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cc: Governors Office
John Hoskyns
bc: Sir R. Armstrong

SUBJECT

10 DOWNING STREET

From the Private Secretary

9 September 1980

Dear John,

As you know, the Prime Minister held a meeting yesterday afternoon to discuss the latest banking figures. The following were present:

The Chancellor of the Exchequer
The Financial Secretary,
Sir Douglas Wass,
Mr. Burns,
Mr. Middleton,
Mr. Fforde,
Mr. George, and
Sir Robert Armstrong.

Much of the meeting was taken up with going over the draft statement which you had sent over, and no doubt the final version will take into account the Prime Minister's comments. In particular, she suggested some reordering of paragraph 4 and the excision of the sentence describing the 1980/81 target, and that there should be a reference to the discussions to be completed within the next few weeks on the Green Paper on Monetary Base Control (MBC).

There was also some discussion of monetary developments and prospects and the options open to the authorities. The Prime Minister said that she understood that the underlying rate of monetary growth was now reckoned to be 15 per cent or higher. This was extremely disturbing - given that the 7-11 per cent target was the centre-piece of the Government's economic strategy. It seemed to her that the Bank had been pursuing an interest rate policy rather than a policy to control the money supply. With hindsight it might have been better if the Bank had not undertaken the continuing money market relief measures, even though this would have meant still higher interest rates in the short-term. As long as the clearers could rely on the Bank to relieve any pressure on their liquidity, they would surely be all too willing to maintain a high level of lending to the private sector. If the clearers' liquidity had been under pressure, they would have reduced their lending and by now interest rates might well be lower. On the other hand, she doubted whether the current high level of interest rates was having any restraining effect on bank lending. On the contrary, it was arguable that - with the quarterly crediting of interest payments to company overdrafts -

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lower interest rates would result in lower borrowing. Furthermore, high interest rates had pushed up the exchange rate, and this was adding greatly to the difficulties of the corporate sector.

The Prime Minister went on to say that in her view the present methods of selling debt and of monetary control had compounded our difficulties. The objections to major changes in the funding arrangements had been rehearsed often. She welcomed the decision to issue a new index-linked certificate, but she was still not convinced that the present arrangements were the best available. On monetary control, she was disappointed that it had taken so long to reach a conclusion on the proposals to change over to a monetary base system. Finally, she wondered whether more could not have been done to put pressure on the clearing bank chairmen to get them to reduce their lending.

The Chancellor said that he too was extremely worried about the latest two months' figures. But it was easy to be wise after the event. Not only the Treasury and the Bank, but also most outside commentators had under-estimated the underlying rate of monetary growth. The siutation was highly uncertain; but quite apart from the effect of reintermediation, there were some special factors - as paragraph 4 of the draft statement pointed out - which had boosted the figures. The much lower level of public borrowing expected in the remainder of the financial year and the likely reduction in corporate borrowing as costs continued to moderate and as the recession took further hold should bring down the rate of monetary growth in the coming months. Until the underlying situation became clearer, and until the likely consequences of the various policy options had been properly considered, he thought it would be unwise to take any immediate action in response to the figures. At the same time, Ministers would need to make clear that the Government was determined to pursue the medium term financial strategy, notwithstanding two months' bad figures.

In discussion, it was pointed out that if the Bank had not provided relief to the money market, interest rates would certainly have risen including in all probability the mortgage rate. But this had effectively been ruled out. As to the effect of interest rates on borrowing, the <u>net</u> effect of high rates was almost certainly to restrain the level of lending - for the crediting of quarterly interest payments to overdrafts was likely to be offset by the demand elasticity factor. This was reflected in the large amount of destocking that was currently going on. High interest rates were helping to bring down the rate of inflation both through their effect on lending and on the exchange rate. As regards methods of monetary control, it was important that the discussions on the Green Paper with interested parties should be completed before final decisions were taken. The issue was extremely complex, and it was not yet clear how the clearers would respond to a monetary base system or that, for example, we would not end up with distortions similar to those that had emerged under the corset. Two seminars on MBC were planned for the next few weeks - one for domestic and a second for overseas participants. Finally, as regards putting pressure on the banks, the Governor had seen the chairmen just before the July figures had been announced and had underlined the Bank's directional guidance. The chief executives

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[illegible] been seen since then. But any attempt to put pressure on them, formal or informal, to restrain the total volume lending would all too soon lead to distortions once more and in particular to borrowing outside the banking system.

In conclusion, the Prime Minister said that it was crucial to get the money supply back under control and to this end a great deal of work was clearly needed. She would want to hold a further meeting in the first week of October.

I am sending a copy of this letter to Tim Allen (Governor of the Bank of England's Office).

Yours ever,

Tim Lankester.

John Wiggins, Esq.,
H.M. Treasury.