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CHANCELLOR

c Chief Secretary
Financial Secretary

CONVERSATION WITH PEPPER

1. There are precedents, such as what happened in February/March this year, for this latest Bank mistake in misreading the ex-ante monetary prospect, mis-timing the gilts calls (part-paid) and (which is less widely known) refusing requests from the market to reactivate taps, which would also have reduced the MS this month.

2. The gilts market is, however, rather dry. The institutions do not seem to have much money to invest, so an MLR hike, (even quite a large one) might not greatly increase investment in government stock. The acuteness of the pressure of current monetary policy raises difficult questions when one looks at what the next target should be.

3. In appraising what happened last month and might happen next one must ask, inter alia, whether the Bank have reason to think that random factors make the standard "make-up" day statistics particularly unreliable. [For your private information, they also collect very confidential weekly statistics, which might show that a more stable pattern emerges if one measures monthly trends between other dates in the month than make-up day. These statistics are not themselves thought to be reliable on a week-to-week basis, so one could only examine what they reveal between eg successive third Thursdays or whatever. The week to week distortions arise from PAYE, salary payments, make-up day and so on.]

4. If next month's MS figures do not reveal that the latest figures were an aberration, then one is likely to face a massive outflow of sterling, and a financial crisis. This would demand Volcker-style action, both on interest rates and, possibly, on techniques of monetary management.

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CHANCELLOR OF THE EXCHEQUER

5. However a major mitigating action would be to announce and publish the consultative document on monetary control at the same time. That, combined with assurances (if possible) that the PSBR really will fall sharply in the last part of this financial year, would make a great difference.

6. In the meantime Bank Base rates will rise very soon - massive arbitraging will occur if not. And one has no alternative but to let MLR follow quickly.

7. In the background, but not far away, lurks the question of what monetary control techniques the Bank really want. One guess is, back to competition and credit control (ie interest rate levers), without active use of reserve asset ratios and management. They would achieve this goal by default if they can knock down all alternatives during a consultation period.

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ADAM RIDLEY
7 November 1979