# 14.B Monetary Targets and Economic Policy

## Control of Monetary Aggregates

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INTERVENTION AND THE MONEY SUPPLY

As agreed, I have examined in detail each period of heavy exchange market intervention since the beginning of 1976. The aim was to produce an accurate summary of events - with particular emphasis on money supply developments - and to highlight any common strands.

2. The periods studied were 1976 Q2 and Q3, 1977 Q1 and second half, and 1978 Q2. (I have not looked at the recent period of upward pressure, since much of the data is not yet available). Each period was examined separately and the material arranged under three headings:

(a) exchange market and intervention - a summary of events in the foreign exchange market;

(b) possible causes of pressure on sterling;

(c) policy measures taken by the UK authorities;

(d) impact on £M3.

3. For the impact on the money supply, I have looked at three effects, all immediate or first round. These effects are:

(i) the direct impact through the private sector counterparts to intervention;

(ii) the possible indirect offsetting effect through bank lending to the private sector;

(iii) the possible indirect effect through gilts sales to the non-banks.

4. Overall, the conclusion is that [illegible] effects do seem to have [illegible]

No simple rule of thumb relating intervention to private sector outflows or DCE offsets would have satisfactorily described developments in every period. For example, the ratio of the external adjustment to intervention on the balance for official financing has varied from about 0.7 in 1976(3) to about 0.3 in 1978(2). Simple relationships between intervention and DCE offsets have been even less stable.

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INTERVENTION AND THE MONEY SUPPLY: RECENT EXPERIENCE

1. This note considers the impact of exchange market intervention on £M3. The approach is to examine in detail each of the various periods of heavy intervention which have taken place since the beginning of 1976. These periods were 1976 Q2 and Q3, 1977 Q1, 1977 second half and 1978 Q2. The most recent experience is not considered because much of the data is not yet available.

2. Each period is examined separately with a summary of the main developments in the exchange market, a review of the possible causes of pressure, a description of the policy measures taken and an assessment of the final impact on £M3. This impact is judged in terms of i. the direct effect through the external flows to the non-bank private sector, ii. the possible indirect effect through the repercussion of these flows on the private sector's demand for sterling bank credit, and iii. the possible indirect effect on gilts sales through the expectation that continued external flows will result in a defensive change in domestic interest rates. Of course it is not possible to quantify ii. and iii, but some rough assessment can be made. The final section of the note considers the record of the monthly money supply forecasts in predicting developments during these periods. The whole note draws on various issues of the monthly report on the monetary aggregates, as well as the BEQB.

3. As might be expected, the overall conclusion is that no simple rule of thumb relating intervention to growth in £M3 would have adequately described developments in all of the various periods. The proportion of intervention feeding through directly onto £M3 has varied considerably, while the supposed indirect effects have been even less predictably linked to external flows. Nevertheless, such indirect effects were apparent during most of the periods of heavy flows.

a. EXCHANGE RATE AND INTERVENTION

4. At the end of February 1976 sterling stood at just over $2.0 where it had remained for about six months. Its effective rate was 73. On 5th March substantial downward pressure developed and despite heavy intervention (about $1¼bn.) the rate fell to $1.91 by the end of the month. The slide continued for two more months taking the rate to $1.76 by the end of May (effective rate 64.2). By continuing intervention the authorities then managed to hold off any further depreciation until September. Early in that month the downward pressure intensified and over the following seven weeks sterling fell to its record low point of $1.55 on 28 October. During the whole of Q2 and Q3 intervention totalled about $5bn. on the balance for official financing.

b. POSSIBLE CAUSES OF PRESSURE

5. During 1976 the current account deficit deteriorated from about £100m. in Q1 to about - £400m. in both Q2 and Q3. This undoubtedly contributed to the downward pressure but as a direct factor it represented only a small shift in relation to the pressure which developed. The main force of this pressure came through the capital account. Initially this may have been partly in response to relative interest rate movements but more importantly it reflected a break in the market's confidence in sterling.

