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10 DOWNING STREET

From the Private Secretary

6 June 1985

MONETARY POLICY

When the Chancellor and Sir Terry Burns came to see the Prime Minister yesterday, she expressed her concern about monetary policy. First, she felt that monetary conditions were too lax. £M3 was persistently above the top of the target range; inflation had ceased to decelerate and, even allowing for the distortions caused by mortgage interest rates, might now be accelerating; house prices were rising rapidly.

Secondly, she was concerned that the monetary arrangements introduced in 1981 were not working properly. £M3 was contained only by persistent over-funding, leading to the creation of the bill mountain. The Bank had originally intended to operate only at the short end of the money market, keeping the seven day rate within an undisclosed band. The band had become a point and the Bank operated all along the yield curve. It, rather than the market, was the dominant influence in setting the bill yield curve which was often inconsistent with rates in the inter-bank market, thereby setting up opportunities for arbitrage. The Bank stood ready to relieve cash shortages at a known interest rate without penalty. There was thus no restraint on bank lending. She believed this perpetuated many of the weaknesses which the studies in 1980-81 had sought to eradicate. Whatever view one took of current monetary conditions, these weaknesses of monetary control created the risk of higher inflation in the future.

Thirdly, she queried the wisdom of selling long-dated gilts. She had hoped that this policy had come to an end.

The Chancellor argued that the rapid growth of £M3 did not necessarily point to lax monetary conditions. Real interest rates were undoubtedly very high; the exchange rate had recovered substantially and narrow money was growing satisfactorily. The rise in inflation was more likely to have been due to monetary conditions in 1984 than to current conditions.

On monetary control, the Chancellor said he too regarded heavy reliance on over-funding and an ever-growing bill mountain as unsatisfactory. The problem of the bill mountain was not that it itself represented a threat to inflation, but that it made it impossible to operate the monetary arrangements in the manner originally envisaged. There were two requirements for breaking out of the present bind - a rise in short-term interest rates and a willingness to place less emphasis on £M3 and see it grow more rapidly for a time.

On funding, he said the Government had kept out of the long end of the market in the hope that companies would move in. This had not happened, with companies preferring shorter-term finance. With the present yield curve long-term gilts were not excessively expensive. The yields being demanded on indexed gilts were higher than had been expected.

Summing up the discussion the Prime Minister asked the Chancellor to discuss these issues with Sir Alan Walters and the Bank of England. A paper should be prepared analysing monetary conditions, the problems of monetary control and funding policy, and suggesting what further action might be taken. This would then be discussed with the Treasury and the Bank. I would be grateful if the paper or papers could reach me during the week beginning 17 June. The Prime Minister will also want to know the views of the Bank of England. Could you let me know whether this would be done in a joint paper or whether the Bank would prefer to submit a separate paper of their own.

A.T says 5/10 no need to chase

I am copying this letter to John Bartlett (Governor of the Bank of England's Office) and to Sir Alan Walters.

Andrew Turnbull

SMH

Mrs. Rachel Lomax,
H.M. Treasury.