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Dear Tim,

The Chancellor thought the Prime Minister might like to see the attached note on the effects of a two point fall in MLR.

The Chancellor thinks the note, which reflects discussion with the Bank, sets out the issues very fairly. As it points out, the short run effect depends crucially on expectations. The monetary, PSBR and public expenditure background are of course not good and it will be necessary to see how recent press reports are taken. But it may be possible to convince the markets that a cut in interest rates of this size will not exacerbate monetary growth in the short run. They are clearly getting ready to believe this. And if they do believe it the consequences for £M3 could even be favourable.

Nevertheless, the risks of adverse monetary consequences pointed out in the note are real ones. Reducing interest rates will increase the growth of £M3 over a year to 18 months, so the prospects for the Government's medium term strategy will depend heavily on the forthcoming budget. Moreover, to get a neutral effect between now and then depends on putting a difficult series of announcements in a wider context in which the Government's medium term intentions for the money supply and inflation are seen to survive.

In the Chancellor's view, the reception of the various announcements he will be making next week depends on convincing people that the problems with the money supply are a combination of corset unwinding and imbalance between sectors. Neither of these can be dealt with by

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manipulating short term interest rates. The intersectoral problem has to await the budget. Meanwhile with inflation coming down, the current account strong, the exchange rate high because of the North Sea, and activity at a low level, the Government can afford to bring interest rates down in advance of the Budget.

If this analysis is right, the Chancellor thinks it unlikely that there would be a big fall in the exchange rate. But companies benefit from the lower interest rates regardless of whether the rate comes down and so does the Government in the form of a lower PSBR (and RPI) next year. Moreover some of the other measures - for example the ENIC and the extension of granny bonds - will be easier to sell if short term interest rates are seen to be coming down.

In short, there are risks about taking this step; but on balance the Chancellor thinks they are worth taking.

Yours

John

A.J. WIGGINS
Private Secretary

THE FINANCIAL EFFECTS OF A 2 POINT CUT IN MLR

This note describes our best assessment of the financial effects of a 2 point cut in MLR in present circumstances. The views outlined here are broadly in agreement with those of economists in the Bank.

Policy and Financial Background

2. The effects are assessed against a background in which if there were no change in MLR from its present level and no fiscal action affecting 1980-81, the growth in sterling M3, adjusted for distortions due to the corset, would probably exceed the top end of the target range by, say, around 4% over the period February 1980 to April 1981. Thereafter monetary growth could probably only be kept to the target in the MTFS for 1981-82 if interest rates are kept at around current levels until the end of 1981 unless action is taken to reduce the PSBR below the level of about £10½ billion in the Industry Act forecast. In terms of the policy background it is assumed that the cut in MLR would form part of an announcement in which:

(i) the PSBR forecast for 1980-81 is revised upwards to £11½ billion.

(ii) revised public expenditure plans are announced for 1981-82, implying higher expenditure than previously planned.

(iii) plans to raise taxes - probably PPT and employers' national insurance contributions - are announced in advance for 1981-82.

Effects on the Money Supply and the Exchange Rate

3. We have tried to assess the impact of just the MLR component, not all the measures taken together, and we have looked at the effects both up to the Budget and over the longer term - say a year to eighteen months. The shorter the timescale the more important in any assessment is the impact on expectations in

the markets, and hence the way in which the change is presented. If it were perceived as heralding a change in the Government's basic strategy, the short term impact on the money supply would be much more adverse than if it were perceived as being consistent with that strategy. By the same token, the reverse is true of the effect on the exchange rate: the more the move is seen as a change of strategy the more likely is there to be a significant fall in the rate. In the longer term, however, underlying economic considerations are likely to dominate purely expectational ones and we can probably be rather more confident about the nature and scale of the effects. Whatever the timescale involved, it is important to make appropriate allowance for the impact on banking sector liquidity: we think such considerations would tend to damp down any short run effect on the money supply but enhance the longer term impact as the effect on bank lending comes through.

4. The impact on the money supply in the period up to the Budget could, plausibly, go in either direction although our best guess is that on balance it is likely to be upward. We would expect the level of £M3 to be higher in March than it would have been in the absence of the MLR cut, but by a small amount - perhaps about 1% or even less - although we cannot be at all sure of this. We are more confident that lowering MLR by 2 points would mean higher money supply after a year to eighteen months, other things being equal, and we think the effect over that period could be perhaps 2-2½%. This would imply a higher growth rate during 1981-82, particularly if the effect before the Budget were to be small or even favourable, and this means that any target for 1981-82 would be that much more difficult to achieve.

