

Correspondence with John Sparrow
and Meetings on Economic Matters.

Economic Policy

May 1979.

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
22.5.81							
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10.8.81							
28.8.81							
9.9.81							
18.9.81							
16.4.81							

PREM 19/436

NB

Prime Minister destroyed
a letter from J Sparrow
to PM dated 31. 10. 80
when she cleared out
her flat on 23. 12. 80

BK

Please substitute
this letter
for previous
letter
MCS sent out



file

cc: Alan Walters
bcc: John Vereker

10 DOWNING STREET

From the Private Secretary

15 April 1982

Mr. Sparrow called upon the Prime Minister this afternoon. There was a wide-ranging discussion, of which I think I need record only two points.

The Prime Minister asked Mr. Sparrow to consider further the interim CPRS Unemployment Report, and to let her have a note on this within the next month or so. She would be grateful if Mr. Sparrow could keep Mr. Alan Walters in touch with his further consideration of these matters.

The Prime Minister also asked us to arrange a further discussion with Mr. Sparrow, when current preoccupation with the Falkland Islands dispute was not so pressing. We will be in touch with you in due course about this.

I am sending a copy of this letter to Alan Walters.

M. C. SCHOLAR

Gerry Spence, Esq.,
CPRS

RECEIVED

2 Econ Pol

Ann Shurish

From: JOHN SPARROW

the Health Service
23 GREAT WINCHESTER STREET
LONDON EC2P 2AX
1-588 4545
18th September, 1981.
are these things
1979

Dear Mrs. Thatcher,

Despite the necessity to bow to the market forces pushing domestic interest rates higher, sterling has been steadily weakening against all major currencies other than the U.S. dollar. In some measure, this is attributable to the expectation of a re-alignment of currencies within the EMS, hinging upon a revaluation of the Deutsche Mark. The immediate outlook for oil prices has also contributed to the decline and it is probably too early for overseas money managers to have taken account of the very clear re-affirmation of economic strategy implicit in the Government changes announced this week.

Those changes have been well received in the City where the general view appears to be that your Cabinet has been significantly strengthened. However, the CBI analysis of possible savings in public expenditure has drawn attention once again to the apparent failure to bring fiscal policy fully into line with monetary policy. In a sense, it does not matter whether or not the CBI conclusions are well-founded, although I believe that generally speaking they are; the real point is the reviving recognition, both in London and in New York, that the size of the respective budget deficits is placing an excessive and, in the end, probably unsustainable burden upon money management.

There was a certain amount of adverse comment about the decision not to proceed with the gas gathering pipeline, which was probably exacerbated by the almost simultaneous and apparently contradictory decision to push ahead with consideration of a Channel Tunnel. Following the demise of the integrated pipeline, the likely pattern of events will almost certainly entail a real cost to the Exchequer in the form of substantially reduced tax revenues instead of a relatively modest and wholly contingent charge which was unlikely ever to have been realised. Perhaps the chief lesson is that part of the case against public sector ownership of industry is that commercial considerations become inextricably linked with and occasionally subjugated to essentially political issues. It is certainly difficult to believe that a Channel Tunnel will offer higher economic returns than a gas pipeline.

Yours sincerely,
John Sparrow

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Professor Alan Walters
Adam Ridley, Esq.

not if
the
multiple
lines
go ahead

Pl.

Prime Minister

23/9/82

John Sparrow thinks we
should not be concerned
about the PSBR implications
of the gas-saving scheme

23 GREAT WINCHESTER STREET

LONDON EC2P 2AX

01-588 4545

From: JOHN SPARROW

9th September, 1981.

Dear Mr. Thatcher,

R.
23/9/82

The renewed weakness of the pound is now assuming disturbing proportions. It is tempting to attribute this to the possibility that Mr. Benn will become Leader of the Labour Party or to certain aspects of the debates now taking place in Blackpool. However, more potent factors are the renewed doubts about the ability of the U.S. administration to control its budget deficit, which is seen as a pre-condition for lower interest rates both there and around the world, and the increasing evidence that oil prices are continuing to fall in absolute terms, let alone real terms. Unless it is decided to use the reserves to support the pound which would be an extremely risky and conceivably fruitless course of action, we are again approaching the Morton's fork of higher sterling interest rates or greater inflationary pressures.

On a longer term view, the prospects for the world economy seem likely to improve considerably in the second half of 1982. The decline in the price of oil will by then have had a full twelve months to work its reflationary effect and, on the assumption that unprecedentedly high real interest rates cannot continue, even on a pessimistic basis, beyond the spring of next year, there will also have been the reflationary stimulus over a period of at least six months of a return to more normal interest rate levels. These two factors combined make it likely that the recovery from late 1982 will be much sharper than we currently dare to hope.

On the domestic front, there has been considerable attention to the debate about the proposed North Sea gas pipeline, which we briefly discussed when I saw you two weeks ago. You will know that Morgan Grenfell are involved in this matter as advisers to British Gas, although I am not personally engaged in it at all: I therefore both declare an interest and deny one. However, I remain of the view that the important question to resolve is whether or not the project is economically viable, as the original Mobil/British Gas study group clearly reported that it was. On the assumption that it is viable, I do not believe that the precise method of financing should disturb anyone and in particular I am sure that technical arguments about whether or not a British Gas guarantee makes the financing package contingently part of the PSBR should not cause the slightest concern.

Indeed I would go further. Had British Gas been privatised by now, there is little doubt that the pipeline could be financed on a project basis making initial use of what would then have been a private sector guarantee. It would be sad to run the risk of being short of gas in the 1990s simply because British Gas remains in the public sector, but so long as it is it will be the natural tendency of bankers to look for the best security available. It is worth remembering that companies like IASMO and Woodside have been able to put together comparably massive financing packages, in each case from a much weaker private sector base than that

enjoyed by British Gas. When one also takes into account the changes that would take place in various bargaining positions once it was clear that the pipeline would be going ahead, it seems to me more than ever necessary to look solely at the project's commercial prospects and then to go ahead as soon as possible in order to achieve those prospects. I do not in any way relax my view that the PSBR is the crucial hinge of domestic economic policy but I continue to believe that the important distinction between current spending, often of dubious value, and capital spending when it is clearly worthwhile must be made. There is also a need to distinguish between actual and contingent risks and to appraise the real likelihood that various contingencies will or will not materialise.

Yours sincerely,
John Major.

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Professor Alan Walters
Adam Ridley, Esq.



E con
PS

10 DOWNING STREET

Note for the Record

The Prime Minister had
a meeting with

John Sparrow on

28. 8. 81.

92
Prime Minister

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MA 28/11/81

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX

From: JOHN SPARROW

01-588 4545

28th August, 1981.

Dear Mrs. Thatcher,

The equity market continues to reflect a slightly happier view of the prospects for the private sector, although this is still largely based on the view that there has generally been a successful adaptation to a lower level of activity, rather than any thought of rapid recovery. There is encouragement drawn from such things as the preferences of the Coventry ratepayers and the attitude of the engineering employers, although there is still an awareness that the firmer negotiating posture of private sector employees might evaporate if a strengthening economy redresses some of the bargaining advantages which employers currently have. In other words, we need to make sure that the legal framework in which pay negotiations take place becomes rather less lopsided than it is.

American interest rates remain high, and too much should not be made of the token reduction in brokers' loan rates announced by two major U.S. banks. The pound continues to move erratically against the dollar as successive waves of optimism and pessimism about the future of dollar interest rates make their way across the Atlantic, but it remains relatively strong against European currencies. The efforts to control money market rates in this country continue to be successful and remain worthwhile.

I greatly appreciated the opportunity to talk to you again to-day and would welcome more frequent meetings in the future. It occurred to me, as the door closed behind me, that you may have thought that I was ungracious in saying that I would come when I was called; I had merely intended to indicate my willingness to talk, and I hope that you did not get the opposite impression.

Yours sincerely,
John Sparrow.

The Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Professor Alan Walters
Adam Ridley, Esq.



10 DOWNING STREET

Prime Minister

Here are John Sparrow's
most recent letters

MA 27/
VIII

Prime Minister

MAP
24/m.

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX

From: JOHN SPARROW

01-588 4545

21st August, 1981.

Dear Mrs. Thatcher,

Both the pound and the equity market have strengthened since I last wrote to you. The pound first showed signs of recovery when the differences within OPEC became apparent and, despite occasional set-backs caused by fears that OPEC would agree on a lower rather than a higher pricing policy and by worries about the ramifications of a rail strike, it has regained its strength supported by some commercial buying, not merely by oil companies providing themselves with the means to meet their PRT bills at the end of the month.

More recently, the pound has also reflected the weakening of the dollar which has followed the spread of the belief that dollar interest rates will soon fall. These rates are, of course, still the key to much of what is happening in the world economy; Mr. Volcker's latest statement seems to be designed both to quell the immediate speculation that rates will fall and to reassure the market that the next significant move will be downwards. Jam tomorrow! Meanwhile significant sectors of the U.S. economy continue to find life very difficult.

Here at home, the picture is partially obscured by the change in the system of monetary control and by the unraveling of the effects of the civil service dispute. The efforts being made to stabilise short-term interest rates during this difficult period have so far proved successful and are certainly worthwhile so long as there is reason to believe that the underlying problems are temporary in their nature. I have mentioned before that a prolonged period of high dollar rates would cause embarrassment in the U.K. and in every other developed economy but in large measure they represent a phenomenon which we can only observe.

Although the evidence is mounting for the view that a slow recovery in economic activity is now beginning, the statistical picture may well be distorted if, as is possible, the return to normal working in the Inland Revenue precipitates the bankruptcy of a number of small businesses which have managed to survive thus far simply because they were not having to pay their various tax bills. If this does happen, it will be important to recognise that what will then be happening will be a delayed reaction to the pressures of the spring rather than an item of contemporary significance.

The F.T. Index began its rise immediately after the Royal Wedding, although I would hesitate to impute cause and effect. There is no doubt that the atmosphere in industry is improving. No one expects a rapid recovery and there will be problems in a great many places for some time to come. Nonetheless we have at least the prospect of stability and the hope of some growth, and the stock market has reacted accordingly.

As I write, it seems likely that the British Rail dispute will be settled to-day but the details are not yet available. I have

heard that British Rail believe that they have achieved a satisfactory outcome and we must all hope that that is the case, particularly bearing in mind the quite disproportionate impact on inflation which still comes from public sector sources. Of course, this merely reflects the continued excessive share of GDP being swallowed up by the public sector.

Now that the pressures on sterling have eased, at any rate for the time being, we may hear less of the suggestions that were being bandied around to the effect that exchange control either should or would be reimposed. The arguments that led to the abolition of exchange control remain as valid as ever and its reimposition would be a considerable set-back to the hopes of restoring health to the economy. It may be worth pointing out that the two main streams of capital flows which followed the abolition were both in their nature likely to have a much more significant once-and-for-all effect than will be the subsequent continuous pattern. A large number of professional and other investors was inspired by abolition to re-consider the distribution of their investment portfolios and I understand that the significant re-allocation in favour of overseas markets is now largely complete. Similarly, those borrowers who took the opportunity to re-structure the currency make-up of their borrowings have now also come to the end of the process of major adjustment. There is, therefore, no justification for extrapolating the capital flows that have taken place since abolition of exchange control.

Finally, the Australian Budget makes interesting reading. Bearing in mind that they were able to come to grips with their economic problems a couple of years earlier than us, it is encouraging to see that they have now got to the stage of having a Budget which is almost balanced, fixed investment expected to increase significantly and unemployment at the lowest level in four years. The measure of the task is, however, emphasised by the Treasurer's expectation of a return to double digit inflation.

Yours sincerely,
John Sparrow

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Professor Alan Walters
Adam Ridley, Esq.

Prime Minister

2

23 GREAT WINCHESTER STREET

LONDON EC2P 2AX

01-588 4545

From: JOHN SPARROW

10th August, 1981.

MS.
Dear Mrs. Thatcher,

11/8

In view of the various doubts and uncertainties which have been only too well publicised in recent weeks, it is encouraging that the London Chamber of Commerce Survey published to-day comes to much the same conclusions as those reached by the economists of the Chase Manhattan Bank and by last week's Financial Times Survey of Business Confidence.

All three surveys indicate that the precipitate slide in economic activity came to an end in the first quarter of 1981 and, in their various ways, predict an improvement in immediate prospects. The Chamber of Commerce findings on orders and production levels are supported by anecdotal evidence from a variety of industrial companies but it appears to be particularly the case in the engineering industry that the process of bumping along the bottom of the recession is coming to an end. Chase Manhattan expect the economy to be growing again in the fourth quarter, although still down on the year, whilst one noticed in the Financial Times Survey that confidence was growing in more or less every economic indicator except investment.

This is, of course, a notable and important exception but it is one which should occasion little or no surprise in view of the substantial spare capacity which now exists, the continuing uncertainties, the real cost of money and the possibility that labour will no longer be such an expensive commodity that it has to be replaced. It is likely that for some little time ahead very stringent standards will be applied to investment propositions in the private sector; it is important that the same stringent tests are maintained in the public sector, but it is also important that investment propositions that meet those tests should be financed, even if this means finding some way of making absolutely certain that the monies are not syphoned off for some less deserving cause.

It now appears likely that the future course of sterling interest rates and indeed of European rates generally will depend upon American domestic economic policy. I remain of the view that American policy is damaging both their own economy and, through pressures on exchange rates and consequently on inflation rates, the economies (and possibly even the social fabric) of their principal partners. One hears suggestions that economic policy will become an integral part of discussions on foreign policy during the autumn, alien though that might be to the American tradition. Certainly dollar interest rates are playing a major part in determining the sterling/dollar exchange rate; the pound remains relatively strong against the European currencies but the dollar has now achieved a real revaluation of an extent which has only been exceeded in recent years by the pound itself, following the first flows of oil from the North Sea. The dollar has no such massive structural advantage to bolster its appreciation and one doubts the maintainability of its present levels once interest rates begin to decline, as one day they must.

/2.

Ahead of that day, there will be pressure on our domestic inflation rate, exemplified by increases in petrol prices directly attributable to the declining value of sterling; this in turn will put upward pressure on interest rates which, if they rise, could well nip in the bud the incipient recovery in the economy.

Despite the alarms and excursions, it appears increasingly to be the case that your economic policies can be seen to be working. The impact of decisions in the United States is not proving helpful at present but is unlikely to be permanent. The success which you have had in the civil service pay dispute must be regarded as the model for such disputes through the winter and it is certainly important that British Rail are not seen to compromise on what was originally a very clear resolve. It is, of course, absolutely vital that the government as a whole, having come this far, should stick to its guns.

I hope that you are having an enjoyable holiday.

Yours sincerely,
John Spenser

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.
Professor Alan Walters

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23 GREAT WINCHESTER STREET
LONDON EC2P 2AX

From: JOHN SPARROW

01-588 4545

17th July, 1981.

Dear Mrs. Thatcher,

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R. 17/7
Ecan Rd

The pound continues to weaken, despite what should have been the favourable influences of some signs of recovery in the spot price of oil, allied to further evidence, however uncertainly based, that the money supply is continuing under control.

The major negative influences on sterling have been, first, the signs of social unrest which have in turn led to fears that the government will be compelled to change its economic policy; and secondly, the continued high level of U.S. interest rates and Mr. Volcker's declared intention to resist international pressure to moderate the Federal Reserve Board's current interest rate policy. So far as the first of these factors is concerned, there is ground for some belief that, although recurring disturbances are still described as 'riots', they have in fact now assumed the proportions of the sort of football hooliganism to which the streets of Manchester and Sheffield have become accustomed on Saturday afternoons in the winter. What seems to be needed is not so much a series of panic measures to impose stringent law and order but more a settled and continued policy of reinforcing discipline and standards of behaviour, probably including a change of attitude in a great many Magistrates Courts.

U.S. interest rates continue to present the international community with considerable problems and, as I have said before, are likely to lead in the end to severe economic problems within the United States. There seems ample evidence that our own interest rates are high enough for domestic purposes and the only justification for increasing them would be to defend the value of the pound. The decline in sterling weakens the fight against inflation but higher interest rates would inevitably lead to higher unemployment, thereby landing us with the worst of both worlds. Other aspects of the inflation scene have included the McCarthy arbitration, which at first sight looks irresponsible and certainly contrasts with the firmness with which the civil service dispute has so far been handled. Local Authority attitudes still remain largely unhelpful although the fears that are spreading about the credit-worthiness of Local Authorities do not seem to me to be particularly helpful. I have suggested before that there might well be a case for specifically disavowing central government's responsibility for future debts incurred by Local Authorities, but the present air of growing uncertainty against the background of what appear to be clear-cut last resort facilities can only be damaging to the reputation of the public sector.

Finally, the BP issue eventually justified the view that it was a milestone in the re-opening of the capital markets to private sector borrowers, despite the last minute alarms occasioned by what

appeared to be rather less than satisfactory handling of the second index-linked stock.

I wish you well in your trip across the Atlantic this weekend; there is much to achieve.

Yours sincerely,
Jim Sparrow

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Professor Alan Walters
Adam Ridley, Esq.

CF

Plan met
in form - Meeting cancelled.
for Sparrow
meeting (written Mrs.)
Dunthorn

2
Econ Pol

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX
01-588 4545

From: JOHN SPARROW

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Mf

3rd July, 1981.

Il
77

Dear Mr. Thatcher,

Much in financial markets continues to depend upon the level of interest rates in the United States of America. Although it appears that the market would bring rates lower, it is repeatedly reined back by official policy. I persist in the belief that the market is right and that the officials will eventually come to realise this, but I have to confess that I am increasingly in a minority in the latter part of that view. So long as the present position persists, the other principal economies are going to find their currencies inconveniently devalued, their domestic inflationary pressures worsened and their interest rates necessarily higher.

From newspaper reports, it appears that recognition of the problems posed by U.S. interest rates formed an important part of the recent discussions in Luxembourg. It remains likely that the American authorities will put their domestic considerations completely ahead of the international consequences of their policies; it would therefore seem sensible that any attempt to persuade the Americans to modify their policies should, even if actually undertaken for international reasons, primarily be couched in terms of ultimate domestic consequences. As happened in the U.K. in 1980, the recessionary effects of high interest rates are likely to be belatedly recognised in the United States. This is partly a function of statistical time lapse, partly a consequence of the difficulties in actually measuring proxies for money, and possibly partly attributable to the difficulty we all have in adjusting policy to changing circumstances. Nonetheless, there are sufficient indications that the growth of the American economy has halted to enable one to infer that interest rates there will eventually be significantly reduced; the question to which one then has to address oneself is not whether but when. It seems to me that this is the message which the markets, so far unsuccessfully, are trying to convey.

In the U.K., the gilt market has been affected by international attitudes to sterling, which have done more than mirror the rise of the dollar. It is common to attribute the decline against other currencies to the change in the short-term outlook for oil, but I doubt that this is a sufficient explanation. It seems to me that at least some weight is being put upon the fact that people can still talk blithely about pay increases of 20% or 25% and, to the extent that this leads to a lower value for the pound and therefore to higher inflation, the people who make that sort of statement will, at least in their own eyes, strengthen their case. Before we get to next winter's battles over pay we have the autumn's battles over expectations to win; and the foreign exchange market may to some extent indicate that those preliminary battles are not being won. The pound is currently rather too low to maintain the necessary pressures on management without which the eventual battles will be lost, despite the valiant efforts of Geoffrey Howe and others.

One very considerable step forward this year has been the extent to which the government has been able to withdraw from the gilt-edged new issue market, and particularly from the longer dated end. If it had not done so, it seems likely that interest rates would have been far higher than they currently are. In addition, we have seen very convincing evidence that the private sector capital market is more than ready to fill any gap that might have been expected to emerge on the demand side. The BP rights issue in itself was fairly convincing evidence of this, but perhaps more significant in the longer term will have been the International Nickel offer of long-dated fixed interest debt. As I dictated this, however, I see that another offering of long-dated stock, albeit index linked, is now to be made; although there must be scope for occasional issues of this kind, I retain the hope that they will not be too frequent or too large.

Finally, I hope that it is not true that British Gas are to be required to dispose of their showrooms on a piece-meal basis. I repeat what I have said previously, that there is every justification for such a disposal provided that it is complete, but that a fragmentation of the only effective retailing network available to the gas appliance industry can only have adverse repercussions on the manufacturers concerned. I declare an interest as a director of such a company, but I believe my comment to be disinterested.

Yours sincerely,
John Sparrow

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Professor Alan Walters
Adam Ridley, Esq.

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX

From: JOHN SPARROW

John Sparrow

01-588 4545

19th June, 1981.

Dear Mr. Thatcher,

R
19/6

ms

I seem to be as out of sympathy with the movement of dollar interest rates this year as I was in the case of sterling interest rates in 1980 and perhaps both failures are susceptible to the same explanation. In any event, the Federal Reserve Board has clearly indicated that they do not regard the continued decline of U.S. interest rates as acceptable and as a result, the dollar has moved back up against all other currencies including sterling. It is possible to detect a little residual strength in sterling vis a vis currencies other than the dollar and this is reflected in the trade weighted figure.

I had expected that developments in the U.S.A. would ameliorate at least part of the weakness of sterling that has been in evidence in the last few weeks. I still believe that that would be a sensible and desirable outcome but we are once again faced with the possibility that U.S. domestic considerations will lead to policies which in turn necessitate defensive reactions in other countries, including the U.K. This would be unfortunate, because a high interest regime here at this stage would be very damaging both economically and politically, but an unduly low exchange rate can in the long term prove even more destructive. I still hope that this week's events in New York will prove only to be a temporary blip, but I am very much afraid that it will continue and face us with a choice between two very real evils. Of these two, I believe that an undervalued pound is worse than an increase in interest rates, but neither is at all attractive.

On the domestic scene there was a form of negative encouragement from such reports as have emerged of the Cabinet discussion on Wednesday. One is pleased that your economic policies are to continue and perhaps in certain aspects to be strengthened; but there is still an unfortunate impression that the support that you gained is less than wholehearted. On the other hand, the Bank of England seems to be warming to the task of carrying out your policies and its views on the course of real wages are particularly timely. Two or three weeks ago I referred to the contrast between the patterns of employment in the U.S.A. and the U.K. over the last decade; the crucial difference in the background is that real wages in the U.S.A. have barely risen, which has permitted the number employed to grow very substantially, whilst real wages in the U.K. have advanced remorselessly, permitting no increase at all in the numbers employed. It is encouraging that the members of the civil service unions by and large seem to be much more aware of this sort of reality than their leaders. The Government's stand is certainly not attracting any public criticism and should be maintained.

More and more, the criticism of government spending is becoming refined and pointed. There appears now to be widespread recognition of the need to move such spending from current account to worthwhile projects on capital account; the emergent strain of criticism focuses on the extent to which government monies are being channelled towards what a few years ago we would have called lame ducks. There is a very real responsibility to ensure that in such cases the recovery prospects are genuine and the funds involved are used exclusively towards recovery and not dissipated. The prime example is the Coal Board but over the last few months it is only one case among many. Turning again to the Bank of England Bulletin the contrast between real profitability and real wages goes a long way to explaining the problems of the economy.

At the grass roots level, the evidence is still that we have passed the worst of the recession but that the recovery will be slow to gather momentum. At present, it seems unlikely that the rate of inflation will fall much further, particularly in the face of the current weakness of the pound.

Finally, there would be a general welcome for a renewed effort to return public sector assets to the private sector. The possibility of such a move in the case of the National Freight Company has been widely welcomed, and there is no reason to shy away from the sale of Gas Board showrooms, provided that they are hived off in sensibly sized groups. This last point is important not simply in terms of the efficiency of the operation itself but also because, mainly for good reasons, the manufacturers of gas appliances are very heavily dependent upon that particular distribution network. There is no need for the showrooms to remain the property of the Gas Council, but there is a need for the only effective means of distribution to remain reasonably intact.

Yours sincerely
John Sparrow

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.
Professor Alan Walters

23 GREAT WINCHESTER STREET

LONDON EC2P 2AX

01-588 4545

12th June, 1981.

Dear Mrs. Thatcher,

In view of the turmoil in the various financial markets over the last two weeks I can only say that I could not have chosen a better time to take a short holiday. However, the severest shocks now seem to be behind us and it is possible to take a rather cooler look at forces than might have been the case last week.

In the first place, the gentle decline in dollar interest rates still continues. These rates remain high both in absolute and in relative terms and, despite the decline, are extremely attractive to international investors worried about a Socialist government in France, a possible Benn government in Britain, no government in Italy, continued uncertainty in West Germany and a deteriorating situation in Poland. One can therefore expect the dollar to remain relatively strong for political reasons even if the immediate financial attractions continue to diminish.

So far as sterling is concerned, it has lost value in two stages. In the first place it moved down only against the dollar which was simply the mirror image of the strengthening of that currency. More significant was the subsequent devaluation against the other major currencies, which appears to have been attributable largely to the sudden recognition of the changes that have been evolving in the world oil situation during 1981. There is no reason in the last fortnight's events why sterling interest rates should be led one way or another; the policy of leaving market forces to determine the cost of money seems to be working perfectly well.

I have no other specific points to make this week but hope to be able to write more fully next Friday after I have had a full week back in the office.

Yours sincerely,
John Sparrow.

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.
Professor Alan Walters

2 Econ PJ

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX
01-588 4545

From: JOHN SPARROW

Russell

29th May, 1981.

R 24/5

mf

Dear Mr. Thatcher,

Dollar interest rates have continued to decline this week and, indeed, the downward momentum increased slightly. Views are still very divided about the way in which things will go in the future in the United States and possibly more attention is being paid to the money supply statistics than is warranted by any figure published weekly. That said, the M1B series, adjusted for NOW accounts, is within the top end of the target range and, ahead of to-day's figures, I still believe that the downward path will be continued.

The foreign exchange markets have reflected the movement that there has been in dollar interest rates, and have confirmed the view that the dollar's parity is very much related to interest rates and the resultant capital flows. It is significant that only Japan of the major economies currently has interest rates in single figures and, even given the very real economic problems being suffered by most developed countries, there is no doubt that real interest rates are unreasonably high in a great many countries. The United Kingdom is one of the exceptions to that rule and money market rates continue to indicate that there is neither the need for nor the expectation of lower short-term rates here.

Flay A |

The Department of Industry has published the results of a survey on investment plans which at first sight makes rather gloomy reading. However, it may be worth pointing out that this sort of survey is atypical and therefore possibly misleading, in that it tends to reflect the views of big companies at a time when their share of future investment is likely to be disproportionately low; what a survey of that kind can never show is whether or not there is a burgeoning of investment plans among the smaller companies and in businesses currently being established.

Furthermore, the fact that a significant amount of new capital investment is specifically intended to be labour saving means that the habit of regarding new investment as an unqualified good thing is less appropriate when there are 2½ million unemployed than it was when we were suffering from over-employment. The real emphasis to-day is, quite properly, on labour productivity. This is another subject which is beset by spurious statistics, because it is not uncommon to attribute to labour the productivity gains which have actually been achieved by capital investment; the true definition of labour productivity would measure increasing output by a constant workforce using constant capital resources. It is the improvement in that direction which is currently taking place which is likely to be the basis for the recovery of the economy.

Despite the continuing increase in the number of people unemployed, it is interesting to note that the average number of people actually in work in 1980 was only marginally less than the size of the employed civilian workforce in 1969, which presumably indicates that the number of people offering themselves for employment has increased by more or less the extent of the increase in unemployment. On the other hand, in the same period the number of civilians employed in the U.S.A. has risen from 78m. to 97m., which demonstrates what can be done in an economy which has enjoyed real growth. If we are successful in creating production led growth in this country, there is no reason to accept the gloomy forebodings about the inevitability of continued high unemployment.

Market forces seem to be the last thing to be considered by the Civil Service unions in their current pay dispute because although one hears a great deal about the great advantages they would enjoy if they were working in the private sector, very few of them seem prepared to leave the Civil Service and seek those advantages. Hope remains strong that the government will continue to conduct the negotiations on the basis of what the country can afford, and will remember that, except to the extent that "the going rate" has an undeniable but unquantifiable impact on the thinking of pay negotiators on both sides, there is no such thing as comparability for employees in the private sector. The dominant influences are need and affordability and the dominant sanction is mobility. It would be a particular pity to give ground now after you have stood firm for so long.

Yours sincerely,
John Ferron

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.,
Professor Alan Walters

123 Victoria Street, London SW1E 6RB TEL: 01 212 5494

Ref: 113

28 May 1981

INDUSTRY'S INVESTMENT INTENTIONS FOR 1981 AND 1982

After a fall of $\frac{1}{2}$ per cent in the volume of investment between 1979 and 1980 for the total of manufacturing, distributive and service industries (excluding shipping), a rather larger reduction of some 3-6 per cent is expected between 1980 and 1981. This reduction is smaller than that given in December last, mainly because of a higher 1981 figure for distribution and services.

Although the estimate for 1982 must be more tentative than that for the current year, the survey suggests some recovery during that year.

Forms for this survey were sent to contributors at the end of March and the results given below are based on replies received up to mid-May. Contributors were asked to give a final estimate of expected capital expenditure in 1981 and a further indication of investment in 1982.

Manufacturing industry

The results of the present survey suggest a decrease in the volume of investment in 1981 of 15 to 18 per cent compared with 1980. This is within the range of 15 to 20 per cent indicated by the previous survey, and consistent with the provisional estimate of investment for the first quarter of 1981 - the fifth successive quarter of decline.

The increasing tendency of manufacturers to obtain assets on finance lease rather than by purchase is considered to have contributed to this fall in expected expenditure. When leasing to manufacturers is added to their direct purchases, the fall in their total investment between the two years is expected to be somewhat lower and in the range of 11 to 14 per cent.

All industry groups are likely to reduce their levels of capital expenditure compared with 1980. The severest reductions (about 20 per cent) are expected by the textiles, leather and clothing, the paper, printing and publishing and the engineering industries. More moderate falls (about 10 per cent) are forecast in the food, drink and tobacco, the chemicals, and the metals industries.

The prospect for 1982 is slightly clearer now than at the time of the previous survey. Some recovery in investment is anticipated during the year probably sufficient to cause capital expenditure for the year as a whole to show an increase over 1981. In addition a further increase is expected in the volume of assets obtained by manufacturers on financial lease.

Distributive and service industries (excluding shipping)

The information from the previous survey implied that there would be no appreciable change in the overall level of investment by the distributive and service industries over the three years 1980, 1981 and 1982. The latest survey, while confirming that substantial changes are unlikely, suggests that small year-on-year increases (of less than 5 per cent) are to be expected both in 1981 and 1982. These gains are mainly attributable to expected further growth in leasing. In terms of the capital assets, the growth will probably come mainly from greater investment in plant and machinery.

Levels of investment

The volume of investment by each sector is its expenditure on the acquisition of fixed assets, at 1975 prices, excluding those obtained on lease from other sectors of the economy. Expenditure on the acquisition of assets intended to be leased out is attributed according to ownership. The following table gives some figures for recent years, with a rounded central estimate for 1981.

<u>Year</u>	<u>Industry's capital expenditure</u> <u>(£ million at 1975 prices)</u>		<u>Total</u>
	<u>Manufacturing</u> <u>industry</u>	<u>Distributive and service</u> <u>industries (excluding shipping)</u>	
1970	4177*	3610	7787
1971	3898	3810	7708
1972	3370	3986	7356
1973	3440	4519	7959
1974	3782	4477	8250
1975	3522	3851	7373
1976	3326	3945	7271
1977	3510	4413	7923
1978	3773	5026	8799
1979	3873	5663*	9536
1980	3499**	5980**	9479
1981 (rounded central estimate)	2925***	6150***	9075

* Highest level yet recorded

** At 1980 prices these estimates would represent expenditure of nearly £7 thousand million for manufacturing industry and nearly £11 thousand million for the distributive and service industries

*** At 1981 prices these estimates would represent expenditure of about £6½ thousand million for manufacturing industry and about £12½ thousand million for the distributive and service industries

1. The above results are based on the latest of a series of regular surveys directed to a panel of companies, mainly larger companies but including some smaller ones, in manufacturing industry and in the distributive and service industries. A full description of the surveys is given in Investment intentions, authorisations and expenditures, Government Economic Service Occasional Papers, 12; a shorter account is available in Statistical News, May 1978 (pages 41.15 to 41.19).

2. Respondents to the latest survey account for approximately thirty per cent of the capital expenditure of both manufacturing and the distributive and service industries.

3. Results of earlier surveys covering 1981 were published by press notice on 3 January, 29 May and 18 December of last year. This is the second survey to cover 1982. A further estimate for 1982, together with a preliminary estimate for 1983, will be published in December 1981.

4. Figures from respondents are generally given in expected future prices and their estimates of price rises are used to convert them to volume. This is an additional source of uncertainty in the interpretation of the surveys.

5. Exploration and development work in the North Sea is classified as a mining activity and is therefore not included in these figures. The coverage is specifically defined in articles in British business on the results of the quarterly inquiry into capital expenditure: the latest of these articles with notes on coverage to appear will be published on 29 May 1981.

6. Expenditure on capital goods acquired for leasing out is classified to the service industries on the basis of ownership of the assets. Insofar as this leasing is to firms in manufacturing there is an apparent switch of investment from manufacturing to the service industries in the figures. An article on investment in assets for leasing was published in British business on 26 September 1980.

Investment by manufacturing industry

£ million 1975 prices

	Capital expenditure	Estimated volume of assets leased from service industries	Total expenditure plus leased assets
1975	3522	188	3710
1976	3326	204	3530
1977	3510	270	3780
1978	3773	367	4140
1979	3873	447	4320
1980	3499	521	4020

7. As background information, a table of quarterly figures of actual capital expenditure is attached. A breakdown of expenditure by industry groups will be published in the British business article referred to in note 5.

Press and broadcast calls to 01-212 5494

Other calls to 01-215 3176/3175 (manufacturing)
01-215 3345 (distribution and services)

2.
1.

Prime Minister

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX
01-588 4545

From: JOHN SPARROW

Tim - I think John should soon come in for a talk re: mt.

22nd May, 1981.

Dear Mr. Thatcher,

I apologise for the fact that my letters recently have been irregular and perfunctory; one or two matters were keeping me fairly fully occupied here at Morgan Grenfell.

The key to much that is happening in financial markets, continues to be the level of dollar interest rates, and it is likely that the future pattern of interest rates in the U.S.A. will be the strongest single influence on developments in European financial markets.

