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CHANCELLOR

cc Financial Secretary
PS/Secretary (No.10) (2)
Sir D Wass
Mr Bridgeman
Mr Middleton

GRIFFITHS, BURNS, ROSE AND FLEMMING

I attach a series of notes on the conversations I was instructed to arrange. That with John Flemming was of necessity very short, but the others were fairly exhaustive. In each case I managed to cover most of the chief issues but not all, partly because to have raised too many questions on my side would have been indelicate.

2. There is a clear unanimity about almost all issues, apart from gauging what has happened to money supply and why and where it will go hereafter. These are matters about which people are understandably very cautious. But this caution does not diminish the firmness of views about the need for action or the general agreement about the form it should take.

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ADAM RIDLEY
9 November 1979

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BRIAN GRIFFITHS

The determinants of and prospects for Bank lending

It is not surprising that money supply and bank lending should be so volatile in the short term, given the many factors which affect them. But one can expect stable relationships over periods of 6 months to a year.

2. Bank lending itself, or rather its trend, will reflect the recession and high interest rates. But one cannot know precisely when.

Interest rates

3. A sharp and substantial increase now a fundamental pre-requisite of monetary policy, and possibly the only thing one can do. It is all the more necessary now that Euro-sterling has become, with the abolition of exchange controls, part of the de facto money supply, since interest rates are the only way one can control it. One must err on the side of caution by acting early and boldly. To do the opposite would threaten a crisis in monetary policy.

4. An MLR increase would probably set off the gilts market, and the rate could be brought down a bit before long. Once recession had set in firmly, rates could be expected to tumble very sharply over a short period - say roughly 6 months hence.

Financial Plan

5. To take an initiative over it before the short term anxieties over trends in and policies for money supply were resolved would be doubly dangerous. It would be deemed a foolish attempt to mask those short-term difficulties. And the plan itself would be thought to be worthless since the existence of unresolved short-term difficulties would make it appear unattainable.

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Monetary Base Control

6. It is vital not to have a repetition of the Competition and Credit Control fiasco. C&C took 4 months between announcement and introduction, and that process was too hasty. MBC would require more. In particular, if one were considering introducing it now, one would need to consider very carefully the role of Euro-sterling, which might otherwise cause broadly analogous problems to the discount houses in 1972/73.

Conventional Controls

7. Special deposits, Reserve Ratios, Quantitative controls and the like would all be useless, since there is an easy foreign escape route from each. All a bank need do is discreetly ask its customers to steer transactions to an overseas branch.

Gilts

8. The present system is necessarily gilt-strike prone and spasmodic in operation. Since the Bank of England cannot in the short-run know a great deal about demand, they will periodically choose to sell stock at what turns out to be the wrong price.

9. The system is wrong. Tap prices are kept still far too long, and should be changed more quickly. There is a very strong case for an open rather than minimum price tender when selling long-dated stock.

10. At the short end of the money markets, more assets are needed; and interest rates should change more frequently and by smaller amounts, though not of course passively. They could still be used to lead the market. This is essential to keep fund managers on their toes, create a measure of uncertainty and thus a two way market. If one decided to do this, it would be vital to warn the market in advance.

Attitudes

11. No one has woken up to the nature of the authorities' monetary

policy till very recently if at all. Both the banking system and the company sector expect or at least feel that they will be "bailed out" if things get difficult.

Exchange rate

12. If Iran or other factors promote an inflow, this could be tricky and one should consider now how one would mop it up. To the extent one cannot do so, it would be far better to endure a temporary rise in the exchange rate than take in a lot of foreign money.

TERRY BURNS

Recent trends in bank lending and money supply

1. On the prospects in the Summer, and assuming no unexpected surprises, the Government's policy had seemed a little risky but not unacceptably so. An £8.4 billion PSBR and 14% MLR should have been enough to bring down the money supply growth within the target range. Now, after the event, it is not difficult to see some reasons why things have gone wrong:

- output has, up till now, been more buoyant than expected; price inflation, and expectations of its future have, too. Both will have bolstered the demand for money and boosted bank lending.

- interest rates have risen unexpectedly high and quickly overseas, thus reducing the incentive to borrow overseas and, by the same token, increasing the incentive to borrow at home;

- exchange control abolition has probably meant that domestic interest rates have to be raised by more relative to overseas to achieve a given degree of monetary stringency.

Sentiment

2. There have recently been sudden but quite unambiguous signs of a gilts strike. In the short-run this is at least in part because an increase in MLR is seen as inevitable, and no one in his right mind would buy gilts till it has happened. But in part this is because there is a growing anxiety about the incompatibility between the PSBR and the monetary targets.

PSBR

3. Published date on the CGBR cause much anxiety, and imply a 79/80 PSBR well above the FSBR projection. Burns' own anxieties on this front are now very marked too, and he suspects action is needed.

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Controls?

4. Direct intervention of any kind would be undesirable, since they would just hide the problem, and would be seen to. People know exchange controls have made a nonsense of them. If there is an imbalance between revenue/expenditure and money supply, it must be dealt with directly.

