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SECRET

PRIME MINISTER

You are meeting (1½ hours) with the Chancellor and Governor on Tuesday afternoon, preceded by ¾ hour with Alan Walters in the morning.

The papers are:-

(i) Overfunding

(ii) Money market operations and interest rates (to come on Monday)

(iii) Background note on bank lending.

The priority for the meeting is to secure a decision on funding policy which is needed for immediate operational needs. The Bank are nervous about the faster growth of £M3 which may result; Treasury feel now is a good time to change policy. £M3 is not giving a good indication of monetary conditions which are better represented by the strength of the exchange rate. Any acceleration in £M3 is likely to be temporary, as has been the benefit of using overfunding in the first place.

The meeting can then debate the issue of penalty lending in the money markets, on which papers will be put to you on Monday. The bank lending rate does not need to be discussed separately.

AT

AT

12 July, 1985.

SECRET

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cc AW 1

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

12 July 1985

Andrew Turnbull Esq
10 Downing Street
London SW1

Dear Andrew

MONETARY POLICY

I attach a joint Treasury/Bank paper on ending overfunding, and a background note on bank lending (also a joint production), as commissioned in your letter to me on 25 June.

I am copying this letter to John Bartlett (Private Secretary to the Governor).

Yours ever
Rachel

RACHEL LOMAX

Paper III — cc AW

BANK LENDING

A Recent Developments

Bank lending to the private sector has grown at an average rate of about 20.5% per annum since 1979/80, see Table 1. Despite some partial offsets*, there is little doubt that bank lending has provided the main thrust to the growth of £M3, see Graph 1. In order to hold £M3 to a much lower average rate of growth, at about 12 1/2% - though that was still on average well in excess of the annual targets - the authorities have resorted to heavy funding.

As shown in Table 1, the fastest area of growth, at least until 1982/83, has been lending to the personal sector, which has grown by 28% pa. Of this, the fastest growing element has been bank lending for house mortgage: the banks entered this market aggressively in 1981/82, and such lending represented a major element in the surge in lending to the personal sector in 1981/82 and 1982/83, before tailing off somewhat thereafter. The current state of competition, eg on relative interest rates, between banks and building societies is, however, such that there could well be room for the banks to regain a larger share of mortgage lending, thus raising £M3 relative to PSL2.

Meanwhile, lending to Other Financial Institutions has continued to grow fast but much of it has represented lending channelled to the company sector, notably via leasing companies, whose bank borrowing has expanded by 31% pa, as the fiscal framework made such indirect routing of funds tax efficient. Thus the fact that lending to ICCs has grown considerably less fast, (with the exception of this last year, 1984/85) should not be taken at face value.**

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*Some bank lending provides funds to finance private sector purchases of gilts or of foreign assets, so it does not necessarily feed through one-for-one on to higher bank deposits. A larger proportion of the funds generated by gross bank lending allows other bank borrowers to repay existing overdrafts: the data, however, only show the net increase in bank lending, after netting out such induced repayments.

**Table 1 includes leasing with ICCs, rather than, as in the published statistics, with OFIs.

In several respects the most surprising feature of recent history is that it took the banks so long to enter into the house mortgage market. The conditions in this market, with a massive unsatisfied demand, encouraged by fiscal advantages, and low default risk, with rising house prices and mortgage interest payments guaranteed at times of financial stress on the borrower by the tax-payer via supplementary benefits, meant that such lending was highly profitable and involved low risks. By entering this market, the banks raised both the average quality and quantity of their loans. Probably the reasons why banks had not been more aggressive in catering for personal loans before then, (not only for mortgages, but also consumer credit), was the combination of ceiling-type constraints on lending (the "corset") together with a failure to appreciate how far their retail deposit base was being eroded by their absence from the personal loans market.

