CONFIDENTIAL AND PERSONAL

3. 2.83

NOTE FOR RECORD

Copies to The Governor
The Deputy Governor
Mr Loehnis
Mr Balfour
Mr Holland
Mr Quinn

CR 4/2

Mr Leigh-Pemberton reported to the Deputy Governor this morning that the clearing banks had been at one with the Prime Minister at their luncheon yesterday as regards the attitude to be taken towards loans for Argentina. The Prime Minister mentioned one argument in favour of this attitude which the Treasury had advised her not to deploy: namely, if a country was driven to default, it would in fact have more money at its disposal for the purchase of arms. This was a dangerous argument to use in public. The Deputy Governor agreed, especially so far as Argentina was concerned, because of their self-sufficiency in food and oil.

The Deputy Governor also took the opportunity to mention the faltering loan syndication for Jamaica. He emphasised that he was only making the point lightly - because it was important for the Bank not to waste its ammunition on relatively minor cases - but wondered if the clearers wished to say anything. Leigh-Pemberton undertook to mention this to his colleagues, but with no commitment.

The Deputy Governor mentioned that we would want to discuss the Brazilian interbank project at the CLCB meeting and Leigh-Pemberton suggested that it would be worthwhile comparing notes on Mexico following Silva Herzog's visit. No other countries will be discussed at next week's meeting.

Governor's Office HO-P
3 February 1983

S P Collins (4122)

SPC

SECRET AND PERSONAL

3. 2.83

NOTE FOR RECORD

GR 4/2

Copies to The Governor
The Deputy Governor
Mr Loehnis
Mr George
Mr Dow
Mr Fforde

When Mr Leigh-Pemberton called on the Deputy Governor this morning to discuss the agenda for next week's CLCB meeting, he briefly described the CLCB Chairmen's discussions on interest rate policy with the Prime Minister over lunch yesterday. As reported in the newspapers, the Prime Minister had gone at the Chairmen hammer and tongs on base rates. The Chairmen had replied that it was debatable for how long they could resist market pressures, without convincing the Prime Minister. Tim Bevan had made the point that Barclays had done just that, and at no small cost.

This conversation had led to an attack by the Prime Minister on the overdraft system - the argument being that the existence of unutilised facilities made it altogether too easy for large companies to switch between different types of short-term finance. Leigh-Pemberton commented to the Deputy Governor that he had himself wondered whether it was a proper use for the overdraft system that large multi-national groups could use it as a tap for their short-term financing needs when the relevant interest rates were favourable, in contrast to its traditional use, of which he thoroughly approved, for accommodating the fluctuations in cash flow of the small business in Penzance.

The Prime Minister had told the clearing banks that they were asking for trouble if they did not, at the very least, have fiercer commitment fees. The alternative, Leigh-Pemberton said to the Deputy Governor, was for the banks to drive their customers into sources of finance which were charged at more market-related interest rates. But, he pointed out, this would only work if the banks colluded: it was no good if one or two banks tried to move alone.

The Deputy Governor said that we had looked at this question before, which had been a particular problem when credit ceilings had been in force. He observed that one factor to be borne in mind was that the banking system should exist for the benefit of the country rather than be manipulated for the purposes of monetary policy. The Deputy Governor added that Leigh-Pemberton had touched on a particular concern of ours - namely, the extent to which competition among banks had led to over-borrowing by both companies and countries.

Leigh-Pemberton asked whether the question of overdrafts could be discussed under item 1 of the CLCB agenda. The Deputy Governor replied that he was happy to do so, assuming that the Chairmen themselves would be happy to talk about it in front of each other. Leigh-Pemberton said that he would check with his colleagues at their meeting this afternoon.

The Chairmen had also discussed with the Prime Minister her views on the exchange rate and interest rates. In view of what she had said to them, Leigh-Pemberton reported, the Chairmen had asked the Prime Minister whether the exchange rate, rather than interest rates, would have to bear the burden if there were any renewed pressure. The Prime Minister had seemed to agree that this would be the case. What was the Bank's view? The Deputy Governor replied that, whatever one thought, it would be inappropriate for anyone in authority to comment publicly because that could lead very easily to an unwarranted fall in the exchange rate.

The Prime Minister had complained that in the early days of her administration, when inflation was very high and monetary growth was excessive, the exchange rate had been greatly over-valued; now, when these indicators had been brought under control, the exchange rate was bad. Why?

The Deputy Governor commented that we had been concerned with this paradox for a long time. The yen, for example, was ludicrously low in relation to the strength of the Japanese economy. The problem was that in a regime where everyone was using monetary targets, and where exchange rates were floating, interest rates had to rise if matters went wrong, in turn engendering capital flows across the exchanges which, in the short-term, dominated exchange rate movements. An example could be seen at present with the rise in the dollar resulting from the pessimistic outlook for US budget deficits.

In response to Leigh-Pemberton's request, the Deputy Governor said that the Chairmen could, of course, refer to this subject at the CLCB meeting if they so wished, but they should not expect the Bank side to respond in substance.

Governor's Office HO-P
3 February 1983

S P Collins (4122)

Spc