6. With respect to relative interest rates, the following table shows that although a movement against sterling may have explained part of the pressure in March, later in the year rates moved strongly in favour of sterling as the authorities sought to stem the outflows. All figures in the table are %pa at end-month levels.

| 3-month rates | Jan. | Feb. | Mar. | Apr. | May | June | Sept | Oct. |
|---|---|---|---|---|---|---|---|---|
| UK interbank | 9.4 | 8.8 | 8.5 | 9.9 | 11.5 | 11.2 | 12.8 | 15.2 |
| Eurodollars | 5.4 | 5.6 | 5.6 | 5.5 | 6.6 | 6.0 | 5.8 | 5.4 |
| Differential | 4.0 | 3.2 | 2.9 | 4.4 | 4.9 | 5.2 | 7.0 | 9.8 |

The loss of confidence in sterling has been attributed to a number of factors, several related. Sterling's fall was sparked off by a small amount of positive intervention on 4 March, which the market interpreted as a signal that the authorities wished to see a depreciation. This view was reinforced by a ¼% fall in MLR later the same week. The following week the Prime Minister resigned, adding to the immediate uncertainty. Once the fall had started a series of one-off events later in the year caused renewed bouts of nervous selling: a proposal by the Labour NEC to nationalise the banks, industrial trouble at Leyland, rumours of a three-day week to conserve water after the drought, and the famous Sunday Times report that the IMF thought sterling should fall to $1.50.

8. However, apart from these immediate factors there were underlying reasons for expecting a depreciation. First, the current account was still in deficit as the year opened and deteriorated further as it progressed. Second, the UK's inflation rate was still high compared to those of competitors. The RPI rose 17% (a.r.) during the first half of 1976 which was at least twice the rate of any other OECD major, except Italy. Moreover, earnings were still increasing at 15-20% (year-on-year).

9. Against this, the UK's recent monetary growth had been relatively modest: £M3 had grown by 7% in financial year 1975/6, almost 10% less than the growth of nominal GNP. Over the same period a weighted basket* of overseas money supplies had grown by about 13% (US M2 grew by 8%). The UK's modest growth was not attributable to negative externals - DCE had been at its lowest level for four years (£5bn.). However, the low DCE outturn reflected a £½bn. contraction of bank lending to the private sector. The PSBR had been a massive £10½bn., offset by debt sales to the private sector of more than £5bn. When the Chancellor announced another £10½bn. PSBR forecast for 1976/7, there was a widespread expectation that monetary growth would accelerate, since a further contraction of bank lending was unlikely and further large debt sales doubtful.

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*Using weights based on those in the MERM.

10. It thus appears that there were three underlying factors which provided the right circumstances for a break in confidence: concern over the existing inflation rate and current account deficit, coupled with a view that the large PSBR for 1976/7 was probably inconsistent with another year of modest monetary growth.

11. Nevertheless, it should be recognised that the effect of these factors was greatly amplified by their apparent influence on the managers of the OPEC sterling balances. Since the oil price rise in 1973, the OPEC countries had built up substantial sterling balances, reaching £3½bn. in 1975 Q1. They had already begun to diversify out of sterling by the end of 1975, but the major reduction in their holdings took place during the first three quarters of 1976. From the start of the year to the end of September, they withdrew almost £1½bn. from short-term sterling assets and reinvested it elsewhere. Some of these funds may have gone into UK equities and property, but it is clear that most of it went abroad. Of course, it is quite likely that a substantial part of these balances would have been taken out of sterling at some stage anyway, since they had been concentrated in short-term assets. However, it is equally likely that the speed of withdrawal in 1976 was largely prompted by the more general collapse of confidence in sterling.

c. POLICY MEASURES

12. The authorities' initial response - once the force of the downward pressure became clear - was to raise short-term interest rates. MLR was increased from 9% to 10½% in the April Budget, and to 11½% in May. Faced with the intensified pressure in September, they increased MLR further to 13% and eventually to 15% during the first week of October. The effect on the three-month differential between UK interbank rate and Eurodollars was to move it to almost 10% (uncovered) in favour of sterling by October (see paragraph 6). However, these changes met with little success in stemming the outflows - they were effectively swamped by the adverse movement in confidence. The increased cost of forward cover meant that the covered differential against sterling moved from ½% at the end of February to 5½% by the first week in October.

13. The authorities also tried to calm the market (as well as preserve the reserves) by negotiating support facilities for sterling. In June they announced a $5.3bn. short-term credit facilities with overseas central banks. Later they let it be known that they were negotiating a multilateral facility to ease the problem posed by the sterling balances. Finally there was the IMF package at the end of the year, containing its own support provision.

14. Exchange controls were tightened in the latter part of the year. In August the rules governing sterling lending to finance third country trade were tightened, and in November such lending was prohibited entirely. These changes were prompted by the very rapid growth of such lending through the early part of the year: in the first nine months external sterling lending, other than credit on UK exports, increased by about £0.6bn. It was clear that this was an important channel for speculation against sterling and the new measures were designed to close it (although in retrospect it seems that pressure here was already greatly moderated by November).

