12/9

CHANCELLOR OF THE EXCHEQUER

cc Financial Secretary
Sir Douglas Wass
Sir Lawrence Airey
Mr Littler
Mr Middleton
Mrs Gilmore
Mr Riley
Mr Williams
Mr Ridley
Mr Cropper

Chief Cashier

MEETING WITH THE PRIME MINISTER: 13 SEPTEMBER
MONETARY PROSPECT

R 13/9

You ~~may~~ like some briefing on the particular points which the Prime Minister may raise when she discusses the note with which you have provided her.

General situation

2. The Prime Minister will presumably be concerned that there has not yet been an opportunity to bring down interest rates, and there is no certainty that it will be possible to do so in the next month or two. It would certainly be premature to think of bringing them down now - indeed it is far from certain that if we brought down MLR at this juncture market interest rates, which is what really matters in relation both to bank base rates and building societies, would follow. We may be in a better position to make a judgement in a month's time, when the new forecasting round will have enabled us to make a comprehensive reassessment of the prospect for the rest of this financial year.

3. It is just possible that developments in the financial markets and the forecasts may be such that it would be justifiable to reduce MLR on Thursday 11 October, to coincide with the next meeting of the BSA Council. But the chance is small. More generally, the BSA recommended share rate (12.5%)* is so far below the present level of market interest rates (local authority three month rate is currently 14⅛%) that it seems extremely unlikely that market rates will fall sufficiently in time for the building societies to be ready to move down their share rate, which is what would be necessary if the increase in mortgage rates on 1 January

* grossed-up

were not to take effect. (Financial markets are so unpredictable, that it is not impossible, just unlikely.)

Bank lending

(a) Credit cards

4. The Prime Minister's Private Secretary has said that she has expressed concern about the extent to which credit cards may have led to increases in bank lending. Credit given through Access and Barclaycard is included in the bank lending to persons figures of the respective banks: the amount outstanding is about one-fifth of total lending to persons, other than for house purchase - about £1 billion - and so under 3% of the total bank advances outstanding. (We do not have precise figures for reasons of commercial confidence.) Credit in respect of such cards may have formed a higher proportion, of course, of the increase in particular months - particularly in June and July last. You may like to draw on the following points in discussion:-

(i) Personal lending as a whole has tailed off. The monthly figures for the clearers, not seasonally adjusted, are:-

	£ million
June	276
July	130
August	62

The August figure is slightly below the average level for the previous three months, March to May.

(ii) Personal lending is therefore, probably, not the main problem.

(iii) The existence of credit cards has almostly certainly made it easier for some people to get bank credit: but to a very significant extent it has replaced other forms of bank lending, notably personal loans for the purchase of durable goods. It has probably also to some extent replaced an element of trade credit which would, in the past, have been financed by the bank lending to the retailer providing the credit.

(iv) The credit card companies agreed, in late 1973, to raise the minimum monthly repayment to 15%, at the same time as there was a sharp tightening of hire purchase controls. The request to do this was removed some 18 months ago, on the grounds that other forms of credit control had been relaxed, and its continuance presented a discrimination against one form of consumer credit. (The diversification of forms of consumer credit, particularly following the Consumer Credit Act, means that hire purchase controls would no longer be effective over the greater part of the field; the possible exception relates to large items, such as cars and caravans.)

(v) Given the relative scope of credit card credit in relation to total bank lending, there would seem to be no case for introducing a discriminatory control in relation to them.

(b) <u>The corset</u>

5. The fact that a number of banks have been in, or near, the penalty zone for the SSD scheme will have caused a number of banks to be more careful about granting facilities to non-priority borrowers. (The directional guidance from the Bank to banks is in terms of restraining lending to the low priority sectors sufficiently to enable the necessary finance to be available to the priority sectors, notably manufacturing, exports etc.) It will also have had an interest rate effect for some borrowers, since many medium term loan agreements provide for the margin over market rates to be widened if the lending bank enters into the penalty zone under the SSD scheme - this therefore reinforces the effect of the general rise in interest rates in deterring borrowers from making full use of their facilities. These two effects should taken together have a progressive effect on bank lending.

6. But, as explained in the paper on monetary control for the July seminar, the SSD scheme has to be regarded very much as a "safety-net" - it is not by itself sufficient to act as a control for sterling M3.

7. It will be necessary to roll-forward the guideline under the SSD scheme within the next two months or so. It will then be for consideration whether the rate of growth allowed for should be reduced. But it would be premature to reach a judgement on this until we have the new forecasts next month.

(c) Acceptances

8. The Prime Minister may seize on the references to the take up of bank acceptances outside the banking system mentioned in the note, and ask whether they should not be brought under control, by for example requiring them to be included within the SSD scheme levels. The simple answer is that any system of direct controls over the banking system, such as the SSD scheme or even a monetary base system, will encourage the development of alternative channels outside the control system when that control system begins to impinge on the financial institutions concerned. The existence of these alternative channels will mean that to that extent the sterling M3 statistic will be understating the growth of liquidity and credit. But over time the alternative channels will also be influenced by the more general factors affecting bank lending, notably interest rates, so that the disparity between the statistic and the effect on the economy will reduce. Acceptances are really the banking system's safety-valve at present. If they were brought within the control, then other forms of disintermediation would develop, and they would almost certainly be less desirable. A great advantage of acceptances is that they are reported, so we know the scale of the problem, and they do not appear to lead to problems on prudential grounds, at least at present. But the alternative routes to acceptances, such as greater trade credit, and bills not accepted by the banks, could not be monitored, and might cause potential problems. It therefore seems preferable to have the avoidance device that we know, than one which we do not.

Other forms of direct control

9. It is presumably possible that the Prime Minister may raise the question of the alternative of other forms of direct control over bank lending. The main points on this were made in your letter to Mr Prior of 25 July last. I attach a copy for ease of reference. (Top copy only.)

J.M.B.

J M BRIDGEMAN
12 September 1979

Your Ref

with compliments

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(Adam Ridley suggested you might like to have this).