MONETARY BASE CONTROL

PART 4

24 October 1986

Monetary Prospects
Including tables 1-4

15/22

B1.

FROM: J W GRICE
DATE: 24 OCTOBER 1986

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Mr George - (Bank)

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Thanks

MONETARY PROSPECTS

This note presents an interim assessment of monetary conditions following last week's base rate rise. It is written with the benefit of the first calendar month data (for September) and the special Treasury/Bank forecast made when that data became available.

<u>Summary Assessment</u>

2. Since the last monetary prospects report of 17 September, several factors have suggested an overall loosening of monetary conditions. The twelve month growth rate in **M0** has accelerated from about 4 per cent, the middle of its target range, to around 4¾ per cent. It could rise a little further before falling back around the turn of the year under the influence of the recent interest rate rises. **£M3** growth remains well above its target range and the calendar September figures suggest some acceleration as compared to earlier banking

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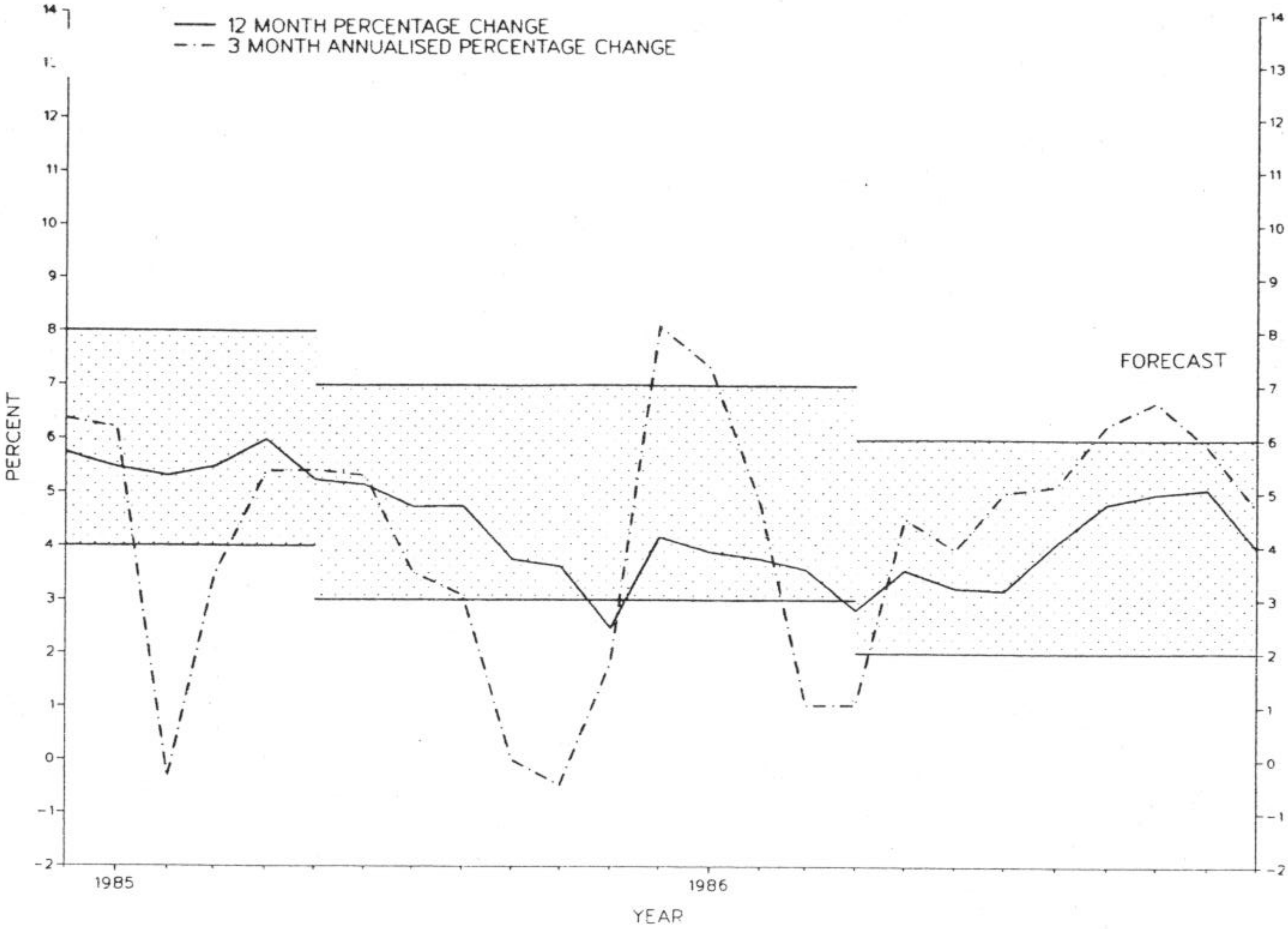
CHART I



