dryly observes: "Alas, boring though it may be to media men, the authorities (broadly speaking) carried out the policy consistent with the principles that had been announced; it is odd that few believed them."

Mr. Lawson, having made a considerable effort to communicate, has become frustrated by his lack of success and has lashed out on two occasions. The first time was the reference in last year's Mansion House Speech to no change in policy being frightfully annoying for the young Turks who write brokers' circulars. His second outburst was in this year's speech: "There are, I know, those who still complain of being confused - and judging by what they write, some are indeed confused. But they are either simply complaining that the world is a complicated place, which sadly is all too true, and is something that grown-ups have to come to terms with; or else they are so wedded to confusion that it would be grossly improper to try and separate them from it."

Again, the dispassionate observer would probably conclude that Mr. Lawson's outbursts, although unwise, are an understandable reaction of a frustrated human being who is basically in the right.

Case of the Market Place

There is an old maxim in the City:

> Ignore what the authorities say;
> Watch what they do.

What, according to this view, has the outcome been?

The Government has persistently either missed the targets set in the Medium Term Financial Strategy (MTFS) or fudged the figures. Asset sales, both the sale of council houses and the privatisation issues, are responsible for the reductions which have occurred in the PSBR. Even more difficult to swallow, asset sales are classified as negative expenditure and are responsible for public expenditure rising by only a small amount in real terms. In the same vein, Mo has been substituted for sterling M3. Missing or fudging the announced targets in the MTFS has made the City very suspicious.

And the proof of the pudding is in the eating. The MTFS should have restored the financial system to health over the medium term. People believed that interest rates would fall and the exchange rate would become firm. Instead, long term interest rates stand at about the same level as in the fourth quarter of 1982, base rates are considerably higher (11% against a low of 9%) and the exchange rate has fallen by about 25% (excluding the gyrations of the dollar). The MTFS has not delivered the goods expected of it. This is the most important reason for the City's loss of confidence.

Confidence is particularly low at present. Base rates had to be raised in October from 10% to 11%, the prices of long dated gilt-edged stocks have fallen by 16% since their peak in April, and sterling's effective exchange rate has fallen since then by 11%. In short, the City's loss of confidence is fact and not fiction.

Reconciliation

The Government's switch from sterling M3 to Mo, a switch from broad money to transactions money, has impeccable academic credentials. The home of monetarism is the

US. Milton Friedman and Anna Swartz were the founders, with Alan Meltzer and Karl Brunner eminent in the field. Alan Walters, the pioneering UK monetarist, was also resident in the US in the late 1970s and in 1980. In Switzerland, too, there is a strong monetarist school with, for example, Jurg Niehans a leading protagonist. In the second half of 1980, when sterling M3 started to deviate from Mo and M1, they were virtually unanimous in stressing the importance of watching transactions money. Walters and Niehans are on record advising the Prime Minister that monetary policy in the UK was viciously tight, quite contrary to the perception of the City. For example, Walters observes in his book:

> "to any scholar who had studied monetary behaviour in countries other than the United Kingdom, this combination of statistics would have been construed as evidence that there had been a substantial and sharp monetary contraction".

Our own position may also be of interest. Our research work, analysing the period between 1920 and 1955, was based on the old series for M2, which was dominated by transactions money. We switched to current accounts with the clearing banks, i.e. to a proxy for M1, between 1956 and 1972 when the official monetary series started. Between 1972 and 1979 we focused on sterling M3. In February 1980 we switched back towards transactions money. Summarising, apart from the period 1972 to 1979, we have in fact concentrated from 1920 to date more on transactions money than on broad money (although our reasons were complex).

As far as the fall in markets is concerned, it is best to analyse sterling first, and to focus on sterling's non-dollar index to remove the gyrations of the dollar. This index has fallen almost continuously, declining by some 25% since its peak in July 1985.

The most important explanation was, of course, the fall in the price of oil. Its price in sterling terms reached a peak in March 1985. This morning it was 62% lower.

A fall in sterling of roughly the size which has occurred was absolutely essential to correct the impact of the reduced price of oil on the UK's balance of payments. The authorities clearly wanted sterling to depreciate.

