

56)

BUDGET SPEECHES: PART E
6TH MARCH 1981 - 9TH MARCH 1981

069/3
12/11/81

[Redacted]

~~Mr Davis~~ HFL

Mr Thatcher
I have KCC -
company.

SIR K COUZENS

cc Mr Burns
Mr Middleton
Mr Monck ✓
Mr Unwin
Mr Wiggins
Mr Grice

M. Jones

33/016

BUDGET SPEECH

1. I have seen the proposed redraft of paragraphs F8-11 which you sent to Mr Wiggins yesterday. The first sentence of your proposed F9 reads:

"An unusual proportion of these savings took the form of an increase in current and deposit accounts which form part of £M3."

This is a crucial part of the explanation of the overshoot in this proposed redraft, so we need to be quite sure it is correct.

2. In 1980 the latest figures suggest that the percentage growth of £M3 was very closely in line with the growth of the net financial wealth of the private sector. Perhaps there is some other way of demonstrating the point you wish to make.

AJC

A J C BRITTON
6 March 1981

[Redacted]

FINANCIAL SECRETARY

cc Principal Private Secretary
PS/Chief Secretary
PS/Minister of State (C)
PS/Minister of State (L)
Sir Douglas Wass
Sir K Couzens
Mr Rynie
Mr Burns
Mr Middleton
Mr Monck
Mr Britton
Mr Unwin
Mr Turnbull
Mrs Gilmore

33/016

FINANCIAL SECRETARY'S SPEECH IN BUDGET DEBATE: WEDNESDAY 11 MARCH

Mr Locke's minutes of 4 and 5 March asked for contributions to speaking notes on the explanation of last year's overshoot, its implications for this year, and the important role of funding policy in the Government's strategy.

2. I attach notes prepared by Mr Middleton on the first two points and, in a slightly different style I am afraid, a piece by me on funding. Also attached is a brief note from Mr Monck on the central inconsistency of the TCSC report. The funding piece refers to the three areas in which innovations are to be made - National Savings, short gilts (in passing since no firm decision has been reached) and the indexed stock, but concentrates on IGs. Mr Locke asked that the notes should include a reference to the 'proposed auction system'. They do, but I have not expanded on the point at any length. The indexed stock will be issued by auction, principally because there is no basis on which to set a price. (We propose to agree a reserve floor figure with the Bank, but this will not be published, and will probably be appreciably below the price at which we expect the stock to sell.) It is likely that for the next few issues we would follow the same practice. We have not agreed with the Bank how indexed gilts would be sold when the market in indexed stock became thicker, and appropriate yields for new issues could be calculated by reference to existing stock. Whether we would continue with auctions or at some stage set a minimum tender price is still an open question. In the light of this, and of speculation about

changes in debt management techniques generally, it might be misleading to make too much of the auction aspect of indexed gilts at this stage. The speaking notes therefore refer to it as an interesting feature of the new instrument, and point out some of the advantages in monetary control terms, but do not draw more general conclusions about the way to sell conventional debt. The question of wider adoption of auction techniques was raised in Sir Douglas Wass's minute of 17 February covering a paper on Funding Techniques. It is to be one of the subjects of a discussion on funding policy in due course.

Howard Series

H J DAVIES
6 March 1981

SECRET

MONETARY DEVELOPMENTS IN 1980-81. IMPLICATIONS FOR STRATEGY

Seems to be general agreement

- that reducing inflation a pre-requisite of sustained growth
- that inflation is in fact coming down
- that this has been brought about by tight financial conditions

Seems self evident

- that this progress could not continue if government resorted instead to fiscal boosts for short lived advantages in terms of output
- that is desirable to let everyone know that the Government does not intend to proceed in this way, and they can be confident that a sustained reduction in inflation will take place
- that a MTFS is the best way to get across this essential message

So the argument is about one important and one secondary question

Important question is: will monetary growth last year fuel future inflation?

Secondary question is: should Government be trying to get off the hook of £M3?

