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1. MR MIDDLETON
2. CHANCELLOR

FROM: A TURNBULL  
14 September 1982

cc Chief Secretary  
Financial Secretary  
Sir Douglas Wass  
Sir K Couzens  
Mr Burns  
Mr Kemp  
Mr Lavelle  
Mr Monck  
Mr Riley  
Mr Sedgwick  
Mr Peretz  
Mr Davies  
Mr Pickford  
Mr Ridley

MONETARY PROSPECTS: SEPTEMBER-NOVEMBER

Mr Middleton held a meeting with the Bank on Tuesday, 14 September to discuss monetary developments and prospects.

2. The main features of the outlook are shown in Tables 1 and 2:

(i) The outturn for August revealed some acceleration for all three target aggregates, though this leaves the growth of £M3 since February in the top half of the target range and M1 and PSL2 in the bottom half. The acceleration of £M3 reflects a more expansionary public sector contribution and an increase in bank lending. For August the increase in M1 was paradoxically in the interest bearing component but taking the last three months together there is a sharp increase in NIB M1, probably reflecting declining interest rates.

(ii) The relatively slow growth of PSL2 (8.8 per cent a.r. in the target period) reflects the fact that the large rise in building society deposits has gone mainly into term shares outside PSL2. More complete data on July when there were a number of "special offers" by building societies has led to upward revisions of the term shares and downward revisions of PSL2. PSL2A which includes all building society deposits has grown by 12.8 per cent over the target period.

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(iii) Over the next three months we expect the growth of  $\text{£M3}$  to average close to 1 per cent a month which would leave the annual growth rate at just over 11 per cent. However we expect the recorded figure for September to be only about  $\frac{1}{2}$  per cent, below the underlying trend. Much of this is due to the quirks of seasonal adjustment. The adjustments for September were calculated using estimates of PRT inflows and CTD surrenders to pay for them. In the event the former were larger than expected and the latter smaller. In both cases the downward seasonal adjustment has turned out too large in September (and too low in the preceding six months). Though the cumulative position is unaffected September is made to look too favourable.

(iv) We expect M2 to grow about 1 per cent a month. While the decline in interest rates will be boosting M1, the slowing in prices and activity will reduce the element of transactions demand.

(v) PSL2 is forecast to average  $\frac{3}{4}$  per cent a month. The recovery of National Savings - see below - may reduce the growth rate of the wider measure, PSL2A.

(vi) The CGBR is forecast to average  $\text{£1}$  billion a month over the period but the PSBR only  $\text{£0.7}$  billion. In September PRT receipts were  $\text{£400}$  million higher than expected but this was offset by higher on-lending to the other parts of the public sector. Although higher on-lending to local authorities has been deliberately sought, ironically it took the form of fixed rate rather than variable rate lending. This higher on-lending should produce a large reduction in the bank borrowing of the rest of the public sector.

(vii) Gross sales of gilts in September were about  $\text{£520}$  million, well down from August's  $\text{£1.3}$  billion. But

with buying in and maturities much lower, net sales are expected to be close to the £550 million in August. For October and November gross sales are projected at £1 billion in each month, though £460 million is already lined up by a call in October.

(viii) The combination of declining interest rates elsewhere and improvements to National Savings products appears to be achieving a revival of inflows to around £230 million a month. If sustained this would take the total for the year over £2 billion.

(ix) We have revised upwards the underlying growth of bank lending to around £1.3 billion. The deceleration between April and June has not been sustained. There could also be some special factors boosting recorded lending in September. Heavy money market intervention in banking September appears to have depressed bill rates relative to deposit rates. Even if this fell short of creating positive arbitrage profits, it could make it relatively cheaper to borrow and hold balances. Also in August and September there could be some effect of the abolition of HP controls, and the new registration year for cars. Lending for housing is still strong and it may be some months before the banks' intention to slow it down is reflected in disbursements.

(x) We are continuing to project a substantive negative contribution from the externals, around £200 million a month in October and November, and somewhat less in September when there could have been inflows to finance PRT payments.

#### Interest rates

3. The meeting discussed the prospects for interest rates. At your meeting with the Governor on 26 August, it was suggested that we should try and look forward to see how far we could and

should go in bringing interest rates down. We will be in a better position to do this when we have the financial forecast available in two or three weeks time. This will enable us to consider factors such as the PSBR and bank lending and the lagged response of the aggregates to interest rate reductions in a more systematic way than is possible in the time horizon of the three months' exercise. We propose therefore to discuss the financial forecast at next month's meeting. In the meanwhile our advice on interest rates is necessarily rather short term.

4. Many of the factors which had been brought forward to justify the recent reductions in interest rates are still present - inflation is falling faster than expected and output growth is weaker, combining to produce a slower growth of GDP in nominal terms, the exchange rate is still firm and the reductions in nominal interest rates appear to have no more than kept pace with downward revisions in inflationary expectations - leaving real interest rates still substantially positive.

5. By contrast the behaviour of our own monetary aggregates which was earlier pointing unequivocally to lower interest rates, is no longer quite so reassuring. With the exception of the monetary base which seems to be strongly influenced by structural changes in means of payment, the other aggregates are showing signs of acceleration. This is not necessarily an unacceptable development as the growth in the first half of the year was noticeably low, and the aggregates are still within the target range.

