COVERING SECRET

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10 DOWNING STREET

PS/CST
PS/FST
PS/MST(C)
PS/MST(L)
SIR D. WASS
SIR L. AIREY
SIR K COUZENS
MR LITTLER
MR MIDDLETON
MR BRIDGEMAN
MR UNWIN MR RIDLEY

From the Private Secretary

12 November 1979

Dear Tony,

I enclose my note of the meeting on monetary policy which followed the Prime Minister's lunch last Friday with Treasury Ministers, the Secretary of State for Trade, the Governor of the Bank of England and senior officials.

I am sending a copy of this letter and enclosure to Stuart Hampson (Department of Trade), John Beverly (Bank of England), Sir Robert Armstrong and Sir Kenneth Berrill.

Yours ever,

Tim Lankester.

A.M.W. Battishill, Esq.,
HM Treasury.

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NOTE OF A MEETING HELD AT 10 DOWNING STREET AT 1400 HOURS ON FRIDAY 9 NOVEMBER 1979

Present: The Prime Minister
The Chancellor of the Exchequer
The Secretary of State for Trade
The Chief Secretary
The Financial Secretary
The Governor of the Bank of England
The Chief Cashier
Mr. Fforde
Mr. Goodhart
Sir Douglas Wass
Sir Kenneth Berrill
Mr. Bridgeman
Mr. Middleton
Mr. David Wolfson
Mr. Adam Ridley
Mr. Tim Lankester

The meeting had before it the Chancellor's minute of 9 November.

The Chancellor said that an increase in MLR up to 16%, or possibly over, next Thursday was inescapable. Against the background of the very bad money supply figures for October and rising market interest rates, failure to raise MLR would precipitate a crisis of confidence. It was essential to get gilt sales under way again on a substantial scale, and a sizeable increase in MLR was an essential pre-requisite for this. In addition, higher interest rates would moderate the expansion of lending to the private sector, though they could not be expected to have a big impact immediately. Ideally, interest rates ought to be accompanied by action to bring down the PSBR. The PSBR was running at a higher rate than had been forecast, and it was making the achievement of the Government's monetary targets that much more difficult. However, there could be no question of a fiscal package. The Government had only just announced its public expenditure decisions for 1980/81, and use of the regulator had to be ruled out on counter-inflationary grounds. But there were still certain possibilities for increasing revenue before the end of the financial year. One such option was to oblige the oil companies to make advance payments of PRT. Although this would require legislation, it could bring in £700 million; and it was worth considering. Speeding up the payment of VAT should also be looked at.

The Chancellor went on to say that he would need to make a statement next Thursday. Besides announcing the MLR increase, he

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proposed to announce the roll forward of the monetary target; on this, he would be bringing forward separately a specific proposal next week. He would also announce the intention to phase out the "corset", and he would also say that the Treasury and the Bank intended to begin consultations shortly on possible forms of monetary base control.

The Prime Minister said that the October money supply figures were far worse than she had been advised they were likely to be when she had discussed monetary developments with the Chancellor and the Governor in September and early October. This appeared to be partly due to the fact that the borrowing requirement in October had been forecast at a much lower level than had transpired, and as a consequence the authorities had not planned on any substantial receipts from gilt sales. It was a pity that the forecast had been so badly wrong. As regards lending to the private sector, it seemed that the existing policy levers were having no effect. High interest rates seemed to be having little effect on loan demand, and existing controls on the supply of credit had proved ineffective. It was disappointing that the Treasury had been unable to come forward with any new proposals for controlling credit on the supply side.

In discussion, it was generally agreed that there was no alternative to increasing MLR to at least 16% if the money supply was to be brought under control. It was suggested that an additional measure might be to intervene in the exchange market so as to push sterling up. Against the background of bad trade figures next week, intervention in support of sterling might be necessary in any case. On the other hand, it was pointed out that supporting sterling would not necessarily improve the figures for M3. In recent months, there had been counter-balancing factors on the external side and it could not be assumed that these would not continue.

As regards lending to the private sector, it was pointed out that it was very hard for the authorities, and even the banks themselves, to bring this under control as long as the demand for credit remained high. Since industrial customers were normally borrowing within existing lines of credit, it was hard - even if they wanted to - for the banks to cut back their lending. As for

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the authorities, measures to control bank lending other than by moving interest rates simply did not work. Schemes such as the "corset", while they might have some effect on bank lending, all too easily led to credit creation outside the banking system. And with the abolition of exchange controls, the opportunities for evasion were now all the greater.