The second, and associated explanation, for sterling's fall was the decline in UK interest rates, both short and long rates. Base rates were reduced from 12½% last March to 10% in May. Twenty year gilt yields fell from almost 11% to 8½%.

The main reason for the reduction in rates was that those in the US were falling fast and the UK authorities wished to make their contribution to preventing an international trade war. Their hope was that the UK, in following the US, would encourage the German and Japanese authorities to reduce their rates.

The overall effect was, however, a substantial reduction in UK rates relative to those in Germany and Japan, the two nations with huge balance of payments current account surpluses to invest. The margin in favour of the UK on short rates fell from 7.1% to 5.4% against Germany, and from 6% to about 5% against Japan. The differential for ten year bond yields against Germany came down from 5% in January to 3% in May, and against Japan from 5.1% to 3.5%. The reduction of these differentials discouraged inflows into the UK of both short and long term capital. It also encouraged an outflow from UK investors.

The third explanation for sterling's fall was fear of a Labour Government and the publicity the Labour Party was receiving. Indeed, my own firm has been accused of starting the run on sterling because we hosted a dinner in New York in September to introduce Mr.

Hattersley to US institutional investors. It appears that they voted not with their feet but with their funds!

These three explanations taken together are fully capable of explaining sterling's fall. There is scarcely need for a fourth - the loss of confidence in Mr. Lawson.

This is probably the point to introduce one of my pet hobby horses. The behaviour of markets often determines confidence. My profession, stockbroking, and I suspect yours, has an unlimited ability to invent explanations for things we failed to predict. We have to have an explanation for the recent behaviour of our market or else we lose face. We invent an explanation, repeat it many times and end up believing it ourselves. Further, as I tease my friends at the FT, they too are human. If markets are rising, good news tends to appear on their front page and bad news on inside pages, and headlines tend towards the optimistic. If markets are falling, bad news appears on the front page, and headlines are pessimistic. The resulting tone of the financial press has a very important influence on confidence.

My point is that, because of the recent fall in markets, a lack of confidence in the Chancellor is absolutely inevitable. This does not, however, dismiss the case against Mr. Lawson because the causality can, of course, also run from confidence to the behaviour of markets, as well as the other way. What evidence is there in the gilt-edged market that the loss of confidence is independent of the behaviour of the level of markets?

One danger sign is the way in which the gap between the yields on conventional and index-linked gilt-edged stocks has widened. This gap should be a direct measure of inflationary expectations. The yield difference between 13½% Treasury 2004/08 and Index-Linked Treasury 2006 has widened from 5% in April to over 7% now.

Closer investigation shows, however, that the yield on the index-linked bond itself rose. If inflationary expectations were truly rising, investors switching out of conventional bonds into index-linked ones would have caused yields on the former to rise but those on the latter to fall. That yields rose on both suggests that investors sought protection in cash and not that inflationary expectations were altering for the worse. The conclusion is that inflationary expectations have probably not risen by very much.

A factor which does concern me is the way in which the yield curve has failed to react to October's rise in base rates. To take the opposite case for a moment, when a central bank is reducing interest rates, a clear warning that they have been reduced far enough for the time being is signalled when the bond market no longer responds favourably to a cut in short rates. Similarly, when interest rates are being raised, the change in the slope of the yield curve signals whether the market thinks that the hike in short rates is overkill or underkill.

