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cc MR WHITMORE
MR WOLFSON
MR WALTERS

Subject

ECOM PDJ
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NOTE FOR THE RECORD

The Prime Minister met the Chancellor of the Exchequer and the Governor at 1700 hours today to consider whether MLR should be reduced tomorrow.

The Chancellor said that this was a very difficult decision. The Governor had advised that a 1% reduction would be desirable and possible provided we could be satisfied that we could justify it in a credible way. By this he meant -

- (i) Acknowledging that the exchange rate was a factor in the decision;
- (ii) Praying in aid the fall in inflation (the 12 month RPI figure to be announced on Friday will be 13.0%);
- (iii) Acknowledging that M3 is no longer the sole guide to interest rate determination (though in effect we had already done this when we decided to reduce MLR in November);
- (iv) Indicating that from now on we would be looking not only at M3 but at the narrower monetary aggregates in determining interest rates and other policy measures.

The Financial Secretary, Mr. Middleton, Mr. Burns and Sir Douglas Wass were arguing against any reduction. They felt that, if there were to be a reduction, it would be better to do it in the Budget - because it would be possible by then to have worked out a full and credible presentation of the decision based on the four points above. On the other hand, he himself felt that it would be difficult to announce an MLR reduction in the Budget because of the high PSBR forecast for 1981/82 which would emerge in it. He also had an instinctive dislike for announcing MLR changes from the Despatch Box.

The Chancellor went on to say that until yesterday he had been in favour of a reduction tomorrow. However, in the light of today's press - following the banking figures of yesterday - he was inclined to recommend against.

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/ The Governor

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The Governor said that after a very good press last week, this week's press had been disappointing. The story in Monday's papers that an MLR reduction was being ruled out until the Budget had depressed the market and made the reception of the banking figures less good than it might have been. This made it all the more important that, if a decision were taken to reduce MLR tomorrow, it should be justified in a convincing fashion; and this would involve invoking the four points mentioned by the Chancellor. But Ministers had to be clear what they were doing: it would be no good justifying a reduction in MLR in these terms tomorrow, and then telling a different story in the Budget. His own view was that we would have to be focussing more on the aggregates other than M3 from now on in any case: for it was going to be extremely difficult to hit an M3 target of 6-10% at least in the early months of 1981/82, and there was also an intrinsic case for paying more attention to the narrower aggregates. The Governor also mentioned that, in the Bank's view, the recession was likely to be more severe and continue longer than the Treasury forecasters believed. This was another way of saying the exchange rate should be considered as a factor.

The Prime Minister said that the exchange rate and inflation considerations were, in her view, very important; and she wanted to give industry a boost. But she appreciated the Treasury's anxiety. She would want to consider the matter further with Treasury Ministers and officials before taking a final decision.

As the meeting was breaking up, the Governor told the Prime Minister that the Governor of the Swiss Central Bank had told him in Zurich that the UK was faced with a similar situation on the exchange rate front to that^{with} which he had been confronted in Switzerland in 1978. In other words, he would put getting the exchange rate down as having immediate priority over money supply considerations. He had also told him that our monetary base had been growing, if anything, too slowly.

TL

11 February 1981

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