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PRIME MINISTER (2)

26 July 1984

FUNDING MEETING, 24 JULY 1984

The Funding Meeting was like a wake following the death of low interest rates.

National Savings now expect brisker sales, as they have raised their interest rates to 12.75 per cent on Income and Deposit Bonds, and 9 per cent on their Certificates - a 1.75 per cent increase.

The Bank is recommending carrying on with its sales policy of tranchettes of a full range of instruments (shorts, mediums, longs and index-linked securities). If market conditions strengthen, the Bank would propose a new partly-paid short, and they are also contemplating putting to the Financial Secretary some proposals for call options and zero-coupon bonds. These would need careful appraisal before agreeing to them.

I argued at the meeting that the market was now worried about 3 issues:

1. Does the Government have a sterling target? Is it going to increase interest rates again if the pound falls further?

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2. Money growth has been excessive in the first 3 months of the year.

3. Is public expenditure under control?

I suggested that the only way to reassure the market is to demonstrate by actions that these problems are of the market's imagining; that the Government does not have a sterling target and is not intervening; that the monetary problem will be corrected as the heavily front-end loaded PSBR comes under control; and public expenditure will remain disciplined as the announcement on local authority spending this week should have reaffirmed in part. The most important thing is to persuade market participants that the next move in interest rates is going to be down. The Bank of England still has considerable influence in money markets and, through its actions, will have to persuade the market that this is both likely and possible.

Some people at the meeting were sceptical about whether it was now possible to create this virtuous circle, decoupling sterling rates again from US rates. The meeting was unsure about whether US rates would go up further or not, was naturally concerned about the industrial background, and felt that US and UK rates would remain closer together for rather longer than we wanted. Some felt there might be another increase in both US and UK rates.

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The Bank did not recommend a new full-scale long stock: this idea is currently out of favour with most at the meeting, and Eddie George, who most favours it, was absent.

The one piece of good news is that equity sales by the public sector are running at a satisfactory level, and companies are still raising substantial sums of money from the equity market (eg recent Nat West and Thorn rights issues).

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