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Econ Pol. JFH
cc M. Vile C.O.
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10 DOWNING STREET

From the Private Secretary

25 September 1979

Dear Martin.

The Prime Minister gave a lunch yesterday for Treasury Ministers and the Governor. They had a wide-ranging discussion. The following is a summary of some of the points covered.

<u>The Domestic Monetary Situation</u>

The Governor said that the monetary prospect was now a little more encouraging. This was for three reasons. First, the Government's funding requirements would be rather lower over the next few months. Secondly, while lending to the private sector was still strong, there were signs that it might begin to edge down soon. Some of the recent lending had been to finance early repayment of foreign currency loans, and this had increased the level of total lending over what it otherwise would have been. Thirdly, the August figures for lending to persons suggested that this category of lending was beginning to moderate.

On the other hand, there were several anxieties. In the first place, there was the engineering dispute, which was causing uncertainty in the market. Secondly, it was still possible that lending to the private sector would continue at a high level - especially if corporate liquidity worsened in response to big pay settlements. Thirdly, there was concern that sterling might fall further. Insofar as this would worsen the inflationary outlook, this would make gilt sales that much more difficult. Finally, there was pressure from rising interest rates overseas.

The Prime Minister asked whether, against this background, interest rates were likely to fall in time to avoid the increase in the mortgage rate in January. The Governor responded that, although the outlook was very uncertain, it seemed more likely that interest rates would stay up than that they would turn down soon enough.

The Prime Minister then asked whether it would not be possible to tighten the "corset" in order to hold back bank lending. The Chancellor explained that, while the "corset" arrangements could in principle be changed so as to eliminate the existing leakages, the banks and borrowers would almost certainly find new ways of evading the controls. For example, inter-company lending would probably increase. There might also be increased borrowing from abroad. Ultimately, the authorities had to rely on interest rates to bring the level of credit creation to the private sector within the desired limits.

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/<u>Exchange Controls</u>

Exchange Controls

The Chancellor said that a decision would have to be taken within the next few weeks on the further dismantling of exchange controls. A firm decision one way or the other was needed partly in connection with the sale of BP shares. His own preliminary view was that the remaining controls should be dismantled.

The Prime Minister said that she would be glad to discuss this after the Chancellor returned from the IMF/Bank meetings: but her initial view was that there should be no further relaxation for the time being. She felt that it would be a mistake to relax the controls further until the Government's market philosophy was being seen to work. To move any further now could all too easily lead to a large outflow of funds.

I am sending a copy of this letter to John Beverly (Bank of England).

T. P. LANKESTER

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M.A. Hall, Esq.,
HM Treasury.

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NOTE FOR THE RECORD

c.c. Mr. Alexander

The Prime Minister had a brief discussion with the Chancellor and the Governor about recent intervention tactics and the EMS before the lunch yesterday. (Other main points discussed are recorded in my letter of today's date.)

Intervention Tactics and the EMS

The Governor explained the background to the Bank's substantial intervention between 13 and 17 September. The present agreed policy was not to "dig in" at any particular level but rather to "lean on" the rate to moderate marked changes in the rate one way or the other. But it had been thought right to intervene fairly heavily in order to moderate sterling's weakness. To have stayed out of the market would have risked a much sharper fall. While sterling had been too high when it reached $2.30, it was important - in his view - that sterling should stay relatively high. This was on counter-inflation grounds and because a weak pound would make it more difficult to sell gilts and therefore to meet the Government's monetary objectives.

The Chancellor said that the recent instability of the pound - both up and down - was worrying. At some point, joining the EMS might help.

The Prime Minister said she agreed with the present policy of intervention, and that the Bank had been right to moderate sterling's fall. She also agreed that it was important to keep the pound strong if it could be achieved at reasonable cost. But she did not think our joining the EMS exchange rate regime was a starter until the Government's stabilisation policies began to see fruit.

R.

25 September 1979

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