Re Governor CONFIDENTIAL

23.9.82

Mr George

B/F

Chancellor of the Exchequer On 23/9 cc Sir Douglas Wass

MEETING WITH THE GOVERNOR TOMORROW

I think your meeting tomorrow can be pretty short. I have not much to add to my minute of 17 September commenting on the prospect. A discussion on the telephone with Mr George confirms this.

attached

Funding

2. There are no current issues outstanding or in dispute. The Economic Secretary has given contingent authority for a partly paid short. The Bank are likely to propose the issue of £1 bn of 1988 stock tomorrow payable 20% this month and 40% each in the next two. There is no disagreement; Alan Walters is content and he and I had a word about it - among other things - with the Economic Secretary before he gave his contingent authority.

3. Mr George and I have started discussing conversion options with Mr Walters, but there is nothing to report yet.

4. We have promised to return to the options for the rest of the year next month when we have seen and discussed the short term forecasts.

Short Term Interest Rates

5. Once again there are no immediate issues. We are agreed that interest rates could come down in the near future by a further ½% - or 1% if the market is very strong. The market is indeed strengthening, buoyed up by the good news on inflation and the strong exchange rate. The Governor's proposal (in his letter of 22 September) for a change in the unpublished band is intended to facilitate a reduction in short rates. You will wish to ask the Governor how he sees the immediate prospect. More generally there is a question of whether we should space any further reductions in interest rates over the period from now to the end of the year

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or whether we should try to get whatever move is thought possible, pretty quickly. But we had intended to return to this question after the forecast and you may therefore wish to concentrate on the reduction immediately in prospect.

Banking

6. You might wish to ask the Governor if there is any further news about the strains on the banking system. But you will have seen from Mr Littler's recent exchange of letters with the Bank that there are aspects - particularly the question of Treasury guarantees - which we wish to discuss further with them at official level.

Papers to PM.

P E MIDDLETON

[redacted]

From: P E MIDDLETON
17 September 1982

Chancellor of the Exchequer

cc Chief Secretary
Financial Secretary
Sir Douglas Wass
Sir Kenneth Couzens
Mr Burns
Mr Kemp
Mr Lavelle
Mr Monck
Mr Turnbull
Mr Riley
Mr Sedgwick
Mr Peretz
Mr Davies
Mr Pickford
Mr Ridley

MONETARY PROSPECTS

1. Perhaps I could add a little to Mr Turnbull's minute below to bring out some points relevant to the discussion you had with the Governor on 26 August.

Short Term Interest Rates

2. There will be no way of giving a precise answer to the Governor's request for an early judgement about how far we should go on bringing interest rates down. And we shall, as Mr Turnbull says, feel more confident in providing advice next month, when we have seen the short term forecasts. Whatever their limitations, the forecasts bring together all the relevant information on both the nominal and the real economy, and will enable us to look at the interest rate prospect together with the fiscal prospect.

3. It might however be useful to give you a bit more of the flavour of our discussion - in which Mr Burns and Mr Walters took part. There was a general feeling that we are moving into more difficult territory so far as short term interest rates are concerned. Though the monetary position is still satisfactory when looked at in the round, monetary growth has undoubtedly picked up and we have still to see the full effect on the monetary aggregates. We may already be at a position on short rates where we shall have to use the precautionary words used at Budget time about the propensity of the narrow aggregates to grow rapidly when

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inflation comes down.

4. No one at the meeting thought that this meant that further interest rate reductions were an unacceptable risk. But in making this judgement we are beginning to rely on non-monetary factors such as the relatively slow growth in money incomes we seem to be experiencing, and the determinedly high effective exchange rate - perhaps now reflecting a relatively stable banking system.

5. So far as one can measure real interest rates - it is always difficult to know whether adequate allowance has been made for future price expectation - our performance seems to have been pretty good. FEU has provided the attached note commenting on recent trends in real interest rates which you might like to have by you in the United States. Because we have succeeded in bringing nominal rates down quite sharply real interest rates at the short end are some 2% lower than in the winter, and are currently in the 2-3% range. If one was to take real interest rates as a bit of a crude guide - and it is crude - it looks as though 9% or so nominal interest rate would not look too bad against a 6½% inflation rate by the end of the year. On that reckoning there could be three, or may be four, further ½% reductions spread over the period as market conditions became appropriate, or we could attempt to bring about all or most of this reduction quicker in order to provide a boost to nominal incomes in the autumn. There are arguments either way, and a major uncertainty in our own minds was the way in which Ministers would view the risk of having to raise interest rates again if monetary conditions started to give cause for concern.

6. The US position is not currently providing much monetary cheer. There are great doubts about whether there have been any fundamental change in Fed policy. With the monetary aggregates all currently running on the high side, Fed funds and Eurodollar rates have been creeping up. This is probably the main factor keeping the market quiet - but if things do look a bit brighter we certainly think you should accept another small fall in base rates. You can expect the Governor to write to propose a further reduction in the unpublished band to facilitate this.

Funding

7. As with short term interest rates, we shall wish to return to the appropriate funding objectives for the remainder of the year when we have the full financial forecast. We will offer advice on that next month. Meanwhile I doubt whether there will be any immediate arguments. If conditions are ripe the Bank will propose a short dated, partly paid stock to help meet our funding needs later in the year. Meanwhile National Savings are going well.

8. The difficult issue is how we interpret what is an agreed objective - that a full fund of the PSBR is about right for the year - into month by month tactics. This is partly affected by the Bank's concern about the heavy redemptions early next year and ours that we do not put the frail recovery in the bond market at risk. It is also related to the question of a conversion issue on which we have started to do some work. As there is no immediate problem I suggest we allow ourselves a little time to short this out.

9. Meanwhile there is one procedural suggestion on which we all agree. That is that the Economic Secretary's meeting on funding ought to take place on a regular basis each month - preferably at a time shortly after regular monthly meethly meetings by Treasury/Bank/No 10 officials. This seems greatly preferable to having ad hoc meetings at short notice when particular proposals come up - though we should still of course put these proposals to the Economic Secretary.

P E MIDDLETON