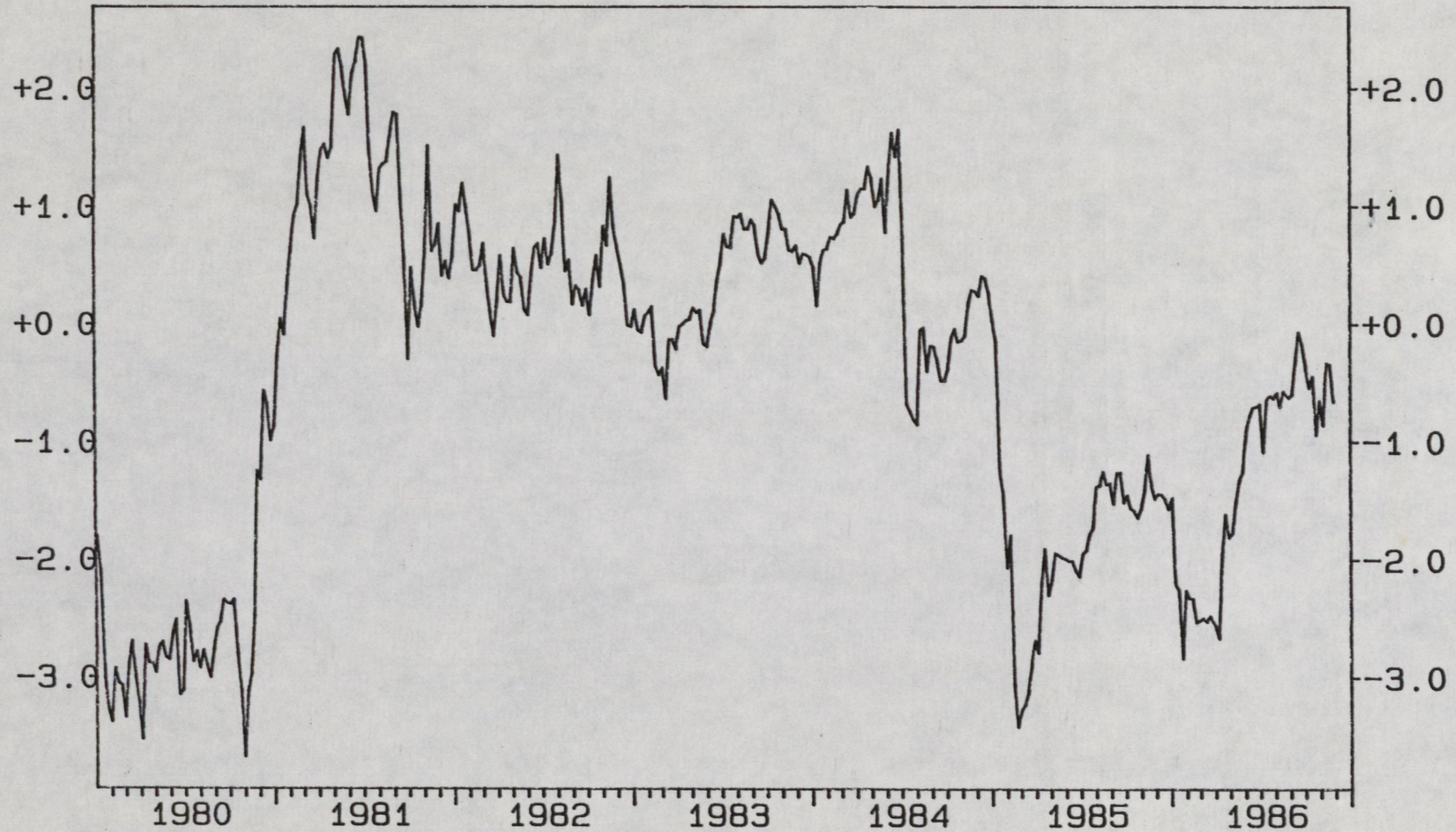
Base rates have risen on four occasions during Mr. Lawson's period as Chancellor. They rose from a low of 8½% to 12% in July 1984, whilst twenty year gilt-edged yields rose by about 1½%, with the gradient of the yield curve, more precisely 20 year par yields less 3 month LIBOR, altering by about 2%. In January 1985 base rates rose from 9½% to 14% and the gradient of the yield curve altered by more than 3½%; this suggested overkill. In January 1986 base rates rose from 11½% to 12½% but three month money rates rose by a further half percent and the gradient of the yield curve altered by almost 1%. In October base rates rose from 10% to 11% but the gradient of the yield curve has not responded as long term interest rates have altered by roughly the same amount; this suggests underkill.

Finally, I come to the recent behaviour of transactions money. I have already reported Mr. Lawson's own observation that Mo edging upward was one of the reasons for the rise in base rates in October. Monetary statistics for 31st October were published yesterday and so

we now have more information. The year on year growth of Mo has risen from 3.1% in July to 4.9% in October. On an annualised and seasonally adjusted basis, its growth in the last six months was 5.9% and in the last three months growth was even higher at 6.3%. This should be compared with the target range of 2-6%.

