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10 DOWNING STREET

From the Private Secretary

7 June 1979

~~Mr Walker~~

This is, briefly, what
 happened last night.

Dear Tony,

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 7/6

The Chancellor of the Exchequer sent the Prime Minister a minute yesterday evening proposing that MLR be raised by 2 per cent to 14 per cent today. The Chancellor and the Governor called on the Prime Minister later in the evening to discuss the proposal.

The Chancellor and the Governor explained the background. The latest banking figures indicated that money supply was growing at more than 13 per cent at an annual rate. This was due to exceptionally heavy lending to the private sector in recent months and a PSBR running at an annual rate of over £10 billion. The post-Budget projections were for a continuation of these trends at least until the autumn. The Bank's and the Treasury's judgement was that, without an early increase in MLR, bank lending would not be held back and gilt sales would not take place on a sufficient scale to bring M3 back within the 7-11 per cent target which it had been decided would be announced in the Budget. A 2 per cent increase was the minimum needed to create the right expectations so as to get gilt sales moving and to bring about a gradual reduction in interest rates in due course.

As regards timing, there were only two realistic options - to announce the move today or on Tuesday. The Chancellor said that he would far rather that the announcement should come today. It would thus be seen as an inevitable, and proper, response to the banking figures. It would also be out of the way and therefore another part of the 'inheritance', and this would make for a better Budget presentation. The Governor said that he felt less strongly about the choice of dates: his principal concern was that the 2 per cent increase should take place. None the less, after the experience of Mr. Healey's Budget in 1978, he tended to go along with the Chancellor.

/ In reply,

In reply, the Prime Minister said that she could not accept the Chancellor's argument on timing. It left out one very important factor - the fact that today is polling day for the European Election. A jump in MLR today could, in her view, have a significant impact on the Election result. But in addition, she did not find the presentational argument altogether convincing. If there had to be an MLR increase, it could just as well be presented as part of the overall strategy of putting the economy right, and also - although it was primarily intended to bring the monetary aggregates into line - as a partial response to the trade figures. In any case, even if the increase were announced today, the Chancellor would still be held accountable for it as part of his Budget package. The Prime Minister said the increase would have to be on Tuesday.

As for the amount, the Prime Minister said she was doubtful whether a full 2 per cent increase was needed. There seemed to be little expectation in the press that there would be any increase; lending to the private sector might possibly diminish in the next few months as recent special factors unwound; and the Budget itself ought to improve the prospect for gilt sales. Moreover, it was very desirable to avoid an unnecessary increase in view of the likely repercussions on mortgage rates. None the less, the Prime Minister said she was prepared to accept the Chancellor's and the Governor's judgement that a significant increase was required. Whether it should be 2 per cent or something less, she would like them to consider finally in the light of developments over the weekend. *

I am copying this letter to John Beverley in the Governor's Office.

*I would be grateful if you could let me know of their decision so that I can inform the Prime Minister on Monday evening.

T.P. Lankester

T.P. LANKESTER

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HM Treasury.