SUBJECT
cc Master.

File

MG 1R7
B/c: Mr Redwood

12

10 DOWNING STREET

25 June 1985

From the Private Secretary

Dear Rachel.

MONETARY POLICY

The Prime Minister held a meeting today to discuss monetary policy. Present were the Chancellor, the Economic Secretary, Sir Peter Middleton, Sir Terry Burns, Mr Cassell; the Governor of the Bank of England, the Deputy Governor, Mr McMahon and Mr Goodhart. Mr Redwood was also present.

The Prime Minister said she was worried about a number of aspects of monetary policy. She doubted whether monetary policy had been tight enough during the second half of 1984 and this had contributed to the current increase in inflation. She also doubted whether the current stance of policy was consistent with bringing inflation down to 3 per cent by 1988. There were a number of worrying indicators of inflationary pressure such as the growth of wages in the private sector and the increase in house prices. Those countries where inflation was under control had built up a reputation for sound finance over many years which enabled them to respond flexibly to external developments without creating doubts about their fundamental commitment to low inflation. There was a danger that recent developments in Britain had damaged the reputation which had been built up over the past six years.

The Prime Minister was concerned at the extent of over-funding and the size of the consequential bill mountain. The Government had argued that it was necessary to keep public borrowing down in order to reduce interest rates but this argument was undermined by the deliberate practice of issuing more debt than was needed to meet the Government's borrowing requirement. She wondered also just how effective this technique was, in the longer term, in controlling sterling M3. It was possible that the issue of more long term debt by the Government pushed companies towards seeking short term, bank provided, finance.

She was also concerned that the Bank's willingness to relieve the shortage each day in full at the prevailing interest rate encouraged banks to extend their lending. Bank lending might be curbed if the the banks recognised that only part of the shortage each day would be relieved at

the prevailing rate while residual money market assistance would be at a penalty rate.

The Chancellor acknowledged that monetary policy may have have been too lax at the end of 1984 but the Government's conduct of monetary policy had been complicated by the need to ensure the success for the BT flotation and by the unexpected surge in the dollar. He believe that this position had now been corrected and that the current stance of monetary policy would deliver a declining rate of inflation over the next year. 3 per cent inflation by 1988 was still attainable.

The discussion then turned to the reasons for the rapid expansion of bank lending in recent years and the implications for monetary policy. It was noted that the banking system in the UK had been freed of controls, other than of a prudential nature. Within this framework, the UK banks had shown themselves to be powerful competitors with the result that the banking system had taken over the provision of credit which had previously passed through other channels e.g. trade credit, off-shore lending and long term capital market issues. The reasons why companies were both borrowing on a large scale and building up their liquidity were only imperfectly understood. This was not helped by the inadequacy of statistics for the corporate sector. The result of these trends had been a rapid expansion of bank deposits and hence of sterling M3. It was a matter of dispute how far the growth of sterling M3 was a reliable prediction of inflation. It had not proved so in 1980-81; on the other hand, the authorities could not safely ignore such a rapid build up of liquidity. The Prime Minister also wondered whether this expansion in bank lending had been consistent with the maintenance of sound banking.

The Chancellor argued that over-funding should be brought to an end though he recognised that this would, for a time, imply a more rapid growth of sterling M3. He considered that the target for sterling of M3 of 5-9 per cent was too low; the adoption of these figures had reflected the financial pressures facing the Government at the time of the Budget. He did not, however, propose an immediate revision in the target. This should be considered in the context of the MTFS at the next Budget. If over-funding were ended the Bank should also undertake the technical measures required to reduce the size of the bill mountain.

The Governor agreed that over-funding was undesirable in principle but explained that, faced with constraints on their ability to raise short-term interest rates, the authorities had been forced back on the expedient of over-funding as a way of holding back the growth to sterling M3. He expressed concerned about allowing sterling M3 to grow more rapidly.

It was suggested that the current level of interest rates could be maintained for some time, rather than

allowing them to fall as might otherwise have been the case. This would reduce the growth of bank lending and hence the need for over-funding. It was noted that while reducing funding would bring down long-term interest rates it might cause short-term rates to rise. For example, some of the investment funds of the institutions which were currently being invested in gilts might be moved abroad, putting pressure on the exchange rate, leading to higher short-term interest rates.

The discussion then turned to money market operations and the determination of the interest rates. The Governor doubted if the mechanism suggested by the Prime Minister for penal rates for some money market assistance could be operated. For example, it would not be clear which banks would receive assistance at the lower rate and which at the penal rate. Since banks operated by adding a margin to the cost of funds, the effect of a penal rate would simply be to force up bank lending rates. Exactly the same outcome could be achieved more simply under present arrangements. Demand for bank credit would be reduced by higher interest rates rather than through an independent effect on banks' willingness to lend.

Summing up the discussion, the Prime Minister said it was agreed that monetary conditions would have to be kept tight for some time and there was little scope in the immediate future for short-term interest rates to fall. It was desirable to eliminate over-funding and a temporary phase of faster growth in Sterling M3 might be acceptable but before decisions could finally be taken it was necessary to consider more fully what the secondary effects would be on long and short term interest rates, on bank lending, the exchange rate and the monetary aggregates. She asked the Chancellor and the Governor to prepare a paper setting out alternative timescales over which a move to end over-funding could be accomplished and the likely consequences of such a course. She would also welcome a note explaining the background to the rapid growth in bank credit and the implications for the control of inflation. This should also consider whether the increased bank lending had been at the expense of banking standards. She would arrange a meeting in the middle of July to discuss these issues further.

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

Yours sincerely

Andrew

(Andrew Turnbull)

Mrs. R. Lomax,
HM Treasury