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10 DOWNING STREET

From the Private Secretary

30 June 1980

Dear John,

As you know, the Chancellor and the Governor called on the Prime Minister this morning to discuss the monetary situation.

The Governor said that he was keen to reduce MLR as soon as it was safe to do so, consistent with the money supply growing within the target range. He and the Chancellor had been considering the possibility of announcing an early reduction. The May money supply figures had been disappointing, though the underlying position was not as bad as they suggested. The main worry now was not lending to the private sector, but public sector borrowing. In 1979/80, the PSBR had overshot by £1.7 billion, despite the policy changes announced in November. This was entirely due to excessive borrowing by the local authorities, though the quarterly profile of total borrowing had been very different from what had been expected. The profile for this year's CGBR, forecast at the time of the budget, was for £2.3 billion of borrowing in the first quarter. The Bank were now estimating that first quarter borrowing would be £4.5 billion on a crude basis, and £3.8 billion after seasonal adjustment - i.e. £1.5 billion above the forecast. Borrowing in July was likely to be fairly low, but the August figure was likely to be large again. The reasons for the high level of borrowing so far this year were not entirely clear. It appeared that there were some deviations on the revenue side; but there was a reasonable prospect that these would be made up later in the year. The main reason, however, seemed to be excess expenditure by central Government. In addition, the local authorities seemed to be overspending. If this was to continue - and there were no obvious reasons for thinking that it would not - it would put at risk the PSBR target and also the monetary target. If the risk of overshooting the monetary target was to be minimised, it was necessary to continue with a large funding programme. Gilts sales were going ahead on a substantial scale. But in order to tap the liquidity of the institutions, the authorities had to offer them the types of security that they wanted - and there was considerable criticism that this involved an excessive debt interest burden in future years. On the other hand, the authorities were not sufficiently tapping personal liquidity. During 1979/80, only £700 million had been raised from National Savings Certificates

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and comparable instruments. With the continued need for a heavy funding programme it was desirable to raise more funds from this source. He therefore intended to consider very carefully the options for improving the terms of National Savings Certificates and other improvements - such as improving the terms of "Granny Bonds". It had to be recognised, however, that any improvements in this area would be unwelcome to the building societies.

The Governor went on to say that, notwithstanding his worries about Government borrowing and expenditure, he still saw a good prospect of moving MLR down in the near future. First indications of the banking figures for June, based on the weekly reporting of the big banks, suggested an increase for £M3 of 0.3%. With the addition of the smaller banks, an increase of £M3 of about ½% seemed probable. MI was likely to show a fall. The reasons for this outturn, which was well below what had been forecast, were two-fold. First, despite heavy borrowing, there had been massive gilts sales (and this had put extreme pressure on the banks' liquidity). Second, borrowing by the private sector was estimated to be about £270 million, which was a third of what had been forecast. Offsetting this was an estimated £230 million of "bill leak" - which was a somewhat surprising development in view of the termination of the "corset" in the near future. Leaving out the "bill leak", M3 would be inside the target range; taking the "bill leak" into account, it would still be running slightly outside.

The Governor added that the eligible liability figures to be announced next Tuesday would be on the high side, but they would be accompanied by a note indicating that the figure for £M3 was going to be low. The banking figures for July were likely to be good, and for August disappointing.

Against this background, he had come to the conclusion that it should be possible to reduce MLR. There were of course risks - in particular, the prospect of continued overspending, the impact on confidence of the relatively large "bill leak", and the possible impact of an MLR reduction on the exchange rate. On the other hand, as regards the latter, there was no doubt that the present rate for sterling was too high for manufacturing; and the longer that sterling remained high, the greater would be the risk of a precipitous fall. On balance, these risks seemed worth taking - though this was on the basis that, if for any reason the reduction failed to work (.e.g if the funding programme came to a halt), it would be necessary to increase MLR once again.

The question now was when to reduce MLR, and by how much. On the first of these, his inclination was to announce a reduction this coming Thursday. In view of the Cabinet meeting on economic strategy, to do so the following week might make it appear as being in response to pressure from certain members of the Cabinet. As regards the amount of reduction, he had not yet made up his mind; his inclination was to go for a 1 or 2% reduction. If it was 1%, the market would probably be waiting for a further reduction; and this could be more helpful for gilts sales. If there were to be a reduction of 2%, that would be taken as the most that could be expected for some time.

The Governor concluded by saying that he would be considering this whole question further, and if he did decide to recommend finally in favour of moving this Thursday, he would like to see the Prime Minister again on Wednesday evening.

/ The Prime Minister

The Prime Minister said that she was prepared to approve an MLR reduction this week on the basis proposed if the Governor were finally to so recommend. As regards the extent of the reduction, her instinct was to go for 1 or 1½%. She thought this would be psychologically better than a full 2%. The Chancellor indicated that he was in agreement with the Governor. But on the question of the amount, he suggested that it was important to avoid too large an impact on the exchange rate in view of the effect a substantially lower rate would have on the RPI. He had in mind particularly the problem of the social security uprating which had to be announced in the next few weeks, and which could only be held to 16½% if the Government was still reasonably confident that the inflation forecast to November was not going to exceed this figure.

I am sending a copy of this letter to John Beverly (Governor's Office, Bank of England).

Yours ever,

Tim Lankester

John Wiggins, Esq.,
H.M. Treasury.

KBB