Deal with secondary question first

- £M3 not a very good guide last year
- this partly because of thoroughly desirable change of removal of corset

- getting rid of distortions essential if £M3 to be retained
- would have been more worrying if had stuck to £M3 with corset still in place
- not important because Government not slave to a single measure: looks at totality of monetary conditions - narrow money, exchange rate, inflation and real interest rates etc - Quote Green Paper
- now distortions largely removed, £M3 decelerating as would expect. Maintain continuity and clear links with fiscal policy

Important question is impossible to answer with certainty

- any increase in liquidity as shown by wider measures of money is worrying - because it might be spent and fuel inflation later
- but seem good reasons why this unlikely to be the case

First: Growth £M3 did overstate build up of liquidity for reasons just given

Second: the unprecedented transfer of income from companies to persons has resulted in companies going to the bank because they had to and people going to the bank because they could afford to. Transfers on this scale are unlikely in future and the growth of bank lending has already slackened

Third: much of the increase in liquidity should be firmly held because it results from an attempt by the private sector to make good the ravages of inflation on their financial assets. We think private holdings of financial assets -

which of course include money - are now at a satisfactory level, and that this once-for-all surge in the demand for money is now over. Confirmed by recent deceleration in growth of money supply, which we correctly predicted when MLR cut last November.

So there is every reason to be confident that the track set out for £M3 will produce right degree of financial tightness in next few years.

- given determined steps to cut PSEK should be substantial gains in terms of lower interest rates in medium term
- but stand ready to clawback if the whole range of indicators show that a resurgence of inflation likely
- applies to next year and subsequent years of strategy

£M3 control requires strengthening of our funding armoury eg indexed gilts and redirection of our attack - more from personal savings

- see Davies Notes

Why do we need an MTFB

- if a short term policy is to be operated flexibly, not relying totally on one monetary aggregate, and taking account financial developments, still need a framework in which to operate, otherwise policy becomes totally ad hoc.
- contrast human frame - flexible but has well defined shape - with invertebrates - e.g. jelly fish - which have flexibility but no backbone.

Inconsistency of TCSC Report

- See Monck notes.

FUNDING

We have announced a number of important innovations designed to improve our funding techniques. The experience of the last year has shown how essential funding is to monetary control. It is vital for the Government to have a range of instruments at its disposal to enable it to respond to different market conditions and financial developments. The three principal changes - National Savings, Short-dated gilts, indexed gilts - will all give us additional flexibility and serve to reduce the pressure on the capital markets which the issue of huge quantities of long-dated conventional gilts has created.

The sizeable imbalance between the company and personal sectors observed in 1980-81, which my rnf pointed to as one of the principal reasons for the £M3 overshoot, is the background to our aims in the National Savings area. Our objective is to draw more funds directly from personal savings which should take pressure off the capital market and allow the monetary target to be met at lower long-term interest rates. The changes we have announced should enable us to draw £3 billion from the personal sector in the next financial year. It is an ambitious target, but one we do expect to be able to achieve. And the very rapid growth in personal financial wealth we have seen recently means that we are confident we can do this without adversely affecting the Building Societies.

My RHF also announced yesterday that the Government would in future be making issues of an index-linked gilt edged stock and the Bank concurrently announced a first tranche of 2% indexed linked stock with a 15 year maturity. This is a radical step. No other major developed country has offered indexed debt of this marketable kind

Its introduction will represent a significant change in the financial landscape and one which deserves detailed explanation.

Many outside commentators have recommended the issue of indexed gilts. The Wilson Committee invited the Government to think seriously about it. We have looked very carefully at the arguments on both sides and have concluded that the case for introducing indexed debt as part of our funding programme is overwhelming.

We believe it is the right thing to do for a number of reasons. The present position is not satisfactory. The Government dominates the long-term capital market. [Companies have in practice been excluded from the market for a number of years.] We believe it would be improvident to continue to rely exclusively on issuing huge quantities of fixed interest stock with high coupons and maturities stretching well into the next century. Of course in recent years long dated stock has proved a bargain for the Government. But it is a bargain at the expense of the rest of the market and can only continue to be so if inflation continues to rise.

