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From the Private Secretary

26 January 1982

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Monetary Policy

The Prime Minister held a discussion about monetary policy on Friday 22 January. The Chancellor, the Economic Secretary, the Governor of the Bank of England, Sir Douglas Wass, Mr. Burns, Mr. Middleton, Mr. George and Mr. Walters were present.

Bank Lending for Housing

The Prime Minister began by enquiring about the Bank's Notice dated 20 January on bank lending for house purchase and improvement. It was explained that the purpose of this guidance was to act on the growth of bank lending to the personal sector. Bank lending in recent months had been growing disturbingly rapidly and a worrying component had been certain aspects of the strong growth in lending to the personal sector which was a by-product of the increasing competition between banks and building societies. This lending was avowedly for house purchase and improvement and thus enjoyed tax relief; but some of it in fact was being used for consumer spending. The Prime Minister said that her immediate reaction to the Notice had been that it was designed to stop kinds of lending which she would like to see encouraged. What was the objection to someone who was moving house increasing their mortgage and realising their capital profit in order, say, to help set up their own children with a house of their own, or to pay for school fees? The Bank's Notice smacked of unnecessary regulation and paternalism. She understood the argument that the Bank wished to limit a growth in lending for consumer finance which, by being mis-described as housing finance, enjoyed tax relief and cheaper rates than applied to industrial lending, given that the consequence of such additional personal lending was higher interest rates generally - and particularly for industry. But this argument had not appeared in her briefing on the subject, and she was not clear that the Bank's action was designed with this objective primarily in view. It was agreed that the Treasury and Bank would have another look at the issue, and would report back to the Prime Minister.

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Short Term Interest Rates

The Governor said that sterling interest rates had fallen each day in the week. The Bank's dealing rate was now 14%. The three month rate on Thursday night was 14¾% - down from 15 and 9/16ths%.

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The yield curve was now almost wholly flat. These moves had been much assisted by the decisiveness of the miners' ballot, and by what was seen as a concerted drive across Europe to reduce rates. Sterling had remained strong throughout the week. The Governor felt confident that one or other of the clearing banks would be urgently considering a reduction in base rates. (Some moments later a message was brought to the meeting that National Westminster Bank had just brought down its base rate by ½% to 14%.)

In discussion, it was agreed that the principal threat to lower European interest rates was the likely movement in US dollar rates. At the moment they were rising: at close on Thursday the three month sterling rate was no more than 1/16th% above the equivalent Euro dollar rate. Today's US money supply figures would be important. Their interpretation might well, again, be difficult, and it was a matter for regret that the market was subject to destabilising fluctuations once a week as these (relatively) unprocessed figures were published. There was wide international agreement on the desirability of stabilising financial markets. It was difficult, however, to identify a practical way of making progress. One way forward would be a decision by the American authorities to intervene to smooth out the biggest fluctuations. But, as a matter of doctrine, they were unwilling to do so, although the threat to market stability posed by their stance had become much more than a mere technical problem.

The Chancellor said that, more important even than this, was the need to bring home to the Administration the damage to the West which would be brought about by an excessive US deficit over the next 12 months. Donald Regan and Paul Volker were advising that a deficit on the scale currently envisaged, of $100 billion, or even $150 billion was far too large. Mr. Beryl Sprinkel, on the other hand, believed that the markets could be persuaded to accommodate sums on this scale. It would be essential to involve President Reagan; it was encouraging that Mr. Haig now saw the force of our worries. Mr. Walters commented that the Supply Side group exercised, through Mr. Sprinkel, great influence on the President. He would not change his policy while the Supply Side group maintained their present position. Sir Douglas Wass said that it was more important to press for a smaller deficit and thus lower interest rates than to argue for intervention by the authorities in order to minimise volatility.

The Prime Minister, summing up this part of the discussion, said that it would be necessary to involve President Reagan in our concern about this problem; it was now assuming a strategic importance. She would need detailed briefing on the more technical aspects of the matter before a discussion with the President and his team.