15. The authorities also tightened fiscal policy during the year. The misgivings about the £10½bn. PSBR forecast have already been mentioned and in July the authorities acted to reduce the PSBR, at least for 1977/8. The measures included a £1bn. cut in expenditure and an £0.9bn. increase in employers' National Insurance contributions. This package also included the first quantified money supply target: 12% for 1977/8. However the July package - leaving the 1976/7 PSBR unchanged - was not enough. Confidence only really returned once the rate had fallen much further during the autumn and it became widely expected that the government were nearing agreement with the IMF. The new packagewas expected to include further reductions in the PSBR for 1977/8, as well as performance conditions relating to monetary growth. The final agreement included a PSBR target of £8.7bn. for 1977/8, and DCE targets of £8.7bn. for the current financial year and £7.7bn. for the next.

d. EFFECTS ON £M3

16. The following table sets out the counterparts to exchange market intervention, by calender quarters. Line f. is the external adjustment to £M3, as normally calculated. However this is not the net direct impact on £M3 since it includes certain accounting offsets to items which are counted in DCE. These items are external sterling lending by UK banks, and public sector transactions with the overseas sector, increasing the PSBR - lending and current account flows. Line i. is an estimate of the net impact on £M3, representing net flows to the non-bank private sector.

(All figures are £M with balance of payments signs; not seasonally adjusted).

| | | 1976(2) | 1976(3) |
|---|---|---|---|
| a. | Balance for official finance: of which: | -1950 | - 860 |
| b. | Public sector direct o/s borrowing above BOF line: (increase +) | - 10 | - 10 |
| c. | Overseas holdings of public sector sterling debt (increase +) | | |
| | Gilts | - 460 | - 210 |
| | Treasury Bills | 0 | 30 |
| | LA debt | - | - 50 |
| d. | External sterling deposits: (increase +) | - 270 | 230 |
| e. | Banks' net foreign currency: liabilities (increase +) | 120 | - 250 |
| f. | External and foreign currency finance | -1330 | - 600 |
| g. | External sterling lending (increase -) | - 260 | - 200 |
| h. | Public sector transactions increasing the PSBR (increase -) | - 730 | - 650 |
| i. | Net flows to non-bank private sector: | - 340 | + 250 |

NB: f=a-b-c-d-e
i=f-g-h

17. The table shows that roughly one-third of the total intervention was the counterpart to flows from the public and banking sectors not offset within DCE. In particular, there were large flows out of gilts, where the general effect of the loss of exchange rate confidence was reinforced by adverse interest rate

expectations (see below). The estimate of net flows to the non-bank private sector (line i) shows that the modest outflow in Q2 was almost reversed in Q3. However, it should be pointed out that this item is usually an inflow, and both Q2 and Q3 were very small compared to the quarterly average for the last few years (about + £ 1,000 m).

18. To gauge the strength of the indirect effects, it is necessary to examine the other counterparts to the growth of £M3. These are shown in the following table, which is on a banking months basis.

All figures are £M seasonally adjusted

| | Apr. | May | June | July | Aug. | Sept. | Oct. | Nov. |
|---|---|---|---|---|---|---|---|---|
| a. CGBR (surplus -) | | + 836 | + 865 | + 244 | + 751 | + 578 | + 584 | + 376 |
| b. Net purchases (-) of CG debt by non-bank private sector | + 623 | - 511 | - 335 | - 139 | - 172 | + 13 | - 966 | - 325 |
| c. Other public sector (surplus -) | | + 70 | + 80 | + 285 | - 90 | + 242 | + 257 | + 236 |
| d. Bank sterling lending (+) | | | | | | | | |
| i. to private sector | + 404 | + 286 | + 218 | + 486 | + 138 | + 496 | + 581 | + 514 |
| ii. " overseas " | + 228 | - 26 | + 33 | + 147 | - 25 | + 83 | + 41 | - 24 |
| DCE | +1255 | + 655 | + 861 | +1023 | + 602 | +1412 | + 497 | + 777 |
| e. External and foreign currency finance (increase -) | - 643 | - 225 | - 522 | - 180 | - 47 | - 515 | - 324 | - 149 |
| f. Non-deposit liabs. and residual | - 117 | - 196 | - 7 | - 249 | + 9 | - 284 | + 277 | - 145 |
| £M3 | + 495 | + 234 | + 332 | + 594 | + 564 | + 613 | + 450 | + 483 |
| £M3% growth at annual rate | + 17 | + 7 | + 11 | + 21 | + 20 | + 21 | + 14 | + 15 |

