E.R.

cc MASTER SET.

RECORD OF MEETING BETWEEN THE PRIME MINISTER AND DR. LEUTWILER ON THURSDAY 4 JULY 1985 AT 10 DOWNING STREET

The Prime Minister said she was concerned about the development of monetary policy in Britain. The broad aggregates were growing very rapidly despite the fact that there was heavy overfunding which, in turn, was leading to a bill mountain. She believed banks would continue to expand their lending so long as they thought the Bank would continue to provide the liquidity required. She also suspected that standards of capital adequacy had been allowed to decline.

Dr. Leutwiler argued that central banks could not control the money supply if the commercial banks had free access to liquidity - what he described as "self-service". The Swiss Central Bank ensured that it provided liquidity only at its own discretion. He recognised that this would, on occasions, cause short term interest rates to rise but he believed this would affect only the very short term rates for a limited period. In the longer term such a policy would lead to lower interest rates.

Dr. Leutwiler said it was not easy to see exactly what the priorities of the Government and the Bank were. Were they to control interest rates, monetary growth or the exchange rate? The Prime Minister said the Government's objective was to bring down inflation which, after correcting for the distortions caused by mortgage interest rates, had been on a plateau of 5% for about two years. The Prime Minister said she favoured a strong exchange rate which would put companies under some pressure to become more competitive and would limit the extent to which they would pass on costs in higher prices. She was happy to contemplate a further rise in the exchange rate to say $1.40. She had been extremely concerned at the relaxed attitude some people had taken when sterling had fallen towards parity.

Concluding the discussion, the Prime Minister thanked Dr. Leutwiler for his advice and said she was always happy to hear from him. The conclusion she drew was that the Government should be prepared to allow short term interest rates to rise if monetary conditions were to be brought under control.

AT

(Andrew Turnbull)

4 July 1985

PRIME MINISTER

VISIT OF DR. LEUTWILER

I MONETARY POLICY IN THE UK

You will want to ask Dr. Leutwiler for his observations on the conduct of monetary policy in the UK.

- Does he have any feel for whether monetary conditions have been or, perhaps, still are too lax?

- What view does he take of the very rapid growth of the broad aggregates and bank lending, combined with slow growth of the narrow aggregates?

- Does he have any comments to make on the way money market operations are conducted here? (You should beware of analogies based on the Swiss model. Switzerland has virtually no domestic money market, in part because Government borrowing has been negligible over the years. The Central Bank conducts its operations by foreign exchange swops rather than by purchases and sales of bills.

II INTERNATIONAL DEBT

Dr. Leutwiler is known to be concerned about the slow progress some countries are making to improve their debt position. He mistrusts the short-term expedients which have been used in the case of Argentina and supports the UK in having no part in them. You could ask him what he thinks governments of the industrial countries should now be doing.

III THE US FISCAL AND MONETARY POLICY

Although short-term rates have come down substantially - three month Euro dollar rates are now $7^3/_4$% - long term rates remain high - a 20 year bond is about 10½%. This reflects continuing concern about the size of the US budget deficit. The two Houses have produced different budget amendments and when Congress resumes after the 4 July break the budget will go into the conference procedure. Each House has put forward deficit reduction measures of about $50 billion though the composition varies, with different emphasis on military savings and cuts in social security. Many observers are concerned, however, that these reductions will do no more than offset the effects of slower growth of the economy. The deficit could thus remain over $200 billion.

AT

(Andrew Turnbull)

3 July 1985