There are two other reasonable measures of transactions money at present. Non-interest bearing M1 has accelerated even more than Mo. Its year on year growth has risen from under 4% in April to over 11%. There has also been an acceleration in M2, although October data are not yet available.

My conclusion is that the 1% rise in base rates in October was absolutely justified. Further, from my analysis of the yield curve, I have already suggested it might be inadequate. Given the latest monetary data, base rates need to rise by a further 1% before I can give Mr. Lawson an unqualified vote of confidence.



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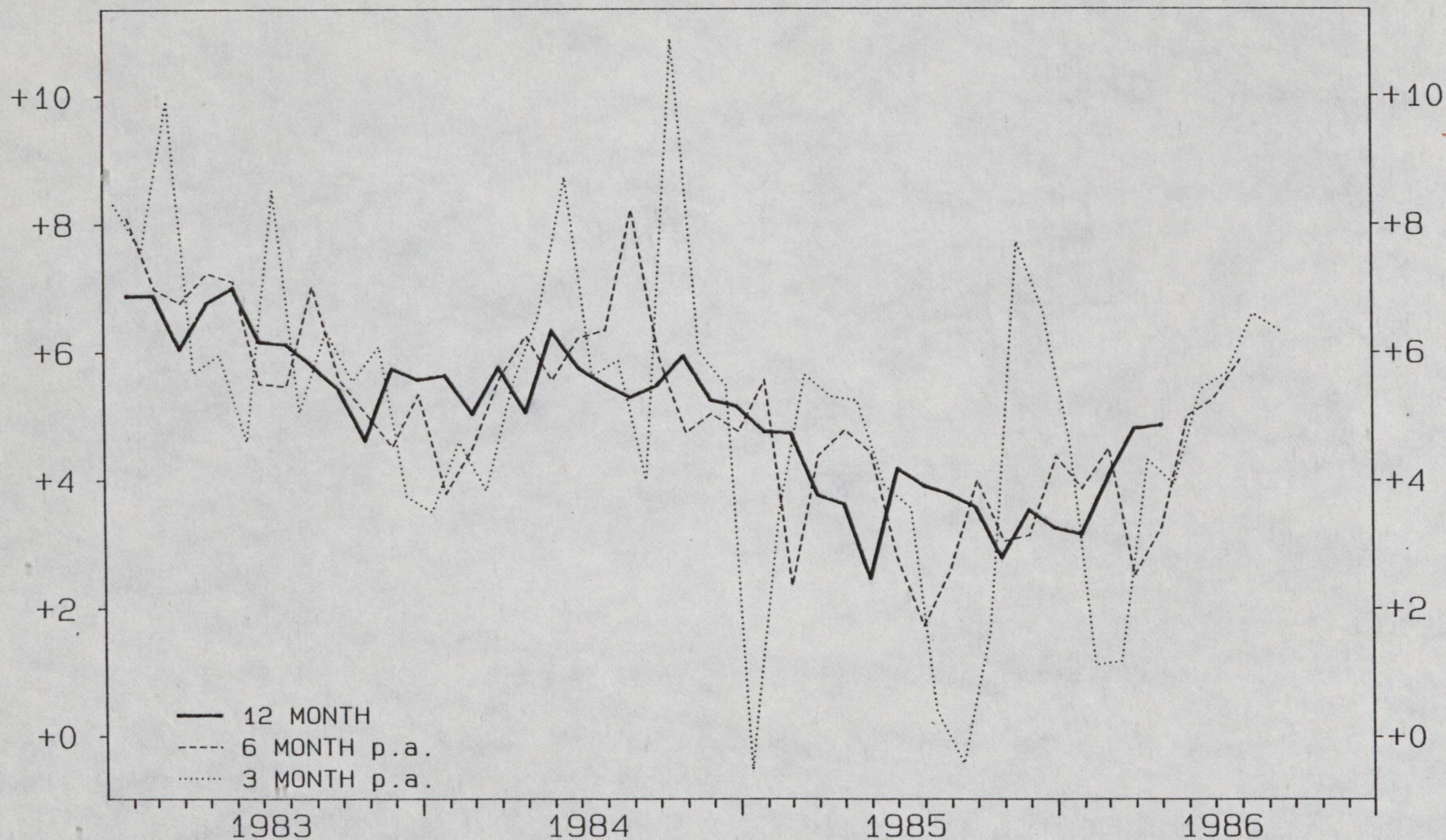