19. In the three months' prior to banking April, bank lending to the private sector had been more or less flat (about + £100m overall) and, as already mentioned, it had been negative over 1975-6 as a whole. Therefore, the figures shown in the table represent a really substantial turnaround. The question is how much was attributable to the pressure on sterling. At the time it was thought that leading and lagging was responsible for a very large part of it and overall it is difficult to disagree with this conclusion. However, it is also worth remembering that the decline in UK interest rates at the beginning of the year would probably have generated some later increase in lending anyway. In addition, GDP was growing again after a year of no growth, and this would also be expected to generate increased lending. Therefore, although it is reasonable to assume that the growth in lending was strongly associated with the pressure on sterling, it should be realised that the straight figures probably give an exaggerated impression of the association.

20. With respect to indirect effects working through gilts sales, it can be seen from the figures in line b. above, that sales of CG debt became increasingly difficult during the summer. Already in banking June, net gilts sales were only £250m against a CGBR of over £850m, and in banking September the authorities made net purchases of £75m. The main reason for the difficulty was that, having already increased MLR by 2½ points since April, the authorities were unwilling to increase it further in view of the fragility of the real economy. However, the continuing pressure on sterling, the rapid growth of bank lending and the £10½bn PSBR forecast convinced the market that rates would have to rise, and demand for gilts virtually dried up. Sales only recommenced after MLR had been increased to 13% in the middle of September. In the subsequent month, gilts sales of £1,300m were made despite the continuing pressure on sterling. It is therefore clear that, while pressure on sterling was probably one of the causes of the slump in gilts demand during the summer, the pressure itself did not rule out substantial sales once interest rates had been adjusted.

21. Overall, events in 1976 suggest that all three of the first round links between external pressure and £M3 were in operation. Between the middle of March and the middle of November, £M3 was reduced by about £2.1bn. through net outflows from the non-bank private sector.

...tting this, bank lending to the private sector increased by £3.1bn, although not all of this was attributable to exchange rate pressure. At the same time gilts sales were extremely sluggish for much of the period, at least partly reflecting the pressure on sterling.

## B. 1977 Q1

### a. EXCHANGE RATE AND INTERVENTION

22. In the final two months of 1976 there had been a marked revival of confidence in sterling. The spot rate had risen from its low point of $1.55 in October to stand at $1.70 by the end of December. Upward pressure continued for much of 1977 Q1 and was countered by the authorities. Their aim was to keep the spot rate around $1.70-1.72, and in this they largely succeeded. In the process intervention amounted to about $3¼bn on the balance for official financing.

### b. POSSIBLE CAUSES OF PRESSURE

23. The most important factor was a strong resurgence of confidence after the low point reached in 1976. This revival was almost certainly based on the government's acceptance of <u>tougher financial policies</u> in its agreement with the IMF. The agreement had brought a standby credit of $4bn. subject to various performance criteria, including quantified DCE targets and further cuts in government expenditure. This had done much to convince market operators that the authorities were now "serious about monetary control". This belief was undoubtedly reinforced by the appearance of better <u>money supply</u> figures. In each of the three months from December to February, both DCE and £M3 contracted. This largely reflected a PSBR much lower than earlier forecasts, and massive gilts sales (£3bn over the three months).

24. Confidence was further boosted by the announcement of a two-year $3bn facility related to official sterling balances. This was to shield the UK's reserves from further reductions in official sterling balances, and it was linked with the offer to existing official holders, of negotiable medium-term foreign currency bonds issued by the government on market related terms. The overall aim was to achieve an orderly reduction in sterling's reserve currency role, in order to limit the potential for a repetition of official withdrawals on the scale of those in 1976.

25. Another factor strengthening sterling during this period was the <u>repayment of sterling lending</u> for third country trade. As described earlier, such lending had been prohibited in November 1976,

substantial repayments took place during the first quarter of 1977. At the time the Bank estimated that repayment gave rise to an inflow of about £1bn over the six months from November.

