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Chancellor of the Exchequer

cc Financial Secretary
Sir Douglas Wass
Sir Kenneth Couzens
Mr Ryrie
Mr Burns
Mr Britton
Mr Lavelle
Mr Monck
Mr Turnbull

MINIMUM LENDING RATE

1. We discussed the possibility of a change in MLR this week. This is given added urgency by the possibility that the revised figure for the PSBR in 1981-82 might leak and cause the market to revise its views about the likelihood of a fall.

£M3

2. There is not much of substance to add to the arguments set out earlier. If MLR was reduced we should not be able to quote changes in £M3 as a reason. Though it is declining sharply compared with the rest of last year - the most favourable period - the last 3 months - still sees it growing at an annual rate of 13% and the rate of growth over the last 6 months is nearer to 15%. Moreover £M3 is expected to increase by about 1% over the next two banking months even allowing for recent heavy debt sales. The figures for next year's PSBR also hardly fit with a reduction in interest rates in which £M3 plays much of a part.

The Other Aggregates

3. Turning next to the other monetary indicators, there is not much of a positive argument here. Again looking at the 6 monthly figures - the growth of M1 and the wider monetary base, at around 8%, is compatible with the target range for £M3. There is of course no reason why this should be an appropriate range for aggregates other than £M3. But equally it would be difficult to make out a case for a higher growth rate for these narrower aggregates - most people think in terms of a lower one. M1 and the base have, over the past been about 2% below the growth of £M3 so an equivalent range for these would be more like 5-8%.

4. The explanation for lower interest rates would therefore

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have to be a complex one. We should have to stress the medium term nature of £M3 and say that we were taking into account factors such as the exchange rate and the real economy. This sounds an easy explanation, but I think it is in reality very difficult to make convincing before your full strategy is unveiled in the Budget. We need to expain why we have not moved already and give some idea of the limits to which we are prepared to go in reducing rates. The markets are discounting a fall of over 1% in MLR. It is therefore unlikely that the exchange rate will react very much. It is even less likely that the real economy will react quickly. So the question we have to answer is: what would cause us to stop reducing interest rates in this way? the best answer we could give would be that we would wish to ensure that the narrower aggregates did not begin to rise at an unsatisfactor rate.

5. I think this is close to the way we shall wish to operate next year. But I must confess to being very apprehensive about going very far down this road until we have discussed this furhter with you, and are a little clearer exactly how it will all work out in practice - a subject on which a further submission is being prepared. It would also be useful to know just where the £M3 target is likely to be put following the latest information about the PSBR.

6. If you do decide to make a move there are other arguments we could throw in which support the case. The fall in inflation is one. Real short term interest rates will look higher even in relation to the annual figures when they are published later this week. But we need to use this with care because real interest rates are high everywhere and ours are among the lowest. Moreover, though we apply judgement to interest rate changes, we still wish to claim that the money supply determines interest rates rather than the reverse.

7. I think it is this latter point which worries me most. I doubt if it would be possible for you to stand back and say that the market was determining interest rates. The market is not following your monetary policy when all is said and done. The market is expecting lower interest rates because it is interpreting ministerial hints that lower rates are on the way, come what may. They are not, at present, forming their expectations in relation

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to any of the monetary indicators. To move now might therefore open up a credibility gap which you would find made life difficult in the Budget. It would certainly lead to a mass of speculation about what it implied for your future intentions.

8. I can see why you would like lower interest rates this week and I am sure that we could present a case for doing so drawing on the points I have outlined. But I have not changed my own view that it would be inadvisable given the crucial need to give a careful presentation of the strategy.

P E MIDDLETON
10 February 1981