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CHANCELLOR

cc Chief Secretary
Sir D Wass
Mr Ryrie
Mr Burns
Mr Middleton
Mr Bridgeman
Mr Unwin
Mr Britton
Mr Ridley

PEPPER AND FORSYTH

I have been giving further consideration to the points raised by Mr Ridley in the notes attached to his minute of 4 June, and to Sir D Wass' submission of 10 June.

It seems to me that there is rather more to Forsyth than there is to Pepper. I agree in particular with the former's thesis that,

> "If long term rates are not sufficinetly high to secure sufficient funding the correct response is to raise long term rates rather than to act on short term rates, for a rise in long rates can have a swift effect on the demand for securities while a rise in short rates can only have a very gradual effect on loan demand."

(The second paragraph on page 4 of his letter to Mr Goodhart of 16 July 1979 refers.)

It is also clear that a fall in MLR would be wholly benign in the short term, with no adverse effect on bank lending and a beneficial effect on funding - provided it can be achieved in a way that is seen to be consistent with the overall policy. All our efforts should be bent towards creating the circumstances in which this can be achieved.

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In the longer run, the appropriateness of a fall in MLR depends on whether bank lending falls as the recession deepens. I believe it will; but if it does not we will simply have to take the appropriate restraining measures when the time comes. It does not seem sensible to base a policy on the assumption that bank lending will not fall as the recession deepens or even on an unwillingness to take any risk on this score.

Finally, and contrary to Forsyth, I believe that an indexed gilt (on which I am minuting you separately), in addition to its own merits, would help us to break out of the present impasse.

NL.

NIGEL LAWSON
30 June 1980