STERLING M3 GROWTH (UA) IN 1984–86

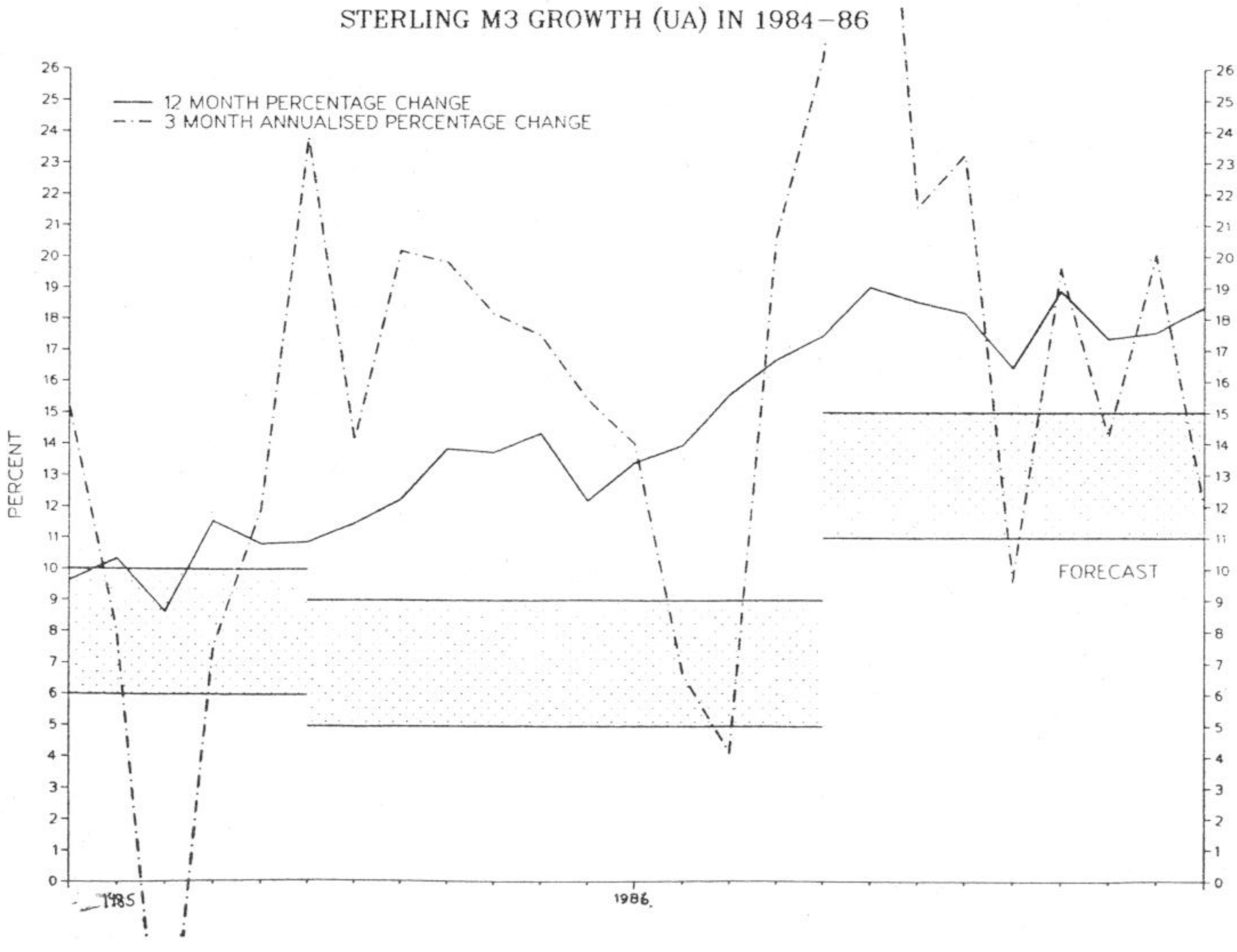


Table 1: Monetary Aggregates: recent experience and forecast

per cent, u.a.

	$M0^+$	£M3	PSL2*
Monthly change to:			
calendar Sept	0.6	3.1	
calendar Oct)	0.2	- 0.1	
calendar Nov)forecast	0.6	1.6	
calendar Dec)	0.3	1.3	
growth at an annual rate			
3 months to:			
calendar Sept	6.3	19.6	12.1
calendar Oct)	6.7	14.2	
calendar Nov)forecast	5.9	20.0	
calendar Dec)	4.7	11.9	10.4
12 months to:			
calendar Sept	4.8	18.9	14.8
calendar Oct)	5.0	17.4	
calendar Nov)forecast	5.1	17.6	
calendar Dec)	4.0	18.4	14.4

* formerly PSL2A; end September is a forecast, calendar monthly data not available.

\+ seasonally adjusted. (Figures for £M3 and PSL2 are not seasonally adjusted.)

month data. At best only a minor deceleration of the twelve month growth rate seems in immediate prospect. The **exchange rate** has been steadier over the last week. But the effective rate index remains nearly 3 points below its level at the time of the last report and about 8½ points beneath the level prevailing six months ago; and the fall is greater than that if adjusted for the firmer oil price. Against this, the higher level of **interest rates** will now be acting to tighten the monetary stance. Three month interbank rates are about 1½ per cent higher than a month ago and the real three month rate has risen to 8 per cent - back to the levels prevailing at Budget time. Recent monetary developments are summarised in table 2.

3. On balance, it seems clear that some rise in interest rates was required in order to keep monetary conditions on track. It is too early to know whether the rise in rates has been of the right size to do what was required. Clearly, the picture will be affected by any further movement in the exchange rate.

Monetary Aggregates

4. **M0** grew at an annualised rate of 6¼ per cent in the third quarter. With personal incomes rising strongly and because the restraining effects of higher interest rates will take time to emerge, the annualised growth rate in the fourth quarter could still be as much as 4¾ per cent. The effect would be to reduce the twelve month