Econ Pol

cc. Master
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Domestic Monetary Policy

NOTE FOR THE RECORD c.c. Mr. Wolfson

Mr. John Sparrow called on the Prime Minister at 1430 hours on Monday, 23 July. The following are the main points which came up in discussion:

(i) President Carter's Cabinet changes.

Mr. Sparrow said that he thought William Miller would be a better Treasury Secretary than Mr. Blumenthal had been. He had consistently said the right things about monetary policy and energy pricing: it remained to be seen whether his words would be turned into action. It was disappointing that the Administration had failed to announce that energy prices would be increased to reflect real economic costs immediately.

(ii) Sterling

The Prime Minister said that it seemed that there was little that the Government could do to moderate the rise in sterling - though, with the very bad trade figures, it must come down before too long. The latest relaxation of exchange controls had, if anything, improved confidence; further relaxation was probably called for, but it would be unwise to move too fast. Mr. Sparrow commented that it was generally assumed in the City that exchange controls would wither away. The trade figures would probably continue very bad for the next few months in his view. Companies such as Courtaulds were rather exaggerating the adverse effect which the exchange rate was having on their operations; but there certainly were some companies which were suffering. In his view, a sterling/dollar rate of between 2.20 and 2.40 was about right.

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(iii) Interest Rates

Mr. Sparrow said that industry was being adversely affected by the high cost of borrowing, which combined with the effect of the high exchange rate on liquidity. He thought that there was a case for a phased reduction of M.L.R.. The July bank lending figures would probably be bad, but there should be an improvement in the August figures. By then the corporate sector should be spending less on inventories partly because of cheaper imports. Loan demand was not sensitive to interest rates; but companies which were borrowing were having to pay dearly. The City were generally convinced that interest rates must come down before long. So if M.L.R. were reduced, there was little doubt that interest rates would follow. In other words, a signal from the authorities in the form of an M.L.R. decrease would not be ignored. The Prime Minister pointed out that interest rates were still below the current rate of inflation. Mr. Sparrow denied this on the grounds that the V.A.T. increase in the Budget was not part of the underlying rate of inflation. The underlying rate of inflation was running at about 12 per cent, which was the same as the yield on gilts. This meant that the bulk of investors in gilts - namely the pension and insurance funds which did not pay tax - were keeping up with inflation. Mr. Sparrow went on to say that the institutions would probably hold back their subscriptions to the new long tap until September when they hoped that interest rates would be on the turn. It was true that, if they firmly believed that interest rates should fall, they would be subscribing now; however, they tended to act like "sheep" and wait until their expectations were confirmed before moving. Falling interest rates would not have much effect on the exchange rate, but they would help to moderate the present high level.

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(iv) Equities

Mr. Sparrow said that the general tone in the equity market was one of gloom and doom. This was due to the strong pound, the poor prospects for profits and the fears of a bad winter.

(v) Aid

Mr. Sparrow said that he hoped the Government would consider the possibility of diverting part of the existing aid programme to E.C.G.D. financed projects. This would help to ensure that U.K. industry benefited from the programme. The Prime Minister explained that the bulk of the aid programme was already tied.

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25 July 1979