SECRET

10 DOWNING STREET

From the Private Secretary

4 June, 1984

[Circulated under cover note my JB 5/6.]

Dear David,

Meeting the Governor and the Chancellor

I attach a record of the meeting with the Governor and the Chancellor last Friday. I am also sending a copy to John Bartlett (Bank of England).

Yours sincerely
Andrew

ANDREW TURNBULL

David Peretz, Esq.,
H.M. Treasury

SECRET

COVERING SECRET 5. 6.84

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THE DEPUTY GOVERNOR
MR LOEHNIS
MR GEORGE
MR WALKER
MR GALPIN
MR COOKE
MR FLEMMING

RLP
12/6

ae A-B to
MJB
DGH
ABC
AMP
LDDP

ADW 10/6.

I attach the record of the Governor's meeting last Friday with the Chancellor and the Prime Minister. For debriefing purposes, relevant extracts may be circulated to senior officials; but the complete record should be restricted to those to whom this note is copied.

Governor's Office HO-P
5 June 1984

John Bartlett (4121)

Record of Meeting at 10 Downing Street, Friday, 1 June 1984 at 1730

Present:

Prime Minister
Chancellor of the Exchequer
Governor of the Bank of England

The Governor gave a report of developments in financial markets that day. These had been satisfactory - the equity market was rising; gilts were up ½ in the mediums and 1½ in the longs; the short tap had been exhausted. Although inter-bank rates had eased only a little, still being near 10 percent, it had been possible to prevent a rise in Treasury Bill rates. At one stage it had been feared that it would be necessary to cut down the size of the Treasury Bill tender to achieve this, but following informal contact with the market, acceptable bids were received.

The Chancellor said he wished to avoid a rise in base rates which was not justified by underlying financial conditions. The monetary aggregates to be published on Tuesday would be better than market expectations; the strength of the exchange rate was also helpful. Nevertheless, a rise in base rates could by no means be ruled out. He would be conferring with the Deputy Governor (in the absence of the Governor in Philadelphia) on Tuesday afternoon or Wednesday morning to reassess the position.

The Prime Minister said she too saw no need for a

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further rise in base rates at present and hoped it could be prevented. It was important not to let increases in interest rates be determined by market nerves. In discussion, it was noted that resisting a rise in interest rates could create the opposite danger of appearing to have shifted policy away from reducing inflation. The position was helped by the fact that one increase in interest rates had already been accepted.

A The discussion then turned to international debt. The Prime Minister asked whether the tax treatment of banks for non performing loans was an obstacle to the proper adjustment of their balance-sheets. The Governor explained that specific provisions were eligible for tax relief, but the banks had to satisfy both auditors and Inland Revenue. In addition, banks could make general provisions to create a reserve from which specific provisions could be drawn in future years. These were not eligible for tax relief.

The Governor said that in some countries there was an intermediate position which he described as "basket provisions". Under this arrangement banks could make a provision for a block of loans without identifying specific bad debts. He said that, given the adverse changes in the tax regime, the banks would welcome reconsideration by the Government of this aspect of the tax system. The Chancellor said that the point had been put to him by CLCB. He had agreed that the Treasury and Inland Revenue would study the issue. The Prime Minister noted this and asked to be kept informed of the outcome of this review.

The Chancellor said the figures produced by De Zoete and Bevan on the exposure of British banks in Latin America had been damaging. The Governor said that, on the basis of calculation used by the Bank's supervisors, the figures for the ratio of debt to capital had been narrowly defined and, in the case of Lloyds, it appeared that the bank's local

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assets had been wrongly included.

The Prime Minister asked how this false impression could be countered. The Governor explained that the bank, for reasons of confidentiality, could not release alternative figures. The possibilities were to encourage De Zoete and Bevan to correct their figures; to encourage the banks concerned to challenge the figures; or for the Bank's press office to provide unattributable briefing. It was agreed that the Bank would consider which approach to adopt.

The Governor said there was a feeling in the financial markets that the debtor countries were gaining the initiative over the creditors. The US authorities were thought to be inhibited from raising interest rates for fear of damaging their banking system and the banks were reluctant to push hard in negotiation for fear of triggering a default which would damage themselves. There was also a tendency for debt questions to be dealt with in the political/foreign affairs ambit rather than by central banks and finance ministries. The Governor said the City was looking to the Summit for reassurance that the macro-economic policies underlying high interest rates and the debt problem were being seriously reconsidered. The Prime Minister said she would need to be circumspect in public but would press the US hard in private. The Summit strategy was basically sound - to control public expenditure and advance towards lower deficits. She would be stressing that the "downpayment" carried the implication that the deficit reducing measures were only a start with more action to come. The Governor said he would be attending next week an international monetary conference in Philadelphia. In the margins the Fed would assemble a meeting of the Advisory Group on Mexico to agree a multi-year resheduling which would remove the hump in repayments over the next few years. If this were successful

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some years. Subsequently, the approach could be applied to Brazil and Mexico, thereby divorcing them from any debtor cartels. <u>The Chancellor</u> said that if the debts to Mexico and Brazil could be put on a longer term basis, the remaining debt problem would be much more manageable. /B

The meeting ended around 1830 p.m.

JT

<u>4 June, 1984</u>