growth rate from about 4¾ per cent currently to around 4 per cent by the end of the year, though this latter figure is distorted downwards by an exceptional rise in M0 in December 1985. Before December, however, because the interest rate effects on M0 will take time to come through, the twelve month rate is unlikely to fall. Indeed in both October and November the twelve month growth rate could rise to 5 per cent or a little over.

5. **£M3** growth in the third quarter was close to what was expected when the last monetary prospects report was circulated. The twelve month growth rate was just below 19 per cent.

6. Growth in the fourth quarter is projected at rather lower rates than in the third. Average monthly growth might be of the order

of £1 billion against over £2 billion in the quarter just ended. Bank lending growth is projected to continue at its average pace of recent months - £2 billion or a little more. But the public sector contribution should be substantially negative so long as we can make progress on funding. Not only is the PSBR likely to be small in the fourth quarter, partly because of the receipts from the sale of British Gas, but, in addition, temporary overfunding is assumed as progress is made in reversing the underfund in September. Moreover, external influences are likely to be downwards reflecting the intervention which has already occurred. Increased non-deposit liabilities are also expected to depress £M3 growth as banks continue to raise capital. But notwithstanding the lower annualised growth, the twelve month growth rate by December is put only about ½ per cent below the present figure - at about 18½ per cent. Growth in the last quarter of 1985 was also relatively sluggish. Against this, the twelve month growth rate in calendar October and November might be as low as 17½ per cent. In October in particular, it will be temporarily depressed by the unwinding of deposits built up in advance of the TSB flotation and by the effects of the intervention. These projections all assume that any distortion to the figures caused by BGC will, for practical purposes, be out of the system by 31 December.

