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PRIME MINISTER

MONETARY POLICY

Inflation Prospects

John Redwood and I agree with Alan Walters and the Treasury that inflation will come down when the mortgage rate increases drop out of the index. The stable exchange rate and high interest rates mean that policy is again prudent after sailing too close to the wind last year. But we are not on target for 3% inflation by 1988. What do the Chancellor and the Governor think we need to do to get there?

Alternatives to Over-funding

If we stop over-funding, then we must:

either: accept that £M<sub>3</sub> will grow faster;

or: raise short-term interest rates to hold down £M<sub>3</sub>.

The Chancellor has cautiously embarked on both approaches. There are obvious risks in going too far. If we abandon £M<sub>3</sub>, the City might misinterpret it as loosening up for a pre-Election boom, and the exchange rate might fall. Higher short-term rates are unpalatable if the mortgage rate rises.

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The Money Markets

Money market operations are the economist's equivalent of the Schleswig-Holstein question. Only 3 people understand them: one's dead, one's forgotten, and the third's gone mad.

The money market position measures the net daily flow of cash between the public and private sectors. It is the balance of payments between them. Bankers' balances at the Bank make the final adjustment.

It follows that private sector bank lending doesn't cause money market shortages. One bank's loan is another bank's deposit. If I borrow money to buy a car, the garage then banks it. These are transactions purely within the private sector.

Moreover, over-funding isn't the only cause of shortages. Just rolling over our current stock of bills, as they mature and cash goes to the Bank, means continuous money market shortages, even if we never over-fund again.

Conclusion

- Although policy is now tighter, we are not on track for 3% inflation by 1988. How do the Bank and Treasury see us getting there?

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- Don't change the way you formulate policy so suddenly that it gives an impression of instability. Can the Bank and Treasury be reconciled on monetary targets and keeping £M<sub>3</sub> for the time being?
- Stopping over-funding won't necessarily stop money market shortages. But would there be agreement to less funding?

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