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RECORD OF A DISCUSSION BETWEEN THE CHANCELLOR AND THE GOVERNOR ON MONETARY PROSPECTS: 6.30 P.M., 13th JULY, AT NO.11 DOWNING STREET

Present:	Chancellor	Sir A Walters	Governor
	Economic Secretary	Mr Littler	Deputy Governor
	Mr Middleton	Mr Cassell	Mr Loehnis
	Sir T Burns	Mr Monck	Mr George

The Governor said that he agreed with the analysis of the present position set out in Mrs Lomax's minute of 12 July. As for the policy response, he agreed that further action on the fiscal side was not possible before the autumn. The question therefore was whether and when to take action on interest rates, and he had to warn that the option of inaction was becoming progressively less attractive. The money markets thought a rise in rates likely, and the upward slope of the yield curve, which had existed for a fortnight and was steepening, was creating tension. Following the announcements about public expenditure, and new funding successes, a period of consolidation might be feasible, and he hoped that no action on interest rates would be necessary for at least a week. But if US rates rose, rises here could hardly be avoided.

2. The Chancellor stressed the desirability of the early introduction of a new instrument, preferably a long IG. The case for this would no doubt be discussed at the Economic Secretary's Funding meeting on 19 July. It was suggested that launching a new long-dated IG might be difficult while the market expected short term rates to rise, and that the IG market was still rather narrow. The options should include a conventional convertible issue, and perhaps an ultra-long conventional issue. It was noted that the market would keep an eye on the exchange rate, and that their expectations of rising short-term rates would increase if the exchange rate fell. It was also noted that the markets might derive some reassurance on borrowing from the June quarter seasonally-adjusted PSBR figure, to be published on 21 July, which might be only some £1.8 billion.

3. Sir T Burns suggested that the key issue was not whether successful funding required higher short-term interest rates, but whether they were necessary for the health of the

economy. It was important to agree on one's assessment of monetary conditions. All the the monetary aggregates were growing above-target but the picture was not too worrying if one took account of the balance between interest-bearing and non interest-bearing money, and the continuing relative strength of the exchange rate. This suggested that the case for higher interest rates had not yet been made out; and that, if a rise was required, it should be small. Sir A Walters agreed that monetary conditions were less lax than a first glance at the aggregates might suggest, though he thought that they might be a little laxer than Sir T Burns had suggested. Nevertheless, he agreed with the policy advice. It would be best not to take interest rates up; though if US discount rates rose, our rates would probably have to rise too.

4. The Chancellor reported that German representatives at ECOFIN on 11 July, and the Japanese Deputy Finance Minister on 13 July, had indicated that neither Government thought a rise in their interest rates desirable. Indeed the Germans had suggested that, if US rates rose, German rates would not follow, and that a policy of benign neglect of the Deutschemark would be pursued. The Governor thought that such a policy would be difficult for the UK, particularly if US discount rates rose steeply. But Volcker had suggested, during the Basle meetings on 10/11 July, that he hoped that US rates would rise only modestly.

5. It was agreed that the right policy for the present was to aim for a further period of consolidation. But a rise in UK interest rates was not excluded; and it was agreed that it might be unavoidable if US rates rose sharply.

National Savings

6. Mr Monck asked about measures to restore the competitive position of DNS instruments. The increases in yields which were under consideration were small in comparison to the recent rise in Buildling Society rates; and it might be appropriate to announce them before long, in order to ensure that they were seen as a response to the Building Societies' action, rather than as a potential excuse for further action. The Chancellor said that he had no doubt that increases were necessary; the question was one of timing, and the key factor was whether conditions in the gilts market would be made more difficult. Mr George said that the Bank had been cautious about increases in DNS yields, which might have been seen as an inadequate response to the PSBR and Funding picture. But following the expenditure announcement on 7 July, and the breaking of the funding log-

jam, this risk had diminished. Moreover, the process of consolidation now might actually be assisted by an increase, for the markets would regard it as a considered move, designed to establish rates for some time, and therefore perhaps reflecting an expectation that short-term interest rates generally would not rise.

7. It was agreed that, while no final decision would be taken before the funding meeting on 19 July, the presumption should be that an announcement of increases in DNS yields would be made in the week beginning 25 July.

BP

8. The Chancellor referred to the abortive plan for a BP placing on 11 or 12 July. He had on reflection concluded that a conventional secondary Offer for Sale in the autumn, which might bring in £0.5 billion, was preferable to a July placing of some £350 million. There should be no difficulty about going for a full £0.5 billion in the autumn: the 1977 sale had been larger. And it might make sense to look again to the New York market, as had been done in 1977, but not 1979.

9. Mr George agreed that an Offer for Sale could be for a larger sum than the proposed placing. He hoped that £0.5 billion would be possible. The comparison with 1977 was however potentially misleading: the market's appetite for oil shares had since diminished with increased supply. And US involvement might be unwelcome to UK institutions: a high proportion of the BP shares sold on Wall Street in 1977 had migrated back across the Atlantic very quickly.

10. The Chancellor said he understood that the Bank and the Company had doubts about an early announcement of the Government's intentions. He was clear that Parliament must be told before the summer recess. It was agreed that this should not cause diffculty, provided that BP were taken into the Government's confidence first. An announcement immediately after the aborted placing might have been unfortunate, but it would be in order to announce before the House rose that an autumn Offer of Sale of up to £0.5 billion was being considered. BP would be informed forthwith. The right timing for the Offer might be shortly after BP's interim results came out on 1 September.

11. The meeting ended at 7.15 p.m.

J O KERR
15 July 1983

Distribution

Those Present
Chief Secretary
Financial Secretary
Mr Battishill
Mr Lavelle
Mr Lankester

Mr Ridley o.r.
Mr Burgner
Mrs Lomax
Mr Turnbull
Mr Hall