5. As regards the exchange rate we expect that this would be lower as a result of lower MLR in both the short term and after a year or so, partly because interest rate differentials would be less favourable to the UK and partly because of the money supply effects. But as with the money supply effects

the impact in the short run is particularly uncertain. If the effect on confidence is good, this could affect both the gilts and the foreign exchange markets: for the same sort of reason as domestic investors might be encouraged to buy additional gilts, reducing or even reversing the adverse monetary impact, foreign investors might be encouraged to buy gilts and the downward exchange rate effect could be reduced or reversed. In other words if the short run impact on the money supply is particularly favourable we would be unlikely to see a pronounced fall in the exchange rate - and the reaction could even be perverse. On balance, however, we would expect a slightly lower rate - perhaps around 2% - in the short term, building up to nearer 3% after a year.

6. A two point cut in MLR might enable the Building Societes to reduce their rates somewhat. The 1 point rise in the mortgage rate which might otherwise occur in April next year because of the rise in the composite tax rate would probably be avoided and the rate could actually be reduced by up to a point. We cannot be sure that this would occur; especially since the Societies' share rate is at present uncompetitive, but the effects quoted here assume that it does. A lower mortgage rate would of itself tend to reduce the RPI somewhat, and this effect could well offset the positive impact of the lower exchange rate.

Effects on the Counterparts of the Money Supply

7. The effects on the money supply described above can be analysed in terms of the familiar counterparts, as follows:

(i) PSBR

This would be reduced by a cut in interest rates generally, mainly, though not solely, because debt interest costs would be reduced. Although the biggest effect is likely to be on short term rates, past experience suggests that long rates would also fall - perhaps by around 1 point. The effect on the PSBR would be small in the first instance - probably less than £50 million in

the remainder of 1980-81 - but would build up as progressively more public sector borrowing was financed at the lower rates. In 1981-82 the effect could build up to perhaps £500 million.

(ii) Gilt Sales

It is here where the greatest uncertainty lies. If the MLR cut was convincingly presented as being consistent with the strategy, and if it was thought to be the first of a series of cuts, the markets could actually be sufficiently encouraged to buy more gilts than they otherwise would have. But on the other hand even on an unchanged view about the appropriate level of interest rates in the longer term, the fact that they had been reduced would mean less capital gains in the future and this would adversely affect sales. The effect in the short run could go either way, but in the Bank's view sales might well be higher in the aftermath of the change. Whether this would be sustained throughout the period up to the Budget is another question, and on balance we think there would be lower sales over the whole four months. Sales could easily be, say, £500 million less over the period but the possibility of sales being greater by £500 million certainly cannot be ruled out. If the impact on sales up to the Budget were adverse as, on balance, we would expect, there might be little further effect after the first few months, but if it were favourable in the first instance some reduction in sales could be expected later as the adverse effect on bank lending (see below) came through.

(iii) National Savings

Normally, if the yield on National Savings were kept in line with yields on competing assets, one would expect little impact on inflows. But if it were decided not to reduce yields on, say, National Savings Certificates immediately some increase in inflows might be achieved. Granny Bonds would probably also look more attractive. Both these effects would tend to reduce £M3.

(iv) Bank Lending to the Private Sector

There would be at least two opposing influences at work here. The first is that interest payments on existing overdrafts would automatically be reduced and this would tend to reduce borrowing, particularly by those parts of the company sector facing the most serious liquidity problems: this effect would be partially offset by reduced interest receipts on financial assets. The second is that the cost of borrowing would be reduced, so tending to increase borrowing. This would take some time to build up - both internal Treasury research and, for example, the research recently reported by Christopher Johnson of Lloyds Bank suggest that the peak effect on the growth of bank lending might be after a year to eighteen months - but we are persuaded that it would eventually dominate the first effect. If, as expected, the exchange rate were reduced, the upward impact on prices would also take some months to come through fully. In the first few months - perhaps up to the Budget - the interest payments effect on company borrowing might match or even possibly exceed the other effects: on balance we would expect a negligible, though perhaps slightly positive, net effect over this period.

(v) External Factors

We would expect negligible effects, given that the exchange rate is floating.

Conclusion

8. Any assessment of the effects of cutting MLR now by two points is inevitably subject to very wide margins of error. This is particularly true for the effects in the first few months. Although we are persuaded that after a year there would be an adverse monetary impact - largely due to the effect on bank lending - and the exchange rate would be lower, we cannot be very sure of the magnitude of the effects. In the short run the impact on expectations is crucial, and the effects on both the exchange rate and the money supply

could go either way : but to the extent that the impact on the money supply was favourable the downward impact on the exchange rate would be reduced - or possibly even reversed. If the short term impact on the money supply were small or favourable, the adverse longer run impact would mean faster monetary growth - perhaps 2% or more - during 1981-82. This would cast some doubt on whether the monetary growth rate envisaged in the MTFS for that year could be achieved with the PSBR in the Industry Act forecast and no further change in interest rates.