We are determined to avoid this and our issue of indexed gilts shows this determination. Only a Government absolutely committed to a sustained reduction in the inflation rate would wish to issue such a stock. We therefore believe that the impact on expectations will be positive.

IGs will also allow us to fund a given level of PSBR at lower interest rates. By linking the principal repayment to inflation we are in effect removing an element of uncertainty from the market place. Uncertainty must be paid for in the form of

higher yields. By reducing the level of uncertainty about returns in the market we can expect lower interest rates which will benefit both borrower and lender alike. It will also, of course, bring nearer the day when companies return to long term capital market themselves.

The third major benefit we see is in improvements in monetary control. The availability of indexed gilts will give the Bank an important additional degree of flexibility in its market operations. With this, the convertible and, in due course, the short gilt, it will have a wide range of instruments at its disposal. It is also of interest that indexed gilts will be sold by auction, so that it is up to the market to determine the appropriate level of yield at the time. These two factors will give the Government greater discretion to vary the size of gilt sales from time to time, which is a vital weapon in a strategy designed to control a broad money aggregate, like sterling M3.

I should say something, too, about the eligibility restrictions we have imposed for this first issue. It is clearly appropriate that an asset of this kind should be held by institutions with long term liabilities, like pension funds. It will also, in time, allow them the possibility of offering indexed benefits. But the criteria we have established also guard against the risk of sudden large inflows of funds from overseas. This, not because debt of this kind would in any sense be a "bargain" for the overseas investor. But because the very existence of an asset with different characteristics from those available elsewhere would induce a sizeable portfolio shift on the part of major overseas investors.

We shall clearly be looking very closely at the takeup of the new issue and at yields and trading patterns. But on the assumption that it is a success, and we have every expectation that it will be, indexed gilts will be an integral part of our funding programme from now on.

The Report is useful as an exposition of some of the issues and the evidence the Committee has gathered is certainly a valuable contribution. But I must say that I am not at all sure what criticisms they are making or what advice they are really giving on policy and the decisions which the authorities have to take continually.

2. On some issues they seem to be facing both ways. They are all for flexibility. But their statement that there has been:

"no true monetarist experiment"

has been interpreted as a fundamental criticism. They base this on their view that:

"The Government moderated upward pressure on interest rates and decided against trying to cut the PSBR to the level consistent with [the] monetary target."

But were we right or wrong in rejecting a mechanistic approach. Presumably we were right since the Committee say that:

"Monetary conditions have been tight."

We thought so too. We made it clear a year ago in our Green Paper on Monetary Control that no single statistical measure can be expected fully to encapsulate monetary conditions and that it was necessary to have regard to a wide range of measures. We explained in November that that was what we were doing and that we expected monetary growth to slow down. We were right about that too. Over the last three months M3 has been growing at an annual rate of 9%. Would the Committee have preferred us to leave MLR at 16% until we had that slackening in monetary growth under our belt?

3. Nor is it true that we have stuck inflexibly to the MTFPS figures. For reasons which my rt hon friend the Chancellor explained why we think that the special factors at work last year are unlikely to be repeated

so that the over-run in the growth of M_2 should not have implications for inflation. You also said that it may prove to be desirable to recover some of this year's growth in the form of lower growth over the medium term.

4. The decision on this year's target and our attitude to future monetary growth should be looked at together. We have felt able to be flexible in the immediate decision on the new target. But it is no good being flexible if you have no guiding framework for policy. It is no use invoking the vague virtue of flexibility without a framework. It is empty of policy content. It is perhaps a word that is likely to appeal to a Committee with a very diverse membership. The Government needs more than that and that is why my right hon friend has reaffirmed the Medium Term Financial Strategy within it, as in any other area of policy, flexibility and the exercise of judgement is a necessity for practical decision taking. If that is the sort of flexibility the Committee mean when they:

"welcome the readiness of the Government to announce medium and longer term objectives which express its policy intentions"

we are with them. We certainly agree with the platitude that it is

"wise to allow for modification of the tactics in the light of developments".

