cc Econ Policy NEDC

BF Dec 11 '79

R 26/11

BF 30/12/79

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PRIME MINISTER

After your meeting with the Chancellor this morning, which had to be cut short, he mentioned to me three points:

(i) He hoped that you might encourage Mr. Whitelaw and Lord Carrington to make a major speech on economic policy. He felt that too much of the burden of explaining the Government's economic policies was falling upon you and himself. It was important, in his view, that other senior Ministers should be speaking out. He suggested that John Hoskyns might provide Mr. Whitelaw and Lord Carrington with suitable material. (I am sure that you will not want to burden Lord Carrington with anything more at the present; but perhaps you might have a word with Mr. Whitelaw).

(ii) The Chancellor said that he was conducting a post-mortem on how the Bank went wrong in their handling of the October funding programme. Gordon Pepper has published some trenchant criticism of the Bank (see Flag A); and although some of his criticisms are unjustified (as explained in the Treasury note at Flag B), their performance was certainly lacking - especially the failure to arrange any funding.

I also had a 'trenchant' criticism of the Bank at lunch on Friday. We really need to overhaul it again – and I must put someone there who I can rely on. MT

(iii) The Chancellor said that David Lea of the TUC had been in touch with Sir Douglas Wass after the resignation of the NEB Board. Lea had said that there was growing pressure within the TUC General Council for the TUC to withdraw from the NEDC Sector Working Parties, and that this could escalate to demands for withdrawal from the NEDC and possibly the MSC and other bodies as well. Lea explained that this would all come to a head at next Wednesday's TUC General Council meeting, where he thought there would be strong pressure on Len Murray to ask for a meeting with you. Lea thought that this would be counter-productive in that you would be unable to meet the TUC's demands, and that this would then make withdrawal from NEDC, etc. inevitable. He suggested that the position of Murray and others who wanted to maintain contact with the

/ Government

Government would be made a good deal easier if you were to take the Chair at the December meeting of NEDC.

The Chancellor does not think this would be a good idea, although he thinks that Lea is trying to be helpful. The December meeting of NEDC is, as you will recall, to review the economic outlook (in lieu of the economic forum idea); and he wants to handle this himself. But, in any case, your attendance on that day would be difficult: you have the memorial service for Betty Harvey Anderson followed by the Press Gallery Lunch at which you will be making a major speech.

I take it, therefore, that you do not want me to pursue the idea of your chairing the December meeting. That said, if Lea's prediction is correct, we may get a request from Murray next week for an early meeting. If you agreed to a meeting, I do not think it need necessarily be unproductive: I think you could help to calm the TUC down. On the other hand, to refuse a meeting would almost certainly aggravate the situation.

From the Chancellor's point of view, a meeting before the December NEDC meeting would no doubt be helpful - we could probably squeeze this in on 4 December. But, for the moment, we do nothing.

TL

22 November 1979

The UK Gilt-Edged Market

Gordon Pepper, in a seminar organised by the Society of Investment Analysts on 19 November, discussed recent events in the gilt-edged market. He made the following specific criticisms of the authorities' tactics:

(a) The Bank were in a position to realise that the CGBR was running higher than expected in banking October, but made no attempt to make additional sales of gilts in order to offset the likely impact on money supply in that month.

(b) The Government broker in fact refused a substantial bid for the long tap on the last day of the banking month.

(c) The banks' position within the SSD guidelines was relatively comfortable in banking October, although it would have been open to the Bank to squeeze them by reducing the supply of reserve assets.

(d) The authorities' apparent confidence about monetary growth in banking October, as suggested both by their tactics in the gilts market and the decision to abolish exchange controls, added to the shock of the October figures and made the market's reaction worse.

A rebuttal of some of these points has already appeared in the press. They may be met as follows:

(i) We did not know that the CGBR would be high until the very end of the banking month when it became clear that the expected VAT receipts would be dalayed. By this time it was too late to take action in the gilts market. Expectations of a low CGBR had meant we had planned no part payments in the month. The Bank did in fact sell a variety of miscellaneous stocks on 17 October (the payment for which will have been received in banking November).

ie - Gordon Pepper was right.

(ii) A bid was also made for the long tap on 17 October, when the market strengthened a little following the BL ballot. But this came after a period of a declining market and there was insufficient reason to suppose that the market had found a level from which it could be expected to move forward. Moreover sales of the tap would have left the authorities with no tap stock, and the forthcoming announcement on exchange controls, coupled with what we were beginning to learn about the October figures, would have made it difficult to issue and price a new tap without giving the market a misleading indication of the prospect. In other words, a decision to sell out the tap might have wrongly and falsely encouraged market expectations. In fact yields continued to drift downwards after 17 October, which supports the Bank's judgement of the time.

(iii) The banks' position on make-up days depends, inter alia, on money market flows on that day. These fluctuate substantially, unpredictably and the authorities have only partial information at the time. The banks' position at the end of banking October reflected the large CGBR, which as explained above was not fully apparent to us.

More generally, two criticisms can be made of Mr Pepper's analysis:

Not about 'the Tap'

(i) He is writing with the benefit of hindsight, and additional information available to the authorities or current developments is much less, and less useful, than he implies.

(ii) Mr Pepper, like the authorities, has emphasised in the past that attention should be focussed on the trend of money supply growth rather than fluctuations from month to month, which can be substantial.

The Background to 1980

Mr Pepper goes on to discuss the monetary prospect for 1980. He chooses a number of series as indicators of the public and private sector's demand for finance. These indicators have been rising, but since they are likely to turn down, dramatically in the case of the CGBR, monetary growth and hence inflation will start to moderate. This will provide the classic conditions for a bull market in 1980.

The indicators chosen by Mr Pepper are not the most relevant for the purposes he has in mind, and his analysis of cause and effect is suspect. But we would agree with his broad conclusion that monetary growth can be expected to slacken under the combination of the current high level of interest rates and a much lower PSBR in the second half of the year. This will in turn offer the prospect of lower interest rates, although the timing of any fall is uncertain and will depend on a number of other factors.

Some supplementaries are attached.

(This note prepared in consultation with the Bank of England)

and is probably too much

Notes for Supplementaries

Bank's tactics inflated October's figures

The size of the CGBR in banking October was not apparent to us until very late in the month. Because we expected a low CGBR we had planned no receipts from part payments. In fact the Bank did sell stock on the last day of banking October.

Bank's tactics meant subsequent crisis

Different tactics might have wrongly encouraged the market. That could have led to much sharper increases in market rates. The hon member has the benefit of hindsight.

Gilt pricing policy too inflexible

Our objective is to sell a substantial volume of stock over a long period. £5 billion has been sold since mid April. Some proposals for changing tactics could put this at risk, although we are constantly reviewing this. Attention should be focussed on the trend of money supply growth; monthly fluctuations are to be expected.

SSD Scheme not tight enough last month

The high CGBR last month meant that the banks were in a slightly more comfortable position. The banks' position will inevitably change with fluctuations in money market flows.