All of that is easy to say; it is rather harder to foretell what those changes will be. Conflicting messages continue to emerge from the various authorities in the U.S. but, on fundamental grounds, the most likely course still seems to be that dollar rates will decline during the summer from their present 19-20% level to perhaps as low (!) as 14% or 15%. This would still represent an excessive level of real interest rates, although not, of course, anything like as excessive as they currently are; given the traditional emphasis in U.S. fiscal and monetary policy, under which domestic considerations heavily outweigh international factors, it is nonetheless as low a level as can reasonably be looked for.

If this analysis is right, the dollar will remain an attractive home for international capital throughout 1981, a state of affairs which would be compounded if (as some people believe) dollar interest rates are doomed to stay at or even above their present levels for much of this year. One might therefore expect sterling to trade against the dollar at levels between the present \$2.07 up to perhaps \$2.20 but probably not significantly higher. More profound repercussions are likely in Europe, where the election of Monsieur Mitterand has already made a marked impact on the value of the Franc and raised some serious questions about the future of the EMS. The French are taking steps to protect their currency but these steps may prove to be inadequate if an actively Left Wing legislature is elected to support the new President. Even if this does not happen, there is at least the possibility that the Franc will have to opt out of the EMS, even if only temporarily. If that were to happen life would become very difficult for the Lira and for the Belgian Franc, and it seems unlikely that accommodation could be arrived at by voluntary adjustments on the part of the Deutschmark. The German economy itself is having to cope in its turn with the problems with which we and the United States are becoming familiar and at best the exchange markets have a turbulent time ahead.

So far as domestic financial policy is concerned there still seems little or no reason to change the present course. It is difficult to argue a case for interest rates being higher or lower than they currently are and a period of stability would probably help the process of adjustment. The outstanding problems are not financial but managerial, as exemplified by various pay disputes including most notably that in the Civil Service, and the broad thrust of diverting resources from consumption into production, from current spending to capital account. All this, of course, is within the context of a PSBR which must continue to be reduced. It is a huge problem but it is essentially one of management.

I should perhaps close by mentioning that many people in the City were disturbed both by the solution that was eventually found for the problems of ICL and by the manner in which it was carried out. I am aware that there were many faults on many sides of that particular problem, but it remains true that private sector solutions to difficulties of that kind will not be forthcoming so long as public sector solutions, however unwillingly, are produced.

*Yours sincerely,
John Sparrow*

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.
Professor Alan Walters

Am. Thatch

Alan Rd

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX

From: JOHN SPARROW

01-588 4545

11th May, 1981.

*B
4/11*

MS

Dear Mr. Thatcher,

The most significant feature of last week was the surge in dollar interest rates designed to control domestic demand for money. Inevitably, one consequence was a considerable flow of international funds into the dollar, which accordingly strengthened against all major currencies. Towards the end of the week, some moderation of interest rates took place and to roughly the same extent the earlier currency movements were reversed. The prospects now seem to be that dollar interest rates will decline and we can therefore expect sterling to show some strengthening.

Against other currencies, sterling has shown very little variation; the French Franc has weakened following the result of the Presidential election.

The flow of funds into the dollar had its counterpart in lower prices in both the equity and gilt markets, and here again there was a slight reversal of trend at the end of the week. Domestically, there seems every reason for your present policies to continue unchanged, the major need continuing to be pressure to reduce current spending in the public sector both in order to cut borrowing and to make room for capital spending. There was a suggestion during the week that the gas gathering pipeline might be delayed because of arguments about its impact on the PSBR; it is such an important development both economically and politically that it illustrates perfectly the need to make capital investment possible by economies elsewhere. It is also worth bearing in mind that major capital investments of this nature, even if originally borne by government, are always capable of being sold to the private sector at a later date. I was not able to see Geoffrey Howe's interview on "Weekend World" but the brief report in the Financial Times was encouraging where it referred to an increase in the share of government spending on capital investment as opposed to current items.

*Yours sincerely,
John Sparrow.*

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London,
S.W.1.

cc. Adam Ridley, Esq.
Professor Alan Walters

Ann M. 5th

2

Alan Pd

23 GREAT WINCHESTER STREET

LONDON EC2P 2AX

01-588 4545

From: JOHN SPARROW

MS

2
1/5

1st May, 1981.

Dear Mrs. Thatcher,

There is little to comment on this week, the main developments being the continuation of trends and events which I have already discussed.

The equity market's reviving confidence has received further support in the recovery at ICI and the progress reported by other companies, including at least one important engineering company. Perhaps more important than the ICI figures are the indications that the management there are maintaining their determination whilst losing some of their anxiety.

The currency markets continue to be dominated by dollar interest rates, which rose again during the week and resulted in a further strengthening of the dollar. The pound mirrored that effect but remained broadly unchanged vis-a-vis other currencies.

Finally, it is increasingly hoped that the outstanding pay claims in the public sector can be settled soon without any concessions being made.

Yours sincerely,

John Sparrow

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Professor Alan Walters
Adam Ridley, Esq.

Econ Pdf

2

PRIME MINISTER

23 GREAT WINCHESTER STREET

MS 24/4

LONDON EC2P 2AX

From: JOHN SPARROW

01-588 4545

MS
24th April, 1981.

Dear Mrs. Thatcher,

During the last two weeks, the equity market has made considerable, albeit intermittent, progress. If this were based on serious expectations of significant reductions in interest rates, it would have been accompanied by some sort of movement in the gilt market. However, gilt-edged stocks are conspicuously discounting very little, if any, improvement in external financial circumstances and it is therefore reasonably clear that the equity market is anticipating the restoration of profitability in industry and commerce. There are now blades of grass poking up here and there to lend credence to the view, previously based largely on nose, that the economic winter is over and spring is on its way. The improvement in the fortunes of ICI during March has been paralleled in a number of other companies and the signs are that the problems caused by the sheer pace of the adjustment to a more rigorous regime are passing and that the problems of living with that regime itself can be coped with.

None of this, of course, diminishes the need for current spending in the public sector to be reduced, both to permit the government deficit to be lower and, within that deficit, to permit a transfer of resources towards investment. It remains of the first importance that the civil service pay dispute should be settled without concessions being made which would be prejudicial both directly, in terms of the aggregate of public spending, and indirectly, in terms of the evidence such concessions would provide that intransigence pays.

Sterling remains relatively steady, except to the extent that it mirrors the sizeable fluctuations occurring in the value of the U.S. dollar. These fluctuations seem to be most closely related to actual and expected moves in dollar interest rates; the Americans are still suffering the problems which you had in 1979, striking the balance between the domestic and the international consequences of high interest rates, although in the case of the U.S.A. the international consequences are much less likely to bounce back into the domestic arena. One therefore expects relatively high, although possibly declining, dollar interest rates throughout the next six months with the dollar currency remaining relatively strong. However, there still seems no great reason to expect further deterioration in the pound in the absence of marked relative changes in sterling interest rates.

The only other noteworthy feature of the last two weeks has been the evidence that the switch to National Savings as a means of mobilising money for the government has been quite extraordinarily successful. This will inevitably pose problems for the building societies, which may take a little while to sink in but which could hold the housing market back throughout the year. This in itself may well be no bad thing. There should also be scope for significantly lower gilt-edged sales, and therefore for a revival of private sector fund raising in the long term market.

Yours sincerely,

The Rt. Hon. Mrs. Margaret Thatcher, M.P.

John Sparrow.

cc. Adam Ridley, Esq.
Professor Alan Walters

Prichard

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX
01-588 4545

From: JOHN SPARROW

10th April, 1981.

12/4/81 *ms*
Dear Mr. Thatcher,

A week in which the equity markets continued to reflect confidence in the medium term future began with another demonstration of the relationship between interest rates and exchange rates. The belief that the money supply figures would provide a suitable basis for a reduction in MLR led to a marked anticipatory fall in sterling, which was promptly reversed when the actual figures indicated that no such reduction was likely to be in immediate prospect. The money supply figures themselves were probably only disappointing in relation to the expectations that had been built up, although it now seems to me that the scope for further cuts in domestic interest rates is limited both by the indications that the rate of inflation is moving on to a plateau instead of continuing to decline and by the combined demand for money from both public and private sectors. Having spent a good deal of breath in arguing against unduly high interest rates during 1980 I hope that it will not be necessary to argue against unjustifiably low ones in 1981.

Reverting to the exchange rate, there are a few more straws of anecdotal evidence that industry can live with the pound at about its 1975 levels which, if it proves to be right, would be an important factor in determining the balance between revived industrial activity and continued control of inflation. In the immediate future, the most conspicuous influence on the value of the pound is likely to be the behaviour of U.S. dollar interest rates; no one is terribly sure what is likely to happen but the nearest one can get to a consensus is that the next three months might see a modest decline, which will probably mean little or no change in the exchange rate - unless change is engendered by events in this country.

Your critics seem to be having a fairly tough time recently. The Select Committee this week has had much the same sort of reception as the 364 economists last week, but in the most recent example I hope that any pleasure that may be felt in the reaction to the Committee's report will not distract attention from the fact that some of the things which the Committee said are in fact extremely sensible and not merely compatible with your policy but important ingredients in its eventual success.

U Finally, it remains the widely held view in the City that the only satisfactory conclusion to the civil service pay dispute would be one in which the employer makes no concessions.

Yours sincerely,
John Sparrow

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.
Professor Alan Walters

2
PRIME MINISTER MS 3/4

Econ Pol

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX

From: JOHN SPARROW

01-588 4545

MS
3rd April, 1981.

Dear Mr. Thatcher,

Since I returned from holiday, the equity market has confirmed in unmistakable terms that it sees a return to profitability in the private sector. This is reflected not only in the movement of the F.T. Index; the All-share Index stands at its all time high and some individual securities have seen such noteworthy changes as a 10% rise in ICI between Monday and Thursday of this week. There is probably an element of anticipating further reductions in short-term interest rates included in the re-appraisal that is taking place but I do not myself believe that that is an essential part of the market's reasoning. More important components are a spreading belief that the recession has bottomed out, in fact although not yet in statistics; and the expectation that you will stick to your economic policies and that they are succeeding.

All of this contrasts with the criticism by the 364 economists who, in the words of the old adage, if laid end to end would not come to a conclusion. It was probably less surprising that they should have said what they did than that their intervention has made so little impact including, so far as I have read, a complete lack of public support for their views from the Opposition benches.

This is not to say that euphoria is widespread. Confidence is being restored but can be expected to remain fragile until your frequently expressed intentions to control current account spending have been seen to have been translated into action. It has been suggested to me by colleagues who have worked in both the public sector and the private sector that the tradition of over-manning is so well entrenched in government offices that it is no longer perceived as such and that it would therefore be desirable in principle to recruit into the civil service at very senior level people who can be expected to contribute, not so much to policy but to housekeeping. Inevitably, the best time for this sort of movement would be at the beginning of a five-year Parliament rather than some way through its term and there are, of course, dangers in establishing a precedent which the lunatic left would be delighted to follow if they ever came to power. However, as so much else would be disastrous in that event, and as that event is becoming more and more remote, I do not believe that that argument is in itself a disqualification and I recommend the idea for consideration for your next term of office.

In the exchange markets, the pound continues to hover around its 1975 level, with fluctuations against individual currencies tending to reflect modifications in short-term interest rates in those currencies.

5114
Pmi Martin

2
23 GREAT WINCHESTER STREET
LONDON EC2P 2AX

From: JOHN SPARROW

01-588 4545

12
1373
13th March, 1981.

Alan Pd

Dear Mrs. Thatcher,

The response to the Budget has been very much a two-stage affair. The immediate reaction was that it was excessively deflationary, but the more considered view which now seems to be gaining ground is that it is much more of an equilibrium budget, the taxation proposals reflecting the amount of money the government is still spending, particularly on current account. Similarly, the Chancellor is emerging with his credit if anything enhanced, even though first reactions were fairly uniformly unfavourable. What has suddenly become widely recognised (with help from you) is that the Chancellor has to raise the money to meet the bills which his colleagues run up, and is hardly the man to shoot at if those bills are (as they are) excessive.

In the markets, the 2% reduction in MLR had just about been discounted, with sterling showing a small increase after the announcement. The proposed index-linked gilt for pension funds led to some unhappiness in the equity market, from which funds would inevitably be drawn if index-linking became more prevalent. There is thus the fear that the private sector is now going to suffer competition from government for its equity funds in addition to the pressure it has long suffered from in the straightforward debt market; additionally, it is argued that offering index linking on a stock confined to institutions will reinforce the undesirable trend away from individual ownership of savings and towards the institutions. There would, I think, be real concern if it appeared that regular large issues could be expected, especially as I suspect that the novelty value of the first issue will lead to its being overpriced at first.

The equity market is moving with whatever happen to be the most recent results. I expect you will have noticed the excellent figures from United Biscuits, reflecting the fact that someone who imports extensively benefits from a strong pound; of course, he sees no need to make a song and dance about it, as do those exporters who are suffering. It is a point to bear in mind when resisting the pleas that you should somehow "intervene" in the exchange market.

Yours sincerely,
John Sparrow

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.
Professor Alan Walters

RG 010
CF 113
R. Mount
Econ Pol
23 GREAT WINCHESTER STREET
LONDON EC2P 2AX
01-588 4545

From: JOHN SPARROW

12
6/4
MS
6th March, 1981.

Dear Mrs. Thatcher,

The foreign exchange markets have been undergoing some remarkable fluctuations in the last couple of weeks, apparently largely in response to actual or anticipated movements in interest rates. The differential between U.S. and German rates for 3 months money, which had shown a consistent advantage to the dollar of 8 or 9 points for at least 3 months up to the middle of February, narrowed in one week to 5 points and a week later to 2 points. Not surprisingly, the tendency for the Deutschmark to weaken against the dollar, which it had been doing throughout the earlier period, was sharply reversed; at this stage, sterling retained its stability in the middle of the see-saw as the respective ends shot up and down.

However, sterling itself then came under pressure, as the widely expected 2% reduction in MLR suddenly, for a variety of reasons, got blown up in the public estimation to the possibility of a 3 or even 4 point cut. My own reading of what then happened is that the markets responded to that possibility up to the time when they came to the conclusion that the response which they had shown would frighten the U.K. authorities away from such a sharp adjustment and that the original hypothesis of a 2% reduction could therefore be restored, albeit with a certain amount of caution, to the top of the list of expectations.

I have long been an advocate of lower interest rates, in part because I felt that they were at a level which kept the currency artificially high. At this stage, I have to say that we must avoid the danger of over-reacting in respect of both interest rates and the exchange rate, because too large a reduction in the first could precipitate an excessive movement in the second. The case for bringing MLR down to 12% is clear but any further movement which is not matched by a suitable reduction in public borrowing will do nothing but plunge us back into the totally de-stabilised vicious spirals which it has been your government's great achievement to pull us out of. There seems always a temptation to cease to trust the market forces just at the time when they can be expected of their own volition to correct a particular trend; the consequence has always been that the trend is doubly corrected and becomes equally adverse in the opposite direction.

I recognise that at this time of the year any government is always beset by conflicting advice and the last two weeks have more than justified that generalisation. What with the NIESR at one extreme and Mr. Donald Regan at the other, you can do no more than cut your own way through the jungle of theory. If there has been a theme to my letters over the last four years, it has been that the budget deficit is the root of all our evils and I remain firmly of that view. I therefore hope that next Tuesday will point us towards less public spending on current account,

such additional taxation as is needed to take the reduction of the PSBR back on course, a move of resources from the personal and government sectors towards the productive sector, and a switch of emphasis away from consumption and towards investment and production. Incidentally, what has been reported of the latest thinking on industrial fuel pricing leads me to hope that we are not in danger of confusing competitive pricing on the one hand with subsidies on the other.

On the industrial front, the flow of reported results has been extremely depressing, but the equity market continues to see light at the end of the tunnel as, on sensible policies, do I. Contrary to my usual custom, I find myself unable to comment on the water workers' pay settlement because I am unable to judge the merits (other than force majeure) of their case. However, the psychological impact of what seemed to be another concession to blackmail (and arguably an unnecessary one) has been damaging, and I am told that it aroused the first signs, fortunately stifled, of private sector employees seeking to re-open their own negotiations. Despite this, other settlements have been reasonably encouraging and one hopes that the attitude to the civil service claim will reflect the realities which most employers are forced to put to their employees - the ability to pay, the inter-action of salary levels and numbers employed, the self-destructiveness of disruption to support unjustifiable demands, and the consequences of breach of contract.

Finally, the burden borne by industry in the form of local government rates at last shows signs of provoking a healthy response from those people who have for so long suffered taxation without representation. In the short term, this could lead to greater pressures on councils to put their houses in order; in the longer term there remains no satisfactory alternative to the complete reform of local government finance.

Yours sincerely,
John Sparrow.

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

c.c. Adam Ridley, Esq.
Professor Alan Walters

2

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX
01-588 4545

From: JOHN SPARROW

ms
Pam Smith

20th February, 1981.

ms

12
ms

Dear Mrs. Thatcher,

I had lunch to-day with Alan Walters and it occurred to me that it would make considerable sense if I were in future to send him a copy of the letters which I send to you most weeks.

If you would not want that to happen, please let me know; otherwise I will start sending him a copy from next week.

Yours sincerely,
John Sparrow.

ms

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

23 GREAT WINCHESTER STREET

LONDON EC2P 2AX

From: JOHN SPARROW

01-588 4545

20th February, 1981.

Dear Mr. Thatcher,

You will be aware of the disappointment and, in some places, bitterness that have been caused by Wednesday's decision to retreat in the face of the N.U.M. There are hints that the full story has yet to be revealed, but the initial presentation immediately provoked a number of strong reactions.

In part, the problem is that this week's events are seen as part of a pattern in which the public sector is cushioned against the consequences both of its own follies and of the harsh facts of life, whilst the private sector is immune from neither; in part it was felt that, although conflict with the miners is always perilous, there is unlikely to be a better time to impose some sort of common sense than one at which coal stocks appear to be sufficient to see us through until the warmer weather of spring, when imported coal is freely and relatively cheaply available and when other forms of energy are in at least adequate supply; in part it is merely a memory of the old saw that those who pay Danegeld will never be rid of the Danes. All told, it was a severe setback not merely for economic and social policy, but also for your support in the country at large.

Turning to the markets, the Bundesbank appears to be facing up to its external problems and to the domestic consequences of doing so and, as dollar interest rates are softening somewhat, the dollar-Deutschmark exchange rate has moved significantly in favour of the Deutschmark. Sterling has accordingly regained ground against the dollar and lost ground against the European currencies, but remains roughly where it was on a trade weighted basis. It is interesting to note that on the new trade weighted index, based on 1975, both sterling and the U.S. dollar are shown as being roughly where they were six years ago: the strong major currencies in that period have been the Yen, Swiss Franc and Deutschmark at the expense of the Lira, the French Franc and the Canadian Dollar.

The British Aerospace offer was well received, and it was particularly pleasing to note the degree of support from employees of the company, of whom I understand 27,000 applied for shares over and above their free issue. This should provide some sort of bulwark against threats of confiscation or penal renationalisation should we ever have another Labour government. The fact that the premium in early dealings was a little more than 20p supports the view that the pricing of the issue was just about right.

This week's batch of economic statistics has been of a varied nature. As might be assumed from Goodhart's Law, M3 is at last moving back towards its target range now that there is increasing agreement that it should not be the sole focus of attention. On the other hand, the figures for public sector borrowing, and the likelihood that the out-turn

for the year is now going to be in the region of £13 billion, serve only to underline the urgent need to reverse the tendency for an ever-increasing proportion of a declining pool of wealth to be attracted in one way or another into the public sector. As I have mentioned previously, 10th March is seen as being perhaps the last real opportunity in the life of this Parliament to do something to put this right.

On present policies, it seems likely that the productive sector of the economy will decline to an extent which corresponds to the access of wealth from the North Sea. Until that point is reached, the pound will be buoyed by inflows of foreign capital feeding the PSBR. When the high exchange rate has had its effect in reducing the productive sector to the extent necessary, we could then see not merely a decline but a collapse in the exchange rate as we would have an economy dominated in one way or another by the public sector and only temporarily supported by finite reserves of oil and gas. The need is to discourage inflows of capital and stimulate outflows and this requires a combination of lower short-term interest rates and significantly lower government borrowing of all periods but particularly in the long term markets. It now is generally accepted that the spending side of the government accounts cannot be reduced, at any rate in the short term, and it therefore follows that the revenue side has to be brought into reasonable line.

The only way in which this can be done is by raising income tax which must be extremely unpalatable, is certainly very unfortunate, but I believe is totally necessary. It does at least have the merit of short-circuiting the arguments about how best to tap the savings of the personal sector. The process of slimming down the productive sector (which process was initially healthy) has now gone as far as it can reasonably be expected to go, and in some cases it has gone too far. The need now is to promote a period of stability and a return to healthy growth in industries which have an economically viable future. This will not be achieved by selective subsidies to industries which happen to make the most effective and heart-rending pleas but by allowing market forces to decide which industries should and which industries should not be allowed to enjoy the funds which, if the PSBR were properly controlled, would be available in the market. Obviously, Britain's productive industry would have to compete for those funds against the attractions of overseas investment, but this would be healthy competition, very different in its nature from the present position where the competition comes from a public sector which will pay whatever price is necessary to out-bid the opposition.

I have disliked writing this letter as much as I expect you will have disliked reading it, but these things have to be said.

Yours sincerely,
John Major.

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX
01-588 4545

From: JOHN SPARROW

13th February, 1981.

910

MB

Dear Mrs. Thatcher,

The dollar continued to strengthen throughout the week, and the influence of interest rates on exchange rates seems now to be becoming a matter of international concern. Herr Matthoefer's comments in Dusseldorf draw attention to the current tendency towards competitive deflation, and also underline the domestic difficulties that the West Germans are experiencing, as a result of the current relative weakness of their banking system and its presumed inability to cope with the eventual ramifications of a significant credit squeeze. From this standpoint, it is natural that the West Germans should feel most strongly about the influence on the value of the Deutschmark being exerted by high interest rates elsewhere in the world; on the other hand, it still seems likely that the United States will stick to a dear money policy until they can see a clear path ahead.

The public comments of the members of the House Budget Committee who have been in London this week seem to confirm the suggestions that the Reagan administration will follow policies similar to yours but might postpone any element of taxation reduction until expenditure has been reduced. If that proves to be the case, dollar interest rates are likely to decline only gradually through the spring, although one might hope that success in reducing expenditure would lead to a somewhat sharper fall later in the year. This will make life very difficult for the Germans and therefore for the EMS, but it should hold out some prospect that the U.K. is now approaching the levels of interest rate at which the exchange rate is likely to show a sympathetic reaction to further reductions.

The decision by Peugeot to close its plant at Linwood seems likely to bring an end to an enterprise which was misconceived from the start. Whilst it would be foolish to suggest that the decision was in any way based on the recent announcements concerning subsidies for Leyland and, presumably, for Datsun, it does remind one that decisions affecting major segments of industry are rarely finite in their consequences.

The position on the wages front is still noticeably better than it has been for some years although the average level of settlement seems to be creeping up. This is partly the result of a tendency seen most winters for a certain amount of leap-frogging to take place, and partly, at any rate in the private sector, a reflection of differences in the ability of companies to pay and, perhaps, of the willingness of managements to manage. Certainly industries such as engineering, automobiles and road haulage are all comfortably within single figures whereas capital intensive industries like oil and people-dependent businesses like newspapers and much of the financial sector still seem to be rather higher. There is probably insufficient attention being paid to the very considerably increased determination being shown throughout the public

sector management in this pay-round because that is a crucial part of the battle and the difference between original claims and final settlements deserves greater recognition.

Finally, people in the City were rather disconcerted by Lord Gowrie's speech to the Institute of Petroleum. His premise that the government had created the right conditions for investment is not universally accepted and his conclusion that the City ought to invest more in the private sector seems to ignore both the dominance of government borrowing and the Wilson Committee finding that, at the interest rate levels set by government borrowing, the problems of industrial investment stem from a lack of demand and not from a lack of supply. I have written at length on this subject many times in the past, and it is disturbing that a Minister should still appear to be unaware that a determined borrower who is not sensitive to interest rate movements can effectively price money at a level which other borrowers cannot afford to pay.

Yours sincerely,
John Sparrow

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.

Am. Invest. Econ Pol

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX
01-588 4545

From: JOHN SPARROW

ms

6th February, 1981.

*R
G2*

Dear Mr Thatcher,

During the last two weeks the pattern of financial markets has not changed greatly. The dollar has remained strong against all currencies other than Yen and sterling; it is likely to remain strong so long as U.S. interest rates are at or about their present level and, although some modest decline is likely over the next few months, it appears that the Fed. will be endeavouring to maintain interest rates until they have a rather clearer picture of President Reagan's economic policies. On that subject, I have sent Tim Lankester a commentary by an American investment analyst which is not directed at the situation in the United Kingdom but which seems to me to have very considerable relevance to our own problems.

Sterling itself remains a strong currency and the Deutschmark is the most conspicuous weak link. There are voices in the City expecting a cut in MLR before the Budget but the consensus is still that the eagerly awaited next reduction will be made on 10th March.

Yesterday's suggestion by Reuter that consideration was now being given to ways of intervening in the exchange market caused some despondency, partly because exchange rate problems are symptoms only, the underlying disease being excessive public sector borrowing, and partly because intervention in the exchange markets would be seen as a weakening of your resolve to control the money stock. Similarly, there is some concern that the work that is being done to explore ways in which the public sector can tap the short-term market and personal savings will end up not by reducing the overload in the long-term market but by adding yet again to the public sector's voracious appetite for funds, to the renewed detriment of production.

in para 4

The need to direct our national attention to production and profitable investment rather than to consumption and subsidy has been highlighted in several ways in the last two weeks. Sir William Barlow's proposals for a new regime for the nationalised industries have a great deal to commend them and they have been widely welcomed as a means of achieving greater realism, more effective control and proper efficiency. On the other hand, the Scott Committee's report on public sector pensions seems only to reflect the national obsession with security and the belief that we should all be protected from the consequences of our follies rather than encouraged to renounce the folly itself. It is significant that the only body which could contemplate issuing index-linked securities is the government and the only reason that it can is that it is immune from the problems of insolvency. The recommendations of the Scott Committee would add another burden to the people who are producing wealth, in order to add another benefit to the consumers and it was most appropriately in "Alice in Wonderland" that it was decreed that everyone had won and all must have prizes.

I am afraid that another facet of the same attitude can be seen in the injection of public money into loss-making activities. This is often done for so-called social reasons, although it is a mistake to equate a receivership with death; in many cases receivership is the most effective

way of enabling profitable activities to survive and flourish, whilst stripping out unsuccessful operations. Indeed, there is some evidence that operations which have been unsuccessful pass through receivership into new hands in which they have found that success is possible. I would not object on ideological grounds to some public intervention in private industry, but on practical grounds it seems that too much of it may soon be going on. The important thing about this sort of intervention is to have and maintain clearly defined criteria.

I believe that the injection of funds into Leyland may well be justified on the grounds that the company can, under its present management, achieve and maintain the necessary level of success; but too much weight should not be placed on the arguments one hears that the closure of Leyland would have dire secondary ramifications until one has considered the likely ways in which other producers would seek to fill whatever gap had appeared in the primary market. It seems to have been assumed that if Leyland stopped making volume cars, nobody else would attempt to replace them; whereas, in all probability, Ford, Vauxhall and Talbot would all make more and, as we have seen, foreign companies can come in to the market not merely as salesmen but also as producers. Reverting from the particular to the general, it does not make sense continually to add to the burdens of profitable industry in order to ease the pains of the unprofitable. If it is thought in any given case that the profitability is temporary and undeserved, the remedy is to look to other aspects of policy and not to pursue the path of subsidy.

Despite the unusual extent to which the Budget proposals appear to be being advertised in advance, 10th March is still seen as likely to mark a watershed for the country and for the government.

*Yours sincerely,
John Sparrow*

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.

23 GREAT WINCHESTER STREET

LONDON EC2P 2AX

01-588 4545

From: JOHN SPARROW

5th February, 1981.

Dear Tim,

I had intended to give you the enclosed speech when we had lunch together yesterday but, as my secretary predicted, I forgot to do so.

Although the style is somewhat racy, I believe that the sentiments expressed are particularly relevant to the United Kingdom as well as to the United States. I particularly like the attack upon the full employment concept of budgeting, which is where the Heath government went wrong and which is the road to the dreaded U-turn.

It was very nice to see you again and I enjoyed our conversation.

Yours sincerely,
John

T. Lankester, Esq.,
10 Downing Street,
London, S.W.1.

John Sparrow

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX
01-588 4545

From: JOHN SPARROW

Am... Thatcher

23rd January, 1981.

MS

12 23/1

Dear Mrs. Thatcher,

The release of the American hostages in Iran, and the associated transfers of reserves, have not as yet created a significant disruption in money markets. Indeed, it seems that a certain amount of precautionary selling of the dollar took place and was being corrected at the end of the week. Allied to hopes of somewhat lower dollar interest rates, this encouraged the dollar to strengthen against more or less every currency except sterling. Sterling meanwhile is close to its highest levels since 1974 and the combined attractions of oil and high-yielding government securities continue to outweigh the profitability problems of British industry.

The realisation that the personal sector has accumulated considerable liquid assets continues to stimulate the search for ways of mobilising those assets. As I mentioned when I saw you last, one should not lose sight of the fact that private sector liquidity is already usefully invested or that its mobilisation by government merely adds to the deprivation of private sector industry unless compensating reductions are made elsewhere in the funding programme. Following my letter last week, I should perhaps point out that income taxes are the most straightforward and easiest way of absorbing personal funds, although the real purpose of that letter was to point out that election pledges have to stand or fall together: taxation and spending have to march in line.

So far as channelling personal savings into government hands is concerned, the arguments of principle against indexation are reinforced by the current unattractiveness of an index-linked security at a time when interest rates are at unprecedented real levels. It has also been pointed out to me that the older members of the community are much more interested in income than in capital protection and that an instrument which offers capital protection should most sensibly be marketed to younger people.

The market seems to be increasingly of the view that MLR will be brought down on or shortly after Budget Day. What will in all probability attract attention between now and 10th March is the likely size of the PSBR in 1981/82. If the outcome seems likely to exceed £10 billion I expect there to be a widespread sharing of the gloom and despondency which I will feel if it exceeds £7½ billion.

Yours sincerely,
John Sparrow

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.
cc. Adam Ridley, Esq.

H. R.

PM has seen

~~PRIME MINISTER~~

12

OUR MR. SPARROW'S LETTER

He is wrong in asserting that if, because of the "buyers strike" for gilts there has to be recourse to foreign borrowing, this would further increase the exchange rate. Indeed confidence would be so seriously eroded that I would expect a fall in sterling - perhaps even the most precipitous decline.

In most of his other points there are no obvious analytical errors. In addition I cannot fault the general tenor of the predicted "funding crisis".

AW

19 January 1981

010

Alan Walters - to see
and other pts.

2

~~Amstrong~~ R.

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX
01-588 4545

From: JOHN SPARROW

16th January, 1981.

R. 19. MB.

Dear Mr. Thatcher,

The pound has continued to strengthen against European currencies and has now regained the trade weighted level at which it stood before the last reduction in MLR. The dollar fluctuates as the market re-assesses the likely future of dollar interest rates, the developments in relation to the hostages in Iran and the various possibilities arising from either a breakdown in the negotiations over the hostages or the release to the Iranians of large sums of money which they may well decide to convert into other currencies.

Pulling all the strands together, it seems to me that the most likely course for the dollar is for it to weaken over the next seven to ten days but then to regain its present relative strength.

At home, the equity market has continued to decline as profit and dividend expectations are revised ever downwards. The gilt market has been over-shadowed latterly by the apparent confirmation that the PSBR is still on the increase and formerly by the indication that increases in direct taxation are ruled out as a means of reducing the PSBR.

This is seen more and more as the central problem of financial policy, particularly as it is now being realised that increasing unemployment and drastically modified wage settlements are both leading to a reduction in the rate of growth of institutional funds. As it has been the habit, certainly of the City and possibly of the Treasury, to relate the prospect for sales of gilt-edged securities to the size of institutional cash flow, it is worrying that the rate of increase in gilt sales likely to be needed is now out-stripping the rate of increase in the domestic funds which supply that need. To the extent that the shortfall is taken up by overseas investors, of course, it is seen that there would be an upward impact on the exchange rate which would make the government's relationships with private sector industry more difficult.

Against this background, and given the difficulties which seem to have arisen in reducing spending, people are beginning to comment on the need to reduce the PSBR by raising revenue. Increases in indirect taxation are in themselves deflationary but have in the past tended to produce an inflationary effect by precipitating high wage demands which have been met. It may be that the climate of wage negotiation has changed permanently for the better, but at this stage there would be something of a hostage to fortune in far reaching increases in indirect taxation; this is not to say that one might not look for £1 billion or more from tobacco,

alcohol and petrol, but it is thought that additional revenue commensurate with the size of the problem would be hard to find with safety in this way. Similarly, steps having been taken to restore the yield of oil taxation to the levels originally estimated, it may be that a real increase can be looked for in 1981/82 but here again sufficient to bridge the gap is unlikely to be forthcoming.

On the other hand, a prima facie look at income tax indicates that 3p on the standard rate and the denial of indexed allowances would between them yield the better part of £4 billion, ahead of any adjustment for the consequences in terms of levels of activity. There is reason to believe that the Treasury model over-states these consequences, but even allowing for some reduction in that way, we are left with the proposition that changes in direct taxation could make a significant, and in City eyes necessary, reduction in the level of the PSBR and could, together with the other changes mentioned above, bring the 1981/82 PSBR down to a level at which interest rates could be significantly reduced, industry could at last see a way out of the financial problems which beset it and the government would have a breathing space in which once again to contemplate the problems on the spending side. I am aware that all of this runs directly counter to election pledges, but I am also aware that a funding crisis now would be the worst possible thing both for the government and for the economy and that, once the thought of a future funding crisis enters into the collective head of the City, it has an unfortunate tendency to become self-propagating because no investment manager wishes to buy securities which he thinks may be cheaper next week.

The good news this week is that inflationary expectations continue to decline which makes it all the more important to consolidate the success you have achieved.

Yours sincerely,
John Stevens.

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.

Box

23 GREAT WINCHESTER STREET

LONDON EC2P 2AX

01-588 4545

From: JOHN SPARROW

14th January, 1981.

Dear Mrs. Thatcher,

MS

It was with some horror that I woke this morning to hear the BBC make the premature announcement of Roy Jenkins' appointment as Vice Chairman of Morgan Grenfell Holdings.