MR BRITTON

33/016

HTL



For Information:

Mr Burns
Mr Middleton -
Mr Monck

BUDGET SPEECH: PERSONAL SAVINGS IN 1980, £M3 and
NET FINANCIAL ASSETS

We spoke. The words I suggested are not being used, so all is well. I had assumed, in my innocence that I was substantially reproducing what was there in an earlier draft but I see that we are now simply saying that private sector investment in rebuilding financial assets in 1980 "has included an increase in holdings of interest-bearing money". That certainly sounds a safe statement.

2. What I have often wondered was whether the familiar business of a rising savings ratio following a surge of inflation was a rather less conscious and deliberate process than is implied in "rebuilding net financial assets". I have wondered whether it might be partly connected with annual wage rounds, and the receipt of considerable nominal pay increases after some months during which people have gradually adapted to lower real incomes. Perhaps this produces involuntary savings (in rather liquid form) while people adapt to the new level of income.

3. This would be consistent with a tendency for the savings ratio to rise as inflation speeds up and fall as it speeds down, and might have a rather similar appearance to "rebuilding net financial assets". It could include doing some of that. But if the involuntary element were greater I suppose there would be possibility that more of it would later be reversed into spending than under "rebuilding net financial assets".

4. One question that occurred to us was: what happens in the US where the annual pay round is much less important? Indeed, until recently their savings ratio was falling in the face of inflation

[REDACTED]

That did not look like "rebuilding net financial assets".
Another question is how closely the savings ratio has moved with nominal income growth here (including perhaps growth outside the normal annual pay increases of Q1 and Q2, like the 1974 threshold payments or income tax reliefs, though these also normally came in Q2). But FEU may know that this line of thought has been tested before and found wanting.

K E

K E COUZENS
9 March 1981

[REDACTED]

504/S

Mr. [redacted]

cc Mr. [redacted] Mr. [redacted]
Mr. [redacted]
AM

MR CASSELL

AFs

33/016

cc Mr Battishill
Mr Bridgeman
Miss Brown
Mr Britton
Mr Evans
Mr Monck
Mr Allen
Mr Folger
Mr Bush

TREASURY SELECT COMMITTEE: POSSIBLE QUESTIONS

I attach a quick list of possible questions and topics that we may be faced with next week. Let us go through this on Thursday. If anyone wants to add to, or comment on, this in writing before then, please do so. Otherwise reserve your fire until then. If you wish to bring any supporters to our next meeting, please do so.

J B UNWIN

9 March 1981

Plans to transfer

Measures to reduce PSBR

measures to reduce PSBR

8724

[REDACTED]

POSSIBLE TREASURY COMMITTEE QUESTIONS

A Budget overall and its effects

- (i) Size and definition of Budget. Why defined so? What about November measures? Budget on revalorised basis.
- (ii) Effects on output, employment etc.
- (iii) Effects on industry and corporate profitability. How much direct help (from tax/spending measures and MLR)? How much all this offset by general deflationary effects and effects of other constituent parts that impact on industry (eg excise duties)?
- (iv) What does Treasury model show as to Budget effects? *Can we see a simulation?*
- (v) What would have happened to output etc. if "present policies" PSBR of £14 billion permitted?

B Economic forecast/prospects

- (i) Unemployment?
- (ii) Turning point? On what basis this expected?
- (iii) Exchange rate? Why assume flat path? Surely Budget/other developments (eg interest rates) likely to affect it one way or other?

C Central Budget judgement

- (i) Why £10½ billion PSBR? How compatible with monetary target?
- (ii) What does this imply for interest rates (and what would have been monetary implications of £14 billion PSBR)?

(iii) Given 1980-81 experience, what reason to believe £10½ billion PSBR attainable? Will Chancellor take measures (unlike 1980-81) to ensure attainment if figures once again off course?

D Tax

(i) Effects of Budget measures on tax burden/balance and incentives? Effect on labour market?

(ii) Effects on/value to industry (possibly criticism here of stock relief on eg CBI lines)?

(iii) Distributional effects (with and without CB and NIC(E)).

(iv) How justify tax on banks given lower 1980 profits? In what sense does this provide scope for more help to rest of industry (paragraph L11 of Speech)? Monetary implications of bank tax?