7. **PSL2** is thought to have been about 14¾ per cent higher in September than a year before. (Final data is not yet available). Building societies are continuing to have difficulty in attracting retail funds and their problems will not be eased by the delay in their response to the recent rise in interest rates. PSL2 is therefore projected to grow by less than £M3 through at least to the end of the calendar year. By December, the unadjusted twelve month growth rate might be about 14¼ per cent - about ½ per cent lower than at present and wholly attributable to the reduction in £M3's growth rate.

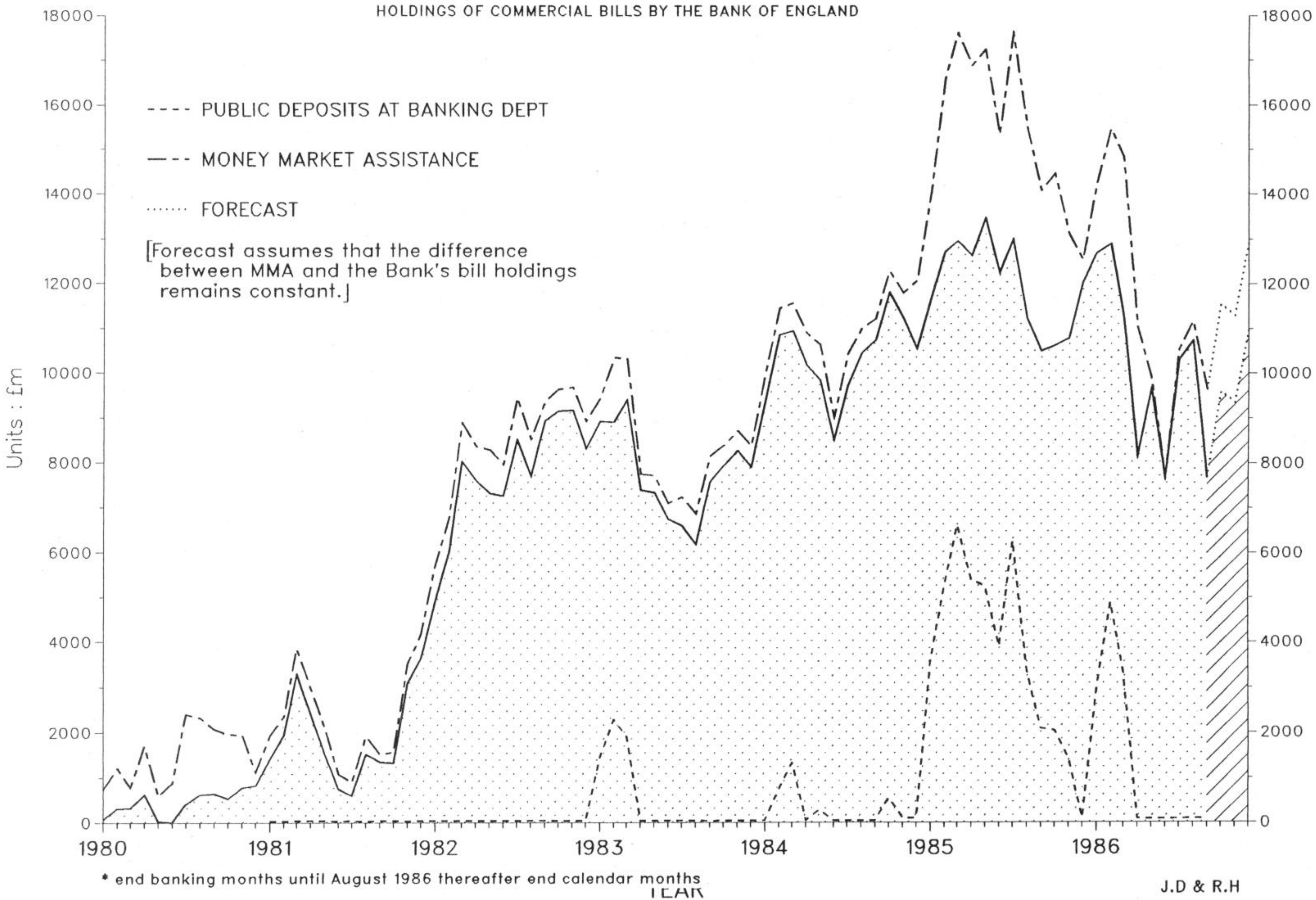
Other Aspects of the Assessment

8. Other points of interest are:

(i) **competitiveness**: the projections were based on the assumption that building societies would react to the recent