Leaving aside their lending to overseas sovereign and other borrowers - which is mostly in currency and has no material effect on domestic monetary conditions - the riskiest segment of banks' £ loan book in recent years has been their loans to manufacturing and to small businesses of all kinds. Manufacturing companies were under particular pressures in the early 1980s, and the banks have had large numbers of such companies in their 'intensive care units'. Small, newly-founded businesses are always particularly at risk, as the Government has recognised by introducing the Loan Guarantee Scheme.

In the context of the early 1980s, market pressures led to considerable distress borrowing, as companies had to finance their deficits, and also sought to build up their liquidity as a precaution against continuing difficult conditions. It is much less easy to understand the causes of the continuing strong demand by companies, either directly or via OFIs, for such external funds. In the last couple of years profitability and liquidity appear to have been very comfortable and in the most recent quarters, companies have obtained additional large volumes of external finance from equity issues on the capital market. Nevertheless company bank borrowing has surged again. Analysis of the reasons for this is made virtually impossible by the parlous state of the company sector statistics, which, in 1984, showed an unidentified net outflow of funds of some £10 bn - greater than the size of total company sector bank borrowing in the same period. In particular it may be that the pace of investment abroad by the corporate sector is very much larger than is recorded in the statistics.

As described earlier, until 1980 with the abolition of the corset following exchange controls in 1979, banks were generally prevented by direct ceiling controls, or the fear of them, from using their full efficiency to compete for business. The most obvious effect of giving banks freedom to compete was their entry into the mortgage market. More generally, however, such competition, for example by reducing the spread between deposit rates and lending rates, will have increased the volume of financial flows passing through the banking system, both by substitution from other channels, eg from trade credit, and by raising the total volume of such flows. It is impossible, however, to quantify such effects, or the theory that bank intermediation has been increased by a widening disparity between cash-rich and cash-deficient companies.

What can be said is that the rise in sterling bank lending to domestic borrowers in recent years has not correspondingly increased the prudential risks faced by banks. Their support of manufacturing companies in difficulty and of small businesses undoubtedly raised the loss provisions which were necessary in the early 1980s. But, with the recent upsurge in corporate profitability the worst of this problem appears to have passed; while the diversification of their business represented by the banks' increased penetration of the personal credit market has brought a large volume of assets onto their books which have normally carried a low risk of loss.

B Means of Control

Insofar as bank lending was restrained before 1980 by direct ceiling-type controls, is there a case for reverting to them? In the absence of exchange control, there would be a risk that their effect would be almost entirely cosmetic - except on small borrowers - since the financial flows would simply move offshore: nor would £M3 necessarily be much benefited, since the deposits would be on-lent to offshore subsidiaries which would lend back to UK companies. It would mainly serve to lessen the efficiency and profitability of the UK banking system to the advantage of the foreigner, and the illusory nature of the control would be obvious. Other measures, which had

the effect of artifically raising the cost of bank intermediation, such as imposing mandatory cash ratios, or capital adequacy ratios in excess of perceived prudential needs, would similarly have their effect through reducing the efficiency and profitability of British banking, and would also lead to a shift of business offshore.

Avoidance of credit restraint by moving offshore would hardly be feasible for small borrowers, because of the transaction costs, and could be further prevented by making any such offshore borrowing deals unenforceable in UK courts. But it is increasingly possible for personal borrowers to obtain funds from mortgage borrowing for uses other than on house investment. Unless mortgage lending were included within the ambit of any consumer credit control, it would be widely avoided and give rise to distortions and inequities.

One, generally unattractive, way of reducing the scale of bank intermediation is thus artificially to make banks less efficient: an alternative approach is to remove barriers to efficient use of other non-bank channels of finance. A further step along this latter route involves removing the barriers to the establishment of a commercial paper market; this is being actively pursued.

