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THE GOVERNORS

GR 9/11

Meeting with the Prime Minister

Others will be providing you with expert and factual briefs. For what it is worth I attach a set of perhaps rather *very!* unsophisticated points.

Crom

8th November 1979.

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3. PSBR

This was much worse in October than had been expected. More seriously, the worsening does not seem all to have been due to accidents of timing. It is very likely that the PSBR for 1979/80 will be significantly above $£8\frac{1}{2}$ *bn*. The degree of deterioration may not be apparent to markets yet but soon will be. If action is not taken to reduce the PSBR the Government's credibility will in any case be somewhat damaged. This will make it more important to demonstrate the determination to stay within the monetary targets while at the same time making it more difficult to do so.

4. Financing the PSBR

Had we known the banking October position was going to be what it was we could have arranged to have done more financing in the month. To some extent this would, however, have been at the expense of financing in the coming months (by changing the timing of calls) so that the problem of financing from now on

Monetary Policy - What has gone wrong
and what can be done

1. The rate of increase of money supply, especially if allowance is made for distortions, is clearly unacceptably high: it is way above the Government's stated target and it is in any case virtually fully accommodative to the going rate of inflation. It is therefore imperative that action be taken which will help bring the rate of growth of M3 back within the target range as soon as possible. To achieve this any policy package will need to carry conviction in the markets that the authorities are in control and tackling the problem appropriately.

2. The problem can be looked at as made up of three ^{points:} the size of the public sector borrowing requirement; the extent to which the PSBR is being financed outside the banking sector; and the rate of growth of bank lending. In each area developments have been adverse recently - and the PSBR and bank lending have been worse than was earlier forecast. I will take the three areas in turn.

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will have been, if anything, greater. Selling gilts from now on will depend on many intangibles but primarily on the establishment of the belief in the markets that the authorities are in control of the situation and that interest rates are attractive. This is likely to mean either that they are judged to be positive in real terms or that they are more likely to fall rather than rise hereafter.

5. Bank Lending

This has continued stronger and longer than was forecast. This probably reflects both higher figures for nominal incomes, both because of higher inflation and stronger activity. There is a strong parallel here in the US. There, as here, interest rates had risen but were still not seen as high in real terms. Hence the Volcker measures freeing interest rates to move to record levels to administer the appropriate psychological shock.

6. There may be many ways of controlling bank lending or selling government stock but unless they are fully dirigiste they will all involve higher interest rates. Any alternative approach of rationing or direction of funds could not work for long, would have many loopholes and would utterly negate the entire Government strategy.

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