Obviously, this has been on the stocks for some time, but it was not yet due for announcement and it had been my intention to have a word with you immediately before the announcement, just as we had planned to speak to our more important clients just before the announcement. However, the best laid plans of mice and men follow a well-known pattern and it appears that a leak in Strasburg was picked up by the Guardian, with the result that the other newspapers had to re-make their front pages in the early hours of the morning after they had seen the early editions of the Guardian.

Had I known what was going to happen, I would naturally have spoken to you when we talked yesterday. However, the important point that I would have wanted to make is that his arrival here is purely a matter of furthering our banking interests and has no political connotations whatsoever. He understands this, we understand it and I hope that you will also. I am still sorry not to have been able to let you know beforehand.

Yours sincerely,

John Sparrow.

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

010

CF For from Mr. ^{Econ Pol} 2
PRIME MINISTER

23 GREAT WINCHESTER STREET MS
LONDON EC2P 2AX 9/1
01-588 4545

From: JOHN SPARROW

R
M

9th January, 1981.

Dear Mrs. Thatcher,

The dominant factor in international financial markets continues to be the level of dollar interest rates. As these fall, they encourage the dollar to weaken, but opinion is divided as to the speed and indeed the direction in which they will move during the first half of 1981. As yet there is no firm evidence that the U.S. economy has peaked and there remain considerable doubts about the size of the budget deficit which the Reagan administration will run. On balance, I would expect dollar rates to fall relatively gently in the early part of the year but to start to move upwards again in the spring. Meanwhile, sterling continues to strengthen against the basket of currencies and is now nearly back at the levels at which it stood before the last reduction in MLR.

It has been noticeable over the holiday period that many perceptions of Britain's economic and financial difficulties are either changing or becoming much more clear. In particular, there now seems to be widespread agreement on the need to distinguish capital and current spending within the public sector, which argues for changes in the system of cash limits but not, of course, that there is any lesser urgency to reduce the overall size of the budget deficit. The idea of running the monopoly nationalised industries as public utilities fits in with this line of thought and also appears to be gaining support.

The equity market continues to suffer from a flow of bad news about profits and redundancies. It remains my impression that we are at or near the bottom of the recession, although the statistics will continue to worsen for some little time ahead. The equity market is likely to continue to receive bad news on the profits front for at least the first half of 1981, but a more important adverse factor is likely to be the recognition that the traditional view that falling interest rates are as good for equities as they are for gilts needs to be modified when we have interest rates that are not merely real but very substantially so. In consequence, the upward movement in equities which normally heralds a turn in the economy may not be evident this year which means that many companies will find it difficult to bring themselves to make rights issues despite their wish and need to rectify the shape of their balance sheets. If this is right, it becomes even more imperative that the long term debt market should operate at a price which the private sector can afford.

Despite the subsequent alarms and excursions, the changes in your Cabinet which you announced this week have been widely welcomed in the City where it is felt that the reshuffle has greatly strengthened your team.

I look forward to seeing you next Tuesday.

Yours sincerely,
John Sparrow

The Rt. Hon. Mrs. Margaret Thatcher, M.P.
cc. Adam Ridley, Esq.

Example



10 DOWNING STREET

Arranged for
Tuesday 13 January
at 12.00.

Tim L. dealing.

et.

24/12.

1) JL to see

2) CF

BF 12. 1. 81

19/12
CF 22/12
Punchline

✓

I think it is
time you saw

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX
01-588 4545

From: JOHN SPARROW

Yes please file this letter
with Mr. Sparrow again.
Shall we set up?

19th December, 1980.

Dear Mrs. Thatcher, R
24/12

I am not sure whether or not I am over-influenced by the approach of Christmas, but it seems to me that nearly all of the news this week has been cause for comfort. Outstandingly, the ending of the Northern Ireland hunger strikes has to be seen as a great step forward.

On the economic front, the pound retains its general strength in the face of exceptionally high interest rates in the U.S. The gilt-edged market seems to be picking itself up from the floor and equities have at last steadied. The flow of company news continues to be bad (but with the occasional outstanding exception); I would expect more bad news to emerge over the next few months, but I still believe that what is actually happening, as opposed to what is being reported, is past the worst.

There has been confirmation this week that private sector pay settlements are now typically in single figures. Here again, as with so many other statistics, important changes of trend are masked for considerable periods by the habit of using year-on-year comparisons and I would not be surprised if many people were confused by the simultaneous announcement that the year-on-year increase in average earnings was still over 20%. However, the decision of the representatives of local authority manual workers to recommend a pay increase of 7½% is another major cause for congratulation, always assuming that the employees accept the recommendation. It was also encouraging to read that the local authorities are shedding surplus labour in numbers that are beginning to be meaningful, and that the control of local authority spending generally is at last to be put on a basis which is not only rigorous but also rational and comprehensive.

There were indications during the week that changes in the methods of controlling nationalised industry finance are on the way, and such details as were published make the proposed changes very welcome. It is important to encourage the control of costs. There is always a temptation, particularly in the monopoly activities, simply to increase the revenues in line with costs and thereby avoid or reduce the pressures to be efficient. This is the agonising change of attitude through which the private sector has largely gone; from the outside, it seems still to be necessary in parts of government; and anything that encourages the same process in the nationalised industries would be useful and constructive. Emphasis on separate control of revenue and capital costs, quite apart from being right in principle, would also facilitate two other developments which could be helpful.

One would be a move towards a public utility structure for monopoly nationalised industries which are intended to stay within the public sector. The other would be the financing of public sector capital expenditure directly from the private sector rather than through the PSBR. It is increasingly clear that there is very considerable scope for this sort of private sector financing on terms which would enable sensible and viable capital projects to be implemented without recourse to the government's credit. This would meet the problem, referred to in earlier letters, that capital expenditure is easier to postpone or to cut than revenue costs and that recurrent squeezes of public spending are having a damaging effect not only on the infrastructure of the public sector but also on the private sector suppliers of the capital equipment concerned. Various schemes are already being drawn up for the private sector financing of specific public sector projects and, if that line of approach were given the go-ahead, it would mesh in with an increased emphasis on performance aims. I should say that this is an area in which my own colleagues have already taken an initiative.

Two other things have been pleasing in a generally pleasing week. One was that the OPEC meeting in Bali proved to be far less disruptive than had been feared; the other was that Professor Walters recognises that high interest rates inflate the money supply as measured by M3, in a week when the Bank of England has pointed out that the annualised increase in M1 since February is the much more modest (although still excessive) figure of 8%.

I hope that you and your colleagues all have a very happy Christmas and that the rewards for your courage become clearer and more certain as 1981 progresses.

*Yours sincerely,
John Sparrow.*

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.

From: JOHN SPARROW

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX
01-588 4545

12th December, 1980.

Dear Mrs. Thatcher,

At last, we have seen some real activity in the financial markets, most of it being what is conventionally regarded as adverse.

To begin with, the increase in dollar interest rates to new high, and in my view unsustainable, levels has encouraged inflows into the U.S. thereby causing the dollar to strengthen. This has reduced sterling's parity against the dollar, but its trade weighted performance and its bilateral relationships with other major currencies remain undeniably strong.

The gilt market showed signs of nervousness in the face of less-than-clear statements thought to have been made by ministers, but may perhaps more reasonably be seen as now discounting rather less future improvement than was previously the case. The equity market has suffered a considerable shake-out, partly in sympathy with the gilt market and partly in response to a continued flow of bad news from companies reporting their results.

Like most statistical indicators, reported results tend to reflect the situation as it was some little time ago, and my contacts with industry lead me to believe that there is at least a possibility that we are now seeing a bottoming out in the level of industrial activity, which will not be reflected in the statistics for two or three months ahead. I base this partly on the attitudes of industrial managers, who often seem to have gone through their period of gloom and facing up much more cheerfully to the very real problems with which they are still faced; there does also seem to be evidence that the process of destocking is coming to an end and that this element of adverse multiplier is about to disappear from the equation.

There were worrying signs at the beginning of the week that the burden of gloom was shifting to Whitehall, although that now seems as if it may have been a misunderstanding. Certainly, it would be very worrying for the financial markets if the idea were to get abroad that the task of moving towards a more balanced budget is simply too big to be manageable. The realisation that the additional tax on oil flows announced last month would merely restore the yield from that source to its previously expected level came as something of a disappointment, although perhaps more logically it should be seen as indicating that there is still scope to reduce the deficit; if I understand the revised picture correctly, it goes once again to demonstrate that taxes which are or can be optional will never yield what is expected from them.

There are signs that the distinction between revenue and capital account, and the importance of that distinction in public finance, are being increasingly recognised. One comment which was made to me this week was that revenue cuts necessarily involve shedding people and that making people redundant, apart from being distasteful, also involves large amounts of time and of compensation. In consequence, economies of people

show little or no return in the fiscal year in which they take place. However, cuts in public spending, when they are called for, seem always to be required before the next April 5th and therefore cannot be achieved to any worthwhile extent by shedding people. This in turn diverts attention to the capital account where cuts are often undesirable and sometimes fictitious.

One of the elements in a medium term strategy has to be a much stricter control of revenue account. Arguably, the control on genuine capital account items should be less rigid than it is, particularly if they can be financed externally. It might be worth considering for this purpose classifying redundancy payments as a capital expenditure because, when seen in this light, they clearly show a very high return on investment.

One other suggestion which has been made to me this week is that the Treasury's ability to control public spending has been weakened since the Civil Service Department was established independently, because one's ability to control the actions of others is immensely strengthened by having the ability to control their prospects of promotion.

Yours sincerely,

John Sparrow

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.

Ann Amirth

Econ Pol.

2

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX
01-588 4545

From: JOHN SPARROW

R/S
2/12

1st December, 1980.

Dear Mrs. Thatcher,

ms

I am sorry that I allowed myself to become so disorganised last week that this letter comes after the weekend instead of at its proper time, particularly as the general drift of the announcement last Monday was really cause for congratulations. It seems to me significant that the public acrimony that occupied most of last week was almost entirely political, with very little criticism of the economic consequences of the changes.

Indeed, most of the criticisms that were voiced would seem to have been more appropriate before the announcement than after it. Cries for a larger budget deficit sound inappropriate immediately after the revelation that that deficit (already too large) would in fact out-strip previous estimates by upwards of £2 billion. Demands for lower interest rates lose much of their punch when MLR has just been reduced by two points - even though I believe that further reductions will be beneficial. The market reaction to the announcement, after a period of initial adjustment, was very much a return to previous positions, and the one point which might have been expected to attract criticism seems to have gone largely unnoticed.

This was the increase in the employees' National Insurance contribution. The criticism that could be voiced is that this step narrows yet again the difference between the rewards for being employed and the rewards for being unemployed, a gap which many people believe is already far too small. At this juncture, it is probably not all that significant a point, because there are currently unemployed probably a million people who are anxious to return to work and will not be deterred by the sum of money involved. As and when unemployment returns nearer to the million mark, we will re-enter the problems of voluntary unemployment and at that stage the latest tax on working may make some people feel that a paid life of leisure is preferable.

You had a difficult week last week but the policies on which you were elected still constitute the best hope for this country. Last week marked a move closer to those policies and this was widely welcomed in the City. The problems of government spending clearly remain formidable but they lead to the excessive borrowing requirement which must be brought back within bounds as soon as possible.

Yours sincerely (and happily)

John Sparrow

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.

Rid CF
24/11/80
AD 24/11

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23 GREAT WINCHESTER STREET

LONDON EC2P 2AX

From: JOHN SPARROW

01-588 4545

Primitivish

21st November, 1980.

received only today.

Dear Mrs. Thatcher,

R
24/11

AK

As the week draws to a close, attention is increasingly concentrated upon next week's economic statements. Dealing first with the past, the continued increase in dollar interest rates has caused that currency to continue to strengthen, but sterling has still been relatively firm against other currencies despite the fall in the direct rate against the dollar. Our own money market rates have fallen during the week, rose this morning partly in recognition of what was happening in New York and partly because of PSBR worries, but as the day has gone on a mixture of hope and expectation about lower sterling interest rates has been reflected in a sharp reduction both in Treasury Bill rate and in the money market. To-day's Treasury Bill rate would, under the old automatic linkage, have put MLR at 14 $\frac{3}{4}$ %.

It is obviously too late for any thoughts that I report this week to have any impact on the immediate future. After the announcements, I will try to let you have an appraisal of City and industrial reaction; I expect that the touchstones will continue to be the size of the PSBR, control of public spending, the likelihood of continued success in controlling and eliminating inflation and more effective taxation based on North Sea oil production, acting to some extent as an automatic regulator of the pressures on the rest of the economy consequent upon increases in the price of oil which may not be reflected in the present taxation base. The chief consequence that is hoped for is a lower level of interest rates combined with maintained and even strengthened discipline in other areas.

Yours sincerely,
John Sparrow.

The Rt. Hon. Mrs. Margaret Thatcher, M.P.
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX
01-588 4545

From: JOHN SPARROW

10th September, 1980.

MS
Dear Mrs. Thatcher,

I am writing this letter, just before I go on an extended holiday, very much happier about economic policy than I have been for some time. If the indications that are creeping through to the Press are correct, there is every hope that the ends on which everyone is agreed will be pursued by means more likely to be successful.

You will certainly be aware that the City is becoming more vocal in its criticism of recent economic events. It is important to recognise that this is against the background of complete support for your basic policies and for the general strategy which you are pursuing; the disagreements are about tactics and about the effectiveness with which some strands of the policy, most noticeably the control of the non-productive public sector, are being pursued. With hindsight, I may have been too strident in my advocacy of alternative tactics during the course of this year. Nonetheless, I am fortified by the hope that those alternative tactics are to be tried.

The news that the number of people registered as unemployed now exceeds two million has revived discussion of a suggestion which I passed on some time ago, that there is no logical reason why some forms of employment are eligible for tax relief whilst others are not. In particular, people employed in a house or garden have to be paid out of net income whilst people employed in a business, even a one-man business, cost only the net equivalent of their wages. This is one of the factors supporting the growth of the black economy, but it is also an obstacle to what could be a significant source of demand for labour. At the anecdotal level, there is also evidence of a willingness to supply a market for what used to be called domestic servants: I myself know one mother who would very much like to find such employment for a daughter who is due to leave school next summer. I was reminded of the idea by a colleague who had a similar experience.

I shall return from holiday on 13th October and will write to you again thereafter. I am sure you would not want me to reiterate in this letter all of the things which I hope will have happened by then. I would, however, just like to confirm Anthony Harris's description of the current wave of economic criticism: it is undoubtedly dry and not wet.

Yours sincerely,

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

John Sparrow.

cc. Adam Ridley, Esq.

EW 10

~~Ann Thatcher~~

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX

From: JOHN SPARROW

01-588 4545

R
ns

ms

8th August, 1980.

Dear Mrs. Thatcher,

The publication of the banking figures has given the markets a good deal to think about and I imagine that the implications are causing concern on the official side as well. It was always inevitable that the ending of the SSD would reveal how much had been swept out of sight and it is more than ever important to look at broad trends rather than at month to month fluctuations in a particular aggregate. However, the conjunction of this week's news with the start of the parliamentary recess encourages me to write a rather longer letter than usual this week.

The corset itself is dead and buried and Sam Brittan has written its definitive obituary. More significantly, a few people are beginning to point out in the public prints that it is unusual to attempt to reduce the supply of any commodity by increasing its price. As one correspondent put it, a reduction in supply leads to an increase in price but an increase in price does not lead to a reduction in supply: indeed, the basic functioning of the price mechanism depends upon supply being stimulated by higher prices, demand meanwhile being constrained.

I remain of the view that interest rates are too high for monetary purposes. There is no doubt that corporate loan demand is still running fairly strongly and it remains true that for all practical purposes that demand can only be satisfied by the banks. However, I suspect that a visitor to this planet would be surprised to find that the accepted remedy for strong corporate loan demand was to impose equally strong State loan demand, thereby increasing the pressures on the credit market. On a rough reckoning £15 billion of gilts have been sold since last November which must surely outstrip any conceivable public sector deficit for those nine months. To the extent that over-funding has taken place, the private sector is crowded out of the capital markets which are the only logical source of the funds it so badly needs. An announcement that no more gilts would be sold in this fiscal year, on the other hand, would rapidly re-open the private capital markets, and would lead to significantly lower bank lending figures. Companies do not go to the banks from choice, they go of necessity; and they notice that the authorities have from time to time felt it necessary to offset pressures on the banking market by repurchasing the gilts which they have gone to such lengths to sell.

But would the lower bank lending be enough to attract the extra credit to the public sector?

In this context, it is interesting that overseas government issues in sterling markets are to be limited to £100 million a month "to permit the revival of the debenture market"; yet overseas issues are but a gnat compared with the camel of gilt-edged sales.

R

Another feature of interest rate policy is its impact upon the supply side of the economy. There is no question that you have been following the right policy by imposing rigorous conditions upon the economy in order to identify and ultimately eliminate the inefficient use of resources. To date, the policy has worked, although the burdens have been unevenly distributed: the productive sector has borne more than the unproductive sector; exporters have borne more than domestic suppliers. But by and large the real economy is responding to the policy. However, there is presently a danger that the policy is too rigorous and that, instead of just the weakest going to the wall, those of average efficiency are getting close to difficulties, and even the hardest are being weakened. If the response to that situation is more government aid for the losers, then we will get the worst of both worlds, in which the efficient operations are both restricted by the rigour of the policy and taxed to support the inefficient. Government aid is often seen as a kiss of life, but it more frequently proves to be the kiss of lingering death. It must be preferable, instead of going down the aid route, to relax the overall pressure on the economy and thereby allow market forces to do their work. This presupposes a fiscal policy which minimises the public sector deficit.

A further point to bear in mind is that high interest rates stimulate the revival of the use of sterling as an international currency. About one-quarter of the gilts sold since last November are thought to have been bought by non-residents; in the same nine months over one-third of the growth in bank deposits has come from non-residents.

To a classical economist, the current position would present far fewer problems than we have convinced ourselves we see. His definition of money would approximate to sterling M1, which is showing no signs of getting out of hand; on the contrary, it has for twelve months now shown a level of stability the results of which are visible in the economy and in the prospective rate of inflation. He would be horrified by the size of the PSBR and by assurances that the PSBR would be gradually reduced enabling interest rates gradually to fall, and he would say that this was no time for gradualism. He would regard the problems of credit growth as deriving directly from an excessive budget deficit and would probably not understand a policy of funding even beyond the needs of the public sector deficit at a time when the most desperate need is to give the private sector room to fund itself from the capital markets and not from the credit creation agencies. Needless to say, I would agree with him and, judging from our conversations in the two years before the General Election, so, I suspect, would you.

Not this time.

I hope you have a very good holiday. I am quite sure that you are winning but I remain a little worried that it is still possible to snatch defeat from the jaws of victory.

Yours sincerely,

John Major

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London,
S.W.1.

cc. Adam Ridley, Esq.,



10 DOWNING STREET

From the Private Secretary

7 August 1980

Thank you for your letter of 6 August.

If I was guilty of being too sanguine about the July banking figures when we had lunch, I certainly stand corrected now. Of course, we all knew that the ending of the corset would mean an exceptional increase; but we have been surprised - I fear - by what appears to be a big bump in lending to the private sector. No doubt the quarterly crediting of interest payments, which you have stressed so often, played a part; and there are also other quarterly payments, for example of VAT, which may not be adequately reflected in the Bank's seasonal adjustment.

I take your point about anecdotal evidence but this is not something which is lost on the Prime Minister, and that is why she (and I) find it very helpful to have your views.

I. P. LANKESTER

John Sparrow, Esq.

GB

23 GREAT WINCHESTER STREET

LONDON EC2P 2AX

01-588 4545

From: JOHN SPARROW

6th August, 1980

STRICTLY PERSONAL

Dear Tim,

Publication of the money supply figures reminds me that, when we had lunch together on 7th July, I expressed the hope that the reduction in MLR which had just taken place (and which I welcomed then and now) would not be put in doubt when the bad money supply figures for July came to be published. It seemed to me at the time that you doubted that they would be bad and that you were even mildly disputatious on the point.

I mention this only because a month earlier, in a discussion at which you were present, the Prime Minister seemed sure that the economy was not at that time in a recession. Taken together, the two incidents lead me to wonder whether or not insufficient weight is currently being put upon anecdotal evidence of what is happening in the economy. Anecdote can never be as accurate as carefully analysed statistics but it does have the virtue of being more up-to-date and, provided you can be sure that it is reliable, should therefore have a value. The problem with waiting for the statistics is that you are always seeing a picture of things as they were two months ago; if you were to put your umbrella up only when you had an analysis of the rainfall, you would probably get wet more often.

I am writing to you personally, partly because it seems to me that some thought should be given to the balance between anecdotal and recorded evidence, but particularly because I see nothing in what is currently happening in financial markets that necessitates a reversal of the July MLR cut. In fact I think that there is a case for further movements in that direction, but that is a theme that I will develop in a letter to Mrs. Thatcher.

With best wishes,

Yours sincerely,

J.S.

Tim Lancaster, Esq.,
10 Downing Street,
London, S.W.1.

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX

01-588 4545

From: JOHN SPARROW

1st August, 1980.

Dear Mr. Thatcher,

*I will get a report
on the energy price
problem mentioned at
the cabinet this week*

T. J.

Your speech in the no confidence debate has attracted a quite remarkable degree of approval; in my experience it is unusual for a speech in Parliament to attract as much attention as this one did, let alone the degree of unanimity in what have been entirely spontaneous reactions. It is an indication of the success you are having in changing people's minds, because I am quite sure that opinions would have been much more divided even a year ago.

In the financial markets, the dollar has shown some strength this week in response to the view that the fall in dollar interest rates has now come to an end. Quite separately, the gilt market has weakened, although a more accurate description might perhaps be that it has ceased to discount quite so much of the decline in U.K. interest rates that is expected.

There has been some premature discussion this week of the conclusions likely to be drawn by the Ryrie Committee. This has coincided with a batch of price increases by the nationalised industries which have demonstrated yet again that the control exercised by cash limits is both incomplete and potentially dangerous. It is incomplete because a monopolist can always expect to increase his prices without losing sales: even this proposition is beginning to look doubtful in such cases as the commuter traffic on British Rail, where there is now tangible evidence of a decline. It is also ineffective in that it fails to distinguish between capital and revenue items and therefore allows (one might even say encourages) the by now traditional sacrifice of capital expenditure in order to preserve current expenditure. This leads to the potentially damaging conclusion, that capital expenditure which is necessary and economically justifiable, is being postponed to the detriment of the country.

Ahead of the Ryrie report, it seems to me that what is needed is a more commercial approach, in which nationalised industries are required to adopt pricing policies which maximise their revenues, as opposed to cover their costs, whilst at the same time having every incentive to control their costs effectively. Quite separately, capital projects should be appraised on their merits, bearing in mind that if they have sufficient merits there is every reason to believe that they could be financed by the private sector instead of having to fund themselves through the Treasury. If, for example, British Rail follow the pattern of the Post Office and the Electricity authorities in putting up their prices in order to finance their capital expenditure without having any pressure brought upon them to reduce their costs (and perhaps without regard to the optimum pricing structure that is currently within their capacity) then we will still be some way from mastering the art of financial control.

Tim -
Please
confirm
re: nit.

Going off at a tangent, I have spent some time recently with people prominent in the chemical industry, who have convinced me that they do genuinely believe that their subsidiaries in France and Spain are able to buy gas originally imported from this country at prices anything up to 33% below those being paid by their subsidiaries here. I do not pretend to know the ins and outs of this particular story, but I hope you will not mind my mentioning that I am personally totally satisfied that the chemical industry believes what it is saying, a view which covers the conclusions they draw as well as their premises.

Yours sincerely,
John Sparrow.

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.

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● ●

Am. Thistle

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX
01-588 4545

From: JOHN SPARROW

R 277

25th July, 1980.

Dear Mr. Thatcher,

The trends in the financial markets remain very much in line with what I have previously discussed in these letters and I have nothing useful to add to what I have said before.

Developments in the real economy are also very much as expected and, whilst there is as yet very little intellectual perception (particularly among trade unionists) of the link between excessive pay claims in the past and unemployment in the future, there is a growing instinctive realisation that the two phenomena are related and confidence about the forthcoming pay round continues to strengthen. This increase in confidence is based on further evidence of growing determination, particularly among industrial managements, to ensure the profitable survival of the companies for which they are responsible. The process of education is still very far from complete, and both British Leyland and the Ford Motor Company appear able to complain about competition from Japan without recognising that at various times in the past they have failed to control their own cost structures. However, it is something that the conclusions of the argument are getting home even though the argument itself is less than fully perceived.

① You were quite right to stress the need for the mobility of labour; nearly all attempts to take jobs to people have failed and jobs must be allowed to develop organically where it is natural for them to do so.
② Another step towards a better labour market would be to move away from national pay agreements, and to allow local labour market forces to reassert themselves. It is unfortunately true that the great bulk of national pay agreements are in the public sector and it really is not sensible for equivalent jobs in, say, Liverpool, Bristol, Dundee and Canterbury to be paid exactly equal rates. The use of national agreements to override local factors prevents a beneficial decentralisation of the labour market, and necessitates the need for comparability studies of doubtful reliability.

← One area to which this problem applies is that of local government, and there is some concern that the current proposals in relation to local government finance will lead to increasing centralisation rather than, as had been hoped, a state of affairs in which much greater and genuinely local accountability could be achieved. The City in its various activities continues to see local authorities spending, often for purposes which seem inappropriate to the present state of the economy. The chief weakness in control of local government spending seems to be that local authority borrowing, quite apart from the security of the general rate fund, appears to be automatically guaranteed by the central government. If that guarantee were not automatically available, any local authority requiring support for its borrowings would have to accept whatever conditions the guarantor chose to impose. One could hope for a position similar to

that of the IMF when it assists a country in significant financial difficulties. The initial impact would be that many local authorities and perhaps all of them would be unable to refinance their existing debts without guarantees. However, well run authorities would soon re-establish their credit rating and those which are less well run would suffer conditions which might at long last provoke the electorate to worry about what their money is being spent on. The two factors which lead me to suggest that it would be desirable to remove the automatic guarantee from future borrowings are the conspicuous over-spending in local government and the equally conspicuous apathy of most ratepayers in the face of that over-spending. To the extent that the outcome were greater decentralisation, albeit after a difficult interim period, I believe that it would result in a much better quality of local government.

Yours sincerely,
John Sparrow.

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.

200

Examined 4

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX
01-588 4545

From: JOHN SPARROW

MS

Am... to

11th July, 1980.

12

117

Dear Mr. Thatcher,

This has been another good week, chiefly because of the growing recognition of the severity of the recession and the consequent determination of management to achieve affordable pay settlements, which seems to be matched by a growing willingness on the part of at any rate local union representatives to accept the necessities of the hour.

To say this at this stage is very much in danger of counting chickens prematurely. Nonetheless, I have this week had direct evidence of a mutual willingness to offer and to accept a very tough bargaining regime this winter. In terms of overall economic policy this can only be encouraging for eventual success, although it remains true that most industrialists believe that they and their workforces are shouldering an undue proportion of the burden.

Confidence in the success of your policies is therefore growing and is certainly shared by the overseas sector. Friends in banking tell me that there has been a very substantial increase this year in the proportion of sterling deposits owned by non-residents and there has certainly been a sizeable acquisition of gilts by foreigners, even though it appears that much of it does not work its way through in the official statistics. The need to export capital, which was recognised by the abolition of exchange controls, is exacerbated by the continued inflow of funds attracted by the present level of interest rates and it would therefore seem desirable to encourage foreign borrowers to consider borrowing in sterling. The government as borrower may regard this as unwelcome competition, but the government as government should welcome such a development. As there are encouraging signs of a move away from the practice of issuing predominantly long-dated high coupon gilts, the time may be coming when a genuine international market in sterling debt can be formed.

The disadvantage of this would be that the return of a private sector issue market would be even further delayed with the consequence that industry would continue to fund itself in ways which are fundamentally unsound and which look bad in the money supply statistics. At the risk of being boringly repetitive, the ideal state of affairs would be one in which there was room for both private sector and overseas borrowing as well as government funding, with no one of the three pre-empting the available funds for any material length of time. The one bad feature of the week has been the indication that government spending is running at a higher level than even the pessimists had believed and certainly at a rate which is incompatible with a healthy economy.

Yours sincerely,

John Sparrow.

The Right Honourable
Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.

PRIME MINISTER

23 GREAT WINCHESTER STREET

LONDON EC2P 2AX

01-588 4545

MS

4/7

From: JOHN SPARROW

4th July, 1980.

Econ Pol.

MS

Dear Mr. Thatcher,

I am obviously delighted that MLR was reduced to 16% yesterday and that flexibility may have returned to interest rate policy. The announcement had its expected effect on the gilt market and on the exchange market, although it is increasingly believed that the pound will remain strong even if interest rates fall much further. Certainly this appears to be the view held in places like Kuwait, where I am told that the expectations are that the pound is on a strengthening trend, whatever short-term fluctuations may take place. A strong pound in itself, of course, need not be a fearsome and damaging phenomenon; I have mentioned before that other successful economies have benefited from the discipline imposed by a strong currency. The peculiar problem in our recent experience has been that people have found it difficult to cope with the damaging effects of a strong currency because of the constraints and costs imposed by simultaneous high interest rates. If interest rates were to fall further, we might then have a clearer idea of the real balance of advantage and disadvantage arising from a highly valued pound. One should not necessarily assume that in those circumstances there would be quite the same strength of feeling that the pound is over valued.

Perhaps the most significant reaction to the announcement was the immediate strength of equities, which is presumably attributable to a feeling of relief that the problems of the supply side of the economy might now be eased. Underlying the whole of the market reaction, however, is the hope that there are now to be renewed efforts to tackle the core of all our problems, which is the budget deficit. In this respect, the impression generated both before and since your Cabinet meeting on economic policy - that you stay firmly on course - has been enormously helpful, because only if we get lower funding demands from the government can we hope to see a real revival of issues from the private sector, which will help to get industrial finances into much better shape and will incidentally reduce loan demand, the figures for sterling M3 and the presumed need to sell gilts to control that statistic.

All in all, it has been an encouraging week.

Yours sincerely,
John Sparrow

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.

Prime Minister 2
Gordon ABT
Duty Clerk

23 GREAT WINCHESTER STREET

LONDON EC2P 2AX

01-588 4545

27th June, 1980.

From: JOHN SPARROW

MS

Dear Mr. Thatcher,

The chief event of the week has clearly been the publication of the Wilson Report which is generally regarded as being much more sensible and constructive than had been expected.

To deal first with the obvious points, the banks and insurance companies were delighted at the clear rejection of the concept that they should be nationalised, and that this was the conclusion of all of the Committee. The Stock Exchange were pleased with the comment that the Office of Fair Trading was not the appropriate body to review their activities; you will know the Stock Exchange themselves have been consistently arguing this point, on the very good ground that the OFT is only permitted to consider the position as it is and not to make constructive suggestions about possible amendments or alterations. Against this background, the Stock Exchange's pleasure at the comment is somewhat mitigated by their recognition that it is not within the Committee's power to move the inquiry from the Office of Fair Trading into the CSI.

The pension funds are disturbed at the prospect of regulation and, not having read the full report in detail, I am unsure just what that regulation is intended to achieve. In a perfect world, pension funds would operate within the law with a duty to account to their members and if that could be achieved regulation in other ways should be unnecessary. There is a fear that the question crops up as a step towards the £2 billion investment fund recommended by half the Committee and opposed by the other half. The investment fund idea ignores the fact, brought out elsewhere in the report, that there is no shortage of money available for investment but only a deficiency of demand. The Committee as a whole explain that deficiency of demand by reference to inadequate prospective rates of return in relation to the cost of money, but this is a fallacious argument. So long as the public sector continues to pre-empt the bulk of institutional cash flow it will do so by selling gilt-edged securities on yields higher than the competition from the private sector can afford to pay and will therefore always ensure that, however high prospective rates of return may be, interest rates will be at a level that makes them unattractive. The corollary, as you are well aware, is that there is a potential investment fund far bigger than £2 billion available to the private sector once the public sector balances its books.

Against this background, the Committee's discussion of various alternative methods of selling gilt-edged securities is very important, but hopefully reflects a problem that will rapidly decline. It is important for the government to fund itself in the best possible way but in the short term it is more important for it to be in a position not to need to fund so much. Similarly, the idea of index linked securities, which I believe would certainly be bad psychologically, comes up against the proposition that the borrower who is already absorbing the whole of

institutional cash flow cannot expect to take any more by changing the format of his borrowing. I would certainly agree that an index linked security would be better than a continued flow of high coupon long dated stocks, so long as one believes that inflation can be brought under control. On the other hand, an index linked stock would be subject to the same sort of extreme price volatility which used to characterise the fixed interest market in the almost forgotten days when the nominal coupon came close to representing the real rate of interest; in other words, when coupons really were low. Because of this, if we are to have index linked securities - and on the whole I hope that we are not - then I believe it could only be a market led by government issues and not one which can be pioneered by private borrowers.

The suggestions about increasing the uniformity of tax relief on savings should provoke constructive thinking. In a sense, special tax reliefs always represent a distortion of the economy but at least relief for savings can be expected to have a more positive effect than the conventional wisdom that tax relief should be given to investment. Beyond that, it would also be better if such tax relief as is given discriminates as little as possible between the alternative forms of saving. Discrimination between permanent and temporary savings is probably sensible and almost certainly necessary, but the current advantages enjoyed by the building societies and, much more particularly, by many forms of lending to the government, seem to me to be unjustifiable. The peculiar privileges of savings certificates, NSB ordinary accounts, low coupon gilts which are exempt from capital gains tax, and so on merely reflect an ethos in which lending to the State is preferred to all other forms of saving. The privileges of the building societies are equally rooted in an historical attitude that lending for house purchase is morally superior to other forms of saving.

The building societies themselves are very unhappy about the report. You may remember that they are something of a hobby horse for me, but one has to recognise that their success has been very firmly based in their willingness to compete with the clearing banks by offering a much better service to their customers. This has inevitably changed the nature of their activities as a savings medium and, without wishing to lose the benefits that their successful competition has brought to the general public, I do feel (regardless of my own prejudices) that consideration should be given to two questions. One is whether the building society route is the best way to provide funds for house purchase; the other is whether their attractive facilities for current account holders can be maintained without eventually endangering the movement as it is presently constituted. The suggestion in the Committee report that the breaking up of the cartel would improve matters is, I am afraid, nonsense. In the first place the cartel does not operate universally; more importantly, it is the function of a totally free market to produce a price for whatever goods or services it deals in and one can therefore expect in any market that the prices for a standard product such as money will show very little variation from place to place.

