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Thankyou. For Jossien

THE DEPUTY GOVERNOR

Cwm

NOTE FOR MEETING WITH CHANCELLOR, THURSDAY 2 AUGUST

One can perhaps see why the recent increase in interest rates gave rise to so much heart-searching by the Chancellor. Looking back over the period from 1979, it would seem that setting inflation on a downward path - and reducing UK inflation relative to our competitors - necessitated a rise in real interest rates and loss of competitiveness (charts). The Chancellor may well feel that with inflation around 5% pa, this adjustment process should by now have been completed; and that having maintained a reasonable balance between fiscal monetary and fiscal policy for some years, real interest rates might be expected to fall, and our competitiveness improve.

Before the recent $2\frac{3}{4}\%$ point increase in interest rates, the three-month real interest rate in the UK stood somewhere between the German rate of 3% and the Japanese rate of 4%. Following the rise in UK nominal interest rates, we now stand somewhere between the French $5\frac{1}{4}\%$ rate and the US $6\frac{1}{2}\%$ rate. Surely we are the odd man out and our financial orthodoxy should be rewarded like the Germans and Japanese?

Against this, it might be argued that an engineered fall in short-term rates could unhinge the already fragile exchange rate and cause the Government to overshoot its inflation forecast, which was already in some doubt. The Chancellor might reply that the HMG's counter-inflationary policy - the MTFS - is couched in terms of the monetary aggregates not in terms of an exchange rate target. Domestic monetary policy is on target and some unwinding of the exchange rate might in any case be expected after the appreciation in 1980/81 so that some of the loss of competitiveness can be recouped (cf relative normalised unit labour cost chart). Just as manufactured import prices, in sterling terms, did not fall on a one-to-one basis as sterling appreciated (ie manufactured import profit margins increased);

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import profit margins now seem to be eroding as sterling depreciates. The inflationary consequences for the UK have therefore been correspondingly muted. One can add to this the benefit of weak commodity and oil prices; the moderating influence of unemployment on an earnings response.

Perhaps there is something in these arguments, but why not allow the money market to adjust of its own accord as the good news becomes available? The political and economic risks of a premature and overt intervention in the money markets are considerable. It would be possible to substantially overdo the money market operations with the effect of reducing overnight and one-week rates. But this would be a clear departure from the 1981 arrangements, and the change would be clearly seen to have been dictated by short-term political expediency. Arguably the 1981 arrangements, which partially depoliticised short-term interest rate setting, are one of the more successful financial reforms of the present Government: it would be a pity to throw this away so easily.

Moreover, it is not clear that the lowering of very short-term rates would have a ripple effect along to three-month and longer rates. The government might indicate that it can tolerate a degree of exchange rate depreciation, but the market may either just not accept this at face value, or think that the inflationary implications of depreciation warranted higher nominal rates. The political risks of overtly trying to move rates down and failing should be self-evident.

The Chancellor's predisposition to abstain from funding, until interest rates fall, is also a high risk strategy. It would be all too easy to enter into a vicious circle where inadequate funding leads to over-rapid growth of £M3; expectations of interest rate rises and therefore a disinclination to buy gilt-edged stock and so on.

From the Chancellor's own point of view, it would surely be sensible to sit it out at least for a month.

MEETING WITH CHANCELLOR 2 AUGUST

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NOTES FOR MEETING WITH CHANCELLOR: 2 AUGUST

A Experience suggests that an active campaign by the Bank to lead interest rates down would be very dangerous.

- (i) Important to be confident that any reduction does not need to be quickly reversed. Unfortunate precedents in 1982 and 1983 (separate briefing).
- (ii) Many factors outside our control (for example, US interest rates - where there is a general expectation of a further rise - and oil prices).
- (iii) Despite Chancellor's comments about the primacy of monetary targets, we cannot let the exchange rate go into a 'flat spin'.

B In any case, we cannot bring down market rates by our own operations without reducing our dealing rates - which would be a very 'heavy' signal.

C Must first see market reaction to money supply figures. In present irrational mood, no guarantee that market will turn bullish.

D But we are not trying to keep rates unnecessarily high. We do want them lower, when conditions are right.

E We should press the case for maintaining satisfactory progress on funding. This will be important for sentiment, and the mood should be greatly helped if we can issue an orthodox partly-paid stock this Friday. We are not keeping rates high simply to ease funding - but successful funding is important in encouraging a move to lower rates.

F Intervention in support of sterling may not be a long-term panacea, but it can have short-term uses, eg in buying time ahead of expected good news. In any case, intervention is less of a major decision than to flood the money market.

G Important to concentrate on the credibility of monetary policy over the next few months.

THE GOVERNOR

We have now heard that the meeting with the
Chancellor to discuss money market management
will be on Thursday 2 August at 4.15³⁰ pm. ✓
The Chancellor will be supported by Middleton,
Cassell and Stewart.

Who would you like in your team, please? Perhaps
the Deputy Governor, Messrs Loehnis and Coleby?

26/7

Phis

Chun
Pl arrange - done 1/1

4.30

Yes

£ mn

SPEAKING NOTES

1 The preliminary money figures for July are now confirmed by the provisional figures covering all reporting institutions. Sterling M3 is shown as falling by 1% on the month to produce an annualised rate of growth over the first five months of the current target period of 9.1%. M0 rises by 0.2% which brings down the annualised rate to 5.7%. PSL2 also falls slightly to produce an annualised rate of 15.6%.

2 The forecast for the current banking month is for a growth in sterling M3 of 0.5%. That was based on projected gross gilt sales of 1250, but also on a forecast of the CGBR which currently looks like being overshoot by some 350. Gross gilt sales to date are ~~1120~~. 1140.

3 The domestic markets have in the past 24 hours become distinctly more cheerful. The origins lie in changing sentiment in the United States, which has seen a sharp improvement in bond prices and an evaporation of fears of higher interest rates though, as yet, no significant decline. Our own money market rates have not declined at all far and the three month inter-bank rate remains at 12 3/16%.

*not monetary laxity
- City not quite same view
- risk of interpretation
of X rate
markets short circuit
- oil price*

The present situation.

1 para 2 in dossier

2. This follows a week in which the market improved last Thurs/Fri after Volker but fell back on Mon with 3m @ 12
- seeming nervousness still there until to-day.

3. Our q. is posed in the letter to me

• a) how disposed to further upward pressure, shd. it develop.

b) if how actively, to seek to promote

or how ii) actively to seek

b first + i) first. how active we shd. be?

"initially fairly cautious" my phrase - solely to ensure reasonable sureness

(see my letter 23rd July)

& reasonable degree of firmness in mkt.

still funding re-established.

- good chance.

b ii) should we actively induce - experience of Oct/Nov '82
June '83.

only acceptable if we are anticipating a market move
prodding us already there

If so, why not be patient - chances of improvement
thru' Aug. & Sept.

a) how to respond to upward pressure, should it develop.

A. - upward flow from fall in £x (combined with ^{Bocheys} minus U.S. ^{hit})
federal as well as \$

- mkt. convinced interest rates wd. go up sooner or later, given no intervention policy.

- once nervousness reached certain level, response of authorities felt it.

Coleby

AT SOME POINT authorities must be concerned (anti-inflationary policy)

paras

4

- the more strongly we rule out intervention }
the greater the pressure on interest rates }

? undermine the present certainty. Greater freedom.

10

CHANGE - nature, presentation, timing careful but otherwise vulnerable.

B. i. avoid technical state of market creating upward pressure

ii contain adverse expectations from being self-reinforcing.

Coleby paras 8-9.