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From the Private Secretary

29 January 1981

As I told you, when the Chancellor of the Exchequer and the Governor called on the Prime Minister yesterday afternoon to discuss the indexed gilt proposal, they also discussed the possibility of a reduction in MLR in the near future. I did not take a detailed note of this part of the discussion; however, you may like to be aware of some of the points that came up.

It was pointed out that the first estimate of the January banking figures would not be available until next Wednesday. But on present information, it looked as if the figures would be relatively good - with M3 growth perhaps about 1%. If the estimate available next Wednesday turned out to be favourable, then a 1% reduction could perhaps be justified on the following day. If, on the other hand, the estimate was less good, and if nonetheless it were considered desirable to reduce MLR, then this would probably have to wait until after the banking figures were announced the following week - i.e. until the following Thursday.

The following arguments were adduced in favour of an early reduction. First, it would improve the funding prospect in the short run and therefore help the February banking figures which were due for announcement on Budget Day. Second, it would provide a useful psychological boost to industry at a time when there was evidence that some manufacturers were beginning to "give up" on their exports. Third, it would help reduce the exchange rate, or at least reduce some of the current upward pressure. Fourth, the real level of interest rates was now substantially positive, and a reduction could be justified and was desirable in its own right.

On the other hand, there were some important arguments against. First, unless the funding programme was going particularly well, a reduction prior to the Budget would look premature. Second, it could make the Chancellor's Budgetary task more difficult insofar as it might increase the pressure on him to restore the credibility of the monetary strategy. Third, there was a risk that a reduction before the Budget would be misunderstood, because this would be in advance of a restatement of the monetary strategy and in particular new targets and the fiscal measures needed to meet them.

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It was agreed that the pros and cons of an early MLR reduction, and its precise timing, would have to be considered further. If it was decided to move, it would be essential to present it in such a way that it was seen as consistent with the Government's future thinking on the monetary strategy; and some indication of the latter might have to be given. In this context it was suggested that the following points might be made: first, that the real extent of monetary pressure had been greater than the M3 fitures suggested; second, that this was reflected in the lower figures for some of the other monetary aggregates; third, that the Government would be paying greater attention in future to these other aggregates; and fourth, although this would be a significant change - that the MLR reduction was being done partly to reduce the upward pressure on the exchange rate.

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

T. P. LANKESTER

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