Turning to current affairs, you may have seen Anthony Harris's critique of the definition of M3. He points out that neither building society deposits nor credit card debts are included in the definition of money and, at the very least, this must make a clear understanding of the money stock at any time more difficult to achieve. The very success of the building societies in competing with the clearing banks has brought this question into greater prominence.

The fact that we are in recession is increasingly clear although I am mildly surprised that the unemployment figures included so many school leavers before the end of the school year. I take it that children nowadays go from their examinations to their summer holidays via the local office of the DHSS, which I cannot regard as either sensible or desirable. Nonetheless, unemployment is a very real problem and, as I have suggested before, is one largely confined to the supply side of the economy. Against this background, the hopes that interest rates will soon fall continue to grow but the expectations, if anything, are diminishing. The gilt market looks more and more as if it was discounting a lot of improvement a long way ahead, but is becoming less inclined to do so.

Yours sincerely,
John Sparrow.

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.

Exam Post

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX
01-588 4545

From: JOHN SPARROW

Ann Smith

20th June, 1980

Dear Mrs. Thatcher, 27/6

I have not written since our meeting on 3rd June (which I enjoyed very much) because no material developments have taken place in the economic situation until this week. However, we have now had the money supply figures to 21st May which are thought-provoking.

It is generally agreed that the most significant element in the May figures is the size of the central government borrowing requirement, and much depends upon whether or not this is freakishly large or reasonably indicative of what we might expect in the immediate future. The question is important, not least because it is at least possible that interest rate policy is approaching, not the bend for which I have been hoping for so long, but a T-junction.

If the May figures prove to have been unusual, and it transpires that central government borrowing in the next few months is at a significantly lower level, then the reduction in interest rates which the market now seems to look for every week should, I hope, at last become a reality. On the other hand, if the next set of figures shows a repetition of what happened in May, alarm and despondency may spread quite rapidly and make the continuation of the funding programme more or less impossible until rates are in fact raised. There is at least a danger that the historical pattern - of a prolonged plateau in MLR always being followed by a rise - will repeat itself yet again.

It is against this background that there is a very widespread welcome for the indications that have emerged recently of a still firmer attitude towards public spending and in particular towards local authorities. These are seen more and more in the guise of an Achilles heel.

Yours sincerely,
John Sparrow.

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.

In meeting
folder for 3/6.

Evon for 2
PRIME MINISTER
MJS
23/5

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX
01-588 4545

From: JOHN SPARROW

23rd May, 1980.

Dear Mr. Thatcher,

During a week in which the gilt market has gently strengthened and the equity market has equally gently declined, the dominant feature has been the continued strength of sterling. Although extraneous factors such as the oil price contribute to this strength, the chief cause is undoubtedly the differential level of interest rates, which has been highlighted by the weakness of the dollar consequent upon the continued decline in U.S. interest rates. It is however worthy of note that, in contrast to previous periods of sterling strength against the dollar, the performance of the currency this time is equally clear when one looks at the rates against the major European currencies. Since the beginning of the year sterling has appreciated by 5% against the dollar and by 8% against each of the Swiss Franc, Deutsche Mark and French Franc.

The impact of a high exchange rate on both imports and exports is therefore much more general than it has been in the past, when at times it has been concentrated very largely on the U.S. and Canadian dollars. I have referred before to the impact that this has on the competitive position of manufacturing industry; it seems to me now that there may be a dichotomy in the impact of economic policy in that high interest rates and a high exchange rate may on the whole have a net beneficial impact on the South of England and the Midlands whilst being disadvantageous on balance to the industrial areas to the north and west.

It is not surprising that corporate loan demand continues to increase. Everybody recognises that the non oil corporate sector is going to be in significant deficit this year. In view of the large sales of gilt-edged stock which continue to occur, the private sector is still to some extent crowded out of the long term capital markets and can therefore only fund its deficit from the banks. Lack of external competitiveness aggravates the deficit and, at current interest rates, bank lending is more or less bound to increase by 5% at the end of each quarter when interest is debited.

We are now approaching the time of the abolition of the corset, when one can expect to see the completion of the process of re-integrating subsidiary forms of lending into the money supply figures. One must hope that this will be recognised as a reclassification arising from an incomplete definition of the money supply rather than as a real increase, particularly because, if it were perceived as a real increase, the most likely reaction would be an attempt to sell more gilt-edged stocks which would increase the overcrowding and exacerbate the situation. I continue to believe that the present level of interest rates is having

a perverse effect upon the economy and in particular, I do not now believe that there would be a danger, with lower interest rates, of an undue relaxation in private sector attitudes towards excessive pay claims.

You will be only too well aware of the widespread view that this year's wage round has shown the beam to be in the eye of the public sector rather than the private sector. Like all generalisations, this is far too sweeping and in many ways extremely unfair, but the real bulwark against a pay explosion can only be intelligent and determined management, and the morale and the determination of some managements has been weakened by some of the public sector settlements. Although you are known to be committed to a reduction in the size of the public sector it has probably gained some ground this winter, in some cases (such as local government) by borrowing heavily and in some cases by exploiting monopoly positions to put up prices. The effect of all this is that the supply side of the economy is suffering whilst the demand side is at worst on a plateau. The need to regenerate the supply side is becoming a matter of some urgency.

One aspect of the declining supply side is the increasing level of unemployment. One despairs when the Chairman of the TUC Economic Committee, no less, can be quoted as saying that high pay claims will continue so long as there is high unemployment, without the least apparent recognition that growing unemployment will continue so long as there are excessive wage claims. One or two private sector companies are beginning to negotiate on the level of payroll costs which they can afford, any settlements at a higher level inevitably being shared by fewer people. It seems to be an approach that is understood by union negotiators and could beneficially be adopted more widely.

I am looking forward to seeing you again on 3rd June, when I would welcome an opportunity to go over some of the ground outlined in this letter. I am particularly concerned about public spending, pay settlements, interest rates, and the state of the supply side of the economy.

Yours sincerely,
John Spence

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.

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Ann Amish

23 GREAT WINCHESTER STREET

LONDON EC2P 2AX

From: JOHN SPARROW

01-588 4545

R
2/5

2nd May 1980

Dear Mrs. Thatcher,

The growing awareness of the scope for lower interest rates later in the year, and the increasing hope that the fall will start sooner rather than later, has been reflected this week in a consistently improving gilt-edged market and in an exchange rate which, when one corrects for the fluctuations of the dollar, has been weakening. The problems foreseen for the private sector are, however, still sufficient to prevent the equity market from sharing in the improvements shown by the gilts.

However, much of the heightened expectation of lower interest rates stems from the rapid fall seen in the United States, which now seems to have come at least temporarily to a halt; indeed there are the first signs of some hardening of American interest rates for periods beyond six months. There is therefore at least a possibility that U.S. rates may have fallen a little too far and, taken in conjunction with the higher rates announced by the Bundesbank, the external arguments for a reduction here may prove weaker than they now appear. The internal arguments, which I have rehearsed before, remain as strong as ever.

Yes,
Eurodollar
rates rose
a little
today.
R

The two topics which have attracted most attention this week (apart from various aspects of the Iranian problems) have been the attempts to reach a satisfactory agreement with the E.E.C. on the level of our subscription to the club, and the cost of Mr. Ian MacGregor's services to the British Steel Corporation.

So far as the E.E.C. is concerned, the City understands and enjoys a good negotiation and your efforts and strategy so far have met with widespread approval. On the other hand, I have heard a very great deal of dismay expressed already this morning on the subject of the arrangements proposed for Mr. MacGregor.

Analysing the very considerable number of unsolicited contributions which I have received on this topic it seems clear first of all that nobody quite understands the nature of the deal. At one extreme, it is a transfer fee for an extremely talented man and as such may look reasonable in comparison with the figures paid for international footballers, but seems high against such cases as there have been involving the release of businessmen for other duties. On this interpretation, too, the inclusion of a large contingent amount is not at all understood.

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At the other extreme, the arrangements are seen as a way of paying Mr. MacGregor something like the salary which he has already shown he can command, provided that he is successful; people who see the deal in this light simply think the numbers are too big and, particularly, that the presentation will cause considerable problems within the steel industry and conceivably in other nationalised industries.

The salient point is that, whatever the basis underlying the package, nobody understands it - and it is natural for people to dislike what they do not understand. Equally, everyone who has spoken to me who actually knows Mr. MacGregor (which I do not) speaks of him in the most glowing terms and there is no suggestion of any doubt as to his capacity and suitability for the job in hand. But I have referred to it at such length because I have never before encountered such a mass of strongly worded criticism on any political matter.

Nevertheless the deal has been done and should, I think, be adhered to. If, as is reported in the newspapers, Mr. MacGregor commands a salary approaching £500,000 a year, then the price to be paid for his services over the next three years will not be excessive if he is successful. Some of the criticism that I have heard simply regards the price as excessive, but the core of most arguments appears to be that the presentation of the appointment has seriously damaged the chances of his being successful. It might have been better to say that the right man for the job commanded that sort of salary, which would be a perfectly defensible and unclouded position.

Yours sincerely,
John Farver.

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London S.W.1.

c.c. Adam Ridley Esq.

From: JOHN SPARROW

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX
01-588 4545

Price limit

John's points about
public sector pay are
only too true. The real problem
is the monopoly industries' ability
to put up prices. Perhaps
we should "regulate" like the

Dear Mr. Thatcher, Americans do. No doubt
the Chancellor's paper will cover this.

Until this week, financial markets have behaved since the Budget very much as expected and there has been little to comment on that has not been more than adequately covered in the Press. To-day, international tensions have become a dominating influence on all markets, most conspicuously so in the case of the dollar exchange rate. Unless and until those tensions are eased, markets are likely to remain confused but there is as yet no reason to doubt the long term trend towards lower interest rates and, eventually, a lower exchange rate.

Within the domestic economy, much attention continues to be focused on the level of pay settlements in the public sector. Despite the various interpretations that can be put on such statistics as are available, it is widely believed that many public sector settlements are excessive and that many of the nationalised industries are in practice regarding cash limits as a restriction on their capacity to invest rather than on their ability to pay higher wages. Both the Post Office and British Rail have recently made the point that their investment plans are being restricted against the background of pay offers which many people outside the respective industries regard as being on the high side.

There is the further point that those nationalised industries which exercise an effective monopoly are also relieved of any obligation to control wage payments by reference to their cash limits, in that they have freedom to pass on the expense involved to their customers. The consequent impact upon the Retail Price Index then ensures that private sector pay negotiations come under increased upward pressure.

Private sector employers are therefore faced with a steadily rising market price for labour and expectations by their labour force that that market price will be available. It is unfortunately not possible in a free market for an employer only to pay what he can afford, because he cannot alone determine the market price of labour. He has to accept the price determined by the market as a whole and can only respond by tailoring his own demand for labour to the number of people that he can afford to pay at that price. Public sector pay increases are therefore leading inexorably to private sector unemployment.

There is a further distortion produced by the practice of national wage settlements. In most activities, there is no national market for labour in this country and a local government job which is only tolerable in the South of England if the pay scale is buttressed by overtime payments becomes, in Dundee, an employment so desirable that it becomes an object of patronage. Because the labour market is in fact a series of regional labour markets, we continue to see a strongly marked pattern of regional unemployment. It remains true that unemployment in

the South East is, broadly, a voluntary situation whereas in many industrial areas further north it is very involuntary indeed.

It therefore seems desirable in everybody's interest to try to move away from national wage settlements on to a more regional basis. It also seems worthwhile reviving the suggestion which I made in a letter some time ago, that some of the nationalised industries should be converted into public utilities, along American lines, with independent utility commissioners charged with the authority to review pricing policy, to check the abuse of monopoly power and to impose sufficient discipline to encourage efficiency and sensible long term development. It seems doubtful that the present system of cash limits and departmental control is likely to prove sufficiently effective sufficiently soon.

Yours sincerely,

John Sparrow

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.

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23 GREAT WINCHESTER STREET

LONDON EC2P 2AX

01-588 4545

From: JOHN SPARROW

John Sparrow

28th March, 1980.

28/3

MS

Dear Mr. Thatcher,

The reaction to the Budget has been relatively muted in the City, not because it is viewed with any disfavour but because it contained no major surprises, the broad lines having been fairly well advertised in advance. It has been seen very much as a Budget to ponder rather than as one which necessitated rapid action.

To the extent that a Budget can be divided into its strategic and tactical parts, there continues to be widespread endorsement of the strategy, such quibbles as I have heard being concerned only with some of the tactics. Both the concept of medium term targets and the targets themselves have been welcomed; here and there one can hear worries about possibilities of being blown off-course at some point during the next four years, but this is balanced by a widespread belief that some at least of the targets are conservatively based; for example, it is thought that the PSBR in 1980/81 will in fact be less than £8½ billion, quite regardless of any improvement in our contribution to the E.E.C.. The most difficult group of targets to assess is that for the money supply. As it is known that the ending of the corset scheme is likely to bring back into the statistics money which has been routed outside the corset, it appears that the real targets for 1980/81 are likely to be nearer to 5%-9% than to the stated 7%-11%. In later years, there may be some conflict between the money supply targets and the rate of growth in the economy, if the assumption about 1% per annum growth proves to be too low; one suggestion is that in a medium term plan it is perfectly possible to express money supply targets as a margin over the rate of growth in the economy, a course of action which would clearly be totally impracticable for short term control purposes.

Yes - the Treasury admit that the PSBR forecast is, if anything, on the high side.

PS.

Still at the strategic level, I have heard mild suggestions that the process of moving from direct to indirect taxation could have been taken further this year, but the much more general view is that a pause in the process is acceptable and probably necessary, given that, for whatever bad reasons, increases in the RPI still seem more likely than not to be reflected in wage settlements and eventually in unemployment. Similarly, there has been a mixed reaction to the increasing use of the concept of indexation either to justify measures or as part of the framework of reference within which measures are set. In particular, those of us who believe that indexation is a dangerous concept are concerned that it may become more difficult to remove it from the field of public sector pensions.

Finally, on the strategic front, there has been a very warm welcome for the various measures designed to help small businesses, to encourage divestment and to establish enterprise zones. There are signs that City imaginations are being captured by these proposals.

Turning to the detailed proposals, I have heard little or no criticism of the decision to leave direct taxation largely unchanged; there was some regret that the investment income surcharge continues, at any rate at its former level, and some worry that the increase in the threshold for this surcharge implies that it has more permanence than had been thought and hoped. The changes in the treatment of unemployment pay and benefits to the families of strikers have been welcomed on both economic and political grounds. Many people wish that stamp duty could be abolished and think that it should be, whilst recognising that it is a remarkably cheap and efficient way of raising money. And it is a very common view that the proposals relating to company cars will encourage rather than discourage this form of benefit in kind, which is not what people had been expecting. In particular, it is surprising that free petrol can still be provided for private use. The only other criticisms I have heard have been based very much on personal interest.

The immediate reaction of the equity market has been to continue the adjustment towards a balanced recognition of the prospects for the corporate sector this year. The gilt market is recovering some of its fairly small early losses and should I think move gradually up. Perhaps the most interesting aspect has been the very severe continued shortage in the money markets, where interest rates remain very high. The view gaining ground is that this might mean that the government's financial position is rather better this year than has previously been the case at this time of year which, taken in conjunction with the fact that the requirement to sell gilts represents the lowest proportion of institutional cash flow since 1971/72, should mean that the long awaited improvement in the gilt market will materialise later in the fiscal year. Meanwhile, sterling continues to be extremely strong.

Yes, the
money markets
are very short
of funds
today

12

Yours sincerely,

John Savory

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.

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Ann Smith

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Econ Pol

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX
01-588 4545

From: JOHN SPARROW

R
7/7

and

7th March, 1980.

Dear Mr. Thatcher,

Perhaps the most significant feature of the week has been the resurgence of the dollar, accompanied by the relative stability of sterling. Events in the currency markets have again demonstrated the powerful influence of interest rates upon exchange rates, and the difficulty experienced by central banks in attempting to resist market pressures other than through the interest rate mechanism. Indeed, at the beginning of the week, there were fears that there might be an outbreak of international interest rate war, resistance to the recovery of the dollar being in some contrast to the intervention which took place last year when the dollar was falling.

I gather that the only noticeable selling of sterling last week came from Middle East sources dealing through New York. However, we will not know what the real market price for sterling is until your domestic economic policy has come to fruition and we have seen how the world values a petro-currency when the budget is balanced and inflation and interest rates are much lower than they have been in the last five years. I would guess that that will not be before 1982/83 and, although the talk about entry into the EMS appears to be reviving, I cannot believe that we could successfully become members before we have achieved domestic economic stability. When we have done so, I hasten to add, I believe that there will be a case for entering the EMS.

On the domestic front, there still seems to be a considerable gap between the gloom of the professional forecasters and the admittedly far from euphoric views of people engaged in industry and commerce. Almost certainly, the forecasters under-estimate the resilience that the private sector can be expected to show when it is allowed to function freely in markets from which it is not crowded out by government; the existence and prosperity of the black economy continue to demonstrate that the private sector's spirit is willing when it is untrammelled. Personally, I would like to see more emphasis given to explaining the benefit of a revived economy to everyone in the country, including trade union members. I am sure that many of these do understand that their real interests are best served by a return to a system which permits and encourages the creation of wealth; but it sometimes appears too easy for trade union leaders, advocating and pursuing destructive policies which none of their members would practice in his own vegetable garden, to claim that disagreement with their political or out-dated industrial views constitutes an attack on the living standards of the trade union movement when it is in fact an attempt to offer trade unionists the prospect of much better living standards than the policies of their leaders could ever offer to them.

Part of the problem is the equivalent to what in other countries would be regarded as a return to tribalism. There is no doubt that Mr. Sirs leads a tribe. I do not myself think that he has acted in the best interests of his tribe, and we should soon see whether or not a majority of the tribe think so, but it is unfortunate that industrial tribes should find themselves set at each other's throats and that the TUC cannot see the folly of consistently supporting each tribe in turn in its war against all the other tribes. Mr. Sirs was quoted in the Evening Standard on Wednesday as saying, apparently with satisfaction, that tens of thousands of workers had been laid off as a direct result of the steel strike. It is a sad comment, but still there is no reason to believe that it is representative. But it would be helpful, in seeking what many people still see as sacrifices, to place rather more emphasis on the rewards that working people can expect once the sacrifices have been made.

Yours sincerely,
John Sparran.

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.

Elon for

23 GREAT WINCHESTER STREET

LONDON EC2P 2AX

01-588 4545

From: JOHN SPARROW

29th February, 1980.

Dear Mr. Thatcher,

In my earlier letter I referred to John Forsyth's forthcoming Economic Review, of which I enclose an advance copy.

*Yours sincerely,
John Sparrow*

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

A FISCAL POLICY FOR THE 1980's

Over the past three years, rising North Sea oil production and a sharp increase in the world oil price have both placed sterling under growing upward pressure. When this pressure finally forced the exchange rate over U.S.\$2.30 last July the authorities relaxed a large number of the existing exchange controls.

At the time it was apparently hoped that this measure alone would generate sufficient capital outflows to alleviate the upward pressure on sterling in the foreign exchange markets. Indeed, for a short period such a view seemed justified as sterling fell back to U.S.\$2.06 at the beginning of November following the final removal of exchange controls. This level marked a low point however, for since then sterling has moved steadily upwards.

This edition of the Review examines the implications of the government's present fiscal and monetary policies for the structure of the balance of payments as the value of North Sea production continues to rise, and concentrates on the effect of these policies on U.K. industry. In particular, it suggests that the government should run a financial surplus while revenues from North Sea oil are at their peak.

THE POLICY DILEMMA

The initial reaction to the discovery of North Sea oil on a scale which would make the U.K. self-sufficient in energy during the 1980's was to regard this development as a straightforward benefit to the economy. It is only in the last year or so that there has been a gradual realisation that development of this finite and unrenowable national resource could seriously

distort the structure of the U.K. economy. In particular it has begun to be appreciated that, unless the benefits are managed appropriately, oil production could significantly undermine the internationally traded sector of the economy, which includes both manufacturing and services.

The reason for this is that there must be a balance of payments counterpart to North Sea oil production. The U.K., virtually alone among the industrial countries, will shortly be self-sufficient in energy and the gain to the balance of payments on this account is very substantial: with the rise in the oil price to over \$30 a barrel the market value of U.K. oil and gas production is now running at some £16bn a year. The gain in respect of energy must be reflected either elsewhere in the current account or in capital outflows which could take the form either of a deficit on capital account or of exchange market intervention and reserve accumulation by the authorities.

However, since North Sea oil production began on a significant scale in the winter of 1976 the capital account has remained in surplus except in 1978 when there was a significant outflow of funds. The cumulative position from the first quarter of 1977 to the third quarter of 1979 showed the capital account in a surplus of £4.5bn and the balancing item in a surplus of £5bn. These inflows were offset by £8bn of official intervention in the form of reserve accumulation so that the current account has shown a cumulative deficit of £1.5bn. Thus, the counterpart to rising North Sea production has so far been principally a sharp deterioration in the non-oil current account in which the rise in the sterling exchange rate has played the decisive role.

There is now a greater recognition that the adjustment to North Sea production should take the form of a net capital outflow rather than a continued deterioration in the non-oil current account. The decision to abolish exchange controls

was influenced by this view but, while it was a necessary step if private as opposed to official capital outflows were to develop, it has not of itself proved sufficient to generate such flows.

The problem is that the present combination of fiscal and monetary policy militates against the development of net capital outflows. The current Public Sector Borrowing Requirement, (P.S.B.R.), is around 5½% of domestic output and the monetary targets imply that it should be funded by gilt sales amounting to some three quarters of the cash flow of the pension funds and life assurance companies. The authorities are committed to raising interest rates to whatever level is necessary to fund the P.S.B.R. within the monetary targets which in practice means raising interest rates to a level at which capital outflows will be minimal. Moreover, in selling so large a volume of securities to domestic investors yields are driven to a point at which considerable inflows of overseas funds occur. Thus gilt sales to the overseas sector amounted to £635 million in the third quarter of last year.

A possible method of dealing with this problem would be to impose inward exchange controls. There are two objections to this course of action. The first is that inward controls are unlikely to be effective in a country such as the U.K. with long established international financial connections. Thus controls on increases in non-resident owned bank deposits, which have typically accounted for over 10% of total sterling deposits, would merely serve to stimulate the already rapid growth of the eurosterling market. Similarly, restrictions on foreign holdings of gilts would create an opportunity for companies to finance their U.K. operations by issuing eurosterling bonds, thus simply diverting the inflows. The second and more fundamental objection is that if the aim of policy is to secure a significant capital outflow, control on inflows cannot be of more than marginal use.

The policy dilemma of the authorities is therefore clear. They may have come to accept that in principle net capital outflows on a substantial scale are a necessary counterpart to oil production and have relaxed exchange controls in order to facilitate them. However, such net capital outflows are unlikely given the size of the P.S.B.R. and the commitment of the authorities to raise interest rates to whatever level is necessary to fund it in the gilt market rather than via the banking system. In other words the authorities' fiscal and monetary policy precludes a deficit on capital account and thus ensures that the counterpart to North Sea production is a loss in the market share of U.K. industry.

THE SQUEEZE ON THE CORPORATE SECTOR

The authorities' commitment to a medium term reduction in the P.S.B.R. is founded on general financial considerations rather than any specific views as to the correct fiscal adjustment to North Sea developments. Although the very large prospective increase in revenue from the North Sea is seen as providing the fiscal means for effecting a reduction in the P.S.B.R. along with further cuts in taxation, it does not appear to be seen as a factor which should influence the medium-term target for the P.S.B.R. In particular, it is not yet clear how far government revenues from the North Sea will in the medium-term be used to improve the government's fiscal position and how far to reduce other taxes as in the 1979 Budget.

There is, in any case, a considerable debate over how rapidly the P.S.B.R. should be reduced, with concern in some quarters that a reduction in the P.S.B.R. at a time of recession would exacerbate the economic downturn and place dangerous pressure on the financial position of the corporate sector.

However, the justification for maintaining a high P.S.B.R. in

order to minimise the falls in output and employment, and in particular to shield the corporate sector, is open to question. Indeed there are two reasons for believing that maintaining the P.S.B.R. at its present level in real terms will, in the particular circumstances of the U.K. economy, have a contrary effect.

The first is that a lower P.S.B.R. is, in current circumstances, more likely to be reflected in the balance of payments than in the corporate sector's position. A lower P.S.B.R. would involve lower gilt sales by the authorities and lower interest rates. This should be reflected in lower capital inflows to the U.K. as the overseas sector is typically sensitive to interest rate changes.

Moreover, a reduction in issuing by the U.K. authorities would probably induce international borrowers, who are now free to borrow in the U.K. markets, to satisfy the very strong institutional demand for fixed interest securities in the U.K. Such borrowing would constitute an outflow of capital across the exchanges.

For these reasons a lower P.S.B.R. would probably be mainly reflected in a weakening of the capital account and a corresponding improvement in the current account. The mechanism for this would be a lower exchange rate which would tend both to improve the cash flow of companies in the internationally traded sector and their willingness to run a financial deficit.

The second point is that a lower P.S.B.R., by making it possible for the corporate sector to look to the capital market as well as the banking system to finance its deficit, and by lowering the interest rates at which its debt is financed, will tend to increase the willingness and the ability of the corporate sector to run a financial deficit.

These arguments would suggest that maintaining the P.S.B.R. at, or near, its present level in real terms will not only exacerbate the squeeze on the corporate sector over the next twelve months but will be the primary cause of this squeeze. Far from exerting an expansionary influence on the economy a high public sector deficit may increase the pressure on output and employment.

THE POLICY IMPLICATIONS

While the correct fiscal stance for the next financial year has been a matter of considerable debate there has, as yet, been little discussion as to the appropriate fiscal position in the mid-eighties beyond a general, but by no means universal, view that the P.S.B.R. should be reduced. In particular, there has been little consideration of the implications of the emergence of the U.K. as a major oil producer for fiscal policy.

However, the prospective scale of U.K. oil revenues make it arguable that government policy should aim not merely for a reduction in the P.S.B.R. but rather for a significant surplus. There are two reasons for this.

The first is that, if the UK. is to export capital on a scale comparable to the balance of payments gain from the North Sea in the mid-eighties, which will be running at some 10% of G.N.P., while at the same time restoring the capital market as a source of funding for the corporate sector, the demands on the capital market will be exceptionally heavy both in relation to the existing level of institutional flows of funds and in relation to G.N.P. In these circumstances for the public sector to add to those demands would be either to reduce the pace of capital outflows or to frustrate the funding of the corporate sector's desired deficit or both. If, however, the public sector uses its North Sea revenues to reduce the outstanding level of domestic debt, that is, to run a surplus, it

will be adding to the flow of funds available to finance both the corporate sector and an adequate capital outflow.

The second and more fundamental point is that during the years of peak oil production the government will be enjoying a very large and non-renewable source of tax revenue whose value in any particular year will be heavily dependent on a commodity price which has a high degree of intrinsic volatility. The government has rightly perceived that to use these revenues to finance higher public expenditure would be to arouse expectations which could not be satisfied when revenue declines. By the same token, to use such revenues as a substitute for other forms of taxation would be to frustrate the capital outflows which are vital if the economy is to adapt smoothly to the decline in oil production which will begin in little over a decade.

In this context it is worth citing Alberta as an example of an economy where a build-up in oil production and government oil revenues has been handled in exactly this way. Clearly as a province within a national economy Alberta is not faced with an immediate exchange rate problem. However, in an attempt to spread the benefits from these oil revenues over the longest possible time period and minimise the dislocation to the local economy, it has bought in the state debt in its entirety and is now looking for opportunities to invest its surplus funds elsewhere in Canada. As a result of this policy the Albertan economy is now booming as investment opportunities in both the oil and non-oil sectors and the availability of finance in the province have attracted new industries.

Following the oil crisis in 1973 the U.K. authorities rapidly accepted the argument that as an oil importer, the U.K. would have to run a higher public sector deficit in order to offset the deflationary impact of the higher oil prices on the economy.

Unfortunately, the authorities have as yet not accepted the corollary to this argument, namely that, as an oil producer, the U.K. should run a smaller deficit and even a public sector surplus in order to preserve the industrial structure of the economy and encourage the growth of the non-oil sector.

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX
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John Sparrow

From: JOHN SPARROW

*R
M*

29th February, 1980.

ms

Dear Mrs. Thatcher,

I am sorry not to have written to you last week. Had I done so, it would have reflected the view that it had been a very good week, with evidence on several fronts that you are winning the battle for people's minds and with encouraging indications that the PSBR in 1980/81 would not, as had been feared, be higher in money terms than it is this year.

There appears to have been some wavering this week, but as far as I can see it is confined to Westminster. Quite apart from the solid evidence of growing realism provided in the private steel sector and at Longbridge, the industrialists I speak to remain firmly behind your policies and are even beginning to recognise that it is part of management's role to protect fellow employees. There has for some years been a reflex attitude that only unions could look after their members' interests, but this is being replaced by recognition that management has a duty in this respect which is all the more compelling when some union leaders are failing to perceive the best long term interests of their members.

In the longer term, the indications that the PSBR will be reduced this year are greatly welcomed. I hope to send you next week a preliminary copy of an article by my colleague, John Forsyth, in which he argues that the correct stance for an oil producer is to run a surplus rather than a deficit, and that this, somewhat contrary to the conventional wisdom, could only be advantageous to the private sector. As you know, I share these views.

The case for lower sterling interest rates has obviously been affected by the pattern of increases in many major economies. Most of these appear to have been for domestic reasons, but the move in Germany seems much more directed towards protecting their exchange rate - with no marked initial success. Anything like an interest rate war would be a most unfortunate development, but a reduction in our PSBR should ensure that our rates begin to fall. For the time being, it would help if the supply of gilt-edged securities could be restricted to whatever amount is needed for funding purposes. It would not be consistent to over fund to control the money supply at a time when considerable and welcome efforts are being made to prevent short-term interest rates from going too high.

Yours sincerely,

John Sparrow

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.

Evon P81²

Dim Mint

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX
01-588 4545

From: JOHN SPARROW

R
15/2

15th February, 1980.

Dear Mr. Thatcher,

In the City, financial developments are still having more of an impact than events in the industrial economy.

The decision of the Bank of England to offer sale and repurchase facilities in respect of the gilt-edged holdings of the clearing banks was generally welcomed as indicating an unwillingness to see interest rates rise still further, although there were a few voices which worried about the possibility that this might indicate a weakening of your resolve; as you know, I believe that it should be consonant with your resolve that interest rates rise no further. There was also a suggestion that confining the proposed facility to the clearing banks might simply divert the pressure elsewhere in the banking system, but it is too early to say whether, or not this fear is justified.

The money supply figures which have just been published did not really come as a great surprise as they were previewed in the banking figures last week. My admittedly partisan eyes did notice that sterling M3 (which is the controlled quantity) has risen by about 9.4% in the nine months since the Election whereas the narrower M1, which is not the subject of control, has risen by only 3.6% in the same period.

In the industrial economy there is growing sadness about developments in the steel dispute accompanied by a feeling that both BSC and Mr. Sirs have failed to take opportunities to extract themselves from the dilemma in which they find themselves. What has been revealed of the Cabinet's reaction, in terms of changes in industrial relations legislation, has been generally welcomed. The precise proposals are not yet clear, but the impression of changes in the laws on secondary picketing and in the ways in which strikes are financed is a welcome one, the provisions on strike pay particularly so. There is widespread acceptance of the unworkability of laws to which people refuse to be subject, but there is equally an awareness that a lot of the people who might be thought to refuse to subject themselves to amended legislation would do so unwillingly and under duress. One feels that you are probably steering as good a path as possible through a mine-field. I should perhaps add that, despite the treatment in some newspapers, most of the people I talk to regard the rumoured split in the Cabinet as no more than healthy discussion on a very difficult subject about which a range of diverse views can perfectly properly be held.

Neither the steel strike nor the apparent turn for the worse in Leyland has significantly impacted on the financial markets. Leyland seems to be another case of premature hopes being at least temporarily dashed and suggestions that the only answer is to appoint a Receiver are again being

heard. That course was remarkably successful in the case of Rolls Royce, but I believe that the financial stringency from which the private sector is now suffering makes it much more doubtful that the recipe would succeed at this time. Yet again the size of the PSBR proves to be an obstacle to what might otherwise prove the right way to restore Leyland to viability reabsorbed in smaller units within the private sector.

Yours sincerely,

John Sparrow

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.

PRIME MINISTER

MONETARY POLICY

You raised some questions on John Sparrow's latest letter:

(i) Would it be possible to reduce interest rates by a tiny amount if at the same time we got an undertaking from the banks that they would limit credit on credit cards?

I think this is not feasible for three reasons. First, as you know, there is considerable pressure for an increase in interest rates at the moment because of the pressure on the banks' liquidity. This in turn is due to the heavy borrowing by the company sector, and to the recent very heavy sales of gilts to the non-banks. Second, personal lending by the clearers was actually negative in January. Third, it is unlikely that the clearers would agree to limit credit on credit cards unless limits were also brought in on in-store credit cards. The latter have become much more important recently, and it would be difficult to get the stores to agree.

(ii) Could we let MLR go free again?

When it was free, MLR was calculated on the basis of the Treasury bill rate plus $\frac{1}{2}$ per cent and rounded to the nearest $\frac{1}{4}$ per cent. This would put MLR at $16\frac{3}{4}$ per cent. However, the Treasury and the Bank would resist a return to the old system since they believe we were getting the worst of both worlds under it: we were being blamed for the level of interest rates and yet we had less control over them than we do now.

(iii) You were told that there is no limit on the amount that local authorities can borrow in relation to their rating income even though the loans are secured on the rates.

There are two types of LA borrowing:-

/(a)

(a) Short-term borrowing through the issue of bills - these are secured on the rates but only for one year at a time. In other words, borrowing at the beginning of the year cannot exceed the total revenue expected from the rates during the course of the year.

(b) Long-term borrowing for capital expenditure. There are no controls on this borrowing as such, but there are controls on capital spending. So the borrowing is controlled by a round-about route.

