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BANK OF ENGLAND
LONDON EC2R 8AH

A. L. Coleby
Chief Monetary Adviser
to the Governor
01-601 4220

29 September 1987

Sir P Middleton KCB
H M Treasury
Parliament Street
London
SW1P 3AG

Dear Peter,

I enclose our regular monthly note on interest rates over the next few weeks for our meeting on Thursday afternoon.

Yours ever,

Tony

PERM. SEC'S. OFFICE
RECEIVED
29 SEP 1987

Action	Sir T Burns
	Mr Cassell
Copies To	Mr Peretz
	Mr Odling-Smee
	Mr Lankester
	Mr Grice
	Mr Pike
	Mr Sedgwick

Mr Richardson
Mrs Lomax
Mr Gr Kelly
Prof. B Griffiths (No10).

4.

£ millions

INTEREST RATES OVER THE NEXT FEW WEEKS

1 The unpublished band for interest rates on bills with up to 14 days to maturity stands at 9-11%. Within the band, we have been buying bills in all maturity bands at a common discount rate of 9 7/8%.

Market conditions

2 Since the last meeting the US discount rate has been raised by 1/2% to 6% and US money market rates have moved up in line with it; moreover the recent trend in bond yields has been upwards, not only in the US but also in Japan and Germany. Oil prices have not reacted very markedly to the continuing tension in The Gulf: they are apparently being held down by above-quota production by some OPEC members.

3 In the foreign exchange markets there has been a modest recovery in the dollar since the last meeting. Sterling strengthened in response to encouraging indicators on industrial production, the PSBR, and money and bank lending, but remained below the DM 3.00 level without the need for heavy intervention on our part. It fell back on the trade figures, though only modestly; and has since recovered the ground it lost. Recent changes are shown in the table below.

	£ERI	£/$	£/DM	$/DM
10 September	72.9	1.6450	2.9725	1.8045
28 September	73.1	1.6387	2.9906	1.8250

4 In the money market, the August money figures caused market concerns about a possible rise in interest rates, which had already been lessening, to diminish further, and the three month interbank rate fell back to around 10%. The August trade figures caused some tightening in rates, though they did not give rise to

any market expectation of an increase in the general level of interest rates in the near future. The one, three and twelve month interbank rates currently stand at 10%, 10 3/16% and 10 1/2% respectively.

5 Sentiment in the gilt-edged market improved with the publication of the industrial production, PSBR and money/bank lending figures; and we were able to sell our residual holdings of the 1991 tap stock, as well as substantial amounts of the 1992 low coupon stock, before the long gilt auction. The August trade figures, coming the day after the auction, set the market back quite sharply, taking the yield on the auction stock to around 9 3/4%, compared with the average yield at the auction of 9.57%.

Monetary conditions

6 Monetary growth in August was as shown below:

	1986		1987				
	Q4	Q4	Q1	Q2	July	August	12 months to August
M0*	1.6	2.4	-1.0	1.1	1.2	0.3	4.7
M3	4.4	1.6	6.8	5.1	2.3	1.5	22.2
nib M1	8.8	-4.6	2.1	7.1	-0.4	0.6	13.4
M1	7.7	-0.3	7.7	7.1	0.9	1.7	24.5
M2	4.3	1.9	1.3	4.0	0.8	0.6	11.0
M4	2.8	2.0	4.1	4.1	1.8	1.3	15.5
M5	2.9	1.9	3.9	4.2	1.7	1.3	14.9

7 The increase of 0.3% in M0 in August included a reversal of July's erratic rise in average bankers' balances. Although the 12-month growth rate of notes and coin remains at around 4 1/2%, the annualised growth rate over the latest three months was some 7%.

8 The broad aggregates all grew by around 1 1/2% in August - in each case more slowly than in July, though their 12-month growth rates nevertheless went up. On the M3 basis (ie not counting

debt sales to banks in the funding total), the PSBR was underfunded by 2,720 (1.6% of M3) over the 12 months to August. In contrast, on the M4 basis (ie not counting debt sales either to banks or to building societies), it was overfunded by 760 (0.3% of M4) over that period.

9 The public sector had a small surplus in August, which was overfunded (on the M3 basis) by 350 thanks to a fall in the reserves and overseas purchases of gilts, and despite a substantial further run-off in the private sector's holding of other public sector debt.

10 The main counterpart to the slowdown in broad money growth was in bank and building society sterling lending, which (including private sector holdings of bills) went up by no more than 3,120 in August, compared to an average of 5,540 in June and July and 4,020 in the two months before that. The indications are that the slowdown in credit growth was mainly accounted for by lending to the corporate sector - the rate of personal lending seems to have been broadly unchanged. Foreign currency lending, however, went up by 1,040; so that the total of sterling and foreign currency lending went up by more in August than in July, though still by less than on average over the year to end-June.

11 The three-month forecast is for some acceleration in M0, taking its 12-month growth rate up to 5% by the end of November. Broad money is expected to grow at a relatively moderate pace, with M3 continuing faster than M4 and M5. The 12-month growth rates of M3, M4 and M5 are forecast to fall back to 20.8%, 15.0% and 14.3% respectively by the end of November. The end-October figures for the aggregates other than M0 are likely to be distorted by the BP share sale, for which lists close on 28 October.

12 The latest GDP figures show strong output growth of around 3 3/4% in the year to the second quarter on the average estimate, and the July industrial production figures suggest that this has persisted into the third quarter. However, even though the August external trade figures were probably erratically bad, the trend in the trade figures since the beginning of the year makes

it clear that, at least over that period, domestic spending for consumption and investment purposes has grown faster even than output.

13 The retail price index rose by 0.3% in August, but its 12-month increase remained at 4.4% (3.7% if mortgage interest is excluded). Manufacturers' input prices rose by a further 1.1% in August to a level 9% higher than a year earlier (though there are signs that commodity price increases have begun to moderate), but manufacturers' output prices (which rose by 0.3% in August) were no more than 3 1/2% higher than in August 1986. The underlying increase in average earnings in the economy as a whole remained at 7 3/4% in the year to July.

Conclusion

14 The evidence that has accumulated since the last meeting on the monetary and economic situation is mixed. On the demand side, broad money and credit growth moderated in August, and the PSBR has been running at a lower rate than expected. On the other hand, rapid growth in retail sales has continued, perhaps associated with the upturn in M0 growth. On the supply side, output has been growing faster than was earlier thought, and unemployment has continued to fall. But although the exchange rate has been firm, it is clear from the trade figures that domestic demand has been growing faster than output.

15 Against this background we continue to think that the risks on inflation are asymmetrical, with a significant rise more likely than a significant fall, and that the case for a move up in interest rates is stronger than that for a move down.

Bank of England
29 September 1987