

Mr Ryrie

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copies attached for:

Chancellor of the Exchequer
Chief Secretary
Financial SecretarySHORT TERM INTEREST RATES

The Governor told the Prime Minister and Chancellor yesterday that he might wish to recommend a change in MLR this Thursday. If so, he would want to put it to them at a meeting on Wednesday evening. (Mr Lankester's letter to Mr Wiggins of 30 June). This submission which has been discussed with OF gives advice on whether there would be such a reduction this Thursday, and if so by how much. It also deals with one of the two specific points on which the Chancellor has asked for briefing - the possible effects on the exchange rate. The assessment of current CGBR and PSBR prospects is being handled by the public expenditure sector.

General

2. It is essential that any change in MLR should be seen as consistent with the maintenance of the Government's economic policy, and should not signal a change in it. Given what has been said by the Prime Minister and the Chancellor and other Treasury Ministers, a start on the process of reducing interest rates has to be presented as being warranted by the trend in monetary growth, and to be accepted by the markets as such. It must not be thought to be a response to pressure from the CBI or an overt attempt to reduce the exchange rate. From this standpoint, a change of 1% would be far more readily accepted than 2% as consistent with the cautious stance which the Government has so far taken on interest rates - a point returned to below.

Monetary Situation

3. The following table shows for the main aggregates provisional estimates of recent growth rates up to the June make up day:

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GROWTH RATES OF MONETARY AGGREGATES (% a year)

	M1	£M3 [‡]	M3*	PSL1 [†]	PSL2 [†]
Growth at <u>annual rate</u> over:					
Last 4 months (the target period)	- 2.9	11.2	19.4	+ 14.7	+ 13.9
Last 6 months	- 2.8	10.3	11.4	+ 11.4	+ 11.9
Last 12 months	+ 3.1	11.3	12.8	+ 12.1	+ 11.0

[‡] These provisional figures are based on a figure of slightly over $\frac{1}{2}\%$ for banking June

* Figures for M3 are available only up to banking May: the figures therefore relate to rates over 3, 5, and 11 months ending in mid May

[†] The PSL figures are highly provisional

4. Latest information is that the growth in £M3 in banking June was between $\frac{1}{2}\%$ and $\frac{3}{4}\%$. There was a "bill leak" of £150-200 million. The figure for £M3 points to growth over the last 6 months just within the target range though since mid-February it has been just above the top end. Growth in all the wider aggregates has been higher - significantly so in the last four months - partly reflecting the continued bill leak.

5. Within the total, there is still cause for concern about the CGBR/PSBR and bank lending to the private sector. The CGBR is running high, although it does not appear on the latest figures to be getting worse. The underlying level of bank lending in banking June appears to have been significantly lower than in either April or May. But there does seem to have been a three monthly cycle in the bank lending figures - even after seasonal adjustment. It is still too soon to be absolutely confident that the underlying rate of bank lending has turned down. Moreover we do not know what the scale of intermediation will be following the end of the SSD scheme - the clearers' pledge in lending for house purchase clearly reduces the potential upsurge on this account.

6. The position in relation to gilt-edged funding is reassuring with significant receipts already secured for both banking July and banking August: here the longer term prospect turns very much on inflationary expectations. Finally the external factor, which was one of the reasons for the high May money figure, reversed itself in

banking June, so there is a reasonable prospect that we can continue with a negative external adjustment.

7. Taken together, these factors are not totally reassuring. There is no sign that if interest rates remained unchanged in the next month or so the money supply would undershoot the target. Indeed, given the prospect of reintermediation following the ending of the corset, which could be equivalent to perhaps $\frac{1}{2}$ % of the money supply or even more in the next few months, there is a risk that recorded monetary growth might have to be allowed to exceed the target range for a while.

The Forecast

8. You will remember that the recent short term forecast suggested that there was some scope for reducing short term interest rates over the coming months, but not very much. The higher output case in the forecast suggested that a fall in short term rates of about $2\frac{1}{2}$ points would be possible by the end of 1980, and in the more pessimistic, lower output case, the fall was put at only $1-1\frac{1}{2}$ points. These internal forecasts are somewhat more pessimistic on interest rates than those of some outside commentators and what seems to be the consensus of City opinion. The LBS forecast published yesterday, for example, suggested that short rates could fall to around 11% by the turn of the year. On the other hand the National Institute in their May forecast foresaw a need to maintain interest rates at current levels for the remainder of 1980, with little scope for falls in 1981.

