

MR BURNS

cc Mr Rylie
Mr Middleton ✓
Mr Bridgeman
Mr Riley
Mr Bell
Mr Grice
Mr Shields

RELATIVE INTEREST RATES AND THE DEMAND FOR MONEY

1. At the Chancellor's meeting this morning, and on various other recent occasions, we have been discussing the possibility of "tilting the yield curve" in order to reduce bank lending to companies. The aim would be to increase the differential of short rates (MLR, Base Rate, etc) over long rates and therefore encourage companies to fund their debt.
2. We have also been discussing at a quite different set of meetings the determinants of the demand for money. In that context, we have argued that a reduction in long rates relative to shorts will increase the demand for money. I would like to bring the two arguments together, to see whether they are compatible, and to see what policy implications they might have.
3. The demand for money approach must be consistent with a pattern of counterparts including the demand for bank lending and the demand for debt. Suppose then that the differential of shorts over longs is increased. In terms of the counterparts of the money supply, this will reduce the demand for gilts, reduce the demand for bank lending (and increase the supply of debentures or perhaps, but less obviously, of equity). For simplicity, one might assume it was neutral on external flows. This analysis does not tell us what happens to the money supply; but if the direct analysis of the demand for money is right, then the fall in demand for gilts must exceed the fall in the demand for bank lending and the net effect must be a rise in EM3 .
4. If, then, we want to tilt the yield curve, and to do so without increasing the money supply, then some additional measures will be necessary. One possibility would be to raise the whole level of

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interest rates - although, as you know, the evidence that EM3 is sensitive to the level of interest rates is not overwhelming. Another possibility would be to cut the PSBR.

5. Is the advantage to be gained by tilting the yield curve worth this cost?

AJCB

A J C BRITTON
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