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Evan B.S.

NOTE OF A MEETING BETWEEN THE PRIME MINISTER AND MR. GORDON PEPPER
at 11.45 A.M. ON WEDNESDAY 4 JULY

The following are the main points which came up in discussion.

I. Asset Disposals

The Prime Minister asked Mr. Pepper for his views on the sale of BP shares. She was particularly worried about the timing of the sale, and whether it would be right to sell any shares outside the United Kingdom. She had earlier taken the view that all of the sale should be in the United Kingdom in order to mop up liquidity and thus have the greater impact on the money supply. But the Treasury were arguing that some sales would be desirable abroad because this would allow a higher overall price, and in any case domestic sales would to some extent be a substitute for sales of gilts. Mr. Pepper said that there was likely to be some substitution between gilts and BP share purchases. But there was a trade-off between higher interest rates and selling these shares in the United Kingdom: the larger the share sale, the smaller the amount of gilts that would have to be sold, and therefore the lower the yield. It would be a mistake, in his view, to flood the London market with, say, £1 billion of BP shares - this would only depress the price. There were various methods of undertaking the sale - for example the market could be "tapped" continuously over an 18 month period rather than in one or two tranches. However, this was a highly technical matter and in any case an extension of the sale over 18 months would not meet the Government's funding requirement. The Prime Minister commented that from a political standpoint it would be better to sell the shares in the United Kingdom, and she still felt it would be better on money supply grounds. However, she understood that, even if the sale did take place entirely in the London market, foreigners would still be able to make purchases. Perhaps a preference should be given in the first place to United Kingdom nationals. Mr. Pepper said that this would not stop foreigners from buying the shares, because a secondary market would quickly develop. He cited the example of the BP sale in 1976: many of the shares which had been sold in

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New York had subsequently been bought by United Kingdom institutions. Mr. Pepper went on to say that Mr. Tom Quinn would be a good person to advise the Government on the details of the sale, although he was sure that the Government was already taking advice from the Merchant Banks.

II. Gilt-edge Funding

Mr. Pepper said that the Bank should have been concentrating to a greater extent on shorter dated stock. Their failure to announce a new short tap immediately after the Budget had been a great mistake. Following the announcement of the MLR increase, they had dropped the price of the long tap by 5½ points. This had caused a shambles amongst the Jobbers and Brokers, and with the shortage of short dated stock it had resulted in a very unsatisfactory yield curve - with yields at the shorter end far below yields at the long end. Both the existing tap stocks were now exhausted and the question arose as to what new stocks should be announced. Mr. Pepper's own view was that it would be right to issue both a new long and a new short stock - perhaps £1 billion of each. But the Bank should try to sell the short stock more vigorously than the long stock and establish a smoother yield curve. The institutions were currently rather short of liquidity, while the corporate sector was reasonably liquid: so this concentration of the shorter end should be feasible. It might also be a good idea for the Governor to indicate in a forthcoming speech that the Bank were going to concentrate more on the shorter end.

III. Money Supply

Mr. Pepper said that it was very difficult to estimate at this stage what the June banking figures would look like. There was a good deal of anecdotal evidence that bank lending to the private sector was continuing at a high level but this was not necessarily conclusive because of the window dressing by the banks for their half-yearly make-up. Nonetheless, he continued to be very worried about the money supply figures. The recent heavy sales of gilts were likely to have been offset by continued private sector lending at a high rate. The latter was suggested by high

retail sales, for example, of cars. The main element in this was likely to be personal lending; corporate loan demand by contrast, which always lagged at this stage of the cycle, was likely to be running at a reasonable level.

IV. Mortgage Rate

The Prime Minister said that it would be disastrous if the mortgage rate rose. If necessary a solution on the lines of the loan scheme devised by Mr. Harold Lever in 1974 should be implemented. But this would only work if interest rates were going to fall before the end of the financial year so that the loans to the Societies would be repaid. Mr. Pepper said that he was certain that interest rates would tumble fast in 1980 because of recession in the USA, the United Kingdom and other major economies. But he was less sure about the next six months. United Kingdom interest rates would fall soon if MLR were reduced. But it would be a mistake to reduce MLR while private sector lending remained high; to do so would be seen as a failure to stick to a policy of monetary discipline. Interest rates ought to fall soon enough to ensure that any loans to the Building Societies would be repaid this financial year; but the timing was still uncertain. Everything depended upon how soon private sector lending came back within reasonable bounds (the latter was currently running at around £800 million per month; it would need to come back to £4-500 million.) The Prime Minister asked if there were other ways of holding back private sector lending other than relying simply on higher interest rates. Mr. Pepper replied that for technical reasons the "corset" was not effective. In fact, the Bank faced a dilemma. Because of the recent heavy sales of gilts, there was pressure on the Bank's liquidity and this was pushing up money market rates. They would, therefore, need to release some special deposits in the near future in order to relieve the squeeze; but if they went too far, the "corset" would become ineffective and private sector lending would not fall. It was very difficult to strike the right balance here: the amount of the special deposit release

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was crucial. Mr. Pepper went on to say that if and when MLR were dropped, it would be better to reduce it by a substantial amount: to reduce it by small amounts and in stages, would add to the foreign exchange inflow.

V. Sterling

Mr. Pepper said the continued upward pressure on sterling was a real worry: the sterling dollar rate above \$2.20 would make it impossible for many industries to stay competitive. However, because of money supply worries, it would not be possible to hold sterling back by reducing interest rates in the near future. This must be achieved by a further early relaxation of exchange controls. The latter might have a perverse effect in the short run, but in due course it would take some of the pressure off sterling.

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c.c. Mr. Wolfson

5 July 1979

✓ Housing (M.A.), May 79.

Ernie Pat.

MY LUNCH WITH GORDON PEPPER

Gordon Pepper and I went over some of the ground which we covered at the meeting this morning. The following points are particularly relevant to the decision on mortgage rates:

- (i) Gordon repeated that he was confident that interest rates would tumble in 1980 because of recession both here and in other major economies. In the shorter term - i.e. the next three months - he believes that interest rates will fall if we reduce MLR. However, he thinks it would be unwise to move MLR before August. This is because of his worries about lending to the private sector which - as he told you - seems likely to be running at a high rate still. A drop in MLR now, and the consequent drop in interest rates would - in his view - put in jeopardy our commitment to controlling the monetary aggregates. (External considerations, of course, none the less, argue for a fall in interest rates. The pound rose to \$2.23 this morning - an effective rate of 71: Gordon, however, would say that sterling must be reduced by a further relaxation of exchange controls rather than an early reduction in MLR.)
- (ii) Gordon argued this morning that we should be prepared to lend the building societies sufficient (for example £200 million per month) to see them through their short-term difficulties, but that this should be repaid before the end of the financial year. The object of the pay-back condition would be to ensure that there was no net addition to public expenditure. I questioned him further about the likely market reaction to this - given that in the short run it would mean an increase in the money supply, even though it would be offset later in the

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year. Gordon in fact admitted that commentators such as himself would react adversely, and would comment that the Government was moving away from its firm intentions on monetary discipline. Such comments could obviously have a bad effect on the market, and if so, would put off the fall in interest rates. So, there are clearly considerable risks in going down the ~~loan~~ road. These have to be set against the effect on family outgoings if people have to pay higher mortgages.

- (iii) Gordon repeated that if the societies are to be assisted, it should be a loan to be repaid a la Harold Lever, and not a subsidy on their interest rates.

12

4 July 1979