9. We therefore see the question in terms of whether the monetary situation is sufficiently secure to risk bringing down rates a little - given that there is always some element of risk in such a move. Now that the rate is an administered one, a change of 1% is about the minimum. (See Annex A).

The Risks for Monetary Control

10. Provided that the fall is accepted by the market as consistent with the Government's present strategy the immediate effect of a fall in short term interest rates might be to reduce $\text{£M}3$, rather than to increase it:

- a. It should help us to exhaust the present tap stocks. A fall

of 1% might leave the market with greater hopes of further falls in interest rates than would an immediate 2% cut, and it would certainly run less risk of seeming inconsistent with the strategy.

b. The PSBR would also fall because of lower interest charges.

c. Bank lending might also be reduced in the short run because of the effect on interest changes - a point mentioned to you by the Clearing Bank chairmen last week. Though in the longer term a fall in interest rates will of course be an upward influence on bank lending; the effect of a change of this magnitude should be more than offset by the deepening recession.

11. A reduction in short term rates now runs two kinds of risk in the slightly longer term:

a. That the growth of the money supply may be accelerating under the influence of an excessively high PSBR.

b. Lower interest rates could make it harder to control the money supply next year.

It is important that if interest rates are to be reduced in the next week or two it should be accepted that:

a. If the PSBR is overshooting on a significant scale, some corrective action will need to be taken in respect of it.

b. Interest rates will be put up again, if that also proves necessary.

c. That it is recognised that the growth of £M3 may be on the high side in the next few months if there is substantial reintermediation.

The Other Effects of a Fall in Interest Rates

a. The Exchange Rate

12. It is difficult to be at all sure what the effect on the exchange rate would be. But a 1% cut in MLR presented as a response to confidence about the money supply would be unlikely to have a major impact on the exchange rate. Looking back over the past year there is quite a striking association between changes in the uncovered interest differential and the sterling-dollar rate, but the magnitudes involved in that relationship point to quite a modest scale of

response. Thus if MLR were now cut by 1% the relationship would suggest a reduction in the exchange rate of only about 1½% (compared with an appreciation of the effective rate of 3½% since March). The Treasury model points to an effect of the same order of magnitude.

13. The risk of a fall would be much greater if MLR were cut by 2%. There would be a real risk that the foreign exchange markets would interpret it as a weakening of the Government's commitment to the money supply target, and possibly even as a step specifically designed to bring down the exchange rate. If that became the view of the market, the resulting fall in the exchange rate could be much more than twice the fall resulting from a 1% cut.

14. Some maintain that the recent strength of sterling is partly a reflection of overseas interest in gilts. If this is correct a small fall in MLR, which was seen as the first step in a progressive reduction, could actually provoke inflows. On the other hand a large fall, which suggested that no further fall was likely could lead to profit taking followed by a more major outflow.

b. The Effect on Industry

15. The effect of a 1% change on industry in terms of cash flow could be slight. But it could help morale considerably by showing that the Government was in fact ready to bring interest rates down where it felt that it was possible to do so in relation to control of the money supply.

c. The Mortgage Rate

16. A reduction of 1% could also help with the building societies, both easing their present uncompetitive position and reinforcing hopes for further improvement. To some extent these hopes are likely to be better sustained and the chances of a mortgage rate increase reduced, by a series of steps than by a 2% step followed by a long period at the new level. Moreover, any subsequent increase in MLR - say from 15% to 16% - would almost certainly be seized on by societies as an opportunity to increase the mortgage rate so that they could improve their competitive position. Both factors point to 1% rather than 2% now.

d. Inflation

17. In the short run at least the only significant effect on inflation is likely to come from the exchange rate adjustment. If we are right in thinking that a cut of 1% in MLR would result in a change of say 1½% in the exchange rate, the effect on inflation this year would be negligible. An immediate 2% cut in MLR might have rather more serious consequences, not only because the exchange rate effect could be disproportionately great, but because it could influence expectations about inflation, and hence price and wage setting, in domestic markets.

18. If a cut in MLR made enough difference to prevent an increase in the building society mortgage rate later this year, then it could actually have the effect of keeping the RPI below what it would otherwise be - 1% on the mortgage rate adds between ¼% and ⅓% to the RIP.

Timing

19. If it is accepted that the change should initially be 1%, with the presumption that the case for a further 1% would be considered when the market sees the July figures, there would probably be advantage in announcing a change in MLR this week. It would involve the authorities effectively saying to the markets that they thought that a change of 1% was the appropriate response to the combined ELs/money supply figures to be published next Tuesday and CGBR figures on Wednesday, and so avoid possible over-reaction in the markets in opposite directions on those two days. The Treasury Bill Rate would, on the old formula, already suggest some fall in MLR, so there is little risk that the markets would subsequently think that an adjustment downward of 1% was unwarranted.