5. Furthermore, anxieties about the Government's possible willingness to intensify controls are already a serious problem, and have aggravated the authorities' problems. The stories indicating a desire to restrain mortgage interest are the chief problem. The PM's recent statement at Question Time (Thursday 6) ? accepting that interest rates might have to rise after all in the New Year had not been noted generally. People are saying that just as petrol prices were the Americans' Achilles heel, mortgages were the British Governments. A positive affirmation that the Building Societies would not be interfered with is urgently needed.

Monetary Base?

6. Not desirable in a hurry whatever its merits. Memories of Competition and Credit control have become obsessive. But the issue is more fundamental. Monetary control, gilt selling and so on are only operable effectively and reliably when monetary policy is right and create very high interest rates, rationing, and distortion when they are wrong.

7. This is not to say that it would be foolish to announce some moves or other on consultation over monetary base. But that, though sensible, is no substitute for the central measures needed, particularly an early increase in interest rates.

Gilts

8. It is not easy to be objective about selling methods when respected observers and commentators - most, however, with axes to grind - bend one's ear this way and that. However, it would

seem sensible to sell gilts by tender and ensure one mopped up one's target of liquidity, month by month. To hit targets for the quantity of money you must be able to control pretty directly the PSBR and gilt sales, its two principal determinants. The present system is one in which the authorities are often fighting with one hand tied behind their backs, and in which it is thus possible for some parts of the markets to make large and easy profits out of that disability.

Interest rates

9. There is no avoiding a sharp increase. The longer one waits the bigger the gilts strike and the larger the jump needed. One should nip the crisis in the bud hard and as fast as possible.

What is to be done?

10. The ideal response would be:

- a sharp and early MLR hike;
- action to reduce the PSBR, ie expenditure cuts or tax increases;
- new gilts sales tactics;
- on the negative front the avoidance of evasions, in particular an unfrank Bray forecast, and the continuation of anxieties about intervention in the mortgage interest levels.

Reducing the PSBR

11. To achieve much this year would evidently be very difficult. To make firm suggestions about how would require a proper examine of the technical and political possibilities on both expenditure and revenue.

12. But in principal one can say something about the orders of magnitude one would be aiming at. One would wish at least to get

the PSBR back to £8.4 bn this year, and may be more to allow for the fact that, if one standardised the FSBR projection for deviations between projected and actual levels of output and prices, the £8.4 bn figure would be equivalent to less in today's conditions.

13. There is a very strong case for overkill now. Timing considerations are becoming very awkward. There is a risk, if one under-reacted now, that one would be driven to an excessively violent package in, say 6 months time, just when the economy is turning down anyway. The case for "quick and hard" is reinforced by the need to be influencing wage bargaining. The present deteriorating prospect on that front is only to be expected given the effective lack of awareness of the intended tightness of monetary policy.

Retrospect

14. Present problems stem from Healey's errors, from late 1977 onwards. But even if they are largely his fault, the need to err on the side of caution is none the less.

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HAROLD ROSE

Money and lending trends since May

A slow-down in either never seemed probable before early 1980. The Bank of England read far too much optimism into the September money supply figures. The Banks have seen no clear signs of higher Vat payments in October, which strongly implies companies are short of money, only in limited measure because of funding income tax rebates, important though that is. Of course the tax position is of little comfort, as the more that is paid back, the lower the PSBR and Government created liquidity, but the higher is demand for Bank lending ceteris paribus.

2. Barclays - and other clearers - expect lending to remain strong for months and not to slacken before 1980 Q1 or possibly even QII.

3. The determinants of the money supply are not that easy to interpret. One factor leading to high demand for money may be that industry now operates with and wants high stock levels in relation to output, since to do so is very cheap with stock-relief plus tax deductible interest (if you have profits); and industrial disruption - now chronic - dictates higher levels for obvious reasons. The surveys suggest recession is only just beginning.

Policy

4. Interest rates must clearly go up immediately. On the one hand arbitraging is already happening and will get much worse if they don't. On the other, a feeling of gilts-striking is growing fast and that demands an increase. With short interest rates so high the authorities simply look silly if they delay.

5. The PSBR is looking too high. Direct controls are no use if there is unsatisfied demand for credit. It will go offshore immediately, and while it could leave the £M3 statistic looking better, people would not be fooled for long.

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6 . The Bank of England should certainly take a tougher line in its guidance. No one has any feeling of monetary policy being tough. The Bank looked like being so only briefly in the Summer, when it failed to repay special deposits in August. But it soon changed its tune. One would have expected it to take a tougher line in a variety of ways, particularly over personal credit.

7. Barclays only issued a circular to branch managers about restricting the net total of personal credit last month. Since the branches always put up excellent "special case" pleas, this guidance will not be fearfully effective in all probability.

8. The increase in house prices is as telling a sign as any of the relative slackness of credit conditions.

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JOHN FLEMMING

Bank lending and money supply

The underlying determinants are very difficult to disentangle. The exchange control relaxation will, for various technical reasons, make it very attractive to borrow at home and run down overseas loans while dollar interest rates are so high relative of ours, all the more so since US inflation is less than here and their exchange rate is more competitive.

Role of interest rates

2. They will certainly have a dampening effect on credit expansion. But the lags and scale will vary a lot depending on a multitude of factors. Even Milton Friedman, who used to deny they restricted credit, has now recanted and admitted they do. They should be raised immediately.

3. Ruthless pursuit of monetary targets requires ruthlessness over interest rate policy.

Gilts strategy

4. This, too, demands higher interest rates.