CHART II

BILL MOUNTAIN RANGE

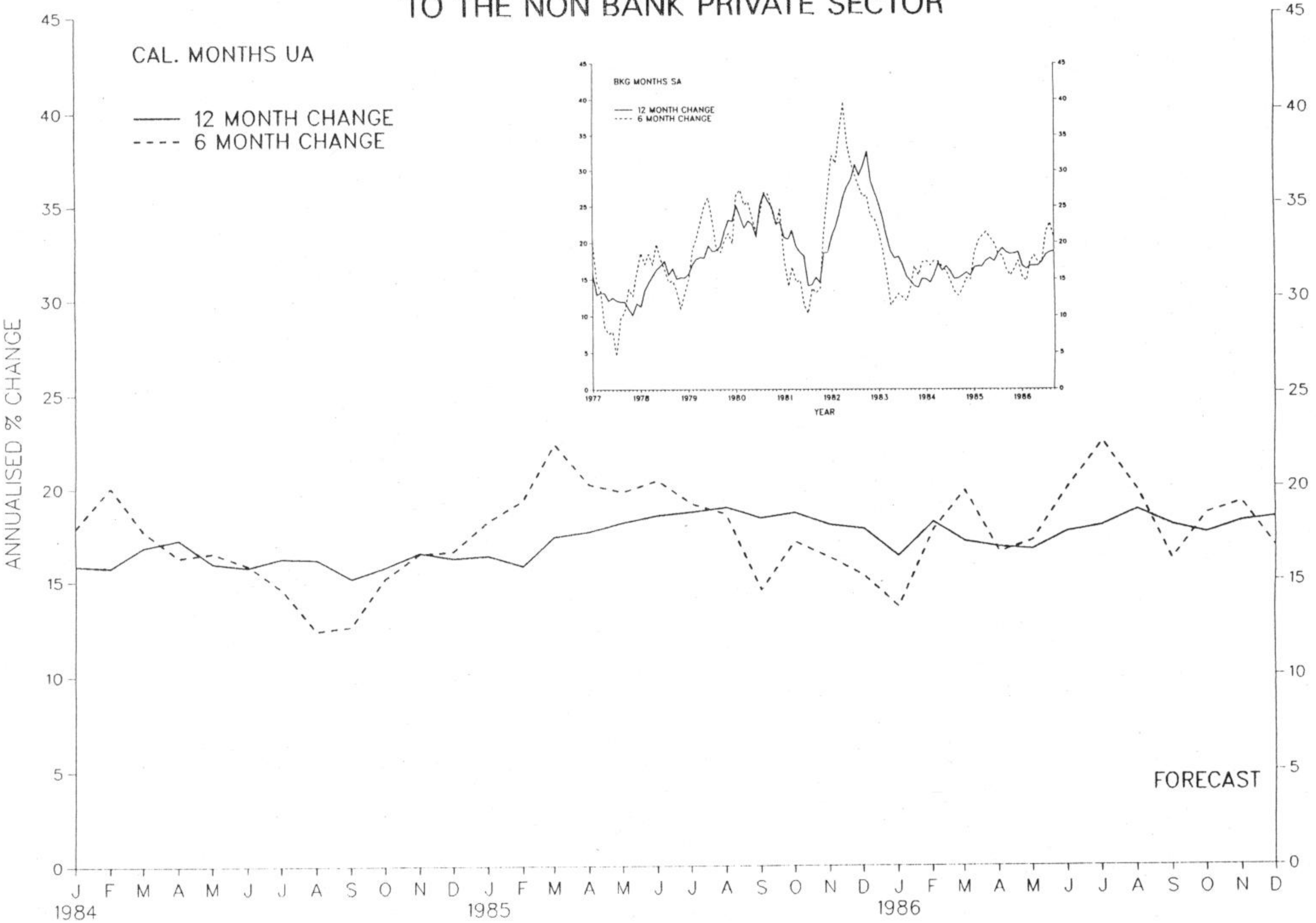


* end banking months until August 1986 thereafter end calendar months

J.D & R.H

CHART III

GROWTH OF THE STOCK OF BANK LENDING TO THE NON BANK PRIVATE SECTOR



interest rate rises to keep their competitive position unchanged. Societies have begun to announce higher ordinary account deposit rates but have not yet moved on premium account rates which are increasingly important as the determinant of marginal retail flows. We have also assumed that National Savings rates will be adjusted upwards to leave the competitive position unchanged overall;

(ii) **gilts prices** fell sharply in September. 20 year yields were over one per cent higher than a month previously. Since then, however, prices have stabilised and substantial progress has been made on the funding programme. The projections assume that the better sentiment continues, allowing funding well in excess of the small PSBR expected in the fourth quarter, and that there is no hold up in the pace of gilt sales because of BGC;

(iii) it remains difficult to explain the unexpectedly low **bank lending** increase in September and we have taken the view that it was largely an erratically low outturn after a series of erratically high ones. Bank lending growth in the third quarter averaged £2¼ billion a month. **Net advances by building societies** increased by an average £1¾ billion a month. By September, total bank and building society lending is estimated to have been 19 per cent higher than twelve months previously. Our projections assume that the recent interest rate and mortgage rate rises will reduce the demand for credit only marginally and that the average monthly increases to the end of the year will be at similar rates to those in the third quarter. By December, the twelve month growth rate would then be around 19½ per cent;

(iv) despite the continued buoyancy of mortgage lending there does seem to be some indication of an easing off in the rate of increase of **house prices.** The twelve month growth rate in the latest Halifax index has fallen back by nearly one per cent to 12¾ per cent;