(v) Why no HFO reduction? Elucidate delphic references in Speech.

E Public Expenditure

(i) Why should new cash system produce better results than old one? Presumably you will clear with Treasury Committee before introducing it?

(ii) Given 1980-81 fiasco, why should anyone believe new plans can be attained?

(iii) What further cuts are likely in this year's review (paragraph H9 of Speech)?

(iv) Variety of questions, as last year, on/ ^{capital v} current and absence of breakdown by economic categories. Also implications for construction industry.

(v) What reason to believe new NI figures any more reliable than discredited ones of last year? Haven't we been proved right?

[REDACTED]

(vi) Why isn't 1981-82 excess over White Paper not carried forward to later years?

F Energy

(i) Relationship of price/boiler proposals to NEDC recommendations? What effects on gas/electricity prices? Implications for EFLs in later years?

(ii) Precise implications next year and in later years of NCB developments? Eg how much now earmarked within 1981-82 contingency reserve?

G Monetary questions

(i) Criteria for interest rate changes. What weight attached to inflation/real interest rates/exchange rate etc?

(ii) Given 1980-81 experience, what reason to believe £M3 target attainable?

(iii) What circumstances would justify claw back next year or later?

(iv) Speech stresses relevance of other financial indicators. Give us complete list of them and explain relative importance attached to them.

(v) MBC and all that. Does this mean a definite decision has been taken to switch to MBC? If so, exactly what kind? And when will the preparatory moves take place?

(vi) Implications of national savings changes for building societies and other institutions?

(vii) Implications of indexed gilts for funding programme and capital markets generally? Does this represent coming to terms with inflation?

[REDACTED]

H Medium Term Financial Strategy

- (i) Isn't it a dead duck given 1980-81 experience?
- (ii) Justification of underlying economic assumptions (especially on GDP).
- (iii) Explanation of North Sea oil revenue projections.
- (iv) Fiscal adjustment. Sensitivity to assumptions and other developments? Implications for current tax burden/rates?
- (v) Terminal PSBR too over/under ambitious? Why raise to 2%?
- (vi) Why keep single case given uncertainties, last year's experience etc?
- (vii) Will you provide missing elements in projections (eg consumption, investment, trade etc.)?
- (viii) Why not roll forward till 1984-85?

I Effects of recession

- (i) Please justify assertions about effects of recession in 1980-81 and 1981-82. Surely arithmetic would suggest (on your arguments) lower PSBR than £10½ billion next year?

33/016

01-211-6402

Steven Locke Esq
Private Secretary to the
Financial Secretary
Treasury Chambers
Parliament Street
London SW1

4 March 1981

FINANCIAL SECRETARY	
REC.	10 MAR 1981
ACTION	MR TURNBULL
FORMS TO	PPS PS/EST
	PS/MSTC PS/MSTL
	SIR D WAES
	MR RYRIE
	MR MIDDLETON
	MR MONCK
	MR WICKS
MR UNWIN	
MR CWARDS	
MR ISHAM ✓	
MR GILBERT D.N.S	
MR CARBONH	

Dear Stephen,

BNOO OIL BOND

My Secretary of State was grateful to the Financial Secretary for his letter of 9 March.

He too is content with the proposed index incorporating both equity and participation oils and will be minuting the Prime Minister accordingly. He is also content to standardise on "BNOO Oil Bond" as the name for the instrument. He is very glad to note that a reference can be incorporated in the Budget speech.

Yours ever,

J D WEST
Private Secretary



33/016

TREASURY
16 MAR 1981
H.F.C.S

HFS

10 DOWNING STREET

From the Private Secretary

9 March, 1981

CH/EXCHÉQUER	
REC.	- 9 MAR 1981
ACTION	CST
COPIES TO	FST
	Sir D. WASS
	Mr Lyall
	Mr Middleton

N. MONAGHAN
M. MURPHY

Don JM ✓

As you know, the Prime Minister held a meeting with the Chancellor, the Governor and Sir Douglas Wass on Friday evening to discuss whether, and by how much, MLR should be reduced on Budget Day. They agreed that the Chancellor should announce in his Budget Speech a reduction of 2%.