26. Against these factors, the current account was still in deficit (- £500m in Q1), and relative interest rates were turning against sterling - the uncovered 3-month differential between sterling interbank and Eurodollars fell from 9.3% at the end of December 1976 to 3.8% at the end of March. However, the effect of these factors was swamped by the upturn in confidence.

c. POLICY MEASURES

27. As already mentioned, the authorities aimed to stabilize the rate at about $1.70-1.72. Initially, they wished to rebuild the reserves, but also they were unwilling to see any further appreciation both because it would damage competitiveness and because it might very well have been reversed later.

28. The authorities were similarly cautious in reducing interest rates. At the start of the year MLR was still at 14% and while the market obviously expected a substantial downward movement (gilts sales to the non-banks were £1.7bn in banking January) the authorities were concerned to avoid large swings. There was a feeling that the market might have temporarily discounted the UK's 16-17% inflation rate, in a wave of post-IMF euphoria. Nevertheless, MLR was reduced in stages to reach 10½% by the end of Q1. The yield on 20-year government stocks fell by 2½ percentage points.

29. The combination of strong confidence in sterling and high UK interest rates confronted the authorities with a familiar problem - how to discourage short-term inflows without reducing interest rates or releasing the exchange rate. A range of options was considered including inward exchange controls, although these were not introduced. One special measure was the withdrawal of UK tax-exemption on new overseas purchases of gilts (from 24th March). A facility for conversion into bearer bonds was withdrawn at the same time. The authorities' problems eased in Q2 when the pressure on sterling moderated - although only after interest rates had been reduced further (MLR reached 8% in May).

## [illegible]. EFFECTS ON £M3

30. The following table shows the counterparts to £M3 during the period, by banking months.

(All figures are £M seasonally adjusted)

| | | Jan | Feb | Mar | April |
|---|---|---|---|---|---|
| a. | CGBR (surplus-) | +157 | +131 | +555 | +727 |
| b. | Net purchases (-) of CG debt by general public | -1740 | -612 | -395 | -96 |
| c. | Other public sector (surplus-) | +252 | -80 | -37 | -47 |
| d. | Banks' sterling lending | | | | |
| | i. to private sector | +422 | -298 | -75 | +238 |
| | ii. " overseas " | -146 | -86 | +52 | - |
| | DCE | -1055 | -945 | +100 | +822 |
| e. | External and foreign currency finance (increase -) | +294 | +402 | +23 | +251 |
| d. | Net non-deposit liabilities and residual | +28 | +135 | -54 | -143 |
| | £M3 | -733 | -409 | +69 | +930 |
| | £M3 % growth at annual rate | -20 | -11 | +2 | +32 |

31. It can be seen that the early part of the period was dominated by a low CGBR and massive gilts sales to the non-banks. High interest rates, coupled with a general expectation of falls in the face of external pressure, produced "propitious circumstances" for sales and the authorities made full use of them, selling well over £2bn during January and February. Also contributing to a contraction of DCE, bank lending to the private sector increased very slowly over the quarter, compared to previous months. This was thought to reflect largely the unwinding of external leads and lags, and the repayment of third country credit to UK merchants. Both factors increased the liquidity of the corporate sector, reducing

...ir need for bank credit, although the slow growth of bank lending also presumably reflected the high level of interest rates. It was generally considered at the time that the SSD scheme (reintroduced the previous November) was not responsible for much of the slow-down, since most banks apparently had no difficulty in meeting the requirements. The reduction in sterling lending overseas directly reflected the repayment of third country trade credit.

32. Thus the resurgence of confidence in sterling seems likely to have had some indirect contractionary effect on £M3 through interest rate expectations and bank lending, although, given the level of domestic interest rates, it is clearly unreasonable to attribute everything to the swing in external confidence.

33. The direct effect of intervention through the counterpart flows to the non-bank private sector is derived below:

| | | 1977(1) |
|---|---|---|
| a. | BOF | +1910 |
| | Of which | |
| b. | Public sector direct overseas borrowing above BOF line (increase +) | +120 |
| c. | O/S holdings of public sector sterling debt (increase +) | |
| | Gilts | +350 |
| | Treasury Bills | +190 |
| | LA debt | - |
| d. | External £ deposits (increase +) | +210 |
| e. | Banks net fc liabilities (increase +) | +260 |
| f. | External and fc finance | +780 |
| g. | External £ lending (increase -) | +80 |
| h. | Public sector transactions increasing the PSBR (increase -) | -850 |
| i. | Net flows to the non-bank private sector | +1710 |

NB f = a-b-c-d-e
i = f-g-h

This table shows that well over half of the intervention was the counterpart to flows to public and banking sectors, not offset within DCE - rather more than the proportion of outflows in 1976. Overseas holdings of public sector debt and bank deposits both increased strongly. Large net inflows to the non-banks (estimated in line i) probably reflected the unwinding of leads and lags, and the repayment to UK merchants of third-country credits.