(iv) John Sparrow suggested that high interest rates are themselves inflating the monetary aggregates by encouraging round-tripping, by attracting money out of the building societies and into the banking system by bringing in money over the exchanges, by increasing the amount of interest which gets debited to over-drawn accounts, and by discouraging domestic deposits from moving overseas. There is some truth in all of these charges, but the question is how to get interest rates down? When we are trying to run a tight monetary policy and the demand for credit from the private sector remains high, interest rates are bound to stay high also. If we were to reduce MLR at the moment the market would almost certainly take no interest. It might even have a ^{not}perverse effect in suggesting that we no longer were worried about the monetary target. In short, although the high level of MLR and of interest rates generally may be inflating the monetary aggregates, the money supply would probably go even higher if they were to fall at the present time. On the specific point of round-tripping, the answer to this is either for the Bank to ease the liquidity of the clearers (as they have done today), or for base rates to rise still further.

T P L

13 February 1980



10 DOWNING STREET

Tim,

(1) Would it be possible to reduce interest rates by a tiny amount if at the same time we gave an undertaking for the banks that they would limit credit on credit cards

(2) n - could we let MCR go free again

and (3) - I spoke on through
increased yesterday. He said there is

10 DOWNING STREET

no limit on the amount that
L.A.'s can borrow in relation to
their net worth even though
the loan is secured on the
net worth. This seems very unusual.

Does anyone else know where

also with domestic rates?

4) See Christopher Ziller, letter.

Paul

11.2.80

Pami Anish

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX

From: JOHN SPARROW

R
8/2

01-588 4545

8th February, 1980.

Dear Mr. Thatcher,

The City generally is in a mood to wait and see what happens next and there is therefore very little to discuss in relation to the behaviour of the financial markets during the last couple of weeks. One merely notes that, despite a series of domestic problems including the steel strike, the behaviour of the monetary aggregates, and the dismissal of Mr. Robinson, the pound and the equity markets have continued to strengthen, whilst the gilt market remains without a real sense of direction.

Your comments at question time yesterday on the subject of a new monetary base have helped to concentrate attention on that possibility. The authorities in the United States have, of course, been working on a monetary base system for some time now and one of the lessons that has been thrown up by their experience is that it is dangerously easy to control the components of a statistical concept without necessarily controlling the realities which it is supposed to reflect. Since the introduction of the Volcker package the authorities in the United States have been conspicuously successful at controlling the statistics but increasingly unsuccessful at controlling the reality - largely, as your answers in the House indicate, because of the growth of what the specialists call "disintermediation".

*consultative
paper
is planned
for publication
at end-Feb:
we will be
sent the draft.

*R.**

This is obviously undesirable in itself; it also has at least one undesirable consequence, which is that the market loses faith in the statistics and recognises their lack of relation to reality. It is for this reason that the U.S. dollar bond market has collapsed in the face of what had been, on the whole, an encouraging series of figures.

There are times when the same sort of danger is already evident in this country. One example is the calculation of the PSBR on a basis which excludes the proceeds from the sale of state owned assets. One has the impression that to the official mind planned asset disposals do not constitute either a part of the PSBR or a supplement to it; it remains a fact that, in market terms, both elements represent a part of the government's financing need and both have identical effects upon the securities markets, and upon the ability of the private sector to finance itself at reasonable cost.

*we are
aware of
this point

*R.**

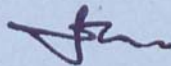
It is possible that we have the same dichotomy between statistics and reality in the case of the monetary aggregates. A policy of high interest rates will itself at some stage inflate the monetary aggregates, by encouraging round tripping, by attracting money out of the building societies and into the banking system, by bringing in money over the exchanges, by increasing the amount of interest which gets debited to overdrawn accounts and, because high rates tend to lead to a high exchange rate, by discouraging domestic deposits from moving overseas. In addition, because capital gains on gilt-edged stocks held for more than a year are tax free, it could to-day prove profitable for corporations to borrow money (inflating the aggregates) to invest in gilts (which may or may not offset the increase).

*This
may well
have a
wonderful
effect.*

To reverse the argument, it is quite possible that a reduction in interest rates at this moment, which is very far from being a text-book move, would act in several ways to improve the monetary aggregates without any prospect of harm at real level except for the medium term possibility that there might be some small increase in loan demand from the corporate sector. As you know, I believe that corporate loan demand is largely involuntary and relatively inelastic at anything like current interest rate levels and I would not therefore expect lower interest rates to cause any real damage: I would expect a significant psychological advantage.

While the clouds are still massing on the industrial front, it is probably not practical to think in terms of lower interest rates. However, I remain convinced that interest rates must move down rather than up and that they must do so sooner rather than later, particularly in view of the scissors effect suffered by the corporate sector from a linked combination of high interest rates and a high exchange rate. I am told that there is a danger that a reduction of interest rates would be regarded as a U-turn; I think there is also a danger of being over-aware of possible allegations of a U-turn. Most of all, I think it important to keep one's eyes on the real situation and to recognise that even the best statistics are only proxies for reality. The two dominant features of our financial and fiscal position are North Sea oil and the PSBR and financial policy must recognise the consequences of the former and minimise the potential damage caused by the latter.

Yours sincerely,



The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.

Econ 407
2

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX
01-588 4545

From: JOHN SPARROW

Ami Smith
MT
R
271

25th January, 1980.

Dear Ms. Thatcher,

On the whole, this has been a steady week in the financial markets apart from the astonishing, albeit predictable, fluctuations in gold and silver. The sale of another large issue of gilt-edged stock has been accomplished successfully, although it has resulted in very straitened circumstances in the short-term money market. In due course the continued sale of gilts will presumably be reflected in a continuation of the recent run of encouraging figures for M3.

It is becoming conventional wisdom that interest rates will not now be reduced until the Budget. This view is not based on a belief that there is no case for an earlier reduction; indeed, more and more people are recognising the need for lower interest rates. The majority view of likely timing derives more from a feeling that lower interest rates would be a useful sweetener in what might prove to be an otherwise depressing Budget. I report this view without sharing it. It seems to me to be out of character for your government to allow questions of tactical advantage to influence the timing of a strategic decision.

In a newsletter published this week by Tim Congdon of Messels there is an article advocating floating rate or indexed issues by the private sector (which I do not wish to discuss) which starts off with an extremely valuable analysis of the recent pattern of lending. His conclusion is that personal sector borrowing, when adjusted to exclude unincorporated businesses and after allowing for the shift in the pattern of housing finance away from building societies and towards the banks, rose only slightly last year. He adds that, as the lending totals are boosted by interest charge debiting and interest rates were much higher in 1979 than in 1978, underlying loan demand from persons was probably down between the two years. It follows from this that personal borrowing has proved elastic in response to higher interest rates, as one would have expected; that company borrowing represents the bulk of the increase in loan demand; and that company borrowing has proved inelastic.

←

This leads one back to the fact that most corporate borrowing is now involuntary and not likely to be choked off by high interest rates. In broad terms, bank borrowing is the only avenue by which companies can currently finance their needs, because few people wish to take on long term commitments at what we all hope will be short term levels of interest. Mr. Congdon also makes the point that, because interest is debited and not paid, higher interest rates inflate the aggregates which they are meant to control. The ultimate absurdity would be to visualise interest rates at 100% a day to choke off lending; the effect would be that M3 would double daily, but this would hardly be a case for even higher interest rates.

The cost of finance is still very much attributable to the size of the PSBR and some unhappiness has been expressed that Nigel Lawson's speech on Tuesday, which was presented as re-affirming your commitment to control government borrowing requirements, nonetheless indicated that the PSBR is likely to rise in money terms in 1980/81 and that the goal is now to keep it level as a proportion of gross domestic product. It may well be that Nigel Lawson has been quoted out of context; however, the unhappiness stems from a belief that the control of money needs to be buttressed by a fiscal policy which moves more rapidly towards a balanced budget. Keynes himself confined his case for government borrowing in a recession to those situations where there was inadequate private sector willingness to borrow, and there is every reason to suppose that in 1980 the private sector will be only too willing to take up the funds not borrowed by the government, at the lower interest rates which would then prevail.

I recognise that the size of the PSBR in 1980/81 may well be a matter of necessity rather than one of preference. However, there are a lot of people in the City hoping that the preference for a lower PSBR will be sufficiently strong for the examination of both expenditure and revenue possibilities to be rigorously continued with a view to seeing whether or not the necessity can in fact be reduced. On the expenditure side, as we discussed when we last met, this is ultimately likely to mean the complete elimination of some activities as well as the removal of fat. On the revenue side, the obvious areas are excise duties and oil taxation and one has the impression that these are already being very carefully examined. But, whatever the method, a lower PSBR is regarded by many people in the City as the most essential pre-requisite of a return to a healthy economy.

Finally, the steel strike continues to have little immediate impact on the rest of industry. I was grateful for your message on the cost of redundancies, and passed it on. The City is still happy with the government's stance.

Yours sincerely,
John Bourn.

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.

16.
BSC have
set aside
£50m to 300m
for redundancies

R.

David Smith

74 Econ PD 2

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX
01-588 4545

From: JOHN SPARROW

[Handwritten signature]
14/1

18th January, 1980.

Dear Mr. Thatcher,

The domestic financial markets have all shown strength this week, and gold has continued to go through the roof. The behaviour of gold and indeed of silver and other commodities is an understandable reaction to the increasingly troubled state of the world. Arguably the reaction has been over-done but it would be a brave man who backed that judgment with money at this juncture.

The strength of the domestic market, on the other hand, appears to fly in the face of the present industrial troubles. To some extent this is because people still do not fear the worst, and comfort themselves with the reflection that strikes, however protracted, do prove in the end to be finite. More important, however, is the cautious but growing belief that interest rates will be lower on or before Budget Day, backed by the view that, difficult though the learning curve may be, your policies will eventually be understood and, when understood, will be successful. I also get the impression that, despite the coverage in the newspapers, the steel strike is not yet biting severely on the rest of industry.

Told John Sparrow

[Handwritten mark]

But we are! Better still him.

Nevertheless, the situation is clearly causing anxiety and the first faint murmurings of appeals for compromise are being heard. One suggestion which may not conflict with your basic philosophy is that the refusal to supply tax-payers' money in order to pay the wages of an unprofitable industry should be steadfastly maintained but that the tax-payer might reasonably supply money to meet redundancy costs involved in restoring plants which are currently over-manned to economic viability based on a smaller work-force. The argument for this is that redundancy costs are in the nature of a once and for all capital payment; the argument against is that it is just another way of pumping money into BSC. If the return to viability were reasonably certain I would myself prefer the argument in favour.

Disagreed with it

You may have seen Sam Brittan's article in the Financial Times yesterday, in which he again argues the case for indexed bonds. As you know, I do not agree with that argument, but the article also draws attention to the fact that the borrowing requirement in real terms has been very much lower than in nominal terms and in some years has been negative. This is to some extent tautologous and misleading. The borrowing requirement in real terms will always tend towards zero, because the larger the deficit, the higher the likely rate of inflation and therefore the bigger the correction from nominal to real. The converse argument would tend to apply if the government were in surplus. It would be unfortunate

if the belief grew that a large nominal borrowing requirement did not matter because the inflationary problems caused by a large deficit have the single virtue of minimising the deficit in real terms. It is unfortunately true that people in general do not think in "real" terms; this is clear from the reactions of finance directors and mortgage borrowers alike.

Yours sincerely,
John Sparrow

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.

Econ Pol

23 GREAT WINCHESTER STREET

LONDON EC2P 2AX

01-588 4545

From: JOHN SPARROW

11th January, 1980

Dear Mr. Thatcher,

The week has been dominated by growing fears about the length of the steel strike and its impact on industry. If the strike does turn out to be a protracted affair, it will provide an early measure of the willingness of the private sector to stand up and be counted in support of more rational conduct of wage bargaining.

This is because a prime victim of the strike will be the engineering industry, which is already fairly stretched in consequence of their own strike late last year. Many companies in the industry are still fairly heavily borrowed at high interest rates and, if they are denied supplies of steel, will soon come to the point at which they will either have to close down some or all of their plants or seek to apply pressure for the steel workers to be bought out. They could conceivably do both. This is not simply a conflict between public good and private self-interest, or between long term and short term views of what is good for the economy; there will certainly be people in the engineering industry who will believe that the public good and the long term interests would not be served by their companies becoming too seriously debilitated. So far, I detect no signs of weakening and any criticisms that are heard have related more to what some see as weak negotiating by BSC than to the general posture that has been adopted and the way in which the government has remained aloof from the battle. As the pressures grow I think it is inevitable that some sign of weakening will develop.

Although the steel strike overhangs the financial markets, the underlying trends are still seen to be favourable. The market is aware that gilt sales in the current month are now at the £2 billion mark and therefore expect that the money supply figures will be favourable for the third month in a row when they are published in February. As a result, the money markets are actively considering the possibility of a cut in MLR in that month although they recognise that their calculations could be upset either by a resurgence of private sector loan demand (which is considered unlikely except as a consequence of the steel strike); or by a renewed inflow of money across the exchanges, of which there are some signs to-day. On the other hand, the general expectation is that the pound will continue to move upwards both against the dollar and on a weighted average basis and, now that exchange controls have been relaxed, lower interest rates are seen as the only mechanism by which the value of sterling can be controlled. It remains true, of course, that the full impact of exchange control abolition will not be felt until interest rates are lower.

Against this background, and with the confirmation that the central government borrowing requirement will be reasonably close to the Budget forecast for the year, the gilt market is weighing up the likely funding strategy. With the suggestion of a BNO share sale raising upwards of £500m., it is felt that the need to fund may well have passed for the current fiscal year but that it might be sound policy to issue a partly-paid stock with the bulk of the calls falling due after 5th April in order to make a start on next year's funding programme. On the one hand this may turn out to be unnecessarily expensive; on the other hand, the gilt market is likely to improve considerably in the absence of a tap stock and when the steel strike is over, could conceivably go to levels at which funding would be apparently cheaper but actually more difficult to achieve. In the end, I think the funding policy has to stem from your intentions about interest rates.

Yours sincerely,

John Sparrow.

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Mr. Adam Ridley

PRIME MINISTER

23 GREAT WINCHESTER STREET

LONDON EC2P 2AX

01-588 4545

From: JOHN SPARROW

4th January, 1980.

ms
Dear Mrs. Thatcher,

Events both at home and abroad have created a sense of fear which has dominated the financial markets in the first week of 1980. Most attention has been given to the behaviour of the price of gold, although there are some grounds for thinking that some part of its recent rise has been caused by people who mistakenly sold short at the end of last year and were forced to cover their obligations at more or less any price.

In any event, there are signs to-day of a gradual return of confidence in some sort of stability. There are hopes that the steel strike will not last too long and that the realities of the situation in that industry are in fact being recognised, underneath all of the talk. There remains a genuine worry about the position of the economy.

This worry stems from familiar sources, which are inter-linked. They are public borrowing, interest rates and inflation; at present, there is rather less concern about the money supply and an increasing expectation of an improving trend in the growth of credit.

Interest rates are having a very considerable impact on the private sector and are certainly not helping to develop the supply side of the economy. In addition, the abolition of exchange control will not produce the desired out-flow of capital until U.K. interest rates are relatively low. Nonetheless, they will have to remain high (although not necessarily at current levels) so long as the overwhelming bulk of institutional cash flow is absorbed by the sale of gilt-edged securities. It is recognised that you are making renewed efforts to control public spending but it is increasingly felt that reductions in the PSBR will also require higher revenues.

The problem about increasing revenues, other than as a consequence of inflation, is that they have an impact either on the retail price index and therefore on the perceived rate of inflation or on personal after tax incomes and therefore on incentives. One area which is outside those objections is the taxation of oil revenues and, as Mr. Howell has indicated that the government now wants to reduce the rate of depletion during the 1980s, it seems that there is a case for re-examining the workings of PRT. A lower depletion rate will presumably mean less emphasis on the development of marginal fields and therefore less need to structure the tax so as to encourage further development expenditure. Furthermore, the sharp upward progression of the price of oil has created very considerable cash flows for the oil companies and has also greatly increased the "rent" or super-profit arising from North Sea activities. It would therefore seem

possible to increase revenues from this source and, to the extent that PRT was conceived as a means of transferring any super-profits to the nation, it would be consistent to do so. There may well be a further psychological advantage in accelerating the flow of revenues from this source and that arises from the length of time it appears to take to change spending plans, whether upwards or downwards.

Because of the rigidity of public spending, an unexpected large flow of income would tend not to be spent but to reduce the PSBR. On the other hand, the current expectations of considerable future flows of revenues from this source must make it harder for people to accept the need to cut spending in 1980 when, they might argue, the cuts will not really have their full impact until a time when the money will be available.

For what it is worth, the consensus of opinion in Morgan Grenfell is that the pound and the equity market will both strengthen in 1980. Looking further ahead, I heard the Editor of Old Moore's Almanac say that he already has his predictions for 1981 and they indicate quite clearly that 1980 is the last of the difficult years. I know the quotation about the fault not being in our stars, but perhaps this means that we shall have corrected the faults in ourselves by the end of the year.

Yours sincerely,
John Sparrow.

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.

Encl. 2

Prime Minister

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX
01-588 4545

From: JOHN SPARROW

R
37.

30th November, 1979.

JK

Dear Mr. Thatcher,

Although the week has been full of interesting developments there has been little to which I can usefully add comment.

For example, one can only say of your discussions in Dublin that you have a very great deal of support from City and public opinion and that the battle that you are fighting is a necessary one. Again, developments at Leyland can only be watched with interest and hope.

The one area which does deserve comment is the extension of the U.S.-Iranian conflict into the banking world. There are already signs that this is causing the dollar to retreat and sterling to appreciate and it seems reasonable to expect other countries which have traditionally held dollar assets to pay more attention to the possibilities of diversifying into other currencies than was already the case. To the extent that diversification is taking and does take place, we will have another factor to strengthen the pound, and sterling will have taken another step on the road back to being a reserve currency.

Any significant build-up in sterling liabilities to overseas countries could in due course be offset by an increase in the extent to which foreigners become indebted to this country by borrowing sterling in London. At present interest rates, this would be improbable, but as the economy starts to benefit from the medicine, overseas borrowing in London would be a desirable development.

Yours sincerely,
John Sparrow

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10, Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.

ow

Even Biting 2

Pam Austin

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX

From: JOHN SPARROW

01-588 4545

2
23/11

23rd November 1979

Dear Mr. Thatcher,

Higher interest rates are beginning to bite and are reflected in the equity market and in the sterling exchange rate. The gilt market has lost some of its initial enthusiasm, although it is worth noting that the yields are still significantly less than might have been expected with MLR at 17%; in other words the gilt market is still discounting a downward trend in interest rates as it has (mistakenly) been doing for most of this year.

In this context, it is pertinent to mention that there is a view held in the City that MLR only goes down if it goes down shortly after a rise, and that any prolonged period of a stable MLR is followed by an increase. This is justified not only by examination of recent history but also by the argument that, in a period of monetary growth, MLR is only held at any given level if it is not working properly, which leads to the presumption that the next move will be upwards. I do not mention this because I believe that it has great rational significance, but because it is part of the psychology which so often is at least as important as the facts in determining the trends of markets. Set against it is the expectation that the authorities will not wish to reduce interest rates until there is clear evidence that the monetary aggregates are growing less rapidly. As market confidence is still going to be important in your funding programme and in your economic policy, there is something of a tight-rope in charting the future of interest rates.

There has been renewed discussion recently of the advantages of issuing Government stock on an index linked basis, and one should not lose sight of the fact that the arguments are not all one-sided. Apart from the familiar points that indexation legitimises inflation and, if applied to Government securities, will lead to pressures for it to be applied elsewhere, there is every likelihood that the issue of such a stock would kill the equity market stone dead. One can understand why investment managers would like to have a portfolio including Government paper which offers a guaranteed real rate of return; it is difficult to see why they should want to hold anything else. The chief argument for indexation is that the cost of the present system to the taxpayer is going to be enormous as the rate of inflation is brought under control. One cannot deny this problem but there will be

alternative methods of tackling it.

For example, a twenty-five year stock issued at par with a 14% coupon might be expected to stand at about 130 when long-term interest rates have fallen to 8%. As investment managers are particularly concerned about protecting capital values, they might well look favourably on a proposal to replace that stock with £130 nominal of 8% stock, which would save about a quarter of the interest burden. I certainly feel that before any commitment is made to indexation full consideration should be given to alternative methods of tackling the very real problem of the accumulating interest burden, as well as to the ramifications of indexation itself.

On the industrial front, I still believe that the prospects for this pay round are not as bad as is generally thought. The tide of management determination is still swelling and is slowly being reinforced by the publicity given to examples like British Leyland. There are obviously considerable worries about the miners, but my guess is that the figure of 20% will not prove to have a disastrous knock-on effect; much more important is the determination with which the Coal Board holds its position. Inevitably, the miners are being asked to ballot on a loaded question, but people I know in mining areas are of the view that there would be no strike if the question were phrased neutrally and that there may well be no strike anyway. They think that the bulk of the mining workers, left to themselves, would accept 20%.

However, the situation is still not being helped by the general acceptance of the imminence of 20% inflation. There is still very little notice taken of the new Tax and Price Index, and I am told that it is sometimes difficult to discover what that stands at any way. The VAT adjustment is rarely remembered and it seems to me that insufficient attention has been drawn to the fact that the last three months have seen the RPI growing at a rate of about 12%. If the pay round is to be brought to a satisfactory outcome, I think that an effort in educating managements and workforces alike is called for. The Treasury forecasts clearly do not help, nor does inflation proofing of payments for not working.

Finally, the need for the proposed study on housing finance has been emphasised yet again. For interest rates to be effective in the housing market it is much more important to have a system which regulates the amount of funds available than to have one which keeps those funds flowing at considerable social and financial cost to people who entered into contracts in totally different circumstances.

*Yours sincerely,
John Sparrow.*

The Rt. Hon. Mrs. Margaret Thatcher, MP.,
10, Downing Street,
London, SW1.

cc: Adam Ridley, Esq.,

① Caroline - see page 2
② Michael A. Dini Smith

of (in Term Abd 2) Ecar PA
Visit to USA

23 GREAT WINCHESTER STREET

LONDON EC2P 2AX

01-588 4545

From: JOHN SPARROW

R R. 16/11
11/11

16th November 1979

Dear Mr. Thatcher.

The package of measures announced yesterday has been generally regarded in the City as convincing, although to regard it as the final turning point is still as much a matter of hope as of belief. At times like these, not everyone reads all of the detail, but those who have particularly welcomed Geoffrey Howe's repeated emphasis on the need to restrain public spending. It is increasingly recognised that it is the size of the PSBR that is forcing interest rates to levels which mean in a very literal sense that public spending takes place at the expense of the corporate sector.

The decision modestly to advance the payment dates for PRT is seen as a sensible method of easing the pressures in this fiscal year by using some of the considerably higher flows of revenue that are expected in the next fiscal year. As you know, it is a move which I welcome; what criticism I have heard seems to be based on the assumption that the PSBR next year will be as high as it is currently and that advanced payment merely means a problem deferred. I think it is most important that this should not prove to be the case and that the bulk of the increased oil revenues will be used to reduce the Government deficit.

As and when markets become convinced that the PSBR is going to trend downwards, so we can expect to see much healthier financial markets and interest rates dropping from their present penal level. We are now at a point where interest rates compound the very aggregates which are chosen to represent the money supply and which the rates are themselves meant to be controlling. In addition, the problems for manufacturing industry and, I suspect, particularly for small businesses are being exacerbated. It is, therefore, highly desirable for rates to start falling as soon as possible.

There was some expectation that fiscal measures would be taken to reduce the PSBR by using the regulator, but it is recognised that you do not want to continue the pattern of having several Budgets every year. More disappointing was the omission of greater restraint on peripheral lending forms like Barclaycard and Access. However, on the whole the general consensus is that rates have now reached the level at which the demand for loan funds will become extremely elastic, and that this is likely to be particularly so in the case of the personal sector.

I believe that you are going to the United States in December and you may therefore like to be forewarned that two of my colleagues had a meeting this week with Congressman Reuss and formed the opinion that he totally misunderstands your economic and financial policies, to the extent that he sees them as being the reverse of what in fact they are. The conversation took place against the background of the difficulties which the US Administration currently faces and it is therefore understandable that he should be looking elsewhere for scapegoats. Apparently he waxed eloquent on the lack of monetary control here and in Germany and on the excessive scale of public sector pay settlements. Possibly he may by now have changed his mind, but my colleagues thought you would like to be aware of the conversation, although they would like you to recognise that it took place privately.

Also on the subject of your American visit, Bill Mackworth-Young tells me that John and Jane Irwin rang to ask if there was any way in which they could be of assistance this time; Bill told them that he thought that the Prime Minister would stay in the Embassy but that he thought you would appreciate the offer.

Finally, I gather that the additional tranche of long gilts has been significantly over-subscribed with the result that the gilt market has regained some part of its recent losses and, one assumes, some part of its confidence. Perhaps this is the turning point after all.

Yours sincerely,
John Seaman

The Rt. Hon. Mrs. Margaret Thatcher, MP.,
10, Downing Street,
London, SW1.

cc: Adam Ridley, Esq.,

They must
be asked to
draw in if we
are joining or
not

CC Master
Econ Pol, PLO
Domestic Monetary
Policy
Econ Pol

Note for the record

c.c. Mr. Wolfson
Mr. Hoskyns

Mr. John Sparrow called on the Prime Minister at 1015 hours today.

Mr. Sparrow said that nobody had expected the October banking figures to be anything like as bad as they had turned out to be. Nor was there any clear reason for the bad figures. One possible explanation was that interest rates were now debited quarterly; if this was not taken account of in the seasonal adjustment, it would tend to push up the figures for October. His own experience was that companies were not increasing their overdrafts.

Mr. Sparrow went on to say that the City were expecting MLR to be increased to 16% on Thursday. Gilts prices had fallen in response to this expectation. But brokers generally felt that today or Wednesday would be the last time to buy gilts cheaply. In other words, they expected the interest rates to come down once the MLR increase was announced.

Besides the MLR increase, many people in the City were expecting additional spending cuts and the use of the regulator; these, combined with the hope of renegotiation of the UK's EEC budget contribution, would help to bring down the PSBR.

The Prime Minister asked whether companies were not borrowing to finance big pay settlements. Mr. Sparrow replied that the current level of settlements was not as high as it might appear. It was the big settlements which got all the publicity. Small settlements did not get publicity because it was not in the interests of managements to publicise them. He cited the example of Mather and Platt which had settled for 12½%, and also the Talbot settlement. It would be a mistake for the Government to try and give such settlements publicity - even though the publicity given to the big settlements

/did have

did have an influence on the general tenor of the pay round.

After the meeting, Mr. Sparrow told me that a general question running through the City was whether the Government were going to embark on a 'U'turn. His own clear impression from what the Prime Minister had said to him, and what she had said at the Lord Mayor's Dinner, was that the Government had no such intention.

R.

13 November 1979

~~PRIME MINISTER~~

Sum R.

MEETING WITH JOHN SPARROW

You might want to discuss with John Sparrow the reasons for the continued high level of bank lending to the private sector. In his last letter, he said that he thought the pressure on loan demand was easing. But this was written before the October banking figures came out.

Mr. Sparrow was one of the optimists on interest rates in the summer (see record of your last meeting with him attached). It will be interesting to hear from him whether he thinks an increase in MLR this week would be a peak and, if so, how soon we can expect rates to fall. (You obviously won't want to go firm on the MLR increase with Mr. Sparrow, particularly on the exact figure; but the City are certainly anticipating the increase.)

R.

12 November 1979

Prima Ministru

I'm not sure whether you have time
to read this. The comment
on the BP sale at x is
galling. Would you like me
to feed in the comments at y
on building society finance
(anonymously of course)?

From: JOHN SPARROW

23 GREAT WINCHESTER STREET

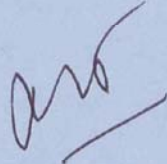
LONDON EC2P 2AX

01-588 4545

12th November 1979

Dear Mr. Thatcher,

TJ
12/11



The publication of the latest figures of banks' eligible liabilities disclosed a rate of growth which came as a complete surprise to the markets and which is widely thought to have been just as much a surprise to the Government and to the Bank of England. Inevitably, in those circumstances some people are questioning whether or not the figures are representative; however, the overwhelming reaction has been one of dismay with marked and serious consequences for interest rate levels and the gilt edged market.

In these circumstances, it seems inevitable that attention will once again focus on the size of the PSBR. It is difficult to produce a sector analysis which satisfactorily explains the increase, and it is recognised that the money supply figures, when they are published on Thursday, may well show a lower rate of growth. But it is generally assumed that the money supply will be seen to have been growing at an excessive rate and that central Government borrowing will have been an important causative factor.

I recognise that questions about the size of the PSBR will be unwelcome so soon after the announcement of your plans to stabilise public spending. I mentioned at the time the problem that cuts in planned spending were being widely seen as real cuts and it must still remain possible that real cuts will be necessary. However, two other possibilities have been mooted both of which may make a psychological as well as a real contribution.

The first possibility is to use the regulator in order to increase the price of alcoholic drinks and tobacco. There was a certain amount of surprise that no such measures were included in the Budget and it is arguable that drinking and smoking are now relatively cheap in real terms. On the other hand, it is recognised that you may not wish to do anything at this stage to give further impetus to the retail price index and it must be admitted that the use of the regulator would probably depend more upon its psychological effects (which would be mixed) than on the flow of income which would result.

The second point is one with which I know you are familiar. That is that our national contribution to the EEC is a very substantial part of the PSBR and that your negotiations in Dublin take on an ever greater importance in the current situation.

The more conventional way of bridging the gap is, of course, to sell gilt edged stocks. At the moment that would be difficult and, to the extent that it proves possible, it will be expensive. No one in the City knows quite where they are

at the moment, but one strand of thought which is developing is that the gilt market must be at or near its bottom and this therefore does give some hope that it will be possible before the end of the year to resume selling stock on to a rising market. My hope would be that, at present interest rates, the emphasis would be on short-dated stock, but I know that the weight of opinion is that there is much more appetite for long gilts and that, in a buyer's market, the seller must accommodate to the buyer's preferences. I would still like to see some test made of the appetite for short gilts.

X | On the evidence of one day's dealings, the BP issue has been a resounding success, in terms of achieving a good price for the Government combined with a satisfactory after market and no suggestion of uncovenanted profits for speculators. It has been described to me by one of the participants as the sort of results one achieves once in a life-time and I do believe that everyone concerned deserves very great credit for the success.

W | I was delighted to see that you have appointed a Working Party to consider the flow of funds into the Building Societies. As you know, this is one of my hobby-horses, the fundamental imbalance which arises from borrowing short-term money to lend on a long-term basis necessarily resulting either in unbearable fluctuations for the house owning borrower or unacceptable swings in the flow of funds for the Building Societies themselves - and, as often as not, both problems simultaneously. To my mind, the central imperative is that borrowers need to feel far more certainty about the nature of the commitment into which they are entering than is possible under the present system; one can draw an analogy with industry, where I believe that the chief constraints on investment plans are not so much the level of interest rates but the uncertainty as to their course in the future. If Building Society customers are to have a clearer idea of their borrowing costs then it seems to follow that the Societies will need to reduce their dependence on short-term money and move much more into financing themselves on a 7-10 year basis (which I understand approximates to the average life of a mortgage). If they were to borrow significantly on a term basis, I would not expect the result to be schemes such as that announced last week by the Anglia Building Society but rather a regular programme of borrowing affording the Societies scope to average their borrowing costs over an interest rate cycle or even to relate the cost of a particular mortgage to the cost of money at the time it was entered into. Any such scheme would be best introduced at a time when the interest rate cycle is at or near its low point, but that merely reinforces the argument for setting up a Working Party when interest rates are high so that they can make their recommendations in good time.

Finally, airport sites are none of my concern but I hear more and more often the view that the third British airport need not and indeed should not be a London airport; there is much more need for labour intensive activity in the North of England than there is in the South-East; that land communications are so greatly improved that journey times are rapidly diminishing; and that the evidence that every visitor wants to come to London depends to some extent on the fact that at the moment they cannot come anywhere else.

Yours sincerely,
John Sparrow

The Rt. Hon. Mrs. Margaret Thatcher, MP,

cc: Mr. Adam Ridley

2
Tom Bor

Pam Thurst

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX
01-588 4545

From: JOHN SPARROW

2
M
M

2nd November 1979

Dear Mrs. Thatcher,

The City has spent most of the week exploring ways in which it can take advantage of the relaxation of Exchange Controls.

It is now common ground that it is no longer feasible to control the money supply by existing physical constraints like the corset. In consequence, we are likely to see some ingenious developments in financing methods, some of which will be beneficial but some of which will result in higher monetary growth. If, as I think, the pressure of loan demand is easing at the moment, then there is probably a lot to be said for waiting for ingenuity to show its forms in order to improve the chances of creating a control system which is not too full of loopholes. In this context, it would seem desirable to frame a control system in such a way as to avoid activity encouraging the growth of a major market in Euro-sterling which would make the control of domestic money supply much more difficult to achieve.

The other immediate aspect of Exchange Control freedom is the need to re-assert the primacy of prudence in banking activities. This is a subject to which the Bank of England has already turned its attention but it is one not to lose sight of.

Sterling and gilts markets have steadied after their adjustments to the new state of affairs. Equities continue to weaken, but this is probably much more in connection with the worsening industrial outlook than a continuation of the reaction to last week's announcement. Opinion is hardening that there will be no sudden rush out of sterling by UK investors, although a gradual and finite increase of interest is likely to be seen, particularly when the prospects for Wall Street improve. No clear pattern is foreseen for inward capital movements, although my guess is that these will also be significant.

The White Paper on Public Expenditure has so far resulted in a fair measure of confusion, largely because there has been much greater emphasis on the relationship between your proposals and those outlined by the previous Government than there has been on the actual pattern of real spending. I can see the possibility that this emphasis on cuts will create a growing recognition of the facts of our economic situation; there is, however, a danger that, if the magnitude of the real cuts gets over-exaggerated, it will foster the creation of attitudes amongst wage earners

which will make this winter's wage negotiations more difficult to contain. It appears that there is likely to be little or no reduction in the proportion of GDP spent by the public sector in 1980/81, which must mean that the PSBR will be on the high side of what we had all hoped to see. There is a danger of getting the worst of all worlds by maintaining a fairly high real level of expenditure whilst at the same time attracting the reputation of making savage cuts in almost every direction. In other words, I wonder whether more attention should be paid, not so much to quantities themselves, but to the light in which you want those quantities to be seen.

*Yours sincerely,
John Smeaton.*

The Rt. Hon. Mrs. Margaret Thatcher, MP.

cc: Adam Ridley, Esq.,

From: JOHN SPARROW

Primi Minist

MOOREAN SARGENT & MADDALL

Econ Rt.

The attached paper, which is rather obscure, argues that we should stay out of EMS so that we can push the exchange rate down, and thereby - i) have an export surplus

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX
01-588 4545

26th October, 1979.

