Copied to ECON POL : Pt 3
Domestic Monetary Policy

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Econ Pol

PRIME MINISTER

MONETARY POLICY

You raised some questions on John Sparrow's latest letter:

(i) Would it be possible to reduce interest rates by a tiny amount if at the same time we got an undertaking from the banks that they would limit credit on credit cards?
I think this is not feasible for three reasons. First, as you know, there is considerable pressure for an increase in interest rates at the moment because of the pressure on the banks' liquidity. This in turn is due to the heavy borrowing by the company sector, and to the recent very heavy sales of gilts to the non-banks. Second, personal lending by the clearers was actually negative in January. Third, it is unlikely that the clearers would agree to limit credit on credit cards unless limits were also brought in on in-store credit cards. The latter have become much more important recently, and it would be difficult to get the stores to agree.

(ii) Could we let MLR go free again?
When it was free, MLR was calculated on the basis of the Treasury bill rate plus ½ per cent and rounded to the nearest ¼ per cent. This would put MLR at 16¾ per cent. However, the Treasury and the Bank would resist a return to the old system since they believe we were getting the worst of both worlds under it: we were being blamed for the level of interest rates and yet we had less control over them than we do now.

(iii) You were told that there is no limit on the amount that local authorities can borrow in relation to their rating income even though the loans are secured on the rates.
There are two types of LA borrowing:-

/(a)

(a) Short-term borrowing through the issue of bills - these are secured on the rates but only for one year at a time. In other words, borrowing at the beginning of the year cannot exceed the total revenue expected from the rates during the course of the year.

(b) Long-term borrowing for capital expenditure. There are no controls on this borrowing as such, but there are controls on capital spending. So the borrowing is controlled by a round-about route.

(iv) John Sparrow suggested that high interest rates are themselves inflating the monetary aggregates by encouraging round-tripping, by attracting money out of the building societies and into the banking system by bringing in money over the exchanges, by increasing the amount of interest which gets debited to over-drawn accounts, and by discouraging domestic deposits from moving overseas. There is some truth in all of these charges, but the question is how to get interest rates down? When we are trying to run a tight monetary policy and the demand for credit from the private sector remains high, interest rates are bound to stay high also. If we were to reduce MLR at the moment the market would almost certainly take no interest. It might even have a perverse effect in suggesting that we no longer were worried about the monetary target. In short, although the high level of MLR and of interest rates generally may be inflating the monetary aggregates, the money supply would probably go even higher if they were to fall at the present time. On the specific point of round-tripping, the answer to this is either for the Bank to ease the liquidity of the clearers (as they have done today), or for base rates to rise still further.

T P L

13 February 1980

10 DOWNING STREET

Tim,

(1) Would it be possible to reduce interest rates by a tiny amount at the same time we got an undertaking from the banks that they would limit credit on credit cards

(2) If so – could we let MLR go free again

and (3) – I spoke to our Borough Treasurer yesterday. He said there is

no limit on the amount that
L.A's can borrow in relation to
their rating income even though
the loans are secured on the
rates. This seems very unwise.
Moreover what happens when we
abolish domestic rates?
4) See Christopher Foster's letter.

[signature]

11.2.80

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Prime Minister

From: JOHN SPARROW

23 GREAT WINCHESTER STREET
LONDON EC2P 2AX
01-588 4545

8th February, 1980.

Dear Mrs. Thatcher,

The City generally is in a mood to wait and see what happens next and there is therefore very little to discuss in relation to the behaviour of the financial markets during the last couple of weeks. One merely notes that, despite a series of domestic problems including the steel strike, the behaviour of the monetary aggregates, and the dismissal of Mr. Robinson, the pound and the equity markets have continued to strengthen, whilst the gilt market remains without a real sense of direction.

Your comments at question time yesterday on the subject of a new monetary base have helped to concentrate attention on that possibility. The authorities in the United States have, of course, been working on a monetary base system for some time now and one of the lessons that has been thrown up by their experience is that it is dangerously easy to control the components of a statistical concept without necessarily controlling the realities which it is supposed to reflect. Since the introduction of the Volcker package the authorities in the United States have been conspicuously successful at controlling the statistics but increasingly unsuccessful at controlling the reality - largely, as your answers in the House indicate, because of the growth of what the specialists call "disintermediation".

This is obviously undesirable in itself; it also has at least one undesirable consequence, which is that the market loses faith in the statistics and recognises their lack of relation to reality. It is for this reason that the U.S. dollar bond market has collapsed in the face of what had been, on the whole, an encouraging series of figures.

There are times when the same sort of danger is already evident in this country. One example is the calculation of the PSBR on a basis which excludes the proceeds from the sale of state owned assets. One has the impression that to the official mind planned asset disposals do not constitute either a part of the PSBR or a supplement to it; it remains a fact that, in market terms, both elements represent a part of the government's financing need and both have identical effects upon the securities markets, and upon the ability of the private sector to finance itself at reasonable cost.

It is possible that we have the same dichotomy between statistics and reality in the case of the monetary aggregates. A policy of high interest rates will itself at some stage inflate the monetary aggregates, by encouraging round tripping, by attracting money out of the building societies and into the banking system, by bringing in money over the exchanges, by increasing the amount of interest which gets debited to overdrawn accounts and, because high rates tend to lead to a high exchange rate, by discouraging domestic deposits from moving overseas. In addition, because capital gains on gilt-edged stocks held for more than a year are tax free, it could to-day prove profitable for corporations to borrow money (inflating the aggregates) to invest in gilts (which may or may not offset the increase).

consultation paper is planned for publication at end-Feb: we will be sent the draft. T.L.

We are aware of this point T.L.

This may well have wider effects.

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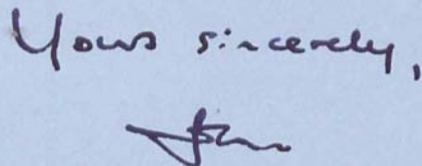
To reverse the argument, it is quite possible that a reduction in interest rates at this moment, which is very far from being a text-book move, would act in several ways to improve the monetary aggregates without any prospect of harm at real level except for the medium term possibility that there might be some small increase in loan demand from the corporate sector. As you know, I believe that corporate loan demand is largely involuntary and relatively inelastic at anything like current interest rate levels and I would not therefore expect lower interest rates to cause any real damage: I would expect a significant psychological advantage.

While the clouds are still massing on the industrial front, it is probably not practical to think in terms of lower interest rates. However, I remain convinced that interest rates must move down rather than up and that they must do so sooner rather than later, particularly in view of the scissors effect suffered by the corporate sector from a linked combination of high interest rates and a high exchange rate. I am told that there is a danger that a reduction of interest rates would be regarded as a U-turn; I think there is also a danger of being over-aware of possible allegations of a U-turn. Most of all, I think it important to keep one's eyes on the real situation and to recognise that even the best statistics are only proxies for reality. The two dominant features of our financial and fiscal position are North Sea oil and the PSBR and financial policy must recognise the consequences of the former and minimise the potential damage caused by the latter.



The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W.1.

cc. Adam Ridley, Esq.