The Governor showed the Prime Minister the draft statement enclosed with this letter; the Prime Minister indicated that she was content with it.

I am sending a copy of this letter to Tim Allen (Bank of England).

~ ~

Tim Allen

A J Wiggins, Esq
HM Treasury

554/3



The Bank of England announce that, with the approval
Chancellor of the Exchequer, they have decided to red
Minimum Lending Rate from 14% to 12%.

NOTE TO EDITORS

Information becoming available for February suggests that t
trend of private sector borrowing from the banks is continui
This, taken together with the fiscal action announced by the
Chancellor in his Budget statement to-day, will help to slow t
growth of M3 and of the other measures of broad money.
Furthermore, the rise in real interest rates as inflation has
slackened [and developments in the economy more generally] confirms
that policy has remained restrictive..

Against this background it has been decided that a reduction in
Minimum Lending Rate can now be made.

1. *Summary for budget speech*

10 March 1981

336/3
13/120

33/016

TREASURY
13 MAR 1981
H.F.C.S.

N. Davies N.F.S.

For Information: *M. G. Jones*

Mr Burns
Mr Middleton
Mr Monck

M. G. Jones

MR BRITTON

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*By repetition
written*

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K E

K E COUZENS
9 March 1981

[REDACTED]

33/016

~~_____~~
~~_____~~ 10 1981
then UNCL

TREASURY
13 MAR 1981
H.F.C.S.

NAG

G1 (Annex)

ANNEX

Monetary growth to mid February

percentages, seasonally adjusted

	3 months annual rate	Last 6 months annual rate	Last 12 months
Wide monetary base ¹	n.a	n.a	5.4
M1	10.4	9.4	8.6
£M3 ²	9.0	14.3	20.1
M3	16.7	17.4	21.7
PSL1	5.8	11.1	16.6
PSL2	11.2	13.9	15.0

- Notes and coin held by the public and by banks plus bankers' balance at the Bank of England, not seasonally adjusted.
- After adjustment for the distortions produced by removal of the corset, the underlying growth of £M3 over the past year about 17½ per cent.

Interest rates

	MLR	3 month interbank rate	5 year gilts	20 year gilts	Real short ³ term interest rates
end June 1979	14	14 1/32	12.34	12.80	-1.6
end Dec 1979	17	16 15/16	15.10	14.67	-1.6
end June 1980	17	16 7/8	13.09	13.35	-5.1
end July 1980	16	15 7/6	13.00	13.11	-3.2
end Aug 1980	16	16 25/32	13.95	13.92	+0.3
end Sept 1980	16	15 25/32	12.93	13.33	+0.8
end Oct 1980	16	16 7/8	13.15	13.15	+7.5
end Nov 1980	14	14 9/16	12.97	13.35	+6.0
end Dec 1980	14	14 13/16	13.19	13.74	+6.8
end Jan 1981	14	13 11/16	13.23	13.90	+6.2
end Feb 1981	14	12 1/4	12.94	13.90	+3.6
early March 1981	14	12 1/2	13.10	14.06	+3.4

- There is no fully satisfactory way of calculating real interest rates because inflationary expectations cannot be measured directly. The figures are derived from 3 month interbank rate less change in RPI over previous six months at annual rate as a proxy for inflationary expectations.

Cont.

[REDACTED]
then UNCLASSIFIED

G1 (Annex) Cont.

Counterparts to £M3 growth (£bn s.a.)

	last 6 months	Last 12 months
CGBR	+5.54	+10.88
less sales of debt to non-bank private sector	-5.48	-9.16
Net other public sector	+0.80	+1.53
Bank lending to private sector	+3.58	+9.64
Bank lending to overseas	+1.30	+2.73
DCE	+5.74	+15.62
External and foreign currency adjustments	-0.91	-2.84
Non-deposit liabilities	-0.45	-1.42
£M3	+4.38	+11.36
(Percentage increase at annual rate)	+14.3%	+20.1%