Dear Mrs. Thatcher, ii) accordingly, export capital.

R 26/10

The major development this week has, of course, been the abolition of exchange controls. The timing was unexpected (which is an excellent thing) and as a consequence quite a lot of people are finding that they have to think through the implications rather more rapidly than they had expected but there is no doubt that the decision is very welcome indeed.

From a narrow City point of view the opportunity is now there to consolidate London's position as the world's leading financial centre, which should have a favourable impact on invisible earnings. More importantly, it is now possible for the first time for sterling to achieve a true equilibrium which diminishes the fears that were being expressed about our international competitiveness and the unemployment that would follow from an excessive exchange rate.

The domestic investment markets have been marked down since last Tuesday, more so in the case of gilts than has been true of equities. The abolition has significant implications for the funding of public sector borrowing, because one can be less sure that institutional cash flow will just mount up awaiting the moment to invest in gilts. However, I believe that the willingness of institutions to invest abroad is probably being over-stated at present. Pension funds in particular have liabilities denominated in sterling and will not want to create an exchange exposure; the detailed knowledge of individual overseas companies is much less than most investment managers would like, except in the case of the very big corporations; there is always the fear that the significant news about a particular company will be known (and acted on) in the local market before it reaches London; and in any event, it has been perfectly possible for institutions to invest abroad in the last few years without a great exposure to the premium. Given the attitudes of mind of most investment managers, therefore, I would expect some greater diversification overseas but not perhaps as much as is currently bruited. And, given a progressive reduction in the size of the PSBR, it follows that the implications for funding, whilst deserving attention, are less serious than had at first been thought.

The dollar continues to behave nervously and U.S. interest rates continue to scale new peaks. Nonetheless, there remains every reason to expect the dollar to strengthen in 1980, creating circumstances in which movements of sterling will be far better judged by reference to the trade-weighted index. It is assumed to be implicit in the strategy that we cannot seriously contemplate full membership of the E.M.S.; you may have seen the recent Chatham House paper on sterling which was written by two of my colleagues here but, in case you have not, I enclose a copy.

I had lunch yesterday with the Manchester branch of the Bank of England, where my fellow guests were northern industrialists and one retailer. It was an informative occasion. The retailer said that there was clear evidence that tax rebates are being spent in the shops, but that he expected an increasingly competitive atmosphere to emerge, partly because no sustained increase in consumer spending was expected and partly because of the cash and interest rate squeeze which is being experienced. He therefore forecast a sustained reduction in stock levels and significant price cuts between now and the January sales. In other words, he confirmed that the VAT increases in the Budget, which are still being treated by everybody as a component of inflation, are in fact having a deflationary effect with favourable consequences for the money supply and the RPI, but unfavourable consequences for unemployment. In his own words, the Government's strategy is working. It is increasingly clear that unemployment is a problem that needs to be considered on a regional rather than a national basis. The consensus of opinion round the table was that the redundancies which have occurred and are expected to occur reflect a continued battle with the problems of over-manning and are neither designed to reduce activity nor expected to lead to lower production.

Attitudes to pay increases varied. At one extreme, a company had already settled at between 9% and 12 $\frac{3}{4}$ %. At the other extreme people were talking about a need slightly to exceed the expected increase in the RPI. Everyone seemed to agree that what happened in the public sector would be significant, although it was pointed out that the Government's current refusal to involve itself directly in public sector pay negotiations offered a much greater hope that the most significant criterion would be an ability to pay. Unfortunately, the industrialist who spoke most strongly on the need for discipline was also the man who felt that he could not really enter into a pay negotiation unless the Government gave him a bench-mark and that he really needed an exchange rate between \$1.70 and \$1.80 to export competitively.

On the whole, there was a clear feeling of support for your economic policies and of acceptance of the consequences. One man in particular said that he would be very happy to put up with current interest rates if inflation can thereby be conquered.

A final comment on interest rates. It seems increasingly possible that domestic considerations would call for gradual reduction in interest rates but that the level of international and particularly dollar interest rates may be thought to make such a reduction impracticable or undesirable. I am not sure that this last point is true. We tend to assume that dollar rates should be lower than ours because we subconsciously believe that the American economy is sounder and more attractive than ours. That subconscious belief may still be right but it does at least deserve examination.

Yours sincerely,
John Sparrow.

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.

From: JOHN SPARROW

Prime Minister

Caroline

*Please file.
13 Nov: 10.00.
28.22/10.*

23 GREAT WINCHESTER STREET

LONDON EC2P 2AX

01-588 4545

Econ Pol.

19th October, 1979.

*Shall we try to
fit in another
meeting with*

John Sparrow?

Yes OK

Dear Mrs. Thatcher,

*12
19/10*

It becomes increasingly difficult to find something meaningful to say about the state of the financial markets on a weekly or even occasional basis, and it has taken me far too long to realise that the major reason for this is that economic policy is following a firm and steady course and does not give rise to the alarms, excursions and fluctuations that we have become accustomed to over a number of years in which policy was often contradictory and rarely continuous.

City support for the policies remains undiminished; City understanding increases steadily. The fears and worries which have been expressed about particular facets of policy (including those which I felt) are heard of less and less. This leads me to wonder whether or not regular reporting is sensible, or even possible and, whilst I am anxious to be of as much help as possible to you and to your colleagues, I would welcome a chance to talk to you for half an hour about the role that you want played and whether or not I should play it. I am available more or less at any time.

The settlement of the engineering strike has been perhaps rather better received in the City than it should have been. I followed this with particular interest because, quite apart from my City interest, I happen to be the Chairman of one engineering company and a director of another. The pressures were considerable, but my impression is that the managements of the individual companies would in fact have been more determined than their representatives in the Federation proved to be. What struck me as particularly significant was the frequency with which one heard that particular groups of employees had neither the wish nor the need to strike but did so because they fear more than anything else loss of their union card. I think that this situation might be improved if, as is proposed, secret ballots are facilitated; I am sure that it is a problem that must not be lost sight of.

Yours sincerely,

John Sparrow

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.

Econ PD

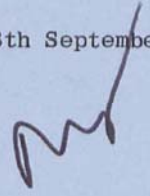
23 GREAT WINCHESTER STREET
LONDON EC2P 2AX
01-588 4545

From: JOHN SPARROW

David Hirst

18th September, 1979.

R
2/15



Dear Mrs Thatcher,

One of the enduring impressions of my visit to Australia in August was the way in which senior managers invest their savings. In this country most senior employees, when they have saved some money, pass on the responsibility for looking after that money either totally by entrusting it to an investment manager or a unit trust, or partially by investing in equities, or opt for what they regard as total security by investing in building societies or national savings or short-dated gilts. In Australia, the attractiveness of this combination of safety and delegated responsibility seems to be much less. More or less everyone that I spoke to in Australia makes little or no use of the Stock Exchange or of the conventional savings media: the former is left to the institution and the latter to small savers. Instead, the people that I met would each have a range of direct investments of remarkable diversity and including shops, garages, office blocks, houses, pig farms and, in one case, the Frostie concession at the Taronga Park Zoo. They spend their working hours in their offices and devote at least as much energy and enthusiasm to their salaried jobs as we do, but they also get real enjoyment and satisfaction from supervising their direct entrepreneurial activities.

Of course, Australia is a much younger country than the U.K. but I came away with the distinct impression that they are much closer to the true nature of capitalism than we are with our much more managerial approach. As it seems quite likely that the next few years will see a diminishing demand for people to work in large factories (and I have a subjective impression that many of the people who work in British factories do not enjoy it in the least and only do it for the money), there will be a growing need for a large number of small pockets of employment as the existing large pockets slim down, and development along the lines of Australian private enterprise could only be helpful.

You may have seen a recent article in the Financial Times in which Peter Riddell pointed out that we have a prosperous, hard working, rapidly growing small business sector which we call "the black economy". The burden of his article was to seek a means of legitimising the black economy without killing its sense of initiative and attitude to work. A participant in the black economy normally has unlimited liability, because companies are easier to check up on; such employees as he has normally have no trade union membership, no pension rights and little or no job security. On the other hand, they tend not to pay their taxes and they do work extremely hard. It is reasonable to draw a connection between the general lack of security, in its broadest sense, and the very positive attitude to work.

(-)

I find it difficult to see how one can truly legitimise the black economy, unless it were by exempting from tax anyone who worked for a small unit which rejected for itself and for its employees the complicated safety net of security with which we all tend to surround ourselves. However, I do think that more could be done to stimulate small employment, and two ways in particular seem to me to be worth attention. The first already exists, in the form of Section 30 of the 1978 Finance Act which, roughly paraphrased, allows anyone setting up a new business with the genuine intention to make profits to offset any losses in the early years against taxation paid on income in previous years. The provision is a generous one, but it is very little known. As is so often the case, a few quick minds have seized on the possibilities opened up by the Section and the chief result so far appears to have been a mushrooming of tax savings schemes devised in the City and using financial mechanisms such as leasing without really doing anything to stimulate small business and small employment. Because the section is being used in this way, it would not surprise me if at some stage its repeal were sought, "to block a loophole". I would be sad if the baby went out with the bath water, because it seems to me that if proper attention were drawn to Section 30, it might well help to encourage the genuine development of small businesses owned and financed in whole or in part by people like me, who work for a salary but could contribute something to a second activity.

The second suggestion is that anyone who employs someone else should be able to deduct the costs of employing that person from his taxable income. The point here is that private individuals cannot currently get tax relief in respect of employees who work in their house or in their garden. The consequence is that a considerable potential demand for labour is either stifled or forced into the paths of the black economy. Gardening has become an activity carried on largely by old-age pensioners with some support from moonlighters; domestic service has virtually passed away. And yet these are employments which could be available and which would, I think, be attractive to quite a few of the school leavers whose prospects of unemployment probably constitute the most serious aspect of that problem. There seems little justification in principle for saying that employment in a factory or a grocer's shop attracts tax relief but employment in a garden or a kitchen does not. I agree that, like any such suggestion, there would be the possibility of abuse but I do not think that that could ever be as great as the potential benefit. And if I am right in thinking that we are going to have more and more need of small units of activity with a bias towards service activities, then some such provision is not only necessary, it is amply justified.

I have written this letter because the subject is one that was brought home to me by my Australian visit and also because the underlying problem and similar solutions are increasingly being discussed. I know that, when you were in Opposition, you gave a lot of thought to the development of small businesses. I certainly see more hope in small businesses than in schemes for share ownership in large and therefore anonymous concerns. If there is work going on in this field, is there anything that I can do to help?

*Yours sincerely,
John Pearce.*

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.

Econ Bl
2

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX
01-588 4545

From: JOHN SPARROW

14th September, 1979.

Ann Amish

12
14/9
No

Dear Mr. Thatcher,

After a fairly dull period, economic news is back with a bang this week.

Sterling fell sharply this morning, to some extent because \$2.20 was regarded as a significant level which, once broken, led to a lot of selling. There are a variety of causes for this movement. First, the advances earlier in the summer were themselves self feeding and called for correction. Secondly, there is a growing perception of the competitive and other problems of British industry, which is thrown into highlight by the engineering strike. Thirdly, the money supply figures for August appear to reflect some outflow of capital following the relaxation of exchange controls, and the proposal by Imperial Group to buy a U.S. company for \$600 million is substantial in itself and also as a guide to the way in which industrial managements are thinking.

The decline in sterling was stemmed by the publication of the latest retail price index which was probably slightly better than had been expected. However, it is quite likely that when the New York market opens this afternoon there will be more selling than buying and further downward movement is possible. Less immediately, there is probably more scope for sterling to fall than to rise, although much will depend upon the outcome of the current spate of industrial disputes.

The most notable development in relation to these disputes is the determination of managements, to an extent which I certainly have never seen before, to resist the payment of exorbitant wage claims. In previous years, one has heard much of the argument that the short term costs of a dispute are greater than the one year cost of conceding the claim, and at that point resistance has crumbled rapidly. The point at which that comparison applies has already been reached for a great many engineering companies, but this year there is a much greater recognition that the one year cost of concession is not a valid part of the comparison, because concession involves paying an annuity rather than a one year figure. One is also hearing much more than before evidence of the recognition that the man who gives way when pushed will tend to get pushed again, harder and more frequently. All in all, the attitudes of those industrial managements that I meet has been very encouraging and reflects a real and growing belief that your government is offering industry a chance to regain some sort of balance if the courage is there to take the opportunity.

On the particular subject of the engineering strike, the consensus is that it can be expected to go on probably for another three weeks. This week, for the first time, people will be receiving pay-packets containing anything down to half what they have been used to. Next week, for the first time, there seem likely to be large factories closing rather than endure the inefficiencies imposed by the strike. The pressures on both sides of the argument are therefore mounting, and there will probably be an element of back-sliding on both sides. As both sides begin to lose control of their membership, we should move closer to a settlement around the end of the month, the level of which will probably be determined by the relative proportion of people cracking under the strain.

Still on the industrial front, the evidence that Michael Edwardes is still trying to make sense of British Leyland was welcomed in the City, where it is hoped that he will be given every opportunity to continue along his present lines, without being given blank cheques which would weaken the incentive to succeed and strengthen the resistance to change. The failure of union leaders to perceive and act towards the true long-term interests of their members is as vividly illustrated in Leyland as is the refusal of those same union leaders to accept the responsibility for the natural and foreseeable consequences of their policies. Even to-day, Mr. Duffy (who I understand wanted to settle weeks ago) appears to be totally unable to comprehend what he is doing, willingly or not, to Leyland and to a much wider spectrum of industry.

The recent outcrop of statistics has generally been interpreted favourably in the City. I have mentioned that the RPI was slightly better than expected; the same comment applies to recent figures on wholesale prices, the money supply and on the central government borrowing requirement, although it is recognised that in each case there is still a long way to go before a satisfactory position is reached. It is now widely accepted that interest rates will not come down until there is visible evidence not merely that they are working but that they have worked. As you know, I have always been somewhat heretical on this subject, and I do hope that the present level of interest rates will not be maintained too far into the coming recession. I am less concerned by arguments about what the building societies will do in January than I am by a wish to see the disciplines currently being applied to the private sector maintained at a level which leads it towards the paths of virtue but falls short of the point at which it does excessive and long-term damage.

The gilt market continues to discount a drop in interest rates, as it has done more or less throughout the summer: I do not expect it to fluctuate very much either way in the near future but if it does move in the next few weeks it will probably be downwards. Equities are still probably fairly reflecting the immediate difficulties and the long term hopes. Among currencies, the dollar will one day soon reflect the very sharp improvement in the U.S. current account which has taken place during 1979, which will have an impact on sterling, as will the re-alignment within the EMS which is now increasingly looked for. The chief question in most City minds is whether the Deutsche Mark will be revalued by something like 2% or 3%, which will still leave it as the strongest EMS currency and probably

But will market rates fall?
Our influence is limited, except insofar as we achieve our monetary objectives.

?

require another re-alignment early in 1980; or whether the revaluation will be of the order of 5%, which will probably take it to the bottom of the band and allow it to work its way up again over a rather longer time span.

There are a couple of longer term themes on which I had intended to write to you this week. However, I think that this letter is probably long enough already and I will write separately early next week.

Yours sincerely,
John Major.

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.

David Austin

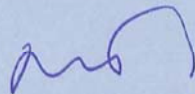
2
Sean Pol

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX
01-588 4545

From: JOHN SPARROW

TL
3/18

31st August, 1979.



Dear Mr. Thatcher,

It is always salutary to return from a visit to the other side of the world and find how little things have changed in the meantime. The fluctuations that take place all the time in financial markets fall into better perspective when one finds that over a period of more than a month the domestic securities indices have barely moved and that the only significant change has been a stabilisation of the pound at something below its peak levels, a process that was not unexpected and which I gather reflects a measure of official intervention.

Thin -
does it? ←

Against this fairly calm background and given that economic affairs have been temporarily overshadowed by events in Lusaka and more recently in Ireland, the most significant development has probably been the debate over the appropriate size of the PSBR next year. It appears that some strands in the debate have in any event been misunderstood, but I remain firmly of the view that a steady and consistent reduction in the PSBR is the most fundamental plank in your economic platform. It is at the root of so many of our economic difficulties and, whilst I accept that there will come a time when one should have regard to the size of the PSBR in relation to gross domestic product and not merely consider it in nominal terms, I do not think that the time is yet ripe to pursue any policy other than reduction in both nominal and real terms. Sound public finance is the touchstone from which all else will flow, and the recent reassessment by Wood Mackenzie of the financial flows to Government from North Sea oil encourage me to continue to think that the PSBR can be reduced without damaging manufacturing industry; indeed, I would expect manufacturing industry to benefit considerably from a reduced Government demand for funds available for investment.

In the United States, Mr. Volcker also appears to be committed to sound public finance, which should make it easier for a similar policy to be pursued here. It should also lead to a strengthening of the dollar in the next few months.

It is interesting that, in Australia, the prevalent attitude in business circles is one of regret that Mr. Fraser's government has not acted as decisively in pursuit of its policies as you have here and the contrast is seen as being very much in your favour. To the extent that Australians really think about the British economy, their chief concern is the attitude of trade unions. This is obviously an understandable worry, but one has the impression that the difficulties are exaggerated by the distance, just as Australia's own problems appear less significant when one is there than when one reads an English newspaper.

/2.

I shall more in the swim of things next week and hope to write more fully, if anything has happened to write about.

Yours sincerely,
John Sparrow.

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Mr. Adam Ridley

PS

Gov PR 2
PRIME MINISTER

To see

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX

M5
30/vii

From: JOHN SPARROW

01-588 4545

27th July, 1979. R27/7

Ans.

Dear Mr. Thatcher,

The chief feature of markets this week has been the continued appreciation of the pound. Interestingly, this appreciation is not now particularly marked only against the dollar but is apparent against most major currencies. This is perhaps explained by the fact that, among the major financial countries, ours is the only central bank which has not been intervening on a significant scale to stabilise the dollar which in turn would indicate that a dollar recovery would tend to have a disproportionate impact on sterling.

The new U.S. team of Miller and Volcker is thought well of in financial circles and may succeed, by its appointment, in stemming the political move away from the dollar. It is true that the economic difficulties of the United States are still very real, but the markets may soon feel that they are adequately discounted at present parities.

It is generally expected that the world will move towards recession as the year progresses and that interest rates world-wide will tend downwards, possibly quite significantly by the end of the year. The U.K. gilt-edged market remains reasonably stable, while equities continue to drift in the face of the very real problems concerning the private sector.

A point which is attracting some attention in the City is the damage done to the government's programme for returning quoted investments to the private sector by the practice of announcing its intentions well in advance. It seems likely that a fund manager wishing to invest in, for example, ICL will defer his purchase in the expectation that he will have the opportunity to acquire a holding later in the financial year at below the market price. The same is true of BP and all the other quoted investments currently owned by the public sector. For all I know, it may be necessary to make these announcements in advance, but the practice does have two deleterious effects.

First, the fact that potential investors refrain from buying in the expectation of being able to purchase a particular share more cheaply will itself cause the market price to fall and therefore reduces the price which the government will eventually realise on the tax payer's investment. Secondly, the recovery in the share price after any government offering will be correspondingly greater (because the fall beforehand has been correspondingly more) and this will lend support to those people who will in any event argue that these transactions constitute some form of give-away.

As I say, the course of action that has been taken may well have been inevitable and it has in any event taken place. However, some thought might be given to the possibility of increasing the sales of gilt-edged stock this financial year, in order to put the government into the position later in the year of being able to say that their funding requirements for 1979/80 have been met and that some or all of the proposed equity sales are therefore not necessary for purely financial reasons; that the commitment to return the investments concerned to the private sector remains as strong as ever; but that it will be done in each individual case at a time of the government's own choosing, when market conditions are favourable and in order to achieve (as any other investment manager would seek to do) the maximum return on the investment. In the absence of some such possibility, I believe that we will see an increasing under-valuation in those quoted shares over which the possibility of significant government sales hangs.

Your statement in the House that interest rates would not come down until borrowing demand was under control was clear and unequivocal but was read by many people as indicating an expectation that there will be no reduction during a rather longer period than I think is likely. It should be borne in mind that a considerable and probably growing proportion of borrowing demand is not sensitive to interest rate levels, either because it is genuinely involuntary, as I believe to be the case in a great many commercial concerns, or because no great attention is paid to interest rates, as I think is true of much of the private sector. One of my colleagues also points out that high rates of interest in themselves enlarge the monetary aggregates to the extent that the interest rate is debited to accounts and not actually paid. The statement did have some effect on the gilt market, largely because of the timing connotations that were read into it which I am sure you did not mean to convey.

I hope that your visit to Lusaka is successful. When you return, I shall be in Australia and on my return I plan to take a short holiday. I shall therefore not be in a position to write to you again before the end of August, though I will try to be in touch if anything really major occurs in what is traditionally a fairly quiet month.

Yours sincerely,
John Pearson.

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.

Econ Pd

eg. Market
Econ Pd. May 79
Monetary Policy

NOTE FOR THE RECORD

c.c. Mr. Wolfson

Mr. John Sparrow called on the Prime Minister at 1430 hours on Monday, 23 July. The following are the main points which came up in discussion:

(i) President Carter's Cabinet changes.

Mr. Sparrow said that he thought William Miller would be a better Treasury Secretary than Mr. Blumenthal had been. He had consistently said the right things about monetary policy and energy pricing: it remained to be seen whether his words would be turned into action. It was disappointing that the Administration had failed to announce that energy prices would be increased to reflect real economic costs immediately.

(ii) Sterling

The Prime Minister said that it seemed that there was little that the Government could do to moderate the rise in sterling - though, with the very bad trade figures, it must come down before too long. The latest relaxation of exchange controls had, if anything, improved confidence; further relaxation was probably called for, but it would be unwise to move too fast. Mr. Sparrow commented that it was generally assumed in the City that exchange controls would wither away. The trade figures would probably continue very bad for the next few months in his view. Companies such as Courtaulds were rather exaggerating the adverse effect which the exchange rate was having on their operations; but there certainly were some companies which were suffering. In his view, a sterling/dollar rate of between 2.20 and 2.40 was about right.

/ (iii)

(iii) Interest Rates

Mr. Sparrow said that industry was being adversely affected by the high cost of borrowing, which combined with the effect of the high exchange rate on liquidity. He thought that there was a case for a phased reduction of M.L.R.. The July bank lending figures would probably be bad, but there should be an improvement in the August figures. By then the corporate sector should be spending less on inventories partly because of cheaper imports. Loan demand was not sensitive to interest rates; but companies which were borrowing were having to pay dearly. The City were generally convinced that interest rates must come down before long. So if M.L.R. were reduced, there was little doubt that interest rates would follow. In other words, a signal from the authorities in the form of an M.L.R. decrease would not be ignored. The Prime Minister pointed out that interest rates were still below the current rate of inflation. Mr. Sparrow denied this on the grounds that the V.A.T. increase in the Budget was not part of the underlying rate of inflation. The underlying rate of inflation was running at about 12 per cent, which was the same as the yield on gilts. This meant that the bulk of investors in gilts - namely the pension and insurance funds which did not pay tax - were keeping up with inflation. Mr. Sparrow went on to say that the institutions would probably hold back their subscriptions to the new long tap until September when they hoped that interest rates would be on the turn. It was true that, if they firmly believed that interest rates should fall, they would be subscribing now; however, they tended to act like "sheep" and wait until their expectations were confirmed before moving. Falling interest rates would not have much effect on the exchange rate, but they would help to moderate the present high level.

(iv) Equities

Mr. Sparrow said that the general tone in the equity market was one of gloom and doom. This was due to the strong pound, the poor prospects for profits and the fears of a bad winter.

(v) Aid

Mr. Sparrow said that he hoped the Government would consider the possibility of diverting part of the existing aid programme to E.C.G.D. financed projects. This would help to ensure that U.K. industry benefited from the programme. The Prime Minister explained that the bulk of the aid programme was already tied.

R

25 July 1979

Gen Bl

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX
01-588 4545

From: JOHN SPARROW

Prin. Christie

I am not as
confident about
Moss Evans as
John Sparrow appears to be!

13th July, 1979.

TJ
13/7

ant.

Dear Mr. Thatcher,

Flag A

This has been a quiet week in the markets, all of which have drifted gently downwards as they so often do when the temperature rises. I have nothing new to report in the financial world, although I would commend to you a letter from Tim Congdon published in to-day's Financial Times. The letter makes a persuasive case for the proposition that steady reductions in the PSBR are central to the restoration of a free economy.

Perhaps the most interesting thing this week has been the evidence that the process of acclimatisation to a free economy is gathering strength. There was a lot of sound and fury at the TGWU' Conference, but my reading of Moss Evans's major speech was that he, like Joe Gormley, is much more prepared to face up to the realities of life than are his more militant colleagues and that his chosen approach therefore is to rival them in words but to lead them more cautiously in action. I hope that I am right in that interpretation, because it becomes clearer day by day that the last five years have been a bad time for working people and, whilst someone like Harry Urwin may well be able to dissociate cause and effect, I am reluctant to accept that Mr. Evans has not learned at least a part of the lesson.

Similarly, the attitudes of management seem to be becoming much more positive than they have been and therefore reinforce the encouragement that I feel. You will know better than I how the CBI's mind and will is working; my own impressions from my meetings with industrialists are that, for the first time for many years, the challenges are being welcomed rather than feared.

The only other thing to which I want to refer this week is the hardening of interest rates in several countries. So far as our own interest rates are concerned, this needs to be seen against the background that we are still at a significantly higher nominal level than any other major industrialised country, we have an inherently strong currency, and we, like the United States and most of Western Europe, are moving into a period of recession in which interest rates will inevitably tend to weaken. But I will not go over old ground.

Yours sincerely,
John Sparrow

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.

Public sector borrowing requirements

From Mr. T. G. Congdon

Sir,—Mr. Samuel Brittan's discussion of the latest L. Messel and Co. *Financial Analysis* in "Economic Viewpoint" (July 5) was accurate and thought-provoking. We are delighted that the calculations we made of rising Government oil revenues, which could have a profound effect on the financial situation in the next few years, have entered the public debate on economic policy.

When he moves from arithmetic to analysis, however, Mr. Brittan reaches a conclusion very different from our own. Our argument was that the oil revenues should be used to reduce the public sector borrowing requirement as one ingredient of a financial policy which would permit a gradual slowdown in monetary growth. To ensure that the oil revenues are deployed to this end and no other, we suggested that the Government should announce a medium-term financial plan relating to both the money supply and the PSBR.

But Mr. Brittan believes that, "all that is necessary is the monetary targets themselves." Apparently, Mr. Brittan considers that the PSBR would have little connection with monetary policy if there were no exchange controls. In that case, "the decision about how large a Budget deficit to run becomes a matter of whether the country concerned wants to be a net lender or borrower overseas."

Private sector capital outflows might well develop after a cut in the PSBR. But monetary policy would still be conditioned by the size of the Budget deficit. Institutional cash flow has been buoyed up in recent years by inflation—and it is the

strength of institutional cash flow which has led to massive gilt-edged sales and the successful financing of the large PSBR outside the banking system. If inflation declined, the institutions' ability to acquire Government debt would weaken. In that sense, a PSBR equivalent to 5 per cent of national income could not be financed in a manner consistent with monetary deceleration. There is also no doubt that the exceptional interest rate volatility in recent years is largely attributable to the big Budget deficit and the resulting uncertainties in the funding programme. Does Mr. Brittan want this state of affairs to continue?

Mr. Brittan says that, "for the pure purpose of monetary control the Messel PSBR projections are far too severe." We find this statement surprising in that the PSBR reductions we envisage year by year after 1980-81 are smaller than those which would occur (in a full year, on a constant employment basis) as a result of the last Budget, which Mr. Brittan criticised on June 13 as not sufficiently tough in its financial targets. More seriously, the notion that a small Budget deficit is "severe" harks back to the worst kind of Keynesianism, which Mr. Brittan himself has ably denounced in many articles for quite a long time. In any case, to describe the PSBR reductions as "severe" is simply a misunderstanding when the reason for those reductions is extraneous to the level of domestic aggregate demand.

It is suggested by Mr. Brittan that "the real reason for reducing the PSBR is to enable the private sector to purchase overseas assets." We pointed out

that, if the PSBR were to be cut substantially, there would need to be a radical reshaping of investment patterns, as the supply of gilts would dry up. But the major financial institutions would be able to decide themselves whether their money should be invested overseas or in debt issued by UK private sector companies. It is inappropriate for Mr. Brittan to prejudge this question by saying that all the surplus funds should be invested overseas. Indeed, "the real reason" for cutting the Budget deficit in our view is that financial institutions could resume their traditional function of allocating resources to companies and individuals. In recent years, that function has been usurped by politicians and civil servants; they have received the finance to back their hunches, prejudices and dogmas from the high PSBR and the accompanying massive gilt sales. Mr. Brittan thinks there would be "a famine of domestic financial assets" if the PSBR were lowered drastically. Why is he so pessimistic about the ability of financial markets to match supply with demand? Isn't it possible that companies might want to issue debentures or new equity to compensate for the cessation of miscellaneous Department of Industry welfare hand-outs?

Reductions in the PSBR are an essential part of sound financial policies—and of the move towards rational resource allocation by private sector decision-takers to which the present Government is committed.

Tim Congdon,
L. Messel and Co.
P.O. Box 521,
Winchester House,
100 Old Broad Street, EC2.

Econ Pol.

David Smith

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX

From: JOHN SPARROW

01-588 4545

MS.

6th July, 1979.

Dear Mr. Thatcher,

Market movements in the last two weeks have reflected the various economic circumstances which I have discussed in previous letters and have also highlighted the continuing divergence between external and domestic considerations. When I pointed out in April that sterling was not cheap other than on a very short historical perspective, I compared the situation then with that which applied in 1974, when the rate against the dollar was \$2.40; I must confess that I had not realised how quickly people would be looking towards \$2.40 as an achievable and sustainable level.

The markets are now looking for a fall in MLR and no doubt will seize on the hint that emerged from reports of governmental discussions with the building societies, that rates can be expected to fall in a month's time. I would have preferred to see them falling now, but I recognise that it may be difficult to act on undocumented feelings that the underlying rate of growth of the money supply has eased considerably since the Budget. In view of the publicity given to the building society talks, I would think that it would in any event now be difficult to reduce MLR in the next two weeks without giving the impression of having been blown off-course by an inconvenient consequence of market forces. It would seem consistent to wait until there is concrete evidence of the slackening of monetary growth which I believe is happening.

Eligible
liability
figures come
out on
Tuesday -
12th. unless
for June.

There are various reasons for this belief. The personal sector enjoyed a considerable spending spree both before and after the Budget and will now be tightening its belt. The corporate sector will benefit to an extent estimated at £750m. from the taxation changes incorporated in the Budget, and most particularly from the increase in VAT. The public sector is assumed to be reducing its propensity to spend whilst the impact of the overseas sector is quite rightly being absorbed by the exchange rate rather than by premature intervention. I expect these threads to knit themselves together in time and allow domestic interest rates to be eased, probably right through to the end of the year. The major external constraint on the reduction is represented by U.S. interest rates, which are currently three percentage points below ours and are expected to fall as they enter the recession which is predicted there as confidently as it is here. The only other thing that needs to be said about exchange rates is the case for shelving exchange controls grows day by day, particularly now the dollar premium factor is very nearly negligible.

Money
supply grows
by 1.1%
in June -
figures out
on 17 July.

Leading to
the private
sector which
to be worse
than the Government
fear - about £900 million.

My last letter set out some thoughts on the management of the gilt market, and I have since then studied the Bank of England Quarterly Bulletin on the same subject.

attached.

The only major point of difference between us is that the Bank argues strongly against the sort of flexible operation which I believe to be necessary. As I understand it, their attitude is based partly on wishing to keep faith with investors to an extent which, in my opinion, unduly weights the balance of advantage towards the buyers rather than the sellers of gilts; and partly on the need to smooth the flow of funds to the government. In their discussion of convertible stocks they make a point which is in fact reflected throughout the article where they say of a particular tactic "to the extent that it does produce an advantage to the investor, it will of course prove correspondingly expensive to the government, although this risk may be worthwhile if it enables the momentum of the funding programme to be maintained without a rise in interest rates". I agree that the risk may be worthwhile but I suspect that it often is not.

The other point which the Bulletin makes but does not pursue is on page 139 where it says "inflation, and the scale of government borrowing, have necessitated high nominal yields". It is precisely these two factors which your policies are aimed at correcting and which, when corrected, will make both monetary control and the management of the gilt market much easier to tackle successfully. The references on page 143 to the position in the United States reinforces this view, although the moral is not specifically drawn.

Elsewhere, confidence in your policies over a range of subjects continues to be expressed. This is particularly so in relation to the energy crisis, but your determination not to get involved in the miners' wage claim is welcomed; the continuing pressure on Local Authority spending is also regarded favourably, as it is widely believed that this part of the public sector is in even more need of discipline than is central government. Finally, the EMS appears to be feeling the pressures of fluctuating exchange rates; as the Deutsche Mark is entering a period of seasonal weakness, changes might well be delayed until after the holiday season, but I shudder to think what would have happened if sterling had been involved. It has gone off the graph on which we chart currency movements!

*Yours sincerely,
Jim Sparrow.*

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.

23 GREAT WINCHESTER STREET

LONDON EC2P 2AX

01-588 4545

From: JOHN SPARROW

6th July, 1979.

Dear Mrs Thatcher,

I should have mentioned in my main letter this week my belief that a decision on whether or not to sell BP shares should be delayed as long as possible.

I say this because present circumstances are such that one would not recommend selling the shares for investment reasons; I do not believe that the sale is propounded for doctrinal reasons, particularly as what is called "the BP solution" has been so heavily canvassed in respect of other state activities; and one is therefore left with the simple argument that the money is needed.

If that is right, then there is certainly scope to delay the sale until the fourth quarter of the current fiscal year, which I believe would be advantageous. It also opens up the possibility that, if the pattern of gilt sales is more favourable than has been expected, the need to sell BP will diminish - particularly as the money will be coming from the same sources. Put another way, one would expect an individual holder of BP who is in need of money to explore the possibility of borrowing against his holding before he contemplated disposing of it, at any rate in current circumstances, where the prospects for the oil industry look favourable and the equity market is extremely depressed relative to gilts.

*Yours sincerely,
John Sparrow.*

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.

The gilt-edged market

The principles on which the marketing and management of marketable government debt other than Treasury bills (gilt-edged stocks) are at present based have been long established and may be summarised as follows.

