CONFIDENTIAL

SUBJECT

Econ Pol

B/c D. Wright

VB

10 DOWNING STREET

From the Private Secretary

3 July 1980

Dear Tom,

As you know, the Chancellor and the Governor called on the Prime Minister at 0900 hours this morning and they decided that MLR should be reduced today by 1%. This is simply to record the basis of their decision.

The Governor said that, since the meeting with the Prime Minister on Monday, new information had emerged on the banking figures for June which was less favourable than he had then indicated. Instead of M3 increasing 0.5%, it now seemed likely that it would have increased by 0.7%. Bank lending was estimated at £410 million rather than £270 million, though the bill leak was somewhat lower than had earlier been estimated. Given these figures, M3 since February would show an increase of 11.2% at an annual rate, which was just outside the target range. This made him more doubtful about the wisdom of reducing MLR at all. Indeed, the money supply figures on their own would scarcely justify a reduction and the new Bank forecasts due the following week could well reinforce his doubts. Bank lending did appear to be moving down as the recession deepened. But the case for a reduction now, rather than waiting for some further improvement in the money supply figures, was that the pressure on the corporate sector caused by high interest rates and the high exchange rate had become too great and needed to be moderated. (If there was to be an early move, it ought to be today: a reduction next week might appear to be in response to the Cabinet discussion on strategy.) A further factor in favour of a reduction was that Barclay's were considering the possibility of reducing their Base Rate. If this happened, and all the more so if the other clearers followed, the authorities would look very stubborn if MLR were held at 17%. Provided he could be sure that Government expenditure was not going to get out of control, it might still be worth taking the risk of reducing MLR by 1%. If it were decided to move, it was essential that the presentation should be got right: the Government must rebut any criticism that it was backing away from the strategy and emphasise that MLR was being reduced by a modest amount because it believed that monetary growth was coming back within the target range.

The Prime Minister and the Chancellor said that on balance they believed it was right to go for the 1% reduction proposed, in spite of the risks involved.

There was a short discussion of a draft press statement - which was subsequently amended in discussion between yourself, myself and the Bank, with the Chancellor's approval.

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

Yours ever

Tim Lankester

A.J. Wiggins, Esq.,
H.M. Treasury.

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SECRET until 12.30pm on 3.7.80.
then CONFIDENTIAL

Econ Pol.

6.

MR J PAGE

cc Chancellor
Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
Sir D Wass
Sir K Couzens
Mr Burns
Mr Ryrie
Mr Barratt
Mr Middleton
Mr Bridgeman
Mr Britton
Mr Unwin
Mr Lavelle
Mrs Lomax
Mrs Gilmore
Mr Riley
Mr P G Davies
Mr Bottrill
Mr Shields
Mr Ridley
Mr Cropper
Mr Cardona

Mr Ingham, No. 10
Mr Prescott, PMG's Office

MLR

The Bank are announcing at 12.30pm today (Thursday) a reduction of MLR of 1% (to 16%). I attach a copy of their press release; the crucial point is to present the change as entirely consistent with the Government's monetary policy. It simply represents a slight adjustment in one of the instruments of monetary control in response to changing economic circumstances. More detailed briefing follows.

Positive

1. The change is warranted by the current and prospective trend of monetary developments. Thus:

(i) There are signs that monetary growth moderated during banking June. (The Bank will not give a precise figure at this stage, but if asked you can indicate that we are confident that £M3 growth in the 6 months to mid June was, at an annual rate, within the 7-11% target range [You can agree that this implies that the figure was under 1% but do not leave the impression that it was ½% or under.])

(ii) With increasing evidence of a downturn in the economy, there are signs that the underlying demand for credit may be beginning to ease. Although the timing of the CGBR has been such that it has been high in the first months of this year, this has been financed by large gilt sales; the long tap was exhausted yesterday and a flow of part payments extending to banking September has been secured. (In detail: part payments totalling over £0.8 billion are due on 13½% Exchequer 1994 and 13% Treasury 2000 in banking August, with a further £0.2 billion on 13% Treasury 2000 in banking September; part payments will also be due in August on 12¼% Exchequer 1985A, but their amount will depend on future sales of this tap.)