(v) the position of the **building societies** looks increasingly uncomfortable; their margins are under pressure from intense competition in both the retail deposit markets and in the mortgage market. Weekly figures for September suggest that they suffered their first retail net outflow for twelve years. The outflow, over £1 billion, is itself entirely attributable to the impact of the TSB flotation (and in fact the funds "withdrawn" will have remained with the societies until the cheques were cashed). Without it, there might have been a recorded inflow of about £½ billion. In the fourth quarter, the underlying inflow is expected to be at about this monthly level and the societies will also benefit from the return of the TSB money. Even so, the net retail inflow will fall well short of what societies want to lend and they will again have to resort to heavy wholesale funding. There are, however, limits to the amounts that can be raised in this way and, abstracting from TSB effects, the liquidity ratio is expected to fall further over the fourth quarter from a position already the lowest for twelve years;

(vi) the rise in short interest rates coupled with the steadiness of longer-dated gilts prices since the end of September have led to the re-establishment of a downward sloping **yield curve.** This contrasts with the virtually flat yield curve prevailing at the time of the last monetary prospects report. **Real short rates of interest** are now back to about 8 per cent, only fractionally below the peak levels seen before the Budget this year;

(vii) faster M0 growth in recent months does not seem to date to have been accompanied by accelerating growth in **money GDP.** Whilst retail sales and consumers' expenditure have been strong - of which the rise in M0 growth may be a symptom - other components of demand, notably net trade, have been weak. On balance, the latest internal forecast suggests that money GDP in the third quarter was below the path expected at Budget time and that for 1986-87 as a whole, money GDP might grow by about 5½ per cent, a full per cent less than expected at Budget time;

(viii) more disturbing is the absence of any sign of a significant slackening in **average earnings growth,** which continues well in excess of inflation. Of itself, this will increase the difficulty of keeping future money GDP on course. The weakness in the nominal exchange rate has not surprisingly been accompanied by a fall in sterling's **real exchange rate.** It is now about 7 per cent lower than its average level in 1986 up to the end of August, though it remains well above the level at the end of 1984 and early 1985 when sterling was also weak.