Banks are increasingly lending money on a variable rate basis, and also to some extent matching the maturing of their liabilities to that of their loans, through their operations in the wholesale money markets. Consequently, they are taking steps to protect themselves from interest rate risk. Such risk is mainly passed on to customers. Nor is it possible to penalise an individual bank, or institution, for 'excessive' lending by charging it a 'penalty' rate: any attempt to do so would cause the bank upon whom the penalty was to fall to revert to the inter-bank market, until rates in the wholesale market for all-comers were driven into equality with the penalty rate. Under these circumstances the prospect of cash shortages only being relieved at penalty rates, and of greater variability of short-term rates, would not be likely to provide a significant direct constraint, or discipline, on individual banks: ie it would not make them less willing to lend money to willing borrowers at the going rate.

There might, however, be an exception in the case of overdrafts, since greater variability in the cost of overnight money might enable such borrowers, when overnight rates were raised by penalty charges, to round-trip at a profit against the banks: to prevent this, banks might have to refuse overdraft facilities to customers in a position to take advantage of round-tripping opportunities. Indeed anyone from whom funds would be withdrawn at call, eg the discount market, would be put at greater risk from more volatile short-term interest rates, and would have to respond by some combination of providing fewer, or no, such facilities and/or a widened spread on such business.

A move towards greater variability of short-term rates could, therefore, lead banks to seek to shift loans increasingly from overdrafts and fixed interest forms to a variable rate term basis, which would protect them from interest rate risk. With bank lending increasingly in this latter format already, there would then be little further direct, supply-side, effect on banks.

Instead any impact of greater variability in, and of any higher level of, interest rates would impact on the bank customer. If bank borrowers did come to reckon that this form of borrowing had become riskier, there might be a (transitional) fall in demand for bank borrowing vis a vis other sources of funds. Once borrowers had adapted to the riskier nature of bank borrowing, their demand would then again come to depend on the expected cost over the lifetime of the borrowing. So, there might be a transitional effect on the demand for borrowing by making interest rates more volatile and uncertain, but the longer term rate of growth of demand would still depend on the (expected) level of interest rates.

Conclusion

There are three main conclusions to draw from the above. First, we judge that influence over bank lending is best achieved through the operation of interest rates upon the demand for bank credit. Second, there may be something in the arguments for greater short-term

variability of interest rates; but, if the approach were carried very far it would generate uncertainty throughout the economy over the cost of money without providing clear offsetting benefits. Finally, it is worth exploring, as a matter of urgency, the development of a commercial paper market which non-banks could use (thereby reducing their dependence on the banking system); this is in hand.

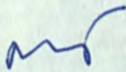

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TABLE 1

Not seasonally adjusted

£ bn (% in brackets)

	1979/80	1980/81	1981/82	1982/83	1983/84	1984/85	Average % over 1979/80-1984/85
Increase in bank lending to private sector*	9.3 (23.9)	9.2 (19.1)	14.9 (26.0)	14.4 (18.8)	15.4 (16.9)	18.8 (17.6)	20.4%
o/w ICCs (incl leasing**)	4.0 (17.6)	3.8 (14.2)	6.9 (22.5)	3.4 (8.9)	4.1 (9.9)	8.7 (19.1)	15.4%
OFIs	2.0 (38.7)	1.6 (22.8)	0.6 (6.7)	1.4 (14.9)	3.3 (30.5)	2.8 (19.8)	22.1%
Personal	3.3 (29.8)	3.8 (26.2)	7.4 (41.1)	9.5 (34.3)	8.0 (21.3)	7.3 (16.0)	28.1%
of which for house mortgage	0.6 (32.4)	0.7 (29.9)	3.1 (98.7)	4.8 (71.8)	3.8 (28.2)	2.5 (16.1)	46.2%
£M3	6.5 (12.7)	10.3 (17.7)	9.8 (14.3)	9.8 (11.3)	7.6 (7.8)	12.0 (11.5)	12.5%
% target≠	[7-11]	[7-11]	[6-10]	[8-12]	[7-11]	[6-10]	

