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Subject file 7
Econ PD- Strategy- 164

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NOTE FOR THE RECORD

My letter of today's date to Battishill records the conclusions of the Prime Minister's meeting with the Chancellor this afternoon. The following additional points came up in discussion.

- (i) The Prime Minister noted that the monetary prospect was now a great deal worse - as recorded in the Chancellor's minute of today's date, and that it might be necessary to raise MLR either this Thursday or next. The Chancellor said that the reasons for the deterioration in banking October were far from clear except that VAT receipts were coming in much more slowly than had been expected. Added to this, sales of gilts had been negligible. A further fiscal package was unthinkable (the Prime Minister agreed) and therefore the only option for bringing the money supply back within the target seemed likely to be a further increase in MLR. The Prime Minister said that she was most disturbed by this, and said that she was not sure that a further MLR increase would do the trick. So much depended upon psychology, and it was not clear to her that increasing MLR again would have the necessary effect. The Chancellor said that he and the Governor might need to see the Prime Minister on Wednesday to reach a decision on whether or not MLR should be moved this week; if not this week, it would almost certainly have to be considered very seriously next. Hearing that the Governor was planning a trip to China starting on 15 November, the Prime Minister said that - if MLR were to be increased - he ought to cancel this visit. The Chancellor pointed out that if the monetary prospect did not improve in the next month or two it might well be necessary to consider a further "cut" in next year's public spending plans.
- (ii) On the issue of what figure to publish for the RPI forecast, the Chancellor pointed out that Phillips and Drew were forecasting a figure of 15% for the coming year in their latest report. This was higher than the forecast published in the FSBR at the time of the Budget because energy prices had increased and because the earnings out-turn for 1978/79

SECRET

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and also earnings assumptions for the current year were higher than then assumed. He had decided to shade the Treasury forecast down to 14 or 15%, but he did not believe it was possible to go lower than this. To do so simply would not be credible - and it would also make it difficult to justify an increase in the National Insurance contribution rates which was needed to help finance the PSBR. The Prime Minister said that she was most unhappy to find that the Treasury were still assuming that inflation would be in the mid-teens at the end of 1980. How could this be so if the Government were pursuing a tight monetary policy and when the underlying rate of inflation at present was only 12-13%? She thought that insufficient emphasis was being given to the beneficial effect of the monetarist approach. The Chancellor replied that, in the short term, the crucial factors determining inflation were the earnings assumption and the exchange rate. Monetary stringency would no doubt influence earnings in due course, but the short term effect would be primarily on output. If earnings continued to grow, as seemed likely, over the next 12 months, by 14% plus, then it was hard to see how inflation could be lower than 14%. The Prime Minister reluctantly agreed that 14% should be used for the Bray forecast and the Government Actuary's Report.

- (iii) The Chancellor raised the question again of Mr. Christopher Macmahon's appointment as Deputy Governor of the Bank of England. He had a solid international reputation, and would - in his view - make an excellent appointment. The Prime Minister said that she was still not happy with this proposal. The Chancellor then said that the Governor would want to go back to her on it.
- (iv) The Chancellor said that he was disappointed that the Government strategy was not being adequately put across by Ministers. He felt that he was carrying too much of the burden himself. The Paymaster General had circulated some good material in September, but Ministers were not making enough use of it. This material also needed to be up-dated continuously. The

SECRET

- 3 -

Paymaster General had had it in mind to appoint an Assistant Secretary from the Department of Industry to expedite this work; so far no-one had been appointed. (After the meeting the Chancellor told me that he did not wish this to be minuted between No. 10 and Departments; I undertook to take the matter up with Sir Douglas Wass and then with the Paymaster General himself.)

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5 November 1979

Distribution: Sir Robert Armstrong, Cabinet Office.
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