- Investors and traders are free to determine the size and composition of their gilt-edged portfolios in the light of their own assessment of current and prospective economic and financial conditions, and of the prices and yields determined by a market made in the stock exchange by jobbers.
- The Bank deals or is prepared to deal continuously in this market within a well-defined and well-known framework, an essential element of which is that the Bank operates at prices close to those determined by the general body of transactions in the market.
- The Bank issues periodically on behalf of the Government new stocks which normally are intended to replenish the portfolio which is available for market operations, although recently some issues have been fully or nearly fully subscribed on application. The terms of new issues too are pitched so as to offer yields very close to those prevailing in the market at the time of the announcement of the issue.

An article in the June 1966 *Bulletin*[1] described the objectives and techniques of the Bank's management of the gilt-edged market within the above framework. The present article describes subsequent changes in those objectives and the consequent adaptation of techniques and instruments, and considers, against that background, a number of proposals for further change that have been the subject of recent public discussion.

The evolution of objectives and techniques

In the 1966 article, the main objective of gilt-edged management was stated to be to maximise the long-run

desire of investors at home and abroad to hold British government debt. This main objective followed from the Government's continuing need for large amounts of long-term finance both to meet its current borrowing requirement (at that time for new capital investment by the public sector) and to replace maturing debt. Other aims of gilt-edged management which were seen as important from time to time were to assist economic policy by promoting or sustaining the most appropriate pattern of interest rates, and to assist credit policy by limiting government borrowing from the banking system. These two aims were regarded as shorter-term and were clearly subsidiary to the longer-run aim of preserving the attraction of government stocks and sustaining the health and capacity of the market.

This concern to maintain the longer-run, structural health of the market has remained an important objective of gilt-edged management. Since 1966, however, as the main emphasis of monetary policy has shifted to controlling the trend in the growth of the money supply (and in particular, in recent years, the growth of sterling M_3), the raising of government finance from domestic investors outside the banking system has become an increasingly important shorter-term objective of gilt-edged market management. This change of emphasis came about by stages and was accompanied by adaptations of the Bank's operating techniques.

In 1966, the principal quantitative objective of monetary policy was limitation of the growth of bank lending in sterling to the domestic private sector, and the principal method of achieving that objective was quantitative rationing. The short-term development of bank lending to the public sector was not a principal consideration. Finance for the Government could be obtained as necessary from the banking system—through the tender for Treasury bills and the Bank's financing operations in the money market—and this left

Net official sales of gilt-edged stock

	Total net official sales(+)	Purchased by:							
		Other public sector	Banking sector	Non-bank private sector				Overseas sector	
				Savings banks	Insurance companies and pension funds	Other financial institutions	Industrial and commercial companies		Persons (residual)
1972	- 519	- 1	-1,114	193	305	- 68	16	- 23	173
1973	1,543	- 13	- 35	113	509	79	39	735	116
1974	664	- 29	- 146	- 4	201	97	- 39	603	- 19
1975	5,208	- 5	812	31	2,503	776	92	1,005	- 6
1976	5,399	4	68	270	2,976	84	123	1,744	130
1977	7,293	2	708	579	3,346	764	88	822	984
1978	5,052	108	- 60	519	3,958	310	- 2	319	-100
Total	24,640	66	233	1,701	13,798	2,042	317	5,205	1,278

[1] Page 141.

a degree of flexibility over the timing of government funding in the gilt-edged market, which allowed the Bank, consistently with, and indeed in pursuit of, its main aim of strengthening demand for government stocks in the longer term, to seek to moderate changes in yields arising from changes in market sentiment.

The essence of the technique of gilt-edged management employed at that time was summarised by the phrase 'jobber of last resort'. Thus the Bank was prepared to deal in gilt-edged stocks of all maturities at prices close to the market level, prime considerations being to preserve the almost unlimited marketability of gilt-edged stocks and, to that end, to limit the pressures experienced from time to time by the gilt-edged jobbers. This technique did not and could not preclude, as a part of interest-rate policy, changes in prices and yields in response to market developments, but it was considered that sharp changes, other than any that might be consequent on a change in Bank rate, would be likely to be disruptive to the market and liable to impair the demand for gilt-edged stocks over the longer term.

Starting in 1968, more importance came to be attached to a wider quantitative aggregate than bank lending as a target for the conduct of monetary policy. In 1968 and 1969, in agreement with the International Monetary Fund, quantitative limits were set for domestic credit expansion (DCE). This step was of limited importance for the management of the gilt-edged market, however, partly because the Government's requirement for finance was quite small at that time and partly because it was not then regarded as a lasting change in the objectives of monetary policy. The basic technique described above remained unchanged but the Bank, while still concerned to avoid disruptive volatility in the market, tended to move more quickly the prices at which it was prepared to deal.

A more significant step was taken in 1971 when direct quantitative control of bank lending was abandoned, and the arrangements for credit control were modified, with the broader aim of regulating the growth of the money supply, principally by variations in interest rates. This new emphasis on the money supply, rather than on interest rates *per se*, as the immediate goal of monetary policy has been carried further since, leading to the public announcement, from 1976, of quantitative targets for the growth of a particular monetary aggregate—sterling M_3 in the last two years—for periods of twelve months ahead.

In May 1971, preparatory to the change in credit control arrangements which took place the following September, the extent of the Bank's operations in the gilt-edged market was modified; and the Bank's position in relation to the market was codified as follows.

- The Bank is not prepared, as a general rule, to buy stock outright except in the case of stocks with one year or less to run to maturity.

- It reserves the right to make outright purchases of stock with more than a year to run solely at its discretion and initiative.
- It is prepared to undertake, at prices of its own choosing, exchanges of stock with the market except those which unduly shorten the life of the debt.
- It is prepared to respond to bids for the sale to the market of tap stocks and of such other stocks held by the Bank as it may wish to sell.

This remains the framework of the Bank's operations.

These adaptations of technique were primarily intended to improve the effectiveness of monetary control. It was clear that the ability of banks and other investors to sell to the Bank large quantities of stock at moments of their own choosing, at prices not far removed from those ruling in the market at the time, was incompatible with monetary policy in its modified form. The principal change was therefore that the Bank ceased to be prepared to respond to requests to buy stock outright, except in the case of stocks with one year or less to run to maturity.

Inevitably this change implied greater short-term fluctuations in gilt-edged prices and some reduction in marketability. It was not felt, however, that the longer-term health of the market need suffer in consequence. It had become clear by 1971 that the Bank's willingness to deal at prices close to the market level allowed speculation too large and too easy a rôle in the management of portfolios; it often meant that in practice the Bank provided the counterpart to dealings by the rest of the market. The curtailment of the Bank's operations therefore made room in the market for others to operate in more realistic conditions.

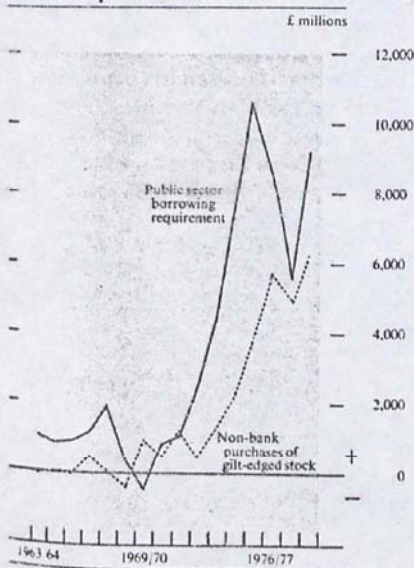
Nevertheless, tension for gilt-edged market management can arise between the objectives of shorter-term monetary control and of sustaining the longer-term health of the market. And this tension became more marked during the 1970s as the emphasis on control of the broader money supply increased.

The choice of the broader monetary aggregates, DCE and sterling M_3 , as the immediate target for monetary policy has tended to concentrate attention on the rôle of gilt-edged market management in implementing monetary policy, in a way that has become increasingly evident. An important characteristic of such broader aggregates—which does not apply to narrower measures of the money supply such as M_1 —is that they can be closely analysed, in an accounting sense, in terms of their credit counterparts. Properly interpreted, and allowing for the inter-relationship between the counterparts, this has the considerable advantage that it can help in understanding the factors contributing to monetary growth. It highlights the extent to which the public sector borrowing requirement (PSBR)—and, indeed, other sources of monetary growth such as bank lending to the private sector or inflows from abroad—are offset by sales of government debt, and more

particularly of gilt-edged stocks, to domestic investors outside the banking system. This direct accounting link between the gilt-edged market and the behaviour of the broader money supply, month by month, means that the extent to which the momentum of official sales of stock is being maintained has assumed much more significance—both for the authorities and for the general public—as an indicator of how far monetary policy is succeeding in its quantitative objective than was the case when the link was seen to be with the liquidity of the banking system.

This development has occurred against the background of a sharply higher government borrowing requirement and of a higher and more variable rate of inflation. In the eight years to 1970, the PSBR averaged a little over £2½ billion (2% of GDP at current market prices). Since then, it has averaged £6 billion (6% of GDP), with a peak of over £10½ billion (10¼% of GDP) in 1975. This huge expansion of government borrowing took place during a period in which not only the rate of inflation but also its variability from year to year increased sharply. In the eight years to 1970, inflation—measured by the increase in the monthly retail price index over the previous twelve months—averaged 4%, ranging from under 1% to 8%; in the eight years since then inflation has averaged just over 13%, ranging from 7½% to 27%. Nominal interest rates have naturally been not only higher but also more volatile as a result, and this volatility, and the associated volatility of expectations about the future rate of inflation, have greatly added to the problems of gilt-edged market management.

Public sector borrowing requirement and purchases of gilt-edged stock by non-bank private sector



Despite the unfavourable background, management of the gilt-edged market on the basis described above has proved capable of raising finance for the Government on a very large scale indeed over a prolonged period, as is shown in the accompanying chart. And this has

helped to contain the trend in the growth of the money supply in the last five years to a rate that has been generally consistent with official policy objectives. Thus, sterling M_3 increased at a rate of around 10% in most calendar years since 1974, which has been well below the rate of growth of nominal national income. This has not been without a cost in terms of high nominal interest rates. Inflation, and the scale of government borrowing, have necessitated high nominal yields, which—given the uncertainties regarding the future rate of inflation—have largely excluded potential private borrowers on fixed-interest terms from the capital market.

Adaptations to deal with the effect of uncertainty

Government finance on this scale involves continuous borrowing. From time to time, however, investors may lack confidence in the outlook, for example in respect of wage demands and industrial disturbance and their implications for future inflation, and in the economic and financial policies being pursued. Some uncertainty and risk are of course always present, and it is for investors and their advisers to assess them. At times, the uncertainties are such that investors cannot be confident that the level of interest rates will not rise, and hence do not feel justified in committing the funds they manage—generally in the interest of others—to investment in fixed-interest securities at that time. Sometimes the extent of uncertainty may be such that some investors are disposed to sell their existing holdings of gilt-edged stocks, keeping the proceeds liquid, and this, within the framework of the Bank's operations described earlier, is allowed to bring about whatever rise in yields may arise from market transactions. Once such an adjustment is completed—and how long that takes will depend upon the degree of uncertainty and the range of investors affected by it—the Bank is then able to resume the Government's funding programme on the higher yield basis. But at other times, perhaps when it is less clear which way a situation will develop, investors generally may lack the conviction to sell their existing holdings but still decide to keep their accruing funds in liquid form. In such situations, while prices in the gilt-edged market may remain relatively stable for some time, turnover contracts, and the market effectively becomes immobilised until the way ahead becomes clearer.

The principal effect of such periods of uncertainty, given the present emphasis of monetary policy on controlling the behaviour of sterling M_3 , is to interrupt the contribution which sales of gilt-edged stocks outside the banking system make to that control. It should be noted, however, that the other factors affecting the growth of sterling M_3 are also subject to similarly large and erratic short-term fluctuations: the PSBR, the growth of bank lending, and the impact of external transactions can all vary from month to month by amounts which are very large in relation to the average monthly increase in the money supply that is consistent with the monetary target. And such variations are predictable—even for just a short period ahead—only with large margins of error. The short-term interruption

Variability of the main credit counterparts of the money stock (sterling M_3)^(a)

£ millions: seasonally adjusted

	Financial years ^(b)			
	1975/76	1976/77	1977/78	1978/79
Central government borrowing requirement	490	260	440	700
Other public sector	70	200	220	350
Purchases of gilt-edged stock by non-bank private sector	520	650	530	480
Sterling lending to the private sector	120	260	250	310
External finance	240	370	450	360
Money stock (sterling M_3)	420	490	280	580

[a] The table shows root mean squares of first differences which indicate the general magnitude of month-to-month changes for each year.

[b] Banking May to banking April, except for 1975/76 where the figures are for banking July to banking April 1976.

of the flow of official gilt-edged sales is therefore not the only reason why there may from time to time be random month-to-month fluctuations in the growth of the money supply; and even if a more regular flow of sales could be achieved, this would not in itself be enough to remove such fluctuations arising from other factors.

The purely temporary divergence of the growth of the particular target aggregate, sterling M_3 , from the intended trend—whatever the origin of the divergence—is not in itself a cause for concern, in the sense that such erratic fluctuations are unlikely to have any significant effect either on the real economy or on inflation. This is more especially true when the origin of the divergence is a temporary interruption of the gilt-edged funding programme, since in this case the additional monetary balances which result are, in some large part, held by long-term investment institutions awaiting commitment in the capital market, and so are not in any direct sense available to finance transactions in goods and services. If, therefore, one could be confident in any particular case that a funding pause would indeed prove to be short-lived, the proper course would be simply to ride it out.

In practice, however, a central difficulty—for financial analysts generally, including investors in the gilt-edged market, no less than for the authorities—is to determine at the time whether an incipient divergence of sterling M_3 from the intended trend is merely erratic or whether it marks the beginning of an important acceleration of monetary growth in some more fundamental sense. Although, as noted above, interruption of official gilt-edged sales is not the only possible cause of short-term fluctuations in the growth of the money supply, any uncertainty on the part of investors in the gilt-edged market is likely in present circumstances to pose this question quite quickly. The size of the PSBR, and the continuous, heavy funding programme it involves, mean that if investors delay their purchases of gilt-edged stocks for only a month or two there is likely to be a noticeable upturn in the growth of sterling M_3 . The authorities then have to assess—in the light of the causes of uncertainty and of other developments (including, for example, the behaviour of other aggregates, such as M_1 , and particularly the non-interest-bearing element of M_3 , which are much less directly affected from month to month by the timing of gilt-edged investment

decisions)—the significance of this upturn and whether it is likely to continue. They may decide that the hesitation on the part of investors generally is well founded and make policy changes; or they may decide that policy changes are not necessary. If, in either case, a sufficient body of investors remains unpersuaded, sterling M_3 will continue to grow above the required trend, and this can lead to more active selling in the gilt-edged market, until yields eventually rise to a point where investors come back into the market and the funding programme can be resumed.

In many cases, such a yield adjustment (or the policy action taken to forestall it) may be accepted in retrospect as having been necessary in the light of outside circumstances to maintain monetary control. But in other cases it may appear to have been part of a self-generating spiral, with the initial uncertainty causing an acceleration in sterling M_3 which in turn affects expectations about interest (and possibly exchange) rates, leading eventually to upward adjustments of yields which are in excess of those justified by the underlying situation and which may subsequently therefore be reversed. The danger of such unnecessary disturbance and interest-rate fluctuations would be reduced if a somewhat smoother pattern of sales of gilt-edged stocks to the non-bank private sector could be achieved in the first place.

Partly-paid stocks

Faced with this problem, the Treasury and Bank introduced an adaptation in their issue technique in March 1977 by providing for only part of the subscription money for a new issue to be paid at the time of application with the balance being payable in instalments timed by reference to the Government's expected funding need. This adaptation, which has been used with varying degrees of success on a number of subsequent occasions, was designed to smooth the flow of funds from outside the banking system into gilt-edged stocks by staging the calls to correspond with the expected funding requirements in successive banking months.

In addition, new gilt-edged instruments have been introduced which were designed to be attractive in conditions of uncertainty.

Convertible stocks

Even before the recent concern, namely in March 1973, a convertible stock, 9% Treasury Convertible Stock 1980, was issued, which offers holders an option, in 1980, to convert at predetermined terms into a stock maturing in the year 2000. With this type of security, investors are offered a short-dated stock at close to the current market yield for that maturity at the time of issue, with an option to convert at a later date into longer-dated stock at a yield close to that prevailing for the longer maturity at the time when the convertible short-dated stock was issued. Such a security gives the investor the option of holding a short-dated stock to maturity, or, by exercising the conversion right, of moving into the long end of the market at a specified

later date (or dates) on terms which are known in advance and which may then no longer be available in the market. The attractiveness of a stock of this kind depends in part upon the relationship between short-term and long-term yields at the time of issue. The attractiveness of the conversion option in particular depends on investors' assessment of the likely course, beyond the immediate future, of long-term interest rates. If they judge that there is a good chance that long-term interest rates will be lower by the time the conversion option may be exercised, they will find the option attractive. To the extent that it does, in the event, produce an advantage to the investor, it will of course prove correspondingly expensive to the Government, although this risk may be worthwhile if it enables the momentum of the funding programme to be maintained without a rise in interest rates. There are a number of possible variations on this general theme.

Variable rate stocks

The second instrument designed to cater for conditions of uncertainty is the Treasury Variable Rate Stock, of which three issues have been made, maturing in 1981, 1982 and 1983. These stocks offer investors a degree of insurance against rising short-term interest rates, always provided that their market price is relatively stable. The insurance takes the form of six-monthly interest payments based on the average discount rate for Treasury bills over the preceding six months. At par, the interest rate payable is a half per cent over the Treasury bill discount rate, and for every one point discount on par the prospective capital gain to maturity effectively widens the margin over the Treasury bill rate, if the stock were held to redemption, by about a quarter per cent. In practice none of these stocks has traded at par, so that the effective margin over the Treasury bill discount rate has always been larger than a half per cent. The variable rate stocks have not yet, however, proved to be more than modestly attractive to investors outside the banking system as stocks to be held; they have not been very actively traded in the market, and, partly as a result, they have not perhaps so far enjoyed sufficient price stability. They have none

the less played some small part in smoothing the flow of funds to the Government, coming into demand when the outlook for interest rates seemed particularly uncertain and when official sales of conventional stocks were depressed, and being bought back by the Bank, against sales of conventional stocks, at other times. This rôle could grow with increasing market experience of the stocks. In the case of variable rate stocks, too, a number of variants are possible. One such variant that has already been adopted by a number of local authorities has the interest rate set half-yearly at a fixed margin above the six-month inter-bank deposit rate ruling at the beginning of each interest period, though these stocks too have yet to establish any significant market outside the banking system.

Some suggested possible further changes in technique and instruments

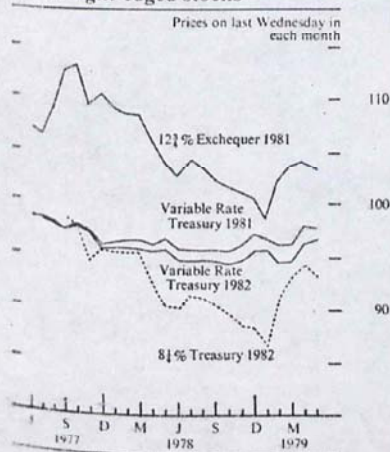
The adaptations so far described have not involved any departure from the established principles on which official management of the gilt-edged market has been based. It remains the case, however, that uncertainty among investors continues to cause occasional interruptions to the Government's funding programme. The rest of this article, therefore, considers a number of possible further changes—some more radical than others—which, it has been suggested, might be introduced to achieve a smoother path of official sales despite recurrent periods of uncertainty attributable to factors external to the gilt-edged market itself. These would involve changes, either of operating technique, or in the range of gilt-edged instruments.

A number of these changes could have significant implications for the structure of the gilt-edged market, and in particular for the market-making mechanism. Despite the developments since 1971 described above, a gilt-edged investor is still normally able to deal almost instantly at his own initiative in large amounts of stock of any maturity at—or at something very close to—a known market price; and this liquidity, provided by the gilt-edged jobbing system, remains an important element in the attraction of gilt-edged investment. It is difficult to avoid the conclusion that the present market-making mechanism would be seriously affected by some of the changes that have been advocated, but it is not easy to predict what alternative mechanism might emerge and how effective such an alternative might be. These questions are touched upon in the discussion that follows, but they would need to be very fully considered in a complete analysis of the proposals.

Changes in technique

In the area of technique, the changes that have been suggested fall into two main groups. The first group of suggestions would involve sharper changes in the prices and yields at which gilt-edged stocks are made available. The second group would involve some form of more direct relationship between the authorities and major investors through which the amounts, the timing and the terms of gilt-edged stocks to be taken up would be determined in advance.

Prices of variable rate and other selected gilt-edged stocks



Suggestions for greater flexibility in the price at which government stock is marketed are based on the proposition that a sufficient fall in the price at which the stock is obtainable will, in any surrounding circumstances and without any associated policy action, produce the required demand. In the Bank's judgment this proposition needs qualification, as is explained below.

These suggestions for greater price flexibility are of two kinds. The first relates to the prices at which the Bank markets stock out of its own portfolio through transactions on the stock exchange, where the initiative for varying the price would fall upon the Bank. The second relates to the method of public issue of government stocks, where proposals have been made for issues by tender (or auction) which, in this variant, would not be underwritten, and under which the variation in price would be determined entirely by the investors.

The pricing of tap stocks

At present, a new stock is normally issued at a price closely in line with the prices of other comparable stocks already in the market, and the amount of the stock not taken up by the public—usually a large proportion—is taken into the Bank's own portfolio, with the Bank acting in effect as an underwriter. If the market remains firm, this tap stock is subsequently sold by the Bank through the market at prices raised in fractional steps above the issue price. If, on the other hand, as a result of a change in conditions giving rise to uncertainty among investors, demand for the stock does not develop, the Bank does not immediately reduce the price at which it is known to be prepared to sell. Instead, the Bank waits until the market recovers or, if the market generally weakens, until the yield adjustment is completed and the market has stabilised, when the tap price will be lowered in a single step in response to bids from the market. This established practice provides assurance to investors who subscribe for stock on issue, or purchase it through the market soon afterwards, that, short of a general weakening in the market, their position will not be undermined by the Bank's supplies being subsequently made available at lower prices.

The main suggestion that has been made in relation to more flexible pricing of stocks from the Bank's own portfolio is that, in order to maintain the momentum of sales through periods of uncertainty caused by changes in outside circumstances, the Bank should be more willing to lower the tap price in one step, going beyond the fall in market prices generally, or in smaller steps, in line with the decline in the market, without necessarily waiting until the market yield adjustment is completed. A difficulty with this approach is that such behaviour, in the conditions of weakening confidence where it would be relevant, could tend to add to, rather than diminish, the uncertainties in the minds of investors.

If the Bank—as by far the largest seller in the market, and with earlier knowledge of some important

developments likely to affect the market, such as imminent policy steps, statistics, etc.—had had to reduce its price once, why should it not do so again shortly thereafter? Given this evidence of official urgency to sell stock, investors might well conclude that, by waiting, they might obtain still higher yields. There could be a danger that prices in the market would move away from the Bank, simply falling further in response to each successive reduction of the official price of the tap stock. At some point one must presume that this process would stop, and that yields would reach a level at which investors were prepared to commit the required funds; but the increase in yields might need to be unnecessarily large in these conditions, and, in the case of the proposal for a single step change, it would be difficult to arrive at a reasoned judgment in advance as to the tap price which would ultimately need to be set. In these circumstances, it could, as a practical matter, become necessary to find other means of establishing an appropriate price, perhaps through tenders or through a process of negotiation with major investors, with the further implications discussed below.

The argument has been put that the authorities already act on prices in the gilt-edged market by changing minimum lending rate (MLR), and that shifts in the tap price would only differ in degree. But the difference in degree would be very considerable. Changes in MLR are made as a result of varying considerations, not necessarily immediately related to developments in the gilt-edged market, and their effect on gilt-edged prices is indirect and may be greater or smaller depending on the surrounding market circumstances. Furthermore, a change in the yield on a three-month bill from, for example, 9½% to 10% changes its price by only one tenth of one percentage point, while to secure a similar change in the yield on a 20-year stock would require a change in price of about 5%. Such changes in price imposed unilaterally by the authorities would involve heavy capital losses which operators would be likely to regard as beyond the normal hazards of business; and the only defence for the market-makers against such behaviour on the part of the authorities would be to narrow the market drastically whenever such conduct appeared to be in prospect.

A modified version of this suggestion is that the Bank should lower the tap price at which it is prepared to sell during periods of a weakening market, but by less than the full extent of the fall in prices generally, so keeping the price a little way above the market as a whole. The intention would be that, because investors would have greater certainty as to the price at which they could re-enter the market, they would be encouraged to sell their holdings and so accelerate the yield adjustment. It would seem, however, that such a policy would in practice be almost indistinguishable from the previous suggestion, and that the Bank's price adjustments would have much the same effects upon market expectations.

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More generally it has been suggested that the Bank's technique in pricing tap stocks is too easily predictable: in (1), it is argued, can, if they are uncertain, postpone their purchases of stock in the knowledge that if prices should improve, they will not, while a tap stock is active, move ahead too rapidly so that the cost of delay is likely to be small. This argument sometimes prompts the suggestion that the Treasury and the Bank could price a new issue some way ahead of the market, or that the Bank could adjust its selling price of the tap stock upwards by larger amounts, so encouraging investors to accelerate their purchases in the immediate situation and weakening their complacency over the longer term. There are circumstances where, within generally rather narrow limits, this tactic can be—and indeed has been—used. But it can only be used where the Bank is reasonably confident that the surrounding conditions in fact justify an unusually sharp decline in yields and where this prospect is likely to carry conviction with investors. If used where the overall circumstances did not in fact justify a fall in yields to the extent implied by the pricing decision, the tactic would be likely to induce an otherwise unnecessary interruption of the funding programme as yields subsequently adjusted back to more appropriate levels. In a similar way, it has been suggested that the authorities should vary their tactics in introducing new stock issues, by periodically standing aside from the market, but this possibility has been largely precluded by the recent size of the funding programme, which has involved more or less continuous borrowing.

In considering these various proposals for a more active pricing policy, the Bank is conscious that a securities market cannot function satisfactorily if there is an operator in a position to exercise overwhelming influence who is liable to enter the market unpredictably both as to timing and behaviour. All of the proposals would—if carried very far—introduce an important new element of uncertainty into the determination of gilt-edged prices. This in turn would seriously impede the making of a market, in any size, in gilt-edged stocks—whether by jobbers, as at present, or under some different institutional arrangement. The restriction on marketability which could then result would tend to reduce one of the principal attractions of the gilt-edged market for investors, damaging its long-term capacity.

Tenders

A different kind of suggestion for achieving a smoother pattern of gilt-edged sales through greater price flexibility is for the adoption of a tender system for new issues. Again there are a number of possible variants, but a common element would involve the Government announcing from time to time the volume of securities it wanted to sell on particular dates, or in a given period, and then leaving it to investors to determine the price and yield at which they were prepared to buy it. As with the suggestion for a more active policy of lowering of the tap price, the object would be to enable the authorities to sell the amounts of stock expected to be required in any given period to achieve shorter-term

control over the growth of sterling M_3 , unhampered by interruptions in government funding arising from changes in outside circumstances. (This would of course still leave sterling M_3 subject to erratic short-run fluctuation arising from unpredicted variations in the other credit counterparts, as mentioned earlier.) The proposal may derive in part from the regular use of the tender technique for new issues of US government securities by the US Treasury. In considering it, however, one needs to bear in mind that there are substantial differences in the size and structure, and in the rôle, of the government bond market in the two countries.

In the United States, the \$330 billion of government bonds outstanding are equivalent to only some 16% of GNP, whereas the £57 billion of gilt-edged stocks outstanding is equivalent to some 42% of GNP in this country. Although government borrowing has increased in the United States—as in the United Kingdom—in recent years, government bonds have not dominated the capital markets to the same extent: in 1977 government bonds absorbed only some 30% of the total funds raised in the US domestic capital market, whereas the comparable figure for the United Kingdom was nearly 90%. In the United States, too, government bonds are typically of much shorter maturity. They include a large proportion of two-year issues, and only about 16% have a life beyond eight years; whereas in this country gilt-edged stocks are rarely issued for less than four to five years, and some 60% are of more than eight years' maturity. This results in an average maturity of US government bond issues of about five years, compared with about twelve years for gilt-edged stocks in this country. Finally, the institutional arrangements in the two government bond markets differ: prices are made in the US market, for example, by dealers in government securities rather than through the stock exchange as in this country. Such differences suggest the need for considerable caution before one can conclude that arrangements found helpful in the United States would be similarly effective in the United Kingdom.

A major difference in the present context is that the US Treasury's debt management objectives are not the same as the present objectives of debt management in this country as described above. In particular, the US Treasury is not directly involved in the implementation of monetary policy and its use of the tender technique for new stock issues is not primarily directed to the achievement of short-term monetary control. In the United States, the main emphasis of monetary policy in recent years has been on controlling the narrower monetary aggregates, which the Federal Reserve authorities influence essentially through management of the level of short-term interest rates. There is consequently not the same direct link between government debt management and the chosen monetary target in the United States as there is here, and debt management policy can therefore be directed to a far greater degree to the narrower objective of providing finance for the Government at the lowest cost consistent with maintaining an appropriate maturity

structure. In this context, the use of the tender technique would seem to be designed to deal with the difficulty that can at times arise with a fixed-price offering if market sentiment should change (in either direction) between the announcement of terms and subscription, rather than as a means of keeping up the volume of sales in circumstances of uncertainty without regard to the effect on market yields. On the contrary, in framing its programme of debt sales, the US Treasury pays considerable regard to the advice given by the Federal Reserve authorities, and by the main government securities dealers (who effectively underwrite the tenders and act as intermediaries in on-selling a large part of new issues to final investors) on the capacity of the market to absorb new issues—particularly of longer maturities—without an undue effect on market prices.

A form of tender technique, with a minimum tender price set in line with market yields at the time of announcement of the issue and designed to secure for the Government—through a lower borrowing cost—a part of the benefit from any sharp improvement in market sentiment between the announcement of terms and the date for subscription, was in fact adopted by the Treasury and the Bank for a new issue (12½% Exchequer Stock 1999) in March 1979. This followed the uniquely heavy oversubscription, resulting from an abrupt reversal in market expectations about the future course of interest rates, of two stocks issued a month earlier. The use of the tender technique for this purpose, however, is basically different from its use to achieve greater short-term control over the growth of the money supply by ensuring the necessary volume of gilt-edged sales in any given period. If that were the objective, it would at times involve pressing ahead with an issue even in a market which was unsettled by outside conditions, and accepting the resulting yield; the objective would in such conditions be likely to be frustrated if there were a minimum tender price, unless it were set on a yield basis substantially higher than the prevailing market level. A change to this method of issue would not of itself help to diminish investors' uncertainties about the future, nor make it easier for them to make a judgment about the future course of yields, and hence about the yield at which they should commit any large volume of funds to long-term fixed-interest investment. Given that they would still have open to them the possibility of buying stock in the secondary market or—because of the continuous nature of the Government's borrowing need—of entering a subsequent tender, by which time the particular uncertainty might have lessened, they could, in uncertain conditions, continue to find it more prudent to stay short and wait. Investors would, therefore, not necessarily enter a tender even of this sort, in the required volume, at the times when it mattered. And to the extent that they did so, it would probably be at prices and yields that discounted an unfavourable outcome in those areas that were the source of uncertainty.

The effect of tenders of this second kind, in terms at least of short-term price volatility, might be somewhat

similar to that of a more active policy of moving the official tap price, with similar longer-run implications for the capacity of the market. Used with the objective of selling a predetermined volume of stock, the tender technique would have a further corollary. It would run counter to this objective for the Bank itself to enter the tender on any substantial scale; the Bank's own dealings in the market would, therefore, be curtailed and would no longer provide a reservoir for adjusting the level of sales to the level of investor demand as under the present tap arrangements. At the same time, as things stand at present, the gilt-edged jobbers do not have the resources to bid regularly at tenders in amounts that would enable them to assume this function. If the tenders were to be successful, therefore, given the present institutional arrangements in the United Kingdom, virtually all the stock offered would have to be taken up directly by investors—whatever the state of market confidence happened to be—with no large intermediary to cushion the impact on prices. In part, the gap left by the implied change in the Bank's rôle might be filled if the capacity of the present jobbers were to increase or if new intermediaries emerged, perhaps of the kind of short-term dealer in government securities that exists in the United States. Such a development would be unlikely to come about overnight, and the market in gilt-edged stocks could be severely affected in the meantime. But even in the longer term, the change in market structure and the greater short-term price volatility that could result from the tender technique—if used to achieve closer short-term monetary control—might well lead to both reduced marketability and a significant shortening of the maturity structure of government debt. In the conditions envisaged, market-makers might be prepared to run a sizable book in short-dated stocks, but they are less likely to be prepared to take in the longer maturities on the same scale because of the higher risks. Any development in this direction would involve a considerable change in the management of the government debt, in view of the already heavy burden of annual maturities that have to be refinanced.

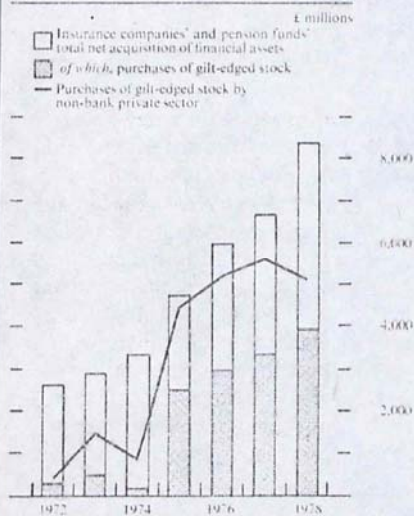
Because of structural changes in the gilt-edged market that could result from a general shift to tenders, some commentators have alternatively suggested that tender issues might be made on occasion, at times of particular uncertainty rather than as the normal method of issue. This more modest step might still, however, have the disadvantage that it would tend to increase rather than diminish uncertainty. There would be the danger that once the tender technique had been used in the manner suggested, the possibility that it would be used again could damage confidence in a hesitant market on subsequent occasions: prospective buyers might be deterred from investing when they would otherwise have done so, by the fear that a subsequent tender would impose capital losses on them. Experimentation in this area is not, therefore, wholly straightforward.