## C. 1977 Q3 and Q4

### a. EXCHANGE RATE AND INTERVENTION

35. Sterling was under sustained upward pressure for much of the period, in the face of a weakening dollar. At first, the authorities intervened heavily to hold the rate at $1.72, and during July the balance for official financing approached £2bn. Some of the pressure obviously resulted from linking sterling to a falling dollar, so on 27 July, the authorities announced their intention to concentrate more on the effective rate. This soon rose to 61.5, but still heavy demand for sterling continued through August and September. By the end of September the effective rate stood at 62.3 (dollar/sterling rate $1.75) after intervention over the two months totalling about £2.8bn. During October, as the dollar weakened further, the authorities sold a further £3bn worth of sterling, in order to hold the rate. However, they were unwilling to countenance continuing inflows on that scale because of pressure on the money supply, so at the end of the October the effective rate was uncapped. It immediately appreciated to 64.6 and by the end of the year had reached 65.2.

### b. POSSIBLE CAUSES OF PRESSURE

36. As already mentioned, one of the main causes of pressure was the weakness of the dollar. This was associated with concern over the US trade deficit which even the US Treasury were forecasting at around $30bn. Many analysts also saw little improvement in store in 1978.

37. Another factor was the turnaround on the current account, which moved from a deficit of £850m in the first half of 1977 to a surplus of £1000m in the second (seasonally adjusted). In part this was

ibutable to an expected improvement on the oil account, but the non-oil account had also improved and the swing there seems to have been greater than expected. Thus as well as directly increasing the demand for sterling and the current account improvement might have generated an upward revision in expectations.

38. Confidence is likely to have been further strengthened by the rapid reduction in the UK's inflation rate. This fell from about 1½% per month at the end of 1976, to about ½% per month a year later. The reduction was partly attributable to the strength of sterling, but it also reflected a slower rate of labour cost increase.

39. By the autumn, the rate of monetary expansion - boosted by the inflows - was causing concern to the authorities, but it does not seem to have deterred market operators. Presumably they were more impressed by the fact that DCE had been running at less than half the rate agreed with the IMF - largely attributable to massive gilts sales.

40. Interest rate differentials were turning against sterling throughout the period, as the authorities acted to discourage inflows. The following table shows the three-month uncovered differential between sterling interbank and eurodollars (end-months):

| % pa | June | July | Aug | Sept | Oct |
|---|---|---|---|---|---|
| £ interbank | 7.8 | 7.6 | 6.7 | 5.8 | 4.8 |
| Eurodollars | 5.8 | 6.2 | 6.3 | 6.9 | 7.2 |
| Differential | 2.0 | 1.4 | 0.4 | -1.1 | -2.4 |

However, this movement was once again swamped by the strong tide of confidence. The covered differential actually moved in favour of sterling from -1.2% at the end of June to -0.4% at the end of October.

c. POLICY MEASURES

40. The authorities become increasingly concerned about the inflows because they threatened to push the money supply beyond the 9-13% target for 1977/8 (see below). One obvious solution was to uncap but

... was much uncertainty about how far the rate might appreciate. It was considered important not to damage an encouraging export performance, which in 1977 recouped much of the UK's loss of share during 1975 and 1976. The authorities therefore first tried reducing interest rates and reflating.

41. The reduction in interest rates took rates to levels not reached for several years. MLR was cut from 8% to 7% in August, and 6% and 5% in September and October respectively. An MLR of 5% was unprecedented and Bank Rate had not been below 5% since 1964. Reductions on this scale carried a risk of stimulating large increases in bank lending but the authorities preferred to try interest rates before uncapping.

42. Reflationary packages were announced in July and October. The July package was aimed at maintaining the Budget PSBR, given lower interest rates. Its main element was a 1p reduction in the standard rate of income tax to 34p. The October package increased personal tax allowances for 1977/8.

