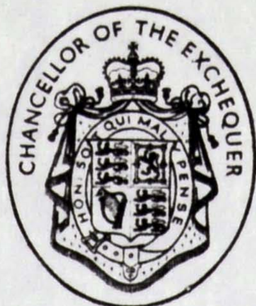
3.45

SECRET

cc - The Deputy Governor



NOTE OF A MEETING HELD IN THE CHANCELLOR'S ROOM, HM TREASURY

AT 10.30 AM ON 11 JULY 1984

RLP 18/7

Present

Chancellor of the Exchequer
Economic Secretary
Sir P Middleton
Sir T Burns (for first half of meeting)
Mr Cassell
Mrs Lomax

Sir A Walters (for second half of meeting)

Governor
Mr George — Bank of England
Mr Loehnis

INTEREST RATES

The Governor described the situation in the markets. The 3 month interbank rate had risen to 11 7/8 per cent, after opening at 11 5/8 per cent. The exchange rate was fairly steady (effective rate 77.4), reflecting the market expectation that base rates would rise. The question was how, tactically, best to respond to this situation. The risks of inaction had to be weighed against the risks of action. Neither course was attractive; but the Governor's views was that the Bank should move to bring about a rise in base rates.

2. The Chancellor asked why we should want real interest rates to rise to the highest levels since the war, when this was not warranted by monetary conditions, in order to protect sterling, when the sterling/deutschmark rate was not particularly low.

3. The Governor said it was not a question of defending the exchange rate. The risk was that if base rates did not rise, the general credibility of monetary policy would be put into question; as a result the exchange rate would fall sharply - sufficiently so to affect our assessment of monetary conditions, and the prospects for inflation, and to bring about a further rise in market interest rates. The Bank agreed there were no objective grounds for interest rates to rise; but felt that decisive action by the authorities on interest rates now would avert the need for even sharper action later on.

4. Sir Peter Middleton commented that in the short run, at least, a fall in the exchange rate might be a lesser threat to inflation than a rise in interest rates and mortgage rates. Commodity prices were weak because of the dollar's strength, therefore offsetting some of the impact of the strong dollar on inflation. A rise in interest rates would be a threat to the recovery, difficult to present, and would risk leading to further rises if the miners' dispute became protracted, or there were a further rise in US rates. Sir T Burns said that the main strain had so far been taken on interest rates, rather than the exchange rate; this was the wrong balance given the interpretation of domestic monetary conditions.

5. The Economic Secretary suggested that there was a good deal of anxiety in the markets about the domestic monetary position. He was more concerned himself than many in the Treasury. Unless we recovered the confidence of the markets the problems would persist.

6. The Chancellor asked about the implications of seeking to resist a rise in base rates, or refusing to raise the Bank's dealing rates. Mr George thought the impact might easily be perverse. It might be possible to bring very short interest rates down from their current levels. But longer rates, and even the 3 month interbank rate itself, might actually rise. The expectation in the market would be that the authorities would be unable to hold out for long. The truth was that while usually the Bank was able to exercise some influence in the market, on occasions like the present it was powerless. While raising interest rates would not by itself immediately reduce the rate of growth of £M3, he felt that a rise of base rates to 12 per cent would be sufficient to bring about substantial sales of gilts, and that this funding would help to reduce £M3.

7. Sir T Burns saw such a move in interest rates as damaging to the economy; damaging to short term inflation prospects; and damaging to the presentation of policy. And he doubted whether a sharp rise in interest rates now would be the end of the story.

8. Sir Alan Walters (on joining the meeting) said that his assessment was that domestic conditions were pehaps a little loose, but not unsatisfactory; that the exchange rate was satisfactory; and that on these grounds no further rise in interest rates was warranted. With the pressure coming from the US however, he felt it might be right to allow a rise of 1 per cent in base rates.

9. The Governor said that the market was expecting a rise of 2 per cent; and that it would be very hard to go for a smaller increase than that. The Chancellor agreed that a 1 per cent rise might get the worst of both worlds, and would not be sufficient to get funding going again.

10. The Governor asked how a policy of resisting any rise in the rate might be presented. We could say that monetary policy remained reasonably on track; that so did fiscal policy; that existing interest rates would deliver the monetary targets over the course of the year; and that the fall in the exchange rate had been mainly against the dollar (and that in any case the Government did not have an exchange rate target). But the question remained whether that would be convincing to the markets. On the other hand, the Chancellor pointed out, it would be equally difficult to present a sharp rise in interest rates. The situation had not changed greatly since the ¾ per cent rise the preceeding Friday. It was not Government policy to follow market interest rates wherever they went; and it was not Government policy to seek to defend any given exchange rate. On what basis could we justify moving to the highest real interest rates since the war?

11. In discussion Treasury officials present concurred, with certain misgivings, with the Bank's advice that base rates should be allowed to rise by up to 2 per cent. The Chancellor concluded that the best presentation would be to say that because of market interest rates the clearers had been obliged to raise their base rates; but that the authorities saw no objective grounds for the rise.

12. After some further discussion, it was agreed that:-

(a) the Bank would not take the lead, but would not seek to stand in the way of the clearing banks should they wish to raise base rates.

(b) The Bank would themselves deal in the market in a way that signalled to the clearers that they were free to move if they so wished, but without giving them any kind of lead, although indicating an upper limit of 12 per cent.

(c) It would be up to the clearers to decide whether to move to 11½ per cent or 12 per cent.

(d) Once the clearers had moved the Bank would bring its dealing rates into line, and seek to consolidate a new structure of dealing rates, with a downward sloping yield curve.

13. It would be explained, as necessary,that the clearers had been obliged to move by the structure of market interest rates; that the authorities saw no need for the rise on monetary grounds, and hoped rates would not stay up for long; and that, alongside industrial unrest, a major reason market interest rates had risen was the level of (and the expectations about) US interest rates.

DLP

D L C PERETZ

13 July 1984

<u>Circulation</u>

Those present
Mr Littler
Mr Lavelle
Mr Lankester