The Prime Minister asked whether there was nonetheless scope for putting pressure on the banks to reduce their lending. The Governor said that he saw the Chairmen of the Clearers every month, and he was ready to use what influence he had. But there was a risk in putting too much overt pressure upon them: if this happened, borrowers might well draw down their overdrafts against the expectation of a worsening credit situation and thus aggravate the position. The Chancellor commented that, while applauding the Government's strategy in principle, the banks did not seem to be taking the message of tight money to heart and putting it into practice.

It was further pointed out that the demand for credit was inelastic in the short run. But consideration should be given to ways of making demand more responsive to interest rate changes. One such approach would be to change the provisions for tax relief on interest payments. The Chancellor said that although changes of this kind could not be introduced until the next Finance Bill, he would consider the possibilities. The Prime Minister suggested that borrowing on credit cards would be lower if people were better aware of the high cost of interest which they were paying on them. More generally, it was argued that the demand for credit would only fall significantly when the economy moved into recession.

As regards measures to reduce the PSBR, the Prime Minister asked about the possibilities of holding back our contributions to the EEC budget. The Chancellor replied that he had had this fully examined, and it was possible to introduce some delay. There had been the possibility, for example, of delaying payment of £50 million earlier that week; but he had decided that in the

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run-up to the European Council that would be unwise. However, this should not be ruled out for the future.

Other possibilities for action on the PSBR were mentioned. First, the Rate Support Grant for 1980/81 was still to be announced. Could it not be reduced below 61%? The Prime Minister said that she did not think it would be possible to re-open the decision which Cabinet had taken on this. Second, additional forward sales of oil - possibly £100 million - might be contemplated for 1979/80. Third, asset sales for the current financial year might be increased somewhat: for example, BGC could be directed to sell Wytch Farm. On the other hand, there was no possibility of selling further BP shares at least for another 18 months: this was effectively ruled out by the prospectus for the recent 5% sale.

The Prime Minister said that she was worried that MLR might be increased to 16%, and gilts sales would still not get under way. She was also concerned about the general psychological effect of raising interest rates still further. She thought the Treasury might be showing excessive zeal in their effort to demonstrate that they were sticking to a policy of monetary discipline. The Financial Secretary commented that, on the contrary, the MLR increase proposed was absolutely essential if the Government's monetary strategy was to have any continued credibility. The Chancellor added that the Government's attitude to interest rates was regarded as an area of weakness. The reports that we were trying to prevent the mortgage rate increase in July had been damaging. It was essential to avoid any further impression that the Government would resist interest rate increases where they were necessary. The Governor said that he was reasonably confident that, following the increase in MLR, gilts sales would start moving again. If they did not, there would indeed be a real crisis; and a fiscal package might then be unavoidable.

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As regards the Chancellor's statement on Thursday, it was argued that it was important to avoid the impression of a crisis. On the other hand, latest developments showed that the Government's decisions on public expenditure were, if anything, insufficiently tough; and it might well be necessary to reconsider the spending plans for 1980/81 in the run-up to the Budget. Reducing public expenditure was much the most effective way of bringing the money supply under control.

As for the announcement of consultations on MBC, it was pointed out that an MBC scheme would not obviate the need for interest rate increases when the demand for credit was excessive. On the contrary, such increases would be more automatic, and possibly larger, than under the present system. It was possible with MBC that interest rates would move in the wrong direction. For example, a large inflow of foreign exchange, by pushing up M3, would tend to push interest rates up automatically. By contrast, under the present system the authorities at least had some discretion to prevent this from happening. It was essential to have adequate time for consultations before any decision to introduce an MBC scheme.

In conclusion, the Prime Minister said that she reluctantly agreed that MLR should be increased to 16% next Thursday. She also agreed that the Chancellor's statement should cover the roll-forward of the monetary target, the phasing out of the "corset", and the intention to start consultations on MBC. The statement should not suggest that further expenditure cuts would now have to be considered. However, the Treasury should pursue the options for reducing the PSBR which had come up in discussion.

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12 November 1979