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Prime Minister (2)

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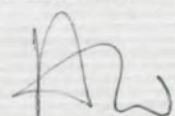
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FUNDING AND THE MONETARY AGGREGATES

1. Yesterday a meeting including the Governor and Chancellor finally approved the new strategy on funding. Essentially this means that, as a rule, we shall not overfund the borrowing requirement. Normally funding operations will be directed towards covering the PSBR. Only if all monetary aggregates are persistently expanding would we consider using the weapon of overfunding. Thus at present when our narrow aggregates are quite depressed and well below the target band while our broader aggregates are within the band, or even if they exceed it somewhat, we should not overfund.
2. This is a great step forward. In a sense it simply rationalises what we have been developing over the past year or so. It implies that our main focus is on the narrow aggregates, as indeed it should be.
3. As you know, overfunding meant that we were borrowing long, normally on conventional high coupon gilts, and lending short through the discount market. The money we took out at the long end we were forced to return at the short end in order to prevent short interest rates from exploding and creating a liquidity crisis. And most important of all we were borrowing long at a high fixed coupon, which meant that as our inflation rate fell the real rate of return on long Government debt increased alarmingly. Furthermore, since much of this debt was held by institutions, this implied a considerable diversion of real resources into the hands of the gross funds.
4. I believe that the new funding strategy is a very considerable improvement. Although it does not go quite as far as I would wish, it achieves as much as I could ever have expected. It provides also a basis for exploring the potentialities for conversion.
5. The Chancellor will be reporting to you shortly on these matters. It is worth recording that the final stages of discussion were entirely harmonious and we easily achieved unanimity. It showed yet again that once we got the basic budgetary and financial conditions right, all other reforms are so much easier.

17 June 1982

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ALAN WALTERS