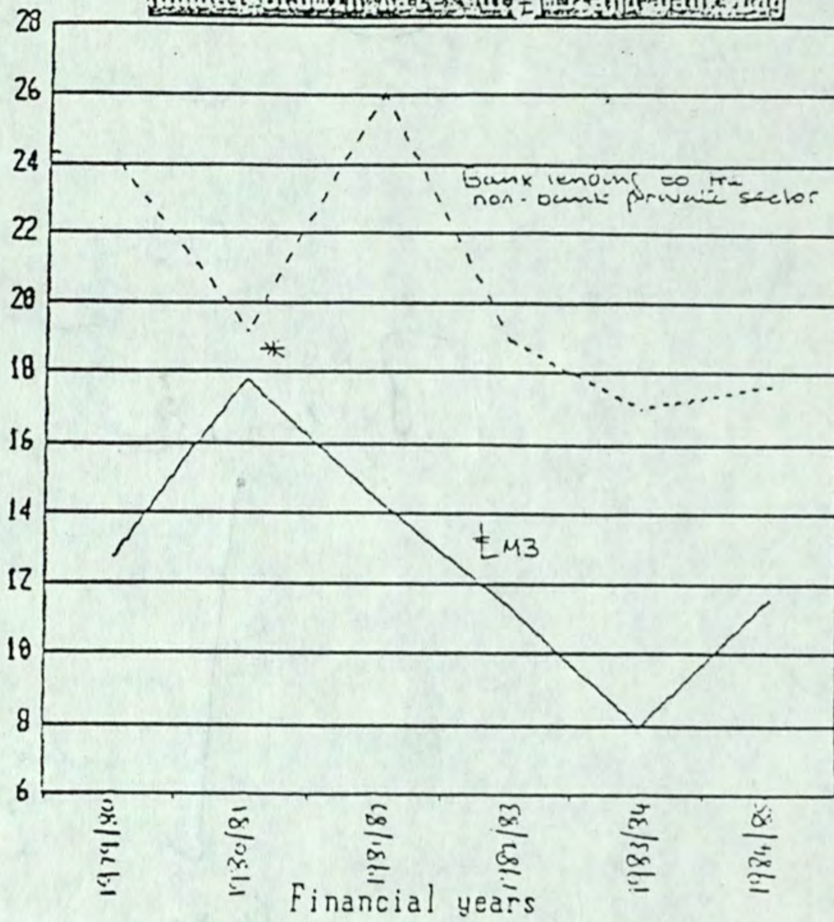
* including changes in Issue Department's holdings of commercial bills.

** these figures should be treated with caution. In particular leasing figures were not separately available until 1981/2 and - when they did become available - were recorded with OFI lending, not with ICCs. The figures in this line have therefore been constructed from a number of not wholly consistent sources.

≠ Targets are for 14 month target periods (Feb to April) except for 1979/80 where the period was June 1979 to October 1980.

GRAPH 1

Annual Growth Rates of £M3 and Bank Ldg



NOTES:

Data not seasonally adjusted.

Including changes in Issue Dept. holdings of commercial bills.

* Distorted by the Civil Service strike which had the effects of increasing the PSBR, and providing companies with additional liquidity which allowed them to reduce bank borrowing.

[illegible] [illegible]

[illegible]
£900 000

[illegible] £1m

[illegible]