(iii) In view of these factors, a slight adjustment in MLR is appropriate for the achievement of the monetary target.

2. Thus the change is entirely consistent with the emphasis Ministers have put on meeting the 7-11% target. They have made clear that interest rates would fall as soon as monetary developments warranted it.

3. The change is not a response to pressure from the CBI or some Cabinet members; nor is it an attempt to secure a lower exchange rate.

4. Caution requires that the change should only be modest. Further falls will follow, but their timing will depend on future monetary developments and prospects.

Defensive

1. Risks for Monetary Control. MLR would not be reduced if we thought this was inconsistent with meeting the target. But clearly we will monitor the position. With the onset of the recession, and the associated easier demand for credit, not to have lowered MLR would have implied we risked undershooting the target.

2. Impact on the Exchange Rate. Interest rates are only one influence on exchange rate; given there is no change in underlying stance of policy we would expect only a modest effect. But the foreign exchange market is notoriously unpredictable.

3. Effect on Industry. The benefit to industry's cash flow will be slight. But it is a step in the right direction. Ministers are well aware of the impact of high interest rates on companies, and they have put considerable emphasis on the need to cut public spending and borrowing to make it possible to meet the money supply target with lower interest rates. Today's cut is a start.

4. Implications for Building Societies. The reduction will ease - but only partially - building societies present uncompetitive position. The implications for the mortgage rate is a matter for the societies, but this change - of itself - is unlikely to mean a reduction in the mortgage rate. However it will reduce the chances of the societies deciding that an increase in rates was required.

5. Impact on Inflation. In the long run, the rate of inflation will be determined by the rate of monetary growth. The short run impact will depend on how the exchange rate reacts.

6. Timing. Given we now have an indication of banking June figures, there seemed no reason to delay a change. [The timing was not linked to today's Cabinet meeting.]

7. CGBR. The CGBR was high in April/May, but it usually is in the first quarter of the year. Tax receipts were particularly affected by the absence of PRT receipts following the decision taken in November to speed up payment. Voted expenditure was over 30% higher than a year earlier in April/May. But movements in the CGBR are always erratic, and we have no reason to think that cash limits for the year will not hold and supply expenditure will not come in line with the forecast. (You can hint that supply issues in June were somewhat lower - the figures will be published on 9 June - hence the word"rather" in the notes to editors.)

3 July 1980 M L Williams M L WILLIAMS

SECRET

PRIME MINISTER

MLR

The Chancellor and the Governor have not yet reached a final view on whether to reduce MLR tomorrow. Accordingly, they want to discuss it with you at 0900 tomorrow morning - the Chancellor hopes he will be able to have ten minutes with you beforehand.

The Governor seems to be vacillating for two reasons. First, the money supply figures now seem likely to be slightly less good than he indicated to you on Monday - 0.7 per cent increase rather than 0.5 per cent. (This is based on further information which has come in from the smaller banks.) Secondly, the money markets have been a bit off - with short-term rates rising. But they have come back today - the long tap is sold out and inter-bank rate is below 17 per cent again. In addition, I suspect that the Governor may be having second thoughts in view of the slight contradiction - which you of course noticed - between his serious concerns about overspending and his view that it is safe to move interests rates down now.

I am told that the Chancellor still thinks it is safe - and worth while - to go for a 1 per cent cut. Even though the money supply figures since February will still be running at an annual rate slightly above the target range, the figure for June does suggest that we are getting back towards the target range; gilt sales are going ahead well; and there is the confidence factor for manufacturing industry. Furthermore, if we do not move tomorrow, it will probably be impossible to move until next month. But there are risks, and it is a difficult decision. If we do decide to go down, it will require very careful presentation.

T.L.

2 July 1980