Conclusion

9. The assessment confirms that the one per cent rise in interest rates was needed to keep financial conditions on track. It also suggests that we will now need to watch developments carefully, particularly the exchange rate and M0 (though we expect M0 to take some time to react to the higher interest rates).

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TABLE 2

MONETARY DEVELOPMENTS SINCE LAST MONTH'S REPORT

	Latest outturns available at time of:			
	April 1986 (bnking April)	September report (bnking Aug)	October (bnking Sept)	October (cal Sept)
Monetary aggregates (12 months % growth, **unadjusted**)				
M0	3.2	4.1	4.5	4.8
£M3	16.7	17,3	17.1	18.9
PSL2	13.5	14.3	14.5	n/a
Bank lending	16.8	18.6	18.8	18.4
Bank + building society lending (est)	17.4	18.8	19.3	19.1
Interest rates (%)	10 April	17 Sept	23 October	
3 month interbank	10.4	10.0	11.4	
20 year gilt-edged	8.7	10.1	10.6	
Yield gap	1.7	- 0.1	0.8	
3 month overseas basket	7.2	6.2	6.2	
3 month interbank/euro dollar differential	3.6	4.0	5.4	
Real 3 month interbank	6.6	6.7	8.0	
Equity dividend yield (all-share)	3.7	4.1	4.2	
IG yields (1996)+	4.0	3.9	4.2	
Exchange Rate				
ERI	75.9	70.3	67.5	
Oil adjusted reference index*	69.8	69.5	69.9	
ERI/reference rate ratio	108.9	101.2	96.6	
Asset prices				
FT-30 Index (% pa)	44.7	27.1	20.9	
FT-30 Level (April peak : 1426)	1402	1275	1250	
Halifax house index (% pa) **	9.7	13.6	12.8	

+ assuming inflation averages 5 per cent to redemption.

* indicates what ERI would be if exchange rate simply responded to oil prices in the ratio 1:4. In determining the reference rate the base taken is the Jan '83 - Nov '85 average for the ERI and oil price.

** monthly figures for the preceding month.

TABLE 3 :£M3 COUNTERPARTS

£m seasonally unadjusted

	SEPT FORECAST	SEPT OUTTURN	FORECAST OCT	FORECAST NOV	FORECAST DEC
1. **CGBR**					
Own-account		2426	84	926	-484
on-lending to LA's		200	150	150	150
on-lending to PC's		-100	-60	-106	176
TOTAL		2526	174	970	-158
2. **OTHER PUBLIC SECTOR**					
LABR		-306	-215	-540	230
PCBR		-37	270	141	-121
TOTAL OPS		-343	55	-399	109
3. **NET PURCHASES OF CG DEBT BY NBPS**					
Gilts		311	-1365	-50	-400
Treasury Bills		-	-	0	-
National Savings		) 63	-246	-181	-167
CTD's etc		)	200	-100	-50
Other (LA debt)		45	100	580	-
TOTAL		419	-1311	250	-617
4. **OVERSEAS FINANCE OF THE PUBLIC SECTOR**		107	-630	-30	-130
5. **£ LENDING TO PRIVATE SECTOR**		1894	1800	2075	2825
6. **NET PRIVATE EXTERNALS***		) -158	90	-290	370
7. **NET NON-DEPOSIT* LIABILITIES**		)	-275	-275	-410
CHANGE IN £M3 £m		4445	-95	2300	1990
(% change on previous year)		(18.9)	(17.4)	(17.6)	(18.4)
PSBR		2183	230	570	-50
WIDE OVER (-) /UNDERFUNDING (+)		2707	-1710	790	-797