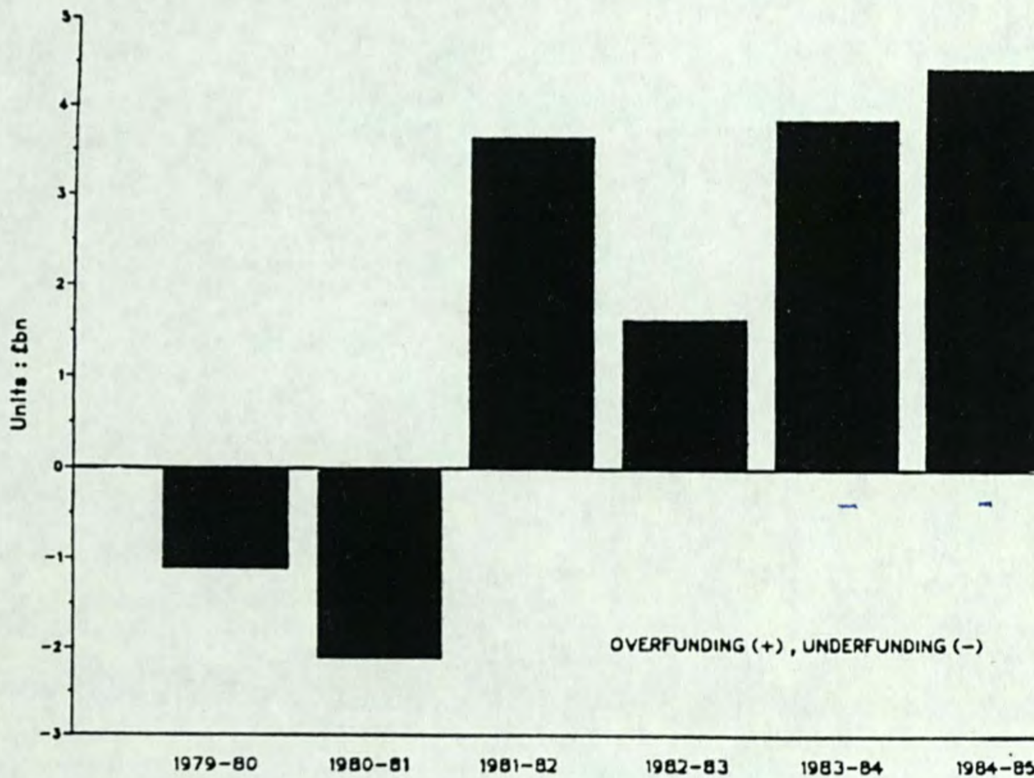
Paper I cc AW

ENDING OVERFUNDING

The following chart shows the extent of overfunding in recent years:-

OVERFUNDING

Defined as the excess over the PSBR of sales of public sector debt outside the banking system*



2. The aim of funding in the first place is to finance the Government's borrowing in a non-inflationary way - in particular by avoiding borrowing from banks or by printing money.

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*This definition of overfunding is that implied by the Chancellor in his 1983 Mansion House speech. See Annex for other definitions.

Overfunding goes further and seeks to offset the growth of liquidity in the economy that would result from non-government influences, particularly bank lending to the private sector. In terms of present policies, overfunding has been directed at containing the growth of £M3. But as well as reducing the liquidity of the economy, over-funding drains cash from the money markets - which has to be replaced by the Bank (usually through purchases of commercial bills).

3. It is obviously desirable to prevent the economy becoming over-liquid. Though high liquidity need have no immediate consequences for inflation, it leaves the economy vulnerable to inflationary shocks. There has been a substantial growth of liquidity in the UK in the past five years. This can be seen in the fall in the velocity of £M3 since 1980, shown in the attached chart. This high growth of liquidity, however, occurred from a low base (reflecting the distortions of the corset) and seems in large part the result of financial liberalisation and the high real rates of return available on liquid assets. The private sector, freed from distorting controls, has wanted to hold larger stocks of liquid assets in relation to its spending. The rapid growth of £M3 and broader measures of liquidity has been consistent with falling inflation and, as again can be seen from the chart, there is no evidence that the economy is, by historic standards, overliquid.

4. Funding is a form of insurance against the risks that go with high liquidity. But it has a price, and a balance has to be struck. A lower level of insurance would be appropriate if we have the means of reacting speedily to any sudden onset of inflationary pressure, and there is confidence that we will take the necessary action. In practical terms this means a readiness to raise short-term interest rates in response to any early warnings of inflation from MO, asset prices or the exchange rate.

