Original & Sparrow's letter on ECON POL: May 79 2

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 ½ per cent and rounded to the nearest ¼ per cent. This would put MLR at 16¾ 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~~ notice. It might even have a 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