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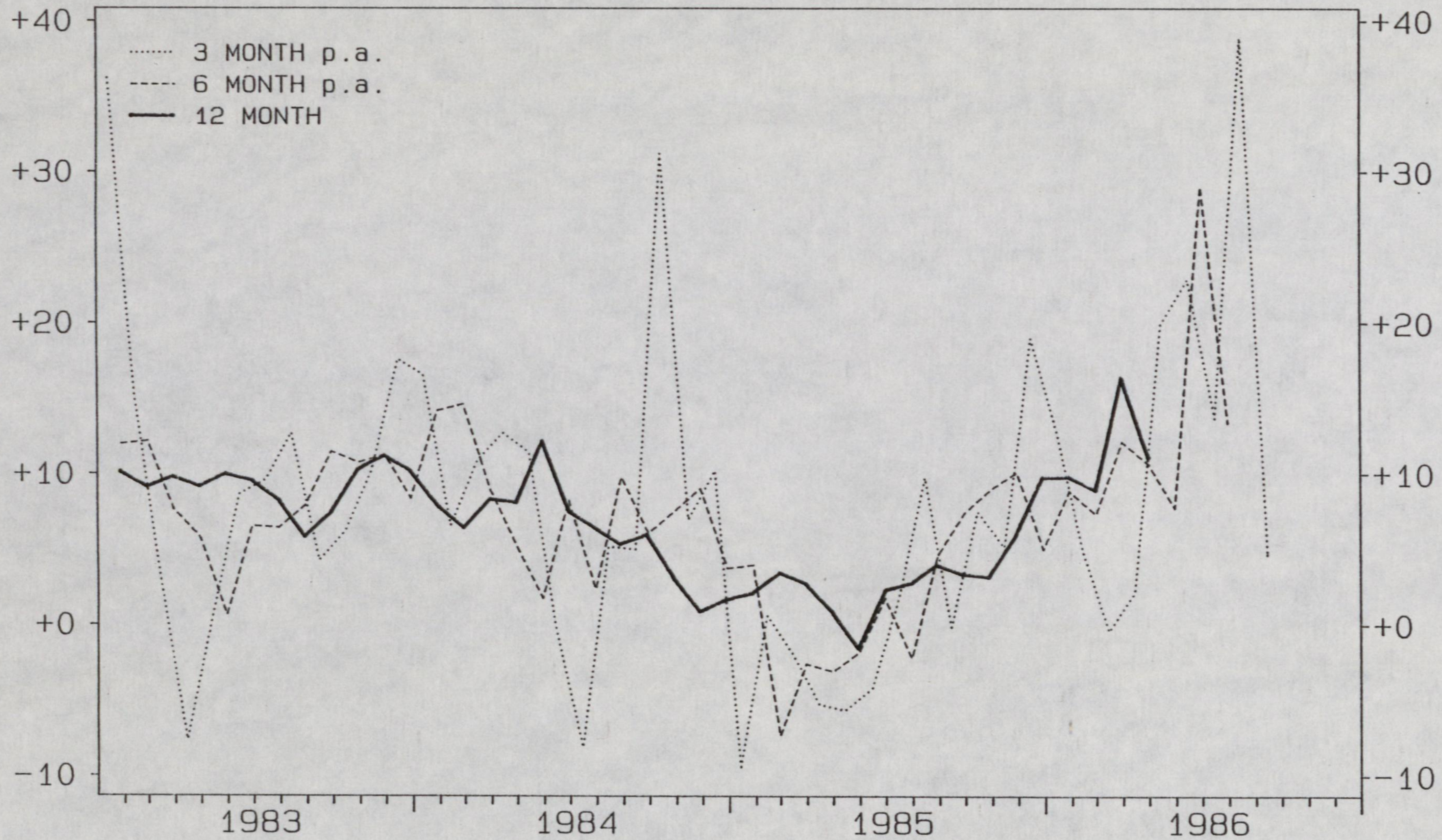
CHANGES IN NON INTEREST BEARING M1 (END MONTH) %



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