5. The extent of overfunding in recent years has caused several problems:-

i. The operation is not well understood. Many commentators regard it as a means of massaging the numbers. The extent of overfunding in recent years and the sheer scale of the bill mountain are damaging the credibility of government policy.

ii. It has been the main cause of the growth of the bill mountain. The stock of money market assistance given by the Bank, mainly in the form of bill purchases, has risen from a negligible amount in 1979 to around £17 billion today. The maturing of these bills causes huge cash shortages in the money markets on most days. This makes the Bank's job of managing the money markets more difficult and can at times give rise to differentials between bill rates and inter-bank rates that encourage round-tripping.

iii. Over time, it probably adds to bank lending by raising long-term interest rates and crowding private sector borrowers out of capital markets, so increasing reliance on bank credit. Consequently, its beneficial effects on £M3 almost certainly diminish with time.

iv. It increases gross debt interest payments by the Government, adding to recorded general government expenditure. There is an offsetting rise in government receipts of interest on the bills the Bank holds. But in most recent years there will also have been a modest net interest cost to the PSBR. The operation involves borrowing long and lending short, and only becomes profitable when - as at present - interest rates on short term bills rise above the rates at which the additional gilts were sold.

6. If present policies of overfunding to constrain £M3 growth continue, these problems will persist and the likelihood is that the bill mountain will go on growing rapidly.

Effects of stopping overfunding

7. Stopping overfunding could have the following effects:-

i. £M3 would grow faster. Our very rough calculations suggest that a cut of £4 billion in gilts sales over a year might be expected to add something of the broad order of 3 per cent to £M3 growth. That was more or less the scale of overfunding last year (but see Annex for different definitions): and at present the prospects for 1985-86 look rather similar.

ii. The effects of this faster growth of £M3 would depend crucially on how markets reacted to it. If it led to a deterioration in confidence and a weakening of the exchange rate, it would add to inflation. If a rise in £M3 brought about in this way left confidence undisturbed it would have little effect on the economy and inflation. In this context, the market's calm response to the 5 per cent rise in £M3 over the past three months is encouraging.

iii. Depending on these influences on confidence, there might at one extreme be little effect on short term interest rates, and a fall in longer term rates; or at the other, if expectations and the exchange rate were adversely affected, a rise in short rates and possibly in longer rates as well.

iv. How long-lasting the effect in i. above would be would depend on the behaviour of bank lending and external flows. An important factor would be how the institutions used the cashflow which would otherwise have gone into gilts. Their choice would lie between holding more bank deposits and investing in overseas assets, property or company securities. The last of these could lead to a helpful switch of company financing away from the banks.

8. The relationships in the Treasury and most other macro-economic models imply that faster £M3 growth brought about by lower funding rather than lower short term interest rates does not increase inflation. It would be unwise to put much weight on this. Nonetheless, it is not implausible that changes in £M3 growth brought about in one way should have different effects from those brought about in another.

9. The key question in practice is what would be the impact of a further £M3 overshoot on market confidence and inflationary expectations. A sharp adverse effect would bring a rise in short term interest rates which it would be counter-productive to resist. It could also bring about a rise in longer rates too - more than offsetting the effect of lower gilts sales. The Bank attach more weight to the risks than do the Treasury. Much would depend on our own presentation. And it should not be forgotten that the alternative is a continuation of overfunding, which is beginning to call into question the credibility of policy.

10. It is clear that the effect on confidence would depend on the conditions prevailing when the policy change became known and on how we were expected to respond to developments. We could watch the market reaction carefully. If we thought that inflationary expectations were rising, we would need to raise short term interest rates. We would not expect this to bring £M3 growth back within its range. But it should raise the exchange rate, probably reduce MO growth, and so keep monetary conditions tight as measured by the balance of indicators. In this way we could keep inflationary expectations down and maintain pressure for a fall in the underlying rate of inflation.