43. However, these measures did not prove sufficient and on 31 October the rate was uncapped. In the event, the subsequent 2 point appreciation was less than many had feared.

d. EFFECTS ON £M3

44. The following table shows the counterparts to £M3 growth, from banking July to banking November.

(All figures are £m; seasonally adjusted.)

| | | July | Aug | Sept | Oct | Nov |
|---|---|---|---|---|---|---|
| a. | CGBR (surplus-) | -586 | -70 | -292 | +450 | +504 |
| b. | Net purchases (-) of CG debt by general public | -583 | -841 | -696 | -767 | -513 |
| c. | Other public sector (surplus-) | +466 | +217 | +528 | -69 | +36 |
| d. | Banks' sterling lending | | | | | |
| | i. to private sector | +195 | +425 | +395 | +439 | +226 |
| | ii. " overseas " | +55 | +107 | -28 | +129 | +42 |
| | DCE | -453 | -162 | -93 | +182 | +355 |
| e. | External and foreign currency finance (increase-) | +877 | +289 | +851 | +383 | +173 |
| f. | Net non-deposit liabilities and residual | -66 | -128 | -28 | +30 | -232 |
| | £M3 | +358 | -1 | +730 | +595 | +296 |
| | £M3% growth at annual rate | +11 | 0 | +24 | +18 | +8 |

It can be seen that the main determinants of low DCE were a low CGBR - albeit partly offset by higher net borrowing by the rest of the public sector - and substantial debt sales to the non-banks. The low CGBR was not connected with the external situation, but large gilts sales were again probably facilitated by external pressure generating favourable interest rate expectations. However, bank lending does not seem to have been particularly depressed by the inflows.

45. As already mentioned, the authorities were concerned over the size of the external adjustment. This is shown in the following table for Q3 and Q4 (line f).

(All figures are £m with balance of payments signs; not seasonally adjusted.)

| | | 1977Q3 | 1977Q4 |
|---|---|---|---|
| a. | BOF | +2619 | +1930 |
| | Of which | | |
| b. | Public sector direct overseas borrowing above BOF line | +50 | +56 |
| c. | O/S holdings of public sector sterling debt (increase+) | | |
| | Gilts | +10 | -290 |
| | Treasury Bills | +280 | +490 |
| | LA debt | +10 | +20 |
| d. | External £ deposits (increase+) | +350 | +730 |
| e. | Banks' net fc liabilities (increase+) | +330 | +110 |
| f. | External and fc finance | +1590 | +830 |
| g. | External £ lending (increase-) | -160 | -150 |
| h. | Public sector overseas transactions increasing PSBR | -680 | -610 |
| i. | Net flows to non-bank private sector | +2430 | +1590 |

NB $f = a-b-c-d-e$

$i = f-g-h$

46. The Q3 figures are probably the more useful since those for Q4 may incorporate some unwinding after uncapping. In Q3, the estimated inflow to the non-bank private sector (line i) amounted to nearly £2½bn - by far the largest quarterly increase over the period examined. It is difficult to believe that this was a continuation of unwinding from 1976, and neither does it seem likely to have resulted from a shortage of domestic credit - the banks had apparently not been constrained by the SSD scheme, which was anyway suspended in August. Apart from the current account surplus, one

[...]sable explanation is that much of the speculation in favour of sterling took place across company accounts, as international companies moved out of the ailing dollar. It is impossible to be any more precise about this because much of the inflow was recorded in the balance of payments accounts merely as a large positive balancing item.

## D. 1978 Q2

### a. EXCHANGE RATE AND INTERVENTION

47. Sterling came under downward pressure during February, on disappointing trade and money supply figures. During March pressure intensified and the authorities allowed the rate to fall from over 65 to 61.7 at the close. Thereafter, they sought to hold the rate at about that level and began to intervene heavily. During April, intervention amounted to over £1bn, with another £½bn in May. The rate was held at about 61½ and the pressure finally eased in June, after increases in interest rates and the reintroduction of the SSD scheme.

### b. POSSIBLE CAUSES OF PRESSURE

48. After the appreciation following uncapping the previous October, some reversal had been widely expected. That the downward pressure was greater than had been anticipated seems mainly attributable to worse than expected outturns on the current balance and monetary growth. The current balance deteriorated in Q1 to a deficit of £300m (sa), compared to surpluses of £500m in the previous two quarters. The reason for this was a large jump in goods imports, and despite various mitigating factors, it seems to have caused a market reassessment of the outlook for 1978.

49. Monetary growth during the first quarter was unexpectedly high, especially during the third month. As a result, the 9-13% target for £M3 growth during 1977/8 was missed by about 3%. This in itself might not have caused concern since it was largely attributable to the large inflows during 1977. However, DCE was £3bn in 1978(1), about twice as much as the previous three quarters combined. All elements of DCE contributed to the acceleration, although the CGBR was unexpectedly high for special reasons which would not continue.

