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SECRET

28.11.79

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NOTE FOR THE RECORD

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Mr.Atkinson/Mr.Curzon/Mr.Reid
Mr.Burman
Mr.Hewitt
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Filists

CAEG

I think you put all this very fairly. The GTP's only legitimate grounds for 'puzzlement' in my view is the action of Oct 23rd (EC abolition). No observer would have thought, without exceptional insight into the moving climate of Whitehall & Bank opinion, that the authorities would go ahead with abolition just in front of horrible M figures. The lesson for GTP and others, I suppose, is that excessive second-guessing can be expensive.

GORDON PEPPER ON THE UK GILT-EDGED MARKET

Greenwell's have now published the text of the talk given by Pepper to the Society of Investment Analysts on Monday, 19th November, on the UK gilt-edged market. This did not arrive with me until Tuesday afternoon, and by the time other engagements left me free to look at it, it had already generated comment in the Press, particularly the passages by McRae in the "Guardian" on 20th and 21st November. Although this note is, therefore, too late for some purposes, others may like to have a note for the record on this.

The second part of Pepper's talk did little more than repeat his view that interest rates should shortly decline, as the CGBR falls away and the economy moves into recession. The events of 15th November did no more than make Pepper feel that interest rates have now reached their peak and that a bull market in gilts would exist in 1980. While there are certainly grounds for challenging this view, [for example as long as the desired rate of growth of the money stock is so much below the probable rate of growth of nominal incomes, it is difficult to see much room for downward movements in interest rates], nevertheless the reasons for Pepper's views in this respect are clear and reasonable and unobjectionable.

The first part of his speech, in which he comments on the events of the last few weeks, enters, however, into trickier and more
✓ disputatious ground. I attach a photocopy of pages 1-3, dealing with
✓ these matters, and also copies of the sections from McRae's Notebook which take this argument further. Pepper describes the Bank's actions as 'very puzzling', but it would seem to me in reading the passage as if

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he may be hinting at some larger accusation, though what is not entirely clear. In part, he seems to be implying that we had the chance to react to developments within banking October quickly enough in order to have prevented the excessive monetary growth that then occurred. Furthermore, in part he seems to be implying that by failing to take such steps, he felt that the Bank was in some sense misleading outside commentators.

Pepper mentions three occasions, on which he implies that the Bank might have behaved differently. The first of these was the bid for the existing long-dated tap stock on the last day of the banking month. The response to that has been set out in McRae's piece on 21.11.79, except that he does not know/refer to the fact that we sold some £145 million of non-tap stocks. More generally, however, the Treasury Accountant continued to indicate that the CGBR in October would be very low, or even in surplus, until towards the end of the banking month, by which time conditions in the gilt-edged market had softened sufficiently that it would have been difficult to envisage any large debt sales, without a major change in policy measures.

Pepper's second point is that "the authorities chose not to make the corset bite, even though bank lending was very buoyant" /underlining mine/. This really is a canard. A major reason why the corset was not tighter was because of the much greater than foreseen CGBR, which was only realised very late in the banking month. Moreover, by the end of the banking month, the Bank only had available the first two weeks of the weekly data from the sample of 80 banks. Although the figures for bank lending over this first fortnight did, in fact, show a very large rise, this series is extremely erratic, has large within month and between month seasonal adjustments which are very hard to calculate accurately on the basis of a very short series. Earlier attempts to use the weekly figures as an indicator had often been frustrated by subsequent sizeable fluctuations in the other direction. We do hope to make more use of the weekly data in future as more information becomes available, but it would have been wrong to have made much use of such very partial data. To summarise, we really were not in a position either to prevent the overrun in the CGBR easing the corset automatically, or even to be clear that bank lending really was so very buoyant by the end of the banking month. The idea then that we had the choice of tightening the corset by the end of banking October, and consciously rejected that choice, is simply wrong.

Thirdly, Pepper claims that the authorities' refusal to accept the bid for the tap on 17th October and the abolition of exchange controls on 23rd October represented a signal that the authorities were confident about monetary growth in banking October. It is difficult to see why Pepper feels that the authorities should have behaved differently in these cases in the light of such information as they had about the monetary figures. Again the question of the response in the gilt-edged market on 17th October has been separately met in McRae's column. As for the abolition of exchange control, by this later date there was available a further week's information from the sample of 80 banks which indicated more firmly that bank lending was probably going to be very high, in conjunction with the overrun of the CGBR, which was of course fully known by then. HMT were apprised of this information, though even by then it was only in a partial and provisional state and the decision was made to go ahead nonetheless.

28th November 1979.

C.A.E.Goodhart.