

Chancellor of the Exchequer cc Financial Secretary
 Sir Douglas Wass
 Sir Kenneth Couzens
 Mr Ryrie
 Mr Burns
 Mr Britton
 Mr Lavelle
 Mr Monck
 Mr Turnbull

MINIMUM LENDING RATE

1. We discussed the possibility of a change in MLR this week. This is given added urgency by the possibility that the revised figure for the PSBR in 1981-82 might leak and cause the market to revise its views about the likelihood of a fall.

£M3

2. There is not much of substance to add to the arguments set out earlier. If MLR was reduced we should not be able to quote changes in £M3 as a reason. Though it is declining sharply compared with the rest of last year - the most favourable period - the last 3 months - still sees it growing at an annual rate of 13% and the rate of growth over the last 6 months is nearer to 15%. Moreover £M3 is expected to increase by about 1% over the next two banking months even allowing for recent heavy debt sales. The figures for next year's PSBR also hardly fit with a reduction in interest rates in which £M3 plays much of a part.

The Other Aggregates

3. Turning next to the other monetary indicators, there is not much of a positive argument here. Again looking at the 6 monthly figures - the growth of M1 and the wider monetary base, at around 8%, is compatible with the target range for £M3. There is of course no reason why this should be an appropriate range for aggregates other than £M3. But equally it would be difficult to make out a case for a higher growth rate for these narrower aggregates - most people think in terms of a lower one. M1 and the base have, over the past been about 2% below the growth of £M3 so an equivalent range for these would be more like 5-8%.

4. The explanation for lower interest rates would therefore

have to be a complex one. We should have to stress the medium term nature of £M3 and say that we were taking into account factors such as the exchange rate and the real economy. This sounds an easy explanation, but I think it is in reality very difficult to make convincing before your full strategy is unveiled in the Budget. We need to explain why we have not moved already and give some idea of the limits to which we are prepared to go in reducing rates. The markets are discounting a fall of over 1% in MLR. It is therefore unlikely that the exchange rate will react very much. It is even less likely that the real economy will react quickly. So the question we have to answer is: what would cause us to stop reducing interest rates in this way? the best answer we could give would be that we would wish to ensure that the narrower aggregates ^{did not} begin to rise at an unsatisfactory rate.

5. I think this is close to the way we shall wish to operate next year. But I must confess to being very apprehensive about going very far down this road until we have discussed this further with you, and are a little clearer exactly how it will all work out in practice - a subject on which a further submission is being prepared. It would also be useful to know just where the £M3 target is likely to be put following the latest information about the PSBR.

6. If you do decide to make a move there are other arguments we could throw in which support the case. The fall in inflation is one. Real short term interest rates will look higher even in relation to the annual figures when they are published later this week. But we need to use this with care because real interest rates are high everywhere and ours are among the lowest. Moreover, though we apply judgement to interest rate changes, we still wish to claim that the money supply determines interest rates rather than the reverse.

7. I think it is this latter point which worries me most. I doubt if it would be possible for you to stand back and say that the market was determining interest rates. The market is not following your monetary policy when all is said and done. The market is expecting lower interest rates because it is interpreting ministerial hints that lower rates are on the way, come what may. They are not, at present, forming their expectations in relation

to any of the monetary indicators. To move now might therefore open up a credibility gap which you would find made life difficult in the Budget. It would certainly lead to a mass of speculation about what it implied for your future intentions.

8. I can see why you would like lower interest rates this week and I am sure that we could present a case for doing so drawing on the points I have outlined. But I have not changed my own view that it would be inadvisable given the crucial need to give a careful presentation of the strategy.



P E MIDDLETON
10 February 1981

The growth of serious foreign borrowing on the capital markets. As promised, I attach the note I put up to the Chancellor then, which records the views of two contacts in the City who were both well versed about the matter. The Chancellor expressed the view that this issue should be considered seriously. I got in touch with Mr Perera. In fact I did so about the issue last night, and he made a number of interesting points to me. He said that, according to the Bank, the obstacle to the growth of the "bulling" market lies in the present level of WLR. As long as borrowers think that it might fall a little more before reaching a plateau, they are naturally reluctant to take the plunge when confronted with a somewhat opportunity. Since they still see the chance of a further fall of WLR of, say, two points, only those with a very urgent need for money are likely to come into the market at the moment (eg Iceland, who borrowed at 15.11 yield in the middle of January).

2. No seem to be faced, then, with two contradictory stories. One explanation of that contradiction is that it may only be an apparent one, since the existence I was retelling related to a situation at the end of last year, since when circumstances may have changed. However my own feeling is that the matter is worth investigating quite carefully, given the relevance with which the original points were put to me, not to mention a fair amount of chatter and rumour which I have not been able to quote.