Bill mountain and definitions of overfunding

11. Stopping overfunding would not of itself reduce the size of the bill mountain, and would not even necessarily prevent further growth, although it would clearly reduce its rate of

growth. (The effect would partly depend on the precise definition of overfunding adopted; there are several possibilities, discussed in the Annex.)

12. So we would be left with a stock of money market assistance of at least around £17 billion. It would thus remain desirable to seek ways of tackling some of the operational problems this has created by reducing the size of the bill portfolio.

A revised approach to funding

13. In practical terms a possible way ahead would be:-

14. First, we should for the rest of 1985-86 exercise restraint in selling gilts, aiming not to overfund over the year as a whole at least on the narrowest definition (see Annex).

15. Second, this would mean accepting a growth of £M3, at least initially, faster than it would have been had overfunding continued. The aim would be to keep policy tight as measured by the balance of indicators, including MO and the exchange rate. Short term interest rates would remain relatively high. Our actions and words would need to convince the markets that, despite the £M3 overshoot, policy was tight and was intended to remain so.

16. Third, before next year's Budget we should consider whether to raise the £M3 target for future years, to allow for changes in velocity, or whether to abandon targetting it altogether, announcing instead that we would take it into account along with other indicators. In the light of that we should also consider whether to set out a more specific target for funding policy, and if so which definition to adopt.

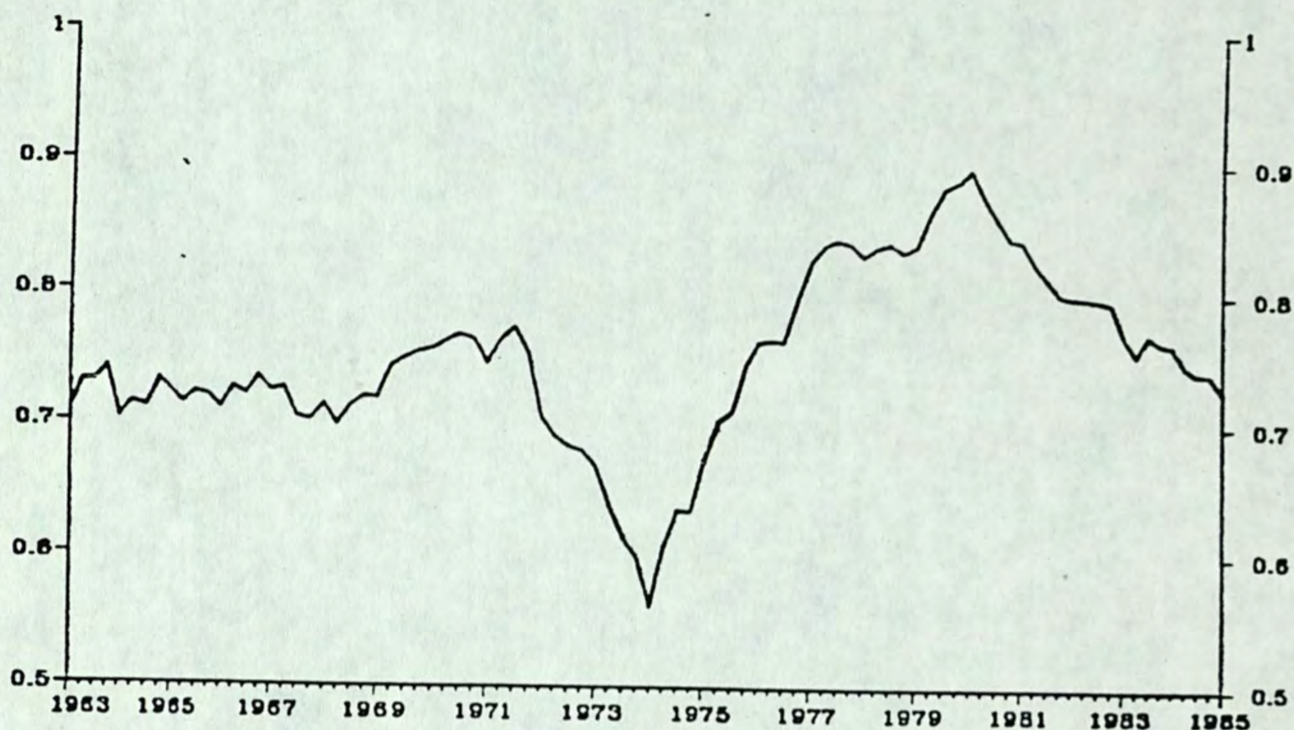
17. Fourth, whatever other steps are taken we also need to consider technical measures for reducing the size of the Bank's bill portfolio. These include:

