521 Add to pps 541/1 Copy in MP 7/OSS

SECRET

BANK OF ENGLAND
Threadneedle Street
London
EC2R 8AH

18 July 1983

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
H M Treasury
Parliament Street
London
SW1P 3AG

Copies to Mr Blunden
Mr Loehnis
Mr George
Mr Walker
Mr Dow
Mr Fforde
Mr Cooke
DGPS

Dear Nigel,

When we discussed the monetary situation on Wednesday, it was, I believe, common ground that the present and prospective development of the Government's intermediate objectives - both for the PSBR and money supply - was disturbing, and could not for long remain unattended. I recognise that further fiscal action may not readily be practicable for the time being, though I believe that if the PSBR prospect has not improved by the Autumn further action on that side may well then become necessary. In the meantime the load will need to be carried by monetary policy.

At the time we spoke, we were in the process of attempting to achieve a consolidation on the gilt-edged market. Nervousness about monetary developments in the United States threatened to frustrate that attempt on Friday, but the gilt market has recovered a little this morning so that we have been able to sell a sizeable amount of the tranchettes announced last Wednesday. Together with the sales achieved last week, this brings gross gilt sales for banking July (which ends on Wednesday) to some £1,300 mn. - a good deal better than at one time seemed likely. It does not however mean that we are out of the wood. In order to keep the situation under reasonable control we will need to achieve comparable gross sales in both banking August and September, and while, of course, we will do all that we can to bring this about, the policy uncertainty both here and in the United States is such that we cannot be confident that the funding programme can in fact be maintained at this rate.

For the time being the consolidation in the gilt-edged market has also helped ease the tensions in the money market. Nevertheless the interbank curve remains upwards-sloping, reflecting the market's expectation that we may not ultimately be able to resist pressure for higher short-term interest rates generally. As I said on Wednesday this is indeed likely to become the case if US interest rates rise much further. In that situation, or indeed more generally should the exchange rate weaken significantly, we could well make matters worse for ourselves if we were to attempt, through high-profile action, to stand in the way of strong market pressure. Nevertheless, we agreed that, short of this, we would for the time being attempt to preserve the present level of short-term interest rates; this would be consistent with maintaining the undisclosed interest rate band at its existing level of 9-11%. We will, of course, revert to you if we believe that this posture is becoming untenable.

Yours ever,

Robin