SECRET

12.7.79

THE GOVERNOR has seen

he called JB 16/7

Subjects discussed unknown, vide RCWM. 16/7.

CALL ON THE PRIME MINISTER: 4.30 P.M. 13TH JULY

Possible Points:

1. The markets - usual briefing will be supplied, including information on intervention.

2. Interest rates - including the building societies' deposit and mortgage rates; MLR.
?also review of building societies.

3. Monetary seminar - to be held at 3.00 p.m. on Wednesday, 18th July. You wished to re-read the Quarterly Bulletin papers. You will recall that CAEG aims to supply a full set of papers before the week-end.

4. Exchange control relaxations.

5. EMS - the Ministerial Committee

6. The euromarket debate - ?mention the Banking Supervisors' Conference.

7. Basle.

8. Meeting with industrialists - 5.00 p.m. 17th July.

9. The Bank's salary settlement.

10. Honours.

I also assume that you may wish to talk about the structure and role of the Bank and perhaps relations with HMT (?the implications of the Select Committee on the Treasury). Perhaps also the Direction.

JB
J.S.Beverly (4121),
Governors' Office.

12th July 1979.

13.7.79.

THE GOVERNOR has seen [initials] 16/7.

SOME POINTS TO MAKE THIS AFTERNOON

1. The World Economic Outlook is deteriorating. We have for some time expected a US recession in the second half of this year. Recent developments on oil prices and supply make it more certain that there will be a recession and more likely that it will be fairly serious.

Previously the expectation had been that the rest of the world would keep expanding reasonably - the link between the US and the rest of OECD is smaller than one tends to think. But the resurgence of inflation and measures to tackle it in other major countries may moderate growth elsewhere and contribute to a more sluggish picture for the world in 1980.

The US ability to pull out of recession - politically very desirable in 1980 - will be limited by the likelihood that their inflationary performance will continue bad; either a tax cut or reductions in interest rates will be likely seriously to weaken the dollar.

2. Exchange Rates. The dollar has in fact already started weakening (after stability from November 1st 1978 to early June and with net intervention not far from zero over that whole period). The weakness started a month ago, since when net intervention by all countries has been nearly 7 billion - a rate of intervention equal to the support given after November 1st.

There is some evidence that the Bundesbank were this time reluctant to start supporting. They make little bones of their belief that the deutschemark should strengthen against the dollar (though preferably of course in an orderly way), both on "fundamentals" and - and this is unhelpful in an international context - because they see a deutschemark reflation as the best way to reducing their own inflation, now accelerating again towards 5%.

Hence yesterday's interest rate rises, but this policy is causing difficulties for other members of EMS. At Basle they urged the Germans not to raise their rates and indicated that a number of them might have to follow - the Dutch and the French have already done so.

For the time being EMS is not under major strain but there has been a good deal of intervention (2 billion dollar's worth since mid-June). There are constant rumours in the markets and everybody fears that if it does not happen earlier there will be speculative pressure which will force a realignment in the autumn while the review of the divergence indicator is being carried out.

3. UK and EMS. In these circumstances and with sterling's strength, none of our partners are pressing us for an early move to join the EMS exchange rate regime. There is everything to be said for not tilting our hand - nor indeed attempting to make up our minds on this until, say, October at the earliest.

4. Sterling. Increases in European interest rates may do something to moderate upward pressure on sterling but these could be easily outweighed if the dollar really starts to fall and, in particular, if the Fed. - in the light of recession - reduces short-term interest rates. There is at present however no sign of this later development.

5. The markets do not appear to be expecting the second instalment of the exchange control relaxations which may perhaps have some moderating effect on sterling's strength, though the effect could be perverse. Even if there was no effect it seems it would be right to delay further major relaxations, or indeed abolition, till the autumn when we have been able to review carefully the implications of total abolition, particularly for our prudential controls over banks, commodity markets, etc.

Cwm