20. However, there are two wider considerations which point to a change this week rather than next. The first is that a change this week, which despite the obvious awkwardness would have to have been decided before Cabinet on the economic situation, is less likely to be seen as a move by the Chancellor yielding to pressure from his colleagues than a change one week after the Cabinet. More important, however, is the point that unless the Chancellor takes a very firm line with his colleagues, ^{that} there is little immediate prospect of a reduction in interest rates the chances must be that any hints he gives

to his colleagues will be reflected in some way in the press over the weekend. This may excite exaggerated expectations, and the markets could run away from us. It would be preferable to give a clear message to the market by moving MLR, rather than an indirect message, which could easily get distorted in transmission.

21. On the other hand there must be risk that a move downward this week of as much as 2% would misfire: the market would not be sufficiently reassured by the banking June money supply figures and calendar June CGBR figures to feel that the move was justified, would therefore see it as a weakening of the Government's position and so would not bring market rates down to match the fall in MLR. (The risk of such a perverse reaction to a 2% cut could be very much affected by the reports reaching the press over the next few days of the Cabinet discussion on Thursday).

Conclusion

22. The arguments on the substance and timing combine to suggest that a reduction in MLR of 1% would offer encouragement to the public and would be an acceptable risk in the light of the run of monetary figures:

- a. The market will not know the June figures. A 2% fall would astonish them. Reductions in interest rates downwards are usually less precipitate than movements up. 1% is consistent with the present cautious approach. And there is very little risk that the markets will judge it to have been inappropriate when they do see the figures.
- b. There is much less risk of a 1% fall being misunderstood overseas.
- c. The risks of leaks and misinterpretation would be minimised by an announcement this week.

23. While clearly market developments in the next 24 hours are important, the Chancellor may feel that it would be wrong to have the initiative entirely with the Governor, and may therefore wait to discuss the issue with him again tomorrow evening, irrespective of whether or not the Governor decides to recommend a change.

P E MIDDLETON
1 July 1980

THE QUANTUM OF A CHANGE IN MLR

The Chancellor asked what the size of the successive reductions in MLR had been during 1977. The attached table from Financial Statistics (Table 13.11) shows that they were between $\frac{1}{2}$ % and 1%. However, that was under the old arrangements for determining MLR, so they do not really provide a precedent for the present situation.

2. Under the arrangements which applied from October 1972 until May 1978, MLR was normally set $\frac{1}{2}$ % higher than the average rate of discount for Treasury bills at the weekly tender, rounded upwards to the nearest $\frac{1}{4}$ %. Special changes in the rate, intended to mark a change in monetary stance, were not precluded, and there were a number of step changes upward in MLR. Falls in MLR were always produced by ^{the} formula. This did not, however, mean that the authorities did not seek to influence the way in which MLR fell: they used combinations of overt signals to the market, by forcing it to borrow at MLR, discrete signals, such as through the Governor's talk to the Discount Houses on Thursday afternoon, and open market operations in order to influence the result of the Treasury Bill tender. In March 1977, when these measures proved inadequate to prevent the rate being carried down too rapidly, the authorities took power to override the result of the Treasury Bill tender either holding MLR at its previous value, or only reducing it to match part of a fall in the Treasury Bill rate. This hybrid arrangement proved to have almost as many difficulties as the so called market related arrangement, and it was ended in May 1978 when we switched to a fully administered rate, like the old Bank Rate.

3. Under the administered rate system, we have, on occasion, allowed market rates to move quite a significant way away from MLR in either direction: for example we did not follow market rates upward when 3 month money market rates went over 18% for a period in February and March. Instead, the administered rate has been used:-

- i. to generate movements in market rates - usually upward since while we can ensure that market rates follow MLR upwards, we cannot ensure that they follow it downwards;

- ii. to confirm movements in market rates which have already taken place.

Given this new role, there would seem little point in moves of a fraction of 1%. Indeed, both the frequency of use and the increase in the absolute level of interest rates have tended to devalue over time the significance of a change. Two per cent is probably now the minimum upward change which is likely to have the desired psychological effect on the market. Given the fact that we cannot force rates down, there probably is still room on occasion for changes down of only 1%, if the authorities want to confirm a slight downward movement in interest rates, and encourage the market to go a little further, without running the risk of the market thinking the action perverse, and so refusing to follow.