's sales had fallen on expectations of further increases in interest rates.

50. Other factors which may have affected confidence in sterling were the strengthening of the dollar from mid-April (although this hardly explains the onset of pressure), the relatively low level of UK interest rates (although it is generally expected that changes in rates are more influential than levels), and the PSBR outlook for 1978/9. The April Budget was intended to relax the government's fiscal stance, mainly by reducing personal taxation. It was estimated that the PSBR for 1978/9 would be increased by about £3bn to £8.5bn. This increase, coupled with the decline in gilts sales, seems to have caused apprehension about future monetary growth, underlined by the disappointing performance in 1977/8. The Budget was shortly followed by intensified pressure.

c. POLICY MEASURES

51. Again, the authorities' initial response was to change interest rates. MLR was increased from 6½ to 7% in the Budget, and to 9% in May. It soon became clear that this was insufficient. The pressure continued - albeit less strongly - and at the same time DCE seemed to be accelerating. Gilts sales remained difficult on expectations of further increases in rates, and bank lending to the private sector increased by about £750m (sa) during banking May. A new package of measures was therefore announced at the beginning of June. These included a further rise in MLR to 10%, a tightening of fiscal policy (through increased National Insurance contributions), and the reintroduction of the SSD scheme.

d. EFFECT ON £M3

52. The following table shows the counterparts of £M3 growth from banking March to banking June.

(All figures are £m; seasonally adjusted.)

| | | March | April | May | June |
|---|---|---|---|---|---|
| a. | CGBR (surplus-) | +341 | +968 | +1073 | +489 |
| b. | Net purchases (-) of CG debt by general public | -646 | -238 | -517 | -1192 |
| c. | Other public sector (surplus-) | +125 | +314 | -222 | +338 |
| d. | Banks' sterling lending | | | | |
| | i. to private sector | +560 | +259 | +743 | +530 |
| | ii. " overseas " | +205 | +125 | +39 | +140 |
| | DCE | +585 | +1428 | +1116 | +305 |
| e. | External and foreign currency finance (increase-) | +7 | -454 | -607 | -66 |
| f. | Net non-deposit liabilities and residual | -309 | +163 | -101 | -90 |
| | £M3 | +283 | +1137 | +408 | +149 |
| | £M3% growth at annual rate | +7 | +34 | +11 | +4 |

53. The table shows that substantial negative external adjustments in April and May were more than offset by high DCE. In large part the DCE outturns were attributable to unexpectedly high CGBR outturns, but gilts sales were sluggish - especially in April - and bank lending was showing a strong underlying upward trend. (The bank lending figure for April was thought to have been artificially depressed by a large repayment by British Leyland.) It does not seem that the growth of bank lending was greatly increased by the external position, as in 1976. The low level of domestic interest rates at the start of the year, and the rapid growth of expenditure are both domestic reasons for expecting an increased demand for bank loans. However, the external pressure presumably contributed to expectations of a rise in interest rates, depressing gilts sales.

. The following table shows the counterparts to intervention during Q2 with a residual estimate of flows to the non-bank private sector (line i).

(All figures are £m with balance of payments signs; not seasonally adjusted.)

| | | | 1978 Q2 |
|---|---|---|---|
| a. | BOF | | -1490 |
| | Of which | | |
| b. | Public sector direct overseas borrowing above BOF line | | +30 |
| c. | O/S holdings of public sector sterling debt (increase+) | | |
| | | Gilts | +30 |
| | | Treasury Bills | -50 |
| | | LA debt | - |
| d. | External £ deposits (increase+) | | -390 |
| e. | Banks' net fc liabilities (increase+) | | -680 |
| f. | External and fc finance | | -440 |
| g. | External £ lending (increase-) | | -290 |
| h. | Public sector overseas transactions increasing PSBR (increase-) | | -840 |
| i. | Net flows to non-bank private sector | | +690 |

NB f = a-b-c-d-e
i = f-g-h

It can be seen that there were large outflows from the banking sector during the quarter with the banks switching almost £700m out of sterling. This was, presumably, partly in response to the widening covered differential against sterling. Net overseas holdings of public sector debt were roughly flat.

55. Since so much of the intervention was the counterpart to outflows from the banks, net flows to the non-bank private sector are

estimated to have remained substantially positive. However, the inflow of about £700m was only half of that in Q1 and about £200m less than that in Q3.