Medium Term Financial Strategy

Mr. Burns said that £M3 had for some time been giving misleading signals about the tightness of our monetary stance. M1 was an important indicator, and it was necessary to look at both the wide and the narrow aggregates, together with the exchange rate; particularly when institutional changes in markets were taking place. Sir Douglas Wass said that Treasury officials were putting to the Chancellor a number of options on the next moves as regards

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the Medium Term Financial Strategy. One of these was the possibility of an arithmetical formula which gave weight both to £M3 and M1. The Chancellor said that he hesitated to move to a mechanistic formula. It would be hard to present it publicly. Equally, it was difficult to rest upon the comfortable conclusion that, given that there must be a judgemental element in these matters, the authorities could do no more than form a balanced view about the appropriate level of interest rates, having regard to all the aggregates and the exchange rate. It would not be possible to substitute a formula less specific than that published in successive Red Books. For the longer term, what was needed was a target aimed at a 2-3 year span, and one which gave greater weight to the more liquid forms of money. This suggested giving greater emphasis to the narrower aggregates. Another problem here was that it seemed likely that M1 might structurally grow more rapidly as interest rates came down; yet there would be presentational difficulty in publishing target figures for M1 which were higher than current rates. There would, too, be great difficulty in attempting to specify an exchange rate objective for the medium term.

The Prime Minister said that she hoped that a conclusion would soon be reached on this matter. There was much to be said for a target which involved a combination of the aggregates. A hard and fast arithmetic formula seemed, however, unlikely to be acceptable: discretion would have to be left to the policy-makers to interpret the signals given by the monetary variables, and to frame policy accordingly.

De-restricted Indexed Gilts

Sir Douglas Wass reported the conclusions of a group he had been chairing on the case for and against the issue of a de-restricted indexed gilt. They had considered the argument (to which the Prime Minister had on a number of occasions referred) that a de-restricted issue would place a "road-block" or "sleeping policeman" in the way of those who desired lax financial and economic policies which would accommodate high rates of inflation. Their conclusion was that much would turn on the size of the issue. A reasonable assumption might be issues of say between £2 and £4 billion a year: they had not considered the issue of indexed gilts as part of a big conversion strategy. It was doubtful, given the scale of the monetary assets held by the private sector, whether a sum of this size or even twice or three times this size, would be sufficiently large to affect macro-economic policy-making in the way desired. Sir Douglas Wass recalled that the principal reason for imposing restrictions on the holders of indexed gilts had been the desire to avoid an inflow of funds at a time when the exchange rate was uncomfortably strong. This argument no longer applied: indeed such an inflow would now actually help. De-restriction would, too, reduce the cost of funding - although this reduction might be offset by the reduction in tax yield. It would allow the authorities to sell debt at a time of uncertainty about inflation; this, in turn, would help maintain the impetus of the funding programme.

The principal argument against this move was the international criticism it would excite: the industrialised oil-importing countries

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had consistently set their face against the issue of indexed securities to the oil producers. De-restriction would be seen as an extension of indexation, and as a prelude, perhaps, to general indexation of wages, pensions and tax allowances. The impression overseas would be that we lacked confidence in our ability to defeat inflation, and were preparing the means to accommodate it. This new step towards indexation would, further, be wholly inconsistent with the thrust towards cash planning and accounting in the Government's economic management. The Government might also be accused of disadvantaging other borrowers, in particular the equity market, by issuing debt on terms no-one else could match.

The Prime Minister said that the issue of a de-restricted indexed gilt, not as a conversion for conventional debt, but on a scale of, say, some £2 - £4 billion a year would build a worthwhile new anti-inflationary bias into the financial system. A Government which paid scant regard to the integrity of the currency would itself have to face the consequences as higher inflation bore up the cost of servicing existing debt. With careful presentation, international criticism could be defused. Far from illustrating a lack of confidence in our policies, issuing indexed stock could be shown to be an affirmation of confidence that inflation would be tamed. There was no question of deluging the market with this new security, and she recognised that the funding picture would not be dramatically changed. De-restriction would be of particular value to those without the protection of employers' pension funds. It would be necessary to proceed cautiously, and to assess at each stage the effects on the equities market.

Summing up this part of the discussion, the Prime Minister said that it was agreed that we should proceed soon with a de-restricted indexed gilt issue. The Treasury and Bank would consider further the amount to be so issued; and the timing of such issues. The meeting then turned to a discussion of the European Monetary System. The conclusions here are recorded separately.

I am sending a copy of this letter to Tim Allen (Governor of the Bank of England's Office).

Yours sincerely,

Michael Scholar

John Kerr, Esq.,
HM Treasury.

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