i. The package we are nearly ready to announce to encourage nationalised industries and local authorities to raise more of their finance from the NLF and less from the banks. This will reduce the need for money market assistance for a given level of gilts sales.

ii. Measures to shift a greater proportion of the outstanding stock of money market assistance into forms easier to manage than bill holdings which turn over every 4-6 weeks. Two possibilities are buying export credit paper from the banks, and placing deposits with the banks; neither, however, is without its own difficulties.

18. This whole approach depends for its success on the Government's policy stance being perceived to be sufficiently tight to keep downward pressure on inflation. This will above all require a strong exchange rate, which has implications for the level of short-term interest rates.

July 1985



The chart shows the ratio of money GDP (by calendar quarter) to the stock of £M3. Velocity measures the rate at which the money stock turns over. A fall in velocity, as in 1971-74 or 1980-85, means that £M3 is rising faster than money GDP.

ANNEX

Definition of overfunding

If the object is to eliminate overfunding altogether, we will have to decide which definition to use. The main possibilities are:-

(i) The "conventional" definition. That is to fund the PSBR with sales of public sector debt in the UK other than to banks.

(ii) The "wider" definition, illustrated in paragraph 1 of the paper. That would imply funding the PSBR by raising finance outside the banking system and from external flows.

(iii) A definition focussed on the growth of the monetary base. This would imply funding the PSBR in any way that did not involve an addition to the growth of MO greater than that allowed for in the target set for it. But it would allow additional gilt sales to offset the monetary effects of any local authority or nationalised industry borrowing from the banks.

(iv) A definition focussed on the level of money market assistance (MMA), ie. a level of funding that would not add to the stock of MMA. The difference between this and (iii) - assuming MO growth is on target - is that there would be no attempt to offset nationalised industry and local authority borrowing from the banks by additional gilts sales.

On the narrowest definition (i) we would have had no overfunding last year with £2.3bn lower sales of gilts. But the bill mountain would still have risen by £3.3bn. To have achieved no growth in MMA (definition (iv)) would have required debt sales £5.6bn less than we actually achieved. The table attached shows the degree of overfunding on each definition in 1984-85, and the relationship between them.

At present the prospects for this year and next look not dissimilar to the 1984-85 pattern. To remain in sight of meeting the £M3 target we may need to contemplate overfunding and a growth in the bill mountain similar to last year. So in relation to this prospect, a decision to end overfunding would represent a large step even on the narrowest definition: and we would not achieve the aim of preventing further growth in the bill mountain - let alone reduce its size - without going a good deal further than that.

Table: Different definitions of overfunding in 1984/85

		£bn
		Excess debt sales
PSBR	10.6	
- Debt sales to UK non-bank private sector	- 12.9	
(i) Conventional definition of of overfunding	- 2.3	2.3
- external finance of the public sector	- 2.2	
(ii) Wider definition of overfunding	- 4.4	4.4
- debt sales to banks and other sectors	0.6	
- allowance for target MO growth	- 0.7	
(iii) "Monetary base" definition	- 4.5	4.5
- local authority and nationalised industry contribution to above	- 1.5	
other finance	0.5	
(iv) Increase in money market assistance	- 5.6	5.6