

SECRET



10 DOWNING STREET

EXCHEQUER

From the Private Secretary

18 FEB 1981 13 February 1981

SIR D. WASS

MR MIDDLETON

MR MONCK

MR BRITTON

*Dear Sir*

I enclose my note of the Prime Minister's meeting with the Chancellor and the Governor on Wednesday evening.

I am sending a copy of this letter and enclosure to Tim Allen (Bank of England).

*— —  
T. Allen*

John Wiggins, Esq.,  
HM Treasury

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NOTE FOR THE RECORD

The Prime Minister met the Chancellor of the Exchequer and the Governor at 1700 hours today to consider whether MLR should be reduced tomorrow.

The Chancellor said that this was a very difficult decision. The Governor had advised that a 1% reduction would be desirable and possible provided we could be satisfied that we could justify it in a credible way. By this he meant -

- (i) Acknowledging that the exchange rate was a factor in the decision;
- (ii) Praying in aid the fall in inflation (the 12 month RPI figure to be announced on Friday will be 13.01%);
- (iii) Acknowledging that M3 is no longer the sole guide to interest rate determination (though in effect we had already done this when we decided to reduce MLR in November);
- (iv) Indicating that from now on we would be looking not only at M3 but at the narrower monetary aggregates in determining interest rates and other policy measures.

The Financial Secretary, Mr. Middleton, Mr. Burns and Sir Douglas Wass were arguing against any reduction. They felt that, if there were to be a reduction, it would be better to do it in the Budget - because it would be possible by then to have worked out a full and credible presentation of the decision based on the four points above. On the other hand, he himself felt that it would be difficult to announce an MLR reduction in the Budget because of the high PSBR forecast for 1981/82 which would emerge in it. He also had an instinctive dislike for announcing MLR changes from the Despatch Box.

The Chancellor went on to say that until yesterday he had been in favour of a reduction tomorrow. However, in the light of today's press - following the banking figures of yesterday - he was inclined to recommend against.

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/ The Governor

The Governor said that after a very good press last week, this week's press had been disappointing. The story in Monday's papers that an MLR reduction was being ruled out until the Budget had depressed the market and made the reception of the banking figures less good than it might have been. This made it all the more important that, if a decision were taken to reduce MLR tomorrow, it should be justified in a convincing fashion; and this would involve invoking the four points mentioned by the Chancellor. But Ministers had to be clear what they were doing: it would be no good justifying a reduction in MLR in these terms tomorrow, and then telling a different story in the Budget. His own view was that we would have to be focussing more on the aggregates other than M3 from now on in any case: for it was going to be extremely difficult to hit an M3 target of 6-10% at least in the early months of 1981/82, and there was also an intrinsic case for paying more attention to the narrower aggregates. The Governor also mentioned that, in the Bank's view, the recession was likely to be more severe and continue longer than the Treasury forecasters believed. This was another way of saying the exchange rate should be considered as a factor.

The Prime Minister said that the exchange rate and inflation considerations were, in her view, very important; and she wanted to give industry a boost. But she appreciated the Treasury's anxiety. She would want to consider the matter further with Treasury Ministers and officials before taking a final decision.

As the meeting was breaking up, the Governor told the Prime Minister that the Governor of the Swiss Central Bank had told him in Zurich that the UK was faced with a similar situation on the exchange rate front to that which he had been confronted in Switzerland in 1978. In other words, he would put getting the exchange rate down as having immediate priority over money supply considerations. He had also told him that our monetary base had been growing, if anything, too slowly.



10 DOWNING STREET

CHANCELLER OF THE EXCHEQUER  
 12 FEB 1981  
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 FT  
 Sin (LMA)  
 W BURNS  
 A WATERS  
 12 February 1981  
 A Middleton  
 A MONTAGU  
 A DUTTON  
 A RIGBY

From the Principal Private Secretary

Dear John,

SHORT-TERM INTEREST RATES

The Prime Minister held a meeting yesterday evening with the Chancellor of the Exchequer and the Financial Secretary to discuss short-term interest rates. Sir Douglas Wass, Mr. Burns, Mr. Middleton, Mr. Walters and Mr. Wolfson were also present.

After discussion it was agreed that there should not be a cut in MLR this week. The possibility of a reduction next week should be left open for the time being. In reaching a decision account would need to be taken of developments between now and next Wednesday and in particular of the market's reactions to the RPI and trade figures to be announced on Friday of this week and Monday of next respectively. It was important, however, that whatever decision was taken then was not reached solely in the light of the immediate situation but within a framework of factors which could be used to determine the management of short-term interest rates in a logical and consistent way over the months ahead. We needed to think through very carefully what our objectives were, what the various factors to be taken into account in deciding interest rates should be and what relative weights to give to those factors. The Chancellor of the Exchequer agreed to circulate such an analysis in time for a further discussion on Wednesday 18 February.

Yours ever,

John Wiggins

John Wiggins, Esq.,  
H. M. Treasury.

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