* Excluding foreign currency nndl's net

TABLE 4: PERCENTAGE GROWTH RATES IN SELECTED MONETARY AGGREGATES

		Weekly averaged MO (sa)	M2 (ua)	£M3)ua)	PSL2 (ua)	Real MO	Real £M3	RPI less Mortgage Element
(a)	Financial years (12 month changes to April) (%)							
	1981-82ƒ	2.9*		12.2	10.9	-6.6	2.8	9.1
	1982-83ƒ	6.3	9.3	10.9	11.4	1.2	5.7	4.9
	1983-84	4.6	11.3	8.2	11.4	-0.3	3.1	4.9
	1984-85	6.0	8.4	10.8	13.0	0.7	5.2	5.3
	1985-86	2.8	11.6	17.4	13.6	-0.6	13.5	3.4
(b)	Changes in 12 months to (%)							
1985	September	3.8	8.9	13.7	12.9	-1.7	7.7	5.6
	October	3.6	9.4	14.3	12.5	-1.5	8.7	5.2
	November	2.5	9.3	12.2	11.6	-2.6	6.7	5.2
	December	4.2	9.1	13.4	12.4	-0.9	7.9	5.1
1986	January	3.9	10.3	13.9	12.0	-1.0	8.6	4.9
	February	3.8	10.3	15.5	13.6	-1.0	10.2	4.8
	March	3.6	10.5	16.7	13.5	-0.4	12.2	4.0
	April	2.8	11.6	17.4	13.5	-0.6	13.5	3.4
	May	3.5	12.1	19.0	14.4	0.3	15.3	3.2
	June	3.2	14.0	18.5	14.7	-	14.7	3.3
	July	3.2	15.0	18.2		-0.4	14.1	3.6
	August	4.1	13.2	16.4		0·4	12.3	3.6
	September	4.8	13.9	18.9		2.0	15.8	2.7
(c)	Changes (at an annual rate) in 6 months to (%)							
1986	March	4.5	12.9	17.3	15.0	1.0	13.3	3.5
	April	4.1	13.3	16.1	14.7	0.6	12.2	3.5
	May	4.7	11.0	20.5	17.0	1.6	16.9	3.1
	June	2.5	14.4	21.1	17.5	-1.1	16.9	3.6
	July	3.0	17.1	24.8		-0.3	20.8	3.3
	August	4.8	14.1	23.6		1.2	19.3	3.6
	September	5.1	14.9	20.6		2.8	18.0	2.2
(d)	Changes (at an annual rate) in 3 months to (%)							
1986	January	7.3	13.2	6.7	11.8			
	February	4.8	7.5	4.1	11.7			
	March	1.0	10.4	20.6	17.8			
	April	1.0	13.5	26.4	17.7			
	May	4.5	14.6	39.4	22.6			
	June	3.9	18.7	21.6	17.2			
	July	5.0	20.8	23.3				
	August	5.1	13.6	9.7				
	September	6.3	11.3	19.6				
(e)	Changes in month to (%) (£m figures in brackets)							
1986	March	0.5 (70)	1.6 (2362)	4.4 (5661)	2.5 (6119)			
	April	-0.3 (-41)	0.9 (1344)	0.7 (993)	0.6 (1608)			
	May	0.9 (131)	1.0 (1470)	3.3 (4430)	2.0 (5003)			
	June	0.3 (50)	2.5 (3808)	0.9 (1271)	1.4 (3519)			
	July	-0.1 (-4)	1.3 (2115)	1.1 (1533)				
	August	0.9 (137)	-0.6 (-918)	0.3 (448)				
	September	0.6 (91)	1.9 (3113)	3.1 (4445)				

* The growth rate of MO over the twelve months to banking April 1982 is adjusted to remove the distortion caused by the changed definition of bankers' balances within MO.

ƒ Banking month financial years except MO in 1982-83.