6. An acceleration of M1, particularly of the non interest bearing component is to be expected given the past falls in rates. In the next three months we are predicting growth of 12-13 per cent at an annual rate, compared with the 4 per cent in the year to May. The growth of £M3 in the three month period is distorted by the special factors which occurred in September. Making rough allowance for this would produce the following pattern:

	Feb-May	May-Aug	Aug-Nov (Forecast)	Feb-Nov (9 months of target period)
£M3	8½	10½	13	11

By the end of November, PSL2 is projected to have grown by around 9 per cent but this in part reflects the benefit of the rapid growth of term shares, many of which are now relatively liquid.

7. As is so often the case, the US prospects are difficult to predict. The growth of MIB has picked up again, with another "bulge" expected and interest rates have also risen. There is uncertainty about the attitude of the Fed.

8. The meeting concluded that there was probably still limited scope for rates to come down, say by another ½ per cent in the near future. At present the market is not actively seeking or expecting a cut, but it was felt that if the opportunity arose to engineer a cut without pushing too hard against the grain of the market, it should be taken. It was recognised that this course placed more emphasis on the behaviour of inflation, the exchange rate and real interest rates than on development of the monetary aggregates.

#### Funding

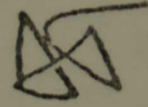
9. There was a discussion of the prospects for funding, but again this was a preliminary one pending the arrival of the forecast. When this was available it would be possible to refine further the ground rules for funding over the rest of the financial year. The outturn for September of gross sales<sup>of gilts</sup> of £525 million was a bit below hopes and expectations. The forecast of gross sales of £2 billion in October and November with nearly £0.5 billion lined up might not look too daunting but it was pointed out that early next year maturities would be extremely heavy - over £3 billion in the first quarter.

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10. The re-engagement of National Savings was welcomed though it was noted that both the 24th Certificate and the Income Bond were paying relatively high rates of interest and at some stage an adjustment would need to be considered.

11. The arguments for and against a conversion issue are being examined and we will report back to you shortly.



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TABLE 1: CCBR/PBRR AND GROWTH IN £M3

Banking months	Actual				Forecast			
	June	July	Aug	12 months to mid-Aug 1982	Sept	Oct	Nov	Mid-Feb. 82 to mid-Mar. 82
<u>£ million</u>				<u>Cumulative</u>				<u>Cumulative</u>
CBRR s.a. (+ deficit)	+800	+923	+1492	+4325	+910	+845	+1295	+6199
PBRR s.a. (+ deficit)	+524	+773	+1087	+4897	+325	+885	+1160	+5577
Loft sales (increase -)	-303	-1272	-863	-10275	-1060	-605	-950	-7495
<u>Per cent</u>								<u>Annual rate</u>
Change in £M3	+0.8	+0.8	+1.4	+11.6	+0.5	+1.2	+1.0	+11.2
<u>£ million</u>								
Estimated underlying growth in bank lending.	+930	+1350	+1440		+1300	+1300	+1300	
Centered 3-month moving average.	+1190	+1230	+1350		+1335	+1300		

Table 2: PERCENTAGE CHANGES IN MONETARY AGGREGATES

Seasonally adjusted data

Banking month	Wide monetary base (M0)	Non-interest bearing M1	M1				PSL	
			M1	EM3	M3	PSL1	PSL2	
Outturn								
- March	-0.5	-0.6	-0.7	+0.7	+0.7	+0.5	+0.7	
- April	-1.2	+0.4	+0.1	+0.6	+1.8	+1.3	+1.1	
- May	-0.2	+0.3	+0.6	+1.1	+0.9	+0.8	+0.7	
- June	+1.7	+1.4	+2.0	+0.8	+0.6	+0.5	+0.6	
- July	+0.2	+2.2	+0.9	+0.8	+1.5	+0.4	+0.1	
- August	-1.7	-	+1.2	+1.4	+1.1	+1.5	+1.1	
Last 12 months	-0.2	+3.1	+8.3	+11.6	+12.3	+11.1	+9.3	
Last 6 months (target period) at annual rate	-3.4	+7.5	+8.4	+11.2	+14.0	+10.8	+8.8	
<u>Forecast</u>								
(1) Percentage change in month			(1 percent (a month)					
- September			+0.5			+1.0	+0.7	
- October			+1.2			+1.2	+0.9	
- November			+1.0			+1.0	+0.7	
(11) Percentage change since Feb '82								
- September			+6.0			+6.3	+5.1	
- October			+7.3			+7.6	+6.0	
- November			+8.3			+8.6	+6.8	
(111) Percentage change since Feb '82 (annual rate)								
- September			+10.4			+11.0	+8.8	
- October			+11.1			+11.5	+9.1	
- November			+11.2			+11.5	+9.2	

Note: ALL figures are on the basis of the new monetary sector.



Re Governance  
(from USOB)  
seasonally adjusted  
24/9

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UR 24/9

Banking  
September

Annualised  
growth over  
target period

1/2 leading to  
private sector

1/2 1860 w

1/2 M3

1.1%

11.6%

M1

1.5%

9.9%

M0

3.8%

3.5%

PSL2

1.1%

9.6%

(NIBMI not yet available: errors still  
under examination, affecting  
split between IB and NIB.)