SECRET 31. 7.84

NOTE FOR RECORD

Copies to The Deputy Governor
Mr Loehnis
Mr George o/r
Mr Walker o/r
Mr Cooke o/r
Mr Coleby
Mr Dawkins (paragraph 4)
Mr Quinn (paragraph 2)
Mr Plenderleith

CONVERSATION WITH THE CHANCELLOR: MONDAY 30 JULY

1 We agreed that we should both deliver shorter speeches at the Mansion House and Overseas Bankers Club dinners.

EXTRACT IN PROVISIONING DOSS

2 He questioned me about our contingency plans should a "Continental Illinois" happen in this country. I said that I thought that it was most unlikely except in the context of a serious development in the international debt situation. He pressed me, however, on a domestic crisis and I answered in rather simple terms by saying that I felt reasonably confident that we ought to be able to arrange appropriate liquidity to see one of our large banks through a difficult period. We then turned to the international scene, where the Chancellor expressed himself to be somewhat pessimistic and reverted to contingency plans. I spoke of a considerable amount of work having been done and a degree of concertation between ourselves and the Fed, but this was not a conclusive discussion and he was particularly resistant to enquiries about how thinking was going at the No.10 Policy Unit. I was aware that Peretz had suggested to GPS in advance of the luncheon that this topic should be avoided as far as possible at this stage and I was aware of Peretz' eye glancing at me throughout this rather bitty and difficult conversation.

3 We then embarked on another fairly difficult discussion of the present monetary and exchange rate situation. He said that he took issue with my last letter in which I spoke of the need to be "very cautious" about a fall in interest rates and he implied that this caution was connected with a desire to use the present situation to improve our funding position. I challenged this and said that we advised caution only to the extent that we needed to be sure that a

fall was fully justified and could be maintained and, that while a successful funding operation this week could have been very helpful both to our programme and to market sentiment, this was now academic and we would probably be issuing new stock by tender next Friday so that the price could take advantage of the money figures to published the following Tuesday. While this contented him to a degree on the immediate point he then said that he must emphasise that the government was pursuing a policy based on domestic monetary targets and that we did not want to allow ourselves to be influenced by movements in the exchange rate; it should moreover be possible to influence the interbank market by our own market operations, particularly in circumstances when M0 was performing so well. I put the case which is given in much greater detail in Tony Coleby's paper but, although the discussion remained amicable, it is clear that we shall have to face a somewhat blinkered approach next Thursday afternoon.

4 The Chancellor finally said that he felt that there had been an omission on our part in not bringing the Treasury into the discussions about the shape of the new gilt-edged market, particularly when the Stock Exchange had a discussion paper ready for publication in which, as a result of this omission, there was no Treasury input. I said that this should be regarded as a Stock Exchange paper and one to which it would be perfectly open to both the Treasury and the Bank to respond, although we had been responsible for a degree of input in the preparatory stages in order to avoid any fundamentally wrong turns being taken even at the discussion stage. I then said that there was one point on which it could be that there would be a difference between ourselves and the government, namely the matter of the last-trade tape. I rehearsed the arguments against this and his response was to question the validity of this distinction between the gilt-edged and the equity markets in this respect. I said that we thought that the distinction was valid and I was left with the impression that he could be brought to our side on this point if we can convince him about the difference between the two markets.

extract on ED

5 I mentioned our anxiety about the prospects for oil prices but the Chancellor seemed more relaxed about this. He said that he could well believe that there would be a fall of $2-3 per barrel but

extract in ED

that the price would then stabilise at that level. He cited his experience in March 1982 when after a period of greater uncertainty and anxiety than this and a fall of about $5 the market then showed itself capable of protracted stability. He seems to think that this would happen again, although we would incur a fall of $2-3 in the process which in turn he did not seem to regard as too serious.

Altogether, this was a more strained luncheon than we have had for a long time and I have no doubt that he puts urgent priority on bringing interest rates down as much and as soon as possible.

R. L. L.