A more direct relationship with the major investors
The suggestions for possible changes in technique discussed so far would maintain the traditional arms-

length nature of the relationship between the authorities and investors in gilt-edged stocks. An alternative approach would involve a more direct relationship between the Government, as borrower, and major investors, for example, the larger pension funds and life assurance companies. Suggestions under this heading include:

- the negotiation of underwriting of government stock issues by the long-term investment institutions, rather than by the Bank as at present (whether such issues were on a fixed-price or tender basis); and
- the negotiation of direct placings of government stock with the institutions.

Purchases of gilt-edged stock by insurance companies and pension funds



The rôle of the long-term investment institutions in the gilt-edged market has grown rapidly in recent years. Even so, these institutions do not generally account for more than about half of all net purchases of gilt-edged stocks by investors outside the banking system, and their combined holdings of gilt-edged stocks still amounted to only a third of the total nominal amount outstanding at the end of 1977. The institutions do not represent the small, tightly-knit grouping that is sometimes supposed: at the end of 1977 there were some 300 life assurance companies and over 2,000 pension funds in the United Kingdom, with over 100 institutions with assets of over £100 million accounting for two thirds to three quarters of the total long-term institutional investment. Thus, while suggestions of this kind might in principle be applied to a significant part of the Government's gilt-edged market borrowing, they would not of themselves provide a total solution to the funding problem.

A key question—as in the case of the proposal for tenders—is whether the suggested change in new issue technique would in itself make it easier for the long-term investment institutions to maintain their purchases of gilt-edged stocks through periods of uncertainty, without wide fluctuations in interest rates. Other things being equal, there is little reason to suppose that

institutional investors would be willing to commit their funds—at times of uncertainty—to fixed-interest stocks offered by way of a placement where they were not prepared to buy the same stock offered by way of a public issue, unless they were given the inducement of a significantly higher yield. Nor is it clear that the institutions could prudently, in the interest of their pension fund members or insurance policyholders, take on the very considerable risks of loss that would be involved in the regular underwriting of government stock issues (which are at present underwritten by the Issue Department of the Bank) on anything like the recent scale, unless they were free to move the underwriting price quite widely to protect themselves in adverse conditions. While, therefore, it is possible to see how this approach could function in market conditions that were reasonably favourable—when the present technique is satisfactory—it is hard to see that arrangements of this sort could be freely negotiated in those conditions where they would be most helpful, without producing much the same effect of greater short-term price fluctuations that would result from the earlier suggestions.

Some suggestions for a more direct relationship between the authorities and major investors would go some way towards displacing a free market and would involve varying degrees of government influence over the decisions taken by the major investors. In the extreme this could extend to statutory direction. It is beyond the scope of this article to discuss the general arguments for and against such an extension of government influence. It is reasonable to assume, however, that the use of such influence would tend, in the first instance, to hold yields on gilt-edged stocks below the level that would otherwise be established in the market; and that this in turn would tend to reduce the attraction of investment in gilt-edged stocks to other investors not subject to similar influence or control. Though it might be possible to achieve in this way a smoother flow of investment in gilt-edged stocks by the major institutions, it would not necessarily follow that gilt-edged sales to the non-bank private sector as a whole would be more regular; nor perhaps that a higher overall volume of sales would be achieved.

The last three suggestions considered—for tenders; for negotiated underwriting of government issues by the institutions; and for some element of direction by the Government of the institutions' investment—have been discussed separately, as logically distinct proposals. In practice, however, this distinction could prove difficult to maintain. The pressures on the Government could tend to lead to a progressive development: in order to avoid the disturbance to interest rates that might be expected to result from the adoption of tenders, there would be a temptation to look for some underpinning of the tenders by institutional investors, and, in negotiating the terms of such underpinning, the Government would need to exercise considerable restraint if a free market was to be preserved. To this extent, therefore, the implications of the various proposals in these areas need to be looked at together.

New forms of gilt-edged instrument

Suggestions advanced for possible new types of gilt-edged stocks fall into two main groups. First, there have been various proposals for new short-term marketable government debt instruments, with maturities ranging from perhaps three months up to about two years. Secondly, some commentators have advocated the introduction of a marketable government stock indexed in some way against inflation.

Short-term instruments

The short-term instruments suggested are principally designed to attract into government debt institutional funds awaiting investment (including longer-term investment in the gilt-edged market) and some part of the liquid resources of industrial and commercial companies currently held with the banking system and so forming a part of the money supply. They could also appeal to personal investors, though in this area particularly they would compete with the range of (non-marketable) national savings instruments already offered by the Government.

At present, there are two marketable short-term central government debt instruments generally available to investors: Treasury bills and gilt-edged stocks approaching maturity. Both Treasury bills and gilt-edged stocks with less than one year to run to maturity are eligible reserve assets for the banking system. They consequently have a particular value to banks as compared with most other short-term assets with which they compete, and their yield, therefore, tends, on occasion, to be bid down to a level unattractive to investors outside the banking system. The suggestion has, therefore, been made that a new instrument could be issued which would not be an eligible reserve asset, and in relation to which—because of the short maturity—a more active pricing policy could be

adopted without the implications such a policy would have if adopted in relation to the gilt-edged market generally.

Although there is no central government instrument of this kind available to the market, it is an area which is already quite heavily drawn upon by local authorities, through deposits, mortgages and negotiable bonds, none of which is eligible as a reserve asset. The total of such temporary local authority debt outstanding is around £4 billion, of which some £1½ billion is held by non-bank financial institutions and about £½ billion by industrial and commercial companies and persons taken together. If the central government raised additional funds from outside the banking system by marketing a new short-term instrument, it would be in competition with local authority short-term borrowing; this would tend to limit the net additional inflow of funds to the public sector as a whole.

It is difficult to establish how large a market, outside the banking system, there would be for a new short-term central government debt instrument of the kind proposed. The behaviour of the groups of potential investors identified above suggests a strong preference for holding their short-term assets in the form of conventional bank deposits which are both highly liquid and wholly capital-certain. For example, industrial and commercial companies' holdings of certificates of deposit amount to only some 5% of their holdings of conventional bank deposits; and the long-term investment institutions typically wish to keep their liquid resources available for immediate investment when they perceive an appropriate opportunity. This might suggest that there would be little demand for any short-term central government instrument that was not a close substitute for bank deposits. If the Government offered such a close substitute, this would not produce a meaningful reduction in the liquidity of the economy. If

Local authority short-term debt by type of holder^[a]

£ millions: amounts outstanding at end-year

	Total	of which: ^[b]						
		Banking sector	Building societies	Insurance companies	Other financial institutions	Industrial and commercial companies	Personal sector	Other
1972	2,408	475	298	83	329	359	294	330
1973	3,274	660	346	236	460	483	266	541
1974	3,976	376	741	582	465	484	242	704
1975	3,758	371	649	362	524	459	211	746
1976	4,349	497	452	407	768	579	243	974
1977	3,013	332	842	269	110	229	203	585
1978	3,872	632		1,405		387	233	716

[a] Includes all loans repayable within one year of their inception.

[b] Excluding revenue bills.

Distribution of main sterling liquid asset holdings at end-1978

£ millions	Bank deposits	Building societies	Other financial institutions	National savings	Local authority debt	Tax instruments	Treasury bills and gilt-edged stocks
Holdings							
Persons	24,174	36,616	4,578	11,238	233	146	..
Industrial and commercial companies	11,904 [a]	337	230	—	665	763	509
Insurance companies [b]	1,537		139	—	269	..	10 [c]

.. not available.

[a] of which, certificates of deposit £440 million.

[b] 1977 book value (net).

[c] Treasury bills only.

holdings of the new instrument were excluded from the definition of sterling M_3 (which does include certificates of deposit issued by banks), the growth in sterling M_3 might statistically be reduced; but this effect would be seen by the financial markets as largely optical.

To attract such liquid funds into a less liquid asset, the Government would need to offer a higher yield. Indeed, action has already been taken to make both national savings instruments and certificates of tax deposit more attractive. The contribution that a new general-purpose, short-term, marketable security could make would depend in part on how far this higher cost was regarded as acceptable.

Indexation

The final suggestion to be considered is some form of index-linked marketable government security. There is little doubt that an appropriately priced, inflation-proofed marketable security could be attractive to a wide range of investors. This is not because it would necessarily yield a higher return to maturity than a conventional fixed-rate security—that would be difficult to judge in advance and would depend upon whether, in the event, the future rate of inflation proved to be greater or less than the rate presently discounted in nominal market yields. (By the same token, the real cost to the borrower would also be difficult to predict in advance and might prove to be greater or less than on a conventional stock.) The attraction would be that the 'real' rate of return to maturity would be fairly clear; this would provide a measure of protection to investors, and would be particularly attractive to institutional investors such as pension funds whose liabilities also rise with inflation. It would also mean that investors would be substantially protected against capital loss as a result of a fall in the market price arising from an upward shift in inflationary expectations (though not from price fluctuations associated with changes in real interest rates). This characteristic particularly means that indexed gilt-edged stocks would remain attractive to investors when they feared accelerating inflation, which is the predominant cause of interruption to the government funding programme at present. The introduction of indexed stocks almost certainly could in principle, therefore, make an important contribution to smoothing the pattern of official gilt-edged sales.

The question of an indexed stock cannot, however, be looked at solely in this narrow context. Frequent recourse to an instrument of this type—and once a start had been made down this road it would be difficult to draw back in future conditions of uncertainty—would create considerable pressure for indexation in the capital markets more generally. There is room for differences of view about how far the introduction of indexed gilt-edged stocks would lead to the spread of indexation through the economy as a whole. But if this were a significant possibility, the authorities would need to be assured that the implications of indexation (e.g. for the tax structure, for the financing of industry, etc.) were fully understood and that the economic and social consequences were acceptable. Whether or not the

generalisation of indexation through the economy would be advantageous is a question that probably cannot be answered in an absolute sense: it would depend to a considerable extent upon the prospect for the development of the economy, in the light of the other available policy options, at the time. But it is not the purpose of this article to discuss that much wider question: the immediate point is that the argument for indexed gilt-edged stocks needs to be made in that wider context, and not considered solely as an expedient to facilitate gilt-edged market management.

Conclusion

The purpose of this article has been to explain the evolution of the rôle of gilt-edged market management, and of the techniques and instruments employed, during the past decade or so; and to contribute to the public discussion of certain possible further developments.

Present policies have enabled the funding in the gilt-edged market of the Government's borrowing requirement—which has itself been very large—to make an important contribution to the objective of controlling the trend in the growth of the money supply over the past years. Closer month-by-month control over the growth of sterling M_3 is not, however, achievable. One reason for this—but one reason only among others—is because the contribution of gilt-edged funding can be interrupted from time to time as a result of a weakening of confidence among investors, particularly relating to the outlook for inflation and the adequacy of economic and financial policies to contain it, which makes yields seem unattractive. Steps have, however, been taken to secure a smoother flow of government funding and to moderate the effect of such interruptions.

The latter part of the article has discussed various suggestions for further change put forward with the aim of improving the authorities' capacity for short-term monetary control, and of reducing the risk of the authorities having to accept interest-rate fluctuations, or to take preventive policy action, not justified by the underlying economic circumstances. Some at least of these suggestions would seem likely to add to, rather than diminish, the short-term volatility of interest rates without necessarily leading to greater stability, or to lower interest rates, over the somewhat longer term. Most of the suggestions that have been put forward would be likely to have far-reaching implications—for the structure and capacity of the gilt-edged market in the longer term, for the nature of the relationship between the Government and the major institutional investors, or for economic management in general—and the question arises whether the objectives aimed at justify such possible consequences.

As noted earlier, erratic, short-run, month-to-month fluctuations in the rate of growth of sterling M_3 , or indeed of any other monetary aggregate, may derive

from a number of causes, and are not likely in themselves to be important. Monetary control is therefore properly directed to the trend of monetary growth over a longer period. As this emphasis becomes more widely understood, and provided that investors are convinced that the authorities are prepared to take the steps necessary to maintain this control, unjustified reaction in the gilt-edged market to erratic short-term

fluctuations in monetary growth may diminish. While there may, nevertheless, be scope for further technical changes in gilt-edged market management, which are designed to improve the authorities' capacity for shorter-term monetary control, one cannot properly expect that such changes will serve in place of substantive policy changes that become necessary from time to time in other areas.

- ① Tim Leakester
② Prime Minister

Economic
Policy

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX

From: JOHN SPARROW

I will ask the Treasury
to take into account

01-588 4545

22nd June, 1979.

Thank you
Dear Mr. Thatcher,

John Sparrow's
criticisms of our gilt
policies in the papers which
they are preparing for the
meeting we have arranged in
mid-July.

PL 24/6

In the markets this week the pound has remained strong, equities have remained weak and gilts have fluctuated fairly narrowly. I referred last week to the conflict between domestic and external considerations: one aspect of this is the effect on the private sector of a combination of high interest rates and a strong currency which, taken together with announcements this week about the actual level of profitability and official expectations about its future trend, has been more than sufficient to upset the equity market.

As you know, my reaction to this is to argue that there is a balance of disadvantage from maintaining MLR at its present level. However, I have heard it suggested in the City that it may in fact be official policy to maintain the pressure on the private sector in order to make it more necessary for managements to resist possible excessive wage demands next winter. If there were such a policy it would need to be kept under very close review because, frightening though the disease of unearned wage claims may be, there are remedies which could eventually be worse if they are pursued to the point at which they too seriously debilitate the patient.

A more obvious justification for the present level of MLR is the need to sell gilts and to control the money supply. You asked me when we met on Tuesday to let you have my thoughts on the management of the gilt-edged market, and the rest of this letter is concerned with that subject. As I write I have not had an opportunity to read the latest issue of the Bank of England quarterly bulletin which I understand is particularly relevant; however, I think it may be better to let you have my own views now and to deal next week with any points raised in the bulletin or in public discussion.

The first thing that needs to be said about the management of the gilt-edged market is that we probably would not even be aware of the problem if the PSBR and, in consequence, the need to sell gilts were significantly reduced. The weaknesses inherent in the present system become apparent only because the market is very much a buyer's market when the seller is a forced seller. It can therefore be argued that no change needs to be made because your policies will lead to the removal of the problem which draws attention to the weaknesses. I tend to take the other view, that weaknesses in the system should be eradicated but I certainly would agree that a significantly lower PSBR would reduce the need for change and, more importantly, would allow a much greater latitude so far as the timing of any change was concerned.

Timing is of the greatest importance, because it would be disastrous to make any changes unsuccessfully. Probably the most important point here is to make any changes at a time when the institutional investors are liquid and are therefore relatively eager to buy stock, a state of affairs which does not apply to-day.

Before suggesting changes, it is worth running over some of the ways in which the present system is thought to be faulty. One family of problems arises from the habit of manipulating MLR, which is a short-term interest rate, to facilitate the sale of stocks, many of which are long-term. This gives rise to an extremely volatile pattern of short-term interest rates which is damaging economically at or near the peaks of the cycle and damaging psychologically because of the uncertainty which it constantly engenders. Another consequence, because the pattern has become accepted and predictable, is that stocks tend to be sold in large quantities only when interest rates are at their highest with the result that the stocks are at their most expensive to the taxpayer.

Another point of criticism is the proportion of long dated securities being sold at a time when interest rates are high. This pattern is not repeated in other countries and is in marked contrast to the instincts and policies of finance directors in the private sector, who try to maximise their short term borrowings when they judge interest rates to be high and to fund on a long term basis only when they judge interest rates to be low. The fact that their judgment is often faulty does not invalidate the principle that they try to follow. The usual justification for a high proportion of expensive long term debt is that this reflects the portfolio preferences of the buyers, who are typically insurance companies and pension funds. Nonetheless, one should note that institutions in the United States, for example, are prepared to buy short term securities in the absence of anything longer term, even though one would assume that their portfolio preferences are similar to those of British institutions; in other words, one's preferences are not necessarily the only determinants of what one will do. In addition, there is to-day a relatively new potential buyer of U.K. government debt in the form of the rest of the world. You know that I expect foreigners to be interested in gilts at present interest rate levels and I am fairly confident that the foreigners' portfolio preference would be for short-dated stocks.

The third group of criticisms relate simply to the mechanics of selling gilts. It is often felt that the relative position of the jobbers, brokers and investors is excessively strong and leads to unnecessarily expensive funding. For example, in times of uncertainty, it would be possible for the jobbers to mark prices down just before applications for a tap stock are due, which would have the effect of discouraging applications and thereby ensuring that the business was ultimately routed through the jobbers.

Turning to possible solutions, I start by rejecting one. The idea of indexation is being canvassed again, but it seems to me that indexation of government securities would kill the equity market stone dead and would result in a degree of crowding out for the private sector much greater than is currently seen. I find indexation of government debt as objectionable as indexation of public sector pensions, for almost exactly the same reasons.

I believe that what is needed is a far greater degree of flexibility on the part of the authorities. One reason why MLR has to be raised to perform the Duke of York manoeuvre is that to cut the tap price without signalling the intention by raising MLR is regarded as a breach of faith with the market. I do not believe that that view can be sustained and I therefore think that the authorities should be prepared to raise or lower the price of the tap stock whenever they feel it necessary. Secondly, and in conjunction with this, they could make much more use of open market operations to buy gilts when they feel that yields are getting excessive or when they judge that market confidence needs a boost. Thirdly, they could introduce

tranches of stock in smaller quantities much more frequently and sell them by tender, in a way not unlike that used in the Treasury bill market.

An increased flexibility in the attitude of the authorities would in turn lead to much less rigidity on the part of the buyers. Given this flexibility, I believe that we would find ourselves funding the government's borrowing requirements more readily and more cheaply and that we would then see that structural change is not necessary. Greater flexibility would help to redress the imbalance between the relative strengths of buyers and sellers and could usefully be accompanied by a gradual reduction in the proportion of long term debt offered to the market. The reduction would need to be gradual because minds change gradually, but part of the process could take the form of a greater willingness to let it be known that there would only be a limited amount of long term debt being issued in any given year, accompanied in the early stages by a greater willingness to issue medium term debt.

Incidentally, one interesting consequence of a move away from the use of MLR as the trigger for gilt sales might be that there was no real need for MLR any more. At present, the principal influence on short term rates is exerted through the Treasury bill market, and the automatic link between Treasury bill rate and MLR has already been abolished. If MLR was not being used to control long term rates it could arguably fade away which would at any rate dispel the illusion that it is the government's action in raising MLR which forces up mortgage rates, overdraft rates and all other interest rates. Those rates will, of course, continue to go up and down but it would be easier for people to see that they were doing so as a result of the play of market forces rather than, as at present, all the blame being laid at the feet of the government. Looking again to America, one does not find there the direct attribution of all interest rate problems to the Administration and it is unnecessary for it to happen here.

I will revert to this subject next week when I will have read the quarterly bulletin.

Yours sincerely,
John Searrow

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.,

NOTE FOR THE RECORD

*for Master Set
Euro Pot - Domestic
Monetary
Pot,*

Mr. John Sparrow called on the Prime Minister at 1600 on Tuesday 19 June. The following are the main points which came up in discussion.

Mr. Sparrow said that the City was basically pleased with the Budget. The immediate marking down of gilts prices was inevitable, given the increase in MLR - which in itself had been somewhat unexpected. But the MLR increase clearly indicated that the Government was intent on keeping the money supply under control, and this ought to provide a good basis for the sale of gilts over the next few months. The take-up of the new tap stocks on Thursday would be watched very carefully. Another more promising aspect was the fact that corporate loan demand was likely to be rather lower over the next few months because of the recent accrual of cash from the pre-Budget spending spree and because of the short-term cash flow effect of the VAT increase.

Mr. Sparrow went on to say that he did not think the current level of sterling could be sustained - given the recent trade figures. The rate was being pushed up by the combination of high interest rates and the fact that many regarded sterling as a "petro-currency".

The Prime Minister said that she was concerned about the current provisions for corporate stock relief. Her impression - and this was confirmed by Mr. Sparrow - was that it had a distorting influence on company behaviour: companies tended to increase their stocks unnecessarily at the end of the financial year, which was a waste of resources and which meant a loss to the Exchequer. Mr. Sparrow added that corporation tax generally had become an "optional tax". It should either be abolished or made operative: he would prefer the latter. Mr. Sparrow then referred to PRT, and said that he was worried that the Exchequer was losing unnecessary funds because of the "uplift" provision. This meant, for example, that BP would be exempted from substantial amounts of tax when they took over part of the Beatrice Field, as they were reported to be proposing to do.

/The Prime Minister

The Prime Minister asked Mr. Sparrow for his views on the present methods of funding the borrowing requirement. Mr. Sparrow replied that he would let the Prime Minister have his views in writing, but did not not accept the Bank's argument that the institutions necessarily required long-dated stock. This was an excessively expensive method of funding. On the other hand, he thought that there must be a revival of interest in equities at the expense of gilts before too long. The Prime Minister commented that she could not see how businesses would be willing to borrow for investment purposes at current rates of interest. Finally, Mr. Sparrow said that in his experience industry was already becoming more aware of the need to negotiate responsibly on the pay front: they were beginning to realise that from now on they, rather than the Government, were responsible for their actions. But it would be helpful if the Government could produce a new "standard of living" index - this would involve regarding tax as part of the cost of living. The Prime Minister said that the Treasury were working on such an index.

R.

21 June 1979

En Bl

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX

From: JOHN SPARROW

01-588 4545

15th June, 1979.

Dear Mr Thatcher,

I was wrong last week when I forecast the reaction to the Budget. The vocal reaction has been favourable, as I thought it would be, but the markets themselves slipped. To some extent this is due to a certain nervousness about possible union belligerency, although I would have thought that everyone should have expected words from the union leaders; the interesting question is whether or not the words will subsequently be matched by actions, and Mr. Gormley's decision to stay on is one small but hopeful straw to indicate that the bite will not be as bad as the bark.

What I had failed to foresee, and what the markets did not expect, was an increase in MLR to 14%. It is this which has set the gilt-edged market back, whilst at the same time adding to the strength of sterling, and it is natural for equities to become relatively less attractive when such higher interest rates are available. You will know that there is a fair amount of unhappiness in the City about the way in which gilt-edged stocks are sold. This is based partly on the argument that it is unnecessary and positively harmful to manipulate short-term interest rates in order to sell 25 year debt. The feeling is strengthened in this case by the very considerable profits which the jobbers are thought to have made, in effect at the expense of the tax payer (although most brokers see it as being at the expense of their clients).

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← The conflict between domestic and external considerations is becoming more and more apparent. Domestically, the effect of the Budget tax changes has been to make gilts less attractive to the personal sector whereas the external reaction has been summed up by the European banker who told the Daily Mail that 14% in a petrocurrency was just too good to believe. I repeat the City view that, even without 14% interest rates, sterling is now a strong currency, although my reading of the Red Book in paragraphs 15 and 16 of the "Economic Outlook to 1980" persuades me that the Treasury is not yet convinced of this. It is a vitally important consideration to be clear about because it has major implications for policy. You may have seen that in his lecture at the City University yesterday the Governor said that attempts to adjust to countries' differences in economic performance through flexible exchange rates had severe limitations. The key reasons for this were "that the exchanges fluctuated on a far shorter time scale than that required to make fundamental adjustments, the statistics were not reliable enough to ensure that the correct action was taken, and efficient industries were hit as much as inefficient ones". A strong pound based on the oil situation and reinforced by high interest rates will be eventually corrected, but only after the resultant lack of industrial competitiveness has been felt. It is for this reason that a colleague said to me this

morning that he hoped the Duke of York would not turn into the Vicar of Bray.

None of this affects the fact that the Budget as a whole is regarded as being a great stride forward. Inevitably, there are pockets of trepidation as people (and in particular, managements) find themselves actually in the sort of world they have been arguing for for years; but the only real misconception that I have encountered is the very widespread one that the rate of inflation is synonymous with the retail price index. This is obviously wrong, not least because the effect of VAT is deflationary although its effect on prices is to increase them. But one of my favourite maxims is that the only truth that matters is what people believe, whether it is in fact true or not, and if people generally continue to believe that inflation is represented by retail prices, then the next twelve months will be harder than they need to be. The interesting thing about the fallacy is that it is shared by all sorts of people, and unless it is dispelled in the City, in Fleet Street, in Whitehall and in Westminster, one can scarcely hope that it will be corrected in Wolverhampton or Wigan.

I am grateful to you for finding time to see me next Tuesday and I look forward with pleasure to our meeting.

Yours sincerely,

Jim Sparrow

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.

Blair PD | please file
CG. 12/6.
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10 DOWNING STREET

MR. LANKESTER

John Sparrow is coming to see the Prime Minister at 1600 hours in the House of Commons next Tuesday, 19 June. In the past Mrs. Thatcher did not have any briefing provided as John Sparrow's letters were always the point of discussion. I have warned John that you will probably be present which I assume you would like to be.

eg.

Caroline

12 June 1979

Many thanks.

Tim

Prime Minister

would you like to
take up the suggestion
in the last para - i.e.
a meeting? *Yes please*

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX
01-588 4545

From: JOHN SPARROW

8th June, 1979.

of course *OK*
8/6

Dear Mrs. Thatcher,

As I write, the City awaits the publication of the trade figures with rather more calm than had seemed likely earlier in the week. It is inevitable that markets will be quiet at this stage, so soon before the Budget, but I would make an exception from my general rule that markets have no political significance in the case of any developments on Wednesday. I believe that the markets want to reflect optimism and can be expected to improve, probably quite significantly, if the Budget approximates to the expectations based on your Manifesto and your actions in office. If the markets do go down on Wednesday, I think that this will have to be read as criticism of the budgetary proposals - criticism which I still believe is more likely to be related to the level of the PSBR than to the size of tax cuts, although this aspect too is of importance.

Developments in relation to the energy crisis have been generally welcomed in the City. There are still voices arguing for rationing, but David Howell's statement yesterday was widely approved. The level of profits announced by BP has significance in relation to the subject matter of my letter last week, and in particular to the suggestion that I made there, that any problems arising from the increased value of our oil reserves could most sensibly be financed by recourse to the cash flow which that oil is producing.

It is difficult at this stage to find anything else of immediate importance to comment on, but there is a longer term problem which I would like to draw to your attention. It is becoming increasingly clear that the very generous level of pension benefits which is now common to managements in practically every sector of industry, as well as in the public service, is having some adverse effects. One is that it tends to restrict the mobility of management, as people become aware even in their 40s that their pension rights are too valuable lightly to be foregone. Secondly, the same perception reduces the incentive to take risks and increases the search for security, which does not chime in at all with the intention to stimulate risk taking by means of tax cuts. Thirdly, the general reliance upon pension rights encourages people to live (and spend) for to-day, because they see much less need to have their own pool of savings outside their pension fund; this again operates against the creation of an atmosphere of self-reliance and increases the likelihood of fluctuations rippling through the economy as consumer booms come and go. The last problem is exacerbated by the present practice of giving preferential tax treatment to pension funds whilst actually penalising capital savings. One hopes that the penalties will soon be removed, but that will only reduce the disparity rather than eliminate it.

In discussion of pension funds, most public attention has been focused on the problems likely to arise in the stock markets as the pension fund movement accrues ever larger sums of money. There are some very real incipient problems here, but I believe that more thought also needs to be given to the effects of very large pensions on individual managers. I put it forward as a subject which might be worth some study when the days of immediate action are over and the pause for reflection and long term planning arrives.

E-1 | I am in touch with Adam Ridley and Peter Cropper and hope to be able to spend more time with them when their period of purdah is over. It would also be helpful to me if I could occasionally have a conversation with you, to ensure that I am still heading in the right directions. I have a feeling that, now that you are in office, I should concentrate less on the detail of each week and more on the broader themes and that would be helped if I could from time to time explore the subjects which interest you.

Yours sincerely,
John Spence.

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.

Box - Political Office

SPARROW

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX

From: JOHN SPARROW

01-588 4545

1st June, 1979.

Dear Mrs. Thatcher,

A great deal of attention is currently being focused on the immediate consequences of the latest oil crisis. On the other hand, very little note appears to have been taken of the medium term consequences for the economy and for the financial markets.

The recent rapid increase in the price of oil transforms all previous calculations about the benefit to be derived by the U.K. from its North Sea assets. Because we are a high cost producer the proportionate impact of price increases will be much greater than would be the case in most other oil producing countries. A fairly rapid move from \$14 a barrel to the level in the low \$20s currently being projected is therefore of considerable significance for the balance of payments.

Taken in isolation, the increased flows into the U.K. will be of such a size as to exert very strong upward pressure on the value of the pound. Subsequently, the peak values of sterling would prove to be unsustainable because of their effect on the competitive position of industry and, if the worst fluctuations are to be avoided, it seems likely that there will be a need to intervene in the foreign exchange market to prevent excessive strains when the size of the flows has become apparent. I do not believe that this need is immediate, and I was very pleased to read reports of John Nott's speech to the Export Association in which he stressed the need to accommodate ourselves to a strong pound. But if the pressures lead, as I think they may, to an unsustainably high value for the pound then intervention will be necessary.

This in turn will lead to very severe strains on the money supply, unless the intervention is financed by gilt edged sales. That would only be possible if the supply of gilts is accommodated to the potential demand, which in turn must mean continuing emphasis on reducing the budget deficit which has in recent years in itself required the sale of more gilts than could comfortably be accommodated. If the analysis is right, it also reinforces most of my favourite hobby-horses: the need to relax exchange control; the impracticability of sterling entering the EMS; and the need to ensure that the Exchequer gets its proper share of the oil revenue.

In this last connection, it has been suggested to me that, if there is a problem (as seems likely) in squaring the circle for this year's Budget, one possibility which ought to be considered is that of requiring advance payment of PRT. The basis for this suggestion is that the estimated revenues from this source are under £½ billion in this financial year and of the order of £4½ billion in 1980/81. As the arguments earlier

in this letter almost certainly mean that both figures will be greater, it is clear that there is a considerable pool of revenue which could be brought forward if there were willingness to do so. Indeed, one can short-circuit the whole of the argument by saying that the proper source of the revenues needed to finance intervention in the exchange market would be PRT which ought to be levied in a way that more nearly matches the problems for the economy caused by the flow of oil revenues.

I mention this last point as much as anything because the views I hear about Budget prospects when I travel out of London are very different from those which circulate in the City. In the City, the emphasis is much more on the PSBR, balancing the books, and giving such tax concessions as can be afforded. Industrialists, on the other hand, are much more convinced of the need to cut taxes, not just for selfish reasons but also very widely at the bottom of the tax scales. I believe that the industrialists have their priorities wrong, and I note that the individual views which I hear are not reflected by the CBI in its official representations to the Chancellor. Nonetheless, the fact that those views are held is worthy of some attention.

Yours sincerely,
John Seaman

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.

Prim Antish

CF P.A. Economic Policy

I found this
res interesting.

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX

From: JOHN SPARROW

01-588 4545

R
25/5

25th May, 1979.

Dear Mrs. Thatcher,

The markets this week, and in particular the gilt market, have displayed something akin to the mysterious behaviour of the dog which did not bark in the night. There has been considerable resilience in the face of some apparently discouraging news, including Mr. Healey's confirmation that the starting point for this year's PSBR is in fact the £10½ billion that had been bruited around as well as the disclosure that last year's PSBR overran an estimate made as recently as 3rd April by the better part of 10%.

Whatever adverse effects these announcements might have had has been more than balanced by the growing evidence that your government intends to stick to what it has said. As you know, markets are more interested in the future than in the past or present and the hopes for the future are growing. It is also significant that the move from one side of the House of Commons to the other has of itself enhanced the stature of many of your colleagues and, in this context in particular, that of Geoffrey Howe. In passing, I would add that people who six to twelve months ago were worried about the quality of the team that you would be able to choose to support you are now volunteering the fact that they are surprised to find how good the team appears to be and how well it is shaping up to its task.

Since I wrote to you last week, the prospective oil shortage has become common currency and it has led people to wonder what other problems are likely next winter. At present, most of the people I talk to regard pronouncements from trade union leaders as sound and fury signifying, if not nothing, then certainly nothing disastrous. Mr. Murray's threat to tear up the TUC guidelines which were annexed to (but, as I understand it, not part of) the Concordat published in February comes rather strangely from somebody whose personal position would be severely weakened by such a course of action and who had in any event previously given the impression that the whole document was torn up anyway. However, there is a feeling that it would be prudent to fund as much as possible of the current year's PSBR before Christmas. This does not imply that action this day is required; if the Budget is along the lines that I believe it will follow, I would expect a much more favourable climate for gilt sales to ensue.

The effect of this on the money supply will be augmented by the current crop of rights issues, whose monetary consequences parallel those of gilt sales. The rights issues are helping to depress the equity market which is also seeing some of the bad results that we have been expecting. Significantly, the disappointing results this week all tended to show the impact of strong sterling on corporate profits; you know my views on the desirability of relaxing exchange control to prevent sterling getting unnaturally strong, although I remain convinced that one should not temper the discipline by attempting to make sterling unnaturally weak. Despite the fact that I expect more bad results during the rest of 1979, I think it likely that this market too will begin to discount the future after the Budget and I would expect it therefore to strengthen as the summer proceeds.

It now looks as if the United States economy is moving into recession sooner rather than later. The situation there shows interesting parallels with the period of Wilson government here. The administration is still arguing that the decline in consumer spending will be offset by industrial spending; whereas it seems more probable that the U.S. is in the grip of a classic stock cycle and that industry's reaction to reduced consumer spending will be at least to contain if not to reduce its inventory levels. On the face of it, a recession in the U.S. should be good for the dollar but it will also have the effect of reducing interest rates and thereby discouraging capital inflows. Again I look to the pattern in this country a few years ago when sterling reached its trough in 1976 at a time when the current account deficit had almost been eliminated.

The first real test for the EMS, whose demise has been predicted by Monsieur Chirac without attracting any attention at all, will come in the autumn when the Deutsche Mark is seasonally strong. The combination of oil, high interest rates and new policies should ensure that sterling continues relatively strong.

Finally, there has been renewed comment on our net contribution to the EEC following on the announcement that this has now reached the level of £1.5 billion. This is, of course, £1.5 billion of taxes and £1.5 billion of PSBR and it is therefore significant far beyond the question of our commitment to Europe. It has been suggested to me that the German commitment to agriculture is now so strong that attempts to alter the CAP are unlikely to reap a rich or even a sufficient reward, but that the election of a new European Parliament opens up the possibility of changing the revenue arrangements by which EEC expenditure is financed. Certainly there would seem to be considerable benefits to be gained from what might prove to be the simpler argument that we are paying too much and should pay less.

I very much enjoyed your party on Wednesday and am grateful to you for inviting me.

*Yours sincerely,
John Sparrow.*

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.